NÁRODNÁ BANKA SLOVENSKA
EUROSYSTÉM

MACRO-PRUDENTIAL ANALYSIS OF THE BANKING SECTOR

SEPTEMBER 2011

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THIRD 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.

List of charts:

1. ANALYSIS SUMMARY

Developments in the third quarter of 2011 induced no substantial changes in the behaviour of domestic banks. Lending to households slowed down somewhat. After recording a marked increase in the middle of 2011, housing loans grew in the third quarter at a slower pace. This was due to a number of factors, the most significant being seasonality, which traditionally causes a certain downturn in bank lending in this period. In the third quarter, bank customers started to perceive the rise in interest rates, which adversely affected the level of demand for loans.

Bank lending to enterprises continued to grow. This growth, however, was not evenly distributed; it was concentrated in selected sectors. Thus, lending to the corporate sector could be considered cautious, on the part of both banks and enterprises.

Compared with the first half of 2011, banks also recorded some changes in their profits. The sector's total profit increased in year-on-year terms, but the rate of increase slowed down. In the middle of 2011, banks recorded a year-on-year increase of almost 80% in their profits. This increase dropped to 50% in September. The slowdown was largely the result of slower growth in bank's interest income, which was determined by the rate of growth in the volume and cost of deposits, as well as by the continuing fierce competition between banks in the market for retail deposits and loans. Compared with the first half of 2011, loan impairment costs also increased in the banking sector. Numerous banks recorded lower revenues or losses from trading activities.

The trends in loan portfolio quality changed to some extent in the third quarter of 2011. While the increase in non-performing household and corporate loans followed a downward trend over the first half of the year, banks recorded a marked increase in credit risk costs in the third quarter.

As in most countries of the EU, the outlook for the further development of credit risk in banks is negative. Economic growth has been reassessed and revised downward in Slovakia, as well as in most of the major economies. The indicators of economic activity and sentiment provide a rather negative outlook for the future. Negative trends can also be expected in the area of employment.

A substantial factor will be the further course of the euro area debt crisis, which currently has a pronounced systemic character. The risk inherent in the debt securities of selected countries adversely affects several areas of the financial system, as well as the prospects for economic growth in the euro area and the world.

2. MACROECNOMIC DEVELOPMENTS AS THEY AFFECT BANKING SECTOR STABILITY

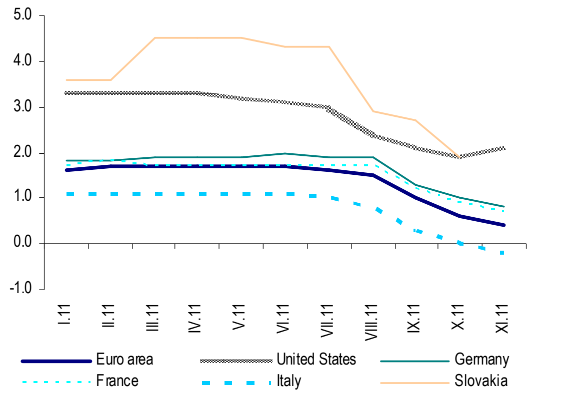
The economic outlook has deteriorated, mainly in advanced countries

The macroeconomic outlook for Europe and the United States, and indirectly for the rest of the world too, has been reassessed and revised downwards in recent months. GDP growth forecasts for the second half of 2011 and for 2012 have repeatedly been revised downwards on the basis of the latest information. The rationale behind this development is the euro area debt crisis, which has a destabilising effect on the financial markets. The macroeconomic situation is also affected adversely through various channels.

The euro area is on the verge of recession as a result of the escalating debt crisis

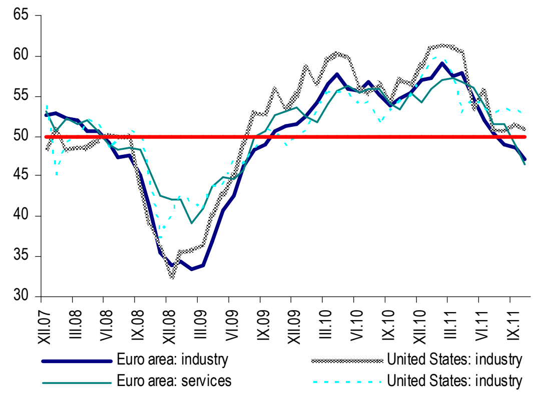
The most problematic situation in economic terms can be observed in the euro area, which is the epicentre of the sovereign debt crisis. According to preliminary GDP data for the third quarter of 2011, the euro area economy managed to increase its output by only 0.8% in annualised terms. The situation is expected to worsen still further by the end of the year. This is also indicated by the PMI (Purchasing Manager Index) for industry and services, which are the most commonly used and most reliable indicators of economic activity. Both indices have shown a falling tendency since May, but, more importantly, their values have been below 50, i.e. in the contraction territory, over the last three months (industry) / last two months (services). A piece of bad news for the euro area is that the PMI values are being pushed down not only by the peripheral countries but also by the more advanced member states. The German indicator for industry also dropped in October, below 50.

Chart 1 GDP growth forecasts for selected economies in 2012



Source: Consensus Forecasts; London, Consensus Economics.
The vertical scale shows consensus forecasts for GDP growth in percent (median of values given by forecasting institutions) made in the respective month.

Chart 2 PMI indices for industry and services in selected economies



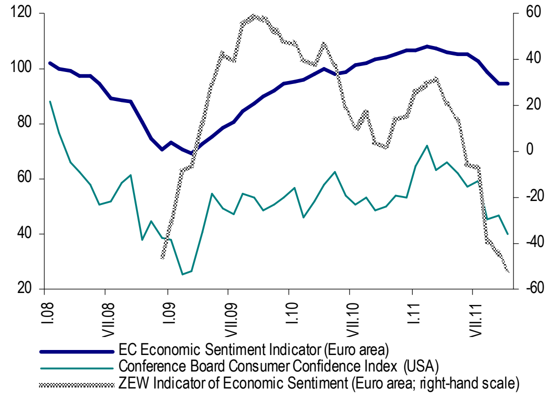
Source: Bloomberg.

A sign of the euro area's weak economic performance is its inability to reduce the level of unemployment in the region. The unemployment rate has been virtually unchanged (around 10%) since the end of 2009. According to the latest data for September 2011, however, unemployment has risen slightly to a new historical high (10.2%). Without Germany, which slows the decline in employment in many other countries, the unemployment rate would be even higher in the euro area.

The most significant output and demand-side factor affecting the euro area economy in recent months is the weakening confidence, caused primarily by the escalation of the debt crisis. The main indicators of consumer confidence and economic sentiment pointed to a sharp fall, mainly in August, which continued in September and October.

