

Management summary

International macroeconomic environment: global growth gaining strength despite subdued mid-term outlook

Macrofinancial conditions and inflation have improved in both advanced and emerging economies amid monetary stimulus from central banks, intensifying international trade and rising commodity prices. The medium-term outlook, however, remains subdued for advanced economies as well as commodity exporters, and the balance of risks remains tilted to the downside given geopolitical uncertainty.

In CESEE, economic conditions were generally solid in 2016. The EU Member States in the region experienced strong economic momentum based on domestic demand and benefiting from benign labor market and wage developments. In Russia and Ukraine, the economic situation also improved, while in Turkey growth decelerated. Euro-denominated government bond spreads for Eastern Europe remained notably below the respective figures for other emerging market regions and – despite some volatility – trended down from their peak registered in the aftermath of the Brexit vote in the U.K. Reflecting solid general economic conditions in an environment of low interest rates, growth of domestic credit to the private sector gained momentum, while bank profitability improved in most countries.

Corporate and household sectors in Austria: debt levels remain low while interest rate risk persists

In 2016, Austria overcame a four-year period of weak GDP growth. The recovery in investment increased the financing needs of nonfinancial corporations. While internal financing remained firms' most important and most stable source of funds, their recourse to external

financing picked up in 2016. Roughly two-thirds of total external financing was raised through debt, the maturity structure of which continued to shift toward long-term instruments. This held true in particular for bank loans. While long-term loans by Austrian MFIs accounted for almost one-third of all long-term debt financing, short-term bank loans were reduced significantly, as firms continued to have substantial liquidity at their disposal. Household loans expanded at a steady pace, mostly driven by housing loans. Still, housing loan growth remained moderate compared to, e.g., pre-crisis growth rates or residential property price developments. The latter continued their upward trend in Austria in 2016, although house price growth abated somewhat over the course of the year.

Historically low bank lending rates, reinforced by the high share of variable rate loans, continued to support the current debt-servicing capacity of the corporate and household sectors. Although both enterprises' and households' recourse to variable rate loans shrank in 2016, both sectors are still subject to considerable interest rate risks. Likewise, despite a substantial decrease in past years, the still elevated share of foreign currency loans in the total stock of lending remains a legacy risk. However, household-level data suggest that a large number of variable rate as well as foreign currency loan debtors have adequate wealth to cover their debt obligations.

Austrian financial intermediaries: banks post strong profits in 2016 amid weaker operating results

Austrian banks stepped up their structural adjustment efforts in 2016 and booked strong profits, propelled by a significant reduction in risk provisioning. The formation of new problem loans has

slowed, as the economies in Austria and in CESEE started to recover and the reduction of nonperforming loans made further progress, especially in CESEE. This positive bottom line trend masks a weakening of underlying operating profits, however, as low interest rates and rising operating expenses continue to take their toll.

Regarding its risk-bearing capacity, the Austrian banking system substantially increased its capital ratios in 2016, as profits were retained and UniCredit Bank Austria AG restructured its CESEE business and Raiffeisen Zentralbank Österreich AG merged with Raiffeisen Bank International AG. Furthermore, banks' liquidity position continues to be solid and intra-group liquidity transfers to CESEE have declined further.

Real estate-induced systemic risks remain subdued for Austrian banks, as lenders have broadly adhered to sustainable lending standards. Nonetheless, future developments require continued supervisory attention.

Finally, the volume of foreign currency loans has continued its long-running decline in Austria and CESEE, as policy measures proved effective. Notwithstanding these positive developments, legacy issues continue to be of concern and warrant close monitoring.

Recommendations by the OeNB

The consolidation process in the Austrian banking sector gathered pace in the last years and led to visible adjustments in 2016. Despite improved profitability, there is no room for complacency, however, as very low risk costs still need to prove their sustainability and operating profitability remains under pressure.

Ensuring cost efficiency, risk-adequate lending rates and strong, sustain-

able and retained profits is essential for a stable banking system. These factors support the internal build-up of capital which is essential for covering loan defaults and allows investing into the (digital) future. A banking system with strong profitability and a high risk-bearing capacity hence contributes to the crisis-resilient provision of credit and a positive economic environment.

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

- Austrian banks' profitability requires a sustainable increase in operating efficiency, especially in the domestic business. In CESEE, banks should continue their efforts to resolve the remaining nonperforming loans.
- Sustainable lending standards in real estate lending must be consistently complied with to prevent the build-up of systemic risks and speculation in residential real estate lending.
- Despite strong improvements in the year 2016, further capital strengthening remains crucial for the Austrian banking system given the still elevated volume of nonperforming loans (especially in CESEE) and in order to ensure resilience against global downside risks.
- Banks should comply with the enhanced FMA Minimum Standards regarding foreign currency and repayment vehicle loans (in force since June 2017) and continue to fulfill the sustainability package.
- Furthermore, banks should continue to prepare for upcoming requirements regarding their liquidity situation and their loss absorption capacity. Additionally, the revised EU Payment Services Directive and new international financial reporting standards require banks' attention.