NÁRODNÁ BANKA SLOVENSKA
EUROSYSTÉM

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Foreword

Národná banka Slovenska contributes to the stability of the financial system as a whole in Slovakia, in particular through its role as the financial market supervisory authority. The financial sector is deemed to be stable when it is able to smoothly fulfil its core functions, even amidst substantial adverse shocks in the external and/or domestic economic and financial environment. At the same time, financial sector stability is perceived as a necessary condition for sound functioning of the real economy.

Národná banka Slovenska believes that regular provision of information to the public about financial sector stability and about any trends that could jeopardise that stability is a key part of its contribution to financial stability. Awarness and discussion of financial stability issues is essential, especially since it is not only financial sector institutions, but also other non-financial corporations and individuals whose behaviour affects financial stability. For this purpose, Národná banka Slovenska publishes a Financial Stability Report twice a year which deals primarily with the identification of main risks to the stability of the Slovak financial sector.

This Financial Stability Report (as at May 2013) features a new structure. The aim is to provide clear and easy to follow information about the development of factors affecting financial stability in Slovakia, with particular attention paid to the most significant risks to stability. For the first time this report includes a separate chapter providing a comprehensive description of changes in the regulatory and legislative environment from the perspective of their implication for the stability of the domestic financial market.

The comprehensive overview of developments in the Slovak financial sector, including all risks in the sector, is complemented by the Analysis of the Slovak Financial Sector, which Národná banka Slovenska publishes twice a year.

EXECUTIVE SUMMARY

RISKS ARISING FROM THE EXTERNAL ENVIRONMENT INCREASED IN 2012

At present, the main context in which the stability of the Slovak financial sector must be assessed is the ongoing sovereign debt crisis and by the negative external macroeconomic developments in the euro area. Furthermore, several macroeconomic imbalances remain a significant source of risks for the future, including private and public indebtedness and the negative net international investment position of certain euro area countries. Given the structural nature of these factors, it can be assumed that these risks will have a longer-term impact on financial stability. Due to the openness of the Slovak economy, adverse trends in the external environment have spilled over into the domestic environment, affecting mainly the labour market and certain sectors of the economy. From a longer term perspective, it will therefore be crucial for Slovakia to maintain competitiveness in export markets, particularly given the domestic economy's high reliance on the automotive industry.

Although financial markets were relatively buoyant in the second half of 2012, that situation was largely the result of central bank measures and was in stark contrast to macroeconomic fundamentals. Such a mismatch constitutes a systemic risk for the euro area financial sector particularly in the form a possible increase in investors' risk aversion and the consequent substantial drop in prices across a broad range of assets, including sovereign debt issued by euro area countries.

THE SLOVAK FINANCIAL SECTOR SHOWS A RELATIVELY HIGH DEGREE OF STABILITY AND SELF-SUFFICIENCY

Amid these persisting risks in the economic and financial sphere, it is important that the Slovak financial sector is demonstrating relatively strong resilience to shocks, mainly due to healthy solvency conditions, the availability of funding, and the relatively conservative business models of financial institutions. The Slovak banking sector is outperforming a majority of other EU countries' banking sectors in several key areas, such as capitalisation, profitability, asset credit quality, and long-term liquidity. The financial sector has also benefited significantly from the price increase of domestic government bonds.

THE MAIN RISK TO THE BANKING SECTOR IS A DETERIORATION IN ASSET QUALITY CAUSED BY ADVERSE MACROECONOMIC DEVELOPMENTS

Since the business strategies of Slovak banks focus mainly on lending to the domestic economy, one of the principal risks to the Slovak banking sector is a deterioration in the ability of firms and households to service their debts or a decline in the value of Slovak government bonds. Several negative trends should be highlighted in this regard, in particular the slowdown in economic growth alongside increasing unemployment, falling real wages and declining activity in the domestic corporate sector. Nevertheless, the worsening economic situation has not as yet been accompanied by a broader increase in non-performing loans. This is largely attributable to deleveraging in the corporate sector, as well as to the low, albeit rising, debt-service burden of households.

Given, however, the above-mentioned negative trends from the external environment, further deterioration in the domestic macroeconomic situation remains a risk. A particular risk is the development in the commercial property sector, since the failure of large, systemically important customers who account for a substantial share of the credit portfolio in one or more banks could have adverse repercussions for the banking sector. Owing to the emerging uncertainty surrounding the quality of assets held by European banks, it is vital for the maintenance of confidence in the Slovak banking sector that banks take a prudent attitude to identification of problematic loans and establish sufficient provisions to cover any future losses on such loans. Since Slovak bonds account for a large share of the asset portfolios of domestic financial institutions and funds, it is also crucial that the stability of Slovakia does not deteriorate to the point that foreign investors in financial markets lose confidence in these bonds and hence cause their price to decline.

The prolonged period of low interest rates could impair the stability of the Slovak financial sector

The domestic financial sector has benefited in several ways from the drop in interest rates that followed the ECB's accommodative policy response to the financial crisis. It should be pointed out, however, that the sector may face future risks if rates remain at their current low level. One of the most significant effects of low interest rates is a decline in returns on low-risk assets, which in turn could affect the profitability or riskiness of the portfolios in certain financial institutions or funds. The insurance sector is most vulnerable to this risk, owing to guaranteed returns in insurance contracts. An important systemic risk for the banking sector – one with the potential to affect the domestic economy as a whole – is the accumulation of credit risk in banks' credit portfolios. With a prolonged period of low interest rates, the risk that an increase in interest rates will adversely affect borrowers could become increasingly significant. This is because during the period of low interest rates, loans can be granted also to clients with low ability to withstand the risk of increase in interest rates.

The Slovak banking sector has not been contributing significantly to the deterioration of the macroeconomic situation

Developments in the household loan market were different from those in the corporate loan market during 2012. The outstanding amount of corporate loans decreased, but a similar trend was reported by banking sectors of other euro area countries as well. This reflected both supply-side and demand-side factors, as banks tightened credit conditions (mainly because of persisting uncertainty about macroeconomic developments), while major exporting firms have long tended to seek funding from abroad rather than from domestic banks.

Unlike loans to the corporate sector, loans to households are growing quite sharply, particular in the housing loan segment. This growth is largely driven by strong demand from customers. Although the housing loan market in Slovakia was among the fastest-growing in the European Union in 2012 no emerging imbalances were identified in the domestic residential property market. The potential for a further acceleration in housing loans is unlikely given the current macroeconomic situation, and the outlook for housing loans over the long-term horizon is further subdued by expected demographic developments.

An increasing risk is that adverse developments in parent financial groups will spill over into domestic financial institution

A majority of banking sectors in the EU have seen their financial position deteriorate in recent years, specifically in terms of solvency, funding availability, and profitability. This situation could indirectly affect the Slovak financial sector, largely owing to the high share of foreign capital in its institutions. Rationalisation measures by parent undertakings could weigh on activities of domestic banks. A particular risk in this regard is if significant subsidiaries are transformed into branches of foreign banks or branches of insurance undertakings, since such a move could contribute to a weakening of stability in the both the domestic financial sector and the economic system as a whole. To mitigate the impact of such risks, it is necessary to maintain the relatively strong position of significant Slovak banks within their parent group and to monitor the effect of legislative changes on the attractiveness of the domestic financial sector. In this regard, it is necessary to view sensitively the risk that current developments in the EU regulatory environment weaken the balance in international cooperation between supervisory authorities or increase the mismatch between competences and responsibilities in certain areas.

Table 1 Overview of the most significant risks to the stability of the Slovak financial sector

Area	Risk	Risk-amplifying factors	Risk-mitigating factors
Risk of a deterioration in the macroeconomic situation	Increase in non-performing loans and credit risk costs in the event of adverse macroeconomic developments		Relatively high solvency in the banking and insurance sectors Relatively high provisioning for non-performing loans Low domestic private indebtedness
	Losses caused by negative developments in the commercial property market		
	Downward pressure on profits due to a slowdown in bank lending as well as to a decline in new insurance contracts		
Risk of low interest rates	Downward pressure on insurers' profits owing to guaranteed returns in insurance contracts		
	Accumulation of credit risk in the banking sector, even if banks' do not change their prudent approach		
	Squeezing of banks' interest rate margins and funds' returns		
Risk of re-escalation of the euro area sovereign debt crisis	A resurgence of investor risk aversion accompanied by a drop in the value of investments, particularly those of SPMC funds and mutual funds		Relatively low share of investments in securities issued by stressed countries
	The debt crisis intensifies and spreads to higher-rated countries, including Slovakia, causing a decline in the price of government bonds issued by these countries	Institutions and funds have a high share of investments in Slovak government bonds	
Risks in the external environment	Negative impact on domestic financial institutions of rationalisation measures adopted by parent undertakings in response to a worsening situation in the external environment, or the transmission of risks from that environment in another way	Transformation of significant subsidiaries into branches Legislative changes reducing the attractiveness of the domestic financial sector	Relatively strong financial position of the most significant domestic banks within their parent groups
Concentration risk	Relatively high concentration of (part of) the portfolio in certain institutions or funds	Relatively low probability, but with a potentially significant adverse impact on a particular institution or fund	High concentration mainly concerns systemically less significant institutions
	Failure of systemically important customers or counterparties		In many cases it concerns strategically important firms or institutions which are unlikely to fail
Legislative and regulatory environment	Increasing mismatch of competences and responsibilities in certain areas		
	Risk of decreased profitabiltiy of financial institutions owing to an increase in their tax or levy burden or to an unstable regulatory environment		
	Risk of weakening balance in the international cooperation between supervisory authorities		

Source: NBS.

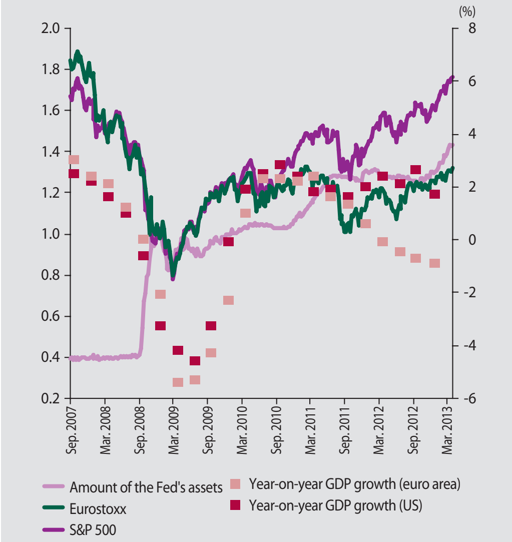
EXTERNAL CONDITIONS FOR FINANCIAL STABILITY

1 External conditions for financial stability

From the view of financial stability in Slovakia in 2012, developments in the external environment in 2012 were largely adverse. This was primarily due to the worsening economic conditions in the euro area, given that the Slovak economy and, by extension, the health of the domestic financial sector are strongly interconnected with that area. The most distinct sign of this deterioration is a year-on-year decline of 0.6% in gross domestic product (GDP), causing the majority of peripheral countries to slide into relatively deep recession. The worsened macroeconomic conditions and weak economic performance were also apparent in the rest of the euro area.

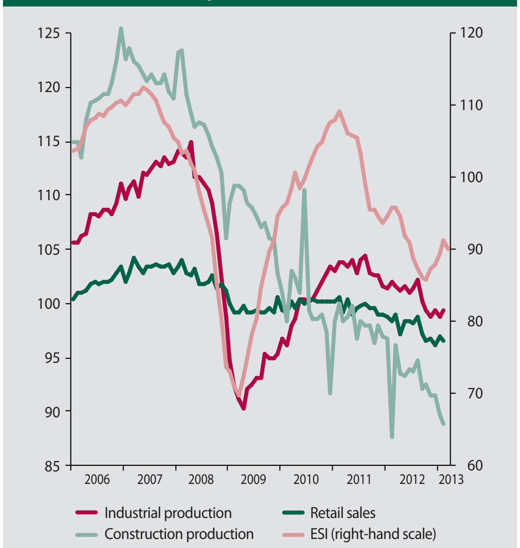
Regarding the future direction of the euro area economy, there is a broad consensus that it is unreasonable to expect a sustainable recovery until the second half of 2013, at the earliest. Although partial indicators for the first three months of 2013 suggest that the situation has stabilised somewhat after a sharp decline at the end of 2012, they show no signs of a potential economic upturn.

Chart 2 Comparison of equity indices with the Fed's[1)] balance sheet and GDP growth in Europe and the United States



Source: Eurostat, Bureau of Economic Analysis, Bloomberg, Board of Governors of the Federal Reserve System.
Note: The amount of the Fed's assets and the values of equity indices on the left-hand scale are standardised (31 December 2008 = 1).
1) Fed – Federal Reserve System.

Chart 1 Selected monthly indicators of economic developments in the euro area



Source: Eurostat.
Notes: Average for 2010 = 100 for data on the left-hand scale.
ESI – Economic Sentiment Indicator of the European Commission.

The negative macroeconomic developments in the euro area, especially those in the first half of 2012, were closely connected with the persisting debt crisis. A critical period was the second quarter of 2012, when financial market tensions re-escalated as a result of investor concerns, leading to speculation about the possible disintegration of the euro area. Panic was prevented from spreading across the market by a statement of the European Central Bank's president at the end of July 2012, confirming the central bank's determination to intervene to preserve the euro area's integrity. This stance was backed up at the beginning of September when the ECB Governing Council approved the 'Outright Monetary Transactions' programme, enabling the ECB, under prescribed conditions, to directly purchase government bonds in the secondary market for its own portfolio. The remainder of 2012 saw an easing of financial market tensions, a return to more standard developments, and a rise in financial asset prices.

A notable feature of advanced economies in the second half of 2012 was the striking inconsistency between, on the one hand, their macroeconomic situation – whether worsening (in the euro area) or stagnating (in the United States) – and, on the other hand, the upturn in financial markets. This trend continued at the beginning of 2013, too. The deviation of financial asset prices from economic fundamentals was most probably caused by the policy of low-interest rates pursued by major central banks. The US Federal Reserve's quantitative easing programme plays a special role in this regard, and a new largest-ever round was launched in the autumn of 2012. Its effect is evident, for example, from the relatively high correlation since 2009 between developments in the Fed's balance sheet and the values of global equity indices. In the short term, however, it is possible to observe how asset prices react to indications of the range of quantitative easing planned for the future. Further pressure on asset prices can be expected in connection with the steps taken by the Bank of Japan, which has recently launched an aggressive monetary expansion.

Divergence between the real economy and the financial sector is one of the most significant sources of potential systemic risks, which may materialise through the revaluation of credit risk premia for a wide range of assets. Over the last five years, central bank measures have undoubtedly contributed positively to the stabilisation of financial markets and played an irreplaceable role in the fight against recession. If, however, financial market developments substantially deviate from the macroeconomic conditions as a result of monetary stimulation, the valuation of assets will be exposed to the risk of downside correction. Negative revaluation may occur, inter alia, in connection with monetary policy tightening in the future. On the other hand, it cannot be ruled out that if macroeconomic developments continue to fall short of expectations and/or uncertainty about further policies escalates, asset prices will correct to a point that is closer to economic fundamentals, notwithstanding the accommodative monetary policy stance.

An increase in risk premia may also be caused by events related directly to the future course of the euro area sovereign debt crisis. Although euro area financial markets were relatively calm at the beginning of 2013, the foundations of this stability are still fragile. The accumulated effect of similar unexpected shocks and events, such as the unclear parliamentary election result in Italy or the Cypriot crisis, may also lead to an increase in risk aversion.

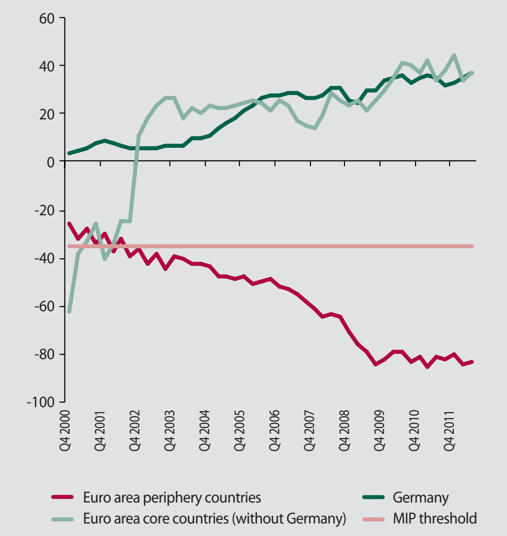
A basic condition for the mitigation of risks to financial stability in the euro area, both risks arising from the debt crisis and risks in general, is a reduction in the existing macroeconomic imbalances that have accumulated in the euro area over the last decade. On the other hand, the process of imbalance reduction itself may adversely affect financial stability in the short term, through its effect on economic activity or on financial markets.

