



NÁRODNÁ BANKA SLOVENSKA  
DIROFYSTÉM



# MACRO-PRUDENTIAL ANALYSIS OF THE BANKING SECTOR

MARCH 2011



NÁRODNÁ BANKA SLOVENSKA  
EUROSYSTEM

## MACRO-PRUDENTIAL ANALYSIS OF THE BANKING SECTOR

### FIRST QUARTER OF 2011

*The aim of this macro-prudential analysis of the banking sector is to provide a comprehensive overview of risk and trend developments in the banking sector. The risks in banks are analysed in the context of developments in the external environment, i.e. the real economy, as well as with regard to the trends in the banking sector itself. Given the increasing interconnection between developments in banks and trends in the real economy, the analysis aims to provide early identification of potential imbalances in the banking sector.*

*The analysis is not concerned with activities performed by the NBS Financial Market Supervision Unit as part of its exercise of supervision over individual banks and branches of foreign banks.*

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## **1. ANALYSIS SUMMARY**

### **The economic recovery continued, but was accompanied by a deepening sovereign debt crisis**

The global economy continued to grow relatively dynamically in the first quarter of 2011. There were, however, significant differences in economic development between various parts of the world. Developing economies maintained strong growth. The United States recorded a slowdown in the rate of economic growth in the first quarter. The euro area, by contrast, experienced surprisingly strong economic growth, though there were marked differences in output between the member countries. The peripheral countries experienced moderate growth or decline, while countries like Germany and France recorded relatively dynamic economic growth. In the quarter under review, Slovakia was one of best-performing countries within the EU.

A common factor in virtually all major economic blocks in the first quarter of 2011 was exposure to the rising commodity prices.

The sovereign debt crisis continued to deepen in the first quarter. Weak economic growth, combined with concerns about the successful implementation of reform measures, caused a further increase in the yield spreads of bonds issued in the countries concerned. The debt crisis involves the risk that a negative trend may quickly spread to other countries or markets.

### **Bank lending to enterprises increased only slightly, but differed considerably across the branches of activity**

The volume of loans provided to the corporate sector had grown by less than three percent year-on-year by the end of the first quarter of 2011. This confirmed the trend from the last few months of 2010, when lending to enterprises ceased to decline in year-on-year terms. Important information is that loan growth was recorded in some of the branches only. Financing was mostly provided to branches that were affected by the crisis to a lesser extent only. Lending to 'classic' branches of economic activity (industry, construction, trade, etc.) continued to decline in year-on-year terms, as well as the share of these branches in the overall corporate loan portfolio of banks.

Banks remained cautious in the first quarter, mainly about the risks involved in the economic situation and risks inherent in selected branches. Customers were also cautious about borrowing money from banks. Demand for loans was recorded only among large enterprises.

The ambiguous developments in the corporate loans market were in contrast with the improving economic position of enterprises in Slovakia. One of the possible explanations was the increased internal funding, mainly from abroad, for financing the corporate sector.

Owing to the improved economic development, the level of corporate credit risk was reduced in the banking sector. The risk also moderated in commercial real estate, which is one of the most significant sectors. The amount of non-performing corporate loans continued to decrease in most of the banks.

The first quarter saw increased investment in debt securities in the banking sector. Besides Slovak government bonds, banks also invested more in foreign government bonds.

## **Lending to households for housing purposes continued to grow dynamically**

Unlike corporate loans, new housing loans to households continued to grow, in line with the trend that started in the second half of 2010. A significant part of these loans was provided for the refinancing of existing housing loans. This indicates that bank customers made use of the still attractive difference between interest rates on new loans and interest rates on outstanding loans.

More and more new loans were provided for house purchase financing. This was also confirmed by data from the real estate market, where the number of transactions in new apartments continued to increase. The housing availability index improved, too.

Interest rates on new house purchase loans rose in the first quarter of 2011, after a long period during which it was the other way around. Thus, banks started to react to the rise in the level of interbank market rates.

Despite the rise in interest rates, competition among banks in the housing loan market remained relatively strong. This was also confirmed by changes in the market shares of banks, which were quite significant in the quarter under review.

Similarly to enterprises, in the case of households credit risk moderated to a certain extent as well. This was connected with the improved economic situation and improved employment situation. On the other hand, a potential source of risk for households was a rise in interest levels. A relatively large part of the loans was provided with a short interest rate fixation period. Hence, customers were more sensitive to upward changes in the interbank rates. Price levels rose substantially in the first quarter of 2011. This led to stagnation in households' real disposable incomes.

## **Increasing profits supported by credit risk reduction; the level of interest income from the household sector reflected the growing competition among banks**

The banking sector's net profit for the first quarter of 2011 increased by 50% year-on-year, up to the pre-crisis level. Profitability was influenced favourably by a decrease in expenses on the coverage of credit risk losses in the loan portfolio, mainly in the retail sector. The growth in net interest income from the retail segment, which was the main factor in profit growth in 2010, slowed down in 2011. This was due mainly to the growing competition among banks in the deposit and loan markets. Its negative impact on profits was mitigated to some extent by an increase in income from fees and commissions, mainly in the category of large banks.

Compared with the end of 2010, the capital adequacy ratio remained unchanged, at 12.6%.

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## **2. MACROECONOMIC DEVELOPMENTS AS THEY AFFECT SLOVAK BANKING SECTOR**

### **Continuing revival in the global economy, accompanied by certain risks**

Economic activity in the world continued to increase sharply at the beginning of 2011, broadly in line with expectations. The global economy was driven largely by developing countries, which still maintained strong output growth. The economies of advanced countries also experienced a revival, but the centre of revival had shifted from the public sector to the private sector, which was a positive and inevitable development on the road to sustainable growth. On the other hand, GDP growth in this part of the world was still relatively slow, so unemployment could not be reduced to a sufficient extent.

Uncertainty regarding the future trend in the global economy, as measured by the spread of growth forecasts, lessened somewhat in comparison with the previous period. The balance of risks, however, remained on the downside, to a greater extent than at the end of 2010. For the time being, the most serious threat is the ongoing crisis in the peripheral euro area countries.

### **The US economy slowed down in the first quarter of 2011; several indicators suggest that this trend will continue**

In the period from the culmination of the crisis to date, the United States managed to surpass the vast majority of advanced countries in terms of the pace of recovery. Economic activity increased most significantly in the second half of 2010, when household consumption started to grow again. At the beginning of 2011, however, the quarter-on-quarter rate of growth changed considerably. Gross domestic product grew by 1.8% in annualised terms, compared with 3.1% in the previous quarter. Slower growth was recorded in various components, mainly in the dominant one, i.e. consumption (2.7%, roughly one-third less than in the previous quarter). One of the reasons behind this slowdown was stagnation in real disposable income in February and March.

The volume of investments in technological equipment, which had exceeded the pre-crisis level already in the previous period, continued to grow dynamically. The overall growth in fixed capital, however, slowed down quite markedly (to 0.7%), as a result of continued decline in investment in residential and non-residential properties. An important contribution to output growth was also made by the accumulation of inventories. In this case, however, it is not clear whether the inventories were replenished in expectation of increased sales in the future, or they accumulated as a result of subdued demand for products. The contribution of net exports to overall growth decreased to zero, because the reduction in the trade balance deficit had come to a halt. Almost one percentage point of the output was absorbed by a fall in government spending.

The key indicator of recovery in the US economy – the net monthly balance of job creation – was sending out ambiguous signals. A positive aspect is that job creation in the recent period has increased to a record level within the current cycle of recovery. Job creation, however, should be increased much more significantly for unemployment to be reduced to an acceptable level. Roughly one-third of the reduction in unemployment to date (by 1 percentage point to 9%) can be attributed to a decrease in labour market participation, which indicates that the labour market is in poor condition. The trend in the number of applications for unemployment benefit provides no reason for optimism: after decreasing at the beginning of the year, the number of applications increased to a level that indicated that the country's unemployment rate could not have fallen.

The PMI indicators for industry and services point to a slowdown in the rate of economic growth in the period ahead. Although industry and services are still in positive territory, they both recorded a decline in March and April, especially services, which represent the centre of the US economy.

The most recent surveys conducted among consumers also provided warning signals. Consumer confidence fell sharply, with the most significant deterioration occurring in the outlook for the future. The change in consumer sentiment was closely connected with a recent steep rise in energy, fuel and food prices, as well as in inflation in general. The year-on-year change in the consumer-price index increased to 3.2% in April 2011, representing a twofold increase over the horizon of three months. Although still rising, core inflation (1.3% in April) was within the range classified as safe for price stability.

