



NÁRODNÁ BANKA SLOVENSKA  
EUROSYSTEM



# FINANCIAL STABILITY REPORT NOVEMBER 2014

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## FOREWORD

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 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 (NBS) contributes to the stability of the whole financial system in Slovakia, in particular through its role as the financial market supervisory authority.

Národná banka Slovenska believes that an important aspect of its contribution to financial stability is to keep the public regularly informed about financial sector stability and about any trends which could jeopardise that stability. Awareness and discussion of such issues is essential, particularly since financial stability is affected not only

by financial sector institutions, but also by the behaviour of other non-financial corporations and individuals. Hence Národná banka Slovenska publishes a biannual *Financial Stability Report* (FSR) that primarily identifies the main risks to the stability of the Slovak financial sector.

The aim of the FSR 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. The FSR includes a section on the implementation of macroprudential policy in Slovakia.

A complementary detailed overview of developments and risks in the Slovak financial sector is provided by NBS in its annual publication entitled *Analysis of the Slovak Financial Sector*.



## EXECUTIVE SUMMARY

### **POSITIVE DEVELOPMENTS IN THE DOMESTIC ECONOMY CONTRIBUTED TO STABILITY IN THE SLOVAK FINANCIAL SECTOR**

The situation in the Slovak financial sector during the first eight months of 2014 was supported by favourable developments in the domestic economy. In contrast to the previous period, economic growth was driven not by external trade but primarily by domestic consumption and investment activity. Recovery was observed in industrial production, as well as in the labour market, with real wages increasing in almost all sectors and unemployment falling. This situation was helped by the relative calm in global financial markets, which saw a combination of asset price growth, low volatility, and easier access to funding sources for both banks and large companies.

### **CONTINUING RETAIL LOAN GROWTH WAS THE MOST SIGNIFICANT TREND; LENDING TO ENTERPRISES PICKED UP, TOO**

The positive development of the domestic economy was also reflected in the financial market environment and particularly in the credit market. Growth in retail loans remained strong, and among some types of these loans, especially mortgage loans, it even accelerated. The main factor behind this trend was the increasing affordability of housing, aided principally by falling interest rates and broadly stable property prices. Much of the credit growth continued to be the result of borrowers increasing the outstanding amount of their loans by refinancing at lower interest rates. The overall increase in retail loans was one of the highest in both the EU and in central and Eastern Europe.

Loan demand from enterprises also picked up, and unlike in the previous period it grew also among private firms and not only state-owned enterprises. Interest rates on new loans to large firms are among the lowest in the euro area.

### **RISKS TO THE CURRENT SITUATION NEVERTHELESS INCREASED IN THE RECENT PERIOD**

The continuance of these trends in the domestic financial sector is, however, exposed to certain significant risks, and the recent period saw an increase in the probability of these risks materialising. The risks lie in both the external and domestic environment.

Externally, the most significant risk is that the euro area economy experiences falling growth and possibly falls back into recession. To the detriment of the domestic economy is the fact that the negative trends are concentrated on major trading partners of Slovakia, including Germany. This situation reflects mainly low levels of domestic demand, weaker global economic growth, and the gradual escalation of geopolitical risks. In addition, the euro area is exposed to mounting disinflationary pressure.

A further development is the emergence of imbalances in global financial markets, evident in the form of price bubbles. Risk premia on many types of asset, including government bonds of euro area countries, remain low, even though in several countries the implementation of agreed fiscal consolidation targets has been deferred. Furthermore, the negative impact of any further increase in investor risk aversion could be amplified by the decline in liquidity caused by structural changes in financial markets. This has become an increasing risk for certain domestic institutions and funds. In the context of the Slovak financial market, this increase in risk exposure has been most evident in the growth of the equity component. The portfolios of some funds have also seen an increase in the share of financial instruments with other risk features, particularly structured or subordinated securities and non-investment grade securities.

By contrast, the principal risk stemming from the domestic environment has been related to the



partial easing of credit standards amid strong competition in the retail loan market, which could lead to credit risk being underestimated. This risk concerns mainly the provision of loans with 100% loan-to-value ratios, the lack of income verification in cases where loans are refinanced with larger loans, and the prolongation of maturity periods (especially in the case of unsecured loans). Furthermore, several banks have not been verifying whether borrowers would be able to repay loans provided at the current low interest rates in the event of an increase in rates. It should also be noted that the ratio of households' loan burden to disposable income has increased more in Slovakia than in most central and eastern European countries and that the concentration of indebtedness in certain household groups is growing.

These risks still did not, however, have a significant upward effect on the amount of non-performing loans during the period under review, although the retail sector reported a moderate increase in the default rate. In the corporate sector as a whole, credit risk did not increase, but the situation across its constituent sectors is heterogeneous. The commercial real estate sector in particular remains in an adverse situation. Detailed analysis of firm-level data showed, however, that banks are, on the whole, focusing their corporate lending on firms whose results are better than average.

Some segments of the financial market, notably the insurance sector, may be negatively affected by the persisting environment of low interest rates. Even though the technical interest rate has fallen gradually, now down to 1.9%, it is becoming increasingly difficult for insurers to deliver the returns guaranteed under insurance contracts entered into in past years. Furthermore, owing to continuing strong competition in motor insurance, insurers are seeing income fall while costs remain unchanged.

**THE CURRENT STRONG RESILIENCE TO RISKS WAS SUPPORTED BY NÁRODNÁ BANKA SLOVENSKA THROUGH ITS ISSUANCE OF A RECOMMENDATION ON RISKS IN THE RETAIL LENDING MARKET**

Although Národná banka Slovenska does not as yet consider the risks related to developments in the retail lending market to be significant, it sought to prevent their further accumulation by issuing a recommendation on several matters concerning the responsible provision of retail loans. The most important part of this recommendation is that the share of new loans that have an LTV ratio exceeding 90% should be gradually reduced, and also that banks should verify whether borrowers would be able to repay their loans in the event of interest rates rising by 2 percentage points.

Capital ratios in the banking sector remain high, although they stopped increasing in the first half of 2014 when banks increased the share of profits distributed to shareholders. Over the course of 2014 banks gradually implemented the Basel III rules, which for most banks did not have significant repercussions. Although profit growth in the banking sector during the first half of the year was eroded by the sharp fall in retail lending rates, it remained relatively high in international comparison. Banks also reported rising credit risk costs in the retail sector.

Looking at the risk-resilience of the banking sector, it is also necessary to note the results of the ECB's comprehensive assessment with regard to the three largest Slovak banks. This assessment, which included an asset quality review and stress tests of banks, demonstrated the strong resilience of these Slovak banks to potential adverse developments as well as their relative prudential approach to credit risk management. Importantly from the view of the stability of the domestic financial market, the parent undertakings of all domestic banks came through the testing successfully.



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

Area	Risk	Risk-amplifying factors	Risk-mitigating factors	NBS's regulatory measures and recommendations
Risk of recession in the euro area	Increase in credit risk costs in the event of adverse macroeconomic developments	In 2014 credit risk costs continued to increase in the retail sector despite falling interest rates and higher employment	Relatively high solvency in the banking and insurance sectors	Given the existing risks, banks are not expected to reduce their capital and are expected to meet the Pillar 1 regulatory capital ratio and the capital conservation buffer through their holdings of highest-quality common equity Tier 1 capital
		Indirect impact of geopolitical risks, through trading partners, on domestic economic developments		
	Higher sensitivity of banks to a downturn in the property market in the event of a worsening economic situation	Higher share of retail loans with an LTV ratio close to 100%	Property prices were relatively stable during the year, with no evidence of emerging imbalances in previous years	Recommendation A (NBS Recommendation No 1/2014 of 7 October 2014)
	Downward pressure on profits of banks and insurers	The potential for further household lending growth is gradually diminishing and interest margins are falling		
		New contribution obligations (ECB, SRM, DPV)		
Weakened financial position of several parent undertakings of Slovak banks	Direct negative impact on banks' parent undertakings owing to capital and credit linkages	Direct exposures of domestic financial institutions and funds to Russia and Ukraine are low		
Household indebtedness	The increasing indebtedness of households could weaken this sector and consequently increase the banking sector's sensitivity to a potential deterioration in the macroeconomic situation	Increasing concentration of borrowing among certain types of household		Recommendation F (NBS Recommendation No 1/2014 of 7 October 2014)
		Debt growth accelerated, while growth in household disposable income remained flat	Real wage growth in 2014	Recommendations B and E (NBS Recommendation No 1/2014 of 7 October 2014)
Risk of low interest rates	Prolonged low returns on assets in insurers and funds; price bubbles in riskier assets	Increasing investment in riskier assets in global markets is heightening the risk that investor risk aversion will rise again		
	Domestic financial institutions increasing their investments in riskier assets		Relatively low exposure of domestic financial institutions to emerging countries	
	Losses or mounting problems in the economy as a result of banks being insufficiently prudent in their retail lending policy	Marked drop in housing loan interest rates in November 2014	Increase in interest rate fixations	Recommendation C (NBS Recommendation No 1/2014 of 7 October 2014)



<b>Table 1 Overview of the most significant risks to the stability of the Slovak financial sector (continued)</b>				
<b>Area</b>	<b>Risk</b>	<b>Risk-amplifying factors</b>	<b>Risk-mitigating factors</b>	<b>NBS's regulatory measures and recommendations</b>
Risks arising from changing business practices	Potential strategic risk from increasing linkages between banks and financial intermediaries	Pressure on banks to ease credit standards and shorten interest rate fixation periods		Recommendation G (NBS Recommendation No 1/2014 of 7 October 2014)
	Risks arising from intensive price competition in the motor insurance market	The current decline in comprehensive motor insurance premiums is unsustainable because it is generating losses		Price competition in motor insurance should not impinge on the due payment of legitimate insurance claims
Liquidity	Maturity mismatch between assets and liabilities	Widening mismatch between assets and liabilities and declining liquidity buffers	Adherence to minimal regulatory limit for liquid assets; sound funding structure	Change in the set liquid asset ratio; banks are expected to meet the current and amended liquid asset ratio through standard trading operations
Risks of concentration, financial market interlinkages and contagion	Relatively high concentration in (part of) the portfolio, or higher intra-group exposure, in certain institutions or funds	The Slovak economy includes a relatively high degree of economic links between domestic firms; the largest of them could pose a threat to the solvency of certain banks		Banks should take a prudential approach to assessing economic links between customers and to the management of concentration risk in both their lending and deposit business; any higher degree of concentration risk should be covered by additional own funds, and/or by an additional liquidity buffer
	Negative consequences of rationalisation measures or strategic decisions implemented in domestic financial institutions by parent undertakings, and contagion risk		The value of profitability ratios in domestic banks is above the EU average	

Source: NBS.



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CHAPTER 1

# EXTERNAL CONDITIONS FOR FINANCIAL STABILITY

1



# 1 EXTERNAL CONDITIONS FOR FINANCIAL STABILITY

**Since publication of the previous Financial Stability Report (May 2014) there has been a slight worsening of conditions in the external environment that affect financial stability in Slovakia.** The global recovery is proceeding more slowly than was projected at the beginning of 2014, with the euro area economy in particular still struggling to achieve positive GDP growth. Financial markets, by contrast, especially in advanced economies, have been experiencing a period of mostly strong risk appetite and increasing asset valuation, to the point that some segments are seeing signs of price bubbles. Furthermore, these developments are playing out against a background of escalating geopolitical tensions.

**World economic growth in the recent period has been weaker than expected.** This fact was reflected in the International Monetary Fund's World Economic Outlook (IMF WEO) published in October. According to the WEO, global growth in both 2014 and 2015 will be lower than previously estimated. This downward revision is largely a response to developments in the euro area, Japan, China and Latin America. On the other hand, the US economy's weak performance in the first quarter of 2014 was a seasonal blip, as shown by its much stronger than expected growth in the subsequent quarter. Based on regular indicators, the recovery has continued to be robust in the second half of the year. Improving economic fundamentals in the United States allowed the Federal Reserve to gradually reduce monetary stimulus in the form of quantitative easing, with the asset purchase programme being tapered from early in the year and wound down completely at the end of October.

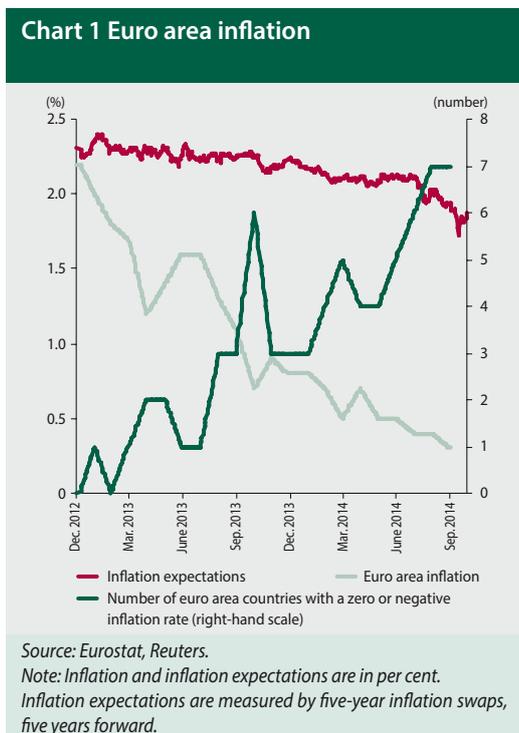
## THE EURO AREA'S NASCENT RECOVERY VIRTUALLY CAME TO HALT IN 2014

**Developments in recent months suggest that the relative optimism about euro area economic recovery which prevailed at the turn of the year was to some extent premature.** Euro area GDP growth fell to 0.1% in the second quarter of 2014, and, according to the flash estimate,

it picked up only marginally in the third quarter, to 0.2%. The gravity of the situation is underscored by the fact that the downturn is caused mainly by large economies, including Germany, which in the second quarter saw its GDP contract by 0.1% year-on-year. The IMF, in its latest reports, warns that the probability of the euro area sliding back into recession has increased to around 40%.

The causes of this situation include, in addition to an inability to generate sufficient domestic demand (stemming inter alia from the ongoing repair of private and public balance sheets), two external factors. The first is the previously mentioned slowdown in the global economy, which accounted for the euro area's weaker export performance. The second shock was the outbreak and gradual escalation of the Russia-Ukraine crisis. The European Union's economic sanctions against Russia and Russia's counter-sanctions had both a direct impact, through restrictions on external trade, and, more significantly, a negative impact on consumer and business sentiment. A partial impact may already be seen in weaker manufacturing and in falling investment demand. However, the overall extent of the impact of these measures on the euro area economy will only become apparent in the following period. At the same time, economic agents are not ruling out a further escalation of the Russia-Ukraine conflict and the possibility of further rounds of sanctions, with the potential for even more negative repercussions.

**A combination of weak activity and falling energy prices accentuated the disinflationary trend in the euro area.** Annual consumer price inflation in the euro area as a whole fell still further, from a relatively low level, and in September stood at 0.3%. Furthermore, seven euro area countries saw their inflation rate fall to zero or turn negative in the period under review. In comparison with the previous period of decreasing inflation, one significant change occurred during the summer. Up to then, long-term inflation expectations had been well anchored despite

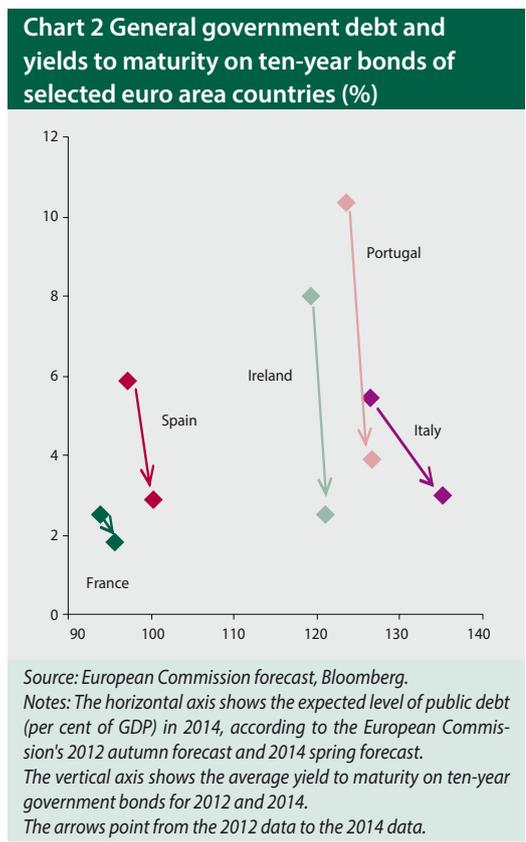


easing in the same way that other large central banks have already done.

