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Foreword

The financial sector is deemed to be stable when it is able to smoothly fulfil its core functions, even amid 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 NBS publishes a biannual Financial Stability Report (FSR), which primarily reports on 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.

Overview

Developments in the external environment in 2016 indicated the persistence of several risks in both the economy and financial sector

Euro area economic growth has been edging down from previous levels amid weakening of the global economy and several bouts of heightened volatility in financial markets. At the same time, euro area banking sector risks are increasingly becoming a focus of attention. In a prolonged environment of low interest rates and falling interest margins, concerns are rising about headwinds for banks' profitability. Furthermore, banking sectors in several countries face challenges related to their large stock of non-performing loans (NPLs) and to weak operational efficiency. The threat of a sudden price slump in financial or property markets remains a significant external risk, with some of these markets showing signs of overvaluation. Despite robust fiscal consolidation efforts, several countries remain saddled with high government debt, and therefore doubts about the sustainability of public finances could re-emerge. Risks related to the potential slowdown of economic growth in emerging market economies (EMEs) has moderated. In the medium term, however, the non-financial corporate sector may be adversely affected by growing debt accumulated in previous years and by falling commodity prices.

The domestic economy remains on a favourable path, although it may be seeing a build-up of systemic risks

The Slovak economy has remained on a stable growth path in 2016. As regards its composition, stable domestic demand has been joined by increasing foreign trade, which has offset a drop in public investment caused by the ending of the absorption of EU funds under the 2007-2013 programming period. The situation was mirrored by positive trends in the labour market, as well as by increasing corporate sales and higher profitability in most sectors. These trends are supporting financial stability in terms of their impact on the debt servicing capacity of both non-financial corporations (NFCs) and households. It should be noted, however, that in the context of persisting external risks and an environment of historically high employment and low loan default rates, risks to financial sector stability may build up in the future. The main concern in this regard is the gradually increasing sensitivity of households, NFCs, financial institutions and the property market to any adverse future developments related to rising indebtedness and potential underestimation of risk.

Retail lending has maintained strong growth, spurred by demand for loan refinancing

Looking at the stability of the Slovak financial sector, the most significant recent trend has been the continuing strong growth in retail loans. This trend has been supported by low interest rates and upturns in the labour and property markets, but even more so by the introduction of a statutory cap on housing loan early repayment fees. The result has been a doubling in the amount of loan refinancings (in which the principal is typically increased), as well as a downward jump in interest rates on new housing loans.

The upward trend in retail lending in recent years has led to rising growth in household debt. On current trends, by the end of 2016, Slovakia is expected to have the second highest household debt-to-disposable income in the central and eastern European region. Slovak households are thus becoming increasingly sensitive to any adverse scenarios. This sensitivity is being exacerbated by households' negative financial asset-to-debt ratios. The positive trends now supporting strong loan growth could, moreover, lead both banks and their customers to underestimate risk. Most households does not have experience of the risk of rising interest rates. At the same time, with unemployment at close to its all-time low, households may not fully realise the risk of income reduction in the event of rising unemployment. It is therefore important that lending is conducted in compliance with prudential standards.

The real estate market has continued to see price growth, for both new and existing flats. The number of flats available for sale has, however, been gradually falling. While the ratio between sales of new flats and the number of new flats available for sale has increased, the number of

existing flats available for sale has fallen sharply. The market is therefore becoming more sensitive to any shocks, whether it be an increased supply of new flats or a rise in demand for these flats.

Lending to NFCs has also maintained a relatively stable upward path

The favourable economic trends have been reflected in the stock of loans to non-financial corporations, with its average annual growth rate remaining at 6%, above the EU average. This lending growth has been broad-based across economic sectors and different banks. Like retail lending, the corporate loan book is increasingly exposed to any deterioration in economic conditions. But although corporate loan growth, together with NFCs' increasing external financing from other sources, is so far being matched by sales growth, sales can be volatile and firms' leverage is increasing.

The macroprudential authority response to credit market developments

The prolonged growth trend in lending to both households and NFCs was the reason that the NBS Bank Board, under a decision issued on 26 July 2016, set a non-zero countercyclical capital buffer (CCB) rate of 0.5% with effect from 1 August 2017. Current trends in economic and financial fundamentals do not indicate the need for any further increase of the CCB rate in the period ahead. NBS will nevertheless continue to closely monitor and assess credit market dynamics, with particular regard to the potential build-up and escalation of systemic risk.

An NBS decree expected to enter into force at the beginning of 2017 will implement principles concerning the provision of housing loans, set out in NBS Recommendation No 1/2014. This decree will enable the recalibration of certain parameters, and so create a secondary legislative framework for supervising whether housing loans are being provided in compliance with prudential rules.

Furthermore, a framework for enacting NBS recommendations in regard to consumer loans will be established as from 1 January 2017 by the entry into force of an amendment to the Consumer Credit Act (No 129/2010 Coll.).

The persisting low-interest rate environment is significantly increasing the sustainability risk of banks' business strategies

In the current low interest rate environment, the profitability of banks and insurers has been exposed to several headwinds, although final profits have increased due to exceptional one-off effects. In the banking sector, in particular, the compression of interest margins has been increasingly weighing on net interest income.

Assuming that current trends continue, a simulated scenario of the banking sector's profitability indicates that profits will fall in 2017. The main reason for that is a marked drop in interest income from housing loans, stemming from the introduction of a statutory cap on early repayment fees for these loans. The effect of that decline could be partly offset by interest income from consumer loans, although that too is being squeezed by increasing competition. Profitability can be expected to continue falling, albeit more moderately, in 2018 and 2019. These trends imply that the banking sector will become significantly more exposed to any additional headwinds. This exposure is more pronounced among smaller and medium-sized bank, whose profitability is already lower than that of large banks. It will therefore be of paramount importance that banks keep credit portfolio risk contained at a time when their business strategies are centred on credit growth. Such strategies are increasing the pressure to increase capital through retained earnings. Although the banking sector as a whole remains sufficiently solvent, its aggregate total capital ratio has in recent years gradually come to stand below the EU median owing to the sector's relatively high dividends-to-earnings ratio. In terms of the quality of their capital, Slovak banks are above the EU median.

This envisaged decline in profitability and increasing vulnerability to adverse shocks mean it is increasingly important to avoid further legislative measures in such matters as the pricing of financial products or the amount of levies and contributions. The fact that the bank levy is not to be reduced as originally planned will weigh on the banking sector's profitability.

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 regulatory measures and recommendations
Risks arising from the external environment	Low interest rates and the impact of accommodative monetary policies	Negative impact on the business model of banks and insurers; Increase in riskiness of pension fund portfolios; Decrease in interest rates (including long-term rates) with a gradual downward impact on profits over the longer term	For banks: Scope for further household loan growth limited by rising indebtedness, falling interest margins, and, in the case of retail housing loans, by a significant reduction of the cap on early repayment fees; Increasing competition may restrict scope for offsetting the decline in interest income from housing loans with income from consumer loans	Potential boost to banks' profitability from gradual pick-up in lending to the NFC sector	The Solvency II regime for the insurance sector entered into force on 1 January 2016 – expected to lead to a significant increase in the risk capital requirement, but not to a marked drop in the solvency margin; Insurers with a low solvency ratio expected to consider curbing dividend payments and to strengthen their solvency
		Formation of price bubbles in riskier assets; Increasing impact on financial markets in the case central banks unwind their operations	Simultaneous declines in short- and long-term interest rates and risk premia increase risk of a sudden and simultaneous fall in prices of riskier assets (manifested in 2015 and early 2016 in financial market turbulence)	Relatively low direct exposure of domestic financial institutions to these assets (at the same time, however, portfolio durations and the share of equities and other riskier assets in investment funds and pension funds are increasing significantly)	
	Macroeconomic developments in the domestic economy and the euro area	Increase in credit risk costs in the event of adverse macroeconomic developments	Slowdown in euro area economic growth and likely stagnation in the next period; Risks arising from emerging market economies, in particular from high corporate indebtedness in these countries	Relatively high solvency in the banking and insurance sectors; Downward impact of low interest rates on debt servicing costs; Historically low retail credit risk costs and falling corporate credit risk costs during 2016	The capital conservation buffer was implemented in full from 1 October 2014; Capital buffers will be phased in between 2016 and 2018 for systemically important banks due to their systemic importance; A non-zero countercyclical capital buffer rate of 0.5% is to be applied with effect from 1 August 2017, in response to growth in retail and corporate loans
		Higher sensitivity of banks to an adverse development in the property market in the event of worsening economic conditions	Rising property prices in all regions; Accelerating sales in the markets for both new and existing flats, and an increasing share of unfinished flats in total sales; Certain specific structural aspects of the Slovak property market – extremely high property-price volatility, low liquidity, the banking sector's relatively high concentration in this market, and the relatively high LTV ratios for new loans (increasing mainly for loans provided at the 90% level)	Provision of new housing loans with an LTV ratio of more than 90% decreased following implementation of the NBS recommendation	Recommendation A (under NBS Recommendation No 1/2014 of 7 October 2014), effective from 1 November 2014 and due to be recalibrated and enacted in legislation as from the beginning of 2017

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

	Area	Risk	Risk-amplifying factors	Risk-mitigating factors	NBS regulatory measures and recommendations
Risks arising from the external environment	Regulatory environment	Potential easing of regulatory rules for bank subsidiaries of foreign banks in the area of liquidity and large exposures under the banking union	The abolition of intra-group limits for banking groups and the centralisation of liquidity management in such groups may exacerbate the adverse effects of any sudden deterioration in the group's financial position or sudden liquidity shortfall		
		Risk arising from the implementation of the minimum requirement for own funds and eligible liabilities (MREL)	Continuing uncertainty about how the MREL is to be determined and concerns about insufficient attuning to the specificities of banking sectors funded primarily by customer deposits	Sufficiency of CET1 capital	
		Uncertainty about the impact of a draft amendment to the regulatory rules on government bond holdings of banks and insurers	High share of Slovak government bonds in the asset portfolios of banks and insurers		
Risks arising from the domestic financial market	Household indebtedness	The household sector could become weakened by its increasing indebtedness and thus increasing the banking sector's sensitivity to any deterioration in the macroeconomic conditions	Increasing concentration of debt among certain types of household, mainly owing to the intensification of the trend of households taking on a significant amount of additional debt through refinancing	The implementation of NBS recommendations has led to strengthening of banks' credit standards, including standards for refinancing in which additional debt is taken on	Recommendation F (under NBS Recommendation No 1/2014 of 7 October 2014), effective from 1 March 2015 and due to be enacted in legislation in 2017
			Household debt-to-income ratio rising faster in Slovakia than in any other EU country	Labour market recovery, real wage growth and increasing household consumption	Recommendations B and E (under NBS Recommendation No 1/2014 of 7 October 2014), effective from 1 March 2015 and due to be recalibrated and enacted in legislation in 2017; Application of a non-zero countercyclical capital buffer rate in response to growth in both retail and corporate loans
			Low interest rates giving rise to overly optimistic assessments of households' repayment ability	Increase of fixation of interest rates mitigates the potential adverse impact of future interest rate hikes on the financial situation of lenders	Recommendation C (under NBS Recommendation No 1/2014 of 7 October 2014), effective from 1 March 2015 and due to be expanded and enacted in legislation in 2017

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

	Area	Risk	Risk-amplifying factors	Risk-mitigating factors	NBS regulatory measures and recommendations
Risks arising from the domestic financial market	Liquidity	Maturity mismatch between assets and liabilities	Widening mismatch between assets and liabilities and a slight decline in liquidity buffers; Ongoing harmonisation of regulatory rules under the banking union may result in significant easing of regulatory rules concerning liquidity and in a marked drop in liquid assets in the domestic banking sector	Adherence to minimal regulatory limit for liquid assets; sound funding structure	Amendment of the liquid asset ratio from 1 December 2014 – the requirements for the coverage of net outflows by liquid assets are stricter than the rules adopted at the European level; The liquid asset ratio also takes into account the potential spread of risk to investment funds; A discussion is taking place about the comprehensive revision of national laws in the area of mortgage bonds, with the aim of making them more effective as a tool of long-term funding for banks
	Concentration, financial market interlinkages, and contagion	Relatively high concentration in (part of) the portfolio, or higher intra-group exposure, in certain institutions or funds	Relatively strong financial interlinkages between domestic firms in the Slovak economy, with the largest firms possibly posing a risk to the solvency of certain banks		Banks should in both their lending and deposit business take a prudential approach to assessing economic interlinkages between customers and to the management of concentration risk; Given their systemic importance, the five largest banks are subject to capital buffers being phased in between 2016 and 2018
		Negative consequences of rationalisation measures or strategic decisions implemented in domestic financial institutions by parent undertakings, and contagion	Weakened financial position of several parent institutions of Slovak banks, owing partly to geopolitical risks; Direct negative impact on banks in Slovakia owing to capital and credit linkages between parent institutions and subsidiaries; Ongoing harmonisation of regulatory rules under the banking union may markedly increase the dependence of domestic banks on their parent institutions	Cost-to-income ratios of domestic banks (especially large ones) still above the EU average	

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

	Area	Risk	Risk-amplifying factors	Risk-mitigating factors	NBS regulatory measures and recommendations
Risks arising from the domestic financial market	Market practices of financial institutions	Potential strategic risk from increasing linkages between financial undertakings and financial intermediaries	Pressure on banks to ease credit standards beyond prudential limits		Recommendation G (under NBS Recommendation No 1/2014 of 7 October 2014), effective from 1 March 2015 was enacted in 2016 through the Housing Loan Act (No 90/2016 Coll.) and Consumer Credit Act (No 129/2010 Coll.)
		Risks arising from intensive price competition in the motor insurance market	Although the situation in this area stabilised in the first half of 2016, there is still a risk that the level of premiums in motor insurance will not be sufficient to cover all legitimate expenses.		Price competition in motor insurance should not impinge on the due payment of legitimate insurance claims
		Potential imbalances resulting from asymmetric relationship between financial entities and their customers			NBS assumed responsibility for the supervision of non-bank lenders in 2015 and at the same time significantly increased its supervisory powers in the area of financial consumer protection

Source: NBS.

CHAPTER 1

EXTERNAL CONDITIONS RELEVANT FOR FINANCIAL STABILITY

1

1 External conditions relevant for financial stability

The decelerating trend in global economic growth has continued in 2016, caused in part by stalling of the euro area recovery

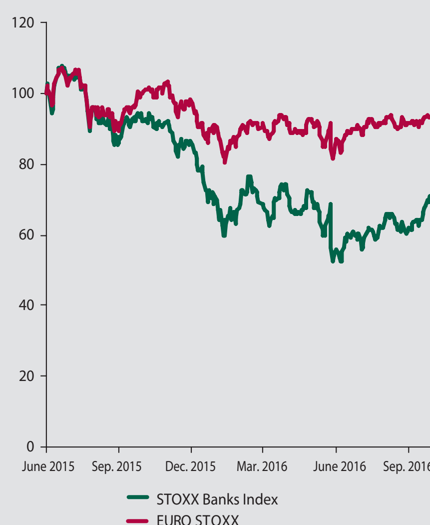
Global economic growth continued its moderate decelerating trend in 2016, although it is projected to pick up gradually in the coming years. After a period in which emerging market economies (EMEs) were largely responsible for the negative trend in global activity, advanced economies have this year again become the principal cause of the slowdown. Financial markets have been experiencing bouts of highly elevated volatility and uncertainty, interspersed with periods of relative calm. After the turbulence at the start of the year, a second wave of instability hit markets around the turn of June and July, triggered by the United Kingdom's unexpected referendum vote to leave the European Union. On both occasions, the subsequent stabilisation of markets and partial restoration of investors' risk appetite was supported by the further easing of monetary policy in several advanced economies. Another steadying factor was the halt in the decline of commodity prices and recouping of some of the previous commodity market losses.

Euro area economic growth has slowed in 2016, not managing to continue its upward trend of the previous year. Furthermore, euro area growth is widely projected to remain flat, or to slow slightly, over the next two years. In that scenario, the pick-up in inflation from its current close-to-zero levels is likely to be slower than originally expected. It was in response to such inflation outlooks that the European Central Bank (ECB) adopted a series of monetary policy easing measures in spring, with the aim of supporting nominal growth and anchoring inflation expectations.

The perception of risks related to the euro area banking sector has become more pronounced, owing mainly to the protracted period of low interest rates

Given the deterioration in the economy's cyclical trends, the inadequacy of adjustment to new conditions, and the legacy burdens from the 2008 financial crisis, the main focus of attention in the euro area since the beginning of 2016 has been the condition of the domestic banking sector. Concern has mounted about the sustainability of the majority of banks' business models as currently configured. Investors have become increasingly concerned that banks' profitability, currently running below pre-crisis levels, may continue to decline and therefore investment in banks would not provide sufficient returns. The reassessment of the euro area banking sector's prospects was re-

Chart 1 The broad STOXX equity index for the euro area and its banking subindex



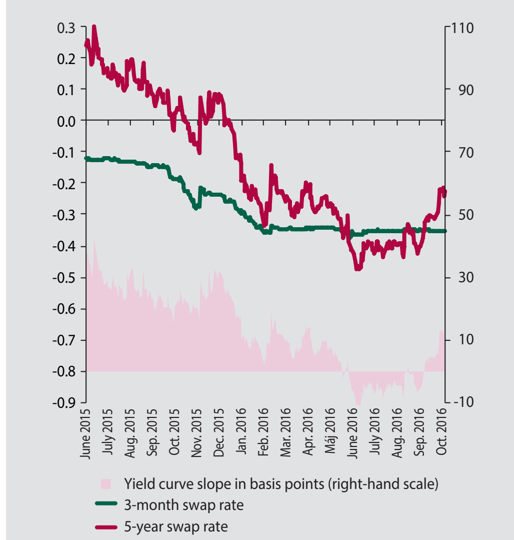
Source: Bloomberg.
Note: Normalised: 30 June 2015 = 100.

flected in financial markets, as bank stock prices fell both in absolute terms and relative to overall equity indices. The deteriorating sentiment towards banks has also been captured by market indicators, such as in the widening of credit spreads.

