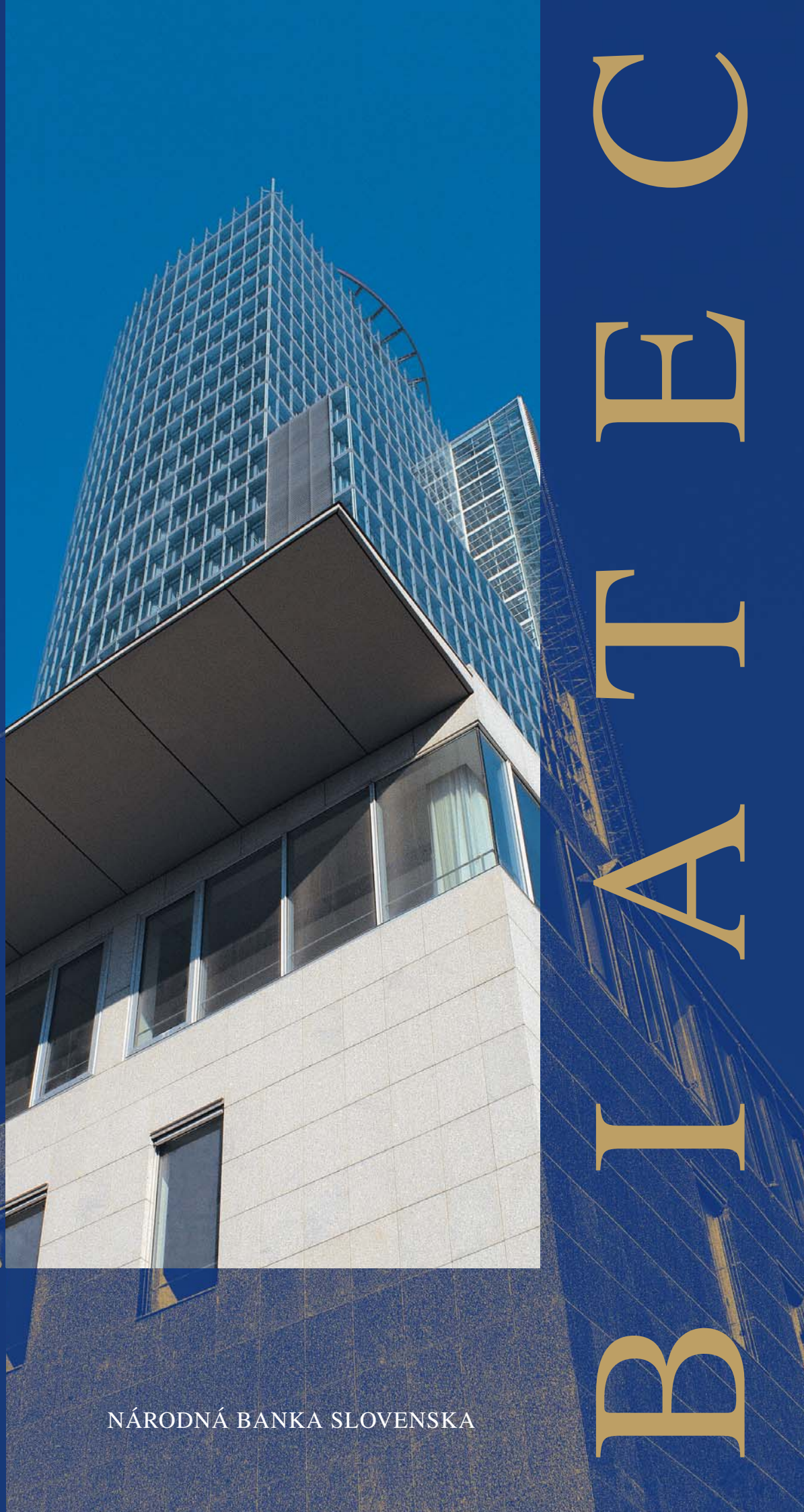


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NÁRODNÁ BANKA SLOVENSKA



Financial market – development and new trends in regulation

Ing. Vladimír Dvořáček

*Executive Director of the Financial Market Supervision Department
Národná banka Slovenska*



In the Biatec journal for the second time we give a more complex overview of current developments on the financial market. The NBS experts from the Financial Market Supervision Department have been mapping the current situation as well as the anticipated development on the Slovak financial market that is, according to the preliminary data, recovering from the negative development caused by the economic crisis. At the same time though, new risks and developmental trends have appeared that we highlight.

The development of the crisis may be documented in the banking sector based on its credit activity with regards to households.

Based on our analysis we reached the conclusion that households have been showing increased demand for housing credits in the recent period. They use credits predominantly to refinance their old credits that had been provided under less advantageous conditions, or to secure a higher standard of housing. However, according to the most recent data this trend is not durable and cannot be used to clearly show the revitalisation of construction in this segment.

Apart from the analysis of the current situation in the banking sector, we also deal with the European discussion on introducing guarantee schemes in the insurance industry sector.

We point out the pros and cons of this solution and deal with the impacts of establishing such schemes under our conditions.

Introducing guarantee schemes is related to increased moral risk and request for public funds. The financial services provided by insurance companies are very varied, and in some cases the introduction of such a scheme is unjustified. At the moment, changes to the system of deposit pro-

tection as well as other changes in the banking sector are being dealt with by legislative staff.

We will inform you about these changes in subsequent issues of the Biatec journal.

The economic crisis also indirectly exposed the problems of the sustainability of public financial resources in relation to adverse demographic developments in Europe.

The European Commission has therefore published a Green Paper on Pensions in which it strives to present a holistic approach to this issue. It started by examining the issue of the adequacy and sustainability of pensions, as well as private pension companies and the obstacles of cross-border undertaking. The Národná banka Slovenska has actively joined this discussion in its sphere of activity.

The global financial crisis has led the European Commission to develop a new regulatory framework, part of which is also the modified organisation of the financial market supervision architecture.

To date, the final versions of the relevant regulations are yet to be published. We will give a comprehensive and critical view of this issue in future issues of Biatec journal.

Photo: Igor Plávka



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FINANCIAL MARKET SUPERVISION

Main trends and biggest risks in the Slovak banking sector in the first half of 2010 2
(Marek Ličák, Štefan Rychtárik)

Is the increase in new credits in the first half of 2010 an indication of the crisis end? 7
(Matej Krčmár)

Analysis of interest rates on retail housing loans with fixation of up to one year 12
(Ján Klacso)

Guarantee schemes in the insurance system 16
(Peter Paluš, Andrea Gondová)

Regulation of pension savings in the European Union and planned changes 19
(Peter Pénzeš, Slavka Polakovičová)

EU COUNTRIES CONVERGENCE

Has the recession had an impact on European integration and catching up? 24
(Tibor Lalinský)

FINANCIAL STABILITY

Household indebtedness in Slovakia 31
(Ing. Anna Strachotová)



Main trends and biggest risks in the Slovak banking sector in the first half of 2010

Marek Ličák, Štefan Rychtárik
Národná banka Slovenska

After 2009, in which the economic and financial crisis was more evident, the first half of 2010 brought a certain revival to the domestic banking industry. The significance of some risks lowered while some others were more strongly reflected. There were also some new trends that may become the source of other risks in the future. The overall situation remains open, especially considering the future macroeconomic situation and interest rate developments.

MAIN TRENDS IN THE BANKING INDUSTRY

In spite of a certain stabilisation of the domestic and foreign economic development, banks behaved quite prudently in the first half of 2010.

Several trends recorded in 2009 continued, especially investments into government bonds. In this way, the banks partially compensated for the decrease in financing the entities of the domestic real economy, especially the enterprises. A significant part of debt securities purchased was traditionally represented by domestic government bonds. However, in some banks investments into foreign government bonds also increased in the first half of 2010. It is interesting that the biggest growth was recorded by the bonds of countries that at the same time recorded quite a significant decrease in prices.

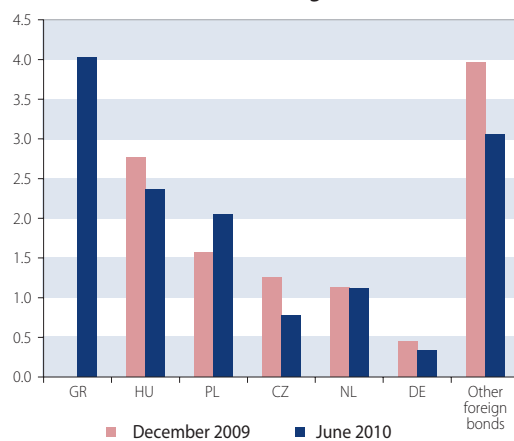
The mentioned trend of the decreased financing of the enterprises was seen in the majority of

banks. Banks in general treated the enterprises quite prudently as was reflected in quite strict credit standards.

The decrease in loans, however, was also influenced by demand development on the side of enterprises. In spite of the improving financial position of the enterprises, several indicators were far from the levels of 2008. Enterprises reported a quite high portion of unused production capacity which was reflected mostly in low demand for investment loans.

A revival was recorded with loans to households, especially housing loans. The dominating

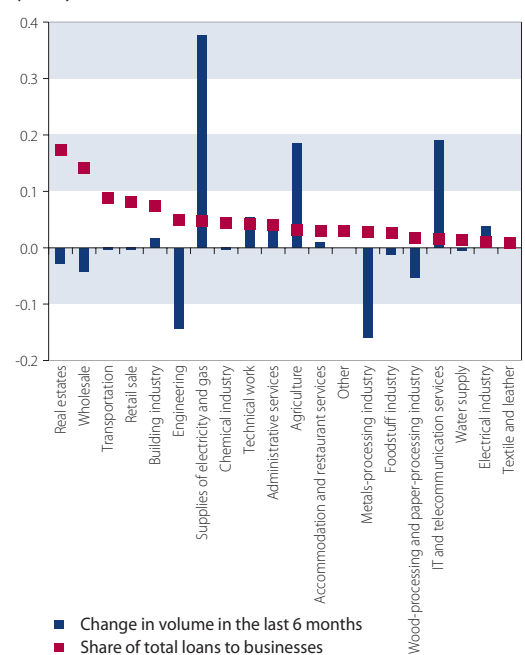
Chart 1 Share of foreign debt securities on the total volume of bonds according to countries (in %)



Source: NBS.

Note: The chart does not include the share of bonds issued in the SR that represented about 86% of total bonds by the end of June 2010.

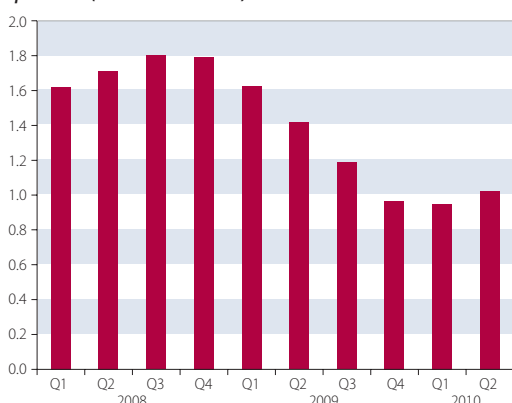
Chart 2 Change in the volume of loans in individual business industries from the beginning of 2010 (in %)



Source: NBS.



Chart 3 Year-on-year increase in average volume of loans to households for housing in a given quarter (in EUR billions)



Source: NBS.

factor of the revival was the increase of demand for new loans on the side of households. This was especially thanks to the current period of low interest rates, economic stabilisation, and improvement of confidence indicators. The trend of decrease in prices of real estate prices for housing also had a positive effect.

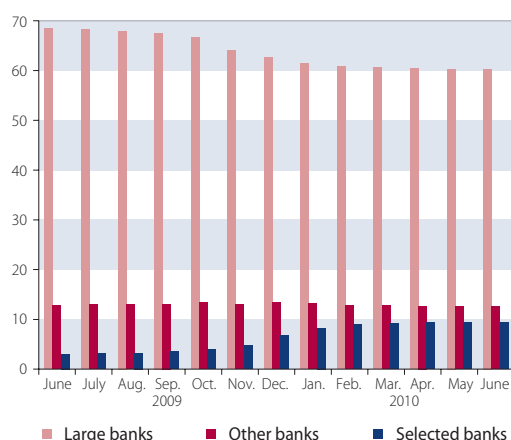
The policy of banks for household financing did not change significantly. The majority of banks did not change credit standards and focused instead on promotions and the simplification of loan processes.

Especially quite low interest rates caused the volume of new loans to increase significantly. May and June 2010 – in absolute numbers – also exceeded the months of 2008 that was the best year in the history of providing loans for housing. However, it was not reflected significantly in an overall increase of loans. In other words, clients were making use of the period of low interest rates especially for financing existing loans, and the volume of loans flowing into the real economy increased only slightly.

These changes were also partially reflected in the market shares of individual banks. However, the trend from the beginning of 2009, when as a result of different credit policies of banks the market shares started to change more significantly, more-less continued. About 75% of new loans in the first half of 2010 were provided by three banks only. Similarly as with the development of new loans, not all banks participated equally in the month-on-month increase of positions.

On the side of passive operations of banks, it was mainly the development of deposits by households that was interesting. While 2009 was influenced by the consequences of the conversion to the euro, in 2010 the situation in the development of deposits changed and started to increase both in month-on-month and year-on-year comparison. In the first half of 2010, the development in the area of deposits by households was again in line with its long-term trend.

Chart 4 Share of selected banks on term deposits (in %)



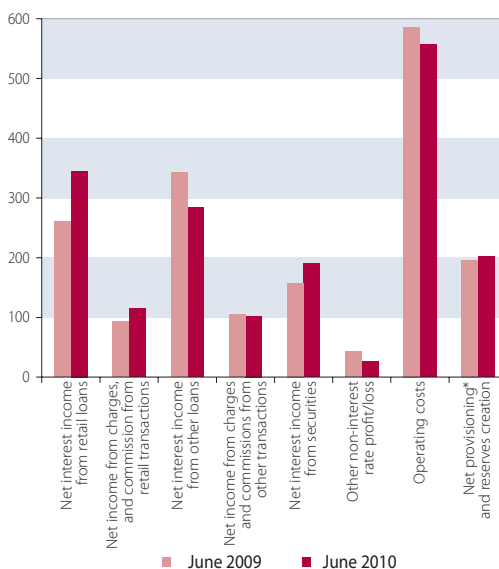
Source: NBS.

However, low interest rates were reflected in the structure of deposits by households. Clients were transferring term deposits with maturity up to one year to longer maturity periods. They provided higher yields to clients. Part of term deposits was moved to investment funds. Similarly as with loans, market shares also changed with household deposits. It was mainly reflected in the share of selected smaller banks attracting clients with new products, and higher interest rates.

FINANCIAL POSITION OF THE BANKING INDUSTRY

The overall financial position of domestic banks improved in the first half of 2010. The total net

Chart 5 Change in the structure of profitability of the banking industry (in EUR millions)

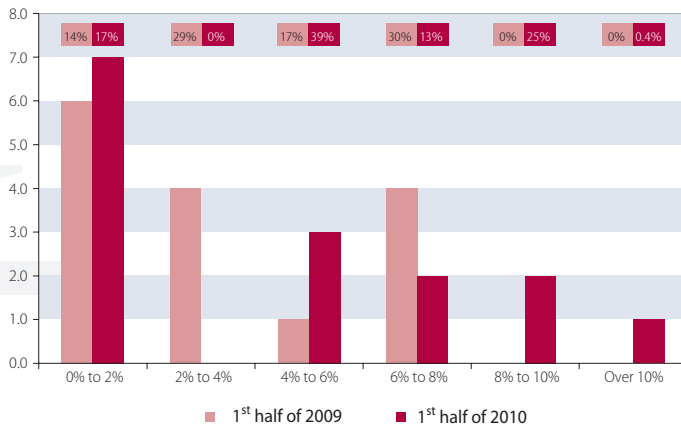


Source: NBS.

Note: Net provisioning and reserves creation also includes net profit from the assignment of receivables from clients to third parties, i.e. adjustment by income or expenses at the sale of receivables not paid



Chart 6 Share of net provisioning and reserves creation to own funds (in %)



Source: NBS.
 Note: Percentage values over the individual columns in the chart express the share of bank assets in the relevant category on the total assets of the banking industry

profit generated in the first half of 2010 increased on a year-on-year basis by more than a third. However, the development in individual banks was quite heterogeneous. Despite of an improving ability to generate profit, the level is still below the pre-crisis levels.

This positive trend in profitability was influenced by several factors. The domestic banks mainly made use of the shape of the income curve, still offering an interesting interest rate differential. This was reflected especially in the increase of interest incomes from households. The banks utilized the decrease of costs of deposits. The income of loans decreased slightly, but the rate of such decrease was much lower than with the costs of deposits.

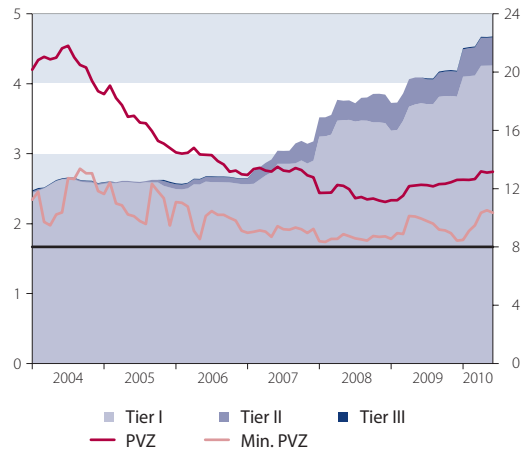
The interest rate differential between the short-term and long-term rates was also used by banks for the increase of income by the increase of purchased debt securities' volume. These deals were largely financed by short-term operations on the inter-bank market.

The decrease in operating costs in the banking industry continued, as a result of which the operating efficiency of banks increased in total.

The net provisioning also had quite a positive impact on profitability. From the point of profit generation, we can assess positively the fact that in comparison with the first half of 2009 the net provisioning recorded only a minimum increase. However, the structure of the net provisioning changed because the higher share of provisions on household loans. Nevertheless, the decreasing tendency of non-performing loan coverage by adjustments continued.

In the first half of 2010, the trend of growth of capital adequacy continued. In this way, the banks increased the so-called buffer for managing unexpected losses. The capital adequacy of the sector was 13.2% by the end of the first half of the year. We can see a similar development as with the indicator of capital adequacy, also with

Chart 7 Capital position in the banking industry (in %)



Source: NBS.
 Notes: The values for Tier 1, Tier 2 and Tier 3 on the left vertical axis are provided in EUR billions. On the right axis is the indicator of capital adequacy (PVZ) and the minimum value of capital adequacy indicator in the banking industry.

