



NÁRODNÁ BANKA SLOVENSKA
EUROSYSTEM



MACRO-PRUDENTIAL ANALYSIS OF THE BANKING SECTOR

SEPTEMBER 2012



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THIRD QUARTER OF 2012

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.

1. Analysis summary	4
2. Macroeconomic developments as they affect banking sector stability	6
3. Trends and risks in the Slovak banking sector	12
4. Financial position of the banking sector	21

List of charts:

Chart 1	Yields to maturity of 10-year government bonds of selected countries.....	6
Chart 2	Selected property market indicators in the United States.....	8
Chart 3	Interest rates on corporate loans and house purchase loans in euro area countries	9
Chart 4	Volume of loans to enterprises and households in selected euro area countries	9
Chart 5	Selected indicators of the Slovak corporate sector	11
Chart 6	Correlation between yields to maturity on 5-year Slovak government bonds and yields in selected EU countries	11
Chart 7	Structure of changes in the total volume of loans to households	12
Chart 8	Demand and credit standards for consumer loans and house purchase loans	12
Chart 9	Property price developments in the secondary market	13
Chart 10	Loan-to-value ratio.....	13
Chart 11	Changes in interest rates on house purchase loans	14
Chart 12	Changes in the volume of non-performing loans to households	14
Chart 13	Index of employment in selected sectors.....	15
Chart 14	Number of job seekers broken down by income category	15
Chart 15	Volume changes in household deposits by maturity.....	15
Chart 16	Comparison of net sales in collective investment funds and new deposits.....	15
Chart 17	Growth in loans to enterprises and the weight of these loans in the balance sheets of banks.....	16
Chart 18	Annual volume changes in loans to enterprises by sector.....	16
Chart 19	Sales in the corporate sector as compared with the pre-crisis level.....	17
Chart 20	Selected indicators for the commercial real estate sector.....	17
Chart 21	Growth in sales in industry	18
Chart 22	Business confidence, exports and sales	18
Chart 23	Corporate debt-servicing burden	18
Chart 24	Non-performing loans and default rates in the corporate sector.....	18
Chart 25	Book value of bonds from selected countries as a share of the debt securities portfolio's total book value	19
Chart 26	Average spreads and maturities of mortgage bonds issued with a fixed coupon	19
Chart 27	Selected items of interbank assets and liabilities	20
Chart 28	Interest rates in the domestic interbank market	20
Chart 29	Changes in the structure of the banking sector's profit	21
Chart 30	Loan impairment costs and the volume of NPLs in the banking sector.....	21
Chart 31	Net interest margin in the retail sector	22
Chart 32	Net interest margin in the corporate sector.....	22
Chart 33	Capital adequacy ratios	23
Chart 34	Comparison of average core capital ratios in the banking sector of EU countries	23

1. ANALYSIS SUMMARY

The main risks to financial stability did not moderate over the third quarter

The exposure of the banking sector to the main risks remained virtually unchanged over the third quarter of 2012. Despite the continuing positive trend in loan repayments by both households and enterprises, credit risk still represented the most significant exposure for the banking sector. This was confirmed by various indicators of the financial position of customers, which suggested that repayment behaviour would probably deteriorate in the period ahead.

The banking sector's profitability had been at risk of decline since the beginning of 2012. Negative developments were recorded in virtually all components of profitability. Conditions in the economic environment also had a profound influence on bank profits. The slow down in bank lending amid strong interest rate competition put downward pressure on interest income. Loan-loss provisioning costs increased, too. The profitability of banks was markedly affected by the introduction of a new bank levy. Thus, banks currently have little room to maintain their profitability.

The debt crisis in the euro area, which affects financial stability in Slovakia both directly and indirectly, moderated somewhat in response to the ECB's measures, but the fundamental problems remained unresolved. Hence, the sovereign debt crisis is expected to remain one of the main factors affecting the global economy as well as the financial markets.

A crucial factor for the banking sector's stability is the initiative to create a banking union. Although this initiative is viewed as positive, it is necessary to ensure a well-balanced division of powers and responsibilities between the national authorities and the common supervisory authority.

Another source of risk is the possible transformation of significant subsidiaries to branches. Such developments would reduce the ability of national authorities to monitor the situation in transformed institutions and increase the risk of negative trends transferred from the external environment.

Although the situation in financial markets stabilised in the third quarter, the euro area's macroeconomic performance is not expected to improve substantially

During the first half of 2012, the debt crisis deepened and numerous financial market players started speculating about the euro area's possible dissolution. The financial market calmed down only between July and September, after the ECB's president announced the central bank's determination to make every effort to stop the nervousness spreading over the financial markets and after the ECB Governing Council approved the programme of 'Outright Monetary Transactions', i.e. purchases of government bonds from countries under increased pressure. The resulting financial market stability, however, is relatively fragile and there are many factors that may trigger a new wave of nervousness.

Although the third quarter of 2012 saw favourable financial market developments, the euro area economy remained under pressure. A combination of falling demand in the private sector stemming from uncertainty about future developments, the efforts of most Member States to reduce the fiscal deficit to below 3% of GDP and the problematic situation in the euro area's banking sector has dampened expectations for any revival of growth in the near future.

Slovakia's growth in the first half of 2012 was driven to a large extent by exports, with car producers launching new production capacities. Due to the one-off effect of that stimulus coupled with the negative trend in private demand and the government's consolidation efforts, the rate of GDP growth is expected to slow down gradually.

Bank lending to the corporate sector continued to decline; the slowdown in lending to households continued as well

Bank lending to households continued to slow in the third quarter of 2012. The falling interest rates on new loans created room for growth in demand, mainly in demand for refinancing loans, but other economic indicators tended to reduce demand. The weakening consumer confidence, stagnating residential property prices, higher inflation, and falling employment created obstacles to lending growth. Bank lending was also negatively affected by banks' tightened loan collateral requirements. However, from the point of view of the sector's financial stability, the current prudent behaviour of banks seems to be warranted.

The year-on-year decline in the outstanding amount of loans to non-financial corporations (observed at the end of the second quarter) deepened still further between August and September. Basically the same declining trend was observed in the segments of large and small and medium-sized enterprises in most of the sectors. Both supply and demand factors contributed to the decline. All this happened in spite of increasing sales in the corporate sector, even when excluding the effect of the automotive industry, which relies on the domestic banking sector to a negligible extent only. Credit standards remained relatively tight, reflecting the uncertainty in the macroeconomic environment rather than banks' needs to deleverage.

While the banking sector's profitability continued to decline year-on-year in the third quarter, its capital adequacy ratio reached a six-year high

The total volume of profits decreased in year-on-year terms, mainly as a result of the new bank levy and a decline in net interest income. The third quarter also saw a modest increase in credit risk costs, which also contributed to the decline in profitability. The negative trend in net interest income affected the majority of banks, while the increase in credit risk costs originated mainly from loans to non-financial corporations and it was concentrated in a small number of banks.

The rise in the sector's capital adequacy ratio slowed in the period from July to August, when own funds were no longer increased through retained profits. The increase in capital adequacy continued to be driven by a reduction in own funds requirements, accompanied by an increase in the amount of own funds.

2. MACROECONOMIC DEVELOPMENTS AS THEY AFFECT BANKING SECTOR STABILITY

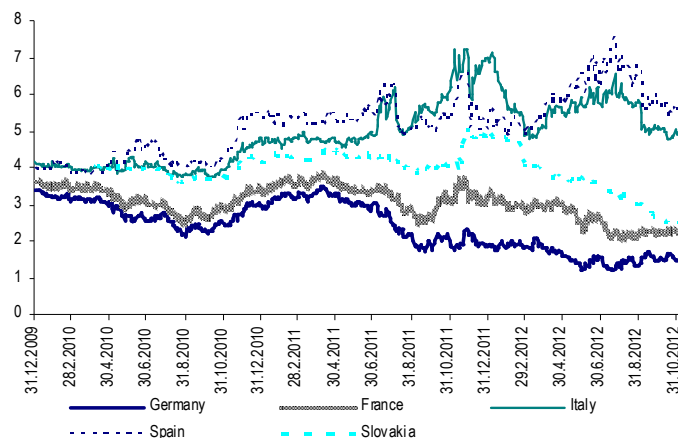
The situation in financial markets stabilised in the second half of 2012, but economic conditions in Europe and in the world remained difficult

From the macroeconomic view, the key feature of the third quarter of 2012 was the calming of financial markets and their subsequent stabilisation. On the other hand, the market indicator moved toward normal levels, but their values still reflected the ongoing increased stress. The negative fact is that the favourable trends in the financial sector were not reflected in the real economy to a significant extent. The growth prospects did not improve in most countries and the risks to growth remained on the downside.

