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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 20/8-3

11:45 a.m., January 24, 2020

3. Austria—Financial System Stability Assessment

Documents: SM/20/9and Correction 1; and Correction 2 ; and Supplement 1

Staff: Melo, MCM

Length: 47 minutes

Executive Board Attendance

M. Furusawa, Acting Chair

Executive Directors	**Alternate Executive Directors**
D. Mahlinza (AE)	
M. Raghani (AF)	
	R. Morales (AG), Temporary
	N. Heo (AP)
	B. Saraiva (BR)
	Z. Huang (CC), Temporary
	P. Moreno (CE)
	A. McKiernan (CO)
	C. Just (EC)
A. Buisse (FF)	
	K. Merk (GR)
	R. Goyal (IN), Temporary
	A. Ribeiro Mateus (IT), Temporary
	K. Chikada (JA)
	G. Nadali (MD), Temporary
	M. Merhi (MI), Temporary
A. De Lannoy (NE)	
M. Poso (NO)	
	L. Palei (RU)
	F. Rawah (SA), Temporary
	K.Tan (ST)
	P. Trabinski (SZ)
	D. Ronicle (UK)
	R. Farber (US), Temporary

G. Bauche, Acting Secretary
H. Malothra, Summing Up Officer
L. Briamonte, Board Operations Officer
M. McKenzie, Verbatim Reporting Officer

Also Present
European Central Bank: K. Nikolaou, R. Rueffer. European Department: J. Franks. Legal Department: C. Claver. Monetary and Capital Markets Department: M. Cihak, L. Gornicka, D. Laliotis, N. Sugimoto, L. Valderrama-Ferrando, F. Melo. Executive Director: Z. Jin (CC), R. Kaya (EC), M. Mouminah (SA). Alternate Executive Director: S. Benk (EC). Senior Advisors to Executive Directors: P. Braeuer (GR), M.Gilliot (FF), P. Harvan (EC), L. Marek

(EC), W. Nakunyada (AE), T. Nguema-Affane (AF), S. Potapov (RU), L. Voinea (NE). Advisors to Executive Directors: D. Andreicut (UK), O. Bayar (EC), M. Mehmedi (EC), P. Mooney (CO), B. Parkanyi (NE), N. Shenai (US), M. Shimada (JA), N. Vaikla (NO), Z. Zedginidze (NE), J. Montero (CE), Y. Pierre (BR), A. Tola (SZ).

3. AUSTRIA—FINANCIAL SYSTEM STABILITY ASSESSMENT

The representative from the European Central Bank submitted the following statement:

> We would like to thank Mr. Just for their buff statement and Staff for their report. We associate ourselves with the statement by Mr. De Lannoy and would like to further highlight a few issues.
>
> We broadly agree with staff on the financial stability analysis of the Austrian banking sector and the identified range of structural vulnerabilities. Such vulnerabilities include the high reliance of large Austrian banking groups on profit contributions from CESEE operations, as well as complex ownership structures and strong financial interlinkages within the three "decentralized segments" of the Austrian banking system. Such interlinkages work through mutual cooperation agreements, such as institutional protection schemes, cross-guarantee schemes, etc. They can act as shock absorbers for idiosyncratic shocks but may also lead to loss propagation in a systemic event. Against this background, the staff recommendations appear plausible, notably to further enhance the stress-testing framework regarding second-round effects and contagion, and to improve data collection. We also note the focus of the analysis on real-estate related risks in the domestic operations of Austrian banks, against a backdrop of strong house price increases and favorable lending conditions in recent years.
>
> We positively note developments on anti-money-laundering/combating the financing of terrorism (AML/CFT) framework. Significant progress has been made in aligning Austria's AML/CFT framework with the Financial Action Task Force (FATF) standards. We also welcome proposals to further strengthen banking AML/CFT supervision.
>
> Overall, we broadly agree with staff's assessment of macroprudential policies and related recommendations. More specifically, we join Staff to commend the Austrian authorities for having addressed financial stability risks since the 2013 Austria FSAP. This includes timely action on taking macroprudential measures (incl. setting of the Systemic Risk buffer, implementation of O-SII buffers and issuing guidance on sustainable lending standards in real estate financing). Moreover, we broadly agree with the FSAP recommendation that national authorities should be prepared to introduce binding borrower-based limits in order to address residential real estate-related risks. We also welcome the innovative model-based FSAP analysis on possible combinations of binding borrower-based measures that could be

applied instead of the FMSB's 2018 guidance on sustainable lending practices. This new analytical approach is an example of value added provided to the authorities in the context of the IMF's financial surveillance. Finally, while we broadly agree with the importance of monitoring the effectiveness of the credit flow-related measures in place, we note that cyclical risks in Austria are also a stock issue; more so as the share of real estate-related loans in total assets increased substantially over the last few years, as mentioned in the FSSA and also acknowledged in the 2019 Austria Art. IV Staff Report.

Regarding bank resolutions, we would like to highlight the European dimension of the resolution framework. From the perspective of the Banking Union (BU), it is group resolution plans, under the Single Resolution Board (SRB), that should ensure the financial stability and protect the real economy. While the implementation of group resolution plans can fall along national lines, the adoption of national plans with a view to shielding the national banking system is not in line with the spirit and ultimate objectives of the BU and would not achieve optimal results for the BU as a whole.

Mr. Just submitted the following statement:

The Austrian authorities thank staff for the professional cooperation throughout the Financial Sector Assessment Program and the high-quality report.

Overall Assessment

The authorities welcome the IMF's positive assessment of Austria's financial system and of its supervisory framework. They appreciate the Fund's recognition of the authorities' efforts to proactively address financial stability risks since the previous FSAP, especially by enhancing the macroprudential policy framework. The authorities also share the Fund's findings that banks are, in aggregate, well capitalized and could withstand a series of severe macrofinancial shocks.

Key Challenges and Risks

The FSSA rightly points to some key challenges and risks in the financial sector such as the large and interconnected banking sector, the high levels of CESEE exposures across banks and insurers, the low domestic structural profitability, as well as recent developments in some parts of the real estate sector. Against the backdrop of higher capital levels and better credit quality, these risks are assessed to be contained, and stress test results

confirm the resilience of the banking sector towards a variety of severe shocks. The authorities agree that data gaps need to be closed and the recent implementation of AnaCredit is a first step towards strengthening supervisory efforts in monitoring domestic and international contagion risks as well as risks stemming from common exposures. The program of the new Austrian government also contains a series of measures aimed at increasing the supply and affordability of residential real estate, which are also expected to reduce price pressure on the market. However, the authorities stand ready to activate further macroprudential measures if needed.

The authorities welcome the Fund's positive view of the institutional framework of micro- and macroprudential oversight in Austria. The authorities would however like to clarify that the depiction in the FSSA to change the supervisory responsibilities of the Financial Market Authority (FMA) and the Austrian National Bank (OeNB), refers to the proposal of the former government which had released the draft legislation of this reform for public consultation in April 2019, but was neither presented to the Council of Ministers nor to the Austrian Parliament. The authorities would like to emphasize that the program of the new Austrian government does not mention a reform.

Deposit Guarantees, Recovery and Resolution Planning

Since January 1, 2019, investor compensation and depositor protection for Austrian credit institutions is performed by Einlagensicherung AUSTRIA Ges.m.b.H (DGS AUSTRIA). Exceptions are the members of the institutional protection scheme of ERSTE Bank and savings banks. Investors and depositors of these banks are protected by S-Haftungs GmbH. The system has been assessed as sound and sufficiently funded. The FSSA also confirms that recovery and resolution planning is well advanced, and the authorities recognize areas with the potential for further enhancements, such as closer collaboration with host authorities in contingency planning. However, the authorities want to emphasize that the further development of the current crisis management framework should be consistent with EU legislation and ECB policies, especially with respect to the provision of state aid and emergency liquidity, respectively, which are intended to reduce moral hazard within the banking union.

Insurance Sector

As concerns the insurance sector, the staff's assessment confirms the smooth implementation of Solvency II and documents the progress in the

analytical framework in insurance oversight in Austria. The authorities welcome 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 as a fundamental building-block towards a formal recovery and resolution framework in the insurance sector. When further developing and modernizing the FMA's supervisory toolkit on the basis of the existing Deckungsstocksystem, standards and principles forming the basis for future EU legislation should be taken into account. It should introduce new powers, with appropriate safeguards and legal protection, as well as a clear delineation of the scope and respective responsibilities of authorities (supervisory and resolution).

AML/CFT

The Austrian authorities are strongly committed to strengthening the effectiveness of Austria's Anti-Money Laundering/Combating the Financing for Terrorism (AML/CFT) framework. The authorities welcome the FSSA's recognition of the significant progress that has been made in this regard. Several measures have been taken recently, such as increasing supervisory resources to further increase the number of on-site measures, establishing a register of beneficial ownership and, most recently, the transposition of the European Union's 5th AML directive into national legislation, which also includes the new responsibility of overseeing virtual asset service providers (VASP). Further measures such as more intensive AML/CFT related training in the area of criminal justice are part of the new government program. These efforts contribute to the zero-tolerance policy of the Austrian authorities with respect to AML/CFT issues.

Mr. Farber, Ms. Pollard and Mr. Shenai submitted the following statement:

We thank staff for their well-written report and Mr. Just for his helpful and detailed buff statement. We agree with the thrust of the Financial Sector Stability Assessment and 2019 FSAP key recommendations and offer the below comments for emphasis.

The Austrian financial system has benefitted from the broad, cyclical upswing and recovery from Euro Area crisis. Efforts since the 2013 FSAP have strengthened financial stability, and the financial system remains resilient to tail risk scenarios. The authorities are continuing to make efforts to build supervisory capacity, enhance the macroprudential policy framework, and address risks.

Nevertheless, we agree that challenges remain, and we encourage the authorities to continue to address these challenges in the coming years. Vulnerabilities include currency mismatches, exposure to downturns in the CESEE and real estate, and aspects of the AML/CFT regime. We commend the authorities' efforts to reduce currency mismatches in the financial system, including by taking steps to limit foreign currency borrowing and lending. Still, the outstanding stock of foreign currency loans is high and susceptible to appreciation pressures, so we urge the authorities to continue to monitor these risks and consider borrower-based limits to limit losses. We welcome efforts to collect data on real estate, nonfinancial corporate, and CESEE exposures while promoting information sharing. More regular onsite inspections for all banks and a review of the National Risk Assessment, including from exposures to the CESEE, would be beneficial to the effectiveness of the AML/CFT regime. Implementation of strong AML/CFT controls at the group financial level would also enhance financial transparency.

Overall, supervisory capacity is strong. We agree with the recommendation to phase out state commissioners on supervisory boards, in line with global standards. We welcome the authorities' commitment to strengthening the insurance resolution regime, including by requesting recovery plans from selected insurers and adopting the overarching principle on first losses. The authorities' commitment to ensure that supervisory and crisis management frameworks are consistent with EU legislation and ECB policies can avoid duplication and preserve international consistency.

Mr. De Lannoy submitted the following statement:

We thank staff for their FSSA report for Austria and Mr. Just for his buff statement that provided useful additional details.

The Austrian financial sector is well capitalized and resilient but its structure, with more than 400 banks, and financial interlinkages can create complexities in a systemic event. Moreover, banks exposures to the CESEE region and the vulnerabilities associated with the increasing exposure of credit institutions to the real estate sector warrant supervisory attention. However, we would like to warn against unwarranted generalizations. Portraying a very large region as a source of vulnerability, without differentiating between countries, puts a stigma on many fast-developing European economies.

Financial Sector Developments and Systemic Risk Analysis

In recent years, the resilience of the Austrian financial sector has continued to increase, as risks to financial stability have been mitigated while banking sector capitalization, liquidity and funding have improved. However, vulnerabilities remain and include low structural profitability domestically, the high reliance of large Austrian banking groups on profit contributions from CESEE operations, as well as complex ownership structures and strong financial interlinkages within the three "decentralized segments" of the Austrian banking system. Such interlinkages work through mutual cooperation agreements, such as institutional protection schemes, cross-guarantee schemes, etc., and can act as shock absorbers for idiosyncratic shocks, but may lead to loss propagation in a systemic event. We support staff's recommendations, notably to further enhance the stress-testing framework regarding second-round effects and contagion, and to broaden data collection

Banking Supervision and Macroprudential Policy

We commend the authorities for their timely macroprudential measures, but we also see the need to further increase their effectiveness. A number of macroprudential measures, including the setting of the Systemic Risk buffer, implementation of Other Systemically Important Institutions buffers and issuing guidance on sustainable lending standards in real estate financing, were important in addressing financial stability risks since the 2013 Austria FSAP. However, we broadly agree with the report that national authorities should be prepared to introduce binding borrower-based limits in order to address residential real estate-related risks and further fine-tuning of the systemic risk buffers can also be envisaged to better reflect systemic vulnerabilities and the contagion potential from foreign exposures.

We positively note developments on anti-money-laundering/combating the financing of terrorism (AML/CFT) framework. Significant progress has been made in aligning Austria's AML/CFT framework with the Financial Action Task Force (FATF) standards. We also welcome proposals to further strengthen banking AML/CFT supervision.

Crisis Management and Financial Safety Nets

Regarding bank resolutions, we would like to highlight the European dimension of the resolution framework. From the European perspective, it is the rules set out in the Bank Recovery and Resolution Directive (BRRD) for

the EU, and the group resolution plans, under the Single Resolution Board (SRB) for the Banking Union members, that should ensure the financial stability and protect the real economy. The resolution strategy chosen by the SRB for the two banks with international operations – multiple point of entry (MPE) – is in line with the BRRD and reflects the decentralized structure of these groups.

Mr. Beblawi and Mr. Al-Kohlany submitted the following statement:

We thank staff for the comprehensive Financial System Stability Assessment (FSSA) for Austria and Mr. Just for his helpful buff statement.

The financial system in Austria is stable and resilient to severe macroeconomic shocks. Austrian banks, which represent the bulk of the financial sector, are well capitalized, liquid, and profitable. Banks' credit quality has improved significantly since the last FSSA, with nonperforming loans declining to 2.6 percent from 8.6 percent in 2013. We welcome staff assessment that the authorities' robust regulatory framework and timely policy actions have lowered financial stability risks. The macroprudential policy framework has been enhanced, the policy toolkit has been widened, and a full-scale guarantee deposit scheme (DGS) was launched last year. Going forward, the authorities are encouraged to address the vulnerabilities, identified in the report, stemming from the large and tiered banking system, complex ownership structures, high financial interlinkages which may fuel loss propagation in a systemic event, and high level of exposure to CESEE markets. Banks are also exposed to rising vulnerabilities in the housing market.

We note the largely positive results of the solvency and liquidity stress tests. However, the tests also suggest possible pockets of vulnerability, particularly among some small banks. In the case of the stress test adverse scenario, most banks CET1 ratio would remain above the regulatory hurdle, although most banks would make use of capital conservation buffers, and only five small banks out of 440 banks would breach capital requirements. Credit impairments and lower net interest income are key contributors to capital depletion in this scenario. Could staff comment on the need to strengthen the identified small banks' capital and non-interest revenue streams?

