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Address:
Národná banka Slovenska
Imricha Karvaša 1
813 25 Bratislava
Slovakia

Telephone:
+421 2 5787 2146

Fax:
+421 2 5787 1128

http://www.nbs.sk

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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.

The central bank believes that a key aspect of its contribution to financial stability involves keeping 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, 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. This latest report includes a new section describing macroprudential policy in Slovakia.

In addition to this comprehensive overview of developments and all risks in the Slovak financial sector, Národná banka Slovenska publishes a complementary biannual report entitled the *Analysis of the Slovak Financial Sector*.

Executive summary

Both the euro area economy and domestic economy picked up during the first half 2013, although several risks remain present

Looking back at the first three quarters of 2013, one of the key facts concerning financial stability of the domestic financial sector was the euro area's emergence from recession. Slovakia's economic growth increased moderately, too, with household consumption making a positive contribution after a long adverse period. This recovery was accompanied by partial stabilisation of the euro area's debt crisis, relative calm in financial markets, and firming of consumer confidence. It should be noted, however, that much of the upturn stemmed from central banks' large-scale operations aimed at injecting liquidity into financial markets.

Several risks remain present, however, and could lead to renewed financial market turbulences, an extended period of depressed growth, or even, at worst, a return to recession. At the same time, developments in preceding months indicated that any tightening of monetary policy, including the unwinding of central banks' non-standard measures, would carry appreciable risks for the global financial system, especially as regards a potential increase in risk premia. The principal risk to euro area economic growth may be described as a negative feedback loop within the complex triangular relations between public finances, the banking sector and the corporate sector. In the European context, despite the considerable efforts made so far, there remains a need for further, and relatively extensive, structural reforms and fiscal consolidation measures. Signs of any significant recovery in the labour market are elusive in both Slovakia and the wider euro area. Meanwhile, certain banking groups stand exposed to negative trends in several central and eastern European countries.

Risks to financial stability are largely mitigated by the strong resilience of the Slovak financial sector

The financial stability of the Slovak financial sector could be adversely affected by the above-mentioned risks in the external environment and domestic economy. The impact of their materialisation would, however, be significantly mitigated by the strong resilience of domestic financial institutions, based on their solvency, profitability and access to funding. The health of the banking sector as a whole is one of the principal factors underpinning the Slovak economy's relatively robust resilience to external shocks.

The Slovak banking sector is not a significant adverse risk to the macroeconomic situation or economic equilibrium

The potential impact of the Slovak banking sector on the economic situation may be assessed mainly in terms of the lending market, in particular the availability and flow of credit. It should be noted in this regard that the situation in the corporate segment is different from that in the retail segment.

Lending to enterprises continued to decline year-on-year, in line with developments in the euro area. This trend was accompanied by an ongoing deterioration on both the supply and demand sides of the lending market. Unlike banks in certain other euro area countries, however, banks in Slovakia showed no sign of tightening credit standards in response to shortfalls in capital or funding. At the same time, the decline in corporate lending was not homogeneous with regard to the structure of the economy. The segment of small and medium-sized enterprises even recorded a moderate increase in loans.

Retail lending, by contrast, grew faster in Slovakia than in any other EU country, by around 10% year-on-year. Despite this relatively strong growth, imbalances did not emerge in the real estate market. Except in certain segments, property prices did not increase. In Slovakia, unlike certain other countries, the price index remains below its pre-crisis high. One reason for this is the increasing tendency for borrowers to prepay housing loans with a moderately larger loan from another bank.

Amidst persisting risks in the economic situation, a prudential approach to risk management is required

Since the Slovak banking sector is heavily focused on lending to the domestic economy, its principal exposure is to an economic downturn that causes a decline in credit portfolio quality and in customers' activity. In this regard, it is positive that in 2012, despite a slowdown in economic growth, banks did not report any significant increase in non-performing loans, although there were signs of a potential future deterioration in the quality of the retail credit portfolio. However, it has been confirmed by both macro stress testing and by analysis of the impact of a concurrent substantial drop in property prices and impairment of credit portfolio quality that the Slovak banking sector, owing to its currently high level of solvency, is relatively resilient to these risks. Given the currently strong growth rate of retail lending and the persisting uncertainty about future economic developments, it is essential that banks take a prudential approach when setting lending conditions, particularly in regard to the value of collateral and the capacity of borrowers to cope with an increase in loan repayments or decline in income. Another cause of mounting risks could be the increasing linkages between certain financial institutions and financial intermediaries. This is because financial intermediaries are primarily concerned with providing a product, and they are only marginally involved in managing the risks attached to that product.

A specific feature of the domestic financial sector is the large share of domestic government bonds in the investment portfolio. The Slovak banking sector has the highest such share in the EU. At the same time, the growth of this share in several countries is prompting discussions at the international level on the potential risks associated with such development. From the view of financial stability in Slovakia, and to support diversification of investors in Slovak government bonds, it is therefore important to avoid any backtracking on fiscal consolidation measures, since that could weaken investor confidence.

With some financial institutions reporting diminishing returns on existing business or investment activities, competition pressure is increasing and risk aversion falling

In recent years, weak economic developments, subdued customer activity and an extended period of low returns on less risky assets have necessitated financial institutions to change their business strategies in global financial markets. This trend has appeared to some extent in Slovakia as well, although in varying forms across financial market sectors. In the banking sector, it has been associated with periods of elevated competition (especially in the retail sector), mainly manifested in price conditions for both lending and deposit products. Some medium-sized banks in particular have sought to retain market share by marketing their banking services at significantly reduced interest margins, and as a result their profit-generating capacity is now declining and their credit risk costs are rising.

A similar situation exists in the non-life insurance sector. The decline in premiums in comprehensive motor insurance, as a result of a long period of strong competition, is unsustainable since it is loss-making. At the same time, low returns on less risky assets are contributing to a partial increase in risk exposure in certain other sectors of the financial market. This is particularly apparent in some collective investment funds that are increasing their investments in lower-rated assets. A notable problem is the potential accumulation of risks associated with an extended period of low interest rates, especially in regard to insurers and their capacity to deliver the returns guaranteed in insurance policies.

In regard to the risks identified, several macroprudential policy responses are now under discussion

The establishment of a system of macroprudential supervision is one of the most important changes in the area of banking regulation. In addition to the new EU legislation concerning banks' prudential business (the CRR regulation / and CRD IV directive), approved in June 2013, a number of legislative tools are being estab-

lished to deal with systemic risks, including most importantly so-called capital buffers. One such buffer is the capital conservation buffer, which NBS believes should be implemented in full immediately after the CRR/ CRD IV starts to enter into force. This is because of the need, given the presence of the risks mentioned above, to preserve the current strong resilience of the Slovak banking sector. In this regard there will be further measures aimed at fully implementing several solvency-related requirements, and NBS will assume prudential setting of risk weights for loans secured with commercial property. At the same time, however, NBS does not envisage introducing a counter-cyclical capital buffer or systemic risk buffer.

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

Area	Risk	Risk-amplifying factors	Risk-mitigating factors
Risk of a deterioration in the macroeconomic situation	Increase in non-performing loans and credit risk costs in the event of adverse macroeconomic developments	Increase in retail loans past due by between 30 and 90 days	Credit portfolio quality has not deteriorated significantly
	Losses caused by negative developments in the residential or commercial property market	Higher loan-to-value (LTV) ratios – close to 100% in certain banks	Relatively high solvency in the banking and insurance sectors
	Downward pressure on profits due to a decline in the business activity of banks and insurers	Potential for further growth in household lending gradually declines	Value of profitability ratios in domestic banks is above the EU average
Risk of low interest rates	Negative impact of low returns in investment portfolios of insurers		
	Accumulation of credit risk in the banking sector, even without any change in banks' prudent approach		Corporate sector is able to cover costs arising from a possible increase in interest rates, although this capacity is changing over time
	Squeezing of banks' interest margins and funds' returns	Low returns on least-risky assets contributes to an increase in riskiness or to a deterioration in the credit quality of investments made by certain collective investment funds	Impact on bank profits is being significantly mitigated by growth in retail lending
Risks arising from a change in business practices	Potential strategic risk from increasing linkages between banks and financial intermediaries		
	Negative profit trends in certain medium-sized banks owing to past structural changes in their business models		
	Risks arising from intensive price competition in the motor insurance market	Current decline in premiums in comprehensive motor vehicle insurance is unsustainable because it is generating losses	

Table 1 (continued)

Area	Risk	Risk-amplifying factors	Risk-mitigating factors
Risk of re-escalation of the euro area debt crisis	Resurgence of investor risk aversion, possibly accompanied by a decline in asset value, particularly in the portfolios of pension funds and investment funds		Securities issued by stressed countries constitute a relatively small share of the portfolios
	Intensification of the debt crisis and its spread to higher-rated countries, including Slovakia, thus causing a decline in government bond prices	High share of Slovak government bonds in the investment portfolios of institutions and funds	
Risk of concentration, financial market interlinkages and external risk contagion	Relatively high concentration of (part of) the portfolio, or higher intra-group exposure, in certain institutions or funds		Higher concentration concerns mainly systemically less important institutions
	Transmission of external risks owing to foreign ownership	Mounting risks in certain foreign banking groups that own domestic institutions	
	Negative consequence of rationalisation measures implemented in domestic financial institutions by parent companies		Value of profitability ratios in domestic banks is above the EU average
Legislative and regulatory environment	Value of profitability ratios in domestic banks is above the EU average	Under the proposal for a Single Resolution Mechanism, a large proportion of competences are to be transferred to the European Commission	
	Decreasing profitability of financial institutions owing to an increase in their tax or levy burden or to an unstable regulatory environment		Implementation of Basel III will not have a significantly adverse impact on the domestic banking sector

Source: NBS.

CHAPTER 1

EXTERNAL CONDITIONS FOR FINANCIAL STABILITY

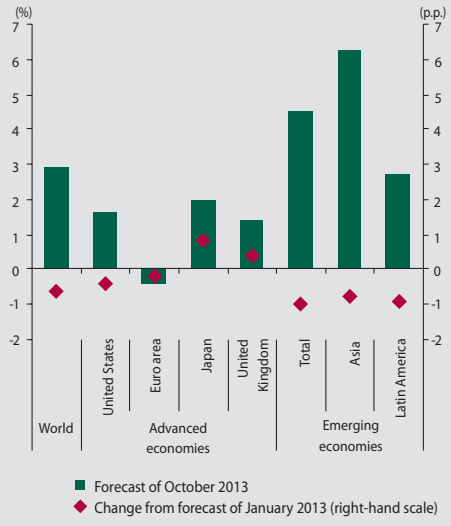
1

1 EXTERNAL CONDITIONS FOR FINANCIAL STABILITY

Global economic growth is set to slow further in 2013, down to a modest 2.9% according to the October forecast of the International Monetary Fund (IMF). It is not expected to pick up until 2014, with the IMF projecting a rate of 3.6% for the year. As in previous years, the weak rate of increase in economic activity is attributable to advanced countries, where the average growth rate is less than one-third of that in the rest of the world.

Recent months, however, have seen a mitigation of this trend, with a majority of advanced countries reporting at least some improvement in their economic situation. At the same time, emerging economies as a whole are underperforming in comparison with earlier forecasts. Thus the global economy may be entering a phase where the division between the two groups of countries in terms of their contribution to global growth gradually becomes more even again. Such rebalancing may in principle be seen as positive for global financial stability; however, over the short-term horizon, the process by which it comes about will entail appreciable risks to the macrofinancial situation.

Chart 1 Economic growth forecast for the world and selected regions



Source: International Monetary Fund.
Note: The forecast is for 2013.

With no major shocks emanating from Europe in 2013, the most significant event of the year for global financial markets originated with the US central bank. At the end of May, the Federal Reserve System announced for the first time that it was considering whether to begin gradually tapering the amount of money being injected into the economy each month through its quantitative easing (QE) programme. Financial markets were startled by this news, seeing it as a sign that the world's largest economy was reaching a turning point in its monetary cycle. Yields on leading lowest-risk bonds, including US Treasuries and German bunds, began to rise quite significantly from historically low levels. These developments were consequently reflected in prices of higher-risk debt securities, which declined to a greater or lesser extent in almost all parts of the world. In response to this initial reaction, the Fed sought to calm investors and stressed its intention to keep the federal funds base rate at de facto zero percent at least until the unemployment rate in the United States falls to 6.5%. That is not expected to happen before the end of 2014/beginning of 2015. Nevertheless, the downward trend in the value of interest-sensitive instruments remained largely unaffected. It eventually corrected, moderately, in September after the Fed surprised market participants by postponing its widely anticipated decision on QE tapering until an unspecified later date.

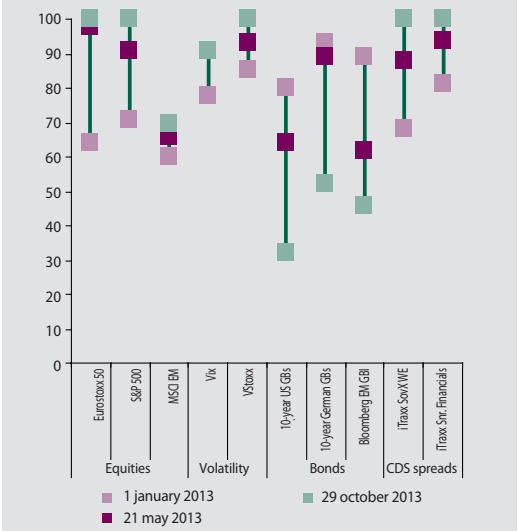
Even though the extent of QE remained unchanged, expectations for interest rate movements reflect assumptions that US monetary policy will be tightened earlier than it was expected before May 2013. A tightening of policy would be beneficial from the view of financial stability, as it would reduce the risks associated with an extended period of low interest rates. On the other hand, such a transition will not be easy to manage and will itself entail considerable risks,

in particular the possible overshooting of long-term market interest rates, which has occurred to some extent since May. A premature increase in the long end of the yield curve and contraction of liquidity could trigger undesirable turbulences in financial markets, which obviously would have global repercussions given the position of the US dollar.

Stock market sentiment in Europe, the United States and Japan was generally optimistic, and equity indices climbed to new multi-year highs.

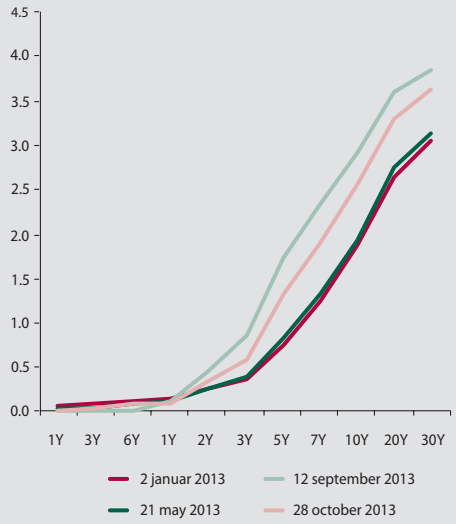
Even though the US monetary policy rate remains unchanged, the fact that the issue of its adjustment is now the subject of intensive attention indicates that the United States has taken a relative lead over other advanced countries in terms of economic recovery. Although US economic growth slowed in the first half of 2013 following the introduction of fiscal consolidation measures, several significant indicators point to an upcoming acceleration of economic activity. A key driver of US economic growth is expected to be the revival of the residential property market in conjunction with the upward effect of increasing equity prices on household net worth and with rising employment.

Chart 2 Asset prices and market indicators of risk



Source: Bloomberg.
Notes: The left-hand scale shows the percentile of the values recorded in the period from 1 January 2011 to 29 October 2013.
The value 100 represents the maximum price of the asset (equities, bonds) for the period, or the minimum value of the risk indicator (volatility, CDS spreads).
EM – Emerging Markets, GB – government bond, WE – Western Europe.

Chart 3 Yield curve for 10-year US government bonds (%)



Source: Bloomberg.
Note: M – month(s), Y – year(s).

The euro area saw a positive turnaround in its macroeconomic situation during the period under review. In the first quarter of 2013, the region's GDP at constant prices declined at a slower pace quarter-on-quarter, and then in the second quarter it increased by an annualised 1.2%. This marked the euro area's emergence from a recession that had lasted one and half years. The surprisingly strong second-quarter performance was largely accounted for by the two principal economies, Germany and France, but there was also economic improvement in most other euro area countries. Although the periphery countries except for Portugal remained in recession, the contraction of their GDP eased markedly.

The euro area recovery, while still extremely fragile, was largely a result of the fact that the debt crisis had been stabilising since mid-2012. Thus, for several months, conditions in euro area financial markets were relatively calm, without any major turbulence, and during the second quarter there was also an upturn in sentiment among real economy participants, leading to a revival in economic activity. Euro area GDP increased again in the third quarter, but more slowly than it had

in the second quarter (by an annualised 0.4%), which was somewhat at odds with the continuing positive developments in all so-called soft indicators.