The euro area debt crisis calmed down after the ECB's measures

The sovereign debt crisis in the euro area had been the main source of financial market tensions for more than two years. Over the first half of 2012, the crisis deepened and part of the financial market players began to speculate about the possible dissolution of the euro area, which translated into the prices of financial assets. Confronted with the financial sector's fragmentation across the euro area, the European Central Bank (ECB) decided to intervene in the market to dismiss such speculation and to support the single currency. At the beginning of September, the ECB Governing Council approved the programme of Outright Monetary Transactions, under which the ECB would purchase government bonds from countries under pressure. The condition for the activation of such purchases, however, is that the given country makes an official request for financial assistance and accepts the economic adjustment programme of the EU/ECB/IMF. Tensions in the financial markets had moderated to a significant extent even before the programme was officially announced. A change in sentiment occurred at the end of July, when the ECB's president announced that the central bank was determined to make every effort to stop contagion in financial markets.

Chart 1 Yields to maturity of 10-year government bonds of selected countries



Source: Bloomberg.

The prospect that the ECB will purchase government bonds (if the need arises) has led to a relatively significant fall in investors' risk aversion and to a cut in credit premiums for a wide range of assets. Decreases were mainly recorded in requested yields to maturity on sovereign bonds and in the spreads of respective CDS contracts. In the case of Spain, which

was under the highest pressure from financial markets at the beginning of July, 10-year bond yields dropped by more than 2 percentage points and 5-year CDS spreads by 300 basis points.

Since sovereign risk is closely linked to the risk of the financial sector, credit surcharges were substantially corrected for instruments that are related to financial institutions. The iTraxx Senior Financials Index dropped to its lowest level since the middle of 2011 and the Euribor-OIS spread reflecting the risk premium in Europe's interbank market fell to an even more historical low. The overall improvement in financial market sentiment had a positive effect on global equity markets, too. An important stimulus for upward asset price adjustments, mainly in the United States, was provided by the expectation that the American central bank would support the economy with another round of quantitative easing. A phenomenon accompanying the decrease in risk aversion was a certain dampening of demand for a narrow group of the safest assets.

The financial markets reacted positively mostly during August and September. The following period was typical of relative stability and the absence of more pronounced trends. This stability, however, was very fragile; it was exposed to numerous persistent threats with a potential negative effect on market sentiment. One of the main threats is the way of implementation of the measures that should accelerate the process of integration in Europe, including, for example, the attempt to create a banking union. At the level of individual countries, nervousness among investors may have been caused by failure in the consolidation efforts or the implementation of structural reforms at a satisfactory pace. With the end of the year approaching, there are indications that many countries have failed to reduce their fiscal deficits in 2012 to the required level. A sensitive and unanswered question is whether and when the Spanish government, or the government of another country, makes a request for financial assistance and thus opens room for the ECB to intervene in the government bond market of the country concerned. Last but not least, panic may also be triggered by the prolongation of negotiations about the second rescue package for Greece.

There are signs of improvement in the economic situation in the United States; the uncertain fiscal outlook, however, represents a serious threat to recovery

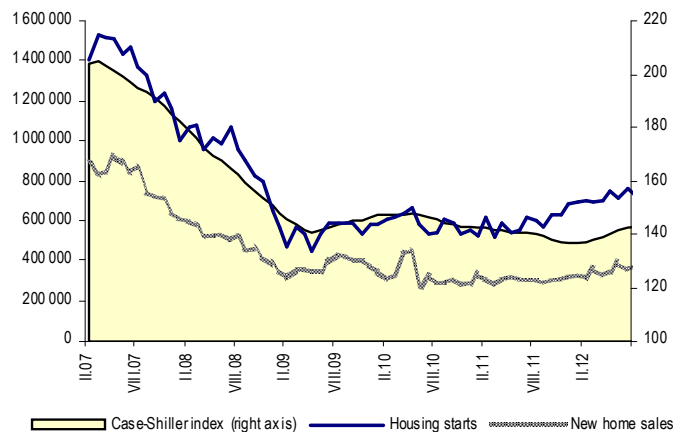
In terms of the pace of recovery from the financial crisis, the leading position among the advanced economies of the world is held by the United States. Looking at the pace of economic activity from the view of the country's potential or developments in the past, the situation is much less optimistic. This is also confirmed by the preliminary estimate of quarter-on-quarter GDP growth for the third quarter of 2012, i.e. 2.0% in annualised terms. The improved performance in comparison with the second quarter was caused by a modest revival in domestic consumption, which corresponds to the relatively sharp rise in consumer confidence in the last few months. The value of one of America's most frequently monitored consumer sentiment indices rose to a level not seen since 2008.

A positive contribution to GDP growth came from investment in residential properties. According to numerous indicators, the US residential property market bottomed out in the first half of 2012 and started to enjoy a relatively robust revival. Thus, activities in the residential property business have the potential to become a driver of the US economy in the years ahead.

On the other hand, non-residential property investments began to follow a negative trend. In the third quarter, expenditure on such investments was lower than in the previous quarter. It is assumed that the main reason behind the unwillingness of enterprises to invest is uncertainty about future fiscal policy settings. Starting from 2013, a series of consolidation measures are planned to be implemented under the valid legislation from 2011, in the total amount of hundreds of billions of dollars. However, the strict observance of this plan would,

in all probability, drag the US economy back into recession. This gives rise to concerns in the corporate sector and acts as a brake on investment activity.

Chart 2 Selected property market indicators in the United States



Source: Bloomberg.
Case-Shiller index is a US residential property price index.
Monthly data on construction and sales are given in annualised terms.

Uncertainty induced by the unclear fiscal outlook was one of the key rationales behind the third round of quantitative easing that was approved by the Fed at the beginning of September 2012. In contrast with the previous two rounds, the volume of securities that the central bank will purchase is now not limited to an amount specified in advance, nor is fixed to a predefined period. The Fed has undertaken to supply liquidity to the economy until the rate of unemployment significantly drops from current level of around 8%.

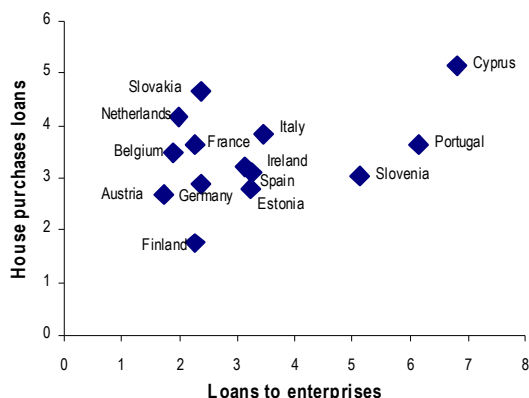
Uncertainty in the private sector and fiscal consolidation are dragging the euro area even further into recession

As we have already mentioned, the European debt crisis has entered a relatively calm period in recent months, but this stabilisation has not substantially improved the current macroeconomic situation in the euro area and its future prospects. According to the European Commission's latest estimates, the euro area economy as a whole suffered a GDP decline of 0.4% in 2012, compared with 2011. Although the forecast for 2013 predicts a positive change in output, the annual rate of GDP growth is not expected to exceed 0.1%. Six euro area countries will probably remain in recession in 2013. The negative trends in the euro area are also indicated by the fact that the European Commission in its previous forecast (of May 2012) predicted a revival in 2013 of around 1%.

Demand in the domestic private sector, which should generate a substantial part of the euro area's economic growth under standard conditions, has shown a negative tendency during 2012 (to date); this is at best expected to be followed by stagnation in 2013. Demand in the corporate and household sectors, which is in large measure a function of expectations, is dampened by negative sentiments in these sectors, stemming from the atmosphere of uncertainty prevailing in the euro area. An indicator of sentiment in the real economy of the euro area as a whole is the European Commission's economic sentiment indicator. Its sharp fall in recent months, well below the long-term average, shows why household consumption and corporate investments are being restricted. The worsening sentiment affects not only the euro area's peripheral countries that are faced with the most difficult macroeconomic

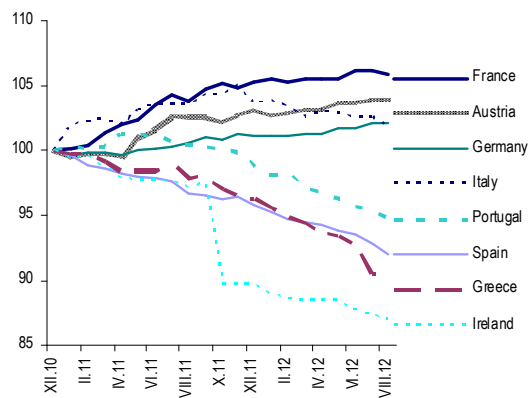
situation, but also Germany, where the prevailing sentiment at the beginning of 2012 was optimistic, especially in the corporate sector.