Further price developments will be determined by the inflation expectations. These increased at the beginning of the year, but after the oil and commodity markets had calmed down somewhat, the inflation expectations also changed downwards. On the whole, they seem to be relatively deeply rooted. Factors that are supposed to prevent an inflationary spiral from developing are the still wide output gap and high unemployment. In view of these factors, the Fed, unlike many other central banks, still maintains a loose monetary policy in support of economic growth. The market does not expect the reference interest rates to be raised before the end of this year. The latest developments, however, indicate that the current round of quantitative easing (ending at end-June) should not be followed by further liquidity injections in the form of government bond purchases, owing to the stabilised situation in the economy.

### **Revision of the United States' rating outlook from stable to negative**

A significant event (not only for the US) occurred in April, when one of the rating agencies revised the country's AAA rating outlook from stable to negative. This was the first such step in the last 70 years. It was necessitated by the high deficits recorded in the last few years, as well as by the underfunded social and health care systems in the longer-term horizon. In the current fiscal year, the deficit is expected to reach a record level in absolute terms. In relation to GDP, the deficit is expected to exceed 10%, which will probably be the highest level among the advanced economies. Although certain expenses have recently been cancelled in the temporary budget, the size of these saving measures is negligible. Although rating outlook revision is not direct downgrading, the symbolic significance of this event is enormous.

The weakest link in the US economy is the real estate market. Residential property prices rose above the bottom of 2009 by a mere one percent, then went down again in the last months of the year. Construction activity and property sales were at low levels. The offer of hundreds of thousands of real properties in tenders clearly exceeded the level of demand.

### **The strong economic growth in developing countries continued; inflation pressures increased**

Economic activity in most of the developing countries continued to increase at a fast pace. Besides export, which is their main strength, these countries are also successful in stimulating domestic consumption.

The year 2011, however, brought a new threat for the economic stability of these countries, and this was inflation. This risk was certainly not a completely new one; many of these countries had already witnessed price increases above the target inflation rates of their central banks in the previous period. The recent rise in oil and food prices, however,

significantly increases the probability that inflation will accelerate to such an extent that it may cause serious economic turbulence. Developing economies are currently more sensitive to inflationary pressures than advanced economies for two reasons. The first is the fact that the utilisation of capital and human capacities is closer to the full potential, in some cases it may have already reached it. The second reason is that the dominant consumer-basket items for households are energy and food, and that the production sector is more energy-intensive owing to the technologies used in the production process. Hence, central banks have intensified the rate of monetary policy tightening. This is not yet reflected negatively in the output of these countries. The risk that the persistent inflationary pressures in some of these countries induce a radical reaction on the part of monetary policy, leading to sudden cooling down of economic activity, is not negligible.

The situation is further complicated by the flow of portfolio capital into developing countries, which also has an inflationary effect and increases the prices of financial assets. Compared with the previous year, however, the capital inflow weakened in the period under review.

### **Economic growth in the euro area was accompanied by marked differences between the member countries**

The beginning of the year saw interesting economic developments in the euro area and numerous significant events. A certain surprise, in the positive sense of the word, was an increase in output in the first quarter of 2011. Gross domestic product in the euro area as a whole expanded in annualised terms by 3.2% quarter-on-quarter, which was more than the figure for the entire second half of 2010. Differences in the economic situation between the peripheral countries and the rest of the euro area (the dynamically growing Germany, plus France), which were already quite noticeable, deepened still further to some extent to the detriment of the former group. This applies not only in terms of GDP growth, but also in terms of other indicators and circumstances.

The second basic macroeconomic variable, i.e. unemployment, failed to react to the increase in the rate of economic recovery. The overall unemployment rate in the euro area fell by only 0.1 percentage point in the period under review, to 9.9%. The only country to succeed in converting the economic growth into job creation is Germany. Unemployment in the peripheral countries is stagnant or even rising in certain cases.

The euro area has also experienced accelerated inflation in the last few months. April saw a year-on-year price increase of 2.8%, which was 0.6 percentage point more than at the end of 2010. The consumer basket prices were pushed up mainly by energy prices. However, inflation was rising even if this effect is left out of account. The ECB also reacted to the sudden rise in inflation by raising its key interest rates by 25 basis points in April, for the first time in this cycle. This happened in contrast with the original expectations. The central bank sent out this signal because there were signs that the current price movements may lead to excessive wage growth and inflation expectations. Such risk is present mainly in Germany and some of the other euro area countries, where unemployment is falling, unused capacities are decreasing, and the economy is getting closer to its full potential.

An increase in the key ECB rates and consequently in the overall level of interest rates may complicate the position of peripheral countries, which are in a completely different phase of recovery. The positive interest rate differential is pulling the exchange rate of the euro vis-à-vis other currencies upwards, despite the escalating sovereign risk crisis. An excessive appreciation in the euro, however, would complicate the export position of all euro area member countries, though it would have a dampening effect on inflation.

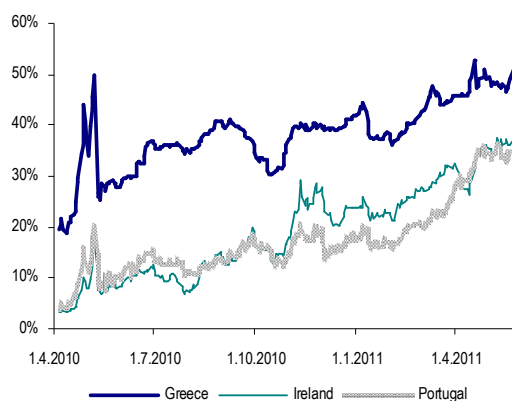


The outlook indicators suggest that the situation in the euro area is heterogeneous. The PMI indicators show values close to the historical highs for both sectors. This, however, does not apply to the peripheral countries, which are fluctuating around a level signalling stagnation in production, orders, and employment. The economic sentiment indicator has fallen in the last two months, after rising for a longer period. Consumer confidence has declined, too. Despite this, the composite indicator is still well above the long-term average. What we have mentioned repeatedly in the previous text also applies to the individual countries in this respect.

### Deepening debt crisis in sovereign countries

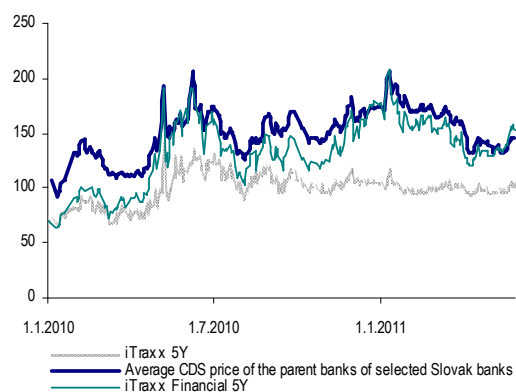
Since the beginning of 2011, the sovereign debt crisis has deepened in the euro area. The government bond spreads of the countries concerned have increased to new historical highs and the rate of depreciation in comparison with German government bonds has accelerated (Chart 1). The rating agencies downgraded these countries several times within a short period. The situation worsened to such an extent that Portugal had to request financial assistance from the rescue mechanism. Aversion among investors to government bonds issued in peripheral countries is fuelled, inter alia, by information about failure to implement the proposed consolidation measures in full. The actual amount of public deficits in 2010 exceeded the prescribed level in numerous cases. The markets also perceive the rate of implementation of principal structural reforms as too slow. This exerts pressure on the respective governments to impose even stricter saving measures, which, on the other hand, represent a threat for economic growth, as well as for the meeting of the prescribed limits. The seriousness of this crisis for the rest of the euro area and the world lies in the possible negative effect of the crisis on economic sentiment and its spreading through the interconnected banking sectors, rather than in the unfavourable macroeconomic situation in the countries concerned.

**Chart 1 Depreciation of government bonds in selected countries**



Source: ECB.  
The vertical axis shows the depreciation of government bonds issued in the respective country, compared with the price of German government bonds (in percent).

**Chart 2 Changes in average CDS prices**



Source: Bloomberg, Thomson Reuters.  
Data are in basis points.  
The iTraxx index expresses the average 5-year CDS price for 125 large European companies. The main component of this index is iTraxx Financial, expressing the average 5-year CDS price for 25 European financial groups.  
The average CDS price of the parent banks of selected Slovak banks includes the parent banks of SLSP, VÚB, Tatra banka, and UniCredit.

