NÁRODNÁ BANKA SLOVENSKA
EUROSYSTÉM

QUARTERLY COMMENTARY ON MACROPRUDENTIAL POLICY

OCTOBER 2018

SUMMARY OF THE NBS BANK BOARD's DECISION

ON THE SETTING OF THE COUNTERCYCLICAL CAPITAL BUFFER RATE

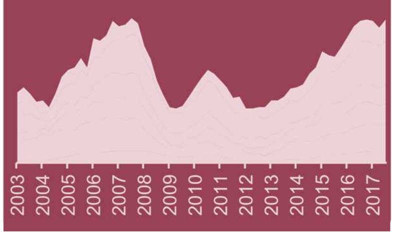
No change to the buffer rate

- The current buffer rate settings are appropriate
- Credit growth stopped slowing in the second quarter; credit and financial market indicators increased (supported by temporary trends - the frontloading of lending to households in anticipation of regulatory tightening)
- Going forward, household credit growth is expected to moderate

Current and future buffer rates

- The buffer rate until 31 July 2019: **1.25%**
- The buffer rate from 1 August 2019: **1.50%**

The financial cycle



- Presence of a strong expansionary phase
- The cycle is close to its historical high
- Macroeconomic developments, housing market trends, and low non-performing loan ratios were putting upward pressure on the financial market in the second quarter of 2018

Outlook for next quarter's buffer rate decision

- Next quarter's decision is not expected to increase the buffer rate
- Key factors in subsequent buffer rate decisions will be developments in credit growth cycle risks and in macroeconomic imbalances

Contents

Introduction

A sound financial system is a prerequisite for a well-functioning economy and sustainable economic growth. The financial sector fulfils certain basic and vital functions in the economy (providing financing, enabling saving and investment, operating payment systems, etc.). A financial system cannot be sound unless it is stable**,** the **financial stability** is a prerequisite for the sound financial system, i.e. the financial sector is sufficiently resilient to potential shocks and risks that could in certain circumstances disrupt the sector's functioning and thus have adverse repercussions on the economy. The purpose of macroprudential policy is to deploy various tools to support financial stability, mainly by increasing the financial system's resilience and by mitigating the build-up of systemic risks. To that end, macroprudential policy aims to identify, monitor, assess and reduce systemic risks to the financial system.

The purpose of the Quarterly Commentary on Macroprudential Policy is to monitor current developments in the financial market – focusing mainly on the credit market – **and to evaluate systemic risk trends** related to these developments. The Commentary provides an analytical assessment of the situation and developments in the financial market. The assessment is structured according to the 'intermediate objectives' set out in Recommendation ESRB/2013/1 of the European Systemic Risk Board. This quantitative and qualitative assessment takes into account the information available for the second quarter of 2018. The Commentary is referred to by the Bank Board of Národná banka Slovenska (NBS) when taking its quarterly decision on the setting of the countercyclical capital buffer (CCyB) rate. The Commentary's analytical assessment may also be referred to for decisions on activating or changing other macroprudential policy instruments. The document is divided into three parts: i) a brief analysis and evaluation of the most significant systemic risk-related developments which occurred during the quarter under review; ii) the current setting of, and any changes to, macroprudential policy instruments, including the latest decision on the setting of the CCyB rate; iii) a table showing the macroprudential policy objectives under review.

1 Assessment of developments in the second quarter of 2018

Credit growth stopped slowing in the second quarter of 2018. Credit to the private non-financial sector[1] increased, year on year, by 9.1% in the second quarter of 2018,[2] which was on a par with its growth in the first quarter (9.2%). Growth remained largely unchanged in both loans to households (11.2% in the second quarter; 11.3% in the first) and loans to non-financial corporations (5.4% in the second quarter; 5.5% in the first). Private sector credit growth was lower in the first half of this year than in the first half of 2017, when it stood at more than 12% year on year. Nevertheless, it continues to outpace economic fundamentals (growth rates for disposable income, GDP, and corporate sales). In absolute terms, the year-on-year increase in total loans to the private sector remains close to its historical high of summer 2008. Among EU countries, Slovakia had the second highest growth in credit to the private non-financial sector in the second quarter (the EU average was 1.7%), and, compared with the average for central and eastern European countries (3.8%), the Slovak credit growth was also significantly higher. Private sector debt remains on an upward path, and in the second quarter the ratio of domestic bank credit to GDP surpassed 60% for the first time ever.