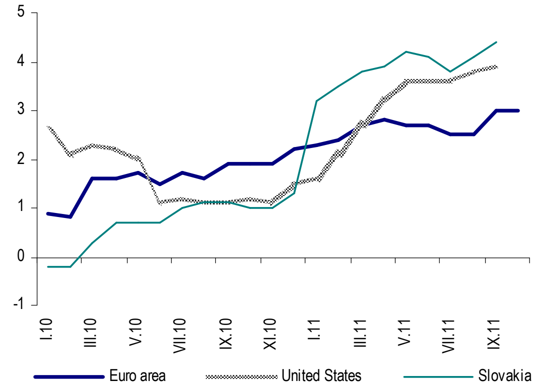
Despite the economic slowdown, the euro area's annual inflation rate unexpectedly rose by 0.5 percentage point, to 3.0% in September, and remained at this level in October, too. The ECB, however, assumes that the price increase will slow down in the coming year, owing to the weakened macroeconomic environment. For the same reason, the ECB lowered its key interest rate by 25 basis points, to 1.25% at the beginning of November.

Chart 3 Selected indicators of economic sentiment and consumer confidence



Source: Bloomberg.

Chart 4 Consumer-price inflation in selected economies



Source: Eurostat, Bureau of Labour Statistics.

The United States showed relatively good economic performance in the third quarter; the long-term outlook, however, remained uncertain

The US economy also showed weaker-than-expected performance in the period under review. A series of bad news about the state of the US economy culminating in July gave rise to further speculation about a second wave of recession in the United States. This, however, proved groundless at that time, which was confirmed by the data on GDP growth in the third quarter of 2011. The US economy improved in that period by 2.5% in annualised terms, which still represents slow recovery, but refutes the threat of negative performance.

A more detailed analysis of the structure of growth, however, indicates that the maintenance of recovery at such pace may be problematic in the long term. The main driver of economic growth in the third quarter was household consumption. The real disposable income of households decreased in the same period. The increase in consumption was financed exclusively from savings. Hence, the saving ratio dropped to a two-year low. The sustainability of consumption growth is also questionable in view of the fact that consumer confidence is currently at the level of 2008/2009, when the country was in recession. Besides this, the budgetary policy is also expected to have a negative impact in the medium term, compared with the neutral effect of government expenditure in the months of July to September, because, in all probability, the United States would also face fiscal consolidation in the near future.

A further slight rise in inflation, up to 3.9%, a new high in this economic cycle, was also recorded in the United States in August and September. The higher rate of price increase complicated the central bank's situation in deciding whether to ease its monetary policy stance. The Fed recognised that the slowdown in the US economy was of a long-term nature but excluded the possibility of announcing another round of quantitative easing as a year earlier. Instead of extending its balance sheet still further, the Fed currently attempts to stimulate the economy by lowering the longer-term interest rates by purchasing bonds with longer maturities, which are financed from the sale of securities at the shorter end of the yield curve.

China's real estate sector seems to have problems

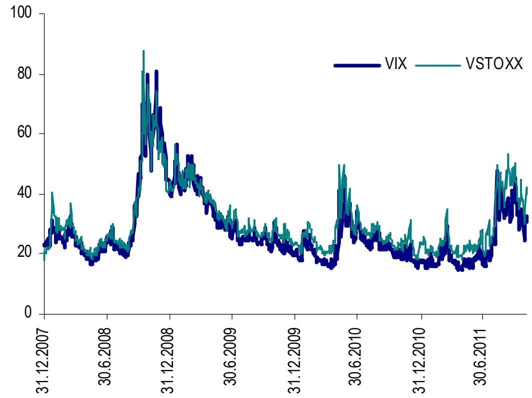
Besides Europe and the United States, global economic developments are beginning to be influenced substantially by the situation in China. Last year, monetary policy tightening in this country resulted in a slowdown in economic growth in the third quarter to 9.1%, a two-year low. This slowdown, however, can be viewed mostly as a welcome result of the effort to cool down the economy in a controlled way. The Chinese economy is not free of problems. A serious threat is the potential collapse of the real estate sector, which shows signs of a price bubble. Since investment in real estate construction projects represents a major contribution to total GDP growth, a sudden contraction in this sector would be a serious shock for the entire Chinese economy. In recent months, negative news have started to spread about problems with numerous property development projects, such as low saleability coupled with price falls in certain localities. As a result of monetary policy tightening, numerous investors (mostly the smaller ones) have problems with loan refinancing. If such debtors default on a large scale, the banking sector will suffer serious losses, which may lead to a sharp slowdown in the lending process. Owing to the economic model used in China, the limited availability of bank financing would deeply affect the country's economic growth.

Steep increase in financial market volatility in recent months

Since the middle of 2011, financial market developments have shown considerable turbulence, mainly in connection with the deepening debt crisis in the euro area. At the beginning of August, nervousness among the market players increased sharply. This was accompanied by a drop in equity prices (by more than 10%). Although the equity indices stopped falling in August and September, volatility remained high. Some of the indicators of nervousness in the financial markets continued to rise slowly, because investors' decisions were heavily influenced by uncertainty regarding the ability of euro area governments to prevent the problems of Greece spreading to Spain and Italy in particular.

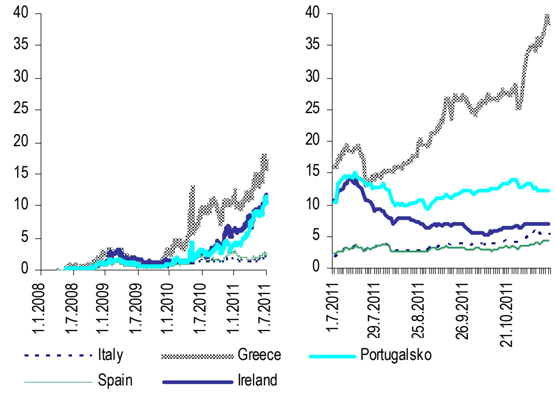
The situation calmed down somewhat in October. The global equity indices recorded monthly increases, close to the historical maximum. The improvement in sentiment among financial market participants resulted from the expectation that, under the pressure of circumstances, the responsible authorities in the euro area will find a comprehensive solution, which will represent a turning point in the euro area debt crisis. A key event was the summit of EU leaders at the end of October, where a definite agreement was reached on a rescue programme for the euro area. The programme contains three related measures: the application of a 50% haircut to Greek government bonds held by private investors, a capital increase in the banking sector by 30 June 2012, and an increase in the financial capacity of EFSF (temporary EMS) through leveraging. The announcement of the summit results was followed by a short period of euphoria, but then the negative sentiment returned to the financial markets owing to the disappointment of investors after the proposed measures had been fully evaluated. The situation was worsened by the expected political collapse in Greece, which could lead to uncontrolled defaults.

