# Recent developments

### Financing to nonfinancial corporations and households in Austria is up as risk indicators improve

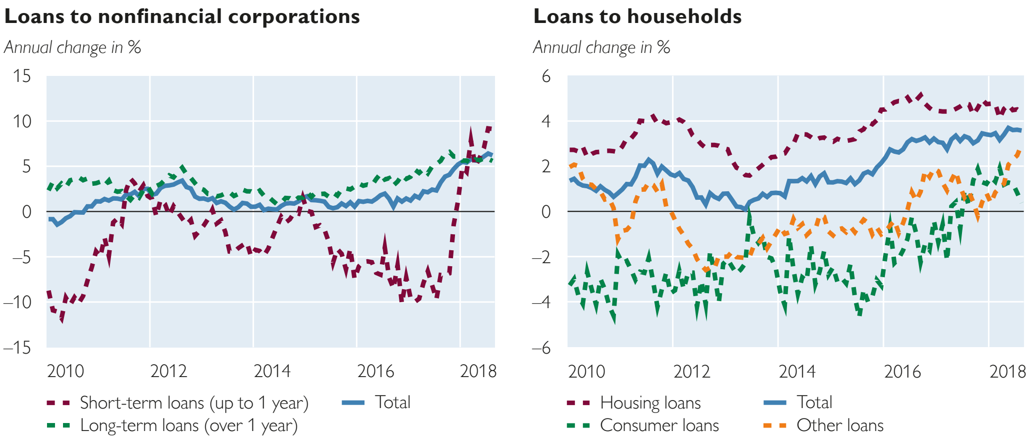
**Lending by Austrian banks to domestic nonfinancial corporations gained further momentum over the course of 2018.** In August 2018, lending reached an annual growth rate of 6.2% (adjusted for securitization, reclassifications, valuation changes and exchange rate effects). The strongest contribution to this upturn came from loans with longer maturities (over five years), which also account for the largest share in outstanding volumes. In terms of specific industries, the increase in corporate loans in the twelve months to August 2018 was strongly driven by real estate activity, which accounted for over half of total credit expansion (i.e. change in stocks).

**Corporate loan demand continued the upward trend that began two years ago.** Reflecting current cyclical conditions, the corporate sector's demand for funding to finance fixed investment was a major driver of increasing loan demand in the first three quarters of 2018, while internal financing continued to diminish loan demand, according to the euro area bank lending survey's results for Austria. In contrast, banks continued their cautious lending policies. While pressure from competition, especially from other banks, was cited most often as the reason banks have eased their credit standards in recent quarters, reduced risk tolerance contributed to a slightly more cautious stance.

**Credit conditions remained favorable.** Historically low bank lending rates continued to support lending to the corporate sector. This reflects the stance of monetary policy as well as narrower interest rate margins for average loans. Margins on riskier loans, however, were largely left unchanged during the last few quarters. This points toward differentiated risk pricing by banks.

Chart 1

**MFI loans to Austrian nonfinancial corporations and households**




*Source: OeNB.*

**To a large extent, bank loans took the place of other forms of finance.** In the first half of 2018, nonfinancial corporations' external financing was down by 17% on the year. Debt financing remained attractive due to low interest rates and thus provided the bulk of nonfinancial corporations' external financing, even if its overall volume was down slightly on the year. Loans by domestic banks accounted for over one-third of debt financing in the first half of 2018. In contrast, debt financing from other nonfinancial corporations – in the form of both loans (to a large extent transactions within corporate groups) and trade credit – decreased markedly. According to financial accounts data, net corporate bond issuance was negative at EUR 0.5 billion in the first half of 2018, low corporate bond yields notwithstanding. Only 5% of nonfinancial corporations' external financing came in the form of equity financing.

**Furthermore, firms drew down on credit lines that had been granted in the past.** The total amount of undrawn credit lines available to enterprises – which had been increased steadily over the previous four years – decreased by EUR 6 billion in the first eight months of 2018. Yet, at close to EUR 27 billion, the levels of unutilized liquidity were still high by historical standards, especially if firms' transferable deposits, which continued to rise briskly (+11.7% year on year in August 2018), are taken into account. Moreover, increasing corporate profitability, as measured by growth in gross operating surplus, improved the corporate sector's internal financing potential (and at the same time facilitated debt servicing).