## **Banks pursue a prudent lending policy in the euro area**

Bank lending has not yet contributed significantly to recovery in the euro area. Lending standards for enterprises and households were tightened still further in the first quarter of 2011, though the tightening cycle seemed to have been completed in the second half of 2010. According to banks, the main reason was liquidity restriction, as well as the overall assessment of the macroeconomic situation. The growing demand of enterprises for operating and investment loans remained unsatisfied, mainly in the case of smaller enterprises, though the volume of loans provided to enterprises increased somewhat after a long period. An unexpected fall in demand was recorded in the segment 'housing loans for households'. The reason in this case was the deteriorating outlook for the residential property market in the majority of member countries and the falling consumer confidence.

The banking sector of the euro area is still far from being in optimal condition. Numerous banks are critically dependent on liquidity supplied by the central bank, because they have no access to financial markets on account of credit risk. In the case of certain countries, the need for additional capital for strengthening the position of banks is particularly high. Increased credit spreads at the beginning of the quarter pointed to another increase in the systemic risk inherent in the EU banking sector and to a fall in confidence in this sector. Credit surcharges in the banking sector increased, though they remained unchanged in other sectors (Chart 2). The situation gradually improved to some extent. The CDS prices of large European bank groups, including the parent companies of Slovak banks, fell in comparison with the record levels seen at the beginning of the year, but they still signal an increased risk in the EU banking sector.

## **Positive economic developments in Slovakia**

The Slovak economy was doing quite well in the first quarter of 2011. Compared with the previous quarter, the annualised rate of GDP growth accelerated slightly, to 4.0%. Owing to this result, Slovakia still belongs to the most dynamically growing economies within the euro area, as well as within the EU. The domestic economy benefits from its close ties with euro area countries enjoying relatively dynamic recovery. The main source of growth is exports, mainly the exports of manufacturing products. Domestic demand is growing at a modest pace only. Domestic demand is negatively influenced by the consolidation efforts initiated in public finances, which are expected to be implemented this year.

Data on industrial production in the last few months indicate that the rapid growth from the previous period has come to a halt. On the other hand, industrial output in absolute terms has already exceeded its pre-crisis level. The situation in the construction industry is much worse. The volume of production is at the lowest level seen in the past few years. The declining trend in construction from the previous quarter deepened still further in the first quarter of 2011.

The indicator of economic sentiment showed a different tendency. It recorded a certain fall in March and April. Within the scope of the overall indicator, the most significant fall occurred in the indicator of consumer confidence. In both Slovakia and abroad, consumer sentiment was unfavourable affected by the rising inflation, as well as by the uncertainty regarding the outlook for macroeconomic developments, arising from the ongoing sovereign debt crisis in the euro area. After a sudden increase in the year-on-year change in consumer prices in January (slightly above 3 percent), mainly in energy prices, inflation continued to show a rising tendency. It was as high as 3.9% in April.

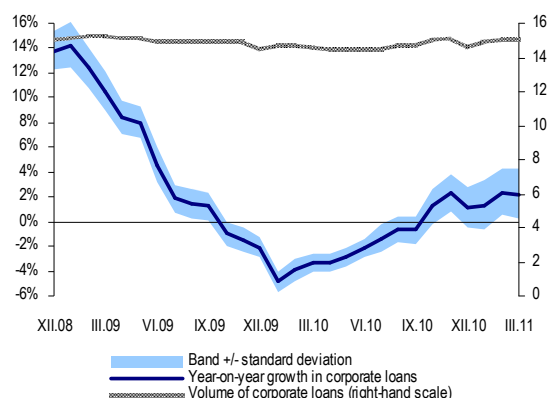
The overall forecast for economic developments in Slovakia this year is relatively favourable, owing to the strong foreign demand coming from the country's main trading partners. The balance of risks is on the upside. A positive surprise in GDP development may be the implementation of postponed investments and infrastructural projects from EU funds (in larger-than-projected measure). Downside risks are not negligible either. They include a potential need for additional consolidation measures and a possible rise in commodity prices to even higher levels.

### 3. TRENDS AND RISKS IN THE SLOVAK BANKING SECTOR

#### Bank lending to the corporate sector showed marked differences

Despite the favourable macroeconomic conditions, bank lending to the corporate sector did not increase en bloc. The total volume of loans to non-financial corporations grew by 2.7% year-on-year, but the internal structure of this growth changed in comparison with the previous period. The main difference was the heterogeneity of growth in lending to various branches of economic activity, which gave rise to an increase in the standard deviation of loan growth in the respective branches. The strongest growth was recorded in selected branches, mainly water, gas and electricity supply; commercial real estate business; administrative services; and professional and scientific activities. By contrast, lending to classic branches, such as manufacturing (except for electrical engineering), construction, trade, transport and agriculture, continued to decline. As a result of heterogeneous developments in lending to enterprises in 2009 and 2010, the share of loans to classic branches in the overall portfolio decreased from 67% to 58%.

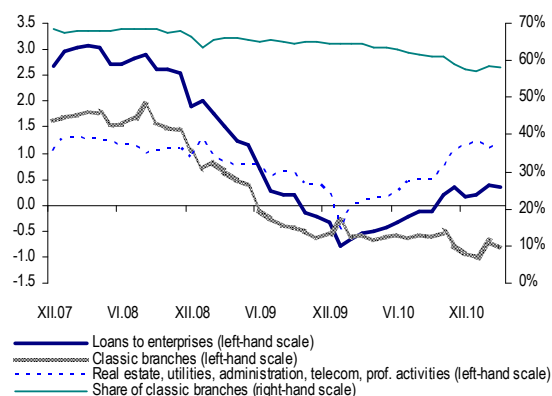
**Chart 3 Lending to the corporate sector**



Source: NBS.

The left-hand axis shows annual percentage changes; the right-hand scale shows data in EUR billions. Standard deviation is calculation from the year-on-year growth in loans provided to individual branches in individual months.

**Chart 4 Lending to the corporate sector by branch of activity**



Source: NBS.

The right-hand axis shows year-on-year changes in the volume of loans.

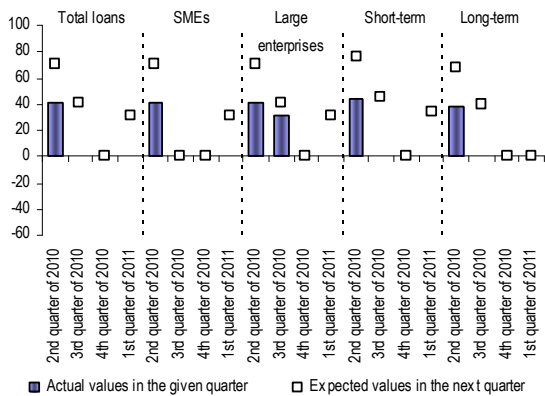
The left-hand axis shows data in EUR billions.

The 'classic' branches of economic activity comprise: agriculture, mining & quarrying, manufacturing, trade, transport and storage, and selected services.

#### The current developments are shaped by demand and supply-side factors

The slow and selective revival in lending activity is the result of a combination of relatively strict credit standards and demand-side changes. Credit standards have remained relatively strict, though they show certain signs of easing. On the other hand, demand for loans shows virtually no signs of revival. A positive change can be observed only in the case of large enterprises.

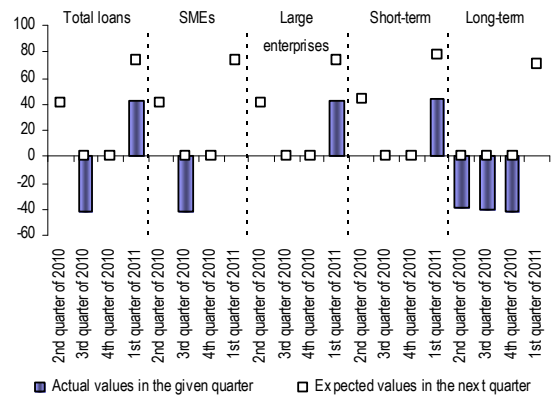
**Chart 5 Credit standards for new corporate loans**



Source: NBS.

Data in the chart are given as a net percentage share; a positive value indicates an easing of standards. Changes express the subjective view of banks. Data are collected from a sample of banks.