The structure of the banking system is a source of strength when the simulated shocks originate from the smaller institutions of the tiered cooperative structure, allowing the IPS to act as a shock absorber. However, when the stress occurs at a central institution, it could result in inward

spillovers due to strong equity linkages between members institutions. Furthermore, a simulated network analysis revealed potential cascade effects induced from banks' hypothetical defaults, which point at the critical role played by the central institution in the tiered banking structures. Although these central institutions withstood the most sever simulated shocks, we encourage the authorities to remain vigilant in view of their critical role for the system's overall stability. Given the complex structure of the banking system, the high cost-to-income ratio and the high branch density relative to peers, we would appreciate staff comments on the need for efficiency-driven banking sector consolidation in Austria?

We share staff concerns about the financial sector's vulnerabilities due to the build-up of risks in real estate sector. Real estate prices have increased rapidly over the past few years and are estimated to be overvalued by around 10-15 percent. Housing loans in total assets of banks have rapidly increased, driven by construction and real estate related activities, and a significant share of new mortgages shows high loan-to-value and debt-service to- income ratios. Given the build-up of risks, the authorities took steps to improve risk profile of new mortgages and issued the September 2018 guidance on sustainable lending standards. However, staff suggests that new mortgages still do not comply with the recommended limits, as evidenced by the high LTV and DTI ratios. We agree that the authorities should consider introducing binding limits. Authorities should continue with their efforts to improve the availability of data, especially regarding real estate exposures.

Profitability in the life insurance sector remains under pressure, due to low investment returns and increased interest-related provisions. Low growth in the sector was driven primarily by weaknesses in the domestic market. We welcome the significant efforts made by the FMA to improve data quality and analytical capacities, as well as the establishment of stress testing as a yearly practice. However, additional resources will be needed for the ongoing validation of Solvency II needs and for scrutiny by supervisors. We welcome the ongoing discussions on an insurance resolution framework and encourage the authorities to reinforce FMA's powers.

Finally, we concur with staff that data gaps need to be closed. We welcome in this regard the recent implementation of AnaCredit which collects detailed information on individual bank loans in the euro area, harmonized across all Member States. This is a first step towards strengthening supervisory efforts in monitoring domestic and international contagion risks, as elaborated in the buff.

Mr. Chikada and Mr. Shimada submitted the following statement:

We thank staff for their informative report and Mr. Just for his helpful buff statement. We welcome that the financial system in Austria remains stable, and commend the authorities for their efforts since previous FSAP. As we broadly agree with the thrust of the Financial Sector Stability Assessment and 2019 FSAP key recommendations, we would limit our comments to the following points.

We welcome that Austria's financial system remains stable and resilient to the tail risk. The country's financial system, which is dominated by banking sector, has improved its resilience to various shocks as shown in the stress test results. We commend the authorities' efforts to proactively address financial stability risks since the previous FSAP.

However, the lower for longer environment could pose different and more serious challenges going forward. The complex structure of the banking sector and profit reliance on the business in CESEE and real estate sector warrant caution. The prolonged low interest rate environment in the euro area could further suppress net interest margins in the domestic market, this in turn could drive the banks to expand their CESEE business or increase their exposure to higher risk assets. At the same time, we would like to caution that the current low profitability environment could gradually erode banks and life insurance companies' capital strength, which in turn could undermine their financial intermediation functions, especially given the importance of smaller banks in the Austrian financial system. In this regard, could staff elaborate on the profit sustainability of banks in the long term, especially those of smaller banks mainly focusing on domestic business, and future necessity of consolidation or operational cost cutting?

The lending and investment to real estate sector, both in domestic and CESEE market, need to be closely monitored, considering the profit reliance on the real estate sector of insurance company as well as banking sector. While the extent of banks' lending to domestic households and estimated overvaluation of house prices seem relatively benign thus far, we encourage the authorities to continue to monitor these risks and use macroprudential borrower-based limits as appropriate.

We welcome the development of macroprudential policy toolkits. To assess the financial situation and activate macro-prudential policy in timely and effective manner, especially sectoral tools, collecting more granular data is indispensable. In this sense, we welcome the authorities' effort to narrow

the data gap mentioned in buff statement and encourage further communication with financial institutions to improve data availability and quality.

Mr. Palei and Mr. Potapov submitted the following statement:

We thank staff for their insightful report and Mr. Just for his informative buff statement. We note that staff and the authorities mostly agree on the assessment of the key improvements and remaining challenges in the Austrian financial system and related policy recommendations.

Over the recent years the financial sector in Austria has benefited from considerable improvements in the regulatory and prudential frameworks, as well as the relatively favorable macrofinancial environment. Overall, the banking soundness indicators have improved since 2013. The FSAP analysis confirms that the banking system is well capitalized and highly liquid. Nonperforming loans (NPLs) have declined and profitability has recently risen. According to the stress-testing exercise, banks are, on aggregate, resilient to severe macrofinancial shocks. Moreover, risks arising from exposure to CESEE have been mitigated. The authorities have also taken several important steps to improve resilience of the system, including the creation of the Financial Market Stability Board, the activation of the Systemic Risk buffer (SyRB) and Other Systemically Important Institutions (O-SII) buffers, the implementation of EU-level regulations and guidance, and the introduction of the full-scale guarantee deposit scheme (DGS).

The Austrian authorities are addressing remaining risks and emerging vulnerabilities. Staff pointed to several structural vulnerabilities in the large and interconnected banking sector, high level of CESEE exposures across banks and insurers, and low domestic structural profitability. Some risks are building up in the real estate sector with possible overvaluation of housing prices, and growing exposure by the financial sector may indicate a potential systemic risk. Against this background, we support staff's recommendations aimed at collecting more granular data on real estate, the nonfinancial corporate sector, and CESEE exposures, while promoting information sharing. The stress testing function should also be further strengthened to fully integrate contagion and second round effects, as well as interconnectedness analysis tools. In view of overvaluation pressures in the housing market in the environment of low interest rates for a prolonged period, the authorities should consider introducing borrower-based limits to contain mortgage lending risks.

While the solvency coverage ratio of insurance firms is high, the sector suffers from low growth, low interest rates, and future profitability risk. The allocation by the insurance sector of about 8 percent of their total assets to real estate is also a source of concern. In this context, we support the authorities' efforts to develop a recovery and resolution framework for insurance firms. Pre-emptive and proportional recovery plans from selected insurers would be helpful to enhance the resilience of the insurance sector.

Strengthening the AML/CFT framework remains one of the key priorities. We would recall that the 2018 Eurozone FSAP highlighted the need for a common EU-wide AML/CFT supervision framework and enhanced exchange of information between the prudential supervisors and the AML/CFT supervisors. What are the recent developments and plans at the EU level and how can they help the Austrian banks in promoting regional cooperation and information sharing, as well as monitoring cross-border risks?

Mr. Mahlinza and Mr. Nakunyada submitted the following statement:

We thank staff for a detailed report, as well as Mr. Just for the insightful buff statement.

We commend the Austrian authorities for progress made in implementing key recommendations of the previous FSAP. The authorities' proactive policy actions to address identified shortcomings have reinforced the robustness of the regulatory framework, enhanced banks' resilience to macro-financial shocks, and lowered financial stability risks. That said, further actions would be important to mitigate emerging vulnerabilities stemming from cross-border exposures, money laundering risks, a complex and interconnected banking sector, low domestic structural profitability, attendant data and regulatory gaps, and emerging risks in the real estate sector. We broadly share staff's assessment and provide the following remarks for emphasis.

Strengthening of the macro-prudential framework has helped mitigate financial stability risks. In this connection, we positively note the bold strides made in strengthening the policy toolkit through issuance of guidance on sustainable lending in real estate financing and measures to address structural systemic risks. Nevertheless, the build-up of risks in the real estate sector, underscore the need to contain mortgage lending risks through appropriate borrower-based limits. We also acknowledge the instrumental role played by the sophisticated buffer-based framework in mitigating risks from structural vulnerabilities but emphasize the need for enhanced monitoring and over-sight

to mitigate inward contagion risks. Further, we agree that the regulatory framework for related-party risks should be enhanced given the high degree of interconnectedness in the financial system. Could staff comment on the adequacy of risk-mitigating factors built in the real estate sector?

More granular data and improved information-sharing would be essential for the effective monitoring and oversight of contagion and spillover risks. To this effect, we view recent steps to implement the AnaCredit, as an important step. That said, we urge the authorities to deploy adequate resources to support gathering of granular data including on the real estate sector, non-financial corporations (NFCs), and exposures to Central, Eastern, and South Eastern Europe (CESEE). We recognize the significant efforts by the Financial Market Authority (FMA) to enhance data quality and analytical capacity in the implementation of the Solvency II regime for the insurance sector. Nevertheless, adequate resources are required to sustain this momentum. Similarly, adequate resources should be deployed towards strengthening stress-testing and macro-prudential frameworks for banks, to enable the full integration of sensitivity, contagion, and interconnectedness tools. Could staff elaborate on the likelihood of spillover risks associated with Italy's fiscal challenges as well as the sovereign-bank nexus?

Containment of anti-money laundering (AML) risks would be important to preserve financial integrity. To this end, we commend the authorities for the significant progress made in aligning their framework with the FATF standards, strengthening the legal and regulatory framework, addressing cross-border related risks, and adopting a risk-based approach to AML/CFT supervision. We also welcome the recent increase in supervisory resources dedicated to strengthening of on-site measures. This notwithstanding, we urge the authorities to address concerns over the adequacy of the AML controls on foreign branches and subsidiaries. In this regard, additional efforts would be essential to enhance groupwide supervision and exploit synergies between prudential and AML/CFT supervisors. Further, we urge the authorities to address capacity and resource challenges amplified by the modifications to FATF recommendations. In this vein, we commend the authorities for the recent transposition of EU's 5th AML directive into national legislation, including the responsibility of overseeing virtual asset service providers (VASPs).

Current efforts should be sustained to ensure the effectiveness of resolution strategies in containing spill- over risks. We note the challenges posed by the complex banking system in implementing the preferred resolution strategy. Nevertheless, we urge the authorities to strengthen

collaboration with home supervisors and European authorities to contain system-wide risks and preserve financial stability, while developing a resolution framework for the insurance sector. Additionally, we encourage the authorities to strengthen deposit protection arrangements, broaden the scope of their annual contingency testing program to include amplification channels. That said, we look forward to progress on current discussions to develop the resolution framework for the insurance sector.

Mr. Mojarrad and Mr. Nadali submitted the following statement:

We thank staff for a well-written report and Mr. Just for his helpful buff statement.

The Austrian bank-dominated financial sector has benefited from the favorable macrofinancial environment, including robust growth in Austria and in the central, eastern, and south eastern Europe (CESEE) region, where Austrian banks' foreign business continues to concentrate. Over the past six years, banks have strengthened their capital levels, supported by strong profits, maintained ample liquidity buffers, and improved their credit quality. We commend the authorities for proactively addressing financial stability risks by implementing some of the 2013 FSAP key recommendations, including enhancing the macroprudential policy framework and toolkit, activating systemic risk buffers, nationally transposing EU directives and regulations, issuing minimum standards to contain risks in CESEE, launching a unified guarantee deposit scheme, and aligning Austria's AML/CFT framework with FATF standards. However, risks remain, including from complex ownership structures and financial interlinkages, rising vulnerabilities in the housing market, and concentration of exposures in the CESEE region. We concur with the thrust of staff assessment and wish to highlight the following:

Stress tests performed by the FSAP team in collaboration with the Austrian National Bank (OeNB) corroborate the resilience of the banking system to severe macrofinancial shocks, as banks remain adequately capitalized, liquid, and profitable. We are pleased to note that outward and inward spillovers between Austrian and foreign banks appear manageable, and that the debt servicing capacity of the Austrian corporates has improved. However, vulnerabilities in the real estate and construction sectors could adversely affect the banking system and the low-for-long interest rate environment could undermine banks' profitability. We see merit in the use of macroprudential borrower-based limits to help reduce losses on mortgage

portfolios in the adverse scenario as well as further strengthening stress tests to better assess the impact of policy decisions on the financial system.

We note the shared responsibility of financial system oversight among the single supervisory mechanism (SSM), the financial market authority (FMA), OeNB, and federal ministry of finance (BMF). Contrary to staff suggestion that reforms to consolidate banking supervision within the FMA have been put on hold because of the change in government, Mr. Just indicates that the new government is not contemplating such reforms. We appreciate staff clarification. While increasing the countercyclical capital buffer (CCyB) could be considered if credit in the real estate picks up, we appreciate staff indication of the timeline for the planned introduction of sectoral macroprudential capital buffers to the European macroprudential framework. Given the incompatibility of the legacy role of state commissioners with international corporate governance standards, staff may also wish to comment if the authorities are ready to phase out the role of state commissioners in supervisory boards. High average guaranteed rates in the insurance sector amid continued decline in investment returns underscores the need to conduct more targeted stress tests to ensure the viability of the insurers' business models that rely on future profitability to meet capital requirements.

Crisis management and deposit protection arrangements are generally sound, and recovery and resolution planning are well advanced. However, financial stability could be enhanced by separating decision making for supervisory and resolution functions within the FMA, providing additional flexibility in the bankruptcy regime, integrating deposit guarantee arrangements with the overall crisis management and safety net regime, and reinforcing FMA's powers on insurance resolution. We also endorse requesting recovery plans from selected insurers based on micro and macro-prudential considerations.

We wish the authorities continued success in their endeavors.

Mr. Heo, Mr. Tan, Ms. Park and Ms. Yoe submitted the following joint statement:

We thank staff for the comprehensive report and Mr. Just for the informative buff statement.

We commend the authorities for the good progress made in enhancing financial sector oversight in line with the 2013 FSAP recommendations, including enhancements to the macroprudential policy and crisis management

frameworks. We also take positive note that Austrian banks' capital levels have strengthened, and credit quality has improved since the last FSAP, contributing to lower financial stability risks. More importantly, stress test results show that banks are resilient to severe macro financial shocks and to sizeable withdrawals of funding.

We agree that continued close monitoring and proactive policies are needed to address key challenges and risks including the large and interconnected banking system, concentrated exposures to CESEE markets and low domestic profitability. In particular, we agree that the complex ownership structure in the banking sector requires careful monitoring and oversight of contagion and spillover risks. We also encourage the authorities to strengthen and enforce the regulatory framework for related-party risk given the highly interconnected financial system. On the observation that domestic profitability is low, do staff see scope for consolidation? Vulnerabilities associated with real estate markets should continue to be monitored, and we welcome the authorities' readiness to activate further macroprudential measures and the announced measures aimed at increasing the supply and affordability of residential real estate. While fintech was assessed to be small and hence out of scope for this FSAP, in many financial systems it is growing quickly – what is staff's assessment of the potential for growth in fintech in the Austrian financial system?

Recommendations on strengthening financial sector oversight should take into account political economy constraints and local context to achieve policy traction and to ensure that regulatory frameworks are fit for purpose. We agree with the need to strengthen the frameworks for supervision and macroprudential policy to better target financial stability risks, however it is not clear from the staff report that the recommendations on the institutional setup (recommendation 2) and the division of responsibilities between the regulatory bodies (recommendation 1 and 4) would lead to improvement in effectiveness and timeliness of financial sector oversight. We welcome staff's comment to clarify how the recommendations would address the apparent gap in the current institutional arrangement, and whether the authorities face any difficulties in implementing the recommendations. As the IEO have highlighted, IMF policy advice is most useful when fully anchored in the local circumstances and not overly reliant on off-the-shelf "international best practice". From this perspective, we encourage staff to focus the FSAP assessments and recommendations on demonstrated outcomes and avoid prescribing specific institutional arrangements as the only way to achieve effective policy outcomes.

