

Management summary

International macroeconomic environment: strengthening global and European growth outlook

The global upswing in economic activity is strengthening. Growth is projected to rise this year and next both in emerging and developing markets and in advanced economies. Financial market sentiment has also been strong overall, with continued gains in equity markets despite gradually less supportive monetary policy.

Growth rates in the countries of Central, Eastern and Southeastern Europe (CESEE) are on the uptick, as consumption is strong and investments are picking up. Unemployment is low, while inflation rates are moderate in most markets. As a consequence, banks in the region are recovering and expanding lending to firms and households. However, several banks active in the region are still burdened by high ratios of nonperforming loans, keeping profitability in the first half of 2017 at the previous year's level.

Corporate and household sectors in Austria: benign financing conditions

The Austrian economy gathered momentum in the first half of 2017, underpinned by both domestic and foreign demand. The exceptionally strong investment cycle fueled the financing needs of nonfinancial corporations. Reflecting the upturn in economic growth, the gross operating surplus of Austrian nonfinancial corporations started to rebound. Internal financing remained the most important and most stable source of funds, but external financing picked up briskly in the first half of 2017. Although firms continue to have substantial liquidity buffers, corporate lending by Austrian banks increased. Supported by historically low bank lending rates, loans with medium-term and longer maturities expanded in particular.

The saving ratio of households edged up in the first half of 2017, which was reflected in a moderate rise of households' financial investments. Amid the low interest rate environment, households continued to prefer highly liquid assets. The expansion of bank lending to households gained momentum, too, with housing loans making the largest contribution to loan growth. Foreign currency loans and the proportion of variable rate loans contracted further. But despite this recent decline, the share of variable rate loans is still very high by international comparison, which implies a considerable exposure of the household sector to interest rate risks over the medium term. Currently though, credit terms remain favorable, as bank interest rates decreased slightly from last year's already very low levels. As the household sector's total liabilities grew at a somewhat slower pace than disposable income, however, the debt-to-disposable income ratio contracted somewhat.

Residential property prices in Austria continued to rise in the first half of 2017, albeit at a slightly slower pace than in the year before. This moderation was mainly driven by developments in Vienna, where prices remained almost flat in the first two quarters of this year.

Austrian financial intermediaries: reaping the benefits of improving market conditions

After major restructuring and a decrease in the number of Austrian banks by nearly one-fifth over the past five years, the Austrian banking sector entered calmer waters in the first half of 2017, as the decline in its total assets and market share in CESEE came to a halt. Also, structural changes began to have positive effects on profitability while consolidated profits improved further in the first half of 2017, spurred by higher operating income and signifi-

cantly lower write-downs and credit risk provisioning. The profitability of Austrian subsidiaries in CESEE continues to support overall results, with the highest profit contributions coming from subsidiaries in the Czech Republic, Russia, Hungary and Slovakia.

In line with the European trend, Austrian banks improved their loan quality in the first half of 2017. Ratios for nonperforming loans (NPLs) in the domestic and foreign business further declined. However, the heterogeneity in NPL ratios of Austrian banking subsidiaries in CESEE remains high, with some host countries still experiencing elevated ratios.

The capitalization of the Austrian banking sector continued to increase in the first half of 2017. This improvement, which further strengthens banks' loss-absorbing capacity and hence also financial stability, is the continuation of an established trend. Since the end of 2014, Austrian banks have expanded their CET1 capital, while risk-weighted assets have declined despite increasing lending activity. The improvement in risk-bearing capacity was also confirmed by OeNB stress tests, which showed solid results thanks to a reduction in foreign exposures, a decline in foreign currency loan volumes and a stable liquidity situation. These positive results notwithstanding, individual banks could still face idiosyncratic risks. Real estate-induced systemic risks remain subdued in Austria, although some developments warrant heightened supervisory vigilance. An increasing proportion of new mortgage loans is granted with relatively high loan-to-value, debt service-to-income and debt-to-income ratios. These developments

confirm the importance of the Financial Market Stability Board's recommendation on applying sustainable lending standards to real estate loans. In this context, the OeNB welcomes the recent amendment to the Austrian Banking Act. It forms the basis for issuing a regulation specifying upper limits to maturities or the above-mentioned ratios, which aims at containing systemic risks.

Recommendations by the OeNB

Despite the above-mentioned improvements, it is crucial for the Austrian financial sector to continuously work on strengthening its sustainable recovery and further increase its resilience, as risks for financial stability still exist. Political uncertainties are on the rise in several regions in the world, and legacy issues such as nonperforming loans and foreign currency loans require continued attention from the banks.

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

- Use the window of opportunity which the currently benign market environment provides to further improve structural efficiency. This will strengthen banks' profitability and help them further increase their risk-bearing capacity.
- Address potential risks emanating from the low interest rate environment.
- Apply sustainable lending standards in real estate lending, both in Austria and in CESEE.
- Continue efforts to resolve the remaining nonperforming loans in CESEE.
- Maintain compliance with the FMA minimum standards regarding foreign currency and repayment vehicle loans and the sustainability package.