Corporate and Household Sectors in Austria: Debt Servicing Capacity Slightly Improved

Corporate Debt Decreased in 2013

Austrian Economy Gained Momentum

Corporate investment picks up

In the second half of 2013, Austria's economy overcame stagnation and slowly began to recover moderately in the wake of the revival of global activity. Exports gained momentum in the course of 2013, primarily driven by demand from countries outside the euro area. Order books began to fill up, and business confidence increased. But despite the significant improvement in sentiment, gross fixed capital formation decreased and destocking continued. Capacity utilization rose slightly, although it remained below its long-term average. Demographic factors put upward pressure on residential construction, whereas other construction spending fell in real terms.

Profits recover in 2013

Corporate profitability picked up slightly in 2013, benefiting from the gradual recovery of economic conditions and from falling raw material prices. Moreover, low interest rates supported the nonoperational component of corporate profitability. After dropping by 0.7% in 2012, the gross operating surplus of nonfinancial corporations grew by 0.8% in nominal terms (see chart 7), which is equivalent to a further drop in real terms by 0.8%. However, while in nominal terms gross operating surplus had surpassed precrisis levels already in 2011, in real terms as well as in relation to gross value added of the corporate sector (i.e. the gross profit ratio), it has remained below its precrisis levels. By the fourth quarter of 2013, the gross profit ratio had been on a downward trend for ten consecutive quarters, falling to 39.3% and thus below the levels registered at the height of the crisis.

Further Reduction of External Financing

Mirroring weak earnings growth, the internal financing potential of the Austrian corporate sector grew only

Chart 7

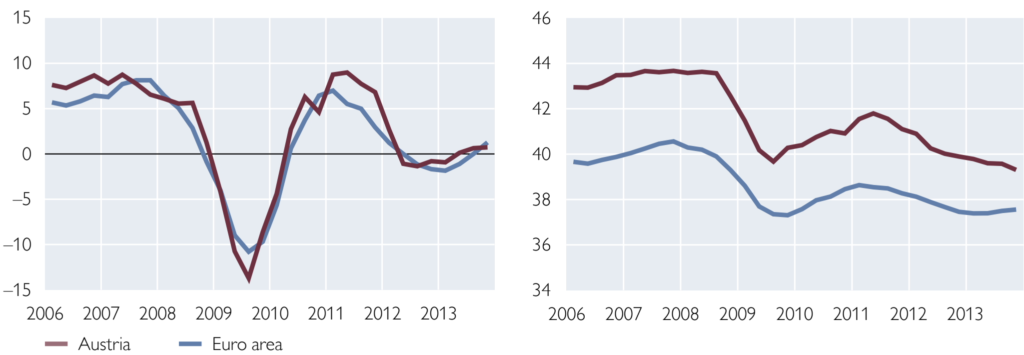
Profitability of Nonfinancial Corporations

Gross Operating Surplus

Annual change in %, four-quarter moving average

Profit Ratio

Gross operating surplus in % of gross value added, four-quarter moving average



Source: Statistics Austria, ECB.

moderately. Measured as the sum of changes in net worth and depreciation, the corporate sector's internal financing increased by 3.5% in 2013. At the same time, external financing of nonfinancial corporations remained subdued in 2013 and at EUR 12.8 billion[1] even fell below the already very low 2012 value according to financial accounts data. On the one hand, this distinctive slowdown might reflect ample liquidity on the asset side of the balance sheet, on the other hand, financing needs for corporate investment increased only gradually. Thus, as in 2012, the ratio of internal financing to external financing was roughly 1:1 in 2013.

Subdued Growth of Bank Loans

Domestic bank loans made almost no contribution to external financing of the corporate sector in Austria in 2013. According to MFI balance sheet statistics, the annual growth rate of Austrian bank lending to nonfinancial corporations (adjusted for reclassifications, valuation changes and exchange rate effects) was 0.3% in nominal terms in April 2014 (see chart 8), implying a real decrease.[2] As enterprises substituted short-term loans with long-term loans because interest rates were low, this slowing was mainly driven by the decline in lending at shorter maturities (up to one year), while loans with longer maturities – on which loan growth had already rested in the past years – continued to record positive growth. However, despite this deceleration, the Austrian corporate sector has so far escaped the reduction witnessed in the euro area as a whole, where the nominal growth rate has been negative since the first half of 2012.

Both supply- and demand-side factors may have played a role in recent loan developments. The results of the euro area bank lending survey (BLS) for Austria show that Austrian banks tightened their credit standards for corporate loans slightly but continuously between the second half of 2011 and the first half of 2013 (and again somewhat in the first quarter of 2014). Large firms were more affected than small and medium-sized enterprises (SMEs). Factors related to banks' capital position as well as heightened risk concerns were behind these tighter lending policies. At the same time, the banks surveyed in the BLS noted a slight decline in corporate loan demand, again primarily from large companies. On the one hand, this can be explained by companies' lower funding requirements for fixed investment. On the other hand, companies still relied to a considerable extent on internal sources of financing, with sizeable amounts of cash available to finance their activities.