Factors supporting credit demand growth also continue to be present in the economy, including the favourable macroeconomic situation, positive economic sentiment, low interest rates, and strong competition in the credit market. Interest rates on housing loans have fallen even further. A build-up of imbalances in the financial cycle is being supported by macroeconomic trends, as the output gap is gradually widening and the economy is beginning to overheat. The economic overheating is expected to gather pace in coming years. The impact of this overheating is particularly evident in the labour market in the form of skilled labour shortages.

At the same time, however, credit growth in the second quarter also reflected temporary factors. Lending to households in the period under review was affected by a tightening of regulatory lending requirements as from 1 July 2018, specifically the introduction of debt-to-income (DTI) ratio limits and the tightening of loan-to-value (LTV) ratio limits. Amid excessive media coverage of the issue, demand for loans surged in the second quarter, with households seeking to obtain loans before the tightening of regulatory lending requirements. It is expected, however, that this effect will only be temporary and will be followed by the further moderation of household credit growth. The NFC credit market remains volatile, and in the second quarter it reflected mainly stronger credit growth in June.

The financial market is in an advanced expansionary phase. Credit and financial market indicators increased in the second quarter on the back of developments in the credit market. Their increase was due in large part, however, to the previously mentioned temporary factors. After dipping in the first quarter, the domestic credit-to-GDP$_{trend}$ gap[3] edged back up in the second quarter (from 5.12% to 5.32%), and so the benchmark buffer rate based on this indicator returned to 1.75%, its level for the last three quarters of 2017. Likewise, the Cyclogram – a composite indicator of financial market developments – also increased in the second quarter, back to its level of autumn 2017. The Cyclogram-

[1] Loans provided by domestic banks to the household sector (S.14 and S.15) and the non-financial corporations sector (S.11) in Slovakia (source: banks' statements - V (NBS) 33 - 12).

[2] Total credit adjusted for the methodological change arising from the acquisition of the non-bank company Consumer Finance Holding, a.s. by Všeobecná úverová banka, a.s. on 1 January 2018. Leaving aside this change, total private sector credit increased by 9.8% in the second quarter of 2018 (after increasing by 9.9% in the first quarter).

[3] The indicator is based on the amount of loans provided by domestic banks to NFCs and households.

based benchmark buffer rate rose to 2.5%. The intensification of pressures underlying the financial cycle has been supported not only by the temporary factors mentioned above, but also by the favourable macroeconomic situation and housing market trends. Furthermore, the currently low level of non-performing loan (NPL) ratios may not necessarily represent the actual riskiness of loan books over the longer term, potentially resulting in the underestimation of credit risk exposure.

Liquidity risk in the Slovak banking sector has continued to rise moderately. In a low interest rate environment and with the financial cycle in an expansionary phase marked also by strong credit growth, the banking sector's exposure to liquidity risk is increasing. The continuing high pace of credit growth is amplifying the maturity mismatch between assets and liabilities in banks' balance sheets. Meanwhile, the sector's aggregate liquid assets continue to decline, and banks are becoming increasingly reliant on the stability of their deposit business. Although deposit growth has been accelerating gradually in 2018, it remains lower than credit growth.

The banking sector's profit in the first half of 2018 was largely unchanged in year-on-year terms. In the second quarter banks were still seeking to offset interest margin compression by increasing their lending activity. Narrow interest margins are increasing the sector's vulnerability to future headwinds. In certain banking groups, low interest rates are undermining business model sustainability.

