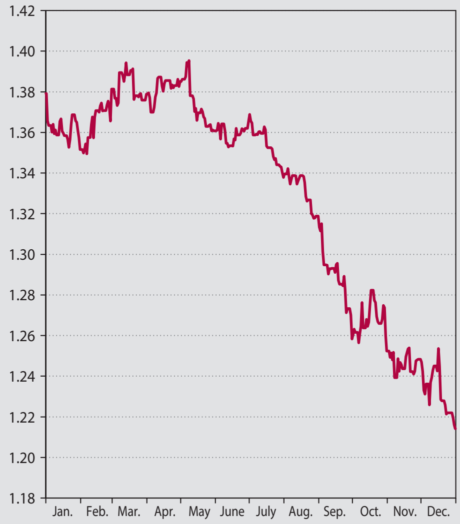
Chart 14 USD/EUR exchange rate in 2014



Source: Bloomberg.

tightening by the Federal Reserve. By the end of 2014 the euro was trading at USD 1.2141, its lowest level for 2.5 years and 12% weaker year-on-year.

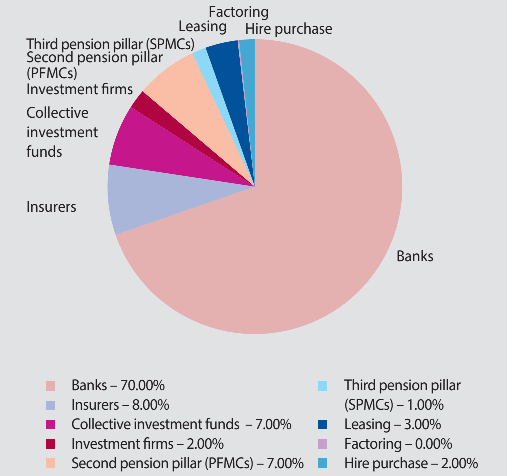
3 Financial market developments

Developments in the external environment are important to the stability of the financial sector in Slovakia. Although the euro area economy improved moderately during 2014, it did so with limited impact on financial stability risks. The labour market situation picked up only slightly, while the euro area's disinflationary trend continued throughout the year. In response, the ECB has decided to embark on an asset purchase programme (also known as quantitative easing), which in conjunction with low oil prices and depreciation of the euro exchange rate is expected to benefit the economy going forward. The environment of weak economic growth and subdued inflation remains a significant risk, one that complicates the position of highly indebted countries. A second sizeable risk is the persisting search for yield, especially with regard to how increases in risk premia would affect the global financial system. These could be triggered by political developments in particular euro area countries, mounting geopolitical tensions, or movements in key US interest rates. On the positive side, Slovakia's economic growth was stable and relatively strong in 2014; nevertheless, a continuation of this trend will be contingent on stability in the euro area.

The potential for such adverse external risks to impair the stability of the Slovak financial sector remains mitigated by the strong position of its main pillar – the banking sector. In terms of solvency, profitability and access to funding, the banking sector in Slovakia is reporting better results than are its counterparts in most other EU countries. The sector's aggregate profit for 2014 was moderately higher year-on-year, at €560 million. Although a sharp drop in interest rates, mainly on loans to households, had a negative impact on profits, this was offset by lending growth and falling deposit costs. The aggregate capital ratio increased only slightly from the previous year, to 17.3%. It should be noted, however, that this stabilisation followed several years in which the capital ratio rose substantially.

The lending activity of domestic banks in 2014 remained marked by heterogeneity between the household and corporate sectors. Lending to the corporate sector recovered slightly after a long downward period, particularly in the second half

Chart 15 Financial sector assets broken down by market segments as at 31 December 2014



Source: NBS.

of the year. The outstanding amount of loans to this sector was significantly affected by both an increase in loans to state-owned firms and by, more importantly, the improving situation in lending to private firms. This reflected rising demand for loans rather than supply-side conditions, which stayed largely the same amid a still uncertain economic climate.

The amount of loans to households maintained robust year-on-year growth with an increase of 12%. The drivers of that growth were housing loans and consumer loans, which increased on yearly basis by 13% and 20%, respectively. Slovakia reports one of the higher rates of household lending growth in the European Union, due largely to falling interest rates and the consequent high rate of refinancing. Refinancing loans made up 40% of the total amount of new loans provided in 2014. This trend in lending growth is also important in terms of its upward impact on household indebtedness.

Looking at banking sector's debt securities portfolio, the principal trends continued in 2014 with decreasing investment in domestic and foreign government bonds. By contrast, the total investments in bonds issued by domestic banks and non-financial corporations increased. As regards debt securities issued by domestic banks, mortgage bonds accounted for more than 70% of the total.

The most significant risk to the banking sector remains that of a deterioration in loan portfolio quality arising from adverse developments in the domestic and external economy. The non-performing loan (NPL) ratio for total corporate loans stayed slightly above 8% for most of 2014, only edging up to 8.6% towards the end of the year. The NPL ratio for household loans fluctuated during 2014, and in December it stood at 4.3%.

Total profits in the insurance sector grew by 13.3% year-on-year, to reach their second highest level on record. Premiums in life insurance declined moderately, due largely to their fall in traditional life insurance policies. In supplementary insurance and unit-linked insurance, premiums continued to increase. Premiums in non-life insurance rose after two years in decline. The greatest risk to the insurance sector continues to be the environment of low interest rates, notwithstanding a reduction in the technical interest rate, which in any case affected only new contracts. In this context, reinvestment risk also remains present, with around one-third of the bond portfolio due to mature before 2020. Credit risk is largely unchanged.

In the second pension pillar, 2014 was the last year in which there was an accumulation stage without any distribution, and therefore results were stable. The increase in the total number of savers was attributable entirely to the increase in savers in pension funds focused on higher-risk investments (in equity and index funds). In the sector as a whole, the pace of asset accumulation accelerated. Equity and mixed pension funds saw an increase in their equity market exposures. The average nominal return on pension funds was among the highest in the history of the old-age pension saving scheme, and the real return showed an even stronger performance.

In the third pension pillar – the supplementary pension scheme – the number of participants and amount of assets under management increased more sharply in 2014 than in 2013. The aggregate asset composition of third-pillar funds did not alter significantly. In several third-pillar funds, the proportion of assets denominated in a foreign currency increased to a significant level. The average annual return of third-pillar funds more than doubled in 2014, from the rate in previous year, to 3.6%. The total profits of supplementary pension fund management companies fell by around one-third owing to reductions in pension fund management fees.

The collective investment sector reported an increase in assets under management for a third successive year. The majority of the growth in 2014 was accounted for by local investment funds. Mixed funds recorded the largest net inflows, closely followed by bond funds. The percentage increase in the net asset value of alternative investment funds was the highest in the sector. Real estate funds experienced moderate net redemptions after a lengthy period of net sales. As in the previous year most of the inflows into investment funds came from households. In all fund categories except for equity funds, returns were higher in 2014 than in 2013. With an increasing amount of assets under management, the aggregate profits of asset management companies in the sector soared by 145%.