**Chart 6 Demand for loans in the corporate sector**

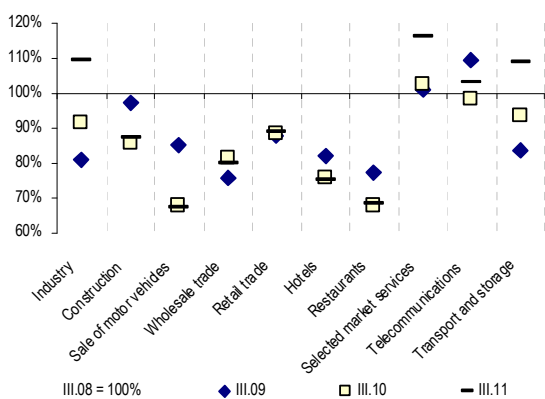


Source: NBS.

Data in the chart are given as a net percentage share; a positive value indicates an easing of standards. Changes express the subjective view of banks. Data are collected from a sample of banks.

Demand for loans on the part of enterprises has been relatively weak for several months, despite the revival in activity in the corporate sector. This has led to revenue growth in most of the branches. In the first quarter, revenues no longer decreased in year-on-year terms; they either increased steeply (e.g. by 19% in industry) or stagnated (e.g. by 0% in trade, hotels and restaurants). A negative fact is that revenues in most branches have not yet reached the level of 2008; revenues in some branches have dropped even in comparison with 2009. The sharpest contrast between lending activity and revenues can be observed in industry, producing one of the steepest year-on-year increase in revenues within the EU. On the other hand, lending to industry shows a declining tendency; the share of loans in the total volume of corporate loans is on the decrease, too (Chart 7).

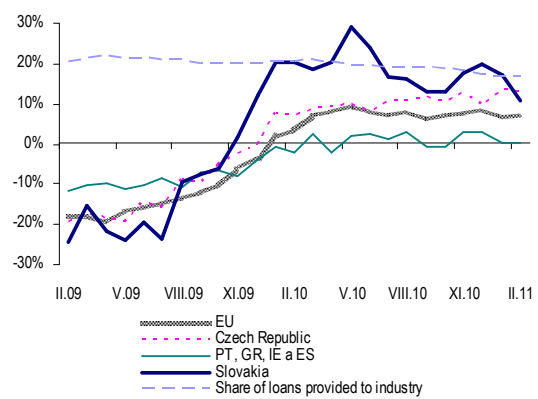
**Chart 7 Comparison of corporate revenues in individual branches**



Source: Statistical Office of the SR.

Average revenues are weighted by the banking sector's exposures to the respective branches.

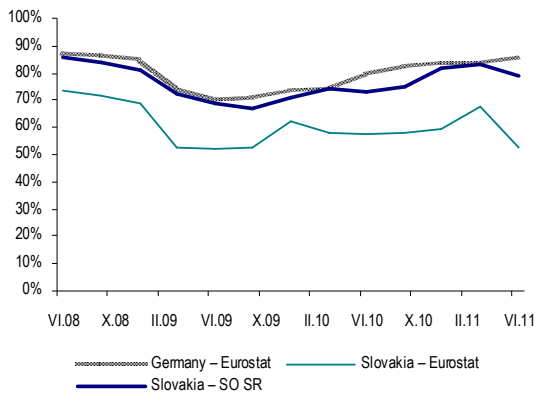
**Chart 8 Industrial production in selected countries**



Source: Eurostat.

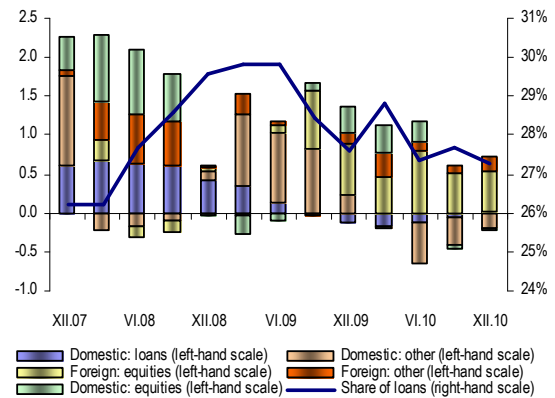
The data express year-on-year changes. Share of loans to industry in the total volume of corporate loans in Slovakia.

**Chart 9 Expected utilisation of production capacities**



Source: Eurostat, Statistical Office of the SR.  
The data express expectations for the next 3 months.

**Chart 10 Changes in the financial liabilities of enterprises**

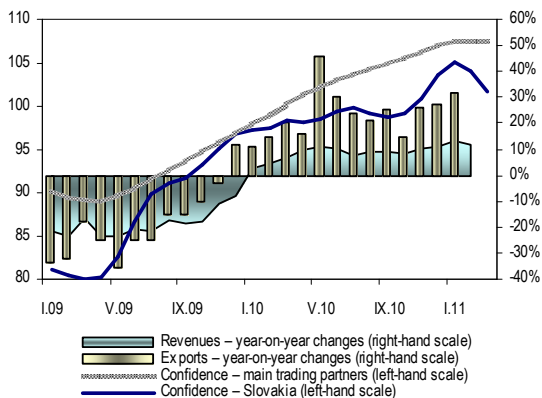


Source: NBS.  
The left-hand axis shows changes in the floating averages of selected financial liabilities of enterprises in EUR billions.  
The right-hand axis shows the share of loans in the total financial liabilities of enterprises.

In this context, two factors are to be mentioned as possible causes of the weak demand for loans (despite the upturn in activity). The first factor is the existence of unexploited capacities, the exploitation of which may be a logical condition for new financing. Data from the Statistical Office of the SR and Eurostat, however, do not agree in this respect. Hence, this explanation cannot be regarded as sufficient. The second factor is the reduction in the share of external resources in the corporate sector, which may be considered a natural consequence of the crisis. While domestic bank loans in 2008 represented a significant contribution to growth in the corporate sector's financial liabilities, the year 2009 saw a marked increase in own funds, mainly funds from abroad (Chart 10).

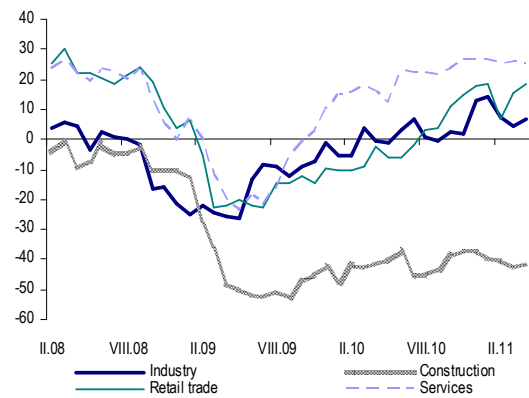
**Increased business confidence, indicating a slight reduction in credit risk**

**Chart 11 Business confidence indicators in selected economies**



Source: OECD.  
The 'main trading partners' index is a weighted index for ten countries with the largest share in Slovak exports.

**Chart 12 Confidence indicators in Slovakia**



Source: Statistical Office of the SR.

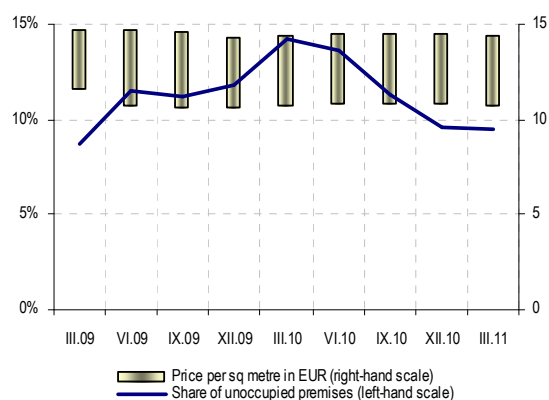
The positive macroeconomic developments are also reflected in the perception of the business environment. In connection with the growth in exports and the resulting increase in

corporate revenues, the business confidence index has risen, too. The economic sentiment indicators released by the Statistical Office of the SR confirm the persistent differences in the business environment of Slovakia. Economic sentiment in industry and services has already returned to their pre-crisis levels, but sentiment in retail trade has only approached its level seen before the crisis. The biggest problem is confidence in construction.

### A slight improvement in the commercial real estate market

In view of the size of the banking sector's exposure, the commercial real estate market remained an important credit risk factor in the period under review. Hence, a positive development was that the situation in this market improved somewhat in the first half of the year. In the office segment, the rate of unused capacities dropped to 9.5%, representing the best value in the last two years, while the prices remained virtually unchanged. An improvement was also recorded in the residential segment, when the share of apartment projects recording positive net sales increased. In this connection, net apartment sales remained relatively high. Credit risk arising from the commercial real estate market also remained relatively significant.