A further risk to financial stability lies in the rising share of loans provided to the commercial real estate (CRE) sector, which is relatively sensitive to economic trends. Likewise, total loans to the building construction sector increased by 19% year on year in the first half of 2018.

In terms of the risk they pose to financial stability, external factors, and in particular developments in world financial markets, are increasing significantly. The most serious risk currently concerns the overvaluation of assets in both equity and bond markets. The low level of risk premia in certain markets may point to investors underestimating risk. The share of investments made through investments funds is currently rising, but such funds are exposed to increasing liquidity risk. At the same time, there is mounting risk from the spread of protectionism in international trade, which, if it results in a chain reaction of protectionist measures, could have a serious impact on global economic growth.

2 Macroprudential policy decisions

2.1 Latest NBS decision taken with respect to developments in the quarter under review

On 23 October 2018 the NBS Bank Board decided that the countercyclical capital buffer rate, which is due to be raised to 1.5% on 1 August 2019, will remain at that level beyond 1 November 2019. In taking its decision on the CCyB rate, the NBS Bank Board gave due consideration to the views of the European Central Bank (ECB) in accordance with Article 5 of the SSM Regulation.[4]

The following points were taken into account when deciding to leave the CCyB rate unchanged:

- **Credit developments in the second quarter of 2018**, when credit growth stopped declining, albeit due to **temporary factors** (the frontloading of lending to households in the second quarter 2018 and a strong June for lending to NFCs).
- **Going forward**, credit growth is expected **to resume its slowing trend**.
- **The credit and financial market indicators under review** (the domestic credit-to-GDP$_{trend}$ gap and the Cyclogram) increased in the second quarter, but were significantly **affected by the temporary factors referred to above**.
- **Credit market-related developments must continue to be monitored, as must the risks arising from economic overheating.**
- **The current settings of the CCyB rate** and of other macroprudential policy instruments appear at present **to be appropriate in view of the accumulated cyclical risks**.

2.2 Current instrument settings

Countercyclical capital buffer

Under NBS Decision No 8/2017 of 10 July 2017, the CCyB rate was set at 1.25% with effect from 1 August 2018.[5]

Table 1 CCyB rates for Slovak exposures

Period of application	Rate
1 August 2017 – 31 July 2018	0.50%
1 August 2018 – 31 July 2019	1.25%
1 August 2019 –	1.50%

Source: NBS.

An overview of current and future CCyB rate settings in other countries is given in the Table 5 in Annex.

[4] Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions.

[5] https://www.nbs.sk/_img/Documents/_Dohlad/Makropolitika/8_2017_EN.pdf

Buffers for significant banks

Under NBS Decision Nos 5/2017 and 6/2017 of 30 May 2017, banks in Slovakia identified as 'other systemically important institutions' (O-SIIs) are required from 1 January 2018 to maintain a total additional capital buffer (comprising an O-SII buffer and in some cases also a systemic risk buffer) of between 1% and 2% of risk-weighted exposures. Under NBS Decision Nos 4/2018 and 5/2018 of 29 May 2018, the total additional capital buffer requirements will remain unchanged from 1 January 2019.[6]

Table 2 Overview of rates for O-SII buffers and systemic risk buffers (SRB) applied to selected banks in Slovakia

	O-SII buffer effective from 1 January 2018	SRB effective from 1 January 2018
Československá obchodná banka, a.s.	1.00%	-
Poštová banka, a.s.	1.00%	-
Slovenská sporiteľňa, a.s.	1.00%	1.00%
Tatra banka, a.s.	0.50%	1.00%
Všeobecná úverová banka, a.s.	1.00%	1.00%

Source: NBS.