Chart 5 Volatility of equity indices



Source: Bloomberg.
The latest data are from 18 November 2011.

Chart 6 Spreads of high-risk 10-year government bonds



Source: Bloomberg.
The left-hand chart is for the period from 1 January 2008 to 1 July 2011; the right-hand chart shows the period from 1 July 2011 to 18 November 2011on a larger scale.

The risk inherent in euro area government bonds continued to increase

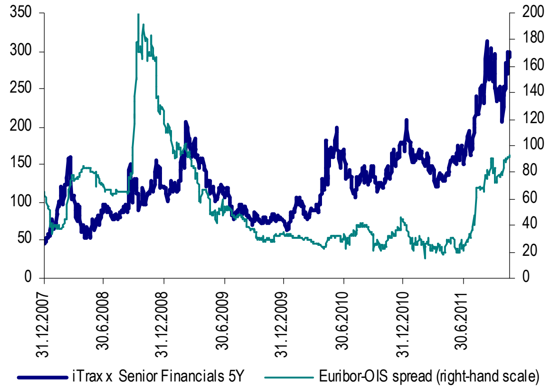
Owing to the nature of the euro area crisis, most seriously affected by the market turbulence are government bond issued in euro area countries with unsound public finances, prospects for slow growth, lagging behind in the area of structural reforms, or in countries where all the former risk factors are present. Yields to maturity on these government bonds reached new long-term highs at the beginning of August and subsequently remained at elevated levels. This trend was also followed by spreads on CDS contracts for these bonds. The situation could be maintained within acceptable limits only with the ECB intervening in the secondary market, mainly in favour of Italian and Spanish government bonds. At the beginning of November, the increased ECB purchases were not sufficient to prevent the yield to maturity on Italian government bonds from exceeding the August high, i.e. 6.5%, which represents the level at which Greece, Ireland, and Portugal requested financial assistance. By the middle of November, confidence among investors waned to such an extent that the sale-out of certain government bonds affected even euro area countries with the highest rating, with the only exception being Germany.

The debt crisis is seriously threatening banking sector stability in the euro area

The falling value of government bonds negatively affected the situation in the euro area's banking sector. Risk aversion in the interbank market increased, seriously disturbing the redistribution of liquidity within the system. This was confirmed by the Euribor-OIS spread reaching a more than two-year high. This indicator is currently at 50% of the level seen after the collapse of Lehman Brothers. Another sign of worsened interbank market functioning is the increased volume of funds deposited in overnight accounts with the central bank. Without the ECB's special support measures, numerous banks would have serious problems with the acquisition of funds. These measures have recently been enhanced through the reintroduction of unlimited tenders for 6 and 12-month liquidity. In addition, the ECB has made an agreement with the Fed and thus ensured a source for supporting the banking sector in the area of dollar liquidity, the availability of which has also deteriorated substantially.

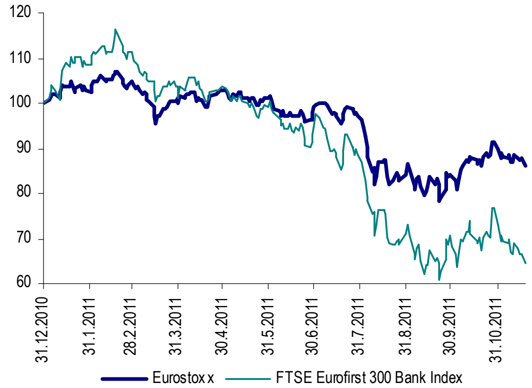
In addition to liquidity problems, however, the euro area banking system is also exposed to problems in the area of bank solvency. The justification of these fears has recently been confirmed by events leading to nationalisation of the Belgian Dexia Group. The serious problems in the euro area banking sector are also signalled by other market indicators. Equity prices fell more significantly than the composite indices and the iTraxx Senior Financials index reached a historical high in September. Even after a downward correction, the index still signals a high degree of risk.

Chart 7 Indicators of stress in the EU banking sector



Source: Bloomberg.
The latest data are from 18 November 2011.

Chart 8 Share prices of EU banks compared with the overall index



Source: Bloomberg.
31 December 2010 = 100
The latest data are from 18 November 2011.

Credit markets were practically closed in the summer months

The tension in the financial system was also reflected in the credit markets. The issuance of corporate bonds (including bank bonds) was almost entirely suspended during the summer months, mainly in the euro area. Starting from September, the situation showed some signs of improvement, as several issues were launched successfully. In September, CDS spreads for Europe's main corporate index (iTraxx Europe) approached the historical peak that was recorded after the collapse of Lehman Brothers, but this indicator currently shows a slightly falling tendency.

Capital flows in the world are concentrated in a narrow spectrum of low-risk assets

Capital flows in recent months have been absorbed in large part by the government bonds of selected low-risk countries (United States, Germany, Switzerland, Japan). Demand for high-risk assets is low. There is a massive outflow of funds from developing countries, which enjoyed large capital inflows last year. The currencies of these countries are weakening. The re-routed financial flows in the global economy and the expected slowdown in economic growth are also reflected in the falling level of commodity prices.

Box 1 Sovereign risk in the euro area

Sovereign risk, i.e. the risk of depreciation of sovereign debt securities currently represents the highest risk for financial stability in the euro area. Sovereign risk is posed mainly by countries in relation to which doubts have arisen over the sustainability of fiscal policy and macroeconomic developments, combined with a risk of loss in the banking sector. This risk has significantly increased over the last few months, mainly for two reasons.

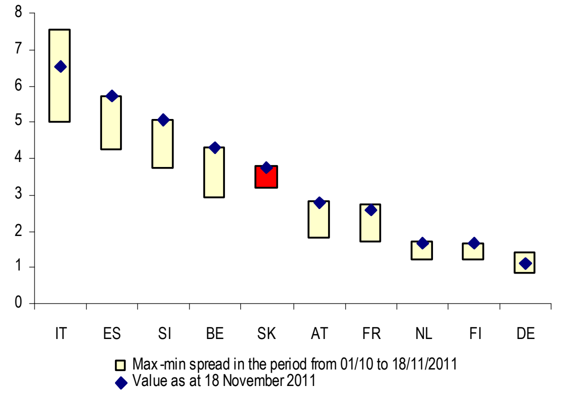
The first is that the rising uncertainty in the markets and the related risk aversion among investors have deepened the negative impact of sovereign debt on economic developments and the situation in the banking sector. Banks having large exposures to risky countries face severely restricted access to funding markets. This increases the downwards pressure on their profits, causing distrust in the banking sector, which further deepens the sovereign risk of these countries. Negative news about macroeconomic developments also tend to increase the doubts about the sustainability of the current level of indebtedness in numerous euro area countries, including some of the large economies. One of the main factors is the risk of political instability, while the subject of concern in such cases is the achievability of the announced fiscal objectives.