A significant imbalance behind the euro area sovereign debt crisis, one that poses a major threat to financial stability, is the deeply negative net international investment position[1], especially in the periphery countries. This negative position occurs in both the private and public sectors. While the deepening external imbalances of countries within the monetary union were underestimated before the crisis, excessive exposure to foreign countries, mainly in the form of debt, is currently considered to be a key factor in a country's economic vulnerability. The euro area periphery countries that are involved in the recovery programme of the European Union (EU) / International Monetary Fund (IMF), as well as other stressed countries, are in this situation largely because of their high external debt and the negative effect this has had on the confidence of foreign investors. Following the outbreak of the crisis, the negative b.o.p. capital account balances of periphery countries started to diminish (in some cases they returned to positive territory). This, however, sufficed only to stabilise net international investment positions at high levels between -90% and -110% of GDP (except in Italy).

Dependence on external financing on a flow basis has been successfully reduced over the last three to four years through an improvement in the net external trade balance. This reflected to some extent a decrease in imports, but mainly

1 *A country's net international investment position is negative when the value of foreign liabilities is higher than the value of investments in foreign assets.*

Chart 3 Net international investment positions of euro area countries (% of GDP)

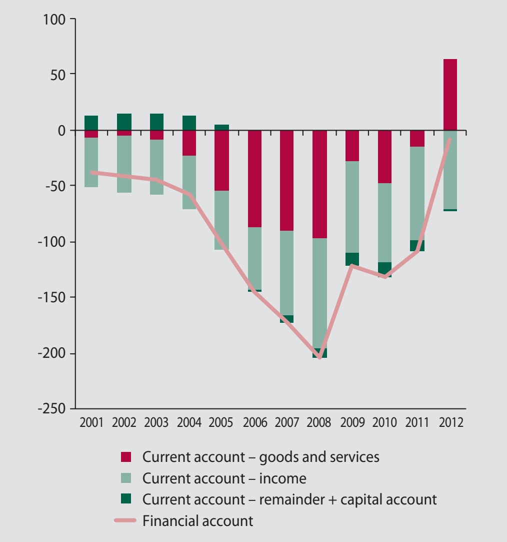


Source: Eurostat.
Notes: Data for groups of countries express the arithmetic averages of individual countries.
The MIP (Macroeconomic Imbalance Procedure) threshold is an indicative threshold of the European Commission for the assessment of macroeconomic imbalances.

an improvement in the export performance of periphery countries.

Further export growth in these countries can only be achieved through an increase in their

Chart 4 Balance of payments in euro area periphery countries broken down by component (EUR billions)



Source: Eurostat.

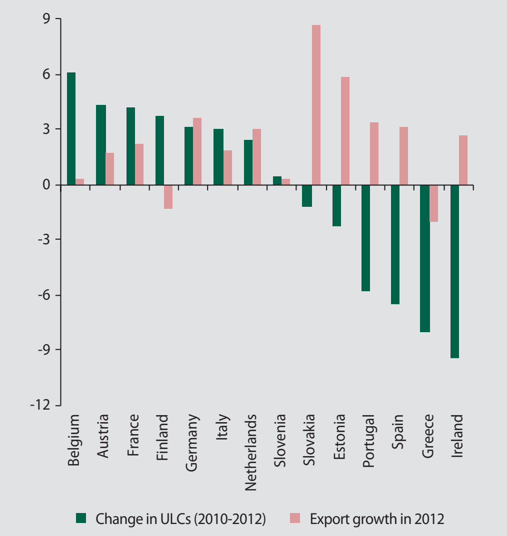
competitiveness. Recent years have seen some positive trends in price competitiveness, notably in unit labour costs (ULCs), which have been falling in the majority of periphery countries since 2008/2009. Considering, however, that this indicator was rising in the decade preceding the crisis, the current downward trend represents only the beginning of the road to restoring competitiveness in these countries. It should also be stressed that the fall in unit labour costs is largely cyclical in nature, with the increase in labour productivity being achieved through a marked fall in employment.

Another significant imbalance in the euro area stems from excessive private and public sector debt. This problem concerns both the periphery countries and many of the core countries. In the pre-crisis period, the debt accumulated in enterprises and households was a source of relatively strong economic growth. At present, however, the simultaneous efforts made in the private and public sectors to reduce the level of debt are one of the main factors behind the low or negative economic output across the euro area.

While the private sector's total debt has stabilised or fallen slightly over the last few years, public sector debt has continued to grow in the majority of countries. Despite the ongoing fiscal consolidation efforts, the budgets of numerous EU countries remained in deficit in 2012, and therefore to achieve structurally balanced budgets or debt reduction will remain a challenge for these countries for a relatively long period.

The worsening economic and social situation in recent years has broken the prevailing consensus that the repair of public finances is a top economic policy priority and represents the best solution to the crisis. An increasing number of voices are demanding that fiscal policies in Europe be eased temporarily for the sake of economic growth. From a purely theoretical macroeconomic viewpoint, a slowdown in consolidation could stimulate economic growth in the short term. In the context of a possible negative reaction from financial markets, however, such a change in strategy would represent a non-negligible risk. In addition, debt reduction and the implementation of deep structural reforms should remain

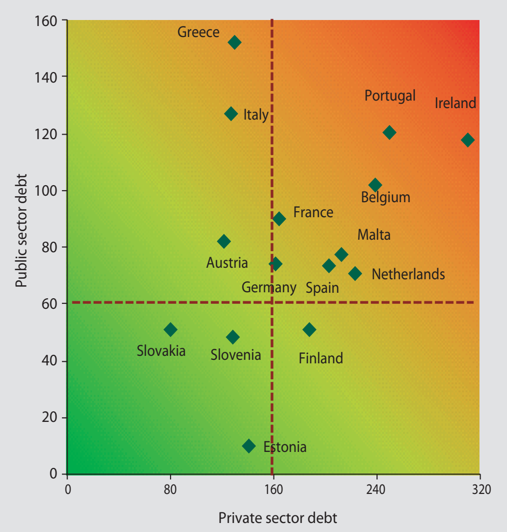
Chart 5 Unit labour costs and exports in euro area countries (%)



Source: Eurostat.
Notes: Export growth is expressed at constant prices.
ULCs – unit labour costs.

a long-term objective, because this is the only road leading to the achievement of strong and sustainable economic growth in Europe.

Chart 6 Private and public sector debt in euro area countries as at end-2012 (% of GDP)



Source: Eurostat.
Notes: The 60% and 160% thresholds are set by the European Commission in the Macroeconomic Imbalance Procedure.
The red highlighted area represents higher risk, green colour indicates lower risk.

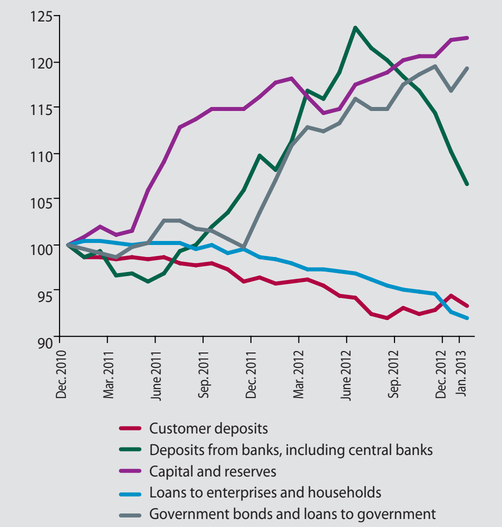
Despite some improvements, financial stability in part of the European banking sector is still at risk. The worst situation is in the banking sectors of periphery countries. On the asset side, the situation in banks is complicated mostly by non-performing loan losses and exposures to government bonds issued in risky countries. The quality of banks' loan portfolios deteriorated in 2012 and is likely to continue deteriorating owing to the ongoing recession in the euro area.

Banks in periphery countries in particular were also under pressure on the liability side in the first half of 2012, when they were faced with an outflow of foreign funds and with customers shifting deposits to banks in other euro area countries. Many of the banks coped with this situation only with the help of liquidity from the ECB. The supply of liquidity to the euro area's banking system in unlimited amounts eliminated the threat of an uncontrollable escalation in the debt crisis. On the other hand, it postponed the necessary purging of non-viable banks from the system, and some private sector risks spread to the Eurosystem amid the ongoing fragmentation and disintegration of the euro area's common banking market.

The negative trends in bank liabilities in the periphery countries and in perceptions of their riskiness changed to some extent in the middle of 2012, when the ECB intervened to reduce the risk of an extreme shock. The revival of activity in the interbank market made it possible to reduce the aggregate volume of borrowings from the ECB. The sector, however, includes an appreciable number of troubled banks, which have no access to market funding. If the debt crisis deepens still further, the problem of reduced access to funding may spread to other banks, too.

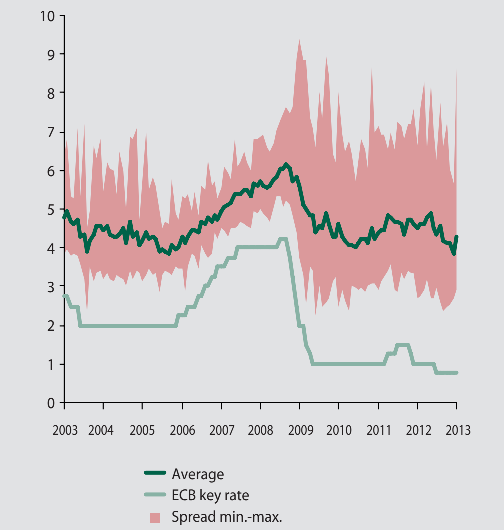
Despite the measures taken, there was virtually no improvement in the access to credit in the euro area, and thus the market remained regionally fragmented in the second half of 2012. This was mainly reflected in persisting differences in lending rates for enterprises between the individual countries. The different interest rates mirrored the credit spreads of countries in which the banks were based.

Chart 7 Selected balance-sheet items in the banking sectors of euro area periphery countries



Source: Bloomberg.
Note: Standardised (December 2010 = 100).

Chart 8 Interest rates on new corporate loans in euro area countries (%)



Source: ECB.

Box 1

EFFECTS OF RISKS IDENTIFIED BY THE EUROPEAN SUPERVISORY AUTHORITIES ON THE SLOVAK FINANCIAL SECTOR

Risk	Brief description of risk in the EU	Possible effect on the Slovak financial sector	
Deterioration in the macroeconomic situation	A deterioration in the macroeconomic situation in the euro-area core countries may weaken the profitability of banks as a result of increased credit risk costs, and thus contribute to the restriction of bank lending. It may also have an unfavourable effect on other sectors of the financial market.	Significant, though mitigated to a large extent by the relatively high capital adequacy of banks and insurance companies.	This risk is analysed in the Report in full detail, in various aspects. The effects of unfavourable macroeconomic developments and financial market developments were quantified through macro stress testing (Box 2).
Increase in risk premiums, deepening sovereign debt crisis in the euro area	Credit risk premia are currently at relatively low levels, owing to the liquidity surplus and search for maximum yield. In some cases, however, this does not sufficiently reflect the real fundamentals and hence there exist concerns that any unfavourable information may significantly re-escalate uncertainty and risk aversion among investors.	Significant, but only if the risk spreads to Slovakia; otherwise relatively low.	This risk would materialise with a systemic effect if it spread to less stressed countries, such as Slovakia. The negative effect of unfavourable developments in stressed countries would be concentrated in individual institutions or funds. This risk is described in more detail in section 3.4 (*Market risks*).

Risk	Brief description of risk in the EU	Possible effect on the Slovak financial sector	
Non-transparent assets' credit quality and credit risk coverage	Uncertainty regarding the quality of assets in the banking sector remains high, especially given the doubts about asset valuation methods, provisioning, internal models, and forbearance (the easing of contractual conditions for existing loans in order to prevent them from being officially classified as non-performing).	The risk is partly present in some banks	Some of the trends (forbearance, decrease in risk weights in internal models) can also be identified in some of the Slovak banks and are analysed in more detail in this Report (in section 3.4, Indicators of *a credit risk increase in the future*). The coverage of non-performing loans is sufficient.
Risk of low interest rates	Insurance companies in particular may be adversely affected by long-term low returns on assets, since they are committed to providing guaranteed returns under insurance contracts. Pressure on interest margins is mounting in banks. Investment in risky assets may increase in all sectors.	Significant, but only if the risk persists for a longer period	Over the medium-term and long-term horizons, the profitability and, consequently, the solvency of insurance companies as well as banks may be negatively affected. Returns on pension funds and mutual funds may decrease, or the riskiness of these funds may increase. This is described in more detail in section 3.4 of the Report (*Risk of low interest rates*).
Worsened access to funding for banks	Despite the improving situation, some signs of market fragmentation remain, such as higher borrowing costs for smaller banks. In addition, difficulties in obtaining funding are reflected in the tightening of credit standards.	Relatively low	This risk in the Slovak banking sector is mitigated to a large extent by the sector's ability to obtain funding from primary customer deposits. The share of funding from volatile sources (e.g. interbank market and short-term securities) is the smallest within the euro area. The risk is analysed in more detail in section 3.3.
Risk of high asset encumbrance (share of assets used as collateral)	The main consequence of growth in asset encumbrance is the decreasing pool of assets that can cover unsecured liabilities in the case of the bank's default. This is also connected with the restricted access to new sources of funding. Since asset encumbrance is increasing at a time of growing distrust and reduced access to unsecured funding for banks, it may have a procyclical effect on the real economy.	Low	Asset encumbrance in the Slovak banking sector is approximately 50% lower than the average level of asset encumbrance in large European banks and shows no rising tendency.
Real estate market begins to overheat again	Despite a modest improvement in the situation, residential property prices in certain countries still appear to be overvalued, while the risk of a downside correction is increasing amid unfavourable economic developments. Hence, it is necessary for banks to have sufficient provisions for this purpose.	Low	In Slovakia at present we do not see any loans being provided for speculative purposes. Residential property prices are stable and the use of real properties as a loan collateral is relatively conservative. This risk is analysed in more detail in section 3.4 (*Real estate market*).

Risk	Brief description of risk in the EU	Possible effect on the Slovak financial sector	
Foreign currency loans	If loans provided to debtors earning income in the domestic currency are largely denominated in foreign currency and the related foreign currency risk is not hedged, a depreciation in the domestic currency may lead to a marked increase in loan repayments and consequently to an increase in non-performing loans.	Negligible	In the long term, the share of loans denominated in foreign currency does not exceed 2.5% of the total volume of loans.
Funding of banks through dollar deposits	Some banks use short-term funds denominated in US dollars to finance their longer-term assets, while the maturity mismatch between dollar assets and liabilities is significant. This mismatch combined with unstable investors and unstable access to dollar funding represents a systemic risk.	Negligible	The share of liabilities denominated in US dollars is approximately 1.5% of the balance-sheet total.

Source: ESRB, ECB, ESRB, EIOPA, ESMA.
Note: The table contains only the most significant risks identified by the European institutions. Other specific risks that are described in this Report may also be relevant for the Slovak financial sector.

CHAPTER 2

DOMESTIC CONDITIONS FOR FINANCIAL STABILITY

2

2 Domestic conditions for financial stability

Macroeconomic developments in Slovakia in 2012 had largely negative effects on the country's financial stability. Amid recession in the euro area and generally pessimistic sentiment stemming from the European sovereign debt crisis, the Slovak economy slowed quite markedly. Real GDP growth fell to 2.0% in 2012, which was around two-thirds of the 2011 performance. Compared with other euro area countries, however, Slovakia has been still one of the most dynamically growing economies.

The only source of economic growth in the period under review was exports; all the other basic components of domestic demand contributed negatively. Looking at the structure of exports, positive developments were concentrated in a small group of core sectors. Exports of the automotive industry played a particularly crucial role in this regard, boosted by the launch of new production capacities in the car assembly plants operating in Slovakia. Almost half of the 8.6% real growth in exports in 2012 was generated in this sector. Domestic consumption declined in year-on-year terms, mainly as a result of uncertainty and caution in the private sector and, to a lesser extent, consolidation in the public sector and restricted access to financing in the corporate sector.

The persisting sluggish domestic demand, combined with weaker export growth, owing to a pronounced base effect, is expected to slacken the pace of economic growth still further in 2013. In its latest forecast (March 2013), Národná banka Slovenska (NBS) estimated the rate of GDP growth to reach 0.7 % at constant prices. Starting from 2014, the Slovak economy is expected to accelerate gradually.