Regulatory conditions for retail lending

On 29 May 2018 the NBS Bank Board approved a Decree amending the NBS Consumer Loan Decree and a Decree amending the NBS Housing Loan Decree. The new decrees tighten regulatory loan-to-value (LTV) ratio limits. Thus, the provision of loans with an LTV ratio greater than 90% is prohibited, and the percentage of new loans that may have an LTV ratio of between 80% and 90% is reduced. In addition, the Decrees introduce a debt-to-income (DTI) ratio limit, set at 8. There is a general exemption from this limit that will be gradually tightened. The Decrees entered into force on 1 July 2018. As of 1 October 2018, in accordance with these amendments, the maximum share of new loans with an LTV ratio of more than 80% was reduced to 30% and the maximum share of new loans with a DTI ratio greater than 8 was reduced to 10%. **The tightening of regulatory requirements for retail lending is being phased in on schedule.**

Under a draft amendment to the Consumer Credit Act, **the exemption of 'pre-approved' consumer loans from regulatory limits** on debt service-to-income (DSTI) and DTI ratios **will be repealed**. The purpose of the amendment is to prevent lenders from using pre-approved loans to circumvent the new regulatory requirements.

[6] https://www.nbs.sk/_img/Documents/_Dohlad/Makropolitika/4-2018.pdf
https://www.nbs.sk/_img/Documents/_Dohlad/Makropolitika/5-2018.pdf

Table 3 Regulatory limits on credit standards

Indicator	Calculation	Parameter	Limit
Debt service-to-income (DSTI) ratio	$\frac{\text{total debt service obligtions}^{1)}}{\text{net income} - \text{minimum subsistence amount}}$	Maximum DSTI ratio	80% [2)]
Loan-to-value (LTV) ratio [3)]	$\frac{\text{amount of loan}}{\text{value of collateral}}$	Maximum LTV ratio	90%
		Maximum share of new loans with an LTV ratio > 80%	Q4 2018: 30% Q1 2019: 25%
Debt-to-income (DTI) ratio	$\frac{\text{total debt}}{\text{annual net income}}$	Maximum share of new loans with a DTI ratio > 8	Q4 2018: 15% Q1 2019: 10%
Maximum term of loan		Loan with immovable property collateral or provided by a home savings bank	30 years [4)]
		Other loan	8 years

Source: NBS.
Notes: Compliance with the limits is checked only when granting a new loan, or when significantly increasing the total amount of an existing loan. The measures do not apply to loans that are to be used to refinance one or more existing loans, nor to loans that are to be topped up, provided that the amount of the loan applied for does not exceed €2000 or 5% of the outstanding amounts, whichever is lower.
1) The amount of loan instalments takes into account interest rate increases.
2) DSTI ratios may exceed 100% in the following cases:
- consumer loans where the sum of the loan applied for and the borrower's existing debt does not exceed the borrower's annual net income;
- leasing contracts that include a down payment of at least 20% and where the sum of the lease and the borrower's existing debt is not greater than 1.5 times the borrower's annual income.

3) The limit applies only to housing loans.
4) Up to 10% of new loans secured by immovable property may exceed this limit.

Other currently applicable macroprudential policy instruments, covering mainly the area of capital requirements, are listed in Table 4 to Table 6 in the Annex.

2.3 Potential application of macroprudential policy instruments over the medium term

Retail lending

Národná banka Slovenska has adopted several measures in regard to retail lending (outlined above), the purpose of which is to contain the build-up of risks related to credit market overheating. The limits introduced by these measures are now being gradually tightened. At this stage, it is necessary to monitor the credit market following the commencement of the measures. If the build-up of risks does not moderate, Národná banka Slovenska will consider further options.

Expectations for the CCyB rate in the next quarter

The benchmark buffer rates based on the domestic credit-to-GDP$_{trend}$ gap and the Cyclogram are currently higher than the approved settings of the CCyB rate. As to whether the CCyB rate will be raised in coming quarters, this depends not only on credit market developments, but also on the extent of overheating in the domestic economy. It will be necessary to assess the impact of temporary factors on household credit growth in June 2018, since this was also accompanied by a further drop in interest rates and strong competition between banks, which could have a more enduring impact on the further build-up of risks. The question of whether to raise the CCyB rate may also have to be considered if the measures already adopted fail to help mitigate risks associated with rapid debt growth to the extent expected.