Substitution of short-term with long-term loans

Tighter credit standards affected not only volumes but also terms and conditions of bank loans. Stronger risk discrimination by banks resulted in wider margins on riskier loans, but margins on average loans were also enlarged, in part dampening the reduction of financing costs stemming from monetary policy easing. Thus, the pass-through of the five ECB key interest rate cuts implemented between November 2011 and September 2013 (by 0.25 percentage points each) was incomplete. Corporate lending rates moved within a very narrow band from the beginning of 2013 and were virtually at the same level in April 2014 as at the end of 2012. While interest rates

Lending rates remain low

[1] *Adjusted for foreign-controlled holdings in special purpose entities (SPEs).*

[2] *At the cutoff date, financial accounts data were available up to the fourth quarter of 2013. More recent developments of financing flows use data from the MFI balance sheet statistics and the securities issues statistics.*

fell for all loan volumes and maturities, the decrease was more pronounced for short-term loans and for larger loans (with a volume of more than EUR 1 million).

Bonds Remain a Major Source of External Finance

A shift toward market-based debt issuance may also have played a role in the muted demand for bank loans. Although the amount of new bonds issued by Austrian nonfinancial corporations was almost 40% lower than in 2012, new bonds continued to play a significant role for corporate finance, contributing one-quarter to the external financing of enterprises in 2013. In March 2014, the nominal annual growth rate of new bond issues slowed down to 1.3% according to the securities issues statistics, but still exceeded that of other financing instruments. While recourse to bonds undoubtedly broadens the corporate sector's financing sources, such funding is available only to a limited number of mostly larger companies. Moreover, a considerable part of corporate bonds in Austria is issued by corporations that are majority-owned by the public sector.

Decreasing bond yields

One major factor for this increased reliance on bond financing was the development of funding costs. Between September 2013 and May 2014, yields on AA-rated corporate bonds contracted by 68 basis points and yields on BBB-rated bonds by 94 basis points, mainly because government bond yields fell, reflecting increased investors' risk appetite. In a longer-term perspective, yields on BBB-rated bonds were 382 basis points and AA-rated bond yields were 254 basis points lower than in October 2011.[3]

Stronger Recourse to Trade Credit

The net volume of trade credit drawn by domestic companies increased from EUR 0.8 billion to EUR 2.6 billion in 2013. One reason might be that as a key element of firms' working capital, trade credit develops broadly along the business cycle. Also, given its relatively informal form and comparatively high cost, increased recourse to trade finance might be an indication that tighter bank credit standards induced firms to seek this kind of finance.

High Contribution of Equity to External Financing

Stock market financing still affected by the crisis

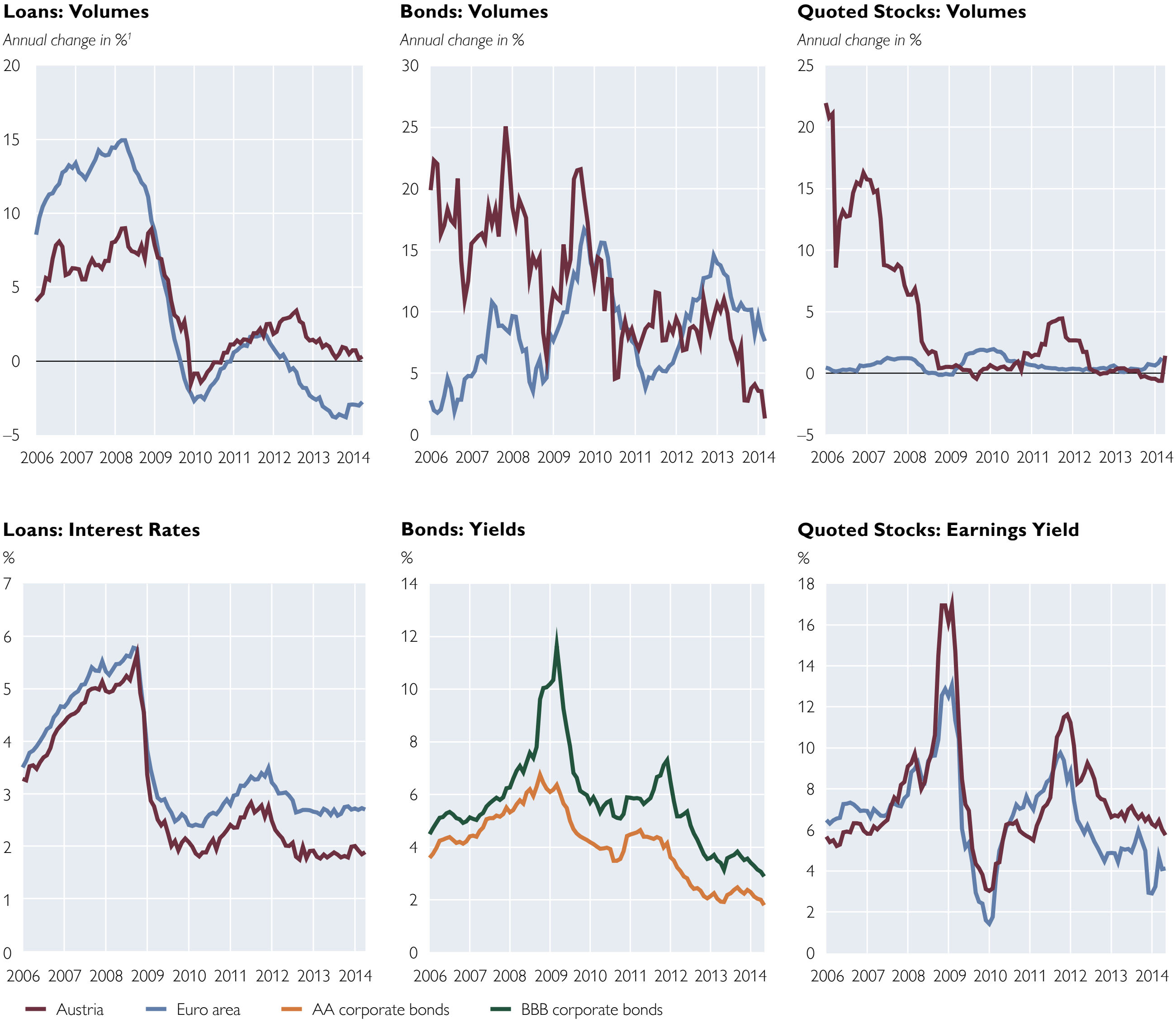
In 2013, EUR 7.7 billion or about 60% of the external financing of nonfinancial corporations came in the form of equity. All of the equity raised in 2013 were unquoted shares and other equity instruments, mostly from foreign strategic investors. Financing via listed stocks continued to be affected by the crisis and shrank by EUR 49 million in 2013. In the first four months of 2014, the net issuance of capital on the stock exchange – netting new listings, capital increases and delistings – amounted to EUR 1.5 billion according to securities issues statistics, which was mainly due to the listing of a spin-off of an already listed property company.