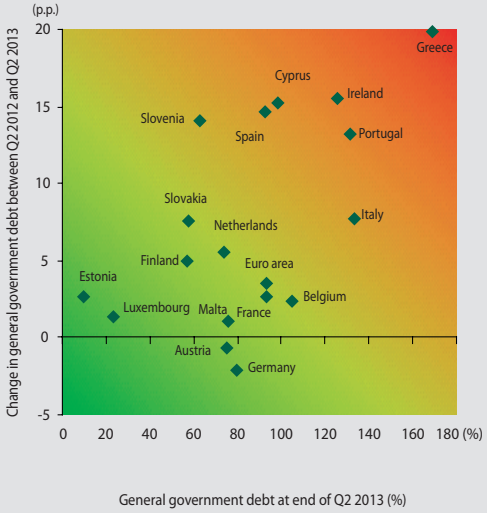
The labour market situation has remained difficult so far in 2013. Employment in the euro area as a whole continued to decline during the first half of the year, although only moderately in the second quarter. Moreover, employers when surveyed did not suggest that they were planning to increase their workforce within the foreseeable future. The average unemployment rate therefore rose above 12%, and in several countries it was substantially higher (in Greece and Spain, for example, the rate was more than 25%).

The euro area economy is expected to recover gradually over the medium-term horizon. Even with relatively optimistic assumptions, however, this recovery will most probably be slow. The IMF is forecasting euro area growth of only 1% for 2014.

In the end, the euro area's economic performance may be even weaker than projected in the majority of forecasts, given that the balance of risks remains tilted to the downside. If the structural reforms now in place to support the economic potential of national economies are not seen through rigorously and as quickly as possible, there will be a real risk of an extended period of below average growth, if not a slide back into recession. The main risk to economic growth, and therefore to financial stability in the euro area, may be described as a negative feedback loop within the complex triangular interactions between public finances, the banking sector and the corporate sector.

The progress achieved in the fiscal sphere in recent years has been quite significant in historical terms, but it is far from sufficient given the scale of the current problems. Most euro area countries are still only at the stage of bringing their budget deficit to below 3% of GDP, at which point the EU's excessive deficit procedure is lifted. Even meeting this commitment is considered to be highly demanding, and as original schedules for excessive deficit correction slip, the European Commission has decided in the case of some countries to extend the correction deadline by one or two years. To comply with the

Chart 4 General government debt in euro area countries at the end of Q2 2013 and its annual rate of change



Source: Eurostat.
Note: The greener the background, the better fiscal position and dynamics, the redder the background, the worser fiscal position and dynamics.

Maastricht criteria for deficit, however, especially the periphery states, is not by far the final target. In four of them, the government debt is above 120% of GDP and in another four it is around 100% of GDP; in each of these countries the public debt continued to increase during the first half of 2013. To instil confidence in financial markets and hence ensure stable funding, it will be necessary not only to eliminate deficits, but also to bring the gross debt down to sustainable levels.

From the relative calm in financial markets, it appears public finances are being brought under control, even in the most indebted euro area countries; the question remains, however, to what extent is this explained by the Outright Monetary Transactions (OMTs) programme which the ECB announced in the summer of 2012 and which has yet to be activated. The stability of financial market sentiment in regard to the debt crisis may soon be tested, as Ireland and Portugal come to the end of their economic adjustment programmes at the end of 2013 and beginning of 2014, respectively, and are expected to return to market funding. Furthermore, the second aid programme for Greece is due to be reviewed in the first half of 2014. Certainly in the case of Portugal and Greece, it appears that additional

external assistance for their public finances will be required.

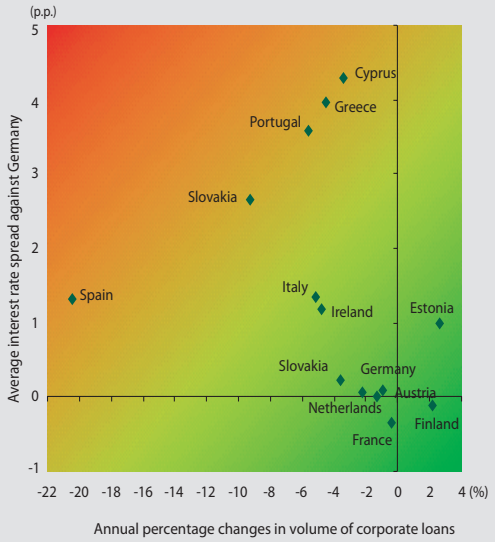
Although stress indicators in the euro area banking sector developed positively last year, there was no substantial improvement in the sector's fundamentals and major risks remain present. The banking sector was a key factor in the evolution of the European debt crisis, being the main source of funding for the real economy and a principal channel for cross-border contagion owing to the interlinkages between national sectors.

The negative trend in bank lending activity in 2012 actually became more pronounced in 2013. The amount of loans to households remained unchanged during the period under review, while corporate lending declined at an increasing pace, reaching close to 6% in August. This problem is most acute in periphery countries, particularly Spain. Although the contraction in lending is partly caused by firms' lower demand for loans, it also to a significant extent reflects supply-side factors related to the situation in the banking sector. It was also the case in periphery countries that even where firms managed to obtained a bank loan, they faced, on average, higher borrowing costs than did similar firms in other euro area countries. Such interest rate spreads between countries are one of the signs of fragmentation in the euro area banking market, and their constancy during the first eight months of 2013 does not suggest that this process is abating.

The incoming Basel III banking regulation, which sets higher capital requirements and introduces liquidity requirements, will in the years ahead be a further obstacle to bank lending growth in the euro area.

Although there has been no recent outflow of domestic deposits and foreign interbank funds from some of the most vulnerable banking sectors, and the risk of an imminent crash has receded significantly, disparities in funding access remain present. The early repayment of a large part of the three-year longer term refinancing operations (LTROs) conducted by the ECB from December 2012 have given the impression that the euro area interbank market is functioning normally. Nevertheless, it was mainly German banks which reduced their central bank borrowings. Banks in Spain repaid a much smaller percentage of their LTROs, while Italian banks have retained almost all of what they originally borrowed.

Chart 5 Annual rate of change in corporate loans as at August 2013 and average interest rate spreads against Germany in euro area countries

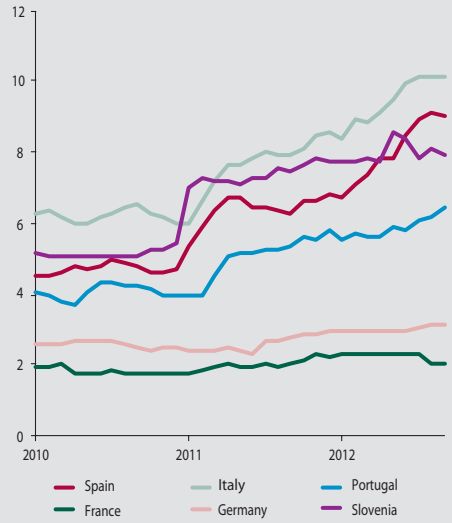


Source: ECB.
Note: The calculation of the average interest rate spread on new corporate loans is based on monthly data from August 2012 to August 2013. The greener the background, the better loan conditions, the redder the background, the worser loan conditions.

A highly adverse trend in 2013 may be seen in the rising share of domestic government bonds in asset portfolios of banks in periphery countries. Such a development increases the interlinkage between sovereign risks and the riskiness of national banking sectors, thereby increasing the potential for a negative feedback loop between the two.

In connection with the introduction of the Single Supervisory Mechanism, a comprehensive assessment of euro area banks is to be conducted under the umbrella of the ECB in 2014; it consists of three parts: a risk assessment, an asset quality review and a stress test conducted in cooperation with the European Banking Authority. The purpose of this exercise is to obtain a detailed picture about the condition of the banking sector in the euro area as a whole and in its member countries. Assuming that both parts of this assessment are carried out with the highest levels of credibility and transparency, they could

Chart 6 Domestic government bonds as a share of the banking sector's total assets in selected countries (%)



Source: ECB.

help reduce the uncertainty that has long been present in the system and thus restore investor confidence. This would therefore support conditions for improving the functioning of the banking sector. But if shedding light on the condition of banks is to actually have the desired positive effect, it is necessary that sufficient funds are set aside in advance to recapitalise any banks whose solvency is found to be inadequate. Otherwise, the banking sector could become even more fragmented.

The euro area also faces some degree of risk from developments in US monetary policy. The cycle of monetary policy tightening is likely to begin earlier in the United States than in the euro area, given the difference in economic performance between the two. However, as expectations since May 2013 have shown, an increase in interest rates could spread from the United States to Europe, where they would constitute a premature and undesirable tightening of monetary conditions.

The process of balancing competitiveness across euro area countries slowed down somewhat during the first half of 2013. Unit labour costs in periphery countries increased, whereas in previous years they had fallen in all such countries apart from Italy.

Box 1

IMF ASSESSMENT OF THE AUSTRIAN BANKING SECTOR[1]

After a regular FSAP[2] mission of the International Monetary Fund (IMF) visited Austria this year, the final report on its assessment of financial sector stability in the country was published on 19 August. As regards the banking sector as a whole, according to the report, its strong stability is confirmed by stress test results, but there are also certain structural strains.

The IMF primarily mentions the deteriorating asset quality in Austrian banks. An increase in the non-performing loan (NPL) ratio on a consolidated basis is driven by the NPL ratios reported by subsidiaries in Central Europe and South Eastern Europe (CESEE), which average as much as 16%. The poor asset quality reflects not only the worsening macroeconomic situation in CESEE, but also to a significant extent the easing of credit standards before the financial crisis, as a large proportion of bank loans (almost a half) was extended in foreign-currencies. Furthermore, the IMF sees a risk in that the coverage of these NPLs in certain CESEE countries is not sufficient.

As regards the stability of funding sources, the IMF notes that Austrian banks are in a comparatively strong position. Overall, non-bank deposits represent around 50% of liabilities and the loan-to-deposit ratio has declined from 140% to 120%. However, those banks that have substantial foreign-currency loan portfolios in CESEE countries remain reliant on wholesale funding based largely on FX swap markets, which makes them vulnerable to any re-emergence of strains in these markets.

The Austrian banking sector remains relatively weak in terms of its capitalisation, according to the IMF. Although Austrian banks have in re-

1 *The report is available online at: http://www.imf.org/external/pubs/ft/scr/2013/cr13283.pdf*
2 *Financial Sector Assessment Program.*

cent years increased their capital through state capital injections and retained earnings, the sector's core Tier 1 capital ratio is just over 11%, which is lower than in most other EU countries. Furthermore, the Tier 1 capital of certain banks includes a large share of government participation capital dating back to 2008 and 2009, which will no longer qualify as regulatory capital after 2017 and which will have to be repaid in full by 2022. If these banks are to comply with Basel III regulatory capital ratios in such circumstances, they will need to raise additional capital.

CHAPTER 2

DOMESTIC CONDITIONS FOR FINANCIAL STABILITY

2

2 DOMESTIC CONDITIONS FOR FINANCIAL STABILITY

So far in 2013, macroeconomic developments have led to two seemingly contradictory conclusions. On the one hand, the full year economic performance is set to be the worst since the recession in 2009. The NBS autumn forecast projects that gross domestic product (GDP) at constant prices will increase by 0.9%, less than half the rate in 2012. On the other hand, however, at least in the first half of the year, there has been no further deterioration in economic conditions. Some indicators are even pointing to a moderate improvement; notable in this regard is seasonally-adjusted quarterly GDP growth, which presumably reached a cyclical low of 0.0% at the end of 2012, and then increased slowly, but steadily, in the first two quarters of 2013, by 0.2% and 0.3% respectively. The second quarter growth in particular was a positive surprise, and resulted in NBS making a slight upward revision to its economic growth forecast for the whole of 2013.

Chart 7 Annual and quarter-on-quarter GDP growth – actual figures and projections (%)

Source: NBS, Eurostat.
Note: The figures from the third quarter of 2013 on are NBS projections.

In line with the trend of recent years, the Slovak economy's growth in the first half of 2013 was driven mainly by exports of goods and services. After an extended downward trend, household final consumption made a positive, and to some extent unexpected, contribution to growth, as it increased very slightly in the first quarter and then more substantially (by 1.1%) in the second quarter. Fixed capital investment remained subdued, falling by more than 5% in the first quarter and making up only a small part of that drop in the next quarter. The contribution of general government final consumption during the period under review was moderately negative.

The modest acceleration in GDP, while undoubtedly welcome, does not mean that the Slovak economy has definitely turned the corner. A broader survey of recent macroeconomic figures provides mixed outlooks for the Slovak economy.

If Slovakia, as a small, open economy and member of the euro area, is to see stronger economic growth, it is crucial that the European debt crisis is resolved and that economic conditions improve across the continent. Europe's economy is expected to recover gradually, thereby increasing foreign demand for Slovak exports; this in turn should be a main driver of Slovak economic growth over coming years. As mentioned in the previous chapter, the situation so far in 2013 has been relatively calm as regards the intensity of the debt crisis, while euro area GDP has returned to moderate growth; all of this clearly influenced developments in Slovakia during the first half of the year. But although the acute phase of the crisis has receded for now, many fundamental problems still remain unresolved. This means that an extended period of slow growth in the euro area, if not a slide back into recession, remains a risk. In the event of any such adverse scenario, external demand for Slovak output would fall short of expectations, almost certainly resulting in a significant downturn in the domestic economy. Any re-escalation of the euro area

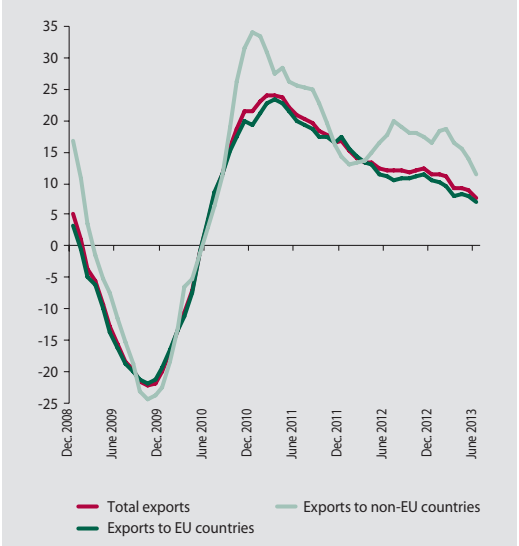
debt crisis would also affect Slovakia through its negative impact on sentiment among domestic economic agents.

Of course, the export performance of the Slovak economy is not merely a simple function of euro area economic growth. In each of the last three years (and probably also in 2013), the growth in domestic exports, although decelerating, was substantially higher than economic growth in Slovakia's export markets. This fact strongly suggests that Slovak exporters have been accurately profiling their output, thus enabling themselves to expand and acquire new market share even while external demand has been relatively depressed.

For Slovak exports to continue making progress in the future, however, they will have to maintain or improve their competitive position. As noted in May's Financial Stability Report, Slovakia has in recent years seen an improvement in its international price competitiveness measured by unit labour costs, and no significant change in this healthy position was observed during the first half of 2013. The strong competitiveness of Slovakia is further indicated by the real effective exchange rate (REER), which is loose compared with its estimated equilibrium value.

Looking at Slovak export outlooks in the context of the potentially ongoing difficulties in Europe, it should be noted that although the European Union remains by far the main destination for Slovak exports (receiving 82.6% of total exports in the first half of 2013), non-EU countries are also a significant factor in the country's export growth. In the first half of 2013, exports to the EU (at current prices) increased year-on-year by 1.9%, but total export growth was almost twice that level (3.5%) by virtue of exports to other countries. It is also worth noting that the annual growth rate of exports for the period January to June 2013 was more evenly spread across several countries than it was in 2012. Accounting for an increased share of annual export growth were exports to countries of the former Commonwealth of Independent States, including Russia, countries in the Middle East, and the large economies of the United States, Japan, Brazil, and Australia. Greater diversification was likewise observed in the commodity composition of exports. This broader distribution of exports, in both geographical and compositional terms, is partly contributing to the increased robustness of Slovakia's export performance.

Chart 8 Export growth broken down by region (%)

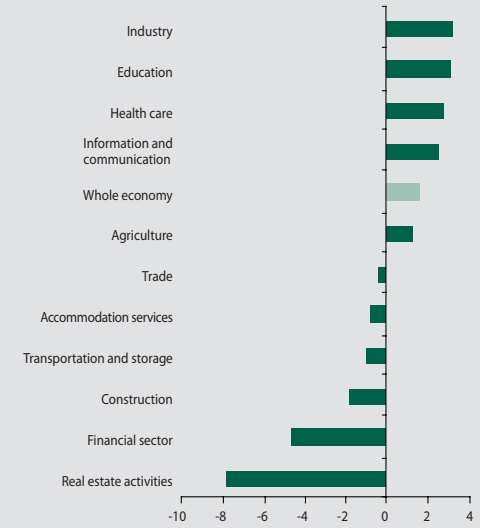


Source: Ministry of Economy of the Slovak Republic, NBS.
Note: The left-hand scale shows year-on-year change in 12-month moving sums of monthly exports (at nominal prices).