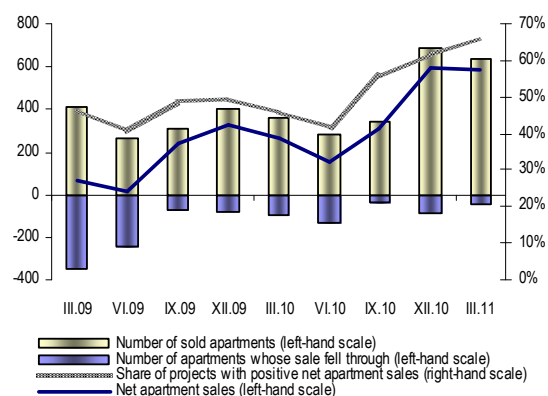
**Chart 13 Commercial properties in Bratislava – office premises**



Source: CBRE.

The right-hand axis shows data in EUR.

**Chart 14 Residential properties in Bratislava**



Source: Lexus.

### Stabilised developments in the area of non-performing loans

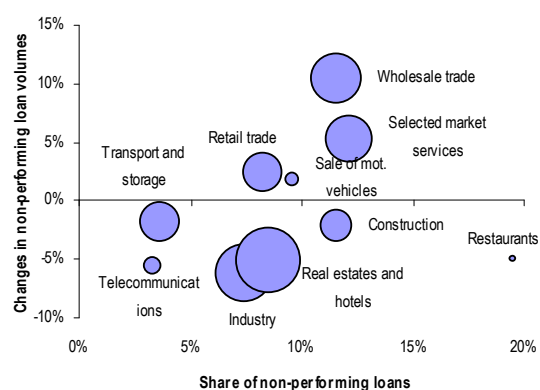
An important positive fact is that there were no significant loan defaults in the first quarter of 2011. The volume and share of non-performing loans in the overall portfolio were more or less stable. There were two exceptions: construction, where the increasing trend in non-performing loans continued, and wholesale trade, where a deterioration occurred in the last three months. On the other hand, numerous branches recorded a decrease in the volume of non-performing loans (Chart 16).

**Chart 15 Non-performing loans (share and month-on-month changes)**



Source: NBS.  
The left-hand scale shows data in EUR millions.

**Chart 16 Share of non-performing loans in selected branches of activity**

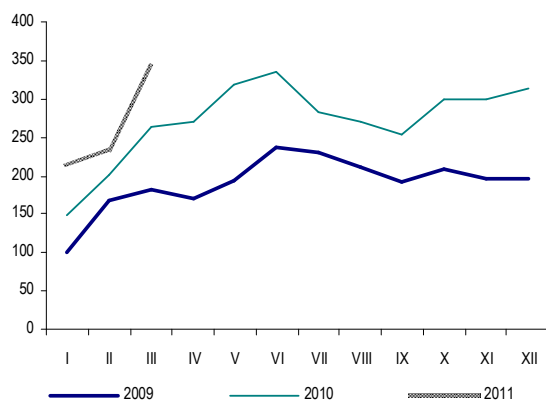


Source: NBS.  
The size of the bubble illustrates the total volume of loans in the given branch.  
The vertical axis shows volume changes recorded in the last three months.

**Lending to households for housing purposes continued to grow**

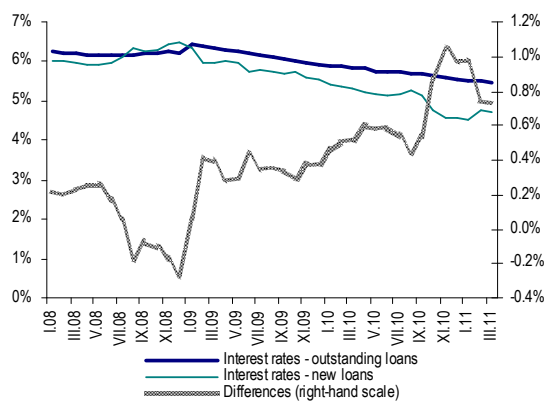
New loans to households for house purchases continued to follow a growing trend in the first quarter of 2011. The volume of new loans provided in the first quarter of 2011 was almost one-third larger than in the same period of 2010 and 75% larger than in the first quarter of 2009.

**Chart 17 Volumes of new house purchase loans in individual years**



Source: NBS.  
Data are in EUR millions.

**Chart 18 Interest rates on new and outstanding house purchase loans**



Source: NBS.  
The chart shows the differences between interest rates on outstanding loans and interest rates on new loans.

The strong growth in new loans was caused by similar factors as in 2010. A large part of the new loans was provided for the refinancing of existing loans. This indicates that bank customers responded to the marketing campaigns of banks aimed at loan refinancing, and to the still significant difference between interest rates on outstanding loans and new loans. This difference decreased in the first few months of 2011, but still enables customers to replace their old loans with new ones at lower interest rates.



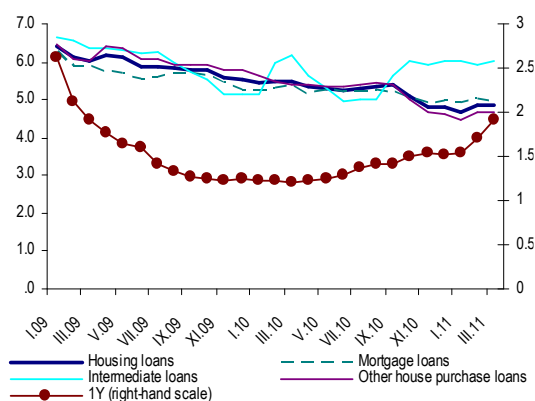
The difference between interest rates on outstanding loans and new loans will probably decrease in the coming months, mainly as a result of the rise in interbank rates. The room for loan refinancing will shrink, owing to the policy pursued by banks. Numerous banks offer loans with longer interest rate fixation periods (loans with interest rate fixation for more than one year accounted for almost 75% of the new loans at end-March 2011), in order to postpone the possibility of loan refinancing at another bank.

### Interest rates on new house purchase loans rose in the first quarter of 2011

After falling sharply in the second half of 2010, interest rates on new loans for house purchases showed a rising tendency in the first quarter of 2011. Although lending rates did not rise for all types of loans, this tendency shows that banks started to react to the rise in interest rates in the financial markets.

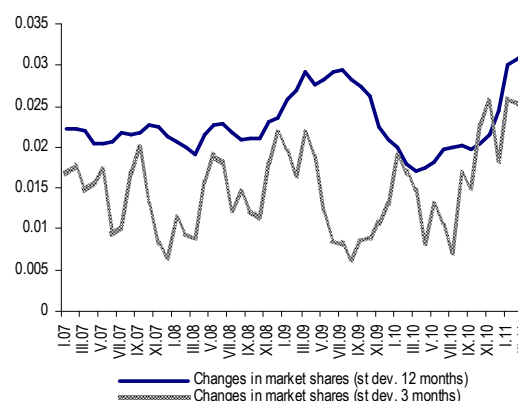
Despite the rise in interest rates on new loans, competition among banks remained relatively strong. This was reflected in the volatile market shares of banks (Chart 20), which increased still further in the first quarter of 2011. This indicates that customers react sensitively to any difference in the financing conditions of banks, and shows how important this segment is for banks for the time being.

**Chart 19 Interest rates on new loans to households**



Source: NBS.  
Data are in percent.

**Chart 20 Changes in banks' market shares in new house purchase loans**



Source: NBS.  
The chart shows the average standard deviations (st dev) of banks' market shares in new loans in the last 3 or 12 months; rising values express more significant changes in the market shares of banks.

### Conditions for growth in demand for real estate financing

The increase in the total outstanding amount of housing loans in the first quarter of 2011 was relatively volatile, with a sharp increase in January followed by a decrease in February. Overall, the increase in the outstanding amount of loans in the first quarter was at the level of the increase recorded in the last quarter of 2010.

