NÁRODNÁ BANKA SLOVENSKA

Analysis of the Slovak Banking Sector 2004

Prepared from preliminary data as at 31.12.2004

Economic environment of the banking sector

The economic environment influenced the Slovak banking sector in 2004 favourably. This applies both to external factors, such as growth in the global economy and continuing positive development in banking groups across the EU, and to domestic factors, in particular the Slovak Republic's macro-economic development.

The effect of Slovakia's accession to the EU was not greatly apparent in Slovak banks' business. The fears of some banks as regards greater competitive pressure were not confirmed. From the aspect of regulation banks are at various stages of preparation for implementing the New Basle Capital Accord.

Macro-economic environment in the SR

The recovery in the global economy in 2004 was seen also in increased growth in the Slovak economy. The level of real GDP growth in 2004 ranged above the five per cent limit, reaching 5.5% for the year as a whole. This growth was supported in particular by the continuing growth in household consumption and increased capital formation.

Both short-term and long-term interest rates continued to fall over the year. The development indicates a continuing convergence of interest rates to the EU level.

The improvement in macro-economic indicators supported the increased interest in the SKK, causing the domestic currency's appreciation against the USD and the EUR.

The perception of the economic situation by households took on a particularly positive trend; the number of households with a positive evaluation of the past as well as future development of the economic situation grew significantly. In 2004 unemployment fell, real wages grew, as did household disposable incomes.

The perception of the economic environment by the corporate sector (expressed by confidence indicators) did not change significantly over the course of 2004. Confidence in the construction sector developed positively. The corporate sector reacted negatively mainly to the development of demand in industry and the expected development of prices in the retail sector.

According to preliminary data, the corporate sector's profitability improved over the year. Almost all economic sectors significant from the aspect of the sectoral classification of bank lending saw in 2004 a year-on-year growth in receipts from own performances and goods.

Banks in the EU

The positive development of EU banks in 2003 continued in 2004. Profitability and operating efficiency rose, diversification of loan portfolios improved and banks continued in implementing advanced risk management systems.

Interest income of banks in the EU was negatively influenced by low interest rates, falling interest rate margins and greater competition among banks. Banks achieved a slight growth in interest income through increased lending volumes, in particular to households.

Banks compensated for the decline in interest income growth via higher non-interest income, in particular from fees charged to customers, as well as from trading and investment banking.

A reduction in operating costs contributed to banks increasing profitability, which showed itself in increased efficiency of banks in the EU.

In 2004 the rate of growth in household lending fell. The lower growth is connected with the historically highest level of household debt. On the other hand, banks in the EU increased lending volumes to small and medium-sized enterprises, and to a lesser extent also to large enterprises. The state of the loan portfolios of some German and Italian banks was problematic[1].

In the near future we can expect to see mergers and acquisitions between European and overseas banks, where this may also affect the Slovak banking market.

Internal banking environment

The character of the banking sector's internal environment saw no significant change during 2004.

Slovakia's accession to the European Union in May made possible the use of the single passport. However no new branches of foreign banks were registered in the Slovak banking sector. As at December 2004 there were 49 foreign banks providing services on a cross-border basis registered in Slovakia. Nevertheless these banks did not contribute greatly to any increase in competition in the banking sector. The possibility to pursue banking business under the single passport was taken up by two existing branches, Commerzbank and ING.

Concentration indices remained at approximately the same level throughout 2004, their dispersion unchanging. The share of assets of the three largest banks in the sector (C3 Index) over the course of 2004 moved in the range of 51.9% and 54.5%, the share of the five largest banks (C5 Index) was at the level from 65.6% to 66.6%. The Herfindhal Index (HHI)[2], similarly as both previous indices, remained at a relatively stable level, between 1113 and 1119. All three indices bear witness to the relatively high level of concentration in the Slovak banking sector. The concentration of loans and deposits is higher in the household sector than in the business sector. The concentration of household lending fell gradually, from 1937 to 1721.