The better than expected results for household final consumption, particularly in the second quarter, may be retrospectively explained not only by the favourable price developments during the period under review, but also by the increase in disposable income and strengthening of consumer confidence. Disposable income growth in the household sector was primarily accounted for by income of self-employed persons as well remittances from people working abroad. For the first time since the end of 2010, workers' wages have increased year-on-year in real terms, although that owed more to falling inflation than to an acceleration of nominal wages. Furthermore, and somewhat significant from the view of financial stability, real wages in some sectors continued to decline.

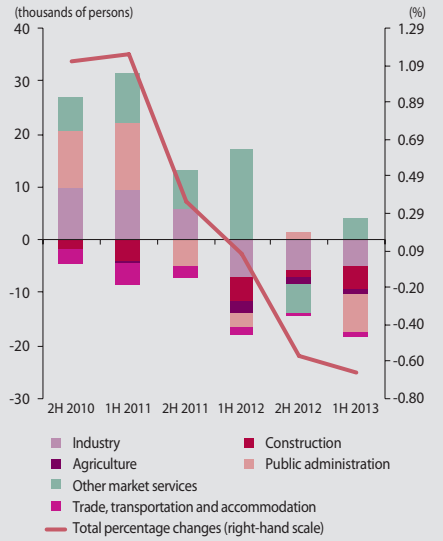
Household final consumption is expected to continue growing in the second half of 2013, albeit at a far lower pace compared with the second quarter. This slowdown is indicated by,

Chart 9 Annual growth rate of real wages in selected sectors in the second quarter of 2013 (%)



Source: Statistical Office of the Slovak Republic.

Chart 10 Change in employment in selected sectors



Source: Statistical Office of the Slovak Republic.
Note: Employed as defined by ESA 95 (seasonally-adjusted)

for example, retail trade sales, which fell appreciably in August over the previous month, down to their lowest level for six months. Another indicator is the composition of household expenditure in the first half of 2013, since its fastest-growing component (year-on-year, at constant prices) was housing, energy and transport costs; this indicates no significant shift in households' propensity to consume "non-essential" goods and services. Although there is some potential for consumption growth, given the relatively high household savings rate of recent years, it appears this will not happen until such time when consumers are sufficiently confident that the macroeconomic situation is improving.

A key factor in household consumption, as well as one of the principal variables affecting financial stability in Slovakia, is the labour market situation. No improvement in this regard was observed during the first half of 2013, notwithstanding the moderate revival in economic activity during that period. Seasonally adjusted employment (under the ESA 95 methodology) declined in both the first and second quarter, and in each case by more than projected (-0.3% and -0.4 %, respectively).

The largest job losses were in the trade and transportation sectors, and employment also fell in manufacturing industry and construction. The unemployment rate maintained an almost constant level during the period under review as it was affected by other factors, such as people leaving the country to work abroad and a change in the size of the economically active population. Some signs of improvement in labour market conditions appeared in July and August, since in each of these months, even after adjusting for seasonal effects, the number of registered job seekers fell quite appreciably and the corresponding unemployment rate also declined. Similarly, indices based on surveys of firms' future employment plans have shown positive developments in recent months in all the sectors surveyed. The acceleration in labour productivity growth in the first part of 2013 may also indicate that firms will finally begin to recruit new staff in greater numbers; on the other hand, the decline in the average working week undermines the assumption that workforces will soon need to be increased.

According to the output measure of GDP, industry was the main driver of Slovakia's economic growth in the first half of 2013,

thus continuing the trend of the previous year. Nevertheless, the annual growth rate of manufacturing output slowed significantly, as the substantial effect of the launch of new car production capacities faded away. Manufacturing output for the first eight months of 2013 increased by 3.5 % year-on-year, but from April on its growth accelerated, reaching 6.4 % in August. Comparing this year to last year, the electronics industry displaced transport production as the largest contributor to overall industrial production growth. Even though manufacturing industry as a whole has performed well in recent years, production in around half of its principal segments was still lower in the period under review than in the pre-crisis period, and in some cases substantially so. And while industry has advanced in terms of output volume in 2013, sales of industrial producers have on average remained flat, and in some months they even declined year-on-year.

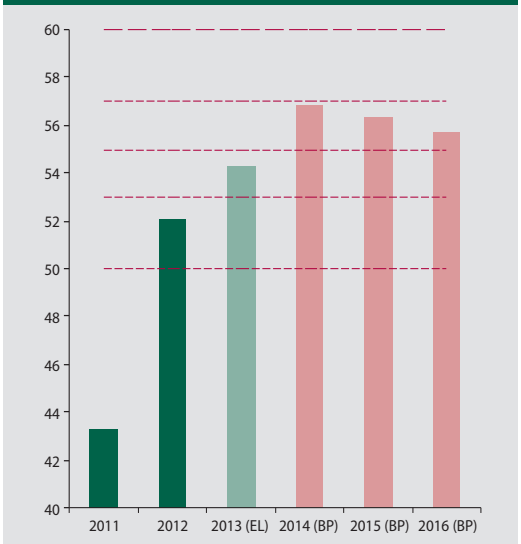
Across other sectors of the economy, sales have been heterogeneous in 2013, making it difficult to reach a clear conclusion about the prevailing conditions in the business sector. At the positive end of the spectrum were selected market services and transportation, which maintained annual sales growth of around 10 %. In the information and communication sector and accommodation services, sales stayed flat year-on-year in the first half of 2013 and then picked up. Retail trade sales were largely unchanged from their 2012 levels throughout the period under review, while construction firms' sales dipped by around one-tenth.

Although the Slovak government is expected to meet its 2013 budget deficit target of less than three percent of GDP, risks in fiscal sphere include a slowdown in consolidation efforts and the increasing government debt. If the deficit falls below the 3% threshold, the European Commission will lift the Excessive Deficit Procedure (EDP against the country. While several other EU countries are falling behind their EDP targets, Slovakia would make progress in repairing its public finances by meeting its deficit commitment. Less positive, however, is how the deficit is to be reduced, since a major part of the reduction consists of one-off measures, such as allowing people to leave the second pension pillar (with their pension contributions being shifted to the first pillar), the sale of strategic oil reserves,[3] and the payment of so-called super-dividends. The new bank levy is also a temporary measure. A significant proportion of spending cuts concern investments and co-financing of EU-funded projects, at the expense of capital generation and consequently of growth in economic potential.

In addition, according to the budget proposal for 2014–2016, the Slovak government is lowering its fiscal consolidation ambitions from those set out in the Stability Programme published in spring 2013. Whereas the original consolidation framework envisaged the general government deficit falling to 2.6% in 2014 and then to 2.0% in 2015, the new budget proposal has moderated these targets to 2.8% and 2.6%, respectively. Since there is a non-negligible likelihood of economic growth in 2014 being lower than projected in the budget and since the target deficit is only 0.2 percentage point lower than the threshold laid down in the Stability and Growth Pact, there is a risk that Slovakia's budget deficit in 2014 will exceed 3% and therefore that the EDP will be renewed.

Certain parallels with the budget deficit situation are apparent in regard to the general gov-

Chart 11 Gross general government debt (percent of GDP; as at 31 December)



Source: Draft General Government Budget for 2014–2016.
Notes: EL – expected level; BP – budget proposal.
The broken horizontal lines show sanction thresholds under the Fiscal Responsibility Act.

3 *This concerns the need to align the new method of strategic oil reserve administration with EU directives that do not permit dual administration of reserves.*

ernment debt. On the one hand, certainly from the view of financial stability, it is positive that the public debt for 2012 was the tenth lowest in the EU and the third lowest in the euro area, at 52.1% of GDP. On the other hand, however, the rate at which public debt increased in Slovakia in recent years was almost as high as that in the euro area periphery countries. And this trend has continued in 2013, as the debt climbed in the first half of the year by 5.6 p.p., to 57.7%. It should be noted, of course, that part of the debt growth, particularly during 2012, is attributable to an increase in the State Treasury's cash reserves amid relatively favourable issuing conditions. Some of these reserves are expected to be used in the second half of 2013 to reduce the public debt to a year-end level of 54.3%, as projected in the budget.

CHAPTER 3

FINANCIAL SECTOR IN SLOVAKIA

3

3 FINANCIAL SECTOR IN SLOVAKIA

3.1 SOLVENCY AND FINANCIAL POSITION OF THE FINANCIAL SECTOR

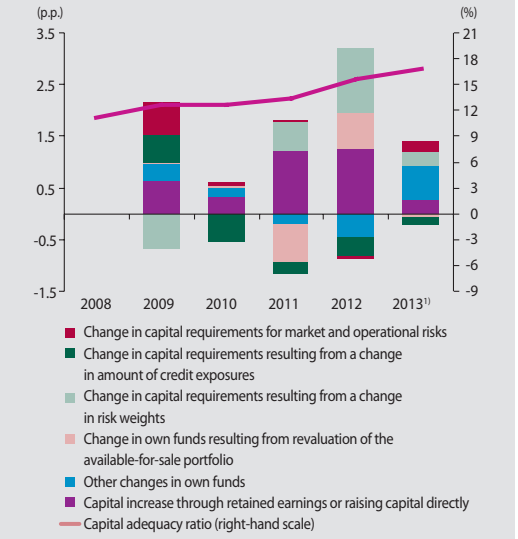
FINANCIAL SECTOR SOLVENCY

As banks in Slovakia have significantly strengthened their solvency in recent years, so the domestic banking sector has become increasingly resilient to potential losses. Solvency ratios continued their multi-year rising trend during the first half of 2013. The sector's average capital ratio rose to 16.9% in August 2013, its highest level since 2005. It should be noted, however, that amidst persisting uncertainty about future developments, ever more attention is being paid not only to the capital ratio itself, but also to the composition of own funds, the consistency across banks of models used to calculate risk-weighted assets, solvency growth factors, and leverage. This section will look at these aspects in greater detail.

Capital quality in domestic banks remains high. The banking sector's Tier 1 capital ratio reached 15.7% in August 2013, representing an increase of 1 p.p. from its level at the end of 2012. In most of the subsidiaries of foreign banks, this ratio is higher than that of the parent undertaking. Tier 1 capital as a share of total own funds in the Slovak banking sector was 93% in August 2013, confirming the high quality composition of the domestic banking sector's capital.

Two key changes are behind the higher capital ratio: first, banks have increased their capitalisation by retaining earnings as well as by raising capital directly from their parent undertakings; secondly, the average value of risk-weights for the capital requirement calculation has been reduced (Chart 12). The upward effect of these factors on the capital ratio was evident mainly from the beginning of 2011 to August 2013. During that period, changes in the amount of own funds had an impact of 2.7 p.p. on the capital ratio and changes in the risk weights had an impact of 2.1 p.p. The latter was most pronounced in 2012.

Chart 12 Factors of changes in the capital adequacy ratio



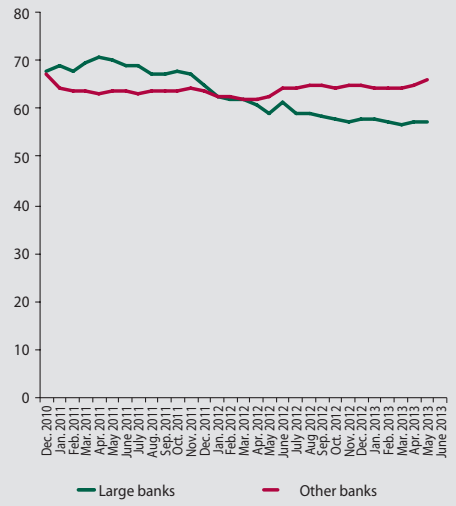
Source: NBS.
1) The data for 2013 are as at 31 August 2013.

The above-mentioned decline in risk weights occurred mainly in those banks that use internal models to calculate their capital requirement. As Chart 13 shows, the decrease in the average risk weight in banks' overall portfolio[4] has in recent years been most pronounced in the group of five largest banks, which calculate their capital requirements using internal models authorised and validated by NBS. By contrast, the average risk weight in the group of other banks increased slightly. In the case of the large banks' group, the lower risk weighting may reflect not only a decrease in the actual weights used in the banks' internal models, but also several other factors, for example, changes in the riskiness of the portfolio, or the size of the off-balance sheet.

The decline in risk weights calculated on the basis of banks' internal models in the corporate and retail asset classes was relatively significant. Other factors behind the lower risk weights included the transition from standardised to internal model, as well as the gradual increase in the proportion of the portfolio for

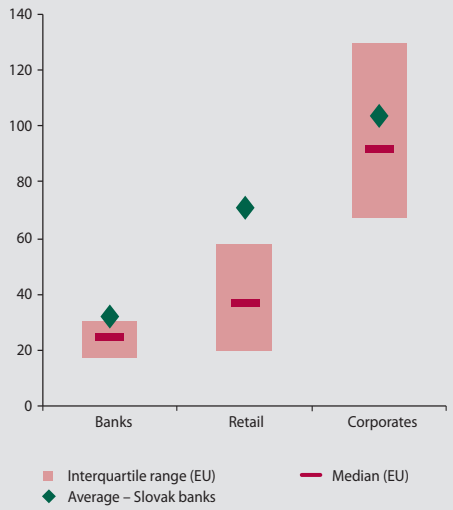
4 *The average risk weight was calculated as ratio of risk-weighted assets to total assets.*

Chart 13 Ratio of risk weighted assets to total assets (%)



Source: NBS.
Note: The group of large banks includes the five largest banks.

Chart 14 Comparison of the global charge in Slovak and European banks (%)



Source: NBS, EBA[5].
*Notes: The global charge takes into account unexpected and expected losses. It is calculated using the formula (RWA + 12,5 * EL) / EAD, where RWA is the level of risk-weighted assets, EL is the expected loss and EAD is the exposure at default.*
The chart shows data only for banks using the internal rating based approach.
The data for Slovak banks are as at 31 August 2013. The interquartile spread for the EU is based on data from 89 significant European banks. Data are as at 31 December 2011.

which the capital requirement is calculated using internal models. At the same time, this differing development in the average risk weights contributed to the fact that the capital ratio increase of recent years has been more pronounced in the group of five largest banks.

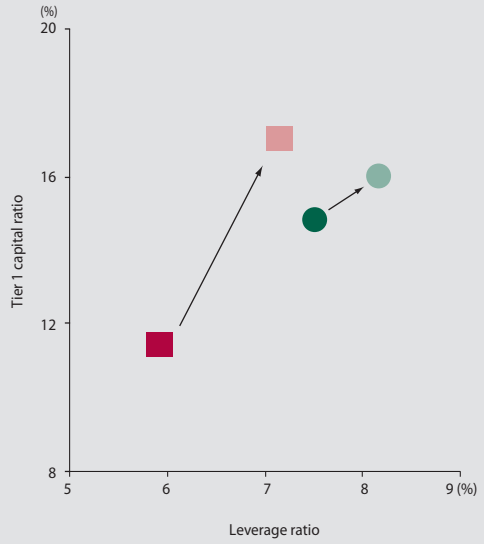
An important point in regard to the decline in risk weights is that they have not fallen below the EU average. This matters mainly with respect to persisting concerns about the consistency of the internal models used for risk-weighted asset calculations across EU banking sectors. As Chart 14 shows, however, in Slovak banks there is no significant asset class in which risk weights calculated by internal models are materially lower than the average level in the EU, and that is the case after taking into account not only unexpected losses, but also expected losses.

Since banks' capitalisation has risen sharply in recent years, their leverage ratio has also increased. This ratio denotes the extent to which the total value of all exposures (not risk weighted) is covered by core capital. The merit of this ratio is that it is not contingent on the level of risk weights, nor, therefore, on any weighting differences across banks. In the context of the new banking regulation, this ratio should complement the existing solvency ratios for banks. Banks are expected to disclose their leverage ratio from 2015, and this may later be followed by the setting of a minimum regulatory limit. It is positive that the current average leverage ratio in the Slovak banking sector is around 7.1%, more than twice as high as the figure for European banks. Therefore this ratio also confirms the self-sufficiency of Slovak banking sector. The average leverage ratio for small and medium-sized banks remains above the average for large banks, notwithstanding the sharp rise in the average capital ratio of large banks (Chart 15). This fact, too, reflects divergence between the two groups in terms of average risk weight developments.

Future capital ratio developments will be determined mainly by the decisions of individual banks concerning longer-term strategy for the level and quality of their capital. After the previous capital ratio increases,

5 *Interim results of the EBA review of the consistency of risk-weighted assets (Figure 17). Published on 26 February 2013.*

Chart 15 Changes in Tier 1 capital ratio and in leverage ratio in individual groups of banks (%)



Source: NBS.
Note: The leverage ratio denotes the ratio of Tier 1 capital to the total value of all exposures (not risk weighted).
The chart shows the changes in both ratios over the period from the beginning of 2011 to June 2013.
The squares represent the average ratios for the group of five largest banks, and the circles for the group of small and medium-sized banks.

several banks are now reporting strong capital buffers that far exceed the threshold proposed by NBS in its January 2012 Recommendation on supporting the stability of the Slovak banking sector. As already mentioned, eventhough an important part of this increase stemmed from the reduction of risk weights in banks´ own models, the resulting risk weights do not seem to be less prudent in comparison with the European average. It may therefore be expected that the capital ratio will not continue increasing at its currently high rate. At the same time, the share of highest-quality capital in total own funds could decrease. However, from the view of supporting financial stability at a time of persisting economic uncertainty, NBS considers it necessary for banks to maintain adequately high capital buffers. NBS therefore expects to exercise the respective national discretions available under the new banking regulation (the CRR Regulation and CRD IV Directive) by fully implementing provisions on solvency ratios and capital conservation buffer levels as from the day that this legislation enters into force, i.e. without applying transition periods.[6]

The effect of Basel III on capital ratios

The regulatory changes coming into force in 2014 may have some impact on the capital ratios of certain banks. These changes follow from the adoption of the CRR Regulation on prudential requirements for banks,[7] through which the Basel III rules are implemented in the EU. These changes could affect own funds (the numerator) as well as the value of risk-weighted assets (the denominator).