The worsening conditions for financial stability in Slovakia can be attributed to the economy's heterogeneous development, with only certain group of enterprises contributing to economic growth. Numerous sectors that are important for the financial sector, e.g. construction, retail trade, accommodation, and agriculture, recorded stagnation or decline in output and sales in 2012. A similar situation was observed in some subsectors of industry. This unfavourable trend continued at the beginning of 2013. The poor performance of part of the corporate sector, especially if it persists for a longer period, may naturally lead to a reduction in the debt-servicing capacity of enterprises.

The financial position of households in the period under review was adversely affected by the worsening labour market situation and decline in real wages (by 1.1%). The labour market developments in 2012 were largely negative. The seasonally adjusted quarter-on-quarter data indicate that employment declined during the year, except in the first quarter. The sharpest fall was recorded in the final quarter of 2012. At the same time, unemployment increased. According to a labour force survey, the unemployment rate in the last quarter of 2012 stood at 14.4%, which was 0.4 percentage point higher than at the end of 2011. According to NBS estimates, labour market indicators will continue worsening in 2013, with real wages falling still further.

Since the Slovak economy is so open and dependent on foreign demand, it is crucial for the country to maintain competitiveness in export markets. Unit labour costs (ULCs) are a major determinant of price competitiveness, expressing the ratio between labour costs and productivity. Unit labour costs in Slovakia remained virtually unchanged in 2012, while they rose in the majority of EU countries. This indicator of the Slovak economy has been at a standstill since 2010. A highly positive fact is that competitiveness as measured by ULCs has in recent years been improving more rapidly in Slovakia than in other central and eastern European countries with which Slovakia competes for export market share and foreign direct investments. The strong competitive position of

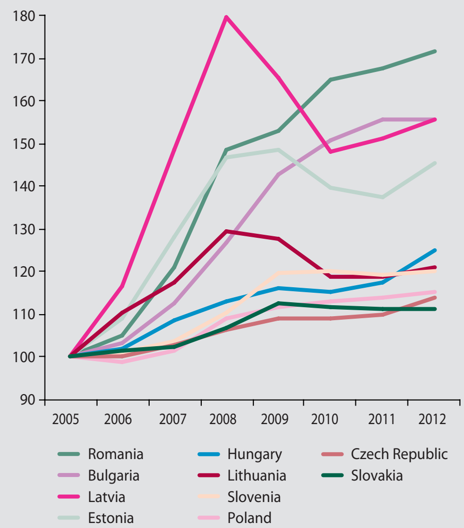
Slovakia was further confirmed by the volume of such investments, as they rebounded to pre-crisis levels. For the sake of competitiveness, it will also be important in coming years to ensure that wage growth is accompanied by labour productivity improvement. In that case, household final consumption could begin to contribute to economic growth through income growth, while the country's export potential would be maintained.

Slovakia's potential economic growth could in future be disadvantaged by the excessive orientation of Slovak exporters to the European market, given that growth in Europe is lagging behind that in the rest of the world. In 2012 the EU market was the destination for 84% of Slovak exports, with no other EU country reporting a higher share. That share has decreased in recent years, but only slightly. On the other hand, some of these exports are subsequently re-exported for final consumption to fast-growing markets outside Europe, thereby reducing the concentration risk.

Although car production is the main driver of the domestic economy, excessive reliance on this sector represents a risk in the long-term horizon. This risk stems from the situation in the European automotive industry. New passenger car sales in the EU declined steadily between 2008 and 2012, and by almost 25% over the period. This slump included a drop of 8.2% in 2012, which was even slightly higher than the decline in 2008, when the financial crisis erupted. In the first quarter of 2013, the decline in demand for new passenger cars deepened to almost -10% in year-on-year terms. On the other hand, the industry's production capacity in Europe has only shrunk moderately from the pre-crisis level. Consequently, car manufacturers will probably come under increasing pressure to close some plants in the coming years and to bring production into line with demand. The decline in car sales in Europe, especially if it proves to be of a structural (not cyclical) nature, may represent a potential risk for Slovakia. However, given the relatively strong competitive position of the Slovak economy, car assembly plants in Slovakia are not likely to be closed down in the case of a production capacity reduction.

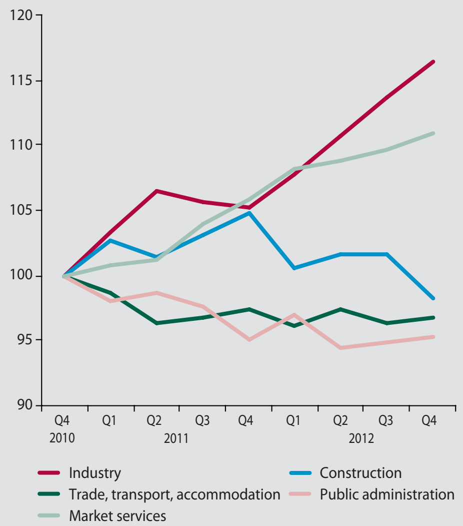
Slovakia's balance of payments saw positive trends in 2012. The ongoing debt crisis in the euro area has shown that an economy's exces-

Chart 10 Changes in unit labour costs in Slovakia and the rest of Central and Eastern Europe in 2005-2012



Source: Eurostat.
Note: Index 2005 = 100.

Chart 9 Value added creation in the Slovak economy's production sectors



Source: Eurostat.
Notes: The chart shows the annual moving averages of quarterly data.
Standardised (Q4, 2010 = 100).

sive dependence on external financing, even within a monetary union, may undermine its financial stability. It should be noted in this regard that Slovakia in 2012 became a net creditor for the first time ever. This was due primarily to a marked improvement in the balance of trade in goods and services. The total net international investment position of Slovakia remained virtually unchanged (negative), at around 63% of GDP. This value is one of the highest within the EU, but a mitigating factor from the view of risks is its composition. A large part of the capital inflow, especially before the crisis, came in the form of foreign direct investment, which represents a far more stable source of financing than portfolio investments or other cross-border investments.

In line with EU–wide trends, the Slovak government continued to consolidate its public finances in 2012. The state budget deficit was reduced to 4.3% of GDP, i.e. by 0.8 percentage point compared with 2011. This reduction was greater than the EU average. According to data from the Ministry of Finance of the Slovak Republic, however, Slovakia's consolidation efforts[2] weakened considerably in comparison with 2011. Fiscal consolidation is expected to accelerate again in 2013, when the government plans to reduce the public finance deficit below 3%, which is a requirement arising from the excessive deficit procedure (EDP). Slovakia has been subject to the EDP since 2009. This objective will be demanding to meet, given that the state budget for 2013 reckoned on real GDP growth rate of 2.1%, but the MF SR later revised the GDP growth forecast down to 1.2% with a tax revenue loss of 0.5% of GDP. The latest NBS forecast predicts that the growth rate will be an even lower, at the level of 0.7%, meaning there will be further losses on the income side of the budget. The European Commission, however, assumes that the plan to reduce the deficit below 3% of GDP in 2013 is economically feasible.

Public debt increased by almost 9 percentage points in 2012 to stand at 52.1% of GDP, i.e. within the range in which sanctions may be applied under the Fiscal Responsibility Act. One of the causes of the debt increase, besides the deficit, was the country's commitments under membership of the European Stability Mechanism (ESM) and European Financial Stability Facility (EFSF). A non-negligible part of the public debt increase resulted from the creation of liquidity reserves by the Debt and Liquidity Management Agency (ARDAL), as it took advantage of positive investor sentiment towards Slovak government bonds (the yields to maturity on these bonds were falling throughout the year, to reach a historical low at the year-end).

Overall, fiscal developments in Slovakia in 2012 were fairly positive from a financial stability point of view, because they tended to stabilise the national debt, which is still relatively low compared with other EU countries. Debt servicing was conducted smoothly, under favourable conditions. There is no indication that the fiscal regime may pose a major risk to financial stability in Slovakia, unlike in many other euro area countries. It is necessary, however, to pay careful heed to the effects of any legislative changes which, by increasing the government's consolidation effort, could alter foreign investors' perceptions of the stability or attractiveness of the business environment in Slovakia, especially given the large share of foreign capital in the domestic financial sector.

2 *The indicator of consolidation efforts expresses the size of a sustainable improvement in the balance of public finances achieved through the government's budget policy. It represents the year-on-year difference in the balance of public finances adjusted for cyclical and one-off effects.*

CHAPTER 3

FINANCIAL SECTOR IN SLOVAKIA

3

3 Financial sector in Slovakia

3.1 SOLVENCY AND FINANCIAL POSITION OF THE FINANCIAL SECTOR

Solvency of the financial sector

A necessary condition for financial stability is that banks must maintain a capital cushion of sufficient quantity and quality. A sufficient amount of core capital (Tier I capital) enables a bank to absorb any unexpected loss without its activity being threatened. A capital cushion is even more important at times when confidence in the banking sector wanes as a result of increased systemic or other risks, which are not fully covered by the minimum capital requirements imposed under Pillar I of Basel II (e.g., concentration risk or sovereign debt risk). For that reason, the regulatory authorities of the EU, including NBS, issued recommendations for banks in 2011/2012 to increase the quantity and quality of their own funds.

The Slovak banking sector's loss absorption capacity increased markedly in 2012, mainly as a result of an increase in the capital adequacy ratio (CAR). The core capital adequacy ratio rose in year-on-year terms from 12.3% to 14.7%, the highest level recorded in the last seven years. Owing to this increase, the Slovak banking sector maintains a sufficiently high solvency ratio in comparison with other EU countries (a detailed comparison of SK and EU banks is provided in Box 3). This growth reflected mainly the significant retention of 2011 profits, as well as a direct increase in core capital. Another factor, though less important from the view of potential risks, was the positive revaluation of debt securities in the available-for-sale portfolio. Banks using the internal ratings-based approach for credit risk recorded a fall in risk weights for credit exposures to retail or corporate customers, which also supported an increase in their capital adequacy ratios.

The increase in solvency is also reflected in the banking sector's strong resilience to unfavourable macroeconomic or financial market developments. This resilience was assessed using macro stress testing. The test results confirmed the banking sector's robustness under adverse scenarios simulating a decline in foreign demand and a deepening of the euro area sovereign debt crisis. Even under the worst-case scenario, banks would have relatively little need to increase their own funds in order to meet the regulatory capital adequacy requirement.

Box 2

MACRO STRESS TESTING[3]

Macro stress tests were used to examine the Slovak financial sector's resilience under three scenarios, namely a Baseline scenario, an 'Economic Downturn' scenario, and a 'Sovereign Crisis' scenario. The **Baseline** scenario was prepared using the official medium-term forecast of NBS. This scenario assumed moderate growth in the domestic economy and a slight fall in unemployment. The Economic Downturn scenario assumes headwinds from a decline in external demand brought on by the worsening global economic performance. Domestic demand declines, as annual GDP falls by 10% and unemployment increases by 3 percentage points in 2013. Under the Sovereign Crisis scenario, the downturn is more moderate compared to the previous scenario, but its repercussions are longer lasting. The euro area sovereign debt crisis escalates, with negative consequences for the domestic

3 More detailed information on the assumptions and results of macro stress tests is available in the Analysis of the Slovak Financial Sector for 2012.

economy, and the euro depreciates against the US dollar.

Under the stress scenarios, the banking sector showed relatively strong resilience owing to its high level of solvency, although some of the banks would suffer relatively high losses. The total amount of additional capital needed to achieve the 8% capital adequacy ratio in all banks would be €7.6 million under the Economic Downturn scenario (0.15% of own funds as at 31 December 2012) and €11.2 million under the Sovereign Crisis scenario (0.23%). This additional capital would be necessitated mainly to cover losses on the corporate loan portfolio as well as revaluation losses on the bond portfolio caused by rising credit spreads. The outcome is similar in the insurance sector, which would suffer a loss mainly if the sovereign debt crisis escalated and non-life insurance costs increased. As for old-age pension funds, the only type seriously affected would be index funds. Supplementary pension funds and mutual funds would be exposed to relatively serious losses on equity investments, which would be partly offset by an assumed depreciation in the euro against the dollar during the euro area crisis.

The insurance sector's solvency increased significantly in 2012, owing to the revaluation of securities amid falling interest rates. The ratio between the real and required solvency levels rose to 3.8 as at end-2012, its highest value for five years, due to an increase in own funds. As in the banking sector, the growth in own funds in the insurance sector was caused by an increase in unrealised gains from the revaluation of bonds amid falling interest rates. This is not a stable increase in capital, but the creation of a capital buffer against potential losses arising from future interest rate movements. From the view of risk management, insurance companies should create provisions also for bonds they are currently purchasing for their portfolio, against potential revaluation losses caused by a future rise in interest rates.

As regards solvency, there could be identified several factors that may have a negative impact on the capital adequacy of financial institutions. One of these factors is the risk of a fall in bond prices, due to a rise in interest rates, and consequently a fall in own funds in the banking and insurance sectors. This risk is mainly associated with the risk that credit spreads widen in case of deepening distrust in financial markets, as happened at the end of 2011. Considering the steep rise in bond prices in 2012, it may be assumed that bonds, as their maturity date approaches, will gradually fall in value even if interest rates are stable. This also applies to bonds purchased in the current period, for which banks and insurance companies have no revaluation gains from the previous period. Another factor may result from the fact that the decline in risk weights registered in 2012 by banks using an internal ratings-based approach might be restricted. This restriction is not in force in 2012 and 2013, but it is planned to be enforced in the future under the new banking regulation (CRR / CRD IV). The third factor is the adoption of stricter regulatory rules within the scope of CRR / CRD IV. On the one hand, these rules introduce a stricter definition of own funds, and, on the other hand, they impose increased requirements on own funds, mainly in banks using internal ratings-based approaches. Eventually, a restriction will be imposed on the minimum leverage ratio (ratio of own funds to total exposure), and several types of capital buffer will be required.

Owing to the persisting risks to the abovementioned strong position of the Slovak banking sector, NBS decided to maintain in force its recommendations for the support of banking sector stability from January 2012. As part of these recommendations, the Financial Market Supervision Unit recommends banks to maintain a core capital adequacy ratio of more than 9%, to pursue a dividend policy with respect to the need to maintain a sufficient capacity for the coverage of potential losses, and to maintain the ratio of loans provided to stable sources of funding below 110%. NBS greatly appreciates the fact that the majority banks now meet these recommendations with a sufficient margin.

Profits in the financial sector

For the banking sector to be able to maintain its capital adequacy ratio at the required level without having to restrict bank lending, it needs to generate sufficient profits. The maintenance of profitability in the long term requires stable net interest income. This was also identified during macro stress testing as one of the key factors mitigating the negative effects of unfavourable economic developments.

Bank profits declined by approximately one-third in 2012. This fall was caused mainly by the recently introduced special bank levy and extraordinary bank levy, an increase in credit risk costs, and the continuing decrease in net interest income. These unfavourable effects were partly offset by gains from banks' revaluation of their bond portfolios, which were increasing in value amid falling interest rates. Lower interest rates to some extent moderated the increase in credit risk costs, as they eased the debt-servicing burden of customers. On the other hand, the lower interest-rate environment put downward pressure on bank's interest income, mainly because interest margins narrowed. Interest income from corporate loans decreased, while interest expenses on deposits received from the household sector increased. It should be noted, however, that the increase in deposit costs was also related to certain structural trends observed in the banking sector in late 2011 and early 2012, notably the strong competition between banks and the growing share of time deposits with a maturity of more than one year, which naturally entail higher costs than do current accounts or shorter-term deposits. Profits also dropped in the insurance sector, by 20% year-on-year (owing to their high level in 2011), but remained relatively high.

Despite an increase in non-performing loans, the majority of banks have a sufficient amount of provisions for such loans. Those non-performing loans that are not collateralised, not covered by provisions, nor deducted from banks' own funds represent a risk in that they could reduce future profit or capital levels. Therefore, the reduction in the proportion of uncovered non-performing loans in numerous banks has been a positive development. Although the data on collateral are only indicative, they show that in most of the banks more than 95% of the non-performing loans are collateralised. This fact reduces the need for additional provisioning for non-performing loans in the future.

Risks to profitability

Regarding the outlook for bank profits, the influence of factors that exerted downward pressure on profits in the previous period is expected to wane. Competition in the area of retail deposits and loans has eased and the share of time deposits is decreasing again. The total amount of bank levy revenue collected in 2013 is expected to increase only slightly in comparison with 2012. This increase will be confined to retail banks. The relatively high coverage of non-performing loans with provisions, or with items deductible from the capital base, ensures that banks will not be exposed to the need to establish additional provisions for non-performing loans.

