Management Summary

Financial Markets Reflect Impact of Central Bank Measures and Geopolitical Tensions

The world economy remains fragile as the pace of economic activity continues to diverge across regions. The recovery in Europe is still delicate, and growth has recently ground to a halt again. Given recent years' fiscal consolidation efforts, the public sector remains a drag on growth. Furthermore, private and government debt levels in many European countries are still high, and it will take time for structural reforms to be implemented and show the expected results. Regulatory initiatives and central bank measures have helped to calm financial markets and to support the economy by easing lending conditions through low policy interest rates and the provision of liquidity.

The economic recovery in Central, Eastern and Southeastern Europe (CESEE) lost some steam in the first half of 2014, and especially in recent months, as weaker growth in the euro area and heightened geopolitical tensions started to weigh on sentiment and external demand. Nevertheless, financial markets remained broadly stable in most countries. CDS premiums and exchange rates traded mostly flat and credit growth improved somewhat in many countries. Also, lending surveys point to stable or improved credit supply and demand. Credit quality continues to be rather weak, however, and bank profits remain subdued, but local banking sectors continue to be well capitalized. Austrian banks' exposure to CESEE is heterogeneous, with some markets still generating stable profits.

Russia and Ukraine are two major exceptions in this regional pattern; the armed conflict in eastern Ukraine and the accompanying geopolitical tensions weigh on economic and financial sector activity. Both countries experienced a marked deterioration in their macrofinancial risk profile, with reduced economic momentum, rising CDS premiums, rating downgrades, weakening credit expansion, currency depreciations and capital outflows. Western sanctions imposed on Russia increased uncertainty, which in turn negatively affected investment and sentiment. The direct impact of the sanctions on the Russian banking sector, however, is expected to be rather small in the short term, as its external position is fairly robust. Likewise, the impact of the sanctions and Russian countersanctions on other CESEE countries has also been limited.

Economic activity in Austria, which had slightly accelerated in the second half of 2013 owing to increased export demand, flattened again in the first half of 2014, as the sluggish euro area economy and uncertainties in export markets weighed on economic performance.

Subdued Growth of Credit to the Austrian Real Economy

As Austrian corporate profitability was on a downward trend in the first half of 2014, the internal financing capacity of the sector weakened noticeably, and given weak growth prospects, recourse to external financing also remained moderate. Bank loans were the primary source of debt finance; corporate loan growth accelerated somewhat in the course of 2014 but remained weak. Equity instruments accounted for almost nine-tenths of external funds in the first half of 2014.

Bank lending to households also remained subdued until the third quarter of 2014. A breakdown by currencies shows that euro-denominated loans continued to expand, while foreign currency loans continued to recede by about 10% year on year. The growth of housing loans has gained some momentum for more than a year, but at 3.3% it remained moderate. In the first half of 2014, the prices on the Austrian residential property market continued to rise, but price dynamics were heterogeneous across regions: While the increase slowed down in Vienna, the upward movement in the rest of Austria accelerated.

Financing conditions for enterprises and households remained favorable. Low interest rate levels supported Austrian firms' and households' ability to service their debt, but an above-average share of variable rate loans (in comparison to the euro area) might pose risks if interest rates were to rise again.

Financial investment by households rebounded slightly in the first half of 2014, with almost one-third going into cash and deposits with banks. While investments in life insurance plans and pension funds had a stabilizing effect on financial investment in the first half of 2014, net investment in capital market assets, which had already been muted in 2013, more than halved.

Austrian Banking Sector Headed for Aggregate Loss in 2014 Due to One-Off Effects

Since the start of the financial crisis, Austrian banks have significantly increased their capital levels and accelerated balance sheet repair both at home and abroad. But progress has been uneven across banks, and many institutions need to do more to close the capital gap between them and their competitors. More than half of Austrian banks' assets are held by banks with CET1 ratios between 10% and 12%. Austrian banks' average (consolidated) leverage ratio was 5.4% in June 2014, with individual ratios varying markedly. More than half of the assets are held by banks with leverage ratios between 4% and 6%. While the results of the ECB's comprehensive assessment of significant banks' balance sheets show the improved resilience of Austrian banks under the simulated conditions of the adverse stress test scenario, the results also indicate that most Austrian banks need to further strengthen their capital positions.

After the Austrian banking system posted a loss in 2013, the negative trend in profitability continued in the first half of 2014 in a challenging environment of slow economic growth and continuously low interest rate margins. Even if exceptional one-off effects are not taken into account, Austrian banks' operating income was below the corresponding 2013 figure, and persistently weak credit quality was an additional burden on profitability. As of mid-2014, the nonperforming loan ratio at the group level increased to 8.9% (+0.3 percentage points compared to year-end 2013). At the same time, Austrian banks raised their loan loss provision ratio. All factors considered, the Austrian banking sector is again expected to close the year with an aggregate loss.

Recommendations by the OeNB

To strengthen financial stability in Austria and in Austrian financial intermediaries' host markets, the OeNB makes the following recommendations:

- Banks should continue strengthening their capital levels.
- After the Asset Quality Review by the ECB, banks should further pursue risk-adequate provisioning and coverage policies to deal with credit quality issues, especially in CESEE.
- Given persistent pressure on profitability, banks should continue to

address structural issues and proactively improve their cost efficiency.
- Banks should continue fulfilling supervisory minimum standards relating to foreign currency loans and loans with repayment vehicles.
- Banks should strive for sustainable loan-to-local stable funding ratios at the subsidiary level and for risk-adequate pricing of intragroup liquidity transfers.
- Banks and insurance undertakings should ensure high standards of risk management so that risks are properly addressed and effectively controlled; they should also proactively prepare for contingency situations.
- Insurance undertakings should continue to prepare for Solvency II.