In response to regulatory tightening, the banking sector's capitalisation has increased in recent years and therefore so has its resilience to shocks. If banks are to maintain this resilience they must be able to continuously replenish their capital through retained earnings. Banks' capacity to generate a reasonable profit is therefore important not only for their shareholders, but also for the banking sector's long-term health and its ability to lend to the real economy. In terms of importance to financial stability in the euro area, the profitability and related condition of banks has recently been identified as a top priority by the European Systemic Risk Board (ESRB) in an assessment of the most material systemic risks.

The current unfavourable outlooks for the banking sector stem mainly from the prevailing environment of low or even negative interest rates. The prolonged trend of historically low euro area interest rates was amplified by the ECB's decisions in December 2015 and March 2016 to further reduce the deposit facility rate (cumulatively from -0.2% to -0.4%) and to adopt additional measures to ease monetary policy. As a result, in the context of weak economic growth at both the euro area and global level, a non-inflationary environment, and elevated uncertainty, financial markets have pushed back their expectations for the duration of the low interest rate environment. What is crucial in terms of the risk to banks is that long-term interest rates have also been falling, even faster than short-term rates, thus causing a flattening of the yield curve. The downward movement of interest rates at the long end of the yield curve was amplified not only by the expected movement of monetary policy rates, but also by term premium reductions stemming largely from central bank purchases under asset purchase programmes.

Chart 2 Long-term and short-term interest rate trends in the euro area and the yield curve slope (percentages; basis points)



Source: Bloomberg.
Note: The yield curve slope is calculated as the spread between five-year and three-month euro swap rates.

In view of banks' core operational principle of turning short-term liabilities into long-term assets, yield-curve flattening is detrimental to net interest income. Compared with other episodes of yield-curve flattening, the current situation is exacerbated by the fact that the curve is partly in negative territory. Since banks do not want to undermine customer confidence by imposing negative deposit rates, their interest margins are being increasingly compressed. It should be noted that the net interest income of euro area banks has not fallen significantly so far, and that the post-crisis drop in their overall profitability was largely attributable to other income statement items like non-interest income or credit risk costs. In the recent period, however, a distinct downward trend in interest margins has become apparent and is expected to become more marked as maturing assets are gradually replaced with new loans and securities subject to lower interest rates. To what extent this trend affects the profitability of particular banks and national banking sectors will depend on several factors, including the degree of reliance on net interest income, the split between market-based and customer funding, and the closeness of deposit rates to zero.

The profitability prospects for part of the euro area banking sector are further overshadowed by low credit quality and weak operational efficiency

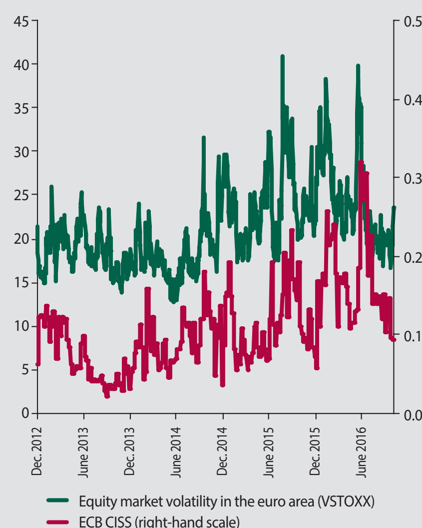
Another matter weighing on the financial condition of banks and on sentiment towards them is the large share of assets whose credit quality has deteriorated. The average non-performing exposure (NPE) ratio is higher for euro area banks than for other significant banking sectors. What is more concerning, however, is that the banking sector balance sheets of several EU countries are reporting as much as double-digit NPE ratios. It is in those countries struggling to cope with the burden of past loan defaults that banking sectors have come under the greatest financial market pressure. The most prominent of these countries are Italy and Portugal. The continuing elevated level of non-performing loans is a burden for banks not only in terms of potential credit losses. It also weighs on their profitability through the drop in interest income from these loans, the additional administrative and legal costs, and the increase in capital charges for the higher credit risk incurred. In general, banks with a lower quality credit portfolio are less able and willing to provide new loans, and may provide them at higher rates of interest. Furthermore, if lower quality assets are kept on banks' balance sheets for an extended period, both the recovery of the corporate sector and the efficient allocation of capital in the economy are held up. This may all have a secondary downward impact on economic growth, consequently leading to further loan defaults.

Weak operational efficiency is a serious shortcoming in the banking sectors of certain euro area countries and is undermining banks' profitability. Although banks have stepped up cost-costing efforts in recent years, they still have much work to do in this area. The excess capacity in some national banking sectors implies scope to increase profitability through rationalisation measures, and to do so immediately at two levels, i.e. at the level of individual banks, through streamlining the branch network, and at the sectoral level, through further consolidation of the banking industry. It is crucial for banks to improve their operational efficiency if they are to remain competitive against the rapidly growing segment of non-bank rivals known as "fintech" companies.

Other significant risks to financial stability in the euro area include the strong rise in risk aversion in financial markets and the re-emergence of doubts about the sustainability of public finances, as well as the rapid and non-transparent growth of the shadow banking sector.

A second serious threat to financial stability is the possibility of an abrupt reversal in risk premia in financial markets. Since early in the second half of 2015, financial markets have experienced several bouts of heightened volatility in response to adverse economic or political events in the wider world. The markets have so far proved their resilience to these episodes, absorbing the shocks without any appreciable impact on the macroeconomic situation. Even so, the conditions that may give rise to further turbulence remain in place. Global risk premia on several asset classes are below their long-run historical averages. With the low interest rate environment in advanced countries expected to continue over the long term, demand for riskier assets is increasing and thereby creating an upward pressure on their prices. Signs of overval-

Chart 3 Indicators of financial market uncertainty in the euro area



Source: Bloomberg.
Note: CISS – composite indicator of systemic stress, compiled by the ECB.

uation have appeared in the euro area property market, particularly in the luxury segment of the commercial real estate market and, in some countries, in the residential property sector. Given that the economic outlook is surrounded by heightened uncertainty and that political risks are proliferating, financial market participants are increasingly likely to recalibrate the risk-return trade-off in their portfolios and embark on a new wave of sales. In the past, central banks were the main stabilising element, but as their scope for action has diminished, there is an increasing risk that what began as uncertainty in financial markets will spill over into a serious systemic crisis.

Although risks related to high indebtedness of euro area sovereigns have abated somewhat since 2013, the danger of falling back into a sovereign debt crisis remains real. Since euro area government bonds have been trading at low yields to maturity for an extended period, it appears that financial markets do not have concerns about the repair of public finances. That includes the public finances of the countries at the centre of the debt crisis, with the possible exception of Greece. To some extent this is attributable to the sizeable cumulative consolidation efforts of recent years, which have reduced fiscal deficits across the euro area. Much credit should also go, however, to the ECB's government bond purchase programme and the general environment of low interest rates, resulting in downward pressure on government bond yields. Despite all the measures taken, however, several countries continue to be burdened with high debt, and some have still not managed to prevent it increasing. At the same time, the reduction of structural fiscal deficits has slowed in the recent period. Given the euro area's subdued nominal growth and the elevated political uncertainty overshadowing the continuance of fiscal and structural reforms, the sustainability of certain countries' public finances could again come to the forefront of financial market concerns.

Prolonged low interest rates are problematic not only for the banking sector, but also for other segments of the financial market. They are a particular threat to the solvency of life insurance business and defined benefit pension schemes, which if the low-yield environment were to persist, would be unable to cover the returns guaranteed to customers. Meanwhile, the current level of interest rates is incentivising investment in shadow banking entities, whose increasing interconnection with other parts of the financial sector and low transparency bring heightened risk to the financial system.

Risks arising from emerging market economies are persisting over the medium term, stemming mainly from the credit boom of recent years, the decline in commodity prices and the threat of an increase in global trade barriers.

Serious concerns about the economic outlook for EMEs and related financial market turbulence were prominent in the second half of 2015 and turn of this year, but these abated over the subsequent months. This shift in sentiment reflected the economic performance of these countries in general and China in particular, as their aggregate GDP growth path stopped falling and showed signs of picking up again. Among the key factors behind this economic improvement are the stabilisation of commodity prices and the pass-through of monetary policy easing in advanced countries to financial conditions in EMEs. After a period of portfolio investment outflows, demand has rebounded for bonds and equities issued in EMEs.

In the medium term, however, there are persisting risks from EMEs, relating mainly to their high indebtedness. This reflects in particular a sharp increase in debt financing in the non-financial corporate sectors of many EMEs, occurring in response to inflows of cheap money and to commodity investments. A still more serious problem than the amount of indebtedness relative to the size of the economies is that a major part of the debt is owed by firms whose debt servicing capacity is threatened by the decline in their profitability over recent years. Commodity firms in particular are faced with a worsening financial position. This could result in an increase in loan defaults, with adverse spillovers to the banking sectors of the countries concerned. That risk would be heightened if the nascent recovery were to stall. If, moreover, events took such a turn, financial markets would be likely to pull capital out of these economies. The probable consequence would be a general deterioration in financing conditions and increase in funding costs, with adverse ramifications for debt servic-

ing, including in other segments of the corporate sector.

Risks to the economic growth outlook of EMEs are now being heightened by a potential increase in protectionism across the world. This threat stems from a developing political situation in which support for globalisation has cooled in several advanced economies. The result of the US presidential election is expected to further strengthen this movement. As a result of the current political climate, the fate of several proposed and existing free trade agreements remains unclear and products imported from EMEs may be subjected to new duties and tariffs. This in turn could trigger a broader wave of anti-globalisation measures across the world, with adverse repercussions for the foreign trade. Since many EMEs are heavily dependent on such trade, their economic potential could be damaged by such outcome.

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CHAPTER 2

DOMESTIC CONDITIONS RELEVANT FOR FINANCIAL STABILITY

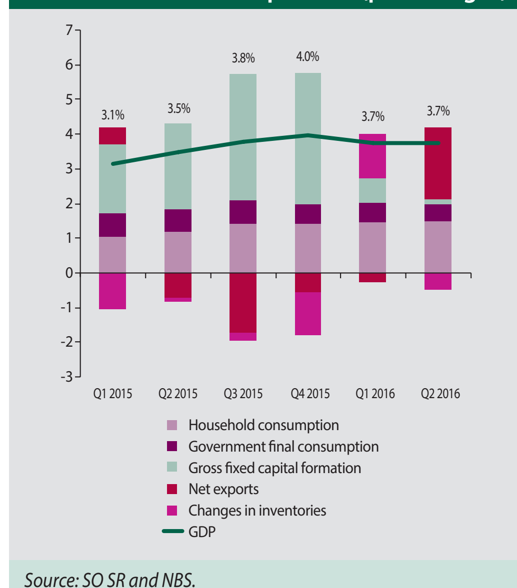
2

2 Domestic conditions relevant for financial stability

Economic growth remains stable in 2016

The Slovak economy grew in the first half of 2016 by 3.7% year on year. Net exports returned to being the main driver of growth. The beginning of the year saw an expected moderation of GDP growth, caused largely by the ending of the absorption of EU funds under the 2007-2013 programming period and the consequent decline in investment. The impact of the decline in government investment was partly offset by private investment growth. The reduction in the absorption of EU funds was reflected in lower growth in government final consumption in the first half of 2016, owing mainly to curbed expenditure on goods and services. Household final consumption has remained a stable component of domestic demand, and it increased in the first half of 2016 by 2.8%. The steady increase in this component stems largely from real wage growth, the continuation of favourable labour market developments, and relatively positive economic sentiment. Thus the spending of Slovak households has continued to contribute to the stable growth of the Slovak economy, one of the EU's six fastest growing national economies in the first half of 2016. After a period in which domestic demand was the main driver of Slovak GDP growth, net exports reassumed that position. The decline in the positive contribution of domestic demand stemmed from a slowdown in government consumption growth and stagnation in investment. The increase in net exports was based mainly on the improved export performance of the car and electronics industries and on services growth.

Chart 4 Annual GDP growth and the contribution of its components (percentages)



Source: SO SR and NBS.

The economy is expected to remain on a growth path in the second half of the year, with the GDP growth rate for the whole of 2016 projected to be 3.5%. The contribution of net exports, however, is expected to have fallen gradually over the course of the year due to the pass-through of weakening external demand to export growth. The impact of the decline in EU-fund related government investment is expected to be partly offset by investments in the car, energy and construction sectors. Household final consumption is assumed to have remained a stable component of Slovak GDP growth. It is expected that wage growth, negative inflation and favourable labour market conditions supported household consumption and resulted in a gradual acceleration of private consumption. Government consumption is expected to have continued contributing positively to economic growth, albeit to a lesser extent than household consumption. Key dynamics of Slovakia's GDP growth in coming years are likely to include external demand fluctuations, steadily growing household consumption, expected investment in public-private partnerships, and the launch of production at a new car plant. The UK's vote to leave the European Union is expected to have only a limited impact on the Slovak economy, mainly via a drop in trading partners' demand for Slovak exports. In terms of financial stability, both the actual and expected macroeconomic developments in 2016 would have a favourable impact on the financial system. Nevertheless, in the context of a gradually closing output gap, relatively strong investment demand, accommodative monetary policy, and heightened com-

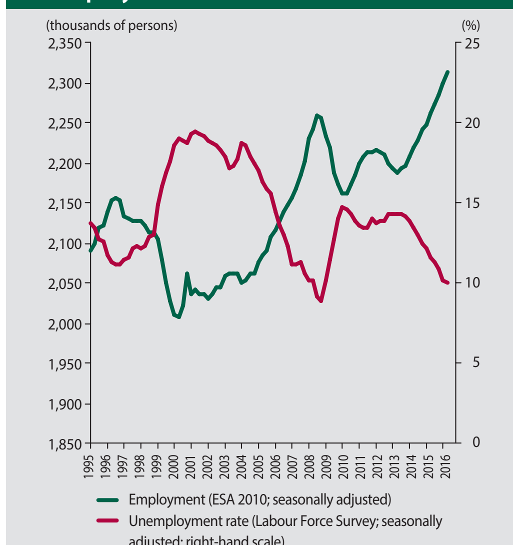
petition in the financial market, there could be a gradual build-up of imbalances, particularly credit-related ones.

Labour market developments remain favourable

Stable economic growth has been reflected in a favourable labour market situation. The number of people employed in the first half of 2016 reached a historical high of 2.3 million. Employment in that period continued a growth trend dating back to the beginning of 2014, as it increased by 2.2% year on year. The strongest job growth was in the services and trade sectors. The growth in employment was accompanied by a falling unemployment rate, which in the second quarter fell to just below 10%. But although the number of people in work is now greater than the pre-crisis high, the unemployment rate remains slightly higher than its pre-crisis low. This is due to demographic developments and to changes in the labour force participation rate. Shrinkage of the working-age population (aged 15 to 64) has stimulated demand for employing people who were previously economically inactive, resulting in an increasing labour participation rate in certain sections of the population (in particular women and older people). Among the factors pushing up the participation rate are the raising of the retirement age (as part of pension reform measures) and an increase in the number of people employed in part-time work.

Average nominal wage growth in Slovakia in the first half of 2016 was 3% year on year, and real wage growth was even higher due to the environment of falling prices. Thus the strengthening labour market situation is supporting growth in private consumption and also in the saving ratio. Going forward, employment and real wages are expected to maintain a growth trend, although that should gradually moderate amid an increasingly saturated labour market and projected increase in prices. Labour shortages may begin to appear in some areas of employment, pushing up wages in the sectors concerned. From a macroprudential view, the current and expected developments in the labour market are conducive to an improvement in credit risk conditions, through the strengthening of households' debt servicing capacity and the containment of loan default rates at relatively low levels.

Chart 5 Employment and the unemployment rate in Slovakia



Sources: SO SR and NBS.

The current economic upturn is creating conditions that support a build-up of systemic risks

The prolonged environment of low interest rates is stoking demand for new loans, with the effect that increasing number of households are becoming more leveraged. As banks compete increasingly harder to retain market share and households show strong demand for loans, there is increasing pressure to lend to riskier customers. With employment at historically high levels and with household sentiment brightening in 2016, demand for loans has increased. At the same time, however, risks are building up which could materialise in future if economic growth stagnates due to cyclical economic factors. In that case there would be an adverse impact on the labour market[1].

Corporate sales growth in most sectors

Economic growth is also being reflected in NFCs' rising sales and increased profitability, in most sectors. The strongest annual sales growth in the first half of 2016 was observed in the wholesale and retail trade sectors, where it reached double digits. Industry and services also reported sales growth, while transportation and storage experienced a mixed trend, with sales falling in the first quarter and then rebounding in the second quarter. Sales in the construction sector fell year on year, in line with expectations,

1 *The issue of systemic risks related to household leverage is covered in more detail in Section 3.4 'Financial sector risks'.*

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EUROSYSTÉM

owing mainly to the ending of the absorption of EU funds under the previous programming period. Given the outlook for economic growth, the period ahead is also expected to be favourable for firms' sales. In terms of financial stability, the current and expected economic trends are creating conditions that strengthen firms' debt servicing capacity. On the other hand, with investment assumed to increase, firms' demand for loans is expected to continue increasing, as is their leverage[2].

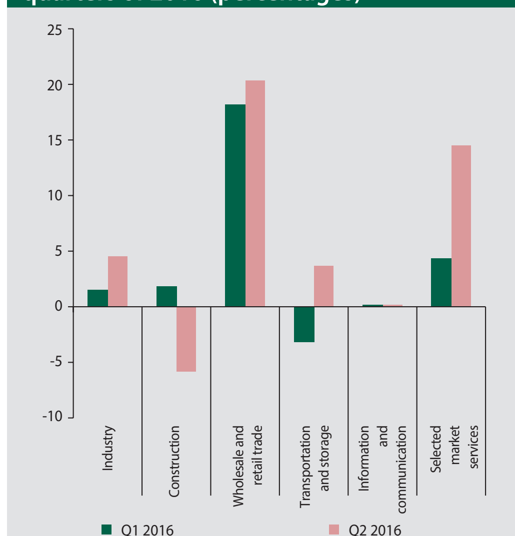
Inflation became increasingly negative in the first half of 2016

Annual inflation as measured by the Harmonised Index of Consumer Prices (HICP) became more negative in the second quarter of 2016, falling to -0.6% for the period. The drop in the price level stemmed mainly from falling prices of energy and food, the latter reflecting subdued food commodity prices. The strongest price growth in the first half of the year was recorded by services, followed some way behind by industrial goods, but their contributions could not offset the impact of energy and food prices. Non-energy inflation thus remained flat in the second quarter, with rising domestic demand not managing to outweigh low prices of cost push factors (energy in particular) and the impact of low import prices. Since inflation remains subdued in both Slovakia and the euro area as a whole, no significant reversal of the low interest rate policy is expected.