The own funds of most banks are expected to increase as a result of the implementation of the new regulation. At the level of the banking sector, this increase will be around 3%, but in some banks it could exceed 20%. The main factor is the inclusion of general provisions – up to as much as 1.25% of risk-weighted assets – in Tier 2 capital at banks using the standardised approach. Some banks using the standardised approach will benefit from the fact that where provisions do not sufficiently cover expected losses, only 80% of the shortfall will be deducted from their own funds. Moreover, this coefficient will decline in the years ahead. Besides these factors affecting the total amount of own funds, there are changes coming into force which will affect the composition of capital:

- Unrealised gains on instruments held in the available-for-sale portfolio will be included in core Tier 1 capital.
- Several deductible items that have so far been deducted partially from Tier 1 capital and partially from Tier 2 capital will in future be deducted entirely from common equity Tier 1 capital.

As regards the composition of own funds, it is also important that the quality requirements for own funds are being tightened, with banks required to hold a proportion of their own funds as highest-quality quality capital, i.e. common equity Tier 1 capital.

6 *The details and grounds of this intention are addressed in the section "Macroprudential policy".*
7 *Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.*

The new regulation is also expected to contribute to the decline in value of risk-weighted assets. The most significant change for the domestic banking sector is the reduction of 23.81% in capital charges for credit risk for exposures to small and medium-sized enterprises. On the other hand, for banks using the internal rating based approach, the capital charge on exposures to financial corporations will increase moderately.

Box 2

MACRO STRESS TESTING OF THE SLOVAK FINANCIAL SECTOR[8]

Národná banka Slovenska regularly conducts macro stress tests in order to assess the capacity of the Slovak financial sector to absorb losses arising from the materialisation of the most significant risks. This stress testing is based on three scenarios, termed "Baseline", "Economic Downturn" and "Sovereign Crisis". The Baseline scenario, based on the official NBS Medium-Term Forecast, assumes a moderate improvement in the economic situation. The Economic Downturn scenario is a stress scenario envisaging a renewed deterioration in the world economy that puts downward pressure on external demand and consequently on domestic demand, too. It assumes that domestic GDP slumps 9% by the end of 2014 and unemployment surges almost 4 p.p. by the end of 2015. Under the second stress scenario, Sovereign Crisis, the consequences of the global economic downturn are assumed to last longer. In addition, the adverse economic situation is compounded by an escalation of the euro area debt crisis, an increase in credit spreads, including those on domestic government bonds, rising investor risk aversion, and depreciation of the euro against the US dollar. These stress scenarios also include increasing loss ratios in non-life insurance.

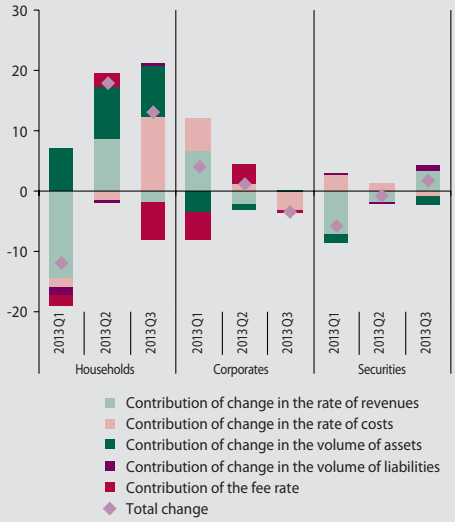
Under the macro stress tests, the banking sector demonstrated comparatively strong resilience in its capacity to meet regulatory limits, although several banks would report relatively heavy losses. Under the Economic Downturn scenario, the sector as a whole would need additional capital of €8 million (or 0.2% of own funds) to meet the regulatory capital requirement of 8%, while under the Sovereign Crisis scenario it would need €89 million (1.8 %). This additional loss-absorbing capacity is required mainly to cover losses on the corporate loan portfolio as well as revaluation losses on the bond portfolio caused by the assumed increase in credit spreads. The outcome is similar in the insurance sector, where the highest losses would be inflicted by an escalation of the debt crisis accompanied by an increase in non-life insurance costs. As for old-age pension funds, supplementary pension funds and investment funds, their asset value would decline by 4% on average. In the case of pension funds, the losses would be largely attributable to interest rate risk and/or credit spread risk on government bonds. In the collective investment sector, the principal cause of losses would be equity risk and foreign exchange risk.

Financial sector profitability

The profitability of the banking sector increased year-on-year, mainly owing to the continuing growth in retail lending. As at 30 September 2013, the banking sector's net profit for the year to date was almost 10% higher than for the same period of the previous year, with the growth rate reaching a peak in the third quarter of 2013. The higher profit was largely accounted for by a decline in financial trading losses as well as a moderate increase in net interest income and fee income (3% year-on-year). Credit risk costs remained largely unchanged from their level a year earlier. As Chart 16 shows, the rise in net interest income was driven mainly by continuing growth in lending to households. This income was also boosted quite significantly in third quarter by a decline in retail deposit costs, which reflected a partial easing of competition in this seg-

8 *More detailed information on the assumptions and results of macro stress tests is available in the Analysis of the Slovak Financial Sector for the first half of 2013.*

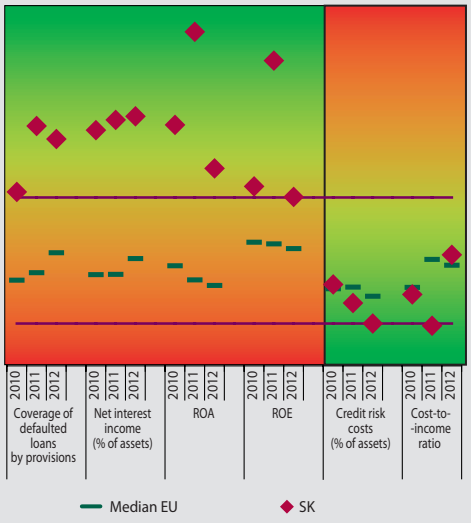
Chart 16 Factors affecting changes in net interest income and fee income for half-year periods (EUR millions)



Source: NBS.

ment and a relatively broadly based decline in deposit rates in the previous period.

Chart 17 Relative comparison of profitability indicators in the Slovak banking sector to their interquartile range in the EU



Source: ECB.
Notes: Data are as at 30 June of each year.
The horizontal lines show the interquartile spread for national banking sectors across the EU. The position of the Slovak banking sector and the EU median are shown relative to the interquartile spread.
The redder the background, the more negative the trend; the greener the background, the more positive the trend.

The profitability indicators of the Slovak banking sector remain highly favourable in comparison with those of other national banking sectors in the EU. This is evident not only in return ratios, but also in interest income generation, loan loss provisioning, and credit risk costs. This is particularly significant in regard to the stability of the domestic banking sector, given the importance of the sector's position, where the largest domestic banks are owned by banking groups.

3.2 BANKING SECTOR ASSETS

Lending growth

The downward trend in corporate lending observed in 2012 continued in 2013, and by September the amount of corporate loans had fallen year-on-year for 16 consecutive months. Within the corporate loan portfolio, however, there were segments that bucked the overall negative trend. Lending to small and medium-sized enterprises has seen slightly more optimistic developments for an extended period, with the amount of loans either remaining steady or even increasing. There has also been year-on-year growth in lending to certain sectors, for example, commercial property and agriculture.

The decline in corporate lending is on a par with developments in the euro area and neighbouring countries. While there were a number of European countries in which corporate loan growth remained positive, Slovakia and its neighbours were among the majority of countries that reported a decline. It is also the case that corporate lending rates, which at this time appear to be negatively correlated to lending growth, are in line with developments in other EU Member States. The factors behind the contraction of lending in the EU are largely similar to those in Slovakia. According to the bank lending survey, most European banks took the view that demand for loans would continue to decline and that credit standards would need to be tightened owing mainly to credit risk. Unlike banks in Slovakia, several European banks also face restrictions on capital and funding sources.

Housing loan growth was higher in Slovakia than in the EU as a whole. Key factors in this

Chart 18 Corporate lending (annual percentage changes)

Source: NBS.

regard are falling lending rates and the low indebtedness of the household sector, as well as the stability of property prices, which remain far below their 2008 level. These factors are not new, and taken together they have been supporting growth in housing loans for the past two years.

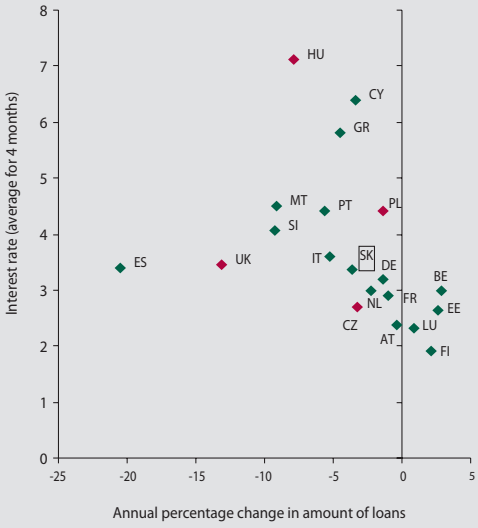
It should be noted, however, that a similar combination of low indebtedness, subdued property prices and low lending rates exists in the Czech Republic, where growth in loans to households has been fluctuating between 1% and 5%.

It is significant from the view of financial stability that the increase in housing loans was not accompanied by widespread growth in property prices. A combination of strong rises in lending and property prices is often a sign of emerging imbalances in an economy, or part of it, and may indicate excessive lending growth. It is therefore important that this type of imbalance has not yet appeared in the domestic economy.

When analysing the property market as a potential source of systemic risk, it is important to compare the dynamics and level of property prices. Unlike markets in which prices are higher now than they were before the onset of the financial crisis, and are still rising, the domestic market appears to be searching for some new equilibrium. Property prices in Slovakia have so far stabilised at around 80% of their 2008 level, and by international comparison they appear relatively stable.

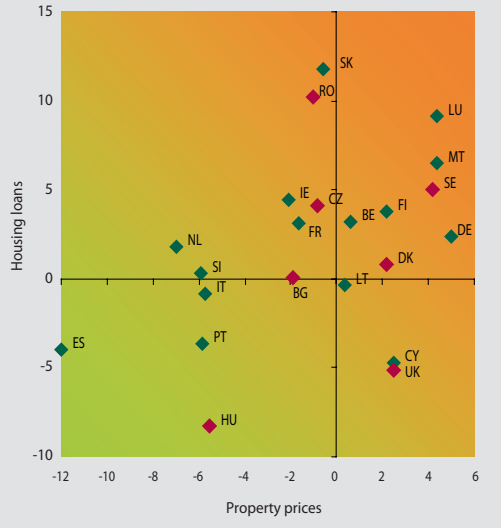
Despite the overall stability of the property market in Slovakia, apartment price trends

Chart 19 Changes in corporate loans and interest rates (%)



Source: ECB.
Notes: States not using the euro (UK, CZ, HU and PL) are marked in red.
The left-hand scale shows the rates on new loans.
Data are as at August 2013.

Chart 20 Growth in housing loans and property prices (annual percentage changes)

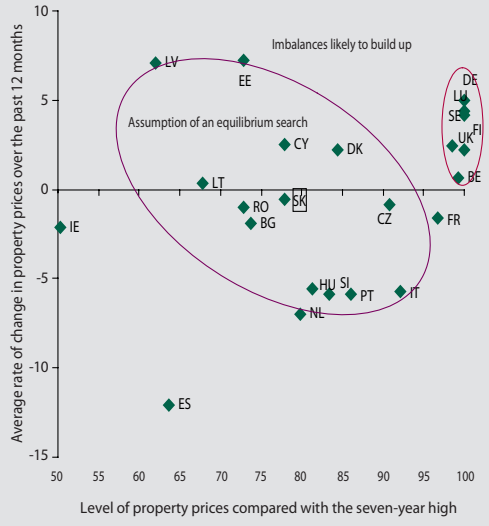


Source: ECB, Eurostat.
Notes: States not using the euro (BG, CZ, DK, HU, RO, SE, UK) are marked in red. The property price figures are averages for the three quarters ending June 2013. The loan figures are as at June 2013.
Lower (higher) risks are marked in green (red).

have not been homogenous. The differences between prices in larger urban centres and rural areas are wider now than they were in 2008, and some parts of the market have seen significant price growth in recent months. In all regions of the country, the disparity between apartment prices in the main regional town/city and other municipalities widened between 2008 and 2013. Bratislava Region, which has long had the smallest gap in property prices between the urban centre and other municipalities, reported the largest increase in this regard (although the nominal difference remained the lowest). This stemmed from rising prices in the Old Town and Petržalka districts of Bratislava city, with prices of 2-room and 3-room apartments recording a particularly marked year-on-year increase of between 6% and 8%. It is important, also in the context of developments in other EU countries,[9] that the nominal prices of such apartments have so far remained below where they were at the beginning of 2009. It should be noted, also in the context of developments in other EU countries, that these increases are more in the nature of isolated movements than a trend that needs to be monitored.

Slovakia is more of an exception among EU countries in having a combination of high housing loan growth and stability in average property prices. Despite the above-mentioned variation in apartment price movements, the Slovak market can still be described as stable. Since, however, the same cannot be said of the vast majority of EU countries, the situation in Slovakia deserves closer attention. Two factors may provide partial explanations.

Chart 21 The level and dynamics of property prices (%)



Source: Eurostat,
Note: Data are as at June 2013.

The first factor may be the growing tendency for borrowers to repay a housing loan using a loan from another bank. In doing so, they typically borrow a slightly higher amount from the new bank so as to acquire additional funds for housing-related investments. Since repaying a loan with a larger loan is not in any way associated with a property market transaction, such behaviour would suffice to explain how housing loans are growing without putting upward pressure on property prices. This explanation is further supported by the strong correlation between the dynamics of lending growth and the repayment of loans with a loan from another bank.

The second partial explanation is that a higher amount of loans was invested in a greater number of apartments sold. This explanation has two premises: first, the supply of new apartments is increasing moderately and developers realise that price is the key criterion for buyers; second, since the property market is stable, with an extended period of no decline in prices, there is greater scope for rational demand. Such a combination would lead to a potential increase in highly price-sensitive demand, which would be fully taken into account in the supply. This explanation is also supported by the positive developments in housing affordability, which posted a new all-time high. Housing affordability, which is a key factor in demand for property, is being influenced by low interest rates. It should be admitted, however, that since this explanation is not supported by any quantitative outputs, and therefore it cannot be verified.

The potential for further growth in loans to households is gradually falling. This reflects a gradual change in demography and the rising indebtedness of the household sector. A culmination in the number of potential loan applicants was already indicated in the previous Financial Stability Report. Along with this trend, however, it is necessary to mention the rising indebtedness of the household sector. Compared with other EU countries, the ratio of household debt to disposable income in Slovakia has been very low in Slovakia; at the same time, however, it has been the fastest ris-

9 *For example, according to a Deutsche Bundesbank analysis, property prices in Germany increased more sharply in all cities than in rural areas and may therefore be overvalued. Similar findings have been published in regard to the property market in the United Kingdom, particularly London.*

ing in Europe. It should be noted, too, that there are a number of countries whose debt-to-disposable income ratio is not among the higher ones in the EU, yet even so has been falling for several years. This is further evidence of the heterogeneity across EU countries as regards the extent to which the debt-to-disposable income ratio is sustainable. In the case of Slovakia, given the absolute level of incomes and composition of household expenditure, it may be assumed that this ratio will not rise to the levels observed in more advanced economies.

Although all banks reported household borrowers prepaying loans with a loan from a rival bank, the extent to which this was happening varied widely across banks. For several banks, this development translated into a decline in market share. Consequently, the concentration index for the household lending market reached its historical low and continued falling.

Important from the view of financial stability is that no easing of credit standards was associated with the refinancing of loans with loans from other banks. This was primarily about price competition, which in certain cases was supported by greater utilisation of financial agents. As a result, several small and medium-sized banks have substantially increased their share of the household lending market over the past six months.