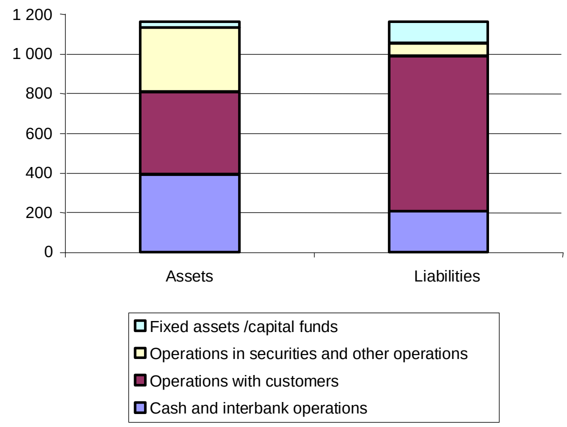
[1] Moody's Bank Risk Monitor, March 2005.

[2] Herfindhal's Index is defined as the sum of the squares of the share of assets of individual banks in total assets.

According to the definition of the US Department of Justice a market is deemed highly concentrated if the HHI exceeds the value 1800 and not concentrated if the value is below 1000. For the integrated banking market of the EU the Herfindhal Index is 579.

Banks' main activities and their funds

Graph 1 Composition of assets and liabilities in the banking sector as at December 2004



- source: NBS
- data are in billion SKK
- cash and interbank operations on the asset side include also Treasury bills intended for trading and for sale

The structure of aggregated assets and liabilities in the Slovak banking sector did not change significantly in 2004. Liabilities were oriented primarily toward customer deposits. The share of foreign banks' deposits in bank funds grew, as did the share of issued mortgage bonds. On the assets side a large growth was seen in cash and interbank operations, primarily reverse repo trades with the NBS. Lending volumes also grew, primarily in loans to households.

Customer deposits

The largest part of banks' funds was formed by customer deposits. Deposits of resident customers in Slovak koruna represented 87% of the total volume of customer deposits. Over the course of 2004 however a change was seen in their structure from the aspect of economic sectors. The level of household deposits, which have the highest share in total deposits, fell slightly, mainly due to the fall in foreign exchange deposits. On the other hand, corporate deposits rose, at the same rate for koruna and foreign exchange deposits. The overall growth in customer deposits received a significant contribution from another economic sector – general government. Thus the banking sector overall received over the course of several months up to SKK 100 billion of funds from general government.

Alongside the change in the sectoral structure, a change was concurrently seen in the time structure of deposits. Long-term saving and time deposits declined, where these reacted more sensitively to the fall in interest rates in 2004. The fall in saving and time deposits was accompanied by a growth in mutual funds. Current accounts were practically unaffected by the fall in interest rates, since the primary purpose of entrusting these funds to banks is not their appreciation, but rather the effecting of payments.

Customer lending

Operations with customers represented the most significant component also on the side of assets. At the end of 2004 they formed 36% of the total assets. One of the most noticeable trends was the high growth of loans to households (mainly long-term housing loans), to financial corporations and self-employed persons, as well as the growth in foreign currency loans to non-financial corporations. The level of koruna-denominated loans to non-financial businesses fell, concerning primarily those to publicly owned companies.

The level of loans to households grew on a year-on-year basis by 37%. The share of individual banks in this growth depended primarily on the size of their branch network. The reason for the high growth in lending to households was the relatively low initial level of debt held by households, the growth in real wages, and lower interest rates on loans. The largest share of loans to households was for housing. The trend of high growth in the volume of mortgage lending continued (from the start of the year of 52%), while building loans and bridging loans grew at a slower rate. Overall the fast growth rate of loans for housing contributed also to the change in the time structure of loans. In contrast to the change seen in deposits, the time structure of loans changed in favour of long-term loans.

As regards corporate lending, a noticeable trend was that of the replacement of koruna-denominated loans by foreign currency loans. One of the reasons for this could be that loans provided in a foreign currency in the current environment of the strengthening domestic currency benefit debtors. It is also necessary to take into consideration here the increasing cross-border activity of Slovak corporations, especially in connection with the inflow of foreign investment and the purchase of technology.

Interbank market

Funds from the interbank market represented the second largest component of banks' funds. Their share in liabilities grew from 14% to 17.4% of total liabilities. This growth was caused exclusively by funds from the foreign interbank market, mostly denominated in foreign currency. The presence of these funds in the Slovak banking sector had a significant influence on liquidity risk also. With the growth in funds from the interbank market the level of interbank assets also grew. Their share in total assets grew from 30% to 33.8%. The growth occurred primarily in funds placed at the NBS in the form of reverse repo trades. Their level in December was roughly 5.3 times higher than the volume of assets on the domestic interbank market. This growth occurred despite a reduction in the key NBS interest rates, which over the year fell by 200 basic points.

