Financial Stability Report

November 2024

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Foreword

This edition of the Financial Stability Report comes at a time when all evidence suggests that the nearly two-year period of elevated inflation, falling real incomes and higher interest rates is behind us. What is more, Slovak households and firms have shown resilience to these adverse circumstances. They have continued servicing their debts, despite many borrowers facing a notable increase in loan payments and many households experiencing a temporary decline in real income. It is encouraging that non-performing loan ratios remain at low levels. After several years of rapidly growing indebtedness and housing prices, we could say that the economy has had a very soft landing.

The journey, however, is not over, and another challenging period lies ahead. On the one hand, risks are expected to gradually recede as interest rates decline, real wages grow, and corporate revenues rise. These are indeed reasons for optimism. On the other hand, risks in the corporate, commercial real estate, and household sectors remain elevated. Both the Slovak and global economies face significant uncertainty, compounded by developments in Ukraine and the Middle East. To put it another way, we are flying in a reliable machine with plenty of fuel, but the weather forecast is fraught with uncertainty. Turbulence is likely to be the norm rather than the exception.

Národná banka Slovenska, like the ECB and the ESRB, considers this a time for caution – a time to maintain a prudent calibration of macroprudential policy tools. This approach will help ensure that banks in Slovakia remain resilient and stable enough to withstand potential adverse scenarios, while continuing to serve as the cornerstone of financing for the country's economy.

Peter Kažimír
Governor

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

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[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.

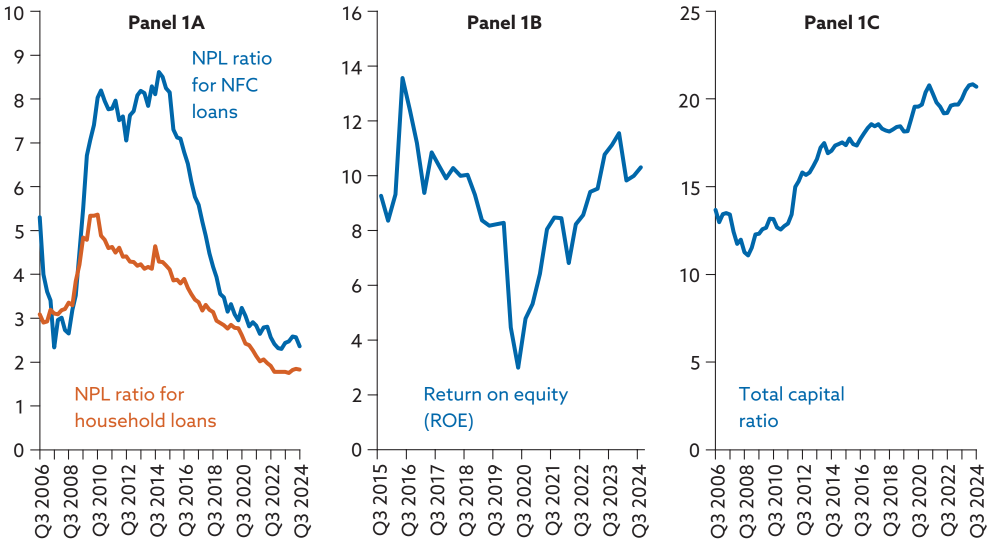
The sector's total capital and liquidity ratios were at near historical highs by mid-2024 (Chart 1, panel C). Banks have translated favourable profitability into stronger solvency, with liquidity improvements stemming mainly from deposit growth outpacing credit growth.

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).

1 Macroeconomic environment and financial markets

The focus in advanced economies is shifting from inflation to an uncertain outlook for economic growth

The euro area's expected recovery is running into challenges. The euro area economy entered 2024 on a relatively positive note, gathering modest momentum after more than a year of stagnation. The recovery was initially driven by stronger foreign demand, with the expectation that rebounding growth in real income would soon stimulate domestic demand and further boost the economy. However, incoming statistics from recent months suggest that economic stagnation, rather than momentum, can be expected at least for the remainder of 2024. Domestic consumption and investment are faltering, not helped by a loss of pace in the global industrial cycle and the euro area's weaker export competitiveness.[4]

The taming of the euro area's excessive inflation seems within reach. In September 2024, the annual inflation rate in the euro area fell below two per cent for the first time in three years.[5] Similar disinflationary trends can be observed in other major advanced economies, suggesting that the threat of persistent rapid price growth is receding. Nevertheless, residual risks remain, including excessive wage growth, pricing pressures in the services sector, and geopolitically induced increases in energy carrier prices, which should not be ignored prematurely.

A synchronised monetary policy easing cycle has begun. The shifting macroeconomic landscape has necessitated a monetary policy response. As a result, most of the major central banks, including the ECB and the US Federal Reserve, have in recent months embarked on a new phase of cutting their key rates. Financial markets are increasingly anticipating further sizeable rate cuts in the euro area and the United States.[6]

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[4] A key concern for Slovakia is the situation in Germany, its major trading partner, as these conditions and domestic structural problems are weighing heavily on the German economy.

[5] Core inflation (i.e. headline inflation excluding the volatile food and energy components) is also close to target, with its downtrend – and that of inflation expectations – resuming since the summer after a brief pause.

[6] With the expected reduction notably larger than that projected in early summer, there has been a sharp decline in the short end of yield curves.

The euro area private sector is in general under moderate financial pressure. A broad range of private sector credit risk indicators – from bankruptcy rates to credit rating adjustments and default rates – have been trending upward in recent years.[7] If the euro area or global economy falls short of expectations, more entities could face financial difficulties, potentially harming the health of the financial sector.

The health of public finances is attracting increasing concern. Several euro area countries face a difficult outlook for public finances, owing to a combination of high existing public debt, persistent deficits, unfavourable interest rate-growth differentials, and looming structural challenges and needs. The new urgency of the focus on public finance sustainability stems not only from such fundamental issues, but also from heightened perceptions of political risk and related uncertainty about the calibration of economic policies and consolidation efforts. Mounting sensitivity to sovereign risk may eventually translate into a deterioration in financial conditions for both the financial sector and the real economy.

Pricing and risk appetite in financial markets are exhibiting increased sensitivity to economic and geopolitical developments, potentially sowing the seeds of broader instability. A generally optimistic and stable first half of the year in financial markets gave way to more cautious sentiment over the summer. Sales of riskier assets spiked briefly in early August amid significant volatility. Investor sentiment recovered within days, restoring asset valuations to prior levels. A similar but less severe bout of turbulence occurred in early September. These episodes underscore the current acute sensitivity of global financial markets to negative economic news and to corresponding shifts in monetary policy expectations, especially concerning the United States. Geopolitical and economic policy unpredictability are further amplifying the risk of turbulence. Such heightened uncertainty contrasts sharply with the current historically high valuations of equity indices, raising questions about further bursts of volatility and price corrections.[8] Moreover, non-banks' significant exposure to risky asset investments may, as the recent past has shown, further exacerbate and spread potential stress across the financial system.[9]

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[7] Debt servicing problems are largely concentrated in certain sectors and segments, such as commercial real estate, smaller firms, and households with consumer loans.

[8] The most pronounced imbalances are seen in the US equity market, driven primarily by a clique of large technology firms, raising the risk that an otherwise idiosyncratic shock could easily morph into a systemic event.

[9] This amplification potential is linked to several characteristics of many of these entities, such as their use of leverage, liquidity mismatches between their assets and liabilities, and their interconnectedness.

Slovak economy driven by households and the public sector

The Slovak economy maintained a real growth rate of more than 2% in the first half of 2024. This rate, the sixth highest among EU countries, was supported largely by growth in household consumption expenditure, as slowing inflation boosted real incomes. Public sector consumption also contributed to economic growth, with increased spending on employees and the health sector. Investment had a weaker impact on economic growth owing to a base effect from the previous year, when Slovakia had to complete the disbursement of funds allocated under the 2014–2020 EU programming period. With the weakening of external demand, Slovakia's export growth has been more subdued this year than last year. The Slovak economy is expected maintain moderate growth in the coming period, but necessary fiscal consolidation will limit its expansion.

The newly approved fiscal consolidation package will support public debt sustainability. The recently adopted fiscal consolidation package[10] is necessary to maintain the sustainability of public finances, as public debt stabilisation cannot be achieved without deficit reduction. Although the consolidation effort will dampen economic growth in the short term, its benefits should eventually become apparent in the form of lower risk premia on Slovak government bonds and cheaper financing of the economy. The key question is whether the measures to improve the long-term sustainability of public finances – currently the weakest in the EU, owing partly to expected demographic changes and to costs associated with population ageing – can be implemented in the years ahead.[11]

Goods and services inflation in Slovakia was within sight of the ECB's inflation target, but started accelerating again in recent months. After running at double digits in the previous two years, annual inflation slowed this year, down to 2.4% in June, before picking up slightly and reaching 2.9% in September. Services prices, which remain affected by wage pressures, are still rising year-on-year, as are food prices, but energy prices have declined. Headline inflation can be expected to accelerate temporarily next year, to around 5%, owing to increases in household energy prices as well as to the price impacts of several of the new fiscal consolidation measures.

The labour market is in good shape. The number of registered unemployed in Slovakia has been below 170,000 for nearly a year, so the unemployment rate has remained largely stable at close to its historical low of around 5%. Although the number of job vacancies has declined in recent

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[10] The fiscal consolidation situation is covered in more detail in Box 1.

[11] European Commission, Debt Sustainability Monitor 2023, April 2024.

months,[12] it remains high. Demographic changes are gradually affecting the supply side of the labour market, as the number of people in work or seeking work[13] has remained unchanged for the past two years – the longest ever period of such stability. This is putting upward pressure on wages and will continue to do so. Wages were increasing faster than prices in the first half of 2024, with an annual growth rate of almost 5%.

Box 1

The fiscal consolidation package and its impact on financial stability

With the aim of reducing Slovakia's high fiscal deficit, the government has introduced a package of consolidation measures. The draft budget estimates the impact of the consolidation package to be €2.7 billion (1.9% of GDP) in 2025.[14] However, the year-on-year reduction of the fiscal deficit will be lower – approximately 1.1% of GDP[15] – owing to financing of the government's priority policies and the creation of budgetary reserves.

Most of the measures, amounting to 1.4% of GDP, concern the revenue side of the budget. The measure expected to generate the most revenue for the state budget is the increase in the standard VAT rate from 20% to 23%, with its impact being partly offset by a reduction in VAT on selected goods and services. Another planned measure is the introduction of a financial transaction tax,[16] which should primarily affect business transactions. The additional revenue from this tax is expected to be similar to that from another measure: the hiking of the corporate income tax to 24% for firms with taxable income exceeding €5 million. Other revenue-boosting measures include increasing the maximum assessment bases for social contributions, raising motorway vignette prices, and increasing toll fees for heavy goods vehicles.

Expenditure-side measures are projected to bring savings equivalent to 0.6% of GDP. These include replacing the parental pension with tax assignments to parents, gradually reducing the child tax credit according to the level of parental income, and moderating wage indexation for certain healthcare workers. The government is also planning to cut salaries in the state administration. These measures will have a direct downward impact on household disposable income.

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[12] The seasonally adjusted decline in the number of job vacancies between April and September 2024 was almost 10% (sources: Profesia online job portal (www.profesia.sk), and NBS).

[13] The size of the economically active population adjusted for seasonal fluctuations.

[14] Draft General Government Budget for 2025 to 2027, Ministry of Finance of the Slovak Republic (in Slovak only).

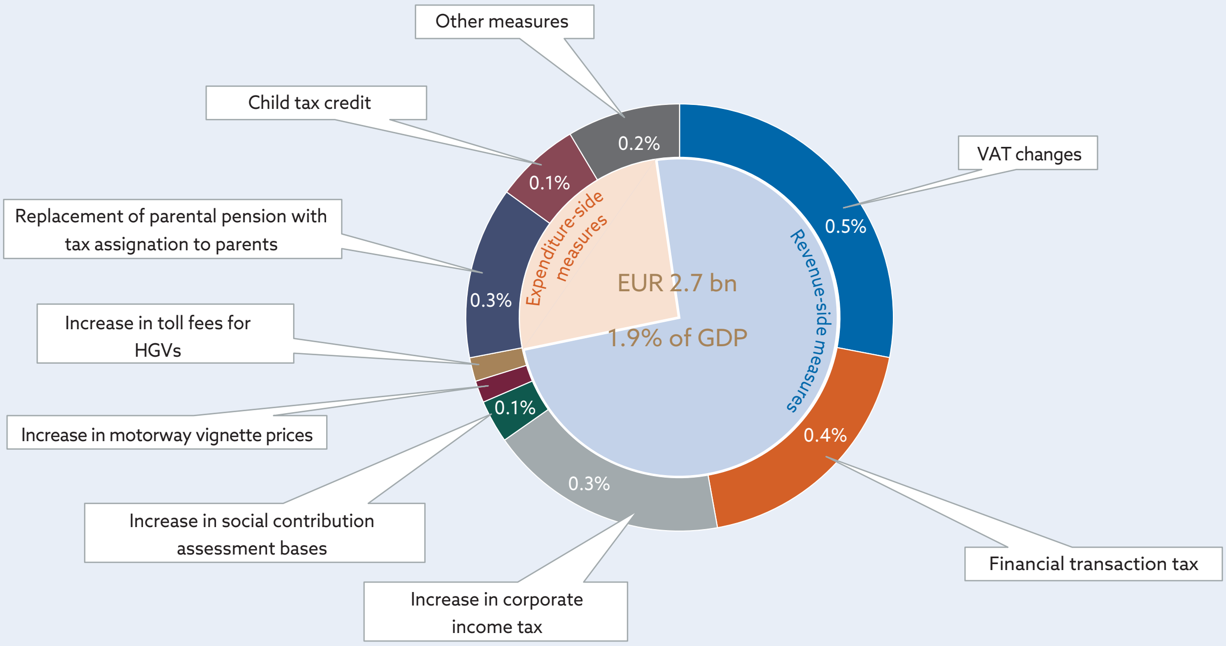
[15] The difference between the expected general government deficit for this year and the deficit budgeted for 2025 (source: Draft General Government Budget for 2025–2027).