Chart 3 Interest rates on corporate loans and house purchase loans in euro area countries



Source: ECB.
Data are in percent per annum.

Chart 4 Volume of loans to enterprises and households in selected euro area countries



Source: ECB.
Index, XII.10 =100.

The decline in demand in the domestic private sector is amplified by the effect of deep consolidation in public spending. In line with the existing and recently adopted legislative measures, the majority of EU countries focus on reducing the fiscal deficit to below 3% of GDP, and subsequently on achieving a cyclically balanced budget. The recovery of public finances represents currently the main economic policy priority in Europe. This was formulated on conditions that, even if the current effect of consolidation on economic growth is negative, the positive effects of this approach will prevail in the medium-term horizon. Up to now, however, developments in this area have followed a negative course, rather than the desired positive trend. More and more experts are of the opinion that the placement of excessive emphasis on the consolidation of public finances at a time when private sector entities attempt to deleverage their balance sheets may be counterproductive to sovereign debt reduction. This has also been confirmed by a recent IMF analysis, which has revealed that the fiscal multipliers are much higher than expected. According to this analysis, they may reach a value ranging from 0.9 to 1.7, and not 0.5 as expected in the previous impact studies. This means that any tax increase and/or public expenditure cut will cause a significant GDP contraction. There are at least two circumstances acting against the current efforts for consolidation and economic revival. The first is the fact that this strategy is employed by virtually all countries in Europe simultaneously, which means that the possibility of relying on demand from trading partners is in large part eliminated. The second fact is connected with the effectiveness of monetary policy in situations where interest rates are close to zero and private sector entities are making every effort to deleverage their balance sheets.

A major obstacle to the revival of economic growth is the problematic situation in the euro area's banking sector, especially in the peripheral countries, and the related problem of restricted credit availability for the real economy. The declining trend in lending to enterprises in year-on-year terms continued in July and August. In addition, enterprises in countries regarded as more risky, are faced with high interest rates compared with those in other countries or the key ECB rates. Outflow of household deposits, owing to concerns about their safety, was another source of pressure to reduce the balance sheets of banks in certain countries. This phenomenon represents a very serious problem, in particular in Spain.

The last few months have witnessed a relatively positive development: the volume of liquidity borrowed by euro area banks from the ECB has ceased to grow. Nevertheless, numerous banks are still dependent on central bank liquidity.

The complicated economic situation is reflected in the growing number of unemployed. The number of people out of work, as well as the unemployment rate, have followed a rising trend in the last few months, too.

The Slovak economy was supported by a demand shock in 2012; however, the rate of growth is expected to slow in 2013

In terms of GDP growth, the Slovak economy was fairly resistant to the crisis in the first half of 2012, when a year-on-year growth rate of almost 3% was recorded in both quarters. According to various forecasts (NBS, Slovak Ministry of Finance, European Commission), GDP was expected to grow by 2.5-2.7% throughout 2012. The forecasts assume that the economy in 2013 will grow at a rate of only 2%, which, however, will be one of the highest in the EU.

The surprisingly strong performance of the Slovak economy under those circumstances was caused largely by a demand shock. Car producers in Slovakia launched new production capacities in 2012. As a result, the number of cars produced will probably increase by almost one third, and will contribute one percentage point to the country's economic output. Since this is a one-off effect¹, automobile production in 2013 is not expected to contribute so significantly to the year-on-year rate of economic growth. To some extent, this explains why a lower growth rate is expected in 2013.

In connection with the launch of new capacities in car production, it is necessary to take into account the structure of the Slovak industry, which distorts the aggregate data on the sector as a whole. The manufacture of transport equipment accounts for more than 90% of the two-digit increase seen in manufacturing production over the first eight months of 2012.

Some of the selected balance sheet and performance indicators of individual companies monitored by the Statistical Office indicate that the Slovak economy is being driven only by a small group of large corporations. The median values of these indicators calculated from a sample of roughly 5 thousand enterprises indicate that the conditions in the *non-financial corporations* sector worsened in comparison with 2011.

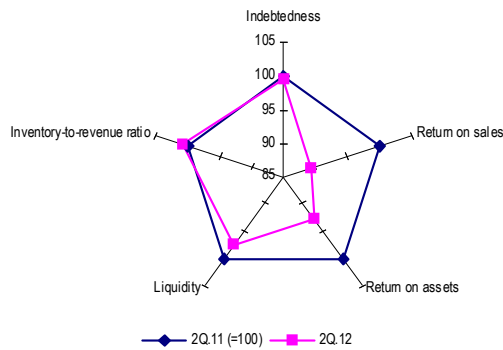
In terms of demand, GDP growth in 2012 was dominated by exports, owing to the country's booming automotive industry. The positive contribution of foreign trade to Slovakia's economic growth is expected to weaken in 2013, and the pace of growth is expected to be supported by domestic demand.

In year-on-year terms, household consumption followed a declining trend in the first half of 2012. This was followed by a similar trend in the third quarter, when the volume of retail sales decreased. For the time being, there are no favourable conditions for a revival in consumption in the foreseeable future. Owing to the relatively high consumer-price inflation, real income is falling in the household sector. The persistent high unemployment rate is another factor behind the low purchasing power of households, while a marked increase in job creation is expected to start in 2014 only.

The rate of growth will still be negatively affected in the coming years by the attempt to reduce the public deficit to below 3% of GDP. In 2013, consolidation measures are expected to amount to roughly 2% to GDP, while about two thirds of this contribution should have a direct impact on the economy.

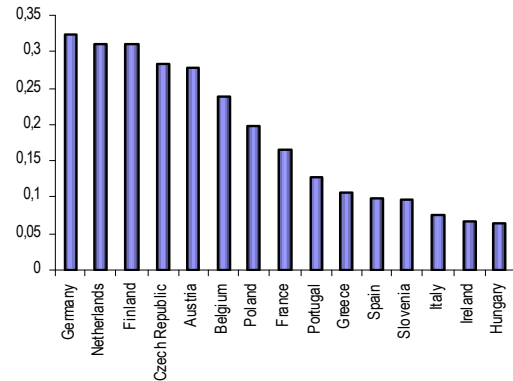
¹ On condition that the volume of automobile production in 2013 will remain at the level of 2012.

Chart 5 Selected indicators of the Slovak corporate sector



Source: Statistical Office of the SR, NBS calculations.
 A value that is closer to the centre of the chart means lower returns or liquidity, or a higher inventory-to-sales ratio or indebtedness, i.e. a deterioration in the business conditions.
 Median values from the sample of enterprises calculated for the second quarter of 2011 are standardised to 100.

Chart 6 Correlation between yields to maturity on 5-year Slovak government bonds and yields in selected EU countries



Source: Bloomberg, NBS calculations.
 Correlations between weekly changes in yields to maturity are calculated for the period from the beginning of 2011.

The worsening situation in the Slovak economy is also reflected in the overall index of economic sentiment, which has been falling steadily since April 2012. A sharp fall in this indicator was recorded in the last month for which data had been released, i.e. in October.

In 2012, there were no turbulences in the government bond market of Slovakia. Yields to maturity on Slovak government bonds followed a relatively balanced downward trend. Yields on 10-year bonds have been falling since the beginning of the year from 5% to 2.5%. Changes in the required yields on Slovak government bonds correlated closely with those on bonds issued in Germany and Finland, i.e. the least risky countries of the euro area.

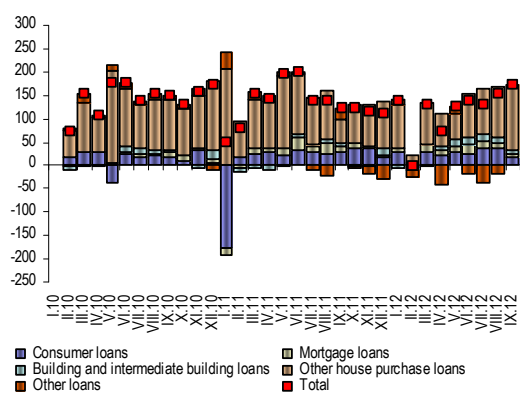
3. TRENDS AND RISKS IN THE SLOVAK BANKING SECTOR

The annual rate of growth in lending to households continued to slow

In the third quarter of 2012, the total volume of loans to households increased by €457 million, which was 14.6% more than in the same period a year earlier. Of this amount, €420 million was accounted for by 'other house purchase loans', for which banks are not obligated to issue mortgage bonds and which do not belong to the 'building loans and intermediate loans' category. In year-on-year terms, the increase in this loan category was 29.5% larger than in the third quarter of 2011, and took place mostly in September.