**The progress of euro area periphery countries in fiscal consolidation efforts has been relatively strong so far in 2014.** The situation in France is different, as its general government deficit will probably be higher in 2014 than in the previous year and its new draft budget assumes that the threshold debt-to-GDP ratio of three percent will be met two years later than the original deadline under the excessive deficit procedure. Italy's public deficit is also expected to be higher than in 2013. All highly indebted countries will find the process of repairing public finances increasingly difficult, owing to low real economic growth and falling inflation. The first half of 2014 saw high demand for government bonds of stressed euro-area countries, and the consequent low yields on this debt contributed in the short term to reducing the risk of the sovereign debt crisis returning. The compression of sovereign credit spreads stands in contrast, however, to signs of longer-term economic stagnation in the euro area and to the fact that public debt in these countries is expected to culminate

the falling inflation rate, but during the summer months these expectations started being revised down.

**These developments, along with those in other economic and monetary indicators, prompted the European Central Bank to adopt a series of measures to ease monetary policy further.** In both June and September the ECB cut its key interest rate by 10 basis points, leaving it at 0.05%. The difference between the main refinancing rate and deposit facility rate was maintained by reducing the latter into negative territory, down to -0.2%. In addition, the ECB resorted to unconventional instruments of monetary policy. The first of the targeted longer-term refinancing operations (TLTROs) was conducted in September. The borrowing banks have until September 2018, at the latest, to repay funds allotted in the TLTRO providing they can demonstrate in the meantime that the funds were used for lending to the real economy. If they cannot, the funds must be repaid by September 2016. The ECB also began supporting the euro area's subdued credit market through purchases of simple and transparent asset-backed securities and covered bonds. This has been accompanied by growing expectations in financial markets that the ECB will in the end launch quantitative





at higher levels than those projected during the peak of the turbulences in 2012.

**ALTHOUGH ACCESS TO FUNDING IMPROVED FOR EURO AREA BANKS, LENDING ACTIVITY AND BANKING SECTOR PROFITS REMAINED WEAK**

**Among the relatively positive trends in the euro area is the improvement in banks' access to funding.** Amid greatly receding perceptions of the risk of an extreme event and resurgence of the sovereign debt crisis, funding for banks became more accessible and cheaper. The more favourable sentiment towards banks stemmed also from the progress achieved in implementing the pillars of the banking union, including the Single Supervisory Mechanism and Single Resolution Mechanism. This may also have been a factor behind the easing of credit standards for loans to non-financial corporations in the second quarter of 2014, which happened for the first time since the outbreak of the financial crisis and was also reflected in the lowering of customers' interest rates. There was likewise a narrowing of the difference between interest rates for customers from periphery countries and those in the rest of the euro area. Nevertheless, the annual rate of change in amount of loans to non-financial corporations remained negative. One explanation may be the downward trend in expected inflation, which particularly in certain countries cancelled out the benefits of lower nominal interest rates. In an environment of persisting economic uncertainty, this situation may also be partly ascribed to the demand-side of the credit market, even though banks have seen a slight pick-up in demand for loans during 2014.

**Although the profits of European banks increased slightly in the first half of 2014, they remain low.** Banks' financial results are being adversely affected by low interest rates in particular (since these are squeezing interest margins and returns on assets in general) and by still elevated costs of credit risk. The recent period has seen these costs increase to include costs for provisioning against regulatory sanctions, whether already determined or expected, relating to the conduct of past activities.

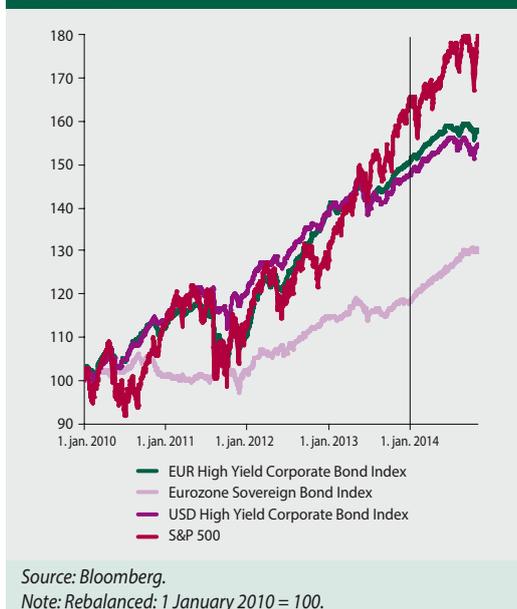
**For almost the whole of 2014, the euro area banking sector was awaiting the results of the comprehensive assessment of banks that preceded the ECB's assumption of supervisory**

**tasks (see Box 1 for further details).** It is widely assumed that the publication of these results at the end of October could be a significant milestone in the recovery of the banking sector and in the laying the ground for a revival in lending. The assessment is expected to be significant in supporting transparency, the removal of uncertainty about banks, the cleaning-up of balance sheets and, as necessary, the recapitalisation of more vulnerable banks. The key information in the published outcomes of the comprehensive assessment is that 25 of the 130 banks assessed would fail to meet the minimum capital requirement under the stress scenario, with their total capital shortfall standing at almost €25 billion. In the short period since this information was disclosed, the reaction in financial markets has been neither significantly negative nor positive.

**A WHOLE RANGE OF FINANCIAL INSTRUMENTS, PARTICULARLY RISKIER ONES, SAW TREND GROWTH IN THE FIRST HALF OF 2014**

**The continuing period of low interest rates, maintained by central banks in advanced economies, has stimulated demand for riskier assets, and this development was particularly marked in the first half of 2014.** Also contributing to the increasing risk appetite of investors was the significantly lower actual and expected volatility in most financial markets, similar to pre-crisis levels. Thus prices climbed across a wide range of assets, but there were also indications that investors, in seeking higher-yielding assets, were paying insufficient attention to the related risks and, as a consequence, asset price bubbles began to arise. This search for yield was evident in the significant and, more unusual still, exceptionally synchronised decline in risk premia on several markets, particularly in the United States and Europe. This compression was most pronounced in credit markets. The lower the credit quality of assets, the higher were their prices in comparison with the past. Investors' increasing readiness to take on even more risk was indicated by non-price signals, including, for example: the record issuance of lower-rated corporate bonds; the rising share of bonds and credits subject to issue and contractual terms that were less favourable to investors; increasing demand for structured products; and a return to riskier forms of securitised instruments. In the United States, where the equity market was beginning to show signs of overheating, large firms were borrowing

**Chart 3 Developments in selected price indexes**



from the money and bond markets in order to fund the purchase of their own stock or dividend payments.

**The risks inherent in these financial market trends relate mainly to the future normalisation of monetary conditions.** While this is clearly a distant scenario in the euro area and Japan, the situation is different in the United States, where the improving economic situation has given rise to the general expectation that the Federal Reserve will adjust its key interest rate sometime in mid-2015 and that thereafter it will raise the rate further in gradual steps. Given the importance of US financial markets to the global financial system, it may be expected that the interest rate hikes would to some extent be transmitted to other regions as well. For those less creditworthy firms that in the recent period have been using looser credit conditions to obtain funding, an increase in interest payments could prove an unsustainable burden on their highly leveraged balance sheets. Banks and investors are therefore exposed to credit risk losses.

**Financial stability could be disrupted even more seriously if a shock resulted in a wave of risk repricing on global financial markets, accompanied by a sharp increase in volatility, fire-selling of certain asset groups, and possible capital flight from emerging market economies.** Like what happened in early summer 2013, such a situation could be triggered by a sudden reassessment of expectations for monetary policy developments in the United States. The assumption that the short-term key interest rate needs to be raised more quickly could put upward pressure on the long end of the yield curve, as could an increase in the maturity premium amid mounting uncertainty about the course of US monetary policy. There may be further triggers of market turbulences if geopolitical tensions escalate or if the sustainability of euro area public finances is revised in the light of expectations for long-term stagnation in the region. Signs of market nervousness related to these scenarios appeared in August and, to a greater extent, in October, but in neither case was there any significant panic.

**Asset-pricing turmoil would be amplified to a greater extent than in the past by lower liquidity in financial markets.** This is because the post-crisis developments included several structural changes that negatively affected market liquidity. Firstly, large international banks reduced their activity as market makers owing to stricter regulation. On the other hand, retail investment funds are taking on a greater intermediary role, and in the recent period, more so than before, they have been investing into relatively less liquid credit instruments. The effect of this on the financial system is to exacerbate maturity mismatches, since the liabilities of these funds are to be redeemed more or less at sight. Furthermore, retail investors have a greater tendency than institutional investors to redeem their shares/units when markets begin to show unease. Other factors that could intensify asset-price volatility include the high concentration of particular issues in large investment funds and the increasing significance of benchmark-linked ETF instruments.



Box 1

## RESULTS OF THE ECB'S COMPREHENSIVE ASSESSMENT

**On 26 October 2014 the ECB published<sup>1</sup> the results of its comprehensive assessment of 130 of the largest banks in the euro area.<sup>2</sup>**

The first part of the assessment consisted of an asset quality review (AQR) by which the ECB sought to examine the state and quality of banks' selected portfolios as at 31 December 2013. The second part comprised a stress test to examine banks' resilience to a deteriorating situation in financial markets and in the real economy, under a baseline scenario and an adverse scenario over a three-year time horizon (2014-2016). The stress test was conducted under the auspices of the EBA<sup>3</sup> and it was the fourth such exercise, following previous ones in 2009, 2010 and 2011. The AQR, on the other hand, was led by the ECB and was the first review of its kind, one that may be seen as a unique event prior to the launch of the Single Supervisory Mechanism. The impact of the stress scenarios on euro area banks was worsened not only by the effect of the AQR results, but also by the ECB's relatively strict quality assurance checks on banks' application of the stress scenarios and assumptions.

**The results of the comprehensive assessment revealed that 25 banks had a capital shortfall, amounting to €24.6 billion in total.** The national banking sector accounting for the largest share of that amount was Italy's, with nine banks reporting an overall shortfall of €9.7 billion. Next came Greece, with three banks showing a shortfall of €8.7 billion, and in third place was Cyprus, with shortfalls in three banks totalling €2.4 billion. On other hand, 12 of the 25 banks have already covered their capital shortfall by increasing their capital by €15 billion. Banks with shortfalls had to prepare capital plans within two weeks of the announcement of the results and they have up to nine months to cover the capital shortfall.

**The AQR showed that as of end-2013 the carrying values of banks' assets need to be adjusted by €48 billion, of which €10.7 bil-**

**lion represents capital shortfall of respective banks.** It was also found that the total amount of banks' non-performing exposures increased by €136 billion to €879 billion. The strictness of the quality assurance check on the stress test calculation and the thoroughness of the AQR were evident in the fact that banks' CET1 ratio under the adverse scenario fell by 4.1 percentage points, from 12.4% to 8.3%, a greater margin than had been estimated in previous similar analyses.

**The results of the comprehensive assessment for Slovak banks are positive.** Since the comprehensive assessment covered at a minimum the three largest banks in each euro area country, the banks it covered in Slovakia were Slovenská sporiteľňa, Všeobecná úverová banka, and Tatra banka. The results for these three banks confirmed the sound quality of their assets and healthy composition of their balance sheets. Not only there was no need for capital replenishment for any Slovak bank, but resulting CET1 ratios under the adverse scenario were significantly above the given threshold. Moreover, these Slovak banks, on which the overall impact of the AQR was €0.1 billion (as against the overall impact on all reviewed banks of €48 billion) were among those least affected by the AQR, with their results similar to those of banks in Latvia, Lithuania, Malta, Luxembourg and Slovenia.

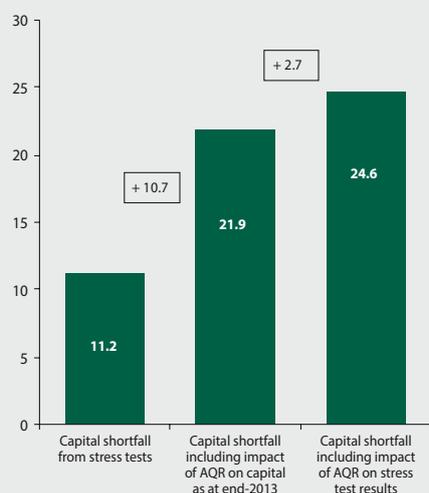
The comprehensive assessment involved Slovak banks not only through the direct participation of the three largest, but also indirectly, through the assessment of the parent undertakings of several other banks, namely: Československá obchodná banka, ČSOB stavebná sporiteľňa, OTP Banka Slovensko (the parent undertaking participated only in the EBA stress test), Slovenská sporiteľňa, Wüstenrot stavebná sporiteľňa, Všeobecná úverová banka, and Tatra banka. The assessment outcomes are also positive for these banks, since not one of their parent undertakings was found to have a capital shortfall.

1 <http://www.ecb.europa.eu/press/pr/date/2014/html/pr141026.en.html>

2 The comprehensive assessment was conducted in the 18 current members of the euro area and also in Lithuania, which will become a member on 1 January 2015.

3 <http://www.eba.europa.eu/risk-analysis-and-data/eu-wide-stress-testing/2014>

**Chart A Capital shortfall identified by the comprehensive assessment in the euro area (EUR billions)**



Source: ECB.

Note: The minimum CET1 ratio was set at 8% under the AQR and baseline scenario, and at 5.5% under the adverse scenario.

As well as quantitative results, which directly affected banks by, for example, requiring an increase in their capital, the exercise also produced qualitative outcomes. These outcomes varied in nature and concerned mainly the approach of banks to the valuation of collateral, the identification of non-performing or restructured loans, the categorisation of customers into segments, etc. These qualitative outputs are, however, to be addressed with the banks

concerned only after 4 November, i.e. after the Single Supervisory Mechanism is launched, as part of the current supervisory regime.

**Overall, the comprehensive assessment can be assessed positively from the banking sector point of view.** The assessment had three goals:

- transparency – to enhance the quality of information available on the condition of banks;
- repair – to identify and implement any necessary corrective actions;
- confidence building – to assure all stakeholders that banks are fundamentally sound and trustworthy.

The publication of the detailed outcomes, and the overall impact of both the AQR and stress test, not only contributed to greater transparency in the banking sector, but also significantly helped identify several problematic areas (some of a qualitative nature, others quantitative), the removal of which will substantially support the strengthening of banking sector stability. The exercise was probably also instrumental in the fact that from the beginning of the 2014, the banks concerned increased their capital by more than €57 billion, which is beneficial for financial stability. While it is too early to assess market reaction to the comprehensive assessment and its outcomes, the initial responses were positive.



# DOMESTIC CONDITIONS FOR FINANCIAL STABILITY

## 2 DOMESTIC CONDITIONS FOR FINANCIAL STABILITY

### FAVOURABLE MACROECONOMIC DEVELOPMENTS IN THE FIRST HALF OF 2014

**In contrast to the external environment, developments in the domestic economy were quite favourable from the view of financial stability.** Several areas of economic development important for financial stability took a positive turn. It remains to be seen, however, which of these trends is sustainable amidst risks in the euro area and in the wider global economy.

The relatively strong pace of GDP growth observed at the end of 2013 continued in the first half 2014, with quarter-on-quarter growth remaining at 0.6%. For 2014 as a whole, the Slovak economy is on course to grow by 2.3% (according to NBS's current forecast), which is more than twice as high as its growth in the previous year. Going forward, economic growth is expected to increase to 2.9% in 2015 and 3.5% in 2016. This acceleration may, however, be jeopardised by a further escalation of geopolitical tensions, a more marked deterioration in consumer and business confidence, and additional weakening of external demand.

The composition of GDP growth underwent a significant change in the first half of 2014, as the contribution of domestic demand overtook that of exports. All components of domestic demand contributed to the turnaround. For the first time since the outbreak of the financial crisis, household final consumption increased significantly in year-on-year terms. This increase in consumption seemingly stemmed from both an increase in consumer confidence and an increase in the real growth of household disposable income. Investment demand increased mainly in the second quarter, as firms undertook overdue renewal of fixed capital and as public investment growth increased.

As for exports of goods and services, their growth initially slowed in the first quarter and then turned negative in the next three months on a quarter-on-quarter, seasonally-adjusted ba-

**Chart 4 Sentiment and industrial production indicators**



Source: Eurostat.

Note: ESI – Economic Sentiment Indicator.

sis. These trends may to some extent be a consequence of the outbreak of the Russia-Ukraine conflict and resulting imposition of sanctions. The impact of the sanctions on Slovakia's export performance was primarily indirect, through lower demand from European trading partners and, in particular, the slowdown in Germany's industrial production. Exports to Russia and Ukraine fell slightly, but they had been declining in the previous year, too.

