NÁRODNÁ BANKA SLOVENSKA
EUROSYSTÉM

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Foreword

The financial sector is deemed to be stable when it is able to smoothly fulfil its core functions, even amidst substantial adverse shocks in the external or domestic economic and financial environment. At the same time, financial sector stability is perceived as a necessary condition for sound functioning of the real economy. Národná banka Slovenska (NBS) contributes to the stability of the whole financial system in Slovakia, in particular through its role as the financial market supervisory authority.

Národná banka Slovenska believes that an important aspect of its contribution to financial stability is to keep the public regularly informed about financial sector stability and about any trends which could jeopardise that stability. Awareness and discussion of such issues is essential, particularly since financial stability is affected not only by financial sector institutions, but also by the behaviour of other non-financial corporations and individuals. Hence Národná banka Slovenska publishes a biannual *Financial Stability Report* (FSR) that primarily identifies the main risks to the stability of the Slovak financial sector.

The aim of the FSR is to provide clear and easy to follow information about the development of factors affecting financial stability in Slovakia, with particular attention paid to the most significant risks to stability. The FSR includes a section on the implementation of macroprudential policy in Slovakia.

The *Analysis of the Slovak Financial Sector*, which is biannually published by NBS, provides complementary information to form a comprehensive overview of developments and risks in the Slovak financial sector.

Executive summary

The euro area economy continued to improve in 2013 and at the beginning of 2014, albeit in an environment where significant risks persist. During this period the gradual moderate recovery in the economies of euro area countries was accompanied by sustained confidence in financial markets as well as improvements in consumer and business sentiment. In a majority of euro area countries the debt ratio increased despite fiscal consolidation measures, and there was no appreciable pick-up in the labour market. Another significant risk for several euro countries was their persisting problems with competitiveness and related dependence on external financing.

A key factor behind the recent upturn in both the economy and financial sector has been the environment of low interest rates. It is this policy that supported liquidity growth, which in turn drove growth in the real economy and financial markets. On the other hand, generally low interest rates entail a number of risks, too.

One risk is that confidence erodes again, leading to a decline in asset prices in financial markets. This would mean not only losses for investors, but also higher costs for issuers, particularly those in euro area periphery countries. The expected rise in US interest rates should be considered in this regard as well.

Another risk amid a fragile macroeconomic recovery is the growth trend in markets in riskier assets, which have been boosted by low interest rates. At the same time, the recovery is directly dependent on low funding costs. The overall situation must also be seen in the context of rising deflationary pressures, which could put further negative pressure on macroeconomic developments and the deleveraging process.

As regards financial stability in Slovakia, the situation was relatively favourable during the period under review, with moderate economic growth and no additional imbalances. The positive contribution of domestic demand to GDP growth was an important development. Investment demand picked up and there were signs of profit growth in the business sector. By far the largest contribution to growth continued to be made by net exports. All the same, certain trends on the fiscal side warrant closer attention, even while Slovakia's debt-to-GDP ratio is one of the lowest in the euro area, at below 60%.

The banking sector in Slovakia continues to show a very high degree of resilience to negative developments. The sector's capital ratio increased to its highest level since 2005. At the same, high capital levels positively influenced also other areas in the forefront of ongoing changes in bank regulation. The higher amount of own funds is therefore bolstering the leverage ratio and net stable funding ratio, and are also having a positive impact on new requirements relating to bank recovery and resolution.

Given the continuing risks in several areas, it is important that the banking sector keeps its own funds at the high levels and maintains Pillar 1 regulatory requirements and macroprudential capital ratios by holding highest-quality common equity Tier 1 capital. In this context, an early implementation of the capital conservation buffer, at 2.5% of risk-weighted assets, should be seen.

Bank profitability increased, although going forward it is expected to moderate. A main cause of the profit growth in 2013 and the first quarter of 2014 was the increase in lending to households and its upward effect on interest income. Banks' interest margins declined, although they remain high compared with those in the banking sectors of other EU countries.

Looking ahead, the assumption is that profitability will decline or increase more slowly and that its composition will change. An important factor will be the continuing competition and downward pressure on interest margins. Other significant aspects are levy obligations to the government, new costs related to fees for the Single Resolution Fund resulting from implementation of the Single Resolution Mechanism and the increase in supervision fees following the establishment of the banking union.

A significant trend in the financial sector was again the rise in household lending. The annual growth rate of loans to households is one of the highest in the EU, largely reflecting low interest rates and the resulting surge in loan refinancing. Household lending was also boosted by developments in the property market. By contrast, the situation in the corporate lending market remained complicated. Although the overall annual growth rate in corporate loans in March 2014 was moderately positive for the first time in almost two years, it was driven up mainly by loans to a small number of state-owned firms. A particular problem is the adverse situation in the construction sector.

While household lending growth had a positive effect on several areas of banking business, it also entailed certain risks. These concern mainly the still high interlinkage between banks and financial intermediaries, the elevated sensitivity of banks to headwinds from the property market, and the rising levels of household debt.

When providing housing loans through financial intermediaries, it is important that banks do not allow their links with an intermediary to expose them to undue pressure to ease credit standards.

The banking sector's sensitivity to developments in the property market was accentuated mainly because the loan-to-value (LTV) ratio in bank lending increased to almost 100, despite stagnation in the real estate market. This trend was especially apparent in certain banks. It is positive, however, that no significant imbalances have yet appeared in the property market. It is nevertheless important that banks' LTV policies are not distorted by intra-bank competition, but rather reflect the riskiness of loans and the situation in the market.

From the beginning of 2014 there was also an increase in the risk related to civil unrest in Ukraine. This new risk could have repercussions for the Slovak financial sector. While financial institutions' direct exposures to Russia and Ukraine are not expected to have significant consequences, the Slovak financial sector could be affected by secondary effects arising from the imposition of sanctions against Russia, as well as by blowback from activities that Slovak banks' parent undertakings conduct in Ukraine and Russia.

The structure of Slovak economy has long been characterised by high concentration, which is evident not only in the composition of exports, but also in respect of the financial sector's systemically imported customers. Hence concentration risk in the domestic financial sector is increasing. A similar concentration risk can be observed in regard to deposits, as the behaviour of a small number of corporate customers has the potential to affect the liquidity position of certain banks.

Table 1 Overview of the most significant risks to the stability of the Slovak financial sector

Area	Risk	Risk-amplifying factors	Risk-mitigating factors	NBS recommendations
Risk of further deterioration in macroeconomic and financial market developments	Increase in credit risk costs in the event of adverse macroeconomic developments	In 2013 credit risk costs increased in the retail sector and remained elevated in the construction sector	Relatively high solvency in the banking and insurance sectors The share of retail loans past due by between 30 and 90 days fell in the first quarter of 2014	Given the existing risks, banks are not expected to reduce their capital and are expected to meet the Pillar 1 regulatory capital ratio and the capital conservation buffer by holding highest-quality common equity Tier 1 capital.
	Higher sensitivity of banks to a downturn in the property market in the event of a worsening economic situation	Certain banks report an increased share of loans with an LTV ratio of close to or above 100%	Property prices were relatively stable in 2013 with no signs of emerging imbalances	When providing loans and setting the maximum LTV ratio, banks should reckon on the possibility of property prices falling. The valuation of property for the purpose of a loan decision should be conservative, based on the price for which the property may be sold.
	Downward pressure on profits of banks and insurers	The potential for further household lending growth is gradually diminishing and interest margins are falling		
Risk of low interest rates	Risk of prolonged low returns on assets in insurers and funds; risk of price bubbles in riskier assets	The growth of investments in riskier assets in global markets is heightening the risk that investor risk aversion will increase again	The exposure of domestic financial institutions to emerging countries is relatively low	
	Losses or mounting problems in the economy as a result of banks being insufficiently prudent in their retail lending policy			Before providing loans, including ones intended to refinance a loan from another bank, banks should thoroughly assess applicants in regard to the amount and stability of their income and their ability to repay the loan in the event of a rise in interest rates. The assessment of a customer's creditworthiness for the purposes of a loan decision should not be based on the value of the collateral.
Risks arising from a change in business practice	Potential strategic risk from increasing linkages between banks and financial intermediaries	Pressure on banks to ease credit standards and shorten interest rate fixation periods		Banks should ensure that the proportion of loans provided through financial intermediaries is kept at a level that does not expose them to pressure to ease credit standards, and they should independently verify and manage the credit risk associated with loans provided in this way.
	Risks arising from intensive price competition in the motor insurance market	The current decline in comprehensive motor insurance premiums is unsustainable because it is generating losses		Price competition in motor insurance should not impinge on the due payment of legitimate insurance claims.
Civil unrest in Ukraine	Direct negative impact on the financial sector owing to capital and credit linkages	Parent undertakings of domestic banks may be adversely affected	The direct exposures of domestic financial institutions and funds to Russia and Ukraine are low	
	Negative secondary effects of sanctions on economic growth and domestic financial institutions	Certain areas of the domestic economy have closer links to Russia	The debt-servicing ability of most of the firms that both export to Russia and borrow from Slovak banks is not expected to be significantly impaired	

Table 1 Overview of the most significant risks to the stability of the Slovak financial sector (continued)

Area	Risk	Risk-amplifying factors	Risk-mitigating factors	NBS recommendations
Risks of concentration, financial market interlinkages, and contagion	Relatively high concentration in (part of) the portfolio, or higher intra-group exposure, in certain institutions or funds	The Slovak economy includes a relatively high degree of economic links between domestic firms; the largest of them could pose a risk to the solvency of certain banks		Banks should take a prudential approach to assessing economic links of customers and to the management of concentration risk in both their lending and deposit business. Any higher degree of concentration risk should be covered by additional own funds, i.e. an additional liquidity buffer.
	Negative consequences of rationalisation measures or strategic decisions implemented in domestic financial institutions by parent undertakings, and contagion risk		The value of profitability ratios in domestic banks is above the EU average	
Legislative and regulatory environment	Increasing mismatch of competences and responsibilities in certain areas	Under the proposed Single Resolution Mechanism, a substantial share of competences will be transferred to European institutions (the European Commission and Single Resolution Board)		
	Decreasing profitability of financial institutions owing to an increase in their tax or levy burden or to an unstable regulatory environment	In 2014 banks will, in addition to paying to bank levy, resume the payment of contributions to the Deposit Protection Fund. Furthermore, the implementation of the banking union will require banks to pay a contribution to the Resolution Fund and will increase their supervision fees		

Source: NBS.

NÁRODNÁ BANKA SLOVENSKA
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CHAPTER 1

EXTERNAL CONDITIONS FOR FINANCIAL STABILITY

1

1 External conditions for financial stability

Euro area economy picking up amid improved sentiment in financial markets and a moderate acceleration of global economic growth

The euro area economy continued its slow recovery in the second half of 2013. Real GDP growth for the period was 0.3%, and although that did not surpass the second-quarter rate, the composition of GDP growth was more robust and the cyclical economic upturn was evident in a greater number of countries. The spread between growth rates of euro area countries fell to its lowest level since 2010, although it remains higher than its pre-crisis level. Towards the year-end, all stressed countries apart from Cyprus reported positive growth.[1]

The situation in the euro area mirrored the moderate acceleration of the broader global economy, which included notable improvements in the outlooks for developed countries. The main engine of economic activity was the United States, where an accommodative monetary policy and a recovering property market significantly stimulated domestic demand. A further reason to assume that the US growth rate will remain strong is that fiscal austerity measures are widely expected to be more moderate in 2014 than in 2013. In Japan, too, economic growth was relatively solid, although the sustainability of the reflationary drive will require rigorous implementation of the fiscal and structural reform pillars, which have so far been lagging behind the monetary easing pillar. As for another major economy, the United Kingdom, its growth projection was revised up significantly. By contrast, the emerging economies that in the post-crisis period were the main engine of global growth are losing some of that momentum. In several of these countries, the slowdown partly reflects an accumulation of macroeconomic imbalances and failure to implement structural reforms.

The recovery of the real economy in the euro area was accompanied by continuing improvement in financial market sentiment in Europe. The likelihood of an extreme event fell, according to investor assessments. Furthermore, ECB measures were no longer the main factor behind the stabilisation of European financial markets. Expectations were further bolstered by the implementation of national and supranational reform measures in Europe. Players in financial markets and in the real economy gained confidence in the new framework for macroeconomic policy based on the repair of public finances, pro-growth structural reforms, and deeper integration (particularly in the banking sector). The negative feedback loop between the diminished solvency of euro area periphery countries and their banking sectors became a far less important risk factor, at least as regards developments in the respective markets.

Structural reforms in the euro area brought about progress in several areas, although the process of removing macroeconomic imbalances remains far from finished

While firmer sentiment is a key precondition for increasing economic performance and strengthening financial stability in the euro area, the crucial factor over the long-term horizon will be the actual scope and quality of economic reforms in the euro area and its constituent countries. Although a number of areas may offer genuine cause for optimism, it should be noted that there are also many other areas where reforms have been insufficient and that therefore caution and prudence are in order.

Owing to low economic growth, fiscal deficit reduction has not yet sufficed to stem the rise in public debt ratios of euro area countries. Since the onset of the European debt crisis, fiscal consolidation has been one of the main priorities of macroeconomic policy in Europe. The intensive reduction of general government deficits continued in 2013, with the average deficit for the euro area as a whole improving from 3.7% of GDP to 3.1% of GDP, just slightly above the Maastricht threshold. The extent of the consolidation effort appears even greater when considering that the average deficit in 2010 was 6.2% of GDP. In some countries, however, additional fiscal austerity will be necessary if they are to bring the

1 This assessment does not include Greece, which is not reporting quarterly GDP growth figures.

deficit below 3% of GDP within the deadline set by the European Commission under the excessive deficit procedure, or to meet the medium-term objective of reducing the structural deficit to 0.5% of GDP.

Whether public finances can be put on a stable footing remains a question, particularly given the high level of government debt. Whereas budget deficits have at least been falling in recent years, public debt ratios continued to rise in 2013. In five countries, the public debt as at 31 December 2013 exceeded 100% and in a further three it was over 90%. The main reason for the mounting government debt of most countries is the 'snowball effect' of adverse real interest rate-real growth differentials. According to European Commission estimates, the average government debt ratio for the euro area is expected to rise further in 2014 as a result of this effect. Periphery countries, which are projected to see only a subdued increase in growth and simultaneous low inflation, are therefore particularly exposed to the risk of failing even over the medium term to put their high public debt on a sustainable path.

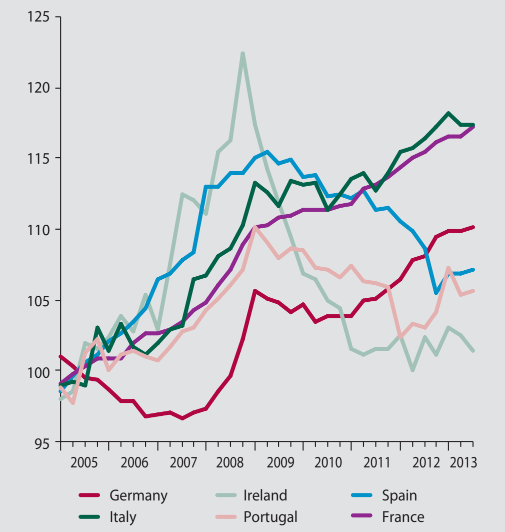
Chart 1 Change in the structural deficit- and gross public debt-to-GDP ratios in selected euro area countries over the period 2010–2013 (p.p.)

Source: Eurostat.

A continuing risk for several countries is their substantial liabilities to non-residents. The argument in respect of public finances can be similarly applied to the issue of the dependence of certain economies on external funding. Countries that before the crisis continuously needed additional external funds for mainly investment and consumption purposes have in recent years seen such demand almost completely eliminated. Indeed, in 2013, the balance of payments current account of several countries moved from a deficit, which had been reflecting the demand for external funds, to a surplus. In a number of euro area periphery countries, however, the net international investment position expressing the economy's exposure to the rest of the world became more negative in 2013, from levels already equivalent to full-year GDP. Hence the dependence of these countries on external funds is now greater than when the euro area debt crisis was escalating. The potential downturn in sentiment among foreign investors therefore remains a risk to the financial stability of these economies. Mitigating this risk to some extent is the fact that part of the external funding for these economies comes from the ECB or other international organisations and is therefore not subject to the vicissitudes of financial markets.