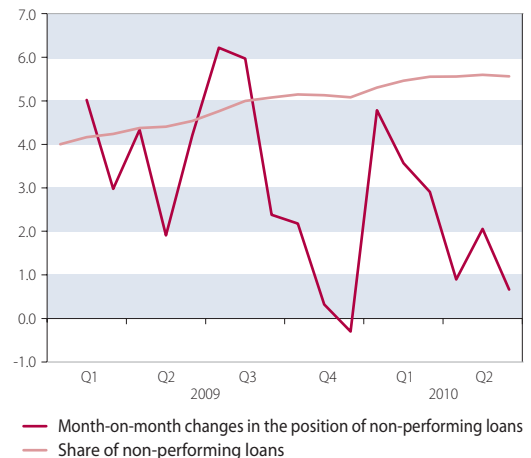
the development of the Tier 1 ratio that achieved 12% in June 2010.

Several banks increased own funds by means of retained earnings., Almost 40% of the profit generated in 2009 remained in the industry in the form of own funds. The increase of capital adequacy was also influenced to by the decrease of risk-weighted assets. It was mostly the lower loan activity of banks to enterprises that was reflected in the the requirements on credit risk coverage on exposures to enterprises on a year-on-year basis.

CREDIT RISK OF HOUSEHOLDS

The sensitivity of households to the deterioration of the economic situation became evident in 2009. The decrease of employment rate and the negative impact on the incomes of households contributed to the increase in non-performing loans.

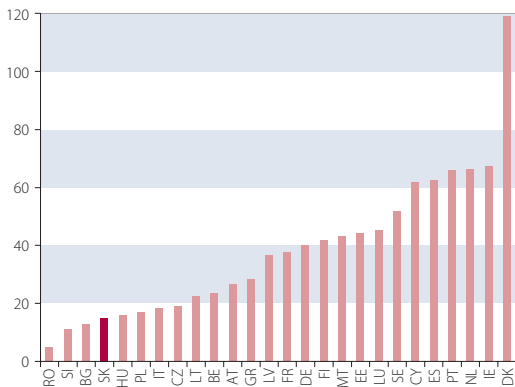
Chart 8 Non-performing loans to households (in %)



Source: NBS.



Chart 9 Share of loans for housing against GDP in individual countries (in %)



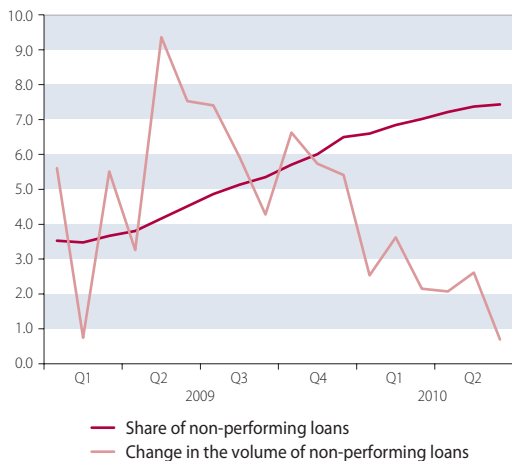
Source: ECB.

The gradual slight improvement of the situation on the labour market – especially in the first half of 2010 – led to a decrease of stress at the repayment of loans. The result was a slow-down in the pace of non-performing loans' volume growth.

The development of the volume of non-performing loans, however, does not show the level of credit risk the banks undergo. In addition to the overall macroeconomic development, credit risk is linked to other factors. These are especially the current rate of indebtedness and the sensitivity to an increase in interest rates determining the ability of households to manage any potentially negative development.

In this context it is positive that overall indebtedness in Slovakia is still quite low, although the debt-to-income ratio is up to 60% with low-income groups. The significant decrease of the share of loans with short fixation of interest rates on new loans is a positive trend. On the other hand, the majority of loans for housing are still represented by loans for which the amount of instalment depends on financial market developments. The potential increase of interest rates

Chart 10 Non-performing loans to businesses (in %)



Source: NBS.

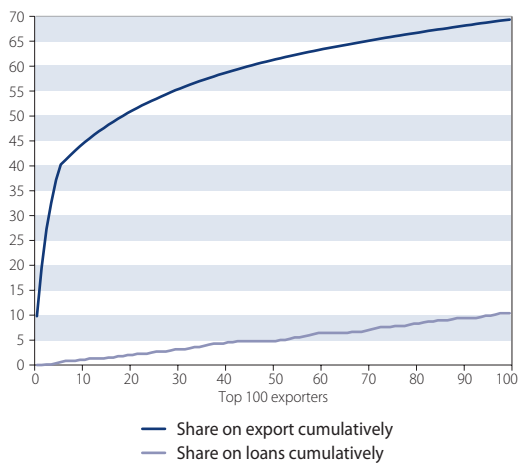
would in most cases lead to a direct increase in instalments.

CREDIT RISK OF ENTERPRISES

In spite of the decreasing pace of non-performing loans' growth, the credit risk in the non-financial sector seems to be more significant than with households.

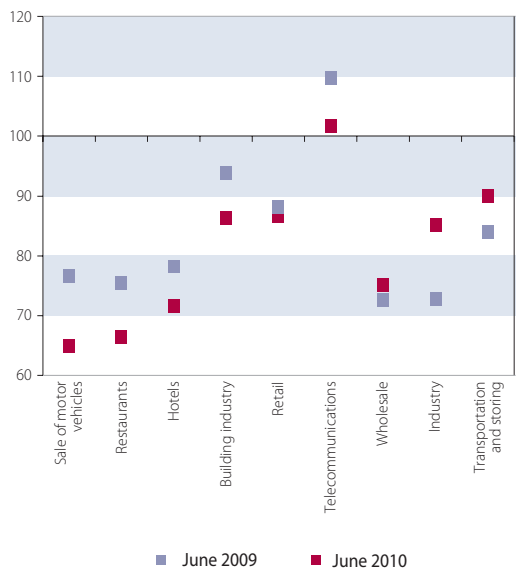
The main reasons include a relatively high dependence of main debtors of banks on domestic demand. The high share of loans to industries such as building, trade, and transportation did not enable banks to fully benefit from the economic recovery that was enjoyed especially by export-oriented industrial companies. It also applies that in spite of the increase in revenues recorded in

Chart 11 Rate of exposure of banks against the biggest exporters (in %)



Source: NBS, Statistical Office of the Slovak Republic.
Note: The chart includes the cumulative share of the top 100 exporters in the SR and loans from domestic banks.

Chart 12 Comparison of the level of revenues in individual industries with 2008 (in %)

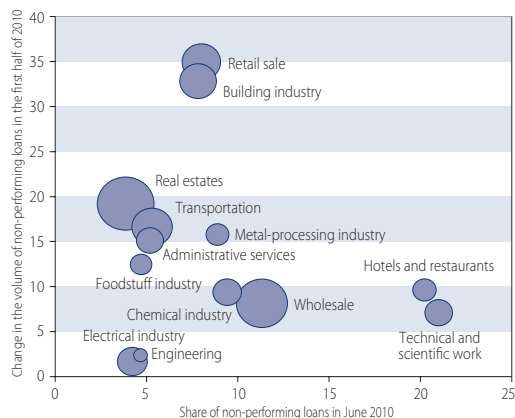


Source: Statistical Office of the Slovak Republic.



- 1 For more information see the article: Lintner, V., Rychtárik, Š.: Význam nehnuteľností pri zmiernovaní kreditného rizika v SR (Importance of Real Estate for Credit Risk Alleviation in the Slovak Republic). BIATEC, volume 18, No. 6/2010.
- 2 For more information see the article: Klacso, J., Rychtárik, Š.: Vplyv krízy na slovenský finančný sektor v roku 2009 a makrostressové testovanie. (Impact of the Crisis on the Slovak Financial Sector in 2009 and Macrostress Testing). BIATEC, volume 18, No. 4/2010.
- 3 In macro stress testing for the first half of 2010 we work with two scenarios – with the basic scenario (corresponding to the official prediction of NBS (P2Q, 2010)) and with the stress scenario “Second wave of crisis”. This scenario has two versions (Second wave of crisis I and II) considering impact gravity.

Chart 13 Non-performing credits in individual business industries (in %)



Source: NBS.

Notes: The bubble size expresses the total volume of loans in the relevant industry. The changes of volume on the vertical axis are for the most recent 6 months.

recent months in the majority of industries, their overall level is still below the values of 2009.

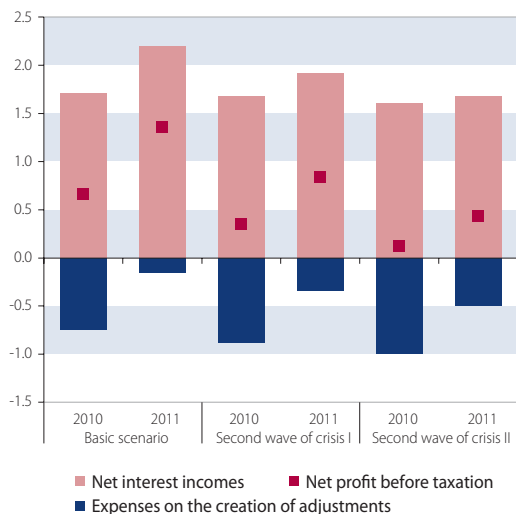
Another important risk factor is represented by commercial real estate. Complicated situation on this market, high concentration of loans, high volume and the high rate of non-performing project occurrence makes this segment one of the major risks that the Slovak banking industry is facing in the short-term.¹

Unlike other non-financial industries, this segment shows quite high sensitivity to potential increases in interest rates.

RISK OF SOVEREIGN STATES

The first half of 2010 revealed a new dimension of the credit risk of sovereign states. The development on markets of government bonds in April and May clearly shows the significant lack of confidence of financial markets. The situation was not sufficiently calmed even after the introduction of unprecedented measures implemented by governments and central banks. Several government bonds issued by EU countries still considered by the banking regulations to be risk-free from the point of capital requirements remain on significantly low values. Although this situation does not represent the same risk for all the banks, it represents a potential risk for the domestic banking industry.

Chart 14 Main estimated components of net profit before taxation (in EUR billions)



Source: NBS, own calculations.

MARKET RISKS

The exposure of banks to market risks remains quite low. Similarly as with the risk of sovereign states, exposure to market risks is also concentrated in selected banks. This applies to equity risk and interest rate risk in the banking book.

The liquidity risk did not change significantly in the first half of 2010, and in the context of credit risk it remains less important.

MACRO STRESS TESTING²

Regular macro stress testing proved the improvement of the Slovak banking industry's ability to face a potentially negative development. Improved robustness is mostly the result of the strengthened capital position in most of the banks.

The scenario of “Second wave of crisis”³ expecting a decrease in economic activity, growth of unemployment, and probabilities of default, depreciation of euro against US dollar, and the decrease in interest rates confirmed the importance of credit risk remaining the main source of losses for the Slovak banking industry. As a positive fact can be considered the ability of banks to largely cover the costs of provisioning by their income,, especially by its interest component.

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- 1 Národná banka Slovenska [2010] Analysis of the Slovak financial sector in the first half of 2010.
- 2 Methodical explanations to the analysis of the Slovak financial sector in the first half of 2010.



Is the increase in new credits in the first half of 2010 an indication of the crisis end?

Matej Krčmár
Národná banka Slovenska

The first half of 2010 brought a significant increase in new loans for housing¹. This increase even exceeded the months of 2008 which is still considered the top year in new loan provision on the Slovak market. This fact naturally evokes the proposition that the crisis is behind us and the market is back to a growth condition, it could even look like it is better than before its recent significant slow-down. Is it really true?

The starting point is the fact that the growth of new loans in the first half of 2010 was not reflected in the same speed of growth of the volume of loans for housing, and the question is why this is so. The high pace of year-on-year increase of the volume of loans up to 29% from mid-2008 was influenced by the slow-down up to the level of 11% by the end of 2009, and the pace of growth of the volume of loans for housing to households did not become more intense even in the month-on-month comparison between the second and fourth quarters of 2010.

In the first part of this article we will take a look at the impact of new provided loans on the real estate market. The question is whether the demand for real estate grew with the increased offer of new loans. Or from the opposite point of view, whether the increased offer and decrease of prices of real estate did not cause pressure on the demand for loans.

In the second part we will analyse why the volume of loans in banks grew at a slower rate, namely also in relation to consumer behaviour.

INFLUENCE OF NEW LOANS ON THE REAL ESTATE MARKET

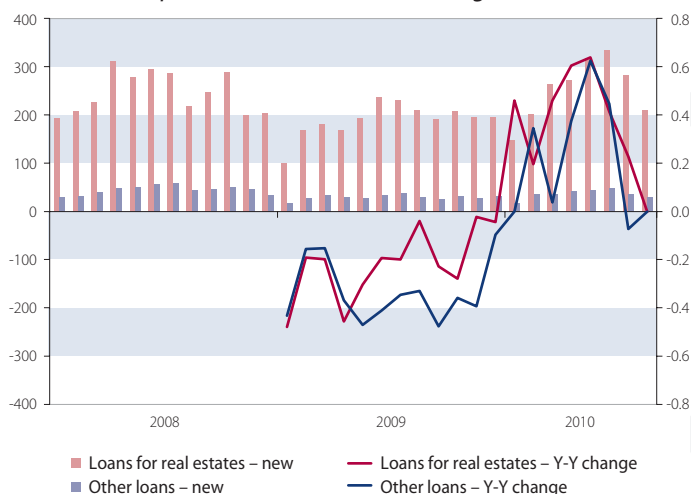
The significant growth of new loans to households, especially in the second quarter was the mainly surprise of the year 2010. May and June – in year-on-year comparison – achieved growth of up to 64%. The volume of new loans provided in the second quarter of 2010 achieved the amount of € 1.057 billion, so it is appropriate to ask where the sources were flowing, or how these flows of finances were reflected in the real economy – on the real estate market in the form of the sale of new and old real estate and the growth of construction. To some extent the development is influenced by the cycle of providing new loans in the course of the current year having two peaks, namely in the second quarter and by the beginning of the fourth quarter.

The previous development shows that the real estate market in Bratislava and the region of Bratislava is the first and also the one with the biggest weight reacting to the changes. As this market is the most significant within the whole SR, only data from this area was used.

For several quarters the development on the real estate market for new flats in Bratislava has troubled many developers. According to research done by Lexxus, there are still many unsold free completed flats on the market, and from mid-2009 the number increased from several hundreds (858) to more than 2,700 flats in the third quarter of 2010. In spite of the fact that the prices per square meter fell and many discounts are offered, no major growth trend in sales but rather only volatility can be seen. One of the reasons may be the fact that the construction of these flats started during the boom in 2008 when input prices were higher, and for this reason there

¹ Loans for housing are loans secured by a real estate, specifically mortgages, other loans for real estate, and other loans (so-called American mortgages), building loans and interim loans.

Chart 1 Development of new loans for housing

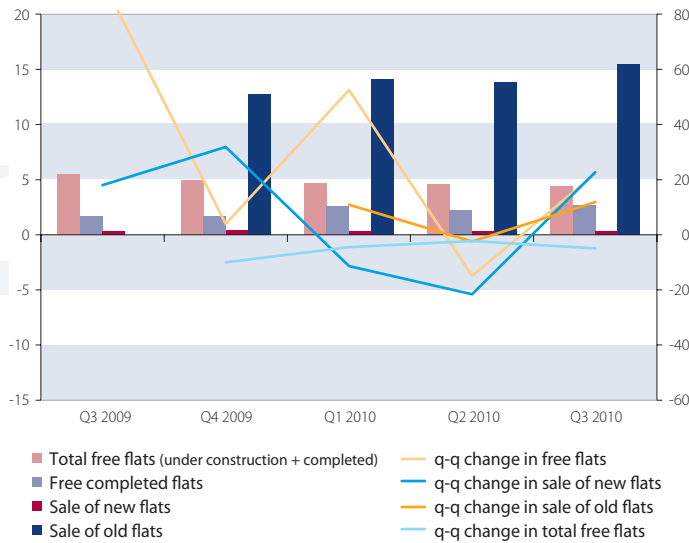


Source: NBS, own calculations.

Notes: The volumes are in EUR millions on the left side of the axis. The year-on-year changes in percentage are on the right axis.



Chart 2 Developments on the primary and secondary property market and the new building market



Source: Property Price Map, Lexus and own calculations.
 Note: The left-hand scale shows quantities in thousands, the right-hand scale shows quarter-on-quarter changes in percentages.

Chart 3 Number of new building permits and building approvals



Source: Statistical Office of the Slovak Republic, own calculations.
 Notes: The left-hand scale shows the number of started flats in thousands based on issued building permits, completed flats in residential houses and family houses based on building approvals. The right-hand scale shows the year-on-year percentage change in started flats.

2 Secondary property market – sale of land, family houses after building approvals and old flats

3 Data from Property Price Map for Bratislava region for the last four quarters (4Q/09 – 3Q/10)

4 New building market – started and completed flats based on issued building permits and building approvals. Source: Statistical Office of the Slovak Republic, macroeconomic statistics, long-term property.

is an economic and psychological barrier on the side of developers regarding a decrease of prices to the level accepted by consumers which would result in the decrease of profit or loss. The developers prefer to wait until the market has revived with prices similar to those of the past. The crisis also weakened the position of developers when determining conditions on the new flats market against banks and clients without adequate respect for potential risks. Not just anything is being bought at present as was the case in the past.

Although during the last five quarters we saw a decrease in the total number of free flats (total free flats, both completed and under construction),

no significant increase in demand is seen, whether due to the withdrawal of flats from the market or mainly owing to the fact that no residential building projects started. It is widely known that a certain part of free completed flats is non-marketable owing to the relationship between price, size and poor layout. Therefore, it cannot be assumed that the growing offer of completed flats will exert pressure on demand for loans.

A moderate recovery is seen on the secondary old property market² while the available data³ indicate that it is to a certain extent dependent on the provision of new loans with a one quarter delay. The recovery is, in a way, logical, as prices on the market dropped and old property is more easily available in terms of both price and time. At the same time, a mild increase is seen in demand for land and family houses.

From the last quarter of 2008 a falling trend can be seen on the new building market⁴ in started residential building, with a soft recovery at the end of 2009. It means that both developers and individual builders put their building plans on hold. Although the development of started building projects was hit by the crisis right away in the first quarter of 2009, so far almost no response to the crisis has been seen in building approvals, as most flats in family and residential houses were completed just in 2009. Comparing the developments in building with the provision of new loans reveals a certain time dependence between started and finished property on one side, and the demand for loans within two years on the other side. The increase in the number of started flats does not necessarily mean an increase in demand for loans; however, it can be expected at the time of building approvals.

