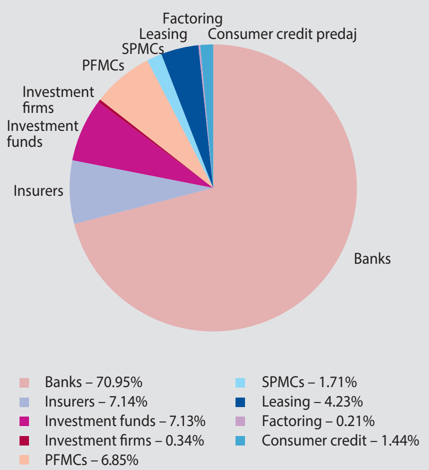
3 Financial market developments

The global macroeconomic outlook deteriorated in 2018, while several downside risks to the outlook – with potentially adverse implications for financial stability – became more pronounced. One of the most significant threats facing the global economy is the imposition of protectionist measures and the risk of an open trade war breaking out. Another ongoing risk is the mounting uncertainty and unease related to Brexit. Several episodes of volatility appeared in the financial market during 2018; the corrections concerned mainly prices of emerging market bonds and later also stock markets, which fell sharply towards the year-end.

Slovakia, like other EU countries, was experiencing an expansionary phase of the financial cycle in 2018, and the domestic economy grew by 4.1%. Slovakia's GDP growth in 2018 was driven primarily by domestic demand, underpinned mainly by household consumption and investment. The expansionary tendencies of cyclical developments were most evident in their impact on the labour market. Since the domestic economy is export oriented, the risks to Slovakia's economic growth outlook lie mainly in the external environment.

Chart 13 Financial sector assets as at 31 December 2018, broken down by market segment (percentages)



Source: NBS.
Notes: Preliminary data were used for the insurance sector, reported as at the end of 2018. PFMCs – pension fund management companies; SPMCs – supplementary pension management companies.

The Slovak banking sector's aggregate net profit for 2018 increased by 6.9%, year on year, to €640 million. The increase was due mainly to growth in interest income from the financing of non-financial corporations (NFCs), as lending rates stabilised and total NFC loans continued to increase. Interest income from retail lending also increased moderately. Another key factor behind the profit growth was banks' low losses on non-performing loans (NPLs), though this trend may not be sustainable over the long term.

The banking sector's aggregate total capital ratio[6] fell from 18.6% at the start of 2018 to 18.2% at the year-end, despite the continuation of more conservative dividend policies. The decline was partly caused by banks' transition to the new accounting standard IFRS 9. An increasingly important factor is banks' efforts to optimise the level and structure of their capital and gradually to reduce voluntary capital buffers above the level of regulatory requirements.

Annual growth in loans to households stood at 10.3% in December 2018, which compared with December 2017 was 1.4 percentage points lower. In absolute terms, total loans to households increased by €3.4 billion, which was almost identical to the corresponding figure for 2017 and therefore remained close to the all-time high of €3.55 billion. Credit growth remained higher in Slovakia than in any other EU country in 2018. The credit growth was supported by one-off effects – in particular expectations about the impact of legislative measures in force from July 2018 – and also by the ongoing trends of low interest rates, property price growth, and improvements in the macroeconomic environment, especially in the labour market. A corollary of rapid household credit growth has been a continuing increase in household indebtedness in Slovakia, which in 2018 remained the highest in the European Union. Therefore, the most significant risk is an increase in the house-

6 *The most recent capital ratio data available when this report was produced were for September 2018.*

hold sector's sensitivity to any deterioration in the economic situation.

Lending activity to the corporate sector was stable during 2018. Annual growth in loans to NFCs ranged between 4% and 6% during the year, and in the end stood at 5.14% The growth was concentrated among loans with a term of more than one year. In the breakdown of the NFC credit growth by the size and ownership of borrowers, large firms and private firms had the largest respective shares. The credit growth reported by the domestic banking sector is slightly higher than the median growth for central and eastern European (CEE) countries, as well as the median for EU countries. The low interest rate environment and continued soundness of the macroeconomic environment shaped the trends in the corporate credit market. The rate of corporate credit growth accounted for the stabilisation of NFC debt, which nevertheless remained higher than the CEE median.

NBS was responsive to developments in the domestic financial sector in 2018, particularly to the rapid increase in private sector credit and debt amid exceptionally favourable macroeconomic conditions. In July 2018 NBS increased the countercyclical capital buffer (CCyB) rate to 1.5% with effect from 1 August 2019. The bank also focused on laying down prudential conditions for bank lending. An important step in this area was the adoption of one NBS Decree amending a Decree on housing loans and another amending a Decree on consumer loans, each entering into force on 1 July 2018. The principal measures introduced by these amendments were a tightening of limits on loan-to-value (LTV) ratios and the introduction of a new limit on borrowers' debt-to-income (DTI) ratio.