We welcome efforts to close data gaps and to enhance stress testing so as to strengthen financial stability analysis, but there should be a closer consideration of the costs and benefits of doing so. On financial stability analysis, several areas are identified as needing additional resources: addressing data gaps and enhancing stress testing to capture second round effects and contagion/spillover effects. We note that initiatives are underway by OeNB and FMA to increase the granularity of corporate and household lending data, and the authorities have also made significant efforts to improve the stress testing capabilities. While we recognize that staff see scope for additional data collections on exposures to real estate, CESEE and non-financial corporates as well as to further strengthen the stress testing framework, we wonder what is the authorities' views in terms of devoting more resources to expand data coverage and to further develop stress testing capabilities? Can staff comment on the extent that the data gaps posed an issue to the authorities and staff from having a full picture of the contagion risks and from allowing them to take timely interventions if the risks were to materialize?

We welcome the opportunity to discuss the Austrian FSSA on a stand-alone basis – and given that the FSAP Review is considering more discussions of FSSAs on a stand-alone basis, we see value in reflecting on some aspects of that review in this context.

Visibility of authorities' perspectives – in comparison to an Article IV staff report, an FSSA does not document the views of the country authorities. Adding an Authorities Views sections to FSSAs may be a way to give greater visibility to authorities' perspectives and assist subsequent assessments (and FSAP Reviews) into understanding why a recommendation was not implemented.

Resource savings where both national and supranational assessments are conducted – 60 percent of Austrian banks are covered by the European Union Single Supervisory Mechanism, and this FSSA draws on work done in the Euro Area FSAP. How has this affected the scoping of Austria's assessment or the resources needed to conduct this assessment, compared with the previous Austrian assessment in 2012? Are there potential resource savings for future assessments for Austria and other countries with similar arrangements?

Thematic approach – the FSAP Review suggests that there may be scope to move towards a more thematic approach where there has been

limited changes since the previous assessment. What themes would staff consider for Austria's next FSAP?

Mr. Psalidopoulos and Ms. Mateus submitted the following statement:

We thank staff for the clear assessment and Mr. Just for his enlightening buff statement. Increased resilience of the banking system and the strengthening of the regulatory and supervisory frameworks since the last FSAP are welcome and commendable developments, but further strengthening is still encouraged. Associating ourselves with Mr. de Lannoy's statement, we would like to highlight the following:

Aware that the euro area framework is covered in the euro area FSAP, we consider that the report is not always explicit about the division of responsibilities between European and national bodies. Indeed, the European Union (EU) regulatory framework and the Banking Union supervisory and resolution frameworks provide the context in which the Austrian authorities discharge their duties, with some duties being undertaken at the EU or banking union levels. While we do not favor duplicating explanations between euro area and national FSAPs, we consider that, in some cases, further descriptions could be insightful. One example is the Recovery, Resolution and Financial Stability section that acknowledges upfront the responsibility of the Single Resolution Board (SRB), but fails to refer to the EU Bank Recovery and Resolution Directive (BRRD) framework and the SRB's decisions over Austrian banks.

While the authorities have been vigilant and used their powers to address risks to financial stability, we note that the macroprudential institutional framework could be enhanced. In line with IMF's and European Systemic Risk Board's guidance, the role of the Oesterreichische Nationalbank (OeNB) could be further strengthened in the macroprudential oversight framework. We agree with staff that tasking the OeNB with chairing the FMSB and strengthening its role in this body would leverage on the central bank's independence and allow exploiting synergies from its other central bank functions.

We agree with the assessment of the main risks to the Austrian financial system and note that some risks, such as low profitability, constitute a broader challenge. We also agree with staff that risks stemming from real estate and construction can pose financial stability concerns moving forward and therefore warrant close monitoring and readiness to act. We consider the guidance on sustainable lending to be a step in the right direction, but the

authorities should be willing to consider binding borrower-based measures in case risks intensify.

Finally, we welcome the improvements of the anti-money-laundering/combating the financing of terrorism (AML/CFT) framework, bringing it closer to the Financial Action Task Force (FATF) standards.

Mr. Saraiva and Mr. Nithder Pierre submitted the following statement:

We thank staff for their well-written and insightful report and Mr. Just for his useful statement. We commend the major reforms proactively undertaken by Austrian authorities since the 2013 FSAP as well the introduction of macroprudential tools, which have helped lower the country's financial sector vulnerabilities and risks. Notwithstanding, as noted in the staff report, there is important scope for improvement as many challenges still weigh on the financial system. We broadly agree with the thrust of the report and encourage the authorities to continue efforts to address underlying vulnerabilities and boost financial stability and resilience.

The financial sector – largely dominated by banks – remains resilient in the face of the rising cyclical vulnerabilities, although there is a need for closely monitoring risks. Stress tests confirm that banks are, in aggregate, resilient to severe macrofinancial shocks. We take positive note of sizeable capital buffers as well as comfortable capital ratios after the simulation of macroeconomic shocks and market risks, even as capital conservation buffers would be used by most banks. Solid counterbalancing capacity and important deposit funding base make banks resilient to sizeable withdrawals of funding. In addition, the liquidity cooperation scheme enhances financial stability through pooling of liquidity among members. Nevertheless, high interconnectedness remains a source of contagion in the hypothetical case of bank failures. As recommended by staff, we encourage authorities to strengthen monitoring and oversight related to contagion/spillover risks, including enhanced stress testing framework to consider second round effects, behavioral elements and dynamic balance sheet stress tests.

Further effort is needed to improve data collection and granularity in support to timely supervisory action and to strengthen AML/CFT controls. Given the complexity of the Austrian financial system, proper data reporting and efficient information-sharing arrangements are paramount for the appropriate identification of risks and better supervisory actions. In this regard, authorities should continue efforts to close data gaps, including in the real estate and nonfinancial corporation sectors, and improve coverage and

granularity of data from exposures to Central, Eastern and South-Eastern Europe (CESEE), where potential spillover risks are high. Additionally, we encourage the Austrian authorities to further strengthen supervision of related party, group-wide, and money-laundering risks, as we echo staff concerns over the adequacy of AML controls on foreign branches and subsidiaries, which may lead to operational and reputational risks. Adequate resources should also be ensured to implement the recent modifications to FATF recommendations regarding virtual assets/virtual asset service providers (VA/VASPs).

We commend the progress in crisis contingency and financial institution resolution and recovery planning but additional flexibility in the bankruptcy regime is needed. Despite advanced steps in that direction, efforts towards effective resolution strategies are crucial to contain spillover risks. Authorities should therefore expand the scope of their annual contingency testing program to include amplification channels, and support funding in resolution. Finally, regarding the non-systemic banks, amendment in the bankruptcy regime should be considered to explicitly provide the ability to transfer a non-systemic bank's covered deposits and its sound assets to an acquirer.

Mr. Poso and Mr. Vaikla submitted the following statement:

We thank staff for a comprehensive report and Mr. Just for his informative buff statement.

The Austrian financial sector is well capitalized and resilient, while also being subject to several risks that require enhanced monitoring and mitigation efforts in an environment of slowing growth. We broadly share staff´s assessment and their recommendations regarding financial sector oversight, financial stability analysis, crisis management, and financial safety nets. We associate ourselves with Mr. De Lannoy´s gray, while adding the following comments for emphasis.

The financial sector is vulnerable due to its exposure to the cyclical risks from the CESEE region and the real estate sector. We share staff´s assessment that structural vulnerabilities include a complex banking system with sizeable financial interlinkages to the CESEE region, which accounted for 42 percent of profits for the Austrian banks in 2018. Furthermore, a correction in the real estate market, estimated to be overvalued by around 10-15 percent by staff, would result in higher impairment charges for banks,

while lower house prices could depress domestic demand and thereby affect banks' profits further.

We welcome the stress test results which suggest that banks are able to withstand severe macrofinancial shocks. We note that, given its sizeable deposit base, the banking system can face sizeable funding withdrawals. Notwithstanding these encouraging assessments, we concur with staff that given the build-up of the above-mentioned risks, further enhancing of the stress testing framework, improving data collection on foreign exposures, and strengthening the supervision of related parties is important. We also encourage the authorities to continue efforts to close the data gaps, including in the real estate and nonfinancial corporate sectors, and improve the granularity and coverage of CESEE data.

Risks in the real estate market are currently contained, but banks' lending standards warrant continued monitoring. We commend the authorities for their timely implementation of macroprudential measures to mitigate financial stability risks. However, given the significant increase in real estate prices over the last decade, increased lending to real estate activities, and the fact that a considerable share of new mortgages do not comply with recommended DSTI limits or the minimum down-payments, call for close monitoring. We agree with the FSAP recommendation that national authorities should be prepared to introduce binding borrower-based limits in order to address residential real estate-related risks more effectively. The authorities should also stand ready to implement further macroprudential measures if needed.

We welcome that significant progress has been made in aligning Austria's AML/CFT framework with the FATF standards. We also welcome the notable steps taken regarding the adoption of a risk-approach to AML/CFT supervision and amendments to Financial Markets AML Act. Going forward, we encourage the authorities to put greater focus on monitoring cross-border risks and increasing the inspections in lower-risk banks. We also agree with staff that the authorities should ensure that strong AML/CFT controls are applied in banks at the group level.

Mr. Ronicle and Ms. Andreicut submitted the following statement:

We thank staff for a comprehensive report and Mr Just for an informative buff statement. The Austrian financial sector has undergone significant change since the 2013 FSAP, as illustrated by Annex II. In particular, the establishment of the euro area banking union entailed a transfer

of responsibilities from the national to the eurozone level for seven significant credit institutions. This was complemented by the adoption and implementation of a swathe of post-crisis financial sector reforms. The scale of change reinforces the importance of frequent assessments for financial sectors judged to be significant by the Fund.

We welcome the good progress made by the authorities' in addressing the 2013 FSAP recommendations. Annex III paints a very positive picture, with the bulk of previous recommendations either completed or largely completed. One exception is the recommendation to strengthen FMA's governance, including the legal protection of its bodies and staff. Could staff comment on why this issue has not yet been addressed?

Financial Sector Resilience

Turning to the 2020 FSAP recommendations, we take note of staff concerns about the interconnected nature of the banking sector, the high level of Central, Eastern, and South Eastern Europe (CESEE) exposures across banks and insurers and the low domestic profitability.

We welcome the positive stress test results which indicate banks are resilient to severe macrofinancial shocks. Nonetheless, we understand concerns expressed by staff about potential cascade effects in the event of a default, due to the clustering of many small banks around a few important nodes. We agree with staff that the complexity of the Austrian banking sector requires a strong stress testing function, with an emphasis on sensitivity, contagion and interconnectedness analysis tools.

We also appreciate the scale of the CESEE interlinkage, with the area representing 24 percent of exposures and 42 percent of consolidated banking net profits in 2018. We agree that these interlinkages warrant close monitoring, bearing in mind the region's vulnerability to financial market volatility, capital outflows and FX swings.

While we broadly support staff recommendations on financial sector resilience, we found it difficult to judge from the report how some of the more resource intensive proposals, such as the recommendation to strengthen the stress testing function, will be addressed by the authorities. Similarly, we were unsure to what extent the authorities would be able to close data gaps in real estate or to improve the coverage and granularity of CESEE exposures. Could staff elaborate on authorities' views on these recommendations?

Financial System Oversight and Crisis Management

We welcome the establishment of the Financial Market Stability Board (FMSB) in 2014, following the recommendations of the 2013 FSAP. We take note of good progress made by the FMSB in strengthening Austria's macroprudential framework. We support staff's recommendations for strengthening the institutional framework, enhancing systemic risk monitoring and preparing for the introduction of borrower-based limits to address the ongoing build-up of risks in residential real estate. We take note of staff's assessment that the current countercyclical capital buffer (CCyB) of 0 percent is appropriate. We also support staff's recommendation that authorities should consider increasing the CCyB if the growth of domestic bank credit to non-financial corporations continues and real estate credit picks up. Given the complex ownership structures and financial interlinkages of the Austrian banking sector, could staff elaborate more generally on the role that the CCyB can play in addressing systemic risk?

Like staff, we agree that the major shifts in banking regulation and oversight since the 2013 FSAP have enhanced Austria's regulatory and supervisory framework. We also agree however that not all concerns have been alleviated. We consider that the Financial Markets Authority's (FMA) operational independence might be at risk as a result of having industry representatives on the supervisory board and encourage the authorities to address this issue. In addition, we concur with staff that having a unified decision-making process for supervision and resolution within FMA could create conflicts of interest and undermine FMA's ability to take timely action.

Considering recent developments in banking regulation, a significant step was the adoption of the revised Capital Requirements Regulation II and Directive V (CRR II / CRD V) in June 2019. CRR II / CRD V implement some of the outstanding Basel rules into EU law, while also introducing EU specific measures. Like other EU member states, Austria will have to implement most measures in the package over the next 24 months. We note that the FSAP report did not address this issue. Could staff elaborate on the implementation progress? How are Austrian banks responding to the new prudential requirements?

Turning to the insurance sector, we welcome the authorities' implementation of Solvency II and agree with staff that ongoing scrutiny by supervisors will be needed. We also concur with staff's support for an emerging insurance resolution framework and the prioritization of pre-emptive and proportional recovery plans for selected insures in the short-term.

Emerging Issues

We agree with staff's judgement that a focus on fintech was not warranted given the small share of fintech activity in the Austrian financial sector.

Looking ahead, we see climate as one of the emerging issues that merit closer scrutiny. We understand that the new conservative-green coalition intends to make Austria a leader in the transition towards a green economy. This includes becoming carbon neutral by 2040 and ensuring that all energy is derived from renewable resources by 2030. Such an ambitious plan comes with opportunities and risks for Austria's large financial sector (relative to GDP). It will therefore be essential for staff to consider the financial impact of transition and the extent to which financial firms are taking this shift into account in their business planning. In this context, we encourage staff and the authorities to consider conducting climate stress tests.

Mr. Chodos and Mr. Morales submitted the following statement:

We thank staff for its clear report and Mr. Just for his helpful buff statement. We note Mr. Just's clarification indicating that no reform is yet envisaged by the new Austrian government regarding changes of supervisory responsibilities of the Financial Market Authority (FMA) and the Austrian National Bank (OeNB). Staff's comments on the implications of this are welcome.

The Austrian financial system is sound and well capitalized. The Austrian large banking system comprises 600 banks, with complex ownership structures and financial interlinkages, and significant presence in Central, Eastern, and Southern Eastern Europe (CESEE). Structural vulnerabilities relate to the size and complexity of Austrian banks, namely high interconnectedness, currency risks, and cross-border exposure. Overall, banks show sizable capital buffers and a large deposit funding base. Mutual financial cooperation arrangements among banks, including institutional protection schemes (IPS), cross guarantee schemes, and liquidity associations act as shock absorbers for idiosyncratic shocks. Financial stability risks have declined over time, with NPLs declining to 3.2 percent in 2018. However, financial vulnerabilities may be building up as the late cycle risks emerge, in particular on household and real estate loans, with corporate leverage indicators pointing to higher vulnerability in the real estate and construction sectors. Moreover, risks in the CESEE region appear to be rising.

