NÁRODNÁ BANKA SLOVENSKA
EUROSYSTÉM

Main trends and risks in Slovak financial sector and macroprudential policy of the NBS

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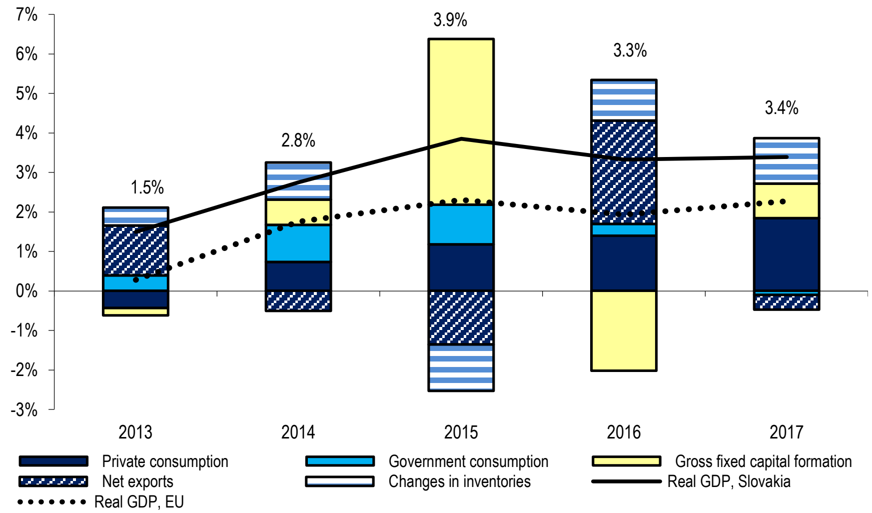
Macroeconomic development

Stable economic growth with especially positive impact on labour market

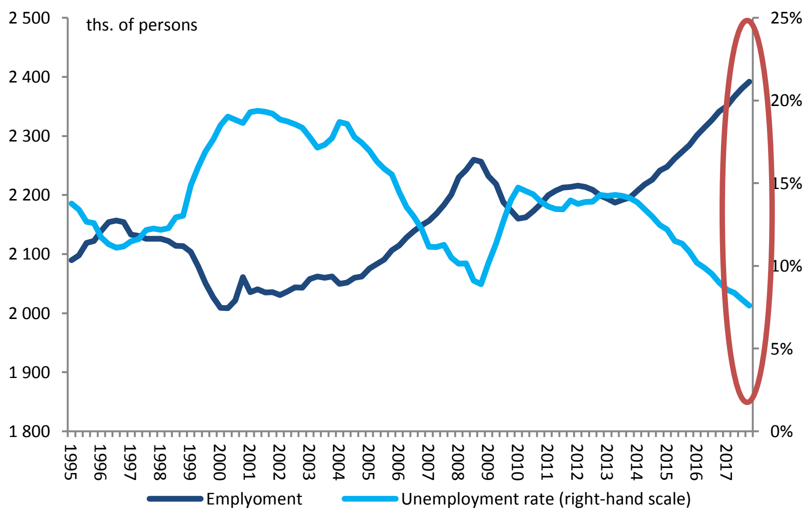
- Steady economic growth is currently driven by domestic demand, GDP growth is well above the EU average
- Actually historically high levels of employment lead to increasing pressures on labour market, lack of skilled workers
- Favorable economic development mirrors also in the increase of sales of companies throughout various economic sectors
- Macroeconomic development contributes to increase of households and companies´ demand for loans

Slovak real GDP growth and contribution of respective components to growth



Source: NBS

Employment and the unemployment rate in Slovakia



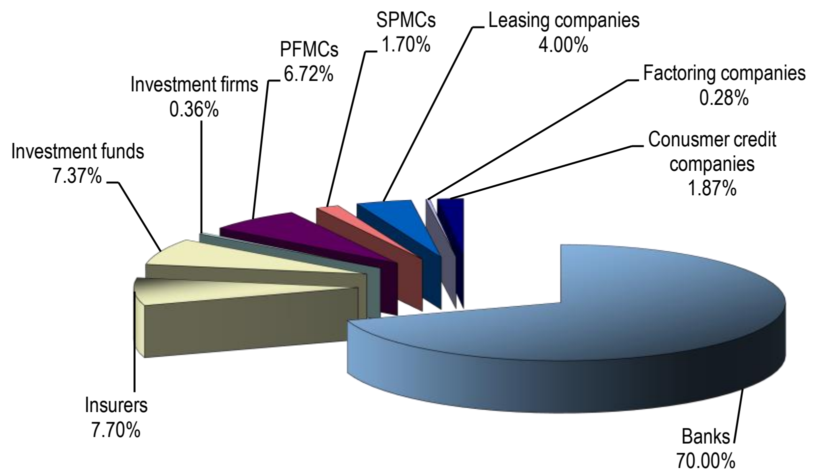
Source: SO SR, NBS

Financial sector: Assets

Positive trends in financial sector due to solid macroeconomic development

- Positive macroeconomic development has contributed to the growth of assets in most of the financial institutions
- Total assets of Slovak financial sector reached € 113 bln. and grew by almost 7 % on annual basis
- Banking sector keeps dominating over the financial sector due to strong lending activity
- Market share of non-bank lenders has been shrinking

Distribution of assets and managed assets in the Slovak financial market

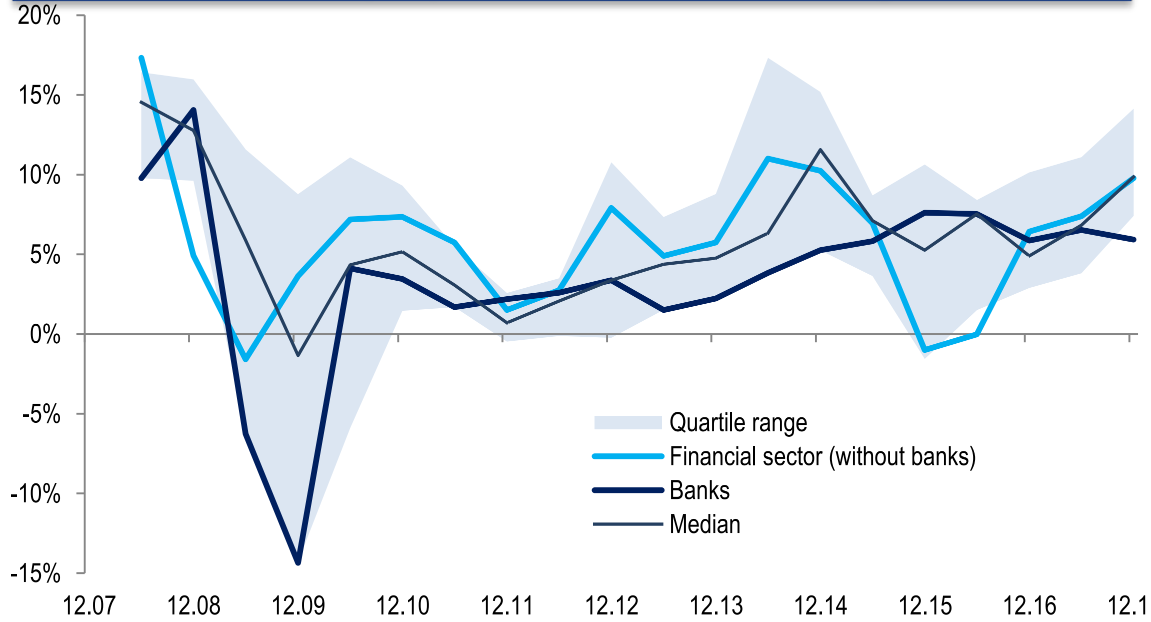


Financial sector: Profitability

Despite positive macroeconomic trends, profitability improved selectively

- While positive trends on labour market and enterprise sector reduced banks' cost of credit risk, low interest rate environment created a downward pressure on banks' profitability
- Despite the new levy on non-life insurance, insurance sector managed to increase its profit
- Increase in assets under management of mutual funds and pension funds contributed to better profitability of asset management companies