Although price competitiveness among euro area countries has been levelling out, some of them have still not made sufficient progress in this regard. In most periphery countries the essential correction of balance of payment imbalances was initially achieved mainly through declining imports, and, later on, it was also supported by a revival of exports. Key to this pick-up in export performance was greater price competiveness based on wage levels and labour productivity. In Spain, Ireland and Portugal unit labour costs fell and thus cancelled out some of their appreciation in previous years. However France and Italy, two of the largest euro area economies, have had a longer-standing difficulty with their ability of penetrating foreign markets. Their unit labour costs relative to those of the group of countries accounting for the bulk of global external trade remained unchanged, which is a problem for their future economic growth and, indirectly, for the rest of the euro area.

Chart 2 Unit labour cost indicies of selected euro area countries



Source: Eurostat.
Note: 2005=100.

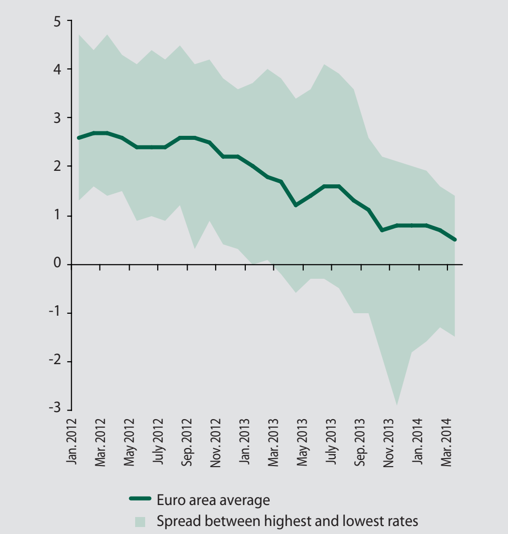
Although signs of modest employment growth and the stabilisation of unemployment have been evident in recent quarters, the labour market remains one of the most serious problems for the euro area. This relates not only to the current adverse cyclical situation, but also to indications that the increase in unemployment in certain countries may also have a structural dimension, which over the medium-term horizon would be reflected in lower potential GDP growth.

Sharp drop in euro area inflation raises fears of deflation

Protracted period of low inflation, as seen in recent months, or, even worse, emergence of deflation would have markedly adverse impact on both the real economy and financial sector of the euro area. In the euro area, falling energy prices combined with still relatively weak activity and high unemployment supported a disinflationary trend in 2013 and at the beginning of 2014. The annual rate of consumer price inflation in March 2014 was only 0.5%. In some euro area countries, consumer prices have even been declining in recent months. According to the baseline scenario for future developments, inflation is expected to remain below the ECB's medium-term target in coming years, but should begin gradually to increase as the output gap narrows. A return to higher inflation is also implied by firmly anchored financial markets' expectations. Should it happen that economic developments in the euro area repeatedly fall short of expectations, as has been the case in recent years, the period of very low inflation could be prolonged. Such a scenario would have largely adverse implications for financial stability. Low inflation at a time when nominal interest rates can hardly fall further would result in higher real interest rates, which in turn would complicate fiscal consolidation efforts and the deleveraging of private sector balance sheets. Were there a low inflation environment in all euro area countries, some of the countries would find it difficult to regain competitiveness. In that case, the necessary disparity in wage dynamics between these countries and strongly-competitive countries would be achievable only by reducing nominal wages.

At the extreme, low inflation could turn into deflation, which would represent an even greater risk. If a deflationary spiral were set in motion, it would lead to deferral of consumption and investment and risk a slide back into recession. The banking sector would face not only an increase in non-performing loans, but at the same time, since the yield curve would have flattened, a further diminution of its ability to generate interest income and profits.

Chart 3 Consumer price inflation in the euro area (%)



Source: Eurostat.

THE PRINCIPAL RISKS IN GLOBAL FINANCIAL MARKETS, IN A LOW-INTEREST-RATE ENVIRONMENT, ARE SURGING DEMAND FOR RISKIER ASSETS AND THE IMPACT THAT ANY TIGHTENING OF US MONETARY POLICY MAY HAVE ON THE VALUATION OF SUCH ASSETS

With central banks keeping interest rates low, investors searching for higher yield are becoming increasingly attracted to riskier assets. Developed financial markets saw increases in most asset prices and low volatility during the second half of 2013 and beginning of 2014, which to a certain extent reflected the above-mentioned improvement in economic outlooks. However, several aspects of these financial market developments raise questions about whether potentially dangerous trends are emerging. Particularly in bond and credit markets there are signs of inattention to risks. For example, yields on government bonds of euro-area periphery countries have fallen in recent months to, and in some cases below, their pre-crisis level. Demand for new issues of Greece, Portugal and Ireland is far exceeding supply, yet until recently these countries were shut out of wholesale funding markets. Similarly, spreads of corporate bonds in Europe have returned to pre-crisis levels thanks to strong investor demand, with the largest decreases observed in lower-rated securities. This compression may be only seemingly explained by low default rates. This time around opposite causality may be at play, i.e. low interest expenses are allowing less viable firms to remain in business and are therefore artificially keeping bankruptcies at a low level. Credit instruments that were often used at the peak of the previous cycle, before the outbreak of the crisis, are again widespread in financial markets, particularly in the United States and to a lesser extent in Europe. An example is the issuance of 'cov-lite' loans (offering a lower degree of creditor protection), which in the United States was three times higher in 2013 than in 2007. There have also been large increases in the issuance of collateralised loan obligations (CLOs), CoCo bonds,[2] and payment-in-kind bonds. In equity markets, too, the mood was largely optimistic during the period under review. European equity indices rallied in response to inflows of foreign portfolio investment, and, in the United States, the S&P 500 reached all-time highs. The common denominator of these trends is the likelihood of a prolonged period of low interest rates in advanced economies. In such circumstances, investors searching for yield have no other choice but to pursue such instruments. In so doing, however, they become exposed to greater risks – whether credit, liquidity or product risks. Moreover, since the financing of such investments is relatively easy when rates are low, risk appetite increases.

A turn in the US monetary policy cycle could, if the Federal Reserve fails to manage expectations, trigger a wave of turbulence. A hike in interest rates could result in widespread adverse revaluation of riskier assets. Upward pressure on interest is most likely to arise from the gathering momentum of the US economic recovery. The Federal Reserve has already begun tapering its asset purchase programme and hinted that the Fed funds rate could be raised towards mid-2015. This was reflected in financial markets through steepening of the US risk-free yield curve. Since most of the increase in long-term interest rates on US government bonds was accounted for by an increase in the liquidity premium, this change partially affected risk-free yield curves in Europe and other countries, too. The growth trend in other assets remained largely untouched by these developments. If, however, markets begin to expect an earlier increase in interest rates, or if the liquidity premium rises further towards its historical average, long-term interest rates in global financial markets will rise. Thus as riskier assets become relatively less attractive investments, they may be sold off and decline in price. For the euro area in particular higher interest rates would be problematical for the real economy. On the one hand, diminishing demand for loans would prematurely choke investment demand, while, on the other hand, the higher interest burden could land some firms in financial difficulty and trigger a wave of loan defaults.

Although European banks strengthened their capital positions, the quality of their assets continued to deteriorate on average and the exposure to sovereign risk increased. Financial market sentiment towards the euro area banking sector also improved during the period under review. Banks' share prices increased, CDS spreads narrowed, wholesale funding became easier, and the sector became generally less fragmented. Nevertheless, the profits of euro area banks remained low, particularly in the banking sectors of periphery

2 Contingent convertible bonds (CoCos) are a type of convertible bond whose conversion to the equity of the issuing company is contingent on a predefined event.

countries, where the rising volume of non-performing loans has been weighing on profits. Since asset credit quality lags the macroeconomic cycle, it may be that provisioning will continue to increase for some time to come. Low profits also make it difficult for banks to carry out the recapitalisation necessary both for meeting new regulatory requirements and for stimulating lending. The rise in banks' capital ratios in recent years is by no means due solely to capital increases. Banks improved their solvency ratio also by considerably reducing their balance sheets and by reducing the risk weighting of some assets. With the latter approach in particular, the question is whether it makes banks more resilient or, on the contrary, exacerbates risks to financial stability. While the bond links between banking sectors and their home sovereign previously tended to generate positive synergies, the repercussions of any re-escalation of sovereign risk are expected to be at least as severe as they were recently. In some periphery countries, the share of domestic government bonds in the banking sector's balance sheet increased further during 2013, although there was a slight downward correction towards the year-end.

A new risk to euro-area financial stability is the emergence of geopolitical tensions surrounding the dispute between Ukraine and Russia. Although its impact on asset prices in global financial markets has been relatively limited, any intensification could potentially increase risk aversion among investors. Furthermore, deteriorating sentiment may not affect only financial markets, but could also feed through to the real economy. Foreign trade with Russia is also at risk, since the EU is considering a boycott of Russian imports and such a move would probably result in Russia taking retaliatory measures against its imports from the EU.

CHAPTER 2

DOMESTIC CONDITIONS FOR FINANCIAL STABILITY

2

2 Domestic conditions for financial stability

Moderate pick-up in domestic economy in late 2013

From the view of financial stability, developments in the domestic economy during the period under review were relatively positive. Slovakia's economic growth picked up slightly in the last quarter of 2013. While net exports were the main driver of growth, domestic demand also made a positive contribution, based mainly on a revival in investment activity. Most of the new investment was accounted for by large projects in the automotive industry and in civil engineering, although smaller firms in the private sector also increased investment. Household final consumption increased only marginally and has still not begun to recover. Households were constrained mainly by the high level of unemployment and decline in real disposable income. However, preliminary monthly figures for retail sales and consumer sentiment in the first quarter of 2014 may point to a pick-up in private consumption. According to the NBS official forecast, Slovakia's economic growth should accelerate during 2014; the annual GDP growth rate for the year is projected to be 2.4%, more than twice as high as the rate for 2013. The European Commission's forecast for Slovakia was virtually the same.

The macroeconomic upturn in the fourth quarter was also reflected in some key microeconomic indicators for the corporate sector. According to data from the Statistical Office of the Slovak Republic from a sample of around five thousand firms, corporate profitability as measured by return on assets (ROA) was lower in the first nine months of 2013 than in the same period of 2012, but it was higher year-on-year at the end of the year. The same turnaround was observed in firms' financial assets as a ratio of their total assets. These tendencies suggest that the financial position of firms may have gradually started to improve. On the other hand, however, actual profit levels remained relatively subdued, with more than a quarter of the firms surveyed reporting a loss for 2013.

No significant macroeconomic imbalances in Slovakia

The economy is recovering and should gather momentum, but although it is creating sound conditions for financial stability in Slovakia, it is far from being the only pillar of that stability. At least as important to considerations of macroeconomic developments over the medium-term horizon is the presence or emergence of imbalances that could pose a risk to financial stability. In this context it is positive that, as part of its regular annual monitoring, the European Commission has included Slovakia among a minority of EU countries in which macroeconomic imbalances are found not to be present.

Among the core eleven indicators included in the regular assessment process for macroeconomic imbalances, only two in Slovakia exceed the indicative threshold. The first is the net international investment position to GDP ratio, which at -65% is far higher than the indicative threshold of -35%. Although the interpretation of this indicator is that the Slovak economy as a whole has disproportionately large gross external debts, the associated risks are substantially mitigated since a large part of that debt position is linked to foreign direct investment. This is because capital inflows to Slovakia in the form of foreign direct investment are in principle more stable than other forms of financing that can be prone to sudden and unexpected outflows. Furthermore, the balance of payments current account has now been in surplus for the past two calendar years, which means external liabilities are not accumulating.

A second indicator which in Slovakia exceeds the 'safety' threshold is the unemployment rate, which is a long-running weakness of the domestic economy. In 2013 the unemployment rate averaged just above 14%. Not only is the level of the jobless rate a concern, so too is the fact that a large part of the unemployment is structural and that youth unemployment is high in comparison with other EU countries. At least

Chart 4 Changes in nominal unit labour costs in central and eastern European countries over the period 2010-2013 (%)

Source: Eurostat.

in regard to its cyclical development, however, the labour market is improving to some extent. In the latter part of 2013 employment began slowly to increase, with the corollary of a slight fall in the unemployment rate.

For the export-oriented Slovak economy, maintaining competitiveness in international markets is vitally important. The key indicator in this regard is nominal unit labour costs. By this measure, Slovakia's price competitiveness is not expected to be at risk, since unit labour costs fell in 2013 after rising moderately in the previous two years. In almost all the other EU countries, nominal unit labour costs increased in 2013. More important still is that in the longer-run, during the past several years, unit labour costs in Slovakia have remained largely unchanged, while those in Slovakia's main competitors in central and eastern Europe (with the exception of Slovenia) have shown a rising trend. As wage dynamics are not running ahead of labour productivity, they are expected to help maintain the strong export performance of the domestic economy and the country's attractiveness to foreign direct investors.

Fiscal consolidation continued, albeit with the support of several one-off measures

Among euro area countries, Slovakia has one of the lowest debt-to-GDP ratios (the main indicator of the soundness of public finances), at under 60%; nevertheless, certain trends on the fiscal side warrant closer attention. In 2013 the Slovak government achieved, and even surpaassed, its objective of reducing the fiscal deficit to below 3% of GDP. The fiscal deficit fell from 4.5% of GDP in 2012 to 2.8% in 2013, one-tenth of a percentage point below the budget target. However tax and non-tax revenues were lower than budgeted and this shortfall was offset mainly by savings on the co-financing of EU projects (owing to lower utilisation of EU funds) and by dissolution of reserves related to opening of the second pension pillar. Reducing the inflow of EU funds for investment activity is probably not an optimal way to make savings, since it also reduces current GDP growth and, in the longer-run, potential growth. A similar criticism may be levelled at local governments, since they opted for deep cuts to capital expenditure instead of planned reductions in current expenditure. The budget also included several one-off measures that are not contributing to the long-term improvement of public finances. Despite these caveats, the consolidation effort (defined as the year-on-year decline in the structural deficit) was a relatively strong 1.9% in 2013.[3] According to the approved budget for 2014–2016, however, the recovery of public finances will moderate in 2014. Although the cash deficit is expected to fall slightly in 2014, to 2.6% of GDP, this drop will be entirely the result of an increase in one-off measures, to 1.7% of GDP. At the same time, the structural deficit is expected to widen to 4.0% of GDP. Therefore, according to the budget, further consolidation measures are being deferred to subsequent years, and that may make the consolidation effort appear less credible to investors.

General government debt continued its upward trend in 2013. The public debt as at 31 December 2013 was 55.4%, which was 0.5 p.p. above the budget target. This means that the debt exceeded the third debt threshold laid down in the Fiscal Responsibility Act.[4] Consequently, blockage of 3 % of (adjusted) expenditures of the state budget are expected to be made in 2014, and the

3 *Figures on the structural balance and consolidation effort (according to European Commission methodology) are taken from documents published by the Council for Budget Responsibility.*
4 *Constitutional Act No 493/2011 Coll. on financial responsibility.*

budget for 2015 submitted by the government to the parliament should not include a nominal increase in expenditures.

Like the rest of the euro area, Slovakia experienced a relatively strong disinflationary trend from autumn 2013

The quarterly inflation rate turned negative from the third quarter of 2013, and even the annual rate of change in consumer prices was slightly negative in February and March 2014. Given the short duration and main causes of the slower price level dynamics (decreasing food and energy prices), it cannot yet be said that there is deflation in the sense of an endogenously-generated, extended decline in prices across the consumer basket. In the current situation, however, such a deflationary scenario cannot be ruled out. Its implications for financial stability would be analogous to those mentioned in the previous section in regard to the deflation risk in the euro area. Besides impairing real economic activity, deflation in Slovakia could increase the financial burden on banks' customers as well as the general government debt. The public debt ratio could therefore exceed the 60% threshold under the Fiscal Responsibility Act. Along with higher real interest rates and lower nominal GDP, the debt-to-GDP ratio would probably be adversely influenced by the worsened primary budget balance, since the budget´s response to price decreases is less elastic on the expenditure side of the balance than on the revenue side.

The dispute between Russia and Ukraine carries risks for financial stability in Slovakia

There are a number of channels through which this crisis could impair stability in the domestic financial sector. The most direct one is a decline in prices of Russian and Ukrainian financial assets. The Slovak financial sector is not, however, expected to be at risk from price movements in Russian and Ukrainian assets, since its direct exposure to them is minimal; the same can be said for almost every individual financial institution in the sector.