The second reason behind the increased risk is the closer interconnection between fiscal developments in the individual countries, perceived by the market players. This further strengthens the systemic element in the impact of the euro area debt crisis. Such development may increase the cost of refinancing in some of the big euro area countries through an increase in credit spreads. This, however, will need a further increase in contributions to EFSF, which may raise further doubts about the feasibility of plans in the area of fiscal consolidation.

On account of sovereign risk concerns, numerous euro area countries have been downgraded in the past few months. Consequently, banking institutions have also been downgraded in these countries. At the same time, risk surcharges have increased in numerous countries, including those not classified as risky in the first half of the year. Credit surcharges have also increased for bonds issued in EFSF. Credit spreads have soared for Greek bonds, and those for Portuguese bonds have increased too. After being classified as risky in the first half-year period, Irish bonds have followed a positive trend, though they are still regarded as one of the most risky government bonds in the euro area. As we have already mentioned, the systemic risk has spread to a number of other euro area countries, which can be classified, on the basis of developments until the beginning of November, into several groups. The first group comprises Italy, Spain and Slovenia, i.e. countries that recorded a marked increase in spreads during the summer months. The most serious concerns are raised about Italy, because the potential of other countries to participate in the rescue of the Italian economy is regarded as insufficient. The second group consists of Belgium and Slovenia, which recorded larger credit spreads that increased still further, mainly over the past week. The third group is formed by France and Austria. Although these countries still have the highest rating from the leading rating agencies, their credit spreads have increased since July (compared with Germany), with the rate of increase accelerating to a significant extent last week. The other highest-rated euro area countries (Finland, Netherlands, Germany) recorded stable spreads until the beginning of November. Credit spreads in Finland and the Netherlands have slightly increased last week, compared with those in Germany.

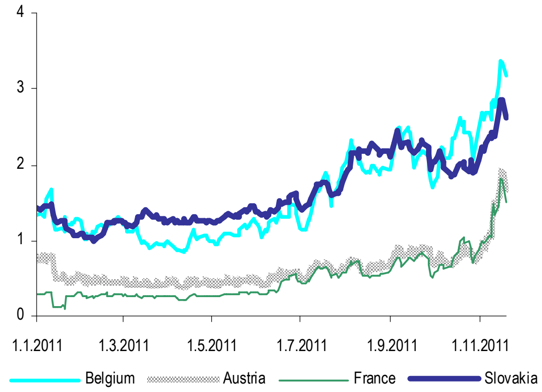
This development indicates that the debt crisis may have a profound systemic impact on most of the euro area countries, including Slovakia. This risk may cause losses for banks and a negative trend in the economy as a whole. The current political situation in Slovakia, which may adversely affect the achievement of fiscal consolidation objectives, is likely to increase this impact still further.

Chart 9 Comparison of 5-year government bond yields in selected euro area countries



Source: Bloomberg.
The vertical axis shows data in percent.

Chart 10 Comparison of 5-year credit spreads in selected euro area countries and Germany



Source: Bloomberg.
The vertical axis shows data in percent.

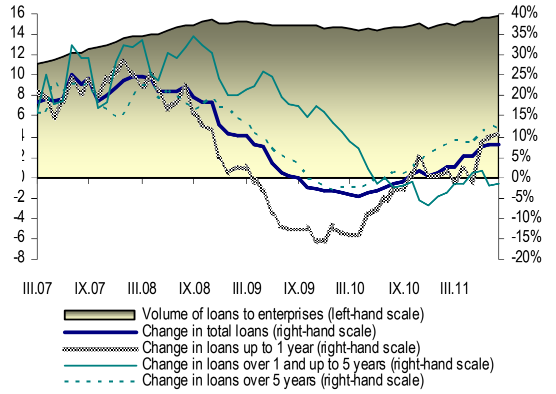
3. TRENDS AND RISKS IN THE SLOVAK BANKING SECTOR

The increase in bank lending continued to be concentrated in selected sectors

The situation in the 'corporate loans' segment in the third quarter was, in many respects, similar to that in the first half of 2011. The total outstanding amount of loans to enterprises continued to grow relatively dynamically. The year-on-year rate of growth, however, ceased to accelerate (owing to a base effect) and stabilised at the level of 8%. This value also supports Slovakia's prominent position within the euro area.

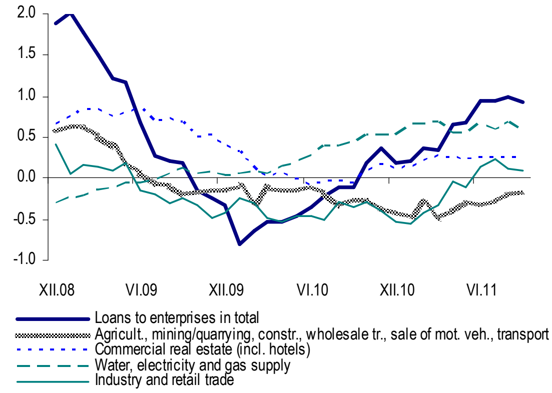
The volume of loans provided over the period under review increased in most of the banks. In some of the banks, however, lending to the corporate sector declined considerably in year-on-year terms, by more than 15%. The total outstanding amount of loans in the banking sector showed more heterogeneous dynamics than in the previous period.

Chart 11 Volume of loans to enterprises



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

Chart 12 Annual volume changes in corporate loans by sector



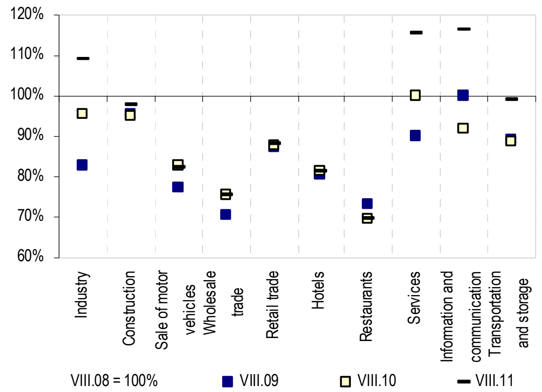
Source: NBS.
Data are in EUR billions.