[16] Payable by self-employed individuals and legal persons, the financial transaction tax has three rates: 0.4% per debit transaction from the taxpayer's bank account (capped at €40 per transaction); 0.8% per cash withdrawal (with no ceiling); and a €2 annual fee for the use of a payment card.

Chart 2

Consolidation measures are largely on the revenue side of the budget

(percentages of GDP)



Sources: MF SR, and NBS.

The new consolidation package will make an important contribution to improving the sustainability of public finances. This is also good news from a financial stability perspective, as public debt cannot be stabilised without reducing fiscal deficits. In the short term, the consolidation effort will weaken economic growth, chipping an estimated 0.6 pp off GDP growth in 2025 and adding around 0.8 pp to the headline inflation rate.[17] In the medium term, however, the consolidation should improve the situation; without it, risk premia on Slovak government bonds would likely rise, leading to higher interest rates and thus adversely affecting the financing of the economy.

The consolidation measures are not expected to weigh too heavily on the debt servicing capacity of households and firms. Households will mainly be affected by the child tax credit reduction and the VAT increase, including its upward impact on inflation. As a result, their real disposable income will decline.[18] The share of household loans at risk is not expected to rise substantially even after these changes. Firms, for their part, will be most affected by the increase in the corporate income tax rate and the introduction of the financial transaction tax (FTT). But although the consolidation measures imply higher business costs, they should

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[17] Economic and Monetary Developments, Autumn 2024, NBS.

[18] The effects of fiscal consolidation on households' debt servicing capacity to repay loans are addressed further in Chapter 3.1.

not significantly weaken firms' debt servicing capacity (the share of NFC loans at risk is estimated to increase from 0.3% to 0.4%).[19]

The fiscal consolidation package will increase costs for the banking sector but will not jeopardise its stability.[20] Banks will face higher tax and levy burdens, primarily due to the increased corporate tax rate and the FTT's introduction. There is uncertainty about what impact the FTT will have. As FTT processors and payers, banks will be deducting and remitting the tax on their customers' transactions and will thus have to modify their information systems accordingly, resulting in a one-off increase in costs. Given, however, banks' current profit levels, these changes are not expected to have a significant impact. The biggest unknown is the FTT's impact on banks' liquidity positions if corporate clients start withdrawing deposits in order to optimise their tax liability. Although banks can withstand higher corporate deposit outflows while still meeting regulatory requirements, such outflows would represent a loss of relatively cheap sources of funding for their activities. Depending on its scale, this trend could have an adverse impact on profitability as well as on lending capacity.

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[19] This topic is discussed in detail in Chapter 3.2.

[20] This topic is addressed in Chapter 4.1.

2 Financing of the economy

2.1 Mortgage market showing increasing signs of recovery

The start of an interest rate downturn has spurred demand for mortgages

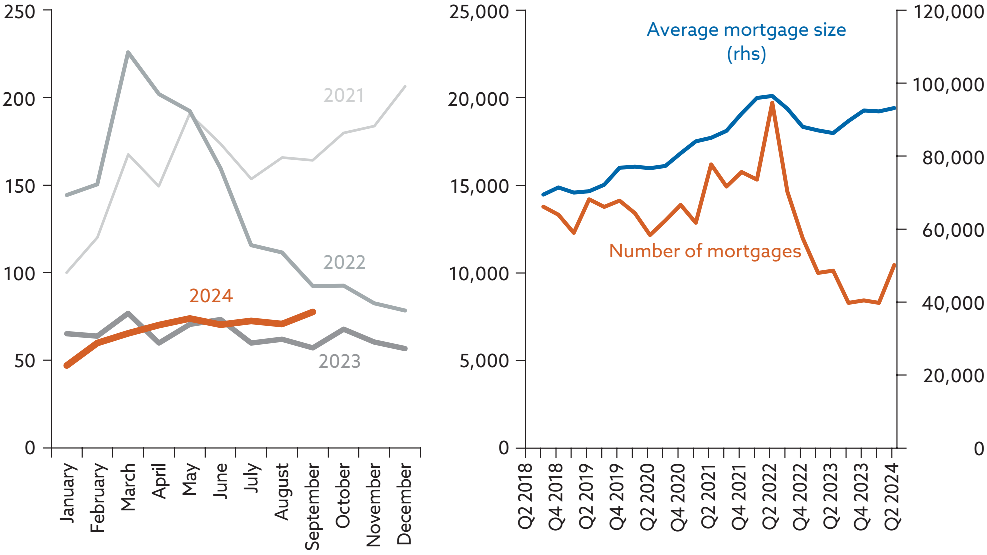
As a result of falling interest rates and shifting prospects in the housing market, demand for mortgages has picked up, albeit modestly for now.[21] Interest rates have been falling since June 2024, and by September, the average rate on new mortgages stood at 4.4%, 0.3 p.p. below its January peak.[22] An exceptionally strong labour market[23] is further boosting mortgage demand, as are rising incomes, which have recently resulted in a moderate reduction in the burden of servicing new mortgages. However, this burden remains higher than in the previous years.[24] Most banks anticipate a further increase in mortgage demand in the coming months.

Chart 3

New mortgage lending is growing (left-hand panel) **due to the increase in their number and the average mortgage size** (right-hand panel)

Left-hand panel: Volume of pure new mortgages (index: January 2021 = 100)

Right-hand panel: Number and average size of pure new mortgages (number, EUR)



Source: NBS.

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[21] The data on actual and future demand are taken from the bank lending survey and were collected in the second half of September 2024. According to this survey, some banks are reporting a decline in their interest margins.

[22] One contributing factor is the decline in yields on government bonds, which, for banks, are an investment alternative to mortgages.

[23] Registered unemployment remains close to historical lows, staying consistently around 5% since April 2023.

[24] The volume-weighted average DSTI ratio on pure new mortgages fell from 47.5% to 45.4% between March 2023 and June 2024, though it remains above its end-2021 level (42.2%).

Annual mortgage growth reached a low of 2.7% in June 2024, before picking up tentatively to 3.1% in September. In the second quarter of 2024, the number and volume of new mortgage contracts increased for the first time since interest rates started rising in 2022.[25] This upturn was broad-based across mortgage-lending banks and continued through the summer months, when there is normally a seasonal lull. The drawing down of these new mortgages added impetus to mortgage portfolio growth in the third quarter of 2024, although the growth rate is still modest compared with 2021 and 2022.

While conditions are favourable for further growth in mortgage demand in the near future, the recovery is expected to be gradual. Although the factors necessary for a recovery are emerging, the intensity of the changes is relatively low. Interest rates are falling and new lending activity has picked up, but in both cases only moderately. A return to the levels seen before the end of 2021 is not expected in the near term. Real wages are rising, but their growth is projected to slow in the coming years. Similarly, housing prices and the number of housing sales are experiencing broad, but so far only modest, growth. Although an adjustment to the DTI ratio limit for new mortgage applicants aged over 40 came into effect in 2023, it not currently constraining the lending market.[26]

The gradual recovery of Slovakia's mortgage market aligns with the broader Europe-wide trend

Although mortgage growth in Slovakia remains around the EU median, the country's mortgage market is recovering more slowly. In recent months, mortgage growth has been higher in most EU countries than in Slovakia. Indeed, the Slovak market is among the slowest-growing in the CEE region.

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[25] From the third quarter of 2018 to the first quarter of 2022, i.e. before the recent period of rising interest rates, the number of pure new mortgage originations averaged almost 14,000 per quarter. The number for the first quarter of 2024 was around 60% of that level, while in the second quarter it started rising again, to 75%. If this level were maintained for four quarters, annual mortgage growth would increase by around 1.5 pp.

[26] The level of the DTI ratio is now lower than it was in the past, and the impact of the DTI ratio limit on lending has actually diminished. The average DTI ratio (volume-weighted) has fallen over the past two and a half years (since before the interest rate upturn) from 5.7 to 4.7. The assertion that the DTI limit is not currently restrictive is supported by the low uptake of regulatory exemptions. Banks are allowed to exempt up to 5% of new mortgages from the DTI limit, but at present they are exempting only 2.9% Moreover, banks can further exempt an additional 5% of new mortgages from the DTI limit provided the loans are granted to applicants aged up to 35 and other conditions are met, but currently only 0.02% of new mortgages are subject to this exemption. These exemptions are being applied even less now than they were in the past.

The downturn in mortgage rates has occurred later in Slovakia than in the euro area as a whole. While the average euro area mortgage rate started falling in late 2023/early 2024, mortgage rates in Slovakia were only stabilising at that time and did not begin to decrease until the third quarter of 2024.[27]

The downturn in interest rates has led to a shortening of interest rate fixation periods. After interest rates started rising, five-year fixation periods became the most popular, but now more than half of new mortgages have fixation periods of three years or less. From a customer perspective, this shift reflects expectations of further interest rate reductions in the near future.

The structure of mortgage demand in terms of age or income has not changed, and credit standards have been adjusted only marginally. The average LTV ratio[28] has increased slightly, while the average DSTI ratio has declined slightly.[24] However, the most recent available data on mortgage characteristics, from June 2024, do not yet capture the interest rate downturn period. Banks, in the periodic industry questionnaire, have not reported any significant changes in credit standards.[29]

Consumer credit is growing at a steady pace

Annual growth in consumer credit has stabilised at around 8%,[30] placing Slovakia consistently between the median and upper quartile for EU countries. While the start of 2024 hinted at a potentially stronger year, credit flows between March and September 2024 were on a par with those in the same period of 2023.[31]

Households' improving financial situation is supporting the sustained strong growth in consumer credit. Survey data[32] show that households'

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[27] By the end of September, both the average and median euro area mortgage rates were 0.5 pp below their peak, while the corresponding rates in Slovakia were 0.3 pp lower.

[28] The volume-weighted average LTV ratio previously fell from 70.7% in the last quarter of 2021 to 67.2% a year later. This year, it was back up to 69.2% in the first quarter and 69.0% in the second.

[29] The quarterly bank lending survey.

[30] New consumer credit grew by around 9% year-on-year, supporting the steady growth of the overall portfolio. With the portfolio expanding, an increasing volume of loans is needed to maintain the percentage growth rate. Moreover, the amount of loans being repaid is gradually increasing.

[31] The contribution of consumer credit to the overall retail loan portfolio has returned to between 15% and 20%, the range typical until 2017, before the consumer credit growth slowed and eventually turned negative. In 2023, by contrast, mortgage growth moderated and consumer lending accounted for an increasing share – up to a third – of retail portfolio growth.

[32] The data are based on the Consumer Barometer Survey published by the Slovak Statistical Office.

perceptions of conditions for major purchases are the most favourable they have been since the onset of the pandemic. Several other indicators related to consumption purchases and consumer lending have also improved since early 2023.[33] At the same time, the slowdown in inflation has reduced the incentive to make purchases sooner rather than later.

Interest rates on consumer credit have remained just below 10% throughout 2024, keeping Slovakia above the euro area's upper quartile. Charges associated with consumer credit, and hence the resulting annual percentage rate of charge (APRC), have also stabilised.

In the spotlight: Mortgage co-financing with consumer credit

With consumer credit growing faster than mortgages, the question arises whether consumer loans are increasingly being used to co-finance mortgages – serving as additional financing on top of a primary mortgage originated at the upper limit of the LTV ratio. While some countries prohibit such co-financing, enforcement can be challenging in practice. In Slovakia, this type of financing is permitted but is considerably limited under the current regulatory framework (particularly the DSTI ratio limit coupled with the shorter maturity of consumer loans). Nevertheless, this practice requires ongoing monitoring.

The data confirm that mortgage co-financing with consumer credit remains low and has even fallen slightly compared with before the recent period of rising interest rates. Among households that have taken out a mortgage at the maximum LTV ratio[34] since the start of 2022, fewer than 15% used co-financing with consumer credit. Compared with the previous year, this represents a decline of around 4 pp. Almost two-thirds of these co-financing loans were consumer loans obtained from the same bank providing the mortgage.[35] Moreover, as shown in the left-hand panel of Chart 4, such co-financing is mostly only partial, not reaching the full real estate value. The risk associated with this practice is also mitigated by the correlation between higher levels of co-financing and lower overall DSTI ratios.[36]

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[33] These include expectations for unemployment, expectations for the financial situation of households, conditions for saving, and conditions for large purchases. Nevertheless, households are not sending a clear signal as to whether they actually intend to take advantage of these favourable conditions. The overall consumer confidence index has returned to almost pre-pandemic levels.

[34] With the LTV ratio limit set at 80%, we consider households with a mortgage 'at the limit' be those with an LTV ratio exceeding 78%.

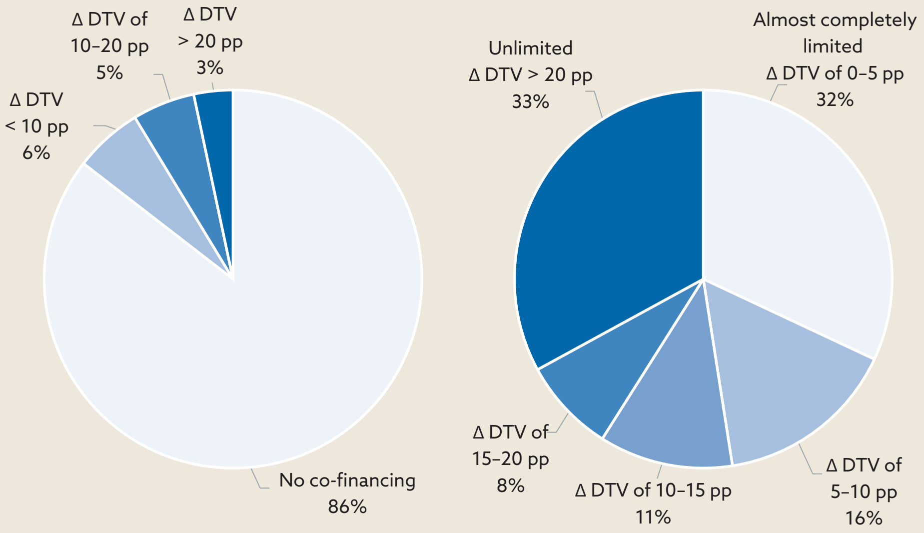
[35] In the second quarter of 2024, consumer loans from the same bank accounted for 61% of co-financing loans, and loans from another bank or a home savings bank accounted for 39%.