Risks to the economic outlook

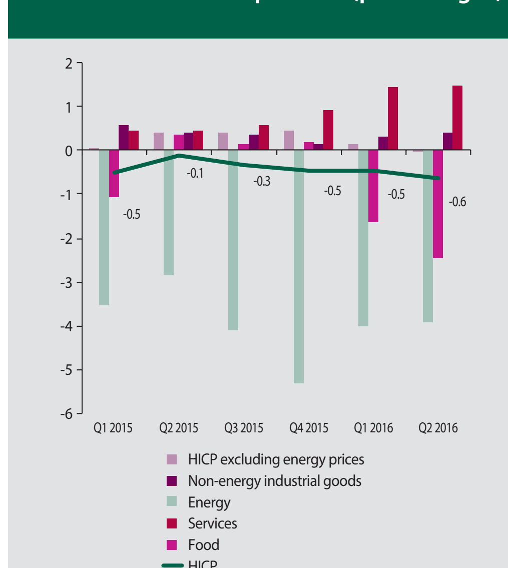
The main risk to the current outlook for economic growth is the downside risk of weaker than expected growth in external demand. This could materialise if geopolitical tensions escalate, if economic growth in China and other EMEs stagnates due to unresolved problems, if banking sector risks crystallise, or if multiple countries erect new trade barriers against EMEs. The potential variants of "hard Brexit" would also weigh on the Slovak economy, mainly through the dampening of demand for Slovak exports from trading partner countries. On the other hand, an upside risk to the growth forecast is the possibility of a significant release of household savings.

Chart 6 Annual nominal sales growth by economic sector in the first and second quarters of 2016 (percentages)



Sources: SO SR and NBS.

Chart 7 Annual HICP inflation and contributions of components (percentages)



Sources: SO SR and NBS.

2 *Systemic risks related to the leverage of non-manufacturing firms are addressed in greater detail in Chapter 3.2 'Banking sector assets'.*

CHAPTER 3

THE FINANCIAL SECTOR IN SLOVAKIA

3

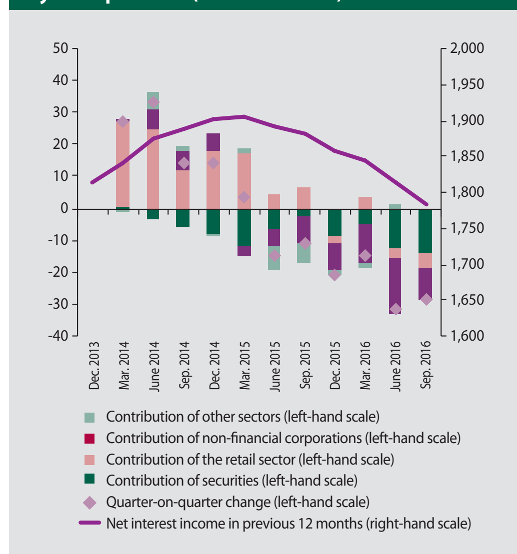
3 The Financial sector in Slovakia

3.1 SOLVENCY AND FINANCIAL POSITION OF THE FINANCIAL SECTOR

Financial position

The profitability of banks and insurance firms has continued to be exposed to the deepening adverse influence of the low interest rate environment. Although net profit has risen over the past 12 months in both sectors, this rise can be attributed largely to one-off effects. Without these effects, the level of profitability would have fallen in the banking sector, as well as in a significant part of the insurance sector. Pension and investment funds, whose investment portfolios changed in structure in the previous period in favour of riskier assets, have recorded a fall in their returns, into negative territory in certain cases, as a result of increased financial market volatility. This fall has been negatively reflected in the profits of asset management companies.

Chart 8 Net interest income and its changes by component (EUR millions)



Source: NBS.
Note: The chart shows the cumulative net profits of banks in the individual quarters, for the previous four quarters, and the factors behind their quarter-on-quarter changes. The chart does not cover a foreign bank branch which commenced operations in 2016.

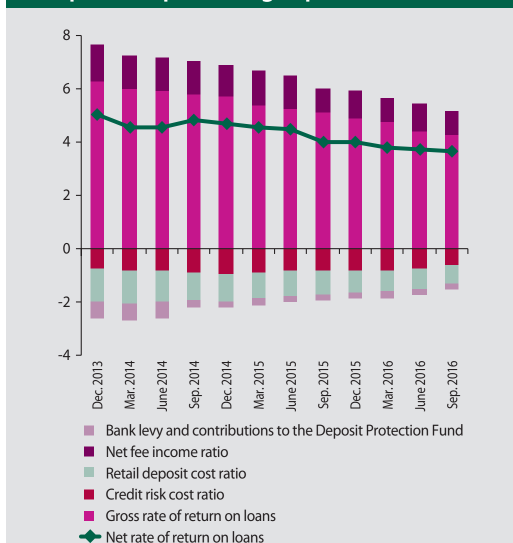
Banking sector profitability

The profitability of banks has been exposed to numerous negative trends, though its overall level has risen in response to one-off extraordinary effects. In September 2016, the banking sector recorded a year-on-year rise of 6% in its aggregate profit. This rise was due to an extraordinary one-off effect caused by the sale of VISA Europe shares. This transaction has boosted the profits of banks across banking sectors throughout Europe.[3] Without this effect, coupled with the profit of a foreign bank branch that commenced operations in 2016, the sector's aggregate profit would have fallen by roughly 8%. This fall would largely have reflected developments in net interest income, started to decrease in March 2015 despite the growing volume of bank lending.

The decline in net returns on retail loans has deepened in comparison with the previous period. Following the introduction of a statutory cap on housing loan early repayment fees as from 21 March 2016, the net margin on retail loans has been decreasing at an accelerating pace. As Chart 9 shows, the sharpest decrease took place in the second quarter of 2016. It should be noted, however, that the new cap is having only a gradual impact on the sector's profitability. This is firstly because it takes several months for a fall in the average interest rate on the stock of loans to be reflected in a fall in interest income, calculated for the previous 12 months. Data on interest income for the first three quarters of 2016 has been influenced by interest rates applicable prior to the introduction of the cap, but that impact is expected to fade away in the coming year. A second reason is that income from loan early repayment fees is increasing temporarily as a result of a marked increase in refinancing loans; however, this only partly compensates for a fall in interest income in the future. Hence, the strongest impact is expected to occur next year when, as a result of this impact, the banking sector's profitability is likely to fall considerably. This issue is addressed in detail in the section on the sustainability risk to bank business strategies.

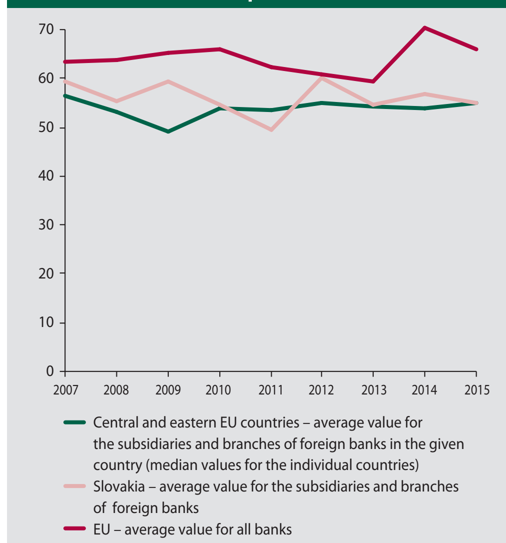
3 *Detailed information on this transaction was published in the Financial Market Situation and Trend Report for the First Half of 2016 (available in Slovak only).*

Chart 9 Net rate of return on retail loans by component (percentages per annum)



Source: NBS.
Notes: The rates of return on the individual items and their cost ratios were calculated from returns and costs recorded in the given quarter, which were annualised by multiplying by four. The only exception was credit risk costs, which were calculated as the sum of costs for the previous four quarters.

Chart 10 Cost-to-income ratio (percentages): an international comparison



Source: ECB.

Falling credit risk costs continued to act as a positive factor over the first three quarters of 2016. In comparison with the previous years, this fall was reflected mainly in the sector of non-financial corporations, where credit risk costs fell to 0.5% of the amount of loans per annum. A modest fall was also recorded in the retail sector. The coverage of banks' non-performing loans by loan loss provisions increased in that period.

The gradual fall in banks' interest income, which is likely to continue in the period ahead, has put the position of local banks within their banking groups under scrutiny. The largest banks in Slovakia are owned by foreign banking groups. In response to the negative trends in the profitability of local banks, the relevant groups may exert intense pressure for an increase in the operating efficiency of these banks and for the centralisation of certain processes, which may have a negative impact on local banks in the long term. As Chart 10 shows, the operating efficiency of Slovak subsidiaries as measured by the ratio of operating costs to net interest and non-interest income (cost-to-income ratio) is at the same level as that of subsidiaries in other central and eastern EU countries. Furthermore, the average value of this ratio is better than the average figure for the EU, because the cost-to-income ratio is higher in the EU.

Profitability of other financial market segments

Besides the banking sector, the insurance sector has also been exposed to one-off effects. The insurance sector's profitability as at 30 June 2016 was 83% higher than a year earlier. This increase was caused in large part by one-off effects, such as dividends from capital participations and the dissolution of reserves for insurance payments after the successful resolution of legal disputes. The increase adjusted for these effects (around 30%) was caused predominantly by one insurance firm. The total profit of the remaining insurance firms dropped by 10%.

The heightened volatility in financial market markets has had a negative impact on the returns of pension and investment funds pursuing a riskier investment strategy. The main factor was stock market turbulence in August 2015 and January 2016, which caused a fall, into negative territory, in the returns of funds with an increased equity component. By contrast, funds

with a more conservative profile earned higher returns than riskier funds. This development caused a marked decrease in the income of pension management companies from fees linked to the performance of investments in funds, and a consequent fall in their total profit. Supplementary pension management companies suffered a decline in profit of almost 90% year-on-year, while the profits of pension fund management companies and asset management companies dropped by one-half and almost one-third respectively.

Capital adequacy

Capital ratios decreased slightly over the first half of 2016. This decrease took place after relatively stable developments in 2015. The common equity Tier 1 ratio fell from 16.0% to 15.7% and the total capital ratio from 17.8% to 17.3%. The leverage ratio decreased from 8.4% to 8.3%. This decrease was caused mainly by the growing volume of loans. The retained earnings ratio fluctuated between 25% and 35% during the period from 2013 to 2016, though in 2015 and 2016 most of the retained earnings were in the form of lower-quality capital. The increase in own funds, however, proved insufficient to compensate fully for the growing volume of loans, and so the capital ratios started to fall slightly.

The aggregate total capital ratio has fallen below the EU median level, though the quality of own funds is better than the EU median. Despite this fall, the common equity Tier 1 ratio is still at the EU median, while the total capital ratio is slightly below that level (Chart 11). On the other hand, when comparing the values of individual capital ratios of the Slovak banking sector with those in central and eastern EU countries, they are at the level of the lower quartile. This is because banks in many countries recorded a steady increase in capital adequacy in the previous years, while upward trend in the capital adequacy of Slovak banks came to a halt in 2013.

Dividend payments will have to be restricted to some extent in the years ahead. The gradual implementation of capital buffers, mainly in systemically important banks, will lead to a gradual rise in capital requirements. In addition, the countercyclical capital buffer (CCB) rate will be increased with effect from August 2017. In the current environment of falling interest rates and margins, banks tend to pursue a business strategy focused on lending growth, which leads to a further increase in their capital requirement. The simulation of possible developments in the banking sector's profitability, which is described in more detail in the section on the sustainability risk to bank business strategies, points to a gradual decrease in the profit generating capacity of banks. Hence, the banking sector will in the period ahead be compelled to increase capital by raising the retained earnings ratio.

Chart 11 Capital ratios (percentages): an international comparison

Source: ECB.
Notes: The data shown are for 31 March 2016.

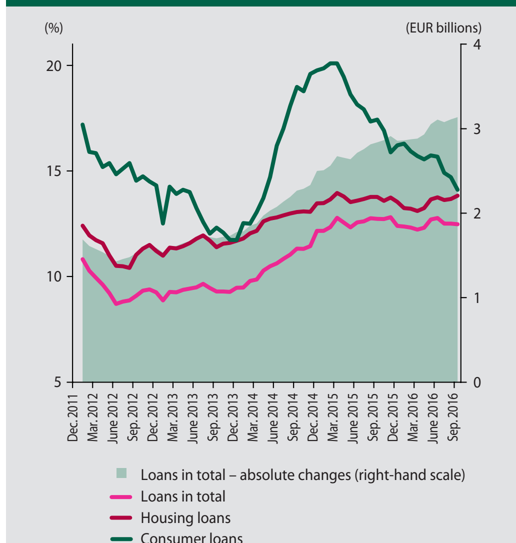
3.2 BANKING SECTOR ASSETS

Retail lending has continued to grow at a rapid pace; loan refinancing and renegotiation[4] has intensified

Retail lending has continued to grow at a steady pace,[5] reaching a new high in absolute terms. In relative terms, the annual growth rate reached 12.5% in September 2016. The volume of retail loans in the sector increased by €3.1 billion, which was 25% more than the maximum increase recorded in the pre-crisis period.

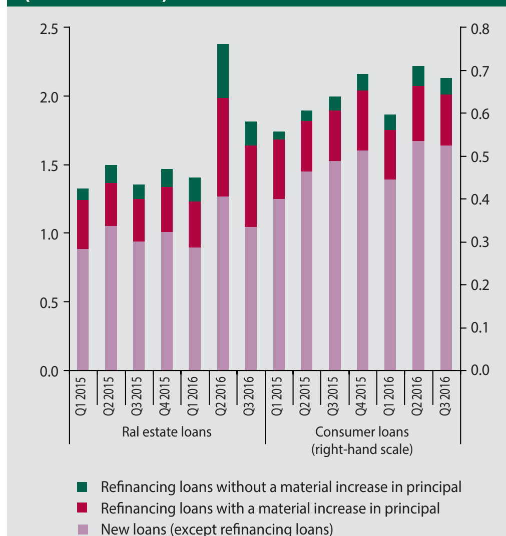
4 *The negotiation of new contractual conditions for existing loans without a switch of bank.*
5 *The trends described in this part are adjusted for the impact of the transformation of a non-bank institution to a foreign bank branch.*

Chart 12 Annual growth in retail loans



Source: NBS.
Note: The 'total loans' category also includes overdraft facilities, revolving loans, credit cards and other loans.

Chart 13 Volume of new and refinancing retail loans (excluding renegotiated loans) (EUR billions)



Source: NBS.

Lending for housing purposes has mainly been influenced, in both volume and price, by a legislative change. The outstanding amount of housing loans has grown by 13.8% by end-September 2016 (compared with 13.2% in the first quarter of 2016), at a rate accelerating somewhat as a result of the Housing Loan Act. This law, effective from March 2016, caps early repayment fees for housing loans at not more than 1% of the loan principal. The effective limit, however, may be as low as 0.8% if the borrower takes up the option to repay one-fifth of the loan free of charge. As a result, the volume of refinanced loans (most of which involve an increase in principal) has grown to roughly twice the standard volume. This can be explained by the improved bargaining position of households, which are thus able, even without switching bank, to negotiate better borrowing rates for their existing housing loans. Such renegotiated loans have increased in number to roughly 50%[6] of the total loans provided in the months under review, and their total amount in these months is higher than that of refinancing loans. One of the results of these substantial changes has been a gradual fall in market interest rates. Thus, the impact of the statutory cap has been transferred from refinancing loans to new lending in this sector.

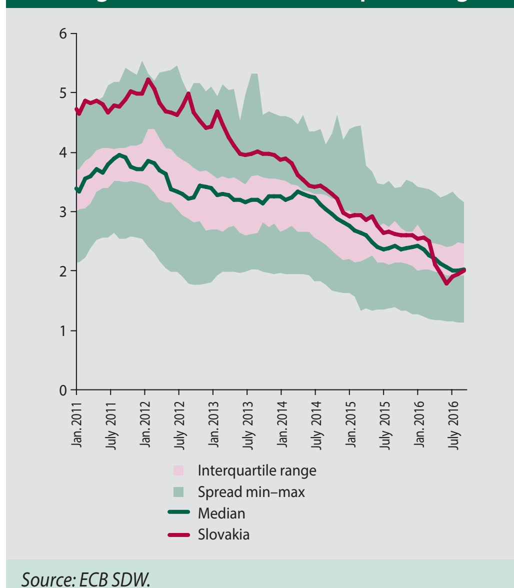
Among EU countries, Slovakia still has one of the most rapidly growing housing loan portfolios with a long-running stable trend.

Lending by home savings banks has differed from lending in the rest of the banking sector this year in that loan portfolio growth has decelerated. The annual growth rate of intermediate loans slowed from the end of 2015 to stand at just above 5% in the summer of 2016.

After a sharp fall, interest rates on housing loans have risen somewhat. The fall in these rates took place between February and April 2016, and exceeded 0.5 percentage point. The lowest rate was recorded in May 2016 (1.8%). In a European-wide comparison, this value was below the level of the first quartile, after being among the highest in December 2015. The rates for housing loans subsequently rose to the level of the European median in September (2.0%). Interest rates on renegotiated loans were 0.2–0.3 percentage point lower than the average rate in the domestic market, which is understandable in view of the attempts of banks to maintain their clientele. The annual percentage rate of charge (APRC) was somewhat more stable in the period under review, though it followed the same trends.

6 *This value was estimated on the basis of data from five retail banks accounting for roughly 70% of the market.*

Chart 14 Average interest rates on new housing loans in the euro area (percentages)



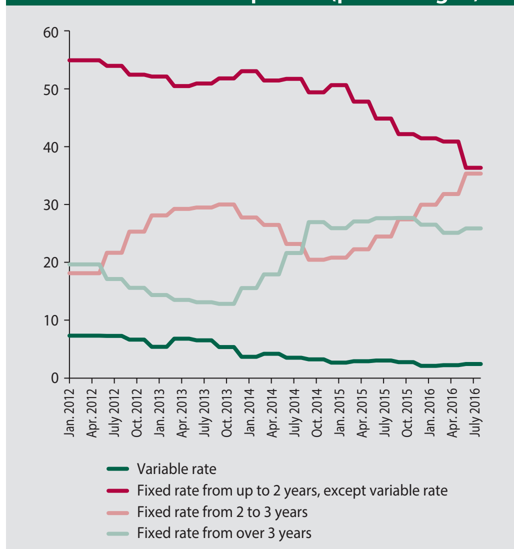
Source: ECB SDW.