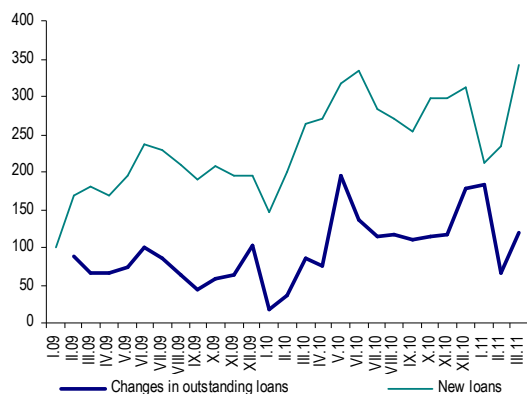
Some of the indicators suggest that the growth in the total outstanding amount of housing loans will accelerate in the coming months. The increased demand for real estate financing is reflected in the housing availability index<sup>1</sup>, which expresses the possibilities of households to obtain loans for house purchase financing with regard to their incomes. This index reached a

<sup>1</sup> Rychtárik, Š. – Krčmár, M. [2011]: Developments in the housing loan market and their interpretation. In: Real Properties and Housing 2010 / Issue 2, Bratislava, 2010.

relatively favourable level at the end of the first quarter of 2011, mainly as a result of the lower property prices.

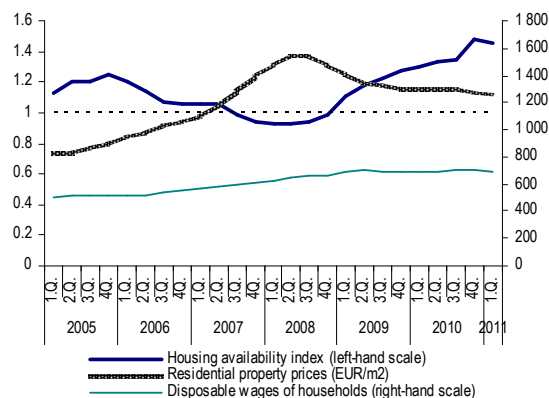
Demand for loans will also be influenced favourably by the continuing revival in the residential property market. The market for new properties in Bratislava followed the trend from the last quarter of 2010, when the number of transactions in new apartments increased in year-on-year terms. On the other hand, it should be noted that some of the market segments experienced no revival.

**Chart 21 Changes in housing loan volumes**



Source: NBS.  
Data are in EUR millions.  
The changes in the outstanding amount of loans are expressed as month-on-month changes.

**Chart 22 Selected indicators of the housing loan market**



Source: NBS, Statistical Office of the SR.  
The right-hand axis shows data in EUR.  
The broken line expresses the availability of loans for housing purposes. An index lower than 1 indicates that financing for an average real property is unavailable for an average household.  
A housing availability index (Krčmár & Rychtárik, 2011) of 1.0 refers to a household with an average income in Slovakia (adjusted for seasonal effects, less taxes, contributions, basic housing costs, and expenses on food and telecommunications), which is able to repay, from its disposable income, a loan amounting to 75% of the price of an apartment with a floor space of 80 m<sup>2</sup>, at the current interest rate, within the average loan maturity period.

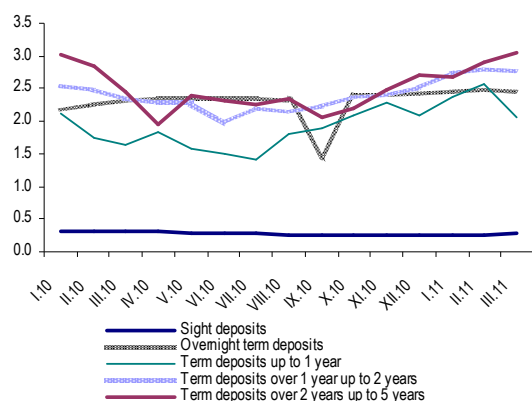
### Banks continued to compete for the term deposits of households

As new housing loans, household deposits also continued to grow relatively dynamically in the first quarter of 2011. Since December, household deposits have increased every month by more than 5% year-on-year. The increases took place mostly in term deposits.

This trend in term deposits was confirmed by the developments observed in the first quarter. Deposits continued to be shifted from short-term to long-term deposit accounts (two to five-year deposits). This was connected with the increasing difference in interest rates and the respective efforts of banks.

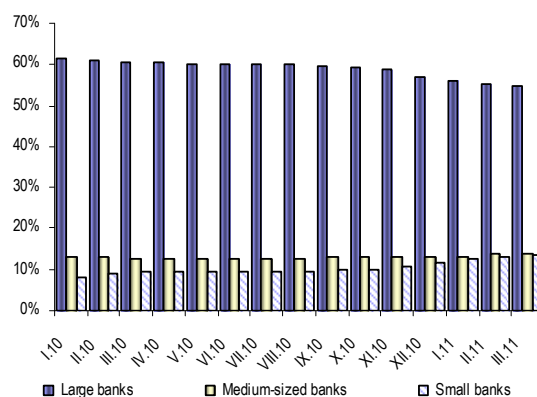
The market shares of banks in term deposits continued to change, too. The share of smaller banks increased still further. After stagnating over the past year, the market share of medium-sized banks grew at an accelerated pace. By contrast, the market share of large banks decreased.

**Chart 23 Interest rates on new household deposits**



Source: NBS.  
Data are in percent.

**Chart 24 Market shares of banks in the term deposits of households by category**



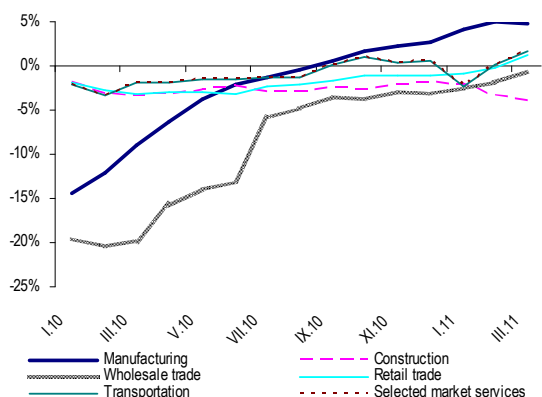
Source: NBS.  
The data express the shares of various categories of banks in the total volume of term deposits received from households.

**Pressures in the labour market eased somewhat**

In the first quarter of 2011, the labour market situation continued to improve slowly, though the overall economic situation remained uncertain. A positive signal was an increase in employment. After falling steadily for two years, employment increased in the first quarter of 2011. The change in trend was caused mainly by industry, which recorded the strongest growth among the sectors and thus was able to create more new jobs. On the other hand, construction, where revenues had been falling over the past two years, recorded a negative change in employment. A similar trend was recorded in the indicator of expected employment.

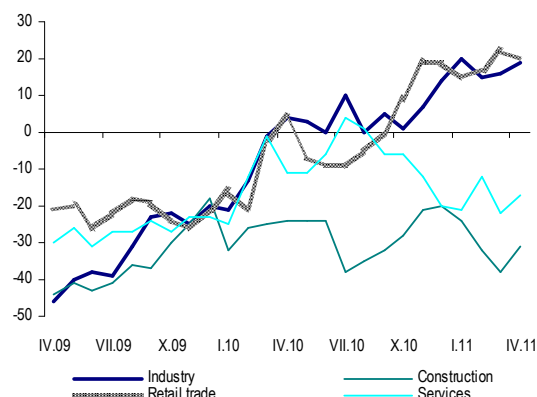
On the other hand, it should be noted that the number of registered unemployed did not confirm the improvement in the situation, therefore the interpretation of labour market developments was unclear. The structure of increases in unemployment remained virtually unchanged in the first quarter, when there were broadly constant increases in the individual income categories.

**Chart 25 Year-on-year changes in employment in selected sectors**



Source: Statistical Office of the SR.  
Data are in percent and express the year-on-year changes recorded in individual months.

**Chart 26 Expected employment in selected sectors**



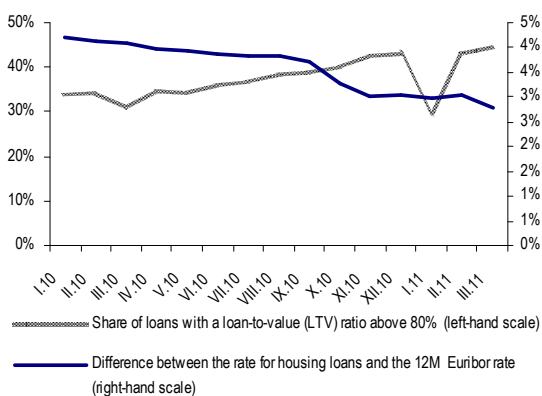
Source: Statistical Office of the SR, economic trend surveys.