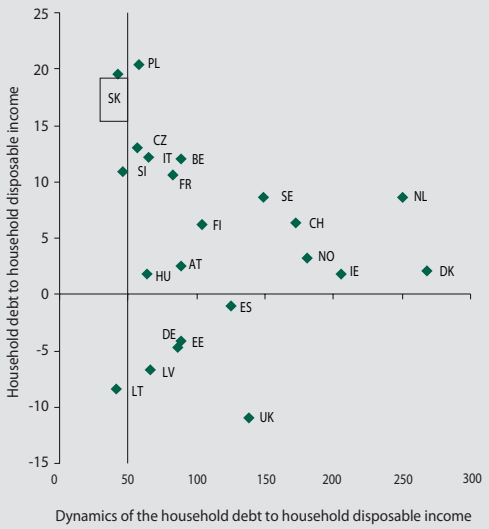
Government bonds

As regards the share of government bonds in the total assets of the banking sector, Slovakia has long reported one of highest figures in the EU. This already high ratio increased even more markedly from the end of 2008, as the global financial and economic crisis resulted in the stagnation of corporate loan portfolios and a consequent rise in investments in Slovak government bonds. As at end-June 2013, the share of these bonds in the sector's total (net) assets was 22%.

As became apparent during the sovereign debt crisis, however, investments in government bonds cannot be considered risk-free in all circumstances. Hence discussions have begun at the European level about the riskiness of government bonds, and about how the regulatory framework may/should take account of this risk.[10]

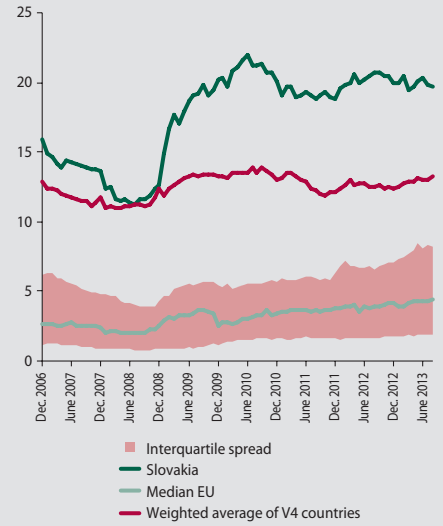
The rising domestic sovereign debt components of bank asset portfolios are increasingly being seen as a potential source of risk, both by national supervisory authorities and certain credit rating agencies. What is important in this regard is that in comparison with banks in other EU countries, banks in Slovakia report the highest share of government bonds in total assets.

Chart 22 Household debt-to-income ratios (%)



Source: Eurostat.
Note: The horizontal axis shows data from 2011, and the vertical axis shows the change between 2008 and 2011.

Chart 23 Government bonds as a share of total banking sector assets in EU countries (%)



Source: ECB Statistical Data Warehouse.

10 The President of the Deutsche Bundesbank also pointed to the risk of preferential treatment of government bonds: www.bis.org/review/r131008c.pdf

3.3 FUNDING SOURCES OF THE BANKING SECTOR

One of the principal risks facing several euro area countries, the risk of a deterioration in access to funding, is less significant in the Slovak banking sector as a whole. A key factor here is the long-standing high and stable share of non-bank deposits on banks' balance sheets. This remains the base for the conservative policy of banks to have a loan-to-deposit ratio of less than 100%, and the current dynamics of loans and deposits do not indicate any change in this strategy.

In the first half of 2013, households continued to show a greater preference for deposits without an agreed maturity; total retail deposits grew at a slower pace, and in July and August they even declined slightly. This situation probably reflected to some extent the decrease in deposit rates and the fact that collective investment funds became more attractive as a result. The net flow of retail deposits has been more volatile since the beginning of 2013, correlating with net sales of investment funds. Nevertheless, the outflow of these deposits has been offset to some extent as asset management companies deposited back some of the investment fund inflows.

Conditions of mortgage bond issues remained largely unchanged in the first half of 2013. Although the credit spread on coupon income remained at the level of the long-run trend, some banks, responding to a regular survey, said that their overall situation in regard to bond issuance had deteriorated. This was also evident from mortgage bond sales, which declined slightly.

The interbank market and ECB continue to be only a marginal source of funding for banks in Slovakia. In almost all banks, funds from other banks and the central bank constitute less than 5% of the balance sheet. Almost two-thirds of the funds drawn under the ECB's three-year longer-term refinancing operations (3Y LTRO ECB) have already been repaid.

Box 3

NETWORK ANALYSIS OF THE SLOVAK FINANCIAL SECTOR

Network analysis is an increasingly common method of studying the structure of the financial/banking sector and its vulnerability due to the possible risk of contagion. It is also an effective way to study more complex and interconnected systems. In this type of analysis, the financial/banking sector represents a network in which individual companies constitute "nodes" (hubs) of the network and interactions between the companies are the "edges" of the network. In this box we will look at some of the outcomes of a simple network analysis of the Slovak banking and financial sector.

As regards the domestic interbank market,[11] even the most simple indicators confirm that the principal significance of this market to the banking sector is its role in providing short-term liquidity. The domestic interbank market is dominated by a relatively small number of banks, and in normal times is not a potential source of contagion.

The dominance of a small number of banks may be demonstrated by, for example, degree centrality, which expresses the extent to which a given bank is exposed to other banks (outdegree) and the extent to which other banks are exposed to that bank (indegree). In the case of both indicators, it is possible to calculate the unweighted centrality (taking into account only the number of ties between banks) and the weighted centrality (where ties are weighted by the volume of transactions). All four indicators (weighted / unweighted indegree and outdegree) show a maximum value that is far higher than the average, median or third quartile, indicating that those banks with the highest number or largest volume of transactions are dominant in comparison with other banks.

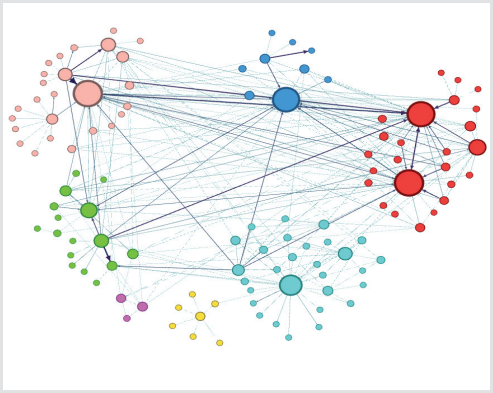
Whether contagion is likely to spread through the interbank market may be examined using so-called indicators of vulnerability or contagiousness. The vulnerability of a given bank denotes the number of banks whose failure

11 The analysis factored in interbank operation as well as bond exposures. The period under review covers 2012 and the first half of 2013, since detailed monthly information about bond exposures are available only from the beginning of 2012.

Chart A Network graph of the domestic interbank market as at 30 June 2013

Source: NBS.
Notes: The size of the bubble expresses the relative number of ties with other banks.
The thickness of an edge corresponds to the degree of exposure.

Chart B Network graph of the domestic financial sector as at 30 June 2013



Source: NBS.
Notes: The size of the bubble expresses the relative number of ties with other banks.
The thickness of an edge corresponds to the degree of exposure.
The "clusters" identified as at 30 June 2013 are differentiated with different colours.

would bring about its own failure, and the contagiousness of given bank denotes the number of banks that would fail as a consequence of its own failure.[12]

A bank may fail owing to an "idiosyncratic" shock or to a shock that affects the banking sector as a whole. As regards the first case, it is to monitor the extent to which the failure of the given bank in "normal" times would represent a serious risk to the banking sector through direct exposure. The results show that the domestic interbank market is not particularly influential in this regard and that the banking sector is well capitalised. Over the eighteen-month period under review there were only two months (February and March 2012) in which any bank would fail owing to the failure of another bank: in February, the failure of two banks would cause the failure of two other banks, and in March the failure of two banks would cause the failure of one bank. No other failures would have happened even in these months. So although there was a moderate risk of contagion in early 2012, this risk in regard to an idiosyncratic shock is not currently present in the domestic banking sector.

In the case of a broad-based shock to the banking sector, the significance of a direct tie through the interbank market may be observed using a stress test (further details of the stress testing of the financial sector are given in Box 2). It is positive to note that even where the financial position of banks is weakened under different scenarios, the vulnerability and contagiousness of individual banks does not increase significantly.[13] In all three scenarios, the additional failure of one bank results in the failure of another bank. Another positive outcome is that even the failure of more than one bank under the Sovereign Crisis scenario does not give rise to further failures resulting from direct exposure.

Certain network analysis indicators may likewise be applied to the financial sector as a whole, not only banks.[14] Since not all entities have an obligation to hold capital, it is not possible to employ the concepts of vulnerability and contagiousness in the conventional sense. Nevertheless, it is important to ascertain which companies are more significant, i.e. have a central role in regard to mutual exposure. Thus, there is a possibility to calculate centrality for

12 The calculation for these indicators assumes that the loss caused by the failure represents 100% of the volume, and it does not take into account mortgage bond exposures.
13 The level of exposure between banks at the end of the stress period is assumed to be the same as at 30 June 2013.
14 Since data for insurers are available on a quarterly basis, all calculations for 2012 and the first half of 2013 are carried out on that basis.

the entire financial sector. Companies, to which other companies have the largest exposure, whether in terms of the number or volume of transactions, comprise mainly banks and certain funds. By contrast, companies that have the largest exposure to other companies comprise mainly insurers and certain banks. There is also one supplementary pension management company that has a relatively substantial exposure to the sector in terms of volume.

Another interesting question is whether it is possible to form clusters of companies, i.e. to identify selected groups of companies whose mutual ties are more substantial. Such information could be useful where a particular company finds itself in difficulty, since it could help determine a smaller group of financial companies that could be directly affected by this situation. Clustering companies can also help in analysing the structure of the financial system in more detail. Such an analysis was carried out using the so-called Louvain method, which in the search for clusters takes into account mainly the total volume of mutual ties between companies. Although only a small number of observations (six quarters) are available for the calculation and the individual clusters appear to be less stable, it is possible to identify several groups of financial companies that have a tendency to form clusters.

3.4 FINANCIAL SECTOR RISKS

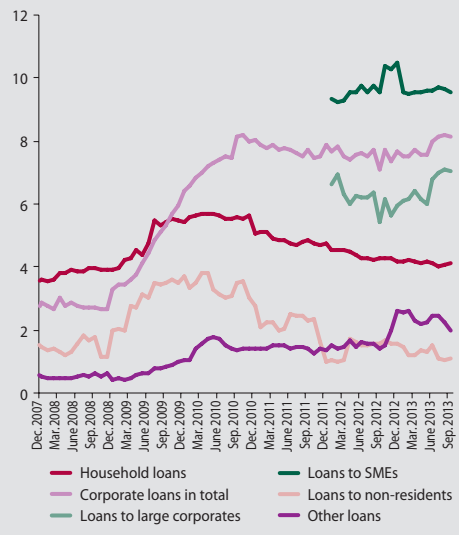
Loan quality

Even though the financial position of the corporate sector remains difficult and the labour market situation has yet to improve, borrowers have so far managed to meet their bank loan repayments.

In the context of high or rising non-performing loan (NPL) ratios in several central and eastern European countries, the Slovak banking sector continues to maintain a prominent position in terms of loan quality. The NPL ratio for household loans maintained its stable trend in recent months, largely because an increase in new lending offset a moderate rise in the amount of NPLs. By contrast, the NPL ratio for loans to large corporates increased, as the amount of loans declined and the amount of NPLs remained largely unchanged.

Current trends in loan quality confirm that credit risk losses do not constitute an immediate threat to the banking sector as a whole.

Chart 24 Non-performing loan ratios (%)



Source: NBS.

Signs that credit risk may increase in the future

Certain indicators may be used to analyse future developments in credit portfolio quality, and they are showing that banks may face a potential increase in credit risk.

The first such indicator is the annual percentage change in the amount of loans past due by more than 30 days but less than 90 days. An increase in this indicator may imply a future increase in the proportion of loans past due by more than 90 days, which in turn relates to non-performing loans. Such a trend has been observed in retail lending in 2013. The amount of retail loans past due by more than 30 days but less than 90 days increased over the previous three quarters by around 13%.

A second indicator, which matters mainly in regard to the corporate segment, is the share of loans with an extended maturity. An increase in the share of such loans may indicate that borrowers are struggling to repay their loans and that banks are responding by extending loan maturities. It is therefore positive that this indicator, after rising in 2010 and 2011, declined in 2012 and did not increase in the first half of 2013. In the first six months of this year, the share of total loans whose maturity was extended for the first time and which were not reclassified as impaired loans did not exceed 0.4% of the outstanding amount of corporate loans. Most of these loans were provided to firms in certain industrial segments, such as wholesale trade, transportation, and real estate activities.

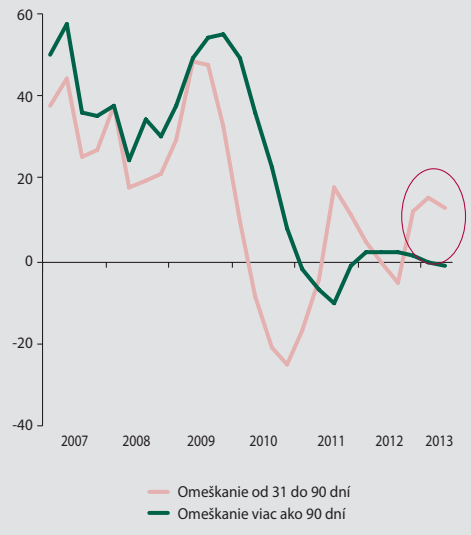
Banks' sensitivity to a decline in property prices[15]

The average loan–to-value (LTV) ratio on new housing loans in the banking sector as a whole remains relatively sound, although some banks are providing large volumes of loans with a high LTV ratio. In the pre-crisis period of 2007 and 2008, the average LTV ratio reached as high as 100%. As property prices fell in late 2008 and early 2009, the average LTV ratio on housing loans climbed up to 120%. Where housing loans with such LTVs became non-performing, the sale of the collateral real estate did not cover the amount owed and banks were forced into provisioning for the unsecured part of the NPLs. Hence loans extended in 2007 and 2008 represent a higher risk to the banking sector. The average LTV ratio fell sharply in 2008 and 2009 and remains stable at around 70%. But although the average ratio is favourable, its distribution within individual banks is considerably heterogeneous.

There is also variation across banks in regard to LTV ratios policy, since in some institutions the share of loans with a ratio of more than 85% fell in each of the last three half-year periods, while in others it increased. In the sector as a whole, the share of such loans declined slightly.

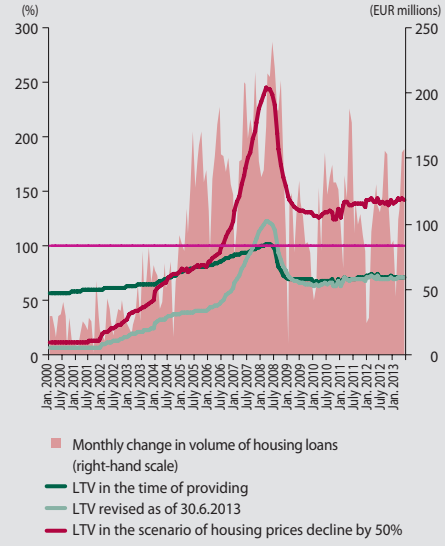
A potential decline in property prices does not represent a risk to banks' solvency. The sensitivity test showed that even in the case of a marked deterioration in the property market (prices falling by 50%), the consequent sharp increase in non-performing loans (by tenfold) would cause the sector's capital ratio to fall from 16% to around 12%. Given the highly extreme

Chart 25 Past due loans to natural persons including self-employed persons (annual percentage changes)



Source: NBS.

Chart 26 Average LTV ratio at time of lending and after decline in property prices



Source: NBS.
Notes: The left-hand scale shows the average LTV ratio on new loans provided in the given month. The LTV ratios reassessed as at 30 June 2013 include the amount by which the principal has been reduced by repayments and changes in property prices.
The stressed LTV ratio on a decline in property prices is based on the LTV ratio revised as at 30 July 2013.
LTV figures before 2008 were assessed.

15 The calculation methodology and further results were published in the following article: Latta, P. and Rychtárik, Š., "Impact of the loan-to-value policy of Slovak banks on losses under scenario of falling real estate prices", Biatec, Vol. 21, No 8, Národná banka Slovenska, October 2013, ISSN 1335-0900.

nature of this scenario, the drop of 4 p.p. also confirms the strong resilience of the banking sector. This resilience is based mainly on the sufficiency of banks' capital ratios and the extent of their exposure to this risk (around 25% of assets). Neither of these factors, however, can be considered to be invariable. The strong growth in housing loans is gradually increasing banks' sensitivity to property prices. Furthermore, banks currently have a historically high level of top-quality capital, but this could change. Hence it is assumed that risks associated with high LTV ratios will become greater.

When applied to banks individually, the same testing showed that all of them would maintain a capital ratio above the 8% regulatory minimum. It confirmed the assumption that the decline in own funds would be greater in those banks with an initially larger share of high LTV loans. Therefore, when providing new loans, banks should give careful consideration to the LTV ratio. This sensitivity test also showed that losses on the housing loan portfolio stem not only from the LTV ratio, but also from the credit quality of the portfolio. Hence, despite the banking sector's current strong resilience, credit standards should be set prudently, particularly in regard to the LTV ratio and the borrower's capacity to withstand an increase in repayments or decline in income.