Measured by the earnings yield (i.e. the inverse of the price-to-earnings ratio) of the ATX, the cost of raising capital on the Austrian stock market, after having already fallen slightly in 2013, continued to decline in the first five months of 2014 from 6.6% in December 2013 to 5.7% in May 2014. But as the volume of new issues was very low, this was mostly a notional figure.

[3] *Euro area figures are used here, as no time series is available for yields on Austrian corporate bonds.*

Chart 8

Key Elements of Nonfinancial Corporations' Financing: Volumes and Conditions



Source: OeNB, ECB, Thomson Reuters, Wiener Börse AG.

[1] *Adjusted for reclassifications, changes in valuation and exchange rate effects.*

Debt Servicing Capacity of the Corporate Sector Improved Slightly

Mirroring the strong slowdown in external financing, corporate debt (in terms of total loans and bonds) sank by 0.7% in 2013. In net terms, enterprises continued to substitute short-term financing, which had diminished for the past two years in absolute terms, with long-term funding, which stalled in 2013. At the end of 2013, long-term funds already accounted for more than 85% of outstanding debt. The negative growth rate of debt together with the moderate expansion of corporate earnings resulted in an 8 percentage point fall of the ratio of corporate debt to gross operating surplus to 525% in 2013, entailing a slight improvement in the sustainability of corporate debt (see chart 9). Never-