Stress test results show that Austrian banks are resilient to severe shocks. Banks comfortably withstand shocks to solvency including a significant correction in real estate prices. However, while stress testing results confirm banks' resilience, they also suggest heterogeneity in the impact of shocks, because of contagion risks in the tiered structure of the cooperative sector from upper tier banks to lower tier banks. In addition, the low-for-long interest rate environment may affect banks' profitability down the road. On liquidity risk, the banking system is resilient to large funding withdrawals, with ample space for banks to accommodate outflows given the stable deposit-based funding structure. Concerning contagion risks, outward and inward spillovers between Austrian and foreign banks appear manageable. Regarding risk mitigation, IPSs prove overall effectiveness as a shock absorber in the event of solvency and liquidity shocks.

The Austrian authorities have been proactive in addressing structural vulnerabilities. The Financial Market Stability Board (FMSB) has broadened the policy toolkit, providing guidance on real estate financing and activating systemic risk buffers to address structural systemic risks. The institutional framework for macroprudential policy is sound, and the systemic risk monitoring framework is advanced. However, structural vulnerabilities require continuous updates on monitoring and oversight practices consistent with EU directives. We encourage the authorities to continue expanding the granularity of corporate and household lending data, and narrow remaining data gaps, and to monitor closely institutions not meeting the FMSB Debt-Service-to-Income guidance levels. Also, early warning criteria should be introduced to the early intervention framework to improve its effectiveness. Finally, we agree with staff that the regulatory framework for related-party risk should be streamlined given widespread interconnectedness between financial and non-financial market players.

The institutional arrangements for crisis management are sound. Recovery and resolution planning are well advanced but could benefit from additional flexibility in the bankruptcy regime for the transfer of covered deposits and its sound assets to a third party. We welcome the launch of a unified ex-ante-funded guarantee deposit scheme last year, in line with FSAP recommendations.

We welcome the Austrian authorities' zero-tolerance policy with respect to AML/CFT issues, highlighted by Mr. Just in his statement. Significant progress in recent times includes the transposition of the European Union's 5th AML directive into national legislation incorporating additional

oversight responsibilities into the AML/CFT framework. Looking forward, a review of the National Risk Assessment could help guide further measures to mitigate ML/TF risks, including from CESEE countries.

With these comments, we wish the Austrian authorities' success in their policy endeavors.

Mr. Jin and Mr. Huang submitted the following statement:

We thank staff for the well-written report and Mr. Just for his informative buff statement. We broadly agree with Austria's Financial System Stability Assessment and would like to limit our comments to the following.

Against the backdrop of strong economic growth in Austria and the authorities' continuous efforts, the Austrian financial sector is broadly resilient. Nevertheless, vulnerabilities remain, including the highly interconnected banking sector, concentrated exposure to the real estate and low profitability in a low-for-long interest rate environment. The authorities are encouraged to continue their efforts to address the vulnerabilities.

We take positive note that according to the stress test, the Austrian banking sector is resilient to a wide range of severe macrofinancial shocks. However, the complex structure of ownership and financial linkages in the banking system is a source of concern. We agree with staff that these risk-sharing arrangements could help to absorb idiosyncratic risks, but may also contribute to contagion in a systemic event. In this regard, we see merits in staff's recommendation to strengthen the regulatory framework for related-party risks.

The housing price is elevated and becoming overvalued in recent years. In the meantime, the exposures to housing market are increasing across the financial system. We encourage the authorities to continue monitoring the housing price and introduce binding macroprudential limits when necessary. As indicated in the buff statement, the authorities' commitment to increase the supply and affordability of residential real estate is also welcome.

The profitability in the banking sector has increased but the net interest margin is narrowing down. The insurance sector is suffering from low interest rate, low investment return and future profitability risk. In this regard, we encourage the authorities to keep a vigilant watch on the risk-taking activities in a low-for-long interest rate environment and promote the development of Fintech so as to increase the cost efficiency of the financial sector.

Regarding the macroprudential policy and supervisory framework, we broadly agree with the staff's series of recommendations, including strengthening the central bank's role in the Financial Market Stability Board and phasing out state commissioners in the supervisory board. We take note that the former government proposed a reform to the banking supervisory framework which the new government has no intention to carry on. Can staff comment on whether this reform would be urgently needed to strengthen the institutional framework of the banking supervisory?

Mr. Merk and Mr. Braeuer submitted the following statement:

We thank staff for their informative report and Mr. Just for his insightful buff statement.

While challenges remain, we take positive note that since the previous FSAP the authorities have proactively addressed financial stability risks and the resilience of the banking system has increased. We associate ourselves with Mr. de Lannoy's statement.

Mr. Moreno and Mr. Montero submitted the following statement:

We thank staff for its FSAP report and Mr. Just for his informative buff statement. We broadly share staff's recommendations and associate ourselves with Mr. De Lannoy's statement. We would like to offer the following comments to emphasize certain issues.

Austria's economic and financial situation is healthy, although some financial vulnerabilities are building up particularly stemming from a booming real estate market—with an estimated overvaluation in house prices of 10-15 percent nationally—and a high exposure to volatility in some CESEE markets which provided 42 percent of consolidated banking net profits in 2018. Low domestic structural profitability is also an issue, common to other AEs. Robust regulatory and prudential frameworks have helped contain financial stability risks, but there are some pending challenges that should be addressed.

The results from the different stress test exercises show that the financial system is resilient to severe macrofinancial shocks. The system is also resilient to liquidity shocks, in part due to the synergies generated by the existing liquidity cooperation schemes. Results from the exploratory analysis of interconnectedness through shock resilience of the two layered Institutional

Protection Schemes (regional and federal) are encouraging, as it seems that systemic shocks (i.e. shocks to a central institution) do not create substantial vulnerabilities. Could staff provide more details on this exercise? What are the impacts on capital ratios of the central institutions?

As highlighted by staff, the institutional framework for macroprudential policy is sound, but there is room for improvement. We see merit in staff's proposals to enhance OeNB's and Financial Market Authority (FMA)'s role in monitoring financial stability to benefit from its resources and capabilities by increasing its representation in the Financial Market Stability Board (FMSB). There is also room to enhance systemic risk monitoring by closing data gaps and deepening the analysis of interlinkages—with improved stress-testing—given Austria's complex ownership structures.

Regarding financial sector oversight, we share staff's view that FMA's operational independence may be endangered due to the presence of industry representatives in the Supervisory Board, while there is a case for phasing-out the role of state commissioners in banks' supervisory boards—which is incompatible with international corporate governance standards.

Ms. Levonian, Ms. McKiernan and Mr. Mooney submitted the following statement:

We thank staff for their comprehensive report and Mr. Just for his informative buff statement. Financial stability risks in Austria have been proactively addressed since the last FSAP. Banks appear to be resilient to severe macroeconomic shocks, including sizeable withdrawals of funding, while institutional arrangements for crisis management are generally sound. However, challenges remain in the form of the exposure of banks and insurance companies to the CESEE region and the challenges associated with the growing exposure of credit institutions to the real estate sector. As we broadly agree with the thrust of the staff appraisal, we offer only the following remarks for emphasis.

We welcome the continuing progress in aligning the AML/CFT framework with the Financial Action Task Force (FATF) standards, and the zero-tolerance policy of the Austrian authorities with respect to these issues, as outlined in the buff statement. We positively note the transposition of the European Union's 5th AML directive into national legislation, which also includes the new responsibility of overseeing virtual asset service providers (VASP). We agree with staff that the authorities should ensure that strong AML/CFT controls are applied at the group level and remedial actions are pursued, where appropriate.

We positively note that recovery and resolution planning are well advanced and welcome the recognition by authorities of the potential for further enhancements, such as closer collaboration with host authorities in contingency planning. We concur with the authorities that any further development of the current crisis management framework should be consistent with EU legislation and ECB policies. We note that the deposit guarantee schemes are appropriately funded and agree with staff that the BMF should secure ex ante standing authority to provide a guarantee for the borrowing of either DGS as a last resort or be provided with the power to lend directly to the schemes.

We welcome the implementation of Solvency II and the associated meeting of capital requirements by insurance providers. We agree with staff that this needs ongoing validation and scrutiny by supervisors, which require resources with the requisite skills and expertise. In terms of insurance resolution, we support the staff recommendation for the authorities to request pre-emptive and proportional recovery plans from selected insurers, based on microprudential and macroprudential considerations.

Mr. Trabinski and Mr. Tola submitted the following statement:

We thank staff for their well-written report and Mr. Just for his helpful and detailed buff statement. We agree with the thrust of the Financial Sector Stability Assessment (FSSA) and its key recommendations and would like to offer few comments for emphasis.

We commend the authorities for their work in enhancing the macroprudential policy framework, broadening the policy toolkit, and addressing structural systemic risks. Despite the notable progress in increasing the financial sector's resilience, the remaining vulnerabilities highlighted in the FSSA should be addressed.

The complex ownership structures and financial interlinkages call for enhanced monitoring and oversight. Staff analysis reveals some underlining weaknesses stemming from the highly interconnected nature of the Austrian financial system. In particular, the related-party risk and the risk from the Less Significant Institutions (LSI) are not properly captured. This calls for an enhancement of the current regulatory framework to allow for an adequate monitoring and market pricing of transactions with related parties, and the establishment of ex-ante approval of LSI significant investment.

We support staff's recommendation to enhance the stress testing framework to capture second-round effects and potential contagion channels. The Austrian financial sector's focus on CESEE countries brings benefits in terms of income diversification and above-average profitability. At the same time, the concentration of exposure makes Austrian financial institutions vulnerable to a sharp slowdown in the region's economies and a depreciation of their currencies. In this regard, we see merit in further work to increase the level of modelling granularity of stress testing, which would allow the geographical breakdown of risks and facilitate the monitoring of contagion channels. We would also appreciate staff's comment on this topic if more information is available.

We agree with staff on the need to introduce binding borrower-based limits to counter real estate-related risks. Given that a large share of new mortgages is still not in compliance with the recommended Debt-Service-To-Income (DSTI) limit, we see merit in the introduction of hard limits to contain risk from mortgage lending, such as a combination of limits on maximum Loan-To-Value and DSTI ratios. Moreover, the quality of the analysis of real estate-related risks could be enhanced by reducing the existing data gaps.

The authorities should closely monitor risks to financial stability related to the insurance sector. This sector has come under stress as a result of the prolonged period of low interest rates and heightened competition, as well as its increasing activity on the mortgage market. About 8 percent of insurers total assets are invested in real estate—the highest rate in the EU. In this vein, we support the creation of preparatory crisis plans by insurers and further efforts to improve the resilience of insurers' business models.

We commend the authorities for their effort to enhance the banking sector's regulatory framework in accordance with EU regulations. The implementation of EBA guidelines and FMA's regulation on credit risk management have broadly improved financial sector oversight in Austria. Nevertheless, we encourage the authorities to move forward with implementation of the intended institutional reform of banking supervision. This could further improve FMA's efficiency, while strengthening the supervisory framework. Could staff comment on the feasibility of implementation of the intended reform in 2020? Finally, we support further efforts aimed at improving FMA's independence.

Mr. Mouminah and Mr. Rawah submitted the following statement:

We thank staff for the comprehensive report and Mr. Just for his informative buff statement. We broadly agree with the findings and recommendations of the FSSA and would limit our remarks to a few issues.

We welcome staff's positive assessment of Austria's financial system. In particular, banks are resilient to severe macrofinancial shocks as capital levels have strengthened, and credit quality has improved. Also, the macroprudential framework is sound, and resolution and recovery planning are well-advanced. Moreover, we take positive note of the authorities' proactive engagement through timely policy actions, which have helped in mitigating financial stability risks. We are also encouraged by the authorities' actions to address previous FSAP recommendations. Nonetheless, there are financial vulnerabilities, including high exposures to CESEE, financial interlinkages, and low domestic structural profitability. In this context, we encourage the authorities to continue their efforts to close data gaps, including in the real estate and NFC sectors, and improve coverage and granularity of CESEE data. Here, the recent implementation of AnaCredit, as noted in the buff statement, is a step in the right direction, which could help in strengthening supervisory efforts as well as in achieving better risk identification and monitoring. Also, as rightly noted by staff, further strengthening the stress testing framework while ensuring efficient information sharing is warranted in light of the large and complex structure of the banking system.

We encourage the authorities to continue monitoring the developments in real estate sector and stand ready to take appropriate policy actions. Here, we are encouraged by the authorities' continued efforts to contain real estate sector risks, including by the issuance of the guidance on sustainable lending in real estate as well as the various risk mitigating measures already in place. This is important as risks are building up, including from the increased exposure of the financial sector to real estate, the overvaluation, and the high share of FX housing loans compared to peers. We also welcome the authorities' readiness to activate further macroprudential measures if needed, as noted in the buff statement.

Finally, regarding financial integrity, efforts should continue to further enhance the AML/CFT framework. In this context, we are reassured by the significant progress that has been made since the 2016 AML/CFT Mutual Evaluation and welcome the authorities' commitment to further strengthen the effectiveness of the AML/CFT framework. This is important due to concerns

over the adequacy of AML controls on foreign branches and subsidiaries, which could pose operational and reputational risks to banks.

With these remarks, we wish the authorities further success.

Mr. Bhalla and Mr. Goyal submitted the following statement:

We would like to thank the Staff for its FSAP report and Mr Just for a helpful buff.

We note that authorities have taken several policy steps since the last FSAP in 2013 to contain vulnerabilities of the financial sector. These include setting up Financial Market Stability Board, issuance of policy guidelines to mitigate risks in the real estate sector, structural systemic risks and risks related to other systemically important institutions, prescription of minimum standards to contain risks in exposures to the CESEE region, the introduction of deposit guarantee scheme and aligning AML/ CFT framework with FATF standards.

Notwithstanding the above policy steps and strong income growth, there are several idiosyncratic reasons imparting vulnerabilities to the financial sector. These include complex financial interlinkages in the banking sector, banks' exposure to the CESEE region and to Italy, and rising exposure to the real estate sector. The CESEE region is vulnerable to financial market volatility.

We note that stress tests highlight the risks associated with the interconnected banking sector. Institutional Protection Scheme (IPS) embedded in the banking system is effective in containing risks only if they originate in the smaller institutions; stress on central institutions is likely to create systemic solvency risk. Liquidity buffers available under IPS do not seem to be very strong. Cash-flow based stress tests indicate that IPS improves the likely liquidity shortfall under the adverse scenario only by about 10 percent.

We would encourage the authorities to revive the proposal of May 2019 to reform the supervisory framework for the banking sector.

We support Staff's recommendations on financial sector oversight, including the relative role of FMA, OeNB and BMF in the supervision of the financial sector and also categorization of various recommendations as

immediate/ near and medium term. However, we have some specific queries seeking elaboration from the staff.

Staff observes that the banking system is resilient to sizeable withdrawal of funding. This is because of the OeNB's ability to provide liquidity through standard or extraordinary facilities. What are these specific facilities? Staff may like to elaborate.

Real estate exposure has risen sharply and has been identified as a key vulnerability to the banking sector. This is based on Staff assessment that real estate assets are overvalued by 15-20 percent. Staff may like to indicate how precise is this assessment and what is the methodology used for this? Secondly, 15-20 percent overvaluation may not be a very major risk. Staff may like to elaborate.