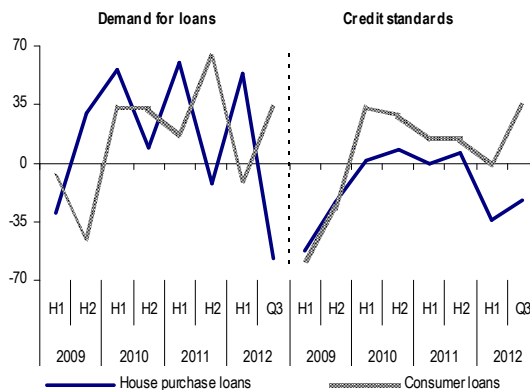
Although these results point to a gradual revival in bank lending, the steep increase in loans was caused mainly by a methodological change in certain banks, which led to the reclassification of corporate loans worth €87.2 million to household loans (for house purchases). With this effect taken into account, the increase in loans in the third quarter of 2012 was approximately 7% smaller than in the same period a year earlier.

Chart 7 Structure of changes in the total volume of loans to households



Source: NBS.
Data are in EUR millions.

Chart 8 Demand and credit standards for consumer loans and house purchase loans



Source: NBS.
Data are given as net percentages. Positive values indicate an increase in demand, or an easing of credit standards. Figures for the third quarter of 2012 refer to selected large banks.

In a recent bank lending survey, large banks operating in the Slovakia pointed out that demand for house purchase loans was declining. This trend can be attributed partly to the gradual tightening of credit standards (higher requirements for loan applicants).

The most important factor that positively influenced demand for loans in the household sector over the third quarter of 2012 was interest rate developments. Except for a slight fluctuation, interest rates followed trends in market factors. The ECB's looser monetary policy was partly reflected in the lower rates of interest on house purchase loans, i.e. in the increased difference between the average rates for existing and new loans. Hence, interest in loan refinancing is expected to increase.

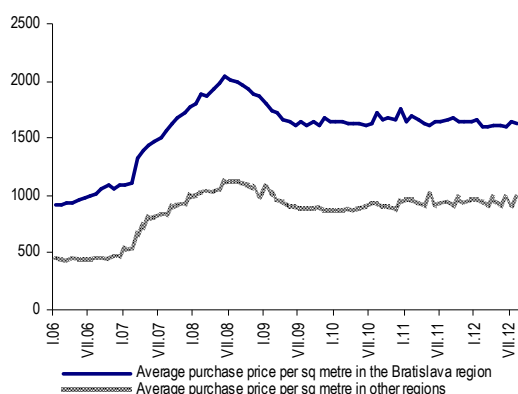
On the other hand, other economic indicators point to negative trends. The components of consumer confidence, resulting from an opinion poll on current and future developments, show no improvement. On the contrary, they point to a deterioration in sentiment among households in the third quarter of 2012, and to increased scepticism about the economic

outlook. Larger banks view consumer confidence as one of the factors behind the fall in demand for loans.

The average purchase prices of apartments in the secondary market, which may motivate households to invest in owner-occupied housing, showed no statistically significant changes in the second half of the year. The data indicate that, apart from price stabilisation, Slovakia's residential property market probably recorded a fall in liquidity in the last one and a half years, which is reflected in the substantially smaller number of transactions in both absolute terms and in relation to total demand.

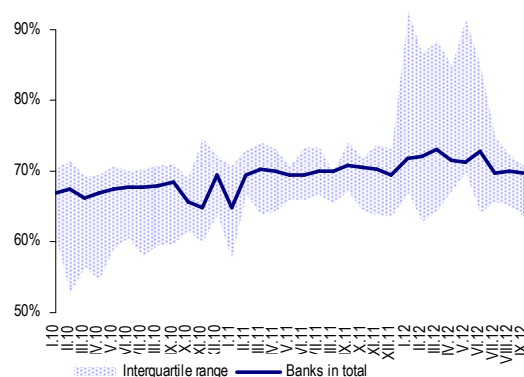
Another important factor affecting the rate of lending growth to a significant extent is employment, which signals no increase in the potential for borrowing. Data from the Statistical Office of the SR (SO SR) point to a year-on-year decline in employment, even in the key sectors, such as manufacturing.

Chart 9 Property price developments in the secondary market



Source: CMN, NBS.
Data on the left-hand scale are in EUR.

Chart 10 Loan-to-value ratio



Source: NBS.
The loan-to-value ratio expresses the ratio between the amount of loans provided and the value of collateral.

Banks tightened their loan collateral requirements

In the first half of 2012, selected banks substantially eased their loan collateral requirements, specifically the loan-to-value (LTV) ratio, which is one of their means of competition. On the other hand, this step increased the exposure of banks to credit risk.

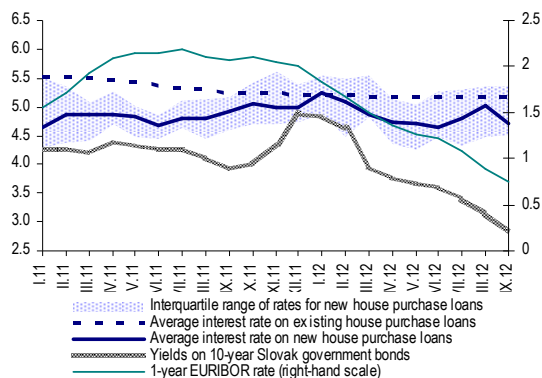
In the third quarter, several positive trends were recorded in loan collateral requirements. The average LTV ratio decreased, as well as the spread of the ratio's unweighted quartiles, which indicates that the tightening of loan collateral requirements is a general trend in the banking sector. Hence, from the view of the sector's stability, the behaviour of banks in the third quarter of 2012 can be considered prudent.

Interest rates on house purchase loans dropped

Interest rates did not follow a clear trend over the course of the third quarter. After rising more or less in July and August, the average rates fell sharply in September. The rate for other house purchase loans dropped to a level not seen since January 2011 and the rate for mortgage loans fell to a new historical low. These developments were influenced substantially by the key ECB interest rates, which have been reducing the price of money for a long period of time, and thus put downward pressure on the interbank market rates, as well as by the ECB's outright monetary transactions, which lower the yields on government bonds.

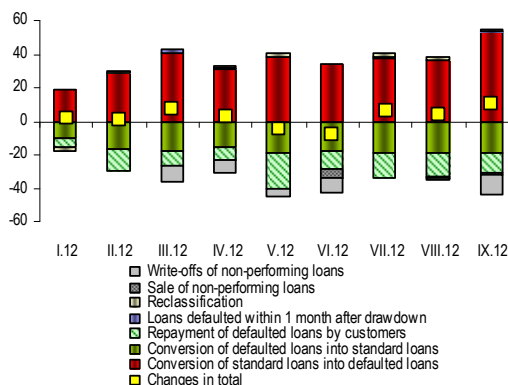
A different trend was recorded in rates for intermediate loans, which belong to the portfolios of building societies, which are exposed to seasonal factors.

Chart 11 Changes in interest rates on house purchase loans



Source: NBS, Bloomberg.
Data are in percent.

Chart 12 Changes in the volume of non-performing loans to households



Source: NBS.
Data on the left-hand scale are in EUR millions.

The share of non-performing loans in total loans remained stable

In the long term, the volume of non-performing loans in relation to the household segment's loan portfolio is stable. The share of non-performing loans in the total volume of loans is below 5% and shows a decreasing tendency in the long term.

However, the structure of volume changes in non-performing loans has had several negative indications. The share of loans with late repayments is still high, which is an indication of worsened repayment behaviour in the household sector. In September, banks recorded a larger volume of non-performing loans, mainly for house purchases. A part of the non-performing loans was written off. On the opposite side, the contribution of customers to the lowering of non-performing loans (e.g. through repayments or return to liability fulfilment) remained unchanged.

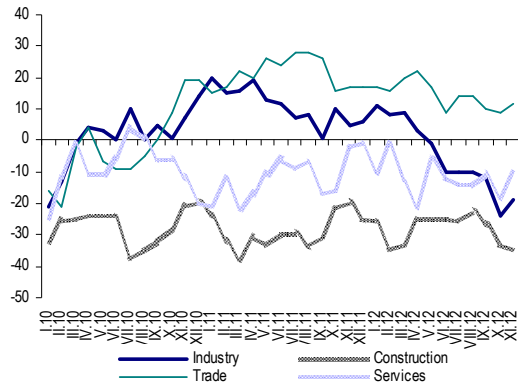
The number of unemployed in medium and higher-income job categories recorded no further increase

The situation in the labour market, which is one of the key indicators of credit risk in the household sector, was relatively unfavourable in the third quarter. In a number of sectors, the employment index pointed to a year-on-year decrease in the number of employees, even in the key sectors, such as manufacturing. The index of expected employment has not indicated that the situation is going to change in the period ahead.