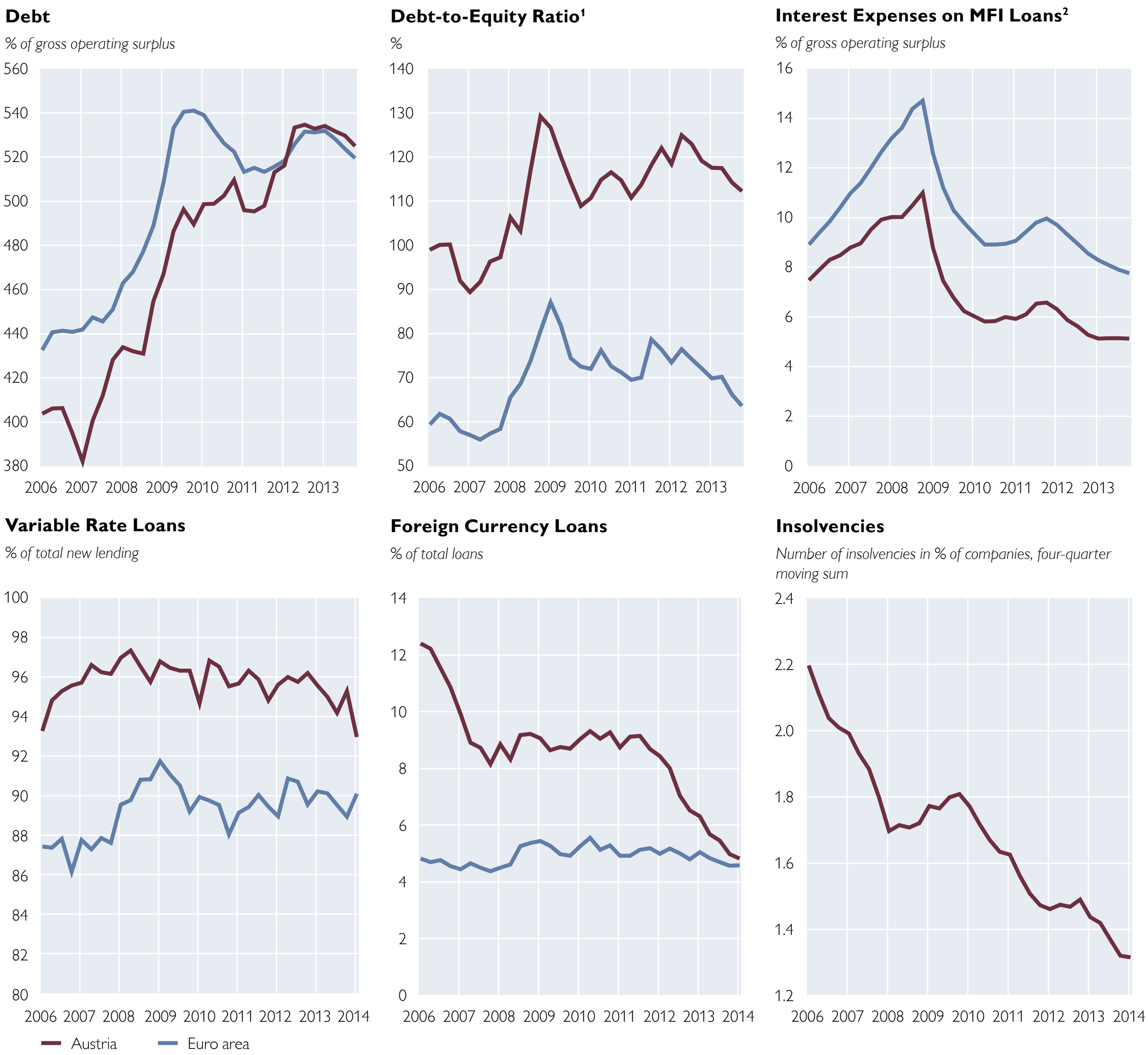
Debt-to equity ratio decreases slightly

theless, the ratio of corporate debt to gross operating surplus remained considerably above its precrisis levels, implying that the rise in the vulnerability of the corporate sector in the years 2007 to 2009 has not yet been reversed.

Likewise, the debt-to-equity ratio came down by 7 percentage points to 112% in 2013. The fact that both the debt-to-income ratio and the debt-to-equity ratio are currently higher in Austria than in the euro area highlights the importance of debt financing in Austria but also reflects the ongoing deleveraging of the corporate sector in a number of euro area countries. The

Chart 9

Risk Indicators for Nonfinancial Corporations



Source: OeNB, ECB, Eurostat, KSV 1870.

[1] *Austria: equity without SPEs.*
[2] *Euro area: euro loans only.*

share of equity in the Austrian corporate sector's total liabilities rose slightly from 42.6% to 43.9% in 2013.

The low interest rate environment continued to support firms' ability to service their debt. In 2013, the fraction of corporate earnings (gross operating surplus) that had to be spent on interest payments for bank loans declined somewhat further. This decline was reinforced by the very high share of variable rate loans in Austria. While Austrian companies therefore currently have lower interest expenses than their euro area peers, their exposure to interest rate risk is higher. Thus, a rebound of the interest rate level might create a noticeable burden, especially for highly indebted companies, even if a rising debt service burden might eventually be partially offset by the positive impact of an economic recovery on firms' earnings.

Variable rate loans imply interest rate risk

The exposure of the corporate sector to foreign exchange risk, which was never as high as that of the household sector, was reduced further, as the share of foreign currency loans declined to 4.8% in the first quarter of 2014 (more than 4 percentage points below the 2010 level), and thus was only ¼ percentage point higher than in the euro area.

The insolvency ratio (number of corporate insolvencies in relation to the number of existing companies) declined until the first quarter of 2014 (based on a moving four-quarter sum to account for seasonality). This may be due to the moderate path of debt financing and the low interest rate level (which makes debt servicing easier even for highly indebted companies). Furthermore, it may also be attributed to the fact that insolvencies usually lag cyclical movements. Insolvency liabilities, however, almost doubled in the period under review due to a large-scale bankruptcy.

