Overview

The financial sector is on a relatively favourable path from a financial stability perspective

Previous risks associated with surging costs and higher interest rates are easing gradually. Inflation in the euro area has fallen below target, and interest rates have started to decline. This shift should in time bring welcome relief to many borrowers, particularly non-financial corporations (NFCs). Households are also seeing an improvement in their financial situation, as real incomes rise and their ability to save increases. For most borrowers, the most challenging period is already behind them.

Looking at future risks, attention is turning from inflation to an uncertain outlook for economic growth. The main threats stem from geopolitical instability and uncertain growth trajectories in a number of major economies. In response, central banks are cutting interest rates more swiftly than anticipated. Moreover, the sensitivity of global markets to adverse news – as witnessed during the summer months – suggests potential turbulence could arise unexpectedly.

In the euro area, another concern is the level of public debt in several countries. Slovakia, for its part, has mitigated this risk through a newly adopted fiscal consolidation package. Nevertheless, the pursuit of public finance sustainability is a long haul that will require further measures, especially given adverse demographic trends. While the consolidation package will impose higher costs on the financial sector, it is not expected to weigh too heavily on financial stability or on the debt servicing capacity of households and firms.

The downshift in interest rates is gradually implying a partial recovery in the mortgage market

While there are now several signs of recovery, they remain only very mild for now, emerging mainly in the second and third quarters of 2024. Annual growth in mortgage lending has accelerated slightly after a prolonged decline, and interest rates have started coming down. Although the number of mortgage originations has increased, it remains lower than it was before the recent period of rising interest rates. Notably, housing prices have risen for the first time in a while, mirroring trends in other euro area countries. It is still, however, too early to say whether these changes will translate into a more sustained recovery. As for consumer credit, lending activity remains quite strong, with the portfolio's growth still relatively robust.

By contrast, corporate lending shows no signs of recovery, with the aggregate portfolio declining in year-on-year terms. The most pronounced slowdown is in lending to large corporates, while lending to small firms has continued growing in line with longer-term trends. The primary reasons for weaker credit flows relate to firms' demand for loans, and another important factor is the impact of higher interest rates. The situation is compounded by firms' reduced need for borrowing due to weaker economic developments, particularly slower international trade, stagnating revenues and falling orders.

Figure 1

The credit and housing markets at a glance

Households		
Mortgages	3.1%	▲
Interest rate	4.4%	▼
Consumer credit	7.9%	–
Deposits	7.2%	▲

Housing		
Flats in Slovakia	4.2%	▲
Flats in Bratislava	6.1%	▲

Firms		
Loans	-4.0%	▼
Interest rate	5.2%	▼

Sources: NBS, United Classifieds, and SO SR.
Notes: For households and firms, the data are as at September 2024; for housing, they represent the average value for the third quarter of 2024. Loan and deposit data show the year-on-year change in volumes. The data for flats indicate the year-on-year change in the average price per square metre for existing flats. The interest rate for households represents the average rate on pure new mortgages, while for firms, it represents the average rate on the entire existing portfolio. Arrows indicate changes vis-à-vis the previous edition of the Financial Stability Report.

Borrowers have so far managed the period of higher interest rates, with no significant increase in non-performing loans

Although the recent period of surging costs (especially energy costs) and higher interest rates has halted the previous long decline in non-performing loan (NPL) ratios, it has not resulted in a marked rise in these ratios (Chart 1, panel A). Signs of deterioration are visible only in the commercial real estate (CRE) portfolio, where there has been a slight increase in loan rescheduling rather than actual defaults. Similarly, we do not observe notable distress among mortgage borrowers, as discussed in a separate note.[1]

The previous period resulted in an increase in the riskiness of loan portfolios, but the outlook remains positive

Although loan defaults have not risen notably, portfolios are now more sensitive to potential economic shocks, with this sensitivity varying by

[1] Jurča, P., Latta, P. and Kandričáková, A., "Vyššie splátky hypoték zatiaľ nespôsobujú výraznejšie problémy" (Higher mortgage payments are not causing significant problems), *Discussion Note*, No 140, Národná banka Slovenska, 17 September 2024 (in Slovak only).

type of portfolio. The main reasons for this are the previous decline in real household incomes, rising interest expenses, and the declining value of real estate collateral.

The most significant deterioration has been in the CRE portfolio. In addition to a cyclical worsening of financing conditions, this sector is facing a number of structural challenges, particularly in the office segment. The increase in interest expenses equated to around 13% of revenues, and unlike operating costs, these higher expenses have not been offset by revenue growth. Nevertheless, the outlook for the CRE sector is moderately positive, with gradual improvement expected from 2025.

Other segments of the NFC portfolio are in better shape. While the overall risk level has stopped declining, it has not increased significantly either. Moderate rises in risk have been seen in only a few sectors, such as agriculture, trade, and administration. These sectors are also, however, expected to start picking up in 2025.