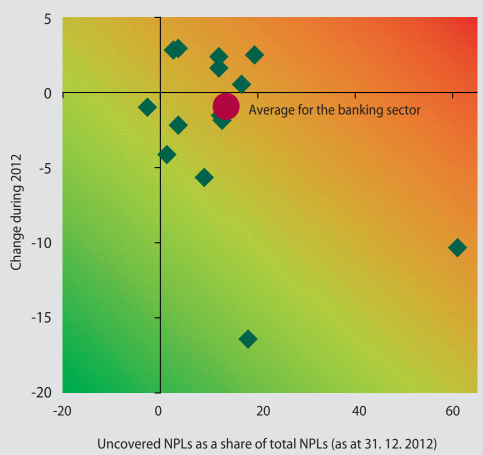
On the other hand, the main risk to profitability in the banking sector is a possible increase in non-performing loans, coupled with additional credit risk costs and increased credit spreads. The stress testing results show that although increased credit risk costs and asset revaluation losses during adverse economic developments should not lead to non-compliance with the capital adequacy rules in banks, they may cause relatively significant losses in the banking sector. An increase in non-performing

Table 2 Year-on-year changes in the banking sector's net profit in 2012 (EUR millions)

	Factor	Value
Net profit in 2011		674
Negative effects	Net increase in transfers to state budget	-105
	Increase in credit risk costs	-126
	Increase in costs related to retail deposits	-51
	Decrease in income from corporate loans	-77
Positive effects	Increase in net interest income due to growth in retail loans	52
	Increase in net income from trading	131
Other effects		-13
Net profit in 2012		486

Source: NBS.

Chart 11 Proportion of non-performing loans that are not covered by provisions (%)



Source: NBS.
Notes: The chart shows the outstanding amount of, or changes in, non-performing loans that are not covered by provisions. The values are expressed as a percentage of the bank's own funds in order to allow a better risk assessment.
The horizontal axis shows the situation as at 31/12/2012. Both provisions and coverage through deduction from own funds are taken into account.
The vertical axis shows the changes recorded in 2012, illustrating the dynamics of developments. The calculation was also adjusted for the write-off or sale of non-performing loans.

corporate loans could have a relatively strong impact.

Another significant risk in the long term is the sustained low-interest-rate environment. Sustained low returns on less risky assets would contribute to downward pressure on the banking sector's net interest income. This effect would stem mainly from declining returns on the bond portfolio, caused by falling coupon payments on variable-coupon bonds, as well as from new bond purchases made after a part of the current portfolio matures. This trend was observed in early 2013 and was one of the main factors behind the fall in bank profits. The adverse impact of the low-interest-rate environment would be even stronger if banks continued to curb their lending activity despite low interest levels, as that would lead to a further fall in net interest income.

The most problematic **of the other factors** is aggressive business strategy pursued by some of the banks, with some ready to obtain new market share even at the expense of negative margins. In addition, it is also important that the sector's transfers to the state budget (e.g., bank levy or income tax payment) should not be further increased, especially at a time of economic downturn. With interest income decreasing, the banking sector may also suffer under measures taken to restrict banks' fee policies. Any decline in the financial sector's future profits could adversely affect efforts to reduce the level of operating expenses. Hence, it will be necessary to monitor the banks' efforts to increase their profits in a low interest rate environment through investment in more risky assets, while achieving operational efficiency improvements by easing control mechanisms and risk management practices.

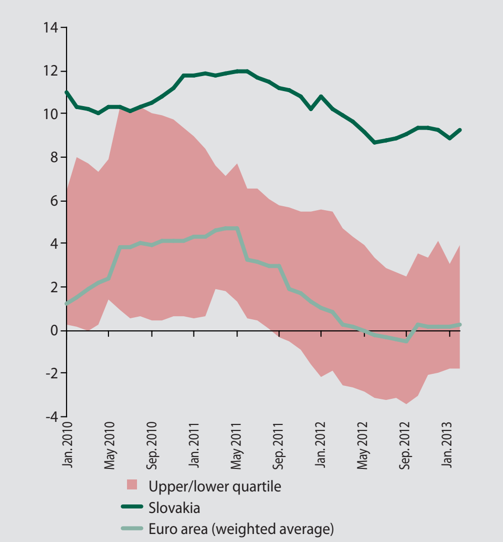
3.2 LENDING GROWTH IN THE BANKING SECTOR

The difference in growth between corporate and household loans deepened in 2012. While the corporate loan market reflected the headwinds from the euro area, lending to households continued to grow relatively dynamically. The positive trend in the household sector resulted from structural factors, while the corporate sector was dominated by uncertainty on both the demand side and the supply side. The strongest growth in household loans was observed in the housing loan market. Demand for housing loans arose mainly from the housing needs of young households, which took advantage of low interest rates and affordable property prices. Such demand is less sensitive to stagnation in real incomes or to subdued consumer confidence, which acts as a constraint mainly on those considering moving home or buying their second home.

The negative dynamics in bank lending to the corporate sector in the second half of 2012 mirrored trends in other euro area countries, as loan demand and supply weakened amid uncertainty about macroeconomic developments in the years ahead.

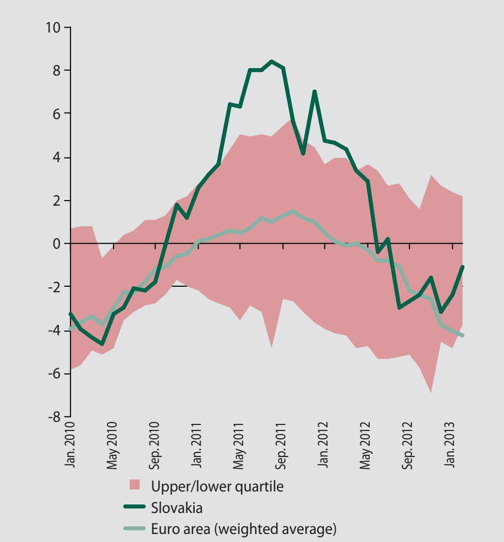
The activities of banks in the corporate loan market in 2012 were slightly procyclical. Lending conditions were tightened in the weakening market owing to persistent uncertainty regarding macroeconomic developments. Lending to enterprises started to decline again in 2012. In this case, the supply of loans showed more intense dynamics. Demand for loans was weak but stable, while banks continued to tighten their lending policy. Since lending to enterprises slowed in 2012 as a result of stagnating demand and weakening supply, the behaviour of banks can be characterised as procyclical. The main reason for banks' tightening of credit standards was uncertainty about the macroeconomic outlook. Since relatively strong competition in the corporate loan market was squeezing interest margins, the expectation of mounting risk was sufficient justification for restricting lending.

Chart 12 Rate of change in amount of household loans, including comparison with euro area average (%)



Source: ECB Statistical Data Warehouse.
Note: The chart shows the first and third quartiles of year-on-year growth in loans in euro area countries, the asset-weighted average growth, and the year-on-year growth in Slovakia.

Chart 13 Rate of change in amount of corporate loans, including comparison with euro area average (%)



Source: ECB Statistical Data Warehouse.
Note: The chart shows the first and third quartiles of year-on-year growth in loans in euro area countries, the asset-weighted average growth, and the year-on-year growth in Slovakia.

It should be noted, however, that such a situation in the corporate loan market does not necessarily have a direct effect on the domestic economy. This is because large export companies do not borrow funds from domestic banks in significant amounts and are therefore not dependent on domestic financing. This can also be seen in their debt-service burden, which in some periods was increased by loans from sources other than resident banks.

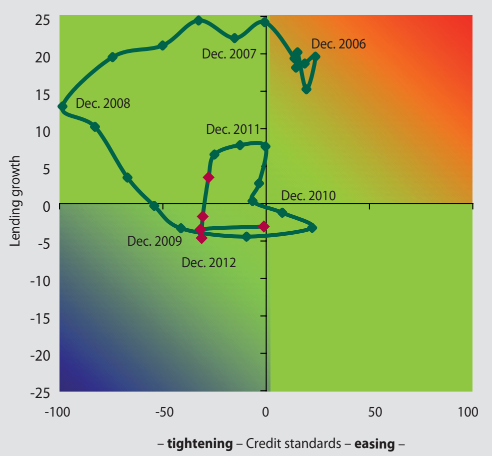
The procyclical policy of banks did not extend to housing loans. Owing to strong demand, this segment was more balanced and credit flows were influenced by banks' lending policy to a lesser extent. Credit standards were eased considerably in the consumer loan market, which is too small to have a significant influence on the domestic economy. Unlike the market for corporate loans, the household loan market witnessed a steady increase in lending activity throughout 2012 and was one of the most rapidly growing markets in the EU. The household loan market was dominated by housing loans, which can have a direct influence on the size and depth of the housing market. It was important for financial stability that the growth in housing loans during 2012 was not strengthened excessively by bank lending policies. Lending growth remained at 10%, while banks were fairly cautious in their lending conditions.

In the case of consumer loans, banks tend to ease their credit standards in the long term, and thus stimulate further growth in loans even if they are growing at relatively fast pace. Credit standards continued to be eased in 2012, even while the volume of lending grew by roughly 14% year-on-year. Since excessive growth in consumer loans may result in an overheated economy, it is important that such loans constitute a relatively small amount and that their impact on macroeconomic developments is insignificant.

The prospects for bank lending growth over the long-term horizon are largely negative, given that the number of potential loan applicants is steadily falling due to demographic trends. The negative impact of these trends could be postponed through further growth in disposable income. The prospects for growth in loans over the short-term horizon are connected with current macroeconomic developments, i.e. the labour market situation and changes in the disposable income of households. The future trend in bank lending can also be assessed in the context of macro stress testing. Since the **Baseline** scenario is predicated on the official forecasts of Národná banka Slovenska, the estimated rate of lending growth under this scenario can be viewed to some extent as a loan market forecast. The expected slowdown in economic growth will probably be reflected in the dynamics of household lending, too. The total volume of loans is expected to increase by 7% in 2013, compared with 9% a year earlier. The expected improvement in sentiment and accelerating economic growth should see lending growth accelerate in 2014, yet still be somewhat lower than in 2012 due mainly to higher growth inertia in this segment. These trends are expected to be reflected in the dynamics of housing loans, the most significant type of household loans (in terms of volume).

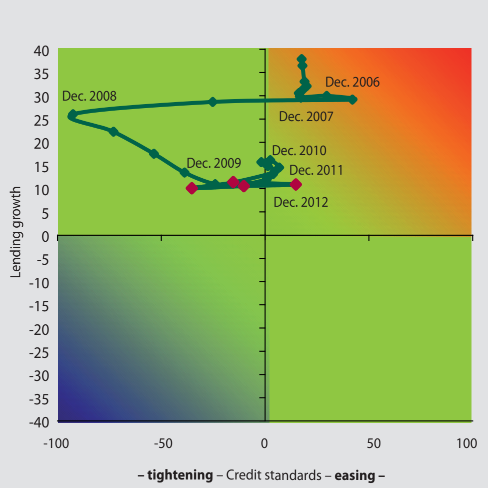
While the macroeconomic factors described above are expected to determine the underlying market trends over the short-term and medium-

Chart 14 Credit standards and credit flows in the corporate loan market (%)



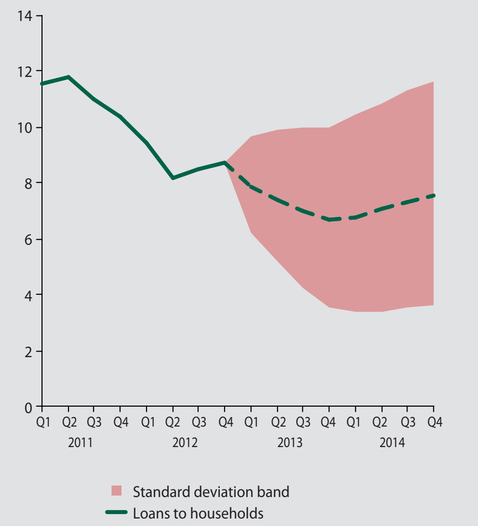
Source: NBS.
Note: The chart shows the changes made in credit standards in the individual quarters and the corresponding year-on-year changes in the volume of loans.
Red and blue colours denote an increased cycklicality of bank lending and green colour denotes non-cyclical behaviour.

Chart 15 Credit standards and credit flows in the retail housing loan market (%)



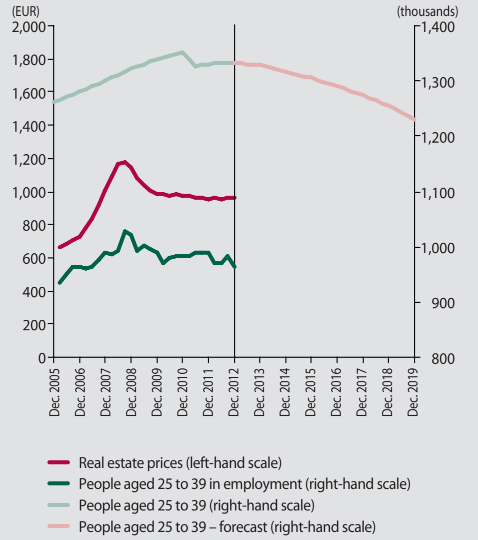
Source: NBS.
Note: The chart shows the changes made in credit standards in the individual quarters and the corresponding year-on-year changes in the volume of loans.

Chart 17 Projection of growth in lending to households (%)



Source: NBS.
Notes: The chart illustrates the projection of year-on-year growth in the volume of loans provided to households.
The projection relates to the baseline scenario used in macro stress testing (Box 2), which is based on the official forecasts of NBS for end-2012.

Chart 16 Demographic trends as a credit growth factor



Source: NBS, Statistical Office of the SR, Infostat.
Note: Real estate prices are in EUR per sq m.

term horizons, a long-term factor affecting the rate of lending growth is demographic development. The vast majority of loan applicants are in the age range 25 to 39, and therefore demand for loans, especially housing loans, is determined by this particular group. According to the demographic projections, Slovakia's population in this age group will be steadily decreasing over the coming 20 years (starting from 2013). Lending growth in the period from 2005 to 2010 was accompanied by a more than 7% increase in this age group of the population. In the years 2013 to 2018, however, a decrease of 5.5% is expected. Such a difference can be classified as a factor that will affect future bank lending.

Nevertheless, the repercussions of this demographic trend could be moderated through economic growth. If a substantial economic recovery occurs along with an increase in the disposable income of households, the age range of potential loan applicants may expand. Such a change may be caused by households wishing to purchase a new apartment or house of a higher standard, even if they have still not repaid the loan taken out to buy their current home. The loan amount requested in loan applications may increase, too. For banks, this would mean an increase in debts and instalments of existing borrowers who can afford a second loan due to their growing income.

3.3 FUNDING SOURCES FOR THE BANKING SECTOR

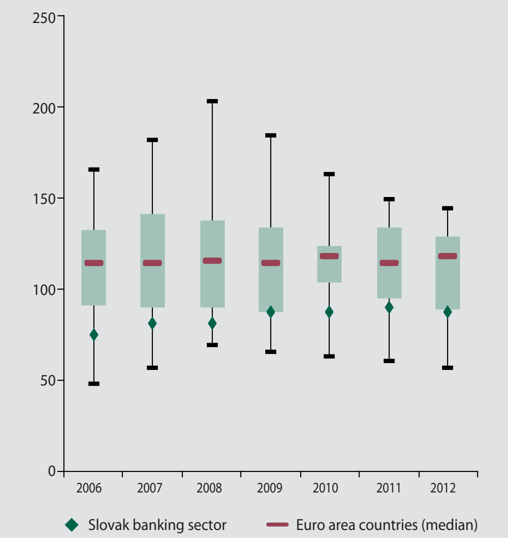
While reduced access to funding is one of the main risks for several euro area countries, it is a less significant risk for the Slovak banking sector. This risk, amplified by fragmented financial markets, is described in the current Financial Stability Review of the ECB[4] as one of the key risks in the euro area (see Box 1). Reduced access is a consequence of, inter alia, outflows of funds from stressed countries, and of difficulties in issuing longer-term debt securities for banks domiciled in their territory. In this context, the situation in the Slovak banking sector can be evaluated as positive. The sector as a whole faced no significant pressure on the liability side during the downturn in the domestic economy in 2009, nor was it hit by the sovereign debt crisis in the following period (up to an including 2012).

