# 3 Financial market developments[1]

## The global economy slowed and a new wave of monetary stimulus mitigated macroeconomic risk

The global economy continued to decelerate during 2019, after showing the first signs of slowdown in the previous year. The economic environment included rising global uncertainty stemming from the trade conflict between the world's two largest economies (the United States and China) and from the ongoing discussions surrounding the United Kingdom's withdrawal from the European Union. The decline in output centred mainly on manufacturing industry, which suffered the consequences of reduced demand for investment-related products. The severe drop in foreign sales weighed most heavily on industrial production, whose downtrend dated back to latter part of 2018.

In Slovakia, like most EU countries, the growth phase had already peaked and was moderating to a significant extent. Cooling global demand was therefore gradually ending the recent expansionary phase experienced by the majority of European countries. The Slovak economy was adversely affected by economic developments in the country's trading partners, in particular Germany, the principal destination for Slovak exports. Household consumption in Slovakia continued to grow, amid a still favourable labour market situation and strong growth in the average wage; nevertheless, its contribution to GDP growth was not as high as in previous years.

In financial markets, periods of asset price growth and risk premium compression were interspersed with bouts of heightened nervousness. Market interest rates, in response to both actual and expected easing of monetary conditions, fell to historical lows, often entering negative territory. Sentiment in financial markets, as well as in the real economy, was anchored by a new wave of central bank stimulus. This appears to have prevented the economic cooling from developing into a more serious crisis.

[1] This text is based on NBS's November 2019 Financial Stability Report. A comprehensive analysis of the financial sector for the whole of 2019 is provided by the Analysis of the Slovak Financial Sector, which was published on the NBS website in April 2020.

## Banks' business models came under pressure from the low interest rate environment

In 2019 the environment of very low interest rates was affecting the domestic financial market and resulted in several risks to financial stability. In regard to the Slovak credit market, these risks included the following: excessive growth in household indebtedness; the long-term adverse impact of low interest rates on the profitability of banks and insurers (in the context of maintaining the traditional business model); the increasing vulnerability of households to the business cycle; the rising pressure in the property market; and, in regard to the investment policy of domestic financial institutions, in the shift to riskier or less liquid investments. These were further exacerbated by certain specificities of the Slovak financial sector which relate mainly to the legislative environment (the bank levy; the insurance levy and tax; a significant reduction in early repayment fees for housing loans) and to the fierce competition in certain segments (supported by the high share of new business arranged through financial brokers).

A development in 2019 which had particular significance for the banking sector's stability was the Government's decision to retain the special bank levy for an extended period and to increase it. With their profit-generating capacity reduced, banks will have less scope to increase their capital and may therefore find themselves less resilient in bad times. Given its size, the levy also has negative implications for the attractiveness of Slovak banks to foreign investors. This could lead to a decline in investment in the banking sector, thereby having a negative impact on lending to the domestic economy (to the corporate sector in particular) and on the quality of customer services.

## The growth rates of loans to households and loans to NFCs moderated, while increasing household indebtedness was one of the most significant risks to financial stability

The growth rate of total loans to households moderated gradually in 2019, and the slowdown was more pronounced in the case of consumer loans. The main causes were NBS's tightening of regulatory retail lending requirements and the incipient saturation of certain market segments. Slovakia's growth rate for household loans went from being the highest in the EU to the fourth highest. In line with credit market trends, the rate of increase in household indebtedness also slowed, while nevertheless remaining among the highest in the EU. The risks related to household indebtedness were accentuated by the low ratio to GDP of households' net financial assets – assets that may be used as a buffer if the financial situation deteriorates. The marked increase in the household sector's vulnerability is therefore the most significant risk in regard to any deterioration in the economic situation.

Economic cooling translated into declines in foreign trade and sales in 2019. The consequent worsening of the situation in the corporate sector was evident in investment loans, as firms' diminishing interest in investment activity meant they had less need to finance such activity. While the non-financial corporate debt-to-GDP ratio is low in international comparison, the greatest risk of a structural nature is the debt-to-equity ratio, which is among the highest in the EU. The downtrend in default rates came to a halt in 2019, but these rates remained at historically low levels.