Mr. Raghani and Mr. Nguema-Affane submitted the following statement:

We thank staff for the insightful report and Mr. Just for his informative buff statement.

We welcome the progress made in implementing the 2013 FSAP recommendations—albeit remaining areas for improvement—and the continued resilience of the Austrian banking sector to severe macro-financial shocks. Significant strides have been achieved since 2013 in strengthening the regulatory and supervisory framework, notably the AML/CFT structure. That said, the 2019 assessment has identified areas, including crisis management, that still need improvements. We urge the authorities to further reduce financial stability risks and implement the recommendations of the 2019 FSAP in this regard. We particularly encourage them to provide adequate resources to enhance the efficiency of the supervisory and regulatory system.

We broadly share staff's recommendations and would like to limit our comments to the following points:

Containing risks from high exposure to Central, Eastern and South Eastern Europe (CESEE) countries will be critical to preserving financial stability. Austrian banks are highly exposed to CESEE countries where profitability is higher. However, we note that risks in the CESEE region and potential spillover factors are elevated, as the economies are in the late stages of their business cycle. Against this backdrop, we wonder whether the 2017 minimum standards on foreign loans issued by the Financial Market Authority

(FMA) to contain risks in CESEE countries should be further revisited. Staff's comments are welcome.

Risks from real estate-related activities require greater vigilance going forward. We note that house prices have become overvalued and exposures to the real estate and construction sectors have increased across the financial sector. In addition, these sectors are more exposed to financial risks under adverse shocks. While there are mitigating factors to the vulnerabilities to real estate, we welcome the issuance of guidance on sustainable lending in real estate financing in 2018 and encourage stricter enforcement of existing regulations. Could staff indicate whether this guidance is also directed to Austrian banks' subsidiaries abroad which have large exposures to real estate in their host countries? We agree that a macroprudential tightening to contain risks from the real estate activities should be considered if developments in this area warrant it.

Vulnerabilities in the insurance sector should be addressed. We welcome the implementation of Solvency II by the FMA to improve risk management in the sector. We note that the low growth in a protracted low-interest rate environment for the insurance sector threatens profitability prospects in the sector. Against this background of heightened risks to the insurance industry, we encourage the authorities to step up their efforts to establish an insurance resolution framework, and support staff recommendation to reinforce FMA's restructuring powers in such process.

Closing data gaps to strengthen financial sector analysis and surveillance should be a top priority. We fully support staff's recommendation to collect more granular data, notably on exposures to real estate, nonfinancial sectors and CESEE countries, given the deep interconnectedness in the financial sector. This will help improve the analysis of linkages between different segments of the financial sector and associated risks. In the same vein, further efforts are needed to lift legal obstacles that hinder the sharing of information related to AML/CFT with third countries.

Further strengthening the governance and responsibilities of supervision institutions is needed. We note that the 2013 FSAP recommendation to enhance the FMA's governance has not been implemented. We would appreciate staff's elaboration on this drawback. We see merit in better delineating oversight responsibilities between the FMA and the central bank. Could staff provide further details on the reasons the current government is not considering pursuing such reforms as indicated by Mr. Just in his statement?

Mr. Buisse, Mr. Rozan and Ms. Gilliot submitted the following statement:

We thank staff for this very interesting report and Mr. Just for his informative buff statement. Since the 2013 FSAP and Heta's large debt restructuring, substantial progress has been made to strengthen the various key areas of Austria's financial system regulatory and supervisory frameworks including macroprudential policies, banking oversight, resolution planning and deposit guarantee scheme. Strong economic growth in the CESEE countries against a low interest rate environment has buoyed so far Austria's exports while also benefited the banking sector's operations through growing demand for housing loans and non-financial corporate sector financing. We commend the supervisory authorities for their efforts in reinforcing the banking AML/CFT supervision and encourage them to continue to monitor closely cross-border risks, in particular in view of the national banks' exposures to CESEE countries. We associate ourselves with Mr. De Lannoy and wish to provide the following complementary remarks.

Background

The Austrian banking sector's solvency and asset quality have greatly improved since the 2013 FSAP and we believe its "inverse ownership" structure as well as strong profits and growing profitability driven by higher margins in CESEE have also contributed to heighten its capital buffer and its resilience. Although banks' return on equity has been risen lately, cost-to-income ratio remains structurally high, especially for Significant Institutions. FSAP key recommendations contemplate possible capital add-ons on insurance firms to address future profitability risk. What would be staff's main advice on banks to tackle subdued profitability issues? To what extent could Fintech and digital payments play a role?

Along with the domestic financial system's structure, the strong presence of Austrian banks in the CESEE region represent a factor of vulnerabilities but also a source of revenues for both banks and insurers confronted to structurally low profitability in a low-for-longer interest rate scenario. Risks of potential contagion over operations and banks' reputation mainly stem from the domestic financial sector's interconnectedness and high dependence to the CESEE region. Staff's analysis demonstrates also quite clearly that the impact on the national financial industry of a prolonged synchronized growth slowdown in Europe, trade dispute and geopolitical uncertainties is not negligible. Cross-border integration with emerging Europe and some of the more advanced European partners stands out, in this context,

as a major channel of contagion of banking and economic slump in Austria. Surprisingly, idiosyncratic factors in Europe such as weak foreign demand or concerns over high-debt countries like Italy are assessed to have a low impact as reflected in the FSAP Risk Assessment Matrix (Table 2). Could staff accordingly explain this "low" rating for risk assessment? We would be interested to know the weight assigned to the Italian risks (widening of the spreads) in the macroprudential stress test performed by the team? Moreover, as Austria's main partner, how does staff assess the impact of Germany's economic slowdown on the Austrian banking sector?

Financial Sector Resilience

Stress tests results are particularly insightful, highlighting the overall resilience of the banking sector to macrofinancial shocks, although the exercise could be further refined. Regarding the IPS structure, we were surprised that the stress test simulation did not take into account the support provided by this type of structure. We thank staff for their explanation. Regarding spillovers, we appreciated the analysis of the interbank cross-border contagion of and from Austrian banks to the EA and the CESEE. We however would like stress the importance of going deeper in the analysis of macrofinancial linkages looking at cross-sectoral spillovers and potential impact on the real economy of the countries involved. Stress test results rely on many factors, including limitations in data quality and granularity, severity or scope of the scenarios, and model risk. In line with staff's recommendation, we encourage the authorities to strengthen further the stress testing function, including more importantly to increase the level of modelling granularity. Given the past recent case of bail-in and debt restructuring of Heta (which is surprisingly not mentioned in the report) and Austria's banking sector concentration and specific structure of ownership (including mutual financial cooperative arrangements), we would see merit in better integrating interactions between individual banks in the stress tests. More attention could be given to microprudential stress test to assess the resilience of an individual bank to macroeconomic and financial vulnerabilities and respective shocks. We thank staff for their opinion on this aspect.

Financial System Oversight

We commend the authorities for the progress made to reinforce the regulatory, supervisory and macroprudential frameworks. We agree that closing data gaps is key to reach a coverage of residential real estate exposures as comprehensive as possible and welcome in this context the recent implementation of AnaCredit as a first step as underscored in Mr. Just's

buff statement. Aside from improvements made on data quality and analytical capacities of FMA for the insurance sector, we are also pleased to acknowledge from the latter document the steps the authorities have taken to complete a formal recovery and resolution framework. Last, we strongly welcome the significant enhancements of the legal and regulatory AML/CFT framework since the 2016 AML/CFT Mutual Evaluation and encourage the authorities to improve information sharing with third countries' counterparts.

The Acting Chair (Mr. Furusawa) made the following statement:

We turn to today's third agenda item on Austria. All Directors issued gray statements. The European Central Bank (ECB) representative also issued a statement.

Since the last Financial Sector Assessment Program (FSAP) in 2013, the Austrian authorities have proactively addressed financial sector risks. All of you noted in your gray statements that they have reinforced the robustness of the regulatory framework, enhanced banks' resilience to macro-financial shocks, and lowered financial stability risks. Nevertheless, the high interconnectedness with other economies and financial systems, data and regulatory gaps, resource constraints, and exposure to cross-border and money laundering risks pose challenges. The insurance sector also faces challenges from low growth, a low interest rate environment, and future profitability risk. As you mentioned in your gray statements, continued monitoring and oversight related to contagion/spillover risks will be important going forward.

With that, I would like to open the floor for discussion. Since all Directors have issued gray statements, could staff make brief remarks at this stage, please.

The staff representative from the Monetary and Capital Markets Department (Ms. Melo), in response to questions and comments from Executive Directors, made the following statement[1]:

Thank you for all your gray statements and Mr. Just for the buff statement. I would like to make just a short statement to inform the Board that we have placed a request for a correction regarding an evident ambiguity regarding the status of the institutional reforms. Therefore, there will be a correction to pages 21 and 24 of the report.

[1] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

We have provided the Board with our technical responses to your questions. I have no further statement, other than to thank the Austrian authorities and the ECB for the excellent cooperative exercise. The engagement and the dedication of our team and our counterparts in both Vienna and Frankfurt were remarkable.

With that, we would be happy to respond to any further questions from the Board.

The Acting Chair (Mr. Furusawa) - Thank you very much. The floor is yours. Do Directors wish to add anything to their gray statements? Mr. De Lannoy.

Mr. De Lannoy made the following statement:

We thank staff for the informative assessments of the Austrian financial sector. We broadly agree with the results and the recommendations. I have issued a gray statement also on behalf of my European colleagues, so I would like to highlight only a few points.

First of all, we agree that the low domestic income-generating ability of banks and their high reliance on profits in Central, Eastern, and Southeastern European (CESEE) countries are a vulnerability that supervisors need to continue to monitor. Speaking of the CESEE region, we do regret that the report did not differentiate between countries in this region, which we believe puts an unfair stigma on many fast-developing European economies.

Finally, we would like to commend the Austrian authorities for taking timely macroprudential measures, such as the systemic risk buffers, and for strengthening their Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) framework. At the same time, we support the staff's recommendations to further enhance that framework.

Mr. Heo made the following statement:

We thank staff for the informative report, the responses to our questions, and Mr. Just for the helpful buff statement. We issued a gray statement; therefore, my remarks will be limited to a few points.

First, we would like to commend the authorities for the good progress made since the last FSAP 2013, with the strengthened oversight framework

and the enhanced resilience of the financial system in general. However, we agree with Mr. De Lannoy and Mr. Trabinski in their gray statements, that binding borrower-based limits will be useful to address the elevated real estate-related risks. At the same time, as explained in the buff statement, the importance of the supply side measures to increase the residential affordability should not be neglected.

Second, I would like to emphasize again that the off-the-shelf recommendations on the regulatory framework would not be helpful. From my firsthand experience with FSAP missions, staff rely heavily on IMF Staff Guidance Notes on every issue, sometimes without properly understanding the local political economy and historical contexts on certain issues. If we need to achieve more traction on our advice, more relevant cases should be made on sensitive issues, in my view.

Last but not least, regarding the frequent use of the wording "qualitative assessment" in the report. In the Executive Summary, as well as in paragraph 40 on page 23, it is recommended that more structured internal guidance is developed to aid the supervisory steps in making decisions based on qualitative factors before impacts on the banks' performance materialize. I could not agree more. But I am not sure whether the staff could provide specific measures and guidelines on this, which would be useful for the authorities to enhance their capacity.

I wish for more studies to be done on qualitative assessments and more practical advice be provided to our membership in a forward-looking way in future FSAP exercises.

Mr. Pösö made the following statement:

We thank the FSAP mission team for the very thorough report, complemented by the informative buff statement by Mr. Just.

The Austrian financial system has benefited from a relatively long cyclical upswing, both domestically and in the CESEE region, which has played a critical role for the profitability of Austrian banks and insurance companies. This upswing has been used wisely by the authorities, who have enhanced the macroprudential policy framework and the AML/CFT framework. Also, the banks have used the favorable conditions to increase their capital ratios. Banks' capital buffers remain sizable, as are the liquidity buffers, thanks to the deposit funding base. However, growth is now moderating also in the CESEE region. As a result, late cycle financial risks are

building, not least in real estate and construction. In this new economic environment, it appears that the business models of Austrian banks are put to a test. On this point, I would like to ask the mission how it sees the Austrian banks' ability to adapt their business models; for instance, if the loan loss provisions start to increase in the CESEE region. How far have the banks gone with utilizing digitalization in their business models, for example?

The stress test results are comforting. However, the plans to further develop the stress testing are welcome. The large and interconnected banking sector, with cross-currency schemes and complex owner structures, may behave in an unexpected way under stress.

The recommended institutional reforms in the Financial Market Authority (FMA) and the Financial Market Stability Board are well grounded. The governance reforms would further clarify the division of responsibilities between different authorities and, at the same time, allow the utilization of their comparative advantages. To further mitigate AML/CFT risks, we encourage the authorities also to better integrate prudential and anti-money laundering (AML) supervisors.

Let me conclude by, once again, thanking the FSAP mission team for a very informative report.

Ms. Mateus made the following statement:

I thank staff for a succinct report and Mr. Just for providing the useful additional information in his buff statement. The Austrian regulatory and supervisory framework and the financial system, as any other, may still be improved; but the developments since the last FSAP are noteworthy and commendable. We have issued a gray statement, associating ourselves with the Mr. De Lannoy's gray statement; and here today, I would only like to underline two points.

First, having both euro area and national FSAP exercises is a useful way to obtain synergies and acknowledges the fact that a subset of European Union countries belongs to the euro area and to the banking union. We recognize that it is challenging to be informative, clear, and succinct in national FSAPs while not duplicating the Euro Area FSAP. However, we would like to underline that it is always necessary to ensure that the assessments are explicit about the division of responsibilities between the European bodies and the national bodies. I think this would help to better understand the context in which national authorities act.

Second, we disagree with the repeated references to the Italian sovereign risks, which do not seem justified, given the recent developments in Italy and the relatively small exposure of Austrian banks to Italy.

Mr. Mahlinza made the following statement:

We thank staff for the report and Mr. Just for his buff statement. We issued a detailed gray statement, in which we broadly welcomed staff's positive assessment of the Austrian financial system. As such, we just want to make a few comments for emphasis.

First, we commend the Austrian authorities for the bold strides in strengthening the bank regulatory and supervisory framework and reinforcing its robustness by implementing the key recommendations of the 2013 FSAP. As a result, the banking sector's resilience has significantly improved on the back of strong capital buffers and improved solvency and asset quality. At the same time, the enhanced macroprudential framework has helped to contain financial stability risks.

Looking ahead, we urge the authorities to monitor and swiftly address the emerging pockets of vulnerabilities in the financial system. Specifically, we emphasize the need to bridge the existing data and regulatory gaps to better contain risks, mitigate money laundering and real estate risks, and to complete the ongoing efforts to strengthen the recovery and resolution strategy.

With these remarks, we wish the Austrian authorities' great success in their policy endeavors.

Mr. Chikada made the following statement:

We thank staff for the well-written report and Mr. Just for his informative buff statement. We commend the authorities for their efforts to proactively address financial stability risks since the previous FSAP. As we have issued a gray statement, I will be brief and would like to focus on one topic.