The changes described above have also affected the structure of banks' housing loan portfolios in terms of interest rate fixation[7]. The share of loans with a remaining interest rate fixation period of 2 to 3 years increased to 35% in the second quarter of 2016, which was roughly equal to the share of loans with a remaining interest rate fixation period of up to 2 years (excluding variable rate loans). Although this was due to a one-off effect, a corresponding trend had already been observed since the beginning of 2015. The prolongation of interest rate fixation is perceived to be a positive change for borrowers, making them better protected against shocks caused by interest rate increases.

The share of housing loans with an LTV ratio above 90% has continued to decrease, since all banks are providing such loans in compliance with NBS's Recommendation No 1/2014. The share of loans with a loan-to-value (LTV) ratio above 80% remained just below 50% throughout the third quarter. At the same time, however, the concentration of loans with an LTV ratio fluctuating around 90% increased further.

Consumer loans have continued to grow at a decelerating pace, which, however, is still the second fastest in the euro area. The most rapid growth in consumer loans since the outbreak of the financial crisis was recorded in March 2015 (20.1% year-on-year). Since that time, the rate of growth has been slowing gradually. Despite this slowdown, the growth rate recorded in September 2016 (14.1%) was among the highest in the euro area. The market for non-bank consumer loans, however, has seen stagnation in the total volume of loans since the pre-crisis period.

Chart 15 Breakdown of the banking sector's housing loan portfolio by remaining interest rate fixation period (percentages)



Source: NBS.
Note: The remaining interest rate fixation periods were analysed on the basis of data for approximately 85–90% of the market.

Chart 16 New and refinancing loans with an LTV ratio above 80% as a share of new loans (percentages)

Source: NBS.
Note: The chart does not cover refinancing loans without a material increase in principal.

7 *The remaining interest rate fixation periods were analysed on the basis of data for approximately 85–90% of the market.*

As a result, the share of non-bank loans in consumer financing has continued to decrease this year, to one-fifth of the total volume.

Interest rates on consumer loans are falling but are still among the highest in international comparison. The spread between the average interest rate on consumer loans in Slovakia and the euro area median was almost 8 percentage points in 2013, and then decreased gradually until mid-2016, when it stood at around 4 percentage points. Although the average interest rate was down to 10.2% in September 2016, it was still above the third quartile in the euro area.

Non-bank loans have remained broadly unchanged in volume terms, but their structure has changed in favour of larger loans with longer maturities. On average, the non-bank sector still provides smaller loans with shorter maturities and higher annual percentage rates of charge than the banking sector. The sector's aggregate portfolio as at September 2016 (amounting to roughly €1.2 billion) accounted for about one-fifth of the total volume of consumer financing.

New business in the non-bank sector is changing gradually in structure. Loans with long maturities are growing in the long run, and thus contribute to the overall stability in the volume of non-bank lending. By contrast, new short-term and small loans have been decreasing since the turn of 2014/2015, probably partly as a result of a regulatory cap on interest rates. In general, the volume of new non-bank loans shows relatively high volatility.

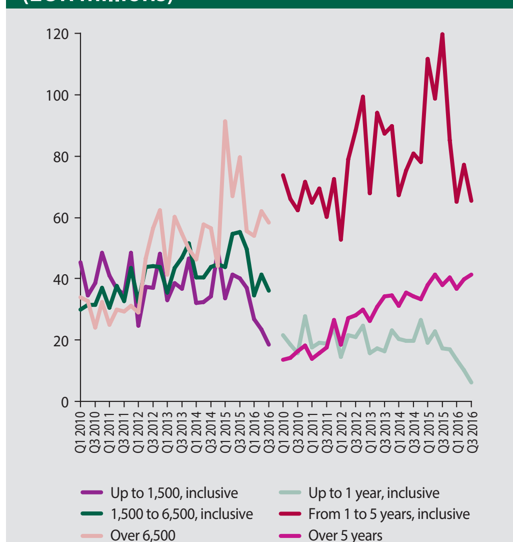
The annual percentage rates of charge (APRCs) for non-bank loans have quite rapidly fallen towards the APRCs for bank loans. This was largely attributable to a downward jump when the above-mentioned interest rate cap was set. The difference between the two sectors has since than stabilised gradually without showing any clear trend.

The share of intermediated loans has remained virtually unchanged this year, with their total volume following the growing trend in bank lending. Over the first nine months of 2016, intermediated housing loans have consistently accounted for around 50% of the total volume of new housing loans.

Lending to the domestic non-financial corporate sector[8] has continued to grow across the entire sector

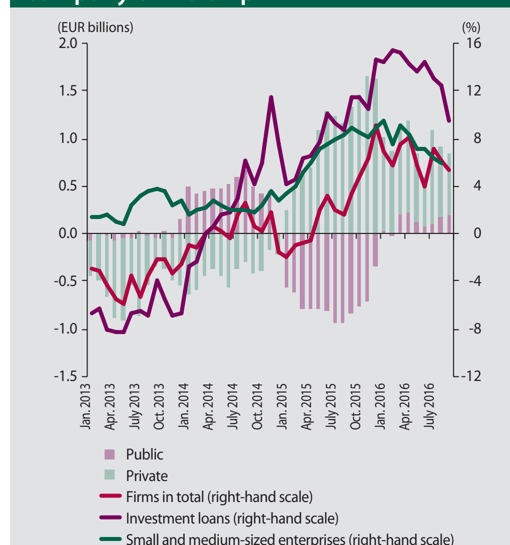
Lending to the NFC sector has maintained its relatively stable growth. Lending to the sector

Chart 17 New non-bank consumer loans broken down by size and maturity (EUR millions)



Source: NBS.
Note: As in the APRC reporting, loans are classified according to size into three categories: small loans (up to €1,500), medium-sized loans (€1,500 – €6,500) and large loans (over €6,500). Loans are classified according to maturity into short-term (up to 1 year), medium-term (1 to 5 years) and long-term loans (over 5 years).

Chart 18 Contribution to the annual growth rate in corporate loans by form of company ownership



Source: NBS.

8 *Loans to the corporate sector are loans provided to resident firms in Slovakia.*

has continued to grow this year at an average annual rate of 6%. The actual annual growth rate of corporate loans has been determined by lending to privately owned firms. The growth rate of loans to such firms has stabilised at around 6% after a correction from end of 2015. Publicly owned firms have also contributed positively to the growth in lending, but only within the bounds of standard volatility.

Certain corrections were also recorded in lending to the corporate sector broken down into loans to small and medium-sized enterprises and investment loans. However, these corrections took place after the significantly positive trends in 2015, when credit growth reached double digit numbers in numerous cases. Loans with a maturity of up to one year showed a negative tendency, which could be mostly the result of growth in sales, i.e. growth in funds for the coverage of short-term operating costs.

Lending growth in the NFC sector is broadly based across banks and economic sectors. Bright assessments of the corporate sector are implied by the fact that growth in lending to NFCs has been broad-based across the banking sector. Most banks involved in lending to firms have recorded an increase in their corporate loan portfolios. As a result of an upturn in lending activity also in smaller banks, the concentration of lenders has decreased; nevertheless, the five largest banks still account for more than three-quarters of the corporate loan portfolio. The flow of loans into most sectors has increased this year, with changes recorded only in the rate of lending growth.

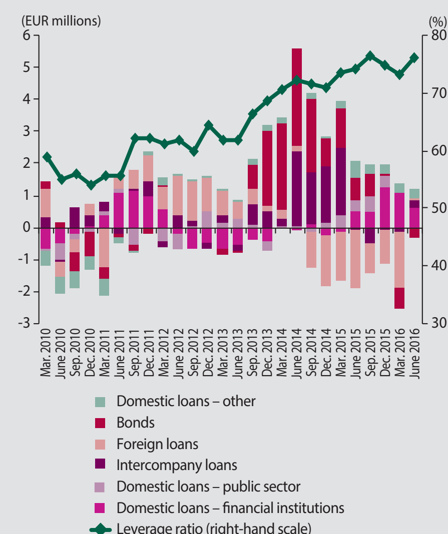
In international comparison, Slovakia is reporting above-average growth in lending to NFCs. Compared with other EU countries, Slovakia has this year reported one of the highest growth rates for bank loans to NFCs. The volume of corporate loans has fallen year-on-year in more than half of the countries.

The total indebtedness of the corporate sector has increased this year as a result of growth in loans from domestic banks. However, other components of the sector's external funding have also increased. At the same time, growth in foreign loans marked a correction of their previous slump. These developments led to a quarter-on-quarter increase in the debt-to-capital ratio. This ratio, however, has been rising continuously since 2010. It should be noted in this context that the corporate sector's credit debt burden[9] has remained virtually

Chart 19 Annual rate of change in corporate loans and interest rates on new loans: an international comparison (percentages)

Source: ECB SDW.
Note: The chart shows the average values of data available for 2016, i.e. for January to August.

Chart 20 Annual changes in the corporate sector's indebtedness broken down by funding source



Source: NBS.
Note: 'Domestic loans – other' are loans provided by resident entities, except banks, the public sector and firms. These entities are mainly from the S125 sector – Other financial intermediaries, except insurance corporations and pension funds.

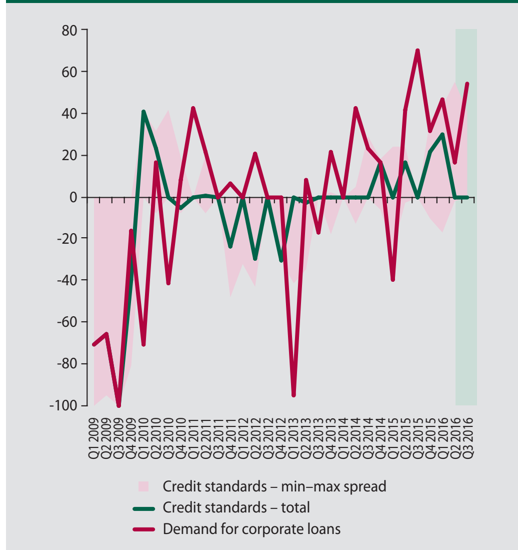
9 Credit burden means the ratio of average annual loan repayment to annual revenue and the ratio of foreign funding sources to annual revenue.

unchanged as a result of growth in revenues. On the other hand, the sector's sensitivity to potential negative shocks in revenues has increased in response to the rising leverage ratio.

The continuing growth in corporate lending has also been supported by favourable economic conditions. The country's strong economic performance is reflected in the corporate sector, too. Sales and exports have maintained dynamic growth throughout this year. The rising economic sentiment indicator over the last few months is a sign of improved confidence in the domestic economy. Several foreign forward looking indicators are also on an upward path. Thus, the relatively dynamic growth in investment loans may continue under the influence of positive sentiment in the economy. Further factors influencing the SME segment and its demand for loans are stable domestic demand and export performance.

The situation on the demand side of the loan market is also assessed as favourable by the banks themselves. The third quarter of this year saw an increase in demand for corporate loans, which is expected to continue in the fourth quarter, too. Demand is still influenced by the low level of interest rates, coupled with firms' need to finance investment and operating activities amid the strong economic growth.

Chart 21 Supply and demand developments in the NFC loan market



Source: NBS.
Note: The left-hand scale shows the net percentage share of responses. A positive value denotes an increase in demand / easing of credit standards. A negative value denotes a fall in demand / tightening of credit standards.

This year has seen a positive trend in the availability of loans for NFCs. The availability of loans has improved slightly, though the relevant internal criteria of banks[10] have not eased. However, the criteria for the parameters of approved loans have eased somewhat. Almost all conditions have eased, irrespective of whether they concern the amount, maturity or margin of the loans provided. In an environment of falling interest rates, combined with a decline in interest income, competition from other banks is a key factor influencing the credit standards and conditions of banks. At the same time, banks do not expect to ease credit standards substantially in the next quarter.

Positive sentiment in the commercial real estate (CRE) market has been a factor in the continuing growth in CRE loans. The CRE segment has experienced positive sentiment on both the demand and supply sides this year. In the residential segment, an upward trend has been observed in both sales and the activity of property developers, through an increase in the number of new flats offered for sale (more information about this segment is available in the section on the residential property market). The office segment has also benefited from the stable economic environment, as reflected in the continuance of several trends. The rising demand for office premises has led to an increase in rented office space. The increased demand has resulted in fewer premises to rent, and a fall in the vacancy rate. Property developers have reacted to this situation by building more new premises, the number of which has exceeded the figure for the post-crisis years. A significant part of these premises are already covered by preliminary rental agreements.

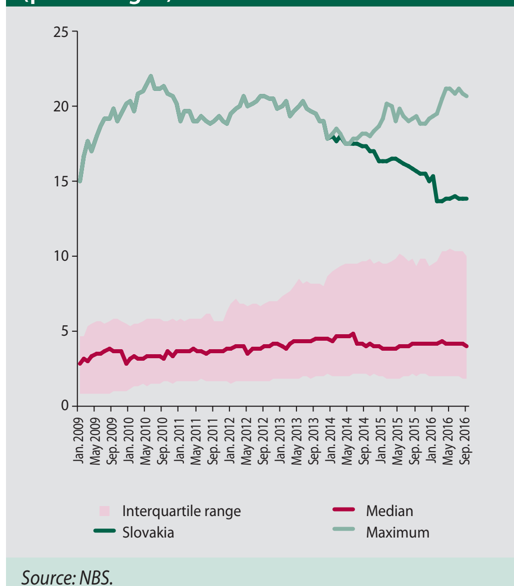
The upturn in sentiment is reflected in growth in lending to this segment, which returned to 10% in the third quarter of this year. Lending activity has shown a rising tendency since the beginning of 2013.

The volume of investment in Slovak government bonds has continued to fall at a moderate pace

The main trends in the banking sector's debt securities portfolio continued over the first

10 Credit standards are the internal guidelines or criteria of banks for loan approval. They are set before the lending conditions are agreed for a specific loan. Credit standards stipulate which types of loans are acceptable for the bank. Lending conditions are the conditions under which a bank is willing to provide a loan, i.e. the conditions agreed for an already approved loan.

Chart 22 Domestic government bonds as a share of total assets in EU countries (percentages)



Source: NBS.

three quarters of 2016. Investment in domestic government bonds continued to decrease in volume in year-on-year terms, with a sharp fall recorded in February owing to the maturity of bonds in a larger amount (€1.2 billion). By contrast, the volume of foreign government bonds and bonds issued by domestic banks continued to increase in that period. As a result of this development, the share of domestic government bonds in the Slovak banking sector's total assets continued to decrease, to 13.5% as at end-September 2016.

As for foreign bonds, investment in Italian bonds continued to grow in volume, especially investment in government bonds. As at 30 September 2016, Italian bonds accounted for 7.4% of the overall debt securities portfolio, with Italian government bonds accounting for 6.6%. At the same time, the share of Polish government bonds decreased to 2.3%. The share of government bonds of any other country does not exceed 1%. Individual banks reported sizeable investment in Italian, Polish, Romanian and Czech government bonds.

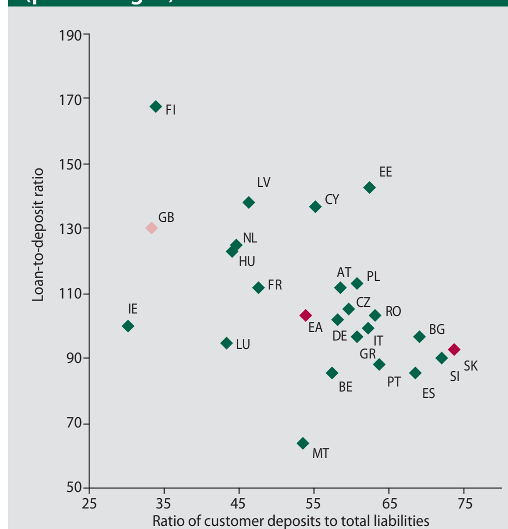
The two largest portfolios, i.e. the held-to-maturity (HTM) and available-for-sale (AFS) portfolios, were stable throughout the period under review; they accounted for roughly 55% and 40% respectively of the total portfolio.

3.3 FUNDING SOURCES OF THE BANKING SECTOR

The banking sector's liabilities still comprise mainly stable funding sources. Customer deposits make up almost three-quarters of total liabilities, with retail deposits accounting for more than 60% of these funds and NFC deposits for more than 20%. Mortgage bonds account for approximately 6% of the total liabilities. Despite the relatively strong growth in lending to customers, the loan-to-deposit ratio has remained below 100% as a result of the large share of customer deposits.

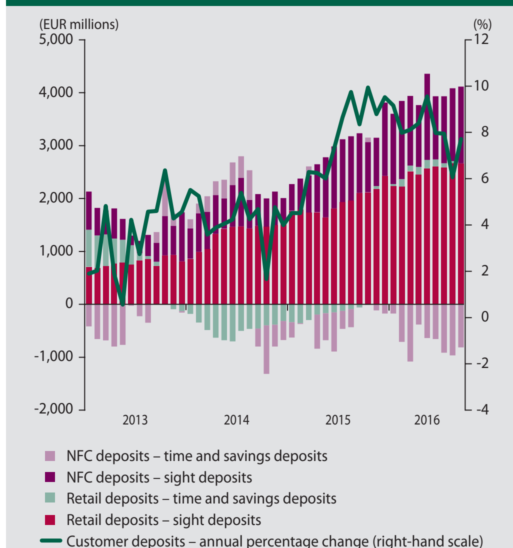
Customer deposits continued to grow in volume over the first three quarters of 2016, with their annual growth rate slowing gradually from 9% in January to 5% in August, then accelerating to 8% in September 2016. This development was driven mainly by NFC deposits, which recorded a year-on-year increase of almost 4% in August and 6% in September 2016, while retail deposit growth fluctuated between 8% and 9% throughout the year to September. In the case of both retail and corporate deposits, their year-on-year growth was almost entirely accounted for by sight deposits. In the retail segment, the stock of time and savings deposits remained flat, year on

Chart 23 Loan-to-deposit ratio and ratio of customer deposits to total liabilities (percentages)



Source: NBS.
Note: The figures shown in the chart were calculated for September 2016.

