

## Management summary

### **Increased volatility in international financial markets amid high economic uncertainties**

In early 2016, economic dynamics in many advanced and emerging market economies were weaker than expected. Forecasts were adjusted downward, confirming the continued fragility of the global growth momentum. Trade growth slowed down, reflecting rebalancing in China as well as the sharp downscaling of investment in commodity-exporting countries. Bouts of financial market volatility were observed in late 2015 and early 2016 amid rising global risk aversion, sagging global equity prices, widening credit spreads and historically low yields for safe-haven government bonds. Regardless of some more recent improvements, these phenomena underline the high degree of uncertainty in the world economy. In Europe, notwithstanding a strong first quarter, uncertainties have been amplified by a series of political events, including the Brexit referendum and the influx of refugees.

Meanwhile, Central, Eastern and Southeastern European (CESEE) countries performed comparatively well. While the risk assessment for the region deteriorated somewhat in early 2016, this development was less pronounced than in other emerging market regions, and growth and the general macro-financial environment remained broadly solid. Asset quality continued to improve in many CESEE banking sectors, as the resolution of nonperforming loans progressed, and profitability benefited from the lower net creation of reserves and provisions. At the same time, banking sectors in Russia and Ukraine are still burdened by the lingering recession, but signs of macro-economic stabilization have become apparent.

### **Financing of corporate and household sectors in Austria started to rebound**

In Austria, economic growth picked up in the second half of 2015, driven by domestic demand, in particular cyclically sensitive investment in equipment. The recovery in economic growth supported the profitability and thus the internal financing potential of the corporate sector. At the same time, the recovery of investment was accompanied by an increase in external financing, to which equity and debt contributed in roughly equal measure.

Lending by Austrian banks to nonfinancial corporations rebounded somewhat, increasing by 1.2% year on year in March 2016. Austrian banks continued their cautious lending policies, but this is unlikely to have constituted an effective constraint for the financing of Austrian enterprises, as loan demand was still weak. Bank lending to households has gained some momentum since mid-2015, relating in particular to housing loans, which grew by 4.8% year on year in March 2016. Despite this acceleration, loan growth remained below the increase of residential property prices in Austria. The latter accelerated notably in the second half of 2015, to reach 7.6% year on year in the fourth quarter. In light of rising valuation levels (as shown by the OeNB fundamentals indicator), the financing of residential real estate in Austria warrants increased attention.

The low interest rate environment continued to support firms' and households' debt-servicing capacities. But while Austrian companies and households currently face lower interest expenses than their euro area peers, their exposure to interest rate risk is higher due to the large share of variable rate loans (even if this share has

retreated somewhat lately, especially in the case of household loans). A rebound of interest rates could thus prove burdensome, especially for highly indebted companies and households.

### **Austrian banks' profitability improved as adaptation process continues**

The Austrian banking sector is still adapting to evolving challenges. Its profitability recovered strongly in 2015, but was driven by nonstructural factors, such as reduced provisioning and lower write-downs. However, net interest income, which is the cornerstone of Austrian banks' business model, remains under pressure. Domestic net interest income was especially affected by decreasing business volumes, while margins decreased in CESEE. In addition, Austrian banks are not only facing traditionally stiff domestic competition, but also have to ready themselves for new digital competitors known as fintech companies.

Austrian banks' subsidiaries in CESEE considerably stepped up their profitability in 2015, but are still faced with legacy issues related to nonperforming loans and country-specific – legislative as well as macroeconomic – risks. As to another legacy issue, the outstanding volume of foreign currency loans in CESEE (as well as in Austria) declined and related provisioning improved markedly. With regard to foreign currency loans, communication between banks and their customers is of utmost importance.

In this environment, Austrian banks managed to raise their capital levels and reduce the respective gap vis-à-vis their international peers. A first assessment of the potential impact of new minimum requirements on own funds and eligible liabilities (MREL) shows that there is still considerable uncertainty

about the potential effects. A baseline scenario suggests no massive shortfalls for the Austrian banking sector, but this assessment is highly sensitive to the assumptions. Moreover, the definition of MREL is still in flux because the European Commission is striving to harmonize it with total loss-absorbing capacity (TLAC), which might fundamentally change both target MREL levels and MREL-eligible liabilities. Austrian banks' refinancing situation remains strong in general. In CESEE, Austrian subsidiaries' funding has become much more sustainable over the years, with subsidiaries reducing their loan-to-deposit ratios (mostly on the funding side) while avoiding disorderly deleveraging.

The key risks facing the insurance sector remain the low interest rates and weak macroeconomic growth. The introduction of Solvency II, which entered into force in 2016, and the related higher capital requirement for long-term guarantees are additional challenges and will also influence investment allocations. Over the last years, Austria's mutual fund industry has developed in line with the European market. Risks may arise from a combination of elevated leverage and lack of liquidity; such a combination would amplify potential vulnerabilities that may surface when significant fund withdrawals were to be attempted simultaneously.

### **Recommendations by the OeNB**

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

- Banks should continue their structural reforms and further adapt their business models to a longer period of very low interest rates to ensure sustainable profitability. This includes an improvement in operational effi-

ciency as well as the resolution of nonperforming loans – especially in CESEE – to facilitate new lending in order to support the (recovery of the) real economy.

- Banks should further strengthen their capital levels to become more resilient.
- Banks should continue to fulfill the minimum standards for foreign currency loans and repayment vehicle loans as well as adhere to the supervisory guidance provided by the Sustainability Package.
- Banks should adapt to new regulatory requirements such as the systemic risk buffer (SRB), the liquidity coverage ratio (LCR) and the minimum requirement on own funds and eligible liabilities (MREL).
- The OeNB supports the Austrian Financial Market Stability Board's advice to the Minister of Finance for the creation of a legal basis for new macroprudential supervisory instruments to mitigate systemic risks arising from a potential credit-driven real estate price boom.