We appreciate the staff's answers to our technical questions, particularly the one on the profitability prospects for Austrian smaller banks, in light of the lower-for-longer interest rate environment. We find it somewhat reassuring that the smaller banks--though themselves are confined in small

domestic markets and have less diversified sources for revenue, they can still benefit from the positive valuation of equity holdings in their upper tier banks, which have more diversified revenue sources. However, this sort of profitability supporting mechanism could be quite unique for Austria. While we acknowledge that the bank profitability issues were thoroughly analyzed in the Euro Area FSAP, we think it would be helpful and valuable to continue doing this kind of profitability analysis and stress testing for other euro area member countries in the coming FSAPs with a little bit more granularity.

More generally speaking, as for jurisdictions in a lower-for-longer/negative interest rate environment, we think it would be very helpful to analyze the structure of the financial system in FSAPs and check how one country's financial structure and the lower-for-longer environment are interacting and affecting vulnerabilities in Article IV consultations. I think this would be a good and a pertinent showcase for the FSAP and Article IV's integration.

Mr. Saraiva made the following statement:

I welcome this stand-alone discussion of the Austrian FSAP. It gives us an opportunity to focus on the issues related to the financial sectors of the membership. And I thank staff for the very insightful and well-written report and Mr. Just for his useful buff statement. We also issued a gray statement, so I will focus here just on a few issues.

First, it is clear that, given the large and highly interconnected financial system in Austria, this is a very important case, especially if we consider the structural challenges that derive from low profitability in the domestic market, which, of course, push Austrian financial institutions to search for profitability abroad; and naturally, the Central, Eastern, and Southeastern Europe region is where the businesses move. It is very important for the health of the Austrian financial system, as a source of profits; but on the other hand, it creates vulnerabilities that need to be well monitored, both in cyclical but also structural terms, and maybe some derived from AML/CFT issues.

The point I would like to raise here is, while we fully understand this movement toward searching for more profitable business abroad, we wonder if there are opportunities in the domestic markets to enhance the profitability of the financial system. I notice that strong consumer protection regulation limits the use of fees for financial services And I would like to understand,

what kind of opportunities could be exploited by Austrian financial institutions to increase and enhance their profitability in the financial market?

Also, the one thing that caught our attention is the small reach of fintech. Fintech could create opportunities for the existing institutions, but it could also challenge the incumbent institutions and create even further pressures in terms of profitability. So, if staff could elaborate on this issue, I would appreciate it very much.

The other point is, we do understand that the structural features of the financial system are usually very peculiar to each jurisdiction; but I noticed the staff has a very positive evaluation of the Institutional Protection Schemes (IPSs). I would like to understand if this is a device that could be used by other countries. Further information on this other issue would be appreciated.

I also noticed that there is this pending recommendation from the previous FSAP on the commissioners. It seems a little anachronistic. I understand there have been some issues in terms of phasing out from this. I would like to understand better, what is the main difficulty of moving out of this toward a more modern approach, more aligned with international best practices?

Mr. Buissé made the following statement:

We thank staff for the very interesting assessment of the Austrian financial system and the answers to our questions. We also thank Mr. Just for his buff statement and we associate ourselves with the statement and comments made by Mr. De Lannoy.

First, on banks' profitability, this is a common issue for many financial systems of advanced economies but also emerging economies. Without being prescriptive and interfering with business model choices, we would have liked to have seen a clearer positioning of staff on the possible, if not optimal, options to help strengthen Austrian banks' profitability, increase earnings and cut costs, where possible, and make the necessary structural adjustments.

Second, we would like to support the point made by the ECB representative on group resolution plans. The wording of paragraph 51 of the report could be misleading, as well as resolution schemes are adopted by the Single Resolution Board (SRB) for the banks falling under its direct responsibility. At the national level, National Resolution Authorities (NRAs) are tasked with executing these schemes. The adoption of national plans

aimed at ring-fencing the national banking system would not be in line with the spirit of the banking union and would not achieve optimal results for the banking union as a whole. In this context, we would also like to support the point made by Mr. Psalidopoulos and Ms. Mateus in their gray statement regarding the need to be more explicit on the division of responsibilities between European and national bodies.

Mr. Moreno made the following statement:

We thank staff for the report and Mr. Just for buff statement. We have just a couple of comments.

The report refers to the healthy financial system in Austria. There are some remaining vulnerabilities. I can support the comments made by Mr. De Lannoy on the exposure to Central, Eastern, and Southeastern European countries, and the need to distinguish between them. I would also add the fact that the Austrian system is, in a way, sealed with a multiple point of entry system, which is also highlighted by the staff in paragraph 50.

On low profitability, I would also support Mr. Buissé's comments. This is a more general problem that must be taken into account.

I have a couple of questions. You give a number of recommendations on the governance of the regulatory system. Here, I support Mr. Saraiva's comments on the commissioners; and I would also add, the industry representatives on the board should be phased out.

My question is more related to your comment on the ministry approving FMA regulations on page 22. I am not sure what you are referring to. I do not know if this falls under the evident ambiguity that you were talking about it at the beginning of your intervention. What is it? I found it normal that the ministry would approve regulations. Are you just talking about the operationalization of those regulations that are normally carried out by the independent authority or not? Because we have some doubts here.

Mr. Palei made the following statement:

I thank the staff for the very good report and also for answering our question in the written replies. As a follow-up to our question, I would like to ask the staff about the regional arrangements in terms of anti-money laundering and the structure of all this work in the European Union.

As we know, the series of high-profile scandals in the European Union economies have illustrated the need for strong regional cooperation. We know that there are substantial limits to what can be done at the national level. I understand from the response by staff that the European Commission should report back to the Council in June of this year and maybe come up with proposals on what can be done at the Union level.

My question is related to the Fund's role in this process. What are the IMF's plans in terms of evaluating the AML/CFT at the European Union level? What would be a part of the FSAP, the next one for the region? Or there could be a stand-alone model to evaluate the state of this work, given the upcoming reforms in this area. Maybe the staff could tell us, when can we expect such an evaluation by the IMF?

Mr. Farber made the following statement:

I would like to thank staff for the report and my chair neighbor, Mr. Just, for his insights on the Austrian FSAP.

When I look at an FSAP, this FSAP is divided into two parts. One represents the vulnerabilities; the other represents tail risks. And I thought staff did an excellent job of representing the vulnerabilities that occur in an economic cycle as risks expand and contract.

On the second point, on tail risk, I will quote from our gray statement, which says: "Efforts since the 2013 FSAP have strengthened financial stability, and the financial system remains resilient to tail risk scenarios." In light of that, I would say that this FSAP report gives me comfort but yet the desire to maintain vigilance.

The staff representative from the Monetary and Capital Markets Department (Ms. Melo), in response to further questions and comments from Executive Directors, made the following additional statement:

I thank Directors for the additional comments and questions. I have some brief answers, and my deputy chief, Laura Valderrama, can complement whatever I forget.

Regarding the CESEE countries question. The terminology "CESEE" is neutral terminology, which is a geographical term and is not an economic term. It is used by both the Austrian authorities in their own analyses and financial stability reports and by the Fund reports, so it is neutral.

Nevertheless, the FSAP, in our work, we did differentiate very much in detail the risks from each one of the countries. The exposure of Austria to different countries in the CESEE region is reflected in the resilience of the banking system under stressed conditions, as mentioned in our report. That is one element.

Regarding guidance on the qualitative assessment, that is one of the recommendations. That is a part of overall supervisory oversight, and it is part of international standards and also European practice. As you know, under the European supervisory review process, there is a major element that includes a qualitative assessment, for instance, of governance and measures taken by the risk management of banks. Supervisors are to follow that up and make a judgment. Of course, the judgment must be based on criteria and on elements which are well defined, so they are usually expressed in manuals or guidance issued by authorities. For instance, in the case of the ECB, there are several manuals and guidance that are issued by the ECB and also by the European Banking Authority (EBA). And in many countries, they need to detail some of those steps in a similar way on issues not covered by the guidance already issued by the ECB or EBA.

On fintech and opportunities, as we mentioned in our response to the Board, we have discussed fintech with the authorities more broadly. What the authorities have observed is that, in general, financial institutions in Austria are more in a cooperative mode with fintech firms than a competitive mode. And the authorities, themselves, are also very busy engaging technology in their supervisory actions. We did not make an assessment on the fintech impact in Austria, given the small size. But our first perception is that, in that one country, the path seems to be more on cooperation than competition, and they may create opportunities for small banks. Nevertheless, it does increase the cost for investments. So cost to income is not expected to get better if you do investment technology for a while. So that is one element. And this topic, again, is discussed extensively in our Article IV missions.

On the IPS recommendations, we are positive about the IPS recommendations, as they increase resilience. It is a very difficult model to be replicated or exported. We recognize that some features of each country have to be seen in the historic context of how they evolved. The issue of the state commissioner is a historic legacy element. Staff fully recognizes these issues are not simple to resolve. There is an evolution. The role for the state commissioners on both sides, the good and bad, evolves, and there are historic reasons why they are there.

On the role of the ministry of finance in approving regulations, it is a bit different. We are not saying that the ministry of finance is approving regulations which are going to be sent to parliament, for instance. What is happening here is different levels of regulatory capacity. And at the regulatory capacity, which is at the level of the financial sector supervisor, the FMA, even that level has to be approved at the ministry of finance. Although the law says to make sure that whatever regulation or guidance that is being issued by the FMA is compliant with the law, it is not so clear. The mandate is so narrow as to only make sure that they are serving their mandate. That is why we have this specific recommendation in our recommendation template.

Finally, on an AML assessment in the next FSAP, on how it will take place in a European context, it is, of course, very early to say. We have to observe how the European framework evolves. If there is a Euro Area FSAP in a few years, then, as a mandatory part of the FSAP, AML needs to be covered. The depth of the analysis of that pillar will depend on the situation at the time. We should expect some level of evaluation of the AML framework at the euro area level when a Euro Area FSAP takes place.

The staff representative from the Monetary and Capital Markets Department (Ms. Valderrama), in response to questions and comments from Executive Directors, made the following statement:

Thank you very much for the questions. I just wanted to follow up on a point related to profitability in the current low interest rate environment. The FSAP team conducted a very thorough analysis of the profitability drivers of Austrian banks' operations, as well as performed projections of profitability baseline, as well as in adverse conditions. The results of this analysis are detailed in the technical note on stress testing that will come out.

More specifically, I wanted to make two points about margins and about profits. The margins in the Austrian banking system have remained quite stable since 2005. However, they have been decreasing steadily in the CESEE region, and they have been then analyzed. There have been some by the team, and there have been recommendations to try to strengthen the capacity to mobilize revenues further.

In terms of the profits themselves, the profits of the Austrian banks have increased substantially since 2014. This is probably driven by trade growth in their portfolios, as well as the historically low loan loss provisions in the CESEE operations. That is why we support the Austrian authorities' policies to monitor and try to strengthen the sustainable profitability of the

Austrian banks going forward. This comprises two issues. One is trying to support the structural efficiency. And that could be, for example, trying to streamline some of the horizontal operations in the sectors, as well as preserving sustainable lending standards, particularly in the real estate market.

Mr. Ronicle made the following statement:

I should really have made this observation in the first round of comments, but I was being a bit slow. I am a little puzzled at the messaging around the exposure to the CESEE region. Clearly, it comes with risks, and those are well outlined in the document. But fundamentally, most countries' financial sectors have the opposite problem, that they are overly exposed to their domestic sectors. I cannot help seeing this as fundamentally a strength, and I find it slightly odd that that is not emphasized, lower relative exposure to the domestic economy, relative to overseas economies.

Ms. McKiernan made the following statement:

I have a process point to make. I think differentiating between Article IV and FSAP discussions through separate Board meetings has, in this instance, proved really helpful. My view is that if we have a set of what we consider to be systemically important financial systems that merit being on the FSAP mandatory list, we should have a discussion like today, which is rich in that regard. And I have certainly learnt a lot from this discussion that I feel would have been lost if it had been an addendum to an Article IV discussion, and I would like to see that model continued.

The Acting Chair (Mr. Furusawa) made the following statement: Thank you very much for the very rich, productive, and constructive discussions, including a discussion on the profitability and fintech. Those are not only issues for the Austrian banks but are shared by many institutions around the world.

Mr. Just made the following concluding statement:

I appreciate Directors' many thoughtful comments in their gray statements and during today's rich discussion.

Stand-alone FSAP discussions are the exception; even though, like Ms. McKiernan, I personally think they should be rather the rule. The Austrian FSAP, like many others, benefited from the hard work of an excellent, technically highly skilled team. It has used a lot of domestic resources; but all of them, they went the extra mile.

I do not want to single out anyone, but my special praise goes to the stress-testing team. Ms. Valderrama is always excited to go to Vienna. She has, with the stress-testing team of the Austrian National Bank, a top-notch counterpart that is open to many of her ideas to capture the risks of a complex, tiered, cross-border banking system. She has the Applied Risk, Network and Impact assessment Engine (ARNIE), which is the Austrian National Bank's systemic risk assessment tool, and a wealth of data. All of this also helped Mr. Laliotis to conduct a very sophisticated, technically and methodologically very complex stress test which, compared to peers, was based on a very severe stressed scenario.

Mr. De Lannoy noted that portraying the CESEE risk as one undifferentiated vulnerability puts a stigma on a very diverse region. My authorities and I fully share this view. The word "CESEE" is now more a term of convenience and does not describe an asset class. Austrian banks operate in countries with very diverse risk profiles, macroeconomic performances, institutional quality, and supervisory practices. I can also confirm Ms. Melo's answer, that an appropriate differentiation among the countries has been made by the team.

Ms. Gornicka and Mr. Shahid proved to be formidable counterparts on macroprudential policies. And, if I am not mistaken, their work on borrower-based measures is recognized in the statement of the ECB observer as innovative and a value added, with which I fully agree.

The follow-up of FSAP recommendations in Article IV is a particular concern. So I was very pleased that the European Department offered the desk economist for Austria, Ms. Karpowicz, the opportunity to join the mission team. She provided valuable macroprudential inputs and, in return, acquired new skills, a better understanding of the intricacies of Austria's financial sector, and its challenges, which will prove useful in the future. Here, Mr. Chikada rightly points to the interplay of low structural profitability in an environment of negative interest rates. Improving cost-income ratios are part of the answer. Domestic fintech solutions will play an increasing role--which, by the way, Austrian banks already use extensively in many CESEE countries. The health of balance sheets will, however, be increasingly on the radar screen to prevent a possible zombification.

Emerging issues, such as climate change, as mentioned by Mr. Ronicle, the sustainability of business models in view of fintech, as

mentioned by Mr. Saraiva, are all topics that could usefully be taken up over the next years in our bilateral surveillance.

AML is, again, another area where my authorities have made significant progress, which is also recognized by colleagues. Austria almost ended up on the FATF's gray list. Since then, we have been in continuous contact with the Legal Department to discuss the challenges and how to increase the effectiveness of our AML framework. We are grateful to Ms. Claver, who gave praise where praise is due, but she also critically pointed to pockets of vulnerability. Mr. Palei and Mr. Buisse asked about or pointed to the need for an exchange of information with third parties. This is, indeed, critical for effective AML, but it is also subject to an equivalence assessment by the European Banking Authority in the case of non-EU countries so that data can be exchanged. For many countries that Austrian banks operate in, this exists, but not for all.