**The debt sustainability of Austrian nonfinancial corporations improved in the first half of 2018.** Compared to the same period of the preceding year, the corporate sector's debt-to-income ratio decreased by 6 percentage points to 381%. Corporate sector financial debt (measured in terms of total loans raised and bonds issued) grew at a slower pace (4.1%) than gross operating surplus (5.6%). The low interest rate environment, together with the economic recovery, continued to support firms' current debt servicing capacity. The ratio of interest payments on (domestic) bank loans to gross operating surplus continued to decline slightly in the first half of 2018, falling to 2.8%.

**Austrian households continued to prefer liquid assets.** Households' financial investments increased by 22% to EUR 9.2 billion in the first half of 2018. In the low nominal interest rate environment, households shifted EUR 12.4 billion into overnight deposits with domestic banks. As this figure exceeds the amount of total financial investments, this implies a considerable shift away from other financial assets. Net financial investments in capital market instruments were negative during this period. While households reduced their direct holdings of debt securities and listed shares, they continued to transfer funds into mutual funds. For all three asset categories, households posted (unrealized) valuation losses of EUR 2 billion in the first half of 2018, or 1.7% of the amount outstanding at the end of last year.

**The growth rate of lending to households remained stable in recent months.** In August 2018, bank loans to households (adjusted for reclassifications, valuation changes and exchange rate effects) increased by 3.6% year on year. While loans for all purposes showed positive year-on-year growth rates – consumer loans grew by 0.4% and other loans by 3.0% –, the main contribution to loan growth came from housing loans, which account for almost two-thirds of the outstanding volume of loans to households. Their growth rate reached 4.4% year on year in August 2018. According to the bank lending survey (BLS), banks' credit standards for housing loans to households tightened slightly in the first three quarters of 2018, after remaining stable overall in 2017. At the same time, the slight but continuous increase in household demand for housing loans reported by banks in recent years abated over the course of this year.

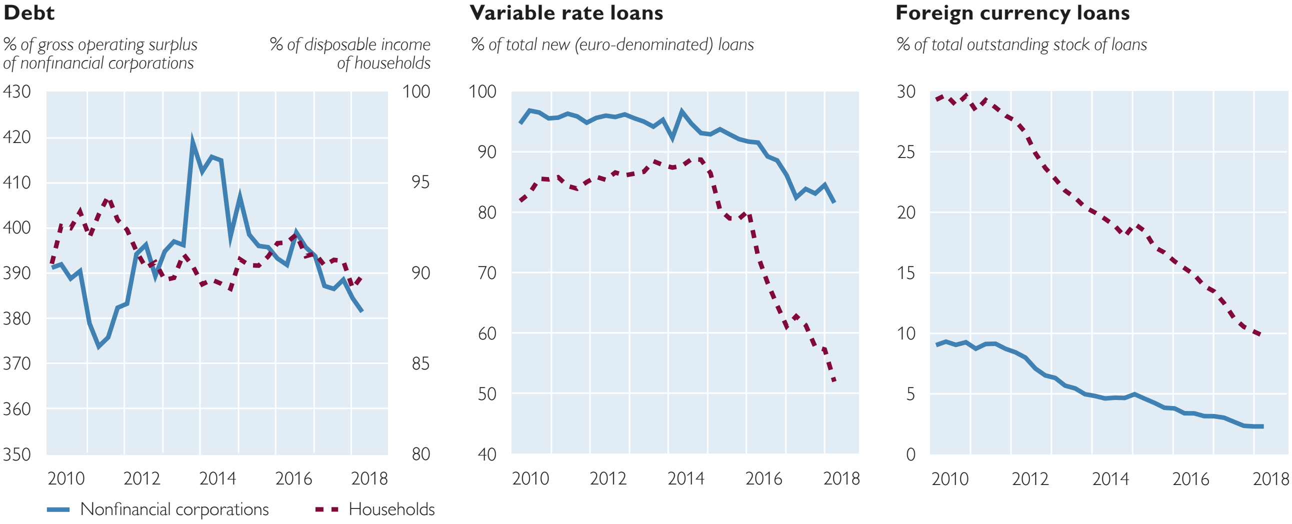
**Conditions for housing loans remained favorable.** Interest rates for new bank loans remained at the very low levels recorded in the preceding years. While banks reported in the BLS that margins for average loans were eased (i.e. lowered) further in the first three quarters of 2018 due to high competition, the margins on riskier loans were tightened slightly. Collateral requirements and other terms and conditions (such as noninterest charges, loan covenants, loan maturity and loan size) remained broadly unchanged during the same period.