One of the factors mitigating the risk of reduced access to funding for Slovak banks is the large share of relatively stable customer deposits in their total liabilities. Such a stable basis enables banks to finance their activities without having to borrow from the interbank market or other volatile sources on a large scale. The current conservative composition of liabilities in the banking sector, due in large part to the conservative investment strategy of Slovak customers, also reflects the fact that the total volume of loans is still exceeded by the total volume of deposits received from customers. This means that banks still have the capacity to finance the real economy from stable funds, without having to borrow from the money market.

The conservative investment strategy of Slovak banks and the perception of the Slovak economy as stable contributed to the stability of customer deposits. Since the Slovak banking sector lends mainly to the domestic economy and has a small share of risky assets, it was not perceived as significantly risky even during times of financial market turbulence. As a result, domestic banks, unlike banks in countries with elevated sovereign risk, were not faced with outflows of deposits and they could therefore maintain a conservative balance-sheet structure (on the liability side). It should also be noted that all banks adhered to prudential rules governing short-term liquidity, according to which banks must maintain a sufficient amount of highly liquid assets for the coverage of increased outflows. The average liquid asset ratio remained virtually unchanged during 2012, fluctuating just below 1.5.

The positive trends continued throughout 2012 as retail deposits steadily increased, though households were preferring shorter-term deposits. Retail deposits increased in 2012, as they did in 2011. Unlike in the previous year, however, this increase was well balanced and there was a shift in demand towards shorter maturities. This change is probably attributable to the currently low interest rates on these deposits. Although the effect of competition on time deposits remained virtually unchanged, foreign bank branches increased their share in the total volume of deposits in 2012, although most of that growth was confined to sight deposits. As for corporate deposits, no significant trend changes were observed.

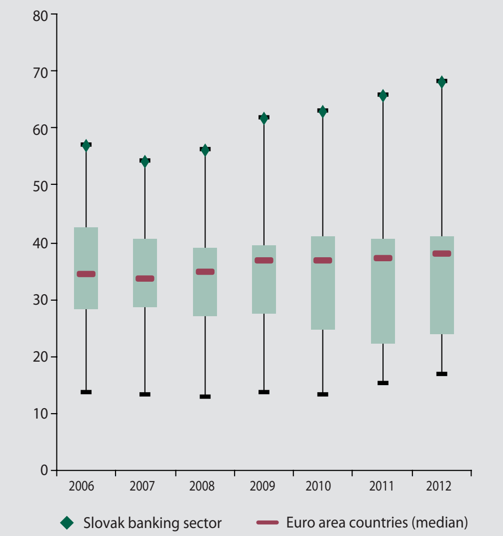
Chart 18 Ratio between loans provided to customers and deposits received from customers in Slovakia and other euro area countries (%)



Source: ECB Statistical Data Warehouse.
Notes: The chart shows the minimum value, maximum value, first quartile and third quartile of the ratio in individual euro area countries, the value for the Slovak banking sector, and the median values for the banking sectors of individual Member States.
The values are as at the end of the respective years.

4 *ECB Financial Stability Review, December 2012, available at www.ecb.int*

Chart 19 Ratio of deposits received from customers to total assets in Slovakia and other euro area countries (%)



Source: ECB Statistical Data Warehouse.
Note: The chart shows the minimum value, maximum value, first quartile and third quartile of the ratio in individual euro area countries, the value for the Slovak banking sector, and the median values for the banking sectors of individual Member States. The values are as at the end of the respective years.

With the banking sector perceived as stable, mortgage bonds were issued under favourable conditions; nevertheless, it is necessary to heed risks arising from the particularities of this market, notably refinancing risk. The price or coupon yield of mortgage bonds, that have the highest share in the debt securities issued, correlate with Slovak government bond yields or with the interbank rates (EURIBOR). In 2012 banks were still able to issue mortgage bonds with adequate conditions, i.e. adequate margins over interbank rates and/or adequate spreads over Slovak government bond yields. But while banks granting mortgage loans have statutory obligation to issue mortgage bonds, demand in Slovakia for these bonds is gradually declining. This is reflected also in the rising share of non-resident investors, with most of those investors probably belonging to the parent groups of Slovak banks. Hence if there is a deterioration in the financial situation of these groups or domestic banks, or in the general perception of the Slovak economy, the refinancing risk faced by domestic mortgage banks in connection with new mortgage bond issues will increase.

Slovak banks still use the interbank market and the ECB only as secondary sources of funding for lending to the real economy. In general, Slovak banks borrow funds from the interbank market or money market in order to manage short-term liquidity or to offset movements in other volatile balance-sheet items. At the end of 2011 and in March 2012, domestic banks also obtained funds from the ECB through three-year refinancing operations. Borrowed funds, however, represented only a small portion of total liabilities and were used mainly for the repayment of interbank liabilities and other volatile liabilities and for investment in securities, while some of them were held with the ECB. Therefore, these funds were not used for financing the real economy and thus they posed no risk to financial stability. Approximately two-thirds of these funds were repaid at the beginning of 2013.

3.4 FINANCIAL SECTOR RISKS

CREDIT RISK IN THE BANKING SECTOR

Given the traditional nature of banking in Slovakia, the most significant risk faced by banks is credit risk. Developments in the last four years have shown that the banking sector is relatively resilient to this risk. Although the sector incurred significant non-performing loan losses, especially in 2009, these losses represented no threat to financial stability. In contrast with the heavy losses suffered by banking groups in the euro area as a result of unpredictable financial market developments, the Slovak banking model, oriented to domestic credit risk, appears to be more beneficial for financial stability.

The labour market situation did not cause a direct increase in the level of credit risk, thanks mainly to the structure of unemployment growth, which was dominated by school leavers and university graduates. The debt-servicing capacity of households is determined primarily by the stability of their employment. The difference between 2009 and 2012 in the composition of the unemployed accounting for the increase in the unemployment rate is a positive development. In contrast with the beginning of the economic and financial crisis, 2012 saw an increase in the number of unemployed without previous work experience, i.e. school leavers and university graduates. Such unemployment growth has no direct effect on the level of credit risk in banks, because people without previous employment usually have no bank loans. Furthermore, the number of unemployed decreased in lower-income groups and, to a lesser extent, in middle-income groups. This trend continued and accelerated in the first quarter of 2013.

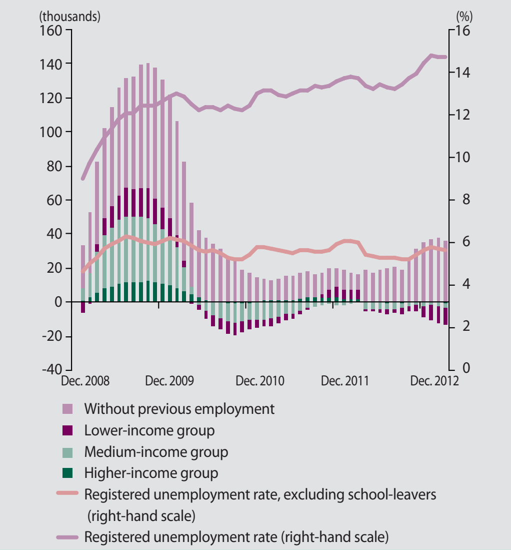
The increase in the number of employed in lower-income groups is to be viewed in the same context. Since the people in these groups do not account for a significant share of banks' loan portfolios, their employment status has no direct effect on the level of credit risk.

The debt-service burden of households increased slightly at the end of 2012. This was mainly due to an increase in household expenditure, which was only marginally offset by a fall in interest rates. This development is unlike the trend observed between 2005 and 2008, when interest rates were higher but the debt-service burden of households fell considerably as a result of growth in real wages. After 2009, however, real income stagnated and interest rates fell sharply. Consequently, more and more households took advantage of falling interest rates to refinance their loans at lower rates. Thus, the easing of monetary policy gradually brought down resulted in lower loan repayments. The effect of low interest rates faded during 2012 and no longer sufficed to compensate for the increase in certain expenditure items, especially those related to housing, transport and food.

This moderate increase in the household debt-service burden needs to be interpreted in the international context.. Slovak households are among the least indebted in the euro area, and they have a significant advantage in their low debt-to-asset ratio, which stems largely from the high share of privately owned apartments and houses in Slovakia and from the way residential property was acquired. Although this indicates a sounder structure of indebtedness, it affects credit risk only indirectly.

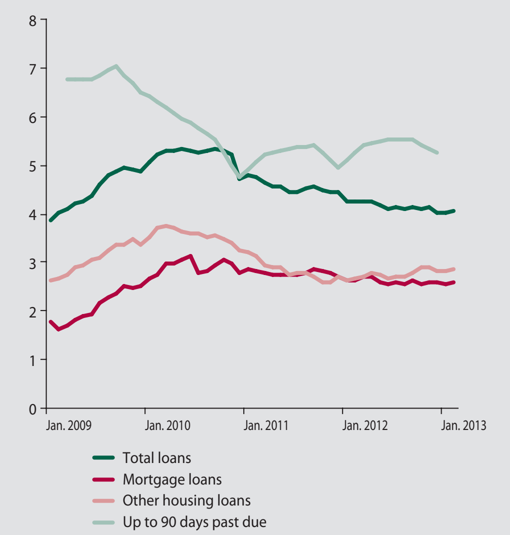
It is positive for credit risk that Slovak households have the lowest aggregate indebtedness in the euro area. Although the debt-servicing capacity of individual households is not directly affected by the ratio of total loans to GDP, it is subject to a significant indirect effect. Loan repayment developments indicate that households' wider familial relationships play

Chart 20 Year-on-year changes in the number of unemployed broken down by income group



Source: Office of Labour, Social Affairs and Family.

Chart 21 Share of non-performing and past due household loans i n total loans (%)



Source: NBS.

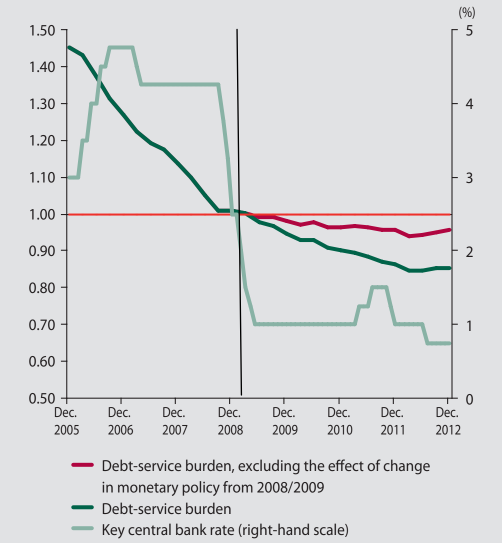
a significant role in addressing loan repayment problems. The willingness of family members to help one another with debt-servicing difficulties is supported by the ability of family members to give such assistance (i.e. by the low loans-to-GDP ratio). In other words, the ability of Slovak households to cope with loan repayment problems also depends on whether or not their siblings or parents are indebted. This is generally seen as one of the factors behind the small share of non-performing housing loans in Slovakia.

The weakening economic performance of Slovakia's main trading partners in the EU led to a slowdown in activity in the domestic corporate sector. Developments in the corporate sector were far more in line with the EU trends than those in the household sector. This was due to the export orientation of the domestic economy, ownership links to foreign companies, and the corporate sector's indebtedness, which was comparable with the EU average. As a corollary of lower export growth, numerous indicators (e.g. expected employment, new orders, etc.) worsened or remained relatively weak in 2012. But although Slovak industry reported its largest fall in sales growth since 2009, it remains among the strongest performing industry sectors in the EU.

The economic slowdown was not reflected in the quality of the banking sector's loan portfolio. The share of non-performing loans remained stable, while default rates in corporate loan portfolio fell during the year. Despite the corporate sector's diminishing performance, mainly in industry, the banking sector recorded no significant credit risk losses. The portfolio quality expressed in terms of the ratio of non-performing loans to total loans remained stable, while the growth rate of non-performing loans was comparable to the figure for 2011. The growth in the volume of non-performing loans, as well as in the default rate in October and November 2012, was caused by the default of a small number of projects in the commercial real estate sector, rather than by the worsening macroeconomic developments.

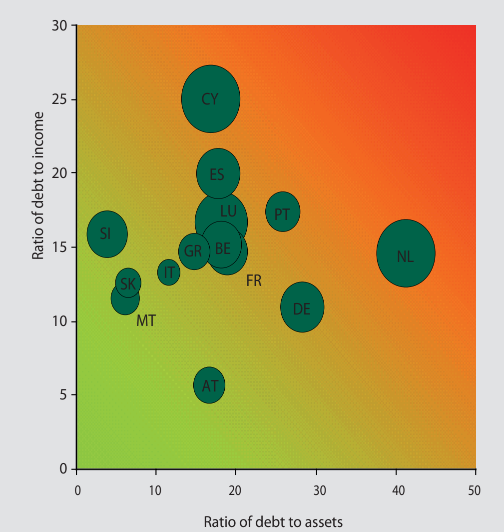
It is important for credit risk that at times of uncertainty about the macroeconomic situation and about future sales growth in the corporate sector, corporate indebtedness stops increasing and the debt-service burden of enterprises continues falling.

Chart 22 Debt-service burden of households



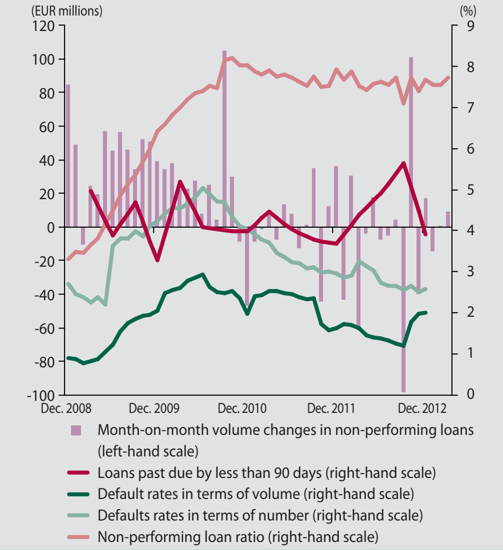
Source: NBS, SO SR.
Notes: Household income is adjusted for basic expenses (food and non-alcoholic beverages; housing costs; water, electricity, gas and fuel; health; transport, post and telecommunications).
Debt-service ratio: March 2009 = 1.0
The key central bank rate until 2009 was the NBS base rate.

Chart 23 Household indebtedness in EU countries (%)



Source: NBS.
Note: The size of the bubble expresses the percentage of households in debt.

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



Source: NBS.
Note: Default rates are calculated on an annual basis.

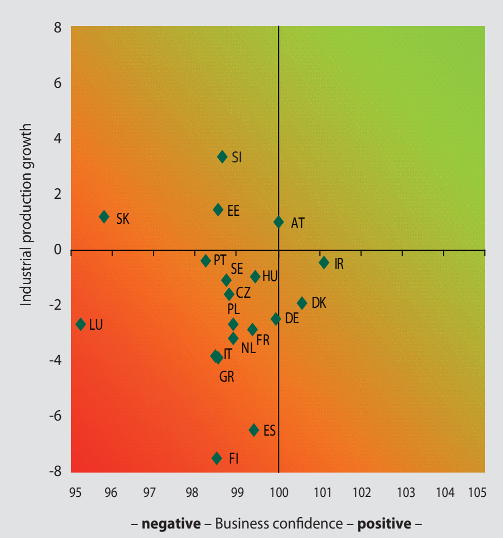
Since such loans are neither rigorously defined nor reported, it is important to monitor at least the proxy indicators of such loans; for example, the share of corporate loans that are more than 90 days past due but are not yet classified as non-performing loans (even though this category should by definition include all loans that are more than 90 days past due). As Chart 26 shows, an increased share of such loans was recorded in the crisis year of 2009, but their volume also represented an elevated risk at the end of 2011. A high percentage of risky loans was recorded in industry, financial activities, and in communication and information.

Indicators of a possible future increase in credit risk

Regarding future developments in corporate credit risk, it is important to monitor the share of loans that are not yet classified as 'non-performing' but are increasingly at risk.

