

## Management summary

### **Global growth declines, reflecting a further slowdown in emerging markets and a weaker recovery in advanced economies**

Macroeconomic conditions have gradually strengthened further in Europe in the course of 2015, amid a more pronounced shift in growth dynamics from emerging to advanced economies. Still, euro area growth prospects remain muted, with the risks surrounding the economic outlook tilted to the downside given heightened macrofinancial vulnerabilities in major emerging economies.

At the global level, the prospect of diverging monetary policy trends in major advanced economies, ongoing geopolitical tensions and continued volatility in emerging economies and global commodity markets could lead to a renewed increase in vulnerabilities.

Macrofinancial conditions and financial market developments in many countries of Central, Eastern and Southeastern Europe (CESEE) continued to be broadly favorable in the first half of 2015, despite a broad-based reassessment of risks in international markets, especially vis-à-vis emerging economies. However, more volatility was observed in Turkey, and geopolitical tensions continued to weigh on dynamics in Russia and Ukraine.

With a few exceptions, the asset quality of the CESEE banking sectors has slightly improved due to the gradual start of nonperforming loan (NPL) resolution processes in several countries. Positive effects on the profitability of the banks concerned were already visible in the first half of 2015. Throughout most of the region, banks continued to be well capitalized. However, announced macroprudential measures in some countries will raise regulatory

requirements and could therefore reduce capital mobility within banking groups.

### **Growth of credit to the Austrian nonfinancial sector stagnates at a low level**

The growth of lending by Austrian banks to domestic nonfinancial corporations remained weak in the course of 2015. Loan dynamics continued to be affected by both supply- and demand-side factors. On the one hand, banks continued their cautious lending policies in 2015. On the other hand, loan demand by enterprises remained weak, reflecting the current cyclical environment. Moreover, firms had built up substantial liquidity buffers in recent years in the form of undrawn credit lines and overnight deposits. Thus, at least in the current environment of weak loan demand, Austrian banks' more restrictive lending policies probably did not constitute a binding constraint for the financing of Austrian enterprises. The subdued external financing of nonfinancial corporations was also reflected in a decreasing issuance of corporate bonds, which had been a major source of external finance for the corporate sector in the past years.

The low interest environment continued to support firms' and households' ability to service their debt. At the same time, the high share of variable rate loans in total lending – which has recently started to recede somewhat for new lending to households – implies considerable interest rate risks in the balance sheet of the corporate and household sectors.

As a result of the low saving rate, financial investments by Austrian households remained subdued in 2015. Given the low opportunity costs resulting from the low nominal interest rate environment, households continued to

display a strong preference for investments in highly liquid assets. At the same time, there are hardly any indications – at least within their financial investments – that households made up for low interest rates by investing in riskier assets.

### **Austrian banks still face headwinds despite improved profitability**

The global low interest rate environment affects Austrian banks in the critical phase of transition from a high- to a low-growth environment. In this regard, Austrian banks are vulnerable to shocks, as their risk profile and risk-bearing capacity still need to be enhanced.

The Austrian banking system's consolidated profits rose significantly in the first half of 2015 compared with the previous year. This improvement can mainly be traced to reduced credit risk costs and an increase in operating profits, both in domestic and foreign business. Nevertheless, operating income was below the corresponding 2014 results mainly due to a decrease in trading and other operating income, while total assets remained stable. The improvement in operating profit was additionally supported by a reduction of operating costs. The improvement in operating efficiency resulting from lower operating costs may, however, not be sustainable as it is attributable to lower depreciation and amortization costs.

Measures taken to reduce operating costs in Austria seem to begin to bear fruit as operating profits in banks' domestic business improved markedly. Some weaknesses still exist, however. The number of local bank branches in Austria, for example, barely changed between 2008 and 2014, while other countries have reported material reductions.

Austrian banks are particularly vulnerable because of their significant exposure to CESEE. Given the higher uncertainty of future economic developments and fragile conditions in important markets like Russia and Turkey, risks deriving from banks' exposure to CESEE could again take center stage. Legal interventions concerning foreign currency loans in Croatia and Poland add to uncertainty. Profits of Austrian banks' subsidiaries in CESEE recovered after the particularly challenging year 2014, but profitability varies considerably between markets. Apart from the flat yield curve environment, Austrian banks are also still confronted with legacy issues, mainly in the form of a large stock of NPLs in several CESEE countries.

### **Recommendations by the OeNB**

To strengthen financial stability in Austria, the OeNB recommends that the following measures be taken:

- Banks should continue to strive for capital levels that are commensurate with their risk exposures. The OeNB notes that the trend of improving capitalization has slowed down. The OeNB thus welcomes the recommendation by the Financial Market Stability Board (FMSB) to activate the systemic risk buffer (SRB) and calls on banks to start preparations proactively.
- Banks and insurance undertakings should thoroughly review their business models, internal structures, branch networks and processes in order to increase their profitability and to be prepared for the possibility of a prolonged low growth and low interest rate environment. The OeNB positively notes ongoing efforts in this direction.
- Banks should refrain from trying to gain short-term growth at the cost of

risk-inadequate pricing, as profit margins in Austria are narrow and margins in CESEE have come under pressure.

- Banks should further de-risk their loan portfolios by continuing to clean up their balance sheets and to pursue risk-adequate provisioning.
- Banks should adhere to the FMA minimum standards on foreign currency lending in their business in Austria and to the FMA's "Guiding Principles" in their CESEE business. This also includes working proac-

tively with borrowers on tailor-made solutions to reduce the risks for both sides. Such an approach also encompasses reducing the risk related to the underperformance of repayment vehicles.

- The OeNB recognizes that major improvements in local funding have taken place since 2011. Nevertheless, banks should further continue to strive for sustainable loan-to-local stable funding ratios at the subsidiary level and for the risk-adequate pricing of intragroup liquidity transfers.