**Credit risk indicators in the household sector improved in the first half of 2018, but risks remain.** Households' debt-to-income ratio remained broadly stable at 90%. The share of variable rate loans (loans with an initial rate fixation period of up to one year) continued to decrease in the first half of 2018. In the second quarter of 2018, they accounted for 52% of new lending (in euro) to households compared to 80% in the same quarter three years earlier; over the same period, variable rate loans as a share of housing loans fell by nearly half from 76% to 40%. Yet the share of variable rate loans is still quite high by international comparison. Likewise, despite decreasing further in the first half of 2018 to slightly below 10% of all outstanding loans to households (and to 12.5% of housing loans), foreign currency loans remain a risk factor.

**Residential property prices in Austria continued to rise in the first half of 2018.** Reflecting this pickup, the OeNB fundamentals indicator for residential property prices in Vienna increased slightly to 21.4% in the second quarter of 2018. For Austria as a whole, the indicator reached 11.1%, implying that the increasing overvaluation observed in recent years continued.

Chart 2

**Risk indicators for Austrian nonfinancial corporations and households**




*Source: OeNB, Statistics Austria.*

## Austrian banks profit from benign environment but clouds are gathering on the horizon

**In the first half of 2018, Austrian banks continued to benefit from a very benign macroeconomic environment with improving credit risk costs and strong loan demand.** However, global downside risks persist and are starting to cloud the horizon after a long period of economic recovery. These downside risks include rising global debt levels, the ongoing sovereign-bank nexus combined with gradual monetary policy tightening and international challenges (e.g. Brexit, trade disputes, volatility spikes in certain emerging markets). In this challenging environment, the Austrian Financial Market Stability Board (FMSB) addressed a key national macroprudential issue by publicly communicating clear benchmarks for sustainable real estate lending standards.

**Consolidation within the Austrian banking sector continued in the first half of 2018.** The number of banks as well as the number of branches declined further in the first six months of the year. At the same time, the banking sector's total assets increased to around EUR 972 billion. CESEE exposures rose to EUR 245 billion, with the strongest increases occurring in the Czech Republic, Russia and Slovakia.

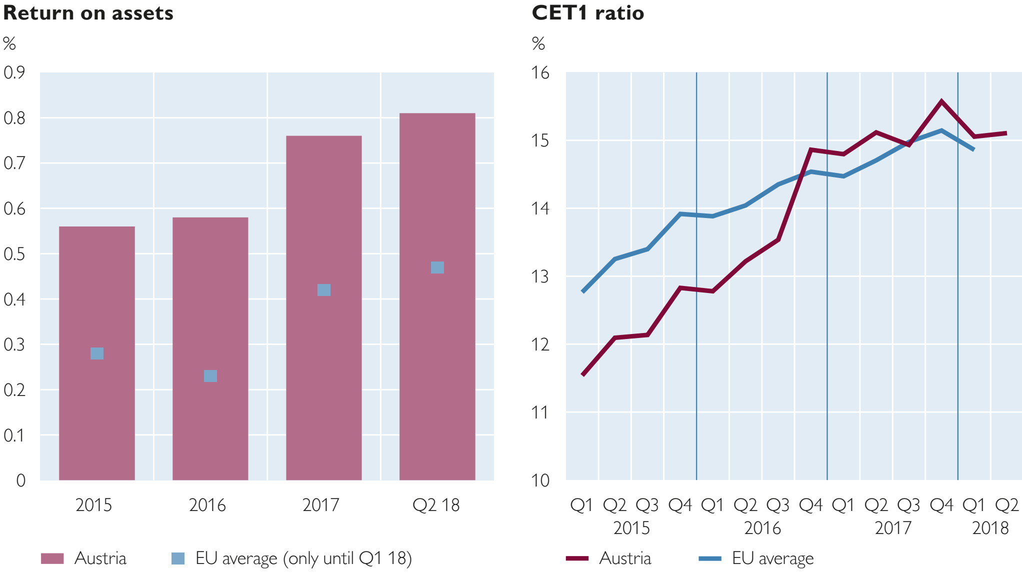
**Austrian banks continued to raise their profits, supported by a release of risk provisions, with net profits increasing by nearly 7% year on year to EUR 3.6 billion in the first half of 2018.** Even though net interest income was up for the first time since 2015, total operating income stagnated due to negative trading results and reduced other operating income. Operating expenses rose slightly, leading to a marginally weaker cost-to-income ratio of around 66%. Finally, net profits were propelled by negative risk provisioning – i.e. more provisions have been released than recognized – amid a favorable macroeconomic environment and improving credit quality. The return on average assets of the Austrian banking system remained constant at 0.8%. Despite this positive development in terms of overall profitability, banks must continue to improve their structural efficiency in order to maintain sustainable profitability in case the economy weakens and provisioning needs increase again.