Despite the contraction in external demand, industrial production maintained relatively even growth during the first eight months of 2014. However, a marked deterioration in forward-looking indicators for Germany and a sharp drop in German industrial production in August make the outlooks for this sector in the near future somewhat less favourable. Another sign of a possible downturn is that the industry confidence indicator fell in October after remaining above its long-run average during the summer months.



**RISKS TO THE CONTINUING RECOVERY AND FINANCIAL STABILITY IN SLOVAKIA ARE MAINLY OF EXTERNAL ORIGIN**

**The greatest threat to the domestic economy as a whole, and therefore to financial stability, is that the euro area economy stagnates or slides back into recession.** The probability of such scenarios is higher now than it was at the beginning of 2014. Already by the third quarter, deteriorating conditions in the euro area were weighing on confidence indicators in Slovakia.

**Another serious downside risk to the Slovak financial sector is a further escalation of the Russia-Ukraine crisis.** This would probably result in a new round of EU sanctions and consequently of Russian counter-sanctions, which could include a total ban on car imports from the EU (a measure already under consideration in the period under review). Such or similar sector-wide restrictions would have considerable repercussions on Slovak industry, both directly and indirectly. The Slovak economy would be even more adversely affected if geopolitical tensions rose to such an extent that energy commodities soared in price or their supply from Russia was severely restricted.

**CERTAIN RISKS IN THE DOMESTIC ECONOMY LESSENE SLIGHTLY IN THE RECENT PERIOD**

**The ongoing recovery of domestic activity formed a positive feedback loop with the labour market in the first half of 2014.** Employment developments in this period even exceeded expectations. Net job creation was particularly strong in those sectors reliant on domestic demand, such as services and trade. And the public sector saw even higher employment growth than the private sector. Thus the labour market managed to absorb part of the labour force that was classified as unemployed. The unemploy-

ment rate fell to 13.4% in the second quarter, a drop of 0.6 percentage point compared to the end of 2013 and the lowest rate since mid-2011.

Wage developments, too, were better in the first six months than originally projected. Nominal wage growth exceeded 4%, at an annualised rate, and with consumer price inflation at a de facto rate of zero, this growth was fully reflected in strong real wage growth. Another positive fact was that the increase in wages was broadly based across almost all sectors.

The combination of higher employment and real wage growth is good news not only for the generation of domestic demand, but also with regard to household credit risk. It should be added, however, that the increasing indebtedness of households is accentuating this risk (for further details on this subject, see the part entitled "Household loan growth").

**The migration to ESA 2010 as the methodology for the compilation of national accounts resulted in a downward revision of Slovakia's public debt for 2013, to below 55% of GDP.** The main cause of that reduction is the upward revision of nominal GDP to reflect the reclassification of small tools and of research and development expenditure. This is a positive development, since revision of the public debt as at end-2013 brought it from above to below the third debt brake threshold of 55% of GDP, laid down in the Fiscal Responsibility Act. Thus, regardless of progress in the fiscal consolidation effort, the risk of the debt rising above the debt brake thresholds in coming years (57% and 60%) has been somewhat reduced, and therefore so has the risk of a fiscal shock in the form of measures triggered by hitting the debt brake.



NÁRODNÁ BANKA SLOVENSKA  
EUROSYSTEM

CHAPTER 3

# THE FINANCIAL SECTOR IN SLOVAKIA

3

## 3 THE FINANCIAL SECTOR IN SLOVAKIA

### 3.1 SOLVENCY AND FINANCIAL POSITION OF THE FINANCIAL SECTOR

#### FINANCIAL POSITION

**The level of net profit remained relatively flat year-on-year, but there were changes in profit structure.** The banking sector's net profit for the first three quarters of 2014 was €452 million, representing an increase of 0.8% over the same period in 2013. Therefore banks' profit growth was significantly lower compared with the previous period. As Chart 5 shows, profitability as measured by return on assets (ROA) fell for the first time since the crisis (except for 2012).

**The main factor was developments in the retail portfolio.** In the corporate portfolio, net income (including interest income, fee income and credit risk costs) increased year-on-year, whereas in the retail portfolio, it remained broadly unchanged.

**The slowdown in profit growth was caused mainly by a significant reduction in retail lending rates and increase in retail credit risk costs.** Although the continuing increase in

**Chart 6 Contribution of retail and corporate portfolios to banking sector profits (EUR millions)**

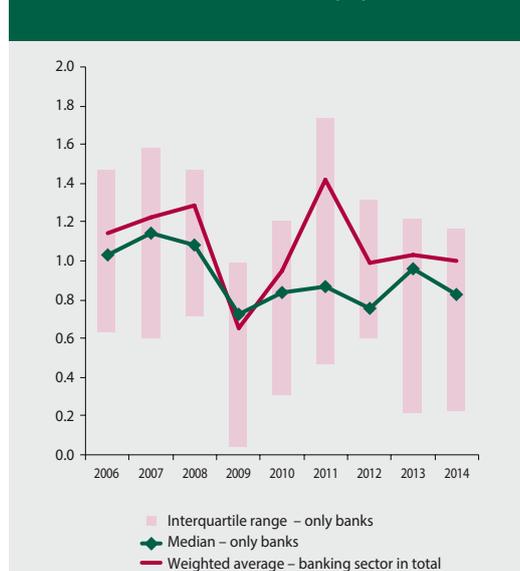


Source: NBS.

Notes: The vertical axis shows the costs and net income for the first three quarters of the given years.

Since the distribution of provisioning costs for the different portfolios is not available, the full amount of these costs is assigned to the corporate portfolio.

**Chart 5 Distribution of ROA (%)**

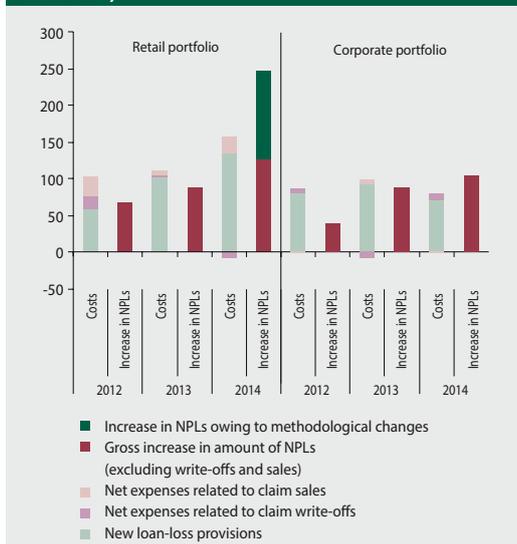


Source: NBS.

Note: The vertical axis shows annualised ROA values for the first three quarters of the given years.

the amount of retail loans and the fall in interest expenses on retail deposits again contributed positively to profit growth, that effect was significantly offset by the decline in the rate of return on loans. This was largely caused by the downward impact of persisting low interest rates on lending rates, the extent of their decline being among the highest in the euro area during the period under review. This fall in rates was also affected by interest rates on older loans, as many borrowers refinanced these loans with new loans at lower interest rates. In the corporate portfolio, by contrast, the increase in net income resulted mainly from decreasing credit risk costs and the continuing fall in deposit costs, as well as from increased non-interest income (fee rates) on operations with non-financial corporations. Even so, net margins (after taking credit risk into account) remain far lower in the corporate portfolio than in the retail portfolio, and may further dampen banks' appetite for financing higher-risk projects.

**Chart 7 Credit risk costs compared with increase in non-performing loans (EUR millions)**

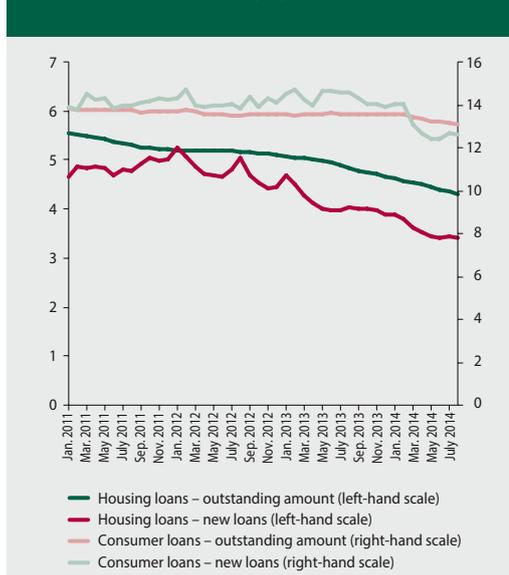


Source: NBS.

Notes: The vertical axis shows the costs and net income for the first three quarters of the given years.

The increase in the amount of NPLs owing to methodological changes relates to compliance with the European Banking Authority's Implementing Technical Standard on Supervisory reporting on forbearance and non-performing exposures. This increase does not affect the quality of the credit portfolio or the profitability of the banking sector.

**Chart 8 Average interest rates on new loans and on loans overall (%)**



Source: NBS.

**Some banks saw increased materialisation of credit risk.** As Chart 7 shows, the increase in retail credit risk costs that the banking sector reported during the first three quarters of 2014 was related to a rise in non-performing loans in certain banks (after accounting for changes in reporting methodology).

**Looking ahead, downward pressure on net interest income in the retail portfolio is expected to continue.** The continuing gap between interest rates on new loans and the average rate in the portfolio as a whole is shown in Chart 8, and it will contribute to a further drop in returns on loans. In respect of mortgage loans, this gap has narrowed slightly since the beginning of 2014, but with consumer loans it has widened.

It should also be noted that lending growth during the first three quarters of 2014, which helped offset the decline in net interest income resulting from the fall in interest income, was most marked in those banks that made

the largest rate cuts. In future, as rates gradually stabilise, these banks could be exposed to a decline in net income on their retail portfolios.

**Other financial market segments also continued to report sound profit levels,** despite the continuing environment of low interest rates. In particular, the return on equity (ROE) of investment fund management companies (collective investment) and pension funds management companies (second pension pillar) increased significantly. This stemmed mainly from commission income and also, in the case of the collective investment sector, an increase in the amount of assets under management. Among supplementary pension management companies, ROE fell but remained at a relatively high level. The drop was largely caused by a reduction in the maximum statutory limit on fund management fees. The insurance sector, too, saw a decline in ROE, owing mainly to the impact of low interest rates on life insurance business, in particular a sizeable reduction in the difference between the rate of return on assets covering technical provisions and the guaranteed interest rate.

**BANKING SECTOR SOLVENCY AND LEVERAGE<sup>4</sup>**

**Despite falling slightly, the banking sector's capital adequacy, i.e. loss-absorption capac-**

<sup>4</sup> This part of the analysis is based on preliminary data; the relevant statements from banks had still not been finalised by the cut-off date for this Report (20 October 2014) owing to the Basel III migration.



**ity, remained robust.** Although the overall capital ratio of the sector edged down during the first half of 2014, from 17.2% to 16.9%, the common equity Tier 1 ratio remained unchanged at 16.0%. It should also be noted that the capital ratio had been rising for several years before it declined. The decrease was caused mainly by an increase in the amount of risk-weighted assets. The downward trend in risk-weights in banks using the internal ratings-based (IRB) approach – a trend of recent years that was being closely monitored with regard to the assessment of banks' solvency – came to an end in the first half of 2014.

**This fall in capital adequacy can be seen to some extent as optimising the capitalisation of banks without adversely affecting financial stability.** The key change compared to previous years is the fact that 88% of the sector's 2013 profit was distributed to shareholders through dividends, as against 75% of the 2012 profit. At some banks, mainly those with higher capital ratios, the total dividend payments even exceeded the earnings for 2013. A key point to note, however, is that the higher dividends were mostly paid by banks with larger capital ratios, while banks with

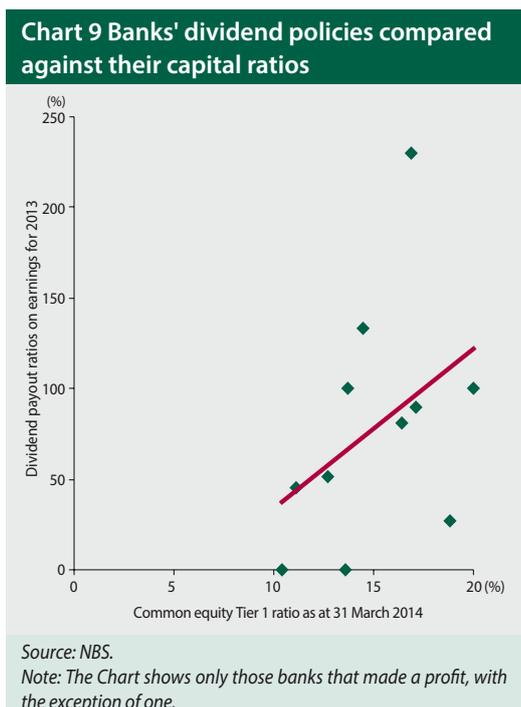
lower capitalisation retained a greater part of their earnings.

As at 30 June 2014 all banks met regulatory requirements for the amount and composition of capital and also satisfied the capital conservation buffer requirement before it came into effect. This buffer was set at 1.5% of risk-weighted assets for the period from 1 August to 30 September 2014 and at 2.5% from 1 October 2014.

**The implementation of Basel III did not have a substantial impact on the Slovak banking sector's capital ratio.** Basel III was implemented through the Capital Requirements Regulation (CRR), which entered into force on 1 January 2014 (with the exception of certain provisions with a later commencement). Subsequently, with effect from August 2014, the Capital Requirements Directive IV was enacted into Slovak law through an amendment of the Banking Act (again with the exception of certain provisions that will enter into force at a later date). The CRR/CRD IV package brought about several changes in the calculation of own funds and risk-weighted assets. The impact of the changes on the banking sector's capital ratio was mixed, with some adding upward pressure and others downward pressure. In Table 2, the most significant changes are listed and their impact is quantified. As the figures show, Basel III implementation did not, overall, have a significant impact on the capital ratio at the sector level and it caused a slight improvement in the composition of capital. It must be pointed out, however, that the Basel III implementation process is still not over and the impact of certain factors, including factors not mentioned in the table, may increase further.<sup>5</sup>

**Slovak banks' risk-resilience is also evident from the relatively high leverage ratio of the sector.** According to preliminary figures, the average leverage ratio as at 30 June 2014 was 8.2%, calculated using the fully implemented definition of the CET1 ratio, or 7.9% using the transitional definition. This level cannot yet be compared with the regulatory minimum since that figure has still to be set, but compared with the average in the European banking sector it is higher by around one-third.

<sup>5</sup> The capital ratio has not as yet been affected (or if so, only very slightly) by certain other factors, for example: a reduction of the risk-weight for loans secured by immovable commercial property, from 100% to 50%; the option to add a general value adjustment to own funds on grounds of credit risk; and stricter calculation of risk-weights for exposures to large banks and non-bank financial corporations which use the internal ratings-based approach.



**Table 2 The key capital adequacy-affecting factors resulting from the implementation of Basel III**

Factor	Impact on capital ratio	Impact on CET1 ratio
Preferential risk weight for exposures to SMEs	+ 0.2*	+ 0.2*
Tightening of requirements for deferred tax assets	- 0.2	- 0.2
Exposures to selected subsidiaries treated as assets attracting a 250% risk weight instead of being deducted from own funds.	+ 0.3	+ 0.3
Tightening of requirements for inclusion of subordinated debt in Tier 2 capital	- 0.1	0.0
Switching of valuation gains from Tier 2 to Tier 1 capital	- 0.4**	0.0**
Cancellation of obligation to deduct provisioning shortfall in banks that use the standardised approach to credit risk	+0.3***	+ 0.3***

Source: NBS.

Data are as at 30 June 2014.

Values are given in percentage points.

\*) The calculation does not include data for one significant bank.

\*\*\*) In 2014 valuation gains are temporarily not included in own funds. From 2015 they will again be included in own funds, in CET1 capital.

\*\*\*) The change came into effect on 1 August 2014.