A more significant risk to financial stability in Slovakia, especially for the banking sector, may lie in the various secondary effect of the crisis. These could arise, for example, in connection with the exposure of parent banking groups to Russia and Ukraine, or with the sanctions that the EU is considering imposing on Russia and its financial sector and with the potential countermeasures from Russia. The impact of sanctions on particular segments of the domestic financial market, as well as on particular financial institutions, may be expected to vary depending on their scope and severity.

One possible scenario is the restriction or freezing of trade between the EU and Russia. In that case, Slovak firms that export to Russia would clearly lose part of their sales, with adverse consequences for their financial position. If this were the case, and the firms are financed by Slovak banks, credit risk in the domestic banking sector might increase. As a closer look shows, however, that the debt-servicing ability of these firms should not be significantly jeopardised, since most of them are not overly reliant on sales to Russia. It should be noted, though, that the focus was solely on those firms that both export directly to the Russian market and have a credit relationship with a Slovak bank. On this basis it not possible to generalise about the overall impact that any trade sanctions would have on the corporate sector in Slovakia as a whole.

CHAPTER 3

FINANCIAL SECTOR IN SLOVAKIA

3

3 Financial sector in Slovakia

3.1 SOLVENCY AND FINANCIAL POSITION OF THE FINANCIAL SECTOR

Financial sector profitability

The total profit of the Slovak banking sector in 2013 was 11.8% higher than in 2012. That growth was driven mainly by an increase in retail lending, which boosted interest income from the retail sector. There was also a drop in credit risk costs in the corporate credit portfolio (although they rose slightly in the retail portfolio). Another key factor was the non-recurrence of the bond portfolio losses posted by certain banks in 2012. The trend growth in profitability continued in the first quarter of 2014, albeit at a more moderate pace. The three-month sectoral profit as at 31 March was 9.2% higher year-on-year, with the drop in growth largely attributable to a further increase in credit risk costs in the retail credit portfolio, as well as to the resumption of contributions to the Deposit Protection Fund.

The profit level in domestic banks is higher than that in the banking sectors of other EU countries, and therefore domestic banks are able to strengthen their resilience to future adverse economic developments. A key factor in this regard is the sector's net interest margin, which is one of the highest in the EU and exceeds even the median of such margings in central and eastern European EU countries.[5] Another important factor, however, is that credit risk costs are still relatively low. Thus the profit structure may be considered sound, since the high share of net interest income makes domestic banks substantially less dependent on other non-interest income from riskier transactions in financial markets. Whereas the median ratio of net interest income to total operating income as at 30 June 2013 was 53% in the EU, it exceeded 80% in Slovakia.[6] The fact that net interest income is relatively more robust than other types of income means there is capacity to absorb an increase in losses arising from a deterioration in credit portfolio quality. The sustainability of this trend is important for the financial stability of the Slovak banking sector. In order to better assess this sustainability, the following text analyses the net margins of banks in both the retail and corporate credit portfolios.[7]

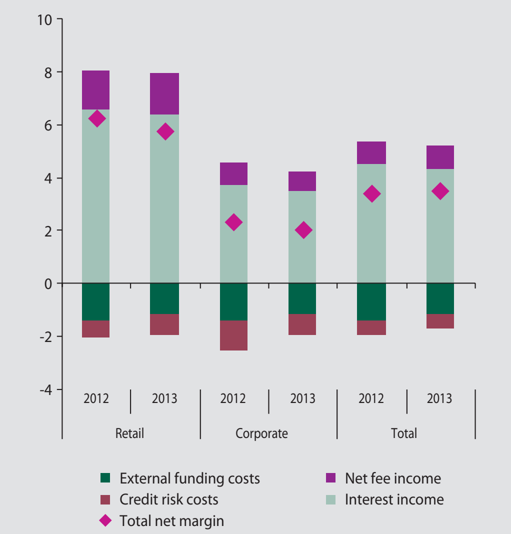
Returns on assets continue to generate an ample and stable profit margin, even after the deduction of funding costs and after adjustment for credit risk costs. This applies particularly to the retail portfolio, notwithstanding that the net margin on this portfolio fell slightly in 2013. That drop reflected mainly a decline in interest income and moderate rise in credit risk costs, which were only partially offset by a rise in fee income. The net return on corporate loans was substantially lower, due mainly to lower level of in interest and fee income, with credit risk costs remaining about the same.

In some banks, however, the net margin on corporate loans reached very low levels in 2013. This is particularly evident in new loans to large corporate customers. As can be seen in Chart 7 (left part), the average net margin on new corporate loans (after adjustments for fee income, credit risk costs and liability costs) is only 0.65%. However, the situation in individual banks is relatively heterogeneous. Low returns are reported mainly by those banks, including several bigger ones, that focus more on lending to large customers. This could result in banks becoming less willing to fund higher-risk projects, since, if situation deteriorates, the margin on such loans may not necessarily be sufficient to cover a moderate rise in credit risk costs.

By contrast, banks are reporting higher net margins in the retail credit portfolio than in the corporate portfolio. There is, however, a difference between the subsets of large banks and smaller banks. Large banks are maintaining higher net margins, and this difference was even more pronounced on new loans provided towards the end of 2013. Nevertheless, the situa-

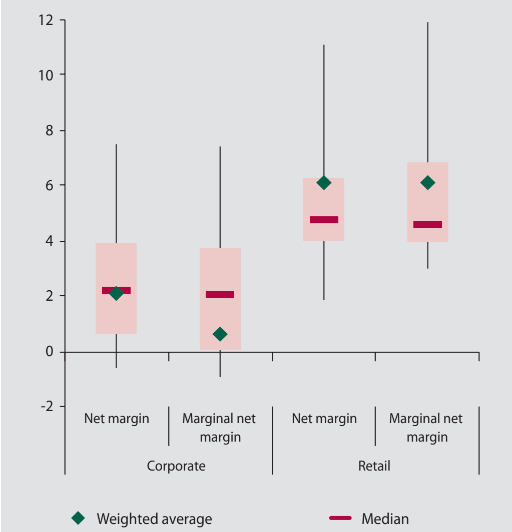
5 This may be because returns on loans are higher, and also because deposits costs are lower owing to Slovak banks' good access to wholesale funding.
6 Source: Statistical Data Warehouse, ECB.
7 The net interest margin means loan income from interest and fees, less credit risk costs and the average cost of external funds.

Chart 5 Composition of returns and costs of assets (%)



Source: NBS.
Note: Returns on assets were calculated as the ratio of total income to the average value of loans in the given portfolio over the whole year.
External funding costs were calculated as the ratio of total interest costs to the average value of external funds for the whole year.
Credit risk costs were calculated as the ratio of credit risk costs, including write off and sell-off costs, to the average value of loans in the given portfolio for the whole year.

Chart 6 Distribution of the net interest margin on retail and corporate loans across banks (%)



Source: NBS.
Note: The chart shows the average, median, interquartile range, and highest and lowest levels of the net lending margin. The net margin was calculated as the return on the respective type of loan from interest and fees, less average credit risk costs for 2012 and 2013 and external funding costs. For the calculation of the net marginal margin, the interest rate on new loans was used instead of the return on the credit portfolio for 2013.
The chart includes only banks that have a share of at least 1% in in the corporate loan market and/or a share of at least 0.5% in the household loan market.

tion in this portfolio is more homogeneous than that in the corporate loan market.

Table 2 Amount of the bank levy and of the contribution to the Deposit Protection Fund (%)

	2012				2013				2014
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Bank levy	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Extraordinary levy	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Contribution to DPF	0.2	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.2

Source: NBS.
Note: In the case of the bank levy, the levy base comprises the bank's liabilities, less equity (if positive), long term funds provided to the branch of a foreign bank, and the value of subordinated debt. For the levy, and also the extraordinary levy, the base was further reduced during the first half of 2012 by the amount of deposits guaranteed by the DPF. The base for the contribution to the DPF consists of the amount of guaranteed deposits.
DPF = Deposit Protection Fund.

Looking ahead there may be several trends that could put downward pressure on the sector's profit and cause changes in its composition. Given the long-standing strength of competition, net interest margins could be expected to decline as they converge towards levels in other EU banking sectors. A corollary of this change will be a rise in fee income as a share of profit and therefore also an increased importance of such income. The primary factor affecting overall profitability will, however, be the growth rate of lending to the retail sector and/or small and medium-sized enterprises. A comparison of net margins and credit risk costs indicates that, in the retail portfolio, the effect of an increase in credit risk costs would be fully offset by net margins, while in the large corporates portfolio it would cause certain banks to make a loss on this business. Another significant factor will be the settings of the bank levy, the contribution to the Deposit Protection Fund, additional supervision fees related to implementation of the Single Supervisory Mechanism, and contributions to the Single Resolution Fund following implementation of the Single Resolution Mechanism.

In most financial market segments return on equity at the end of 2013 was higher year-on-year. ROE increased the most in the sector of supplementary pension management companies (third pension pillar) and to a moderate extent, after falling in the previous year, among pension funds management companies (second pension pillar) and insurance companies. By contrast, a year-on-year drop in ROE was reported by investment fund management companies. ROE growth in SPMCs was driven by improved cost-to-income ratios. Among PFMCs, too, cuts in operational expenses supported profit growth, as did an increase in income from pension fund performance fees. In the insurance sector, ROE growth reflected mainly one-off effects stemming back to 2012. The decline in the technical result in non-life insurance was offset by positive trends in life insurance.

Capital adequacy

The capital ratio of the banking sector increased further in 2013, to its highest level since 2005. Climbing from 15.8% to 17.2%, it remained at that level during the first two months of 2014. This trend mirrors that in other central and eastern European EU countries. The banking sector's capacity to absorb potential losses caused by adverse economic developments or other unexpected losses has therefore increased.

The rise in the capital ratio was again largely based on the retention of part of the previous year's earnings, around one-quarter of the overall profit for 2012. Also boosting the capital ratio, however, were certain factors that resulted in a drop in the amount of risk weighted assets. These included principally a decline in the amount of corporate lending, as well as a further decrease in risk weights in banks that use internal models to calculate their capital requirement. It should be noted, however, that these risk weights have not yet fallen below the average level in the EU.

The relatively high amount of own funds in the domestic banking sector is important in regard not only to capital adequacy but also to other areas at the forefront of ongoing changes in banking regulation strategy. As regards the leverage ratio – for which European institutions are considering setting mandatory requirement – its level in the Slovak banking sector is around twice as high as the average for banks in the EU. A higher level of own funds gives banks greater funding stability based on long-term liquidity and balance-sheet composition. These funds are important also in regard to the draft Bank Recovery and Resolution Directive (BRRD), which would require banks to maintain sufficient instruments, including own funds, with which to write down debt and/or covert it into equity instruments.

Thanks to its strong capitalisation, the banking sector is not expected to be exposed to a significant stability risk even in the event of relatively adverse scenarios. As macro stress testing results show, banks would not need to increase their own funds significantly even if faced with a combination of macroeconomic headwinds (with negative repercussions for the domestic economy) and a further increase in risk aversion in financial markets. Nevertheless, several banks, as well as other financial institutions or funds, would make a loss. Further details on the results of macro stress testing are provided in Box 1.

Being now so high, the capital ratio of the banking sector is not expected to increase significantly further in the period ahead. According to banks' preliminary plans, the share of profit to be paid out as dividends to shareholders will be higher than in previous years, which should not have adverse effect to the stability of the Slovak banking sector. On the other hand, given the continuing risks in the macroeconomic situation, as well as in financial market developments, banks need to have a sufficient buffer against any losses arising from the materialisation of such risks. Hence the transposition of the CRD IV Directive will include invoking the option of earlier implementation of the capital conservation buffer, which is expected to be set at 1.5% of risk-weighted assets as from the entry into force of the transposing Act and at 2.5% from 1 October 2014. Apart from the buffer, all banks should also maintain sufficient own funds to cover any risks, including those not covered by regulatory (Pillar II) requirements. In order to ensure financial stability, it is also necessary that these own funds remain in domestic banks, i.e. that they are not allocated to other parts of the group; this applies also to banks that will be supervised directly by the ECB under the Single Supervisory Mechanism.

The solvency of insurance companies has remained high despite a slight year-on-year decline. In the insurance sector as a whole, the weighted average ratio of the available solvency margin to the required solvency margin[8] was 3.37 at the end of 2013, down from 3.55 at the end of 2012. In this regard there remains relatively marked heterogeneity across insurance companies. The year-on-year drop in this ratio was largely accounted for by a decline in the value of the AFS portfolio of bond securities, which was in line with the price movements of these instruments in global financial markets. It should be noted, however, that this decline may to some extent have been a correction of the relatively strong increase in their prices in 2012, when there was also a notable rise in the ratio of the available solvency margin to the required solvency margin in the Slovak insurance sector.

Box 1

MACRO STRESS TESTING

For this report, macro stress testing was focused on analysing the stability of the domestic financial sector under a Baseline scenario and two stress scenarios, labelled 'Economic Downturn' and 'Financial Market Crisis'. The stress testing was carried out on data as at 31 December 2013 and its time horizon was covering the years 2014 and 2015.The Baseline scenario is based on the official Medium-Term Forecast published by NBS as of the fourth quarter of 2013. It assumes that economic activity will gradually pick up amid increasing external, and also domestic demand, and low inflation. The Economic Downturn scenario assumes weaker external demand with negative repercussions for the domestic economy (GDP falls by more than 9%), adverse developments in the labour market (unemployment rises to 16.6%), and a partial increase in financial market nervousness, particularly in equity markets. The Financial Market Crisis scenario envisages an even more severe and extended deterioration in the macroeconomic situation (an overall decline in GDP of more than 13%) as well as relatively adverse developments in financial markets, include falling prices of government bonds issued by EU countries (higher risk countries, in particular).

The domestic banking sector showed relatively strong resilience to the stress scenarios, thanks to its high solvency margin and ability to generate net interest income. While around half of banks would report a loss under the stress scenarios, the total amount of additional capital required to ensure that each bank meets the minimum regulatory capital ratio of 8% would be €3 million (0.1% of own funds) under the Economic Downturn scenario and €7 million (0.2% of own funds) under the Financial Market Crisis scenario.

The impact of the stress scenarios on other financial market segments was notably greater compared with the 2012 stress test, especially on pension funds managmeent companies, whose portfolios saw a marked increase in risk during 2013. This is especially evident under the Financial Market crisis scenario, with the current pension-point value of PFMC-managed mixed funds and equity funds falling by between 6% and 7%. Similar levels of losses were observed in SPMC funds. In the collective investment sector, the majority of funds would not be expected to make a loss of more than 5%, but in funds with a riskier investment strategy, the loss could

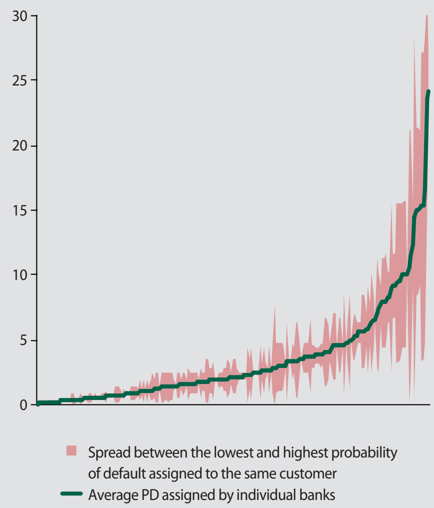
8 In the case of insurers for which the required solvency margin was lower than the minimum amount of the guarantee fund the value of the former was replaced by the latter.

be substantially higher. In the insurance sector, under the Economic Downturn scenario, losses should be offset by interest income from assets. Under the Financial Market Crisis scenario, however, such income would not be sufficient to cover additional losses from the revaluation of financial assets, and/or insurance risk losses.

Degree of consistency between bank's internal models

With risk weights falling as a result of banks' internal models, it is important that they do not diverge significantly between banks It would be particularly concerning if one or more banks deviated towards less conservative outputs, which could result from inconsistent or insufficiently prudent application of internal model requirements. In that case, expected and unexpected losses could be underestimated, and thus the extent to which they are covered by provisions, reserves and equity could be too low. That in turn could stoke doubts about the actual capital ratios of the most significant banks. Hence this issue is being addressed by institutions on both the global and European level, for example, the IMF and EBA. Since much of the increase in the capital ratios of the largest Slovak banks is attributable to risk weights being reduced by the implementation or recalibration of banks' internal models, the state of this issue in Slovakia needs to be examined more closely.

