Management summary[1]

Real GDP in Austria contracted by 0.7% in 2023. This was due to persistently high inflation, the very weak external economic environment and the resulting poor sentiment. In its June 2024 outlook, the OeNB expects the economy to grow by 0.3% in 2024 and 1.8% in 2025. The inflation rate will fall by more than half to 3.4% in 2024. This is attributable to all main HICP components, but above all to industrial goods excluding energy as well as energy and food. Austria's inflation differential to the euro area narrowed substantially in recent months and is expected to record long-term average levels in 2025 and 2026 (0.6 percentage points). The risks to the growth forecast are balanced. Geopolitical tensions and Austria's dependence on Russian gas represent downside risks, while a stronger recovery in domestic demand represents an upside risk. For the inflation forecast, in contrast, all three risk factors result in an upside risk. In the EU member states of Central, Eastern and Southeastern Europe (CESEE), real economic growth fell significantly in 2023 and inflation peaked at the beginning of the year. While Russia's invasion of Ukraine continued to affect (energy) prices and sentiment, the second half of the year saw some improvements. Also, the region's central banks ended their interest rate hikes. Some already started loosening monetary policy.

In 2023, the Austrian banking sector earned a record profit of EUR 14 billion. Its common equity tier 1 capital ratio climbed to 17.5%. The capitalization of Austrian significant institutions surpassed the average in the Single Supervisory Mechanism (SSM) after years of trailing it. This means that Austrian banks have used their profits to increase their resilience to future uncertainties. Profits were driven by a rising net interest margin, as monetary policy tightened and ensuing rate rises translated into higher income from borrowers on variable interest rates. At the same time, loan loss provisioning was stable despite rising loan defaults. For the first time ever, the sector recorded a cost-to-income ratio slightly below 50%. Earning EUR 5.5 billion, the subsidiaries in CESEE also continued to be highly profitable in 2023.

Loan growth lost further momentum in Austria. Real estate lending growth turned negative in mid-2023 and the demand for corporate loans declined. Depositors continued to shift savings from sight to term deposits. This increased banks' funding costs. Credit quality started to deteriorate in late 2023, especially in the corporate loan portfolio. By contrast, the quality of loans to households remained stable. At the end of 2023, the Austrian banking sector recorded an increase of the consolidated ratio of nonperforming loans (NPLs) to 2.6%, up from around 2%, where the rate had stood since 2021. Compared to historical figures, however, an NPL ratio of 2.6% is still moderate. The coverage ratio decreased on the back of new NPLs, for which provisions are still low, and the write-down of highly provisioned vintage NPLs. While the share of variable rate loans in new residential real estate (RRE) lending fell, it was still above 40% at the beginning of 2024. This is more than double the euro area average. Interestingly, this share remained high even though interest rates for variable rate loans exceeded those for fixed rate loans – indicating that market participants expected falling rates.

In a rapidly changing macrofinancial environment, systemic risks from real estate markets continue to be elevated. They are, however, being addressed effectively by borrower-based measures. Since these measures were introduced, lending

[1] *For a German-language management summary of the Financial Stability Report 47, see Finanzmarktstabilitätsbericht – Oesterreichische Nationalbank (OeNB).*

standards have improved significantly. The share of sustainable loans[2] has risen substantially, namely from 12% to 80%. A large part of the exemptions to the regulation for sustainable lending standards for residential real estate financing (KIM-V for short) remained unused in 2023, which suggests that this regulation is not a major factor behind declining lending volumes. When it comes to commercial real estate (CRE) lending by Austrian banks, both exposure and riskiness are high. At end-2023, 30% of CRE loans had a loan-to-value ratio above 100% or were unsecured. For one thing, this is attributable to cyclical factors, such as higher interest rates that led to a deterioration in the credit quality of CRE loans. For another, structural pressure is at play, including the trend toward remote work, online shopping or the need for climate-related adaptations.

The revised EU instant payments regulation published in March 2024 will lead to further innovation in financial services. Cases in point are the promotion of real-time transfers and the introduction of IBAN checks that verify that the beneficiary's IBAN and name match. Last, but not least, the EU is one of the first jurisdictions that has implemented a recovery and resolution framework for central counterparties that will strengthen the resilience of securities markets.

Recommendations by the OeNB

The profitability of the Austrian banking sector was strong in 2023. However, high net interest margins and low credit risk costs are likely to fade over time. Austrian banks profited from rising incomes resulting from the automatic repricing of variable rate loans. Besides, low unemployment and the post-pandemic recovery kept provisioning low. Both trends may soon go into reverse: If interest rates on loans decrease and depositors rush to lock in current rates that are still high (as published on a new OeNB transparency platform), the net interest margin is set to fall. Meanwhile, lagged effects of tighter monetary policy and geopolitical shocks may further affect the macroeconomic situation and lead to more nonperforming loans. Also, wage increases are still catching up with inflation and will continue to exercise pressure on banks' operating costs. From a financial stability perspective, it is thus positive that Austrian banks have used their high profits of 2023 to build up risk buffers. The OeNB recommends that banks further strengthen financial stability by taking the following measures:

- Continue to safeguard or, where appropriate because of exposed business models, the risk situation or the current capitalization, further strengthen the capital position by exercising restraint regarding profit distributions (i.e., dividend payments and share buybacks).
- Adhere to sustainable lending standards for residential as well as commercial real estate (CRE) financing and prepare for higher risk weights for CRE loans as defaults increase.
- Ensure adequate credit and interest rate risk management practices, including higher provisioning and conservative collateral valuations.
- Ensure sustainable profitability by
    - maintaining cost discipline and
    - investing in new information technologies as well as protection against cyber risks and the impact of climate change.

[2] *A sustainable loan has a loan-to-collateral ratio of up to 90%, a debt service-to-income ratio of up to 40% and a maturity of up to 35 years.*