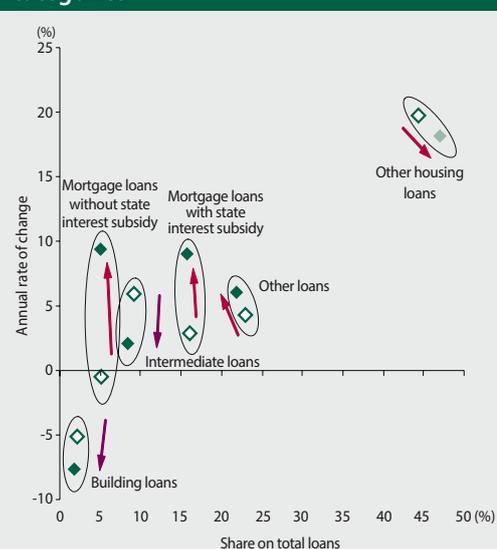
### 3.2 BANKING SECTOR ASSETS

#### GROWTH IN LENDING TO HOUSEHOLDS

**Growth in loans to households remains one of the key trends in the Slovak financial sector, and, unlike in other EU countries, it has continued to increase in 2014.** In September 2014, the annual growth rate of loans to households was 12%, with most of the acceleration attributable to mortgage loans (both with and without a state interest subsidy). This confirms the long-run rising trend in the concentration of Slovak households' debt in housing loans. Housing loans as a share of total household debt (including leasing and hire purchase) increased to 80%, while their absolute growth rate reached an all-time high in the third quarter of 2014, exceeding even the levels from 2007 and 2008. This happened despite a decrease in building loans and slower growth in intermediate loans, which were unable to benefit significantly from the environment of falling interest rates and the related high degree of loan refinancing.

The growth rate of loans to households is high not only in historical terms, but also in comparison with corresponding rates in other EU coun-

**Chart 10 Dynamics in selected housing loan categories**



Source: NBS.

Note: The arrows point from the September 2013 data to the September 2014 data.

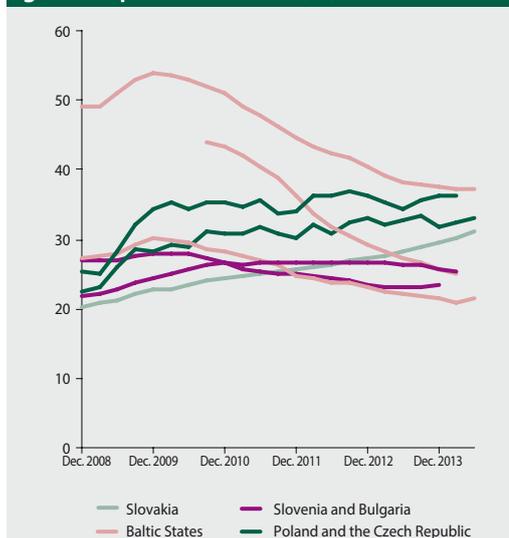
tries. The acceleration in this growth rate also contrasts with the situation in other central and eastern European countries.

**Chart 11 Housing loans growth rates in Slovakia and the EU (%)**



Source: ECB.  
Note: CEE – central and Eastern Europe.

**Chart 12 Ratio of household bank loans to gross disposable income (%)**



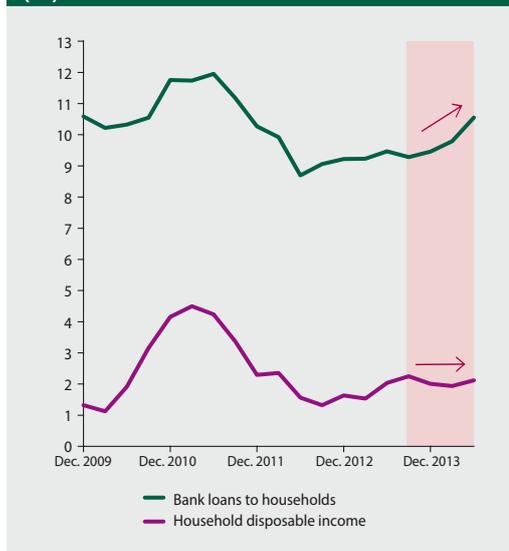
Source: Eurostat.

Lending growth is, however, usually accompanied by an increase in household indebtedness, which is a central concern of macroprudential policy. It is therefore vital that such growth be consistent with economic fundamentals. The key indicator in this regard is the ratio of households' gross disposable income to their overall debt. Its relation to the overall debt cannot describe the financial situation of individual households, but provides an overview of debt developments in the household sector. Two trends should be noted here.

The first concerns the rate of change in the ratio of household debt to gross national disposable income, which was different in Slovakia and in other CEE countries. In December 2010 this ratio was lower in Slovakia than in any other CEE country apart from Romania, but by June 2014 the ratio in Slovakia was one of the four highest. No other CEE country has seen this ratio increase so clearly and markedly since the outbreak of the economic and financial crisis. Therefore questions about the sustainability of household debt growth in Slovakia should not be explained only in terms of its convergence with levels in other EU countries.

The second trend is rising growth in household loans alongside rather more stable growth in household disposable income. This was particularly evident in the first three quarters of 2014 and the result is a higher rate of increase

**Chart 13 Rates of increase in household disposable income and household loans (%)**



Source: NBS, SO SR.

in the household debt to disposable income ratio.

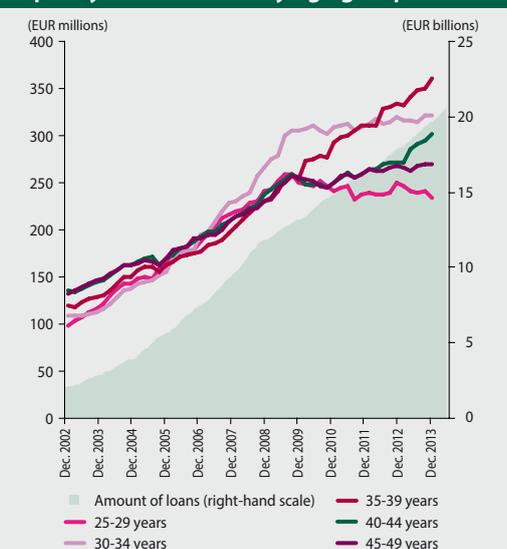
**There remains the risk of debt concentration in certain household groups.** Since the recent acceleration in household debt growth cannot be fully explained by developments in gross disposable income, the question arises about a possible concentration of loan growth in a particular household group. In this regard, banks are now facing new challenges. Until mid-2008, borrowing capacity<sup>6</sup> increased evenly across all age categories from 25 to 49 years, but the pattern since then has been different. Owing to a combination of demographic trends and labour market developments, the borrowing capacity of the key 30-34 age group remained virtually unchanged and that of the 25-29 age group even fell slightly. On the other hand, the 35-39 age group continued to see an increase in borrowing capacity, as it experienced a favourable combination of a rising number of income-earners and the highest average gross wage, which also increased more than the average wage in the economy. The 40-44 age group has seen a similar positive development, particularly since 2011. These age groups may be attractive for banks owing not only to their increasing borrowing capacity, but also to their existing credit history.

#### INCREASE IN CREDIT TO THE CORPORATE SECTOR

**Growth in lending to non-financial corporations was accompanied by a slight increase in loan demand and an unchanged situation on the supply side of the credit market. A significant proportion of the lending growth was, however, accounted for by loans to state-owned enterprises.** The supply side of the corporate credit market remained largely unchanged, with banks remaining cautious vis-à-vis the current economic situation and with the outlooks for its future development still uncertain. Bank credit standards<sup>7</sup> have remained substantially unaltered since the beginning of 2013, after being tightened several times in 2011 and 2012. Hence they are still relatively strong, as indicated by banks' cautious behaviour with regard to current and future developments in the corporate sector. At the same time, the majority of banks have not given any indication that credit standards will be eased in the months ahead.

A key factor affecting the willingness of banks to provide loans is the interest spread<sup>8</sup> on different types of loan. From this viewpoint, the situation for large firms is somewhat different from that for the rest of the corporate sector. Interest spreads on loans to large firms have changed only slightly in 2014 and remain at

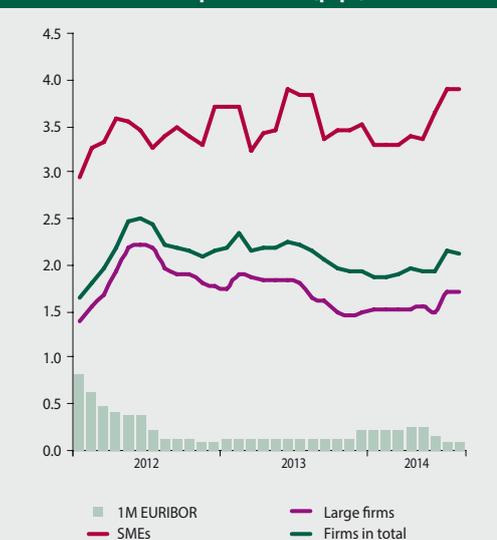
**Chart 14** Increases in loans and borrowing capacity broken down by age group



Source: SO SR.

Note: Borrowing capacity is the product of the number of income-earners and their total gross salaries.

**Chart 15** Interest spread on new loans to non-financial corporations (p.p.)



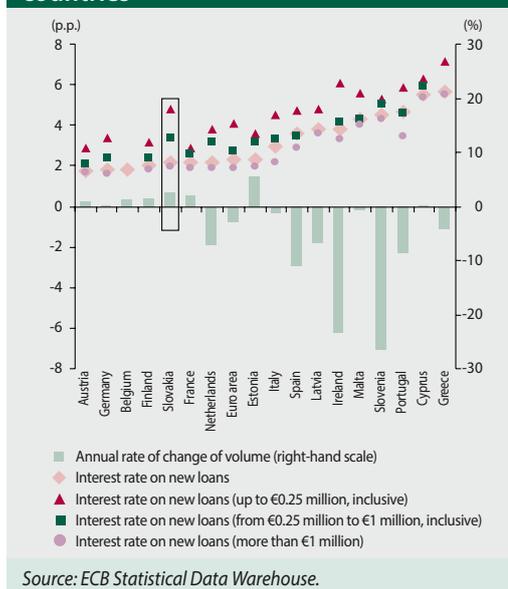
Source: NBS.

- 6 The product of the number of income-earners and their total gross salaries.
- 7 Information obtained from the regular Banking Lending Survey.
- 8 The interest spread is defined as the difference between interest rates for the respective categories of enterprises and the one-month EURIBOR.

the low levels recorded in the previous year. The current low interest spreads could result in loans being provided at marginal profitability and they may insufficiently cover the potential risks associated with lending to these firms. On the other hand, these spreads are creating favourable conditions for the financing of large firms. For small and medium-sized enterprises (SMEs), interest spreads are more than twice as high as those for large firms. This may be caused by weaker competition as well as by the greater risk involved in lending to these firms. The falling share of corporate loans in banks' balance sheets is probably a consequence of this complicated situation in the corporate sector. Banks are therefore focusing more on lending to households, which appears to carry less risk and be less vulnerable to macroeconomic headwinds, and which is currently far more profitable, notwithstanding the falling pace of growth in profitability of the household sector.

**Interest rates on new loans are among the lowest in the euro area, while lending activity was the second highest during the period under review.** Corporate lending rates are lower in Slovakia than in most other countries. Their average level as at August 2014 was 2.15%, while the average level in the euro area was 2.3%. Thus corporate rates in Slovakia are drawing closer to levels observed in the country's main trading partners. This is only the case, however, for interest rates on loans exceeding €1 million, which are typically provided to large firms. Such loans constitute a major share of the total stock of loans and hence have a marked effect on the overall average rate for the corporate sector, even though their share in the total number of loans is insignificant. By contrast, the average interest rate on other corporate loans exceeds the euro area average. That these loans consist mainly of credit to SMEs confirms the tougher borrowing conditions faced by such firms. Such loans make up a significant share of the total number of all loans. Among euro area countries, Slovakia reports the largest spread between interest rates on small loans (up to €250,000) and large loans (more than €1 million). On the positive side, lower interest rates are not creating an environment that could stimulate growth in

**Chart 16 Interest rates and the annual rate of change in loans (%) in the EU countries**



firms' utilisation of foreign funding, which is already increasing moderately. The rate of lending growth in Slovakia (Chart 16) was higher than in any other euro area country apart from Estonia (4.5%), while the average rate in the euro area as a whole was negative. The situation across euro area countries was relatively heterogeneous, as the annual growth rate of loans was slightly positive in most core countries but fell significantly in other euro area countries. Similar divergence was observed in non-euro area EU Member States, ranging from significant lending growth in Poland (6.2%) to modest growth in Hungary and the Czech Republic.

**The slight pick-up in credit demand was accompanied by an increase in the amount of corporate loans.** According to the Bank Lending Survey, signs of increasing credit demand were particularly evident in the second quarter of 2014. Several banks reported rising demand for all types of loan, but the largest increase was in demand from large firms. The recovery in demand is, however, contingent on further economic developments in Europe, particularly in Slovakia's main trading partners. The impact of adverse economic and geopolitical trends was reflected in Slovak firms' sales and exports, for

which the annual rates of change as at August 2014 were, respectively, 0% and -2%. A number of banks do not expect further improvement in credit demand.

Despite an uncertain economic situation, the annual growth rate of total loans to enterprises reached 2.5%, its highest level since April 2012. The annual rate of change in loans to large firms also improved, thus ending a prolonged downward trend. The increase in lending to large firms and in loan demand from them may to a large extent be related to the above-mentioned easing of credit conditions for such firms. Growth in loans to SMEs remains in positive territory, at around the average level for 2014.

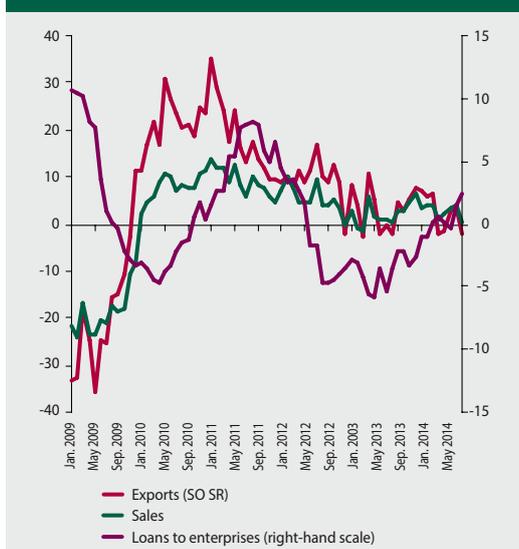
**Growth in lending to non-financial corporations was mostly accounted for by loans to state-owned enterprises. At the same time, though, lending to private enterprises also improved.** As the annual rate of change in corporate loans became less negative during the first half of 2014 and then turned positive in August, the main driver of this trend was lending to state-owned enterprises, which had begun to pick up in the last quarter of 2013 and

recorded annual average growth of 34% during the first eight months of 2014. The situation in this regard developed in a similar way across the banking sector, with most banks reporting relatively strong annual growth in loans to such firms.

The downward trend in lending to the private sector became less negative during the period under review, and the annual rate of decrease in August (-2%) was more moderate than that in any previous month of 2013 and 2014. It was a different situation in loans to foreign-owned firms, as their annual rate of change fell into negative territory for the first time in almost a year. Lending activity with regard to these two types of firm remained unclear, as it was relatively heterogeneous across banks.

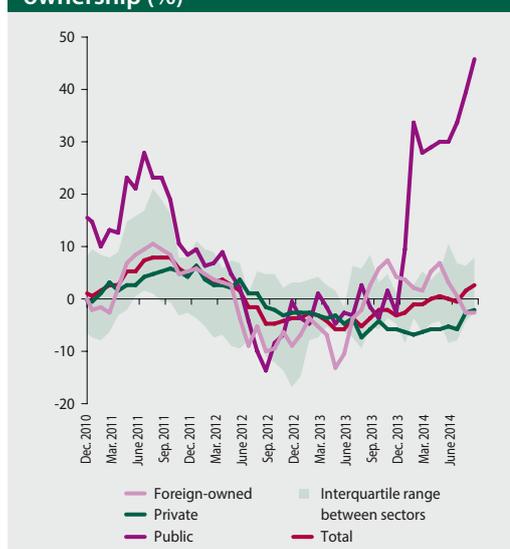
Looking at lending from the view of economic sectors, the most marked loan growth was in energy supply and in transportation and storage. It is likely that loans to large state-owned enterprises in these sectors accounted for the sizeable increase in total loans to large firms. Trends in lending activity to the sectors of industry, construction and real estate activities were unfavourable.

**Chart 17 Annual rates of change in exports, sales and loans to enterprises (%)**



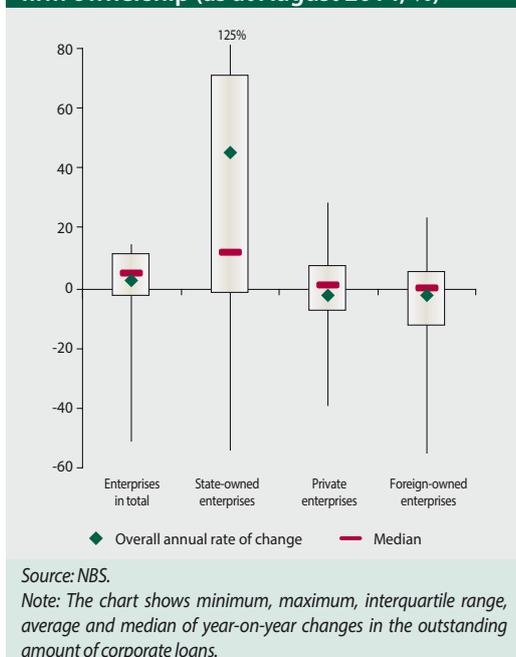
Source: NBS, SO SR.