The CCyB rate is not expected to be increased in the next quarter. Key factors affecting its future level will include developments in credit growth cycle risks and in macroeconomic imbalances.

2.4 Recent ECB decisions concerning the Slovak banking sector

As of 16 October 2018 the European Central Bank had not issued any macroprudential policy decision concerning the Slovak banking sector.

3 Macroprudential policy objectives

Objectives	Risks	NBS response
To mitigate and prevent excessive credit growth	Household and NFC debt growth; lending to the NFC sector, including commercial real estate lending; risks related to macroeconomic developments at home and abroad and to financial market trends	· Activated countercyclical capital buffer (set at 1.25% until 31 July 2019 and at 1.5% from 1 August 2019) · Decrees concerning the prudential provision of housing loans and consumer loans (introduction of lending limits and tightening of LTV ratios)
To mitigate and prevent excessive maturity mismatch in banks' balance sheets and market illiquidity	Increasing maturity mismatch between assets and liabilities; increase in long-term assets as a result of credit growth; rising loan-to-deposit ratios	· A new legislative framework for the issuance of covered bonds, with a potential positive impact on the stability of banks' long-term funding
To limit direct and indirect exposure concentrations	Relatively high concentration in (part of) the portfolio, or higher intra-group exposure, in certain institutions or funds	· Additional capital buffers applied to the five largest banks on grounds of their systemic importance – comprising O-SII buffers and in some cases also a systemic risk buffer (SRB)
To limit the systemic impact of misaligned incentives with a view to reducing moral hazard	Existence of banks that are too large from the view of the global/domestic economy; increasing linkages between financial entities and financial brokers; under the EU's banking union, the potential relaxing of EU regulatory rules for banks that are subsidiaries of foreign banks, particularly in the areas of liquidity, capital, and large exposures; risks in non-bank sectors	· Application of O-SII buffers, and in some cases also an SRB, to the five largest banks · The Housing Loan Act and Consumer Credit Act require financial institutions to take a prudential approach when cooperating with financial brokers · Supervision of non-bank lenders · Since 2015, significant strengthening of NBS's competences and supervisory powers in regard to financial consumer protection
To strengthen the resilience of the financial system	Business model sustainability; macroeconomic developments at home and abroad	· Capital conservation buffer implemented at a rate of 2.5% · Activated countercyclical capital buffer (set at 1.25% until 31 July 2019 and at 1.5% from 1 August 2019) · Application of O-SII buffers, and in some cases also an SRB, to the five largest banks · Decrees concerning the prudential provision of housing loans and consumer loans (introduction of lending limits and tightening of LTV ratios)
To strengthen the resilience of financial infrastructures	Functioning of payment systems; level of deposit coverage; impact on financial stability of digital innovation in financial services	

Note: Legend for the importance of the objectives: **High** Medium Low.

Annex

Table 4 Capital buffer rates currently applied in Slovakia

Macroprudential instrument	Value	Note
Capital conservation buffer (Article 33b of the Banking Act)	2.5%	
Countercyclical capital buffer rate (Article 33g of the Banking Act)	1.25%	To be increased to 1.5% as from 1 August 2019
O-SII buffer (Article 33d of the Banking Act)[1]	0.5% to 1%	
Systemic risk buffer (Article 33e of the Banking Act)[2]	1%	

Source: NBS.

[1] An O-SII buffer is applied to Československá obchodná banka, a.s., Poštová banka, a.s., Slovenská sporiteľňa, a.s., Tatra banka, a.s. and Všeobecná úverová banka, a.s.

[2] A systemic risk buffer is applied to Slovenská sporiteľňa, a.s., Tatra banka, a.s. and Všeobecná úverová banka, a.s.