Chart 24 Changes in the volume of customer deposits



Source: NBS.
Note: The chart shows the annual percentage changes in customer deposits and the annual absolute changes in the main components of these deposits.

year, during the first nine months, while in the NFC segment it fell.

Deposit rates have declined steadily in 2016.

Banks' bond issues continue to be dominated by mortgage bonds in particular. Over the first nine months of 2016, mortgage bonds again accounted for more than 80% of all bonds issued by banks in Slovakia. Mortgage bonds continued to be issued in response to developments in the volume of mortgage lending. Thus, the ratio of mortgage bonds to mortgage loans remained above 70% in each bank during the year to September.

Box 1

NETWORK ANALYSIS OF THE SLOVAK BANKING SECTOR

A network analysis of the Slovak banking sector was first carried out as of June 2013. The analysis confirmed the importance of the interbank market mainly in the maintenance of short-term liquidity, the dominance of a relatively small number of banks, and the low risk of direct contagion across that market. This box provides an updated overview of the interbank market through the results of a network analysis for the period from July 2013 to June 2016.

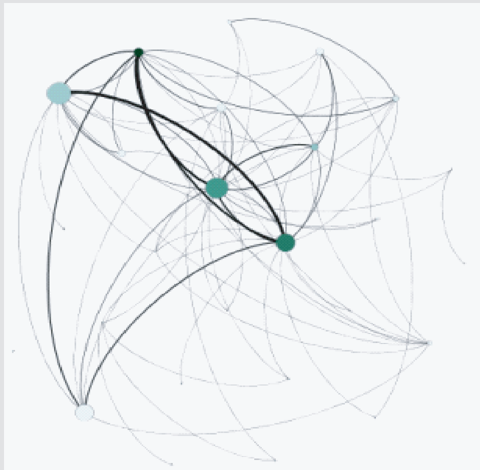
The analysis focused on the interconnections between banks through interbank deposits or bond investments. Given that the function of the interbank market is mainly to ensure short-term liquidity and that there are few dominant banks, the network analysis should primarily investigate the size of the risk of direct contagion across the Slovak banking sector through the interbank market.

The contagion risk was analysed in terms of whether the failure of a bank would lead to the failure of another bank as a result only of direct exposure[11]. The analysis was based on relatively conservative assumptions: in the case of a bank's failure, the other banks will create provisions for 100% of the volume of loans they have provided to the failed bank and of the volume of bonds they have purchased from that bank,[12] and another bank will be deemed to have failed as soon as its capital ratio falls below 8% due to losses from direct exposures.

A bank may fail as a result of an idiosyncratic shock, i.e. a shock occurring under normal conditions or a shock affecting the entire banking sector or a shock at a time of increased stress. In general, the analysis confirms the low level of contagion risk in the Slovak banking sector.

11 Failure caused by a 'bank run' was not estimated.
12 Or, if these bonds are not held in the HTM portfolio, the banks record a loss in the total amount of bonds purchased.

Chart A Network graph of the Slovak banking sector

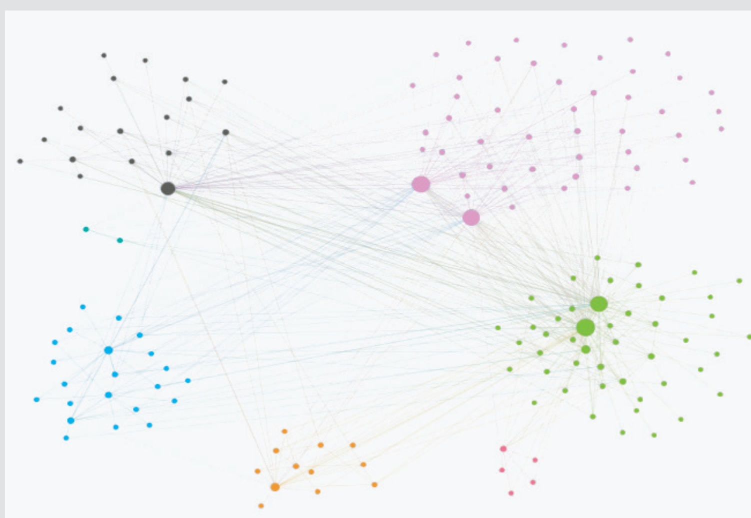


Source: NBS.
Notes: The chart shows the average exposures of banks through loans and bonds in the first half of 2016.
The size of nodes is proportional to the size of the given bank's exposures to other banks.
The darker the colour of a node, the larger the exposures of other banks to the given bank.
The width of edges between two banks is proportional to the size of the exposure existing between the two banks.

The risk of direct contagion at times of increased stress can be monitored, for example, on the basis of the results of stress testing. The most recent stress was conducted as of 31 December 2015. The analysis took into account the year-end profits, own funds and risk-weighted assets of banks as at 31 December 2017 (as the stress test covered the period 2016–2017) under the long-term recession[13] scenario and interbank links as at 30 June 2016 (as at the date of the analysis). The analysis confirms the low risk of direct contagion across the Slovak financial sector at times of increased stress.

If the entire financial sector is taken into consideration, some of the network analysis indicators can be applied, too. Since certain entities are not required to hold capital, the direct contagion risk cannot be analysed here as it is for banks. Nonetheless, it is important to know which institutions are of greater importance or play a central role in terms of interconnectedness.

Chart B Network graph of the Slovak financial sector



Source: NBS.
Notes: The data used in the chart include the average exposures of individual firms through loans, bonds and shares in the second half of 2015. The size of nodes expresses the relative number of links to other institutions. Different colours are used to distinguish the individual 'clusters' identified.

13 A more detailed description of stress testing is available in the Analysis of the Slovak Financial Sector for 2015.

From this point of view, it is fairly logical that the sector is relatively concentrated in terms of the number of institutions to which other institutions have exposures. This refers mainly to banks or asset management companies to which a relatively large number of funds (pension funds or collective investment funds) have significant exposures in aggregate terms. On the other hand, the concentration is not so great in the case of institutions that have exposures to other domestic financial corporations, because such institutions are relatively evenly distributed in terms of number as well as exposure.

An interesting question is whether the individual institutions can be divided into clusters (groups identified on the basis of the total volume of links between the individual institutions), i.e. whether selected clusters of interconnected institutions can be identified. This information may be useful when an institution gets into difficulty, because it is possible to identify a narrow circle of financial institutions that are directly affected by that difficulty. This may also be helpful in performing a detailed analysis of the structure of the financial system. The existence of such clusters may be established, although their structure may change slightly over time.

3.4 FINANCIAL SECTOR RISKS

3.4.1 Sustainability risks to bank business strategies

The sustainability of banks' business models is assessed mainly by simulating scenarios for their profitability

The continuance of the low or falling interest rate environment is creating a major risk to banking sector profitability in terms of its sustainability at levels consistent with banks' business strategies. The negative impact of falling interest rates on banks' interest income was covered in detail in the May 2016 Financial Stability Report. Since this risk has become even more elevated in the recent period, this report includes a comprehensive analysis of the potential development of banking sector profitability up to 2019, assuming the continuation of current trends in the volume, rate of return, and cost of the principal balance sheet items. Separate estimates are made for banks' interest income, interest expenses and net fee income arising from business with the most significant economic sectors. As for the retail portfolio, a separate simulation is carried out for income from housing loans and consumer loans. In regard to the interest rates on these loans, however, the simulation in this report is notably different from that in the May 2016 Financial Stability Report. This is mainly due to the marked heightening of competition in both segments, related to sharper interest rate reductions. As mentioned earlier, in respect of housing loans, this change mainly relates to the introduction of a statutory cap on early repayment fees for housing loans and the consequent increase in loan refinancings at lower interest rates and downward pressure on interest rates on new loans.

Box 2

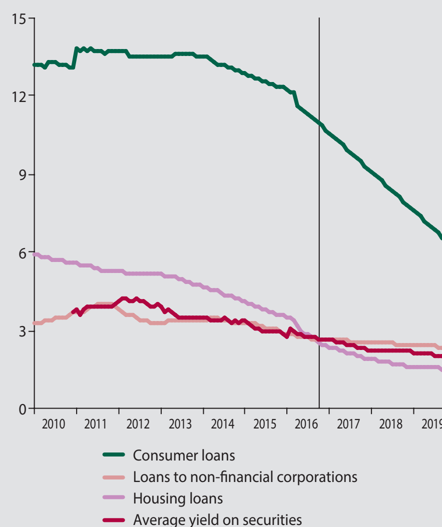
SCENARIO PARAMETERS USED IN THE PROFITABILITY SIMULATION

The profitability prospects of the Slovak banking sector were simulated using a scenario of potential developments in parameters that have the greatest impact on banks' profitability. The individual parameters are listed in Table A.

The simulation captures not only the impact of falling interest rates and decreasing fees related to loans and deposits, but also the impact of expected growth in banks' balance sheets. This growth, on the one hand, partly offsets the adverse impact of falling interest and fee income, and, on the other hand, it means higher credit risk costs, bank levy payments and corporation tax.

As regards retail loans, it is assumed that their growth rate will moderate and that interest rates will fall appreciably. Retail loan growth is assumed to decrease gradually year on year, but even in 2019 it is not lower than 10% for housing loans or 8% for consumer loans. At the same time, however, interest rates fall significantly. The average interest rate on housing loans, which decreased by -0.7 percentage point between March and August 2016, is assumed to continue falling at a significant but gradually moderating pace, decreasing from the level of 2.7% in August 2016 to 1.5% by the end of 2019 (Chart A). The pronounced difference in consumer loan interest rates between Slovakia and other euro area countries[14], together with increasing inter-bank competition related to high demand for refinancing, is creating substantial pressure for further interest rate cuts. Thus the simulation assumes that consumer loan interest rates fall from 11.2% to 6.2%. The stock of loans to non-financial corporations is assumed to increase by 4% year on year, slightly less than its average increase for the past 12 months (5.9 %), while interest rates on these loans decrease only marginally. As well as a decline in the interest margin, it is assumed that the recent downward trend in rate of charge from retail transactions continues, although with a gradually moderating trajectory. Yields on securities are also assumed to diminish, with securities maturing sequentially and the funds received being reinvested in bonds yielding 0.8%.

Chart A Lending rates, yields on securities, and the simulation of their trend until 2019 (percentages)



Source: NBS.
Notes: The vertical line marks the divide between the actual trends up to August 2016 and the subsequent simulated trends. Details of the scenario for the simulated trends, for the period from September 2016 to December 2019, are given in Table A.

The projected balance sheet growth is assumed to be funded mostly from increases in retail and corporate deposits, as well as by the issuance of mortgage bonds. In the case of retail loans, however, it is further assumed that, owing to low interest rates on time deposits, customers will have increasingly less incentive to maintain savings for an extended period and that therefore the trend outflow of funds from time deposits to current accounts will continue. At the same time, deposit rates continue to fall. In the case of NFC, financial institution, and government

14 The average consumer loan interest rates in Slovakia in August 2016 was 6 percentage point higher than that the average of such rates across Germany, France, Belgium, the Netherlands, Austria and Finland.

deposits the average deposit rate is even assumed to edge down into negative territory (to -0.1%)[15], although in terms of its impact on the simulation as a whole, this fact is not significant.

In the scenario, no increase in credit portfolio risk is assumed compared to 2015. The credit risk cost ratio has so far this year been the same for both retail loans and NFC loans, at 0.78%. And although interim data indicate the ratio could still fall slightly this year, to 0.66% for retail loans and 0.49% for NFC loans, the simulation retains this risk ratio reduction only for 2016. In 2017 and 2018, the risk ratio is assumed to return to its 2015 levels, since, given the ratio's historical trend, its sustainability at the 2016 level is questionable, especially in respect of the corporate loan book. Even if the risk ratio remains unchanged, an increase in the stock of loans naturally leads to an increase in total credit risk costs, and this is taken into account in the simulation.

Table A Parameter changes in the scenario of banks' profitability prospects up to 2019

	Annual rate of change in amount	Change in average interest rate or yield on outstanding amount
Consumer loans	Gradual decrease from 14% to 8%	Linear decrease from 11.2% to 6.2%
Housing loans	Gradual decrease from 13% to 10%	Decrease from 2.7% to 1.5%, more pronounced in 2016 and 2017
Loans to NFCs	Stable at 4%	Linear decrease from 2.7% to 2.3%
Securities purchased	Zero	Gradual decrease from 2.7% to 1.9%
Time deposits	Stable at -5%	Gradual decrease from 1.2% to 0.4%
Retail deposits / current accounts	Stable at 15%	Stable below 0.1%
NFC and non-resident deposits	Stable at 4%	Decrease from 0.1% to -0.1% by end of 2017
Financial institution and government deposits	Zero	Decrease to -0.1% by end of 2017
Securities issued	Gradual decrease from 10% to 8%	Decrease from 1.7% to 0.8%, more pronounced in 2016 and 2017

Additional assumptions:
The rate of charge in the retail portfolio falls from 0.95% to 0.82% of the average amount of deposits and loans, with the decrease being more pronounced in 2016 and 2017.
The rate of charge in the NFC portfolio remains unchanged.
The credit risk cost ratio in 2016 is 0.66% for retail loans and 0.49% for NFC loans, and subsequently it returns to its 2015 level (0.78%) for both portfolios.

Source: NBS.
Notes: The scenario covers the period from August 2016 to December 2019.

The simulation indicates a potentially greater decrease in profitability in 2017, followed by more moderate declines in 2018 and 2019

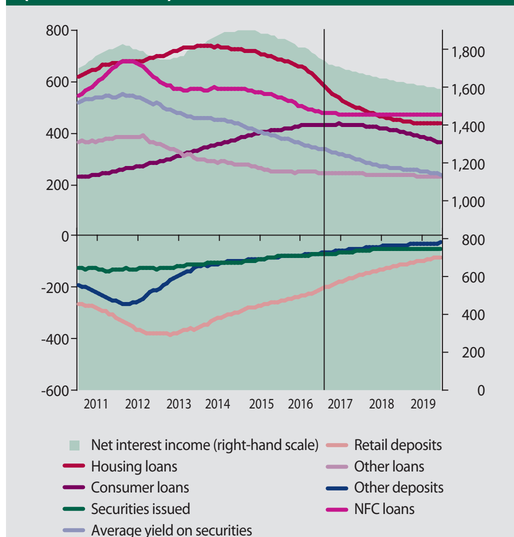
The simulation of profitability prospects notably indicates a substantial drop in interest income from the housing loan portfolio, which will markedly affect the adjustment of banks' business strategies for the retail sector. The significant fall in interest rates since March 2016 has so far only slightly amplified the decline in interest income, but that impact is expected to become more pronounced in

15 In September 2016 the average interest rates on NFC sight deposits and NFC time deposits with an agreed maturity of up to one year was already negative in some countries (Denmark, Belgium, Germany, Luxembourg and the Netherlands).

coming months. Interest income from housing loans, once the largest component of profitability, could fall by as much as one-third by 2019 (without taking account of changes in interest expenses). This decline is expected to be most marked in 2017. The implication of that trend is an increase in the importance of consumer loans at the expense of housing loans. In consequence, banks may seek to maximise their provision of consumer loans, for example by increasing the indebtedness of current customers to the limits of sustainability. This may be achieved, for example, by allowing customers to take on more debt through refinancing. Housing loans, on the other hand, may become products which in themselves are only modestly profitable, but which serve mainly to incentivise customers to use other, more profitable banking products.

The extent to which the decline in interest income from housing loans can be made up for with income from consumer loans is limited by increasing competition. With consumer loans gradually becoming more important to banks' profitability, interbank competition in this segment is naturally increasing. Furthermore, assuming this trend continues in the period ahead, growth in interest income from these loans can even be expected to fade. In addition, the long-running downward trend in interest income from the debt securities portfolio will continue. Although these negative trends will be partly mitigated by falling costs, particularly in relation to retail deposits, net interest income on the retail portfolio is assumed to fall by 15% over the period 2016-2019, and total net interest income (net of interest expenses) for all sectors, including securities, is assumed to fall by a similar margin. This decline has a relatively significant impact on banks' net profit, since interest income constitutes the largest component of the Slovak banking sector's profitability.

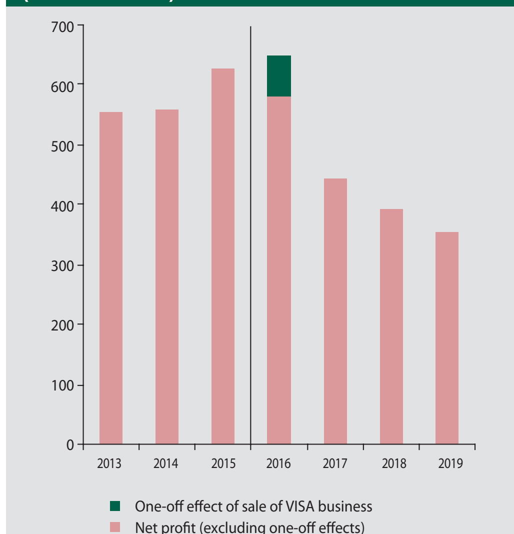
Chart 25 Interest income (positive value) and interest expenses (negative value) and the simulation of their trend until 2019 (EUR millions)



Source: ECB.
Notes: The chart shows, as at each month, the cumulative interest income or cumulative interest expenses for the previous 12 months.
The vertical line marks the divide between the actual trends up to August 2016 and the subsequent simulated trends. Details of the scenario for the simulated trends, for the period from September 2016 to December 2019, are given in Table A.

The simulation outcomes for banks' profitability show it falling sharply in 2017 and continuing to decline moderately in subsequent years. The outcome for 2017 is largely determined by a slump in net interest income on housing loans related to a legislative change introduced in 2016 in respect of this market. This fall is also partly attributable to a slight increase in the credit risk cost ratio to its 2015 level. The moderate drop in profitability in subsequent years (2018 and 2019) reflects mainly a continuing decline in interest income from securities and retail loans. As mentioned above, the fall in interest income on housing loans may also be accompanied by a fall in interest income on consumer loans if competition continues to intensify. Although these adverse effects are mitigated by the assumed continuance of credit growth, it must also be noted that this growth itself probably entails an increase in certain expense items. Credit risk costs, in particular, increase as a result of credit growth, even where the risk ratio and bank levy remain constant. All in all, the simulation under the given parameters shows the banking sector's aggregate net profit falling over the period until 2019, by around 40% to 50% in comparison with its level in 2015.