A more detailed analysis of the sectoral structure of corporate loans, however, reveals that excessive optimism about bank lending growth, which may be evoked by the aggregate data, is hardly justified. A large part of the increase in the outstanding amount of loans was concentrated in two sectors, i.e. the power industry and real estate sectors, which are very specific in character. Some signs of recovery in bank lending have been observed in trade in recent months. The banking sector's exposure to other 'classic' sectors such as industry, construction, or transport and storage, however, stagnated or decreased slightly in the third quarter of 2011. In year-on-year terms, each of these three sectors recorded a decrease in the volume of loans received (as at end-September 2011).

Activity in numerous sectors is still below the pre-crisis levels

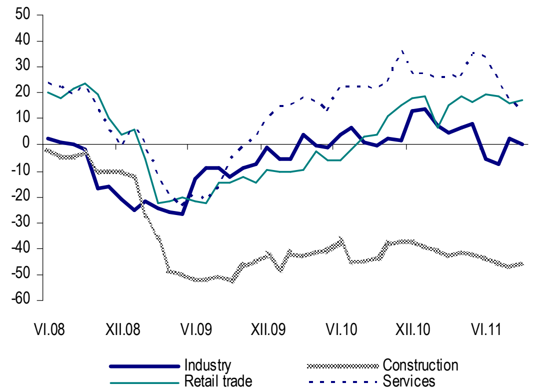
The relatively weak lending activity, except in certain sectors, can be attributed to demand and supply-side factors. Although banks have recorded growing demand from enterprises in recent months, the number of loan applications has increased only to a limited extent. Macroeconomic developments in Slovakia have been relatively favourable to date in 2011, but this is not a sufficient basis for enterprises to be willing to get into debt. The current growth in the corporate sector has not yet offset the decline from 2008/2009 in full. Activity in the majority of corporate sectors, measured in terms of revenues, is below or at the level of 2008. Over the course of 2011, revenues in industry exceeded the pre-crisis maximum; this, however, does not yet apply to the utilisation of production capacities in the sector. In addition, this indicator has again followed a declining trend over the last few quarters, so Slovakia has fallen well below the EU average. Such circumstances do not create good conditions for a marked increase in demand for investment activity or operation financing in the corporate sector, i.e. for the recovery of bank lending across the entire segment.

Chart 13 Corporate revenues by sector



Source: Statistical Office of the Slovak Republic.

Chart 14 Economic sentiment indicators for selected sectors



Source: Statistical Office of the Slovak Republic.

Sentiment in the Slovak corporate sector is negatively affected by the financial turbulence in the euro area

Besides objective variables such as output or revenues, enterprises considering the possibility of requesting bank financing are influenced by their subjective perceptions of the economic situation and the outlook for the future. Such decisions are made at three levels – at sectoral level, at the level of Slovak economy, and at all-European level. A key negative factor in this process is the euro area debt crisis, which represents a source of major risks and uncertainty. Owing to the ongoing crisis in the euro area, the economic sentiment index for Slovakia recorded a relatively sharp fall in the third quarter. The subindices for construction, retail trade, and services decreased, too. The subindex of sentiment in industry was the only index to rise somewhat, above its two-year low, but its cumulative change for the entire year was definitely negative. The medium-term trend in the Slovak economy, i.e. the situation in most of the domestic enterprises, will depend to a significant extent on the economic health of Slovakia's most important trading partners (through exports). The business confidence index, compiled from the indices of individual countries weighted according to their importance for Slovak exports, showing a falling tendency since the second quarter, is one of the early indicators of potential complications in the Slovak corporate sector in the future.

The relatively tight credit standards also had a dampening effect on lending activity in the corporate segment

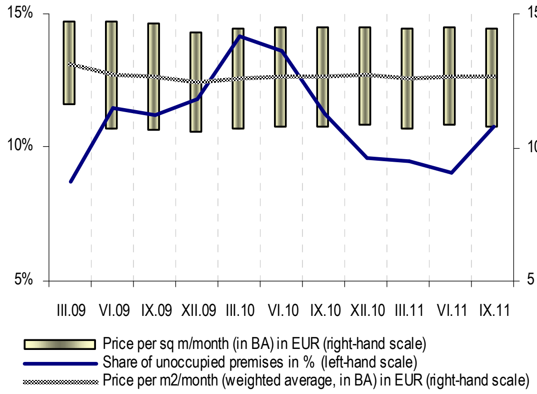
Factors restricting bank lending to enterprises on a larger scale were also present on the supply side. Credit standards for such loans were tightened only slightly in the third quarter (during the previous part of the year, they were kept virtually unchanged), but the standards can be classified as conservative enough owing to their cumulative tightening in the past. Banks are still very cautious when approving new loans and/or specific conditions, and the parameters of loans are relatively strict.

The real estate sector is virtually at a standstill

The real estate sector requires special attention, owing to the volume and concentration of banks' exposures to this sector. In the 'office buildings' segment, several new projects were completed in Bratislava in the third quarter of 2011, so the offer of office space was increased. Demand for modern office premises remained virtually unchanged in comparison with the first half of the year. After falling for a long time, the occupancy rate increased in the months of July to September, by 1.7 percentage points to 10.8%. Regarding the relatively low level of supply in the market, unoccupied premises are expected to be gradually used in the future. The average rent for new office space has been constant since the end of 2009.

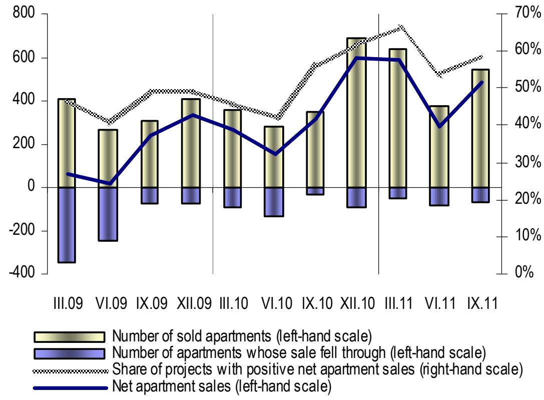
Residential property prices continued to decline gradually. The saleability of apartments in residential projects showed a relatively positive tendency. The share of projects with positive net apartment sales increased in year-on-year terms.

Chart 15 Real estate market – office segment



Source: CB Richard Ellis.