Table 5 Countercyclical capital buffer (CCyB) rates currently applied to external exposures (Articles 33i and 33j of the Banking Act) and changes scheduled for these rates in coming quarters

	Country	31 Dec. 2017	31 Mar. 2018	30 Jun. 2018	30 Sep. 2018	31 Dec. 2018	31 Mar. 2019	30 Jun. 2019	30 Sep. 2019	Effective date of changes scheduled after 1 July 2018
EEA countries	Czech Republic	0.5	0.5	0.5	1	1	1.25	1.25	1.5	↑ to 1.25% from 1 January 2019 ↑ to 1.5% from 1 July 2019
	Bulgaria	0	0	0	0	0	0	0	0	↑ to 0.5% from 1 October 2019
	Denmark	0	0	0	0	0	0.5	0.5	1	↑ to 0.5% from 31 March 2019 ↑ to 1% from 30 September 2019
	France	0	0	0	0	0	0	0	0.25	↑ to 0.25% from 1 July 2019
	Ireland	0	0	0	0	0	0	0	1	↑ to 1% from 5 July 2019
	Lithuania	0	0	0	0	0.5	0.5	1	1	↑ to 0.5% from 31 December 2018 ↑ to 1% from 30 June 2019
	Norway	2	2	2	2	2	2	2	2	
	United Kingdom	0	0	0.5	0.5	1	1	1	1	↑ to 1% from 28 November 2018
	Sweden	2	2	2	2	2	2	2	2.5	↑ to 2.5% from 19 September 2019
Non-EEA countries	Iceland	1.25	1.25	1.25	1.25	1.25	1.25	1.75	1.75	↑ to 1.75% from 15 May 2019
	Hong Kong	1.25	1.875	1.875	1.875	1.875	2.5	2.5	2.5	↑ to 2.5% from 1 January 2019

Sources: ESRB and BIS.

The table shows only countries where a non-zero CCyB rate has been set.

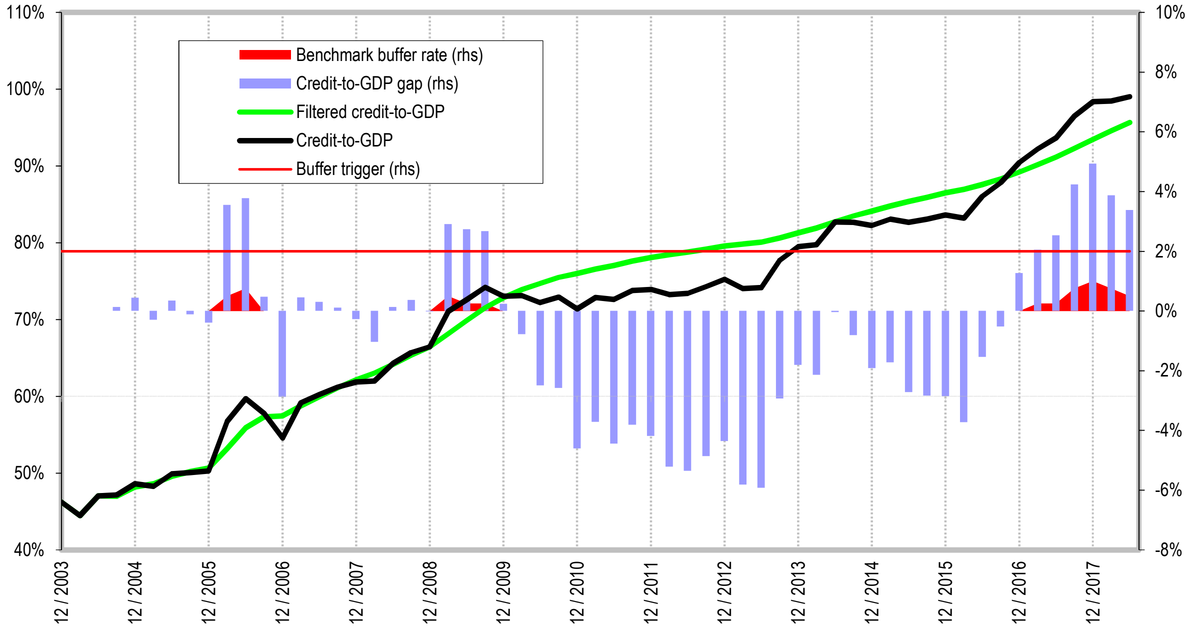
The scheduled rates are based on decisions currently in force; they may, however, be changed by subsequent decisions.