### The household loan portfolio continued to improve in quality

The behaviour of banks in lending to households for housing purposes was not really affected by the unclear interpretation of the overall labour market situation. Banks continued to reduce their interest rate spreads for new house purchase loans, i.e. the difference between the average rate for new household loans and the interbank market rate. The share of loans with lower collateral coverage and/or a higher LTV ratio continued to increase (Chart 27). Although both trends are connected with the growing competition, they indicate that there are positive expectations in the banking sector regarding the outlook for household credit risk.

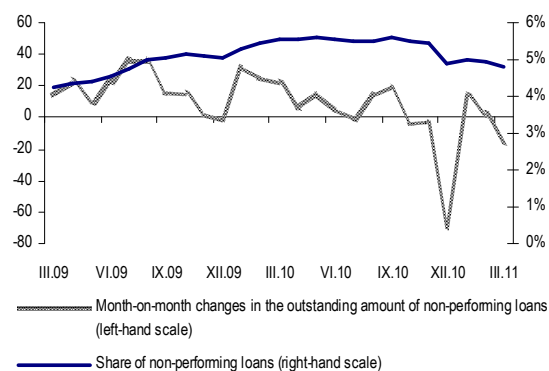
Since the household loan portfolio was adjusted at the end of 2010, the quality of loans has undergone no substantial changes. The volumes of non-performing loans are on the decrease and their share in total loans has returned to the level of July 2009.

**Chart 27 LTV ratios and interest rate spreads of new housing loans**



Source: NBS.  
The spreads of housing loans are calculated as the difference between interest rates on new housing loans and the 12-month EURIBOR rate.

**Chart 28 Non-performing household loans**



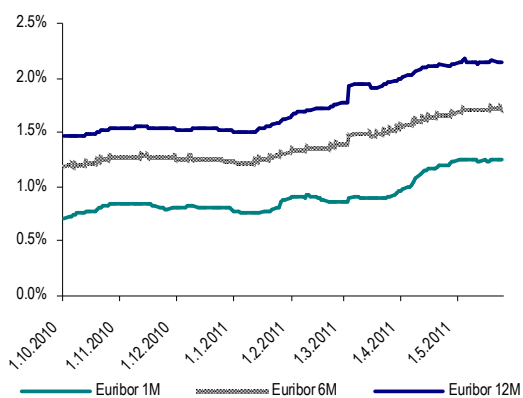
Source: NBS.  
The right-hand axis shows data in EUR millions.

### A source of credit risk in the coming years may be the rising interest rates and prices

Despite various positive changes and expectations, credit risk in the household segment remained virtually unchanged in the period under review. This was attributable to the risk factors that have already been mentioned in the *Analysis of the Slovak Financial Sector for 2010*. While in 2009 the dominant factor in credit risk was the rising unemployment moderated to some extent by the falling interest rates, the main risk factor today is the combination of rising interest rates and price levels. The rise in market interest rates, which began in the autumn of 2010, has accelerated in the last few months. On the other hand, the risk of rising interest rates is likely to be offset partly by an increase in the share of loans with interest rate fixation for more than 1 year. The transmission of interbank rates is expected to be slowed down by the growing competition in the market for housing loans.

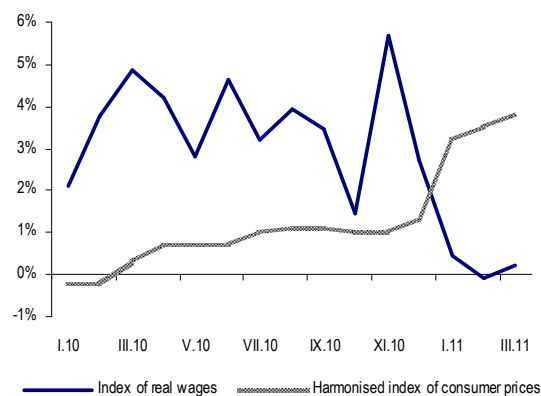
In the first quarter of 2011, the negative effects of consumer price changes were immediately reflected in real wages. While the year 2010 saw an increase in real wages in each month, real wage growth in 2011 was fully absorbed by the increased inflation (Chart 30). A fall in the real disposable income of households, coupled with an increase in their debt service costs, would substantially increase the level of credit risk in this segment.

**Chart 29 Interbank market rates in the euro area**



Source: euribor.org.

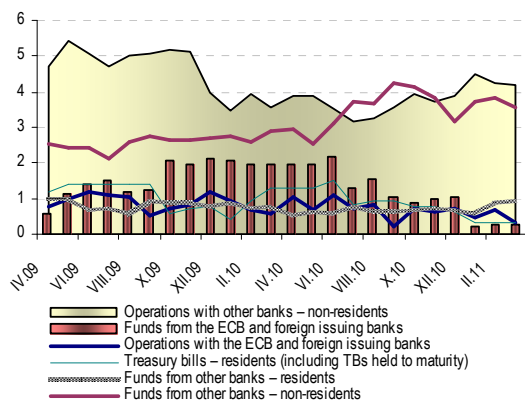
**Chart 30 Inflation and real wages**



Source: NBS, Statistical Office of the SR.

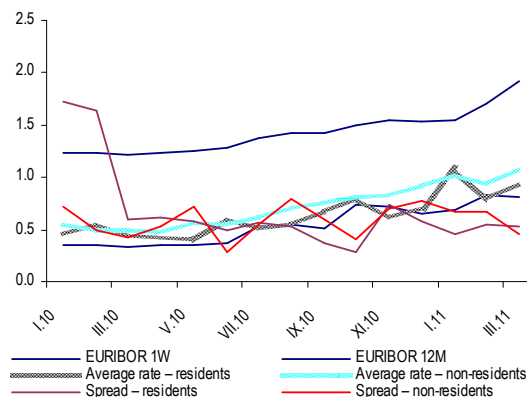
## Decline in ECB financing, followed by growth in interbank market transactions with foreign banks

**Chart 31 Selected items of interbank assets and liabilities**



Source: NBS.  
Data are in EUR billions.

**Chart 32 Interest rates in the domestic interbank market**



Source: NBS.

Average rate for non-residents – average interest rate on interbank deposits taken from non-resident banks.  
Average rate for residents – average interest rate on interbank deposits taken from resident banks.  
The interest rates were calculated on the basis of the stock of euro-denominated short-term (up to 1 year) loans and deposits reported as at the end of each month. The rates were calculated as an average weighted by the volume of individual transactions.  
Interest rate data are in percent.  
The spreads were calculated as the difference in interest rates between the bank with the highest average rate and the bank with the lowest average rate.  
In the case of non-residents, the spread calculations omitted rates for J&T, since their average has long been higher than the sectoral level.

Interbank market developments underwent no significant changes in the first months of 2011, compared with the previous months. Changes were recorded only in some of the banks.

The volume of funds supplied by the ECB decreased as a result of maturing two-week operations with the ECB. Hence, banks started to borrow more funds from foreign banks.

A marked increase was recorded in asset-side operations with foreign banks, mainly banks belonging to the same financial group. In this way, banks invested their free funds earned from other operations.

### Developments in the implied interbank rates of domestic banks were in line with the rates in the euro area

The implied interest rates used in transactions with domestic and foreign banks indicated that the prices of interbank funds for domestic banks were fluctuating parallel with the EURIBOR interbank rates. Thus, domestic banks were not exposed to higher credit surcharges in the interbank market, compared with the euro area interbank market.

Apart from the low implied rates at the level of 1-month EURIBOR, the spread of interest rates between banks also deserve positive assessment: they remained virtually unchanged even during the first quarter of 2011.

## Banks started to invest more in foreign government bonds

The first two months of 2011 saw another increase in investment in securities in the banking sector. In January, banks started to purchase foreign government bonds. In February, they invested in both foreign and Slovak government bonds.

Investments in foreign bonds were more or less concentrated in a small number of banks. Most investments were made in Hungarian, Cypriot, Irish, and Italian government bonds.

In March, however, the debt securities holdings of banks decreased, owing to the sale-out of selected foreign bonds.