The falling employment was not fully reflected in the number of registered unemployed. On the contrary, the number of registered unemployed started to fall in the second quarter of 2012, by approximately 4% year-on-year, while this number did not include not enlisted job seekers, where the number of registered unemployed increased. In terms of credit risk, however, it is important that the number of unemployed in medium and higher-income job categories, representing the main group of bank loan takers, is not growing.

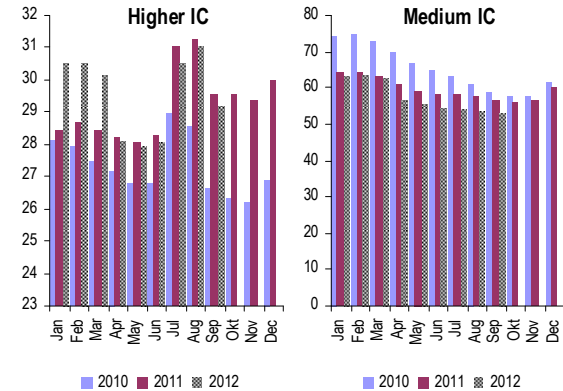
Another important factor related to credit risk is the inflation rate. This has been more or less stable since the beginning of the year, but rather at a high level of around 3.8%.

Chart 13 Index of employment in selected sectors



Source: Statistical Office of the Slovak Republic.

Chart 14 Number of job seekers broken down by income category



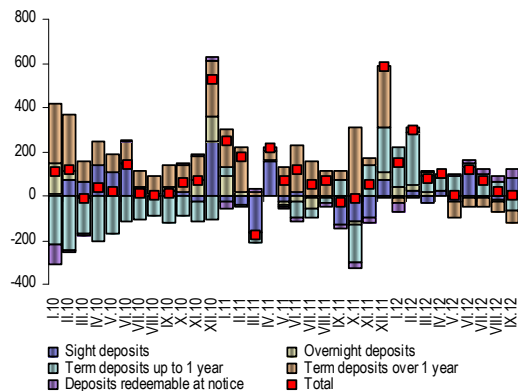
Source: Central Office of Labour, Social Affairs and Family. Data are in thousands of persons. IC – income category.

Deposits grew in volume, mainly at branches of foreign banks and collective investment funds

Household deposits continued to grow in the third quarter. They increased by €84.7 million in that period, which was 6.6% less than in the same period a year earlier. Thus, the weaker growth trend observed in the first half of 2012 continued. After giving preference to time deposits in July and August, households deposited their free funds mostly in sight deposit accounts in September.

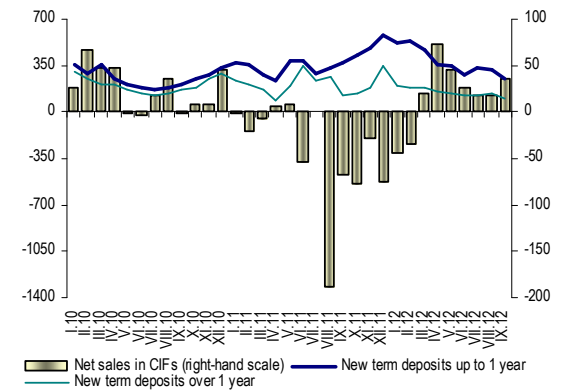
The increase in deposits was concentrated mainly in branches of foreign banks (€89 million) and, to a lesser extent, in medium-sized banks (€17 million). On the other hand, large banks and building societies recorded a decline in deposits (-€21.7 million).

Chart 15 Volume changes in household deposits by maturity



Source: NBS. Data are in EUR millions.

Chart 16 Comparison of net sales in collective investment funds and new deposits



Source: NBS. Data are in EUR millions.

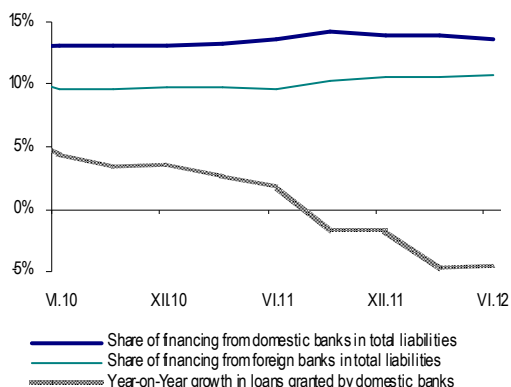
The structure of changes in deposit volumes recorded in the period under review indicated a declining preference for time deposits. An important factor behind these developments was the shift of retail deposits to collective investment funds (mainly to specialised funds). This trend was less pronounced than in the second quarter of 2012; nevertheless, it played an important role. A likely motivation were low interest rates on long-term deposits (falling since the beginning of the year), as well as a marked fall in the average rate for short-term time deposits in September.

Loans to non-financial corporations decreased in volume year-on-year

The outstanding amount of loans to non-financial corporations continued to decrease in the third quarter of 2012. Thus, the decreasing trend in loans as described in the *Analysis of the Slovak Financial Sector for the First Half of 2012* was confirmed in September, when loans fell by 4.6% year-on-year. Virtually the same trend was observed in the segments of large and small/medium-sized enterprises.

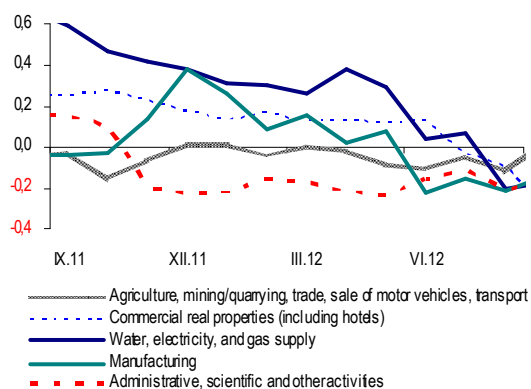
Despite the persistent differences between sectors, the decrease in loans was relatively evenly distributed across most of the economic sectors. It is also necessary to draw attention to the fact that the decline in financing provided by domestic banks was accompanied in the corporate sector by a modest increase in financing from abroad. Unlike in 2009, when the shortage of financing from domestic banks was partly compensated for by increased capital inflows from abroad, financing from abroad was channelled through debt instruments this time.

Chart 17 Growth in loans to enterprises and the weight of these loans in the balance sheets of banks



Source: NBS.

Chart 18 Annual volume changes in loans to enterprises by sector



Source: NBS.
Data are in EUR billions.

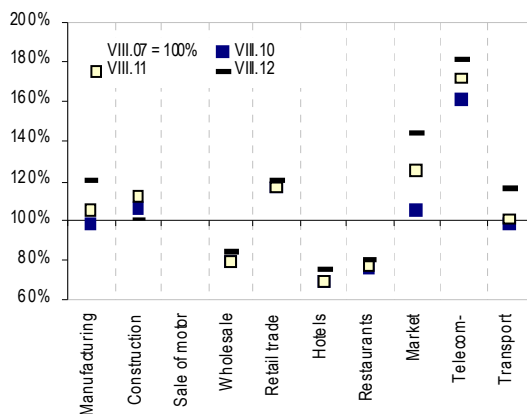
Credit standards remained unchanged in the third quarter, i.e. they were relatively tight. The tight lending conditions, combined with a decrease in the volume of new loans, may cause the fears of deleveraging to materialise. Hence, it is worth mentioning that the reasons for conservative credit standards are related to uncertainty about macroeconomic developments and are not the result of balance-sheet restrictions at the financing banks. Demand for loans among enterprises also remained virtually unchanged; its low level was again connected with the macroeconomic risks.

Continuing modest increase in sales in the corporate sector

From the view of stability, it is important that sales in the corporate sector continued to grow in the third quarter of 2012 (by 4.5% year-on-year). In year-on-year terms, economic activity increased in all of the main sectors, except in construction. The strongest growth was as usually observed in the manufacture of transport vehicles (20%), which, however, was financed by domestic banks in small measure only. Even if the effect of automobile production is excluded, enterprises achieved an increase in sales (2.9% year-on-year). A persistent problem is that the corporate sector's output has not yet returned to its pre-crisis level and that numerous industries fluctuate around 80% of their pre-crisis performance.