Return on equity in financial market segments



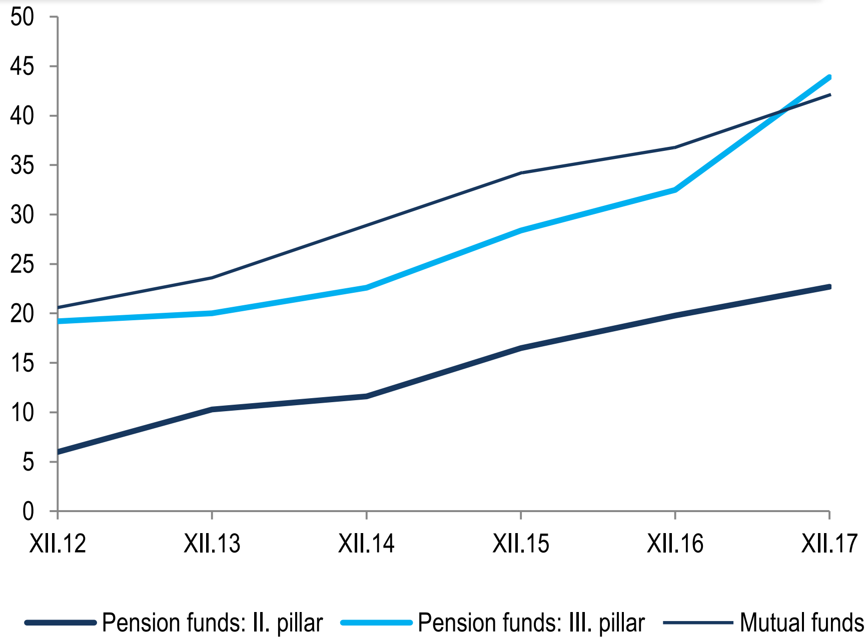
Source: NBS

Financial sector: Risks

Good actual performance of portfolios increased the overall risk appetite

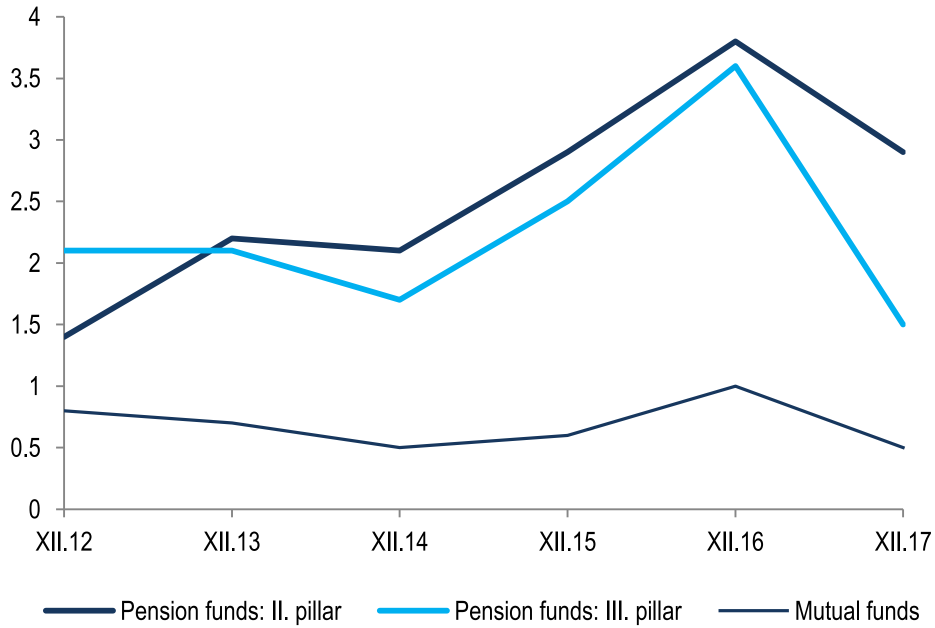
- Credit risk: positive short-term development in non-performing loans to households and enterprises
- Mutual funds and pension funds continued to increase their investments in equities; this resulted from higher risk appetite of their clients in current low interest rate environment
- Exposure to interest rate risk has decreased due to expectations related to interest rates

Share of equities in mutual and pension funds (in %)



Source: NBS

Duration in mutual and pension funds



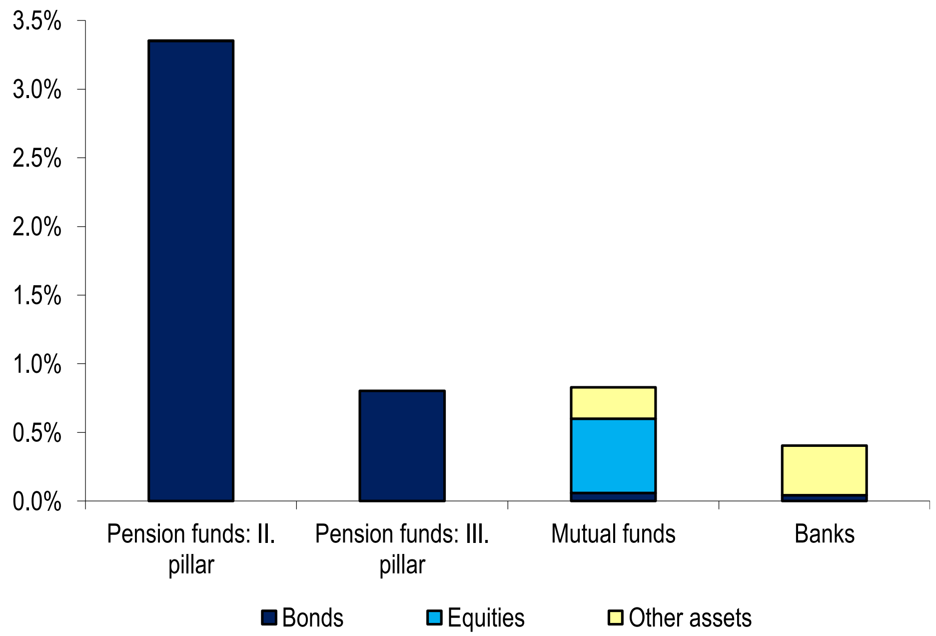
Source: NBS

Financial sector: Brexit

Direct impact appears to be very limited

- Brexit can negatively affect financial institutions with material exposure to United Kingdom
- Generally, exposure of Slovak financial institutions to United Kingdom remains to be low
- Highest exposure in the form of bonds is within the II. pillar of pension funds
- Exposure of all other sectors is below 1 %