Falling number of insolvencies

Households' Financial Investment Decreases Further

Real Income of Households Declined in 2013

Although the economic recovery set in only gradually, employment augmented markedly in 2013 and early 2014. At the same time, unemployment increased because labor supply, in particular labor from abroad, rose. Yet real disposable household income fell in 2013, mainly reflecting weak real wage growth as well as a marked decline in property income. This reduction in turn dampened private consumption, and spending on durable consumer goods even decreased in real terms. At the same time, the saving ratio diminished to 6.6% in 2013. On the one hand, the low interest rate environment may have reduced the attractiveness of saving. On the other hand, the decline in the saving ratio may reflect the muted development of property income, as this portion of disposable income is more likely to be saved than labor income.

Further drop in the saving ratio

Financial Investment of Households Fell by One-Third in 2013

In parallel with the drop in the saving ratio, financial investment by households[4] continued to recede in 2013 and at EUR 6.9 billion amounted to little more than one-third of the precrisis peak value recorded in 2007 (see chart 10).

More than 40% of households' financial investment went into cash and deposits with banks. Looking at the

Shift to cash and bank deposits with shorter maturities

[4] *Nonprofit institutions serving households are not included here.*

maturity structure of bank deposits, deposits with agreed maturity declined both in 2013 and in 2014 so far, whereas large inflows into overnight deposits were recorded. This shift to cash and shorter maturities suggests a high liquidity preference of households and reflects the low opportunity cost resulting from low interest rates. A breakdown by types of deposit shows that demand deposits continued to grow and time deposits remained stable while savings accounts registered a net decrease. Deposits at building and loan associations, which rose by 1.3% in the first quarter of 2014, represented the only exception on the back of the comparatively attractive interest rates for building loan contracts.

(Unrealized) valuation losses

Capital market investment shrinks

Households' net financial investment in capital market assets fell to EUR 0.3 billion in 2013 (from EUR 0.9 billion in 2012). Households reduced their holdings of long-term debt securities but increased their portfolios of mutual fund shares. Additionally, there was a slight net inflow into direct holdings of foreign equities. This development reflected the search for yield in a low interest rate environment as well as the recovery of share prices in international markets in the course of 2013.

Foreign currency loans continue to decline

At EUR 2.0 billion, investment in life insurance contracts and pension funds still had a stabilizing effect on financial investment in 2013, accounting for more than one-quarter of financial investment in this period. However, a large share of inflows into these instruments was not the result of current investment decisions, but – given the long maturities and commitment periods – reflected past decisions. One key factor in this context is the demand for funded pension instruments; moreover, life insurance policies often serve as repayment vehicles for foreign currency bullet loans.

Austrian households registered (unrealized) valuation losses of EUR 1.4 billion in their securities portfolios in 2013. These losses were equivalent to 1.4% of their securities holdings at end-2012. While debt securities and mutual fund shares in the portfolios of Austrian households registered (unrealized) valuation losses, the increase in share prices in 2013 resulted in valuation gains of quoted stocks equivalent to 6.4% of households' holdings at end-2012. Taking financial investment, valuation losses and other changes[5] together, financial assets rose by EUR 6.8 billion in 2013.

Slight Increase in Housing Loan Growth

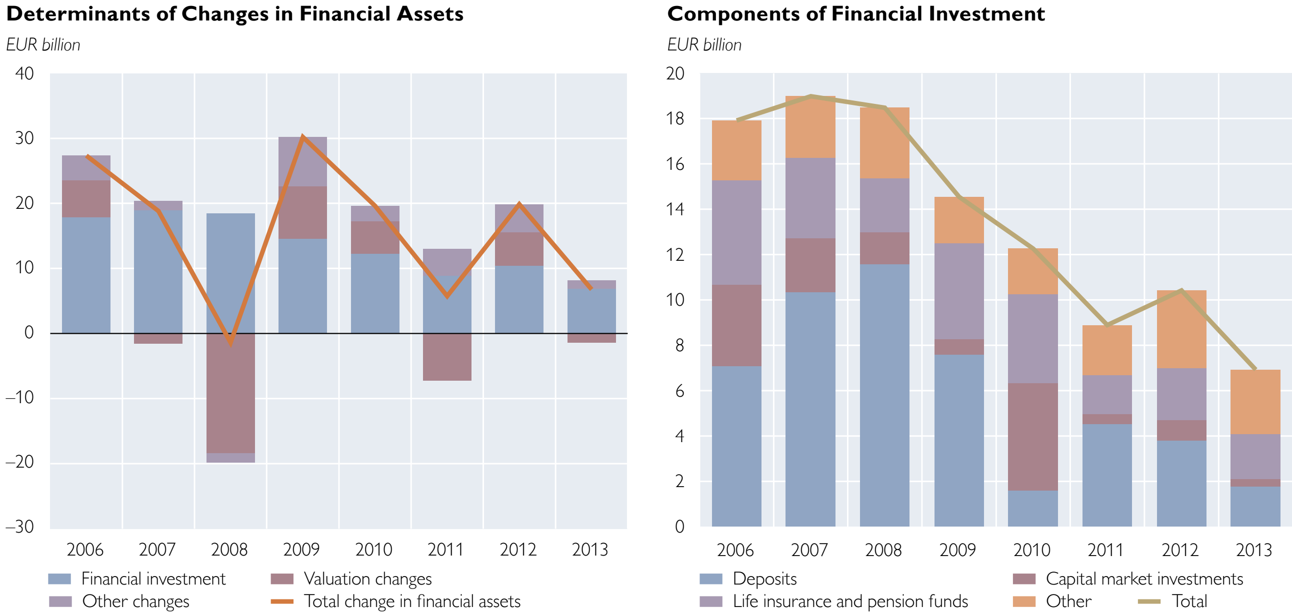
Growth of bank lending to households was subdued in early 2014 even if annual growth rates, which had contracted continually for almost two years, recovered slightly from mid-2013. In April 2014, bank loans to households (adjusted for reclassifications, valuation changes and exchange rate effects) increased by 1.3% in nominal terms.

