

Management summary

International macroeconomic environment: global and European growth slows down somewhat as downside risks prevail

Global growth has been weakening since the second half of 2018, leading to downward revisions in current forecasts. The revised outlook suggests a delay in the return of euro area inflation to its target rate. Hence, the ECB is expanding its accommodative monetary policy stance, while international stock indices have been volatile amid global trade tensions and geopolitical downside risks.

Favorable macroeconomic conditions supported banking sector activity in most countries of Central, Eastern and Southeastern Europe (CESEE) in 2018. Growth was especially strong in the CESEE EU Member States, benefiting from booming labor markets and strong investment demand. Robust GDP growth went hand in hand with a further acceleration of credit growth amid low interest rates and ample liquidity. This contributed to a further reduction of nonperforming loans (NPLs) and an increase in banking sector profitability. Economic growth and banking sector results were also solid outside the EU, for instance in Russia and Ukraine. Only Turkey suffered from economic turbulences sending the economy into recession in the second half of 2018, which weighed on credit growth, loan quality and banking sector profitability.

Corporate and household sectors in Austria: income growth supports debt service capacity

The Austrian economy continued to grow in 2018. Despite a slowdown in the second half of 2018 and early 2019, growth still supported the earnings-generating capacity of Austrian nonfinancial corporations. Consequently, companies' internal financing, which constitutes the most important source of funds, remained at a high level in 2018, whereas the use of external financing sources more than halved. Given the low interest rate environment, debt instruments once again were the most important source of external financing in 2018. Lending by Austrian banks to nonfinancial corporations gained further momentum, substituting for other debt instruments, such as intra-company loans, loans from foreign banks and corporate bonds, which all contracted in 2018. In early 2019, the annual growth rate of corporate loans by Austrian banks reached more than 7%, the highest value in more than a decade. Lending to the corporate sector was strongly driven by lending for real estate activities. Likewise, the main contribution to the growth of bank lending to households – which increased slightly in recent months – came from housing loans; they remained the most important category of loans to households and grew at a slightly faster pace.

Overall, companies' and households' debt levels rose moderately in 2018, but remained below euro area averages when measured against income. Moreover, debt sustainability benefited from increased profits and income resulting from favorable economic conditions. In addition, the low interest rate environment has been supporting current debt servicing capacities, which has been reinforced by the still high share of variable rate loans. So while companies and households presently have lower interest expenses, their exposure to interest rate risk is considerable.

The upward trend of residential property prices in Austria persisted in 2018 and early 2019. Reflecting this price growth, residential property prices continued to deviate from fundamentally justified values, according to the OeNB's relevant indicator.

Austrian financial intermediaries: bank profits reach another post-crisis high, while insurance sector results are under pressure

Austrian banks continued to benefit from macroeconomic tailwinds in 2018, with consolidated profits reaching another post-crisis high. This trend was driven by rising income on the one hand and historically low risk provisioning on the other. However, cost efficiency remained weak. The reduction of nonperforming loans together with an acceleration in credit growth led to further improving credit quality indicators both in Austria and in CESEE. At the same time, Austrian banks' capital ratios declined due to a rise in risk-weighted assets and a doubling of the dividend payout ratio. Yet, high liquidity coverage ratios attest to domestic banks' solid short-term resilience against liquidity shocks, as funding is mostly based on retail and corporate deposits.

Since the establishment of the Financial Market Stability Board (FMSB) five years ago, macroprudential measures have crucially contributed to strengthening the resilience of the Austrian banking sector, reduced the probability of public bank bailouts and positively influenced the external assessment of Austrian banks. In 2018, Standard & Poor's ranked the domestic banking sector among the most stable in the world. That said, close supervisory monitoring remains necessary in particular in mortgage lending, as interest rates for housing loans have continued to decline, mortgage growth has remained strong and prices for real estate have been increasing further. Furthermore, banks have been issuing a nonnegligible share of new mortgage loans without adequate deposit payments, and debt service in relation to borrowers' incomes has been rising. Against this backdrop, the FMSB has issued quantitative guidance related to sustainable mortgage lending standards, whose effectiveness the OeNB is currently evaluating.

Thanks to supervisory measures, foreign currency loans have continued their sharp decline and, at present, do not represent a systemic risk to the Austrian banking system in general. Nevertheless, the risks to individual borrowers may still be high. For this reason, the OeNB, in cooperation with the FMA and the Austrian Economic Chambers, issued a new information leaflet earlier this year in order to further increase borrowers' awareness of the risks inherent in these loans, especially when they are linked with a repayment vehicle.

Persistently low yields have remained a challenge for the insurance sector, especially for life insurers, and the profitability of the whole sector has deteriorated. However, the solvency capital ratio of Austrian insurance companies is at a comfortable level that corresponds to the European average.

Recommendations by the OeNB

In the current phase of slowing economic activity, Austrian banks should focus on tackling persistent challenges in order to foster the sustainability of their profits, improve their resilience, and ensure that they have enough room for maneuver in the future. Against this background, the OeNB recommends that banks take the following measures:

- Use the window of opportunity provided by cyclically-induced low risk costs to further improve structural efficiency. This would help safeguard banks' profitability.
- Reinvigorate efforts to further improve capitalization, especially at significant institutions, as strong credit growth may pave the way for the emergence of future credit risks.

- Apply sustainable lending standards in real estate lending, both in Austria and in CESEE, and comply with the quantitative guidance issued by the Financial Market Stability Board.
- Develop and apply adequate strategies to deal with challenges linked to new information technologies and digitalization (e.g. fintech competitors, update of existing IT systems).
- Continue with efforts to resolve NPLs in CESEE and comply with the aforementioned sustainable lending standards to prevent the buildup of NPLs.
- Continue to comply with the supervisory minimum standards for foreign currency and repayment vehicle loans as well as the Sustainability Package.