[36] For co-financing not exceeding 10% of the real estate collateral, the resulting DSTI ratio is 52% on average, while for that exceeding 20% of the collateral, the average DSTI is only 48%.

Chart 4
Mortgage co-financing with consumer credit is not widely used (left-hand panel) **and its maximum level is limited** (right-hand panel)

Left-hand panel: Actual use of co-financing – breakdown by actual increase in the DTV ratio (percentages)

Right-hand panel: Theoretical scope for co-financing – breakdown by potential increase in the DTV ratio (percentages)



Source: NBS.
Notes: DTV – debt-to-value, the ratio of total debt (including consumer credit) to the value of the real estate collateral. Δ DTV – change in the DTV ratio.

Mortgage co-financing is slightly more used by younger borrowers (aged up to 35 years), [37] which is positive from a financial stability perspective. Younger borrowers are less likely to buy a home for investment (speculative) purposes, hence the risk associated with such co-financing is lower.[38]

Moreover, the current regulatory framework significantly limits the potential use of co-financing. For one-third of households, such financing is entirely constrained, and for another third, it is only partly feasible. Only one-third of households can use co-financing to increase by more than 20 pp the ratio of their total debt – their mortgage and consumer credit – to the value of the property securing both loans (Chart 4, right-hand panel).

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[37] On average, more than 15% of mortgage borrowers aged up to 35 and less than 14% of borrowers aged over 35 have used co-financing with consumer credit since the beginning of 2022.

[38] International experience confirms that mortgages for investment property purchases are riskier and contribute to more amplified cycles in both housing prices and the credit market.

Household indebtedness continues to decline owing to slowdown in new mortgage lending

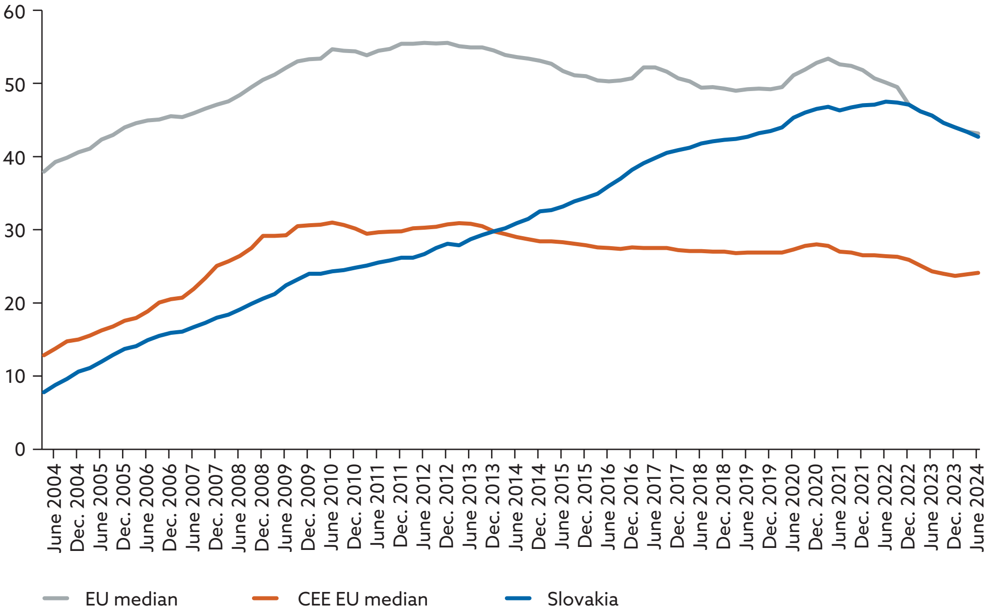
As a result of higher interest rates, the household debt-to-GDP ratio has been falling for more than two years. Since peaking at 47.5% in 2022, Slovakia's household debt-to-GDP ratio has declined by a tenth, or nearly 5 pp. This trend is expected to continue until annual mortgage growth rises to at least 4–5%, which would require mortgage origination to be around 5–12% higher than its current level.[39]

The falling indebtedness of households in Slovakia aligns with the EU-wide trend. On this measure, Slovakia lies at the EU median. For central and eastern European EU countries, the median household indebtedness is roughly half that of the rest of the EU, and its decline over the same period was half as well. But while household indebtedness has been decreasing for some time in the CEE region overall, Slovakia has only experienced this trend over the past two years.

Chart 5

Household indebtedness is falling in Slovakia as in the EU as a whole

Loans to households (sectors S14 and S15) as a ratio to GDP in the EU (percentages)



Source: Eurostat.

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[39] This calculation assumes that nominal GDP between 2024 and 2026 will evolve as projected in NBS's autumn 2024 medium-term forecast (MTF-2024Q3) and that consumer credit growth will remain at its current level.

2.2 The housing market has responded mainly to the expected fall in interest rates

The second and third quarters of 2024 saw the start of a slow recovery in the housing market

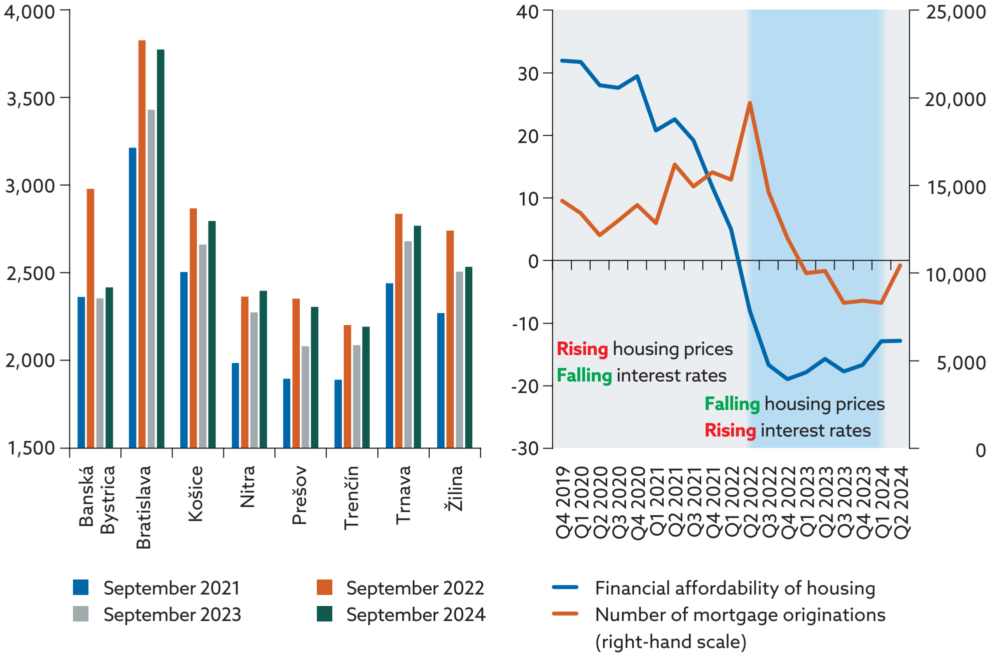
The upturn in housing prices has been due mainly to higher demand. This shift in buyer sentiment began largely in response to signs that interest rates would rise no further and were more likely to fall. Home purchase demand has been further supported by rental prices, which were rising even while sale prices were stagnant. As a result, prices of existing flats increased by around 4% year-on-year in the third quarter of 2024. However, in all Slovak regions, these prices are still below their 2022 peak (Chart 6, left-hand panel).

Chart 6

Slight upturn in housing prices in all of Slovakia's regional capitals (left-hand panel)**, with the recovery due mainly to expectations for a decline in interest rates** (right-hand panel)

Left-hand panel: The evolution of prices for flats is expressed through the average unit price of flats listed for sale in the given month (EUR)

Right-hand panel: Financial affordability of housing and number of monthly mortgage originations (percentages, number)



Sources: NBS, and United Classifieds.

Notes: The financial affordability of housing is calculated as the ratio of a mortgage payment for an average flat to average income, expressed a deviation from its long-run median. The higher the mortgage repayment burden, the lower the financial affordability of housing.

Bratislava has seen the most significant changes in prices of flats. The increase in average prices of existing flats in Bratislava has been largely driven by higher demand. At the same time, the share of nearly new flats and high-end flats in the supply mix has increased. Sales of new-build flats have also risen, but while they are now twice as high as in 2023, they remain lower compared with before the recent period of rising interest rates. Additionally, new-build developments are adding more high-end flats to the housing supply, thus increasing the average price of new-build flats.

The housing market has been affected more by interest rates and property price expectations than by the current financial affordability of housing.[40] When housing prices were surging, especially in 2021 and the first half of 2022, the financial affordability of housing deteriorated, placing increasing strain on household incomes. Nevertheless, the number of mortgages originated for the purpose of purchasing a flat rose during that period. The number of flats newly purchased with a mortgage peaked in the summer of 2022, even as the financial affordability of housing dropped to its lowest (worst) level in a decade. The shift in the housing market has changed only because of rising interest rates and falling prices of flats. The financial affordability of housing has not changed notably during this period and has actually improved slightly; nevertheless, new purchases of flats have declined significantly (Chart 6, right-hand panel). In other words, purchases of flats were less numerous when housing was more affordable and its purchase was less of a strain on household income than when changes were expected in interest rates and housing prices. This trend was also evident in the second and third quarters of 2024, when the number of mortgage originations increased even as housing affordability was relatively low.

In the spotlight: Mortgage-financed purchases of flats by younger and older borrowers [41]

Both the average younger and average older worker have less capacity [42] to buy housing now than at any time in the past decade. Since younger people have historically had lower average incomes than older people, their capacity to buy a home is also lower[43] (Chart 7, left-hand panel). At the same time, the gap in home-buying capacity be-

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[40] The financial affordability of housing refers to the technical relationship between housing prices, interest rates and household incomes. The calculation does not take into account the number and quality of properties on the market, nor the prospects and profitability of the investment over time.

[41] Younger and older (as well as younger and older households) are defined, respectively, as borrowers aged up to 35 and those aged over 35.

[42] The theoretical maximum capacity is calculated as the maximum square metreage of floor area of a flat that an average working person in a given age group can finance with a mortgage charged at the average interest rate (with the DSTI ratio at 60%, the DTI ratio at 8, the LTV ratio at 80%, and the maturity at 30 years).

[43] Expressing this income gap in terms of a flat's square metreage, the theoretical maximum for a borrower aged up to 35 has consistently been around 6 square metres lower than that for a borrower aged over 35. In Bratislava Region, this difference has consistently been around 9 square metres.

tween younger and older households has been stable over the past five years.[44]

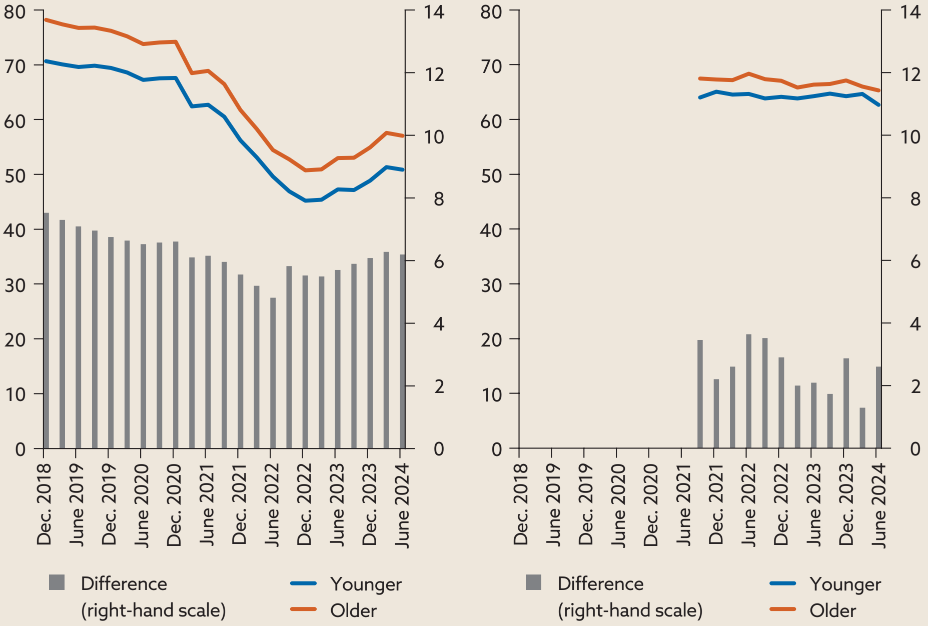
Both older and younger households have been buying similarly sized flats using mortgages. Despite significant movements in housing prices and interest rates, the average size of newly purchased flats[45] has remained largely unchanged over the past five years. For younger households, the average size of a flat purchased with a mortgage has ranged between 62 and 65 square metres, which is, on average, only 2.5 square metres smaller than the average for older households. This suggests that although households have in recent years experienced worsening of conditions for buying a flat, the average size of flats purchased by younger households has been similar to past levels and only slightly smaller compared with flats purchased by older households (Chart 7, right-hand panel).

Chart 7

The capacity to buy a flat has fallen for younger and older borrowers in parallel (left-hand panel)**, but the actual area of newly purchased flats has not changed** (right-hand panel)

Left-hand panel: The theoretical maximum capacity is calculated on the basis of the average wage in the economy for a given age group (square metres, square metres)

Right-hand panel: The actual size of newly purchased flats is calculated from the mortgages originated for their purchase, typically provided to one or two co-borrowers (square metres, square metres)



Sources: NBS, and United Classifieds.

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[44] This capacity initially deteriorated and then, after a price correction in 2022, improved slightly for both younger and older households, notwithstanding the upturn in interest rates.

[45] Flats purchased with a mortgage.

Compared with older borrowers, however, younger borrowers tend to have larger mortgages relative to income, higher LTV ratios, longer repayment periods and higher repayment burdens, Additionally, younger borrowers typically belong to smaller households with relatively lower incomes. Although the flats purchased by younger borrowers are very similar to those purchased by older households, mortgage financing can be comparatively more demanding for younger borrowers due to the differences in mortgage terms and income levels. It is therefore encouraging that these disparities between younger and older households have tended to narrow in recent times.

