

Management summary

International macroeconomic environment: growth outlook remains subdued in many advanced economies

The macroeconomic outlook has been weakening modestly in many advanced economies in 2016. Central banks have provided additional monetary stimulus in response to the subdued outlook for growth and inflation, which has eased monetary and financial conditions.

Macrofinancial conditions in the countries of Central, Eastern and South-eastern Europe (CESEE) have remained broadly favorable in 2016. Moreover, the outlook for the region is robust as economic dynamics have been solid. In the period under review, the situation in Russia and Ukraine improved gradually, whereas Turkey was negatively affected by rising political uncertainty and a decelerating economy. In many CESEE banking sectors, asset quality continued to improve, as the resolution of nonperforming loans (NPLs) progressed and profitability rose.

Corporate and household sectors in Austria: financing conditions remain favorable

In the first half of 2016, Austrian economic growth was fueled by domestic demand. Investment was driven by both equipment and construction investment. In the corporate sector, the recovery of equipment investment increased the demand for financing. But with ample liquidity on firms' balance sheets, external financing volumes still remain well below pre-crisis figures. Lending by Austrian banks to domestic nonfinancial corporations remained muted in the first half of 2016. Firms continued to have substantial liquidity at their disposal. The structure of enterprises' short-term funds changed,

however, with the share of short-term bank loans decreasing. Loans with medium- term and longer maturities, which are most relevant for business fixed investment, continued to expand.

Austrian residential property prices accelerated in the first half of 2016. While property price growth in Vienna – where the strongest increases had been registered in the past years – lost pace, prices accelerated in Austria excluding Vienna.

The growth of housing loans to households, which had accelerated in the second half of 2015, stabilized in the course of this year. As loans expanded at a slower pace than household disposable income, however, household debt fell slightly. The share of variable rate loans in household loans came down gradually, even though loans with fixed interest rates are more expensive. However, variable rate loans are still very popular in Austria, leaving borrowers with considerable interest rate risks.

Austrian financial intermediaries: structural reforms gain momentum in a challenging environment

Throughout 2016, the European financial sector has still faced subdued economic growth and low interest rates. In this challenging environment, increasing pressure on interest margins and legacies of nonperforming loans continue to dampen the profitability outlook. Therefore, Austrian financial intermediaries are continuing their adaptation process and structural reforms to improve efficiency.

These measures are necessary, as operating profit weakened in the first half of 2016. Austrian banks' interest income continues to decline due to lower margins and lower business volumes, while fee and commission income is burdened by weak securities

business, leading to lower operating income. Given that operating expenses rose slightly, operating profits dropped sharply. Nevertheless, compared to 2015, the net profit of the Austrian banking system still increased, owing to further reductions in the flow of credit risk provisions. This opportunity should be used to continue to address structural issues, as constrained operating profitability requires further cost management (including consolidation) in the Austrian banking market.

The transfer of ownership in UniCredit Bank Austria's CESEE subsidiaries to its Italian parent bank in the second half of 2016 has significantly lowered the Austrian banking system's foreign risk exposure. At the same time though, the contribution from CESEE subsidiaries to the overall profitability of the Austrian banking system is expected to shrink by more than one-third. For the remaining subsidiaries, profitability in the first half of 2016 improved considerably year on year due to positive results in Hungary and Ukraine and rising profits in Croatia, the Czech Republic and Slovakia. While the restructuring of UniCredit Bank Austria reduced the total size of the Austrian banking system's NPL portfolio, sizable NPL volumes at some remaining subsidiaries continue to be a burden for their new lending and profitability.

The capital situation of Austrian banks improved markedly in the first half of 2016 due to retained earnings and capital increases, which helped reduce the gap between Austrian banks and their peer groups in terms of their capital ratios. Nonetheless, Austrian banks' capitalization is still perceived as below average and the upcoming phasing-in of new rules will lead to higher minimum requirements.

Two topics are currently in the spotlight of macroprudential policy and are being monitored very closely to assess potential risks to financial stability: First, in the area of foreign currency loans, substantial funding gaps relating to repayment vehicles have been identified in an OeNB survey and should be addressed. Second, the European Systemic Risk Board (ESRB) has issued a warning regarding medium-term vulnerabilities in Austria's residential real estate sector. However, the OeNB currently considers systemic risks from mortgage lending in Austria to be limited, as long as sustainable lending standards – e.g. conservative loan-to-value and debt (service)-to-income ratios – continue to be met.

Like banks, Austrian insurance companies face headwinds from the low interest rate environment, which has caused their liabilities to rise due to lower discount factors and their investment income to decline, as maturing investments are gradually replaced by lower-yielding securities.

Recommendations by the OeNB

Against this background, the OeNB recommends that the following measures be taken:

- Banks need to continue to pursue structural reforms and adapt their business models to further increase operational efficiency.
- Lenders need to consistently comply with sustainable standards in real estate lending, especially in Austria, to prevent the buildup of systemic risks and speculation in residential real estate lending.
- Efforts to reduce remaining NPL volumes should be continued, especially in CESEE, in order to ease the burden from legacy issues and to pave the way for new lending.

- Banks and customers should proactively address funding gaps affecting loans with repayment vehicles. Banks should also continue to fulfill the related supervisory minimum standards.
- Capital levels have improved markedly, but are still below the EU average. Consequently, banks should further strengthen their capital base, also in view of the phase-in arrangements of regulatory requirements.