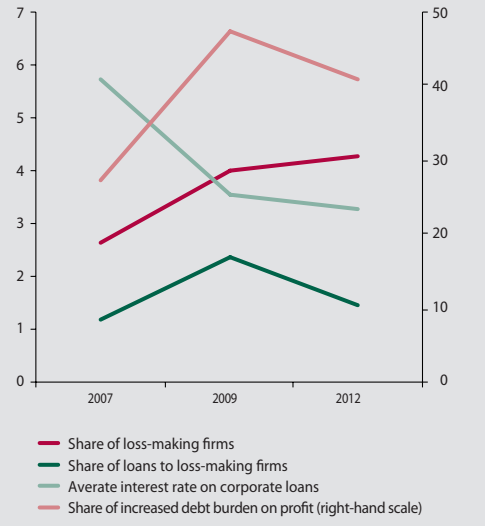
Although the policy of high LTV ratios does not in itself jeopardise the stability of the banking sector, in combination with other factors such policy constitutes a potential risk. Any adverse changes in the property market would probably be related to other economic imbalances. Overall, banks' financial stability would therefore be affected by several negative factors, and losses on the housing loan portfolio would be compounded by losses on other portfolios. In this context, high LTV housing loans may be seen as a risk to financial stability.

Firms' sensitivity to a potential increase in interest rates

The corporate sector has capacity to cope with an increase in lending rates, but this capacity is changing over time. Most of the larger firms that obtain financing through domestic banks are using short initial rate fixation periods, which means their loan repayment costs are sensitive to current developments in financial markets. This risk is monitored by testing the corporate sector's sensitivity to a hypothetical interest rate hike of 200 basis points (b.p.).[16] In the three test periods (2007, 2009 and 2012), the outcomes varied considerably. The simulated increase in corporate lending rates would have the least impact in 2007. In 2009, the proportion of firms that would make a loss owing to the rate increase climbed by 50%. In other words, despite average interest rates being half of their 2007 level, the capacity of firms to cope with a rate increase would deteriorate. This largely relates to the macroeconomic situation, as firms' performance declined by more than 10% between 2007 and 2009. The test conducted in 2012 saw more firms post a loss, albeit on a substantially lower amount of loans, which suggests that the impact was greater on smaller firms. At the same time, the share of increased debt servicing burden fell between 2009 and 2012, and although it has still not reached its pre-crisis level, its trend is positive.

From the view of the banking sector, loans of loss-making firms would not exceed 2.5% of the corporate loan portfolio in any of the periods un-

Chart 27 Impact on corporate loans of an interest rate increase of 200 b.p. (%)



Source: NBS.
Notes: The sample of firms used in the sensitivity test included only firms in profit. All shares are calculated after application of the sensitivity test and represent the shares of the respective category in the whole sample.
Average interest rates are rates for the whole corporate loan portfolio in the given period.

16 All other parameters remain unchanged. The test is not dynamic – it does take account of how firms respond to new market conditions.

der review. It may therefore be concluded that a 200 b.p. increase in interest rates does not in itself represent a significant risk to the Slovak banking sector's corporate loan portfolio. If combined with other factors, however, this risk could escalate.

Market risks

During the first half of 2013, the exposure of domestic institutions to market risks was affected by two factors in particular: legislative changes in the second pension pillar and persisting low returns on less risky assets.

Legislative changes brought a marked increase in the riskiness of funds in the second pension pillar, managed by pension funds management companies (PFMCs), as well as in the heterogeneity across these funds. The most significant factors in this regard were the cancellation of the guarantees that PFMCs provide for their riskier funds and the extending of the performance assessment period for such funds. Because of these changes, non-guaranteed funds became substantially more sensitive to interest rate risk, equity risk and foreign exchange risk. At the same time, the risk profiles of these funds became significantly more differentiated. After a relatively long period in which the asset portfolios of all types of PFMC funds were almost uniformly conservative, the investment strategies of equity and mixed funds began to be far more in line with what the names of these funds would indicate. At the same time, however, the market share of higher-risk funds fell significantly, as savers were automatically switched to guaranteed funds unless they explicitly requested enrolment in a non-guaranteed fund. Owing to this marked rise in the share of conservative funds, the overall level of risk in the sector remained low.

Low returns on least risky assets contributed to a partial increase in the risk exposure in certain other segments of the financial market. The recent period in global financial markets has seen such a tendency towards higher-risk investments. As noted by the European Systemic Risk Board, however, an excessive search for yield could lead to an increase in systemic risk in the event that investor risk aversion rises again.[17] As it was described in details in the Analysis of the Slovak Financial Sector for the first half of 2013, the exposure of the domestic financial market to interest rate risk, equity risk and foreign exchange risks did not increase significantly, except in the case of the PFMC funds mentioned above. Only in third-pillar pension funds was there a slight increase in sensitivity to interest-rate risk.

In the collective investment sector, by contrast, increased risk exposure arising from a search for yield was evident mainly in investments in lower-rated bonds. From the end of 2012, the share of bonds with BBB-rating as at mid-October 2013 saw the largest increase. A rising share of investments in lower-rated bonds was observed in the portfolios of most investment funds, although the rate of increase was considerably heterogeneous across asset management companies.

Chart 28 Stock of bonds and newly purchased bonds in investment fund portfolios broken down by credit rating (%)

Source: NBS, Bloomberg.
Notes: Investments in debt securities issued by domestic banks are included in the group of assets with the highest rating (AAA / AA / A) regardless of their actual rating.
The credit rating is given as the average of the ratings assigned by the credit rating agencies Moody's, Standard and Poor's and Fitch as at 18 October 2013. Therefore rating adjustments over time do not affect the shares shown.
The issue rating, if available, was given preference over the issuer rating. Where issue ratings were available from several agencies simultaneously, the average of these ratings was used.

17 Source: Press release from the meeting of the General Board of the European Systemic Risk Board on 21 March 2013.

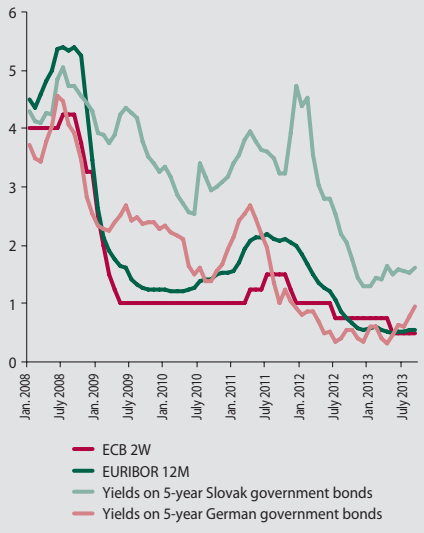
Risk of low interest rates

The period of low interest rates is persisting, resulting in a continuing decline in rates of return on the investment portfolios of financial institutions and funds. Short-term and long-term interest rates remain low, although long-term rates started to slowly increase in the second and third quarters of 2013. In this extended period of low rates, the share of low-yielding investments is gradually increasing, leading to a decline in investment returns across a whole range of entities. It is positive, however, that most financial institutions and funds have not significantly increased the riskiness of their portfolios in a search for yield. The only exceptions are some types of investment fund that have increased their investments in lower-rated assets, as mentioned in the sub-section "Market risks".

The life insurance sector is at most risk from the extended period of low interest rates, since insurers need to secure investment returns in excess of the interest rate guaranteed in insurance policies. The sector overall is meeting this requirement, but some individual insurers are not.

Financial institutions shall avoid building up risks associated with low interest rates and be ready for when rates return to more normal levels. Although borrowers have benefited from declining interest rates by reducing repayments, an excessively long period of low rates could have adverse effects, such as the emergence of price bubbles and the accumulation of credit risk through lending to customers with low repayment ability. In the event of a sudden rise in interest rates, the consequences for financial institutions could be severe.

Chart 29 Selected interest rates and government bond yields (%)



Source: NBS, ECB, www.euribor.org, Bloomberg.

Financial agents

The interlinkage between several banks and financial agents has increased during 2012 and 2013. This has been supported by current legislation that allows housing loans to be prepaid at no charge, in order, for example, to arrange a new interest rate fixation. In some cases, loans obtained through agents constitute the largest proportion of new loans.

The banking sectors links with financial agents could lead to a build-up of several risks. Individuals can find it difficult to navigate the range of financial products, and therefore the transactions between them and banks are often brokered by financial agents, who should provide an overview of the products on offer and help select the one most suited to the customer's needs. At the same time, this should increase competition between banks, since experienced agents can exploit minor differences between their products. On the one hand, this model of product provision has beneficial effects; on the other hand, it may also entail potential risks.

The first potential risk is that banks become overly reliant on financial agents for the provision of loans. A bank is more likely to favour such a model where it does not have a sufficiently developed branch network. A high reliance on agents involves risks, however, particularly in regard to their motivation. As their primary objective is to sell the loan, agents have minimal interest in the customer's ability to repay it, i.e. in the risk parameters of the loan (for example, the loan-to-value ratio or debt-to-income ratio), which are usually set by the bank. In cases where banks become dependent on the agents, they may come under pressure to moderate risk parameters in order to make loans more competitive, even at the price of increasing risk exposure.

Another risk concerns the fact that financial agents are paid by banks and not by customers. Banks providing substantially higher com-

missions could therefore increase their market share, despite, for example, offering above-average interest rates and less suitable credit standards. This could ultimately have a negative effect on customers, who may not necessarily obtain the most suitable loan on the market, but rather a loan from the bank that pays the agent the highest commission.

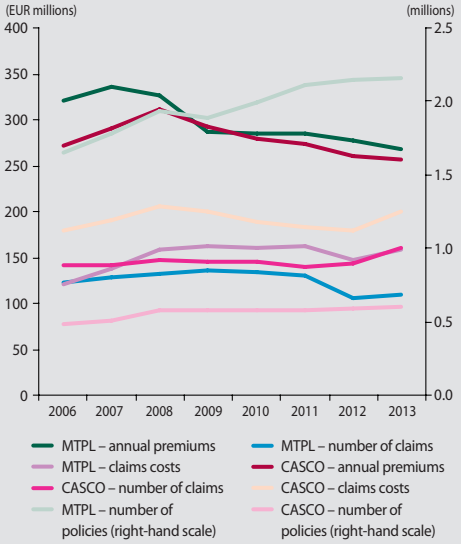
Competition in motor insurance[18]

In motor insurance, competition is putting downward pressure on premiums while the number of policies is increasing. The recent period has seen competition in the Slovak motor insurance market increase markedly. This is mainly reflected in a continuing decline in premiums and uninterrupted increase in the number of insurance polices, which has been observed MTPL insurance[19] since 2005 and in comprehensive motor vehicle insurance (CASCO) since 2008. These trends are driven largely by domestic insurers, since the share of foreign insurance undertakings in total premiums is less than 4.5% in both MTPL insurance and CASCO insurance.[20]

As far as customers are concerned, the competition had a positive impact on policy prices. In MTPL insurance, the average premium fell from €194 in 2006 to €124 in 2013, and in CASCO it declined from €564 to €425 over the same period. All insurers reported a drop in average premiums. Whereas in 2007 and 2008 competition resulted in a high movement of policyholders between insurers, since 2009 there has been a stabilisation of insurance portfolios, particularly in MTPL insurance. In CASCO, however, the proportion of new policies has recently started to increase again.

The drop in premiums earned lead to an increase in the cost ratio and, in the case of CASCO, also a substantial rise in the loss ratio. Lower insurance prices had a downward effect on premiums earned in the insurance sector, which was reflected in the loss ratio and cost ratio. Despite relatively stable operating expenses, the cost ratio in both MTPL insurance and CASCO is slowly rising. In MTPL insurance, the loss ratio has so far remained at a sufficiently low level, but in CASCO this ratio has been increasing in recent years and the combined ratio exceeded 100% in both 2012 and in the first half of 2013. Such a situation is unsustainable, since CASCO is a loss-making line of business.

Chart 30 Developments in motor vehicle insurance



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

Questions are also raised by the markedly differing developments in MTPL insurance and CASCO. At the same time, it is difficult to explain this divergence on the basis of accident rates. Since 2009 there has been a significant decline in the ac-

Chart 31 Distribution of new policies as a share of total policies

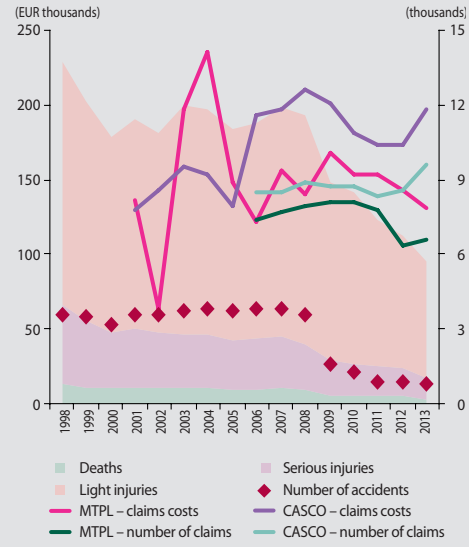
Source: NBS.
Note: MTPL – motor third-party liability insurance; CASCO – comprehensive motor vehicle insurance.

18 All stock data are as at the end of the respective year and as at 30 June 2013. All flow data are for the respective calendar year, and those for 2013 are annualised from data for the first half of the year.
19 Motor third-party liability insurance.
20 In the MTPL insurance line, branches of foreign insurance companies increased their share from 1.5% in 2009 to 4.5% in 2012, while in comprehensive motor vehicle insurance, their share fell from 4.3% in 2009 to 3.1% in 2012.

cident rate on Slovak roads, especially in terms of deaths and injuries. Furthermore, the period since 2009 has seen a drop in insurance claims in CASCO, but not in MTPL insurance. Subsequently, however, the amount and number of claims in MTPL insurance fell substantially in 2012 and 2013, while those in CASCO increased significantly.

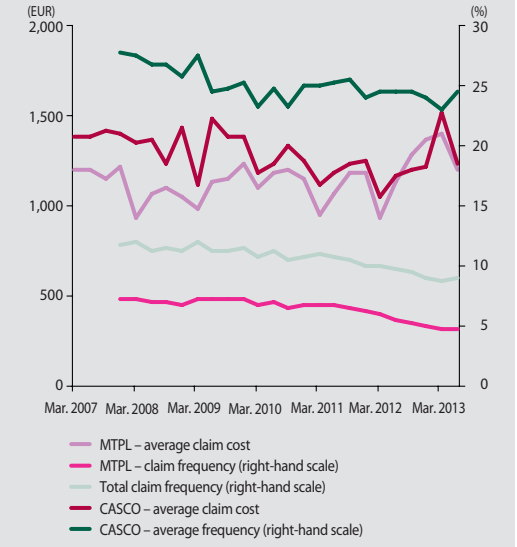
In MTPL insurance, the frequency of insurance claims[21] fluctuated at 7% after 2007 and then fell below 5% in 2012 and 2013. The claims frequency in CASCO remained stable through that period, in the range between 23% and 28%. In both lines of motor insurance the average claim increased in 2012 and 2013.

Chart 32 Accident rate and claims in MTPL insurance and CASCO



Source: MV SR, NBS.
Notes: The number of accidents in 2009 fell due to the introduction of a loss event not included in the figures of the Slovak Interior Ministry. MTPL – motor third-party liability insurance; CASCO – comprehensive motor vehicle insurance.

Chart 33 Frequency and average amount of claims



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

Box 4

STRUCTURAL CHANGES IN THE BUSINESS STRATEGY AND PROFITABILITY OF SELECTED BANKS AFTER 2008

Up to the end of 2007, the profit trends of banks operating in Slovakia were highly similar, but after the domestic economy's downturn in 2008, considerable differences in profitability appeared between institutions. While the sector as a whole has seen profits rebound since 2008 (increasing in every year except for 2012, when a bank levy was introduced), a group of medium–sized banks has been reporting a loss since 2008.[22] In the following part, we therefore analyse the competition between this group of medium-sized banks and the rest of the sector and the effect of this competition on the profitability of these banks. Although inter-bank competition continued to be present in the rest of the sector, too, the point here is not to assess and describe competition between individual banks.

Looking at the individual components of profit, the difference in profitability is largely the result of differing developments in net interest in-

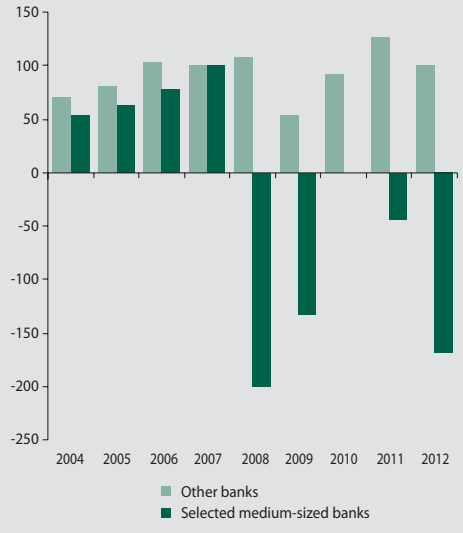
21 The ratio of insurance claims to the total number of policies.
22 Although certain banks in this group managed to make a profit in some years, the size of the profit was far lower than the pre-2008 levels and the group as a whole has made a loss since 2008.

come and provisioning. In the sector as a whole, net interest income continued to increase after 2008 and began to decline only from 2010; in the group of medium-sized banks, however, this income remains far below where it was in 2007 and 2008. But whereas a gradual decline in provisioning costs is observable in the other banks, this is not the case for the medium-sized banks.