Exposure of financial sector to UK

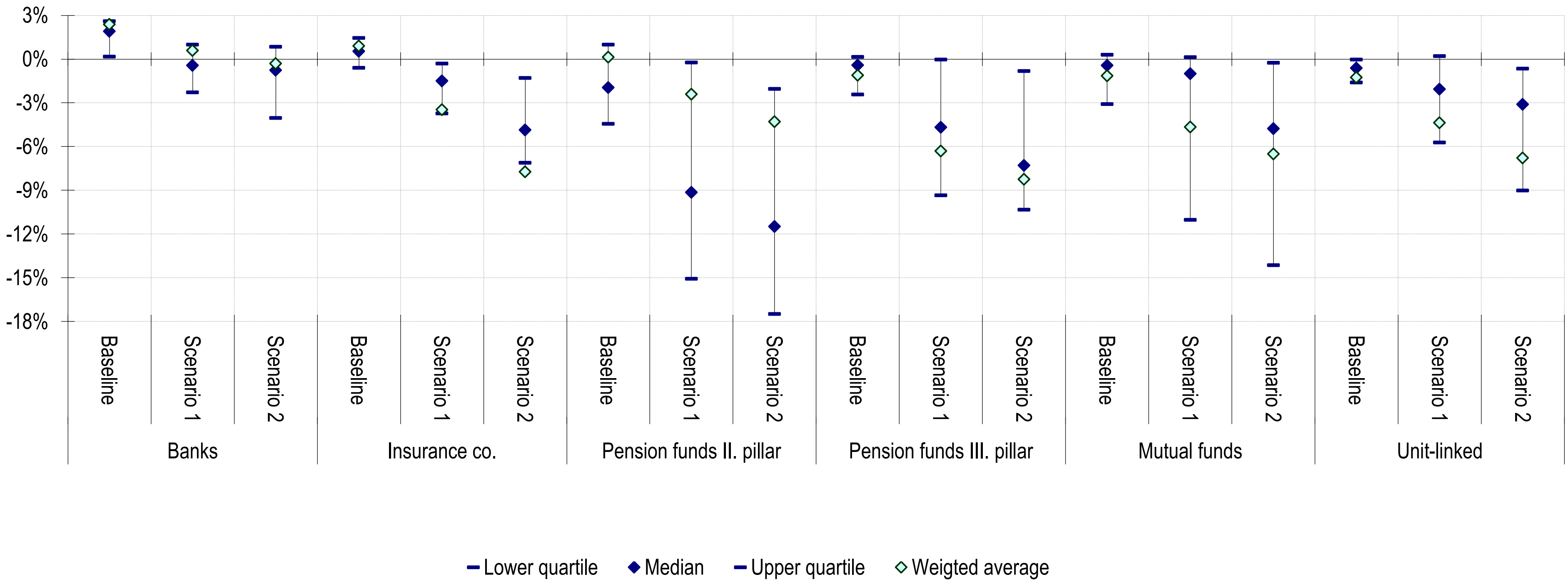


Source: NBS

Financial sector: Stress-testing

- Sensitivity of pension funds on adverse scenario is lower than in 2016
- Mutual funds reaction on adverse scenario was very heterogeneous
- Insurance companies are more sensitive on financial stress than on insurance risk
- Banking sector remains to be resilient, though some extra capital is needed to face cyclical losses

Profit or loss under different scenarios as % of assets



Summary assessment of main risks

Most significant risk – medium high risk category

Strong retail credit growth and growth of household indebtedness
Growth of indebtedness is considered to be excessive; pressure on easing of credit conditions

Other significant risks – medium risk category

Low interest rate environment
Increasing banks' sensitivity to any adverse trends in portfolio quality

Increasing liquidity risk
Decreasing loan to deposit ratio

Macroeconomic risks and signs of underestimation of risks on global financial market
Build-up of imbalances; risk of overheating of domestic economy

Other increasing risks

High exposure to **commercial real estate sector**

Accelerating growth of **corporate indebtedness**

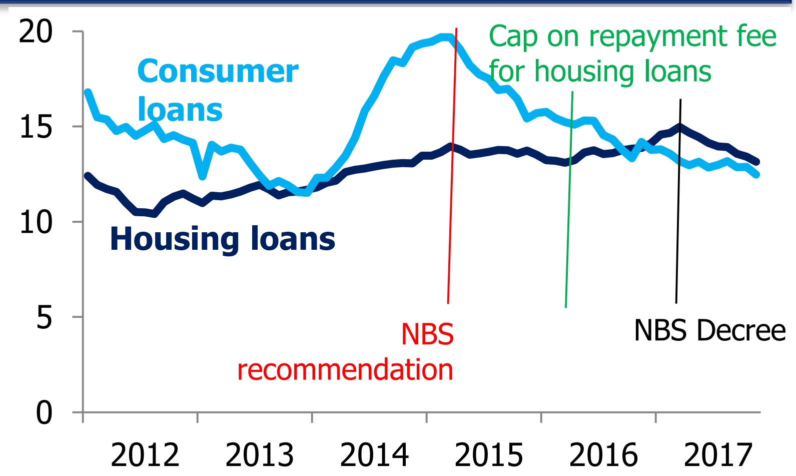
Increasing impact of **legal and regulatory changes**

Risks related to household indebtedness

Strong growth of retail loans continues: 12.1 % (Dec 2017)

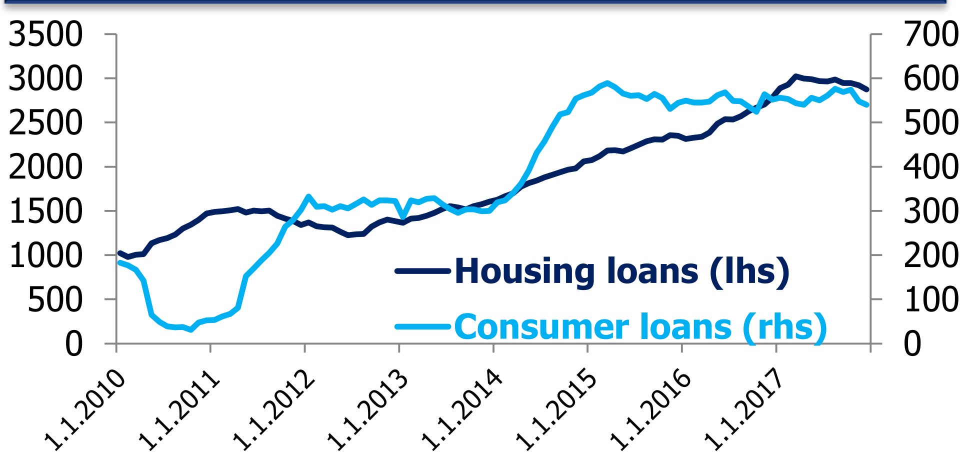
- Growth of retail loans has been the strongest in the EU for six years (with rare exceptions of short periods in some countries)
- **Housing loans**
  - Absolute changes of housing loans reached its historic maximum in March 2017 and has roughly stabilised since then
  - Media exacerbated concerns related to the effect of implementation of the NBS Decree (Q1 2017)
  - Interest rates on new housing loans in 2017 changed only moderately in contrast to previous years, but their level remains low compared even to several mature euro area countries
- **Consumer loans**
  - Absolute changes has been rather stable on historical peak, relative growth gradually slightly moderates due to basis effect

Retail loans – relative changes (y-o-y, %)



Source: NBS

Retail loans – absolute changes (y-o-y, € mil.)