**Chart 18 Annual rate of change in corporate loans broken down by type of firm ownership (%)**



Source: NBS.

**Chart 19 Distribution of annual rates of change in corporate loans across the banking sector, broken down by type of firm ownership (as at August 2014; %)**



#### PORTFOLIO OF DEBT SECURITIES

**The banking sector's portfolio of debt securities underwent only marginal changes between the beginning of 2014 and the end of August.** Holdings of domestic government bonds remained the predominant asset in the overall portfolio and their share barely changed during the period under review. As the banking sector's total assets increased moderately and the amount of its bond investments remained virtually unchanged, the share of Slovak sovereign debt in the total assets maintained the slight downward trend that began in June 2013. Despite that drop, this share as at the end of August remained the second highest in the EU, at 17.3%, after Romania (18.2%) and ahead of the Czech Republic (14.0%) in third place. Potential risks from this high share remain significantly contained, however, by the large share (more than 65%) of domestic government bond in the held-to-maturity (HTM) portfolio.

**Although the composition of the debt securities portfolio did not change markedly at the sectoral level, there were some quite**

**significant changes in the portfolios of individual banks.** While some banks continued to reduce their holdings of Slovak government debt, other banks increased their holdings. The amount of Slovak government bonds remained broadly flat, while the overall amount of banks' holdings of foreign debt securities decreased during the period under review. This fall reflected mainly a reduction of investments in Hungarian bonds and Treasury bills. At the aggregate level, it was offset by increased holdings of bonds issued by domestic firms and domestic banks.

### 3.3 FUNDING SOURCES OF THE BANKING SECTOR

**The annual growth rate in retail deposits increased moderately from the end of the first quarter of 2014, reaching 3.6% as at the end of August.** Until the end of the first half of 2014, the growth rate for sight deposits was increasing and the rate of change in time deposits was becoming more negative, but July and August saw both of these trends moderate. The changes in these trends have been only slight so far, and it will be important to monitor their development in the period ahead since the prolonged period of low interest rates is not conducive to any significant pick-up in demand for time deposits.

**Deposits from non-financial corporations increased during the first eight months of 2014, continuing their upward trend from the second half of 2013.** Both time and sight deposits increased, albeit with some volatility. This trend is assumed to reflect a moderate improvement in the liquidity situation of the corporate sector, which is based on, among other things, relatively favourable sales figures.

**Securities issued by banks during the period under review again comprised mainly bonds, almost all of which were mortgage bonds.** From January to August, banks issued mortgage bonds with a total nominal value of €550 million and with no significant changes in the issue terms and conditions. Except for three issues linked to the three-month and six-month EURIBOR, all the bond issues had fixed coupons, which varied mostly in line with the yields of government

bonds of the same maturity. Consequently, the average spread remained largely unchanged.

**Interbank operations ranked among the more volatile instruments in banks' balance sheets during the period under review, being used mainly for the liquidity management.**

A key trend during the first half of the year was the slight decrease in the overall amount of domestic interbank transactions reported as at the end of each month (caused partly by the transformation of one subsidiary into a branch of a foreign bank) and the increase in the amount of funds that banks deposited with the ECB. The increase in deposits with the ECB far outweighed the fall in the volume of interbank transactions, and it was not therefore simply a parallel shift of funds from domestic banks to the ECB. June saw a moderate increase in interbank operations and a significant drop in funds deposited with the ECB, the likely cause of which was the reduction in the ECB's key interest rates on 11 June to an all-time low (the rates were then cut again on 10 September).

### 3.4 FINANCIAL SECTOR RISKS

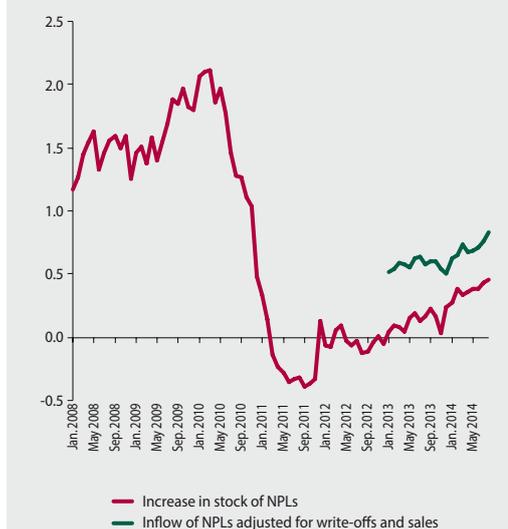
#### CREDIT RISK ON LOANS TO HOUSEHOLDS

**Although the non-performing loan (NPL) ratio remained stable at 4.2% during the first eight months of 2014, the stock of NPLs followed an increasing trend.** The past three years have seen both an overall increase in the stock of loans (i.e. the denominator of the NPL ratio), and a rising growth rate in the stock of non-performing loans (i.e. the numerator). This trend is reported by most of the banks with larger market share.

The default rate<sup>9</sup> also increased. The growth in the stock of NPLs is in some measure a natural consequence of the higher volume of lending, but it must be viewed in the context of the appropriateness of credit standards.

As Chart 20 shows, the default rate may be rising, but its growth rate is far lower than it was during the crisis years of 2008-2010. Interest rates are at all-time lows and the unemployment rate has not recorded any significant adverse shocks. The increase in NPLs probably stems from certain imbalances which in the recent period have

**Chart 20 Default rate for loans to households (%)**



Source: NBS.

Notes: The default rate is calculated as a ratio in which the numerator is the increase in the stock of NPLs (or the flow of NPLs) over a 12-month period and the denominator is the stock of NPLs at the beginning of this period. The increase in the stock is not adjusted for claim write-offs and sales, while the flow indicator is adjusted.

been reflected in growth in loans to households. A majority of these imbalances are to a large extent related to the moderate easing of credit standards.

**Národná banka Slovenska has repeatedly drawn attention to the excessive provision of loans with high loan-to-value (LTV) ratios.**

This trend is largely induced by the pressure of inter-bank competition and may not necessarily be consistent with prudential risk management. In the event of adverse developments, it could result in a build-up of foreclosure losses as well as additional debt burdens on customers.

In the second quarter of 2014, fully 28% of new loans (excluding loans for refinancing) had an LTV ratio greater than 90%, and of them, two thirds had a ratio of over 99%.

It is also apparent that banks differ quite considerably in their approach to property valuation. Moreover, they make relatively significant revisions to external appraisals. During the first half of 2014, banks in total revised one-third of the appraisals produced by registered appraisers,

<sup>9</sup> The default rate is calculated as the change in the stock of non-performing loans over a 12-month period divided by the stock of non-performing loans at the beginning of this period.



while the proportion of such revisions in individual banks ranged from 7% to 55%. In consequence, the calculation of LTV ratios is not uniform across banks.

**A majority of banks do not evaluate the impact of an increase in interest rates on borrowers' repayment ability.** In the environment of low interest rates, loans are becoming increasingly affordable. On the other hand, the repayment ability of borrowers may be significantly reduced by future increases in interest rates. The failure to distinguish between borrowers who would, and who would not, be able to repay their loans under higher interest rates is therefore making housing loan portfolios more sensitive to any such change.

To some extent the market is seeing banks apply lower LTV ratios as a substitute for income verification. Thus they are relying less on due repayment and more on the enforcement of collateral. In addition there is the increasing practice of accepting a declaration of honour about income instead of verifying the borrower's income.

**Another current risk is excessive interlinkages between banks and financial intermediaries.** The task of intermediaries should be to simplify customers' access to financial products, to increase competition, and to help banks with higher quality products to acquire market share. Under the current system of remuneration, however, intermediaries are incentivised to sell as many products as possible, to focus on maximising commission income, and to utilise short fixation periods and frequent loan refinancing.

The key risk associated with the activities of financial intermediaries is pressure to ease credit standards. If external agents gained excessive leverage in the market, they could unduly negotiate with banks on the easing of credit standards; those banks dependent on the activities of such intermediaries would be forced to accede to their demands. Under their system of remuneration as it stands, intermediaries would not be significantly affected by the consequences of any underestimation of risk, with no pressure put on them to behave prudently.

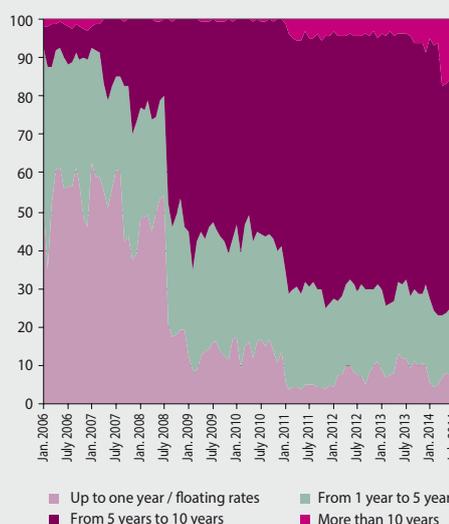
**The elevated demand for loan refinancing is accentuating several of the risks mentioned**

**above**, including the increase in LTV ratios, the lack of verification of borrowers' repayment ability, and the utilisation of financial intermediary services.

A risk specific to refinancing is the practice of examining a borrower's repayment record as a substitute for verifying their income. While this may sometimes be more meaningful than confirmation of income, it may not be sufficient in cases where the amount borrowed is increased or the loan maturity period is extended to the maximum acceptable limit. Banks are then left without information about the borrower's ability to cope with any future increase in instalments.

Where refinancing involves increasing the loan, it heightens the risk of debt becoming more concentrated. As mentioned in the previous Financial Stability Report, household debt in Slovakia is relatively low by European standards, but it is growing. Where refinancing increases the principal borrowed, it adds to the debt burden of already indebted households. Given the current low interest rates, the total nominal debt of such households may even rise above the amount originally borrowed. Debt concentration increases banks' sensitivity to a rise in unemployment or other adverse development in the market.

**Chart 21 Distribution of consumer loans broken down by initial rate fixation period (%)**



Source: NBS.

Note: The jumps are caused by revisions in the reporting of selected banks.

A key point about refinancing is that it is a relatively significant trend, with more than one-third of new housing loans used for this purpose. Refinancing is offered in particular by medium-sized and smaller banks as a way of attracting new customers.

**Banks are increasingly providing loans with an unduly long maturity and loans with deferred payment.** The recent period has seen a rising trend in the provision of loans with a longer maturity, the purpose of which is to make loans more affordable. This trend has been more marked and widespread among consumer loans.

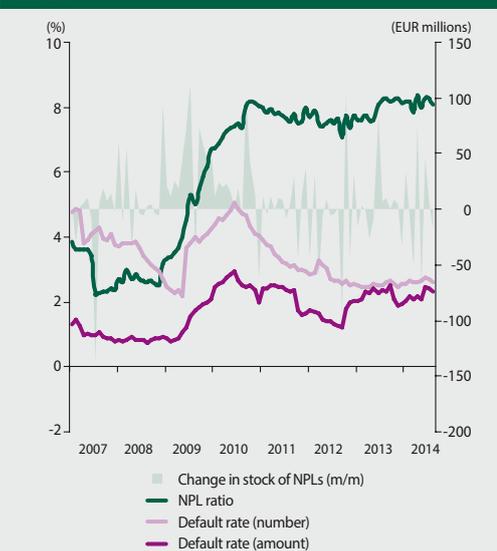
It is important that loans include some leeway for extending the maturity, particularly where borrowers are unable to meet repayments. In such cases, banks will in the main ease the debt burden by prolonging the maturity. The provision of loans with unduly long maturities increases the interest-rate sensitivity of loans, especially during crisis periods.

#### CORPORATE CREDIT RISK

**Credit risk in corporate business did not change significantly in the period under review, but the situation was heterogeneous across economic sectors.** The overall quality of loans to non-financial corporations was largely unchanged, with the NPL ratio edging down to 8.1% in August 2014. This reflected mainly an increase in the amount of loans, since the stock of non-performing loans remained flat. As for lending across economic sectors, loan quality remained heterogeneous. The differences in quality between loan portfolios for different economic sectors became slightly more marked during the first eight months of 2014, as NPL ratios rose moderately in the portfolios for construction, industry, and real estate activities – all sectors in which the stock of loans fell. The energy supply sector, too, saw an increase in non-performing loans, despite a substantial increase in the stock of loans to this sector. Credit quality trends in particular sectors of business may indirectly affect the supply side of the lending market, whether the availability of loans (through the tightening of credit standards) or borrowing costs (through increases in risk premia).

**The overall situation in commercial real estate (CRE) loans did not improve during the**

**Chart 22 Non-performing loans and default rates**

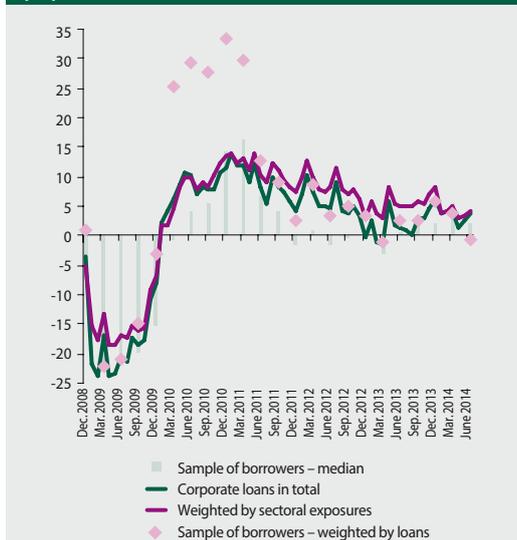


Source: NBS.

Note: Default rates denote the ratio between, on the one hand, the number/amount of loans reclassified from "performing" to "non-performing" during a 12-month period and, on the other hand, the number/amount of loans classified as "performing" at the beginning of the period.

**first eight months of 2014.** CRE loans constitute the largest part of both total loans to enterprises (20.6%) and the total amount of non-performing corporate loans (28.2%). Hence CRE loans are a significant source of credit risk in the event of falling demand for particular property development projects. Banks' exposure to CRE sector has not, however, changed significantly since the beginning of 2010. During the period under review, the situation in the residential segment improved slightly, since a rising number of apartments were sold and this could support the repayment of liabilities related to the funding of development projects. The share of residential projects reporting sales of apartment units also increased. Furthermore, the profitability of some projects may be boosted by the moderate rise in prices of new apartments. As it seems, returns on projects in the office segment have not improved, most probably owing to developments in vacancy rates and office rents. The vacancy rate fell slightly in the last quarter, although it remained unchanged year-on-year (at 13.5%). Office rents fell in central Bratislava, which was reflected in a drop in vacancy rates in that area.

**Chart 23 Annual rate of change of revenues in the whole corporate portfolio and in banks' corporate credit portfolio (%)**



Source: NBS.

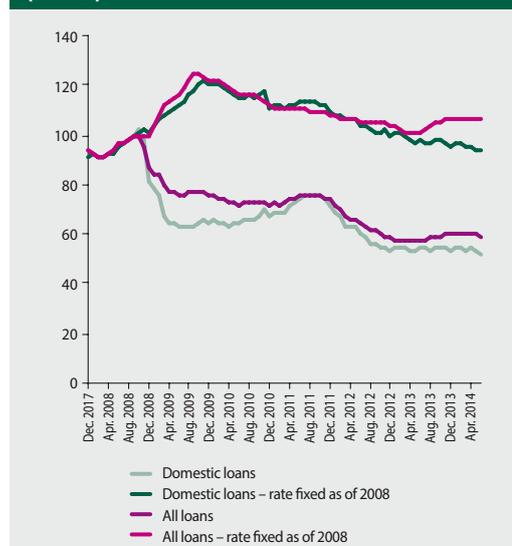
Notes: Revenues in banks' corporate credit portfolio are defined as overall revenues in the corporate sector weighted by banks' exposure to different economic sectors. The sample of borrowers comprises those firms about which the SO SR regularly collects data.

paid to risks related to the sustainability of debt service burden in different sectors, with particular regard to the possibility of interest rates rising in future. The debt service burden for firms<sup>10</sup> reached a peak in the last quarter of 2008 and then fell relatively sharply in 2009. This drop stemmed from the rapid reduction in interest rates, which offset the slump in revenues occurring at that time. Thereafter, the debt service burden for firms fell more moderately. This burden eased mainly as a result of the post-crisis recovery of revenues and relatively uneven developments in the amount of loans. The past twelve months have seen the debt service burden increase slightly, owing to a higher flow of loans from abroad. Interest rate movements resulted in marked fluctuations in the debt service burden, and that is why the principal risk related to the debt burden is considered to be a future increase in interest rates, possibly associated with stronger growth in lending to this sector. If interest rates rose to their end-2008 level, i.e. by more than 2.5 percentage points, the debt service burden for firms would be slightly higher than it was in the pre-crisis period.