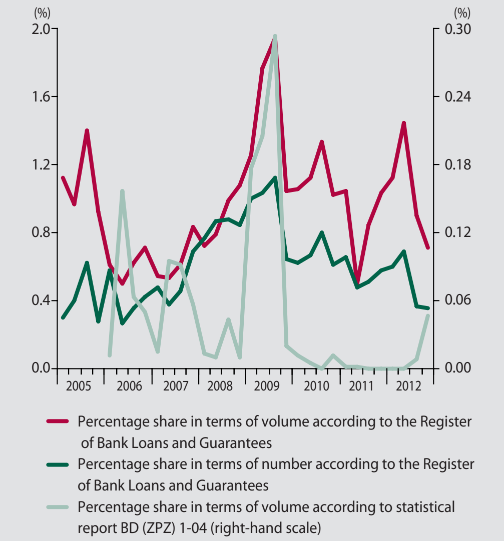
Another indicator of a possible increase in credit risk is the share of loans with a prolonged maturity. Cases of banks easing the conditions on existing loans in order to avoid default (*forbearance*) are currently attracting close attention from the relevant European institutions, namely the European Systemic Risk Board (ESRB), the European Banking Authority (EBA), the European Securities Market Authority (ESMA), and the European Commission (EC). Although the easing of lending conditions makes it easier for customers to repay their loans (which may have an anti-cyclical effect), banks often do this to cover

Chart 25 Activity in industry and business confidence (%)



Source: OECD, Eurostat.
Note: The chart is based on data as at February 2013.
Red colour denotes a less favourable situation and green colour denotes a better situation.

Chart 26 Share of corporate loans past due by more than 90 days and not yet classified as non-performing

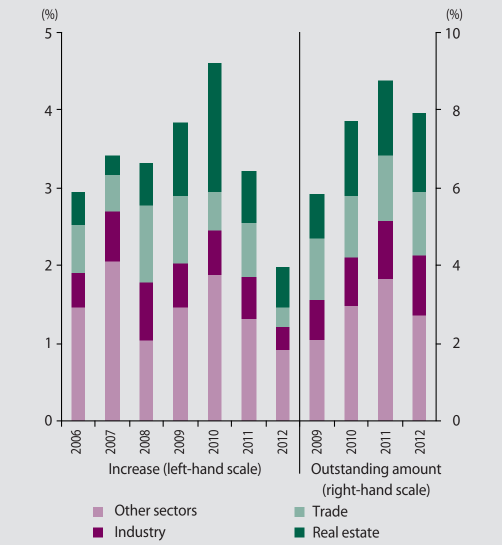


Source: NBS.
Note: Data from statistical report BD (ZPZ) 1-04 are not fully consistent with the data from the Register of Bank Loans and Guarantees, because they contain only data on loans that are rated individually, not at the portfolio level.

potential problems that may materialize in the future (a practice known as "*evergreening*"). The key questions in this regard concern the internal processes applied in the area of risk management and transparency rules. Asset quality risk, which might lead to a threat to confidence in the financial sector, currently represents one of the main risks to financial stability in the euro area.

The risk of asset quality deterioration diminished in 2012 according to this indicator, but it is still present in some sectors. Despite a significant slowdown in the growth rate for loans with a prolonged maturity not classified as 'non-performing', bank credit portfolios still contain loans whose conditions were eased in previous years. Such loans are recorded mainly in the real estate and trade sectors. Although the standing of some of these loans may improve as a result of their maturity being extended, a potential future default in the case of other loans cannot be excluded.

Chart 27 Share of prolonged corporate loans (increase and outstanding amount)



Source: NBS.
Note: The vertical axis shows prolonged corporate loans as a share of the total loan portfolio.
The chart was compiled on the basis of loans with an initial agreed maturity of over 1 year, showing no excessive volatility (i.e. the average quarter-on-quarter fall in volume did not exceed 20% of the average remaining amount of the loan). Current account overdrafts were excluded, as were non-performing loans, because the aim was to identify loans with a default risk not yet recorded. Prolongation was taken into account only where the maturity was extended later than 1 year before the expiration of the original maturity.

Real estate market

The real estate market is traditionally closely linked to financial stability. This is mainly due to the large volume of bank loans used for the purchase or construction of apartments, houses, and commercial or industrial buildings. With real properties also being used as security for other types of loans, there is a close connection between the real estate market and the health of the banking sector.

As Slovak banks are heavily focused on the domestic economy, this connection is strengthening in local banks. The significance of real properties used as collateral for loans is steadily growing, and the value of such properties exceeded 40% of total assets in December 2012.

Although housing loan growth in Slovakia was stronger than that in any other euro area country, the domestic residential property market did not show imbalances. Prices remained stable and banks' lending policies remained virtually unchanged. The residential property market was relatively stable during 2012. Offer (advertised) prices remained largely unchanged, as did actual purchase prices. This was also confirmed by the availability of housing, which remained at a relatively high level. This implies there is potentially stronger demand for housing, which may materialise if consumer confidence strengthens again.

In addition, banks' average loan-to-value (LTV) ratios fluctuated within a healthy range of between 69% and 73% during 2012. This not only limited banks' exposure to the property market, but also restricted the potential emergence of imbalances.

The situation in the commercial property market was broadly stable; nevertheless, this market remains to be a potential source of risks. Compared with the housing market, the commercial real estate market is less stable and more sensitive to changes in macroeconomic developments. Another difference is the high concentration of loans on both the supply and demand sides. The default of a real estate loan, unlike that of a simple mortgage

Chart 28 Housing affordability and the loan-to-value ratio

Source: NBS, SO SR.
Note: The index equalling 100 means that a household with average income and expenditure can buy an apartment with 80 m^2 of floor space from a loan provided with average maturity at an average rate. A higher index means higher reserves in the household budget.

loan, represents an appreciable loss for a bank and the total costs may increase as a result of low liquidity in the market.

Chart 29 Ratio of non-performing loans to total loans (%)

Source: NBS.

The market for office premises remained virtually unchanged. The stable trend in prices was accompanied by a modest fall in demand for office premises and a cautious climate in the supply of new offices. The increase in the office vacancy rate in the fourth quarter was caused by the relocation of one large company. The fact that a single business decision can change market indicators is evidence of the market's high concentration and insufficient depth.

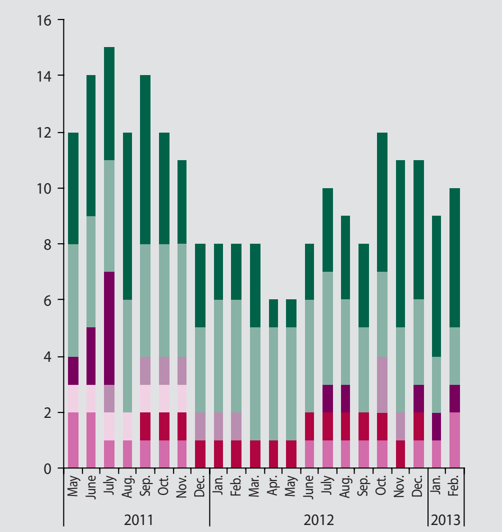
In the residential property market, a large number of apartments built during the booming years remain unsold. Demand for larger, upper-end apartments has fallen away, and the preference now is for smaller properties offering better value for money. Hence banks are increasingly focusing on smaller development projects comprising only one, two, or three-room apartments.

Concentration risk and large exposures

The high concentration of exposures to a single entity, or to a group of interconnected entities, represents a relatively high risk for individual institutions in the event that the borrower defaults. The significance of the risk of heavy losses on individual exposures is also indicated by the experiences of certain Slovak banks from the past. It is negative for financial stability that losses from large individual exposures, unlike other risks, may arise unexpectedly and thus the institution concerned may have insufficient scope to mitigate their effects. Intra-group exposures are a separate case, often resulting from the transfer of liquid assets to other members of the group. Such exposures may contribute to the outflow of liquidity and may create a channel for the spread of external risks to the Slovak banking sector. For these reasons, the amount of individual exposures in several segments of the financial market is limited. In the banking sector, such limits are set in the form of large exposure rules.

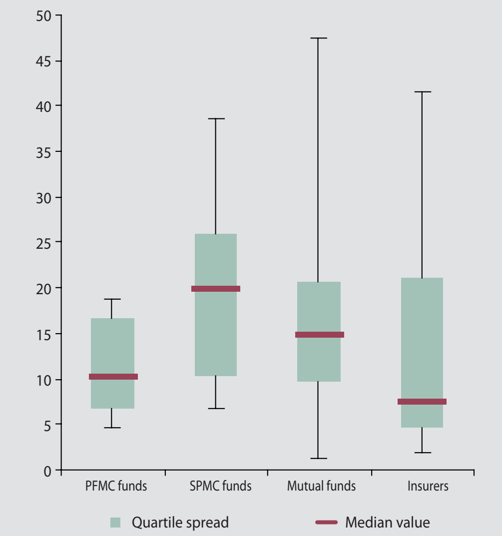
The existing capital buffers are large enough to cover any individual exposure to a non-bank customer. The risk, however, is that several large loans default at the same time. Individual exposures to non-bank customers do not exceed 25% of banks' own funds. Therefore no

Chart 30 Number of exposures (amounting to 20% to 25% of own funds) to non-bank customers



Source: NBS.
Notes: The vertical scale shows the number of exposures amounting to 20% to 25% of the bank's own funds.
The individual banks are illustrated in different colours.

Chart 31 Share of the largest exposure to a single group – broken down by financial market segment (%)



Source: NBS.
Notes: The chart shows the percentage share of the largest exposure to a single group in the total asset value or net asset value. Exposures to management companies in the case of investment in funds were not taken into account.
PFMC – pension funds management company
SPMC – supplementary pension management company

bank would see its capital adequacy ratio fall below the 8% regulatory threshold even if its largest corporate loan defaulted. However, Chart 30 indicates that some banks have relatively large exposures (exceeding 20% of the own funds) to certain clients, and they may therefore face significant risk in the event that more than one of these loans default simultaneously. In these banks, the regulatory rules governing large exposures represent an important regulatory element in their lending policy.

One of the risks arising from exemptions from large exposure rules is the high value of individual interbank claims, which in smaller banks can reach 100% of own funds. Starting from April 2012, the number of large interbank exposures (exceeding 25% of the creditor bank's own funds) increased gradually, indicating that banks are increasingly exposed to concentration risk. Mostly, but not always, the cases involved exposures to domestic banks. On the other hand, the total number of such exposures at the beginning of 2013 was smaller than in the second half of 2011, i.e. in the period following the implementation of the exemptions. It should be noted, however, that banks could also grant interbank claims exceeding 25% of their own funds in the period before 1 April 2011, because interbank exposures attracted a weight of 20% in the application of this limit. This risk category also includes banks' intra-group exposures, which in the case of two banks at the beginning of 2013 amounted to approximately 80% to 90% of their own funds.

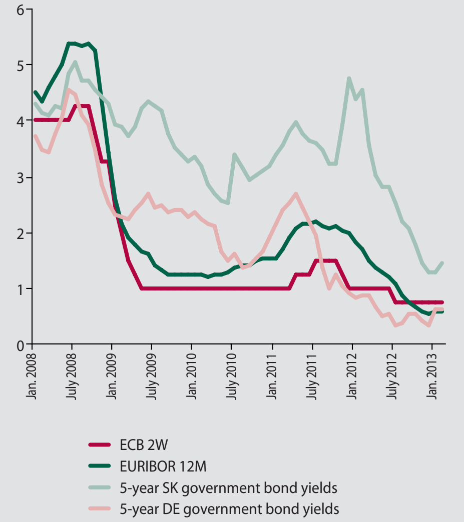
Concentration risk is also higher where several banks have large exposures to the same customer. There are cases where several banks have significant exposures to the same customer, which increases the potential systemic effect in the event of that customer's default. It should be noted, however, that where three or four banks have significant exposures to the same customer, the customer is always a large and strategically important Slovak company. The term 'systemically important customers' might also be applied to customers to which two banks have significant exposures. There are more than ten such customers (or economically connected groups of customers) and they are from a range of sectors.

Exposure to concentration risk affects not only banks, but also institutions and funds from other segments of the financial market. As Chart 31 shows, supplementary pension funds are the most exposed to this type of risk. There are numerous cases involving intra-group exposures, mainly among mutual funds and insurance companies. In the mutual funds segment, this reflects mainly the ratio of bank deposits to total net asset value, which is in Slovakia the highest in the euro area. Bank deposits appear to be relatively highly concentrated. Since the counterparty is sometimes the parent group of the institution or fund, the probability of a loss is relatively low but its impact on group members would be significant. Other 'systemically important counterparties' are certain foreign banks or domestic enterprises.

Risk of low interest rates

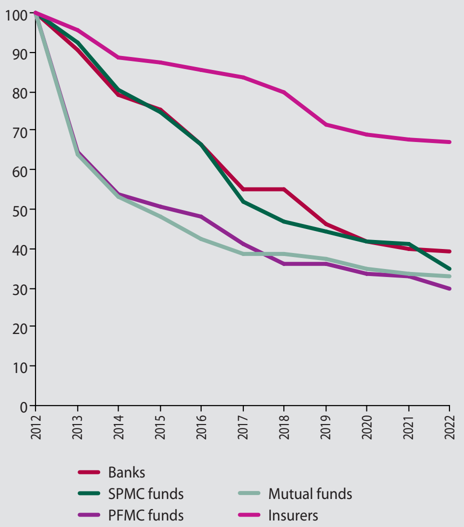
The substantial fall in interest rates after the ECB eased its monetary policy in response to the financial crisis has brought numerous advantages for the domestic financial sector, but, on the other hand, it is necessary to draw attention to the risks that may endanger financial stability in the future if interest rates remain low for a prolonged period. The fall in lending rates created conditions for borrowers to have their old loans refinanced under more favourable terms or to have lower interest rates after refixation and thus reduce their debt-service payments as a percentage of income (retail) or sales (enterprises). This positive trend in the debt-service burden of households and enterprises was beneficial to the real economy, as well as to the banking sector, which was thus relieved of the negative effects of increased credit risk. These trends are described in more detail in the section on credit risk and in the *Analysis of the Slovak Financial Sector for 2012*. On the other hand, the current period brings various other risks that may endanger the financial sector's stability if they materialise. Since the period of low interest rates was also evaluated by the ESRB[5] as a specific systemic risk, this section is devoted to the analysis of the low-interest-rate environment and its potential adverse effects.

Chart 32 Selected interest rates and government bond yields (%)



Source: NBS, ECB, www.euribor.org, Bloomberg.

Chart 33 Decline of bond and term deposit yields assuming that interest levels remain low over the long-term horizon (%)



Source: NBS.
Notes: The vertical axis shows the predicted future values of interest income based on the assumption that interest levels remain depressed, compared with the interest yields observed in 2012 (representing 100%).
In the case of insurance companies, investments where the risk is borne by the customer are left out of account.
In the case of banks, income from loans and deposits is not taken into account, only income from securities.
PFMC – pension funds management company
SPMC – supplementary pension management company

5 http://www.esrb.europa.eu/pub/pdf/ar/2011/esrbar2011en.pdf?96ff08033867999db841c1f286cfd392

The risk of low interest rates has an adverse effect on investment returns across the entire financial sector. After the outbreak of the global financial crisis, the ECB lowered its key interest rates to historically low levels, around which they have been fluctuating since mid-2009. Along with non-standard ECB operations (annual refinancing operations in 2009/2010 and three-year refinancing operations in 2011/2012) and the fragmentation of financial markets, this created an environment in which returns on less risky assets dropped to historical lows. This could have a direct adverse effect on investment returns, mainly in financial institutions with a conservative investment strategy. The intensity and the speed of this effect depends on the type of investment portfolio. The shorter the average duration of a bond portfolio is, the sooner its yields will fall; this is because the yields will change as a result of maturity/reinvestment and/or an interest rate change (e.g. in the case of debt securities with a floating coupon). Similarly, the more conservative the investment strategy – i.e. the greater the proportion of less-risky (lowest-yielding) securities in the institution's portfolio – the stronger the adverse effect, since the most significant relative fall is expected to be recorded by such type of debt securities.

The quantification of potential reinvestment risk effects indicated a significant fall in asset returns that, in certain fund types, could arise within a time horizon of two years. Reinvestment risk, i.e. the risk of a gradual change in the portfolio composition in favour of low-yielding securities, was quantified separately[6]. The results indicate that, if interest rates remained low for an extended period of time, asset returns would fall significantly, mainly on bonds and term deposits. In the case of portfolios of shorter duration (mutual funds and pension funds), returns would within a horizon of two years be roughly 50% lower than in 2012, meaning that investors in mutual funds and savers in pension funds would earn lower returns if interest rates remained low for a longer period. In banks and supplementary pension funds, this situation would occur in a horizon of approximately 5 years, owing to the longer portfolio duration. The longer duration does, however, entail a higher risk of loss from the revaluation of securities in the case of an interest rate increase.