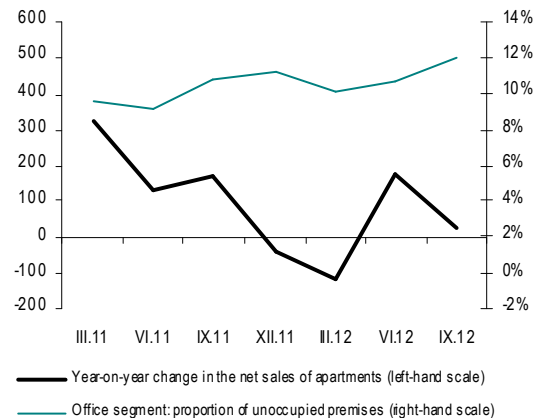
The situation in the residential property market remained unstable. Despite the relatively favourable trend in the economy as well as in the corporate sector, the office vacancy rate continued to increase in September 2012. On the other hand, the residential property market showed no signs of cooling; the sale of new apartments continued at an even pace. The number of vacant apartments in new projects continued to decrease gradually, and thus the prices of new apartments increased. Despite these partially positive signals, the risk inherent in this segment remained an important factor for financial stability.

Chart 19 Sales in the corporate sector as compared with the pre-crisis level



Source: SO SR, NBS calculations.

Chart 20 Selected indicators for the commercial real estate sector

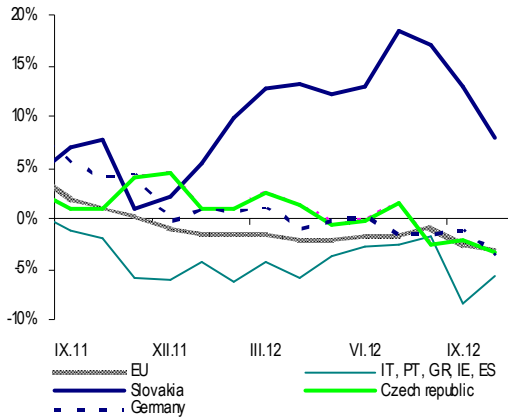


Source: CBRE, Lexxus, NBS calculations.

Different developments within the EU

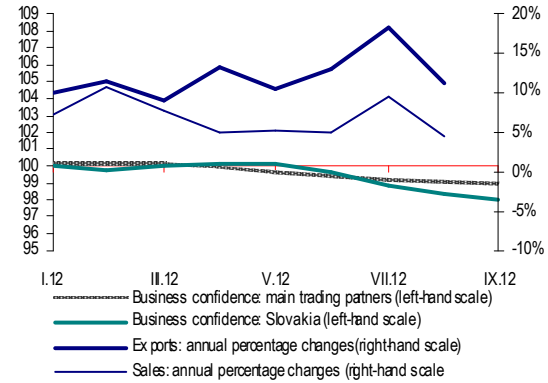
Heterogeneous economic developments within the borders of the European Union continued in the third quarter of 2012. The differences in growth rates were in line with those in manufacturing output in which Slovakia is well ahead of its main trading partners. The slowdown in economic activity in countries to which Slovak goods are exported was reflected in the indicators of economic confidence, but had no direct effect on the rate of export growth, which remained very favourable.

Chart 21 Growth in sales in industry



Source: Eurostat.

Chart 22 Business confidence, export and sales



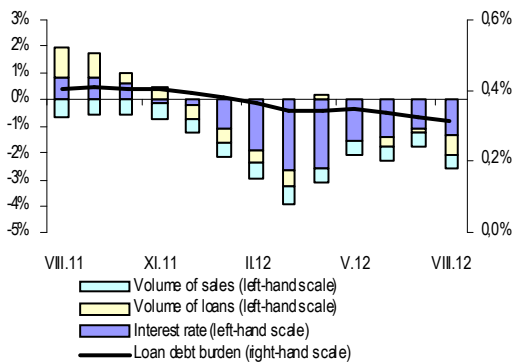
Source: SO SR, OECD, NBS calculations.

Credit risk improved to a certain extent

Credit risk posed by non-financial corporations continued to be influenced by two factors. The first was loan-debt burden reduction. The debt-servicing burden on corporations can be eased by a combination of the following variables: decrease in the loan volume, increase in sales, and interest rate reduction. A significant effect was exerted by a fall in interest rate levels, caused by a cut in the key ECB rates. In the long term, however, it is questionable to what extent an environment of low interest rates is sustainable and how a possible rise in interest levels will affect the volume of loans provided in a given period. The second factor was the persisting uncertainty about the further course of economic development, which was reflected mainly in the setting of credit standards. In this case, an increase in banks' interest-rate margins for loans to enterprises moderates the downward pressure on interest rates. Thus, debt servicing is lower, but relatively more expensive owing to the wider margins, and creates a healthier environment for financial stability.

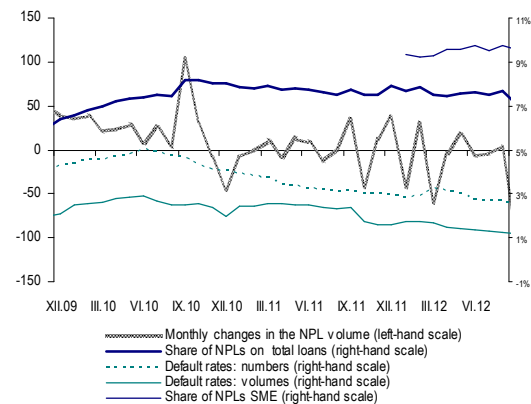
The easing of the debt-servicing burden was partly reflected in the falling loan default rate, which was gradually approaching its pre-crisis level. At the same time, banks continued to cleanse their portfolios and thus the share of non-performing loans decreased to a 30-month minimum. On the other hand, the share of non-performing loans increased somewhat in the segment of small and medium-sized enterprises.

Chart 23 Corporate debt-servicing burden



Source: NBS, SO SR, NBS calculations.

Chart 24 Non-performing loans and default rates in the corporate sector



Source: NBS.

Growing investment in domestic government bonds, accompanied by a fall in foreign government bond holdings

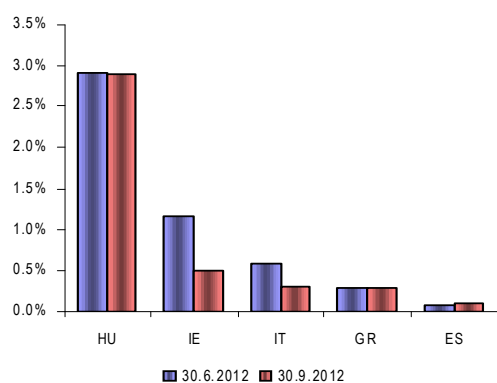
Over the third quarter, banks' purchases of debt securities moderately increased. Investments consisted mainly of Slovak government bonds and Treasury bills, while the portfolio of foreign government bonds decreased by more than 13%.

Investments in bonds issued in countries with an increased sovereign risk remained at a negligible level in the sector as a whole. Nevertheless, such bonds remain highly concentrated in certain banks.

Bond issuance by domestic banks remained virtually unchanged

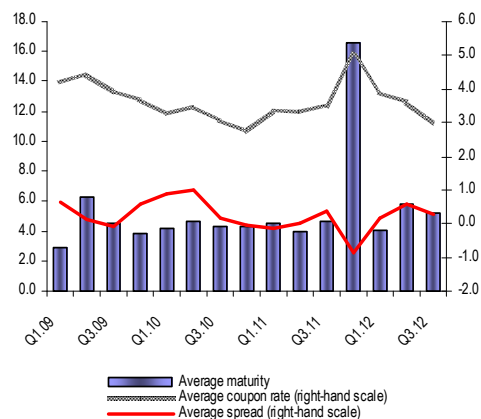
Concerning securities issuance, in the third quarter of 2012 domestic banks issued almost exclusively mortgage bonds. In line with the growing volume of maturing mortgage bonds, the volume of mortgage bond issued also increased during the year; the total issue amount in the third quarter of 2012 reached the level of issues made in the second to fourth quarters of 2010. The parameters of bonds remained virtually unchanged.

Chart 25 Book value of bonds from selected countries as a share of the debt securities portfolio's total book value



Source: NBS.

Chart 26 Average spreads and maturities of mortgage bonds issued with a fixed coupon



Source: NBS.

Data on the left-hand scale are in years.

Data on the right-hand scale are in percentage points.

Spreads, coupon rates, and maturities are weighted by the nominal amount of mortgage bonds issued.

Spreads were calculated as the difference between the coupon rate for the given mortgage bond and the yield on government bonds with the same maturity at the time of issuance. If there was no government bond with the same maturity, the yield was calculated on the basis of linear interpolation.

Only mortgage bonds with a fixed coupon rate were used in the calculation.

