

Management Summary

Central Bank Action Supports Economic Outlook and Reduces Financial Tensions

The outlook for the global economy remained subdued in the first half of 2013. While GDP growth in emerging economies was slightly below expectations, economic activity has been stronger in the U.S.A. The euro area is still struggling to grow, facing its second year of economic weakness in 2013. Across euro area countries, however, growth remained quite mixed.

Strong policy signals by the ECB – such as the announcement of Outright Monetary Transactions (OMTs) – helped substantially ease financial tensions in the euro area in the review period. Tighter sovereign bond spreads in stressed economies also reflected this improvement. Fiscal and structural reforms at the Member State level and the completion of the negotiations on a financial assistance program for Cyprus contributed positively to financial stability, alongside with the progress toward a banking union. However, the financing conditions for SMEs in stressed economies have remained difficult.

Against the background of improving financial stability in the euro area and reflecting the ongoing accommodative stance of some key central banks, conditions in the financial markets in Central, Eastern and Southeastern Europe (CESEE¹) remained broadly calm in the first half of 2013. Notable cross-country heterogeneities have persisted, however. The amount of outstanding loans to the private sector decreased in most countries in the second half of 2012. In particular, cross-border loans and domestic credit denominated in foreign currency de-

clined, while domestic loans in local currency increased. Credit supply factors may have contributed to this reduction at least in some economies, although deteriorating macroeconomic conditions are likely to have adversely impacted on credit demand as well.

Subdued Growth of Austrian Enterprises' and Households' Indebtedness

In the first quarter of 2013, the Austrian economy stagnated for the fourth quarter in a row. Consequently, corporate profitability lost momentum in 2012 while at the same time external financing of nonfinancial corporations was less than half the – extraordinarily high – 2011 figure. Loan growth has been on a downward trajectory since last autumn. On the one hand, this mirrored lower financing needs due to lower investment activity. On the other hand, Austrian banks have tightened their lending policies slightly because of both the costs related to their capital position as well as heightened risk concerns reflecting the economic slowdown. Despite this deceleration, the Austrian corporate sector escaped the decline in bank loans witnessed in the euro area as a whole. Additionally, bond financing by corporations remained vigorous.

Financing conditions for enterprises and households have remained favorable despite somewhat tighter terms and conditions as interest rates fell further until the first quarter of 2013, supporting firms' and households' ability to service their debt. However, an above-average share of variable rate loans also exposes the private sector to interest rate risks. Both corporate and household debt grew only modestly in

¹ All CESEE countries as listed in this report are listed in Table A24.

2012, but corporate debt relative to income still exceeded pre-crisis levels.

The continuously high share of foreign currency loans remains a significant risk factor for households (and the banking sector). In the first quarter of 2013, the share of household loans denominated in foreign currency had fallen by roughly 8 percentage points since 2008, but at 23%, it was still very high.

Households' financial investment remained subdued in 2012 while at the same time the low interest environment fostered a shift to short-term deposits. After the substantial (unrealized) valuation losses in their securities portfolios recorded in 2011, Austrian households registered valuation gains in 2012.

Austrian Banking System Needs Further Strengthening

2012 turned out to be a better year for the Austrian banking system than 2011. But these improvements may not be of a lasting nature, as the rebound of profitability was mainly due to one-off effects, and asset quality is still an issue of concern. While at home, credit quality remained fairly good, at Austrian banks' CESEE subsidiaries it continued to deteriorate. Operating results were rather weak in 2012, as risk costs continued to weigh on net profits. Net interest income, which traditionally accounted for more than half of total operating income, as well as fees and commission income decreased while trading income and other operating income grew relatively strongly. Austrian banks' activities in CESEE again contributed substantially to the sector's consolidated profit. However, developments in individual CESEE countries have become increasingly heterogeneous, and the higher profitability of CESEE subsidiaries has to be seen in

the context of higher risks with which business in this region is generally associated.

Although Austrian banks took further steps to restructure their balance sheets in 2012, concerns about widespread deleveraging – most notably with regard to the CESEE region – have not materialized; Austrian banks have remained committed to their CESEE business. Their exposure is still broadly diversified, with a focus on investment grade countries.

Austrian banks' capital ratios continued to improve in 2012, also due to reductions in risk-weighted assets. The tier 1 capital ratio of the Austrian banking system had risen to 11.0% by year-end 2012. The aggregate results of the stress tests conducted by the OeNB as part of the IMF Financial Sector Assessment Program (FSAP) in early 2013 reflect this improvement. But the results are again highly dispersed; in light of elevated medium-term risks and with tighter regulatory requirements about to take effect, Austrian banks need to improve their risk-bearing capacity further. Still, the leverage of the Austrian banking system continues to be below that of their international peers, whose need for capital is also higher.

The recent implementation of regulatory measures continues to show effects. Foreign currency lending in Austria has almost come to a halt, and subsidiaries have become less dependent on intragroup funding. Nevertheless, the IMF FSAP mission team in particular recommended that the Austrian authorities further strengthen the legal framework for banking supervision and financial stability.

Thanks to better market conditions since mid-2012, the performance of Austrian mutual funds, pension funds and insurance companies has substantially

improved. However, life insurance policies with guaranteed interest rates over long terms have been increasingly challenged by a sustained low-yield environment.

Action Recommended by the OeNB

The OeNB reiterates its recommendations of the previous Financial Stability

Report, calling for a strengthening of financial stability in particular by improving bank capitalization and enhancing the sustainability of bank's business models. Furthermore, banks are expected to continue to limit foreign currency lending.