Securities

The volume of securities in banks' portfolios rose over the year, where this could be seen in all bank groups, with the exception of building societies. This trend was primarily due to the growth in government bonds by SKK 20 billion in the third quarter of 2004. These government bonds supplemented the portfolio of higher-yield bonds issued prior to 2003, which are gradually reaching maturity. Government bonds formed 76% of the total volume of securities.

The level of investment in securities was also a result of the growth in mortgage bonds. On the other hand, a permanent growth was noticeable in securities issued by domestic and foreign companies (banks or corporations).

Securities issues by banks were restricted to mortgage bonds and bills. The growth in the volume of issued mortgage bonds was connected with the dynamic rate of growth in mortgage lending. By the end of 2006 the amount of issued mortgage bonds must cover 90% of mortgage loans provided. At the end of 2004 total coverage in the sector stood at 74%. Over the course of the year the total amount of mortgage bonds grew from SKK 14.7 billion to SKK 30.1 billion. Investors were often banks themselves, which owned approximately half the total amount of mortgage bonds issued. Some banks offered bills as an alternative to their deposit products. The volume of bills issued over the year grew from SKK 3.9 billion to SKK 9.9 billion.

Off balance-sheet accounts

Alongside the gradual growth in the balance sheet total, the size of the off-balance sheet also grew. In many banks it exceeded the size of the balance sheet. The most significant item comprised receivables from guarantees and collateral, the growth of which is connected with the increase in loans secured by real estate and in the value of securities held as collateral in reverse repo trades. Dynamic growth was seen in operations in options (81%) and receivables from future loans (78%). The volume of monetary and interest rate instruments also had a high share in the balance sheet total (55%). A trend in 2004 was that of the growth in the share of monetary and interest rate business, with non-residents forming the counterparty.

Increased profitability of the banking sector

The net profit of the banking sector in 2004 increased on a year-on-year basis by 14%. Banks' return on equity at the end of 2004 reached 16.5%, against 15.5% for the same period in 2003. This growth in the banking sector's profit came about largely due to an increase in income from banking operations.

Despite the fall in interest rates, banks increased the largest item of their incomes, net interest income. The growth was caused by a more significant decline in interest expense than a decline in interest income of banks. The decline in interest expense occurred due to the interest policy of banks, where banks radically reduced their deposit rates, as well as due to changes in the assets and liabilities of the banking sector. On the liabilities side the volume of time and saving deposits decreased and the volume of non-interest bearing current accounts increased. On the other side, banks compensated for the decline in interest rates in their asset operations through an increased volume of lending to households.

The fall in interest rates created increased pressure on the net interest margin of the banking sector. For the first time since 2001 this was slightly reduced, at the end of 2004 reaching 2.84% against 2.91% at the end of 2003.

The course of the interest margin was to a large extent the result of competition in the banking sector. The relatively high concentration of banks, particularly in the households sector, was manifested in a growth in the interest margin of the largest banks. On the other hand at most small and medium-sized banks the interest margin decreased.

The trend of growth in non-interest income continued in 2004, where at the end of 2004 these formed 27% of the total gross income from banking operations. It is probable that with the further decline in interest rates and downward pressure on banks' interest margins, the significance of non-interest income will continue to grow. The largest item of non-interest income was formed by net income from fees. The most significant growth in fee income was recorded by banks with a dominant position in the household sector. The growth in income from trading was driven primarily by income from securities trading.

In line with the growth in banks' activities in the household sector operating costs in the banking sector also rose. Purchased performances and employee costs also grew at most banks. The process of improving operating efficiency through reducing operating costs continued at several banks.

Despite the increase in operating costs, their share in total income from banking operations (the cost-to-income ratio) in 2004 decreased to 61%.

In comparison with the same period of 2003 the banking sector significantly reduced income from the dissolution of reserves[3]. Income from the use of provisions in the banking sector increased, in connection with certain banks writing off in a higher rate claims towards customers.

Risks in the banking sector

Growth in household lending

The size of credit risk was influenced to a significant extent by the growth of lending to households. Household lending largely comprised secured loans for housing. Consumer lending and overdrafts formed a smaller share.

The significant growth in household lending led also to an increase non-performing loans[4] towards the sector in 2004. The share of gross non-performing loans in total gross loans to households at the end of 2004 stood at 2.7%. This proportion did not change significantly over the course of the year, thanks in large part to the growth in the volume of total loans.

