

Management summary

In reaction to the COVID-19 pandemic, we have shortened the reports section of this edition of the Financial Stability Report and included a first assessment of the impact of the crisis on financial stability (from page 39). The reports section focuses on developments in 2019 and early 2020 (depending on data availability), with May 12, 2020, as the cutoff date for data. The cutoff date for the special report on the impact of the COVID-19 crisis was June 2, 2020. More recent news and updates on the COVID-19 crisis are continuously being published on our website (<https://www.oenb.at/Publikationen/corona.html>).

Austrian banks are resilient against external shocks as they enter the COVID-19 crisis

The pace of the global economy was slowing already in 2019, affecting growth in Austria and Central, Eastern and Southeastern Europe (CESEE), but the COVID-19 outbreak at the beginning of 2020 and the ensuing lockdown measures sent the world economy into a tailspin. Unprecedented monetary, financial and fiscal policy measures launched simultaneously all over the world helped stabilize market sentiment. For instance, the ECB responded to the crisis by adopting a wide-ranging set of measures that will help mitigate the economic and financial fallout of the pandemic. Nevertheless, market volatility remains high and risks to financial stability have been increasing.

During the slowdown in 2019, Austrian corporate profitability weakened, affecting both the resilience and the internal financing of Austrian nonfinancial corporations, whose use of external financing declined slightly as slower investment growth reduced their financing needs. Like previously, the bulk of external financing came in the form of debt. Thus, the debt-to-income ratio – which was still higher than before the onset of the financial crisis in 2008 – rose slightly further. In contrast, the debt-to-income ratio of households was slightly lower than during the financial crisis. The debt servicing capacity of both nonfinancial corporations and households was supported by the current low interest rate environment.

Loans by Austrian MFIs contributed almost half of nonfinancial corporations' external financing in 2019. Lending by Austrian banks to domestic nonfinancial corporations gained impetus due to crisis-related short-term funding needs from March 2020 onward, after having abated somewhat toward the end of 2019 and in the first two months of 2020. Households invested in capital market instruments encountered sizable (unrealized) valuation gains in 2019, but the sharp correction of financial asset prices due to the COVID-19 crisis brought about an erosion of valuations. Given that Austrian households are not heavily invested in the capital market, the recent volatility does not jeopardize financial stability in Austria.

Driven by mortgages and lending to the real estate sector, Austrian banks' annual loan growth accelerated in 2019. However, new housing loans are increasingly showing higher debt service-to-income and debt-to-income ratios, highlighting the importance of banks complying with the guidance on sustainable real estate financing issued by the Austrian Financial Market Stability Board (FMSB).¹

Austrian banks' profits declined slightly year on year, to EUR 6.7 billion, in 2019, which can be attributed to rising operating and risk costs that offset increases in the main sources of income. However, as cyclically low risk costs appear to have bottomed out, and cost inefficiencies persist, the COVID-19 crisis will weigh on the

¹ See <https://www.fmsg.at/en/publications/press-releases/2018/17th-meeting.html>.

sustainability of profits. Especially increasing provisioning needs due to deteriorating credit quality will take a toll on banks' profitability in 2020 and beyond.

The Austrian banking sector's common equity tier 1 (CET1) ratio had stood at over 15% before the COVID-19 crisis hit, as significant macroprudential capital buffers had been built up in time. The recently completed IMF Financial Sector Assessment Program (FSAP) also confirmed the resilience of Austria's banking sector, and the IMF-OeNB stress test showed that the sector can withstand severe macrofinancial shocks. Given the supervisors' strong recommendation that banks should be prudent in their profit distribution policies, Austrian banks have enough room for maneuver to continue providing their critical services to the real economy in Austria and in their host markets.

COVID-19 crisis increases financial stability risks

The COVID-19 crisis has led to a massive slump in the global economy, as companies reduced their activities or even closed down production, and consumption plummeted. To support firms' liquidity, a number of policy measures were implemented. In addition, central banks and banking supervisors acted to support banks' capacity of lending to the real economy. However, additional bank lending will increase corporate indebtedness, which could result in a growing number of defaults in the future. Compared to the great financial crisis, Austrian banks were more resilient when the COVID-19 crisis struck and supported lending to the real economy, thus being part of the solution of the current crisis. OeNB scenario analyses show that operating income will decline significantly and credit risk costs will be elevated over the coming years, but banks' strong capitalization can buffer these negative effects. Still, many uncertainties cloud the systemic risk assessment. The biggest strain on financial stability is likely to result from a deterioration in banks' loan quality, especially when payment moratoria and government guarantees expire. Furthermore, the strong V-shaped recovery on capital markets highlights that there is a disconnect between the situation in the real economy and investors' expectations, which may lead to further volatility in asset prices.

Recommendations by the OeNB

The Austrian financial market has weathered the COVID-19 crisis well so far but reduced economic output and a higher debt burden are increasing medium-term risks to financial stability. Alongside persistent challenges from the low interest rate environment, deteriorating credit quality and rising provisioning needs will put downward pressure on banks' profitability. Against this backdrop, the OeNB recommends that banks take the following measures:

- Refrain from and/or postpone share buybacks and consider the distribution of dividends, profits as well as bonuses with particular care² in line with national and international recommendations and regulation in order to preserve capital.
- Prepare for the time when public support measures expire and ensure transparency regarding the credit quality of loan portfolios.
- 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.

² In line with the FMA's current information about COVID-19 measures: <https://www.fma.gv.at/en/covid-19/>.

- Continue efforts to improve cost efficiency and operational profitability, even under the currently difficult circumstances.
- Develop adequate strategies to deal with the challenges of digitalization, new technologies and cybersecurity, in particular in light of the experience of the COVID-19 crisis, which has highlighted the importance of digital services.