Chart 26 The banking sector's net profit and the simulation of its trend until 2019 (EUR millions)



Source: NBS.
Note: The vertical line marks the divide between the actual trend up to 2015 and the subsequent simulated trend. Details of the scenario for the simulated trend, for years 2016 to 2019, are given in Table A.

In addition to a decline in profitability, the banking sector becomes significantly more sensitive to further headwinds. The resilience of the Slovak banking sector has previously been described as relatively strong, due in large part to the sector's capacity to generate ample and stable net interest income. As the simulation shows, however, that capacity is weakening amid current trends. This means that the simulated decline in the sector's profitability may in the period ahead be further amplified, for example by even a modest increase in credit portfolio risk, by additional changes in the regulation of fees or pricing policy, or by increasing competition. If, for example, the credit risk cost ratio increases from 0.78% to 1% from 2017 to 2019, the decline in profitability is amplified by a further 10 percentage points. The banking sector is gradually reaching a stage where it can at least partly maintain its current level of profitability only by growing its loan portfolio, while its interest margins continue to compress. The net interest margin on retail business, taking into account net income from interest and fees as well as credit risk costs, stood at 5.3% in 2013 and fell to 4.4% by the end of 2015; under the simulation it is assumed to fall to close to 2.3% by the end of 2019. Any additional unexpected compression of this margin, stemming from a more pronounced drop in lending rates or increase in credit risk, will thus have an increasingly significant impact on the overall profitability of the banking sector.

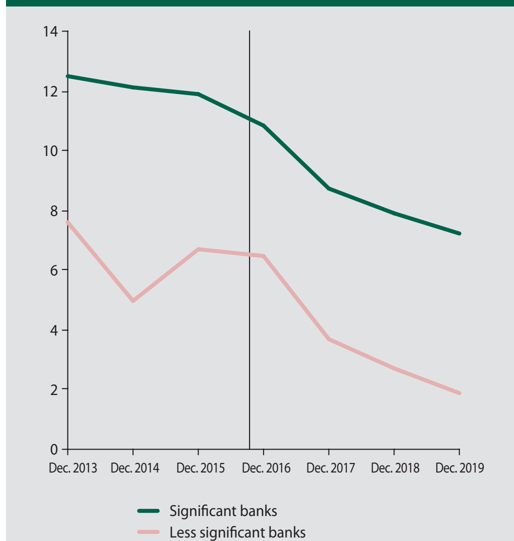
It is therefore crucial to banks' profitability prospects that their credit portfolio risk does not increase significantly. What makes this more difficult to ensure is that banks must make up for falling interest rates and fees by increasing their amount of lending. Therefore, on the one hand, banks will need to adjust their business strategies to the above-mentioned trends, while, on the other hand, their increasing sensitivity to any adverse developments greatly constrains their room for manoeuvre. The aim to mitigate the negative pressure of heightening competition on loans (making them riskier) and unsustainable credit growth is one of the reason that NBS issued a decree concerning prudential approaches in the provision of housing loans. This measure is described in more detail in Chapter 5 'Macroprudential policy'.

The simulated adverse trends in profitability have an even greater impact on less significant banks. Over the period until the end of 2019, the average return on equity (ROE) for significant banks[16] in Slovakia is assumed not to fall below the average ROE for all significant banks in the banking union (5.9% in June 2016). By contrast, the average ROE of less significant banks declines significantly, since these banks have long been reporting lower levels of profitability compared to significant banks. A further drop in their profitability could threaten the sustainability of their business models, possibly leading to a bout of consolidation in the banking sector.

With banks having to increase their lending to the retail sector and NFCs in order to maintain profitability, they also have a mounting need to increase capital through retained earnings. As Chart 28 shows, in the scenario where banks do not retain any earnings, the average capital adequacy ratio for significant banks falls gradually in 2016 to below the minimum requirement. As for less significant banks, their average capital adequacy ratio falls to the minimum requirement. In addition to declining capital adequacy stemming from the increasing amount of risk-weighted assets, the scenario includes a gradual increase in capital requirements

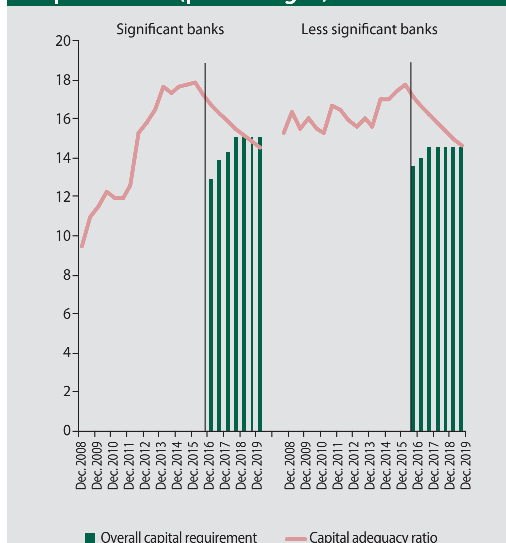
16 Significant banks are under the ECB's direct supervision.

Chart 27 Average ROE and the simulation of its trend until 2019 (percentages)



Source: NBS.
Notes: The vertical line marks the divide between the actual trends up to August 2016 and the subsequent simulated trends. Details of the scenario for the simulated trends, for the period from September 2016 to December 2019, are given in Table A.
The ROE calculation in 2016 does not include one-off income from the sale of VISA business.
Income and expenses in individual categories were simulated at the level of the whole sector; they were assigned between banking groups on a proportional basis, according to their mutual shares of these income and expenses in 2015.

Chart 28 Scenario of potential trends in capital adequacy ratios and capital requirements (percentages)



Source: NBS.
Notes: The overall capital requirement is the sum of the Pillar 1 requirement (at 8%), the Pillar 2 capital requirement, and capital buffer requirements (the countercyclical capital buffer requirement is assumed to be 0.5% during the period 2017-2019). The Pillar 2 requirement is assumed to remain at a constant level.
The aggregate figures for the whole banking sector are calculated as the average of the individual ratios weighted by risk-weighted assets.
The vertical broken lines mark the divide between the actual trends up to August 2016 and the subsequent simulated trends. Details of the scenario for the simulated trends, for the period from September 2016 to December 2019, are given in Table A.
The capital adequacy ratios from 2016 to 2019 are estimated on the assumption that banks do not retain any of their earnings.

resulting largely from the application of capital buffers. This mainly concerns significant banks and the gradual raising of their capital requirements due to their systemic importance. According to the simulation, the banking sector must retain almost half of its earnings for the year years 2016 to 2018 if it is to continue meeting its overall capital requirement. Thus the dividend payout rate, which during the period 2012-2015 was between 65% and 75%, needs to be below 50% in subsequent years.

The assumed trend is not, however, expected to be significantly constrained by requirements related to balance sheet structure and long-term funding. Because customer deposits account for a large share of its funding, the Slovak banking sector is at present equipped to meet requirements concerning the sufficiency of stable funding sources, requirements that are expected to arise from the implementation of a long-term stable funding ratio. Given that lending growth in the period ahead is expected to be funded mainly through deposits and, to a lesser extent, mortgage bonds, compliance with these requirements is expected to be maintained.

3.4.2 Risks in the household and NFC portfolios

The indebtedness of households has accelerated dangerously, significantly increasing households' sensitivity to any economic headwinds

Households' credit-to-disposable income ratio continued its upward trend in 2016. Even though the leveraging of households in Slovakia is gradually approaching levels observed in the most advanced euro area economies, its rate of increase has accelerated in recent years. As recently as in 2010, the credit-to-disposable income ratio of households was lower in Slovakia than in any other central and Eastern European country apart from Romania. On current trends,

Chart 29 Household credit-to-disposable income ratio (percentages)

Source: Eurostat, ECB.
Note: Calculations include loans provided by the banking sector only.

Chart 30 Net financial position of households

Source: Eurostat.
Note: The net financial position is the ratio of financial assets to financial liabilities.

however, in terms of this ratio, Slovakia will rank second among CEE countries at the end of 2016. The turnaround in this situation over the past six years has therefore been considerable. No longer can Slovakia be described as having low household indebtedness compared with other countries in the region. As a result, the sensitivity of Slovak households to any economic headwinds is far higher than it used to be.

The elevated sensitivity of households resulting from their rising indebtedness has exacerbated the deficiency in their financial asset-to-debt ratio. The sharp growth in the debt of Slovak households has turned their financial asset-to-debt ratio into one the worst in any EU country. Although their savings (financial assets) are still greater than their debts (financial liabilities), the ratio between the two in the first quarter of 2016 was the second worst in the EU. Furthermore, due to increased leveraging, this ratio fell more in Slovakia than in any other EU country. The general shortage of financial assets means that households are more vulnerable in terms of their debt servicing capacity and that their exposure to potentially adverse economic shocks is greater. On the other hand, the distribution of financial assets and liabilities across households is not clear from the data. Moreover, not all financial assets are sufficiently liquid to be used for debt servicing in the event of an economic downturn.

Favourable trends in the household sector are leading to the underestimation of risks

The continuing strong growth in retail loans stems from the interplay of a number of factors. A trend shift in one or more of these factors could have a significant impact on developments in the retail sector. The most important of these factors are falling interest rates, falling unemployment, wage growth, the related low loan default rate, the simplification of housing loan refinancing, the property market situation, and the medium-to-low leverage of households. Several of them are reaching historically most favourable levels. In good times such as this, however, it is imperative to be vigilant for signs that one or more of these factors are turning negative.

The first of the above-mentioned factors are interest rates on housing loans, which are not only at historical lows for Slovakia but are also among the lowest by international standards. Absent some substantial external changes, the scope for their further decrease is limited. Although interest rates remain low and the base of potential customers is expanding, the upward impact of low rates on indebtedness may fade.

Furthermore, a majority of customers in Slovakia are now habituated to falling interest rates and may therefore not perceive the risk of a potential increase in interest rates and their loan repayments.

The second factor is the marked fall in the registered unemployment rate in Slovakia, which since summer 2016 has dropped to 9.4%, just 2 percentage points above its historical low recorded in 2008. Some sectors are already experiencing labour shortages (see the section on the domestic environment). The signs are similar to those observed in 2008, which at that time led to systematic underestimation of risks by households and banks alike.

Closely related to the previous two factors is the credit quality indicator. The non-performing loan (NPL) ratio for retail loans remained below 4% in 2016, with the average net default rate for housing loans standing virtually at 0%. The low delinquency rate implies two things. On the one hand, it is a sign that loans are being repaid; on the other hand, it could support a trend of less creditworthy customers qualifying for loans, meaning customers who could default even in times of minor market turbulence. By the same token, there is a risk that banking models based on loan defaults will fail to distinguish between creditworthy and less creditworthy customers.

The simplification of refinancing, particularly in respect of loan prepayment fees, had a marked impact on lending trends during 2016 (further details are provided in the section on retail trends). But once the potential stemming from the spread between interest rates on existing and new loans has been exhausted, this trend, too, is expected to lose momentum. A decline in refinancings that involve an increase in the debt burden could in particular have an impact on credit growth.

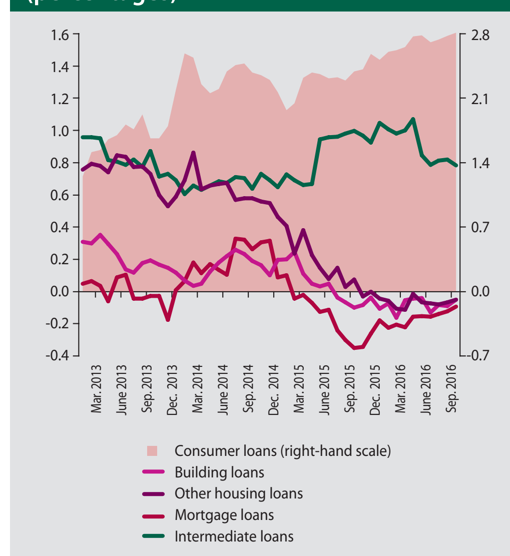
It is also important to note the interlinkage between the property market and housing loans. Phases of property price growth such as the current one are typically the most opportune times for increasing the amount of housing loans. When the cycle turns and property prices flatten or fall, the result is likewise a slowdown in financing of residential real estate. Furthermore, loans provided at the end of the property market's growth phase are typically riskier.

Last but not least, retail loan growth reflects actual household indebtedness, which, however, has been increasing strongly. Not only is that trend different from what is happening in other, similar EU economies, it also means Slovakia could, in the near future, have the most leveraged household sector in the region (see the section on household indebtedness).

The banking sector's aggregate housing loan portfolio has historically been of high quality; the consumer loan portfolio is worsening slightly

The aggregate non-performing loan ratio for retail loans remains below 4%, while the net default rates for housing loans and consumer loans are moving in opposite directions. For the housing loan portfolio, the NPL ratio continues to improve (now standing at 2.4%), while the net default rate stood around zero during the previous 12 months. Among the housing loan categories, intermediate loans had the highest default rate during the period under review (increasing from 0.8% to 1.1%). The other types of housing loan reported negative default rates, meaning that the amount of loans that defaulted was lower than the amount of non-performing loans that were reclassified as performing.

Chart 31 Net default rate for retail loans (percentages)



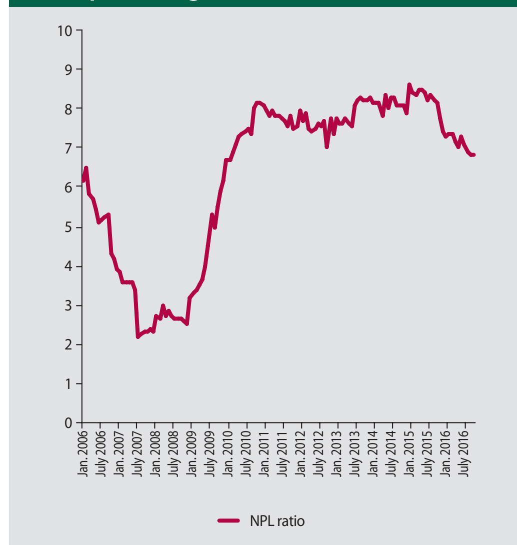
Sources: NBS.
Note: The net default rate denotes the net change in the amount of non-performing loans over a 12-month period as a share of the outstanding amount of loans at the beginning of the period. The numerator is adjusted for the effect of loan write-offs and sell-offs.

Credit risk across loans to non-financial corporations continues to fall

The quality of the Slovak banking sector's aggregate loans to NFCs, as measured by the NPL ratio, has continued to improve. The NPL ratio has been falling since the beginning of 2015 and is now below 7%, significantly lower than the average figure for the whole post-crisis period. This result stems from several trends. First, the outstanding amount of NFC loans has been increasing as sentiment in the economy has continued to improve. Second, a combination of economic growth, rising sales and falling interest rates has benefited firms' debt servicing capacity, resulting in a falling amount of defaulting loans, an increasing amount of loans reclassified from non-performing to performing, and an increase in the amount of previously non-performing loans that were paid off. Thus, overall, in several months, the stock of non-performing loans decreased, while the amount of loan write-offs and sell-offs remain below the level of previous periods.

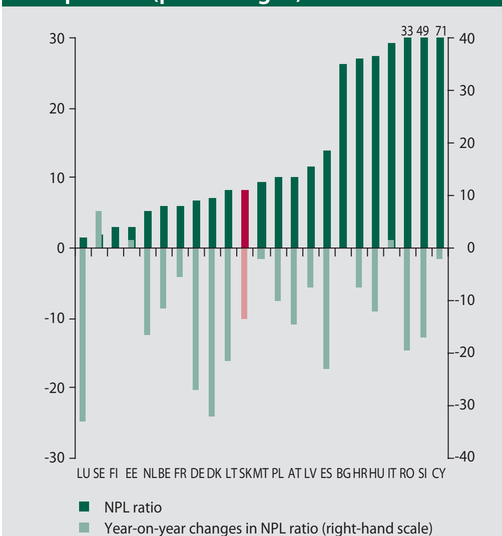
In the aggregate breakdown of loans by their provision to particular sectors of the economy, the majority of portfolios are seeing a downward trend in the NPL ratio. Likewise, a majority of banks are reporting an improvement in their overall credit portfolio quality, although in terms of NPL ratios there continues to be considerable heterogeneity across banks.

Chart 32 Aggregate non-performing loan ratio (percentages)



Source: NBS.

Chart 33 Credit portfolio quality and its year-on-year changes: an international comparison (percentages)



Source: ECB, SDW.
Note: The values in the chart are calculated on the basis of the total amount of NFC loans including loans to non-resident firms from other EU countries. Consequently, the NPL ratio for the domestic banking sector may differ slightly, since in other sections of the report the focus is primarily on loans to resident NFCs.
Information on loans provided in the Czech Republic, Portugal, Greece, Ireland, and the United Kingdom was not available in the required structure. The amount of the NPL ratio for Romania, Slovenia and Cyprus is given above the respective country.

In international comparison, it may be noted that while the dynamics in lending to NFCs vary significantly across the EU, a majority of EU countries have a trend of falling NPL ratios. The quality of the Slovak banking sector's NFC loan book is above the EU median.

The commercial real estate (CRE) sector remains a significant source of credit risk, while the NPL ratio for loans to this sector has remained largely unchanged. The NPL ratio for the aggregate CRE loan book is not following the broader downward trend across the banking sector's credit portfolios. During 2016 the NPL ratio for the CRE portfolio stayed around 10%, far higher than the figure for overall lending. The NPL ratio for CRE loans was not reduced by the increase in their outstanding amount, because growth in non-performing CRE loans also increased.

It is the share of non-performing CRE loans in total non-performing loans that makes this sector significant. As a result of the trends described

above, this share has increased during the course of 2016. In contrast to the situation in total loans, this concentration is more pronounced in the case of larger banks.