My authorities are also fully supportive of establishing an European AML authority with supervisory powers. They are also actively using the already existing possibilities within the Single Supervisory Mechanism (SSM) to address AML; and, most recently, the SSM decided to withdraw a license of an Austrian bank on AML grounds.

Mr. Tan and Mr. Heo made extremely useful broader observations relating to the FSAP Review. I am still of two minds, whether a fully-fledged FSAP is strictly necessary in a country with high supervisory standards and which is a member of the SSM. Indeed, 40 percent of assets are still under local supervision; it is a banking-based sector; so the national FSAP does make sense. On the other hand, there is a strong focus on other risks, which may appear a bit out of proportion. Here, I am thinking of the real estate sector, where staff, in their technical answers, rightly point to the significant risk mitigating factors in Austria.

How the Euro Area FSAPs and national ones are conducted still have ample scope to evolve. I agree with Ms. Mateus, that a better differentiation between the euro area and the national authorities would have been helpful. On my wish list, there would also be more consistency checks between national initiatives and the supranational level and a more conscious recognition by staff that this is a system and not parallel universes. For example, we had questions on how Austria can ring-fence its financial sector which, to me, was very odd, given our single market and at times when the Fund is pushing strongly for a banking union.

Ms. Melo, our mission chief, should not be forgotten. What should have been a smooth FSAP suddenly turned into a complex, delicate, and difficult task, as my authorities announced a reform of the institutional setup of supervision. I think when I first related the concept of the proposal to you, you looked as incredulous as me. But my authorities and I also saw the chance, with your presence, to help improve key aspects of the reform, in particular, relating to the independence of the Austrian National Bank and the FMA, as well as on finding proper accountability. Ms. Melo delivered fully. Politics interfered again. The reform is off the table. But her work on banking supervision will be kept on file, as will her wise recommendations, in case my authorities contemplate another reform.

Lastly, I appreciate Ms. Melo's information on the correction, which is very important to my authorities. I would, however, like to express my slight bewilderment that the Strategy, Policy, and Review Department did not propose to issue a supplement, factually stating that we have a new government which has different priorities than the previous one.

The following summing up was issued:

Executive Directors agreed with the thrust of the findings and recommendations of the 2019 Financial System Stability Assessment (FSSA). They welcomed the significant progress that the Austrian authorities have made in proactively addressing financial risks since the 2013 FSAP. The macroprudential policy framework has been strengthened and the banks are, in aggregate, well capitalized and resilient to severe macrofinancial shocks. Important steps have also been taken to further align the anti-money laundering and combating the financing of terrorism (AML/CFT) framework with FATF standards.

Directors noted that while a robust regulatory framework and prudential policy actions have lowered financial stability risks, challenges include interconnectedness, data and regulatory gaps, resource constraints, exposure to cross-border and money-laundering risks, and recent developments in the real estate sector. The solvency of insurance firms is high, but the sector suffers from low growth, a low interest rate environment, and future profitability risk.

To maintain the stability and efficiency of the financial system, Directors called for enhanced monitoring of intra-group transactions and spillover risks. Accurate calibration of prudential buffers and enhancing data collection would help in timely identification of emerging risks, in particular

from real estate and nonfinancial corporate sectors. Granularity of CESEE data will also be important.

Directors encouraged the authorities to further strengthen the related-party risk and major acquisitions framework, as well as the governance of financial institutions, the supervision of AML/CFT risk, and the institutional framework for financial sector oversight. Directors underscored the importance of ensuring that the size of prudential buffers is appropriate to mitigate financial stability risks and that adequate staffing and resources are available for supervision, resolution, financial stability monitoring, and stress testing. They noted that further regulatory actions may need to be taken if mortgage markets remain buoyant.

Directors underscored the need to continue enhancing the resolution framework for banks and insurance companies, in particular ensuring that resolution strategies are effective to contain spillover risks and that efficient information sharing and cross-border cooperation arrangements are in place. They noted the authorities' plan to abandon the institutional reforms in the banking oversight. Close collaboration between national and European bodies in the context of the resolution framework will also be helpful. Directors noted that the scope of the annual contingency testing program should be expanded to include amplification channels and encouraged the authorities to ensure funding in resolution.

APPROVAL: August 30, 2021

CEDA OGADA
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Risk Assessment and Stress Tests

1. ***Could staff elaborate on the likelihood of spillover risks associated with Italy's fiscal challenges as well as the sovereign-bank nexus? Could staff elaborate on the weight assigned to the Italian risks in the macroprudential stress test performed by the team?***

- Direct exposures of Austrian banks to Italy are small. In terms of overall credit exposure distribution, Italy's share is below 1 percent (Italy is not one of the ten largest countries by exposure size). Furthermore, in aggregate terms, Austrian banks do not hold large fair value instruments linked to the Italian sovereign.
- A stronger link with Italy is due to the fact that a subsidiary of an Italian bank is a systemically important financial institution for Austria. However, such structural risks are addressed by higher capital requirements and buffers for the Austrian entity at the solo level and by actively monitoring recovery and resolution plans for this institution. Also, the entities are under SSM supervision.
- The macroprudential stress test scenario included term premium decompression together with the re-emergence of sovereign stress in high spread economies, raising long-term government yield spreads by 200 basis points in Italy.

2. ***As Austria's main partner, how does staff assess the impact of Germany's economic slowdown on the Austrian banking sector?***

- This is reflected in the stress test scenarios as the baseline scenario follows the IMF WEO projections, which already incorporate projections of economic slowdown for Austria (and Germany). Bearing in mind that in both scenarios examined growth prospects are strongly correlated between the two countries, the exercise did not find strong signs of additional spillover effects.

3. ***We note that risks in the CESEE region and potential spillover factors are elevated, as the economies are in the late stages of their business cycle. Against this backdrop, we wonder whether the 2017 minimum standards on foreign loans issued by the Financial Market Authority (FMA) to contain risks in CESEE countries should be further revisited. Staff's comments are welcome.***

- Minimum standards for foreign currency loans (FCLs) were required in order to contain the potential risks on the borrowers' side affordability related to a large FX move and the fact that borrowers do not usually actively manage FX risks. The

introduction of such standards did manage to contain such risks and, as a result of the introduction of the standard, the outstanding volume of Austrian subsidiaries' FCLs has been decreasing at 30 bn EUR in June 2019, while the share of these loans amounts to almost one quarter (with regional heterogeneity high). The currency split is 80 percent in EUR, 10 percent in CHF, and 9 percent in USD (mostly in Russia). Losses from FCLs in Austria (9 percent of outstanding loans) and the CESEE are manageable as suggested by stress testing results.

- Spillover factors are also elevated because of the point in the economic cycle those economies are currently in. Due to the persistently low global interest rate environment and the positive growth experienced in most economies in the CESEE region, non-performing loan formation and impairment losses have been really benign during the past few years. This enabled banks to experience substantially elevated profits and increased capital generating capacity, stemming from the activities in the CESEE. A global downturn in economic activity might signal the start of a new phase for the banking sector, where credit losses start to become substantial, pressure on profit margins increases and inward spillover effects because of the equity cross-participation scheme also increase.

4. ***Regarding the IPS structure, we were surprised that the stress test simulation did not take into account the support provided by this type of structure. We thank staff for their explanation.***

- In terms of the solvency stress test in the FSAP, the IPS structure becomes important when there are banks with capital shortfalls under any stress test scenario. Under such conditions, IPS and any other type of contractual support becomes important for the solvency of the individual banks and the resiliency of the IPS as a whole. Given that in the adverse scenario there are no significant capital shortfalls, there was no actual trigger for the IPS capital support.
- Nevertheless, this was covered as part of the sensitivity analysis performed by the team, which was conducted in a reverse stress test mode: an increased severity of shocks was applied to the central institution of the IPS and the resiliency of the entire IPS was assessed against various scenarios of capital support contributions. This type of reverse stress testing was conducted for the first time and in close cooperation with the authorities. The results illustrated the high degree of centrality and importance for solvency purposes of the higher-level central entities in the IPS structure and their key role for the resiliency of the entire IPS structure.

5. ***Results from the exploratory analysis of interconnectedness through shock resilience of the two layered Institutional Protection Schemes (regional and federal) are encouraging, as it seems that systemic shocks (i.e. shocks to a central institution) do not create substantial vulnerabilities. Could staff provide more***

details on this exercise? What are the impacts on capital ratios of the central institutions?

- The exercise was conducted as a reverse stress test, that is, the FSAP team applied shocks of increased severity to the central institution and examined how the shock propagates to the lower-level/tier banks. Although this type of stress exercise is hypothetical in the sense that losses are not directly linked to a real economic scenario, it is useful in shedding some light on the impact of contagion and spillover effects. In the particular case the IPS is designed to enhance the resiliency of the system in the case of several external or idiosyncratic shocks. While this is generally confirmed and the IPS appears to be beneficial in absorbing large idiosyncratic shocks (a result which was expected since there are additional capital buffers from the contractual support arrangements to help failing institutions), the team also found out that the inverse ownership structure partially reverses such benefits: if the external shock is applied to the central institution the capacity (and ability) of all lower tier institutions to contribute to the capital injection required for the central institution is negatively affected because of the revaluation of their equity participation in the higher-tiered entities (negative inward spillovers).

6. ***We would see merit in better integrating interactions between individual banks in the stress tests. More attention could be given to microprudential stress test to assess the resilience of an individual bank to macroeconomic and financial vulnerabilities and respective shocks. We thank staff for their opinion on this aspect.***

- The stress tests performed by the FSAP team included a fully-fledged microprudential stress test across all banks (in total 440 banks, including all OSIIs and non-OSIIs) for a comprehensive set of risks. Effort was given to also integrate market structure specificities (such as the IPS schemes or the contractual liquidity commitments) in this type of analysis.
- While the analysis is performed at an individual bank level (i.e. microprudential stress testing approach), the disclosure of results and the policy recommendations focus on system-wide resilience. The analysis also yields insights by type of bank (i.e. O-SIIs vs. non-O-SIIs). Where bank specific vulnerabilities are identified they are also discussed with the authorities, but the emphasis of the FSAP stress test exercise remains on identifying and assessing system-wide risks and resilience.

7. ***The Austrian financial sector's focus on CESEE countries brings benefits in terms of income diversification and above-average profitability. At the same time, the concentration of exposure makes Austrian financial institutions vulnerable to a sharp slowdown in the region's economies and a depreciation of their currencies. In this regard, we see merit in further work to increase the level of modelling granularity of stress testing, which would allow the geographical breakdown of***

risks and facilitate the monitoring of contagion channels. We would also appreciate staff's comment on this topic if more information is available.

- Staff believes that the task of setting up a consistent and more granular stress testing framework for Austrian banks should be a priority for the authorities. In that context the FSAP team had extensive discussions with all stakeholders involved on the level of data granularity required, the set of methodological approaches that appear to be more suited for this task, the perimeter of financial (and non-financial) risks that should be covered and on ways to incorporate both econometric and structural modelling approaches. Some of these recommendations have already been integrated in the existing framework and included in the results produced for the FSAP, some would require additional effort or depend on acquiring additional data. The latter would fall within the scope of recommendation to the authorities as medium- or longer-term targets. Overall it has been a very intense and productive exchange of views with the FSAP counterparts on such issues.
- The FSAP stress test exercise has also contributed significantly in demonstrating the importance of having access to granular data, the impact they might have on the final outcome and the significance of adapting and extending the framework in identifying and assessing system-wide risks from a macroprudential perspective

8. ***We found it difficult to judge from the report how some of the more resource intensive proposals, such as the recommendation to strengthen the stress testing function, will be addressed by the authorities.***

- The recommendation refers to the increase of the scope and capacity of the stress testing function. Strengthening of the scope includes the gradual widening of risk coverage (including non-financial risks) by the current infrastructure (for example operational risk, market risk, and climate-change risks should be fully incorporated), the granularity of the methodological approach (asset and liability class segmentation, major geographies covered, use of complementary modelling approaches) including the expansion of the data repository in order to support and facilitate the increased scope.
- The capacity strengthening should include the number of people employed in the function, the efficient planning and allocation of resources for discrete tasks (microprudential stress testing for setting P2R and P2G, macroprudential stress testing for systemic risk assessment, IPS stress testing for ex-ante and ex-post fund assessment, stress testing for the assessment of buffers), the streamlining and further development of the existing infrastructure (risk coverage, model coverage, macro-feedbacks, solvency liquidity interactions) and the increase of resources (in terms of FTEs, skillset and budget allocation) for this function. The objective and scope of recommendations was well understood by the authorities.

9. ***Can staff comment on the extent that the data gaps posed an issue to the authorities and staff from having a full picture of the contagion risks and from allowing them to take timely interventions if the risks were to materialize? Similarly, we were unsure to what extent the authorities would be able to close data gaps in real estate or to improve the coverage and granularity of CESEE exposures. Could staff elaborate on authorities' views on these recommendations?***

- Data gaps and constrained granularity could pose an important hurdle when it comes to a full and granular assessment of the full picture of contagion risks and their drivers. The Austrian banking system is highly fragmented and, as a result of this fragmentation, potential risks appear to be multiple and diverse. The strong dependence of banks revenue-generating capacity on non-domestic operations requires an enhanced level of monitoring and assessment on how the relevant risky components of the balance sheet would behave in an economic downturn. The high net interest margin gained at some of these geographies comes at a higher market price of risk, which would inevitably materialize in a downturn in these countries. On the insurance sector, the FSAP team found that authorities do not have granular data on the currency mismatches between the assets and liabilities of the large internationally active groups on CESEE exposures.
- Monitoring these risks at the country/geography level is key in order to enhance risk-based supervision and efficiently operationalize micro- and macro- prudential measures. Therefore, developing and maintaining a granular data repository is a critical milestone. Although overall not a straightforward task, data gap bridging could be assisted by global or regional data project initiatives (like the Anacredit project launched by ECB at 2011 on individual bank loans), a wider set of relevant data sources (for example credit register data, data submitted by individual banks in the context of other stress testing exercises or household survey data) or even ad-hoc data-requests (for example on the LTV/DSR/DSTI distributions by country). Most importantly, there is a need for the authorities to define a clear, efficient and sufficiently forward-looking data strategy that would cover all aspects of data acquisition, maintenance and access policy in order to fully support the operationalization of their micro- or macro-prudential mandate. The recommendation was well received by the authorities.

Banking Sector Profitability

10. ***Could staff comment on the need to strengthen the identified small banks' capital and non-interest revenue streams?***

- The total capital shortfall of the small banks that end up with a capital ratio below the regulatory minimum is 0.01 percent of the system CET1 capital. This is considered to be a very small capital need under an adverse macroeconomic scenario and can be easily addressed with a medium-term capital raising plan. Indeed, domestic non-

interest revenue streams are small compared to a relevant peer group (for example European LSIs). This can be partially attributed to the strong consumer protection regime in Austria that does not allow banks to apply freely adjustable fee and commission charges for some of the services they provide.

- However, the main driver underpinning the low internal capital generation capacity is the high operating cost that can be linked to the fragmentation of the sector, with a large number of small-sized entities operating at a regional level. Going forward and assuming that the segmented business model is not questioned increased profitability could be sought by streamlining horizontal operations (e.g. re-allocating the provision of such services to the federal level central entities in order to achieve economies of scale) in order to further reduce overlapping operations and optimize service delivery cost efficiencies.