The banking sector's holdings of debt securities did not change significantly in 2018, as the total amount of banks' bond investments fell slightly. Slovak government bonds remained the main component of the aggregate portfolio, constituting almost three-quarters of the total. In second place were investments in foreign government bonds. The share of aggregate bond holdings assigned to the held-to-maturity (HTM) portfolio underwent a change in 2018, as banks, following the transition to the new accounting standard IFRS 9, switched part of their bond holdings from the available-for-sale portfolio to the HTM portfolio. This has made banks' bond investments less sensitive to movements in the market value of bonds.

Favourable macroeconomic conditions continued in 2018 to support the debt servicing capacity of NFCs and households. The non-performing loan ratio for loans to households fell from 3.2% in December 2017 to 2.9% in December 2018. This drop was accounted for entirely by the housing loan portfolio, since the NPL ratio for consumer loans increased year on year. As for the corporate sector, the non-performing loan ratio for NFC loans improved significantly, from 5.2% to 3.9%.

The insurance sector[7] reported a net after-tax profit of €176 million for 2018, which compared with its profit for 2017 was lower by 1.6%. The sector's aggregate return on assets (ROA) also fell moderately, year on year, to 2.27%, while the return on equity (ROE) stood at 14.4%, although that figure masked a significant decline in equity. The aggregate solvency of insurers in Slovakia declined in 2018, particularly in the second half of the year. The sector had a solvency capital requirement (SCR) coverage ratio of 187% as at the end of 2018; by comparison, the SCR coverage ratio was 201% at the end of 2017 and was still at around that level at the end of the first half of 2018. The minimum capital requirement (MCR) coverage ratio showed a similar trend, dropping from 519% in December 2017 to 487% in December 2018. In traditional life insurance, gross premiums written fell by a quite substantial 9.8% in 2018, after increasing in the previous year. In unit-linked life insurance, on the other hand, gross premiums written maintained their upward trend in 2018, increasing by 5.8% year on year. In non-life insurance and inwards reinsurance together, growth in gross premiums written accelerated, year on year, in 2018 and at the end of the period stood at 11.2%.

In the second pillar of the pension fund sector,[8] the number of savers continued its strong growth trend in 2018 and by the end of year stood at almost 1.5 million. Most of the people who joined the second pillar in 2018 opted to invest in equity or index pension funds. The number of savers investing in these funds was

7 *The insurance sector's profit was analysed on the basis of the accounting reports produced by insurers and branches of foreign insurers. Other areas were analysed using regulatory reports submitted by insurers other than branches of foreign insurers.*

8 *The second pillar of the Slovak pension system – the old-age pension scheme – is a largely compulsory defined-contribution scheme operated by pension fund management companies (PFMCs). The third pillar – the supplementary pension scheme – is a voluntary defined-contribution scheme operated by supplementary pension management companies (SPMCs).*

further boosted by savers switching from other funds, notably from bond funds. Nevertheless, a clear majority of savers continued to invest in bond funds. The net asset value (NAV) of second-pillar funds grew more slowly, year on year, in 2018 than in 2017. This can be attributed to funds' negative performance, which to some extent offset the impact of the increase in inflows through new contributions. Behind the growth in inflows from savers were three main factors: a 25 basis point increase in the assessment base; a favourable labour market situation; and the above-mentioned expansion of the saver base. The NAV of second pillar funds stood at more than €8 billion as at the end of 2018. Among the different types of pension fund, mixed funds recorded the largest shift in asset structure during the period under review, with their equity investments declining largely as a result of the slump in share prices near the end of the year. The current pension-point value showed significant volatility over the course of 2018, in particular when stock markets were plummeting in December. The result was a significant deterioration in pension fund performance.

Developments in the third pension pillar in 2018 were similar to those in the second pillar. The growth in the number of the pillar's participants was the highest in more than ten years, bringing the total to around 800,000. The impact of rising contributions on the aggregate NAV of third-pillar funds was largely offset by the negative impact of the repricing of assets in the funds' portfolios, which occurred mainly in equity funds. The highest inflows were recorded by those funds that have an aggressive growth strategy; nevertheless, funds with a balanced strategy retained their dominant position. Looking at the asset structure of third-pillar funds in 2018, the situation was similar to that with second-pillar funds: the equity component declined and investments in bond instruments and bank deposits increased. All third-pillar funds apart from one distribution fund recorded a negative annual return.

In the context of its long-running expansion, Slovakia's investment fund sector had a less successful year in 2018. The year-on-year growth in investment funds' aggregate NAV fell from 14% in 2017 to less than one per cent in 2018. This decline stemmed from a combination of funds' somewhat lower marketability and weak performance. Compared with 2017, the net issuance of investment fund shares/units was less than half; furthermore, the impact of these net sales on the aggregate NAV was almost entirely cancelled out by the negative average return on funds, resulting from the broad-based decline in financial market asset prices. In the breakdown of net sales of shares/units by type of fund, mixed funds had by far the largest share, followed by real estate funds. Looking at the sectoral breakdown of investment fund inflows, the household sector held the leading position. The average annual return across investment funds was -3.5% as at the end of 2018.