The insurance sector has the lowest exposure to reinvestment risk, but due to insurance contract commitments to provide guaranteed returns, the sensitivity of insurers to this risk is the highest. If interest rates remain low for at least two years, approximately one-third of the bond portfolio covering the sector's technical reserves will be purchased at these lower yields. Thus a seven-year duration will ensure that interest income will fall to a lesser extent than in other sectors. Over a ten-year horizon, interest income would fall by roughly one-third. The situation in the insurance sector, however, is complicated by the fact that even this fall would lead to investment returns below the average rate guaranteed in life insurance contracts.

In the current period of low interest rates, the question arises whether insurance companies will be able to generate sufficient investment returns for the coverage of returns guaranteed in life insurance contracts. The insurance sector as a whole managed to generate the required investment returns in 2012. This, however, does not apply to all insurance companies. The number of such insurance companies may increase in the future as a result of reinvestment risk. This is also indicated by the fact that 10-year Slovak government bond yields in 2012 fell below the average guaranteed return. For insurance companies, low interest rates also mean a real increase in the value of liabilities. Since liabilities usually have a longer duration than assets (due to long-term life insurance contracts), the fall in interest rates coupled with a possible increase in credit spreads may lead to a fall in the solvency of insurance companies.

Net interest income in the banking sector was adversely affected by low interest rates already in 2012. Apart from investing in debt instruments, banks, unlike other regulated financial institutions, provide loans to customers and take deposits from them. The low-interest-rate environment may affect the asset and liability sides of their balance sheets to different extents, depending on the length of inter-

6 *The following test was carried out to assess this risk. Interest rates are assumed to remain at their level of 31 December 2012 for the following ten years. During this period, financial market entities will replace their maturing bonds and term deposits with new bonds and deposits at lower interest rates (i.e. reinvestment risk). It is assumed that the bonds and term deposits purchased will have a maturity twice as long as the average duration of the relevant portfolio as at 31 December 2012.*

est rate fixation period for loans, the maturity of deposits, the sectoral composition of customers, and the degree of competition in the loan or deposit market. Although it is a relatively difficult to evaluate the effects of low interest rates on the individual segments of the loan or deposit portfolio, it is already evident that net interest income in the banking sector as a whole decreased in 2012, albeit only slightly. Since this income forms a dominant part of the profits of domestic banks, the continuation or deepening of this trend may impair the sector's ability to tackle unexpected problems and may undermine its stability.

A prolonged period of low interest rates may lead to credit risk accumulation in the banking sector even if banks remain prudent. Low interest rates also mean easier access to loans for a wider range of customers (including less solvent ones), which may led to credit risk accumulation. While interest rate increases always raise the interest burden on customers, this effect is stronger where rates are extremely low, since loans are also granted to less solvent customers who are more sensitive to interest rate increases. Such a situation may also occur if banks will not ease their credit standards. If lending rates remain low for a longer period, the increased demand may exert upward pressure on asset prices, e.g. property prices, as a result of easier access to bank financing. This indicates that, even in the case of an unchanged loan-to-value ratio, the average volume of loans provided may increase, which even if interest rates remain unchanged will result in a gradual increase in the debt-service burden of households.

An excessively long period of low interest rates may lead to the emergence of price bubbles. It is therefore important that monetary policy should provide a due and timely response to any change in the economic situation. As mentioned above, low interest rates ensure easier access to bank loans for a wider range of customers. A situation in which the economy picks up while interest rates remain low could stimulate demand artificially, possibly leading to the emergence of price bubbles (as happened in the United States in regard to property prices between 2001 and 2006)[7]. The ECB's cautious approach to this risk was seen back in 2011, when it raised its key rate to neutralise inflationary pressures, and it is important that this cautious approach is maintained in the future.

Market risks

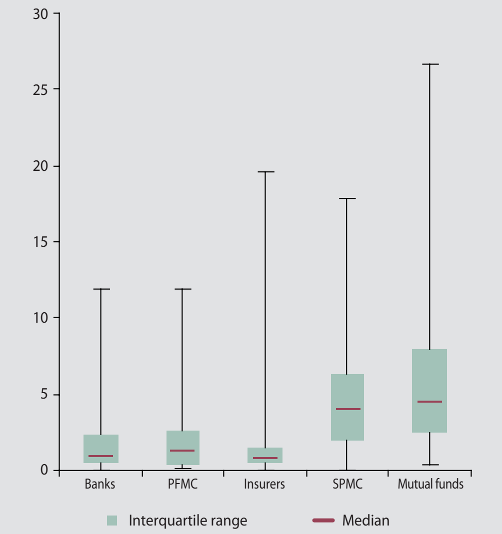
The most significant market risk that could adversely affect the Slovak financial market is a renewed increase in credit spreads. This risk is closely associated with the possible deepening of the euro area sovereign debt crisis. Bond portfolios as a share of total assets are relatively high in all sectors, with the impact of this scenario expected to differ from sector to sector. In banks and insurance companies, bonds revalued to fair value against profit/loss account for a relatively small share of the portfolio. Except in individual institutions, an increase in credit spreads is not expected to affect profits in these sectors to a significant extent. On the other hand, a relatively large part of the bond portfolio in these institutions is formed by bonds revalued against own funds. This means that a fall in their value would directly reduce the solvency of the bank or insurance company that invested in such bonds. Such a situation was observed at the end of 2011, and numerous institutions recorded a rise in solvency in 2012 as a result of a decrease in credit spreads back to lower levels. In pension funds and mutual funds, all bonds are revalued to fair value, and hence an increase in credit spreads, would directly affect the performance of these funds.

An increase in credit spreads would affect the Slovak financial sector more severely if the less stressed countries (including the central European economies) were also affected, too. Although investments in bonds issued in countries with higher risk[8] are relatively small at the level of individual sectors (up to 4.3% of the assets), their concentration in certain institutions or funds may pose a risk. If the increase in credit spreads spills over to less stressed countries (including Slovakia), the negative impact may be relatively significant. This can be explained by the Slovak banking sector's increased exposure to

7 This period is discussed in the articles: Federal Reserve Policy and the Housing Bubble (L.H. White) or Systemic Risk and the Role of Government (J.B. Taylor).

8 Countries with a higher risk here include Greece, Cyprus, Portugal, Spain, Italy, Ireland, Slovenia, and Hungary.

Chart 34 Proportion of bonds issued in countries with higher risk– broken down by sector (%)



Source: NBS.
Note: The vertical axis shows the share of bonds issued in countries with higher risk (Greece, Cyprus, Portugal, Spain, Italy, Ireland, Slovenia, and Hungary).
PFMC – pension funds management company
SPMC – supplementary pension management company

domestic bonds[9], which is the highest within the euro area[10].

Other market risks are present mainly in non-bank entities. Exposure to these risks in the second half of 2012 increased still further in some segments of the financial market, notably in insurance companies and pension funds belonging to the second and third pillars of the pension system. In these segments, the duration of investment portfolios continued to increase, i.e. the fair values of portfolios became more sensitive to a potential rise in interest rates. Since guarantees in mixed and equity funds had been cancelled, the exposure of these funds to equity and foreign exchange risks increased, too. As the stress test results indicate, a deterioration in the financial market situation may lead to a relatively sharp fall in the performance of certain funds pursuing a more risky strategy. On the positive side, the potential adverse impact of the deepening debt crisis in the euro area would be partly offset by the assumed depreciation of the euro against the dollar.

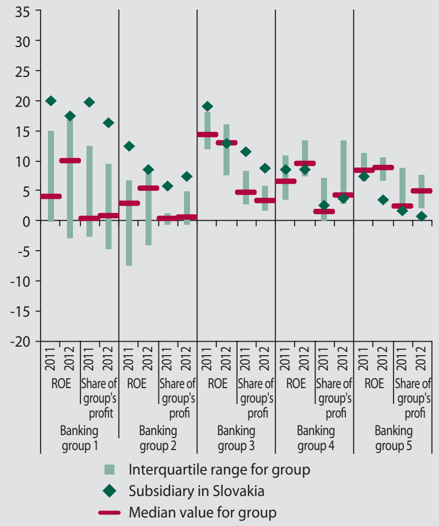
Risk of negative trends spreading from parent banks to their subsidiaries in Slovakia

The financial crisis has brought several new trends in the relationship between parent banks and their subsidiaries. Since the Slovak banking sector is largely owned by foreign capital, the relationship between foreign banking groups and banks in Slovakia plays an important role in the domestic banking sector's stability. In the pre-crisis period, this relationship was relatively healthy, because, on the one hand, banks in Slovakia contributed significantly to the profits of their parent groups, while, on the other hand, banking groups in the EU enjoyed a period of dynamic growth, which enabled them to export banking activities to other countries. In recent years, mainly as a consequence of the financial crisis, several trends with a tendency to affect this relationship have emerged.

The first such trend is the worsening financial situation in the banking sectors of most countries in the EU, in the area of capital adequacy, access to stable sources of financing, or profit generation. The worsened position of banking groups may require parent banks to take certain measures that could adversely affect the activities of subsidiaries. For example, parent banks (i) may attempt to reduce credit flows into the real economy with the aim to improve the banking group's capital position (through a reduction in risk-weighted assets); this refers to the deleveraging process (targeted deleveraging by parent banks can be observed, for example, in Hungary), or (ii) are less willing to 'invest' in subsidiaries by allowing them to retain their profits, or (iii) can exert pressure to reduce costs, etc. A significant risk to which countries with a larger share of subsidiaries are particularly sensitive is the attempt of parent banks to transform their subsidiaries into foreign bank branches. The significance of this risk is growing in connection with the changes that are under preparation in the regulatory area (for more details see section 4 'Legislative and regulatory environment').

9 See section ,Concentration Risk and Large Exposures'.
10 See Box 3 ,Comparison of the Slovak Banking Sector with Banking Sectors in the EU'.

Chart 35 Position of selected Slovak banks within their parent group (%)



Source: Bloomberg, Annual reports and press releases of banks and banking groups, and other publicly available sources.
Note: Return on equity (ROE) is net income divided by the total amount of equity capital invested. The 'share of group profit' indicator expresses the proportion of a subsidiary's net profit to the parent group's total net profit. The group's net profit is calculated exclusively on the basis of data from quarters with a positive result (profit); the value is subsequently annualised.

The spillover of negative trends is largely dependent on the position of subsidiaries within their parent group. The probability that such trends will spill over from parent banks depends not only on the situation in the parent banks concerned but also on the performance of their subsidiaries. On the positive side, the largest Slovak banks still have a relatively strong position within their banking groups, as they are relatively attractive in comparison to other subsidiaries within the groups. Similarly, their exposure to risks is lower than that of the other banks. On the other hand, the position of some domestic banks within their parent groups (measured in terms of profitability) worsened in year-on-year terms.

It should be noted that the Slovak banking sector has lost some of its attraction, mainly due to certain legislative changes. The recent period has seen several important changes, mainly in the legislative environment. These changes have upset the 'equilibrium' between parent banks and their subsidiaries to the detriment of Slovak banks. The most important of these changes is the bank levy, which has significantly impaired the profits of banks and has reduced the attraction of investing in Slovak banks. The sector can also expect to be adversely affected by proposed financial transaction tax, if its most recent proposal is adopted. It is important that any legislative changes concerning the banking sector are drafted with regard to their potential impact on the sector's attractiveness, as well as on the predictability of the business environment.

Risk of subsidiaries being transformed into foreign bank branches

Owing to the large share of Slovak banks in foreign ownership, the transformation of subsidiaries into foreign bank branches represents a major risk for Slovakia. Such transformation would have negative consequences in various areas of the financial and economic system, possibly increasing risks to financial stability as well as to the domestic economy. The main risk arises from the fact that subsidiaries and branches are subject to different statutory requirements for risk management and operations. The essence of these differences is that foreign bank branches have no legal personality and are not subject to regulatory requirements concerning own funds and large exposures.

Under the regulatory framework for branches, any risks of the parent group are automatically and immediately transmitted to its branch. At the same time, it is not possible to mitigate or influence this risk to financial stability by implementing measures at the national level, notwithstanding that any costs arising from this risk will be borne by the Slovak economy. The risk will be even more pronounced in an environment of negative external shocks. This represents a direct threat to the favourable current levels of capital and liquidity in the Slovak banking sector, which currently enables banks to finance local households, enterprises, as well as the government (through bond purchases). If the share of foreign bank branches increases, the effectiveness of macroprudential policy measures will diminish in the event of systemic risks.

If the risks materialise, it will not be possible to employ the crisis management mechanism in an effective way. Foreign bank branches cannot be recapitalised directly, even if they are of systemic importance. In addition, the supervisory authority will have only limited scope to prevent negative or untrue information being spread via public statements amid a general crisis of confidence in the financial markets.

A separate problem is the centralisation of the decision-making processes. In practice, such centralisation would reduce the foreign bank branches to points of sale, thereby bringing numerous disadvantages to customers. Since Slovak banks are relatively small compared with their parent groups, the central management is not really motivated to take into account the specific needs of the local economy, the local financial market, and of the local customers when making decisions at the group level. This may also affect the risks related to customer protection, for example in connection with compensation payment for inaccessible deposits in the event of a bank's default, as well as strategic risks in the domestic banking sector.

Box 3

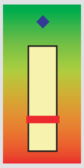
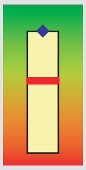
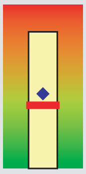
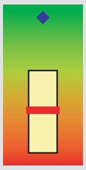
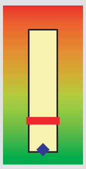
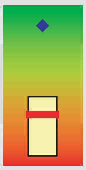
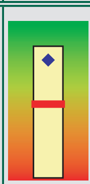
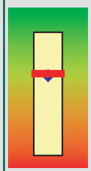
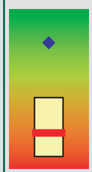
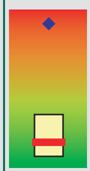
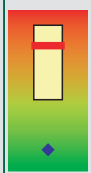
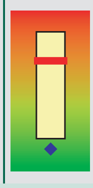
COMPARISON OF THE SLOVAK BANKING SECTOR WITH BANKING SECTORS IN THE EU

Compared with other banking sectors in the EU, the Slovak banking sector shows trends that contribute significantly to its stability. The sector has better results than other banking sectors in the EU in almost all areas important for the stability and resilience of banks.

Despite a year-on-year decline in profits, the domestic banking sector generates higher returns on both assets and equity. Another positive indicator is the above-average capital adequacy ratio. As for developments in core banking activities, the sector reports the strongest lending growth to households within the EU. Lending to enterprises declined in year-on-year terms, in line with trends observed in other banking sectors. On the other hand, the percentage of domestic government bonds in total assets is high in the domestic banking sector (one of the highest in the EU).

In the area of credit risk, domestic banks report far better results than the majority of EU banking sectors, due mainly to the small ratio of non-performing loans and and their higher coverage by provisions. The domestic banking sector reports even better results for liquidity. The dependence of domestic banks on the financial market is minimal, since their activities are financed primarily from customer deposits.

Table A Comparison of the Slovak banking sector with banking sectors in the EU

Area	Indicator		SR	Lower quartile	Median	Upper quartile
Profitability	Return on assets (ROA)		1.0	0.1	0.3	0.8
Profitability	Return on equity (ROE)		8.9	1.2	5.7	8.8
Profitability	Cost-to-income ratio		58.5	49.8	57.1	65.7
Profitability	Net interest margin		3.1	1.1	1.7	2.3
Credit risk	Ratio of non-performing loans		3.8	3.7	5.3	10.0
Credit risk	Coverage of non-performing loans by provisions		81.0	40.3	53.2	58.8
Solvency	Core capital adequacy ratio (Tier I ratio)		14.4	11.3	13.2	14.8
Loans and securities	Year-on-year change in loans to enterprises		-1.0	-6.7	-0.9	2.0
Loans and securities	Year-on-year change in loans to households		9.2	-2.3	0.1	3.7
Loans and securities	Share of investments in domestic securities		20.4	1.7	3.7	7.6
Liquidity	Share of financing via the interbank market		5.2	11.4	18.1	20.6
Liquidity	Loan-to-deposit ratio		90.3	93.6	119.0	128.4

Source: ECB.
Note: The third column illustrates the distribution of individual indicators across the EU. The blue square illustrates Slovakia; the red line shows the median value for the EU (or the euro area in the case of indicators marked with stars) and the yellow bar shows the interquartile range in the EU. The red background indicates a negative trend; the green background a positive trend.

