Management Summary

Search for Yield in the Financial Markets Continues

After a slight deceleration in 2013, the global economy has gradually recovered. While the economic dynamics in emerging economies remained largely unchanged amid uncertainties and tighter financial conditions, growth in the industrialized countries picked up, although in early 2014 the ongoing recovery in the U.S.A. lost some momentum. In the euro area, following six consecutive quarters of contraction, economic output began to expand again in the second quarter of 2013, though at a moderate pace. Inflation continued to decrease in the first months of 2014, reflecting still large output gaps as well as a recent decline in commodity prices.

As three EU countries successfully exited their support programs in late 2013 (Ireland) and 2014 (Spain and Portugal), the sovereign debt crisis abated. The reduction of the perceived credit and country risks contributed to a further compression of risk premiums on euro area bonds in the first months of 2014 amid an ongoing search for yield. At the same time, financial market developments in Central, Eastern and Southeastern Europe (CESEE) were driven by the U.S. Federal Reserve System's "tapering" of the bond purchases it had conducted as part of its quantitative easing policy and the geopolitical tensions caused by the situation in Ukraine. Russia, Turkey and Ukraine were affected in particular and experienced capital outflows and pressure on domestic currencies whereas the impact on the other CESEE countries has been broadly contained so far.

Economic conditions in the CESEE region improved somewhat in the second half of 2013, benefiting from more favorable economic activity in the euro area and an incipient recovery of domestic demand. However, improving economic activity was not accompanied by livelier loan dynamics. Growth of domestic credit to the private sector remained muted, even showing a downward trend in several countries. Credit quality continued to be weak, with nonperforming loan (NPL) ratios remaining elevated throughout the region, but at least showing some signs of improvement in most countries in 2013. Bank profits remain subdued and have declined in most CESEE countries, but local banking sectors are still well capitalized.

Debt Servicing Capacity of Austrian Businesses and Households Improved

In the wake of the muted expansion of global economic activity, Austria's economy began to recover moderately in the second half of 2013. Corporate profitability picked up slightly and thus only marginally strengthened the internal financing potential of Austrian nonfinancial corporations. At the same time, external financing activities of enterprises remained subdued, reflecting ample internal liquidity as well as low financing needs for investments. About 60% of the external financing obtained by nonfinancial corporations in 2013 came in the form of equity, mostly unquoted shares and other equity instruments acquired by foreign strategic investors, whereas bank loans were of minor importance. Bonds remained a major source of financing in 2013, primarily for larger companies.

Overall, financing conditions for enterprises and households remained favorable, despite somewhat tighter terms and conditions. Low interest rate levels supported firms' and households' ability to service their debt, as did the reduction of both corporate and household debt levels in 2013. How-

ever, an above-average share of variable rate loans might pose risks if interest rates were to rise again.

Households' financial investment remained subdued in 2013. The low interest rate environment fostered a shift to short-term deposits. After recording (unrealized) valuation gains in their securities portfolios in 2012, Austrian households registered (equally unrealized) valuation losses in 2013.

Prices in the Austrian residential property market continued to rise, but the price increases abated somewhat in the first quarter of 2014. Though growth rates of mortgage loans remained moderate, developments of residential property prices certainly merit closer attention from a financial stability and macroprudential perspective.

One-Off Effects Caused Decline in Bank Profits

The incipient economic recovery and further strengthening of the regulatory and supervisory framework marked the year 2013 for the European banking system. Austrian banks nevertheless faced noticeable headwinds. Low interest rate margins as well as one-off effects resulted in the first system-wide loss in recent history. The corresponding net loss after tax and minority interests amounted to about EUR 1 billion, but even without one-off effects, net profits would have been considerably below precrisis levels. Net profits of Austrian subsidiaries in CESEE increased by 5.8% in 2013, but were almost entirely eroded by write-downs of goodwill linked to CESEE subsidiaries. Moreover, compared to precrisis years, profits in CESEE became ever more concentrated, implying a growing reliance on relatively high profits from just a few countries.

While the credit quality situation in Austria remained fairly benign in 2013, Austrian banking subsidiaries in CESEE – although operationally still profitable – were facing considerable loan quality issues in several countries. This trend can be explained by two factors: the inflow of NPLs continued and credit demand has remained sluggish overall.

Austrian banks continued to strengthen their capital ratios through a combination of capital increases, e.g. via rights issues and retained earnings, and reductions in risk-weighted assets. After a low in the second quarter of 2008, the aggregate tier 1 capital ratio and the capital adequacy ratio of all Austrian banks continued to improve and reached 11.9% and 15.4%, respectively, by end-2013. Nevertheless, there is still market pressure for higher capital ratios, as the gap between Austrian banks and banks in the international business model peer group has widened. In order to strengthen the structural profitability situation and capital generation capacity of banks, it needs to be ensured that banks with an unsustainable business model can leave the market without jeopardizing its stability. This objective has been at the center of recent European legislative initiatives.

Before the Single Supervisory Mechanism (SSM) becomes fully operational later this year, the ECB – together with the national competent authorities – is carrying out a comprehensive assessment of significant banking groups, including six from Austria. This includes an asset quality review and a stress test to promote transparency, dispel lingering concerns about loan quality and provisioning and thereby improve confidence in financial market stability.

Recommendations by the OeNB

The OeNB acknowledges the Austrian financial sector's progress toward improving financial stability at home and

in host markets and recommends further strengthening the sustainability of business models.

- Banks should continue strengthening their capital levels – by retaining earnings and/or tapping capital markets – to close the gap between them and their international peers.
- Given the persistent pressure on profitability, banks should strive to address structural issues and improve their cost efficiency.
- Risk-adequate provisioning and coverage policies should be further pursued to deal with loan quality issues.
- Banks should continue fulfilling the supervisory minimum standards relating to foreign currency loans and loans with repayment vehicles.
- Banks should strive for sustainable loan-to-local stable funding ratios at the subsidiary level and for the risk-adequate pricing of liquidity transfers.
- Banks should prepare for increased market pressure for disclosure of liquidity coverage ratio (LCR) data; both investor communications and liquidity risk management, especially at smaller banks, need to be adapted.
- Banks and insurance undertakings should ensure high standards of risk management so that risks are properly addressed and effectively controlled; they should also proactively prepare for contingency situations.
- Insurance undertakings should proactively prepare for Solvency II.