2.3 Weaker lending to firms amid an uncertain economic outlook

Corporate borrowing remains subdued

Lending to non-financial corporations (NFCs) has been sluggish in recent years. The stock of loans to NFC was almost 4% lower in September 2024 than a year earlier, although that decline masks considerable heterogeneity across the corporate sector. In some segments, the credit cycle has contracted sharply, while in others, credit growth is relatively strong. The year-on-year decline is also due in part to the comparison base, as September 2023 marked the peak of corporate lending. Although corporate lending has also slowed in other EU countries,[46] the trend is far more pronounced in Slovakia,[47] partly because the country previously experienced higher cyclicality in corporate lending.[48]

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[46] Slovakia is below the first quartile for both EU countries and CEE countries. Among EU countries, only four countries have reported a significant decline, while among CEE countries, Slovakia ranks second last.

[47] The annual rate of change in the corporate loan portfolio as at August 2024 was -2.9% in Slovakia, while the EU median stood at 0.6%.

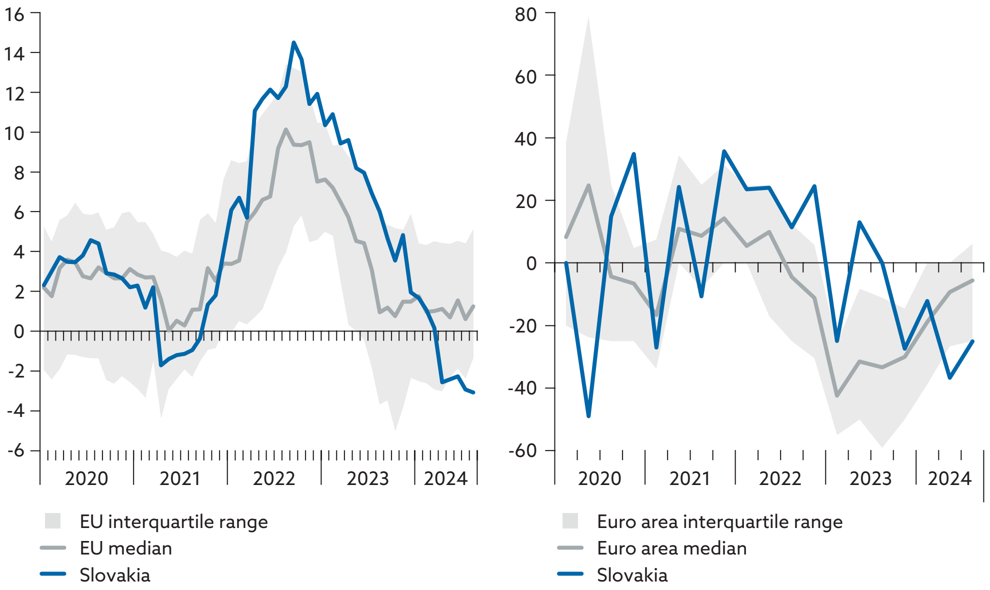
[48] Slovakia, as a small and relatively concentrated economy, is characterised by more amplified cyclicality, experiencing significant credit growth during expansionary phases, but also a more pronounced contraction in lending activity during credit cycle downturns.

Chart 8

Lending activity is weaker in Slovakia than in most EU countries (left-hand panel), **owing to subdued demand** (right-hand panel)

Left-hand panel: Annual rate of change in total NFC loans in Slovakia and across EU countries (percentages)

Right-hand panel: Annual rate of change in firms' demand for loans in Slovakia and across euro area countries (net percentage)



Source: ECB.

Note: The net percentage in the right-hand panel denotes the difference recorded by the bank lending survey between the percentage of banks reporting an increase in firms' demand for loans and the percentage reporting a decrease in that demand.

The subdued credit market activity is consistent with the trend in corporate revenues, which, like credit growth, have been slightly weaker than in the past.[49] Moreover, business sentiment deteriorated towards the end of the third quarter of 2024, primarily due to industrial firms experiencing a decline in order book levels and therefore reducing their production expectations.

The decline in lending stems mainly from lower corporate demand.[50] Firm's weak demand for financing for fixed investment, coupled with their declining need for working capital financing, is linked to underwhelming revenues and an uncertain economic outlook. Nevertheless, banks have not tightened their credit standards. At the same time, an in-depth firm-level analysis of loan growth in relation to the estimated risk asso-

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[49] Total NFC revenues for the first eight months of 2024, adjusted for price developments, were 1 pp lower compared with the same period of 2023.

[50] This conclusion is based on data from the bank lending survey conducted in the second half of September 2024. According to this survey, some banks are reporting a decline in their interest margins. The analysis of available capital buffers and liquidity presented in Chapter 4.1 confirms that banks have ample room to continue lending.

ciated with borrowing firms shows that banks have not been more constrained in lending to firms that have become higher risk.

The possibility of any notable turnaround in corporate lending in the near term is fairly limited. Elevated interest rates are having a notable impact on firms' appetite for bank loans. Lending rates peaked in April 2024, and although they have since fallen to some extent, they remain far higher than before the start of their upturn.[51] There is, however, no clear positive outlook for the domestic economy or for the economies of major trading partners. On the other hand, the year-on-year decline in loan growth could gradually ease owing to the fading of the base effect of the period of strong loan growth.

Lending activity is higher among smaller firms than larger ones

Among micro firms and, to a lesser extent, small and medium-sized firms, lending activity is more pronounced. The credit flows to micro firms in the third quarter of 2024 were the second highest for any quarter on record, though they were in line with the long-term growth trend in such lending.[52] Lending to small firms[53] made a similar contribution to overall corporate lending growth, followed by lending to medium-sized firms.[54]

Lending to large firms has had the largest negative impact on overall loan growth. This sector largely shapes the overall trend in corporate credit growth, mainly through short-term working capital loans. In the past year and a half, up to a third of these loans have been repaid, bringing their total amount down to its 2019 level.[55] This trend indicates large firms' ongoing weakening demand for working capital financing. Holding excess funds is also becoming relatively expensive in the current period.

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[51] The average interest rate on total NFC loans fell by 15 bp between April and August 2024 (from 5.53% to 5.38%). The lending rate downturn is passing through quite quickly to existing corporate loans, since most of them carry a variable rate – a contractually agreed rate linked to the EURIBOR.

[52] Monthly credit flows are above the average of recent years, and annual loan growth reached 3.8% in September 2024.

[53] As with micro firms, credit flows to these firms exceeded the levels of recent years, and the portfolio's year-on-year growth as of September stood at 5.5%.

[54] In terms of its contribution to total corporate loan growth, lending to medium-sized firms was around two-thirds of the contribution of lending to micro firms and small firms. Credit flows to medium-sized firms are at the level of previous years, and the annual growth rate in September stood at just below 1%.

[55] There were two waves of short-term borrowing by large corporates between 2019 and 2024. The first wave occurred in the immediate aftermath of the pandemic outbreak, when large firms made mostly precautionary use of approved credit lines. Once the pandemic receded, these additional borrowings were largely repaid. The second wave of borrowing occurred when inflation started rising sharply, and these additional loans have also been repaid.

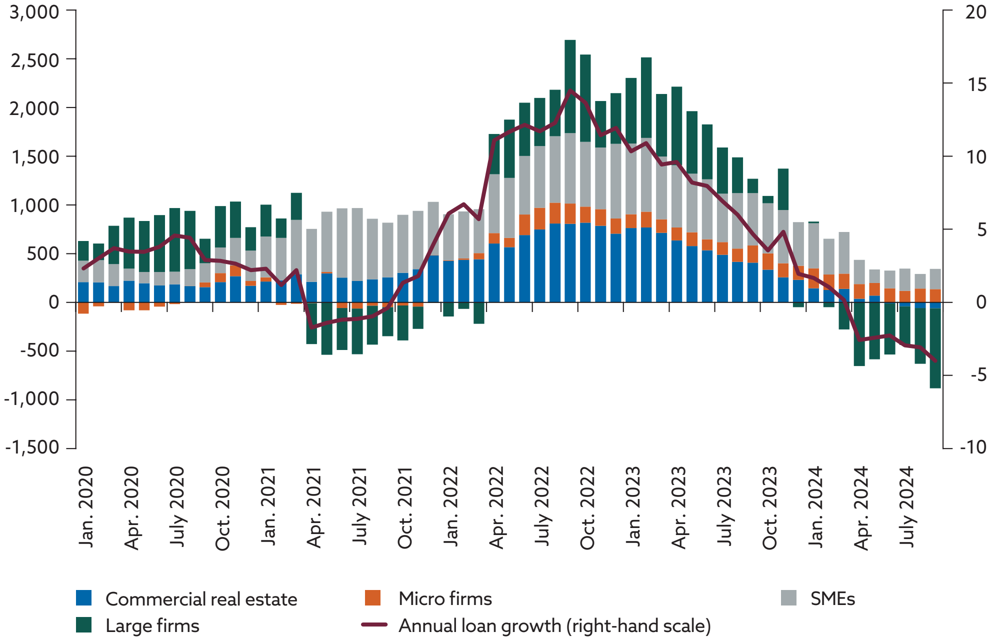
One reason that lending to larger firms is evolving differently from lending to smaller firms is that larger firms have a different financing structure, one in which short-term credit lines play a significant role and there are greater opportunities for more efficient liquidity management at the firm-level or group level.

Lending to the commercial real estate (CRE) sector has also stopped rising (with an annual growth rate of -1%). Monthly credit flows to the sector have mostly been negative since September 2023. It should be noted that this does not reflect a significant drop in lending but rather a certain stagnation – only slightly fewer loans are being taken out than are being repaid. As a result, the size of the CRE portfolio is essentially stable, with a very slight decline.[56] The slowdown is primarily due to subdued investment activity, which is associated with reduced financing for new construction projects.

Chart 9

Downturn in corporate credit cycle, but recovery in lending to smaller firms

Contributions to annual growth in total NFC loans by type of firm, and annual growth in total NFC loans (EUR billions, percentages)



Sources: NBS, and RBUZ.

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[56] Total loans to CRE firms were 1.1% lower in September 2024 than a year earlier.

In the spotlight: Banks' role in financing business investment activity

In September 2024, NBS published a Discussion Note that took a closer look at the topic of investment financing in the corporate sector.[57] This issue has been a major focus of public discourse in recent months, especially in the context of the recently released report by Mario Draghi on competitiveness in the EU,[58] which highlights the low level of investment financing. The financing of long-term investment in the corporate sector is seen as a crucial pillar for the EU's economic growth and long-term prosperity.

The NBS Discussion Note attempts to answer the question of which sources are used to finance business investment in Slovakia. Understanding the financing structure is important for identifying potential channels for financing growth. The largest source of funding for business investment is firms' own funds (37%), followed by bank financing (19%) and intra-group financing (18%).

The Discussion Note also explores opportunities to increase the flow of bank financing. It is important to stress that firms themselves are not reporting difficulties in obtaining credit financing for investment. Compared with other CEE countries, Slovakia is not underperforming in terms of bank financing of business investment. Nevertheless, there is scope for growth in this area of financing, especially for smaller investments and non-real estate investments. There is also capacity to increase the share of lending to new firms that have not yet had recourse to bank financing.

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[57] Jurča,P. and Perniš, Ľ., "Ako sa banky podieľajú na financovaní investícií podnikov?" (How do banks contribute to the financing of business investment?), *Discussion Note,* No 139, 3 September 2024 (in Slovak only).

[58] Draghi, M., "The future of European competitiveness", European Commission, September 2024.

3 Financial situation of households and firms

3.1 Households' financial situation is already gradually improving

The previous temporary deterioration in households' financial situation did not lead to significant debt servicing difficulties, and the outlook is favourable

The improving financial situation is primarily driven by favourable labour market developments and declining inflation. Real disposable incomes rebounded in the second quarter of 2024, nearly returning to pre-inflation uptrend levels, and continue to rise. Household consumption shows a similar trend but remains well below the level it was at before inflation started climbing. The unemployment rate remains broadly stable at close to historical lows. Households' ability to save has also recovered, although the saving rate is still around a third below normal (pre-pandemic) levels. This upturn has had an impact on household deposits, with their annual growth rate rising to pre-pandemic levels. From a financial stability perspective, it is encouraging that financial asset growth has been more pronounced among borrowers with higher debt burdens (Chart 10, right-hand panel).[59]

Although the previous decline in real incomes and rise in loan payments temporarily worsened the financial situation of households, it did not significantly impair debt servicing capacity. While the non-performing loan (NPL) ratio for the household loan portfolio has stopped decreasing, it has shown no significant increase. The NPL ratio for the mortgage portfolio remains close to its historical low (1.1%). Similarly, the consumer credit portfolio has experienced minimal deterioration in credit quality.[60] Barring unexpected developments, households seem to have weathered the worst effects of falling real incomes and rising interest rates. Consequently, no serious deterioration in debt servicing is anticipated in the near term.

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[59] At the same time, the median amount of financial assets of borrowers with higher debt burdens has increased. While the median financial assets for households with a DSTI ratio of up to 55% increased by 2.6% year-on-year in the second quarter of 2024, the median figures for those with a DSTI ratio of 50–55% and 55–60% increased, respectively, by 4.4% and 8.5%.