Chart 16 Real estate market – residential segment

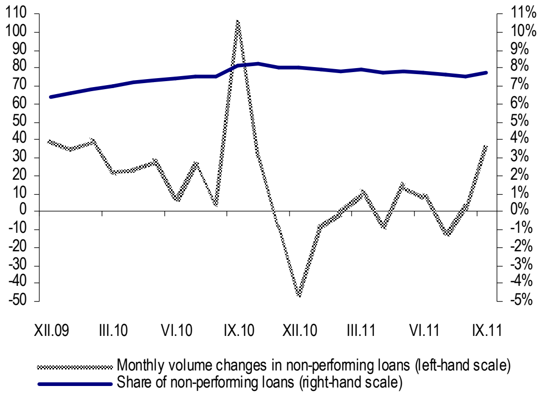


Source: Lexxus.

The increase in the volume of non-performing corporate loans was concentrated in a small number of banks

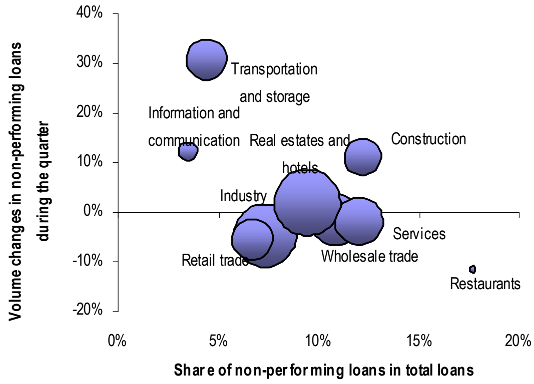
The corporate loan portfolio deteriorated somewhat in quality in the third quarter. The share of non-performing loans in this sector increased to 7.8%, after a large volume of loans defaulted in September. Thus, the decreasing trend in the default rate, continuing since the end of 2010, came to a halt. In fact, three banks were responsible for the entire increase in the volume of non-performing loans in the period under review. In other banks, loan portfolio quality measured as the share of non-performing loans remained unchanged or improved somewhat. Broken down by sector, new loan defaults were concentrated in construction, transport and storage, and in the real estate sector.

Chart 17 Loan portfolio quality in the corporate segment



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

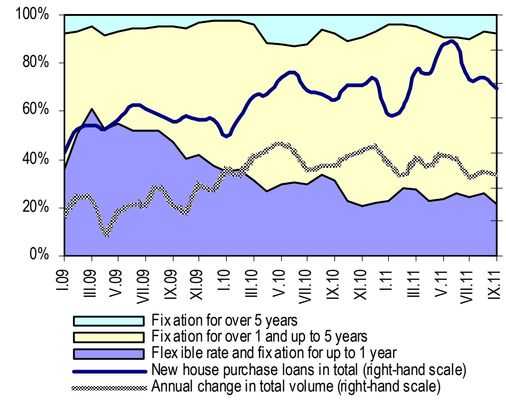
Chart 18 Non-performing corporate loans in selected sectors



Source: NBS.
The size of the bubble illustrates the share of the given sector in the total volume of loans to enterprises.

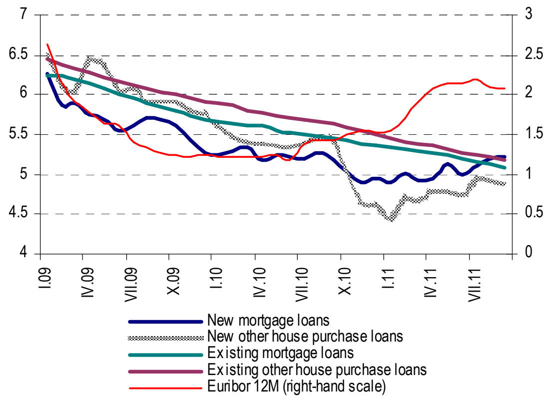
Demand for new loans for house purchases declined

Chart 19 Breakdown of new house purchase loans by fixation and their total volume



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

Chart 20 Interest rates on new and existing house purchase loans



Source: NBS.
Data in the chart are in percent.

The volume of new loans for house purchases continued to grow in the third quarter of 2011, but the year-on-year changes in volume decreased in comparison with the previous years. This was due partly to a massive year-on-year increase in housing loans in the third quarter of 2011, as a result of subdued lending during in the crisis year of 2009. Irrespective of this effect, the rate of lending slowed in the third quarter of 2011. This was attributable to a number of factors. The key factor was a decline in customer demand for new loans The significant increase in new loans recorded by banks since the second half of 2010 was mainly the result of demand for refinancing loans for existing loans, because the average interest on new loans in the last two years was much lower than the average rate for existing loans. But this difference has been largely offset by a rise in interest rates on new house purchase loans in the last two quarters. If this trend continues, loan refinancing will be less intense and demand is likely to fall still further.

In recent months, demand has also been influenced by the population's worsening expectations regarding the overall economic situation. The slower growth in new loans over the third quarter of 2011 was probably also influenced by the high concentration of demand in the second quarter of 2011, which led to the exhaustion of the demand side.

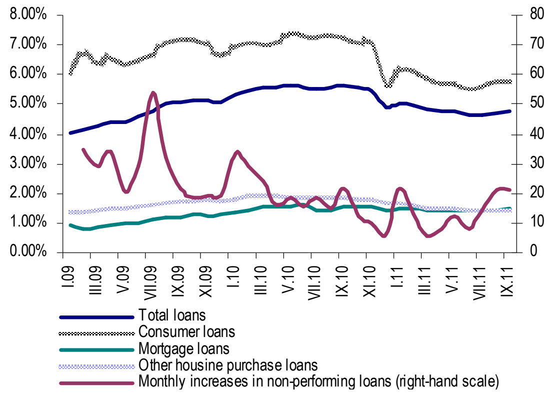
Deterioration in the quality of household loans

After following a falling trend virtually throughout the first half of 2011, the volume of non-performing loans showed a growing tendency in the third quarter of 2011. Most defaults were recorded in consumer loans. Mortgage loans and other house purchase loans also defaulted to a greater extent than in the first half of 2011.

Banks' expectations regarding credit risk in the household sector are negative, not only in Slovakia but also in the neighbouring countries. The increase in credit risk is due to several factors, mainly the rising interest rates and the expected economic downturn. After rising steeply in the previous period, the index of expected employment in industry dropped sharply in the third quarter. The situation in the area of real wages is not favourable either. Owing to a rise in inflation (+4.4% in September 2011), real wages decreased by an average of 3.22% year-on-year over the first half of 2011.