A breakdown by currencies shows that euro-denominated loans were still expanding briskly (April 2014: 4.7%), while foreign currency loans continued to recede by double-digit rates – in April 2014, they had fallen by 10.2% year on year. Broken down by loan purpose (see chart 11), consumer loans as well as other loans contracted by 2.6% and 0.4% year on year, respectively, in April 2014. Housing loans grew by 3.0% year on year, and their growth rate has gained some momentum since

[5] *Mainly valuation losses in the net equity of households in life insurance investments, primarily fund-linked and index-linked life insurance.*

Chart 10

Changes in Households' Financial Assets



Source: OeNB.

mid-2013. The favorable financing conditions probably supported the growth of housing loans, and housing market indicators also pointed to an increase in credit demand. As housing prices continued to rise in Austria (see below), households may have needed more funding to purchase real estate. Although no current data on newly completed housing projects are available, the considerable rise in the number of residential building permits in 2013 (+15.8% over the previous year) suggests a rise in construction activity.

Financing conditions remain favorable

Loan conditions remained favorable. Interest rates for short-term loans (up to one year) stood at 2.83% in April 2014, 0.71 percentage points below their October 2011 level, reflecting the five key interest rate cuts between November 2011 and November 2013 and the associated decline in money market rates. Looking at data across the entire maturity band, interest rates on new housing loans stood at 2.34% in April 2014, which was 0.69 percentage points lower than the value recorded in October 2011. In the same period, interest rates on consumer loans dropped by 0.19 percentage points to 4.94%.

Households' Currency and Interest Rate Risks

Household debt slightly reduced

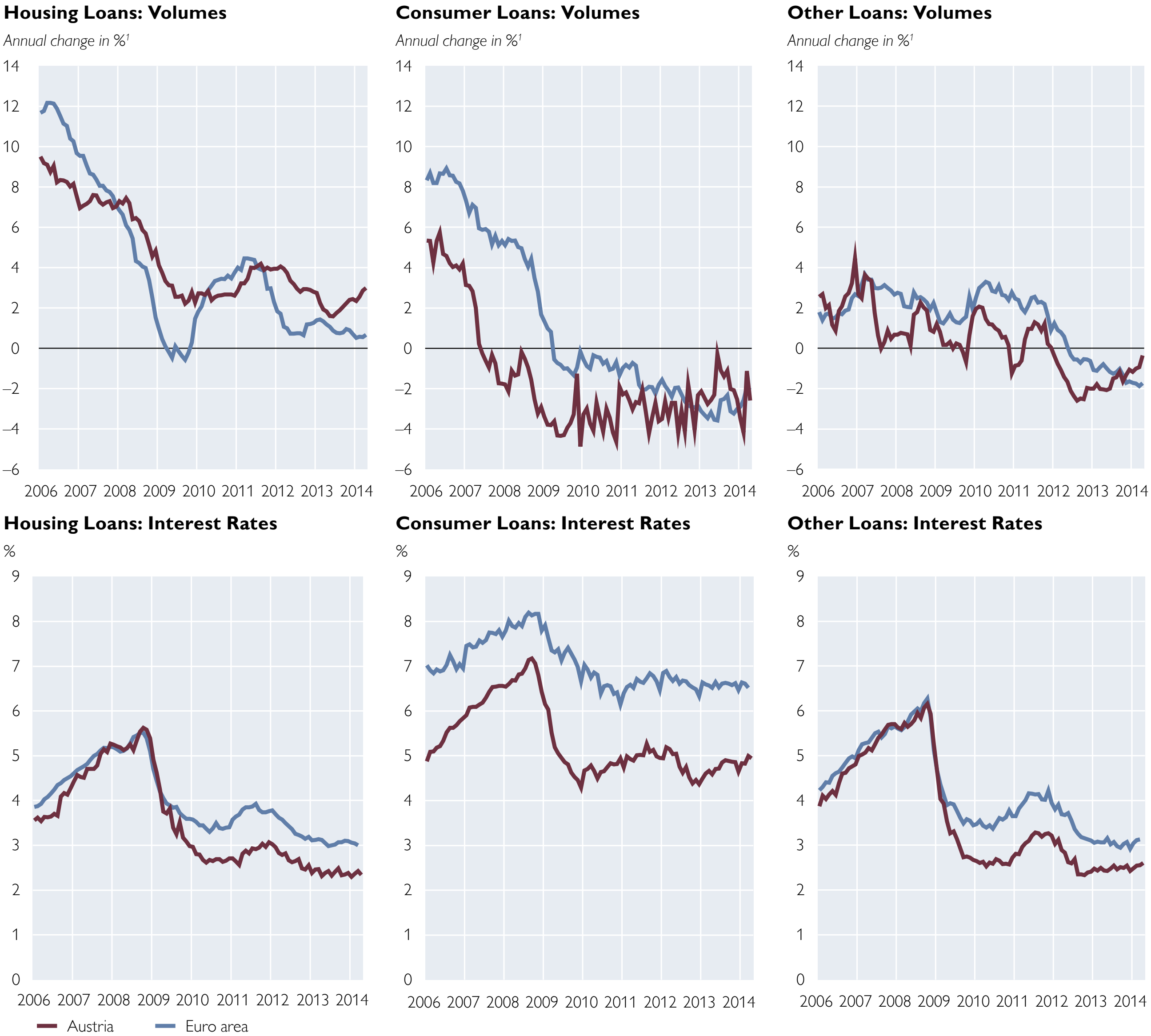
The indebtedness of Austrian households is rather low by international comparison. At the end of 2013, total household liabilities stood at EUR 168.0 billion according to financial accounts data, down by 0.4% in nominal terms from the 2012 year-end value. As a percentage of net disposable income, household debt shrank by 1.3 percentage points to 91.4% (see chart 12).