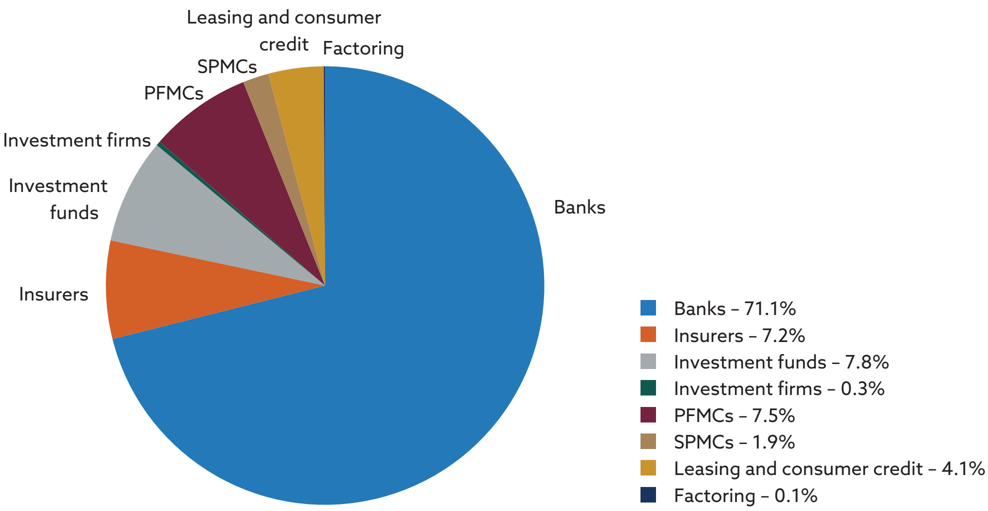
## The banking sector's profitability and capital adequacy became increasingly vulnerable to any economic deterioration

The main cause of the decline in the banking sector's profit in 2019 was lower net income from the retail sector. This stems from the fact that banks are less able to offset the substantial impact of declining returns on loans by increasing their volume of lending or reducing their cost of funds rates. Compared with other banking union countries, the profitability of banks in Slovakia remains above average; however, that gap is gradually narrowing.

Given the ongoing build-up of cyclical risks associated with the increase in household indebtedness, the strengthening of domestic banks' solvency is positive news. Their improving resilience is also supported by other significant features of the sector, not least that it has one of the highest NPL coverage ratios (including provisions and collateral) in the whole EU. The funding structure of banks also improved during 2019, owing to stronger growth in deposits and to banks' issuance of covered bonds.

**Chart 14**

**Financial sector assets as at 31 December 2019 broken down by market segment**




**Source:** NBS.
**Note:** PFMCs – pension fund management companies; SPMCs – supplementary pension management companies.

## The insurance sector was facing long-term risks, while pension funds and investment funds were investing in riskier assets

In 2019 the insurance sector was facing several long-term risks. The first risk was lower than originally expected returns on assets, which resulted in insurers having to top up their reserves at the expense of their profitability. The second risk was the introduction of a new tax on non-life insurance business, which is eroding profits and, in certain segments, also reducing customer, and therefore premium, growth. This is further exacerbating the long-term problem of losses on motor insurance. A significant structural risk is that a large part of insurers' capital comprises the volatile component that is *expected profits included in future premiums (EPIFP)*, which will not be ready to absorb any sudden, unexpected losses. Although the EPIFP share in the insurance sector's aggregate capital has fallen slightly, it remains the highest in the EU.

The low interest rate environment of recent years has also been reflected in the search-for-yield in non-bank sectors in Slovakia. Among companies managing customer assets (pension fund management companies, supplementary pension management companies, and investment fund management companies) and insurers, 2019 saw a gradual increase in their equity investments and a lengthening of the duration of their bond portfolios. Another trend within bond holdings was an increase in the share of bonds of a lower investment-grade credit rating, and in the case of investment funds, also in the share of speculative-grade and unrated securities. Across investment funds there was also an uptrend in investments in less liquid assets, such as assets related to the financing of property or financial instruments not traded on an exchange. The main risk is the extent to which such assets can be realised in the event that funds face a sudden wave of redemptions. At present, this risk is mitigated by regulatory minimum requirements for the amount of liquid asset holdings. Funds are comfortably meeting this requirement as well as requirements for the regular stress testing of their liquidity.