This situation is probably a result of several factors. After 2008, when the Slovak economy contracted, banks' provisioning reflected to a large extent the riskiness of their portfolios, i.e. the investments they had made before 2008, while net interest income was additionally affected by changes in the behaviour of individual banks.

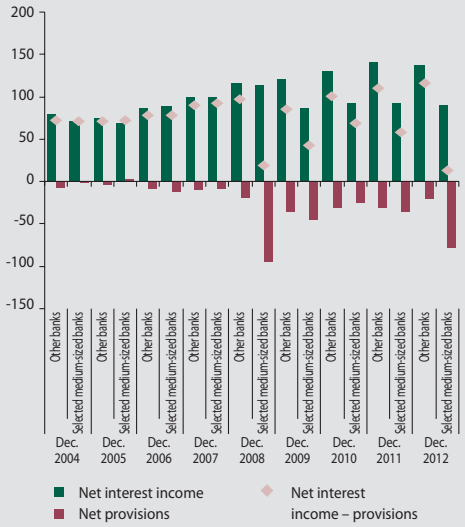
In the case of loans to non-financial corporations, the principal differences are in the total amount of lending. While the amount of these loans provided by medium-sized banks has declined continually since the end of 2008, the amount provided by other banks has shown positive trends, particularly in the second half of 2011.

Chart A Profitability in selected groups of banks (%)



Source: NBS.
Note: For each group, data are indexed against the profit for 2007, i.e. the 2007 profit equals 100% in both groups.

Chart B Provisioning and net interest income in selected groups of banks (%)



Source: NBS.
Notes: The chart shows changes in net interest income, provisioning costs and their difference.
For each group, data are indexed to net interest income, i.e. the net interest income for 2007 equals 100% in both groups.
Net provisions include net provisions and reserves, and net income from the write-down and assignment of claims.

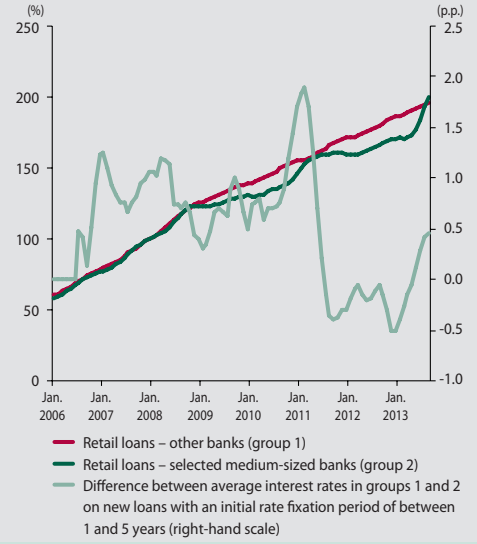
As for retail loans, differing trends were observed in both the amount of lending and in interest rate policy. Until 2008, the development of the retail loan portfolio showed similar trends in the banking sector, but for almost the entire period since then, retail loan growth in the medium-sized banks has been lower than in the rest of the sector. This divergence has happened even though the group of medium-sized banks practically always, even after 2008, charged lower interests than did the rest of the sector on both loans with an initial rate fixation of up to one year and those with a fixation period of between one and five years.

It appears that while until 2008 the selected medium-sized banks were able to use interest rate policy to offset their size-related weaknesses (for example, smaller branch networks), this unchanged policy has not been sufficient since the economic downturn. That is probably why these banks, seeking to increase their share on the housing loan market, pursued more aggressive interest rate policies in the second half of 2010 and first half of 2011, particularly in the

case of loans with a fixed interest rate period of between one and five years. As interest rates fell, the gap between the rates offered by the medium-sized banks and by the rest of the sector widened.

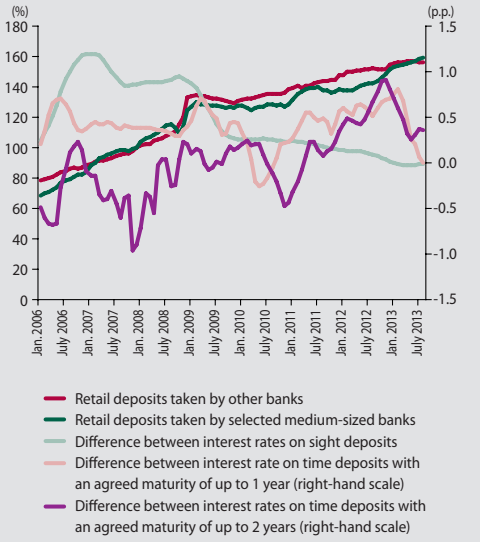
As a result of the divergence in lending rates, along with large-scale advertising campaigns for the respective loan products, the medium-sized banks substantially increased their volume of new lending at the expense of the rest of the sector. This increase was so marked that it changed the market shares of these banks in the overall amount of loans. After this period, the medium-sized banks raised their interest rates on these loans, even bringing them close to parity with those offered by the rest of the sector. It is difficult to distinguish the extent to which this development was caused by the medium–sized banks returning to a standard lending policy and by the response of the other banks, which also began to cut their lending rates and focus more on loans with longer fixed interest rates. Another As a consequence, market shares of medium-sized banks declined again.

Chart C Total amount of retail loans in selected groups of banks



Source: NBS.
Notes: For each group, data are indexed against the amount of loans reported at the end of 2007, i.e. the total amount of loans as at 31 December 2007 equals 100% in both groups.
The chart shows the three-month average of the difference between the interest rates.

Chart D Amount of retail deposits taken by the groups of banks



Source: NBS.
Notes: For each group, data are indexed against the amount of deposits reported at the end of 2007, i.e. the total amount of deposits as at 31 December 2007 equals 100% in both groups.
The chart shows the six-month average of the difference between the interest rates.

The market share of the group of selected medium-sized banks began to increase again from the second quarter of 2013 (because of the rising amount of new lending), and, as in 2010 and 2011, their interest rates are declining. What has been observed so far, however, is only the trend of a decrease in interest rates and increase in the spread between rates charged by the medium-sized banks and by the rest of the sector; the spread between the rates is far lower than it was in 2010 and 2011. This trend may be partly affected by the changed ownership structure of certain medium-sized banks. The extent to which this trend will continue and its overall effect on the interest income of the selected medium-sized banks compared to the rest of the sector will be crucial for the financial stability. It will also be important that these banks pay heed to the credit quality of borrowers who qualify for these loans because of the low repayments, since such loans represent a potential source of loss to banks in the event of an increase in interest rates and hence in repayments.

Another area of diverging developments between the two groups of banks is interest rate

costs. In the sector as a whole these costs increased gradually until 2008 and then fell, but the rate of increase was far higher in the group of medium-sized banks while the subsequent decline was more pronounced in the other banks.

As regards the medium-sized banks, the rise in their interest rate costs in 2008 was driven largely by the expected increase in deposits associated with the introduction of the euro. The efforts of these banks to acquire customers are also apparent from their interest rates on sight deposits and on time deposits with an agreed maturity of up to one year, which substantially exceeded the rates offered by other banks. In the case of sight deposits, however, a more effective transmission of monetary policy decisions was observed in the group of medium-sized banks than in the rest of the sector, and this fact also affected the difference in developments in interest costs of the two groups.

After 2008, the overall amount of deposits, like that of loans, showed a moderately lower growth trend in the group of medium-sized banks. Apparently this fact, and the hunt for market share, also explains why interest rates on time deposits with agreed maturities of up to one year and up to two years have increased in the medium-sized banks compared to the rest of the sector. This increase has translated into a higher amount of new deposits and consequently a higher overall amount of deposits. Nevertheless, at the end of the period under review there was a narrowing of the gap between the deposit rates offered by the two groups of banks, and in the case of the group of medium-sized banks, a decline in the amount of new deposits with agreed maturities of up to one year and up to two years.

In regard to financial stability, it is important to what extent low interest income weakens the ability of the group of medium-sized banks to withstand potential economic headwinds. It also remains to be seen how these banks will compensate their low interest income or higher interest rate costs.

CHAPTER 4

REGULATORY AND LEGISLATIVE ENVIRONMENT

4

4 REGULATORY AND LEGISLATIVE ENVIRONMENT

SINGLE SUPERVISORY MECHANISM

Implementation of the Single Supervisory Mechanism (SSM) will be preceded by a comprehensive assessment of banks. An EU Regulation on the Single Supervisory Mechanism was published in the Official Journal of EU on 29 October 2013, as the implementation of the first pillar of the banking union. In accordance with this Regulation, the ECB together with national supervisory authorities is carrying out a comprehensive assessment of the quality of banks' balance sheets and of banks' risk profiles, which is to be completed before the ECB assumes its supervisory role (on 4 November 2014). The principal aim of the process is to increase transparency and undertake any corrective measures that may be necessary, all of which is intended to strengthen the credibility of the banking sector. This assessment will comprise three parts, namely a risk assessment, an asset quality review (as at 31 December 2013) and a stress test. In the Slovak banking sector, this assessment will be carried out on the three largest banks. The results of the comprehensive assessment, where necessary, will be followed by corrective measures (for example, recapitalisation, profit retention, asset separation and sales), with preference given to utilisation of private sources of capital.

CRISIS MANAGEMENT

Two key documents concerning the resolution of potential crisis situations in the banking sector were published in June 2012 and July 2013, namely the draft Bank Recovery and Resolution Directive (BRRD)[23] and the draft Regulation establishing a Single Resolution Mechanism (SRM Regulation).[24] These changes, which are expected to be in force from the beginning of 2015, are aimed mainly at minimising the effects of banking crises on society as a whole, including taxpayers, and at reducing moral hazard, which in the past was supported by implicit guarantees from governments to bail out troubled banks. A key aspect is that the mechanism should focus not on individual banks, but on safeguarding the financial stability of the single market as a whole. The most important elements of the changes are the introduction of the "bail-in tool" – allowing claims to be written down or converted into equity – and the establishment of the second pillar of the banking union in the form of a Single Resolution Mechanism.

The debt write down tool allows the bail-in of a distressed bank's unsecured creditors. In Slovakia, these creditors comprise mainly depositors who are not covered by the deposit protection scheme, as well as investors in unsecured bank bonds (i.e. bank bonds other than mortgage bonds). At the same time, banks will be required to have sufficient bail-inable liabilities, meaning that the share of these liabilities in total liabilities satisfies the minimum requirement set by the competent authority. This minimum requirement will be set in such a way that a bank whose debt has been written down or converted into equity would remain sufficiently solvent to be able to continue performing its essential activities. The domestic banking sector would not be significantly affected by the requirement to have sufficient bail-inable liabilities, since the share of such liabilities in the sector's aggregate balance is already around 30%; nevertheless, some individual banks may find themselves exposed to increased funding costs.

In the view of NBS, the Single Resolution Mechanism[25] is a key part of the banking union but the related transfer of competences to the Europe level is not yet sufficiently matched by the transfer of accountability for these decisions. The SRM should be largely based on the establishment of a Single Resolution Board as a new European authority, as well as a Single Resolution Fund. At the same time, however, the European Commission is expected to have key 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 consequences on the fiscal situation and on the deposit protection scheme, which, in the absence of the implementation of the banking union's third pillar, remains at the national level. The principle of matching powers and accountability is also not being observed in regard to the Single Resolution Fund, since host

23 Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010.

24 Proposal for a Regulation of the European Parliament and of the Council establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund and amending Regulation (EU) No 1093/2010 of the European Parliament and of the Council.

25 For a more detailed discussion of the proposal for a Single Resolution Mechanism and the NBS opinion on this proposal, see: Čillíková, J., Dvořáček, V. and Pénzeš, P., "Druhý pilier bankovej únie a jeho výzvy" ("The second pillar of the banking union and its challenges"), Biatec, Vol. 21, No 7, Národná banka Slovenska, 2013.

countries, including Slovakia, have relatively few decision-making powers.

Changes in the supplementary pension scheme

Under a new amendment to the Supplementary Pension Scheme Act, participants in the third pension pillar will be able to choose their supplementary pension management company (SPMC) and there should be greater competition between SPMCs. The Supplementary Pension Scheme Amendment Act, passed by the Slovak Parliament on 13 September 2013 and due to enter into force on 1 January 2014, will introduce several significant changes. First, participants will be able to choose their SPMC, whereas up to now they have had to enter into a pension scheme agreement with the SPMC contracted to their employer. From next year, where an employer pays part of an employee's supplementary pension contributions and has entered into an employer agreement with at least one SPMC, the employee will be able to enrol with any SPMC and the employer will be required to transfer its contributions for the employee to that company. Along with the shortening of the period in which a participant may switch to another SPMC at no charge (to one year), this amendment increases the scope for competition between SPMCs. It is important, however, to see that inter-SPMC switching does not become simply a lucrative business for financial intermediaries, with adverse effects on both participants and SPMCs.

CHAPTER 5

MACROPRUDENTIAL POLICY

5

5 MACROPRUDENTIAL POLICY

MACROPRUDENTIAL POLICY – A NEW INSTRUMENT FOR MAINTAINING FINANCIAL STABILITY [26]

The financial crisis led, inter alia, to changes in how the financial market is supervised by competent authorities. Particularly significant in this regard was the establishment of a macroprudential supervision system. The ultimate and strategic objective of macroprudential policy is to contribute to the safeguard of the stability of the financial system as a whole, including by strengthening the resilience of the financial system and decreasing systemic risks, thereby ensuring a sustainable contribution of the financial system to economic growth.

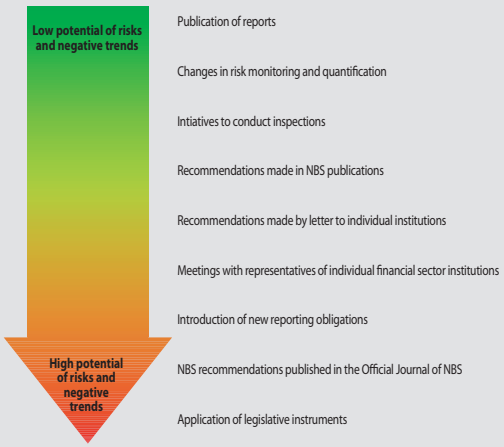
In Slovakia, the institution entrusted with full responsibility for the conduct of macroprudential policy is the central bank, Národná banka Slovenska (NBS). NBS is also responsible for several areas closely related to macroprudential policy, including the supervision of individual financial market institutions, financial market regulation, the monetary policy, financial market operations, and so on. The supreme governing body for the conduct of macroprudential policy is the NBS Bank Board.

For NBS, macroprudential supervision is not an entirely new area. Since 2004, the central bank's Financial Market Supervision Unit has been analysing, monitoring and assessing systemic risks. However, the obligation to mitigate risks is what constitutes a separate policy field in macroprudential supervision.

BROAD SET OF INSTRUMENTS FOR CONDUCTING POLICY

The actual conduct of policy encompasses several areas. The most important aspect of policy conduct is the application of legislative instruments, what constitutes a comparatively strong response to the existence of risks. However, policy conduct also entails other instruments and approaches. This primarily concerns active communicating with the public through the publication of reports and analyses. Communication may include commentaries, assessments or recommendations for the financial sector. The remit of policy conduct can include communicating directly with financial institutions in order to influence their behaviour. A separate aspect of policy implementation consists of initiatives to conduct on-site inspections and off-site supervision (which should respond to facts found out) or initiatives to amend the regulatory framework. There may also be an internal response in the modification of risk quantification models. NBS may further respond to certain trends and or risks by introducing new reporting obligations for financial institutions.

Chart 34 Macroprudential policy instruments



Source: NBS.

COMPETENCES SHARED WITHIN THE ECB'S SINGLE SUPERVISORY MECHANISM

The conduct of macroprudential policy under the Single Supervisory Mechanism will be shared between national authorities and the ECB. National authorities have the power to conduct policy to the full extent stipulated in EU legislation. The ECB may only tighten requirements offset in decisions of national authorities, but it may not revoke or moderate these requirements.

APPLICATION OF THE MOST SIGNIFICANT LEGISLATIVE INSTRUMENTS IN MACROPRUDENTIAL POLICY

The instruments used in macroprudential policy are to a large extent already included in existing prudential requirements for finan-

26 The policy framework is provided for by the following ESRB Recommendations:
Recommendation of the ESRB of 22 December 2011 on the macroprudential mandate of national authorities; and
Recommendation of the ESRB of 4 April on intermediate objectives and instruments of macro-prudential policy.

cial institutions, in particular requirements for capital and risk weights, large exposures and liquidity. Several new instruments are, however, coming into force, primarily in the form of capital buffer requirements. The new regulatory framework introduces four new capital buffers:

- a countercyclical capital buffer,
- a G-SII or O-SII buffer,
- a systemic risk buffer, and
- a capital conservation buffer.

