

Management summary

International macroeconomic environment: global and European economies see sustained upswing amid growing risks

The global upswing in economic activity continues to firm. Growth is projected to rise in emerging and developing markets as well as in advanced economies in both 2018 and 2019, despite some softening momentum in the first quarter of 2018 and growing risks amid geopolitical uncertainty. Financial market confidence, while remaining strong, has suffered from higher volatility in equity markets, reflecting trade tensions and less supportive monetary policy.

Central, Eastern and Southeastern Europe (CESEE) continues to experience one of the strongest economic expansions since 2008. Growth has been increasingly broad based amid vivid international demand, high capacity utilization, the inflow of EU funds, brightening sentiment, favorable financing conditions, high wage growth and tightening labor markets. The strong economic momentum notwithstanding, the increase in price pressures has remained limited, and inflation rates are well within targets in most countries. In Russia and Ukraine, growth is noticeably less brisk than in the rest of the region, albeit still positive. Firming credit growth and a further reduction in nonperforming assets have kept banking sector profitability broadly stable despite some decline in operating income.

Corporate and household sectors in Austria: improving risk indicators

The Austrian economy recorded fast-paced growth in 2017, underpinned by both domestic and foreign demand. Strong investment demand increased the financing needs of nonfinancial corporations. While internal financing remained the most important source of funds and firms continued to have substantial liquidity at their disposal, Austrian nonfinancial corporations' recourse to external financing picked up in 2017.

A notable increase in equity funding notwithstanding, debt instruments provided the bulk of nonfinancial corporations' external financing in 2017 as lending by Austrian banks gained further momentum. In March 2018, its annual growth rate reached the highest value in nine years, even though Austrian banks continued their cautious lending policies. The expansion of bank lending to households also gained momentum in recent months. The main contribution to loan growth came from housing loans, not only because they are the most important loan category for households but also because of a slight acceleration of their expansion rate.

Historically low bank lending rates, reinforced by a high share of variable rate loans, continued to support the current debt-servicing capacity of the corporate and household sectors. The take-up of variable rate loans by both enterprises and households decreased further in the first months of 2018, but borrowers continue to be exposed to considerable interest rate risks. Foreign currency loans also remain a risk factor for vulnerable households, despite these loans' substantial decrease in past years due to supervisory measures. But given that the remaining volume of such loans is small, they do not represent a systemic risk for the Austrian financial system. Nonetheless, loans linked to repayment vehicles continue to warrant close monitoring.

Residential property prices in Austria continued to rise in 2017 and early 2018. Reflecting this pick-up in price growth, residential property prices in Austria continued to deviate from their fundamentally justified values, as the OeNB fundamental indicator implies.

Austrian financial intermediaries: strong profits, but banks need to further improve structural efficiency

Almost a decade after the onset of the global financial crisis, the Austrian banking sector recorded its highest post-crisis profits in 2017, marking a recovery to pre-crisis levels amidst a highly supportive macroeconomic environment and historically low credit risk costs. Even though operating income was slightly higher and expenses fell year on year, the cost-income ratio remained elevated. Banks continued to benefit from their subsidiaries' activities in CESEE, where the net result after taxes was boosted by low provisioning levels.

Austrian banks' credit quality improved further, with nonfinancial corporations making up two-thirds of the remaining NPL portfolio. A positive trend was also observed at banks' subsidiaries in CESEE, where the situation remained highly heterogeneous across countries, however.

In this benign phase of the economic cycle, Austrian banks slightly increased their common equity tier 1 (CET1) capital ratio, but there is a clear loss in momentum compared to previous years, as profit-sharing demands from investors were successful and banks increased dividend payments. The CET1 ratio of Austrian significant institutions (SIs) fell further behind the average recorded for the Single Supervisory Mechanism (SSM) in 2017. The funding position of Austrian banks remained solid, and CESEE subsidiaries showed a strong reliance on local stable funding (as indicated by the Sustainability Package).

As to macroprudential policy in Austria, systemic risks in residential real estate lending continue to be limited, which is mainly due to the high risk-bearing capacity of lenders and borrowers. Yet, against the backdrop of record low interest rates and strong increases in property prices, the OeNB calls on banks to exercise caution with regard to real estate lending standards, especially since they show indications of unsustainability for a non-negligible share of newly granted loans.

Despite improved economic conditions, the persistently low yield environment remains a challenge for Austrian life insurance companies. The insurance sector has been adjusting to this environment as well as to regulatory changes by adapting its investment mix, both in terms of securities' issuers and duration. In payment services, challenges remain regarding the revised EU Payment Services Directive, as essential technical issues of the legislation are still unresolved.

Recommendations by the OeNB

In the current phase of buoyant economic activity, Austrian banks should continue to address outstanding issues in order to foster the sustainability of their profits, improve their resilience and prospects, and ensure that they have enough room for maneuver for potential future downturns.

Against this background, the OeNB recommends that banks take the following measures:

- Use the window of opportunity which the benign market environment provides to further improve structural efficiency. This will strengthen banks' profitability, allow investments in digitalization and help to further increase banks' risk-bearing capacity.
- Reinvigorate efforts to further improve capitalization, especially at significant institutions, as the current upturn may sow the seeds for the emergence of future credit risks.

- Apply sustainable lending standards in real estate lending, both in Austria and in CESEE.
- Continue efforts to resolve remaining nonperforming loans in CESEE.
- Maintain compliance with the FMA minimum standards regarding foreign currency and repayment vehicle loans and intensify bilateral negotiations with borrowers to find tailor-made solutions; and maintain compliance with the (recently) reviewed Sustainability Package.