Interest expenses remain low

Given the combination of moderate debt growth and low interest rates, household interest expenses remained subdued. In 2013, they amounted to 2.0% of disposable income, about 2 percentage points less than in 2008, before interest rates began to fall. One factor that accelerated this decline was

Chart 11

MFI Loans to Households: Volumes and Conditions



Source: OeNB, ECB.

[1] *Adjusted for reclassifications, valuation changes and exchange rate effects.*

the high share of variable rate loans: In the first quarter of 2014, 87.4% of new loans[6] were granted with an initial rate fixation period of up to one year, a very high share by international comparison. Therefore, when the ECB lowered its key interest rates, lending rates in Austria were reduced at a faster rate than those in the euro area; in addition, retail rates in Austria have generally been below euro area rates in recent years. Loan quality may have also played a role, given the comparatively modest indebtedness of Austrian households.

[6] *Euro loans only.*

The still high proportion of foreign currency loans in total loans remains a major risk factor for the financial position of Austrian households. Although the share of foreign currency loans in total loans has fallen by more than 10 percentage points since 2008, 20.0% of the total loan volume to Austrian households were still denominated in foreign currency in the first quarter of 2014. The considerable reduction is a consequence of the Austrian Financial Market Authority's minimum standards for granting and managing foreign currency loans, which aim at substantially limiting new foreign currency lending to households. Almost 95% of the foreign currency loans outstanding were denominated in Swiss francs, around 5% in Japanese yen.

Foreign currency loans remain major risk

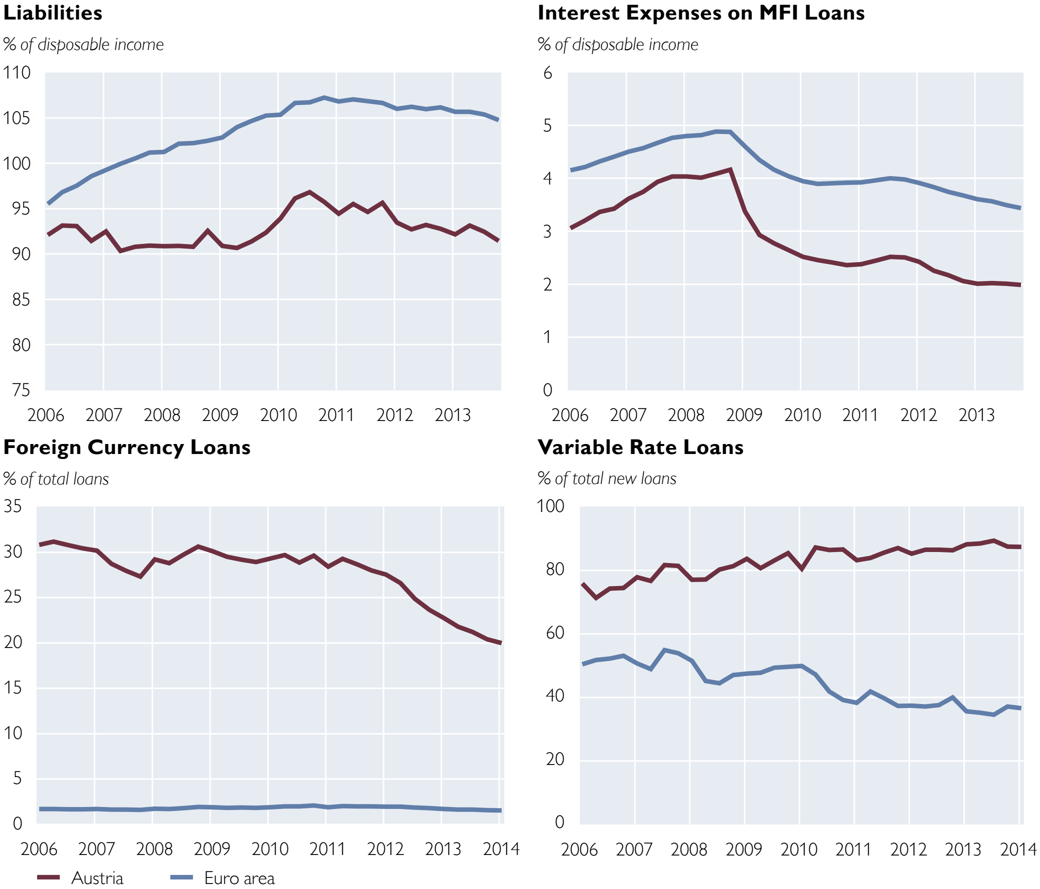
Residential Property Prices Continue to Rise