Table 6 Buffers and parameters which are currently applied to exposures to foreign countries and are also applied to Slovak banks

Country	Macroprudential instrument	Value
Estonia	Systemic risk buffer (Article 33f of the Banking Act)	1%
Sweden, Romania	Risk weight for exposures fully secured by mortgages on commercial immovable property (Article 124 of the EU's 2013 Capital Requirements Regulation/CRR)	100%
Norway	Minimum value of the exposure weighted average loss given default (LGD) for all retail exposures secured by residential property and not benefiting from guarantees from central governments (Article 164 of the CRR)	20%

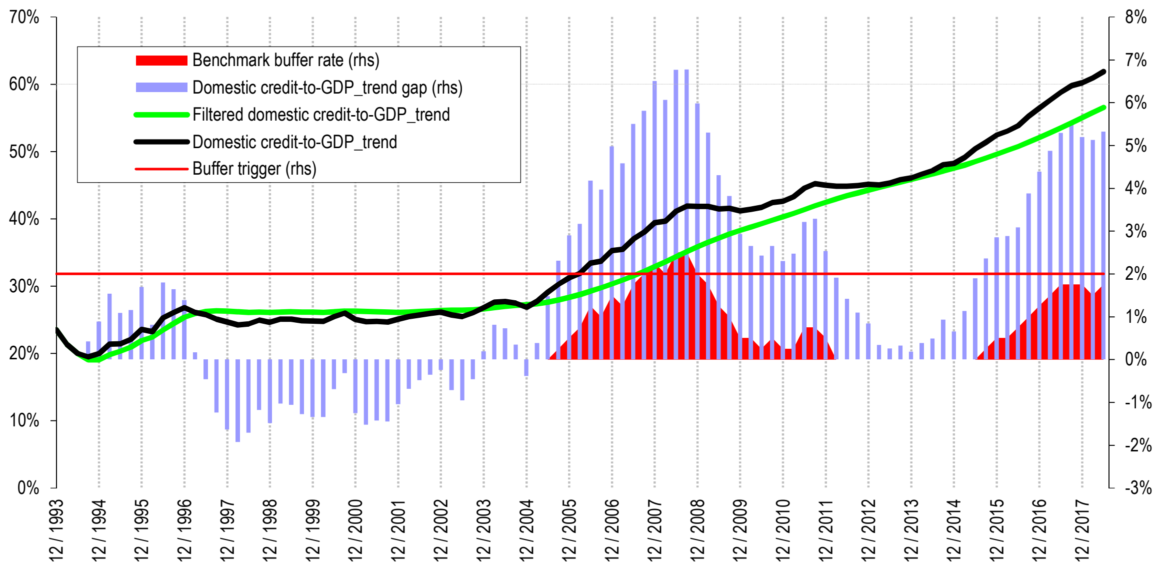
Sources: NBS and ESRB.