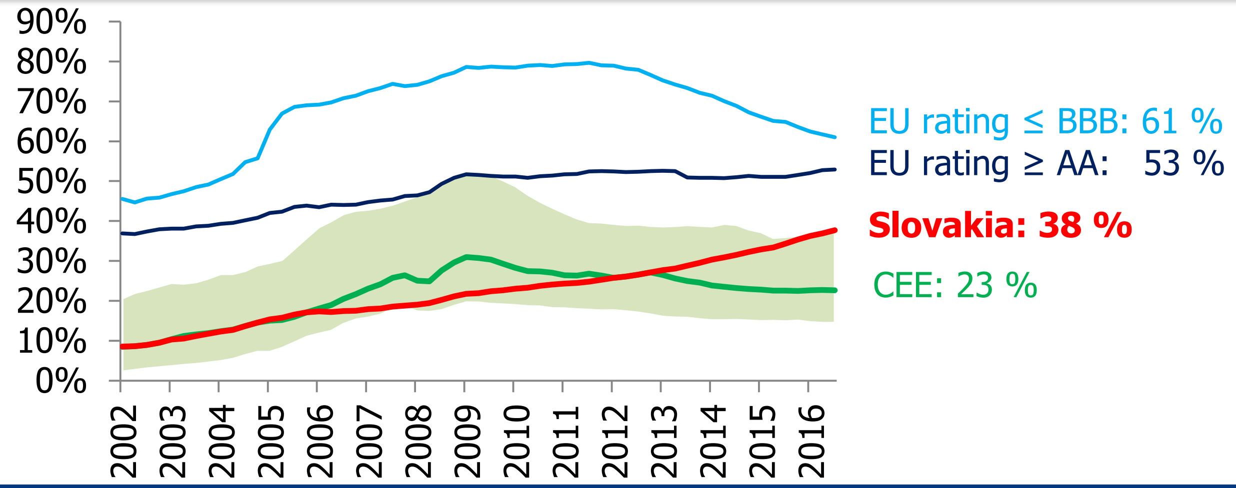
Source: ECB

Risks related to household indebtedness

Indebtedness level is already the highest in the CEE region

- **Trends:**
  - The share of loans to households in GDP in Slovakia reached the highest level in Central and Eastern Europe
  - An increase in this indicator is also the highest in the euro area and within CEE countries
  - Slovakia is the only EU country where household indebtedness increases steadily every year since 2005
  - Indebtedness in main age categories (most active in taking loans) is already comparable to EA average
- **Main risk:** Increasing the vulnerability of Slovak households to potential shocks
- **IMF** study warns against significant negative secondary effects of high indebtedness
- **Standard&Poor's** warned that it downgrades credit rating of the Slovak republic in case that the brisk credit growth continues

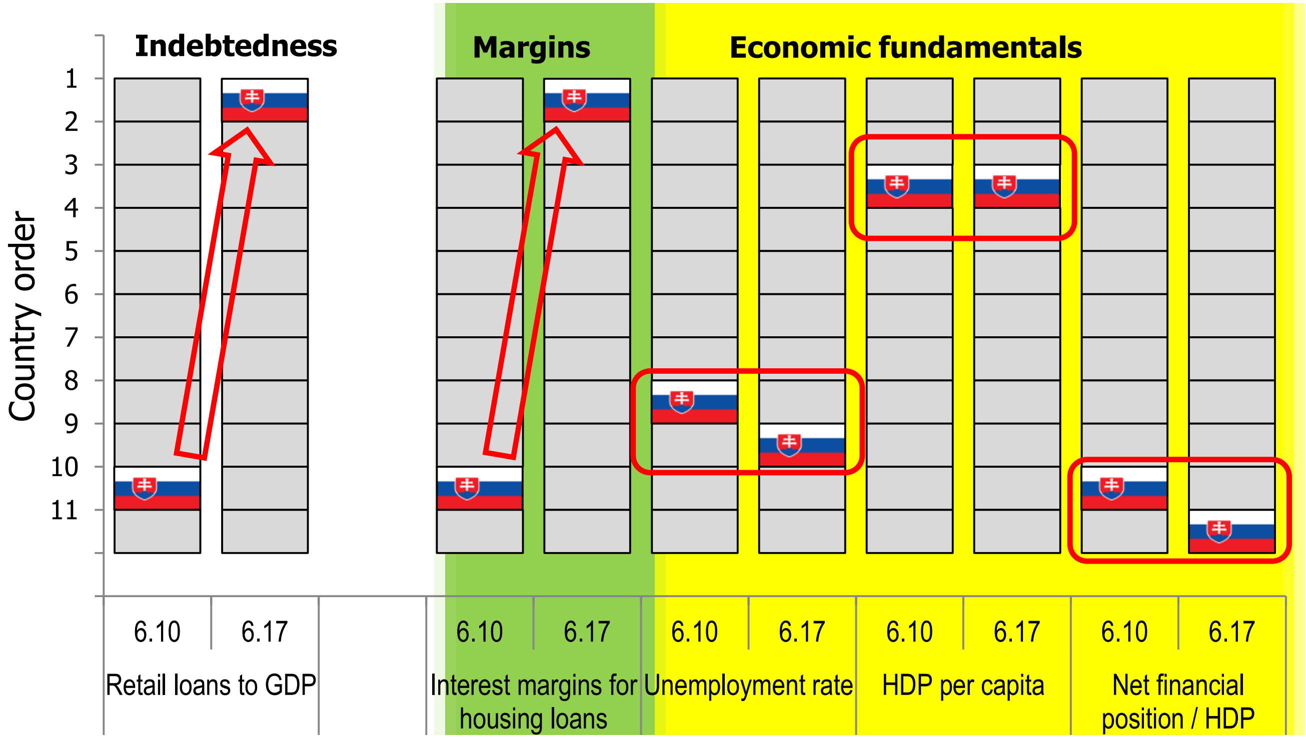
Retail loans to HDP



Source: Eurostat

Risks related to household indebtedness

Does the growth of indebtedness outperforms fundaments?