This is natural, as the purchase or building of a new property is a sizeable investment in which own funds are invested in the first phase. In the second phase, external funds are applied, mainly bank loans, which are often additionally increased compared to the original plans, and the most intense draw-down is seen at the time around flat inspection.

Certain inaccuracy of data and the time discrepancy between the sale and the beginning of construction of new residential building in relation to the increase in new loans owing to different methodology can cause that the increase in new loans will not be seen in data about sales of new property. While banks report higher growth rates in new loans and volumes, this will not be seen on the primary market through increased quantities as purchases of new flats or started building projects have already been registered in the past upon signing a sale and purchase agreement and/or upon the issuance of a building permit.

There is another interesting phenomenon that becomes evident in the examined relations; it is ignored at the moment, but it can have an inversely proportional impact, up to the extent that loans will experience either a mild increase or a decline, while sales and new loans will expe-



rience more intense growth. The aforementioned phenomenon is the change in housing trends in terms of one life-long property. It means that at the beginning of their careers, people purchase starting housing, usually a one-room or two-room flat with smaller floor space, which is almost fully financed with a loan. Later, after starting a family in their middle ages, people replace such property with secondary housing – a larger flat or family house. The fact of purchasing a second residential property usually financed from the sale of the first property, own savings and, possibly new loans, can in various combinations and depending on the situation on the financial and property markets cause that the growth in new loans (for the first residential property combined with a loan or without a loan for the second residential property) and increased residential property (both old and new) sales will be faster than the growth in volume of loans as such can be accompanied by extra payments to settle old loans for the first residential property.

IMPACT OF THE CRISIS ON BANKS' STRATEGIES AND CONSUMER BEHAVIOUR

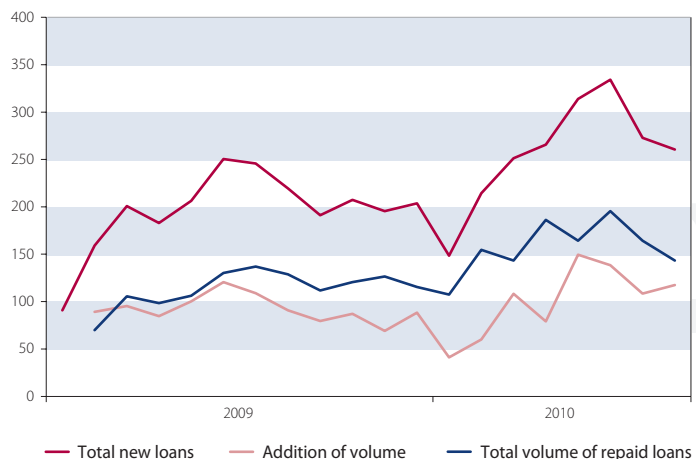
How is the growth of new loans reflected in loan volumes in banks? The first months of the second half of the year indicated a slowdown in the inflow of new loans⁵ and in August the year-on-year comparison even ended up in negative figures. In the following months, the growth rate of new loans is expected to accelerate, as autumn is the second busiest season for residential loans and will be supported by banks' promotional campaign. However, the high month-on-month changes prove that actual real demand (after the effect of the marketing campaigns passed away) is significantly lower and is approaching the level of 2009 rather than the levels reached in the years of pre-crisis growth.

Although it was natural to expect that the enormous growth in new loans would drive faster growth in loans, this expectation did not materialise. During the eight months of 2010, the month-on-month growth rate in loans increased by 1.1% on average (May was the only month with an increase by 1.5%), while in 2007 and in the first half of 2008 the average month-on-month growth rate in loans was reported at 2.2%.

Loan balance is driven by the inflow of new loans and by the outflow of repaid loans⁶. As seen from Chart 4, from the beginning of 2009 repayment of loans exceeded the incremental growth in loans and since then the share of repaid loans in the loan balance is more or less increasing or fluctuating, but maintaining its position above the incremental gain level.

The reasons for the slowdown in the growth of the loan balance compared to the pre-crisis period can be seen on two levels. Owing to the crisis, banks got a more realistic understanding of the risk of default and therefore they focused their efforts on the consolidation of their loan portfolios. The first level involved the immediate adoption

Chart 4 Developments in residential loans (in EUR mil.)



Source: NBS, own calculations.

of strict lending standards for new loans. For that reason, some banks almost stopped the provision of new loans and/or provided only loans with minimum risk, and consequently lost their previously gained market shares. This diverse approach resulted in a slowdown of growth (in some banks even a decline) of overall loan balances.

The second level involved loan portfolio management, as there was a threat of losses from increased credit risk as a result of the sharp rise in unemployment. Slovak banks lacked such real experience, as the last dramatic rise in unemployment was in 1998-2002, when mortgage financing was in the early stages of its development and indebtedness of the population was substantially lower. Later on expansionary strategies were changed into a defensive and consolidation one. In order to be able to maintain healthy portfolios, banks responded to the increased credit risk by offering new loans to restructure the old ones, aiming to mitigate the potential risk of default. The historically low interest rates provided (and still provide) opportunities for mitigation of client monthly liabilities through the reduction of monthly payments and, at the same time, the long-term interest rate fixation eliminates interest rate risk, i.e. a sudden increase in monthly liabilities. Both the above described strategies proved to be successful as there was no dramatic increase in non-performing loans and the proportion of non-performing residential loans is below 5%. This level is slightly exceeded only by other loans as they are subject to less strict criteria. Additionally, banks managed to redirect client preferences from short-term interest rates to long-term. By the end of 2009 the amount of new loans with long-term rates exceeded the amount of short-term and keeps growing. Presently, the share of loans with long-term fixations in new loans is almost 50%.

On the other hand, this situation involves risk as the provision of new loans for refinancing and consolidation purposes resulted in the "robbery" of loan portfolios in certain banks, and among

⁵ Provided new loans are reported as contracted transactions (signed loan agreements), not an actual drawing of loans. In the loan balance they can be reported at a different amount and, moreover, certain parts can be delayed.

⁶ Repaid loans are defined as the difference between new loans and loan balance increments. These are loans repaid by the initial due date and early repaid loans.



7 Availability of housing (Housing Availability Index) is the ratio of the average price of property in the Slovak Republic to either average gross wage in SR or disposable average wage.

8 Disposable wage has been calculated as gross monthly wage less percentage gross basic (necessary) monthly expenses for housing, food and telecommunication per person.

them the highest losses were incurred by building loans. Their decline has not stopped; it has persisted over the whole period from the beginning of 2010. This trend in the provision of new loans to repay old ones results in a situation where more and more new loans are needed per incremental unit of loan balance. While in February 2009, a loan of € 1.78 was sufficient to cover € 1 of incremental growth, a year later the amount of lending needed to ensure the growth of balance was as high as € 3.6. Presently, in August 2010, the aforementioned figure dropped to € 2.2. Under certain circumstances banks may face the threat of an increase in cost of an incremental unit of loan balance, mainly if such does not involve consolidation within own portfolio.

Another driver, which is likely to be of similar importance for banks to encourage demand, is to secure the inflow of new loans as they have a large amount of free funds available and interest income is one of the major sources of bank income.

When deciding on credit indebtedness, people respond most sensitively to job security levels. The belief in job security, which resulted in increased indebtedness during the economic upswing, has been replaced by fear and in many cases actual loss of employment, which was the reason for the suspension of loan demand. On the other side, clients accepted the offered option to consolidate their liabilities.

The negative developments on the labour market during the last year stabilised in 2010 and the Consumer Confidence Index indicated an improvement of the situation. Nevertheless, worries over the loss of employment with respect to long-term indebtedness persist. The uncertainty holds back a substantial increase in demand, which would be reflected in the economy through in-

creased demand for new flats in family or residential houses, although the prices of all properties and building materials has dropped.

A peculiar feature of the Consumer Confidence Index is the "building a house, chalet or cottage" component, keeping its strongly negative value (-85) despite the improvement in other items and total index. It should be noted however, that in the long-term customers have expressed a negative attitude to this component, without any substantial changes whether it was during the economic upswing accompanied by growth in loans or during the economic downturn. Although the subjective attitudes of respondents and consumer behaviour on the credit market differs from that written in research, it can reflect an adverse emotional response to high property prices and high loans for a very long period.

Their perception of the existing situation is proven up by the Housing Availability Index⁷. When comparing a flat sized 50 m² (a two-room flat), its availability is relatively acceptable and in terms of time is ranked from 6 to 9 years. However, for a flat sized 100 m², the availability increased from 12.5 to 17.5 years (in the period from 2004 until present). As to the ratio of the property to disposable income⁸, the availability is substantially worse reaching almost 29 years. Despite the long period, the availability is within the maturity of residential loans, which is a precondition for an effective source of financing and development of residential loans. Nevertheless, customers' subjective attitude may be a factor as total indebtedness is high and the repayment period is long.

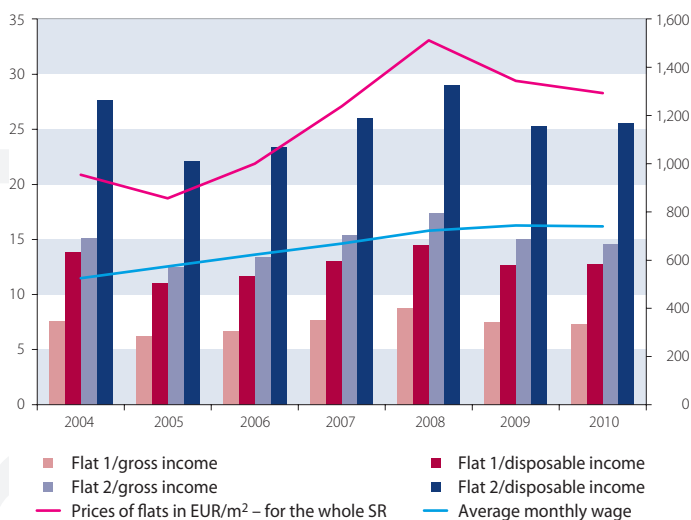
As the Housing Availability Index (Chart 5) in all four cases decreased from the peak reached in 2008, the improvement in availability is expected to become evident in stronger demand for housing through higher sales of new flats and started buildings, and in the form of increased growth in loans and the growth of sustainable demand for new loans, with low volatility rates. So far, however, no such trends have been noticed on the market and uncertainty on the labour market combined with persisting effects of collective redundancies have a larger impact on the behaviour of the population than the drop in the Housing Availability Index.

SUMMARY

Although the first half of 2010 showed signs of improvement, the very beginning of the second half of the year confirmed that the basis for a sustainable revival is still uncertain. The level of uncertainty in personal attitude and the fears of losing employment counteract the substantial increase in demand for loans directed to the real economy. It is necessary that banks and/or developers provide stronger support to the demand for loans in the form of marketing events and discounts.

It appears that a quarter or half-year are too short to assess whether the crisis is over or not. A partial revival is apparent, but the inflow of loans

Chart 5 Development of the Housing Availability Index



Source: NBS, Statistical Office of the Slovak Republic.

Notes: The left-hand scale shows the development of the index in years. The right-hand scale shows the development of property prices in EUR/m² for the Slovak Republic and the development of the average wage in the Slovak Republic in EUR.



has probably been to a large extent tied to the refinancing of old loans and to additional charges on building projects started in 2008. Presently, considering the mutual credit relations with other sectors, we are unable to conclude with certainty whether the strong increase in new loans in the second quarter means improved demand owing to the improved economic standing of the population and thus the end of the crisis. We can conclude that the balance of loans is growing more slowly than the amount of new loans, and their reflection in the increase in new transactions and/or building projects is not clearly seen. However, we can say with certainty that the amount of repaid loans and loans that were not drawn in full exceeds the increments of new loans. On the other side, however, we do not know exactly the proportion of early and regularly repaid loans, loans which were not drawn in full, and consolidated loans in repaid loans within a bank.

The examined factors can be strongly affected by the time discrepancy in the applied recording methodology, i.e., by the time discrepancy between the commencement of the construction and/or purchase in the case of new flats, and

the provision of the loan. On the other side, new loans are reflected in total loan balance with a certain time lag. Another factor making it difficult to clearly identify existing trends is the number of diverse partial data on the market in various structures and qualities. To be able to make a comprehensive assessment of the existing situation and risks, necessary data should be prepared in line with a uniform methodology and made available from one administrator which would enable the monitoring of mutual links and relations.

Finally, it can be concluded that the crisis brought a new experience in the development of loans in the economic cycle for all participants on the Slovak market. The positive aspect of the understanding of real credit risk is both on the side of banks – in the form of returning standards to normal, and on side of clients – by defining acceptable price levels for property in terms of indebtedness and the risk of losing a job. On the side of developers it means fair prices and reasonable layouts of flats. Such responsible behaviour restrains the occurrence of a potential bubble on property market, which is a threat for everyone from the long-term perspective.



Analysis of interest rates on retail housing loans with fixation of up to one year

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After the European Central Bank under the pressure of the financial crisis started the gradual reduction of its basic interest rates and certain non-standard operations, interbank rates in the euro area dropped to their historical minimums. The drop in interbank rates should in time result in the reduction of interest rates on loans provided to clients.

As there are differences between the loan products of similar types in individual countries (rate fixation period, maturity of loan, etc.) and in the financing of loans, it is natural that there are differences between interest rates in individual member states. In this respect it can be concluded that interest rates on retail house purchase loans in Slovakia rank among the highest interest rates in the euro area, and during 2009 their decline was substantially milder compared to most member states.

Therefore, in the following section we will address the issue as to what level the interest rates on newly provided retail house purchase loans with fixation of up to 1 year can be explained by the development of interbank rates and/or other market indicators.

Based on Unit root tests, interest rates will be regarded as non-stationary time series of order 1

(so called "I (1) processes"). If banks really derive interest rates on house purchase loans from the level of interbank rates and the determination method, and/or other market conditions are not subject to any significant changes, apparently there is a provable long-term relationship (so called "cointegration"). As the ECB came up to non-standard operations and started reducing its basic rates from the end of 2008, the cointegration relations were tested first for the period 2005-2008 (the next major change for banks was Slovakia's accession to the euro area in 2009).

After verifying the existence of the cointegration relations, the EC (error correction) equation was estimated for client rates in the following format:

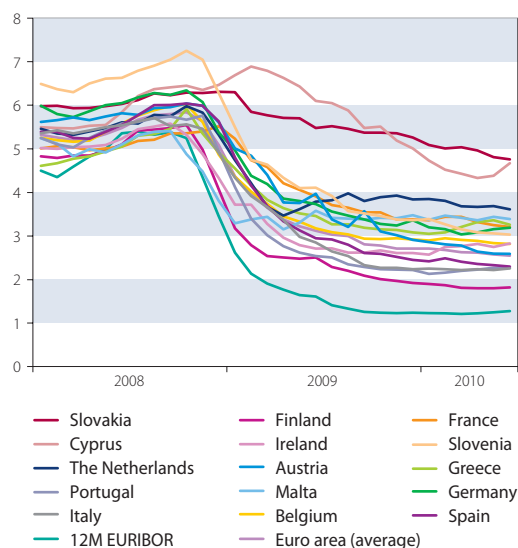
$$\Delta IR_t = \alpha(IR_{t-1} + \beta_0 + \beta_1 IBR_{t-1}) + \gamma_0 + \sum_{i=1}^p (\gamma_i \Delta IR_{t-i} + \delta_i \Delta IBR_{t-i}) + \varepsilon_t,$$

where IR_t is the relevant client interest rate, IBR_t is the interbank rate, adjustment coefficient α means the response time to return back to the long-term relationship in the case of deviation, β_1 coefficient means to what extent is a change in an interbank rate reflected in a client rate, and β_0 coefficient is the estimate of the long-term spread between client rate and interbank rate. All the above three coefficients are expected to have a negative sign.

As seen from Table 1, a long-term relationship is provable for rates applied on loans with fixation of up to 1 year with interbank rates for all maturities, and the estimates provide best results for rates below 1 year (6M, 9M and 12M). Therefore, only the aforementioned interbank rates will be used for further estimates.

As the long-term relationship was provable for the period 2005-2008, a further question is whether, and to what extent, does the relationship persist after 2008. To be able to answer the question, the time series was extended to the end

Chart 1 Developments in interest rates on newly granted house purchase loans with fixation of up to one year (in %)



Source: ECB.



Table 1 Estimated coefficients for EC equations with interbank rates – 2005-2008¹

Discount rate	β_0	β_1	α	# of lags	aR ²
1-month	-3.2375	-0.6457	-0.2708	1	0.3075
2-month	-3.1773	-0.6489	-0.2720	1	0.3438
3-month	-2.7948	-0.7348	-0.2615	1	0.4134
6-month	-1.9822	-0.9100	-0.2427	1	0.5549
9-month	-1.9376	-0.9110	-0.2454	1	0.5744
12-month	-2.0065	-0.8877	-0.2441	1	0.5799
2-year	-2.3067	-0.8271	-0.2227	1	0.4747
3-year	-1.5834	-1.0003	-0.1922	1	0.4668
4-year	-1.1471	-1.1021	-0.1848	1	0.4635
5-year	-0.6740	-1.2088	-0.1762	1	0.4503
6-year	-0.2688	-1.2970	-0.1753	1	0.4483
7-year	0.0539	-1.3645	-0.1761	1	0.4456
8-year	0.4801	-1.4510	-0.1734	1	0.4350
9-year	0.9208	-1.5376	-0.1679	1	0.4140
10-year	1.3725	-1.6265	-0.1585	1	0.3924

¹ Explanation for Tables 1 to 6:
 α – the value of the coefficient in the estimated EC equation expresses the response time to return to the long-term relationship in the case of deviation;
 β_1 – the value of the coefficient in the estimated EC equation expresses the extent at which a change in inter-bank rate/government bonds yields is reflected in a client rate;
 β_0 – the value of the coefficient in the estimated EC equation means the estimate of the long-term spread between the client rate and the inter-bank rate/government bonds yields;
 # of lags – number of lags included in the EC equation for short-term dynamics;
 aR² – adjusted determination coefficient.

of the first half of 2010 (and effective from January 2009, crown interbank rates were replaced by euro interbank rates) and cointegration relations were retested.

The tests did not prove any long-term relationship between client rates and the extended time series of interbank rates, which means that since January 2009 the relationship between the rates and/or the market conditions have substantially changed. Potential reasons for the elimination of the long-term relationship include:

- Euro interbank rates extending the time series from January 2009 do not reflect the credit risk, which was specific for Slovakia and was reflected in the Slovak koruna interbank rates (i.e. by how much, compared to banks of other member states, do Slovak banks pay more on the money market if they wish to borrow funds);
- Differences between short-term and long-term interbank rates have been substantially changed since the beginning of 2009. That could have become evident through an increase in the liquidity margin included in the client interest rate (expressing the risk associated with the fact that despite shorter fixation of the interest rate, the maturity of house purchase loans is usually relatively long and the bank has to increase long-term funds to cover the loans and/or create a buffer to secure the availability of funds in the future, and their price can be higher than the present price). The liquidity margin is not reflected in the estimated EC equations, however, by the end of 2008 spreads between

short-term and long-term rates were relatively negligible compared to values from 2009.