**The credit quality of the Austrian banking system improved further in the first half of 2018, as the overall NPL ratio of Austrian banks decreased to 3.1%.** The improvement was especially pronounced in corporate loan portfolios, while the quality of consumer loans weakened slightly. Due to provision releases, the coverage ratio of NPLs deteriorated slightly. Nonetheless, at 51%, it is still well above the European average of 46% reported by the European Banking Authority. The potential for further loan quality improvements is expected to moderate, which is one reason why the credit rating agency Moody's reduced its outlook for the banking system from positive to stable in August 2018.

**The increase in the capitalization of Austrian banks subsided in the first half of 2018.** The common equity tier 1 (CET1) capital ratio of Austrian banks was 15.1% at the end of both the first and second quarters of 2018, slightly above the EU average of 14.9% (this figure refers to the first quarter). Although Austrian banks increased their capital in absolute terms, risk-weighted assets also grew, driven by a pickup in loan growth in Austria and in CESEE.

Chart 3

## Profitability and capitalization of banks




*Source: OeNB, ECB.*

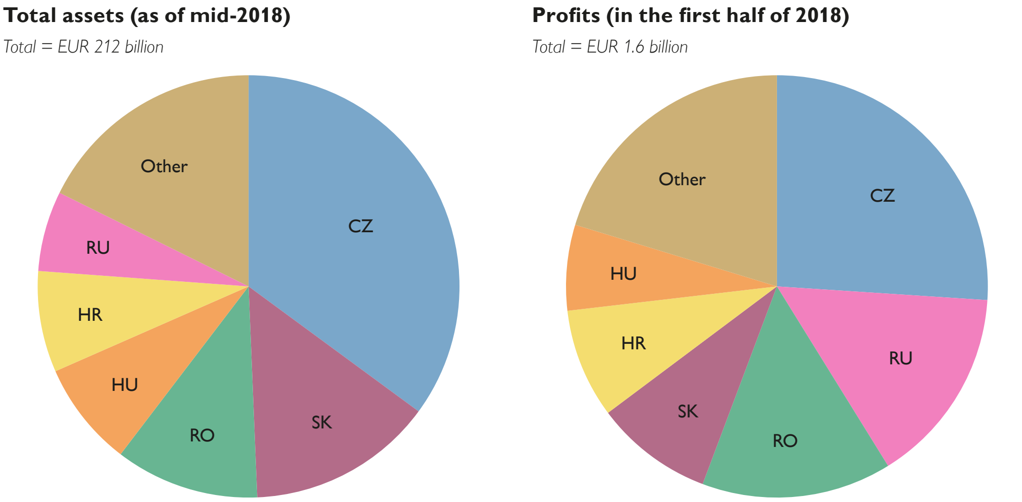
**After several years of restructuring, activities of Austrian banking subsidiaries in CESEE are fairly concentrated, albeit in EU Member States.** Over a third of these subsidiaries' total assets are located in the Czech Republic. When assets in Slovakia, Romania, Hungary and Croatia (in descending order) are added, these five countries account for over three-quarters of the total. The picture is similar for profits in the first half of 2018, even though the Russian host market gains in importance due to its high return on assets: Subsidiaries in the Czech Republic account for slightly over one-quarter, and when Russia, Romania, Slovakia and Croatia are added, these five countries account for nearly three-quarters of all profits.

**Austrian banking subsidiaries in CESEE earned EUR 1.6 billion in the first half of 2018, aided by continued loan growth and net provision releases.** These profits were 3.6% higher in year-on-year terms and translate into a 1.5% annualized return on average assets. While the main source of operating income, i.e. net interest income, was higher due to loan growth (with the net interest margin remaining broadly flat), lower trading income as well as higher operating costs meant that operating profits were virtually unchanged year on year. The release of loan loss provisions helped push profits higher, with net provision releases in nearly three quarters of all CESEE host markets.