Rising overvaluation of property prices in Vienna

In the first quarter of 2014, the prices in the Austrian residential property market continued to rise, although the price increases abated somewhat. Price dynamics remained very heterogeneous across different regions. In Vienna, prices surged 8.1% year on year, implying ten consecutive years of house price hikes. In the first quarter of 2014, the

Chart 12

Household Risk Indicators



Source: OeNB, Statistics Austria, ECB, Eurostat.

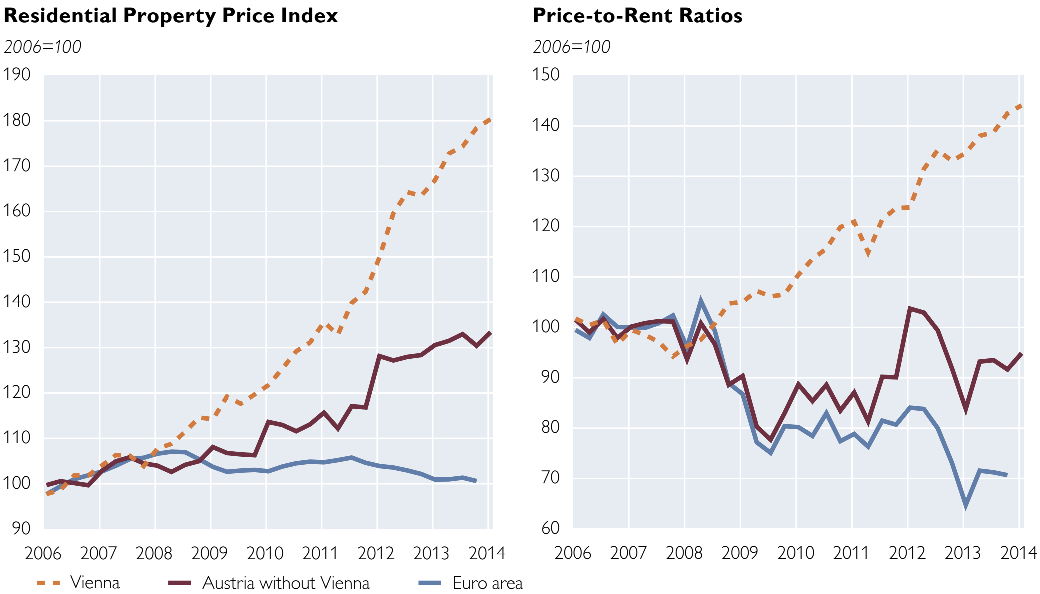
Note: Figures for the euro area reperesent only the interest rate expense on euro-denominated loans.

fundamental residential property price indicator of the OeNB[7] pointed to an increasing degree of overvaluation in property prices in Vienna (22%). The price increase in the rest of Austria has been considerably more moderate, amounting to 2.2% in the first quarter of 2014, and the fundamental residential property price indicator does not indicate any overvaluation. On aggregate, residential property prices in Austria increased by 40% between 2007 and the first quarter of 2014 (+22% in real terms, adjusted for HICP inflation) which contrasts with a slight reduction of residential property prices in the whole euro area (see chart 13).

From an investor's perspective, the rising relation of property prices to rents observed in Vienna indicates a decreasing yield on property investments. In part, the price increases in Austria reflect a catching-up, as prices had been virtually flat in the years before 2007. Other factors behind these price developments were increased demand due to immigration and possibly also a flight to real assets.

Chart 13

Residential Property Price Indicators



Source: OeNB, Vienna University of Technology, ECB, Statistics Austria.

[7] *See Schneider, M. 2013. Are Recent Increases of Residential Property Prices in Vienna and Austria Justified by Fundamentals? In: Monetary Policy and the Economy Q4/13. 29–46.*