- After euro introduction banks lost certain sources of income (EUR/SKK foreign exchange operations, sterilising operations with the NBS, etc.), which could be replaced by increasing margins on products with relatively low competitive pressures (e.g. retail house purchase loans) compared to other products (e.g. municipal loans or corporate loans). Moreover, from 2009, household credit risk might have been perceived more sensitively owing to the adverse developments in the global (and consequently local) economy, which became evident in increased uncertainty regarding future developments on the labour market.

As from 2009 interbank rates have not reflected the credit risk specific for the Slovak Republic; they can be approximated by government bond yields. Cointegration tests confirmed the existence of the long-term relationship between rates on house purchase loans with fixation of up to 1 year and 2-years government bond yields, both for the period 2005-2008 and for the period extended until the end of the first half of 2010.

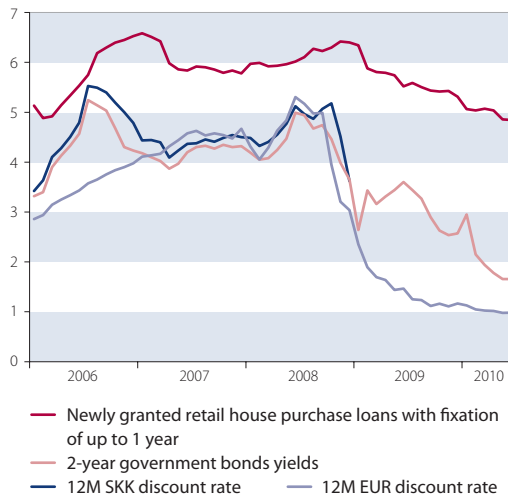
Although the estimates for the period 2005-2008 do not indicate as good results as the estimates based on interbank rates, the existence of the long-term relationship and the relatively good estimate for the period from 2005 to 1st half of 2010 show that the 2-year government bond yield is a relatively reasonable approximation of interbank rates to reflect the risk specific for Slovakia.

Table 2 Estimated coefficients for EC equations with interbank rates – 2005-1st half of 2010

Discount rate	β_0	β_1	α	# of lags	aR ²
6-month	-4.7302	-0.2975	-0.1329	1	0.2705
9-month	-4.6022	-0.3307	-0.1494	1	0.2848
12-month	-4.5138	-0.3532	-0.1479	1	0.3051

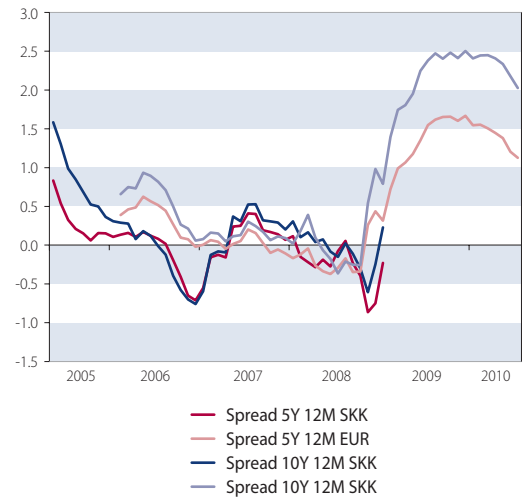


Chart 2 Developments in interest rates and government bond yields (in %)



Source: NBS, ECB.

Chart 3 Development in the difference between short-term and long-term interbank rates (in percentage points)



Source: NBS, ECB.

2 Similarly was estimated the equation including the spread between the 10-year and 1-year interbank rate and between the 5-year and 2-year, or 10-year and 2-year government bonds; however, the estimates showed the best results for the aforementioned approximation of the liquid margin.

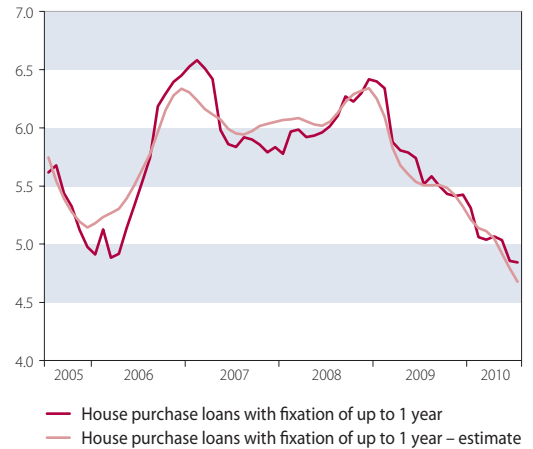
In order to reflect the liquidity margin, in addition to the client interest rate and the 2-year government bond yield, the cointegration equation also includes the spread between the 5-year and 1-year interbank rates.² After the existence of a long-term relationship between the three time series has been confirmed, the extended format of the EC equation has been estimated as follows:

$$\Delta IR_t = \alpha(IR_{t-1} + \beta_0 + \beta_1 GY_{t-1} + \beta_2 LS_{t-1}) + \gamma_0 + \sum_{i=1}^p (\gamma_i \Delta IR_{t-i} + \delta_i \Delta IBR_{t-i} + \rho_i \Delta LS_{t-i}) + \varepsilon_t,$$

where GY is the 2-year government bond yield and LS is the spread between the 1-year and the 5-year interbank rate. Coefficients α , β_0 , β_1 and β_2 are expected to have negative signs.

Another question is if the euro introduction or higher perceived credit risk led to a flat increase of the interest margin in the Slovak banking sector. There were two ways to look for an answer to this question. First a dummy variable was included in the suggested EC equation, with value = 1 in January 2009, and value = 0 in other months. This variable has been included among variables explaining the short-term dynamics of a client's

Chart 4 Interest rate on house purchase loans with fixation of up to 1 year – development and estimate (in %)



Source: NBS, own calculation.s.

interest rate, and it helped to test if there was a one-time flat increase of interest rates in January 2009 (or a flat increase of interest margin in January 2009).

Table 3 Estimated coefficients for EC equations with government bond yields

	β_0	β_1	α	# of lags	aR ²
2005 – 2008	-1.7836	-1.0336	-0.1722	1	0.4643
2005-1 st half of 2010	-3.0802	-0.7382	-0.2211	1	0.4642

Table 4 Estimated coefficients of EC equations with government bonds yields and liquidity margin

	β_0	β_1	β_2	α	# of lags	aR ²
2005-1 st half of 2010	-3.1394	-0.7059	-0.0029	-0.2426	1	0.4999



Table 5 Estimates of coefficients of EC equations including the dummy variable – type 1

	β_0	β_1	β_2	α	dummy	# of lags	aR ²
2005-1 st half of 2010	-2.9761	-0.7669	-0.0001	-0.2091	0.0918	1	0.4614

Table 6 Estimates of coefficients of EC equations including the dummy variable – type 2

	β_0	β_1	β_2	dummy	α	# of lags	aR ²
2005-1 st half of 2010	-3.0829	-0.7056	0.4259	-0.7512	-0.2548	1	0.5360
2005-2 nd half of 2010	-3.1428	-0.7232	-	0.0302	-0.2226	1	0.4630

Table 7 Stability test of estimated coefficients

	12/2008	1/2009	2/2009	3/2009	4/2009	5/2009
F-statistics (p-value)	0.8266	0.8413	0.5737	0.5572	0.6266	0.7608
Log likelihood ratio (p-value)	0.7749	0.7930	0.4858	0.4683	0.5431	0.6959
Wald statistics (p-value)	0.8291	0.8439	0.5691	0.5519	0.6241	0.7623

However, in this case the suggested equation produced the expected signs of individual coefficients only when the liquidity extra charge was approximated, instead of the difference of 5- and 1-year banking rate, by a difference in revenues of 10- and 2-year state bonds. In this case, the liquidity extra charge had almost no impact in a long-term relation, and the quality of estimate was also lower than with the dummy variable excluded.

Another way was the inclusion of the dummy variable into the co-integration relation, with value = 1 for the period January 2009 – June 2010, and value = 0 in other months. In this way a change of the long-term relationship (margin increase) after 2009 was tested. It was expected that with a flat margin increase, the coefficient with the dummy variable would have a negative value.

When the dummy variable was included into the co-integration equation together with a liquidity extra charge (the difference between 5- and 1-year inter-banking extra rate), the coefficient for the liquidity margin did not have the expected sign. When the liquidity extra charge was not included in the suggested equation, the coefficient for the dummy variable did not have the requested sign. Thus the mentioned tests

did not confirm that euro introduction or higher household perception of credit risk would result in a flat increase of interest rates.

The last tested question was if there was a structural change in the behaviour of banks when determining their interest rates. To test this question, we used the EC equation without the dummy variable, while the Chow breakpoint test was used for the period December 2008 – May 2009. The test results did not confirm a structural change in the banking sector's behaviour.

We may therefore summarise that although interest rates on house purchase loans with fixation of up to 1 year are higher when compared to other member states, their amount is influenced mainly by the amount of sovereign risk of Slovakia, and to a lower extent also by higher liquidity extra charges. We cannot confirm that after euro introduction and the onset of the financial and economic crisis there was a huge structural change in the determination of interest rates, nor can we confirm a flat increase of interest margins. However, it must be noted that banks responded quite heterogeneously to these events, and we would have to analyse the interest rates of individual banks if we wished to have a more detailed analysis.



Guarantee schemes in the insurance system

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Guarantee scheme¹ for insurance products has been discussed at the European level for more than 10 years. This topic started to be heard of in Slovakia in relation to the EU accession process. The initiative of creating a harmonised system in the EU has been unsuccessful until now, mainly for the reason that it was not possible to reach an agreement on the optimum solution of guarantee schemes in Europe, nor on the appropriateness of guarantee schemes in the insurance sector.

1 For the purpose of this article, the 'insurance guarantee scheme' shall be understood as a special fund for the insurance sector which should have a similar function to the Fund for Protection of Deposits in the banking sector or the Investment Guarantee Fund in the capital market sector.

2 Insurance guarantee schemes in the EU. Comparative analysis of existing schemes, analysis of problems and evaluation of options. Final report prepared for European Commission DG Internal Market and services, November 2007.

3 Report on financial supervision in the EU (De Larosière report), March 2009.

4 Directive 2009/138/EC of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II).

5 White Paper on Insurance Guarantee Schemes, COM(2010) 370.

Moreover, in EU member states where guarantee schemes are already established (currently there are 12 such countries, i.e. fewer than half of member states), their transformation would be demanding and particularly rather costly due to their variability. However, the European Commission has not given up this ambition and with an effort to get a global overview, to check the situation in all member countries, and to better understand guarantee schemes it authorised OXERA Consulting Ltd. to make an analysis, and on 7 January 2008 it submitted a summary report on guarantee schemes². After the financial and then economic crisis began, the intensity of efforts to introduce guarantee schemes in Europe increased. One of the initiatives of the European Commission within the anti-crisis measures was to create a Wise Men Committee, which under the lead of Jacques de Larosière, prepared Report³ which, among other things, recommends the creation of a system of guarantee schemes in the insurance sector (Recommendation No. 5) which was also reflected in the wording of a new directive regulating the insurance market – Solvency II.⁴ Recital No. 137 to this directive indicates the need to examine the adequacy of valid systems of guarantee schemes in the insurance sector, and to submit an appropriate legislative proposal. The result of current efforts at the European level is the submission of the White Paper on insurance guarantee schemes⁵ together with supporting documents, which is being discussed now.

Creating a system of guarantee schemes covers various aspects that influence providers of insurance as well as the behaviour of insurance services' consumers. In our opinion these influences can be divided into the following areas:

- protection of consumers and market stability;
- cross-border provision of services and competitive environment;
- fiscal influences;
- insurance accessibility.

CONSUMER PROTECTION AND MARKET STABILITY

The main contribution of the creation of a guarantee scheme is the fact that clients will be provided with further guarantees, as the scheme will be applied when compensating clients in case of an insurance company/companies' failure. Moreover, failure of one subject may affect the trust of the whole market, expressed in the behaviour of potential as well as existing clients in the form of losing interest in insurance coverage. Even in the case of a failure of an insurance company with sufficient resources for satisfying clients (insurance obligations), the guarantee scheme is a benefit, as the settlement of obligations of such insurance company is rather a time-demanding process and the guarantee scheme ensures that client claims are settled more quickly.

CROSS-BORDER PROVISION OF SERVICES AND COMPETITIVE ENVIRONMENT

Insurance services in our territory can be provided by insurance companies seated in the Slovak Republic, supervised by the Národná banka Slovenska, and insurance companies seated in another member state of the European economic area without a branch office or with a branch office, supervised by the corresponding authority of the home member state. The second category of insurance companies (insurance companies from other member states) can participate in the guarantee scheme established in Slovakia (so-called 'host approach') or in a guarantee scheme established in the member state where they have their seats (so-called 'home approach').

When applying the 'host approach' conditions of insurance companies providing insurance services are harmonized within one member state; however, there is a risk of potential financial consequences (fiscal) on the state budget if these insurance houses fail; while the respective state has no competences to prevent such situation (taxpayers of one member state could pay for the failures of a supervisory body of another



member state). Such a situation is partly going to be covered after 1 January 2011 in relation to introducing a new architecture of supervision and regulation execution in the EU, mainly due to the establishment of a European Insurance and Occupational Pensions Authority. From the point of view of insurance companies operating in various member states, this approach complicates their activity by participating in various guarantee schemes.

In the case of the 'home approach', client protection will depend on the guarantee scheme of the insurance company home member state, what can be difficult to recognize clients (i.e. clients do not need to distinguish the insurance company's regime which it works within or a guarantee scheme which their insurance contracts fall under, while there can be more such regimes in one country), and from the point of view of insurance companies there might appear competitive advantages/disadvantages between insurance companies providing their services on a cross-border basis and companies seated in the respective country.

An alternative to the home/host approach is establishing one common European guarantee scheme; however, it is not expected to be created in other sectors with richer harmonisation history that is mainly connected with an absence of a subject providing a guarantee in the case of insufficient means from the scheme. Such an approach would probably require a transfer of at least some fiscal competencies from member states to the European level.

The crosssector aspect plays an important role too as such regimes are already established in other financial market segments, namely the banking sector⁶ and capital market sector⁷. However, we should realise that the business model of insurance companies is different from other subjects of financial market, as insurance companies must be able to fulfill its obligations on any date which is guaranteed by technical provisions, and their insurance products should be protected against so-called attacks on the part of clients and the resulting liquidity problem, namely by set insurance conditions (insurance companies usually have a time lag for compensating the client and the client can terminate the contract only as of the anniversary date, while, for example, a bank or a stockbroker has to pay their clients on request for several financial products). However, the accompanying psychological effect of such a 'competitive disadvantage' for insurance companies is disputable.

FISCAL IMPACT

For the guarantee scheme to work efficiently it is necessary to provide financial resistance; that is the reason why the state usually guarantees its stability. The risk of a significant impact on the state budget is directly proportional to market concentration. In the Slovak Republic five major insurance companies have almost 73% share in

life insurance and 91% share in non-life insurance⁸. The Guarantee Fund would most probably not be as robust as to cope with the bankruptcy of one of the major insurance companies without state participation.

INSURANCE AVAILABILITY

Apart from high concentration, the Slovak insurance market is characterised by a relatively low proportion of insurance holders, particularly that of non-compulsory insurance⁹. This may be caused by the high price as well as an insufficient awareness of the impact of possible future events (e.g. various natural disasters or events affecting individual lives) as well as the low motivation of individuals to take responsibility for dealing with life situations. A obvious issue is dealing with consequences of catastrophic events caused mainly by floods in our territory; it is also mentioned in more details in the recently published proposal of preventive measures and compensation system in exceptional situations, elaborated on the basis of conclusions of the 2nd session of the Committee of the Government of the SR for dealing with the damage caused by floods in 2010. The mentioned low interest in insurance in the Slovak Republic is apparent also in comparison with other countries, e.g. the proportion of insurance premium to GDP is the lowest in Slovakia of V4 countries and is also one of the lowest of EU or OECD countries.¹⁰

Costs related to the establishment of a guarantee scheme and the costs of the creation of a guarantee fund will be reflected in the amount of insurance premium, which will not have a positive impact on insurance penetration. The costs of implementing a guarantee scheme could be significantly reduced by ex-post funding (the fund would not be created in advance, but resources would be accumulated when necessary), but such form of funding seems to be unfair (neither the failed subject nor its clients would participate in creating the means of the fund), and also it might be difficult to accumulate the necessary resources when needed, e.g. during a crisis.

CONCLUSION

When dealing with the issue of consumer protection and financial stability there are alternatives in the insurance sector to guarantee schemes, namely the effective supervision of sufficient financial coverage of liabilities of insurance companies and of unexpected losses, risk management of the insurance companies themselves, transparency, and enough information not only about products but also about the financial situation of the insurance company as well as the priority treatment of insured clients in the case of an insurance company's bankruptcy. The very important aspect is management of insurance companies; which should estimate their liabilities on a regular basis in the form of technical provisions. Should any problems occur, these technical provisions together with corresponding assets can be transferred to a "healthy" insurance company.

6 Deposit Protection Fund

7 Investment Guarantee Fund

8 Status as of 31 December 2009. Source: NBS.

9 E.g. obligatory contractual insurance for the liability for damage caused by operating motor vehicles, obligatory contractual insurance of an independent financial agent or financial consultant for the liability for damage caused by pursuing the activities of financial mediation or financial consulting.

10 Status as of 31 December 2007. Source: Insurance Statistics Yearbook 1998-2007: 2009 Edition, OECD

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In contrast to the banking sector, for the insurance sector the creation of a guarantee scheme system need not automatically mean a guarantee for all products (e.g. a guarantee might only be provided for general and liability insurance), which is mainly related to the financial volume of the guarantee for the benefit of a whole range of provided insurance. Another limitation of the guarantee scheme scope is the group of people who such scheme will apply to, for example, if it will also be applied to some legal entities or will only be limited to natural persons. Additionally, compensation from an insurance guarantee scheme is usually limited – in percentage and/or

absolute terms from the insurance money drawn by the clients.

Within the Slovak Republic it will be necessary to evaluate if the advantages of establishing a guarantee scheme will outweigh all related costs, as well as potential negative impacts on insurance accessibility. If it is suitable to introduce such schemes, it will have to be evaluated if such introduction should be performed on the EU level; and in this way to contribute to unifying business-making conditions in the insurance sector in the Single European Market, or as a state initiative which could better address the mentioned specific features of the Slovak insurance market.