Despite the significant increase in household debt over the past years, households in 2004, according to available macro-economic data, remained sufficiently able to repay bank credit.

The financial position of households was positively influenced by the sufficient volume of financial assets (in 2003 households financial liabilities formed 31.5% of financial assets), by the growth in real estate prices, and the fall in unemployment, the growth in real wages and households' gross disposable income. The burden on households formed by repayments of loan principals and interests[5] was relatively low, where the proportion of such instalments to households' gross disposable income in the last quarter of 2004 was 13%.

A large part of household lending was at a variable or short-term interest rate, which on the one hand reduced the interest rate risk for banks, but on the other hand increased households' sensitivity to any increase in interest rates, and thereby also the credit risk to banks.

The level of credit risk was closely connected with banks' appetite for risk. The growth in competition between banks led to a loosening of the conditions under which banks would provide loans to households.

The further development in the credit risk of households will depend to a large degree primarily on the level of their debt, nature of their debt and the development of macro-economic variables.

Despite a moderate growth in credit to corporations, this lending formed the largest part of banks' loan portfolios. The quality of overall lending to corporations improved over the course of 2004. The efforts of several banks, in particular those having incurred a high share of non-performing loans towards businesses in past years, were directed at the recovery of corporate loan portfolios. This resulted in a fall over the year in the volume of non-performing loans by almost 20%. The share of gross non-performing loans in total gross loans to corporations fell from 10.9% in January to 9.9% in December 2004.

[3] According to the Methodological Instruction of the Ministry of Finance No 24 658/2003-92, by 31.12.2003 banks should have accounted reserves as a profit/loss from previous years. According to NBS Decree No 1/2004 (effective as of 31.1.2004) reserves shall be gradually dissolved, within at most four years, each year at minimum by 25% of their balance as at 31.12.2003.

[4] Non-performing loans are defined as loans to customers and banks that are 90 days or more overdue.

[5] Interest repayments of households are calculated from loans to households broken down by maturity and from their average interest rates.

Decreased interest rate risk in the banking book

The time structure of interest-rate-sensitive assets and liabilities in the banking sector in 2004 was liability-sensitive, meaning that liabilities were prevalent in shorter time buckets and interest-rate-sensitive assets prevailed in longer time buckets. This structure of interest rate-sensitive assets and liabilities exposed the banking system to negative impacts on the real value of assets and liabilities.

Banks' interest rate risk in the banking book fell in 2004, primarily in consequence of a greater time match of assets and liabilities according to the period to the next setting of the interest rate. On the asset side, banks transferred to a greater extent interest rate risk from loans over to customers, and reduced the interest rate sensitivity of securities.

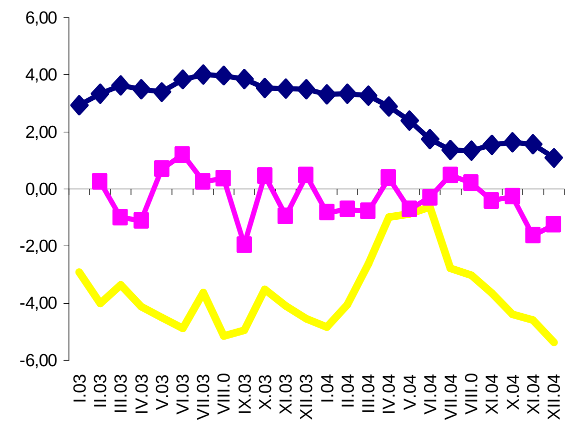
The indirect impacts of a change in interest rates on banking sector business remain significant. The continuing decrease in interest rates is creating pressure on banks' interest rate margins, which can lead to a negative impact on interest income. On the other hand, a growth in interest rates can lead to reduced ability of households to settle their obligations.

Growth in foreign exchange funds from foreign banks in the second half of 2004

Despite the growth in the foreign exchange deposits of foreign banks, banks' foreign exchange risk fell during 2004. The growth in foreign exchange funds from banks in the balance sheet in the second half of 2004 was accompanied by a growth in foreign exchange lending and by the use of off-balance-sheet operations for hedging open foreign exchange balance sheet positions. The total foreign exchange position of the banking sector throughout the year was short, exposing banks to a positive impact in the event of the domestic currency's strengthening.