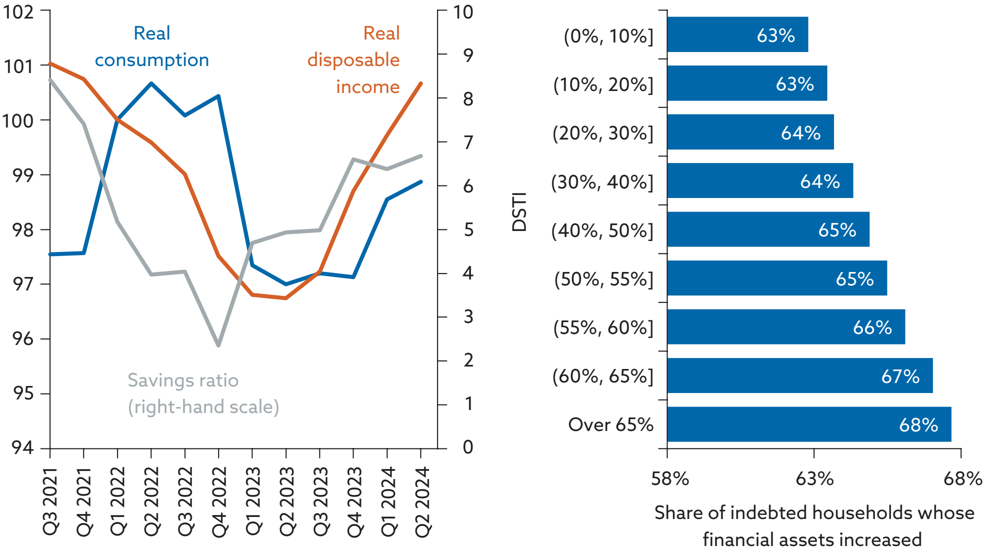
[60] The NPL ratio for consumer credit fell from over 9% six years ago to an all-time low of 6.7% in the second half of 2023, before edging back up to 7.1% by September 2024 – still a very favourable level in historical terms.

Chart 10

Households' financial situation is gradually improving (left-hand panel) **and savings are rising, especially among borrowers with higher debt burdens** (right-hand panel)

Left-hand panel: Real household consumption (index: Q1 2022 = 100, left-hand scale), real household disposable income (index: Q1 2022 = 100, left-hand scale) and household savings ratio (percentages, right-hand scale)

Right-hand panel: Share of indebted households whose financial assets increased year-on-year as of June 2024 (horizontal axis, percentages) by DSTI ratio (vertical axis, percentages)



Source: NBS.
Note: DSTI – debt service-to-income less the minimum subsistence amount (ratio).

Most households can manage loan payments despite higher interest rates[61]

The majority of borrowers are meeting increased loan payments without needing to modify repayment terms. The share of mortgages fully adjusted to higher interest rates is increasing only gradually; by June 2024, around a quarter of all mortgages had undergone full adjustment, with an average payment increase of €89. Some borrowers are taking the opportunity to prepay their mortgages (the average amount of mortgage prepayments has also increased), while the uptake of mortgage top-ups has declined. These changes, however, concern only a relatively small share of total mortgages (less than 5% of mortgages that have undergone an interest rate reset).

Higher mortgage payments have not so far caused significant repayment difficulties. Nor has there been an increase in the share of mortgages requiring a maturity extension upon a rate reset – an indicator of potential difficulties. This situation is not expected to worsen, provided that the la-

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[61] This topic is addressed in further detail in the following note: 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).

bour market remains robust. In individual cases, debt servicing difficulties may also be partially alleviated by the government subsidy towards the cost of higher mortgage payments. As of 30 September 2024, a total of 20,508 borrowers – accounting for around 13% of the mortgages repriced to higher interest rates – were receiving the mortgage subsidy.[62]

The mortgage portfolio's sensitivity to external shocks remains elevated

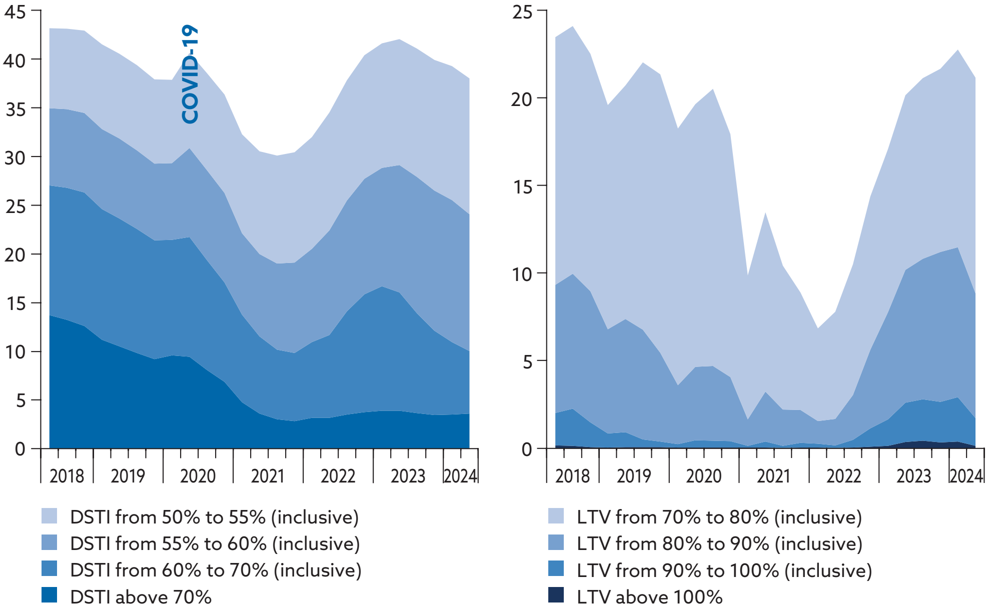
The mortgage portfolio became increasingly sensitive to external shocks during 2022 and the first half of 2023. While this deterioration did not have an adverse impact on mortgage servicing, the response to a negative economic shock to the portfolio could be worse. The portfolio's sensitivity increased because of declining real incomes, payment increases due to rising interest rates, and a downtrend in real estate collateral values.

Chart 11

The risk parameters of the mortgage portfolio are gradually improving, with decreases in both the average DSTI ratio (left-hand panel) **and the average LTV ratio** (right-hand panel)

Left-hand panel: Share of mortgages with a higher current DSTI ratio (percentages)

Right-hand panel: Share of mortgages with a higher current LTV ratio (percentages)



Source: NBS.

Notes: LTV – loan-to-value (ratio); DSTI – debt service-to-income less the minimum subsistence amount (ratio). The current LTV ratio is calculated as the ratio of the current outstanding amount of the loan to the current value of the real estate collateral indexed according to a region-by-region real estate price index. The current DSTI ratio is calculated as the ratio of current cost of loan payments (applying a stressed interest rate) to the difference between the borrower's income indexed by real wage developments and the minimum subsistence amount.

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[62] Disbursements of the subsidy for the period from January to September 2024 totalled €9.6 million.

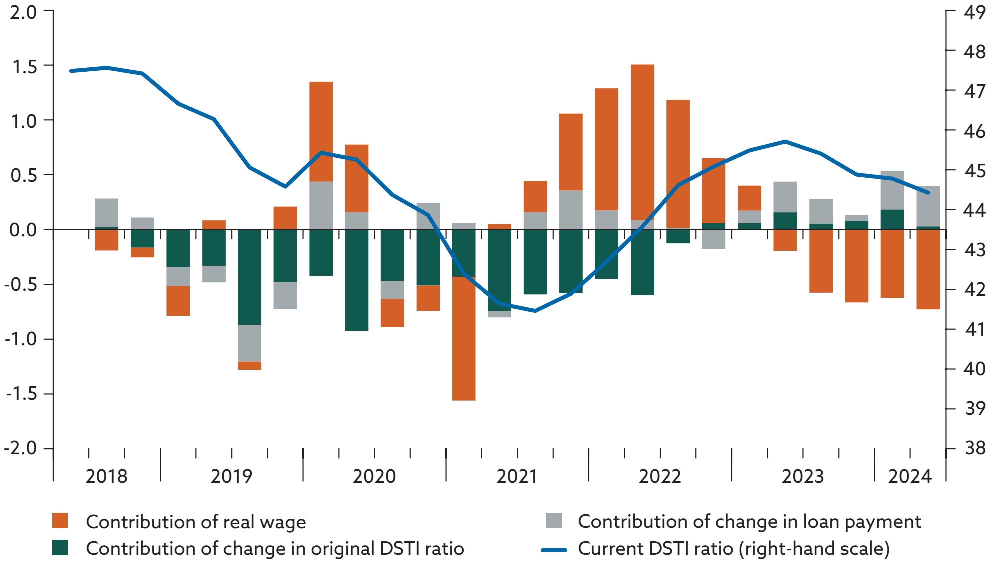
This sensitivity subsequently diminished slightly, but it remains elevated compared with the period before inflation starting rising. This is evident mainly in higher current DSTI ratios as well as higher current LTV ratios.

The average DSTI ratio across the mortgage portfolio has shed almost a third of its previous increase. This improvement stems mainly from rising real wages, whose impact, however, has been curbed by interest rate increases and, to a lesser extent, by new loans' higher DSTI ratios. Given, however, expectations for further real wage growth and for an upturn in the housing market, the outlook for the portfolio's sensitivity is favourable.

Chart 12

The average current DSTI ratio has improved, owing mainly to renewed growth in real household incomes

Evolution of the average current DSTI ratio and contributions to its change (percentages, percentages)



Source: NBS.

Notes: DSTI – debt service-to-income less the minimum subsistence amount (ratio). The current DSTI ratio is calculated as the ratio of the current cost of loan payments (applying a stressed interest rate) to the difference between the borrower's income indexed by real wage developments and the minimum subsistence amount.

Stress testing of the retail loan portfolio confirms our expectations of no significant worsening of credit quality under the baseline scenario

The stress testing covered two scenarios over the next three years. The baseline scenario follows NBS's current medium-term forecast, assuming real wage growth (despite a temporary rise in inflation in 2025) and a moderate drop in mortgage rates. By contrast, the adverse scenario assumes a decline in real wages and, notably, a relatively sharp rise in unemployment. Interest rates are assumed to decrease, though less sharply than in the baseline scenario.

Table 1 Assumptions for the simulation of loans at risk

	June 2024 (year-on-year growth or level)	**Baseline scenario** (cumulative growth from July 2024 to June 2027, or level as at June 2027)	**Adverse scenario** (cumulative growth from July 2024 to June 2027, or level as at June 2027)
Inflation (change in price level)	2.5%	10.3%	7.3%
Average nominal wage (change)	7.4%	12.5%	6.7%
Unemployment rate (level)	5.3%	5.7%	11.3%
Mortgage rate (level)	4.6%	3.0%	4.0%

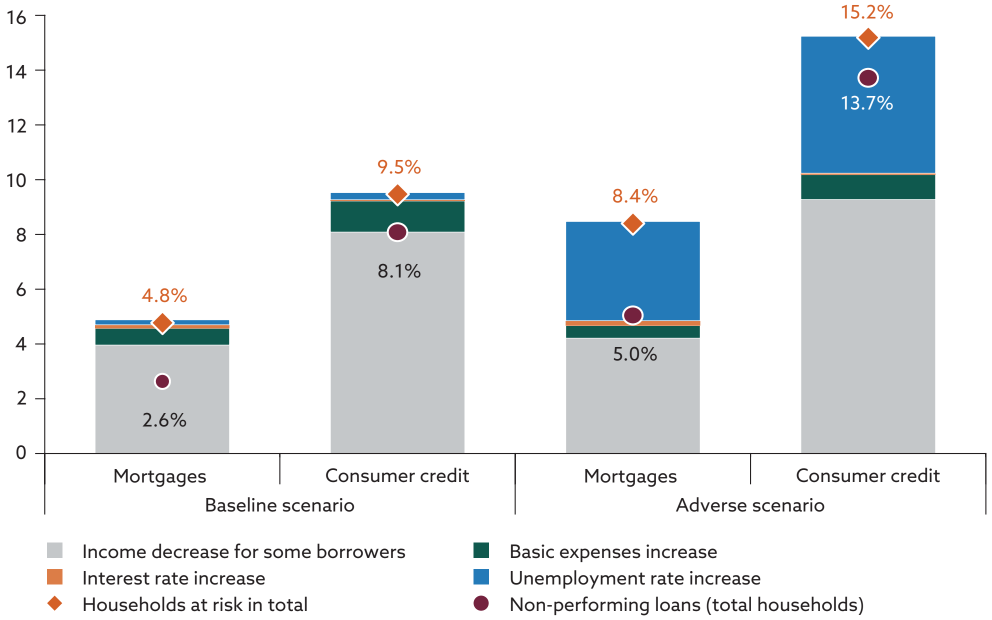
Source: NBS.
Notes: The baseline scenario assumptions are based on NBS's autumn 2024 medium-term forecast (MTF-2024Q3). Inflation is measured by the Harmonised Index of Consumer Prices (HICP). For inflation and wages, a linear change is assumed over the adverse scenario horizon (July 2024 – June 2027); for unemployment, growth is faster. The mortgage rate figure is not based on the forecast; it is a technical assumption made for the purposes of this analysis and aligned with current trends.

Under the baseline scenario, the estimated increases in the share of loans at risk[63] and the NPL ratio do not significantly exceed the levels typical in previous years. The primary risk factor in this case is ordinary income fluctuations, which may result in reduced income for a small proportion of households, potentially leading to debt servicing difficulties.

Chart 13

Impacts of different shocks on household loans at risk

Share of household loans that may become at risk, by type of shock (percentages)



Source: NBS.
Notes: The increase in loans at risk in the period from June 2024 to June 2027 is simulated using the scenarios described in Table 1. Households at risk are here defined as households whose loan payments and basic expenses exceed their income and accumulated savings. The income decline of certain borrowers refers to the standard fluctuation in household incomes, which, even in periods of increasing average nominal incomes, may rise for some households and fall for others.

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[63] Households at risk are here defined as households whose loan payments and basic expenses exceed their income and accumulated savings.

In the adverse scenario, compared with the baseline, an additional 3.6% of mortgage-paying households and 6.8% of households with consumer credit are estimated to become at risk of financial distress. The risk in this case stems mainly from rising unemployment and, to a lesser extent, slower income growth.

The consolidation package is not expected to worsen the situation

From a financial stability perspective, it is important that the newly adopted fiscal consolidation package does not lead to increased riskiness in the household loan portfolio. In both the baseline and adverse scenarios, the share of households at risk is virtually the same whether or not the consolidation measures are taken into account (with the impact of the consolidation package not exceeding 0.02% in either scenario). The calculation of the potential consolidation impact focused on changes to the child tax credit (lowering the eligibility threshold, and reducing or removing entitlement for higher-income households[64]) and the VAT rate increase. The reduction or removal of entitlement to the child tax credit is estimated to affect around 6% of borrower households, with the average tax credit reduction equating to approximately 2.8% of their income.