Concentration risk remains present, but largely unchanged

Concentration risk remains at a largely unchanged level, but is still one of the significant risks in the domestic banking sector. A feature of the Slovak banking sector is its relatively high exposure to concentration risk. One of the forms of this risk is the concentration of specific economic sectors in banks' corporate loan books, in regard to customers, or groups of closely-linked customers, which have sizeable exposures towards individual banks. Should such an exposure to a small or medium-sized bank become non-performing, the bank's total capital ratio could fall below 10.5%.

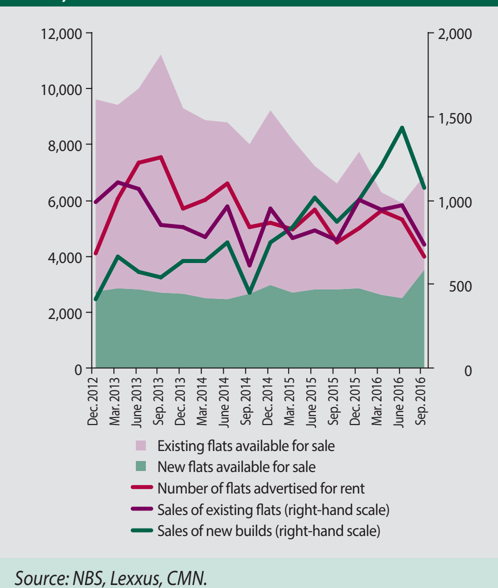
Some banks continue to have sizeable intragroup exposures. It is important for financial stability that the level of the different types of concentration risk remains largely unchanged or falls slightly.

Continuing price growth has been a feature of the market for residential new builds in Bratislava, as has an increasing number of flat sales. The number of new flats coming on to the market is so far keeping up with sales.

In Slovakia, the market in flats is significant for financial stability. The conventional business model of domestic banks, with its focus on the domestic market, translates into a relatively strong interlinkage between the banking sector and the property market. The significance of this market lies in the high share of housing loans in the banking sector's total assets. This share is, moreover, among the highest in the EU.

The market in new builds is an important part of the residential property market in Slovakia's capital city. The recent period has seen new builds increases as a share of the total number of flats on the market in Bratislava. This is due to the combination of a falling number of existing flats available for sale and the stable trend in new builds available for sale. The drop in the number of existing flats advertised for sale reflects the falling number of flats being put up for sale, while the supply of new builds remains stable thanks only to increasing inflow of new flats. As regards the number of flat sales, the situation has been very similar, as sales of new builds first gradually caught up with sales of existing flats and then, recently, started to account for the majority of total sales.

Chart 34 Decomposition of the residential property market in Bratislava (numbers of flats)

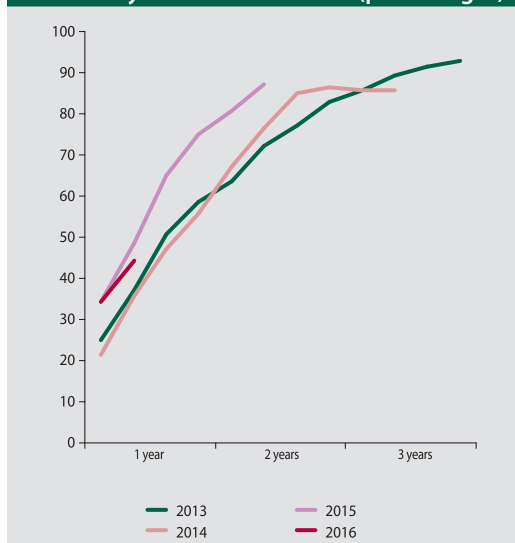


Source: NBS, Lexxus, CMN.

New build prices in Bratislava have recorded stable growth of just under 9% in 2016. This growth rate remained comparable with that observed towards the end of 2015. The price growth has been broad-based across different areas of the capital city and across different sizes of property. The price trends are to a large extent determined by the inflow of unfinished flats into the market, as their prices increase more sharply than the overall growth rate in new build prices.

Demand for new builds has risen strongly in the recent period. The first indicator of this rising demand is the rapid increase in new-build sales, which in 2015 and 2016 recorded substantial year-on-year growth of more than 30%. The second indicator is the speed of property development sales, i.e. the ratio of flat sales to the total number of flats available for sale in a property development at a given point in time after the flats were first marketed. Projects put on the market in 2015 and 2016 have been selling out far more quickly compared to earlier projects.

Chart 35 Speed of sales of property developments differentiated by the year in which they were first marketed (percentages)



Source: NBS, Lexxus.
Note: The years on the horizontal scale denote the period since the developments were put on the market.

This partly contributed to an increase in the ratio of unfinished flats to total sales, which in 2016 exceeded 80%.

The growing ratio of flat sales to flats available for sale is increasing the sensitivity of the new-build market to potential shocks. On the supply side there are two key trends. The first is in the number of flats available for sale, which has remained largely flat despite strong growth in sales. This reflects an increasing inflow of new flats. It therefore appears that the number of new flats coming on to the market is keeping up with sales. The second trend is a relatively marked increase in the ratio of flat sales to the total number of flats available for sale. Hence, the market is becoming more sensitive to potential shocks, whether in regard to the current inflow of new flats or to the demand for them. Another direct consequence of this trend is that unfinished flats make up a high share of new flats available for sale.

In the market for existing flats, supply has continued to fall while prices have risen steadily

The number of flats advertised for sale in Slovakia has continued to decline rapidly, while flat prices remain on an upward path. The number of flats advertised for sale has fallen gradually and now stands at half of what it was in 2013. At the same time, price growth in this market has continued to accelerate moderately (by 1 percentage point per quarter) to reach 9%, year on year, in the third quarter of 2016. Both trends are relatively homogenous across regions, urban and rural areas, and flat sizes. The only exception is strong price growth in Nitra region, apparently linked to the fact that a new car plant is being established in the locality.

The number of flat sales has not changed significantly, but newly advertised flats are increasingly fewer in number. The rise in prices for which flats are sold is somewhat higher (around 15% year on year) than the rise in prices for which they are advertised, while the number of flat sales remains at around the same level. It seems that the cause of the falling supply is not an increased number of sales, but rather a decline in the number of newly advertised flats. It may be that potential sellers are deferring putting their properties on the market in the expectation that prices will rise further.

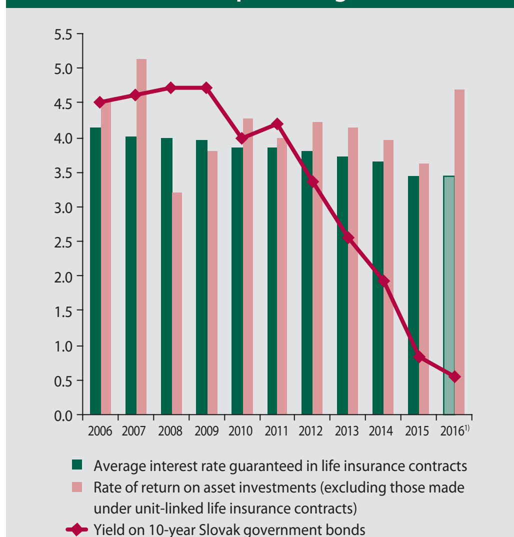
The low interest rate environment means the cost of borrowing for flat purchases is lower now than at any other time in the post-crisis period; there is still, however, sensitivity to potential increases in interest rates. Not even the growth in flat prices since autumn 2014 has reversed the impact of falling interest rates. Average housing loan instalments are still only around 70% of what they were in 2009. But although low lending rates mean it is now easier to qualify for a loan, borrowers remain vulnerable to changes in these rates over the term of the loan.

3.4.3 Risks arising from the prolonged period of low interest rates

The insurance sector remains resilient to risks related to the prolonged period of low interest rates

The impact of persisting low interest rates on the insurance sector has been most pronounced in traditional life insurance (TLI) business, where insurers have to earn enough from investments to cover the returns guaranteed in insurance contracts. The impact of low interest rates on the insurance market was analysed in depth in the May 2016 Financial Stability Report. That assessment did not change significantly during the first half of 2016.

Chart 36 Comparison of guaranteed returns and actual returns (percentages)



Source: NBS and Bloomberg.
1) The data for the average guaranteed rate in 2016 are not available and are imputed with the figure for 2015.
Investment returns in 2016 are affected by one-off dividends from participating interests.

Chart 37 Average duration of debt security portfolios (years)

Source: NBS.

Investment returns in the first half of 2016 were boosted by one-off factors, most notably by dividends from participating interests. These one-off effects resulted in the average annualised return on investment increasing to 4.7%; in their absence, it would have been 3.7%, close to its 2015 level. The overall rate of return on assets therefore remains above the rate of return guaranteed in TLI contracts. Owing to reporting changes made as part of the transition to the Solvency II regime, no figures are available for returns on assets covering technical provisions in TLI business.

3.4.4 Market risks

Exposure to market risks continued to increase

The exposure of pension funds and investment funds to market risks continued to increase during the first half of 2016, due to the search for yield in an environment of low interest rates. The value of pension fund investment portfolios became increasingly sensitive to any rise in interest rates. The duration of bonds across portfolios continued to increase. In terms of the riskiness of issuers, bond portfolios remain relatively conservative. The only notable exposure to lower-rated countries is in sector of supplementary pension management companies (SPMCs – managing funds in the third pillar of the pension system). In pension funds, and to a lesser extent, investment funds, the equity component of investment portfolios has increased.

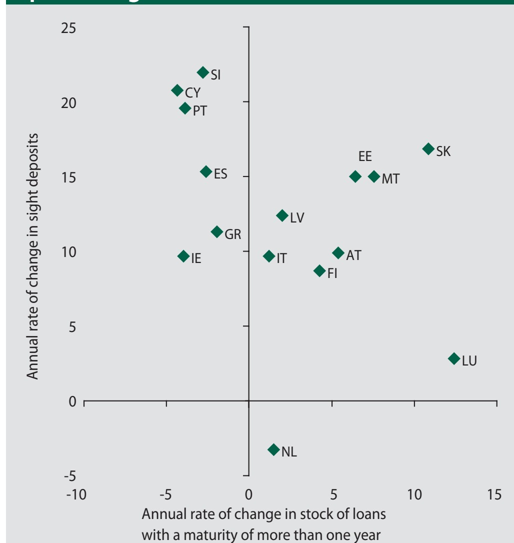
3.4.5 Liquidity risk

The nature of liquidity risk has changed

The banking sector's liquidity position has this year continued to reflect, in particular, trends in the retail sector. Owing to strong growth in the stock of housing loans, the share of long-term illiquid assets in the banking sector's total assets has continued to increase. Meanwhile, household deposits have grown sharply in conjunction with an outflow of funds from time deposits to current accounts, the result of which has been an increase in short-term liabilities. The combination of growth in long-term loans and short-term deposits has been more pronounced in Slovakia than in any other euro area country.

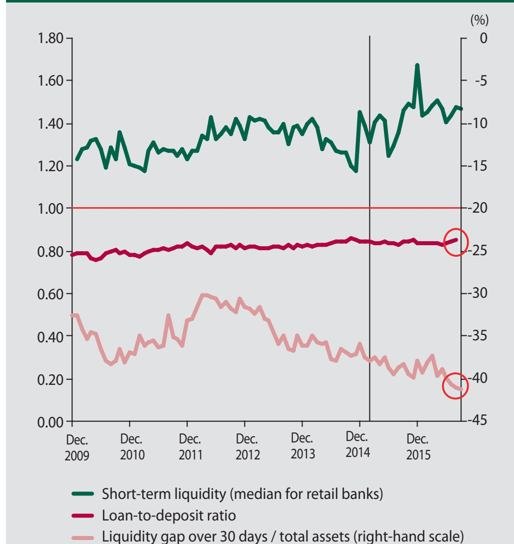
Since both domestic and European regulatory regimes treat retail deposits as one of the most stable sources of bank funding, the growth in these deposits has not been detrimental to the liquid asset ratio. The stability of the liquid asset ratio during 2016 has also been greatly supported by an above-mentioned outflow of funds from time deposits to current accounts, which

Chart 38 Changes in the balance sheet structure of euro area banking sectors (percentages)



Source: NBS.

Chart 39 Key liquidity indicators

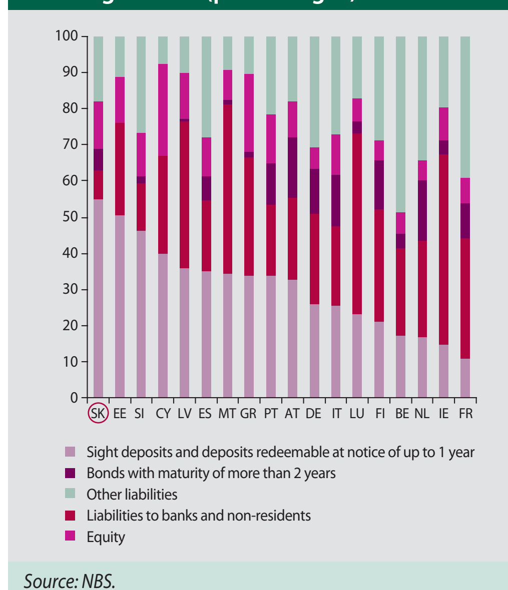


Source: NBS.

because they are not investment products are considered more stable than time deposits.

Retail deposit growth has been contributing to the ongoing increase in the maturity mismatch between assets and liabilities, which on the asset side is attributable to growth in long-term housing loans. Thus the liquidity gap over one year has reached a new high this year. In the context of the increasing liquidity gap, Národná banka Slovenska has long been drawing attention to the major importance of liquid assets to financial stability. Nevertheless, liquid assets as a share of the banking sector's total assets have been falling, due in large part to a decline in banks' investments in government bonds. Therefore the widening liquidity gap is to a lesser extent covered by liquid assets and is to a greater extent reliant on the stability of short-term deposits, in particular from the retail sector. While this trend does not have a significant impact on liquidity risk in the banking sector as a whole, it does increase the sensitivity of individual banks to deposit withdrawals. The reliance on short-term deposits in the Slovak banking sector is also elevated in international comparison. The share of sight deposits and other short-term deposits in the banking sector's total deposits is higher in Slovakia than in any other euro area country. What is favourable in terms of liquidity is that Slovak banks are less reliant on funding from other banks and non-residents. What may not be so favourable is the relatively low issuance of bank bonds for funding.

Chart 40 Liabilities structure of euro area banking sectors (percentages)



Source: NBS.

CHAPTER 4

REGULATORY AND LEGISLATIVE ENVIRONMENT

4

4 Regulatory and legislative environment

An amendment to the Consumer Credit Act supplements the requirements of the Housing Loan Act

NBS Recommendation No 1/2014 ("the Recommendation") has been fully enacted into Slovak law by the Housing Loan Act (HLA) and by an amendment to the Consumer Credit Act (CCA). As for the calibration of individual instruments, NBS will specify them through secondary legislation. An amendment to the CCA was signed into law by the Slovak President in October 2016 and it will enter into force on 1 January 2017. Like the HLA, this amendment introduces an obligation to verify the debt servicing capacity and income of consumer loan applicants, and a maturity limit for consumer loans. Furthermore, it extends the remit of measures to include the non-bank sector. This amendment included several technical amendments to the HLA, none of which significantly affects the macroprudential provisions of the law. Both laws contain enabling provisions, under which NBS will provide details of statutory requirements.

An NBS decree will implement principles contained in NBS Recommendation No 1/2014

A major legislative development is the translation of the Recommendation's provisions into an NBS Decree in the area of housing loans. The Decree will be issued on the basis of an enabling provisions contained in the HLA, and is due to enter into force at the beginning of 2017.

The main purpose of the Decree is to ensure that credit growth is sound and sustainable. This will reduce risks to both customers and banks and stem the build-up of imbalances in the property market. The aim is not to curb credit growth or house prices per se.

The Decree will also include the recalibration of certain parameters. The purpose is above all to take account of current developments in the housing loan market, including changes that have taken place since the Recommendation was issued. The Decree is most significantly different from the Recommendation in the following two ways:

- It is proposed to require that housing loans be provided only to customers whose monthly income – less the loan instalment amount, minimum subsistence amount (including the minimum subsistence amount for dependants), and instalment amounts for existing loans (taking into account potential interest rate increases) – leaves them a financial buffer to cope with financial shocks. The size of this mandatory buffer will gradually increase, and from 1 July 2018 it will stand at 20% of the customer's income, less the minimum subsistence amount. This mandatory buffer will be phased in from 1 March 2017, at a level of:
  a) 5% from 1 March 2017 to 30 June 2017;
  b) 10% in the second half of 2017;
  c) 15% in the first half of 2018;
  d) 20% from 1 July 2018.
- It is proposed to introduce an additional upper limit for the share of new loans that have an LTV ratio of more than 80%. For the first half of 2017 this limit will be set at 50% of the total amount of new secured housing loans, and from 1 July 2017 it will fall to 40%.

The adoption of the measures is not expected to have any significant impact on the retail loan market. The Decree is to a large extent based on principles laid down in the Recommendation, which NBS issued back in 2014. Therefore banks are already complying with a majority of the measures. Furthermore, the additional two tightening measures mentioned above are based on current loan market practice and will be implemented only gradually. The requirement that loan applicants have a sufficient financial buffer in their income (less loan instalments and the minimum subsistence amount) is being phased in over one and a half years. As regards the draft limit on the share of loans with an LTV ratio of more than 80%, Chart 16 shows that the share of these loans in total housing loans fluctuated at around 47% to 48% in each quarter of 2016. Therefore the purpose of the measure is, in the first stage, to prevent the share from increasing further and, subsequently, to bring it reasonably down. None of the measures in the Decree are expected to have a significant impact on the market.

The Special Levy Act may have an adverse impact on financial stability

Act No 384/2011 Coll. on a special levy on selected financial institutions („the Special Levy Act") has been amended in a way that will have a significant impact on the banking sector's profitability with potentially adverse consequences for the financial stability of the domestic financial sector. The amendment sets the levy rate at 0.2% for the period 2017-20. After 2020, under the legislation currently in force, the levy is to be cut to 0%. In addition, the amendment repealed the provision that linked a reduction in the special levy to the volume of cumulative proceeds from the levy. That provision required the levy to be reduced to 0.1% when the proceeds exceed €750 million, which is expected to happen in mid-2017.