GUARANTEE



Regulation of pension savings in the European Union and planned changes

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Pension savings in the Slovak Republic is provided by Pension Funds Management Companies (2nd pillar) and Complementary Pension Insurance Companies (3rd pillar). They are financial market subjects which, together with the state Social Insurance Company, provide pension saving services. The legal regulation of pensions within the EU is to a great extent in the hands of member states as part of their social policy. However, as part of providing common market freedoms, some competencies are performed by the EU. In July 2010 the European Committee published a Green Paper on Pensions¹ which should launch a discussion on pensions in the broadest sense across the EU. This article gives a brief review of the current situation in the pension savings regulation area; it introduces the Green Paper's contents and indicates possible directions for further developments of the European legal regulation.

CURRENT PENSION SAVINGS SITUATION IN EU MEMBER STATES

As a result of the different social-economic evolution in single countries and the social convention on minimum social standard, pension systems² are very heterogeneous in EU member states. In practice the categorisation of pension systems into so-called pension pillars is often used. It is necessary to say that such categorisation has no legal background; it is purely a theoretic distinction which, moreover, has no established methodology. In Europe you can often see a 3-pillar typology; the World Bank uses a 5-pillar system.

Within European categorisation which is historically accepted in the original EU member states, the first pillar is an obligatory state system of pension insurance, and the second and third pillars represent pension savings provided by Occupational Pension Companies and Individual Pension Companies. Retirement pension insurance, which in Slovakia is referred to as the 2nd pillar, is in the European categorisation a subset of the first pillar and is referred to as the "first pillar bis". The second pillar, as understood in the European context, is not present in Slovakia in its pure form; however, we can say that its elements are part of our third pillar.

The pillar-categorisation, as used in our understanding, corresponds to the World Bank categorization which in the 1990s provided technical help to central-European countries, as well as participating in social welfare reform. In this article we are mainly going to deal with pension insurance which we will understand as the 2nd and 3rd pillar according to the World Bank classification.

From the point of view of the subject which bears an investment risk, there are generally two kinds of pension systems in the single EU member states: defined contribution and defined benefit. Defined benefit systems guarantee their savers that their pensions will be paid out at a particular amount, and the risk of meeting this obligation towards the client is borne by the Pension Funds Management Company or a third subject, e.g. employer who has established such Pension Funds Management Company for their employees.³ In defined contribution systems, the Pension Funds Management Companies do not take over the liability for capitalisation of invested assets.⁴

Recent years have seen a global decrease in using defined benefit systems, mainly for the following reasons:

- lack of transparency;
- unwillingness of employers to bear the risk connected with a guaranteed pension amount for their employees as in most countries with private defined benefit systems, the Pension Companies are established by employers;
- higher labour force mobility – defined benefit systems are rather oriented at employees who work for most of their lives with one employer;
- too complicated regulation aimed at laying down mechanisms guaranteeing achievement of promised pension amounts.⁵

The Slovak pension saving system reflects this receding trend from defined benefits systems, and since it started it has been established as a defined contribution system. So the saver will still bear a certain risk, while the legal regulation should try to mitigate risk to the lowest possible

¹ Green paper towards adequate, sustainable and safe European pension systems, SEC(2010) 830. Available at <http://ec.europa.eu/social/main.jsp?langId=en&catId=89&newsId=839>

² For the purposes of this article, pension system shall include pension insurance, pension saving and complementary pension saving. This term shall not be identified with the legal term of 'social insurance' which, in line with Article 2 of Act No. 461/2003 Coll. on social insurance as amended, includes health insurance, pension insurance (retirement pension insurance, disability insurance), accident insurance, guaranty insurance and unemployment insurance.

³ It has to be said that also the pension insurance system, i.e. 1st pillar, is based on a defined benefit principle in Slovakia.

⁴ See Bodie, Z., Marcus, A. J., Merton, R. C.: Defined Benefit versus Defined Contribution Pension Plans: What are the Real Tradeoffs? Available at: <http://www.nber.org/papers/w1719.v5.pdf>, displayed on 5 October 2010.

⁵ See Ross, D., Wills, L.: The shift from Defined Benefit to Defined Contribution Retirement Plans and the provisioning of retirement savings. Discussion paper PI-0210. The Pensions Institute, University of London, 2002. http://www.pensionsatwork.ca/english/pdfs/scholarly_works/sw_edition1/ross.pdf, displayed on 5 October 2010.



6 Regulation (EC) No 883/2004 of the European Parliament and of the Council on the coordination of social security systems.

level. We believe that when preserving its main idea, it is not possible to introduce an absolute guarantee of revenues.

As for the groups of people who can become clients of Pension Companies, in EU member states we distinguish between Individual and Occupational Pension Companies. Individual Companies are free for practically any adult natural person to conclude contracts with. They are usually professional institutional investors; a relationship between them and clients is established on the basis of a contract. The companies usually do not limit the number of people who they provide their services to. Occupational Pension Companies are established by employers for their employees, or several employers from a similar area or a Labour Organisation. Only employees of the establisher or people performing a certain profession are allowed to be members (e.g. teachers).

Companies providing their services in the area of pension saving on an individual basis are present in every EU member state. In many cases they are insurance companies, because it is not necessary that such services are provided only by specialised institutions as is the case in our country. Occupational Pension Companies are typical for older EU member states where they have more than a 50-year-long history. For example in Great Britain there are about 50,000 such subjects which have the legal form of a trust. Their disadvantage is that they do not have sufficient know-how to manage the obtained assets. This is the reason why they outsource investment activities to professional investors, which brings increased costs. Such companies may not even use their savings of scale, as the managed assets volume is usually low. At the same time the level of regulation and obligations which a supervisory body may require has to be proportional with respect to size. Certainly there might be very large subjects managing the assets of a few tens of per cent of a total country's GDP. This is the case, for example, in the Netherlands where the PMT fund intended for employees of metallurgical and engineering companies held assets of EUR 36 million in 2010. However, with big occupational funds there might be a problem if a client goes to a different employer or decides to leave and work in a different area of the national economy. In the end, the critical point of all Occupational Pension Companies of defined-benefit-type is their binding on the employer who takes over guarantees for the company's liabilities. Unfavourable evolutions in the financial market put great pressure on the potential supplementing of assets in the fund from employer's means.

EUROPEAN LEGAL REGULATION OF PENSION SAVING

As for the current status of European pension regulation, member states retain a significant part of competencies in the area of social policy at the national level. After adopting the Lisbon Treaty, the EU has so-called shared powers with

member states. It means that if it adopts a regulation in some area, member states lose the right to adopt a divergent regulation. However, as long as there is no European legislation, each member state can adopt their respective relations at the national level. Nevertheless, the shared powers only apply to those aspects of social policy which are expressly laid down in the Treaty on the Functioning of the European Union (hereinafter referred to as the "Treaty"). Moreover, the EU has coordination powers in the area of social policy, which is a weaker competency than the shared competency, its aim is the right to coordinate (not harmonise) the social policies of the member states.

The mentioned general definition of powers is connected with Article 21 of the Treaty, conferring all EU citizens the right to move freely and stay in the territory of other member states (freedom of movement). Then Article 48 of the Treaty lays down that the European Parliament and the Council will adopt measures in the area of social welfare which are necessary for enabling the free movement of workers. An example of such measure is the so-called Coordination Regulation⁶ which applies to all social welfare, and in pension insurance it ensures that when a person has been working for all his/her life for several employers in different member states, the periods of participation in pension insurance achieved in these countries are computed for the purposes of calculation of their final pension amount. The regulation is applied to the first pillar, and in our country also to the second pillar. Apart from that it also stipulates the minimum scale of benefits and the principle of equal treatment in this area (i.e. conferring the same rights to citizens of other member states as citizens of the respective state).

The EU social welfare right also contains other regulations related mainly to guaranteeing equal treatment and the ban of discrimination, and the fight against poverty and social exclusion. These regulations are beyond the scope of this article though.

In addition to social policy, the pension insurance regime in our country greatly overlaps mainly to the interior market issue. This is also an area where the EU shares its powers with member states. However, the Treaty confers it a strong mandate for issuing regulations necessary for providing the free provision of services (Articles 56 – 59 of the Treaty) and rights to settle (Articles 49 – 55 of the Treaty). In the area of pension insurance there has been a directive adopted on activities and supervision of institutions of occupational pension systems (IORP Directive) which was implemented in our country into the Act on Complementary Pension Saving (third pillar). It applies to Occupational Pension Companies and its subject is the minimum harmonisation of some elements of the business-making of these financial institutions (conditions for issuing licenses, basic rules of cautious business-making, information disclosure, supervision). Apart from



that, it also lays down rules of cross-border business-making of these companies; their implementation by member states should remove barriers to allow free settling, and the free provision of services in the internal market. It includes the concepts of mutual recognition and home country control into a legal regulation of the third pillar. As the EU has rather limited powers in the area of social policy, the regulation laying down the complementary pension saving scheme places a duty on cross-border business-making pension institutions to follow the provisions of social and labour law in force in the host member country, as long as they refer to employee pensions, such as defining and paying out pension benefits and the conditions of transferability of pension rights. The stated directive does not define the concepts of social and labour law in detail, which causes rather big problems in practice. It also leads to the fact that there is practically no cross-border business in this area. Another obstacle in more intensive cross-border activity in this area is the difference in taxation among single member states.

MAIN CHALLENGES IN THE AREA OF PENSION SYSTEMS

The European Commission has long been aware of the worsening demographic situation and is closely watching current reforms of pension schemes in single member states. However, the last financial and economic crisis has emphasised the mutual dependency of these systems and at the same time has revealed weak points in some of them. This has significantly accelerated, in our opinion, the start of the present consultation process. The crisis has increased pressure on both pensions funded by public resources (economic growth has slowed and there is great uncertainty regarding its further development), as well as on private defined contribution or defined benefit schemes. As some member countries have introduced more pillar systems working on the principle of reallocation of obligatory pension levies, the crisis has even deepened the problem with lacking means in the state budgets of respective member states. Some countries thus had to reassess the proportion of reallocation of levies between the private and public sector. In the short-term also Pension Management Funds in both the second and third pillar were affected by the crisis. According to OECD data⁷, this sector lost more than 20% of the value of assets in 2008 and although the following year saw a partial compensation of these losses, some defined benefit schemes still have problems to meet the solvency requirement⁸.

As the economically active public currently has a choice of alternatives how to secure themselves a pension, they are also exposed to several new risks. So the adequacy of future pensions is also dependant on labour market opportunities (job which is sufficiently long and uninterrupted), as well as obtained revenues from savings with private fund managers. Member states are trying to

deal with the risk resulting from an ageing population by different systems to support the increase of the retirement age⁹ and shifting responsibility for retirement provision from the state to the individual. This is the reason why there are gradually new measures starting to be adopted connected with creating job opportunities for elderly citizens (drawing pension benefits will be suspended), but also funding dropouts in incomes of women as their poverty risk in old age is higher than men.

The last demographic projections show that the gradual prolonging of life expectations together with a low birth rate will lead to dramatic changes in the age distribution of people (65+ year olds will make up more than 30% of the population by 2060)¹⁰. If currently for each 65+ year old person we have four economically active people, by 2060 it will be only two people¹¹. Other long-term trends which the European Commission focuses on and which might affect the sustainability of pension systems are among others: a later job start as a result of growing educational need, increasing number of single-living people, married couples without children, and more generations of families living further away from each other. All these observed trends will gradually increase the costs of formal care and support on the part of the state, and will mean redirecting more and more public finance to the provision of health care and long-term care services for these groups.

PRIORITIES OF EU PENSION POLICY

As it is impossible to reach safe, sustainable, and adequate pensions only with the increase of retirement age, it will be necessary to create and adopt a whole range of other measures: employ older people, develop cross-border activities of Pension Fund Managers, etc. However, we cannot perceive the Green Paper on pensions as a generally applicable guideline to solve the problem with increasing implicit debt of member states or determining retirement age; it cannot be understood as a list of well-working and verified measures to be applied to the labour market. This document only brings a primary impulse to provoke a broader discussion of the professional public, and the consultation process at EU level is only starting. With its ambitious and holistic approach, the Green Paper mainly tries to “check” opinions on creating a safe and simple pension scheme. And although the deadline for submitting opinions and comments is 15 November 2010, there is also a very interesting discussion and the first reactions of the market and of the regulators which appear at conferences, seminars, or in the media.¹²

In the Green Paper, the Commission emphasises the fact that the **adequacy and sustainability of pensions** are basically two sides of the same coin. Until now the ongoing reforms in member states have mainly focused on dealing with the long-term sustainability problems; however, governments are lagging behind with implementing measures to decrease differences between the

7 Private pensions and policy responses to the financial and economic crisis. OECD 2009.

8 Capital requirements for defined benefit schemes.

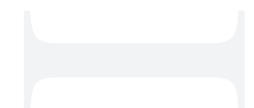
9 The age when a person really retires. It need not be equal to the retirement age or the age of leaving the labour market.

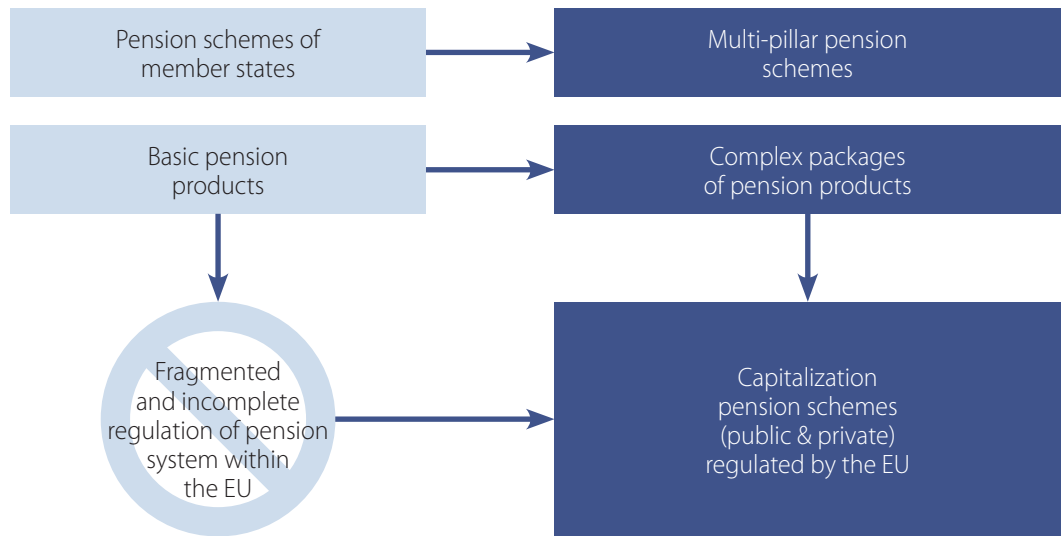
10 European Commission and Economic Policy Committee (Ageing Working Group): 2009 Ageing Report: Economic and budgetary projections for the EU-27 Member States (2008 – 2060). *European Economy* 2/2009.

11 See 10.

12 For more details see e.g.: Pensions Green Paper co-author warns several White papers could be on the way, *Investment and Pensions Europe*, 8 October 2010, http://www.ipe.com/news/pensions-green-paper-co-author-warns-several-white-papers-could-be-on-way_37196.php.

Green Paper's solvency suggestion would be 'unfair' on pension scheme, *Investment and Pensions Europe*, 9 July 2010, http://www.ipe.com/news/green-papers-solvency-suggestion-would-be-unfair-on-pension-schemes_36093.php.



*Coordination of pension policies according to the Green Paper*

13 Indicator defined as a ratio of gross average salary to gross average wage; however, calculation methodology differs in single countries and comparability of data and its subsequent interpretation has its limits.

14 E.g. in 2007 in SR the substitute rate was 45% and the view to 2060: incomes from all pillars will drop to 40%. See also "2009 Ageing report", Note 11.

15 See the Decision of the Parliament and of the Council of 6 September 2010 on the European Year of Active Aging (2012).

amount of an income during the economically active life of people and their pension. As predictions regarding the average substitute rate¹³ evolution are rather pessimistic¹⁴, countries should try to create additional opportunities to increase income for older age groups, e.g. by prolonging the number of years spent in a job or creating opportunities to enter voluntary pension schemes. In connection to pension sustainability, the Commission mainly stresses active limitations of government policies, including pension policy, while they find the Stability and Growth Pact as an efficient tool.

Another priority for reform efforts should also be to reach a balance between time spent in work and retirement. According to the Green Paper, an average European spends one third of their adult life in retirement. And although the Commission emphasised the need to stop postponing the period which we spend in retirement, and they speak about the benefits of the regular reassessment and increase of the age of retirement, having in mind lengthening life expectancy we must not neglect other facts either. For example there are ongoing discussions about considering the health status of employees who, for various relevant reasons, cannot perform their job at a higher age (e.g. miners). Therefore, with the aim to create better labour market opportunities for elderly citizens, the Commission declared 2012 as the European year of active aging¹⁵. They can see potential in improving health care (bad health condition is one of the main reasons for early retirement), tax and social benefits, new technologies, or requalification courses.

The third priority according to the Green Paper is removing obstacles connected with **free movement within the EU**. One of the first steps when removing these barriers should be a revision of the IORP Directive adopted in 2003. On the basis of the experience gathered until now, if we want to strengthen the internal market it will be neces-

sary to mainly remove barriers that are results of unclear definitions of 'cross-border' activities and insufficient harmonisation in supervision. Other problems are caused by the lack of interaction between Communitarian and national law. However, as a part of this consultancy, the Commission would like to focus on stipulations about depositary activities, the supervision of investment management, and socially responsible investment. At the same time the Commission wants to use the Green Papers for dealing with problems where they have not been able to reach consensus for a long time, in spite of an existing discussion (technical difficulty, easy misusing, etc.). It mainly applies to the transportability of pension rights. The EU regulations currently protect the pension demands of citizens and their family relatives, as long as conditions and the manner of pay-out are stipulated in an Act (in our country demands from the first and second pension pillar). The Green Paper can also be a fresh impulse when looking for the right solution for mobile workers. As the modern and developed European labour market requires flexibility on both the demand and offer side, we believe that the Commission has already answered the question of whether the unified obligatory pension system should be part of European regulation. Nevertheless, some member countries could implement and start using a "pension-watching service", while it would probably be mainly mobile staff who would be interested in such a service. This package of measures for unifying free movement rules should also include a revision of tax laws.