The consolidation package has a low impact on households' debt servicing capacity because the changes are across-the-board and their overall impact is less than, for example, that of an increase in mortgage payments or the eventual unwinding of energy price subsidies. Whereas the recent increase in mortgage payments represents an additional annual cost to households of around €170 million (affecting around a quarter of mortgage-paying households, rather than all), the tax credit reform represents a comparable cost, but one which is borne by both mortgage-paying households and households without a mortgage, with a more pronounced impact on higher-income households. Subsidies towards the cost of increased energy prices in 2023 amounted to over €2 billion, while the VAT rate increase is estimated by the MF SR to generate revenues of around €0.75 billion.

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[64] The calculations include a planned reduction in the child tax credit which predates the consolidation package and is due to take effect from 1 January 2025 (cutting the credit from €140 to €100 for children aged up to 18).

3.2 The riskiness of the corporate loan portfolio has stopped decreasing

Firms' financial situation improved slightly in 2023

The financial situation of firms in Slovakia improved moderately during 2023. While the preliminary data available for the May 2024 Financial Stability Report covered only part of the corporate sector and indicated a slight improvement, the picture was further enhanced once all financial statements were finalised. Profitability and liquidity ratios have increased slightly, and the share of firms reporting losses or negative equity has fallen.

The situation is expected to remain stable in 2024, with no significant improvement or deterioration anticipated. The cost of loans is expected to remain similar to its 2023 level, with reductions envisaged only from 2025 onwards. Corporate revenues in 2024 are also projected to be on a par with their 2023 level. While private consumption is expected to continue growing, foreign trade – a key driver of revenue growth – is expected to decline slightly, according to NBS's autumn 2024 medium-term forecast (MTF-2024Q3).

Table 2 Evolution of firms' financial situation

	Non-borrowing firms			Borrowing firms		
	2021	2022	2023	2021	2022	2023
ROE (median)	13.5%	14.3%	14.9%	10.1%	10.8%	11.0%
Gross margin (median)	30.3%	31.2%	33.0%	25.4%	24.2%	25.1%
Profit margin (median)	2.8%	2.9%	3.1%	2.4%	2.3%	2.3%
Share of loss-making firms	30.9%	29.0%	27.2%	28.9%	28.0%	26.5%
Share of firms with negative equity	15.7%	15.1%	14.4%	13.0%	13.2%	12.4%
Cash liquidity (median)	23.9%	22.7%	23.5%	5.2%	5.0%	5.5%

Sources: NBS, and FinStat.
Notes: The figures represent the average of the medians or values for each firm category. 'Non-borrowing firms' are firms without a loan from a Slovak bank. Gross margin is calculated as the ratio of value added (i.e. income from the sale of goods and services less direct costs related to goods and services output) to total revenues.

The riskiness of the corporate loan portfolio has stopped decreasing and has risen slightly in some sectors

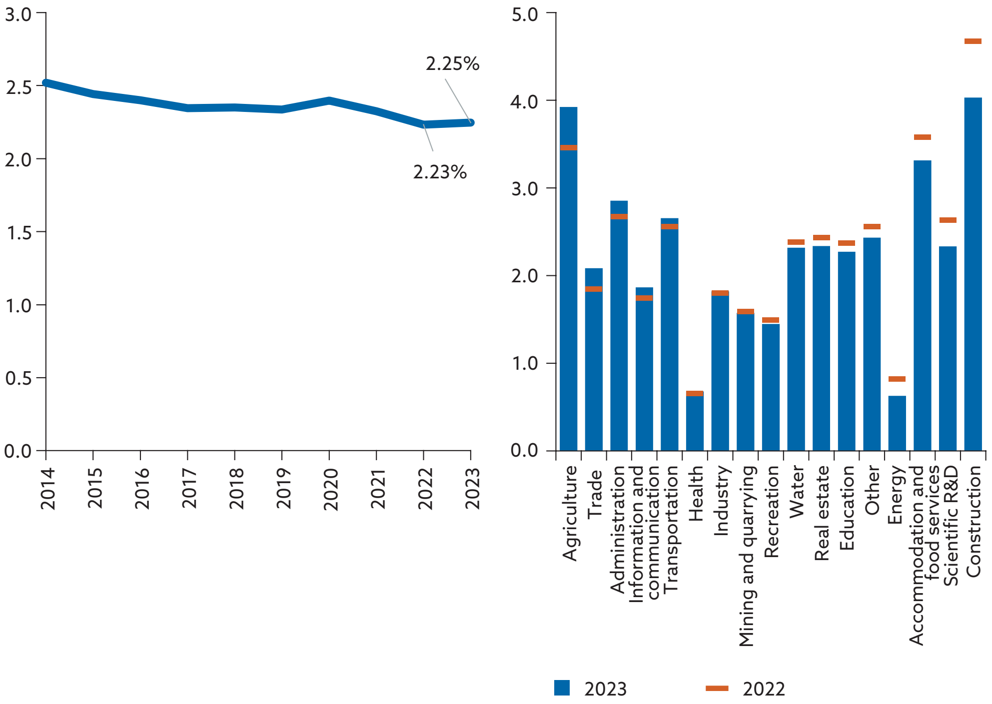
In 2023, the riskiness of total bank loans to non-financial corporations (NFCs) came to the end of a long downward trend. In some segments of the portfolio, the estimated probability of default increased slightly. Among sectors with a significant share of the portfolio, riskiness worsened mainly in agriculture, trade, administration, information and communication, and transportation.

Chart 14

The NFC loan portfolio’s riskiness is showing signs of increasing after a long downward trend

Left-hand panel: Evolution of the average probability of default for the NFC loan portfolio (percentages)

Right-hand panel: Average probability of default by economic sector and its level compared with the previous year (percentages)



Source: NBS.

Notes: The left-hand panel shows the weighted average of the probability of default for the NFC loan portfolio, estimated using a logistic model described in Table 3. The weights used were the outstanding amounts of bank credit to the respective firm as at 30 September 2024. The right-hand panel shows the weighted average of the probability of default by economic sector. The sectors are ordered by the size of the change in the probability of default compared with the previous year.

The end of the downtrend in the riskiness of the NFC portfolio and signs of deterioration have occurred despite a slight improvement in the corporate sector’s profitability. There are two main reasons for this:

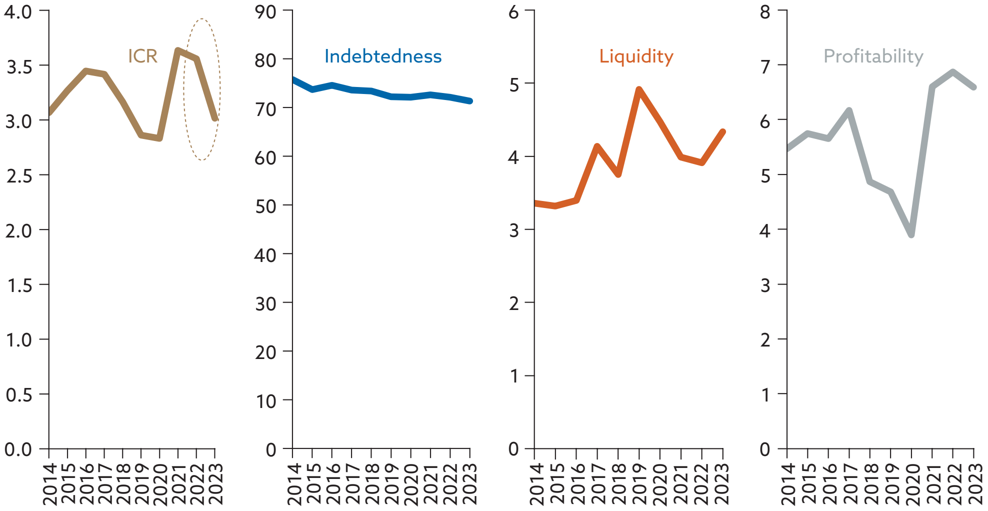
- Profitability growth has been more pronounced among non-borrowing firms (Table 2) and firms with smaller loans. Profitability weighted by loan size declined moderately year-on-year (Chart 15, right-hand panel).
- As a result of the rise in interest rates, the interest coverage ratio (ICR) has fallen, leading to a decline in debt servicing capacity (Chart 15, left-hand panel).

On the other hand, these negative effects have been partly offset by higher liquidity and a year-on-year increase in firms’ solvency.

Chart 15

The end of the downtrend in portfolio riskiness has stemmed largely from a decrease in the ICR

Evolution of the values of the main indicators used in the probability of default estimation model (percentages)



Sources: NBS, and FinStat.
Notes: ICR – interest coverage ratio (the ratio of earnings to interest expenses). The significance the individual variables for portfolio riskiness and their definitions are provided in Table 3 and the accompanying notes.

Barring unforeseen developments, the NFC portfolio's riskiness is not expected to start improving again until 2025. Although interest rates have already started falling in 2024, their decline will not be reflected in the total annual interest expenses for the year.

In the spotlight: Model for estimating corporate portfolio riskiness

The NFC loan portfolio's riskiness and sensitivity to external shocks can be analysed using a logistic regression–based model. This model aims to capture the relationship between past defaults in the corporate sector and the financial situation of firms in the year prior to the default. The main factors contributing to a higher probability of default include higher indebtedness, a lower interest coverage ratio (ICR), weaker profitability and liquidity, and a negative trend in the equity-to-assets ratio. The model also captures the fact that, *ceteris paribus*, smaller firms are more likely to fail compared with larger firms. Further details about the model are given in Table 3.

Table 3 Coefficients of the logistic regression-based model for estimating firms' probability of default

Variable	Coefficient
Debt servicing capacity (ICR)	-0.10
Indebtedness (ratio of external financing to assets).	0.89
Profitability (ratio of earnings before tax to assets)	-1.34
Firm size (decadic logarithm of revenues)	-0.19
Liquidity (cash-to-assets ratio)	-0.31
Non-standard balance sheet indicator (negative illiquid assets)	1.09
Financial situation evolution (year-on-year change in equity-to-assets ratio)	0.25

Sources: FinStat, and own calculations.
Notes: ICR – interest coverage ratio. Profitability is calculated only for profitable firms; for loss-making firms, it is zero. The model was estimated on a sample of 48,766 observations, with defaults making up 50% of the total. In addition to the variables given in the table, the model includes fixed effects for different economic sectors. All coefficients are highly statistically significant (at a 99.9% confidence level). The model's quality coefficients are as follows: AUROC – 70.6%; Gini coefficient – 41.4%.

Corporate stress testing results show that the credit quality of the NFC portfolio is not expected to deteriorate significantly under the baseline scenario but may do so under the adverse scenario

The potential evolution of the NFC loan portfolio's credit quality was estimated in two scenarios. The baseline scenario, based on NBS's autumn 2024 medium-term forecast (MTF-2024Q3), assumes that revenue growth starts recovering from 2025 and is not significantly lower than cost growth. The adverse scenario features a demand shock in the form of a more pronounced economic downturn in the first year of the simulation. In both scenarios, corporate lending rates are assumed to be slightly lower compared with end-2024 levels.

Table 4 Assumptions for the simulation of firms at risk (percentages)

	Baseline scenario				Adverse scenario			
	2024	2025	2026	Total	2024	2025	2026	Total
Revenue growth	0.6	5.5	4.2	10.6	-16.1	2.8	2.3	-11.8
Increase in unit costs								
… inputs, goods and services	5.0	2.8	2.2	10.3	4.2	1.6	1.4	7.3
… employees	5.1	4.6	3.2	13.5	0.5	3.6	3.3	7.6
Three-month EURIBOR	3.0	2.3	2.2		3.0	2.3	2.2	

Source: NBS.
Notes: The assumptions for the baseline scenario are based on NBS's autumn 2024 medium-term forecast (MTF-2024Q3). The three-month EURIBOR is given as its average value for the respective year.

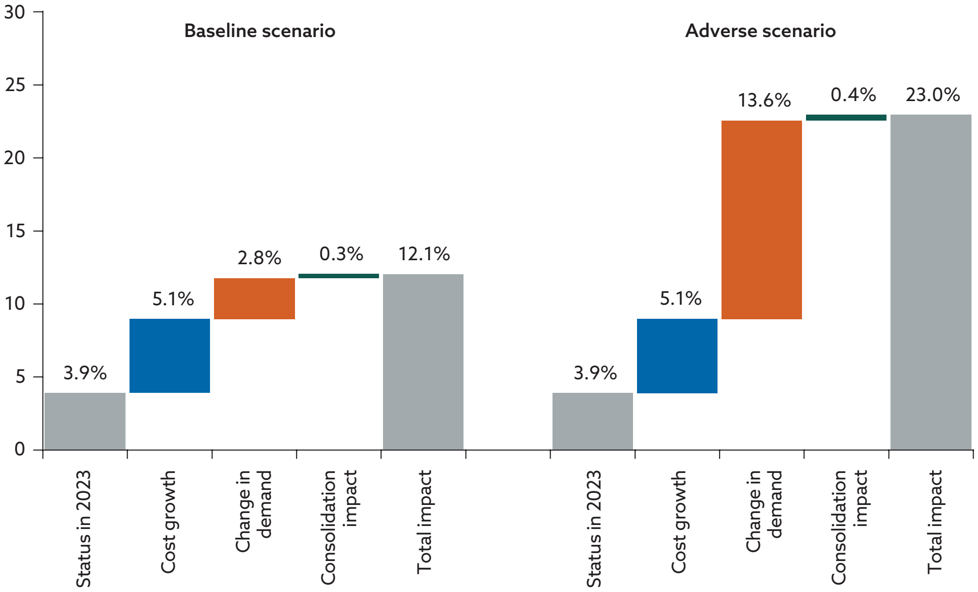
In the baseline scenario, the share of total NFC loans that become at risk[65] during the three-year horizon is estimated not to exceed 7%. Most of the loans that become at risk do so because of the normal impact of firm-level developments. Therefore, in this scenario, no significant increase in either loan defaults or corporate losses is envisaged.