Chart 7 Comparison of the PD values assigned by banks to customers (%)



Source: NBS.
Note: The horizontal axis shows individual customers, and the vertical axis shows probability of default.

As regards their probability of default estimates for corporate customers, domestic banks show considerable heterogeneity. However, average values calculated for subgroups of like borrowers do not differ significantly. The probability of default (PD) that different banks assign to particular customers are often quite varied. The average difference between the lowest and highest PD is 5.2 p.p., while the average weighted by size of exposure is 2.2 p.p. This means that the degree of variability is lower in the case of more significant customers. As regards the identification of non-performing customers, the data under review show relatively higher consistency. On the other hand, despite the substantial differences in respect of individual customers, the average PD values for like subgroups do not show any significant divergence. That would also be the case when the focus is solely on riskier exposures with higher PDs.

It may be concluded that domestic banks' internal models, despite their considerable diversity, do not entail the risk of one or more banks taking an imprudent approach. This is positive from the view of financial stability. The diversification of internal models that is not leading to undesirable underestimation of risks in individual banks while not being based on an excessive degree of uniformity may increase the resilience of the banking sector as a whole to any cyclical shocks.

3.2 BANKING SECTOR ASSETS

Retail lending increased

The annual growth rate of outstanding retail loans in the Slovak banking sector was almost 10% in 2013, one of the highest rates in the EU. The acceleration of lending growth continued a trend that began in the second half of 2012, with increases in both housing loans and consumer loans. The main driver of this trend is low interest rates. These also account for the increase in the share of new loans used for refinancing, which rose to 35% and is expected to remain flat. That there remains scope for further refinancing of existing loans is indicated also by the difference between the agreed average interest rates on the stock of housing loans and on new housing loans, which has been fluctuating close to its all-time high (almost 1 p.p.) since the outbreak of the financial crisis and subsequent decrease in interest rates.

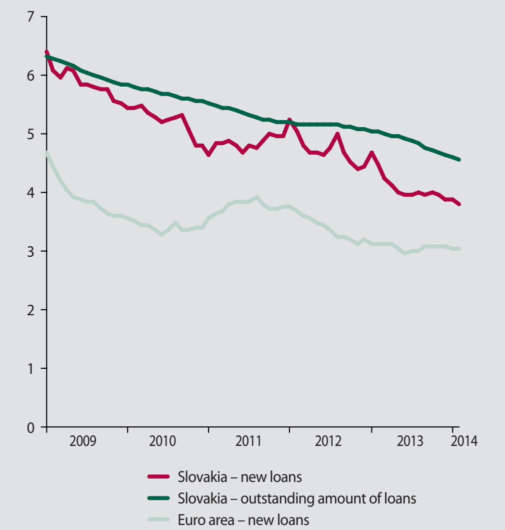
The highest lending growth was reported by certain medium-sized banks. Inter-bank competition was largely in the form of low lending rates and high LTV ratios. Customers were opting for longer interest rate fixation periods, which to some extent lessened the banking sector's sensitivity to any future rate rises and its exposure to indirect credit risk.

The ratio of non-performing loan to total loans increased slightly at the beginning of 2014, to 4.4% at the end of February, after falling in each of the previous three years. However, the value of this ratio was distorted by a sharp increase in the outstanding amount of loans. The rising trend in the amount of non-performing loans extended to 15 consecutive months and the rate of increase accelerated slowly. This increase was confined to certain banks.

Positive trends in corporate lending largely attributable to financing of state-owned firms

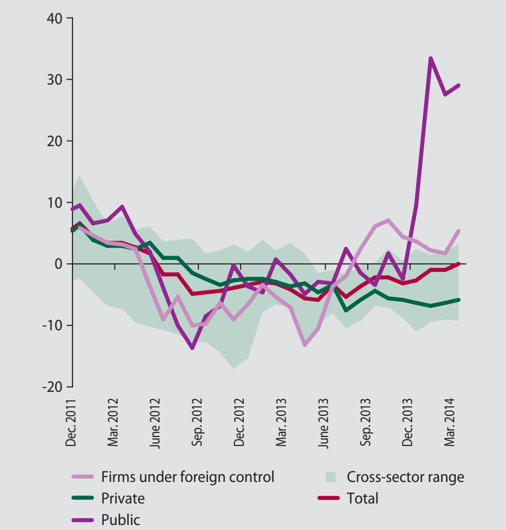
An upturn in the corporate lending market in the second half of 2013 and first quarter of 2014 was mainly accounted for by lending to state-owned firms. In March 2014, the total amount of corporate loans provided by domestic banks increased year-on-year for the first time since May 2002, by 0.07%. That increase, however, was driven mainly by lending to two state-owned firms. The gap between growth in corporate lending to the public and private sector was wider than at any time since 2006. In March 2014 loans to state-owned firms made up almost 14% of the overall corporate credit portfolio. There was also an increase in the flow of loans to foreign-owned firms, particularly in the second half of 2013.

Chart 8 Comparison of average interest rates on retail loans (%)



Source: NBS, Statistical Data Warehouse.

Chart 9 Annual growth rate of corporate loans provided by domestic banks (%)

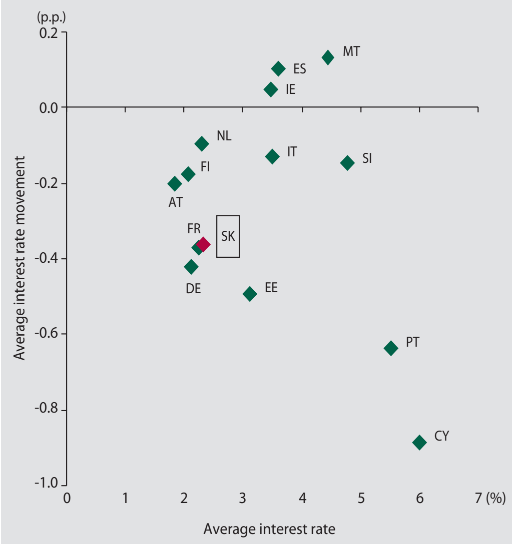


Source: NBS.
Note: The range is interquartile.

Lending to domestic private firms remained complicated during 2013 and the first quarter of 2014, with the flow of loans still in negative territory. Both firms and banks played a part in this development. Firms' weak demand for loans reflected mainly their subdued investment activity. Banks, for their part, kept the supply of credit relatively tight owing to persisting uncertainty about macroeconomic trends and their effect on credit risk. The combination of relatively compressed interest margins and uncertainty surrounding future credit risk developments may explain why banks are being cautious in their approach to lending to domestic firms.

Consequently, the rate of decrease in lending to domestic private firms is now the seventh highest among EU countries, even though the overall increase in loans from domestic banks (including loans to state-owned firms) is among the highest in the EU. Furthermore, growth in lending to small and medium-sized firms also decelerated during the first months of 2014.

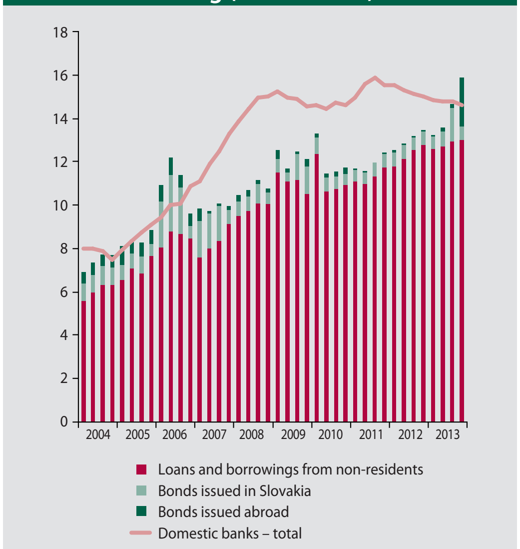
Chart 11 Interest rates on new corporate loans and their movement



Source: ECB.
Note: The interest rate on the horizontal axis denotes the average for 2013; the movement on the vertical axis represents the difference versus the average for 2012.

Firms in Slovakia did not confine their borrowing to loans from domestic banks. Cross-border borrowing accounted for an increasingly significant share of firms' liabilities. While the amount borrowed in this way increased year-on-year in 2013, the amount of loans received from domestic banks fell. Most cross-border borrowing comprises intra-group financing, which implies either foreign ownership or the establishment of foreign entities with Slovak capital. Not only did cross-border borrowing increase, so did the issuance of bonds. The largest growth in bond issuance was observed in the last two quarters of 2013, and was attributable to sales of bonds abroad.

Chart 10 Corporate sector financing: loans from domestic banks and alternative sources of funding (EUR billions)



Source: NBS, ECB.

Consequently, a higher proportion of funding was provided through alternative channels (cross-border borrowing and bond issuance) than through loans from the Slovak banking sector.

Interest rates on new corporate loans are among the lowest in the euro area. Given the scope for cross-border financing, it is important to compare interest rates. Any significant interest rate differential would be a direct incentive to increase cross-border lending. In that regard, it is positive that domestic banks' interest rates on new corporate loans have long been lower than the euro area average and are at the level of the euro area core. Similarly, the rate of change in these rates has been closer to that in Germany or France. But while this situation benefits firms, it has a downward impact on the banking sector's profits (see Section 3.1).

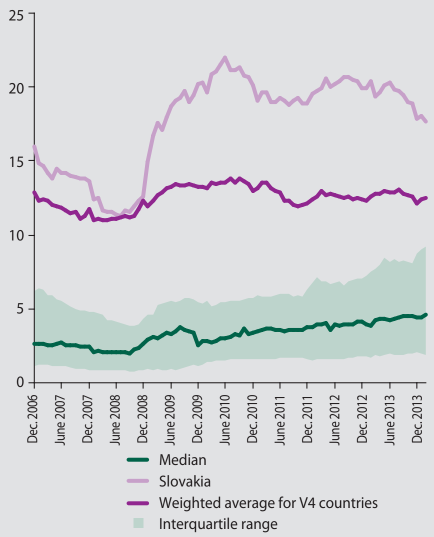
On the other hand, interest on new loans of up to €250,000 (typically provided to small and medium-sized enterprises) remained above the euro area median during 2013.

The share of domestic government bonds in banks' portfolios fell

In Slovakia, the share of domestic government bonds in the total assets of the banking sector remains among the highest in any EU country. Although this share has been falling since mid-2013, it is still the second highest in the EU (behind only Romania). Furthermore, the share of domestic government bonds held by the banking sector in Slovakia in the total amount of domestic governemnt bonds issued is also, like the share of such bonds in banks' assets, one of the highest in the EU, although it is on an extended downward trend. Therefore a large part of the banking sector's balance sheet is exposed to single counterparty risk. This in turn means that the stability of the banking sector is closely connected with the stability of domestic public finances.

As a factor in the potential impact of market risks on the banking sector, this high share is not at present a direct risk. This is due largely to the high share of bonds in the held-to-maturity (HTM) portfolio – more than 67% as at the end of February 2014 – since these are not revalued through equity or through profit and loss. Bonds held in the available-for-sale (AFS) portfolio constituted just under 29% of the total portfolio as at the end of February 2014 (the revaluation of AFS assets is recognised directly in equity). A sensitivity analysis showed that if all bonds not held in the HTM portfolio were revalued directly through equity, not one bank's capital ratio would fall below 8% even if the market price of Slovak governments fell by 20%. In that case, the average capital ratio in the sector would drop from 17.2% to 15.0%.[9] However, if a downward revaluation of Slovak government bonds occurs in case of economic headwinds in conjunction with developments in other portfolios of the banking sector, it may represent an additional burden that could weigh on the sector's capital ratio. In that regard, it is important that the decline in the share of government bonds leads at least to a lessening of market risk concentration in the banking sector's portfolios.

Chart 12 Domestic government bonds as a share of banks' total assets in EU countries (%)



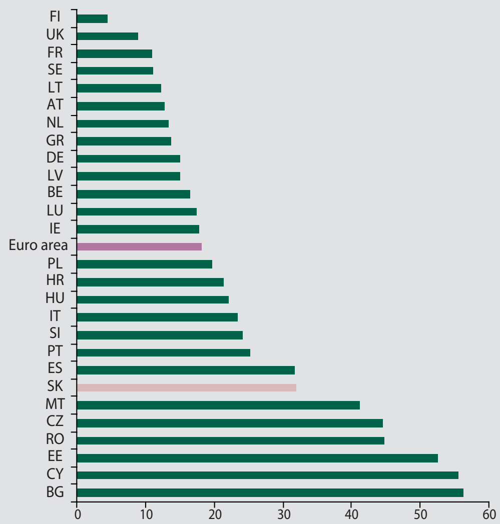
Source: ECB Statistical Data Warehouse.

It follows that a restructuring of Slovak government debt would represent a risk to the banking sector. Such risk, however, would be significant even if the share of Slovak government bonds in the banking sector's total assets was substantially lower. On the other hand, given the relatively favourable indicators for the Slovak economy and public finances, as well as the current monetary policy of the ECB and macroeconomic developments, any such restructuring in the near term may be considered highly unlikely.

On the positive front, the high share of Slovak government bonds in the banking sector's assets and in the total amount of Slovak government bonds issued are on a downward trend. Domestic banks' holdings of Slovak government bonds as a share of the total issued amount of such bonds may be expected to decrease further, since non-resident banks' are purchasing an increasing proportion of new issues of these bonds. At the end of 2013 domestic banks held just over 30% of all outstanding Slovak government bonds (down from over 55% at end-2009), but they held only slightly more than 16% of the amount of those bonds newly issued in 2013. The share of Slovak sovereign bonds held by other domestic financial companies is relatively

9 *This outcome is based on the assumption that the amount of banks' own funds and risk-weighted assets is the same as reported as at February 2014 and that the amount of own funds will be affected solely by losses on the revaluation of Slovak government bonds.*

Chart 13 EU national banking sectors' holdings of domestic government bonds as a share of the outstanding amount of such bonds (%)



Source: ECB Statistical Data Warehouse.
Note: The chart shows each banking sector's holdings of domestic government bonds as a share of the total outstanding amount of such bonds.

low compared with the share held by banks (less than 10% at end-2013).

As well as a decline in this share, as noted above, the share of Slovak government bonds in the total assets of the Slovak banking sector has also been falling. Given the possibility within the medium term for changes in the regulatory framework, in international accounting standards relating to government bonds, or in the macroeconomic environment, a gradual decline in investment in domestic government bonds (in both absolute and relative terms) is instrumental in reducing the potential burden on the Slovak banking sector.

The banking sector generally has a somewhat specific role in the domestic government bond market. The pattern of investment in government bonds indicates a certain cyclicality. In the period of strong economic growth and credit boom, approximately until the end of the third quarter of 2008, the decline in the total asset share of domestic government bond holdings was partly caused by the rapid expansion of credit portfolios, whereas towards the end of 2008 and during 2009 this share increased significantly. In that period, banks were to a large extent compensating for the drop-off in lending growth (especially in loans to non-financial corporations). In the event of a downturn in the domestic economy, investments in government bonds could pick up again for the reasons given above, thereby increasing their share of the sector's total assets. Thus at times when non-resident financial companies are looking to sell (from their view) foreign government bonds in response to general nervousness in financial markets, adverse developments, and a shortage of information about the respective economy, the domestic banking sector may to some extent compensate for such negative trends by increasing its holdings of these bonds.

3.3 FUNDING SOURCES OF THE BANKING SECTOR

SOUND FUNDING STRUCTURE OF BANKS

The risk of deteriorating access to funding, identified in recent years as one of the principal risks in several euro area countries, remains less significant in the Slovak banking sector. The relatively stable basis of non-bank deposits continues to ensure banks' strong position in regard to funding sources. The loan-to-deposit ratio remains below 100%, and on current trends in deposits and loans it is not expected to change significantly in the short-term horizon.

This view holds even though the annual growth of retail deposits has been falling gradually since the beginning of 2012 (by the end of 2013, it was approximately half of its rate at the end of 2012). That decrease is largely caused by the stock of term deposits, which in April 2013, after a period of falling growth, declined year-on-year and which has since been decreasing at an ever increasing pace (by 4.7% at the end of February 2014). The decrease in term deposits is probably a consequence of low interest rates. These low rates stem not only from the monetary policy stance, but possibly also from the reduced pressure of competition. It is therefore likely that customers are seeking alternative investment opportunities, such as savings deposits, investment funds, or the direct purchase of bank bonds (at several banks customers may directly purchase mortgage bonds and subordinated debt). As for sight deposits, the average growth of their total amount in 2013 was around 8%.