The net foreign exchange balance-sheet position during 2003 was open, primarily due to the influence of the interest rate differential. In the first quarter of 2004 this position closed concurrently with a decline in the differential. Its further opening in the second half of the year was no longer caused by a difference in interest rates on the money markets, but by the Slovak koruna's increasing appreciation.

Graph 2 Growth in foreign exchange deposits of foreign banks in connection with the strengthening of the Slovak koruna and interest rate differential



- source: NBS, www.nbs.sk
- data on y axis are in percent
    - interest rate differential: difference between 3-month interest rates on the EMU and Slovak money markets
    - exchange rate: percenage monthly changes in SKK/EUR
    - foreign exchange position: share of the balance-sheet foreign exchange position in assets

Time mismatch of assets and liabilities

In general it may be said that time mismatch in the maturities of assets and liabilities widened in the banking sector in 2004. This was connected with the growth in the share of long-term loans and the fall in the share of long-term deposits. The interbank market was characterised by a growth in the deposits of foreign banks and an increase in asset transactions with the NBS. At several banks sensitivity to the potential withdrawal of the interbank deposits of foreign banks was thereby increased.

These changes were manifested in a worsening of immediate liquidity. The median of the acid ratio indicator fell from its January value of 61% to 42% in December. The worsening in the maturity mismatch of assets and liabilities occurred particularly in the shortest time range.

The structure of the interbank market changed over the course of 2004, noticeably under the influence of foreign banks.

On the one hand trading on the domestic interbank market, credit from the NBS and credit provided to foreign banks decreased, or, as the case may be, grew in small measure, on the other hand, the growth in foreign banks' deposits in the second half of the year was higher than the growth in asset transactions with the NBS (in particular reverse repo trades), whereby the sensitivity of the Slovak banking sector to the behaviour of foreign banks was increased. This to a certain extent increased the risk of contagion from the euro area.

Decline in capital adequacy in the second half of 2004

In 2004 the banking sector reported relatively high capital adequacy, which at the end of the year moved around 19%. The high capital adequacy of the banking sector thus created a basis for growth in risk-weighted assets. This trend was confirmed in the second half of 2004, when risk weighted assets grew quite markedly and the capital adequacy of the banking sector fell.

Capital adequacy fell even despite a growth in own funds, when unsettled losses from previous years in the banking sector were reduced, and paid-up registered capital, reserve funds and other funds created from profit were increased.

Terminology used

Acid ratio – immediately liquid assets / highly impermanent funds

C3, C5 index – concentration of the three, or five, largest banks, i.e. the sum of the shares of their assets in total assets

Corporations – financial, non-financial and insurance companies

Cost-to-income ratio (CI) – defined as the ratio of total operating costs and net income from banking operations (purchased performances + employee costs + social costs + tangible and intangible asset depreciation + taxes and fees / net interest income + dividends and other income from variable yield securities + net income from fees and commissions + net income from securities trading + net income from derivative trading + net income from forex trading + net income from other operations + net income from assigned claims against banks and customers + net income from the transfer of equities, tangible and intangible assets + net income from a share in the profit from equities + net income from leasing)

Non-performing loans – defined as loans to customers and banks 90 days or more overdue.

Cumulative gap – the sum of open positions (short or long) within certain time buckets

Financial corporations – companies dealing with financial intermediation and ancillary financial activities -- other than insurance companies and pension funds, a central bank and financial institutions dealing primarily with financial intermediation -- whose role is to accept deposits and/or deposit substitutes from institutional units and to provide loans, and/or invest in securities on their own behalf (i.e. with the exception of banks, savings banks, mutual funds, credit institutions of local authorities)

General government – state bodies, local authorities, the Social Insurance Company, health insurance companies, the National Property Fund, and other funds

Herfindhal Index – defined as the sum of the squares of the shares of assets of individual banks in total assets.

Households – the population, i.e. citizens' accounts.

Long position – a position in which assets are greater than liabilities

Net foreign exchange balance-sheet position – defined as the difference between foreign exchange assets and liabilities in the balance sheet

Net foreign exchange off-balance-sheet position – defined as the difference between foreign exchange assets and liabilities in off balance-sheet accounts

Short position – a position in which liabilities are greater than assets

Total net position – defined as the difference between the net balance sheet and the net off balance-sheet position