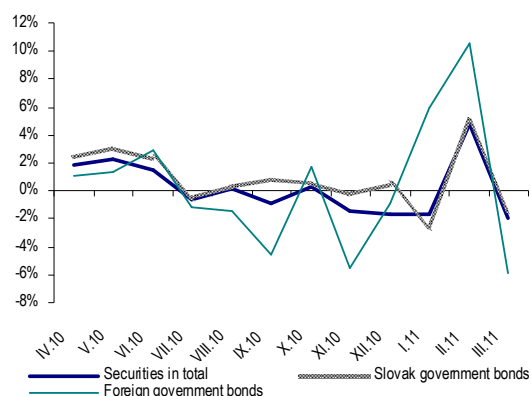
## Securities continued to be issued without any significant structural changes

In respect of security issuance, no significant structural changes were adopted in the banking sector in the quarter under review. The volume of mortgage bonds issued was relatively small in comparison with the previous three quarters. This was influenced mainly by the relatively low volume of mortgage bonds maturing in the same period. Since a relatively large volume of mortgage bonds will mature in the quarters ahead, the volume of new issues is expected to increase in comparison with the first three months of 2011.

## Shift towards mortgage bond issues with a constant coupon rate – probably a result of retail sales

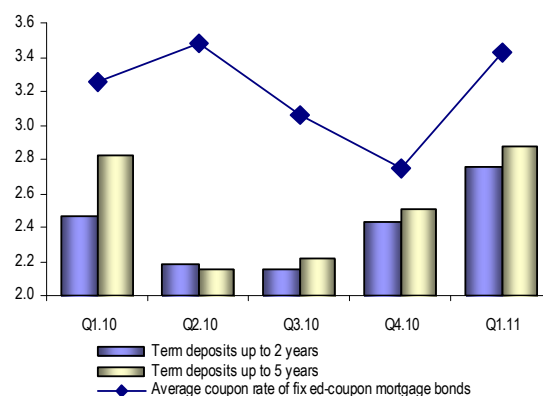
An interesting aspect is the ratio between mortgage bonds issued with fixed and floating coupons. In the last quarter of 2010, bonds were issued in large part with a floating coupon, but in the first three quarters of 2011, all bonds were issued with a fixed coupon. A partial explanation is provided by two factors. The first is the relatively small issue amount in the first quarter of 2011. The second factor is the continuing increase in the attractiveness of these bonds for retail investors, while the offer of an attractive fixed yield for a longer period may increase the level of demand among the population.

**Chart 33 Year-on-year percentage changes in investment in debt securities**



Source: NBS.

**Chart 34 Comparison of coupon yields and interest rates on household deposits**



Source: NBS.

Data are in percent.

The chart illustrates the average interest rates on new deposits received from households (weighted by the volume of deposits) and the average coupon yields on newly issued mortgage bonds with a fixed coupon yield in the given quarter.

### **The degree of liquidity risk differed across the banking sector**

In the short-term, the degree of liquidity risk in the banking sector as a whole was virtually unchanged over the first quarter of 2011. The ratio of liquid assets was broadly stable, at 1.4. Some of the banks recorded a fall in the value of this indicator, mainly as a result of a steep increase in retail loans financed through a decrease in the volume of liquid assets. On the other hand, the value of this ratio rose slightly in numerous banks, mainly as a result of an increase in retail term deposits, and/or an increase in the share of funds from the interbank market with a longer maturity.



## 4. FINANCIAL POSITION OF THE SLOVAK BANKING SECTOR

### Net profit in the banking sector continued to grow in year-on-year terms

The continuing economic revival over the first quarter of 2011 stimulated a further increase in net profit. As at 31 March 2011, the banking sector recorded a net profit of EUR 175 million, representing a year-on-year increase of 50%. The net profit achieved even exceeded the pre-crisis level to some extent. A net loss was reported by one bank and six branches of foreign banks. Although most of the banks recorded an increase in profits, the overall increase was not evenly distributed over the banking sector. Large banks accounted for 94% of this increase.

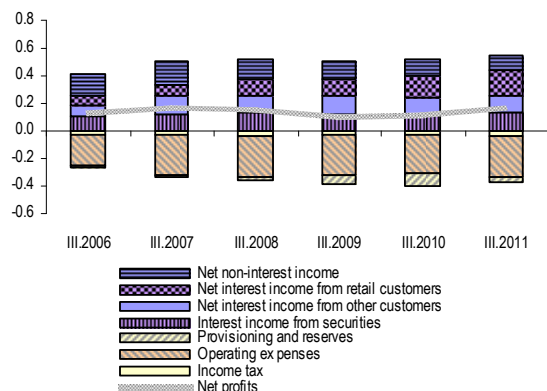
The sector's financial result (i.e. net profit less tax-adjusted losses from the revaluation of financial instruments in the available-for-sale portfolio) was somewhat lower than the profit reported (by 2.2%).

### The profit increase was caused mainly by a fall in provisioning costs, combined with an increase in interest income

The increase in the Slovak banking sector's profitability was supported by a pronounced fall in expenses on the creation of provisions for depreciated receivables from customers (by 52% year-on-year). Provisioning costs fell in the majority of banks. The sharpest year-on-year fall was recorded in expenses on the creation of provisions for retail loans.

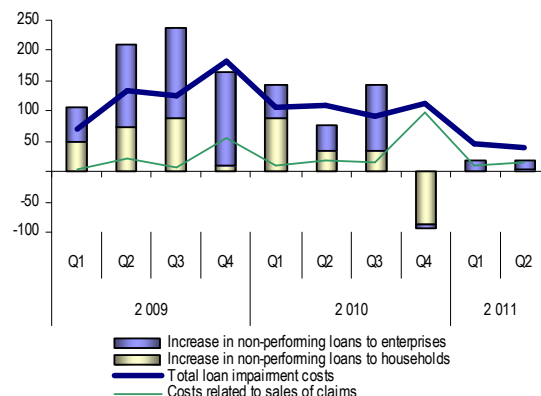
Apart from the credit risk reduction in the loan portfolio, the profit increase was also influenced positively by an increase in net interest income (by 8% year-on-year). The most significant increase was recorded in interest income from the debt securities portfolio (by 14% year-on-year). This increase was concentrated largely in two banks.

**Chart 35 Changes in the composition of the banking sector's profit**



Source: NBS.  
Data are in EUR billions.

**Chart 36 Amounts of non-performing loans and loan impairment costs**



Source: NBS.  
Data are in EUR millions.

### The growth in interest income from households slowed down

Although the banking sector recorded continued year-on-year growth in net interest income from the retail sector, this growth slowed down in comparison with 2010. The slowdown was caused by developments in the last quarter of 2010 and the first quarter of 2011, when the banking sector as a whole recorded an increase in the volume of deposits

(+6% year-on-year). The growing competition among banks in the loan market caused a year-on-year decline in return on retail loans (from 7.1% p.a. to 6.8% p.a.).

The continuing growth in net interest income from retail operations, however, was unevenly distributed over the banking sector. Strong growth was recorded in large banks, owing to an increase in the retail loans portfolio. However, numerous banks recorded a decline in year-on-year terms. These were mostly banks that recorded a marked increase in the volume of retail deposits, or a decrease in return on retail loans.

Net income from fees and commissions continued to grow (by 8% year-on-year), in most of the banks. The growth in this income was moderated by the negative impact of competition in the retail loan market on bank profits. Banks recording a marked increase in net income from fees and commissions also comprised banks that had reduced the margin for retail loans to a significant extent. On the other hand, the efforts of home savings banks to attract new savers caused a fall in net income from fees and commissions in these institutions.

After falling a year earlier, the level of operating costs (mainly the cost of purchased output) increased somewhat, by 4% year-on-year. Despite this, the indicator of operating efficiency, expressing the ratio of operating costs to gross income from banking activity, remained at a relatively low level (53%).

### **The capital adequacy ratio of the sector as a whole remained unchanged**

Over the first quarter of 2011, the capital adequacy ratio remained unchanged, at 12.6%. The ratio of Tier 1 capital to risk weighted assets stood at 11.5%; the lowest figure within the sector was 7.6%. This development was positively influenced by an increase in the volume of own funds from retained earnings from 2010. On the other hand, the capital adequacy ratio was influenced in the opposite direction by an increase in risk weighted assets. This was caused by an increase in the volume of loans.

In addition, downward pressure on the volume of own funds was exerted by the introduction of a new item that is deductible from capital. This represents a reduction in the amount of capital for a bank using a standardised approach but failing to create a sufficient amount of provisions for an expected loss. The adoption of this deductible item means a contribution of 0.2 percentage point to the capital reduction. In the coming period, a further reduction is expected in the volume of own funds in banks in which debt securities recorded in the available-for-sale portfolio of financial instruments are negatively revalued, because this value will be deducted from own funds with effect from 31 May 2011.

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