The capital buffers comprise own funds of the highest quality (Common Equity Tier 1) and they are held in addition to minimum own funds requirements, as well as to internal capital for the purposes of the Internal Capital Adequacy Assessment Process under Pillar II of the Basel Accord. The level of these buffers, set within the process of macroprudential policy implementation, is binding on banks. A bank incurring losses during a stressed period does not have to meet the combined buffer requirement in full; however, it should be subject to measures designed to ensure that it restores its level of own funds in a timely manner. The most important measures in this regard are restrictions on distributions of profits, as well as on payments of variable remuneration. Another measure is to require such banks to draw up a capital conservation plan and have it approved by NBS.

COUNTERCYCLICAL CAPITAL BUFFER

Objective and profile of the buffer

The countercyclical capital buffer is one of the core instruments of macroprudential policy. Its purpose is to ensure that banks accumulate, during periods of economic growth, a sufficient capital base to absorb losses in stressed periods. In general, the countercyclical capital buffer will be built up when aggregate growth in credit is associated with a build-up of systemic risk. The obligation to maintain the buffer is analogously related to the amortisation of losses that arose from the pre-crisis excessive credit growth.

Decision on setting the countercyclical buffer rate

According to the Basel Committee on Banking Supervision (BCBS), the decision to build up a countercyclical capital buffer is to be based on the ratio between credit and GDP: the buffer will as a rule be built up where the credit-to-GDP ratio deviates from its long-run trend. Since this methodology is not suitable for all types of economy, the CRD IV Directive allows Member States to use other variables as well. A quantitative analysis of the credit-to-GDP ratio is expected to serve as a starting point for decisions on buffer rates, but should not give rise to an automatic buffer setting. These decisions must therefore take into account predefined variables, while leaving sufficient leeway to respond to any new developments.

Decisions on the buffer rate will be taken on quarterly basis and will enter into force no later than 12 months after the date of their publication. Along with its decision on the countercyclical buffer rate, Národná banka Slovenska will, in accordance with the applicable legislation, publish the calculations and reasons on which the decision was based.

Key indicators to be used for setting the countercyclical buffer rate in Slovakia

The decision on the countercyclical buffer rate takes into account (in addition to the credit-to-GDP ratio and deviation from the long-run trend) other predefined variables that better capture the financial cycle in Slovakia. The principal indicator categories for these purposes are defined as:

- gross domestic product,
- credit growth,
- non-performing loans,
- the debt service ratio.

A general economic interpretation of this approach is as follows: the first two indicators decompose the original Basel concept into the numerator (credit) and denominator (HDP) in to order to allow clearer interpretation of financial cycle deviations from the economic cycle; and credit risk indicates the extent to which banks are affected by the economic cycle. Looking at credit risk more closely, an increase in non-performing loans may indicate that the countercyclical buffer rate should be reduced in line with the buffer's objective: to absorb losses in stressed periods. By contrast, an increase in the debt service ratio points to a potential rise in unexpected losses. It should be noted at this point that none of the indicators can be interpreted in isolation, but only in the context of the other three.

Rate-setting decisions for the countercyclical capital buffer will take into account not only the above-mentioned principal indicators, but also additional supplementary indicators, in particular:

- property prices,
- the housing affordability index,
- loan-to-value ratios,
- employment,
- confidence indicators,
- credit standards,
- stress testing results.

Property prices are, as a rule, a highly relevant indicator of the economic cycle; in countries (like Slovakia) that do not have another source of asset prices, they may carry significant weight in decisions on the countercyclical buffer rate. This relates also to the housing affordability index, an indicator of imbalances between property prices and household income, which is often linked with the loan-to-value ratio. Employment figures and confidence indicators provide additional information about the state of the economic cycle. Similarly, stress test results help in setting the countercyclical buffer rate more precisely, as well as in preventing its premature reduction.

Developments in most of the indicators under review confirm that the financial cycle in Slovakia reflects the complicated macroeconomic situation. Since no combination of excessive credit growth and increased systemic risk had been identified as at September 2013, it is assumed that, when the CRD IV Directive is implemented, the countercyclical buffer rate will be set at 0%.

G-SII OR O-SII BUFFER

Under the Capital Requirements Regulation and Directive (CRR/CRD IV), macroprudential authorities may require systemically important institutions to hold an additional capital buffer. The regulatory framework distinguishes between global systemically important institutions (G-SIIs) and other systemically important institutions (O-SIIs). G-SIIs are institutions that by virtue of their size, interconnectedness with the financial system, complexity, and other attributes represent a potential risk to the financial system and to the real economy. O-SIIs are significant institutions in the context of the economy of a particular Member State.

Since no Slovak bank or subsidiary is sufficiently large to be identified as a G-SII, Národná banka Slovenska is required only to identify O-SIIs and may set an additional capital buffer for these institutions.

Specific criteria for identifying O-SIIs have not yet been set. By 1 January 2015, the EBA, in consultation with the ESRB, is expected to draw up guidelines on criteria for the identification of O-SIIs.

In Slovakia, NBS has drawn up a draft methodology based on the BCBS methodology for the identification of G-SIBs and on BCBS recommendations published in a consultation material in June 2012 that deals with the identification of domestic systemically significant institutions. Nine indicators are used for identification, namely: size; intra-financial system assets; intra-financial system liabilities; share of funding obtained through financial markets; assets under custody; payments made through payment systems; notional amount of over-the-counter (OTC) derivatives; value of the HFT and ASF portfolios; and amount of protected deposits (the indicators of size and amount of protected deposits each have three times the weight of the other indicators.

Where an institution is identified as an O-SII, the competent authority may require it to maintain an O-SII buffer of up to 2% of its total risk-weighted assets. This buffer is to consist of the highest quality capital – Common Equity Tier 1 (CET 1). Where a bank identified as an O-SII is part of a group that is identified as a G-SII or O-SII and is subject to a buffer on a consolidated basis, the buffer applied to this bank shall not exceed the higher of:

a) 1% of the bank's total risk weighted assets;
b) the G-SII or O-SII buffer rate (as a percentage of risk-weighted assets) applicable to the group at the consolidated level.

Under transitional provisions (Article 162(5) of the CRD IV Directive), national authorities shall identify and set capital buffers for G-SIIs and O-SIIs from 1 January 2016.

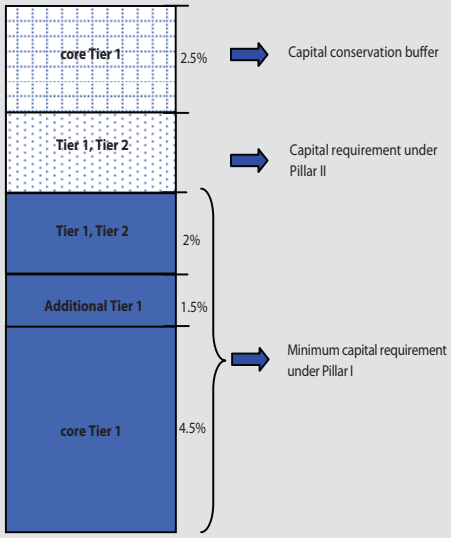
SYSTEMIC RISK BUFFER

The systemic risk buffer is designed to cover long term non-cyclical systemic risks. Of all the buffers established in the EU legislation, this is the most broadly defined and gives competent authorities the most freedom in how to apply it. The buffer may be applied to the financial sector as a whole or to a selected part of it, and either on an individual or consolidated basis. A key task in regard to this buffer is to monitor the additional capital that banks are required to hold under Pillar II, so as to prevent duplication of risk coverage in the event that capital has already been allocated to the given risk.

For banks in Slovakia, Národná banka Slovenska is authorised to set the systemic risk buffer rate. Where NBS decides to apply the buffer to a selected part of the banking sector, the amount of the buffer that banks are required to maintain must be at least 1% based not, however, on overall risk-weighted assets, but on exposures to which the systemic risk buffer applies. In this case, a distinction is made between domestic exposures, exposures located in other EU Member States, and exposures in third countries. Before setting a systemic risk buffer rate of up to 3%, NBS will have only a notification obligation. The buffer is to consist of the highest-quality capital (Common Equity Tier 1).

NBS does not as yet envisage introducing a systemic risk buffer for any domestic bank as part of the implementation of the CRD IV Directive.

Chart 35 Capital requirement related to the capital conservation buffer



Source: NBS.

CAPITAL CONSERVATION BUFFER

The purpose of the capital conservation buffer is to ensure that banks accumulate a sufficient capital base to absorb losses in stressed periods. This capital buffer is to be equal to 2.5% of the bank's risk-weighted assets. If a bank is making a loss, this amount may be reduced, but in that case the bank will be subject to restrictions on distributions of profits until it has recovered. Under the CRD IV Directive, the capital conservation buffer is to be implemented in gradually rising amounts over a transition period, from 2016 to 2019. Member States however have the option to apply this buffer in full as from the Directive's implementation date, and Slovakia will be taking this option.

The main reason for the earlier implementation of the buffer is that, consistent with the domestic banking sector's relatively high level of solvency, all banks in Slovakia have already built-up this buffer. The lowest capital ratio of any bank in the sector as at 31 August 2013 was 11.4%, easily meeting the Pillar 1 regulatory capital requirement (8%) as raised by the capital conservation buffer (2.5%).

RISK WEIGHTS FOR EXPOSURES SECURED BY REAL ESTATE

The setting of risk weights for loans secured by real estate is an important instrument of macroprudential policy, since the capital reserve requirement can consequently be sufficient to cover future losses. In recent years, developments in the domestic banking sector showed that losses from the financing of property construction projects (residential and commercial) could potentially be quite substantial. The non-performing loan ratio in the commercial property segment of the credit portfolio increased gradually, by 12%, between mid-2011

and the end of the first half of 2013, to stand at 29%. In banks using the standardised approach to credit risk, the risk weight currently applied to loans secured with commercial property is 100%. Under the new regulation on prudential requirements, however, this risk weight should be reduced to 50%.

In the view of NBS, the riskiness of commercial property exposures corresponds to a risk weight of 100%. There are several reasons for this, the most important being the relatively high degree of credit risk in the segment, which is largely a result of subdued demand. The vacancy rate remains high, and the increase in new apartments sales is entirely based on cutting price margins. Another reason is that the relatively significant reliance of borrowers on the performance of the respective property development put pressure on the loan-to-value ratio. A third reason is high concentration in the financing of large construction projects for residential or commercial property. The adverse effect of this concentration was evident in 2012, as some banks recorded relatively heavy losses on certain construction projects and their profits were significantly affected as a result. A fourth reason is that banks using the internal rating based approach for credit risk are calculating the risk weights for this segment at more than 50% on average, based on their own rating models.

Table 2 Recommendations of the European System Risk Board

Recommendation	Description of systemic risk	Significance and implementation of Recommendation in Slovakia	Form of implementing Recommendation in Slovakia
Recommendation of the ESRB of 21 September 2011 on lending in foreign currencies (ESRB/2011/1)	Excessive foreign currency lending to unhedged borrowers: • increases the exposure of banks and their customers to credit and market risks; • hinders the monetary policy transmission channels of the domestic central bank; • may lead to emergence of asset price bubbles; • is usually related to borrowers' inadequate awareness of risks embedded in foreign currency lending.	Insignificant risk. Recommendation A implemented; Recommendations B to G not implemented.	On 9 August 2013, NBS sent a letter to all banks and foreign bank branches recommending them to ensure that their customers are adequately informed about the risks involved in foreign currency lending and to offer customers domestic currency loans as an alternative. In doing so, NBS implemented Recommendation A, which all EU Member States are required to implement. NBS decided not to implement the other Recommendations, and provided the ESRB with a sufficient explanation of its inaction.
Recommendation of the ESRB of 22 December 2011 on US dollar denominated funding of credit institutions (ESRB/2011/2)	After the start of the financial crisis, the supply of US dollar liquidity became limited for European banks. Maturity mismatch in US dollars and short-term funding in US dollars implied risks to bank liquidity, and losses if sales of US-dollar denominated assets happen at fire-sale prices.	Insignificant risk. Recommendation not implemented.	Given the low significance of this risk in Slovakia, NBS decided not to implement the Recommendation and provided the ESRB with a sufficient explanation of its inaction.

Table 2 (continued)

Recommendation	Description of systemic risk	Significance and implementation of Recommendation in Slovakia	Form of implementing Recommendation in Slovakia
Recommendation of the ESRB of 22 December on the macro-prudential mandate of national authorities (ESRB/2011/3)	This Recommendation does not address a specific systemic risk. However, for the effective mitigation of systemic risks in the EU, each Member State is required to designate an independent authority entrusted with the conduct of macroprudential policy, whether upon their own initiative or as a follow-up to ESRB recommendations.	Very significant (issue). Recommendation implemented in full.	The Act amending the Act on Financial Market Supervision was passed by the Slovak Parliament on 15 May 2013 and entered into force on 10 June 2013. This amendment states that NBS shall perform supervision of the financial market including macroprudential supervision, and that NBS shall identify, monitor and assess risks to financial stability, and, by mitigating and preventing such risk, contribute to the resilience of the financial system as a whole.
Recommendation of the ESRB of 20 December 2012 on money market funds (ESRB/2012/1)	The financial crisis in 2007 and 2008 showed that money market funds, particularly constant net asset value funds: • are substantially interconnected with the banking sector; • perform maturity and liquidity transformation; • are subject to the risk of an investor run; • have the potential to spread a crisis. Investors may perceive MMFs, in particular constant net asset value funds, as a safe alternative to bank deposits, even though these funds do not have access to a public safety net, are not subject to solvency or liquidity requirements, and do not have explicit support from their sponsor companies.	Less significant risk. Recommendation addressed to the European Commission.	The Recommendation does not need to be implemented in Slovakia since it has been addressed to the European Commission. All MMFs in Slovakia are variable net asset value funds, which pose lower systemic risks compared with constant net asset value funds. A risk in Slovakia may be that investors see investments in money market (and other) funds as an alternative to bank deposits, without being aware of the risks associated with these investments. Financial market participants may be accentuating this risk through their inappropriate sales strategy.
Recommendation of the ESRB of 20 December 2012 on funding of credit institutions (ESRB/2012/2)	The funding structures of banks have undergone substantial changes since the beginning of the crisis, as the previous strategy of interbank funding was revealed to be unsustainable. Banks' secured funding has increased sharply; as a result, however, demand for eligible collateral is rising and the supply of quality collateral is tightening. The increase in secured funding implies further subordination of other creditors, in particular depositors, which increases the potential usage of funds from deposit guarantee schemes. At the same time, banks should be careful that their funding structure does not become overly concentrated on one source and should be prudent in their use of innovative, less transparent instruments.	Less significant risk. NBS plans to implement the Recommendation in accordance with the stipulated schedule.	Recommendation A on the monitoring of funding sources must be implemented by 1 January 2015; Recommendation B on the requirements for banks' internal procedures, by 30 June 2014; Recommendation C on the monitoring of asset encumbrance, by 30 September 2015; and Recommendation E on covered bonds, by 31 December 2013. According to Recommendation E, it is necessary to identify best practices regarding covered bonds. Banks in Slovakia have a conservative funding structure based on deposits from households and firms, the issuance of mortgage bonds, and additional wholesale funding. Hence they did not report any funding difficulties during the crisis.

Table 2 (continued)

Recommendation	Description of systemic risk	Significance and implementation of Recommendation in Slovakia	Form of implementing Recommendation in Slovakia
Recommendation of the ESRB of 4 April 2013 on intermediate objectives and instruments of macro-prudential policy (ESRB/2013/1)	This Recommendation does not address a specific systemic risk. It follows up on Recommendation ESRB/2011/3 by elaborating on intermediate objectives and instruments of macroprudential policy. Member States should consider whether these instruments are sufficient to achieve the ultimate objective of macroprudential policy and, if they are not, should ensure that the macroprudential authority is entrusted with the additional instruments required to achieve that objective.	Very significant (issue). NBS plans to implement the Recommendation in full.	By 31 December 2014, NBS should assess the instruments and intermediate objectives of macroprudential policy. By 31 December 2015, it is necessary to adopt a macroprudential policy strategy, including an update of the intermediate objectives of macroprudential policy.

Source: NBS.

Abbreviations

CCP	countercyclical premium
CRR	Proposal for a regulation of the European Parliament and of the Council COM(2011) 452
CRD IV	Proposal for a directive of the European Parliament and of the Council COM(2011) 453
ECB	European Central Bank
EIOPA	European Insurance and Occupational Pensions Authority
ESFS	European System of Financial Supervisors
ESM	European Stability Mechanism
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
EU	European Union
FED	Federal Reserve System
GDP	Gross Domestic Product
IMF	International Monetary Fund
LTV	Loan-to-Value ratio
MB	mortgage bonds
NBS	Národná banka Slovenska (central bank of the Slovak Republic)
OECD	Organisation for Economic Cooperation and Development
PFMC	Pension Funds Management Company
ROA	Return on Assets
ROE	Return on Equity
SO SR	Statistical Office of the SR
SPMC	Supplementary Pension Management Company
ULC	unit labour costs

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