- Although the growth of indebtedness can partly be attributed to economic convergence and exceptionally favorable economic situation, it is significantly higher than in other peer countries in the CEE region with similar development
- In particular, the strong impact of decreasing margins is confirmed
- The economy is beginning to overheat

Indebtedness growth can be assessed as excessive

Assessment of credit standards

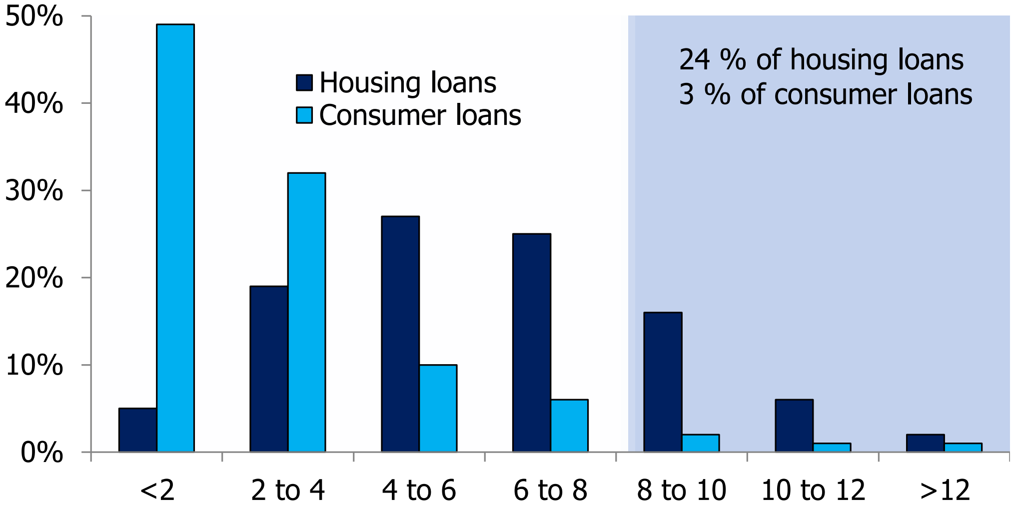
Too high level of debt-to income (DTI) ratio

- Common limits in other countries are between 4 and 6 (UK, IE), or 6 to 7 (Norway)
- Though competition – high aggressiveness of certain banks

Increasing maturity

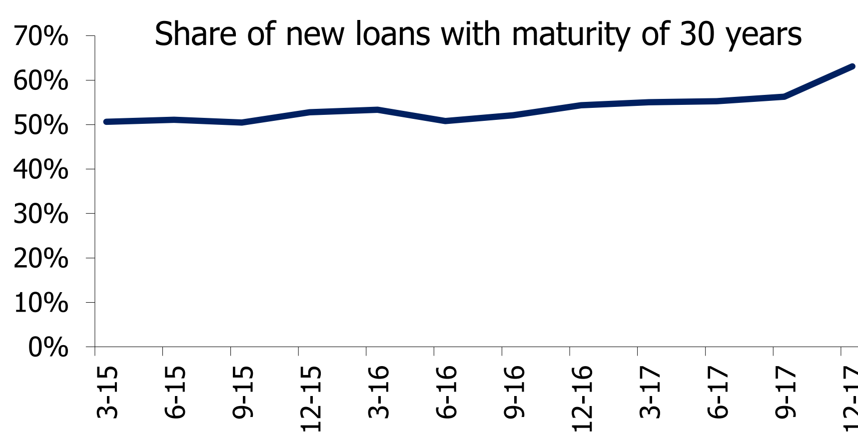
- Average maturity of new housing loans increased from 25.5 to 26.4 years in 2017
- Increasing share of new housing loans with maturity exactly at the level of 30 years (reaching 61%)
- These trends also indicate high growth of indebtedness of individual households facilitated by low interest rate environment

Debt-to income (DTI) ratio: distribution



Source: NBS. Data as of 4Q 2017

Maturity of new housing loans



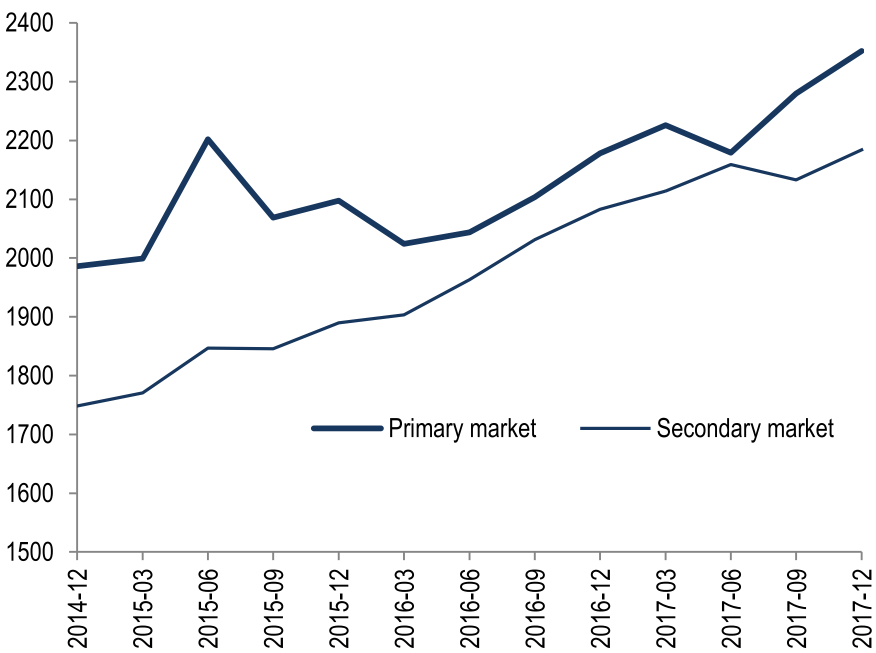
Source: NBS

Real estate market

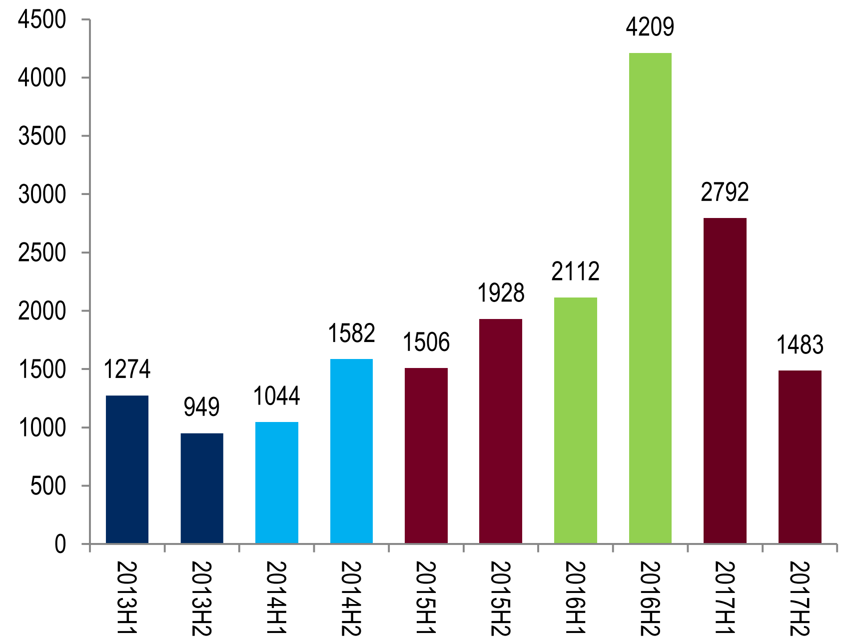
Decrease in property prices dynamics; some imbalances persist

- Real estate prices continued to grow, however at a lower pace
- Primary market in Bratislava is becoming more relevant
- Number of available flats has been gradually decreasing