The last priority of the Commission which occupies most space in the Green Paper is the creation of a **safer and more transparent pension system**. The Commission believes that the gradual move from 1-pillar pension systems and simple contracts on more-resource funding towards complex packages of pension products presumes the need to create a unified European



framework. There is a question in relation to this issue, if it would be beneficial to delimit the term 'pension' as a product bearing certain features. The Green Paper mainly emphasises rules for approaching such product and rules for paying out benefits in the form of regular payments during retirement. Certainly, such a step requires a revision of social welfare systems, occupational and individual schemes, as well as obligatory and voluntary pension contributions as applied in individual member states. The Commission takes into account also the growing importance of defined contribution schemes and the fact that currently almost 60 million Europeans are registered in them.¹⁶ Even though members of defined contribution schemes have to bear risks connected to inflation, longevity and investment, there are mechanisms to reduce such risks. Reportedly one of the solutions could be a gradual transfer to hybrid schemes, such as defined contribution systems with minimum revenue guaranteed or defined contribution systems with elements of defined benefit schemes, etc. The Commission at the same time is asking if the current European regulation will ever be able to catch this trend. That is the reason why they are re-opening the issue of the IORP directive, mainly in the areas of risk management, custody of assets, rules on limiting, and distribution of risk and provision of information, and is stressing that it will be necessary to create a regulatory framework for the accumulation phase and payout phase. The Commission finds the absence of a single legal framework in two such important areas to be unacceptable from the long-term perspective.

As for elaborating the solvency rules for defined benefit systems and their application in hybrid schemes or net defined contribution schemes, we must say that in their Green Paper the Commission is not asking if rules equal to Solvency II are to be applied, but are directly checking how member states imagine such a regime. However, we believe that only universal rules regarding society management, internal checking, risk man-

agement, outsourcing, etc. will be relevant and generally applicable for both schemes.

It goes without saying that employers play an important role in funding pensions. In Slovakia this problem indirectly touches all three pillars of the pension scheme (obligatory contributions to pillars 1 and 2, voluntary to pillar 3); however, for this issue the Green Paper more or less refers to separate simultaneous studies and will probably make its decision about how to improve protection against the financial insolvency of employers on the basis of these findings.

Transferring choice and responsibility to individuals requires EU citizens to understand information about options how to secure themselves for retirement. That is the reason why facilitating their decisions on the basis of a clear and understandable communication closes the framework for the creation of a safer and more transparent pension system. The Commission stresses the need to equip each person with economic literacy and a certain type of planning skills in order to be able to assess the need for financial or social protection (e.g. the growing importance of defined contribution schemes creates pressure to decide about investment).

As the pension funds have become quite an important institutional investor and their behaviour might significantly influence financial market stability, the Commission is also setting a goal to improve statistics connected to pensions. In connection to the unfavourable evolution of public finance in member states, there will probably be a more detailed monitoring of implicit debt introduced gradually.

The conclusion of the Green Paper is, certainly intentionally, a little idealistic. According to the Commission member states themselves acknowledge that cooperation and joint action can be more efficient, and the EU platform can represent added value not only because the Community is facing similar challenges but also because all reform policies must be consistent with the Stability and Growth Pact for Europe 2020.¹⁷

¹⁶ EFRP survey.

¹⁷ Europe 2020 – Strategy to secure intelligent, sustainable and inclusive growth, http://ec.europa.eu/eu-2020/pdf/1_SK_ACT_part1_v1.pdf

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Has the recession had an impact on European integration and catching up?

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Neither a healthy financial sector or the introduction of the common European currency could protect Slovakia against the negative impact of the global economic recession. From the point of view of a year-on-year change in the development of the real economy, Slovakia was one of the EU countries that has been more affected by the crisis. Has the general trend of mutual convergence of economic indicator values within the EU changed? Has this evolution had an impact on the process of nominal convergence? Have chances of non-euro area EU countries wishing to continue European integration and to introduce the euro decreased? These are the main questions that we will try to answer in this article.¹

1 The paper offers a brief overview of the main findings and updates various conclusions regarding the convergence pace presented in the Convergence Analysis of the Slovak Economy 2010 [10].

2 In July 2010 the group of candidate countries of Croatia, Macedonia and Turkey expanded to include Iceland. Potential candidates are Albania, Bosnia and Herzegovina, Kosovo, Montenegro and Serbia.

3 In line with previous assessments we deal with all Maastricht criteria, although Slovakia and other euro area countries are formally only obliged to meet the fiscal criterion.

4 From among EU countries, only Estonia and Malta managed to have a lower deficit than the previous year.

5 Only Estonia, Luxembourg and Sweden met Stability and Growth Pact rules.

When the economic crisis reached its peak, several statements appeared supporting the adoption of steps to ease the euro area accession criteria and to accelerate the process of common currency introduction in some countries with the aim to stabilise the evolution in Europe. Looking beyond the analyses made up to now, we are therefore also dealing with the convergence of candidate and potential candidate EU countries.²

STATUS OF NOMINAL CONVERGENCE³

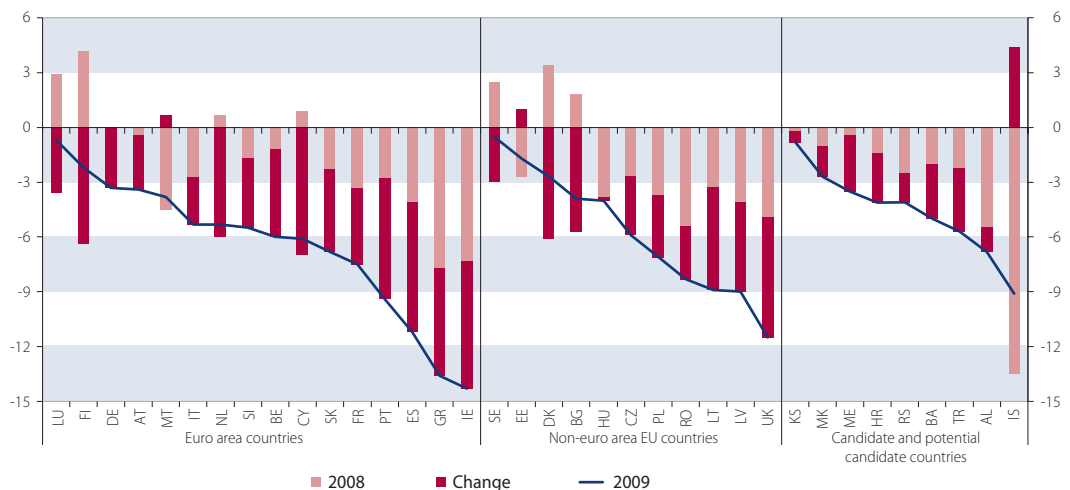
The situation in the public finance of the Slovak Republic has considerably worsened. Following the disclosure of expected public administration management results (increase of 2009 public finance deficit to 6.8% GDP), the Council of the EU

adopted the decision of excessive deficit in the SR; thus Slovakia stopped meeting the fiscal criterion.

The negative impact of the global economic crisis was also reflected in a considerable worsening of the fiscal situation in other countries.⁴ In August 2010 excessive deficit procedure was applied to 24 EU countries, 15 being members of the euro area.⁵

The effect of the fall of economic growth and additional fiscal measures on the deficit amount varies for each country. Slovakia is one of the countries that tried to stimulate national economy by means of a higher fiscal deficit. The year-on-year increase in the negative balance of public finance was at the average EU level and slightly above the

Chart 1 General government budget balances in EU member states, EU candidate countries and EU potential candidate countries (% GDP)



Source: Eurostat, European Commission.



euro area average, but the share of expenditure on anti-crisis measures was relatively low.⁶

Available data suggests that before the economic crisis began, all candidate and potential candidate countries with the exception of Albania would have met acceptable levels of deficit and public finance debt. Their economic development in 2009 was very similar to the development in other European countries. In an effort to boost economic growth with public finance by a drop in budget income, public finance management results in these countries were significantly worse. Only Macedonia and Kosovo kept the public finance deficit below 3% of GDP.

In all countries under assessment, the total indebtedness of public administration sector; several countries exceeded 60%. In Iceland, the proportion of debt to GDP rocketed above 100% of GDP as a result of the huge negative impact of the financial crisis (while in 2007 it amounted to less than 30% of GDP).

In the course of 2009, the growth of consumer prices in Slovakia decreased. October was the first time that prices of goods and services dropped year-on-year. As a result of a drop in consumer demand, the prices of energy as well as non-energy commodities went down. In consequence of deflation, the 12-month average of year-on-year inflation also decreased. At the end of the year, the SR started to meet the inflation criterion again. Since 2Q 2010 Slovakia has been seeing a gradual increase of overall inflation. In August 2010 the year-on-year change of consumer prices reached 1.1%. The 12-month average was 0.3%, and being one of the lowest in the EU it entered into the calculation of reference value. Low inflation is also seen in other euro area countries (with the exception of Greece and Luxembourg). Currently

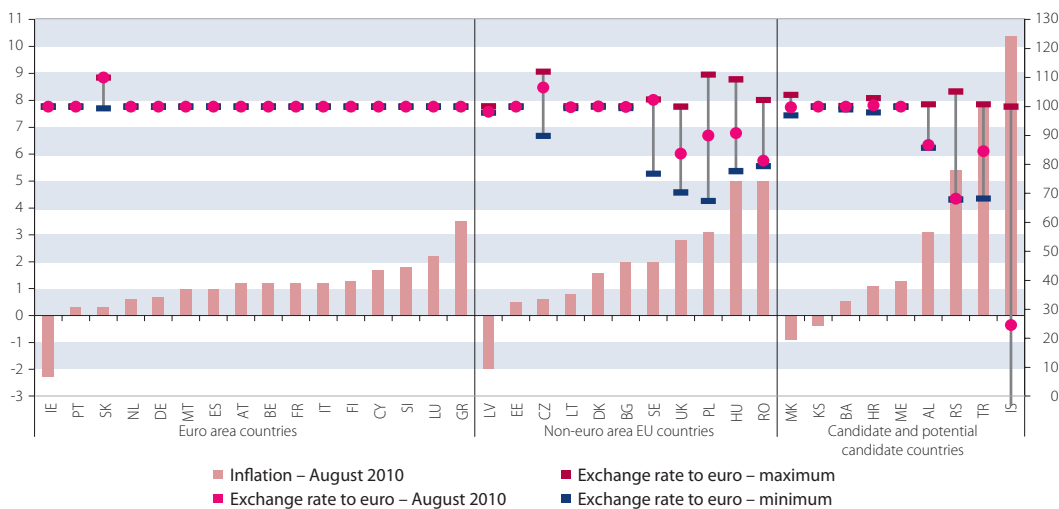
5 out of 11 non-euro area EU countries meet the inflation criterion – the Czech Republic, Denmark, Estonia, Lithuania and Latvia.⁷

The economic crisis has led to a slow-down of price rises also in candidate and potential candidate countries. Iceland is a specific case that faced a considerable devaluation of the national currency and related increase in import prices. In spite of the year-on-year drop by a few percentage points, Turkey and Serbia also saw a high increase of consumer prices. On the basis of the available data, the inflation criteria would in theory have been met by two candidate countries (Croatia and Macedonia) and three potential candidates (Kosovo, Bosnia and Herzegovina, and Montenegro)⁸.

In spite of a higher investors' risk aversion, the development of the long-term interest rate in Slovakia was relatively stable. Since the second half of 2009 we could see a drop in the average interest rate of government bonds. There was a year-on-year decrease in all euro area countries except Greece. The growing indebtedness was seen in the 2Q 2010 in the increase of risk premium and in the rise of the long-term average interest rate also in other euro area countries, mainly Spain, Portugal and Ireland. In August 2010, Slovakia saw a 12-month average of the long-term interest rate at 4.1%, i.e. well below the reference value (6.3%). Most non-euro area EU countries⁹, as well as candidate and potential candidate countries, finance their debts under worse conditions. In August 2010 5 out of 11 non-euro area EU countries saw the long-term interest rate exceed the reference value. Although candidate countries are not economies with excessive public finance levels (with the exception of the recent dramatic increase of Iceland's indebtedness), average inter-

- 6 Slovakia (contrary to other countries) did not need to spend financial sources on saving its bank system.
- 7 When applying the approach used in convergence reports of the ECB and EC, i.e. after excluding Ireland and Latvia from reference value calculation with regard to specific evolution in these countries.
- 8 With the exception of Croatia, Iceland and Turkey, we only have a non-harmonised CPI index available whose values can differ from the harmonised index (HICP).
- 9 Except for Denmark, Sweden and the UK.

Chart 2 Development of consumer prices and exchange rates against the euro in EU member states, EU candidate countries, and EU potential candidate countries



Source: Eurostat, European Commission, OANDA.

Notes: The value of inflation corresponds to the 12-month average of the year-on-year HICP inflation. In the case of Albania, Bosnia and Herzegovina, Montenegro, Kosovo, Macedonia and Serbia we used the 12-month CPI average valid in June 2010. For exchange rate development we used average weekly exchange rates from the beginning of 2008 to the end of August 2010. An index value of more than 100 means currency appreciation (lower than 100 – depreciation).



est rates of the bonds they issue are considerably higher than the reference value for the long-term interest rate. Macedonia and all potential candidate countries finance their debts by short-term or medium-term securities, average interest rates for bonds with maturity up to 10 and more years are therefore not available.

From the point of view of assessing exchange rate stability, it is important to say that a sharp weakening of the currencies of neighbouring countries against the euro, which was an expression of higher aversion to risk during the crisis period, stopped in 1Q 2009. The average exchange rate of V4 countries gradually returned to its 2008 level. So the worsening of Slovak price and expenditure competitiveness was only temporary (Chart 2). The development of exchange rates of neighbouring countries, influenced by fears of growing indebtedness, was still volatile in 2010. This indicates that if the euro had not been adopted in Slovakia, the evolution of the Slovak currency exchange rate would have been greatly volatile not only in 2009 but also 2010. The list of countries involved in the ERM II exchange rate mechanism did not change. From the point of view of exchange rate stability, four countries are ready to join the euro area – Estonia, Lithuania, Latvia and Denmark. In spite of significant uncertainty and strong pressures in the financial markets, the Baltic States managed to keep a fixed exchange rate to the euro. The exchange rate of the Danish Krone was still moving around the central parity. Even when external pressures were the strongest, Croatia and Macedonia managed to keep a stable exchange rate of their national currencies to the euro. The exchange rate of the Turkish Lira to the euro weakened by more than 30% in March 2009 in comparison with early 2008. However, the Lira also saw great volatility in previous years. The most extreme was the short-term evolution of the Icelandic currency. The collapse of the

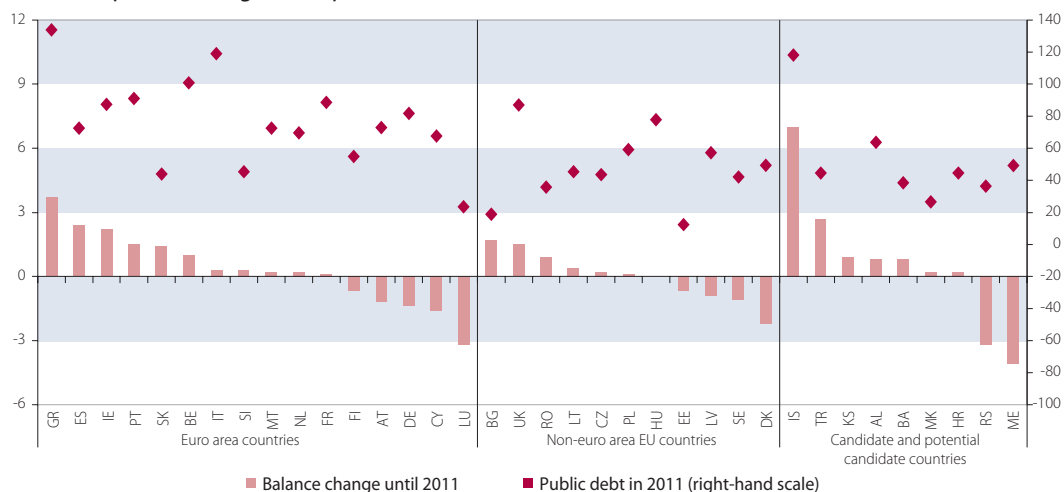
banking system led to its extreme devaluation. In late 2008 the Icelandic Krona was at ISK/EUR 187, while at the beginning of the same year it was sold at ISK/EUR 92. Bosnia and Herzegovina has its currency pegged to the euro. Montenegro and Kosovo are currently using the euro as their national currency, but they have adopted it unilaterally (without the approval of euro area member countries). The currencies of the remaining two potential candidate countries weakened considerably as a result of the impact of the financial and economic crisis. In the course of 2009 the depreciation of the Albanian Lek and the Serbian Dinar stopped; however, the depreciation trend of the Serbian Dinar continued again in 2010.

Conclusions of the convergence reports of the ECB and the EC assessing the level of economic convergence of the EU member states that are not members of the euro area presented in May 2010 remain valid. Estonia is the only country that meets the economic criteria for euro area accession. As a result of changes in global economic conditions, the originally relatively advantageous evolution of the nominal convergence of current as well as potential candidate countries worsened. In August 2010 none of these countries would have met the Maastricht criteria. From the point of view of meeting the Maastricht criteria, Macedonia seems to be the best prepared country on the basis of available data.

NOMINAL CONVERGENCE OUTLOOK

According to the Stability Program of the Ministry of Finance of the SR for 2009 – 2012 [7], the public finance deficit in 2010 should have decreased to 5.5% of GDP, and then fall to 3% of GDP by 2012, which was supposed to ensure abrogation of the excessive deficit procedure in 2013. The planned reduction was aimed at leading to a balanced budget in 2015. The general drop of economic activity and the related shrinkage in incomes of

Chart 3 Expected change in the public finance balance in 2009 – 2011 (% GDP)



Source: Eurostat, European Commission.

Note: Balance increase means a deficit drop; balance decrease means a deficit rise.



households and companies were shown in even lower tax incomes and higher additional expenditures.

The public finance balance development for the first half of 2010 indicates that the deficit is going to be significantly higher than expected. At the same time the current trend in the evolution of public finance worsens preconditions for the long-term sustainability of public finance. The European Commission [4] has included Slovakia in the group of countries with a high risk of long-term public finance sustainability¹⁰.

According to the Commission Spring Forecast [3], the euro area fiscal deficit was supposed to reach its top (6.6% of GDP) this year, and in 2011 it should slightly drop. However, public debt will continue growing. In comparison with other euro area countries, the increase in Slovakia's indebtedness forecast by the Commission in the mid-term (8.3% of GDP) does not seem to be inadequate. The originally expected consolidation rate of the negative balance of public finance in the SR (1.4% of GDP) was higher than the euro area average (0.2% of GDP).¹¹ The public finance consolidation proposal approved by the Government of the SR in late September 2010 counts on a significantly more dynamic year-on-year consolidation pace, but it is based on a higher expected deficit value in 2010.¹² The real mid-term deficit drop in the SR could finally be lower than the Commission expectations.