Deposits of non-financial corporations began to increase strongly in the second half of 2013, after subdued dynamics in the first six months. Deposit growth is probably related to sales growth, which increases firms' liquid assets.

The trend of mortgage bonds accounting for most of the issuance of debt securities continued in 2013. Most of the bonds issued by banks in 2013 had a fixed coupon. The gradual drop in the average bond yield during the first three quarters mirrored yields on government bonds, and therefore the spread between yields on mortgage bonds and Slovak government bonds was stable. This indicates that the perception of the riskiness of these bonds relative to that of Slovak government bonds remained largely unchanged.

In general, interbank funding is still a secondary source of funding for banks. The situation in wholesale funding, particularly at the beginning of the year, was affected mainly by the repayment of funds borrowed under the ECB's three-year longer-term refinancing operations (from December 2011 and March 2012). In 2013 banks repaid around three-quarters of these funds. What matters with regard to financial stability is that the decrease in these funds did not significantly affect banks' capacity to finance the real economy.

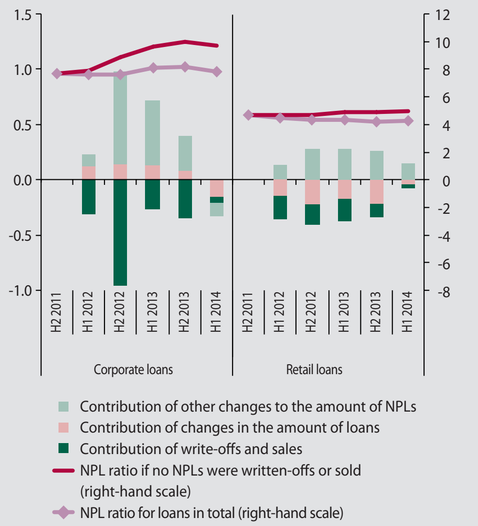
3.4 FINANCIAL SECTOR RISKS

Loan quality

The non-performing loan (NPL) ratio for corporate loans increased in 2013 (from 7.6% to 8.1%), while the NPL ratio for retail loans fell (from 4.33% to 4.16%). This situation was partly determined by trends in the overall amount of loans, as corporate loans decreased and retail loan increased. Both in the corporate portfolio and, to a lesser extent, in the retail portfolio, sales and write-offs of NPLs significantly declined in year-on-year terms.

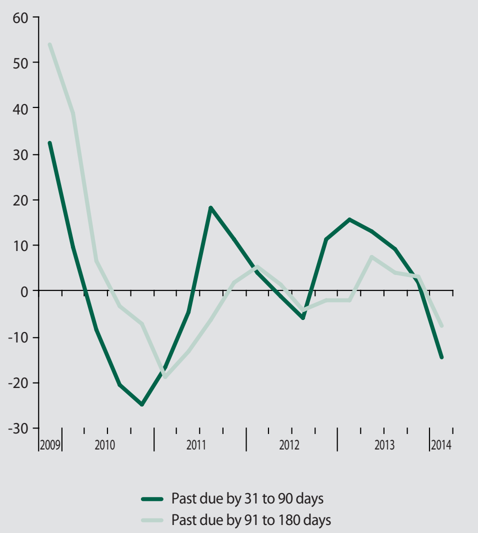
If no NPLs had been sold or written off, the NPL ratio for corporate loans would be higher (by 1.1 p.p.) and the NPL ratio for retail loans would also increase (by 0.2 p.p.). The first quarter of 2014 saw a slight shift in the trends observed in 2013. The NPL ratio for retail loans, increased moderately, while the ratio for corporate loans dropped.

Chart 14 The non-performing loan ratio and its breakdown (%)



Source: NBS.

Chart 15 Past due loans to natural persons including self-employed persons (annual percentage changes)



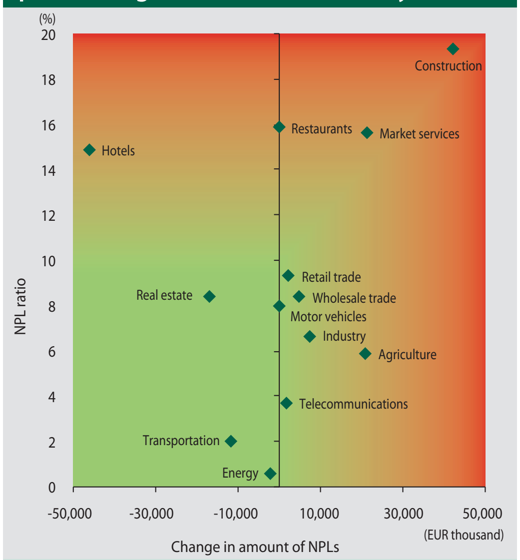
Source: NBS.

Based on indicators of potential future changes in credit risk costs, it is assumed that the above-mentioned increase in non-performing retail loans will accelerate in the near term. The amount of retail loans past due by between 30 days and 90 days fell in the first quarter of 2014 after rising in the first half of 2013.

The amount of loans past due by between 90 and 180 days also began to drop in the first quarter of 2014. Based on historical experience, this situation is assumed to indicate that the growth rate of non-performing retail loans will moderate in the near term.

The presence of as yet unidentified credit risk losses in the banking sector may be indicated by the fact that exposures to certain firms designated as non-performing by one bank are in some cases not deemed non-performing in other banks. The NPL ratio for corporate loans was 7.8% at the end of March 2014, but if these exposures were taken into account, it would rise to 8.8%. Losses on such exposures not yet identified as risky would, assuming a recovery rate of 70%, reduce the overall annual profit by around one-fifth.

Chart 16 The amount and ratio of non-performing loans broken down by sector



Source: NBS.
Notes: Outstanding amount of NPLs as at 31 March 2014. Change in amount of NPLs refers to the change over the 15 months from 1 January 2013 to 31 March 2014.

The differences in loan quality between different sectors became more pronounced, with loans to the construction sector performing the worst. Although the NPL ratio for corporate loans was marginally lower as at March 2014, and several credit risk factors had moderated, the situation was heterogeneous across sectoral loan portfolios. The most difficult situation was observed in loans to the construction sector. A combination of the highest NPL ratio for loans in total and the largest growth in the stock of non-performing loans for 15 months means an increase in credit risk. The exceptional deterioration in construction lending is almost entirely due to the civil engineering portfolio, for which the NPL ratio soared from 5% at the start of 2013 to 46% in March 2014.

Concentration risk

A significant factor in the corporate credit portfolio is concentration risk arising from the systemic significance of certain customers. This concerns mainly firms that have substantial borrowings from several banks, given the size of such exposures both in absolute terms and relative to the amount of the bank's own funds. The concentration risk stems mainly from the relatively high degree of ownership and other financial interlinkages between firms in the Slovak economy, as well as the fact that the banking sector in Slovakia, more so than in several European countries, is quite small relative to the size of the national economy. This, in conjunction with the concentration of the sectoral composition of the Slovak economy, means that the degree of interconnectedness is increased also through indirect links such as supplier-customer relations, and the like.

The banking sector's sensitivity to this risk was analysed using data on banks' larger exposures and information from the Register of Bank Loans and Guarantees as at 31 March 2014. On this basis, it was possible to identify several customers, or groups of customers, to which several banks are substantially exposed and whose default would cause the capital ratio of some banks to fall below 10.5%.

In some medium-sized banks, the higher level of concentration risk is also reflected in the relatively high value of their exposure to the parent banking group. That exposure amounts to more than 50% of their own funds, meaning that these banks are more heavily exposed to possible spillover of external risks from foreign banking sectors. In order to mitigate this risk, NBS is reducing the maximum limit on a bank's exposure to its parent group, from €150 million to €50 million, where such exposure is equivalent to more than 25% of the bank's own funds.

Although household debt in Slovakia is among the lowest in the EU, it is on an upward path

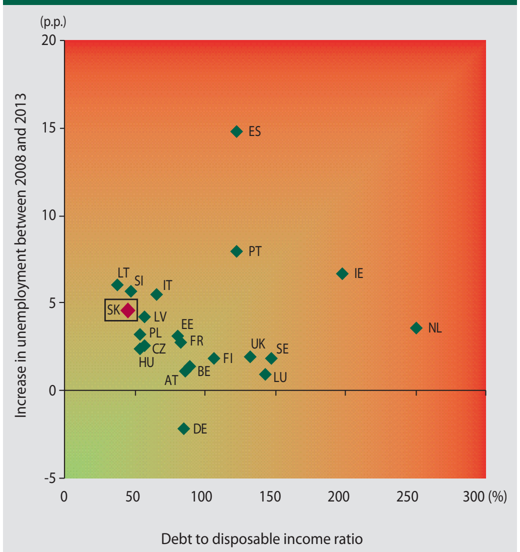
Because the overall indebetedness of households in Slovakia is one of the lowest in the EU, households in Slovakia have favourable conditions for debt servicing. The ratio of Slovak households' bank loans to their gross disposable income was 45% at the end of 2012. While this ratio does not indicate the debt-servicing capacity of individual households, its relatively low level creates greater scope for households, with support from extended family, to cope with financially stressed periods. The total debt to disposable income ratio in Slovakia is due mainly to the relatively smaller number of households that are servicing debt.

What represents a dangerous combination for credit risk is a combination of high household debt and mounting difficulties in the labour market. By this measure, the situation in Slovakia remains very favourable, as is confirmed by the positive trend in credit portfolio quality in the Slovak banking sector.

In 2012 household debt growth in Slovakia was among the highest in the EU. This strong growth is put in a positive context, however, by the fact Slovakia has one of the lowest levels of household debt in the EU. There are two important trends in this regard. First, central and eastern European countries as a whole have recently ceased converging towards the debt levels common in western European countries. Whereas between 2005 and 2008 household debt ratios in new Member States increased at a similar pace and were catching up with those in western Europe, the situation today is far more heterogeneous. The continuing upward trajectory of indebtedness in Slovakia, the Czech Republic and Poland contrasts with the situation in other central and eastern European countries.

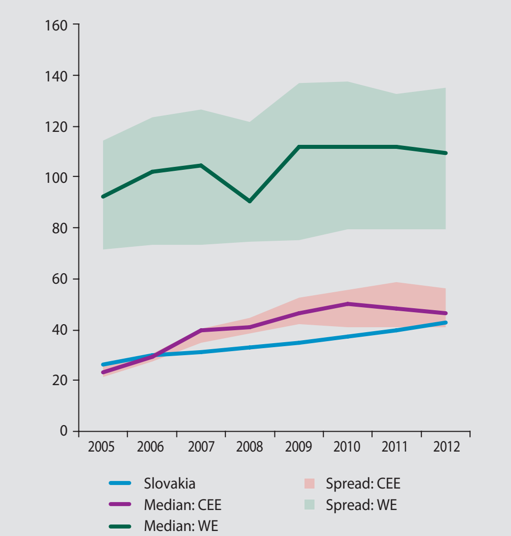
The second trend is the strong growth in household debt, which has shifted Slovakia towards the median of CEE countries. Given the similarities between the economies and banking sectors of CEE countries, the household debt ratio in Slovakia should be compared with that in these countries rather than in western European countries.

Chart 17 Debt to disposable income ratio and unemployment



Source: Eurostat.

Chart 18 Ratio of bank loans to gross disposable income of households (%)



Source: Eurostat, ECB.
Note: The spread is interquartile. WE – western Europe; CEE – central and eastern Europe.

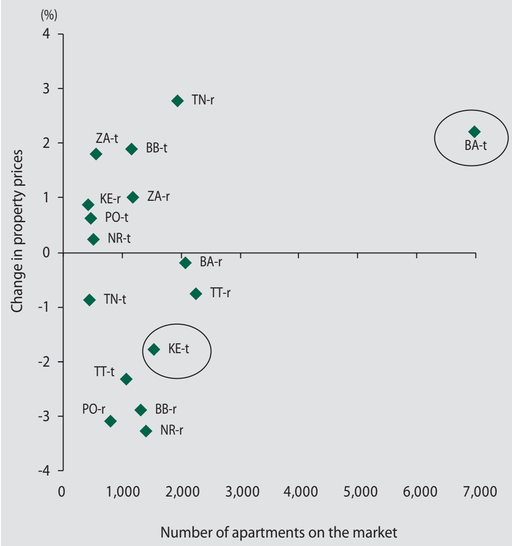
Residential property market

There are two impacts of the property market on financial stability. One is the macroeconomic aspect of property price stability, in other words the potential for the emergence of imbalances or price bubbles. The other is the linkage between the property market and lending market in the context of the risks that banks undertake when providing housing loans.

The situation in the housing market in 2013 was similar to that in 2012. Prices were generally stable and did not point to the emergence of imbalances. Despite robust growth in housing loans, among the highest rates in the EU, general prices of residential property did not change significantly. This trend that was apparent in prices of both new and older apartments is important for the overall equilibrium.

While the gap between price movements in Bratislava city and the rest of Slovakia widened, the difference remains small.

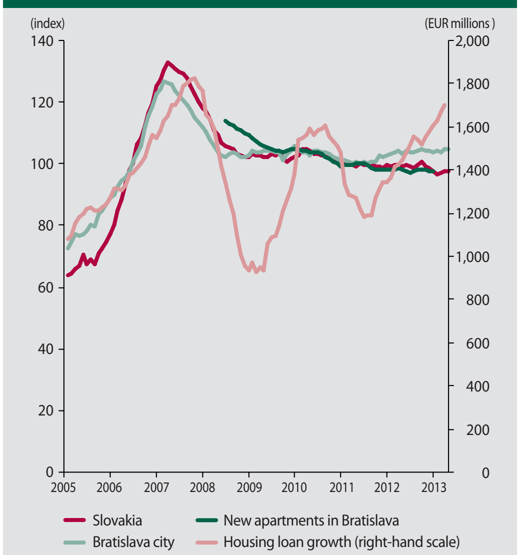
Chart 20 Size of property market and change in property prices



Source: Real Estate Price Map.
Note: Data are calculated as the average for the 12-month period ending on 31 March 2014.
The designation 'r' denotes the region not including the regional town, while 't' denotes the regional town.

Regional differences in property market size and apartment price movements continued in 2013. Market size is affected mainly by whether properties can be sold at current market prices. The higher the number of properties on the market in a given area, the lower the probability that a bank would not be able to sell a property at the current market price. If, on the other hand, fewer properties are on the market, it will be more likely that banks, in selling apartments, will put indirect downward pressure on prices in that market and thus suffer a loss on such sales.

Chart 19 Property prices and housing loans



Source: Real Estate Price Map, NBS.
Note: Lending growth is calculated as the year-on-year change in the outstanding amount of loans. Index: May 2012 = 100.

A second key factor is the movement of apartment prices in the given market. Price movements are a major determinant of banks' LTV ratios, mainly because the relatively slow amortisation of a housing loan's principal translates into a very slow drop in the LTV ratio, even when property prices are stable.

Bank policies for housing loans are expected to more closely reflect developments in the housing market. This relates particularly to loan-to-value ratios. This relationship between the value of a loan and the value of the collateral is the main channel through which the risk related to a change in property prices or market liquidity is transmitted to a bank; in the event of a default, the LTV ratio determines bank's exposure to the property market. It is therefore necessary to note not only the current stagnation in apartment prices, which are not allowing an increase in LTV ratios, but also the different nature of housing markets in different parts of Slovakia.

Particularly interesting in this regard is the property market in Bratislava city, which on the one hand is the largest market (by both number of properties for sale and number of property sales) and, on the other hand, has recently seen an increase in prices. Such a combination currently appears favourable from the view of LTV ratio policy, but at the same time there is the possibility of a price bubble arising as a consequence of price growth in excess of the Slovak average. In this regard, the housing market in Bratislava contrasts with that in, for example, Košice city. Although the property market in Košice, a regional capital, is the second largest in the country it is far smaller than that in Bratislava. Furthermore, property prices in Košice were falling in 2013, with the result that LTV ratios increased.

Another reason for the stronger caution in LTV policy is that current European regulatory trends in the field of consumer protection could potentially make it less efficient for banks to realise collateral (real property) following foreclosure.