The mortgage portfolio has shown an improving trend since early 2024. The previous increase in sensitivity to external shocks was more pronounced in this portfolio. Households are currently being helped primarily by an upturn in real wage growth. Meanwhile, a renewed uptrend in the value of residential real estate collateral is further mitigating risk.

Owing to the increased sensitivity of loan portfolios, the macroprudential policy stance remains unchanged for now. This aligns with the ECB's statement[2] recommending against easing capital buffer requirements or borrower-based limits for the time being. Since lending limits are deemed to be a structural type of measure, Národná banka Slovenska is not currently contemplating any adjustments to them. In most other EU countries, too, there are no moves towards relaxing these limits. On the other hand, if credit sensitivity gradually diminishes, a reduction in the countercyclical capital buffer rate could be considered. When making its decision, NBS will also take into account potential risks, in particular any deterioration in economic and labour market developments.

Banks continue to demonstrate strong resilience and adaptability to new challenges

The banking sector's strong risk resilience is confirmed by its robust profitability (Chart 1, panel B). Although bank profits have fallen year-on-year as a result of the bank levy, they remain well above the level seen before the recent period of rising interest rates. A key factor is the evolution of

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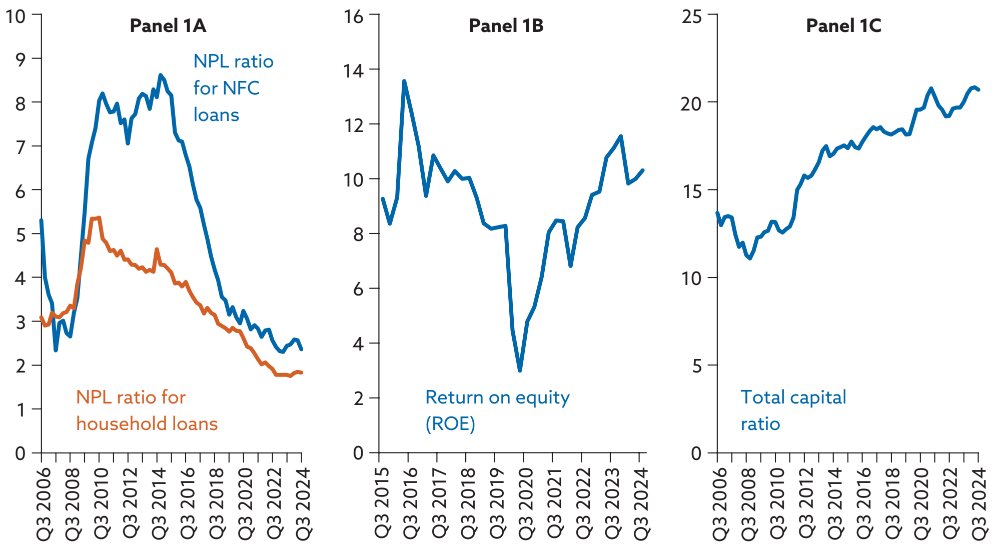
2 ECB, Governing Council statement on macroprudential policies, 28 June 2024.

interest income, which is expected to remain an important pillar of profitability in the period ahead.

The sector's total capital and liquidity ratios were at near historical highs by mid-2024 (Chart 1, panel C). Banks have translated favourable profitability into stronger solvency, with liquidity improvements stemming mainly from deposit growth outpacing credit growth.

Going forward, banks are thus well placed to cope with new challenges, although with the number of challenges constantly increasing, banks' financial position could come under pressure in the long term. The main sources of this pressure are the bank levy, the phased implementation of stricter banking regulations, and the recently approved fiscal consolidation package, notably the financial transaction tax. On the deposit side, banks will face new competition from retail government bond issues and, in the medium term, from the introduction of the digital euro.[3]

Chart 1
NPL ratios remain low, profitability is favourable, and bank resilience is at a record high
(percentages)



Sources: NBS, and United Classifieds.

Other financial market segments show favourable developments

Like banks, insurers have also been reporting higher profits. As for the insurance sector's solvency, it is virtually unchanged from a year ago. Life insurance has maintained its long-term growth trend, while non-life writ-

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[3] The outflow of deposits to the digital euro is analysed in the following note: Hajdiak, D., "Bude digitálne euro pre naše banky výzvou?" (Will the digital euro pose a challenge for our banks?), *Discussion Note*, No 141, Národná banka Slovenska, 6 November 2024 (in Slovak only).

ten premiums have risen at their fastest pace in recent years, largely driven by inflation.

The pension and investment fund sectors have seen strong asset growth, particularly in equity-oriented funds. Asset growth has reached record levels, buoyed not only by investment inflows, but also by favourable fund performance. In the case of pension funds, assets have been growing for some time, while for investment funds, this year's growth marks a turnaround after two years of decline. This growth in fund portfolios has been accompanied by a nearly two-year trend of rising demand for equity investments, which now make up more than half of total fund assets. In other countries, funds are often viewed as potential sources of financial stability risks due to a various imbalances. In Slovakia, however, such imbalances are either virtually absent (leverage), present in only a small portion of portfolios (liquidity mismatch) or generally low (interconnectedness).