Following the structural changes seen in the first half-year period, only minor changes occurred in interbank operations during the third quarter

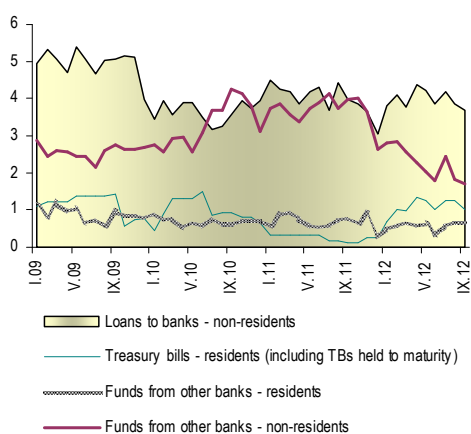
After interbank assets (and partly liabilities) recorded a marked fall towards the end of June 2012, relatively significant changes occurred only on the liability side in the third quarter

of 2012. The increase in deposits received from foreign banks in July and their subsequent decrease in August, however, compensated to a large extent for the fluctuation in other more volatile items in the balance sheet of banks (corporate deposits and loans, or deposits and loans from/to non-residents); these funds were in part invested into Slovak Treasury bills.

In the months of July to September, the volume of deposits received from the general government sector continued to fall, as well as the volume of free funds deposited with the ECB, though at a slower pace than in June. Part of the free funds was reinvested by banks in the domestic interbank market.

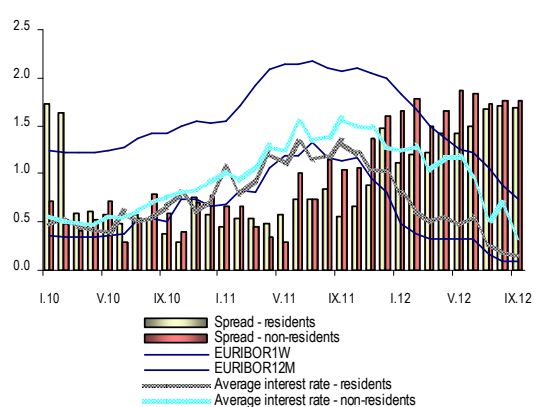
Developments in implied interbank market rates continued to follow a similar trend than the EURIBOR rates; the third quarter witnessed another fall in these rates. The large spreads between banks resulted from the heterogeneous structure of maturities, rather than from differences in credit quality associated with different banks.

Chart 27 Selected items of interbank assets and liabilities



Source: NBS.
Data are in EUR billions.
The chart shows month-end amounts reported by banks in the individual categories.
TB – Treasury bills.

Chart 28 Interest rates in the domestic interbank market



Source: NBS.
Average interest rate – non-residents: average interest rate on interbank deposits taken from non-resident banks.
Average rate – 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.

4. FINANCIAL POSITION OF THE BANKING SECTOR

The banking sector's total profit fell in year-on-year terms, mainly as a result of the new bank levy and the declining net interest income

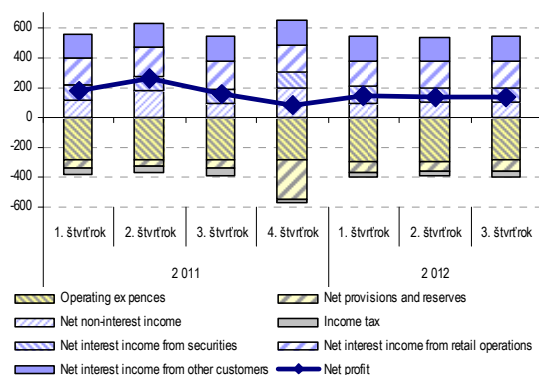
The net profit of the banking sector for the first third quarters of 2012 was €413 million, representing a year-on-year decline of 30% (if profits from the previous year had been calculated without taking account of the extraordinary one-off effects, the change would have been at the level of 22%). A net loss was reported by two banks and nine branches of foreign banks.

The main cause of the lower net profit was the introduction of the new bank levy. For the period from January to September 2012, bank levy was collected in the total amount of €69 million. This means that if the new bank levy had not been in force, the year-on-year drop in the sector's net profit would have been only 18%.

Further factors that contributed to the year-on-year decline in profits were rising credit risk costs and a decrease in net interest income.

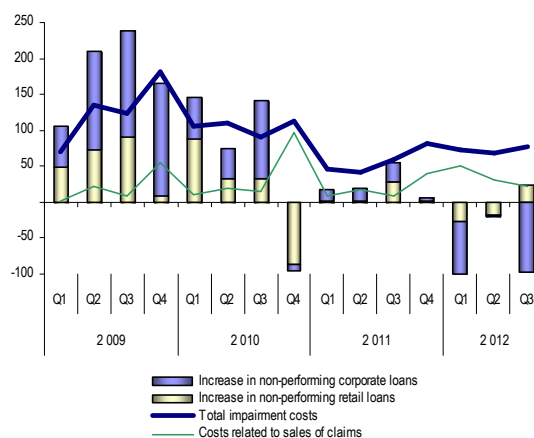
Credit risk costs recorded a modest increase in the third quarter of 2012, after falling slightly in the first half of 2012 (Chart 30). This increase was caused mainly by the corporate sector and was concentrated in a small number of banks. By contrast, credit risk costs in the retail sector decreased gradually over the course of 2012.

Chart 29 Changes in the structure of the banking sector's profit



Data are in EUR millions.

Chart 30 Loan impairment costs and the volume of NPLs in the banking sector



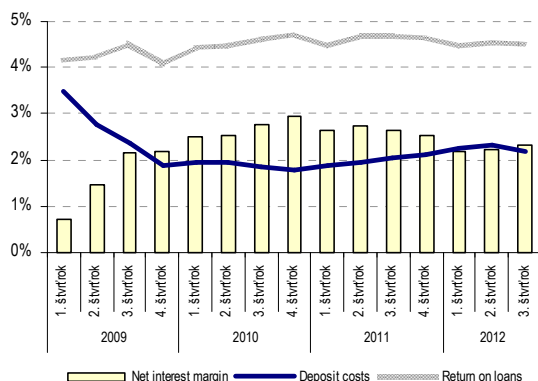
Data are in EUR millions.

Net interest income followed a negative trend in most of the banks. Over the first half of 2012, it was influenced mainly by the continuing rise in costs of retail deposits (Chart 31). This was caused by increased competition in this sector, for banks attempted to ensure a relative stable source of financing through retail deposits in particular. The rising costs of retail deposits resulted from a long-term increasing trend in the share of term deposits, accompanied by a decrease in the share of sight deposits. This trend came to an end in the third quarter, when the margin in the retail sector again increased somewhat.

The net interest income of banks also fell in the corporate sector, mainly as a result of two factors. The first was the decreasing net interest margin, mainly in the second quarter of 2012. This decrease was caused mainly by a fall in returns on loans, which exceeded the fall in deposit costs (Chart 32). The second factor was a gradual decrease in the volume of corporate

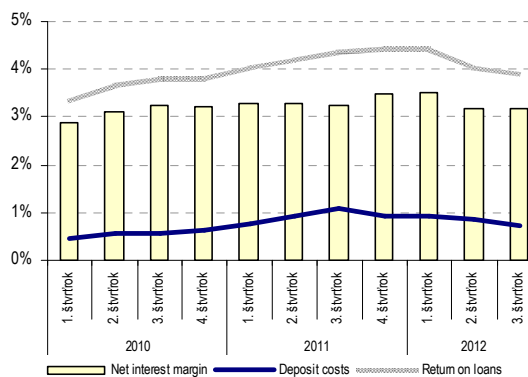
loans during the second and third quarters of 2012, which led to a marked fall in net interest income in numerous banks, mainly in the third quarter.

Chart 31 Net interest margin in the retail sector



Data are in % (p.a.).

Chart 32 Net interest margin in the corporate sector



Data are in % (p.a.).

From the view of the trend in net interest income described above, it should be noted that, in contrast with the previous period, the trends observed in the individual groups of banks were not homogeneous in 2012. The net interest margin decreased mainly in the five largest banks, while medium-sized banks recorded an increase in the net interest margin. One of the significant differences was observed in the volume of corporate loans, which decreased in the portfolios of large banks, while medium-sized banks recorded an increase in the third quarter of 2012.