REGULATORY AND LEGISLATIVE ENVIRONMENT

4

4 Regulatory and legislative environment

The regulatory environment has recently seen significant changes, the most important of which concern the tightening of regulatory rules in the banking sector, the single supervisory mechanism, and the financial transaction tax. Other key areas include liability valuation in insurance companies and legislation in pension saving. Although these changes are at various stages of implementation, each of them has major implications for the Slovak financial market. As regards the implementation of regulatory measures, it is crucial for financial sector stability in Slovakia that competences are not to an excess extent transferred to the supranational level, especially in those areas where the liability for potential costs remains at the national level. It is also important that new measures do not foster uncertainty about the future situation, that they do not jeopardise the Slovak financial sector's strong self-sufficiency in terms of liquidity and solvency, and that they give sufficient regulatory leeway at the national level, which is an essential premise for the effective implementation of macro-prudential policy.

Single supervisory mechanism

The implementation of a single supervisory mechanism (SSM), as the first pillar of a banking union, will involve transferring supervisory competences for banks from national supervisory authorities (including NBS in Slovakia) to the ECB. The SSM is likely to be introduced in the second half of 2014, as the schedule may change depending on when the respective legislation is finally approved. Under the SSM, the ECB would be responsible for the supervision of all banks in the euro area, but it would directly exercise supervision over only the most significant banks or banking groups, which in Slovakia are Slovenská sporiteľňa, VÚB, Tatra banka, ČSOB, UniCredit and ČSOB stavebná sporiteľňa. Direct supervision of other banks would be delegated to the national supervisory authorities, which in the case of Slovakia is Národná banka Slovenska. Since the previous Financial Stability Report[11] included a detailed examination of the SSM issue, we will now look at only the most significant risks in the current version of the draft legislation.

Since the ECB, as sole supervisory authority, will be both the home and host supervisory authority for certain international banking groups, the question arises as to how it will handle any conflicts stemming from the potentially differing interests of the two sides. For Slovakia, which is almost always the host country in these situations, the issue is significant. To take one example, a conflict could arise where intra-group support is provided during a crisis, i.e. if a Slovak subsidiary bank is required to provide capital or liquidity support to another part of the parent group. Given that Slovak banks (including the largest) account for a small share of the assets of their parent groups, the risk of any such support is that the interests of the parent group take precedence over the financial stability of the subsidiary's host country. The importance of this issue is further underlined by the fact that the other two pillars of the banking union – implementation of the resolution mechanism and deposit guarantee schemes – will remain at the national level. In other words, the supervisory competences are being centralised, while the adverse repercussions of a bank failure will still largely be borne at the national level. Hence a substantial mismatch between competences and liability remains for the time being. Regarding the issue of SSM implementation, it should be stressed that several details of the procedural functioning of the mechanism have yet to be clarified and that the future impact of the mechanism may depend to a large extent on those details.

New banking regulation (CRR / CRD IV)

The new regulatory framework in the form of the Capital Requirements Regulation (CRR) and Capital Requirements Directive (CRD IV) brings changes in several areas, the most important of which, from the view of financial stability in Slovakia, are capital adequacy, liquidity, international cooperation between supervisory authorities, and macro-prudential policy. This regulatory frame-

11 *Financial Stability Report – November 2012, Annex 1.*

work, constituting the EU's implementation of the Basel III international agreement, is due to enter into force on 1 January 2014. Its main objective is to strengthen loss absorption capacity in the event of risks materialising, as well as to increase the harmonisation of banking regulation across countries. To this end, the CRR/CRD IV strengthens limits on the level and quality of capital, brings in a stricter capital requirement calculation, and introduces a new quantitative requirement for the minimum amount of liquid assets. Furthermore, it provides scope for the implementation of long-term liquidity requirements and for a minimum leverage ratio (meaning the ratio of own funds to total exposures). The CRR/CRD IV also addresses cross-border cooperation between supervisory authorities. Accordingly, any inter-supervisor disagreements are to be handled by the European Banking Authority through the mediation mechanism, with the results of this process binding on the supervisory authorities.

Although the benefits to financial sector stability are obvious, certain risks can also be identified, for example, in regard to the supervision of branches of foreign banks. Under the new regulatory framework there will be a significant transfer of competences to the home supervisory authority that exercises supervision over the parent undertaking of a foreign bank branch. This transfer of competences mainly concerns less significant branches of foreign banks, but in some areas (such as liquidity or the implementation of supervisory measures), it involves also significant branches of foreign banks and may therefore further heighten the risk that significant subsidiaries of foreign banks would be transformed into branches.[12] As a result of the EBA's binding mediation mechanism, the autonomy of supervisors' decision-making powers may also be constrained in respect of their supervision of subsidiaries.

Funding self-sufficiency, in which the Slovak banking sector is particularly strong in comparison with other euro area banking sectors, faces risks from substantial regulatory changes concerning liquidity. The current regulatory framework, requiring liquidity ratio compliance at the national level, will from 2015 gradually be replaced by harmonised rules. It should be noted at this point that when taking into account the changes adopted in January 2013 by the Basel Committee on Banking Supervision, the new requirements will be significantly less strict than those currently in force in Slovakia, largely because there will be a marked reduction in the proportion of liquid assets required to cover an unexpected outflow of retail deposits. A cautious approach should also be taken to a possible further centralisation of intra-group liquidity management and preferential treatment of intra-group exposures, which might be to a certain extent allowed under the new regulatory framework.

Financial transaction tax

Slovakia is one of eleven countries that have agreed on the implementation of enhanced cooperation in the area of financial transaction tax.[13] The European Commission's current proposal for the financial transaction tax schedules its implementation for 1 January 2014.[14] The reasons stated for introducing the tax are: to harmonise legislation concerning indirect taxation on financial transactions; to ensure that financial institutions make a fair contribution to covering the costs of the financial crisis; and to reduce the amount of speculative transactions that adversely affect the efficiency of financial markets. The tax would be levied on financial transactions and it would be paid by financial institutions.

According to NBS calculations based on 2012 data, the amount of the financial transaction tax (FTT) for the financial sector as a whole would be around €46 million per year, of which the banking sector would pay €28 million. NBS calculated the potential impact of the FTT on individual financial institutions, basing its calculations on the current version of the proposed FTT directive and on the 2012 data that these institutions reported to NBS. Banks would pay the highest share of the FTT – more than half of the estimated total – followed by insurance companies, pension companies in Pillars II and III of the pension system (PFMCs and SPMCs), collective investment undertakings, and investment firms. It should be stressed, however, that not all the relevant data were available and that the final calculation is therefore approximate.

12 This risk is examined in more detail in the section „Risks in the Financial Sector".
13 Belgium, Germany, Estonia, Greece, Spain, France, Italy, Austria, Portugal, Slovenia and Slovakia.
14 COM/2013/71: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2013:0071:FIN:EN:PDF

Table 3 Estimated amount of the financial transaction tax (EUR thousands)

	Banks	PFMCs	SPMCs	Investment firms	CI undertakings	Insurers	Total
Total tax	28,227	3,987	3,531	1,527	2,947	6,277	46,497

Source: NBS.

Although it is relatively difficult to estimate the tax amount precisely, it is possible to identify risks related to its implementation. The calculation mentioned above is static, i.e. it does not take account of the possible and probable response of financial institutions to the FTT's implementation. To quantify that response is relatively demanding, not least because no such tax has ever been implemented in Slovakia before. Hence the next part of this section will focus on potential risks related to the FTT's implementation, rather than on quantifying the potential response of financial institutions. While the advantages of the introduction of the FTT are listed in the Comission's proposal (mentioned above as the reasons of implementation), there may be several risks associated with its implementation (see Table 4 – Risks of FTT implementation).

The FTT could potentially reduce liquidity in the secondary market for Slovak government bonds, thereby putting downward pressure on the price of Slovak sovereign debt in the primary market. Since the tax is charged at the same rate regardless of the riskiness of the underlying asset, it is the prices of the highest-rated bonds that will rise the most. With Slovak government bonds currently among the more secure, lower-yielding bonds, the amount and number of secondary-market transactions in these securities is likely to decrease and the bid-ask spreads to widen, thereby adversely affecting liquidity and also the price of Slovak sovereign debt. The effect on Slovak government bonds will be more pronounced given that the market liquidity is lower than that in larger countries, owing mainly to the lower amount of bonds issued.

Customers are likely to be adversely affected due to the reduced performance of collective investment funds and pension funds in Pillars II and III of the pension system, and

Table 4 Risks of FTT implementation

Tax implementation risks	Brief description of risks
Intra-group shift of transactions	A large majority of Slovak banks belong to foreign financial groups. Such groups may respond to the implementation of the tax by shifting certain types of transaction to other parts of the group outside Slovakia.
Increase in trading book risk	The level of the tax is the same regardless of the risk of the underlying asset. Hence the tax may increase investor preference for riskier, higher-yielding assets.
Negative impact on government bond market	A negative impact is expected in the form of reduced liquidity in the secondary market, higher bid-ask spreads, and a decline in bond prices (especially for sovereign debt of higher-rated couintries). This negative impact could pass through to the primary market.
Negative impact on banking sector liquidity	Reduced liquidity in Slovak government bonds could be adversely reflected in the liquidity position of the domestic banking sector.
Negative impact on customers	Customers will experience a direct negative impact through lower returns on collective investments and pension funds (in the second and third pillars of the pension system). They may be indirectly affected through increases in fees or in lending rates.
Impact on banks' investment strategies	It could happen that banks modify their investment strategies, meaning that the composition of the banking sector's debt portfolio would be adjusted in order to maximise profitability.
Impact on funds' investment strategies	Funds, too, may moderately increase the riskiness of their investments so as to become more competitive and therefore more profitable.
Change in the financial market composition	This risk concerns mainly insurance companies and collective invesment funds, which by transforming into a branch or providing cross-border services could offer their products to customers without having to charge the FTT.

Source: NBS.

they could also face indirect repercussions through higher fees or higher lending rates. According to the current legislation, the additional tax burden on management companies for collective investment funds and pension funds will automatically pass through to the funds themselves, causing a decline in their performance. While higher fees are a direct corollary of higher transaction costs (in the case, for example, of investment firms or "custody"), NBS analyses demonstrate also a certain relationship between interest rates on housing loans and government bond yields. This means that any increase in the yield on Slovak sovereign debt could put upward pressure on these lending rates.

Insurers and collective investment funds could reduce their FTT liability by transforming into branches or by providing cross-border services. Since these companies provide products that are not directly linkable to specific financial transactions, they could reduce their FTT liability by providing services in one country and managing the related assets in another countries where the tax is not charged. Such a transformation could, however, have negative consequences for the government bond market and undermine the regulatory power of NBS.

Levy on banks and insurance companies

The way in which the new levy on banks and insurance companies has been implemented may create some risks to financial sector stability. As of the beginning of 2012 banks in Slovakia were subject to a special levy at the rate of 0.4% of their liabilities not including own funds and covered retail deposits. As of 1 October 2012 the levy was extended to include retail deposits, and a new extraordinary one-off levy was imposed on banks at the rate of 0.1% of their total liabilities. From 1 September 2012 insurance companies were subject to a new special levy on regulated businesses charged at 4.356% of pre-tax profit exceeding €3 million. From the financial stability perspective the most significant risk is that the duty to pay the levy (unlike the duty to pay tax) applies to banks irrespective of whether they made a profit or loss. This gives the levy a procyclical effect, since a loss-making bank would have its loss increased by the levy, thereby increasing the pressure on its solvency. Another risk is that the pressure on the efficiency of Slovak financial institutions that are majority-owned by foreign undertakings, will result in a gradual transfer of some of their activities abroad.

Liability valuation in the insurance sector

The Solvency II regulatory framework introduces market valuation of liabilities using a risk-free interest rate, which substantially increases the volatility of the value of an insurance company's liabilities and therefore also of its profit or capital. Insurance companies' liabilities have up to now been discounted at the technical interest rate, which remained the same throughout the duration of the insurance contract and therefore their level was stable. Under Solvency II, provisions are to be valued over time using a risk-free interest that will be set by the European Insurance and Occupational Pensions Authority (EIOPA), meaning that the value of provisions would change over time. Since periods of elevated uncertainty are often accompanied by high credit risk premia alongside a low risk-free interest rate, such a period may see the value of assets decline while the value of liabilities remains stable or even increases, consequently impairing profits and solvency.

The high volatility of own funds under the new regime is one of the reasons why the entry into force of the Solvency II Directive has been delayed. Measures to mitigate this volatility are being sought and tested. Two principal measures in this regard concern adjustment of the discount rate curve:

- Matching Adjustment – where the portfolio of contracts can be clearly matched to a group of particular assets, the risk-free interest rate will be replaced by the market rate for these assets for the purpose of discounting liabilities.
- Countercyclical Premium (CCP) – an artificial increase in the risk-free rate implemented during large and unforeseeable shocks in financial markets based on an EIOPA decision adopted in accordance with rules and conditions stipulated in the regulation.

Despite offering certain benefits, the proposed CCP could result in liabilities being artificially undervalued and therefore profits or own funds being overvalued. The reasoning behind the CCP is that the value of assets can fall only as a result of insufficient market liquidity, even where a stable risk-free interest rate is applied. The main problem is that any such large shocks in financial markets will be addressed by an artificial adjustment of liabilities, leading to a virtual improvement in the situation of insurance companies, but without establishing a capital buffer for this situation in advance. According to one of the proposed rules, the CCP, after its application, will be stable for at least 12 months. In the event of an earlier stabilisation of financial markets, the capital of insurance companies will be overvalued by artificial adjustment while valuation of assets will be standard. In this situation, it would be appropriate for insurers to have the option to select, and then disclose, whether and at what level they will apply the CCP (up to the maximum level set by the EIOPA). It will also be important that the factors according to which the EIOPA sets the CCP, or decides to cancel it, are correctly calibrated.

Impact of legislative changes on the second pillar of the pension saving system

The pension saving system has previously been the sector most affected by regulatory changes, and 2012 saw a further raft of new regulation for this sector. Rules on the functioning of the old-age pension saving system were extensively modified not only by the Pension Saving System Amendment Act of August 2012, but also by the previous 2011amendment to the Pension Saving System Act, the key provisions of which entered into force in April 2012.

The most significant change from the long-term perspective was probably the reduction in the monthly contribution to pension funds, from 9% of the assessment base to 4%. Immediately after this measure entered into force, as from September 2012, it slowed the growth rate of the net asset value of pension funds. This means, in principle, the growth rate of assets under management in the sector (which is largely attributable to the level of monthly contributions) will decelerate by more than half of its past rate.

In 2012 Pillar II of the pension saving system was opened for the third ever time, from September 2012 to January 2013 inclusive. According to data from the Social Insurance Agency, a total of 89,439 savers withdrew from Pillar II and 14,720 new savers were enrolled; hence the total number of savers declined by around 75,000 and, as a result, the amount of assets under management in the system fell by €280 million. It is important to note, however, that the vast majority of people who withdrew from Pillar II were from low-income groups.

The 2011 amendment to the Pension Saving System Act included two measures that extended the possibilities for savers to adjust the risk profile of their Pillar II savings more in line with their individual requirements. Therefore, from April 2012, it became possible to save in two Pillar II pension funds simultaneously and a fourth type of pension fund, passively managed index funds, was introduced.

However, the 2012 amendment act, in force since 1 May 2013, substantially changed the rules for establishing pension funds and, relatedly, the setting of so-called "guarantees". Under this amendment, pension funds management companies (PFMCs) are required to establish only one bond guarantee fund. PFMCs themselves now decide on the number and profile of the other pension funds under their management and these funds will not be guaranteed by law.

While the above measures and their implications are not expected to have a marked impact on financial stability in Slovakia, they nevertheless represent some risk, in the context of all the past and potential future regulatory interventions in the functioning of Pillar II of the pension system. The legislative environment for the old-age pension saving system has from the outset been characterised by volatility and frequent changes, which adversely affect the stability of the whole old-age pension saving system.

Abbreviations

CCP	Countercyclical premium
CRR	Proposal for a regulation of the European Parliament and of the Council COM(2011) 452
CRD IV	Proposal for a directive of the European Parliament and of the Council COM(2011) 453
ECB	European Central Bank
EIOPA	European Insurance and Occupational Pensions Authority
ESFS	European System of Financial Supervisors
ESM	European Stability Mechanism
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
EU	European Union
FED	Federal Reserve System
GDP	Gross Domestic Product
LTV	Loan-to-Value ratio
MB	mortgage bonds
NBS	Národná banka Slovenska (central bank of the Slovak Republic)
OECD	Organisation for Economic Cooperation and Development
PFMC	Pension Funds Management Company
ROA	Return on Assets
ROE	Return on Equity
SO SR	Statistical Office of the SR
SPMC	Supplementary Pension Management Company
ULC	Unit labour costs

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