Property price development (Eur/m2)



Number of new apartments in primary market supply



Source: CNM, Lexxus

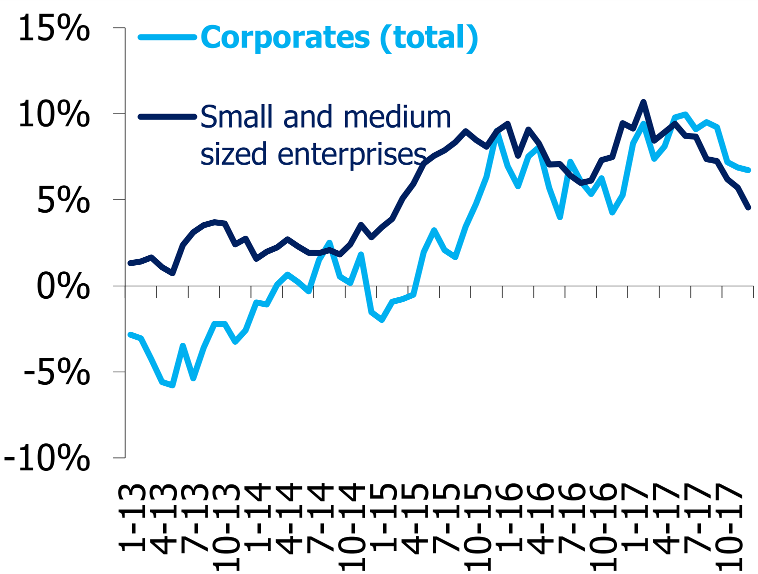
Source: Lexxus

Corporate credit growth

Positive economic trends and the low interest rate environment were the main factors beyond a significant growth of loans to enterprises

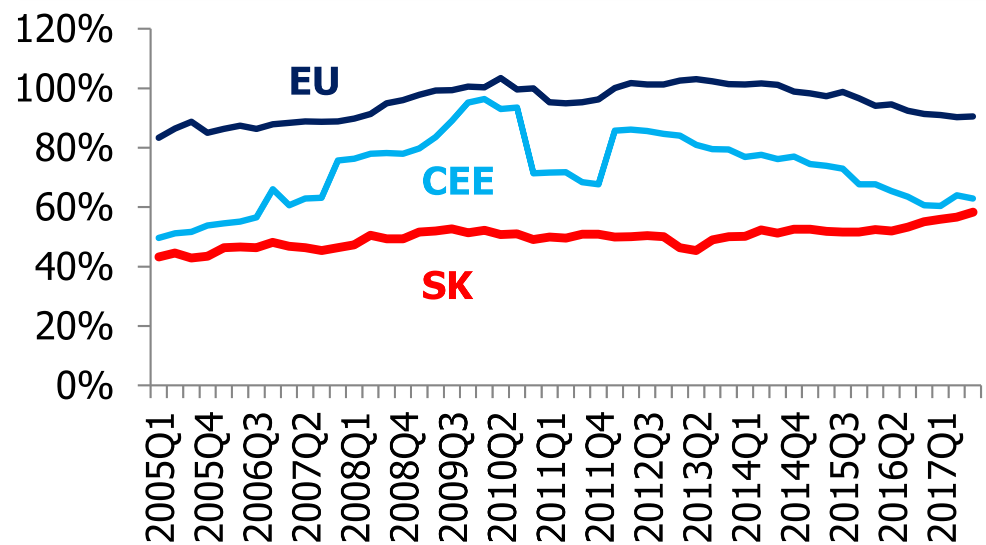
- The growth of corporate loans started 2 years ago and currently (around 8.5%) outperforms majority of EU countries, with some slowdown at the end of 2017 (to 7%)
- The credit growth is robust across different loan types, economic segments as well as banks
- The corporate indebtedness started to increase substantially when compared to GDP – third highest growth in the EU and largest growth within the CEE region
  - Growth of indebtedness not only driven by loans from domestic banks, but also from foreign sources and issuances of corporate bonds

Corporate credit growth (y/y)



Source: NBS.

Increase of corporate indebtedness (% of GDP)



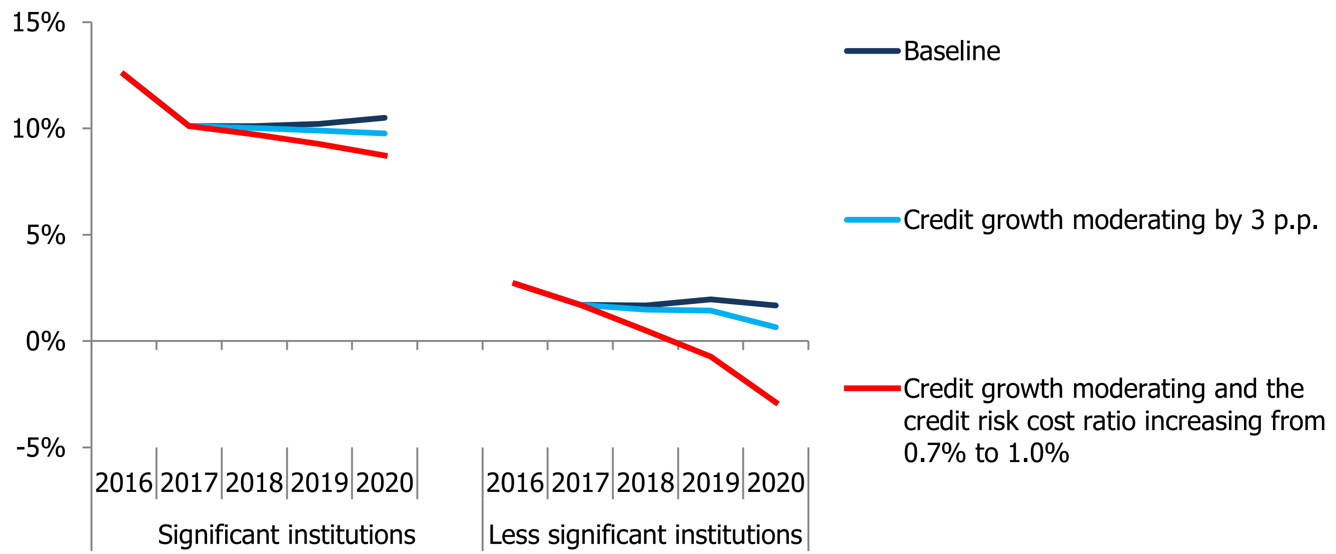
Source: ECB.

