

Management summary

Declining yields in early 2015 amid modest global recovery

Global economic dynamics weakened in the first half of 2015 as a result of slower growth in the U.S.A. as well as a continued economic slowdown in emerging economies, where financial outflows brought sustainability issues to the fore. Despite geopolitical tensions, the euro area economy emerged from recession in 2014. It gained further momentum in the first months of 2015 as the monetary policy measures adopted by the Governing Council of the ECB – including an asset purchase program and the supply of further long-term liquidity to the banking sector – as well as low energy prices and a relatively low exchange rate provided further stimulus.

Given the accommodative stance of monetary policy and a subdued inflation outlook, the yields on euro area government bonds continued to decline in the first months of 2015. The significant yield decline benefited all economies of the euro area (with the exception of Greece) as a search for yield in an environment of low interest rates caused risk premiums to contract. However, volatility in bond markets, stock exchanges, foreign exchange rates and commodity prices has intensified since then. Whether this reflects temporary corrections or more fundamental changes in line with macroeconomic developments is an issue that will shape the future financial risk environment.

The economic recovery in many countries of Central, Eastern and Southeastern Europe (CESEE) continued in the second half of 2014, and financial market developments were broadly favorable, especially in the EU Member States of the region, reflecting a comparatively sound macrofinancial environment and favorable global li-

quidity conditions. However, more volatility was observed in Bulgaria and Turkey, while turbulences in Russia and Ukraine persisted. Credit market developments in CESEE were also broadly favorable, especially in Hungary, Poland, the Czech Republic and Slovakia, and a further deceleration of credit growth in Russia and Ukraine was noticeable. Credit growth in CESEE is increasingly being financed by domestic deposits, and the share of foreign currency-denominated loans in total loans has decreased further. Nonperforming loan ratios have remained broadly stable or decreased somewhat. Banking sector profitability, however, continues to be weak and has even deteriorated in several countries against the background of increasing provisions and write-offs. On the plus side, banking sectors throughout most of the region continue to be well capitalized.

Growth of credit to the Austrian nonfinancial sector still low

In Austria, economic growth remained weak in 2014 and the first quarter of 2015. Reflecting this subdued economic environment, the gross operating surplus of nonfinancial corporations fell slightly in 2014 in real terms, while low interest rates continued to support corporate profitability.

Loans by Austrian banks to domestic nonfinancial corporations grew at a modest pace, reflecting both supply- and demand-side factors. On the one hand, banks continued their cautious lending policies, while on the other hand, loan demand by enterprises remained low in the currently weak cyclical environment. Bond issuance, which had been a major source of external finance for the corporate sector in the past years, was negative in 2014 in net terms. Bank lending to house-

holds, which was driven primarily by housing loans, was also subdued. Residential property price growth moderated considerably in the course of 2014. According to the OeNB fundamentals indicator for residential property prices, prices were justified by fundamentals in the fourth quarter of 2014.

Modest debt growth and low interest rates eased the interest burden for firms and households, reinforced by a very high share of variable rate loans in total domestic lending. While the latter undoubtedly advanced the pass-through of the ECB's lower key interest rates, it implies considerable interest rate risks for debtors. The still significant share of foreign currency loans in total lending also remains a risk factor, especially for Austrian households, despite a noticeable decrease in the past years as a consequence of stepped-up supervisory efforts. However, the appreciation of the Swiss franc as of mid-January 2015 has increased both the outstanding volume and the funding gap (between the repayment vehicles' expected final value and the amount outstanding at loan maturity). In April 2015, this gap amounted to EUR 6 billion. Another source of risk is the repayment vehicles' future performance, as valuations might erode when financial markets turn, thereby further widening the funding gap. Although the majority of foreign currency bullet loans will mature after 2019, hoping for exchange rates or asset valuation to turn for the better is a risky strategy.

New macroprudential measures will improve systemic resilience of Austrian banking sector

On June 1, 2015, Austria's macroprudential policy body, the Financial Market Stability Board (FMSB), recommended that the Austrian Financial

Market Authority (FMA) activate the systemic risk buffer (SRB) and the buffer for other systemically important institutions (O-SII) for selected banks. These macroprudential measures had been previously recommended by the OeNB as they will improve the financial stability of the Austrian banking system by addressing structural and systemic risks.

In 2014, the consolidated profit of the Austrian banking sector was back in positive territory and the overdue consolidation has now started in earnest. However, these positive developments were driven by the restructuring of Hypo Alpe-Adria-Bank International AG (HAA) and the outlook for banks' profitability remains under pressure also due to geopolitical developments.

Austrian banks' consolidated operating profit improved, as banks were able to increase their net interest income, but the low interest rate environment may compromise this trend over the medium term. Loan loss provisions remained at elevated levels in 2014, although they decreased compared to 2013. Also, the increase in Austrian banks' capital levels that had been observed over the past years came to a halt in 2014: The three largest Austrian banks even faced a reduction in their capital ratios and continue to lag behind their peer groups.

Subsidiaries in CESEE continued to make a positive contribution to the Austrian banking sector's consolidated profit, but total earnings plummeted to a historic low in 2014, and – similar to past years – profits were concentrated in just a few countries. In general, the outlook for Austrian banks' profitability in CESEE remains weak due to ongoing political and geopolitical uncertainties as well as the protracted resolution of legacy issues, i.e. nonperforming loans, in some countries.

Recommendations by the OeNB

To strengthen financial stability in Austria, the OeNB recommends that the following measures be taken:

- Banks should continue to strive for capital levels that are commensurate with their risk exposures. Systemic risks caused by a bank's size, interconnectedness and emerging market exposure should be addressed by means of the systemic risk buffer (SRB) and the buffer for other systemically important institutions (O-SII) as proposed by the FMSB.
- The still difficult profitability situation requires active cost management and risk-adequate pricing.
- The close monitoring of risks related to foreign currency loans and loans with repayment vehicles remains important. Against the background of increased funding gaps and risks regarding repayment vehicle values, banks and customers should assess the latter's risk-bearing capacity and take risk-reducing measures if deemed necessary.
- As to CESEE subsidiaries, the resolution of nonperforming assets is crucial and on-going initiatives to deal with legacy issues should be proactively pursued. Banks should also continue to strive for sustainable loan-to-local stable funding ratios at the subsidiary level and for risk-adequate pricing of intragroup liquidity transfers.
- The effects of the ultra-low interest rate environment are still difficult to assess, but banks and insurance companies may need to adapt their business models to this challenging environment.
- Insurance undertakings should continue to prepare for Solvency II.