**The asset quality of all loans granted by Austrian banking subsidiaries in CESEE continued to improve, while capitalization levels remained stable.** The decline of the NPL ratio to 3.9% as of mid-2018 marks the continuation of an established trend, while the coverage ratio for NPLs rose to 64%. It is worth noting, however, that a quarter of all gross loans granted by Austrian CESEE subsidiaries were issued to central banks, credit institutions and governments, i.e. counterparties that have negligible NPL ratios. The aggregated CET1 ratio of Austrian subsidiaries in CESEE remained stable at 15%.

Chart 4

**Total assets and profits of Austrian banking subsidiaries in CESEE**




*Source: OeNB.*

**Intra-group liquidity transfers to CESEE credit institutions rose substantially in the first half of 2018, while local funding positions remain sustainable.** These liquidity transfers amounted to EUR 26 billion in mid-2018. The increase was dominated by transfers to credit institutions in the Czech Republic, which make up two-thirds of the total, as the positive yield differential to the euro area continues to attract intra-group funds. At the same time, the local funding positions of all foreign subsidiaries of Erste Group Bank and Raiffeisen Bank International are considered to be sustainable (in accordance with the Austrian supervisory Sustainability Package[1]), and the aggregated loan-to-local stable funding ratio remained stable year on year. At 76%, the latter is substantially below 110%, which Austrian authorities consider to be an early warning threshold at the individual entity level.

**Macroprudential supervision has contributed substantially to reducing systemic risks in the past few years.** In July 2018, the FMSB adopted three recommendations[2] to the Austrian Financial Market Authority (FMA) concerning macroprudential capital buffers. First, the FMSB concluded that the systemic risk buffer is key to countering long-term, noncyclical systemic risks in the Austrian banking system. In particular, banks should be able to absorb potential shocks stemming from stress at other banks (systemic vulnerability), i.e. risks stemming from the risk-sharing mechanism in the financial system, and from reputational effects. Second, having re-evaluated the systemic importance of individual banks, the FMSB recommended that the buffer for other systemically important banks be applied to seven Austrian banks. In addition, the FMSB concluded that banks may also be systemically relevant at the unconsolidated level. Standard & Poor's upgrade of the Austrian banking system (Banking Industry Country Risk Assessment in

[1] *For more details, see https://www.oenb.at/en/financial-market/financial-stability/sustainability-of-large-austrian-banks-business-models.html.*

[2] *For more details, see https://fmsg.at/en/publications/warnings-and-recommendations/2018.html.*

May 2018) underpins the success of macroprudential activities. Austrian banks and, by extension, the Austrian economy may consequently benefit from lower risk premiums.

**In September, the FMSB decided to enhance its public communication regarding sustainable lending standards.** The share of a borrower's down payment/own funds in real estate financing should not be below a benchmark of 20%. Maturities at origination of new mortgage loans should exceed 35 years only in exceptional cases. In order to limit borrowers' debt service expenses (including interest payments), the FMSB expects banks to assess borrowers' income and living expenses in a prudent manner. Only regular, verified and sustained sources of income should be acknowledged in the loan granting process. As a benchmark, debt service expenses should not exceed 30% to 40% of a household's net income.

**Foreign currency loans in Austria continued to trend downward in 2018.** In the first half of 2018, the volume of foreign currency (FX) loans to domestic nonbank borrowers declined by more than 7% to EUR 21 billion. FX loans as a share of total loans fell to 6%. However, this legacy issue continues to be a concern, since around three-quarters of FX loans to households are bullet loans coupled with repayment vehicles. Due to unfavorable exchange rate movements and the underperformance of repayment vehicles, these loans may face a funding shortfall at loan maturity. At the end of 2017, the estimated total shortfall stood at EUR 4.4 billion or 29% of the outstanding loan volume. Therefore, the OeNB strongly recommends that banks and borrowers intensify their bilateral negotiations to find sustainable, tailor-made solutions in order to mitigate risks stemming from these loans. Austrian banks' CESEE subsidiaries also continued to reduce their FX loan volumes. In the first half of 2018, the outstanding FX loans to households and nonfinancial corporations fell by 4.2% to EUR 29.8 billion. The euro is by far the dominant currency in the FX loan segment of CESEE subsidiaries, accounting for 81% of total FX loans.