Increase in LTV ratios on new housing loans

In 2013 the average LTV ratio on new housing loans remained at around 71%, but in early 2014 it increased to a two-year high. There is, however, considerable heterogeneity in LTV ratios across banks. In some banks, the proportion of new loans subject to a high LTV ratio (i.e. more than 85%) has long been above 40%, and in early 2014 there were even cases where it increased to half of new housing loans. This means that in the event of a decline in property prices, or the need to quickly realise collateral, the value of the collateral could be significantly lower than the value of the claim. If the realised price of collateral is low, then both the borrower and the bank may incur an additional loss.

At the same time, recent months have seen a rising trend in average LTV ratios in those banks, or foreign bank branches, whose LTV ratios are already above the sectoral average.

The situation in loans that are subject to a high LTV ratio is to some extent consistent with the increase in the number of loans in the respective categories and with the market shares of the banks concerned. It is therefore likely that LTV ratios are being used as an instrument of competition.

Several EU countries have begun regulating LTV ratios for housing loans. Although national policies differ, an LTV ratio ceiling of around between 70% and 80% is typical. Another common feature has been the introduction of the option of a higher LTV ratio for a selected subgroup of loans, usually determined simply as a percentage of new loans. In some of these countries, the regulation of LTV ratios is based on recommendations (as, for example, in Poland), while in others the limits are mandatory (for example, in Cyprus, Finland, Lithuania, the Netherlands, Romania and Sweden). The method of regulation thus reflects the particularities of the national banking sector.

Risks associated with financial intermediation remain present

The substantial links between banks and financial intermediaries in the area of lending, and consequent potential pressure on credit standards, may be seen as a particularly significantly risk.[10] An individual bank may find it difficult to limit its cooperation with intermediaries unilaterally, since to do so could reduce the number of loans it provides. Hence it is important for banks to have diversified cooperation with intermediary companies.

A significant risk channel lies also in the current pressure from intermediaries to shorten interest rate fixation periods, their intention being to allow more frequent refinancing and therefore more frequent commissions. Hence, banks and customers are becoming more sensitive to potential increases in interest rates.

The quality of the portfolio of intermediated loans has not lessened significantly. The credit quality of loans provided through financial intermediaries is so far not notably lower than that of other loans. However, intermediaries are providing an increasing share of total loans, and the credit risk of this portfolio may also rise. Any materialisation of risk arising from unsound credit standards could therefore concern an increasingly large amount of loans. A key catalyst in the financial intermediation market is the current low level of interest rates. Furthermore,

10 This issue is addressed in more detail in the Financial Stability Report – November 2013.

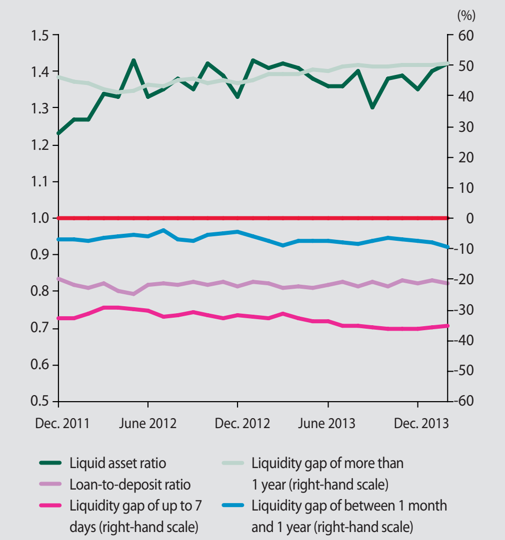
2013 saw a widening of the gap between average overall lending rates and interest rates on new loans, and therefore even greater incentives to refinance old loans. It may be expected that activity in the financial intermediation market will decline when interest rates rise again.

Amid strong growth in housing loans, liquidity risk is not increasing

The growth in long-term lending has had a broadly negative effect on the quick and long-term liquidity ratios of the banking sector. As a rule, short-term liquidity is adversely affected by an increase in illiquid assets in the form of long-term loans, while long-term liquidity may be impaired by a widening maturity mismatch between assets and liabilities. As lending increases, so usually does the loan-to-deposit ratio, thereby exposing banks to greater volatility in their funding sources.

Despite this principle, the Slovak banking sector does not as yet report adverse trends in either short-term or long-term liquidity. The regulatory liquid asset ratio and loan-to-deposit ratio have been steady in the recent period. This is because the increase in long-term loans was accompanied by an increase in deposits (particularly retail deposits), which continued to ensure that banks had not only sufficient primary funds, but also stable funding from the view of the liquid asset ratio.

Chart 21 Liquid asset ratio, loan-to-deposit ratio, and liquidity gap



Source: NBS.
The liquid asset ratio is calculated as the median ratio among commercial banks (not including home savings banks).
The denomination of the loan-to-value ratio includes mandatory issues of mortgage bonds.

The growth in long-term loans and short-term deposits naturally resulted in a slight increase in the maturity mismatch between assets and liabilities. This showed up in a moderate widening of the liquidity gap in maturities of up to seven days and in maturities of more than one year. The trends in short-term and long-term liquidity ratios do not as yet indicate an increase in liquidity risk, but are the natural consequence of developments in traditional banking in Slovakia.

Net stable funding ratio

The net stable funding ratio will form part of the new banking regulatory regime, although its precise definition and mandatory limit have not yet been determined. The purpose of this ratio is to ensure that banks' balance sheets are structured in such a way that long-term or illiquid assets are sufficiently funded by relatively stable funds. Stable funds are deemed to include mainly total capital, liabilities with a maturity of at least one year, and retail deposits (including deposits provided by small and medium-sized enterprises). This is expected to prevent a situation in which banks' activities are excessively funded by volatile funds from the interbank or financial market, or by short-term deposits of large customers. Several banks in the EU have struggled to meet these requirements. Consequently, in January 2014, the Basel Committee on Banking Supervision approved a proposal[11] to partially moderate these requirements by easing some of the factors applied in the ratio calculation.[12] Given the provisional nature of regulation in this area, the following analysis is based entirely on a simplified estimate of the values of the net stable funding ratio.

The Slovak banking sector reports a relatively high proportion of stable funding sources. As Chart 23 shows, almost 80% of the sector's liabilities may be categorised as relatively stable sources. This is largely due to the quite high share of primary deposits (especially from retail customers and small enterprises), as well as equity. Thus, in the banking sector as a whole, the available stable funding is around one-third higher than the required stable funding.

11 Basel Committee on Banking Supervision: Basel III: the Net Stable Funding Ratio - consultative document, January 2014.

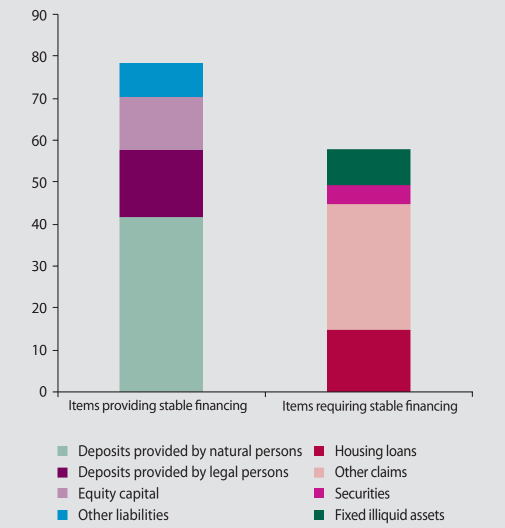
12 At the European level, adoption of the rules is at present not mandatory. The European Commission will prepare draft legislation as necessary, before the end of 2016.

Table 3 Simplified overview of the net stable funding ratio

Components of available stable funding	Factor	Components of required stable funding	Factor
Liabilities with residual maturity of more than one year	1.00	Claims on customers with residual maturity of less than one year	0.50
Equity capital	1.00	Claims on banks with residual maturity of between six months and one year	0.50
Stable deposits with residual maturity of less than one year provided by retail and SME customers	0.95	Residential mortgages with a residual maturity of more than one year	0.65
Less stable deposits with residual maturity of less than one year provided by retail and SME customers	0.90	Corporate loans with residual maturity of more than one year	0.85
Deposits with residual maturity of less than one year provided by non-financial corporations and general government entities	0.50	Loans to financial corporations with residual maturity of more than one year	1.00
Deposits with residual maturity of not less than six months and less than one year provided by financial corporatiions and central banks	0.50	Debt securities issued by governments and EU central banks	0.05
		Other assets	1.00
		Irrevocable credit and liquidity facilities	0.05

Source: Basel Committee on Banking Supervision.
Note: This is a simplified summary of components. showing only those items that are most significant with regard to the Slovak banking sector. The calculation of factors for certain components is subject to additional criteria.

Chart 22 Components of available stable funding and of required stable funding by their share of total assets and liabilities (%)



Source: NBS.
Note: Components are shown after application of the factor. NP – natural persons; LP – legal persons.

Chart 23 Distribution of estimated values of the banking sector's net stable funding ratio (%)

Source: NBS.
Notes: The chart shows the average, median, interquartile range, and highest and lowest values of the net stable funding ratio. The ratio values were calculated as available stable funding (ASF) divided by required stable funding (RSF). The ASF and RSF components are estimated approximately using several imputations for missing data.

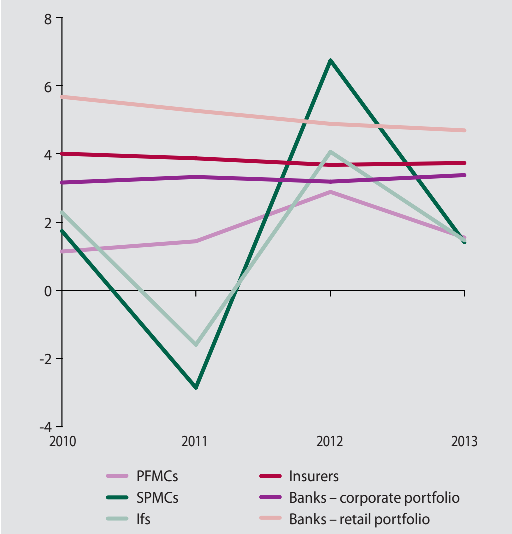
The application of the NSF ratio is not expected to pose any significant difficulties for most banks. According to the simplified estimates, all banks are expected to meet the minimum amount of stable funding, although the actual ratios will depend on how the ratio is finally calibrated. Following adjustments to the banking sector's balance sheet in 2013, there were increases in the amount of both available stable funding and required stable funding, largely owing to the increase in the amount of housing loans to retail customers, which was closely associated with the increase in customer deposits.

Market risks

As regards market risks in the domestic financial sector, 2013 was notable for the relative calm and absence of significant turbulences in financial markets. The volatility of asset prices was relatively low towards the end of 2013 (also in year-on-year terms). There remains, however, the risk that riskier assets will decline in value if investor risk aversion increases again. This risk can be said to have become more significant in the recent period, particularly owing to the continuing growth of investment in riskier assets on global markets.

The most marked change in the composition of investments was observed in funds in the second pension pillar (managed by PFMCs), with a shift towards riskier investments. This followed the introduction of amendments to pension-scheme legislation, which included cancelling mandatory guarantees for all pension funds other than bond funds and extending the performance assessment period for these bond funds. Hence it was the investment profiles of mixed funds and equity funds that underwent the largest changes, although at the same time the market share of these funds fell sharply. The riskiness of bond funds also increased, however, with the value of securities' portfolios becoming more sensitive to interest rate movements. Changes in other sectors were less significant.

Chart 24 Returns in different financial market sectors (%)



Source: NBS.
Notes: The overall return in each setor of the financial market calculated as the ratio of the total profit and average asset value for the given period.
In insurance companies, it is the return on assets covering technical provisions, where the investment risk is borne by the insurer and not the policyholder.
For banks, the chart shows the net interest rate spread in the retail portfolio and corporate portfolio.
PFMCs – pension funds management companies; SPMCs – supplementary pension management companies; IFs – investment funds.

Period of low interest rates continues

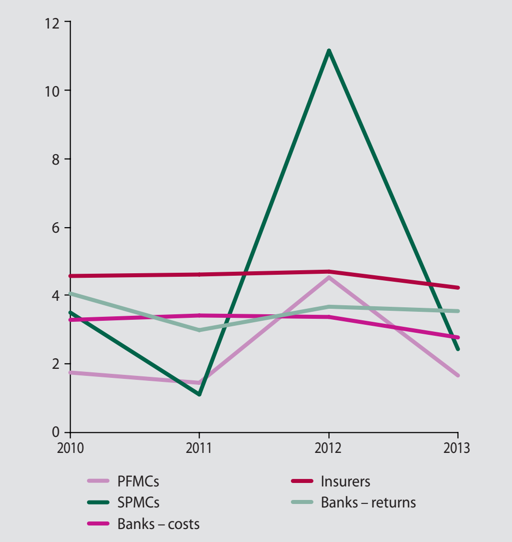
The period of low interest rates that began in 2012 continued in 2013, despite some upward movement in rates. As mentioned in the previous *Financial Stability Report* and *Analysis of the Slovak Financial Sector*, this risk is most pronounced in the insurance sector, since traditional life insurance contracts include a guaranteed minimum return. However, the period of low interest rates is weighing on investment returns in all segments of the financial market.

The turbulence in 2011 and 2012 affected mainly the collective investment and pension sectors, as a decline in asset prices and increase in bond spreads led to losses in 2011. The subsequent slump in risk-free interest rates in 2012, however, substantially increased returns on investments in debt securities. That effect was less pronounced in banks and insurance companies, since a large proportion of their bond holdings are held in hold-to-maturity and available-for-sale portfolios, in which movements in securities prices are not reflected in current income and expenses. Thus in insurance companies and, to a lesser extent, banks there is a more gradual decrease in returns and as well as in the cost of securities issued by banks.

The extended period of low interest rates is gradually resulting in low returns on assets. Banks and insurance companies are partly protected by the longer duration of their assets, while in the PFMC sector the risk is partially mitigated by the desired increase in the riskiness of portfolios.[13] In the Slovak financial sector there is not as yet any flight to riskier assets in response to the extended period of low interest rates, although if this period continues, such flight may arise. It is therefore important that market participants adequatly assess risks associated with new investments and that they prepare for the possibility of interest rates returning back to more usual levels. What also matters for banks is

13 The easing of regulatory provisions again resulted in differentiation between the investment strategies of various types of PFMC funds. For further details, see the Analysis of the Slovak Financial Sector for the First Half of 2013

Chart 25 Returns on debt securities (%)



Source: NBS.
Notes: For insurers and banks, the revaluation of AFS securities (which are revalued through equity) is not taken into account.
Banks – the rate of return is the return on securities included in the bank's assets.
Banks – the cost is the cost of securities issued by the bank.
PFMCs – pension funds management companies
SPMCs – supplementary pension management companies.

that their borrowers are able to cope with any increase in loan repayments resulting from a hike in interest rates.

Exposure of the Slovak financial sector to emerging countries[14]

After the Federal Reserve announced a shift in policy in 2013, capital flowed out of several emerging countries. In the event of a sudden reassessment of investor risk aversion, a similar situation could arise again, putting downward pressure on asset prices in these countries. It is therefore worth monitoring the exposure to these countries of the Slovak financial market participants. The events of 2013 and beginning of 2014 also showed that there are sizeable differences between emerging countries in terms of how risky they are perceived by investors.

The banking sector's asset exposure to nonresidents amounts to between 11% and 13% of its total assets and comprises mainly exposures to advanced EU countries, the Czech Republic and Poland. At the level of individual sectors, the direct and indirect exposure of institutions is relatively low. Among individual entities, the situation is highly heterogeneous, varying according to the investment strategy of the fund or institution. Only in a few funds, however, is the exposure to emerging countries more than 20% of NAV. Further variation stemmed from the fact that some funds and agents increased their holdings of these assets while others reduced theirs.