**The financial results of firms that borrow from Slovak banks are better than the average results for all firms in Slovakia.** A potential risk for the banking sector could be that certain banks are not sufficiently able to assess the credit risk of firms applying for loans. This could be a problem if, over the longer term, firms borrowing from Slovak banks reported worse results than the overall average for firms in Slovakia. What the following chart shows, however, is that these borrowers recorded a lower fall in revenues in 2009 and that they coped better than the corporate sector as a whole with the adverse economic situation in the subsequent period. It follows from this that banks are lending to firms that appear to be less sensitive to economic developments, which may mitigate losses on non-performing loans in the event of significant shocks in the corporate sector.

**The debt service burden for firms did not change significantly during the first eight months of 2014.** In the current environment of low interest rates, increasing attention is being

**Chart 24 Debt service burden for firms (index)**



Source: NBS.

Note: The chart compares the debt service burden for firms at current interest rates and at rates fixed as of September 2008. The information is shown for loans provided by domestic banks and for all loans, including foreign loans. Index: September 2008 = 100.

<sup>10</sup> The debt service burden is defined as the ratio of annual loan interest payments to annual revenues.

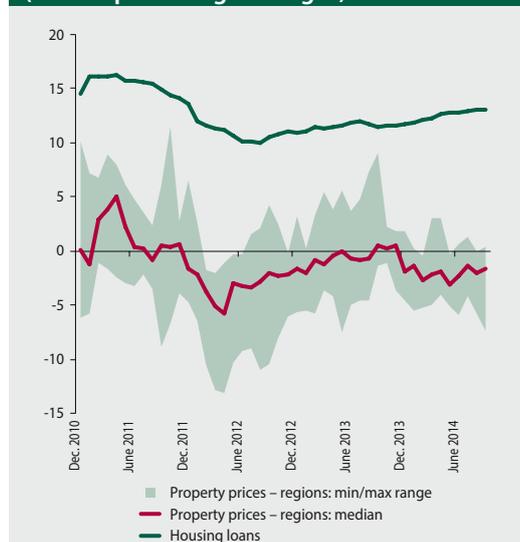
### PROPERTY MARKET

**The property market was stable during the first eight months of 2014, without any new trends or significant risks.** The residential property market did not experience any marked changes during the period under review. Average prices had a slight downward tendency, although price movements varied between regions and regional towns.

Differences in average price movements between regions and regional towns were relatively small. These differences do not yet reveal any trend, correlating neither with employment nor income levels in the regions. Other key indicators of the property market also remained largely unchanged across regions; these included the number of private property adverts, the average size of apartments for sale and purchased, and the average price of apartments purchased. The trend of property prices in large towns rising relative to prices in rural areas came to a halt in 2014, and a similar development was observed in several European countries.

Another important indicator is the difference between average prices in the primary and secondary residential property markets in Bratislava. From 2009 to 2013 this difference narrowed to below 20%, but in 2014 it stopped declining and

**Chart 25 Average residential property prices and the stock of housing loans (annual percentage changes)**



Source: NBS, CMN.

**Chart 26 Property price indexes – comparison of prices in selected segments**



Source: Lexxus, CMN.

Note: The “difference between regional town and rest of region” is calculated as the ratio of, on the one hand, the difference between the average price in regional towns and average price in other parts of regions to, on the other hand, the overall average price.

even increased at one point, owing to a slight rise in average prices of new properties.

A lack of clear trends in residential property market developments was not unusual in the EU and was also observed in some neighbouring countries. What remains specific to Slovakia, however, is the combination of strong growth in housing loans and stability in the residential property market (Chart 26).

### INSURERS FACE RISK STEMMING FROM LOW INTEREST RATES

**The period of low interest rates is continuing to put downward pressure on returns in the financial sector.** In its publications, Národná banka Slovenska has repeatedly noted the attendant effect of accommodative monetary and particularly low investment returns. In several financial market segments there are falling interest rates on assets and, similarly, on liabilities, but in traditional life insurance this is only partly the case. Even though the technical interest rate has fallen gradually, now down to 1.9%, it is becoming increasingly difficult for insurers to deliver the returns guaranteed under insurance contracts entered into in past years. Nevertheless, returns on assets covering technical provisions have so far remained above the average guaranteed interest rate in life insurance contracts.

On the positive side, almost one-third (29%) of the bond portfolio was purchased in the low interest rate environment after the first quarter of 2012. Approximately 10% of the current portfolio will mature over the next two years.

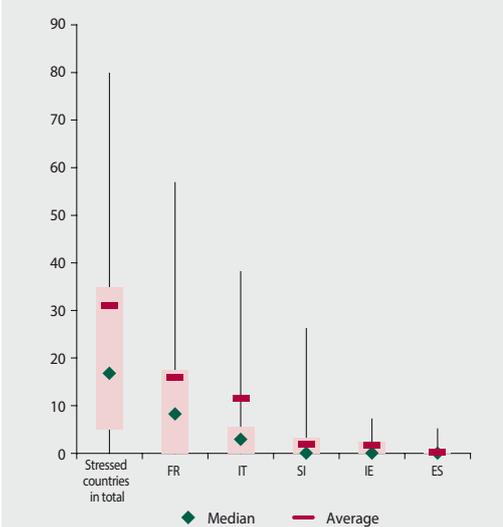
### CONCENTRATION OF EXPOSURES IN THE INSURANCE SECTOR<sup>11</sup>

**Despite some concentration of exposures, the investment strategy of insurance companies can be described as conservative.** As much as 78% of the securities portfolio consists of bonds, with state bonds alone accounting for 43%, far ahead of the next largest component, bond exposures to foreign bank groups (7%).

For most insurance companies, investments in Slovak government bonds are among their three highest exposures, and for several of them, intra-group exposures also rank in the first three.

Exposures to stressed countries<sup>12</sup> are the largest group of exposures in the selected insurance companies, as they amount to 80% of the firms' own funds. The largest exposure of any one insurer to a particular stressed euro area country was an exposure to France that totals 57% of the company's own funds. In second and third place were exposures to Italy (38%) and Slovenia (26%). Exposures to Ireland and Spain are insignificant

**Chart 28 Exposures to stressed euro area countries by share of equity (%)**

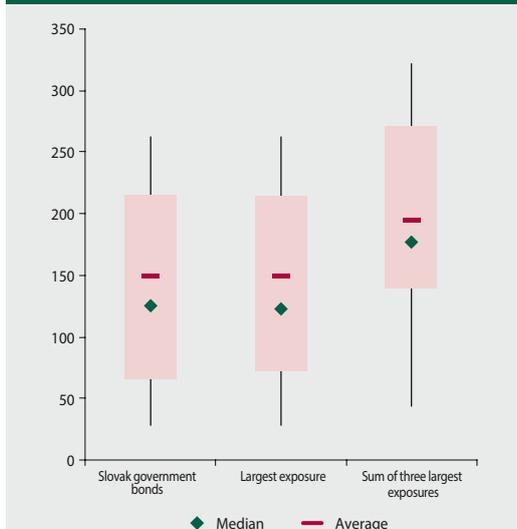


Source: NBS.

Notes: The chart shows the minimum, maximum, interquartile range, average and median of this value in the insurance sector. It does not include exposures covering technical provisions under unit-linked policies. "Stressed countries in total" represents the sum of the other five exposures.

and there are no exposures to Portugal and Greece. While some insurers have diversified their exposures to these countries, many others have concentrated them on one or two counterparties in the countries.

**Chart 27 Selected exposures of insurance companies by share of equity (%)**



Source: NBS.

Notes: The chart shows the minimum, maximum, interquartile range, median and average of this indicator in the insurance sector. It does not include exposures covering technical provisions under unit-linked policies.

### COMPETITION IN MOTOR INSURANCE

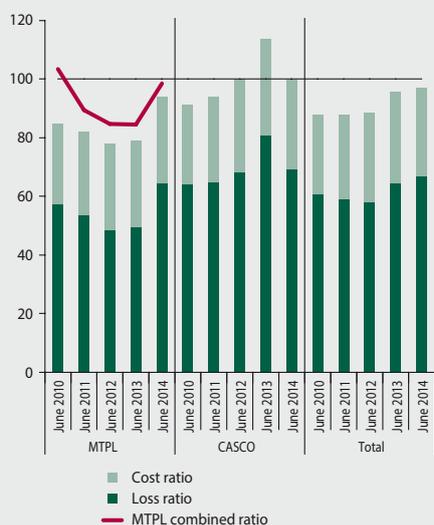
**Competition in motor insurance is leading insurance companies to cut income while costs remain unchanged.** As mentioned in previous Financial Stability Reports, premiums and premiums earned have been falling almost continuously in both motor third-party liability (MTPL) insurance, since 2005, and comprehensive motor vehicle (CASCO) insurance, since 2008. At the same time, the number of insurance contracts is rising. Consequently, since 2007, the average annual rate of change in the average premium is -8% in MTPL insurance and -6% in CASCO business. The average premiums in MTPL and CASCO insurance as at June 2014 were, respectively, €114 and €398.

This trend has pushed up the loss ratio and cost ratio in motor insurance, and the combined ratio exceeds 95% for a second successive year. The combined ratio in CASCO insurance fell in June, but this can be ascribed to an increase in sole reliance on MTPL insurance rather than to any real reduction.

<sup>11</sup> The exposure concentration analysis does not include assets covering technical provisions under unit-linked policies. Exposures are not to individual counterparties, but to groups of counterparties with close links, for example a parent undertaking and its subsidiaries.

<sup>12</sup> The stressed countries are considered to be France, Italy, Slovenia, Ireland, Spain, Portugal and Greece. The geographical concentration does not include equities and investment fund shares/units, which as at 30 June 2014 accounted for 3.2% of insurers' investments.

**Chart 29 Loss ratio, cost ratio and combined ratio in the insurance sector (%)**



Source: NBS.

Note: The MTPL combined ratio is calculated similarly as the combined ratio except that the technical cost of claims paid is increased by the contribution to the Slovak Insurers' Bureau (SIB) and change in provisions vis-à-vis the SIB and that the amount of premiums earned is reduced by transfers to Slovak Interior Ministry.

The rise in the combined ratio for the insurance sector may reflect, in addition to competition, developments in the car market. Not only, as

mentioned above, is the average premium decreasing, but claims paid are increasing. This fact may be related to domestic consumer behaviour. The index of motor vehicle prices in the consumer basket of Slovak households is showing a decline, which to some extent is reflected in the premium level. By contrast, the price index for spare parts and accessories remains flat. It should be noted, however, that these indexes have limited meaningfulness. In particular, the first of them is distorted by prices of used cars, which have little effect on the premium level.

**MARKET RISKS**

**Some financial market segments saw a slight increase in risk exposure during the period under review.** This was caused mainly by the persisting low-yield environment in less-risky assets. The increase in risk exposure was, however, far less pronounced when compared with the global trend in financial markets, where this development is seen as one of the most significant risks.<sup>13</sup>

**In the context of the Slovak financial market, the increase in risk exposure was most evident in the growth of the equity component.** This, as Chart 31 shows was most marked in funds of the second pension pillar (managed by PFMCs)

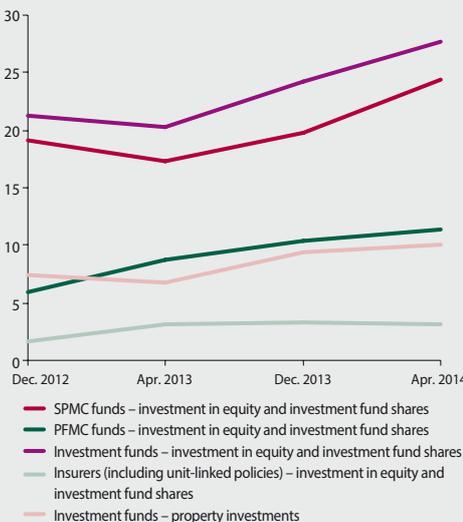
**Chart 30 Price indexes for motor vehicles and for spare parts and accessories**



Source: ECB Statistical Data Warehouse.

Notes: The data are based on the consumer basket used to calculate the inflation rate. The index of motor vehicle prices includes purchases of both, new and used vehicles, which distort its meaningfulness.

**Chart 31 Investments in equities, investment fund shares/units and property, broken down by sector (%)**



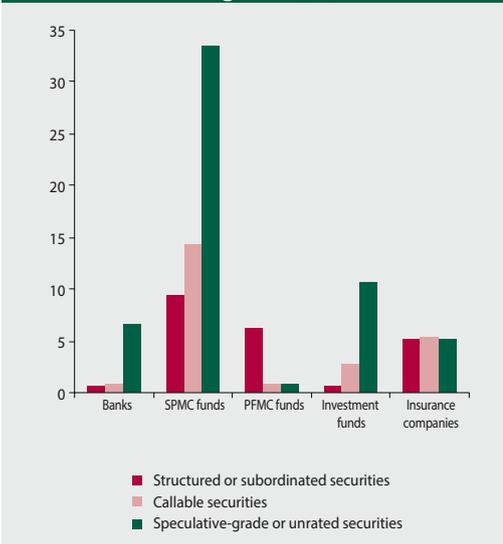
Source: NBS.

<sup>13</sup> A more detailed account of this risk from the global view is given in the section "External conditions for financial stability".

and in investment funds, the upward trend having started to be more pronounced in the second half of 2013. In some funds of the third pension pillar (managed by SPMCs), investments in investment fund shares/units were accompanied by increasing exposure to commodity price risk. The sensitivity of portfolios to interest rate risk had a rising trend in 2013, but this rise did not continue to any significant extent during the period under review. The collective investment sector also saw an increasing exposure to the property market, related mainly to rising customer demand for such investment.

**Certain funds saw an increase not only in their sensitivity to market risks, but also in their holdings of financial instruments with other risk characteristics.** These investments comprised mainly non-investment grade or unrated securities, structured or subordinated products, and callable securities. As Chart 32 shows, however, such financial instruments continue to account for a relatively low share in the portfolios of financial market segments. The segments with the largest exposure to these instruments are SPFC funds and investment funds (in particular, real estate funds and alternative investment

**Chart 33 Securities with risk characteristics as a share of the total assets of entities not owned by foreign groups, broken down by financial market segment (%)**

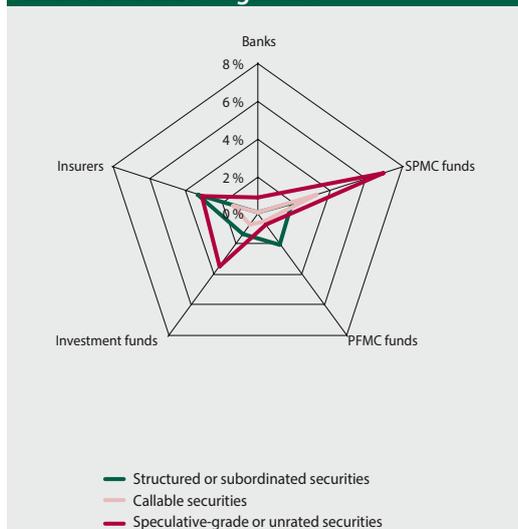


Source: NBS.

Notes: Data are as at 30 June 2014 with the exception of credit rating data, which are as at 17 October 2014.

The chart shows each type of instrument as a share of total assets.

**Chart 32 Securities with risk characteristics as a share of total assets, broken down by financial market segments**



Source: NBS.

Notes: Data are as at 30 June 2014 with the exception of credit rating data, which are as at 17 October 2014

The chart shows the shares of different types of asset in total assets.

funds). Index-linked securities are held in the portfolios of some insurance companies.