The Commission forecast for 2010 and 2011 suggests that other EU countries will also find it hard to meet the originally planned consolidation pace. Without additional measures, the only countries to achieve a deficit lower than the reference value are Sweden, Bulgaria and Estonia. The UK's indebtedness will further increase to the highest level among non-euro area EU countries. Public debt significantly over 60% will also remain in Hungary. The indebtedness of Poland and Latvia will come very close to their reference value. Of candidate countries, the only country to maintain its deficit below the level of excessive deficit will probably be Macedonia. Preliminary drafts of public finance developments does not indicate that at least some of the potential member states could manage to decrease their deficit below 3% of GDP until 2011. The indebtedness of candidate and potential candidate countries (with the exception of Iceland and Albania) could stay below 60% of GDP.

The revival of economic activity increases inflation pressures. As a result of a drop in regulated energy prices, the slower growth of prices in services, and the decrease of the excise tax on oil, Slovakia will see its average yearly inflation value of 2010 remain at a low level. According to a mid-term forecast by the NBS¹³, average year-on-year inflation measured in HICP will amount to 0.9%. In the following years prices will rise more quickly. Increased economic activity together with increasing excise tax rates and VAT should lead to an acceleration of inflation in 2011 to 3.8%. In

2012 year-on-year inflation should slow in connection to the end of indirect tax rise to 2.6%.

It results from the Commission forecast that as a consequence of a gradual recovery, inflation measured in HICP will accelerate in subsequent years also in most other euro area (and EU) countries. The average total inflation in the Slovak Republic will, however, probably be 1.5 p.b higher in late 2011 than the average of the three countries with the lowest inflation, and so Slovakia may stop meeting the inflation criterion. The expected relatively low growth of consumer prices resulting mainly from the slow growth of national demand in countries under evaluation, together with rising average inflation in the EU will, conversely, increase in EU/ non-euro area countries to meet the inflation criterion. According to the Commission, the most significant price growth will probably be seen in Romania and Hungary. With the exception of these two countries, inflation in non-euro area EU countries could be maintained below the reference value. Inflation pressures should not be significantly higher in the candidate countries either; the CPI evolution estimates indicate that inflation under the reference value would in theory be seen in subsequent years only in Macedonia, and of potential candidates perhaps only in Bosnia and Herzegovina, and Kosovo. The main inflation risks in all countries under review are a higher increases of energy and food prices. Inflation pressures may also increase in connection with the need to intensify the consolidation process of public finance, which can be reflected in the more dynamic growth of regulated prices and higher indirect taxes.

The development of long-term interest rates and nominal exchange rates will be closely connected to the evolution of the fiscal situation and inflation. On the basis of the available data, Sweden and Bulgaria (except for Estonia) have the chance to meet all Maastricht criteria in two years¹⁴. Continuing to meet conditions resulting from the pre-accession talks could be reflected in a lower risk premium and a drop in long-term interest rates in candidate countries. The highest chance to meet the Maastricht criteria has Macedonia, according to the available data. Easing global financial uncertainty and decreasing risk aversion should be reflected in the stabilisation of exchange rates in the Icelandic, Albanian and Serbian currencies. But neither the published future development forecasts nor the current evolution trend would indicate that potential candidate countries could meet the reference values of the Maastricht criteria in the following two years.

STATUS OF REAL CONVERGENCE

Slovakia has seen a dramatic drop in exports, production and subsequently also in GDP. The evolution of both foreign and national demand was also unfavourable. With regard to great openness and high proportion of cyclical sectors, the Slovak economy was one of the countries more affected by the global economic crisis (Chart 3). Not only

¹⁰ To a great extent, it was caused by applying common methodology of calculating production gap, which did not take into account specific features of the Slovak economy.

¹¹ The difference between the public finance balance in 2011 and 2009 (Chart 2).

¹² In 2010 the public finance deficit should reach 7.8% of GDP and in 2011 fall to 4.9% of GDP.

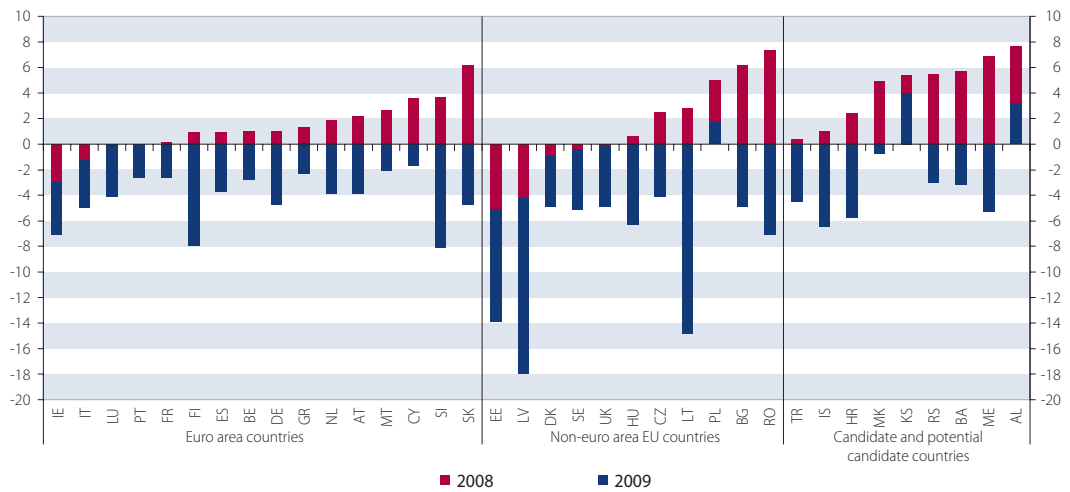
¹³ Medium Term Forecast Q3 2010, NBS September 2010.

¹⁴ In view of meeting the basic condition for evaluating the stability of the exchange rate, they would have to join the ERM II mechanism of exchange rates as soon as possible though.

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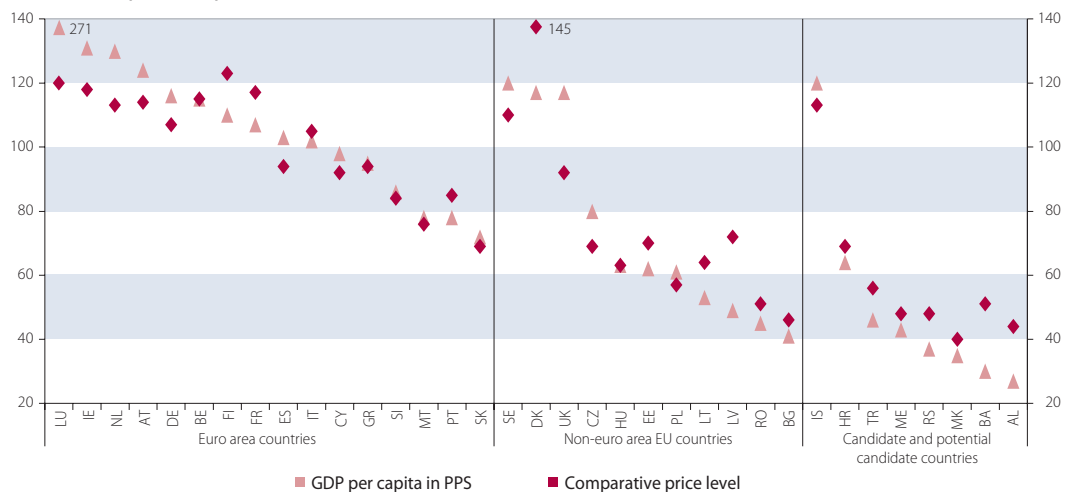


Chart 4 Real economic growth in 2008 and 2009 (GDP, in %)



Source: Eurostat, European Commission.

Chart 5 Output and price level in 2009 (EU = 100)



Source: Eurostat.

15 For a more detailed analysis of business sector evolution in 2009 see [6].

euro area countries, but all EU member states (with the exception of Poland) have seen a year-on-year GDP drop. The greatest slowdown was in the Baltic States. Latvian GDP fell by 18%. The 2009 recession did not avoid current and potential candidate countries either, only Albania and Kosovo were able to maintain positive economic growth.

The unfavourable economic development was reflected in the worsening of the situation on the labour market. In their effort to mitigate the negative impact of falling demand, businesses reduced labour costs. Businesses in Slovakia preferred lay-offs to the decrease of nominal wages¹⁵. In 1Q 2010 the unemployment rate amounted to 15%; the average euro area value increased to 10%. Unemployment also grew in all candidate and potential candidate countries. More flexible changes in employment caused average labour productivity in Slovakia to drop by almost the same proportion as in the EU (approximately 2.4%). So the relative value of labour productivity

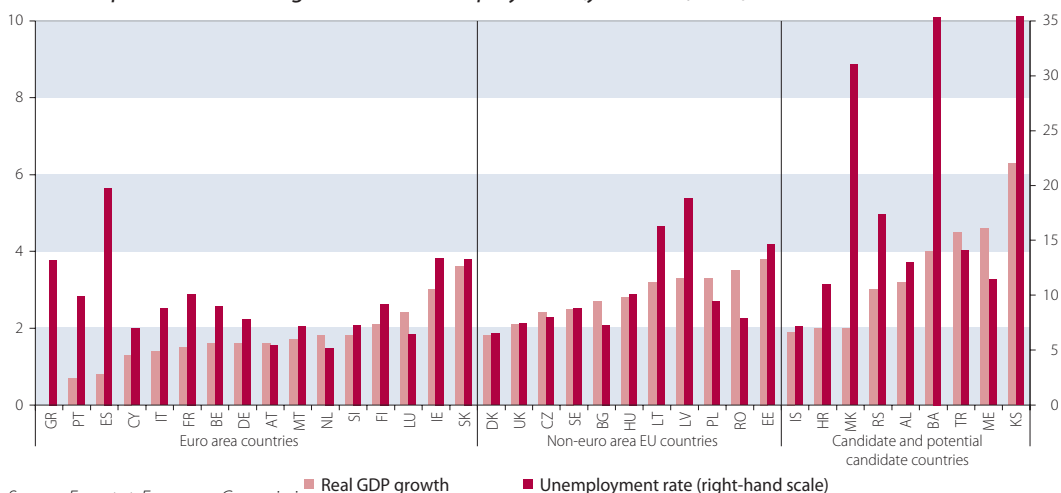
in Slovakia maintained last year's value (79.3% of the EU average). As a result of higher increase of wages, Slovakia was one of the countries with the fastest growth of unit labour cost in the EU.

The economic performance of the Slovak Republic measured by GDP per capita in purchasing power standards (PPS) partially dropped year-on-year (to 71.6% of the EU average). The relative price level in the Slovak Republic significantly increased (by 3.5 p.b.) in 2009 as a result of the depreciation of currencies of the non-euro area EU countries, and it exceeded the relative output level of the SR. We could see a real divergence in several euro area countries (the biggest in Finland, Slovenia and Ireland). Non-euro area countries mostly diverged. Price convergence continued in Lithuania, Latvia, Bulgaria and Denmark. Relative output increased year-on-year only in Poland.

The economic crisis had a positive impact on the deepening external imbalance. The Slovak trade balance was positive and the current account deficit of the balance of payment (BOP)



Chart 6 Expected economic growth and unemployment (year 2011, in %)



Source: Eurostat, European Commission.

Notes: Unemployment estimate in potential candidate countries and in Macedonia was not available; the stated value represents the 2009 average. The real unemployment rate in Bosnia and Herzegovina was 42.7% and in Kosovo 47.5%.

dropped to 3.2% of GDP (approximately half lower value than in 2008). We could see a similar trend in almost all countries under assessment. Not only deficit, but also surplus balances of BOP current accounts changed (only the Czech Republic and Kosovo saw a higher current account deficit than last year).

REAL CONVERGENCE EVOLUTION OUTLOOK

The recovery of global demand creates the conditions for further growth of European economies. The evolution of real GDP in the first two quarters of 2010 confirms the trend of expected gradual recovery. According to the current NBS forecast, foreign demand will remain the main source of growth for the Slovak economy in coming years. Higher production, with some delays, will be reflected in a favourable labour market development, having a positive effect on domestic demand. With real GDP exceeding 4%, Slovakia will probably continue to be the fastest growing EU country. In 2010 Poland will maintain the position of fastest growing non-euro area EU country. Next year Estonia and Rumania should see more dynamic growth. Assuming that the intended public deficit consolidation steps are carried out, economic growth in the Slovak Republic in 2011 will slow to 3.0%. In 2012 GDP could grow again year-on-year by more than 4%. Of candidate countries, Turkey will see the fastest pace of coming closer to the EU average; its real GDP could rise this year by 4.7% year-on-year. In Croatia, Macedonia and Iceland the year-on-year GDP growth in 2011 will amount to approximately 2%, i.e. only slightly higher than the EU average (1.7%). According to the current economic forecasts in potential candidate countries, the least developed candidates (Kosovo and Albania) will converge to the EU average output with the highest pace.

The situation in the labour market in EU countries started to stabilise slowly in 2010. A greater drop in unemployment will eventually be seen in

forthcoming years. However, unemployment in Slovakia will probably fall only slightly under 14%. Other euro area countries can see a rigid employment development due to their slower GDP growth recovery. From 2011 on, the expected more dynamic evolution of employee compensations rather than labour productivity will be seen as faster growth of unit labour cost. Slovakia will be one of the countries with the strongest growth of labour costs in the EU. In Baltic States and some other EU countries (in particular Ireland, Germany and Netherlands) unit labour cost decreases will continue. With regard to a slow decrease in unemployment, both current and future candidate countries should maintain their cost competitiveness in future years.

In 2010 higher domestic demand will be reflected in a more favourable export development and in a partial year-on-year decrease of Slovak trade balance surplus. Further evolution of foreign trade should be a positive impulse, mainly for the export of goods. In 2011 the current account deficit of the SR should fall to 1.2% of GDP. For the euro area as a whole, the Commission forecast a stabilisation of the current account balance at about -0.3% GDP. In the non-euro area EU countries the external imbalance will increase. The highest (but sustainable) deficit in 2011 should be seen in Romania. Sweden and the Baltic States should keep their relatively high surplus balance. With growing economic activity we can expect a repeated rise in current account deficits in candidate and potential candidate countries (apart from Iceland where a surplus balance is expected). At the same time, we must be aware of the foreign debt increases in these countries which, in some cases, are already highly indebted.

CONCLUSION

After years of fast economic growth, Slovakia saw a drop in GDP in 2009. Lower economic activity was reflected in a worsening of the labour market situation. Increase in the relative level of labour



productivity came to a standstill, and the economic performance of the Slovak Republic decreased in comparison with the EU average. Contrary to that, the relative price level increased in relation to the appreciation of the effective exchange rate. We could see a divergence in the development of the real convergence indicators in several EU, as well as accession countries.

The current developments confirm the high correlation between real and nominal convergence. The economic recession even led to a short period of price decrease. In late 2009 Slovakia started to meet the inflation criterion again. Recession and related policy measures had a strongly negative impact on the fiscal situation in almost all countries under assessment. Excessive deficit procedure started to be applied to Slovakia as well as most other EU countries.

Estonia is the only country that meets Maastricht criteria. EU member states, but also countries applying for accession to the EU, are failing to meet mainly fiscal criterion. From among candidate and potential countries, Macedonia currently achieves the best level of nominal convergence. The most developed candidate country, Iceland, in spite of higher level of real convergence has a relatively long way to go to meet the Maastricht criteria.

The outlook for next years suggests a gradual recovery of the economic growth of countries under assessment. Slovakia should be the second fastest growing EU country. After some time, the situation on the labour market will also start to improve. In spite of that, neither Slovakia nor most current and future EU countries will probably be able to eliminate the excessive deficit in coming years.

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Household indebtedness in Slovakia

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The growth of household indebtedness represents a common trend across practically all EU countries. In recent years the absolute volume of debts, as well as the debt-to-income ratio of households, grew relatively quickly. In 2008, Slovak household debt reached 40% of GDP.¹

Compared internationally, this is not a level considered risky (according to Kaminsky and Reinhart, 1999). A credit boom where the credit-to-GDP ratio grows by more than 9% per year is considered to be undue and potentially dangerous for financial stability. However, considering the long-term trend of growth as well as the negative development of incomes caused by the current economic crisis, mainly due to unemployment growth, the development of household indebtedness deserves attention.

The growth of household indebtedness may have significant macro-economic impacts. A high level of debt increases the sensitivity of households – their balances – to shocks, for example in the case of an interest rate increase or income decrease. The situation of households having problems to pay for their debts consequently impacts on their creditors. Households react to the significant growth of indebtedness with a decrease of consumption, and an attempt to increase their savings: this impacts on economic growth and in the present situation leads to a slow-down in the rate of economic recovery.

THE IMPORTANCE OF THE HOUSEHOLD SECTOR FOR FINANCIAL STABILITY

A certain level of indebtedness is a normal economic phenomenon, because it helps households optimise consumption in the case of unequal development of income. It becomes a problem when a household is no longer able to fulfil its obligations without reducing its expenditures under the level necessary in order to maintain a minimum standard of living, or if it is not able to cover its obligations at all. Such excessive indebtedness presents risks not only for creditors, but also has social consequences for households. A situation when a household takes up excessive debt must not only be a result of an inadequate increase of obligations (financial liabilities). A decrease of financial assets of households (total net wealth) works analogically. A role is also played by the transfer of various forms of risks into household balances.

In connection to the changed behaviour of financial institutions and the introduction of financial innovation, as well as the realisation of

reforms of the pension systems (introduction of capitalisation pillars), a shift of market risks into the household sector took place, as pointed out by the MMF (2005). Financial institutions tried to decrease the volatility of their balances and to minimise impact on profits. Several risks that were managed by financial institutions were redirected into the balance of the household sector. However, households are less ready to diversify risks. There are several channels through which these risks seep into the balances of households. On the side of assets, these are mainly more risky instruments, such as shares and unit-linked insurance products (products of investment life insurance, where the risk of investment is borne by the insurance company client) and the transition from pension programs with defined benefits to programs with defined contribution.

On the side of liabilities, these are for example credits with flexible interest rate. Types of risks transferred into household balances depend on economic policy as well as specific policies and standards applied in the regulation by individual countries. The main risks that households deal with are market risks (e.g. from investments to pension funds, from changes of interest rates, from derivatives included in structured products), inflation risk (through indexing of household benefits), risk of investment planning, and risk of longevity.²

Other factors related to the reform of public finances is the transfer of governmental expenditures for households (e.g. for healthcare, education), for which households need to have financial resources. It also means further (potential) transfer of risk into the sector of households. Households do not need to be aware of the change of their risk profile. Neither do they need to be ready to manage and absorb risk (e.g. by creating adequate savings in low-risk forms of assets). In relation to this, the question rises if the net wealth of households is of an adequate level for households to tackle these (potential) pressures on their financial position.