**The current benign market environment – featuring robust economic growth, improving credit quality and rising interest rates in important host markets – provides banks with a "Goldilocks economy" that may not persist in the long run.** For that reason, Austrian banks should consistently comply with sustainable lending standards and ensure that they have enough room for maneuver in the case of a future downturn. The OeNB therefore recommends that banks take the following measures to strengthen financial stability:

- safeguard sustainable profitability by enhancing structural efficiency in order to further increase capitalization levels and to invest in information technology;
- comply with the FMSB's expectations regarding sustainable lending standards in real estate financing;
- continue to reduce nonperforming loans; and
- continue to comply with the supervisory minimum standards for foreign currency and repayment vehicle loans as well as the Sustainability Package.

Box 1

## Results of the 2018 OeNB LSI and system stress tests and of the EBA EU-wide stress test

***Over the last years stress tests have evolved into a standard tool employed by different stakeholders that serves various purposes.*** *Central banks tend to take a system-wide view when assessing the implications of various scenarios for financial stability.[1] Bank supervisors use stress tests to identify risks and determine capital requirements and expectations within the Supervisory Review and Evaluation Process (SREP).[2] The OeNB conducts annual stress tests for all Austrian banks under its legal mandates for banking supervision and financial stability assessment. Stress tests are also performed at the European level. As one lesson learnt from the last financial crises, the European Banking Authority (EBA) was mandated to initiate and coordinate EU-wide assessments.[3] The results of the 2018 stress test exercise, in which two Austrian significant institutions (SIs) participated, has recently been published by the EBA.[4]*

***Whereas the EBA/ECB setup requires active contributions from the participating banks (bottom-up approach), the OeNB runs its stress tests based on available reporting data (top-down approach).*** *This allows a full coverage of all Austrian banks and provides a solvency and liquidity perspective. Therefore, the OeNB's stress tests do not only support banking supervision but also provide a systemic perspective for the whole Austrian banking sector to facilitate an assessment of financial stability. In running its stress tests, the OeNB follows the stress test methodology developed by the EBA for the EU-wide stress test and makes targeted adjustments to account for the specificities of the Austrian banking sector. Such adjustments include an increased coverage of risks stemming from foreign currency loans, risks from participations in other banking entities and enhanced assumptions on the modeling of sight deposits.*

***Also in 2018, the OeNB conducted stress tests for the entire Austrian banking system, focusing on less significant institutions (LSIs).*** *Both the OeNB stress test and the EBA/ECB exercise are based on the same macrofinancial scenarios. The baseline scenario uses the ECB's December 2017 forecast, while the hypothetical adverse scenario, which was provided by the ESRB for this purpose, assumes a severe deterioration of the economic outlook over a horizon of three years. For Austria, it includes a contraction of GDP of 9.2 percentage points relative to the 2020 baseline projection or –2.7% versus the 2017 year-end level.[5] The shock to the Austrian real estate market under this scenario is significant: prices for residential real estate would drop by 33.3% (19.1% EU), prices for commercial real estate would drop by 26.3% (20.0% EU). This shock is driven by historical volatility and current valuation levels, with the latter explaining the more severe shock in Austria compared to the EU average. The shocks to other macro variables of the Austrian economy are more in line with or below the EU average, most notably unemployment, which would increase by 2.1 percentage points over three years versus the 3.0 percentage point increase in the EU average. The adverse scenario implies severe shocks to most CESEE countries as well: the aggregate GDP of CEE and SEE countries would decrease by 11.4 and 9.6 percentage points, respectively, versus the 2020 baseline projection. It is important to note that a stress test is a hypothetical "what if" analysis, not a forecast.*

*[1] Article 44c Federal Act on the Oesterreichische Nationalbank mandates the OeNB to maintain financial stability and reduce systemic risk "by analyzing the financial market facts relevant for financial stability and reducing systemic risk and by identifying threats to financial stability."*

*[2] Article 100 of the Capital Requirements Directive IV requires competent authorities (i.e. the ECB for the six Austrian significant institutions (SIs) and the FMA and the OeNB for the remaining less significant institutions (LSIs)) to carry out as appropriate but at least annually supervisory stress tests on institutions they supervise.*

*[3] Article 32 Regulation (EU) No. 1093/2010.*

*[4] http://www.eba.europa.eu/risk-analysis-and-data/eu-wide-stress-testing/2018/results.*