Risk of low interest rates

In the low interest rate environment, banks become more sensitive to adverse shocks

- If the higher lending pace of 2017 continues in the coming years, banks could maintain a relatively stable rate of profit
- However, generating the same profit with a significantly growing volume of loans increases the sensitivity of banks to possible adverse trends in the interest margin or credit quality of the loan portfolio
- This sensitivity is particularly pronounced in a group of less significant institutions

Simulation of the impact of various factors on ROE



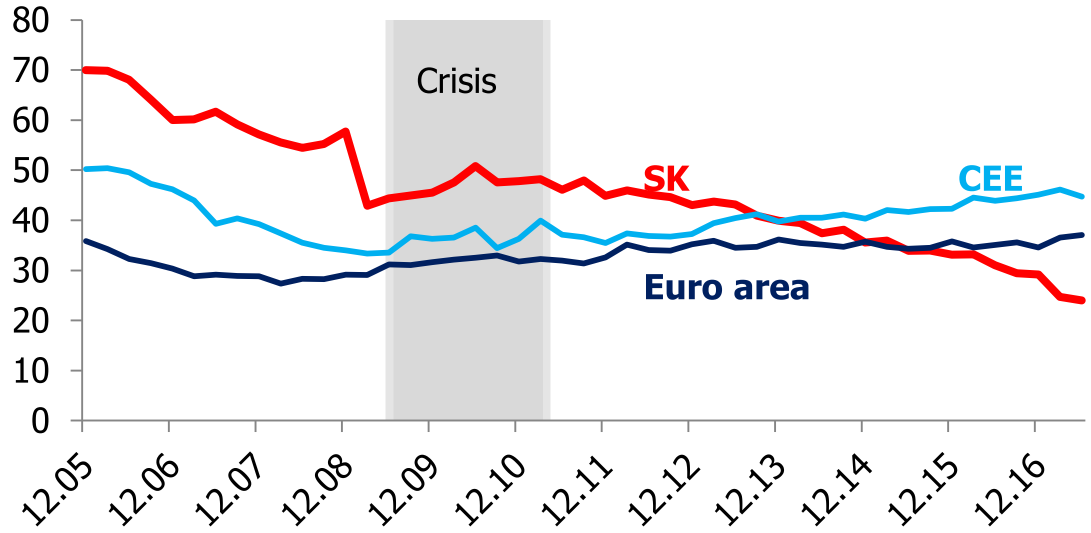
Source: NBS.

Liquidity risk

Liquidity risk and maturity mismatch risk has been increasing

- **Risk**
  - As a result of strong credit growth, maturity mismatch and liquidity coverage is worsening - this trend is significantly worse compared to other EU countries
  - The rate of deposit financing is decreasing
- **Partial mitigation of the risk:** new legal framework for covered bonds (since 1 January 2018)
  - Higher attractiveness for investors - cheaper and more accessible sources of long-term funding
- New European liquidity coverage requirements are less stringent than previous regulation in the SR - a possible outflow of liquid assets

Share of liquid assets to short-term liabilities



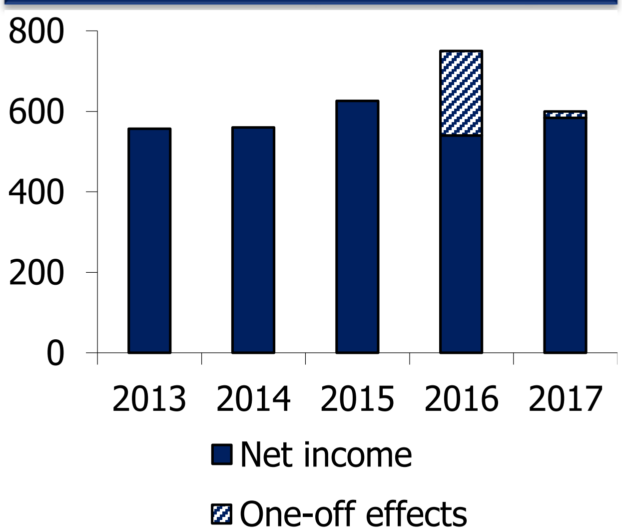
Source: ECB.

Profitability

Apart from one-off effect, profitability remained largely stable

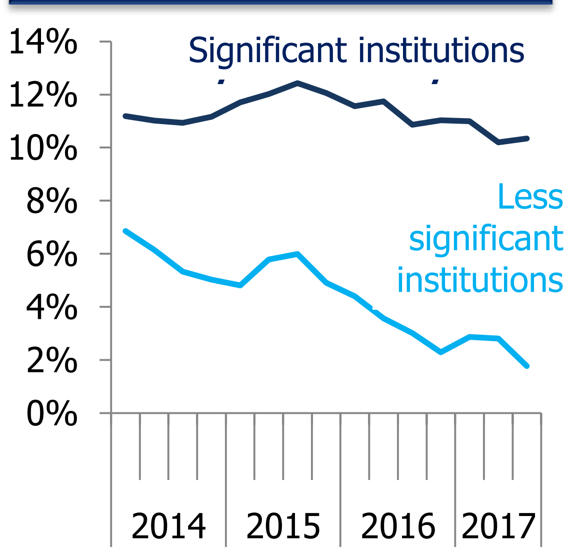
- If we do not take into account the extraordinary income (e.g. the sale of VISA shares in June 2016), the level of banks' net profit remained stable
  - ROE declined slightly due to an increase in equity
- The continued decline in interest margins was moderated in 2017 by accelerating loan growth and declining losses on defaulted loans - the question is the long-term sustainability of low credit costs
- Smaller and medium-sized banks are increasingly weaker in comparison with the largest banks
  - This is mainly due to higher losses from credit risk

Net income (in EUR mil.)



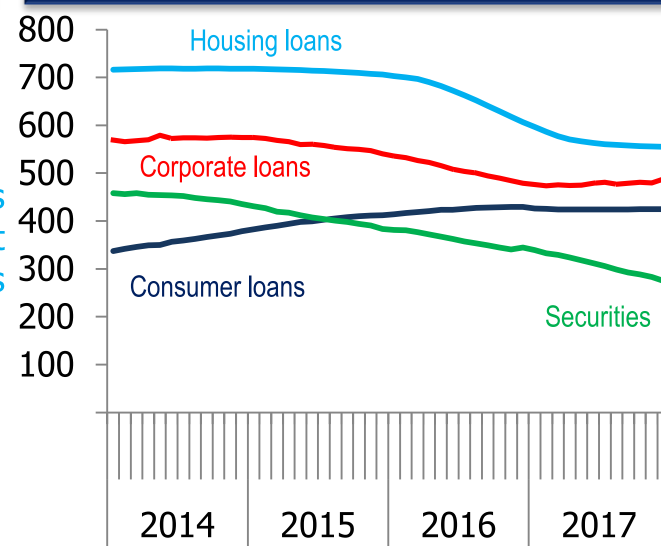
Source: NBS.

ROE



Source: NBS.