Chart 1 Standardised credit-to-GDP gap



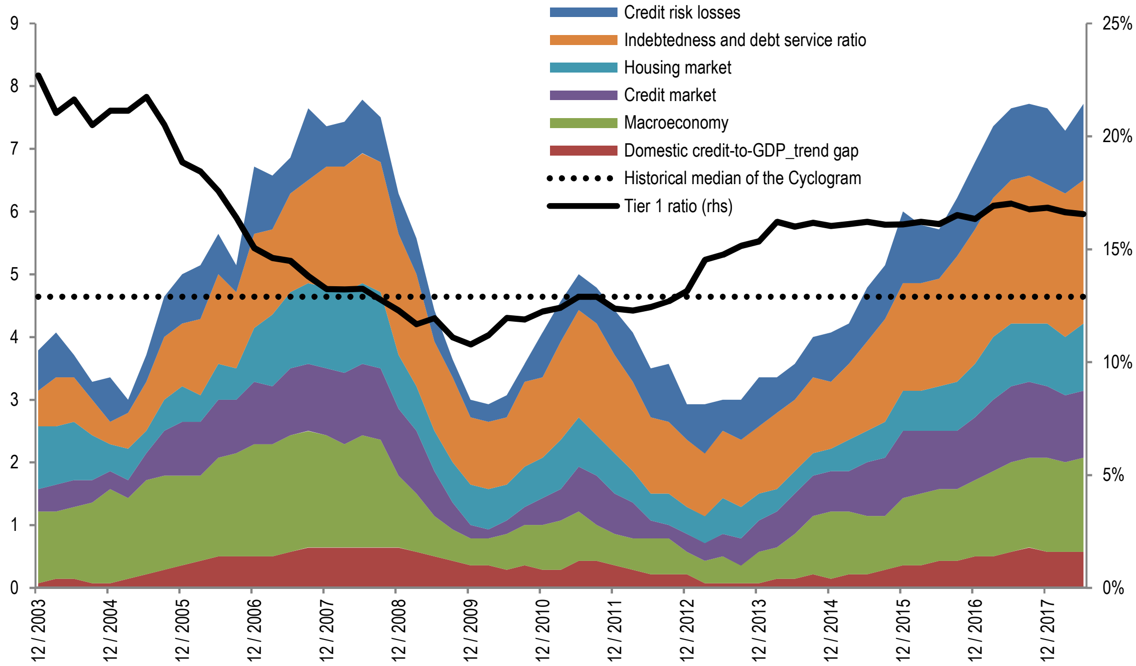
Sources: NBS and Statistical Office of the Slovak Republic (SO SR).
Notes:
In the standardised credit-to-GDP gap, credit refers to the total outstanding amount of debt of NFCs and households.
The benchmark buffer rate is calibrated in accordance with Part 2 of the Annex to Recommendation No ESRB/2014/1.
The trigger value for a non-zero CCyB and the values of the 'gap' are shown on the right-hand scale.

Chart 2 Domestic credit-to-GDPtrend gap



Sources: NBS and SO SR.
Notes:
In the domestic credit-to-GDP_{trend} gap, domestic credit refers to total outstanding amount of credit provided by the domestic banking sector to NFCs and households.
The domestic credit-to-GDP_{trend} gap is calculated in accordance with Article 33g(2a) of the Banking Act and with Recommendation B 2, of Recommendation No ESRB/2014/1.
The trigger value for a non-zero CCyB and the values of the 'gap' are shown on the right-hand scale.

Chart 3 Cyclogram



Sources: NBS, SO SR and CMN.
Note: The indicator is calculated in accordance with Article 33g(1c) of the Banking Act and with Recommendations C and D of Recommendation ESRB/2014/1.

Table 7 Headline indicators for the countercyclical capital buffer as at 30 June 2018

Indicator	Benchmark buffer rate	Credit-to-GDP ratio	Deviation of the credit-to-GDP ratio from its long-term trend
Standardised credit-to-GDP gap (Chart 1)	0.50%	99.0%	3.38%
Domestic credit-to-GDP$_{trend}$ gap (Chart 2)	1.75%	60.4%	5.32%
Cyclogram (Chart 3)	2.50%		

Source: NBS.
Notes: The table is compiled on the basis of requirements arising from Article 33g(2) of the Banking Act and in accordance with Part II of the Annex to Recommendation ESRB/2014/1.
Owing to its short time series, the standardised credit-to-GDP gap does not yet provide a meaningful value for the countercyclical capital buffer.