CHARACTERISTICS OF NET WEALTH OF HOUSEHOLDS IN SLOVAKIA

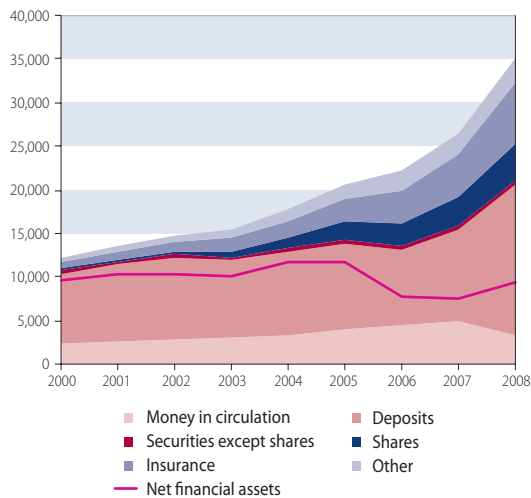
The development of financial assets and liabilities of Slovak households at the aggregate level was

¹ Based on the data of sector financial accounts, (System of National Accounts), Infostat.

² The risk that the person will live longer than the period for which financial assets are created, or that in the case of pensions from the capitalisation pillar, income flow from annuities will be limited or eliminated.

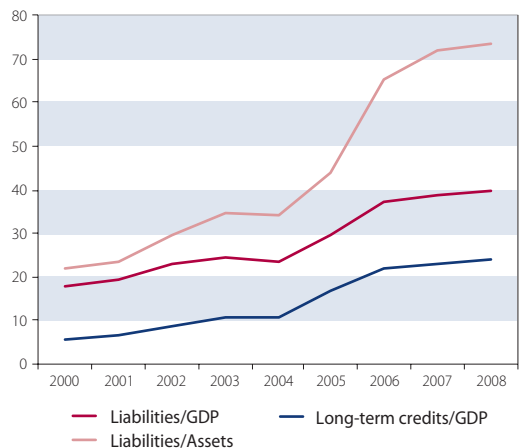


Chart 1 Financial assets of households (in million €)



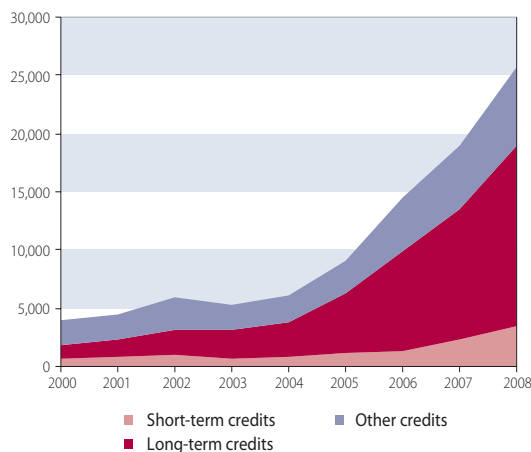
Source: Eurostat.

Chart 3 Debt of households, (% of GDP)



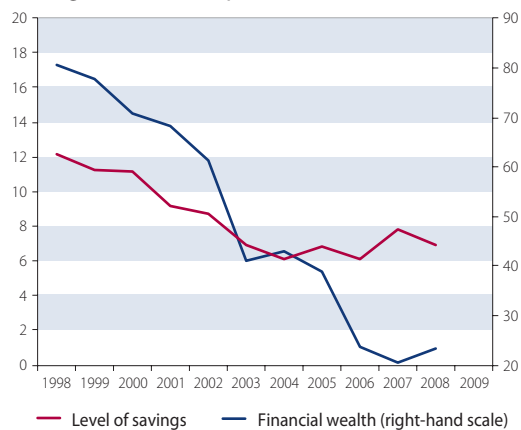
Source: Eurostat.

Chart 2 Liabilities of households (in million €)



Source: Eurostat.

Chart 4 Level of savings and net financial wealth (% of gross available pension)



Source: Eurostat.

³ Factors affecting household demand for credits for housing were discussed, e.g. in the addendum Reports on financial stability in Slovakia for 2006, 2007, 2008.

⁴ Leasing and factoring companies and hire-purchase sales companies.

characterised in the period from the beginning of the transformation of the economy after 1989 by the following:

- significant focus on low-risk assets such as cash and deposits, while the share of more risky and less liquid instruments was increasing,
- growth of liabilities, especially of long-term credits that has accelerated since 2005,
- associated decrease of net financial assets (financial assets minus liabilities),
- while the level of indebtedness related to GDP may be considered to be adequate, related to financial assets it is relatively high.

At the same time, the creation of savings was decreasing in the long run and was stabilised only through the introduction of the second pillar of the pension system. Households used credits mostly for the purchase of real estate. Non-financial assets mostly represented by real estate tended to grow. The growth of non-financial assets was compensated for to a certain extent by a decrease of net financial assets.

The majority of credits were credits for housing. Factors of credit growth were the process of follow-up, demographic factors, as well as competition between banks.³ In the case of Slovak households, their most significant creditor is the banking sector followed by other financial agents.⁴

Households also have obligations with non-financial companies and public administration.

Financial assets are only part of the overall assets of households, another substantial part is allocated in non-financial assets. An evaluation of the overall asset position of Slovak households is complicated by the fact that in the case of Slovakia, there is no statistical data on the status of non-financial assets available. It is only possible to follow year-on-year increments of non-financial assets. By cumulating the annual increments of non-financial assets, it is possible to gain information about how the concentration of household assets in non-financial assets increased. In the period from 2000 to 2008, non-financial assets increased at a similar rate as the growth of the available income of households.



HOUSEHOLD INDEBTEDNESS

In the following part, we focus on the characteristics of the development of indebtedness on the side of household liabilities, and on the identification of those households facing financial difficulties.

The growth of household indebtedness increases concern caused by the growth of credit risks on the stability of the financial system. Household indebtedness is evaluated as a rule in relation to the financial sector that is dominant in terms of household financing. Risks of household indebtedness however need to be seen in a broader perspective, since households are exposed not only to banks through credits, but also through obligations with other sectors, mainly leasing and factoring companies and hire-purchase companies, non-financial companies (e.g. electricity bills), and the fiscal sector.

Excessive indebtedness may be characterised as a situation when a household (or person) is no longer able to pay its debts and defaults. At the moment, there is no single unified definition of excessive indebtedness (EC, 2008). Options to evaluate the debtor position of a household (or individual) are several – e.g. based on the start of the process of personal bankruptcy. More flexible criteria is when a household itself sees that it has problems with the payment of contracted obligations. Another option is the definition applied in the banking industry: if the debtor is in delay with three payments of an obligation.

The reason for excessive indebtedness may be an accumulation of debts. Economic circumstances, such as low income, economic inactivity, and ownership of real estate burdened by mortgage also play a role. The main factor of an inability to pay for obligations, however, is often serious external factors, such as events seriously damaging the economic management of household budget (most often unemployment or an illness). Personal characteristics of the debtor also have an impact – the way they manage their finances, tendency to risk, and insufficient knowledge in the area of financial management.

DATA ON HOUSEHOLD INDEBTEDNESS

An important source of data on household indebtedness is the annual Statistics on Income and Living Conditions (EU SILC) carried out in all EU countries according to comparable methodology so it is possible to compare internationally individual characteristics of households. The project provides data on the social and economic situation of households – on the income of households, level and structure of poverty, social exclusion, and material deprivation (the data was proposed and monitored with the aim to better understand the worsening of living conditions and the impact).

To characterise household indebtedness, EU SILC project data may be used on the part of material deprivation in the dimension of Economic burdening.⁵ It contains objective indicators of types of data on arrear payments of households

on items such as rent payment, mortgage or credit payment, hire-purchase payment, electricity bills, as well as subjective indicators such as an evaluation of own financial situation of households, and perceived level of burden connected with the payment of selected obligations. These indicators may be considered as a sufficient source of information on the long-term financial situation of households.

In this article, data from EU SILC 2008 research concerning income from 2007 is used, thus the full effect of the crisis as reflected in the household sector in Slovakia only at the beginning of 2009 is not depicted.

FINANCIAL STRESS

Financial indicators of deprivation indicated in the following part have a subjective character since they also depict the preferences of households:

- household has problems to cover regular costs,
- household has limited ability to cover unexpected costs,
- household considers paying total costs for housing to be a financial burden,
- household has instalment payments for credits after maturity date,
- household has problems covering energy bills.

Financial problems are not limited to households at risk of poverty, therefore they are not sufficiently detected by the indicator of income type. Problems to pay for obligations or unexpected costs also have households with income above the limit of the risk of poverty.

Since data is in equal structure available for all EU countries, we can compare the level of financial distress of households. We chose to compare Slovakia with countries in the euro area⁶ as well as within the group of new Member States⁷. Since it involves a sample of population, we consider it to be more significant to consider the trend of development rather than the level of individual indicators. Indicator of the Ability to cover regular costs has the nature of a subjective poverty indicator (Guio, 2009), since it defines households that consider their own financial situation as insufficient to cover regular consumption and household functioning.

Difficulties to cover regular costs indicate existing tension in household budgets. Households evaluate their ability to cover regular costs in six possible response variants.⁸

In Chart No. 1 we include two extreme variants indicating the highest level of financial distress.

Results show that more than 10% of the Slovak population was in an extremely weakened situation, and approximately one third of Slovak households had limited ability to cover the current level of regular costs.

The situation of Slovak households is more tense compared with the average of the euro area and is comparable with the average of the new Member States, but unlike Slovakia the trend in the new Member States has improved.

5 When evaluating the financial position of households based on data from findings, we must remember the fact that this type of micro data may underestimate the real situation in the area of available income, since households have the tendency not to acknowledge income that is not officially registered (tax shortages, income from the grey economy). Households are not motivated to hide their obligations, so the overview in fact provides true information on indebtedness.

6 The group of the euro area is composed of the current number of euro area countries.

7 The group of 10 new Member States comprises CZ, EE, CY, LV, LT, HU, MT, PL, SI, SK.

8 The variants were: with great difficulties, with difficulties, with certain difficulties, relatively easily, easily, very easily.

FINANCIAL
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COVER
REGULAR
COSTS

**Table 1 Ability to cover regular costs (share of households in %)**

		2005	2006	2007	2008
Euro Area	With great difficulties	7,1	7,5	7,4	8,6
	With difficulties	14	14	13	14
New Member States	With great difficulties	19	16	13	13
	With difficulties	24	24	22	22
Slovakia	With great difficulties	12	12	11	12
	With difficulties	18	22	20	23

Source: Eurostat.

Another indicator refers to the ability of households to bear additional burdens of the budget. Indicator of the Ability to cover unexpected costs indicates the share of households without immediately liquid resources available. Households respond to the question of ability to cover unexpected amounts on the level of a monthly median income per person from own sources, thus relatively comparable share of income for various countries.

In the case of this indicator, the difference between households with low income is shown very significantly when compared with the rest of the population. A significant difference in the situation of households in the euro area is seen when compared with the new Member States with significantly more households having problems covering unexpected costs. In the group of households with mortgages, a slightly lower share of households in Slovakia (41%) has liquidity problems than in the group of households without mortgages (45.6%).

The total costs of housing are a significant part of household costs. However, there is also a group of households that does not need to cover these

costs, especially if they are owners of their housing or their rent is zero.

In the case of households perceiving high financial distress with regards to overall costs related to housing, it is probable that they are forced to modify their consumption and may be at higher risk of arrear payments for obligations connected to the funding of housing.

In Slovakia, the group of households for which housing presents a serious burden decreased. However, the group of households for which housing is somewhat burdening increased. The share of the group for which housing was not a burden at all slightly increased.

Indicator **Arrear payments with mortgage/rent payment or credit, leasing, hire-purchase payment**: During 2005 – 2008, only a narrow group of households in the countries of the euro area as well as new Member States declared arrear payments in connection with mortgage or rent, or arrear payments related with hire-purchase or other credits.

Inability to cover energy bills is closest to depicting material deprivation of financial problem indicators. This is also reflected in the character-

Table 2 Inability to cover unexpected financial costs (share of households in %)

		2005	2006	2007	2008
Euro Area		29	32	32	31
New Member States		58	53	51	49
Slovakia		59	49	43	38

Source: Eurostat.

Table 3 Financial burden of households with paying overall costs for housing (share of households in %)

		2005	2006	2007	2008
Euro Area	Very burdening	32	33	32	36
	Somewhat burdening	48	47	47	46
	Not burdening	20	20	20	19
New Member States	Very burdening	38	36	34	34
	Somewhat burdening	50	53	55	55
	Not burdening	12	11	11	11
Slovakia	Very burdening	40	40	35	33
	Somewhat burdening	53	54	57	58
	Not burdening	6	6	8	9

Source: Eurostat.



Table 4 Arrear payments for mortgage/rent or credit, leasing, hire-purchase (share of households in %)

		2005	2006	2007	2008
Euro Area	Mortgages	3,6	3,4	3,6	3,9
	Credits	3	2,6	2,6	2,4
New Member States	Mortgages	3	3	2	2
	Credits	5	4	4	2
Slovakia	Mortgages	4	5	3	3
	Credits	2	3	2	1

Source: Eurostat.

Table 5 Arrear payments for energy bills (share of households in %)

		2005	2006	2007	2008
Euro Area		6	7	6	7
New Member States		18	15	13	9
Slovakia		8	6	6	4

Source: Eurostat.

istics of household behaviour – the effort with which they try to prevent debt. This risk is concentrated in low-income households.

MULTI-DIMENSIONALITY OF FINANCIAL DISTRESS

Information from the individual indicators of financial distress can be linked since various dimensions of economic burdening and deprivation have the tendency to correlate positively (Guio, 2009). We may expect that a household in an unfavourable situation will show higher distress, and therefore it is possible to indicate households with potentially greater problems. In the case of Slovak households there is a connection between the inability to cover regular as well as unexpected costs – more than 80% of households covering regular costs with great difficulties or problems would not be able to cover unexpected costs from own sources. This group of households overlapped in more than 70% of cases, with the group of households for which total costs of housing present a great burden. Similarly, arrear payments in the case of mortgage or rent payments often applied to households for which costs of housing represent a great burden (Gerbery, 2008).

In spite of the aggregate growth of mortgage financing, mortgage debtors probably do not represent the group of households for which financial stability would be the main source of risk. Data from the EU – SILC project (for the period of 2005 – 2007), Beck, Kibuuka and Tiongson (2010) use the study examining if mortgage debtors are at greater probability of dealing with financial difficulties when compared with other households. An analysis has not detected systemic evidence that mortgage debtors would be more vulnerable. This group of households did not show a higher probability of tackling the financial burden of being in a delay with paying for their obliga-

tions than tenants or group of owners without a mortgage.

The fact that in the quoted study mortgage debtors in Slovakia show also show increased financial distress may be caused by lower predictability of the level of instalment payments for mortgage with regards to preferring contracts with variable fixation of interest rate (Georgarakos, 2010).

In the monitored countries of EU, the occurrence of financial vulnerability decreased during 2005-2007, probably reflecting the strong increase of household income. Similar characteristics that caused ownership status in old EU Member States also apply to new EU Member States.

CONCLUSION

The financial standing of Slovak households may come under the pressure of development on the part of liabilities (due to the increase of indebtedness), as well as a result of insufficiently generated savings and evaluation of financial assets. In connection with the problems of the public financial budget, households may be forced to bear unexpected and increased costs in the future.

The traditional orientation of Slovak households on financial assets with low level of risk, and thus also low level of revenue, has shifted due to the development of the domestic financial market to more risky and more profitable instruments. Development on the financial markets, however, indicates that household assets face risks that households can control and diversify less easily. The financial standing of Slovak households seems to be vulnerable with regards to the relatively high volatility of the development of financial assets, as well as net financial assets.

There is a group of households with financial problems due to excessive indebtedness. The financial indicators of deprivation tended to de-





crease during 2005 – 2008. This suggests that Slovak households could enter the period of economic crisis with relatively stable balances. The current period of economic crisis means increased risk of insolvency, e.g. due to the loss of employment, absence of income planned to cover a debt, or increased tension in budgets, in the case of excessive optimism of households at the time of accepting obligations when it comes to the expected development of their future income. The probability of the growth of negative

economic and social impacts due to excessive household indebtedness thus increases.

At the moment it is desirable that the vulnerability of household balances reduced, and an improvement of balances was realised through the more intensive creation of financial assets and/or the reduction of obligations on the side of liabilities. Corrections in household balances however have an impact on the rate of domestic demand recovery, and thus also on the future growth rate of the domestic economy.

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The exhibition: Euro Our Currency

The series of the NBS exhibitions has been extended with the new exposition – Euro Our Currency. It presents on six large panels the history of the origin of euro banknotes and coins, the role of the NBS in the euro adoption and its function after joining the euro area, its position in the European system of central banks, and the responsibilities of the European Central Bank, as well.

The exhibition also describes the historic first common currencies used in Europe, such as the tetradrachmas, Roman coins, hrivnyas, dukats, toliars and crowns, as well as the first attempts at currency unions and the establishment of the Economic and Monetary Union – its founders, political situation, choice of title, symbol, and the history of euro adoption.



Photo: Igor Plávka

The exhibition was opened at the end of September 2010 by the Vice-Governor of the NBS, Viliam Ostrožlík (in the photo, on the left) and Peter Zsapka, the deputy chairman of the Representation of the European Commission in Slovakia. They both highly evaluated the fact that the euro continues to generate discussion. Presenting the past and present of the unified euro currency is useful and necessary, especially in the turbulent times of the financial crisis.

Open Day at the NBS

The NBS opened its doors for the fourth time, making accessible to the public selected premises of the building, such as the NBS Governor's office, the Bank Board's meeting rooms, and the library. Central bank staff prepared an interesting program for visitors.



The Banknotes and Coins Department, the Archives as well as the Museum of Coins and Medals prepared stimulating presentations.

For the first time in its history, the ECB also introduced itself to Slovaks. Around three thousand people visited the NBS building.

Visitors could see four exhibitions, as well as films from the NBS and ECB. Part of the event



Photo: Igor Plávka

Visitors showed great interest in the presentation and actively took part in the discussion with the NBS Governor Jozef Makúch.

was also a presentation by the NBS Governor and a discussion with visitors, as well as a presentation on currency circulation, and an accompanying program for younger visitors.