11. ***Given the complex structure of the banking system, the high cost-to-income ratio and the high branch density relative to peers, we would appreciate staff comments on the profit sustainability of banks in the long term, and the need for efficiency-driven banking sector consolidation in Austria?***

- Structural challenges for profitability were a main theme in the Euro Area FSAP, as the topic is not restricted to Austria but common the other European countries. While there is a persistently high cost-to-income ratio, the Austrian banking sector's profitability is supported by its international diversification because of the higher returns on their CESEE activities. This is reflected in the baseline stress test results showing an increase in the system's aggregate CET1 ratio by 2.3 percentage points by 2021 under the 2019 April WEO baseline low interest rate projections (i.e. policy rates increasing gradually to 17 basis points by end 2021).
- While Austria's largest international banks are better positioned than smaller, domestically focused lenders (LSIs) to raise profitability because of their international diversification, ROE of Austrian LSIs is comparable to that of SSM peers (6.3 percent ROE for Austrian LSIs against 6.1 percent for SSM LSIs). A key channel supporting LSI's internal capital generation capacity, for example, is the positive valuation of equity holdings in upper tier banks in the cooperative sector. This is confirmed by stress testing baseline results which project a capital increase for non-OSII banks of 2.1 percent by end-2021 (slightly below the 2.4 percent increase for OSII banks). The team's analysis points at the sustainability of the sector as a whole.

12. ***What would be staff's main advice on banks to tackle subdued profitability issues? To what extent could Fintech and digital payments play a role?***

- As noted in the Bali Fintech Agenda, Fintech has the potential of bringing innovation and lowering costs of services to the consumers. At the same time fintech can represent a threat to traditional banks inasmuch as they compete in some core areas of

service, such as payments. Fintech development in Austria so far have not been found to have jeopardized the sustainability of traditional banks' business model, and authorities have observed buy-outs of innovative solutions (cooperation rather than competition). Please see response to question 24.

Supervision

13. ***Annex III paints a very positive picture, with the bulk of previous recommendations either completed or largely completed. One exception is the recommendation to strengthen FMA's governance, including the legal protection of its bodies and staff. Could staff comment on why this issue has not yet been addressed? (Ronicle) We note that the 2013 FSAP recommendation to enhance the FMA's governance has not been implemented. We would appreciate staff's elaboration on this drawback.***

- The recommendation is derived from the detailed assessment of the Core Principles for Effective Banking Supervision conducted in the previous FSAP. The full report was published in 2014: Austria - Detailed Assessment Report (DAR) of Basel Core Principles for Effective Banking Supervision. Core Principle 2 in the international standard establishes the requirements for independence and legal protection of supervisors. The assessment at the time was very clear on elements of the governance framework which could create potential for undue political or industry interference, as well as legal protection for supervisors, and the importance that changes were made so that these potential risks did not materialize and the perception of independence of supervisor was not tarnished. Most of the specific recommendations (page 309 of the DAR) required legal changes, which authorities informed were not yet addressed.

14. ***We agree with the need to strengthen the frameworks for supervision and macroprudential policy to better target financial stability risks, however it is not clear from the staff report that the recommendations on the institutional setup and the division of responsibilities between the regulatory bodies would lead to improvement in effectiveness and timeliness of financial sector oversight. We welcome staff's comment to clarify how the recommendations would address the apparent gap in the current institutional arrangement, and whether the authorities face any difficulties in implementing the recommendations.***

- The recommendation regarding the governance of the FMA draws directly from the previous FSAP recommendation (see response to question 13 above)

15. ***Contrary to staff suggestion that reforms to consolidate banking supervision within the FMA have been put on hold because of the change in government, Mr. Just***

indicates that the new government is not contemplating such reforms. We appreciate staff clarification. Can staff comment on the potential implications of the reform, and whether this reform would be urgently needed to strengthen the institutional framework for banking supervision

- The reform was announced in November 2018, and draft legislation was published for consultation on April 2019, just before the first mission of the FSAP. While the team did have discussions with authorities to better understand the objectives and structure of the reforms, during the mission itself a change of government caused the project to be immediately put on hold. No draft legislation was presented to the Council of Ministers and Parliament. Under these circumstances, staff did not discuss potential implications of the reform during the main mission. Authorities have since then clarified that the reforms are not in the new government's program.
- We would like to clarify that the international standards are agnostic about supervisory structures, and there is no one institutional format that has consistently performed better than others. There are key principles and pre-requisites that underpin effective supervision and these elements can work in a variety of institutional settings. According to the international standards, wherever located, the supervisory agency(ies) need(s) to have a high degree of independence, strong accountability, a clear mandate, adequate resourcing, and strong regulatory capacity. Drawing on crisis lessons, institutional arrangements also need to support an enhanced focus on macroprudential supervision of systemic risk. Generally, staff recommends that changes in supervisory models need to be based on a careful assessment of the most effective and efficient means of achieving desired supervisory outcomes, taking into consideration the potentially significant costs of reorganization.

16. ***Given the incompatibility of the legacy role of state commissioners with international corporate governance standards, staff may also wish to comment if the authorities are ready to phase out the role of state commissioners in supervisory boards.***

- The phase-out of the legacy role of state commissioners was one of the recommendations of the previous FSAP, which seem to depend on legal changes. In the meantime, given the requirements placed on the supervisory board members (which have become more technical and related to monitoring the safety and soundness, internal controls and closer engagement with the executive board over operating policies and risk appetite statements) the FMA is providing some training to commissioners to help them with the changing roles and technical issues. The ECB supervision and the Austrian authorities have also increased supervisory engagement with boards.

17. ***Considering recent developments in banking regulation, a significant step was the adoption of the revised Capital Requirements Regulation II and Directive V (CRR***

II / CRD V) in June 2019. CRR II / CRD V implement some of the outstanding Basel rules into EU law, while also introducing EU specific measures. Like other EU member states, Austria will have to implement most measures in the package over the next 24 months. We note that the FSAP report did not address this issue. Could staff elaborate on the implementation progress? How are Austrian banks responding to the new prudential requirements?

- The set of measures envisaged in CRR II / CRD IV refine and continue to implement Basel III in the EU by tightening requirements in a number of areas including: credit risk (standardized approach for counterparty credit risk; revised large exposures framework), market risk (fundamental review of the trading book), capital (revised leverage requirements), liquidity (NSFR), Pillar 2 requirements, regulatory reporting and Pillar 3 disclosures. They also introduce a new holding company requirement for large third-country G-SIBs.
- The team discussed the main elements of CRD V and CRR II. Authorities and banks are generally on track for implementation. Staff's views are that the overall impact should be contained given the business model and the risk profile of Austrian banks (e.g. limited reliance on internal models for capital requirements, low market risk, high risk weight density, low leverage, high liquidity).

Macroprudential

18. ***Given the complex ownership structures and financial interlinkages of the Austrian banking sector, could staff elaborate more generally on the role that the CCyB can play in addressing systemic risk?***

- According to the Austrian macroprudential authorities' macroprudential policy strategy, the countercyclical capital buffer can be used in order to tackle risks stemming from excessive credit growth/credit-related vulnerabilities. This is consistent with the IMF's Staff Guidance Note on Macroprudential Policy—Detailed Guidance on Instruments.
- High interconnectedness and the complex ownership structure present in the Austrian banking system are examples of a structural dimension of systemic risk. Structural systemic risk can be addressed by a range of complementary tools, including capital surcharges (for large institutions, for certain type of exposures, or certain source of risk), limits on the size of interbank exposures, or liquidity requirements.
- In the Austrian macroprudential oversight framework, the systemic risk buffer ("SyRB") is calibrated to mitigate the spread of risk in the case of a systemic event due to high interconnectedness and concentrated CESEE exposures whereas the capital surcharge for systemically important institutions ("O-SII") is used to lower the probability of a systemic event (failure of a systemic bank). As of Jan 2019, 13 banks were subject to the SyRB buffer at the consolidated level, and 7 also at the

unconsolidated level, whereas 7 banks were subject to an O-SII buffer at the consolidated level, and 7 also at the unconsolidated level.

19. ***While increasing the countercyclical capital buffer (CCyB) could be considered if credit in the real estate picks up, we appreciate staff indication of the timeline for the planned introduction of sectoral macroprudential capital buffers to the European macroprudential framework***.

- The package of regulatory changes to the EU capital requirement legislation (CRD-V package) was approved by the European Commission in May 2019. The new framework will allow the systemic risk buffer to be used for sectoral exposures and subsets of these exposure categories, and to apply several systemic risk buffers for different exposures at the same time. The member states have one to two years to transpose the new regulation to the national law or to implement it locally.

20. ***Staff observes that the banking system is resilient to sizeable withdrawal of funding. This is because of the OeNB's ability to provide liquidity through standard or extraordinary facilities. What are these specific facilities?***

- The liquidity assistance facilities refer to the standard central bank open market policy operations, such as the standing lending facility, and the emergency liquidity assistance (ELA). The Eurosystem's ELA aims to provide central bank money to solvent financial institutions that are facing temporary liquidity problems, outside of normal Eurosystem monetary policy operations.
- To clarify, in the FSAP's liquidity stress tests do not take into account any access to extraordinary facilities. In other words, none of the tests that have been conducted indicated that ELA should be used. Given the small size of liquidity needs under stress, the liquidity shortfall in EUR could be covered using central bank standard lending facilities. The USD liquidity shortfall could be covered using swap markets to tap USD funding using excess EUR liquidity.

21. ***Real estate exposure has risen sharply and has been identified as a key vulnerability to the banking sector. This is based on Staff assessment that real estate assets are overvalued by 15-20 percent. Staff may like to indicate how precise is this assessment and what is the methodology used for this? Secondly, 15-20 percent overvaluation may not be a very major risk. Staff may like to elaborate***.

- Staff's real estate overvaluation estimates are based on two sources:

(i) The OeNB's "Fundamentals Indicator for Residential Real Estate Prices", which combines seven subindicators that monitor a variety of data related to households, investors and systemic factors. The subindicators include real residential property prices, households' disposable income and interest rate levels, price-to-rent ratio, and

price-to-build ratios, housing investment-to-GDP ratio. Representing the aggregate result of these seven subindicators, the fundamentals indicator reflects the percentage by which residential property prices deviate from the prices of the underlying fundamentals.

(ii) IMF's price misalignment measures and House-Price-at-Risk (HaR) analysis. Staff's estimates of house price overvaluation include deviations of the price-to-rent and price-to-income ratios, and residuals from an error-correction model. By quantifying downside risks to future house prices, the HaR provides complementary information on the likelihood of a large house price correction going forward.

- While estimates of overvaluation are always associated with a level of uncertainty, the overvaluation of the magnitude observed in Austria warrant, in staff's view, close monitoring of the developments in the real estate sector. While the structure of the housing market, and overall low household indebtedness will likely soften the impact of realized risks, the worsening risk profile of the new mortgage flows indicates that the risks might be building up, which calls for heightened vigilance.

22. ***While there are mitigating factors to the vulnerabilities to real estate, we welcome the issuance of guidance on sustainable lending in real estate financing in 2018 and encourage stricter enforcement of existing regulations. Could staff indicate whether this guidance is also directed to Austrian banks' subsidiaries abroad which have large exposures to real estate in their host countries? Could staff comment on the adequacy of risk-mitigating factors built in the real estate sector?***

- The guidance issued by the FMSB in September 2018 is applicable only to loans originated and backed by real estate located in Austria.
- The risk-mitigating factors in the Austrian real estate sector include i) low house ownership rate and well-developed rental market, ii) large role of subsidized social housing, and iii) a broad range of available arrangements for housing finance (for example, regional mortgage banks, contract savings banks, and housing construction banks) that reduce dependence on conventional banks for mortgages.

AML/CFT Framework

23. ***What are the recent developments and plans at the EU level and how can they help the Austrian banks in promoting regional cooperation and information sharing, as well as monitoring cross-border risks?***

- Consolidation of AML/CFT supervision at the regional level has the benefit of better contributing to enhancing the quality and consistency and addressing any gaps or "weak links" that could be exploited for ML/TF purposes. Similarly, this should help Austrian banks in enhancing regional cooperation and information sharing.

- Although there are still no significant steps with respect to the consolidation of AML supervision at the EU level, some important developments have taken place at the EU level. In particular the EU Council adopted conclusions on strategic AML/CFT priorities in December 2019, which focus on AML/CFT supervision and improving cooperation and information-sharing between relevant AML/CFT authorities, including through addressing impediments on exchange of information between them.
- The EU commission should report back to the Council in June 2020, including by presenting legislative proposals on conferring certain responsibilities and powers for AML supervision to a Union body.

Fintech

24. ***While fintech was assessed to be small and hence out of scope for this FSAP, in many financial systems it is growing quickly – what is staff's assessment of the potential for growth in fintech in the Austrian financial system.***

- Authorities are monitoring fintech developments, conducting surveys and analysis on Fintech and digitization. Authorities are also actively using technology for supervisory purposes, both at the FMA and at the OeNB, in particular regarding processing of supervisory data and reporting. The FMA has established a point of contact for Fintech and a dedicated webpage (https://www.fma.gv.at/en/cross-sectoral-topics/fintech-navigator/). The FMA has published an extensive draft report on the Digitalization in the Austrian Financial Market, covering the strategies of existing supervised entities in relation to digitalization, new business models, new risks, and new technologies. The OeNB included a chapter in its latest Financial Stability Report ("Small but buzzing: the Austrian fintech ecosystem") where it discusses the small but rapidly growing fintech ecosystem, in particular in the payments area. Staff broadly agrees with the report's conclusion that fintech is not yet important for Austrian economy or financial system but needs to be closely monitored.

Other Issues

25. ***Resource savings where both national and supranational assessments are conducted – 60 percent of Austrian banks are covered by the European Union Single Supervisory Mechanism, and this FSSA draws on work done in the Euro Area FSAP. How has this affected the scoping of Austria's assessment or the resources needed to conduct this assessment, compared with the previous Austrian assessment in 2012? Are there potential resource savings for future assessments for Austria and other countries with similar arrangements.***

- The Austria FSAP was carefully scoped not to overlap or duplicate the work of the Euro Area FSAP. The coverage of the work was discussed with Austrian authorities

and the ECB so that our analysis focused on issues not covered by the Euro Area FSAP, in particular in what regards banking supervision and stress testing, where our focus was on Less Significant Institutions and Austria-specific risks and vulnerabilities. This was fundamentally different from the previous Austria FSAP, which, for example, conducted a full detailed assessment of the Basel Core Principles for Effective Banking Supervision. This country-specific focus provides value added to both national and European authorities. Resources implications are not only dependent on the scope but also on the depth and modality of the exercise, and coordination with various counterparts may require additional engagement from the team.

26. ***Thematic approach – the FSAP Review suggests that there may be scope to move towards a more thematic approach where there has been limited changes since the previous assessment. What themes would staff consider for Austria's next FSAP?***

- The next FSAP will need to follow up on the recommendations of the current FSAP and address relevant new issues that may emerge. With regards the thematic approach, the Austria team would like to refer this question to the ongoing 2020 FSAP Board Review. Nevertheless, we would like to note that the current assessment—even though it was not formally using a 'thematic approach'—was risk-focused and as such it did not go in depth in areas where there have been limited changes since the previous assessment and where there were no issues to be followed up.