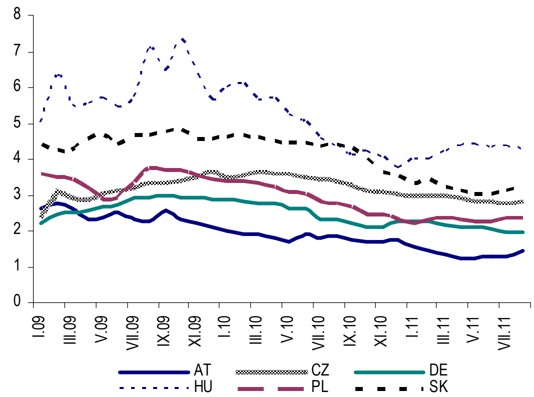
In numerous countries, the increased risk is already reflected in the spreads of interest rates on loans secured with real properties, which ceased to decrease or started to increase.

Chart 21 Increases in non-performing loans and the share of such loans in total loans by type of loan



Source: NBS.
Note: For each loan type in each bank, we determined the increase as the difference between the maximum month-on-month change and zero, then we calculated the aggregate value for the sector as a whole.

Chart 22 Comparison of interest rate spreads on loans secured with real property in Slovakia and the neighbouring countries



Source: ECB.
Spread is the difference between the rate of interest on new loans and the interbank market rate (for domestic currency).

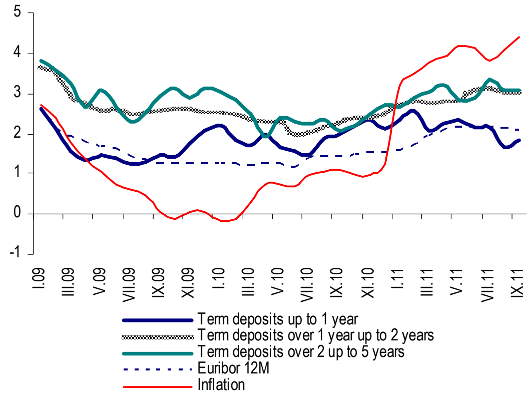
The withdrawal of retail funds from collective investment funds caused increased competition in the term deposit market

The volume of retail deposits continued to grow in the third quarter of 2011. The growth was largely driven by term deposits, the total volume of which started to increase in January 2011 (after decreasing in 2009 and 2010). The volume of non-term deposits remained flat in the period under review.

Banks continued to make efforts to attract more and more funds from shorter-term deposit accounts to accounts with a maturity of over 1 year. Thus, the fierce competition among banks for longer-term deposits, which started in the middle of 2010, continued in the period under review, with bank competing by offering attractive interest rates. Small and medium-sized banks were the most active in this area. These efforts intensified in the second and third quarters of 2011, when a large number of retail clients withdrew their money from collective investment funds, which thus suffered a loss of almost €300 million in assets.

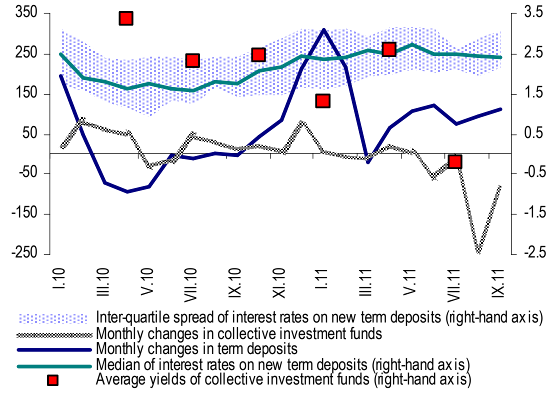
Despite the competition in the retail deposit market, funds held on term deposit accounts depreciated as a consequence of inflation. The average interest rate on deposits with a maturity of over 1 year was 1 percentage point below the level of inflation.

Chart 23 Average interest rates on term deposits by maturity



Source: NBS.
The left-hand axis shows data in percent.

Chart 24 Shifting of retail funds out of collective investment funds into term deposits



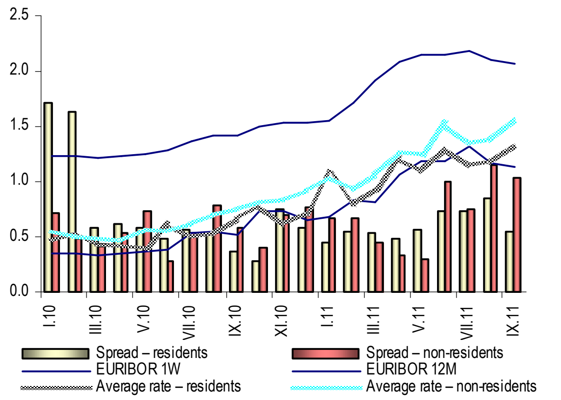
Source: NBS.
The left-hand axis shows data in EUR millions.
The right-hand axis shows data in percent.

The interbank market experienced a virtual standstill in the third quarter of 2011

The third quarter saw a relatively volatile trend in operations with foreign banks, which represent the largest item in the interbank market. In most of the cases, however, this was a compensation for movements in other more volatile items on the liability side, or the movements were accompanied exclusively by interbank market investments.

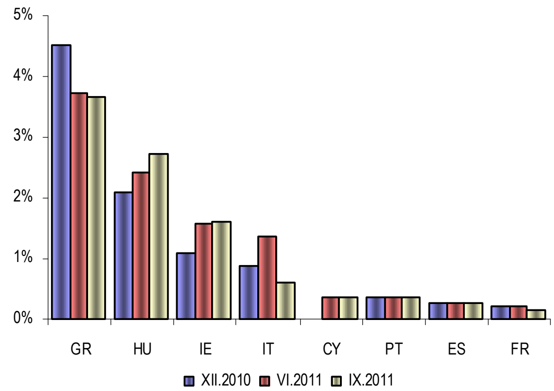
In the third quarter of 2011, mainly at the end of October, a modest increase was recorded in the volume of refinancing operations with the ECB. Domestic interbank market rates continued to rise in the third quarter, in response to the rising EURIBOR rates. Although the differences between the highest and lowest rates increased somewhat in the period under review (mainly in August), they were influenced by a fall in the minimum value of the average rate, rather than by a rise in its maximum value.

Chart 25 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.
Data on interest rates 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.

Chart 26 Share of bonds from selected countries in the total nominal amount of purchased bonds



Source: NBS.

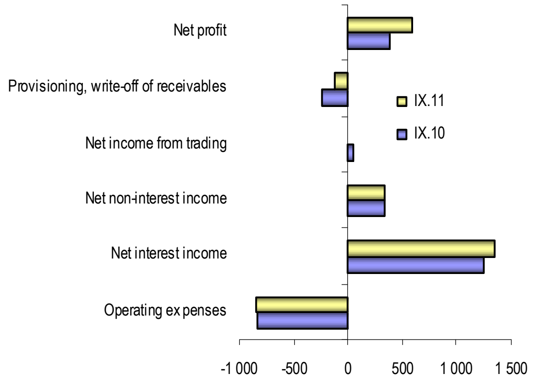
Investments in securities remained virtually unchanged in the third quarter

In the months of July to September, the volume of Slovak government bonds in the portfolios of domestic banks increased somewhat. Investment in foreign government bonds stagnated. The share of bonds issued by the governments or financial institutions of Hungary and Ireland increased slightly (government bonds accounted for almost 100% of this increase). By contrast, the share of Greek and Italian government bonds decreased.