*[5] All subsequent figures related to the adverse scenario are available in the ESRB's document "Adverse macro-financial scenario for the 2018 EU-wide banking sector stress test" of January 2018, available on the EBA's website at http://www.eba.europa.eu/documents/10180/2106649/Adverse+macroeconomic+scenario+for+the+EBA+2018+Stress+Test.pdf*

***The results of the two Austrian SIs participating in the EU-wide stress test are in line with supervisory expectations, given the scenario and the methodological assumptions underlying this exercise.*** *Erste Group Bank (EGB) and Raiffeisen Bank International (RBI) report hypothetical post-stress common equity tier 1 (CET1) ratios of 8.5% and 9.7%, respectively, well above their results in the 2016 EU-wide stress test. However, while both banks have significantly improved their capitalization they are still lagging behind their peers compared to the EU-average. The full results including the underlying data are available on the EBA website.*[6]

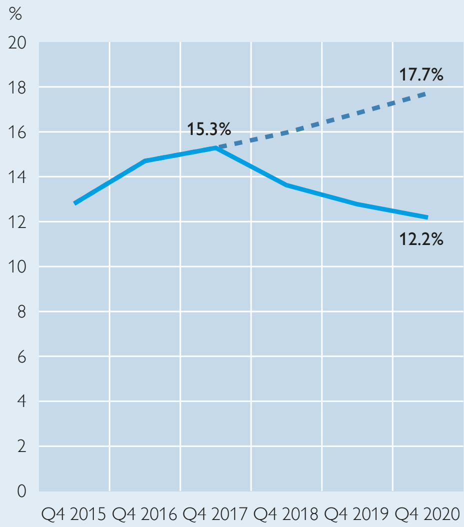
***The OeNB stress test shows that the Austrian banking sector has improved its risk-bearing capacity, with post-stress capital ratios above last year's stress test.***

*The aggregate Austrian banking sector started from a CET1 ratio of 15.3% at end-2017,*[7] *an improvement of 0.6 percentage points compared to end-2016. In the baseline scenario, this ratio improves to 17.7% by end-2020, while in the adverse scenario, it decreases to 12.2%, down by 3.1 percentage points versus the starting point.*

*Compared to the OeNB's 2017 results, this year's stress test reveals a moderately higher impact, which can be attributed to several partially offsetting factors. While risk factors are stressed more pronouncedly than in the past due to the more severe calibration of the adverse scenario, the overall economic environment – i.e. the baseline scenario – has improved considerably. Therefore, the adverse scenario unfolds from a better starting position than last year, resulting in better bank profitability, which provides a bigger cushion against losses incurred in the adverse scenario.*

Chart 1

**CET1 ratio of the Austrian banking system**




*Source: OeNB.*

*Credit risk is still the most important risk factor for Austrian banks by far; the 2018 stress test's adverse scenario generally translates into more pronounced shocks to PDs (probabilities of default) compared to last year, but shocks to LGD (loss given default) parameters are slightly lower than last year. This is despite the substantial shock the adverse scenario implied for Austrian real estate prices as banks only incur losses when they must foreclose and sell real estate collateral, i.e. when borrowers actually default on their mortgages. The shock to unemployment in Austria – a more important driver than the general GDP shock, specifically for mortgage default rates – is less pronounced over the three-year scenario, contributing to the lower LGDs. In addition, risks from foreign currency loans have been reduced further, and banks have continued to reduce NPLs, which overall results in credit losses that are comparable to those in last year's OeNB stress test.*

***Overall, both exercises confirm that banks should continue their efforts to improve their capital base.*** *The OeNB's stress tests reveal that the Austrian banking system has further improved its risk-bearing capacity. These results are confirmed by the EU-wide stress test carried out by the EBA. However, the stress test outcome also needs to be interpreted within the context of the current positive economic conditions and policy measures taken over the last years, both of which contributed to an extremely benign environment of historically low credit risk parameters and the availability of ample central bank liquidity. To be able to successfully weather less favorable conditions and to be prepared for unexpected events, banks should therefore continue their efforts to further improve their structural efficiency and capitalization.*

[6] *http://www.eba.europa.eu/risk-analysis-and-data/eu-wide-stress-testing/2018/results.*

[7] *The system-wide 2017 year-end CET1 ratio in this section deviates from the one in other parts of this report due to a slightly different composition of the sample of banks that were subjected to the stress test.*