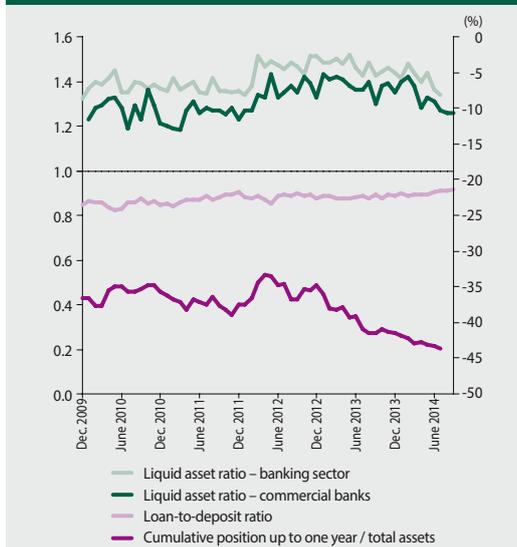
**The institutions and funds holding the highest share of instruments with risk characteristics are those not owned by foreign financial groups.** In their case, these instruments comprise mainly speculative-grade and unrated securities. In the case of unrated bonds, a number of them are issued by domestic firms and in certain cases these firms are linked to the company investing in the issue.

#### LICQUITY RISK IN THE BANKING SECTOR

A long-term structural feature of the Slovak banking sector is its ample liquidity. This is evident in the healthy loan-to-deposit ratio, the negligible extent of borrowing from the central bank, and the self-sufficiency of local banks in relation to their parent groups. Another strength is banks' funding structure, in which stable, primary deposits predominate. But although this traditional banking model (providing loans and taking deposits), contributes to a stable structure of deposits, it also results in widening of the maturity mismatch between assets and liabilities. Howev-



**Chart 34 Liquidity ratios in the banking sector**



Source: NBS.

er, housing loan growth is increasing the amount of long-term illiquid assets, while the growth in deposits (albeit a stable funding source) is making the banking sector increasingly sensitive to potential deposit runs in stress periods. That is why it is important for banks to have a cushion of liquid assets at their disposal. The minimum liquidity buffer is determined by the regulatory liquid asset ratio.

The effect of the mentioned trends during the first eight months of 2014 was to extend the asset and liability maturity mismatch to a historical high. This year has also, however, seen a new downward trend in the banking sector's liquid asset ratio, which relates not only to the other trends but also to the decrease in the share of government bonds in total assets. Although this ratio has come down, its conservative setting is the reason why the banking sector still has a comfortable liquidity buffer.



# REGULATORY AND LEGISLATIVE ENVIRONMENT



## 4 REGULATORY AND LEGISLATIVE ENVIRONMENT

### LAUNCH OF THE SINGLE SUPERVISORY MECHANISM

**The first pillar of the banking union, the Single Supervisory Mechanism (SSM), entered into operation in euro area countries on 4 November 2014.** Within the SSM, the ECB has assumed tasks in the area of microprudential supervision and some also in the area of macroprudential supervision. As regards macroprudential supervision, the ECB is authorised to comment on decisions of national competent authorities (NCAs) and, where necessary in its view, to adopt stricter macroprudential measures than those adopted at the national level. The main purpose of the SSM is to reduce the interlinkage between banks and sovereigns in order to increase confidence in the European banking sector. As an independent institution at the European level, the ECB is expected to conduct supervision from a European perspective. In so doing, the ECB is expected to strengthen the functioning of the Single Market across the EU.

**The ECB is authorised to exercise prudential supervision over “significant” credit institutions, i.e. institutions defined as such on the basis of criteria laid down in the relevant EU legislation. These at present number around 120 groups, representing approximately 1,200 significant supervised entities, whose assets constitute almost 85% of the total assets of euro area banks.** To ensure consistent conduct of supervision, the ECB will cooperate with NCAs through the exchange of information concerning credit institutions classified as “less significant”, numbering around 3,700 entities (the NCA in Slovakia is Národná banka Slovenska). The Slovak banks that will be subject to the ECB’s direct oversight are Slovenská sporiteľňa, Tatra banka and Všeobecná úverová banka, on the grounds that they are the three largest banks in Slovakia, and also Československá obchodná banka, ČSOB stavebná sporiteľňa and Sberbank Slovensko, owing to the classification of their parent groups as significant. Those Slovak banks which for SSM purposes are classified as less significant remain under NBS’s supervision. NBS is also responsible for those supervisory tasks relating to significant banks which were not assumed by the ECB (for example, oversight in regard to the provision of in-

vestment activities, payment services, anti-money laundering, and financial consumer protection).

In order to prevent conflicts of interest between the ECB’s powers in the areas of monetary policy and supervision, the ECB’s organisational structure has been adapted to the new conditions and competences. The responsibility for decisions on supervisory matters lies with the ECB’s Governing Council, and these decisions are drafted by the Supervisory Board.

**Along with the organisational changes in regard to supervisory tasks is a change in way supervision is directly exercised over individual credit institutions.** The direct supervision of a given institution or group will be conducted by Joint Supervisory Teams (JSTs), with each JST led by a coordinator at the ECB and comprising staff from both the ECB and from the relevant NCAs. Hence direct supervision is conducted not simply by national-level experts, but by mixed teams led and coordinated by the ECB. It may therefore be expected that while day-to-day supervision will continue to be conducted largely at the level of national competent authorities, decision-making and coordination will be transferred to the ECB level.

### DRAFT LAW ON RESOLUTION IN THE FINANCIAL MARKET

The Ministry of Finance of the Slovak Republic (MF SR) in cooperation with Národná banka Slovenska has produced a draft law on resolution in the financial market, which will enact the EU’s Bank Recovery and Resolution Directive (BRRD) and is due to enter into force on 1 January 2015.

The Slovak law will introduce a new framework for prevention and resolution in the financial market, with the primary objective being to implement an effective crisis management system, consisting of three stages.

**In the first stage, selected financial institutions will be required to draw up and update recovery plans, setting out the measures they would take to restore their financial position in the event of significant deterioration.** Among the information that must be included in



each recovery plan is the following: a summary of the key elements of the plan and a summary of overall recovery capacity; a range of capital and liquidity actions; a timeframe for executing the plan; identification of critical functions of the bank; the processes for determining the value and marketability of the bank's operations; measures to reduce risk; measures to restructure liabilities; and measures to conserve or restore the bank's own funds. In Slovakia, such plans will be subject to approval by NBS, with the exception of certain matters addressed therein which are regulated at the group-level.

**The second stage of the crisis management system – early intervention measures – is governed by the Banking Act, through an amendment that grants NBS additional powers vis-à-vis banks in which shortcomings are identified.**

Among its principal early intervention measures, the national resolution authority (in this case, NBS) is empowered: to require the implementation or updating of the recovery plan; to require the convening of a meeting of shareholders and to set the agenda for that meeting; to require one or more members of the management body to be replaced and/or changes to the institution's organisational structure; to require the drawing-up of a plan for negotiation on restructuring of debt with creditors; and to require changes to the institution's operational structures and/or business strategy.

**The third stage of the system, representing the central point of the draft law, is resolution, the objective of which is to ensure the continuity of the bank's critical functions and to avoid a significant adverse effect on financial stability in Slovakia.** The core resolution tools are the sale of business tool; the bridge institution tool; the asset separation tool; and the bail-in tool.

Resolution action constitutes interference with rights of shareholders; however, shareholders are guaranteed appropriate compensation by application of the principle that resolution action may commence only if the shareholders will receive better treatment thereunder than they would do under insolvency proceedings. For this purpose, a Resolution Council ("the Council") will ensure the valuation of the bank's assets before and after the resolution action, so as to determine whether and to what extent shareholders received better treatment under the resolution action than they

would have done under insolvency proceedings. If a comparison of valuations shows clearly that the shareholders concerned would have received better treatment under insolvency proceedings, the difference in value shall be paid to them from the national resolution fund (NRF). The NRF will be established as a special-purpose fund that will be managed by the Council; it will collect financial contributions from selected institutions for the purpose of resolution funding, and the amount of the contributions will be set for each bank according to their risk profile.

**In Slovakia, the national resolution authority will be the new Resolution Council.** The Council will have nine members, including four from the MF SR, four from NBS, and one from the Debt and Liquidity Management Agency (ARDAL). The key tasks for the Council in 2015 will be to set the level of contributions to the NRF and the minimum requirement for own funds and eligible liabilities (MREL) for selected institutions, and to draft resolution plans for selected institutions.

**Based on enabling clauses in the BRRD, the EBA and European Commission will adopt implementing regulations in the form of 23 implementing technical standards (ITSs) and 13 guidelines,** which will lay down more specific provisions concerning, for example, determination of the extent of MREL, resolution plans, valuations, the principle of proportionality, and the bail-in tool. Most of these implementing regulations are due to be published in mid-2015.

**THE SECOND HALF OF AUGUST 2014 SAW THE ENTRY INTO FORCE OF THE EU REGULATION ESTABLISHING UNIFORM RULES AND A UNIFORM PROCEDURE FOR THE RESOLUTION OF CREDIT INSTITUTIONS AND CERTAIN INVESTMENT FIRMS IN THE FRAMEWORK OF A SINGLE RESOLUTION MECHANISM AND A SINGLE RESOLUTION FUND ("THE SRM REGULATION").**

The SRM will consist of the Single Resolution Board (SRB), which will be fully operational by the end of this year (until then, the European Commission is responsible for the establishment and initial operation of the SRB) and the Single Resolution Fund (SRF). The SRM participants will also include the national resolution funds of all the countries participating in the first pillar of the banking union. The SRB will begin exercising its powers, in the area of resolution planning, next year, and it will apply other resolution instruments including the bail-in tool from 2016. From



the perspective of organisational and personnel structure, its task will be fulfilled by 300 employees (gradually), chaired by an Executive Director. The most important decisions will be taken in the SRB's plenary session, composed of the Chair, four further members, and a member appointed by each participating Member State representing their national resolution authorities; there will also be two permanent observers, one representing the European Commission and one the ECB. The SRF will be filled from 2016, on the basis of an intergovernmental agreement, with contributions from selected institutions; these contributions will subsequently be allocated to different compartments corresponding to each Member State in which the contributing institutions are established and the SRF will be fully mutualised within eight years. The SRF will be used to fund resolution actions.

**AT THE SAME TIME, RULES ARE BEING ELABORATED FOR THE CALCULATION OF CONTRIBUTIONS TO NATIONAL RESOLUTION FUNDS AND TO THE SINGLE RESOLUTION FUND**

**In October 2014, the European Commission adopted a delegated act laying down detailed rules for the calculation of annual contributions of different financial institutions to national resolution funds (NRFs).** In accordance with the establishment of the Single Resolution Fund (SRF) as from 2016, discussions are now taking place about the final version of the implementing act under which countries participating in the SSM will transfer contributions to this fund. The NRFs of the participating countries will be replaced by the SRF from 2016.

Contributions to NRFs and the SRF are based on the same methodology set out in the delegated act. The difference is that in 2015 the target level, and therefore the amount of the annual contributions, will still be calculated separately for each country, while in 2016 it will be calculated jointly for all countries participating in the SRM. Similarly, the coefficient to be applied in setting the annual contribution will from 2016 be calculated for institutions not individually on a country-by-country basis but on the basis of all institutions participating in the SRF.

The total amount of annual contributions shall be set on the basis of both the target level (1% of covered deposits by the end of 2024) and the average amount of covered deposits of the relevant

financial institutions for the preceding calendar year. This amount of the annual contribution shall be divided between these financial institutions on the basis of a coefficient, calculated in two steps. First, a basic coefficient is determined according to the ratio of total liabilities less own funds and the given bank's covered deposits to the total liabilities (less own funds and covered deposits) of all institutions concerned.

This basic coefficient is then adjusted to take account of the given institution's risk profile, determined according to selected indicators. These indicators are divided into four risk pillars, as follows:

1. risk exposure – own funds and eligible liabilities held by the institution in excess of the MREL; leverage ratio; common equity Tier 1 capital ratio; ratio of the total risk exposure amount to total assets;
2. stability and variety of funding – net stable funding ratio (NSFR); liquidity coverage ratio;
3. importance of an institution to the stability of the financial system or economy – share of interbank loans and deposits in the EU;
4. additional risk indicators to be determined by the national resolution authority – this fourth pillar gives the national authorities discretion to determine additional risk indicators which could take into account in particular: trading activities and off-balance sheet exposures; membership of the bank in an Institutional Protection Scheme); and the extent of possible previous public financial support.

Based on these indicators, which carry different risk weights, a risk coefficient is determined (in the range 0.8 to 1.5) and applied to the basic coefficient. Therefore a bank in the highest risk bracket will pay 50% more than it would under the basic coefficient, and a bank treated as lowest risk would pay 20% less. An exception is made for small institutions, which are to pay lump-sum contributions in one of six amounts ranging from €1,000 to €50,000.

In several countries, the changeover from NRFs to the SRF as from 2016 is accompanied by marked fluctuations in the total amount of contributions that institutions are to pay (in the case of Slovakia and other countries, for example, the relatively high ratio of covered deposits to liabilities should mean, according to preliminary calculations, that contributions to the SRF will be lower



in 2016 than in 2015). Hence the ongoing discussions about transitional provisions in the implementing act, which would provide for a gradual transition from the calculation of contribution amounts on a country-by-country basis, to their calculation based on all the countries participating in the SRM, as well as for the addition of a group of small institutions that would pay part of the contributions on a lump-sum basis.

#### AMENDMENTS TO LEGISLATION ON CONSUMER CREDIT

The legislation governing consumer credit was amended in several key ways during 2014 in order to strengthen consumer protection. First, an amendment to the Civil Code, in force from 1 April 2014, defines usury, annulment of such agreements, and sets a maximum permissible rate of charge for consumer credit. This lending rate ceiling applies to all loans and credits provided to consumers by business entities, i.e. both banks and non-bank institutions. The Civil Code amendment also tightens execution provisions, restricts the scope for execution in respect of property collateral for low-value loans, imposes stricter conditions on extra-judicial courts for consumer credit providers, prohibits the provision of consumer credit in cash, and introduces a minimum font size for contractual documentation.

The definition of the rate of charge and its maximum permissible level was adopted in an amendment of 28 May 2014 to a Slovak Government Regulation. In addition to the methodology for calculating the rate of charge, this regulation stipulates that the maximum permissible rate of charge is two times the average annual percentage rate of charge for the respective quarter on similar credits or loans provided by banks and branches of foreign banks. The definitive provision on the maximum permissible rate of charge was laid down with effect from 11 August 2014 in a Regulation of the Ministry of Finance of the Slovak Republic, which is the basis for the publication of reference values for the calculation of the maximum permissible rate of charge.

At present in the legislative process there is also a further amendment to the Consumer Credit Act. This amendment, which is expected to enter into force on 1 January 2015, will, most importantly, make Národná banka Slovenska responsible for the supervision and authorisation of consumer credit providers. Non-bank consumer credit pro-

viders already operating in the market will also be required to apply for an authorisation to provide consumer credit (banks are not required to do so since their provision of consumer credit is governed by the Banking Act).

#### PUBLICATION OF THE DIRECTIVE AND REGULATION ON MARKETS IN FINANCIAL INSTRUMENTS (MiFIR AND MiFID 2)

In June 2014, the new Regulation on markets in financial instruments (MiFIR) and Directive on markets in financial instruments (MiFID 2), repealing and replacing the original MiFID, were published in the Official Journal of the European Union. The main objective of this new regulatory framework is to make markets in financial instruments more efficient, transparent and resilient. Member States have two years to enact the new rules, which will be applicable as from 1 January 2017.

The key changes are in the following areas:

- commodity derivatives – MiFID 2 provides for increased transparency in and oversight of commodity financial derivative markets;
- transparency – the current regime of pre and post trade transparency applies only to shares admitted to trading on a regulated market, while the new regime will apply also to other financial instruments for which there is a liquid market;
- high frequency trading – MiFID 2 introduces special provisions aimed at ensuring that high frequency trading does not adversely affect the quality and integrity of financial markets;
- market structure – new provisions on market structure should lead in particular to comprehensive regulation of fair, efficient and secure secondary trading;
- organisational requirements – MiFID 2 is designed to strengthen investor protection by introducing many rules concerning the organisation and management of investment firms and also to strengthen the role and responsibility of their management bodies;
- transaction reporting – the legislation should contribute to improvements in the clearing of financial instrument, with new transaction reporting rules designed to address shortcomings in the quality and availability of data, which under the MiFID regime were proved to be inadequate;
- conduct of business rules – MiFID 2 strengthens these rules by increasing the levels of protection provided to different categories of clients.