Table 4 Exposure to emerging countries as a share of total assets (%)

		Direct exposure	Indirect exposure
Banks	XII. 2012	0.7	0.0
	II. 2014	0.7	0.0
Insurers	XII. 2012	0.8	0.1
	II. 2014	1.1	0.1
Unit-linked[1)]	XII. 2012	0.0	7.2
	II. 2014	0.0	6.8
PFMC funds	XII. 2012	3.9	0.6
	II. 2014	6.8	0.8
SPMC funds	XII. 2012	2.1	6.0
	II. 2014	3.0	4.3
IFs	XII. 2012	3.5	1.9
		3.3	1.5

Source: NBS:
Notes: The values are given as a percentage share of total assets or net asset value (NAV); they represent the asset-weighted average for each group of institutions.
For the banking sector, the data include only values for securities.
1) Assets invested by insurers under unit-linked insurance policies.
Direct exposure – exposures to counterparties in a given country or holdings of securities issued by a resident of that country.
Indirect exposure – investments in exchange-traded funds or investment funds with an investment strategy oriented to emerging markets.
PFMCs – pension funds management companies; SPMCs – supplementary pension management companies; IFs – investment funds.

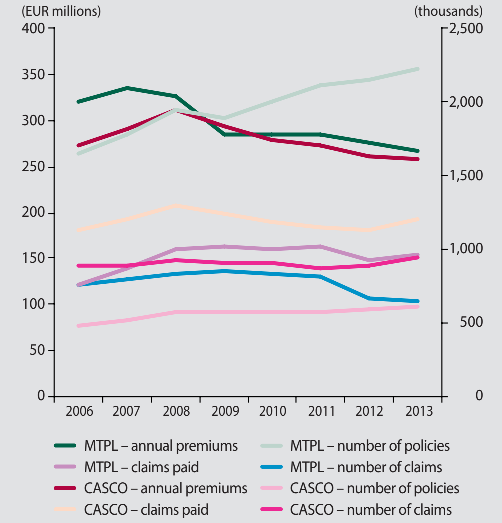
Strong competition in motor insurance continues

As mentioned in the Financial Stability Report in November 2013, the motor insurance market continued to experience strong competition, resulting in a fall in premiums, a rise in the number of policies, and a broadly-based decrease in the average price of insurance.

From 2008 the average premiums charged by insurance companies in the Slovak market converged substantially owing to strong competition, but from 2011 they became notably more diverse. At the same time, the proportion of new policies declined, which indicates a stabilisation of insurance portfolios. In comprehensive motor vehicle (CASCO) insurance and, to a lesser

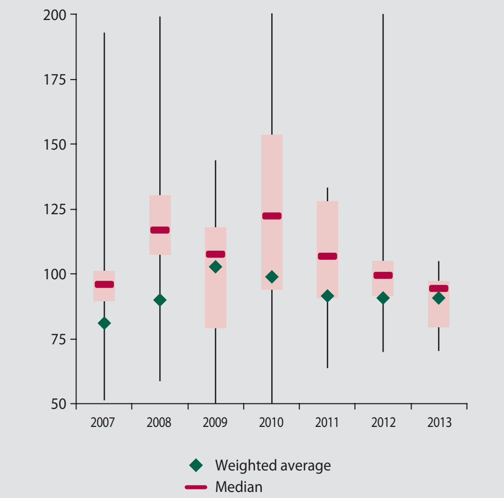
14 For the purposes of this analysis, emerging countries are understood to include all countries apart from advanced economies, euro area countries, the Czech Republic and Poland. The Czech Republic and Poland are excluded since they report a low inflow of speculative capital and, in recent periods, no net outflow of capital.

Chart 26 Motor insurance trends



Source: NBS.
Note: MTPL – motor third-party liability insurance; CASCO – comprehensive motor vehicle insurance.

Chart 27 Distribution of the MTPL combined ratio (%)



Source: NBS.
Note: The left-hand scale shows the maximum, minimum, interquartile range, median, and average of this indicator in the insurance sector.

extent, in motor third-party liability (MTPL) insurance, the frequency and amount of claims paid was not homogeneous, as a falling frequency of claims paid at some insurers was often linked to a rising frequency at others. This may indicate that policyholders who make claims have a tendency to switch insurance companies.

Lower prices of insurance had a downward effect on premiums earned in the insurance sector, which was reflected in the loss ratio and cost ratio. The situation in MTPL insurance escalated in 2009 and 2010 when the MTPL combined ratio[15] exceeded 100%. In CASCO insurance the situation worsened markedly in recent years, when the combined ratio reached almost 109%. It is necessary to point out again that such a ratio is unsustainable since it means CASCO insurance is making a loss.

The increase in the MTPL combined ratio in 2008 and 2009 was caused mainly by a sharp drop in the cost of insurance. When this ratio fell in the period from 2011 to 2013, however, it reflected mainly a substantial drop in the frequency and number of claims paid. It is difficult to explain such decrease as the result of a drop in accident rates, which fell markedly in the period 2008–2011 but not over the next two years. It is also unusual that the frequency of claims paid in CASCO insurance similarly declined in the period 2008–2011 and has since increased moderately.

In comprehensive motor insurance, the frequency of claims paid affected the combined ratio less than did the decrease in cost of premiums and average amount of premiums. As the cost of premiums went steadily down, the increase or decline in the average amount of claims paid affected the rise or fall of the combined indicator.

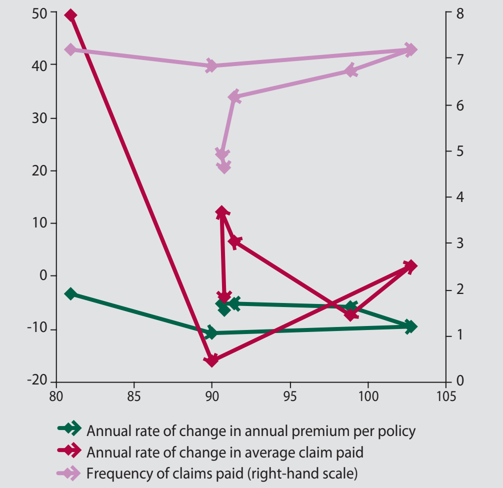
Strong competition in the motor insurance market put at risk the efficiency and profitability of these products in the long-run horizon. It is necessary that the price of motor insurance reflects its costs and that insurance companies, in seeking to restore profitability in this segment, do not refuse or reduce payouts on legitimate claims. NBS will continue to monitor this situation and take necessary measures as appropriate.

Operational risk including computer crime

The financial system is becoming increasingly interlinked and dependent on IT systems. All activities of financial institutions include an element of operational risk, whether in the form

15 The MTPL combined ratio is calculated similarly as the combined ratio except that the technical cost of claims paid is increased by contribution of the Slovak Insurers' Bureau and that the amount of premiums earned is reduced by the transfer of a proportion of premiums to a special account of the Slovak Interior Ministry.

Chart 28 Factors affecting the MTPL combined ratio across the insurance sector (%)

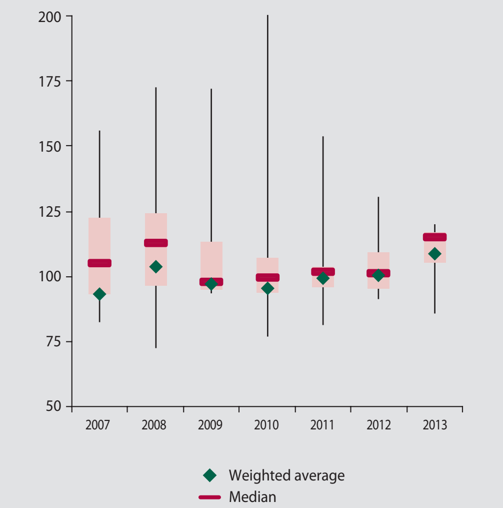


Source: NBS.
Notes: The horizontal axis shows the level of the MTPL combined ratio.
The frequency of claims paid is calculated as the ratio of the number of claims paid to the total number of insurance policies.
The direction of the arrow indicates the chronology from 2007 to 2013.

Chart 30 Factors affecting the combined ratio for comprehensive motor insurance across the insurance sector (%)

Source: NBS.
Note: The horizontal axis shows the level of the combined ratio for CASCO insurance.
The frequency of claims paid is calculated as the ratio of the number of claims paid to the total number of insurance policies.
The direction of the arrow indicates the chronology from 2007 to 2013.

Chart 29 Distribution of the combined ratio for comprehensive motor vehicle insurance (%)



Source: NBS.
Note: The left-hand scale shows the maximum, minimum, interquartile range, median, and average of this quantity in the insurance sector.

of human error, system error or external factors. In Slovakia as elsewhere, the growth in online services in recent years is bringing to the fore risks associated with information technologies, including computer (cyber) crime. Figures for operational risk losses in the banking sector confirm the rising trend in the number of operational incidents and losses over the past two years.

In recent years the world has seen numerous examples of cyber crime in the financial sphere,[16] including for example denial of service attacks and attacks that directly inflict losses on market participants. In its 2013 Annual Report, the macroprudential authority in the Unites States – the Financial Stability Oversight Council – recommended in regard to this issue the sharing of information between market participants, the training of employees and customers, and further development of systems and capabilities to counter attacks. Similarly, in 2013, the Bank

16 According to the FSOC's 2013 Annual Report, several banks were the targets of cyber attacks in 2012. In the Czech Republic banks were the target of a large-scale cyber attack in 2013, and in Slovakia banks have become more active in warning their customers about the risks of computer crime.

of England's Financial Policy Committee, the authority responsible for macroprudential policy in the UK, issued Recommendation 13/Q2/6 advising public sector entities and banks to improve resilience to cyber attack. In this context, a simulation exercise was carried out in November 2013 with the prime aim of coordinating communication between all entities vulnerable to cyber attack. In Slovakia, this coordination role is to be fulfilled by CSIRT.SK.[17]

In the Slovak financial market, too, it is vital that information is shared between participants and public sector entities so as to continually improve the resilience of IT systems and the capability to prevent and respond to cyber crime.

17 Computer Security Incident Response Team Slovakia (www.csirt.sk).

CHAPTER 4

REGULATORY AND LEGISLATIVE ENVIRONMENT

4

4 Regulatory and legislative environment

Crisis management in the banking sector[18]

In April 2014 the European Parliament approved the Bank Recovery and Resolution Directive (BRRD). Given that the banking sector performs several core functions – such as payment system operations, financial market infrastructure administration, deposit-taking and lending, etc. – and that public confidence in the sector is crucial to its operation, cases may arise where it is in the public interest to rescue a distressed bank. The fact that sovereigns are ready to rescue troubled banks using public money creates moral hazard. The main purpose of the approved changes is to minimise the impact of banking crises on the broader society, including taxpayers, in order to maintain the financial stability of the market as a whole.

The establishment of national resolution authorities[19] with power to order the dilution of shareholders and write-down of debt means that the resolution of a distressed bank should be achieved with a greater contribution from its shareholders and unsecured creditors. Where a bank's position deteriorates and will not be resolved by the private sector, and its bankruptcy would give rise to financial instability, the national resolution authority (NRA) is entitled to intervene in time. The purpose of restructuring a bank is to maintain financial stability and the essential activities of the institution. Resolution tools are to be applied only if it is in the public interest that a bank be rescued without being subject to bankruptcy proceedings. The main tools which NRAs will have at their disposal,[20] and which they will be able to implement without requiring the consent of the bank's management or shareholders, are:

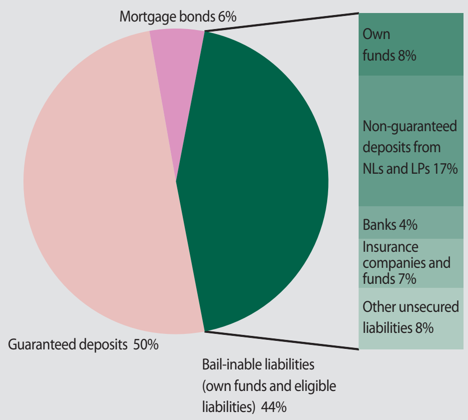
- a sale of business tool
- a bridge institution tool
- an asset separation tool
- a bail-in tool – allowing liabilities to creditors to be written down after dilution of the bank's shareholders

Most notable is the new bail-in tool, which allows the NRA to write down part of a bank's liabilities that are not guaranteed deposits or convert them to equity. It is to enter into force by 1 January 2016 at the latest. Liabilities will be subject to the bail-in tool in the following order: subordinated debt, unsecured and non-preferred liabilities, non-guaranteed deposits from natural persons and from small and medium-sized enterprises, and, finally, liabilities to the deposit guarantee scheme The bail-in tool will not apply to deposits protected by a deposit guarantee scheme, short-term interbank deposits, secured liabilities (e.g. mortgage bonds), and salaries. In exceptional circumstances, other liabilities may be excluded from bail-in.

The domestic banking sector is not significantly affected by the requirement to have a sufficient amount of bail-inable liabilities. Within the remit of resolution authorities is the power to set a minimum requirement for own funds and bail-inable liabilities.[21] Their share of the Slovak banking sector's balance sheet as at 28 February 2014 was around 44%.

Cooperation and the legislative framework will play a key role in the bank resolution process. In the case of cross-border groups, the whole group will be included in the recovery process. For groups supervised by the Single Supervisory Mechanism, decisions on their recovery will be

Chart 31 Types of liabilities in the Slovak banking sector



Source: NBS.
Note: NPs and LPs – natural and legal persons.

18 Since the final texts of the Bank Recovery and Resolution Directive (BBRD) and the SRM Regulation have not yet been published in the Official Journal of the European Union, this report describes NBS's current view of the agreements that have been reached.
19 The national resolution authority is the authority that decides to proceed with a bank resolution and exercises powers laid down in the BRRD.
20 It is assumed that in Slovakia NRA tasks will be vested in a new, independent authority.
21 This is known as the minimum requirement for own funds and eligible liabilities (MREL).

taken by the Single Resolution Board (see below), while for other groups such decisions will rest with resolution colleges whose members are drawn from the competent NRAs. Problems may also arise if the priority of creditors in bankruptcy proceedings is different from that prescribed for the bail-in tool. Creditors may claim compensation for damage suffered if they can prove that they would gain more under the bankruptcy process than under the bail-in. There is also the possibility that a court may rule to annul the whole recovery. It is therefore crucial that the new rules are applied uniformly across the EU.

Single Resolution Mechanism – second pillar of the banking union

In April 2014 the European Parliament also adopted the Regulation on the Single Resolution Mechanism (SRM). The SRM Regulation applies to banks in all countries participating in the Single Supervisory Mechanism. It establishes the Single Resolution Board which will take decisions on banks supervised directly by the ECB. The NRAs will take resolution decisions on other banks and implement SRB decisions in their country. The SRB is authorised to take resolution decisions directly on any bank and will be involved in any resolution decisions that assume the use of financing from the Single Resolution Fund. Members States may decide that the SRB will be responsible for all banks in their country.

NRAs will draw up plans and assess the resolvability of banks, set the MREL, supervise compliance with the obligations affecting banks under the BRRD, and decide on the implementation of tools under the BRRD. A key aspect is cooperation with supervisory authorities, especially when assessing the situation in a bank and initiating a resolution process. The SRB has two formats for decision-making: a plenary session[22] and executive session.[23] The executive session will take all resolution decisions. Such decisions may be subsequently amended by the European Commission or the Council, or be rejected within 24 hours after their adoption. The plenary session will take all decisions of a general nature, decisions involving the use of the SRF above €5 billion, decisions on increasing contributions to the SRF, and decisions on other forms of SRF funding. Decisions on the SRF will be taken by simple majority vote with the majority representing at least 30% of the contributions to the SRF.

The SRF has a target level of 1% of guaranteed deposits held by banks supervised by the SSM, to be reached within eight years of its establishment. After the SRF's establishment, contributions will be accumulated in national compartments. These resources will be progressively mutualised, starting with 40% of their total in the first year, rising to 60% in the second year, and gradually increasing to 100% after eight years, when they will all be included in the SRF. During this transition period any use of the SRF will firstly draw on resources from the national compartments (constituting 100% of the SRF in the first year, 60% in the second year, 40% in the third year, and gradually declining amounts in subsequent years). The SRB should also, in cooperation with Member States, ensure other forms of funding for the SRF. The assistance that any bank may receive from the SRF is capped at 5% of its total liabilities and conditional on at least 8% of its liabilities being bailed in. Furthermore, in August 2013 the European Commission issued a guideline that any state aid to a bank must be preceded by the dilution of shareholders and write-down of subordinated debt.