The sector's capital adequacy ratio reached a six-year high in the quarter under review

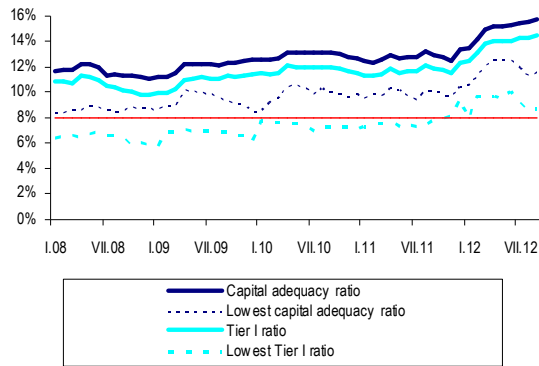
The capital adequacy ratio (CAR) of the banking sector as a whole rose slightly over the third quarter of 2012, from 15.3% to 15.8%, representing the highest average CAR value since 2005 (Chart 33). Thus, the rising trend in the sector's solvency from the first half-year period continued, though at a slower pace, because own funds were no longer increased from retained profits.

The continuing rise in capital adequacy was again caused by an increase in the amount of own funds (+1.4%), accompanied by a decrease in capital requirements (-1.8%). The Tier I ratio also increased, from 14.1% to 14.6%. Increased capital adequacy was reported by most of the banks. One of the most important causes was the optimised amount of risk-weighted assets in some of the banks (owing to the IRB approach). In some of the banks using a standardised approach to credit risk assessment, however, the capital requirements for credit risk coverage raised in response to an increase in the volume of exposures, mainly towards the retail sector. Two banks recorded a decrease in the amount of own funds as a result of negative financial results produced in the first three quarters of 2012. This also contributed to the fall in the lowest capital adequacy ratio from among individual banks, to 11.5%. The lowest Tier I ratio dropped to 8.7%. In this connection² it should be noted that, in January 2012, NBS recommended that banks maintain a Tier I ratio of at least 9%, in support of the banking sector's stability and self-sufficiency during the current debt crisis. The recommended ratio was not observed by one bank as at September 2012.

² Recommendation No. 1/2012 of 16 January 2012 on maintaining the stability of the banking sector, issued by the Financial Market Supervision Unit of Národná banka Slovenska.

Regarding the solvency of the Slovak banking sector in comparison to other EU countries, it is noteworthy that the sector's Tier I ratio was above the EU average as at 30 June 2012 (Chart 34). This also applies to the quality of capital: Tier I capital represents 92% of the total amount of own funds in the Slovak banking sector.

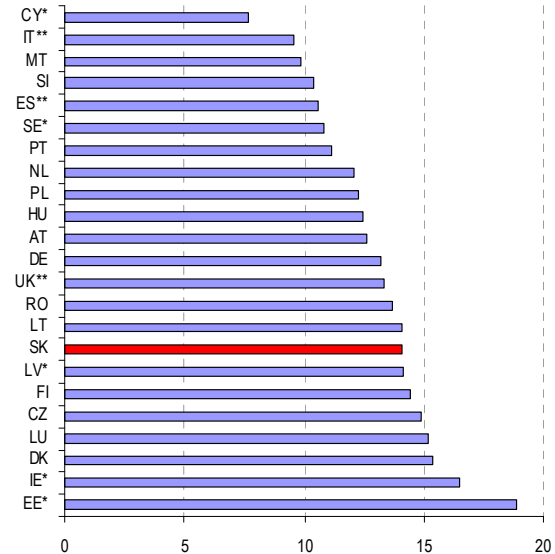
Chart 33 Capital adequacy ratios



Source: NBS.

Horizontal lines indicate the regulatory limit set for the capital adequacy ratio (8%) and the recommended Tier I ratio (9%).

Chart 34 Comparison of average Tier I ratios in the banking sectors of EU countries



Source: International Monetary Fund.

Data for countries marked * are as of 31/12/2011; data for countries marked ** are as of 31/03/2012. Data for other countries are as of 30/06/2012.

* * *

Box 1 Risks related to the transformation of significant subsidiaries into foreign bank branches

As mentioned above, the Slovak banking sector as a whole currently has a relatively high level of self-sufficiency in terms of its capital position and sources of funding. There remains, however, an elevated risk of adverse external shocks. It is therefore necessary that national supervisory authorities have sufficient powers to implement effective tools that can prevent such developments from impairing the Slovak financial sector and Slovak economy.

Given the high proportion of foreign capital in the domestic banking sector, the extent to which Národná banka Slovenska (NBS) can influence banks depends on two fundamental factors. Firstly there are regulatory changes at the European level related to the transfer of certain responsibilities of national supervisors to the ECB (as part of the single supervisory mechanism, the first step toward a banking union), or to the supervisory authorities of parent undertakings (under the draft Capital Requirements Directive/CRD IV and Capital Requirements Regulation/CRR). The new regime will limit NBS's powers, particularly in regard to its supervision of liquidity and its scope for independent decision-making on the implementation of supervisory measures – areas for which NBS has so far had direct responsibility.

The second factor relates to the transformation of significant subsidiaries of foreign banks into entities without legal personality, i.e. to the provision of banking services either by foreign bank branches under the single banking licence, or on a cross-border basis. This box also looks at risks related to the transformation of subsidiaries with significant market share into foreign bank branches.

The main risk posed by the transformation concerns the differences in the statutory regulation of the activities and risk management of subsidiaries and branches. Among the most important changes is that branches have no legal personality and are not subject to legal provisions regulating equity capital and large exposures. As a result, all the risks related to a banking group will automatically and immediately apply to its branches, without NBS being able to mitigate or influence such risk to financial stability by the application of instruments at the national level, notwithstanding that the Slovak economy could ultimately bear the brunt of any costs resulting from these risks.

The absence of effective tools for implementing macro-prudential policy in relation to foreign branches is also complicating the application of recommendations issued by the European Systemic Risk Board (ESRB). The past ESRB recommendations dealt for example with high shares of foreign currency lending and with US dollar denominated funding of credit institutions. As an example, it is worth noting in this regard that the Estonian authorities sought to limit a dramatic rise in the indebtedness of the Estonian economy during 2001-2008 and that their efforts fell short partly due to difficulties in the application of regulatory instruments to branches.

Any transformation of significant subsidiaries into foreign bank branches also represents a threat to the currently favourable combination of capital and liquidity buffers of the Slovak banking sector as a whole. The situation as it stands provides sufficient financing to local households and enterprises. The transformation of subsidiaries into foreign bank branches will open the way to capital and liquid asset transfers to parent undertakings or other members of a group, which may substantially limit the self-sufficiency of institutions and their capacity to provide sufficient financing to the economy, particularly during crisis periods.

Furthermore, the transformation into branches may reduce the banking sector's investment in the domestic country's sovereign debt. Investment in government securities helps banks

create liquidity buffers and optimises compliance with capital requirements. For branches, however, these incentives will no longer exist due to the absence of regulatory rules for liquidity and solvency. Moreover, empirical experience shows that local managements of subsidiaries are more inclined to invest in domestic government bonds than are central managements when deciding on the investment activities of foreign branches.

At times of crisis and financial market strains, heightened exposure to external shocks may adversely affect transactions with financial assets in other segments of the market or with large corporate customers linked to these banking institutions.

Another risk-related issue is the complicated implementation of crisis management mechanisms in foreign bank branches. It is generally the case that financially sound and solvent subsidiaries that are sufficiently independent of their parent undertakings, are better prepared to overcome difficult times or the failure of their parent undertaking or another member of their banking group. Such cases raise the likelihood that the banking group will undergo suitable restructuring in which the sound subsidiaries may be separated from the group in order to operate as an independent entity, to be sold, or (temporarily) to be nationalised. Branches, by contrast, cannot be directly recapitalised – not even if they are systemically significant – owing to their legal form and lack of equity capital. Another problem is that, during confidence crises in financial markets, the supervisory authority would be heavily circumscribed in its ability to prevent the spread of adverse or false information in public statements. With incomplete information about the risk exposure of branches or about their financial situation, the supervisory authority would be vulnerable to reputational risk.

Participants in Slovakia's deposit protection scheme include both banks and foreign bank branches, but unlike banks, foreign bank branches are not obliged to participate in the scheme. Deposits held with a foreign bank branch in Slovakia are covered by the deposit protection scheme of the country in which the branch's parent undertaking has its registered office. So customers of a foreign bank branch in Slovakia may face difficulties in recovering their deposits if the branch's parent undertaking fails, given that the deposits are insured under the deposit protection scheme of the bank's home country.

Customers of a foreign bank branch who are seeking repayment of their inaccessible deposits may find that they have to travel to the home country of the parent undertaking or communicate in the local language, or that their deposits are repaid in the local currency. It may also be difficult to obtain the information that the repayment process is proceeding or any other details of the process.

Given the risks associated with the transformation of significant subsidiaries into foreign bank branches, it is essential to have in place effective legislative measures designed to prevent the emergence or escalation of such risks, or at least to mitigate as far as possible any headwinds arising from their materialisation. Such measures should in particular strengthen the powers of national supervisory authorities to participate effectively in the transformation process.