# MACROPRUDENTIAL POLICY



## 5 MACROPRUDENTIAL POLICY

### NBS DECISIONS IN THE AREA OF MACROPRUDENTIAL POLICY

**Under a Banking Act amendment in force from 1 August 2014, NBS has the power to set capital buffers and risk weights for selected exposures and to take other decisions on macroprudential policy instruments.** The purpose of such decisions is to help strengthen the financial resilience of the financial system and contain systemic risks, in order to protect the stability of the financial system as a whole. Some macroprudential policy instruments have been enacted in Slovak law with a shortened implementation period. This concerns mainly the capital conservation buffer<sup>14</sup> and the option, where necessary, to set a countercyclical capital buffer. On 7 October 2014, the Bank Board of Národná banka Slovenska approved two documents that will be looked at further in this section, namely:

- a) NBS Recommendation No 1/2014 of 7 October in the area of macroprudential policy on risks related to market developments in retail lending;
- b) NBS Decision No 12/2014 of 7 October on the setting of the countercyclical capital buffer. Under this Decision, the buffer rate was set at 0% with effect from 1 November 2014.

Further information about instruments adopted and planned, indicators, and the assessment of intermediate objectives in the macroprudential field is provided in the Quarterly Commentary on Macroprudential Policy – October 2014.<sup>15</sup>

### 5.1 RECOMMENDATION ON RISKS RELATED TO MARKET DEVELOPMENTS IN RETAIL LENDING

#### A BRIEF SUMMARY OF THE RECOMMENDATIONS AND THE MAIN REASONS FOR ISSUING THEM

The main objective of the individual recommendations set out in the Recommendation is to eliminate several potential risks and imbalances that, to a greater or lesser extent, have begun appearing in the retail credit market, and thus to support sustainable credit growth. Table

3 provides a brief summary of these risks and the recommendations adopted in response to them. It should be stressed that the aim of NBS is not to restrict growth in retail loans or their re-financing, notwithstanding that the growth rate of these loans in Slovakia is one of the highest in the EU.

**These recommendations are above all intended to have a preventive effect with regard to the risks.** For that reason, NBS issued them at a time when the risks have still not materialised to an extent that significantly affects banks and their customers. There are not as yet any substantial credit risk losses, increases in non-performing loans, property price bubbles, or deterioration in housing affordability. In addition, several of the banks providing retail loans have a capital adequacy ratio far higher than the minimum requirement, and they are therefore more resilient to potential risks. Nevertheless, the identified risks and imbalances are increasing the exposure of retail credit portfolios to potential adverse developments, and therefore it is necessary, in the view of NBS, to support the banking sector's resilience and to prevent the respective risks from negatively affecting banks' customers and the economy as a whole. To that end, NBS has issued recommendations concerning the conditions under which retail loans are to be provided.

**These risks are viewed by NBS to be more structural than cyclical in nature.** This is because the risks are related not primarily to a phase of the financial cycle,<sup>16</sup> but to the objective of implementing prudential lending principles in banks' processes and standards. Of these principles, the key ones are: to require that borrowers pay part of the purchase price for the property being financed; to verify that borrowers have sufficient income to meet their loan repayments (even in the event of a rise in interest rates); and to take a prudential approach to the provision of loans through external sales networks, including financial intermediaries. These principles are based on several current regulatory and legislative initiatives adopted at global and European levels, including the EU Directive

<sup>14</sup> For further details, see Section 3.1 "Solvency and financial position of the financial sector".

<sup>15</sup> The document is available on the NBS website at [http://www.nbs.sk/\\_img/Documents/\\_Dohlad/Makropolitika/Quarterly\\_commentary\\_2014\\_October\\_EN.pdf](http://www.nbs.sk/_img/Documents/_Dohlad/Makropolitika/Quarterly_commentary_2014_October_EN.pdf)

<sup>16</sup> For further details, see Section 5.2 "NBS Decision on the setting of capital buffer rate".



**Table 3 Recommendations on risks related to market developments in retail lending**

Risk	Reason for issuing the recommendation	Recommendation
Loans with 100% loan-to-value (LTV) ratios may result in property market imbalances and greater price volatility.	The financing of property purchases without requiring the borrower to contribute part of the amount creates greater scope for the build-up of housing bubbles. This in turn heightens the adverse impact of a decline in property prices on both banks and borrowers, which in the case of a non-performing loan reduces the foreclosure recovery rate for the bank.	Not more than 25% of loans provided should have an LTV ratio greater than 90%, and that share should fall to 10% from 2017. No loan should have an LTV ratio greater than 100%.
Credit demand is heavily affected by the environment of low interest rates; however, the ability of borrowers to continue meeting repayments in the event of an interest rate increase is largely not verified.	Banks should be responsible for assessing whether a borrower has sufficient income to meet loan repayments, including in the event of an interest rate increase. When assessing repayment ability, banks should not rely on the sale of collateral.	Banks' current credit standards should include a mandatory, internally-set, limit for the indicator of a borrower's repayment ability. Banks should verify whether the limit would still be met if the interest rate was raised by 2 percentage points, and they should periodically stress test the whole credit portfolio.
Several banks are not verifying the income of borrowers when allowing them to refinance older loans, not even when the new borrowing involves an increase in the outstanding principal.	The effect of refinancing that involves increasing the outstanding principal is to further concentrate debt among existing borrowers. If banks rely on past verification of repayment ability, they may underestimate the risk associated with borrowers taking on more debt.	Where refinancing of older loans involves a material increase in the outstanding principal, banks should verify compliance with the above-mentioned limits for LTV ratios and the indicator of a borrower's repayment ability.
Some banks, although so far only to a limited extent, have begun providing housing loans with a maturity of more than 30 years or loans with rising instalments. Maturities for consumer loans are also being substantially increased.	The provision of loans with an unduly long maturity and loans with deferred or rising instalments creates new systemic risks that have not so far been addressed in risk management systems and loan valuations.	No more than 10% of new housing loans should have a maturity of more than 30 years. For consumer loans, the maximum maturity should be reduced to eight years from 2016. Loans with deferred repayment should not be provided at all.
In their provision of new loans, several banks rely on financial intermediaries to a significant extent.	The focus of financial intermediaries is on the provision of loans; they are not exposed to any potential losses on the loans. If a bank provides a significant proportion of its loans through intermediaries, it may come under pressure from these intermediaries to ease its credit standards.	Banks should avoid being too dependent on financial intermediaries and maintaining an overly concentrated pool of intermediaries. Banks should separately monitor the risk characteristics of loans provided through financial intermediaries.

Source: NBS.

on credit agreements for consumers relating to residential immovable property,<sup>17</sup> which was reviewed in greater detail in the Financial Stability Report of November 2013. The main objective of the recommendations is to ensure that banks do

not ease credit standards in respect of the stated principles, nor underestimate risk as a result of competition pressure and efforts to gain ground in the credit market. Such developments have been observed in the recent period.

<sup>17</sup> Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 on credit agreements for consumer relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No 1093/2010.



**PRELIMINARY ANALYSIS OF THE IMPACT OF THE RECOMMENDATIONS**

**The most significant expected impact on the retail credit market is that concerning the assessment of borrowers' repayment ability.** This concerns in particular the call to verify borrowers' incomes in cases of loan refinancing that involve a material increase in the outstanding principal, albeit without any change in the amount of instalments. The second ranking recommendation in terms of impact is that advising against lending to customers who would be unable to repay the loan if interest rates were raised (even with the maturity prolonged to the maximum period). The result of these recommendations may be some cases in which customers are allowed to borrow only an amount that they would still be able to repay in the event of adverse economic developments. Thus the overall amount of new loans may fall, but the recommendations should also help ensure that the loans provided are sound and sustainable.

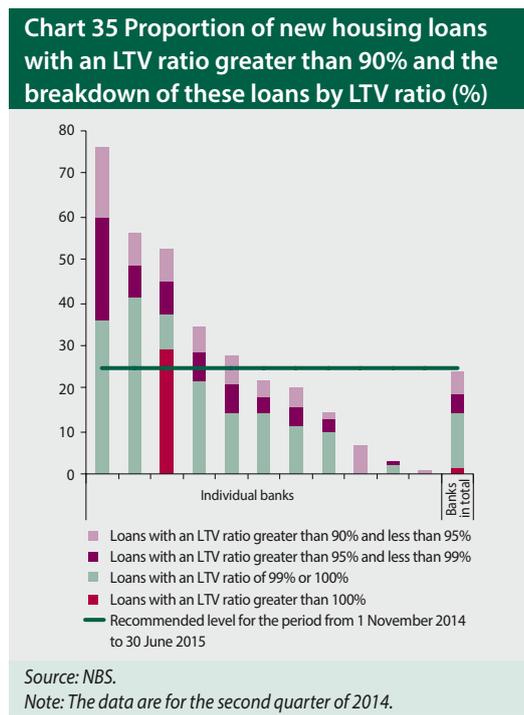
**The recommendation on the setting of LTV ratio limits is not expected to have a substantial impact from the view of the market as a whole.** It is recommended that initially, from 1 November 2014 to 30 June 2015, no more than 25% of new loans have an LTV ratio exceeding 90%; as Chart 35 shows, that limit is close to the

actual proportion recorded by the banking sector in the second quarter (24%).

Consequently, this recommendation should not, in its first phase, have a significant impact on the credit market as a whole and may be seen as a measure to maintain the current situation. The recommended limit for LTV ratios will become stricter only later. Nevertheless, the recommendation as it stands now will have repercussions for some individual banks – particularly small and medium-sized banks – that in the second quarter exceeded the recommended level.

**The other recommendations are aimed mainly at preventing the provision of loans under non-standard conditions** that could represent a future risk. These include mainly loans with an unduly long maturity period and loans with deferred repayment. Since such loans are currently more the exception, the recommendation is not expected to have an impact on the credit market.

**As for what impact these recommendations may have on the economy as a whole, NBS expects them in particular to mitigate additional adverse effects on retail credit arising from any future economic downturn.** Over the medium-term horizon, stricter LTV ratio limits are expected to create an environment that is less conducive to the levels of property price growth observed between 2006 and 2008. Implementation of the recommendations may also have a downward effect on overall household debt and on the growth in its concentration. Experience from EU periphery countries in recent years has shown that indebtedness is a key factor in households' vulnerability to economic and financial crises.



**IT IS IMPORTANT TO ASSESS THE EFFECTIVENESS OF MEASURES AND TO IDENTIFY ANY ADDITIONAL AREAS OF CONCERN**

**Along with the issuance of the recommendations, it remains necessary to monitor developments in the retail credit market and to consider whether additional measures need to be taken.** NBS will follow up the issuance of the recommendations by conducting a relatively thorough assessment of their implementation in banks, as well as an analysis of their effectiveness with regard to mitigation of the risks

and imbalances identified. NBS expects that all banks and branches of foreign banks will be in full compliance with the recommendations. If the recommendations are shown to be insufficiently effective, NBS will consider whether their implementation needs to be enforced through legislation.

**Regarding current developments in the retail credit market there are additional areas of concern** which are not addressed by the recommendations and which will require further discussion on possible legislative measures. It may be necessary, for example, to address overvaluing of properties by appraisers, to ensure that borrowers are clearly informed about the risks associated with potential increases in interest rates, and to amend legislation on financial intermediaries in order to bring commission schemes more in line with the extent of the risks attached to the loans provided through intermediaries.

## 5.2 NBS DECISION ON THE SETTING OF THE CAPITAL BUFFER RATE

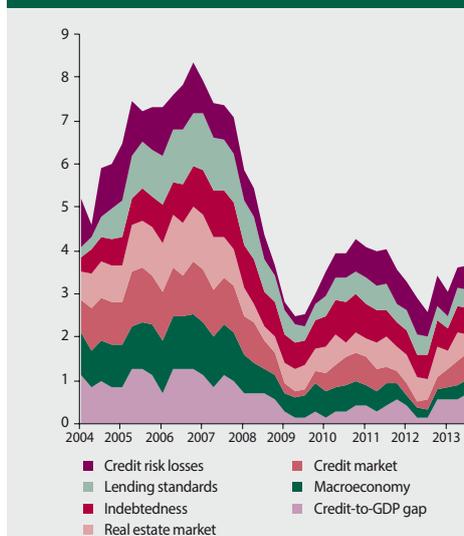
### NBS SET THE COUNTERCYCLICAL CAPITAL BUFFER RATE FOR THE FIRST TIME

On 7 October 2014, Národná banka Slovenska adopted a Decision by which it set the coun-

**tercyclical capital buffer rate at 0%.** The Decision was based on information available as at 30 June 2014 and entered into force on 1 November 2014. The rate was set at zero on the grounds that NBS had not identified any excessive growth in loans to enterprises and loans to households. As measured by the common EU methodology mandatory for all Member States, specifically the credit-to-GDP gap, the increase in private debt-to-GDP ratio was below its long-run trend, due to GDP development. Thus looking at the trends to date, the private debt-to-GDP ratio is not rising excessively. Similar conclusions can be drawn from the Cyclogram in Chart 36, which shows most of the principal indicators to be at a relatively low level. The only significant contrast to this picture is provided by developments in the household sector, in particular the growth rate of credit to households and consequent increase in household debt.

Although these conclusions based on data up to 30 June 2014 can be clearly interpreted with regard to the financial cycle, developments in the third quarter point to an acceleration of credit growth. This applies not only to the current rapidly-growing retail credit sector, but also to the corporate credit market, which is showing signs of picking up. At present, however, key macroeconomic data for the third quarter of 2014 are

Chart 36 Cyclogram



Source: NBS, SO SR, CMN.

Note: The vertical axis shows values corresponding to percentiles of the historical distribution of the respective indicator<sup>18</sup>.

Chart 37 Growth rate for bank loans to households and enterprises (%)



Source: NBS.

<sup>18</sup> The methodology is described in the following article: Rychtárik, Š, "Analytical background for the counter-cyclical capital buffer decisions in Slovakia", *Biatic*, Vol. 22, No 4, Národná banka Slovenska, Bratislava, 2014.



not available and therefore it is not possible to say whether credit growth for the period is excessive. A key component of corporate credit growth, however, is lending to state-owned firms, whose debt cannot be unambiguously in-

terpreted from the point of view of the countercyclical buffer. For the time being, it is assumed that the countercyclical capital buffer rate will not be increased on the basis of figures for the third quarter of 2014.

## Box 2

### QUARTERLY COMMENTARY ON MACROPRUDENTIAL POLICY

A new NBS publication entitled “Quarterly Commentary on Macroprudential Policy” (QCMP) was published on the NBS website in October 2014. The Bank Board of Národná banka Slovenska discussed the QCMP prior to its publication and on this basis adopted the Decision by which the countercyclical capital buffer rate was set at 0% and entered into force on 1 November 2014. The obligation of NBS to issue this Decision is laid down by a Banking Act amendment in force from 1 August 2014. This amendment inter alia implemented EU legislation concerning macroprudential policy. Rate-setting Decisions on the countercyclical capital buffer will be adopted by NBS on a quarterly basis, in January, April, July and October of the particular year. The next Decision will be published in January 2015.

The main purpose of the QCMP will be to provide regular information about potential systemic risks in the Slovak financial sector. It will also state the countercyclical capital buffer rate

set by NBS’s Bank Board (quarterly) and, after 2016, the buffer rate for other systemically important institutions (annually). In the event that systemic risk is building up, the QCMP will serve as the basis of Bank Board decisions to activate other macroprudential policy instruments in accordance with the Banking Act and the EU’s Capital Requirements Regulation (CRR).

The QCMP is structured according to five intermediate objectives as defined by the European Systemic Risk Board. The document is divided into three parts. The first part contains a brief analysis of the most significant developments related to systemic risk which occurred during the quarter under review. The second part focuses on decisions taken in the area of macroprudential policy, including decisions of both NBS and the ECB, if any. The third part, the annexes, includes tables of indicators used to monitor the intermediate objectives and reference materials for decisions on the countercyclical capital buffer rate.



## ABBREVIATIONS

BRRD	Bank Recovery and Resolution Directive (Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council)
CEE	central and Eastern European countries
CET1	common equity Tier 1
CMN	Cenová mapa nehnuteľností (Real Estate Price Map)
CRD IV	Directive 2013/36/EU of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC a 2006/49/EC
CRR	Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
ESA	European System of National and Regional Accounts
ESI	Economic Sentiment Indicator
ETF	exchange-traded Funds (funds traded on a stock exchange and usually linked to a financial market index)
EU	European Union
Fed	Federal Reserve System
GDP	gross domestic product
IMF	International Monetary Fund
IPS	Institutional Protection Scheme
JST	Joint Supervisory Team
LCR	Liquidity Coverage ratio
LTV	loan-to-value (ratio)
MiFID 2	Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU
MiFIR	Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012
MREL	minimum requirement for own funds and eligible liabilities
MTPL	motor third-party liability (insurance)
NBS	Národná banka Slovenska
NSFR	net stable funding ratio
PFMC	pension funds management company
ROA	return on assets
SME	small and medium-sized enterprise
SO SR	Statistical Office of the Slovak Republic
SPMC	supplementary pension management company
SR	Slovak Republic
SRF	Single Resolution Fund
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism





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