4. FINANCIAL POSITION OF THE BANKING SECTOR

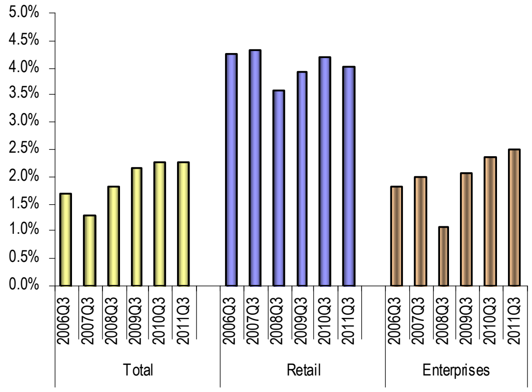
The year-on-year increase in profits slowed down

Chart 27 Selected components of profits in the banking sector



Source: NBS.
Data are in EUR millions.

Chart 28 Interest rate spreads in banks by sector

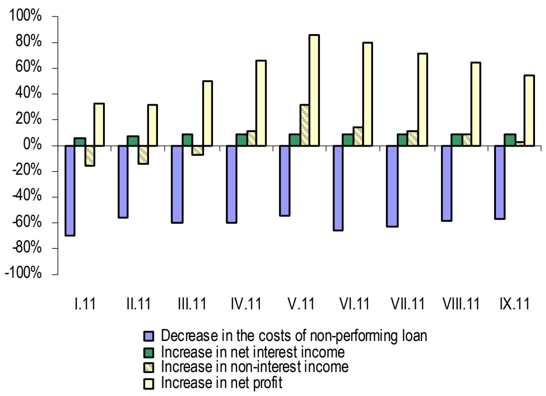


Source: NBS.
The data express the net interest rate spreads of banks in selected sectors, always in September of the respective year.

The net profit of the banking sector followed a relatively favourable trend over the third quarter of 2011, and reached €591 million. This represented a year-on-year increase of approximately 54%. A net loss was reported by one bank and seven branches of foreign banks.

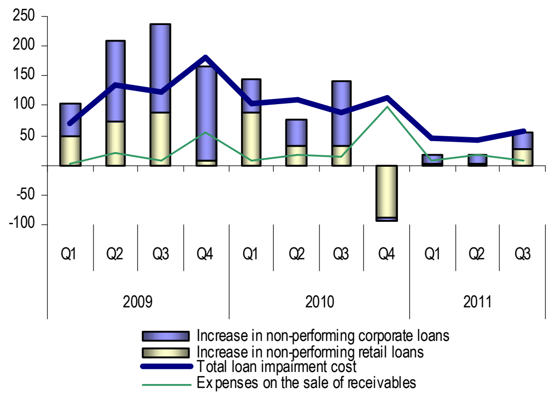
Compared with the first half of 2011, however, the year-on-year rate of profit growth slowed down quite markedly, from almost 80% in June 2011. Slower growth or decline in profits in year-on-year terms was recorded in numerous banks.

Chart 29 Year-on-year changes in banking sector profits in individual months



Source: NBS.
The data express year-on-year changes in selected items affecting profitability in the individual months of 2011.

Chart 30 Amounts of non-performing loans and loan impairment costs



Source: NBS.
Data are in EUR millions.

The slowdown was reflected in various components of profitability. Bank recorded slower growth in their net interest income. This was mainly the result of continuing growth in the volume of deposits and the related increase in interest costs. The slower growth in interest income was also influenced by competition in the market for housing loans to households.

The rate of growth slowed most significantly in income from trading. Banks recorded negative developments in connection with the revaluation of debt securities, as a result of a deterioration in the government bond market. Some of the banks also recorded losses from interest rate and credit derivatives.

Loan-loss provisioning costs increased

The marked increase in profits can be attributed mainly to the low level of loan-loss provisioning costs, which have increased only minimally this year. These costs dropped sharply in the last quarter of 2010, then remained at low levels during 2011, too. In the third quarter, the banking sector recorded certain acceleration in the rate of growth in loan-loss provisioning costs. This trend was perceived by numerous banks. However, it probably resulted from the creation of additional provisions for loans defaulted in the past, or from the creation of provisions for loans the quality of which worsened but were not yet regarded as defaulted. In most banks, the net creation of provisions in July and August exceeded the increase in the volume of non-performing loans.

The sector's capital adequacy ratio increased

The average value of the sector's overall capital adequacy ratio (weighted by the amount of risk-weighted assets) increased slightly in the third quarter, from 12.7% to 12.9%. At the same time, the quality of banks' own funds improved somewhat. The share of core capital (Tier I) in the total volume of own funds increased slightly, from 91.1% to 92.6%. Thus, the average core capital adequacy ratio (Tier I ratio) rose from 11.6% to 11.9%. This rise was supported by an increase in own funds, mainly in Tier I capital, which grew by 3%. The quality of overall capital also improved, because some of the banks increased the share of Tier I capital (mainly share capital and capital in excess of par value), while reducing the share of other lower-quality components.

The volume of risk-weighted assets remained virtually unchanged in the sector as a whole. The regulatory requirements concerning the amount and quality of own funds were met by all banks, with a sufficient margin. The capital adequacy ratio exceeded 10% in all banks (the minimum required ratio is 8%). The Tier I ratio, expressing the share of core capital in risk-weighted assets, reached 7.9% (minimum), exceeding the valid regulatory requirement (4%), as well as the limit value set for the EU-wide stress testing of banks (5%).

The requirement to increase banks' capital positions is not expected to have a serious impact on the availability of loans

One of the requirements approved at the EU summit and presented on 26 October 2011 was to strengthen the capital positions of banks by requiring them to maintain a core (Tier I) capital adequacy ratio of 9% (calculated with regard to losses from exposures to risky countries), with effect from 30 June 2012. The Financial Market Supervision Unit of NBS is taking steps to ensure that this requirement is met by that date in all banks.

Although in the context of the EU banking sector there are concerns that the recapitalisation requirement may restrict banks in their ability to provide loans, these concerns are not warranted for the majority of Slovak banks, which have an adequate capital cushion for meeting the current regulatory requirements.

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