Interest revenues



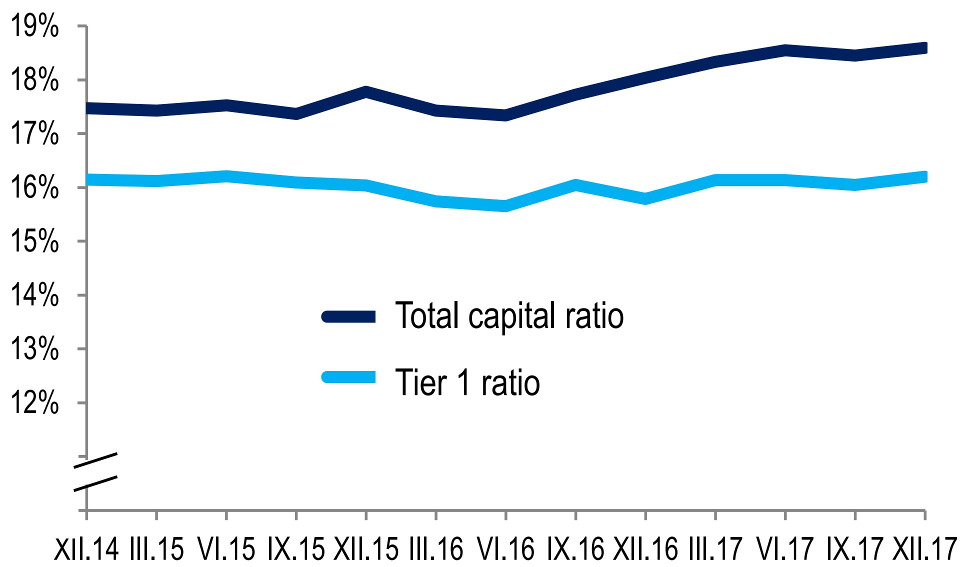
Source: NBS.

Solvency

Total capital adequacy increased in 2017

- Total capital ratio has increased to 18,6 % compared to 18 % in 2016
- Increase in capital adequacy was driven by retained earnings
- Tier 1 ratio increased only slightly
- Leverage ratio reached 8,3%, sufficiently above expected regulatory minimum of 3%

Capital adequacy in banks



Source: NBS.

Macroprudential policy measures

Macroprudential policy measures

Responsible lending requirements (borrower-based measures)

Strengthening resilience of banks (capital buffers)

Responsible lending requirements (borrower-based measures)

Objective

1. Sound and sustainable credit growth based on prudent credit standards
2. To address risks related to increasing household indebtedness

Characteristics

- **Quantitative limits** (LTV, DSTI, maturity, DTI)
- **Qualitative requirements** (income declaration, RRE appraisals standards, mandatory amortization with annuity)

Strengthening resilience of banks (capital buffers)

Objective

Prevent excessive dividend distributions in the period of rising vulnerabilities

Characteristics

Countercyclical capital buffers

currently at **0.5 %** (since 08/2017)

increase to **1.25 %** (since 08/2018)

Additional buffer for 5 largest banks at the level of **1-2 %**

Current / proposed measures

LTV: 90 %

- **Objectives:** higher level of collateralisation, discouraging speculative purchases, mitigate risk of RRE price bubble
- Max. share of loans with LTV between 90 % and 100 %: 10 % (to be cancelled from 1 July 2018)
- Max. share of loans with LTV between 80 % and 100 %: 40 % (to be gradually decreased to 20 %)

Financial reserve: 20 %

- **Objectives:** balance between clients' financial situation and his/her debt burden, financial reserve for economic downturns and/or interest rate increase
- Installments (subject to increase of interest rate by 2 p.p.) ≤ Net income – subsistence minimum – financial reserve
- Financial reserve = 20 % of the difference between net income and subsistence minimum

Maturity: 30 and 8 years, resp.

- **Objective:** possibility to decrease installments by prolonging maturity in times of financial difficulties
- RRE-secured loans: 30 years
- Unsecured loans: 8 years
- Unsecured loans granted by building societies: 30 years

Maximum indebtedness: 8x yearly income (proposed measure)

- **Objective:** mitigate risk of overindebtedness of individual clients and household sector as a whole
- The maximum share of loans exceeding limit 8 should gradually decrease from 20 % to 5 %

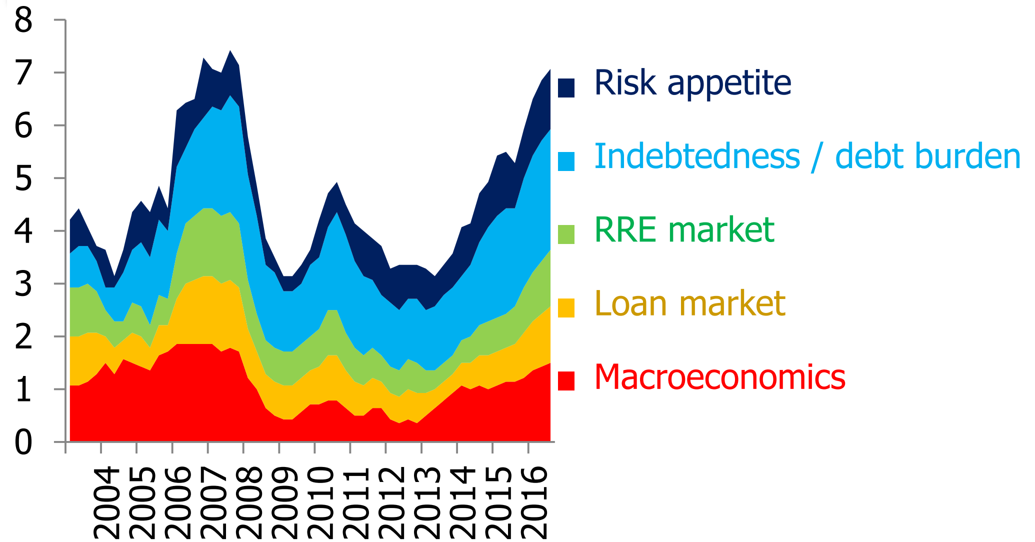
Countercyclical capital buffer

Actual setting

From 1.8.2017 to 31.7.2018	0,50%
Since 1.8.2018	1,25%

A further increase might be considered if the pressure on the credit market continues.

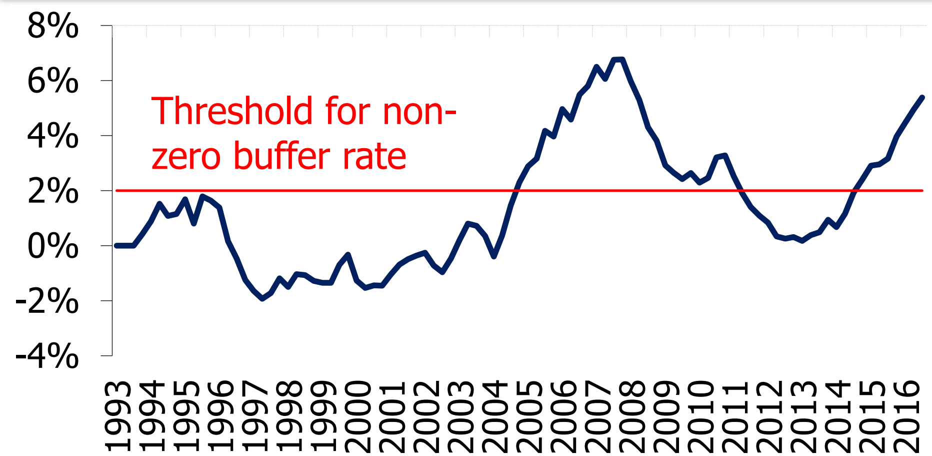
Cyclogram



Further considerations

- On the fastest credit growth rates in the EU in both household and corporate sectors
- Growth in loans to the private sector outperformed the growth of the economy, household income as well as business revenues
- Risk of overheating of the economy

Domestic credit-to-GDP$_{trend}$ gap



Source: NBS

Thank you for your attention

Vladimír Dvořáček

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