In the adverse scenario, however, the share of NFC loans that become at risk is estimated to be as high as 20%. In this case, the primary risk factor is a demand shock related to a decline in sales, which firms cannot fully offset by reducing costs. The share of newly defaulted loans during the stress testing horizon is estimated to rise by 2.5 percentage points from its current level.

Chart 16

NFC loans at risk

Share of loans at risk in the total NFC loan portfolio and factors affecting its increase over the simulation horizon (percentages)



Sources: NBS, SO SR, and FinStat.
Notes: The chart shows the share of loans at risk at the end of the three-year simulation horizon (i.e. in 2026). The chart does not include data for the CRE sector, which is analysed separately in the following section.

Both estimates also take into account the impact of the newly adopted fiscal consolidation measures. The calculation of the share of loans at risk specifically included an estimate of the impact of the hike in corporate income tax and the introduction of the financial transaction tax (FTT). For the purposes of the analysis, it was assumed that the effective tax rate for the FTT (i.e. considering statutory exemptions, caps, and potential tax optimisation) could be around 0.25% of total revenues. However, the impact of these measures on the increase in loans at risk is relatively small: 0.3 pp in

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[65] We define loans at risk as loans to firms that, by the end of the three-year horizon, are at risk of severe financial distress (i.e. of having negative equity).

the baseline scenario and 0.4 pp in the adverse scenario. The share of loans to loss-making firms is approximately 0.8 pp higher when the measures are taken into account than when they are excluded. The average ROE of borrowing firms (weighted by loan size) is estimated to decline by 0.6 p.p. as a result of the consolidation package, with the impact being more pronounced (-0.8 pp) on larger firms than on smaller firms.

In addition to a deterioration in the credit quality of the corporate loan portfolio, the adverse scenario results in a marked worsening of the financial situation of firms themselves. In this scenario, the average ROE falls by up to three-quarters and the share of loss-making companies doubles.

3.3 Commercial real estate faces a combination of cyclical and structural risks

Increased risks persist, mainly in the office segment

Elevated interest rates with their upward impact on debt servicing costs are the main source of cyclical risks. Higher rates reduced the revenues of bank-financed firms by an average of 13%[66] in 2023, according to final financial statements. Some firms sought to mitigate the impact of higher interest rates by means of interest rate derivatives or fixed-rate loans. However, this approach was only partially successful, reducing the impact by around one-fifth.[67]

In addition, firms also faced further increases in operating costs; however, these costs were already rising far more slowly compared with 2022, and firms were able to fully offset their increase with higher rental income. Many firms have this compensation embedded directly in their rental contracts through ‘inflation clauses’, but these do not normally apply to interest expenses.

Structural risks are reflected in the vacancy rate, which remains particularly high in the office segment. This is due to the rising prevalence of remote working, job cuts in the shared services sector, and tenants’ efforts to manage costs more efficiently. An encouraging sign, however, is that after its increase in the second half of 2023, the vacancy rate has corrected slightly in 2024. This shift was to some extent expected, as the number of property development projects offering new office spaces has fallen sharply compared with the previous period.

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[66] This is the weighted average for individual firms, with the weight being the amount of credit received from domestic banks.

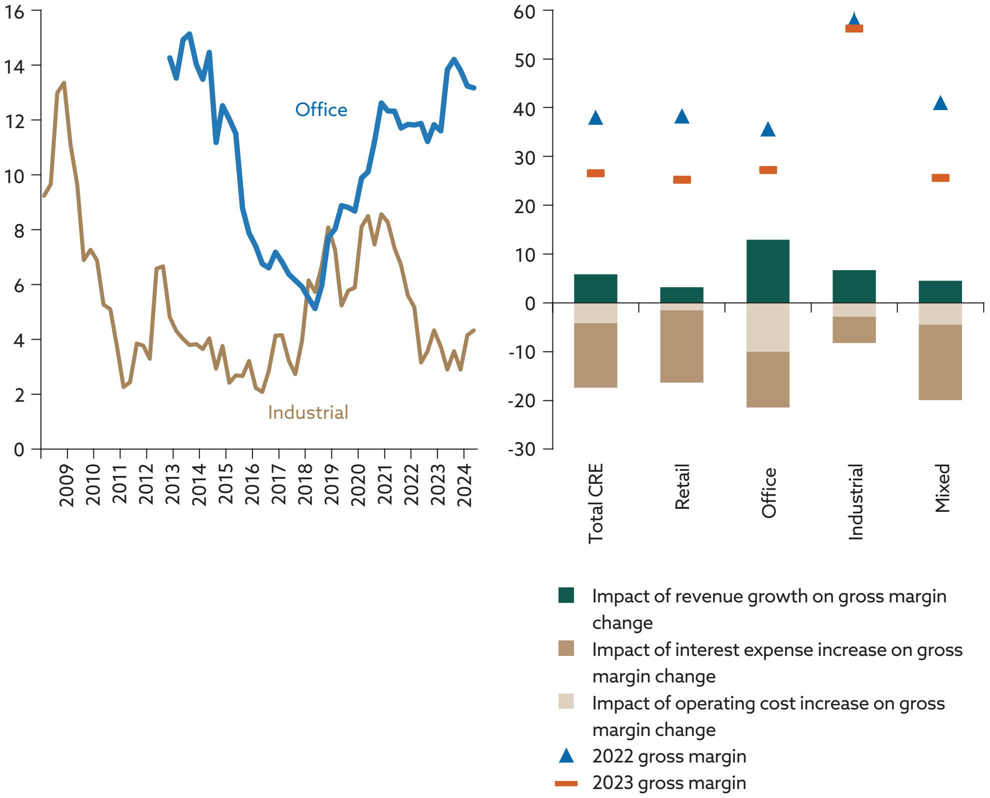
[67] The cost of loans increased, on average, by 2.4 pp. The average level of the three-month EURIBOR – the interbank rate used as the reference interest rate for most loans – rose by 3 percentage points year-on-year.

Chart 17

The office vacancy rate has fallen slightly (left-hand panel), **while interest margins on the CRE portfolio remain compressed by elevated interest expenses** (right-hand panel)

Left-hand panel: Office vacancy rate in Slovakia (percentages)

Right-hand panel: Gross margins in 2022 and 2023 and the factors contributing to their year-on-year change (percentages)



Sources: Cushman & Wakefield, FinStat, and NBS.

Notes: For the purposes of this analysis, the gross margin also takes into account interest expenses. It is calculated as the ratio of rental income less direct costs and interest expenses to total rental income. The values in the right-hand panel are calculated as a weighted average, with the weights being the outstanding amounts of bank credit to the respective firm as at 31 December 2023.

As a result of these risks, several segments of the CRE loan portfolio are in worse shape now than in 2022, making them more vulnerable to external shocks. The average gross margin declined by almost a third during 2023.[68] The share of loans to firms with a negative gross margin increased from 6% to 10%, and the share of loans to loss-reporting firms rose from 26% to 37%.

From a financial stability perspective, what matters is that the CRE sector appears to have navigated the most difficult period, with the portfolio so far showing no significant increase in non-performing loans. Although NPL ratios are showing signs of deterioration, their level remains low. Approximately 0.7% of CRE loans default annually, with that rate being only

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[68] For the purposes of this analysis, the gross margin is calculated as the ratio of rental income less direct costs and interest expenses to total rental income. Its average, weighted by loan size, decreased year-on-year in 2023, from 37% to 23%.

slightly higher compared with the rate before the upturn in interest rates and costs (0.5%). On the other hand, some CRE firms are facing difficulties to repay their loans, as indicated by a slight increase in CRE loans whose maturity is extended in a given year.[69]

According to a simulation, the riskiness of the CRE loan portfolio should start improving gradually from 2025

Two scenarios were used to simulate how the CRE loan portfolio's riskiness may evolve over a three-year horizon. The key assumption for both scenarios is a decline in interest rates, the same in both cases. Based on current trends, the cost of loans is assumed to be roughly the same in 2024 as in 2023, before following a downward path thereafter – more pronounced in 2025 and slower in 2026.

Where the scenarios differ, however, is in their assumptions for rental income and operating costs. The baseline scenario assumes that both increase by a cumulative 10% over the three-year simulation horizon. This rate of increase is lower than the recent trend. In line with empirical experience, it is assumed that firms can pass the entire increase in costs on to rents. In the adverse scenario, the evolution of rental income is assumed to depend on the quality of the property development project. For higher-quality projects, rental income growth matches that in the baseline scenario. For lower-quality projects, rental income gradually declines (by a cumulative 20%) owing to higher vacancy rates, with their impact mitigated by a slower increase in operating costs.[70]

Table 5 Assumptions for the simulation of loans at risk (percentages)

	Baseline scenario			Adverse scenario		
	2024	2025	2026	2024	2025	2026
Rental income growth						
... higher-quality projects	5%	3%	2%	5%	3%	2%
... lower-quality projects	5%	3%	2%	-10%	-6%	-4%
Rise in operating costs						
... higher-quality projects	5%	3%	2%	5%	3%	2%
... lower-quality projects	5%	3%	2%	3%	2%	2%
Cost of loans	6.2%	5.0%	4.8%	6.2%	5.0%	4.8%

Source: NBS.
Note: Lower-quality projects are considered to be those that already had a lower gross margin in 2023 (below 30%).

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[69] Of the total number of CRE loans, 6.3% had their maturity extended in the first three quarters of 2024, while 8.5% of the total volume of CRE loans underwent the same. These figures represent a slight increase compared with the average for the same period in 2021, 2022 and 2023 (5.4% and 5.8%, respectively).

[70] Such a revenue decline equates to a vacancy rate increase of around 5 pp.

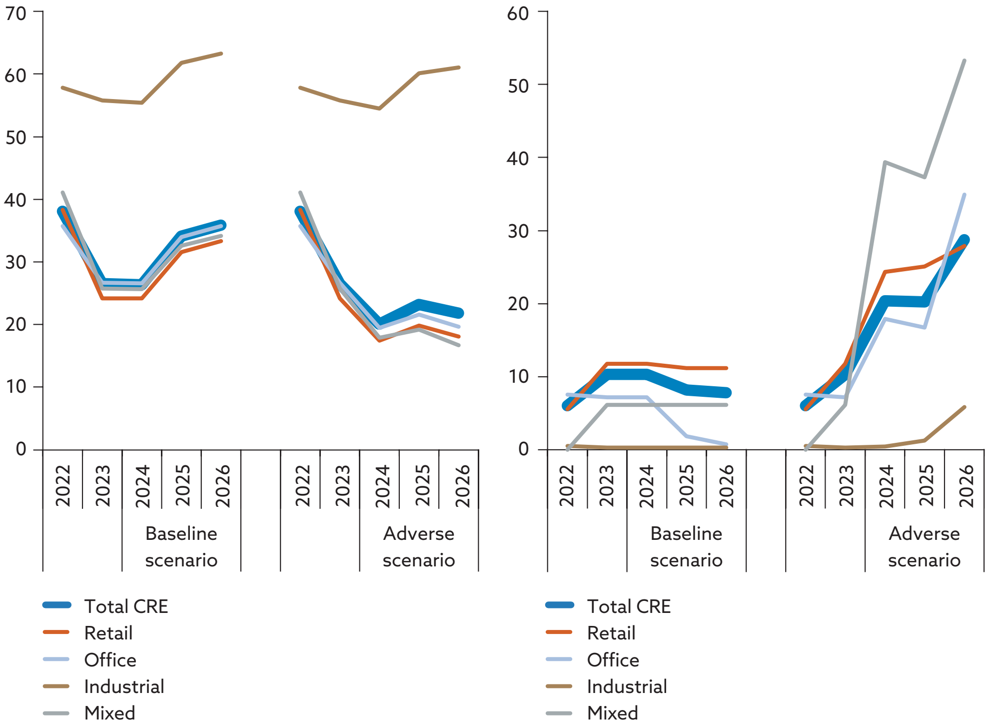
In the baseline scenario, the portfolio's riskiness is estimated to remain elevated in 2024 and then gradually decrease, with no significant materialisation of losses, returning to its 2022 level by 2026. The share of loans at risk (i.e. loans to firms with a negative gross margin) also decreases.

In the adverse scenario, where firms face an increased vacancy rate alongside their currently higher debt servicing burden, losses on the loan portfolio are likely to be unavoidable. Despite the partial mitigating effect of the decline in interest rates, the gross margin is estimated to fall by an additional quarter. A further 19% of loans become at risk under this scenario, with most of the additional risk attached to the office and retail segments, while the riskiness of the industrial segment is considerably lower.

Chart 18

Evolution of the gross margin (left-hand panel) **and share of loans at risk** (right-hand panel) **by CRE segment**

Left-hand panel: Gross margin (percentages)
Right-hand panel: Share of loans at risk (percentages)



Sources: NBS, and FinStat.
Notes: The gross margin is calculated as the ratio of rental income less operating and interest costs to total rental income. The chart does not include projects under construction or projects that have been certified for occupancy for less than two years and therefore may not yet be capable of fully generating rental income.