The costs that the special levy imposes on the banking sector will therefore double in these years and weigh quite heavily on its profitability. The overall increase in levy costs over the period 2017-20 is estimated to be €260 million, which per year translates into an increase in the range of €60 to €70 million, a sizeable share of the banking sector's net profit. For some banks, the de facto doubling of the levy could significantly reduce their net profit or even cause them a loss.

The risk that banks will not maintain adequate profitability in the current low interest rate environment is seen as one of the most significant risks to financial stability in the European banking sector. Hence, these changes may be viewed as having potentially adverse consequences in several areas.

- There could be a negative impact on banks' capital formation and consequently on their lending to the real economy.
- The substantial impact on bank profits may heighten the risk of multiple subsidiaries being transformed into foreign bank branches. Such an outcome would be detrimental to the conduct of supervision.
- Customers may be adversely affected by these changes through higher bank charges.
- The frequent tweaking of the Special Levy Act is creating uncertainty about the amount of levy payments and use of levy proceeds (see, for example, the amendment now in force, or a previous provision allowing levy proceeds to be used to support wholly state-owned enterprises and the subsequent repeal of that provision). Moreover, amendments to this law should not be made with the intention of consolidating public finances.
- There is a lack of clarity about what actually is the primary purpose of the levy proceeds; they are designated to cover financial crisis resolution costs in the banking sector and to protect the banking sector's financial stability, while at the same time they may be used to top up the Deposit Protection Fund. For both these purposes, however, alternative mechanisms already exist (the Deposit Protection Fund and the Single Resolution Fund).

A Delegated Regulation on MREL was published in the Official Journal of the EU on 23 September 2016

On 3 September 2016 an EU implementing regulation[17] was published in the Official Journal of the European Union, specifying the criteria relating to the methodology for setting the minimum requirement for own funds and eligible liabilities (MREL) („the Regulation")[18]. According to the Regulation, the levels of MREL are to be set on the basis of the following elements, which are subject to further adjustment:
1. the loss absorption amount (LAA);
2. the recapitalisation amount (RCA);
3. contributions of the deposit guarantee scheme (DGS).

The final MREL is calculated as follows:

MREL=LAA (after adjustments)
+ RCA (after adjustments) – DGS contributions

Two elements, LAA and RCA, are the sum of capital requirements (pillars 1 and 2) and combined buffer requirements. The RCA, however, is adjusted to the resolution strategy, as identified in the resolution planning process and depends on which of the following resolution tools are selected:

1. the bail-in tool – the highest RCA
2. the sale of business tool, the bridge institution tool, or the asset separation tool – a mid-level RCA;
3. normal insolvency proceedings – a zero RCA.

17 At the beginning of July 2015 the European Banking Authority submitted a draft regulation to the European Commission, acting in accordance with Article 45(2) of the Bank Recovery and Resolution Directive.

18 Commission Delegated Regulation (EU) 2016/1450 of 23 May 2016 supplementing Directive 2014/59/EU of the European Parliament and of the Council with regard to regulatory technical standards specifying the criteria relating to the methodology for setting the minimum requirement for own funds and eligible liabilities.

Resolution authorities may increase or decrease the individual elements according to criteria laid down in the Regulation. The LAA may be increased mainly where, taking into account information from the supervisory authority, it is found that the need to absorb losses in resolution is not fully reflected in the default LAA, or where it is necessary to reduce or remove an impediment to resolvability.

On the other hand, the LAA may be decreased mainly where part of the pillar 2 capital requirement, which has been determined on the basis of the outcome of stress tests or to cover macroprudential risks, is assessed not to be relevant to the need to ensure losses can be absorbed in resolution, or where part of the combined buffer requirement is assessed not to be relevant to the need to ensure losses can be absorbed in resolution.

The RCA may be decreased mainly, by the level of the combined buffer requirement, where the resolution authority determines that a lower amount would be sufficient to sustain market confidence in the bank and ensure both the continued provision of the bank's critical functions and the bank's access to funding.

Resolution authorities may reduce a MREL by the amount of the DGS's potential contribution to the resolution, but by no more than 50% of the target level of the DGS fund.

The Regulation entered into force on the 20th day following that of its publication, but it appears to require recalibration. On the basis of the Regulation, the EU's Single Resolution Board and Slovakia's Resolution Council will set MREL for all banks in Slovakia. Resolution authorities may determine an appropriate transitional period, as short as possible, to reach the final MREL. In the light of preliminary impact analyses, however, it appears that the stipulated criteria need to be recalibrated.

The insurance sector well managed the transition to the Solvency II regime, in force from 1 January 2016

The Solvency II framework[19] replaces the regime in force since 1973 and brings fundamental changes to the insurance market. The new regime represents the first comprehensive risk-oriented code harmonised for the whole EU insurance market, and it is based on three pillars: 1) quantitative requirements, 2) qualitative requirements, and 3) transparency and disclosure. The transition to the Solvency II regime has brought changes in, among other areas, reporting by participants in the Slovak insurance sector, since a majority of reporting templates were replaced with new templates harmonised at the EU level. This resulted in an extension of deadlines for transmitting reports to NBS. Further details of the regulatory changes in the insurance sector may be found in the *November 2015 Financial Stability Report*.

All insurers in Slovakia comfortably meet the new Solvency Capital Requirement (SCR) and Minimum Capital Requirement (MCR). In terms of quantitative requirements, the main regulatory changes include, in particular, the fair valuation of assets and technical provisions, the calculation of technical provisions on a best estimate basis, and new (higher) capital requirements. Their aggregate impact on the Slovak insurance sector has been a slight drop in the value of assets and a more marked decline in the value of technical provisions. This has resulted in an increase in eligible own funds, which are therefore ample to cover the increased capital requirements.

Introduction of an 8% levy on non-life insurance premiums

On 21 September 2016 the Slovak Government approved a draft law that extends the 8% levy on premiums written to all lines of non-life insurance. At present the only insurance line subject to such a levy is motor third party liability (MTPL) insurance. Under the original draft of the law, all existing non-life insurance contracts were to be subject to the levy as from 1 January 2017, but the sponsor committee of the National Council subsequently proposed that the levy apply only to new contracts signed after 31 December 2016.

The imposition of the levy on new contracts is not expected to have an impact on financial stability. The original draft, covering also existing insurance contacts, would have heavily weighed on the aggregate profitability of non-life insurance business, as well as on the profitability of the insurance sector. The fact, howev-

19 The Solvency II framework comprises Directive 2009/138/EC of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance ("the SII Directive"), and related delegated acts of the European Commission. The SII Directive was enacted in Slovak law by Act No 39/2015 Coll. on insurance.

er, that the levy will apply only to new business gives the insurance sector sufficient time to adjust smoothly to the new situation.

The principal effects of the draft levy are therefore expected to be a gradual increase in insurance prices and, over the short term, some dampening of market competition. The draft levy constitutes a cost that prudent insurers will include in their premium calculations. Some lines of insurance would face unsustainable losses if the levy were introduced without a corresponding increase in prices. It may therefore be expected that premiums will be raised in new insurance contracts, but the impact across insurance lines will be heterogeneous. As a result, new insurance contracts will be less competitive than existing contracts, and customers will have less incentive to change their contracts. This impact will fade over time, as the number of insurance contracts entered into after 31 December 2016 increases. The rate of insurance contract renewals is expected to increase; the current rates in the main insurance lines are as follows: around 90% in property insurance and general liability insurance, and 60–70% in motor insurance, accident and sickness insurance, and credit and financial loss insurance. A higher renewal rate indicates that the period of weaker competition in the given segment will last longer.

MACROPRUDENTIAL POLICY

5

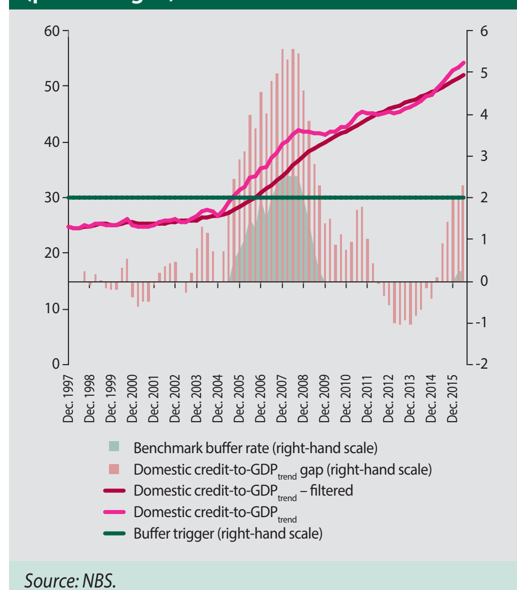
5 Macroprudential policy

The countercyclical capital buffer rate will be set at a non-zero level of 0.5% with effect from August next year

In its quarterly review of the countercyclical capital buffer (CCB) rate, the Bank Board of Národná banka Slovenska decided on 26 July 2016 to set a non-zero CCB rate with effect from 1 August 2017. From that date a CBB will be applied to banks and foreign bank branches operating in Slovakia, in respect of their exposures in Slovakia, at a level of 0.5% of the total risk exposure amount. The decision to apply a CCB was made in response to long-running trends in the credit market, in both lending to households and lending to non-financial corporations. The annual growth rate in the stock of household loans has been in double digits since 2014[20] and this year it was higher in Slovakia than in any other EU country. The growth in household loans is being driven mainly by housing loans, which make up three-quarters of loans to households. The past year has also seen growth in lending to NFCs. Their outstanding amount began rising sharply in 2015 after a long period of decline, owing mainly to strong growth in investment loans. The NFC credit market in Slovakia was among the five fastest-growing in the EU in 2016. The robust growth in lending activity has been reflected in the deviation of the ratio of credit-to-GDP from its long-term trend, measured by the domestic credit-to-GDP_{trend} gap indicator, which rose above the 2% threshold at which the ESRB recommends[21] increasing the CCB rate.

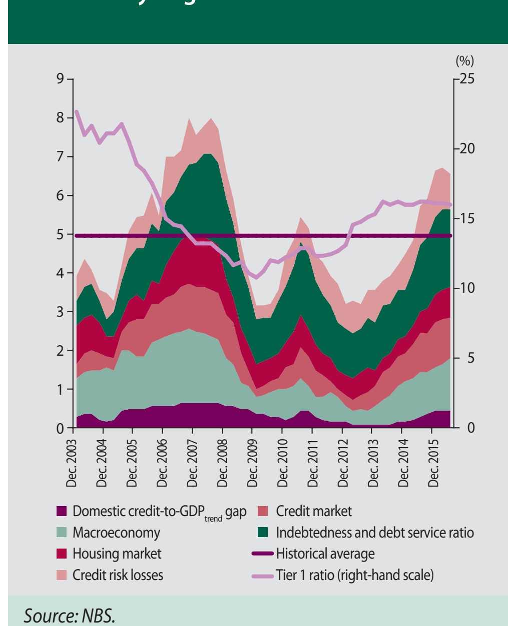
The strong growth in the credit market has been reflected in private sector indebtedness, which in the case of both NFCs and households has increased in year-on-year terms. The current expansionary phase of the financial cycle may be inferred from another indicator of financial market developments, the Cyclogram, which since the beginning of 2015 has been fluctuating above its long-run average. Its increase over the past year has stemmed not only from credit market trends and private sector indebtedness, but also from rising property prices, the labour market situation, and households' debt service ratio.

Chart 41 Domestic credit-to-GDP_{trend} gap (percentages)



Source: NBS.

Chart 42 Cyclogram



Source: NBS.

20 The stock of loans provided by domestic banks to the household sector (S.14 and S.15) and the non-financial corporation sector (S.11) in Slovakia.

21 Recommendation ESRB/2014/1.

Národná banka Slovenska was from the end of 2015 making clear that the need to apply a countercyclical capital buffer may arise, given that most of the indicators informing CCB rate decisions suggested that the credit market was developing favourably, i.e. it was in a phase when, as a rule, market risks are only just emerging. Historically low interest rates, favourable macroeconomic developments, and a property market upturn are stimulating credit demand and consequently, amid strengthening competition in the credit market, increasing the propensity to lend to riskier borrowers or to provide unduly high loans under easier credit standards. Thus conditions are gradually being created for a build-up of risks related to the cyclical situation, with loan loss provisioning appropriate in such an upswing phase of the financial cycle. For that reason, the NBS Bank Board decided on 26 July 2016 to apply a countercyclical capital buffer of 0.5% with effect from 1 August 2017.

The application of the CCB is not expected to have a significant impact on the banking sector

The decision to apply a countercyclical capital buffer is not expected to have a significant impact on the Slovak banking sector, nor on lending activity, given that banks in Slovakia are currently sufficiently highly capitalised. For these banks, whether or not they are under the ECB's direct supervision, the application of a CCB will not significantly affect their ability to meet capital requirements, and therefore it is not expected to have a direct impact on lending activity. Nevertheless, some banks will have to adjust their dividend policy and increase their share of retained earnings in order to meet capital requirements (Chart 28).

According to the current outlook, the present trends are set to continue in the period ahead. Since the economy's stable growth is projected to continue (with a positive impact on firms' sales) and given the favourable labour market trends and monetary policy easing, the private sector's indebtedness is expected to continue increasing. Current trends in economic fundamentals and financial developments do not indicate the need for any further increase in the CCB rate in the near term. NBS will nevertheless continue to closely monitor and assess credit market dynamics, with particular regard to the build-up and escalation of potential systemic risk.

The Czech Republic is to apply a CCB rate of 0.5% from the beginning of 2017

Under a decision taken by Česká národní banka in December 2015, a CCB rate of 0.5% will be applied from 1 January 2017 to exposures located in the Czech Republic. Therefore Slovak banks that have exposures to the Czech Republic must also, from the beginning of 2017, maintain a countercyclical capital buffer of 0.5% of that risk-weighted exposure amount. In other words, their overall CCB will be increased by this requirement.

Within the regular annual review of the identification of other systemically important institutions (O-SIIs), NBS did not make any significant changes

In 2015 NBS adopted its first decision identifying certain banks in Slovakia as O-SIIs and setting additional buffers for these banks (comprising a combination of an O-SII buffer and a system risk buffer)[22]. In 2016 NBS conducted an annual review of the list of banks in Slovakia identified as O-SIIs and did not make any changes to that list. Owing to persisting structural risks in the form of financial sector concentration, as well as concentration in several segments of the banking sector, the sums of the O-SII and systemic risk buffers applied to specific O-SIIs across the banking sector continue to range between 2% and 3% of the bank's total risk exposure amount[23]. In order to maintain consistency over time in the identification of O-SIIs, the assessment methodology has been adjusted slightly, in accordance with national discretions referred to in the applicable EBA Guidelines. Since parent undertakings of a number of Slovak O-SIIs have been identified as O-SIIs in their home countries, the composition in which O-SII and systemic risk buffers are summed for specific Slovak banks has been modified slightly. These changes have only marginal impact on the overall capital buffer assigned for these banks on the grounds of their systemic importance[24].

22 NBS Decision Nos 4/2015, 5/2015 and 6/2015 of 26 May 2015.

23 NBS Decision 18/2016 and 19/2016 of 24 May 2016.

24 Further details of the process of identifying O-SIIs may be found in the following document: http://www.nbs.sk/_img/Documents/_Dohlad/Makropolitika/O-SII_dodatocne_informacie_2016.pdf

In September 2016 NBS for the first time reciprocated a buffer applied by another EU Member State

On 30 May 2016 the Estonian central bank, Eesti Pank (EP), decided that a systemic risk buffer would be applied to all credit institutions authorised in Estonia at the level of 1% of their total domestic risk exposure amount. Since a relatively large volume of the lending in Estonia is conducted through foreign bank branches or on a cross-border basis, EP requested the European Systemic Risk Board (ESRB) to recommend other EU Member States to reciprocate this SRB rate. In response, the ESRB issued a Recommendation of 24 June 2016 amending Recommendation ESRB/2015/2 on the assessment of cross-border effects of and voluntary reciprocity for macroprudential policy measures („Recommendation ESRB/2016/4"), with the new text recommending that all EU Member States reciprocate the SRB rate applied by EP. The ESRB Recommendation applies to Member States irrespective of whether their banking sector has significant exposure to Estonia (through branches or directly).

In Slovakia, reciprocation of the SRB rate for all exposures located in Estonia[25] means that banks established in Slovakia which have exposures to borrowers established in Estonia, whether arranged through a branch in Estonia or a cross-border transaction, must hold a systemic risk buffer of 1% based on exposures located in Estonia and this requirement must be met with common equity Tier 1 capital. Since this case does not involve an NBS Decision to apply an SRB under Article 33e of the Banking Act, this buffer is not limited by any O-SII buffer imposed on the given bank. If an SRB applied by another Member States is reciprocated under Article 33f of the Banking Act, the different buffers are to be summed (i.e. the sum of the total buffers activated under Articles 33d and 33e of the Banking Act pursuant to the respective rules and the buffer activated under Article 33f thereof). The reciprocation of the Estonian buffer is not expected to have a significant impact on the Slovak banking sector[26].

25 NBS Decision No 21/2016 of 27 September 2016.

26 Further information on the reciprocation of this buffer may be found in the following document: http://www.nbs.sk/_img/Documents/_Dohlad/Makropolitika/SRB_EE_dodatocne_informacie.pdf

Abbreviations

AFS	available for sale (portfolio)
APRC	annual percentage rate of charge
CAR	capital adequacy ratio (the sum of a bank's Tier 1 and Tier 2 capital expressed as a percentage of its risk-weighted assets)
CET1	common equity Tier 1
CMN	cenová mapa nehnuteľností (Real Estate Price Map)
DGS	deposit guarantee scheme
EBA	European Banking Authority
ECB	European Central Bank
ESRB	European Systemic Risk Board
EU	European Union
GDP	gross domestic product
HICP	Harmonised Index of Consumer Prices
HTM	held to maturity (portfolio)
LAA	loss absorption amount
LTV	loan-to-value (ratio)
MCR	minimum capital requirement
MREL	minimum requirement(s) for own funds and eligible liabilities
MTLP	motor third party liability (insurance)
NBS	Národná banka Slovenska
O-SII	other systemically important institution
PFMC	pension fund management company
RCA	recapitalisation amount
ROE	return on equity
SCR	solvency capital requirement
SO SR	Statistical Office of the Slovak Republic
SPMC	supplementary pension management company
TLI	traditional life insurance

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