

Management summary

The Russian invasion of Ukraine puts Austria's economic recovery at risk

The global economic recovery from the COVID-19 pandemic that started in 2021 proved just a brief respite, as several challenges are rearing their heads in 2022. As the effect of pandemic support measures is waning, the war in Ukraine, persistent supply bottlenecks and gradual monetary policy normalization in a highly inflationary environment are creating an uncertain backdrop to global financial stability. Nevertheless, higher household savings during the pandemic and still strong labor markets should continue to support income and spending.

In Austria, rising energy and commodity prices and negative confidence effects have started to weigh on economic growth. Before the outbreak of the war in Ukraine, Austrian companies' external financing volumes had been recovering in 2021 from the reduction in the year before. Throughout the pandemic, bank loans have been the backbone of firms' external financing. Despite their strong recourse to debt financing, Austrian companies' aggregate debt sustainability recovered in 2021. The rise in debt was accompanied by an improvement in gross operating surplus, which, as in 2020, was not only driven by the rebound in economic activity, but also, to a large extent, by public support measures. Thus, the corporate sector's aggregate debt-to-income ratio almost returned to its pre-pandemic level. Moreover, the increase in gross corporate indebtedness was accompanied by a significant increase in firms' liquid assets. Even though the number of corporate insolvencies returned to pre-pandemic levels in the final quarter of 2021 after the expiry of a number of mitigating measures, the widely expected surge in insolvencies has not materialized so far.

Household incomes recovered in 2021, after having fallen the year before. Growth of loans to households accelerated further in the first months of 2022. As in the preceding years, the main contribution to loan growth came from housing loans, bolstered by favorable financing conditions and continued housing demand. Reflecting the increase in consumption of durables, the growth rate of consumer loans returned to positive territory in late 2021. Households' aggregate debt-to-income ratio has increased slightly since the onset of the pandemic, with rising debt in part offset by a slight increase in net disposable incomes, aided by government support measures.

Austrian banks benefited from the recovery in 2021, but new challenges await

The Austrian banking sector recovered strongly in 2021, as the immediate impact of the pandemic slowly faded. Propelled by continued loan growth and a sharp decline in risk costs, profits nearly doubled to their highest level since the global financial crisis. However, given compressed margins, net interest income has solely been driven by growing lending volumes since 2019. This raises questions regarding the sustainability of a business strategy aimed at outgrowing underlying profitability pressures. Although the share of nonperforming loans has reached new lows, still nearly one-fifth of all loans are classified as having recorded a significant increase in credit risk.

Residential real estate (RRE) lending to Austrian households has grown vigorously. Over the last decade, RRE prices have doubled in Austria. This trend

has gone hand in hand with an increasing deviation from fundamentally justified values, as implied by the OeNB fundamentals indicator. In this regard, the still high (though reduced) share of variable rate loans to households also remains a matter of concern. Market conditions continue to be driven by fierce competition, which has led to increasingly unsustainable lending standards. As a result, a broad consensus has been reached that risks stemming from unsustainable lending policies must be addressed not only to reduce risks for the banking sector and consequently for financial stability, but also to protect borrowers from the consequences of excessive debt. Therefore, Austria's Financial Market Stability Board (FMSB) issued a recommendation to activate legally binding borrower-based measures, following an OeNB initiative and the recommendation to do so by a number of international institutions, including the European Systemic Risk Board and the International Monetary Fund. Specifically, the FMSB advised the Austrian Financial Market Authority to set binding upper limits for loan-to-value ratios, debt service-to-income ratios and loan maturities (subject to exemptions giving credit institutions adequate operational flexibility). These new measures shall apply to all new housing loans to households as soon as possible and it is important that they ease cyclical risks stemming from unsustainable lending standards and potentially excessive credit growth. Should they, however, turn out not to be sufficient, further macroprudential measures may be advised.

The Russian invasion of Ukraine and its consequences will affect the Austrian banking sector both directly, because of its subsidiaries in Central, Eastern and Southeastern Europe (CESEE), and indirectly, via increased macrofinancial uncertainties. Although subsidiaries in Russia, Ukraine and Belarus make up only 2% of the Austrian banking sector's total assets, they accounted for close to 10% of its profits in recent years. Still, as Austrian banks should benefit from a well-diversified international exposure, potential losses, although painful, currently appear manageable in light of the sector's solid profitability and capitalization. In addition, past micro- and macroprudential measures by Austrian authorities have significantly helped reduce risks for Austrian parent banks. Over the past decade, these measures have contributed to greatly reducing foreign currency loans and the need for cross-border intragroup liquidity transfers, and at the same time strengthened banks' risk-bearing capacity, thanks to the systemic risk buffer, for instance. Therefore, first-round effects from the war in Ukraine and the ensuing sanctions against Russia have been well contained. However, second-round effects, such as reduced business activity or a deterioration in credit quality, are still difficult to assess and are overshadowing the outlook. Consequently, banks and supervisory authorities keep monitoring the situation very closely and are constantly assessing the impact of the war, sanctions and countersanctions.

Recommendations by the OeNB

The Austrian banking sector faces challenging times in 2022. During the pandemic and the initial shock from the war in Ukraine, it benefited from a capitalization level that has doubled since the great financial crisis. Improved capital ratios have helped maintain confidence and positively influenced external assessments. That said, it should be noted that, in the course of 2021, capital ratios fell slightly because

of strong loan growth and a resumption of profit distributions. As a result, the gap vis-à-vis the European average has widened. It is therefore important to preserve past improvements in resilience, especially given growing uncertainties related to the war in Ukraine. The OeNB therefore recommends that banks take the following measures:

- Focus on a solid capital base, inter alia by exercising restraint with regard to profit distributions.
- Ensure sustainable lending standards in Austria and CESEE.
- Ensure an adequate level of loan loss provisions, especially after the expiration of COVID-19-related support measures and considering the war in Ukraine.
- Continue efforts to improve cost efficiency and operational profitability.
- Further develop and implement strategies to deal with the challenges of information technologies, increased cyber risks and climate change.