In the view of Národná banka Slovenska, the SRM is a key part of the banking union but the related transfer of competences to the European level is not yet sufficiently matched by the transfer of accountability for these decisions. The European Commission is expected to have substantial decision-making powers in this area, despite the fact that its decisions could have significant consequences for banking sector stability in the Member State concerned, as well as negative repercussions for the fiscal situation and deposit guarantee scheme. The above-mentioned principle of aligning powers and accountability is also not applied in the case of the SRB, since host countries in particular (including Slovakia) have relatively few decision-making powers. At the same time, contributions to the SRF will represent an additional burden for Slovak banks.

Deposit guarantee schemes

In April 2014 the European Parliament adopted the recast Directive on deposit guarantee schemes. The Directive sets a coverage level for the aggregate deposits of each depositor at €100,000 and reduces to seven days the period in which repayment for unavailable deposits is to be made. The target level for funding of the

22 Comprising the Chair and four permanent members, an observer from the European Commission, an observer from the ECB, and one representative from each NRA.

23 Comprising the Chair and four permanent members, an observer from the European Commission, an observer from the ECB, and one representative from the NRA of each country concerned.

deposit guarantee schemes is 0.8% of covered deposits within ten years.

Comprehensive assessment in preparation for transition to the Single Supervisory Mechanism

As from November 2014 the ECB will, under the Single Supervisory Mechanism, assume the supervision of the largest banking groups in the euro area. As part of preparations for the launch of the SSM, the ECB is performing a comprehensive assessment of banks in cooperation with the national competent authorities (NCAs) of the Member States participating in the SSM. The comprehensive assessment has three goals:

- **transparency** – to enhance the quality of information available on the condition of banks;
- **repair** – to identify and implement any necessary corrective actions;
- **confidence building** – to assure all stakeholders that banks are fundamentally sound and trustworthy.

The comprehensive assessment consists of three parts:

- a risk assessment;
- an asset quality review (AQR);
- a stress test (performed jointly by the ECB and the EBA).[24]

The currently ongoing AQR is, inter alia, reviewing the valuation of selected assets, provisioning for the most important portfolios of particular banks, and potential risks hidden in banking books.[25] The results of the AQR will be incorporated into the stress test, which will test the resilience of particular banks based on their adjusted balance sheet and capital position. The final results of the comprehensive assessment will be published at the national level and by individual banks, along with recommendations for remedial actions.

Although the results of the comprehensive assessment will not be known for some time, banks are, as it seems, already seeking to pre-empt possible corrective measures. According to estimates by Morgan Stanley, banks have raised their equity by more than €30 billion since the ECB announced it would be launching the comprehensive assessment.[26] At the same time, the situation in financial markets this year has been relatively conducive to raising capital. As well as raising capital, banks have been writing down losses; it is also apparent that their capital ratios have benefited from adjustments to risk-weighted asset calculations.

In Slovakia, the comprehensive assessment covers the three largest banks, which are due to fall under the supervision of the ECB from November 2014. Given that these banks have high capital ratios and relatively conservative balance sheets, they are not expected to be significantly affected by the assessment.

Directive on credit agreements relating to residential property

On 4 February 2014, Directive 2014/17/EU of the European Union and the Council on credit agreements for consumers relating to residential immovable property entered into force.[27] This Directive was instigated by the European Commission, which in March 2003 launched a process of identifying and assessing the impact of barriers to the internal market for credit agreements relating to residential immovable property. The Directive is thus expected to make the internal market more transparent and efficient, as well as, importantly, to ensure a high level of consumer protection.

The principal and most important areas covered by the Directive are:

- **financial education** – Member States are to promote measures that support the financial education of consumers in order to increase their awareness in relation to loans;
- **conditions applicable to creditors, credit intermediaries and appointed representatives** – Member States are required, inter alia, to ensure that creditors, creditor intermediaries or appointed representatives act "honestly, fairly, transparently and professionally", to strictly apply remuneration policies (for example, by providing that remuneration is not contingent on the number or proportion of applications accepted), and strictly apply knowledge and competence requirements for staff;
- **information and practices preliminary to the conclusion of the credit agreement** – Member States are to regulate the standard information that is to be provided to consumers before the conclusion of a credit agreement, such as information in advertisements (which should include information about the borrowing rate and related details, the total

24 http://www.ecb.europa.eu/ssm/assessment/html/index.en.html
25 http://www.ecb.europa.eu/pub/pdf/other/assetqualityreviewphase2manual201403en.pdf?e8cc41ce0e4ee40222cbe148574e4af7
26 http://www.ft.com/intl/cms/s/0/4a870568-cdf9-11e3-9dfd-00144feabdc0.html#axzz30GutOU63
27 http://register.consilium.europa.eu/doc/srv?l=SK&t=PDF&f=PE+25+2013+REV+1

amount of credit, the annual percentage rate of charge, the number of instalments, etc.) or personalised information which enables the consumer to compare the credits available on the market and forms part of the European Standardised Information Sheet (for example, information on the amount and currency of the loan, including a risk warning for foreign currency loans, and on the borrowing rate and other costs, including a warning about the risks attached to given types of rate, etc.);

- **the annual percentage rate of charge** – the Directive provides a precise standard formula for calculating the APRC;
- **creditworthiness assessment** – Member States are to ensure that, before concluding a credit agreement, the creditor makes a thorough assessment of the consumer's creditworthiness. As the Directive states, "the assessment of creditworthiness shall not rely predominantly on the value of the residential immovable property". They are also required to ensure reliable standards for the valuation of residential property;
- **foreign currency loans and variable rate loans** – the Directive introduces strict rules for foreign currency loans. For example, the consumer has a right to convert the credit agreement into an alternative currency under specified conditions, and/or other arrangements should be in place to limit the exchange rate risk to which the consumer is exposed under the credit agreement. Similarly, creditors are to be required to warn the consumers on a regular basis at least where the value of the total amount payable by the consumer which remains outstanding or of the regular instalments varies by more than 20% from what it would be if the exchange rate applicable at the time of the conclusion of the credit agreement were applied;
- **sound execution of credit agreements and related rights** – Members States are to ensure that consumers have the right to make early repayment. Consumer are, however, to be warned about the conditions to which early repayment is subject, and the creditor may be entitled to fair and objective compensation. If, in the event of foreclosure, the price obtained for the property affects the amount owed by the consumer, Member States are to ensure that procedures are in place to enable the best efforts price for the foreclosed property to be obtained. Where after foreclosure proceedings outstanding debt remains, Member States are to ensure that measures to facilitate repayment in order to protect consumers are put in place;
- **requirements for establishment and supervision of credit intermediaries and appointed representatives** – the Directive regulates details relating to the granting and withdrawal of admission of credit intermediaries and appointed representatives, and the supervision of such entities.

Member States are required to transpose this Directive into their national law by 21 March 2016. Národná banka Slovenska, in cooperation with the Slovak Finance Ministry, is in the process of analysing the Directive and preparing its transposition into the necessary statutory law and decrees.

Solvency II Directive

In March 2014 the European Parliament adopted the Omnibus II Directive, which amends certain aspects of the Solvency II Directive,[28] including the role of the European Insurance and Occupational Pensions Authority. Omnibus II also amends valuation and capital requirements for insurance products with long-term guarantees and postpones the application date of the Solvency II Directive until 1 January 2016. The new regulatory framework includes provisions on risk-sensitive and market-based valuation of liabilities, the option to use internal models of risk measurement models, the improvement of internal processes, risk management and internal control, the assessment process carried out by supervisory authorities, and increased transparency and disclosure of information. Based on Quantitative Impact Studies (QISs) and the impact study entitled Long-Term Guarantees Assessment (LTGA), it may be concluded that the insurance companies operating in Slovakia are expected to meet the regulatory requirements that will come into force under the new legislation. At the same time, however, the preparations needed to meet these requirements will constitute a significant burden.

Structural reform of the banking sector

In January 2014 the European Commission published a draft Regulation on structural reform in the banking sector.[29] The purpose of the reform is to separate deposit-taking from high-risk financial trading activities. Hence it is proposed that large

28 Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II).

29 Proposal for a Regulation of the European Parliament and of the Council on structural measures improving the resilience of EU credit institutions.

and complex banking groups in the EU (groups whose total assets exceed €30 billion and total trading assets exceed €70 billion or 10% of their total assets) be prohibited from proprietary trading and that supervisory authorities have the power (as well as an obligation in certain circumstances) to compel banks to separate other high-risk trading activities into a separate legal entity within the banking group (with financial flows between the group and this entity to be regulated).

The proposed Regulation is not expected to have a significant impact on the Slovak banking sector. The assets of domestic banks are lower than the minimum threshold stipulated in the draft Regulation, and these banks do not conduct trading in sufficient volume as to fall with the Regulation's remit. Some repercussions may be expected to the extent that the new regulatory framework affects the parent banking groups of Slovak banks.

CHAPTER 5

MACROPRUDENTIAL POLICY

5

5 MACROPRUDENTIAL POLICY

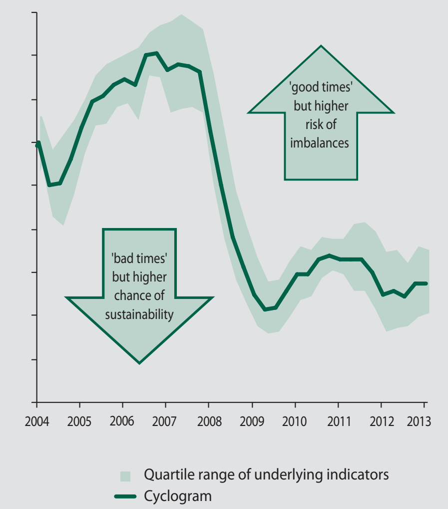
THE FINANCIAL AND BUSINESS CYCLE IN THE CONTEXT OF THE COUNTERCYCLICAL CAPITAL BUFFER

The countercyclical capital buffer (CCB) is a core component of macroprudential policy. The purpose of this instrument is to ensure that banks accumulate, during periods of economic growth, a sufficient capital base to absorb losses in stressed periods. The buffer rate will be expressed as a percentage of the total risk exposure amount (excluding government debt). Hence in order to apply the CCB, it is necessary to outline the overall financial cycle and to assess the extent of heterogeneity across sectors, segments and products. One way to outline the financial cycle is by using a countercyclical indicator (cyclogram), which is an aggregate indicator of selected macroeconomic and financial indicators. The core concept of the cyclogram is to compare the values of individual indicators with values registered by these indicators in the previous ten years. [30]

The current financial cycle is still far from its peak of September 2007. The situation, however, it not homogenous across indicators. The level of all indicators included in the aggregate calculation was significantly lower at the end of 2013 than in 2007. The current level is closer to the values reported over the past four years, although it still falls short of the 2011 figure. Among the main factors behind the stagnation of the countercyclical indicator are a decline in domestic banks' lending to enterprises in a majority of sectors, the relatively low level of property prices, a more conservative tendency in the setting of credit standards, as well as persisting difficulties in the labour market related to sluggish economic growth. Another key factor in this regard is low interest rates, which are reducing the debt-servicing costs of firms and households and thus making dept repayment easier and creating an illusion of sustainability.

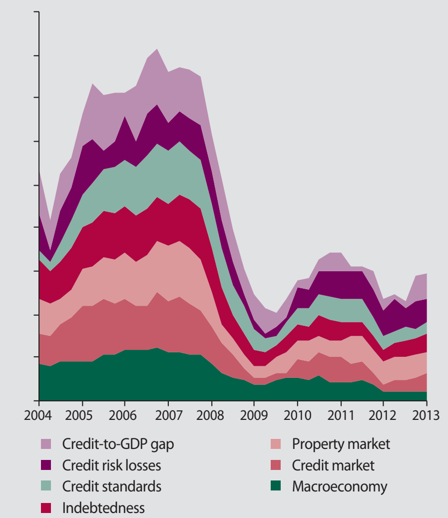
Another feature of 2013 was the relatively larger differences between the indicators making up the cyclogram. Worth noting in this regard is the increase in firms' external debt and developments in the retail sector.

Chart 32 Cyclogram



Source: NBS.

Chart 33 Decomposition of the cyclogram



Source: NBS.
Note: The credit-to-GDP gap expresses the deviation between the debt-to-GDP ratio from its long-run trend.

In terms of the overall cycle, the increase in the ratio of total private debt to GDP during the second half 2013, from 75% to 80%, appears to be significant. This was the ratio's first nota-

30 This concept was elaborated at Národná banka Slovenska and further details of the methodology may be found in the following article: Rychtárik, Š., "Analytical background for the counter-cyclical capital buffer decisions in Slovakia", Biatec, No 4, Národná banka Slovenska, Bratislava, 2014.

ble increase since 2009, when it levelled off at 75-76%. The marked rise in debt stemmed not, however, from domestic banks, but from the issuance of bonds, which, however, were then sold abroad. Since these bond issues were concentrated among a very small number of firms, this trend should be treated with caution. Such trading of bonds in foreign markets fully accounts for the increase in the countercyclical indicator in the third and fourth quarters of 2013.

Despite the generally low level of the financial cycle, there are strong dynamics in the retail sector. As mentioned in Section 3.2, the situation in this sector contrasts with developments in corporate lending, as well as in the labour market and property market. Among EU countries, Slovakia reported one of the highest growth rates for housing loans, which resulted in a sharp rise in household debt. Although low interest rates led to a drop in their debt-servicing costs, households saw their total debt increased more than their disposable income.

Such developments concentrated in the household sector do not provide room for consideration of a countercyclical capital buffer, but rather raise questions about the use of specific instruments for that sector.

Benefits from the reduction of LTV ratios for housing loans

A sound limit on LTV ratios has direct and indirect positive implications for both the financial sector and the real economy.

As mentioned in Section 3.4 (Financial Sector Risks), a recommended or mandatory upper limit on LTV ratios for housing loans has been introduced in several countries (including Poland, Finland, Lithuania, Cyprus, the Netherlands, Romania, and Sweden) and is being considered in others. Where an LTV ceiling is set at a sound level, it should support financial sector stability for a number reasons (direct and indirect).

First, the LTV ratio directly affects a bank's resilience to losses given default (LGD). Although the market value of collateral cannot be quantified precisely and, following foreclosure, its realised value may differ considerably from the market value, it is generally the case that lower loan amounts result in smaller losses given a fixed realised price.

Second, an upper limit on LTV ratios stems demand for loans with higher LTV ratios, which are generally perceived as more risky. Consequently, a higher proportion of customers are expected to be able and willing to finance property purchases using more of their own equity, and they therefore may be perceived as more creditworthy.

Finally, bank policies on LTV ratios may be seen as instruments of competition. In other words, LTV policy may be focused more on the acquisition of market share than on setting ratios that are sound with regard to customer and portfolio risk. A sound upper limit on LTV ratios may serve to curb unhealthy competition and the accumulation of excessive risk.

The development of LTV policy and the regulatory response may, however, have broader consequences, not only direct, but also indirect through their impact on the real economy. In general, the upward trend in LTV ratios is attributable to two phenomena. The first is of structural character and is related to the composition of the market, which is seeing a greater number of first-time buyers, i.e. people who are seeking a loan to make their first purchase of real property. Loans for these customers generally have a higher LTV ratio. The second is the above-mentioned pressure of competition. In both cases, however, there may be excessive demand for real property, which may fuel price growth in the market and lead to a property price bubble. The bursting of such a bubble would adversely affect both the economy and financial sector. Hence a sound LTV ratio limit can to some extent smooth the cyclical movements of residential property prices and therefore mitigate the damage caused when a price bubble bursts.

Abbreviations

AFS	available for sale
AQR	Asset Quality Review
BRRD	Bank Recovery and Resolution Directive
CDS	credit default swap
CLO	collateralised loan obligation
CRD IV	Directive 2013/36/EU of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC a 2006/49/EC
SPMC	supplementary pension management company
PFMC	pension funds management company
EBA	European Banking Authority
ECB	European Central Bank
EC	European Commission
EIOPA	European Insurance and Occupational Pensions Authority
EU	European Union
IF	investment fund
GDP	gross domestic product
HTM	held to maturity
LTV	loan-to-value (ratio)
IMF	international monetary fund
NAV	net asset value
NBS	Národná banka Slovenska
NRA	national resolution authority
Omnibus II	Directive of the European Parliament and of the Council amending Directives 2003/71/EC and 2009/138/EC in respect of the powers of the powers of the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority
MTPL	motor third-party liability (insurance)
ROE	return on equity
Solvency II	Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II)
SR	Slovak Republic
SRB	Single Resolution Board
SRF	Single Resolution Fund
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism

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