4 Banking sector profitability and resilience

4.1 Banks' profits have decreased slightly in 2024

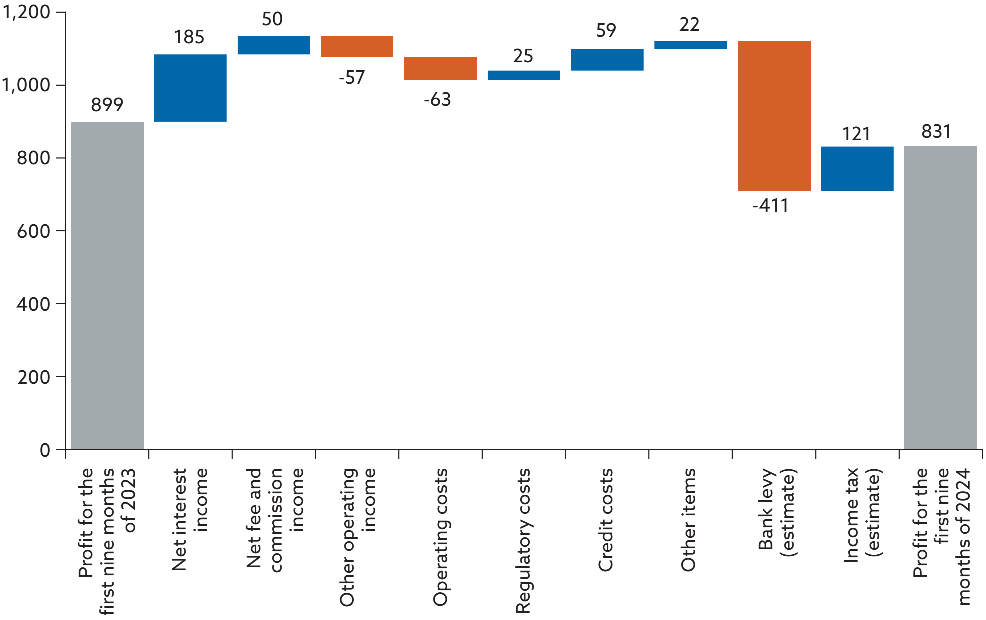
The bank levy's impact has been offset primarily by interest income growth

Banks' profitability since May 2024 has been lower compared with 2023. The domestic banking sector's aggregate profit for the first nine months of 2024 fell by 8% year-on-year, to €831 million. The primary cause of this decline was the introduction of the bank levy (+116%) as well as an increase in operating costs (+6%). However, these negative impacts were largely offset by other items of the profit and loss account. Profitability was supported by the two traditional pillars of revenue generation – net interest income and net fee and commission income (with respective annual growth rates of 11% and 9%). However, their pace of growth slowed over the course of the first nine months. Another positive contribution to the sector's profit was a sharp drop in net provisioning, which decreased by nearly a half (45%) year-on-year.

Chart 19

Main profit and loss account items mitigate bank levy impact

Decomposition of the year-on-year change in the banking sector's profit for the first nine months of 2024 (EUR millions)



Source: NBS.

The retail[71] segment is once again becoming the primary source of banks' net interest income. When interest rates were rising, especially in 2023, net interest income growth was driven mainly by the non-financial corporations (NFCs) segment owing to shorter interest rate fixation periods. Now, however, with interest rates stable or falling, the retail segment is accounting for most of the growth. The retail segment's share of total interest income rose to nearly 50% in third quarter of 2024, with its growth rate accelerating.[72] Since the loan portfolio's growth rate is currently low, net interest income growth is due primarily to the change in the average interest rate on the portfolio.[73]

The credit quality of the loan portfolio remains stable. The volume of impaired loans[74] as at September 2024 was 18% lower year-on-year. Half of this decline occurred in the last quarter of 2023, with the downward trend continuing into 2024.[75] The overall NPL ratio as at September 2024 was still 2%, with the provisioning coverage ratio standing at nearly 60%. Trends in impaired loans have had a major impact on provisioning. Net provisioning over the first nine months of 2024 was lower than in the same period of all but one year since 2018 (the exception being the post-pandemic year of 2021).[76]

The near-term outlook for profitability is favourable, but uncertainties remain. A key condition for renewed profit growth is the continued phased reduction of the bank levy rate in the coming years.[77] Also important from an income generation perspective is the expected ongoing gradual growth in net interest income in the period ahead.[78] Current credit quality trends in loan portfolios do not imply a need to step up provisioning. The impact

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[71] For the purpose of this report, the retail sector comprises households, sole traders and non-profit institutions serving mostly households.

[72] Net interest income from the NFC segment declined for a third consecutive quarter, leaving its share at 40% in the third quarter. Net interest income from the retail segment was €99 million higher for the first nine months of 2024 than for the same period in 2023, while net interest income from the NFC segment was €12 million higher.

[73] The net interest margin reached 2.01% as at September 2024, an increase of 19 bp year-on-year.

[74] Exposures classified as Stage 2 loans and Stage 3 loans.

[75] The volume of Stage 2 loans fell by €1.1 billion (12%) over the first nine months of 2024, while the volume of Stage 3 loans edged up by €20 million (1.2%).

[76] Net provisioning was 46% lower year-on-year, with most of the decline occurring in provisioning for retail loans. Net provisioning for off-balance-sheet items did not have a significant impact on the overall allocation of credit costs. The off-balance-sheet provisions reversed over the first nine months of 2024 amounted to €6 million (down from €14 million over the same period in 2023).

[77] Reducing the bank levy rate will also help banks in international comparison. As at June 2024, the average annualised return on equity (ROE) of Slovak banks was 10%, while the median for EU countries was 14.1%. By September 2024, the ROE of Slovak banks had increased 10.3% (according to preliminary data).

[78] This assumes a moderate and gradual decline in the ECB's key interest rates.

of the new fiscal consolidation package on banks' profitability remains uncertain, although it is not expected to be significant.[79]

Bank resilience close to record levels

Capital and liquidity ratios approached historical highs in the first half of 2024. The sector's increasing resilience is largely predicated on capital accumulation and an increase in stable sources of funding. Another important factor is slower usage of capital and liquidity, due to the weakening of credit growth since the ECB's monetary policy tightening. In almost all euro area countries, deposit growth is outpacing lending growth.

The Slovak banking sector's total capital ratio on a consolidated basis is nearing its all-time high from 2007.[80] The ratio reached 20.26% as at the end of September 2024, with the voluntary capital buffer accounting for 4%.[81] The leverage ratio amounted to 8.2% as at the end of September 2024. Domestic banks also comfortably met the minimum requirement for own funds and eligible liabilities (MREL). By June 2024, banks' surplus of capital resources above all regulatory requirements – their capital headroom – totalled €1.54 billion (or 3.4% of risk-weighted assets) on a consolidated basis. Although the capital adequacy of domestic banks is improving, it remains just below the EU median.[82]

Banks are reporting high surpluses in both short-term liquidity and structural funding. The liquidity coverage ratio (LCR) was near a record level of around 200% at the end of the second quarter of 2024, before dipping to 178% as at September (its lowest level since July 2023).[83] Similarly,

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[79] Further details are provided in Box 1.

[80] The sector's Common Equity Tier 1 (CET1) capital ratio on a consolidated basis reached 17.73% as at the end of September 2024, representing an increase of 42 bp since the beginning of 2023. Total capital growth over that period stood at nearly €280 million, with highest-quality CET1 capital increasing by almost €360 million. The faster growth in CET1 capital was primarily due to the retention of 2023 earnings (the retention rate as at September 2024 amounted to 37%) and equity increases. The volume of lowest-quality Tier 2 capital decreased by €80 million. The increase in risk-weighted assets (RWAs) since the end of 2023 totalled almost €980 million.

[81] The total capital ratio increased by 18 bp over the first nine months of 2024. Among the component ratios, Pillar 2 capital recorded the largest increase of 31 bp. The volume of the macroprudential buffer in the form of the combined capital buffer fell by 2 bp, to 5.33% of risk-weighted assets. Consequently, available capital constituting the management buffer declined by 11 bp over the nine months.

[82] In Slovakia, the total capital ratio of the banking sector was 20.4% as at end-June 2024, while the EU median stood at 20.6%.

[83] The quarter-on-quarter decline in the LCR from 203% to 178% was due to a €1.4 billion decline in liquid assets and a €650 million increase in net liability outflows. An analysis of LCR changes across banks did not reveal a common driver of these changes, which rather stemmed from various transactions independently concentrated in September 2024. The absolute surplus of liquid assets exceeded €8.5 billion.

the net stable funding ratio (NSFR) peaked in June 2024 at its second-highest level since measurements began in 2018, before edging down to 132% in September[84] – still above its long-run average. But although these indicators show high liquidity surpluses, Slovak banks still ranked just below the EU median as at June 2024. [85]

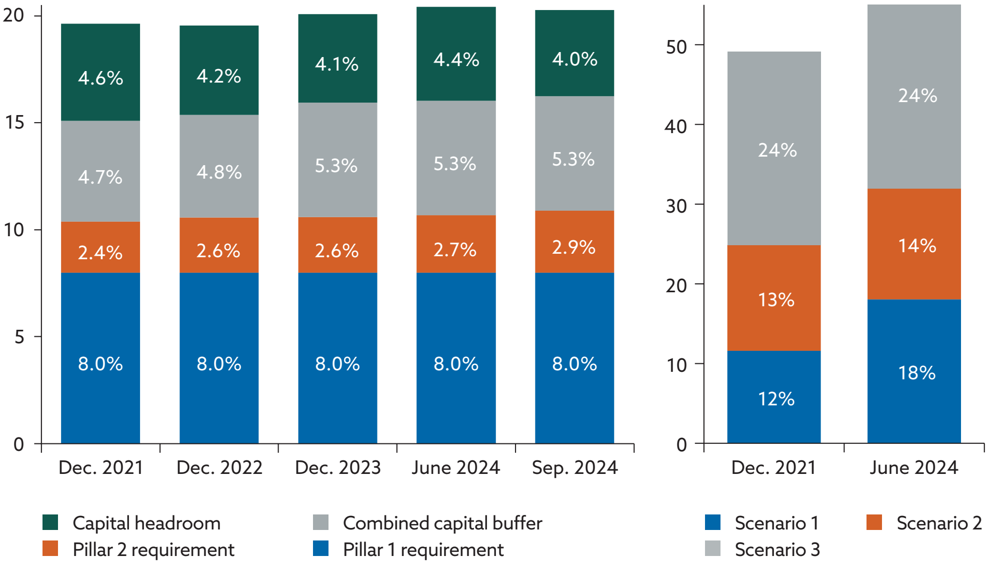
The loan-to-deposit (LTD) ratio has remained relatively stable in 2024, at its lowest levels in the past two and a half years.[86] When bank-issued bonds are included in the denominator, the ratio appears even more favourable.[87] However, it remains elevated compared with pre-pandemic levels and relative to other euro area countries.

Chart 20

Slovak banks' resilience is increasing both in terms of capital adequacy (left-hand panel) **and liquidity** (right-hand panel)

Left-hand panel: Evolution of total capital ratio components (percentages)

Right-hand panel: Potential coverage of deposit outflows (percentages)



Source: NBS.

Notes: Left-hand panel: the Pillar 2 capital requirement consists of the Pillar 2 requirement (P2R) and the Pillar 2 guidance (P2G). The capital headroom does not take into account leverage constraints and the minimum requirement for own funds and eligible liabilities.

Right-hand panel: LCR – liquidity coverage ratio; NSFR – net stable funding ratio; TLTRO – targeted longer-term refinancing operation. Scenario 1: depletion of liquidity buffers to the level of 100% for both the LCR and NSFR. Scenario 2: depletion of liquidity buffers to the level of 0% for both the LCR and NSFR. Scenario 3: Scenario 2 extended to include potential additional liquidity from operations with the central bank backed by the issuance of covered bonds. Figures are adjusted to exclude the impact of TLTROs and covered bonds already issued in the bank's own portfolio.

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[84] The absolute surplus of stable funding amounted to more than € 19 billion.

[85] As at June 2024, the Slovak banking sector had an LCR of 203% and an NSFR of 134%, while the respective EU medians were 205% and 137%.

[86] As at September 2024, the loan-to-deposit stood at 104%, down by more than 1 pp from its end-2023 level.

[87] The expanded ratio of loans to deposits and issued bonds amounted to 89% as at September 2024, almost 2 pp lower than at the end of 2023 and the lowest level since February 2017.

The results of reverse stress testing of liquidity ratios as at December 2021 and June 2024 show an increase in the banking sector's capacity to absorb deposit outflows. Since December 2021, when it started to be expected that the ECB would embark on monetary policy tightening, the domestic banking sector's potential coverage of deposit outflows has increased by 7 pp to 56%. The main contributor to this increase has been the strengthening of the first line of the defence – the LCR and NSFR liquidity buffers. As at June 2024, these buffers could cover an immediate outflow of 18% of deposits (up from 12% in December 2021). A subsequent full depletion of liquidity buffers[88] would cover an additional nearly 14% of deposits (compared with 13% in December 2021). The potential additional liquidity that banks could access from monetary policy or emergency operations with the central bank, using their own covered bonds as collateral, remained unchanged at 24%.[89]

Banks are well placed to face new challenges in the period ahead while still smoothly financing the economy

With their resilience growing, banks in Slovakia are in a stronger position to meet the challenges that lie ahead. From a capital perspective, a key challenge will be the gradual implementation of the new EU banking package (CRR3/CRD6), amending the Capital Requirements Regulation and Directive (CRR/CRD), from January 2025. On the liquidity front, banks will encounter new competition in the deposit market from retail issues of government bonds[90] and, in the medium term, the introduction of the digital euro.[91] As regards profitability, the recently introduced bank levy will remain a challenge.

The impact of the new fiscal consolidation package on banks' performance is a separate issue. The increased tax and social security contribution burden will weigh on profitability and, consequently, on banks' capital accumulation. The financial transaction tax alone could affect banks' liquidity, as corporate customers may change the way they make transactions and shift some of their payment activities abroad to minimise their tax liability.[92] Any significant change in liquidity positions could lead to reduced profitability, as banks become compelled to secure costlier alternative sources of funding.

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[88] The potential deposit outflow coverage to the level where the LCR or NSFR stand at 0%.

[89] For this scenario, we assumed a minimum collateralisation level of 105%, a minimum issuance volume of €250 million, and a 20% haircut on the value of the bond collateral.

[90] In spring 2025, a first issue of government bonds for retail investors, amounting to €300 million, is due to take place.

[91] Further details are provided in Box 2.

[92] As at June 2024, banks would have been able to cover an 89% outflow of corporate deposits while maintaining a liquidity coverage ratio of 100%.

Banks' capital headroom and liquidity as at June 2024 were sufficient to potentially fund more than €9 billion in new loans without requiring additional sources of funding.[93] At the average loan growth rate of the past ten years,[94] this would be sufficient to fund new lending for nearly 20 months. Although the LCR has constrained up to half of domestic banks, the potential increase in deposits would not significantly boost the sector's capacity.[95]

Box 2
Estimating the impact of the digital euro on banks' retail deposits

The possibility of paying with digital euro is one step closer to reality. One of the ECB's key projects has been in its preparation phase since late 2023. Although a final decision on its future is expected by the end of 2025,[96] many questions remain unanswered. What we do know is that the primary users of the digital euro are expected to be retail customers, but it will also bring benefits to merchants. The aim is to offer households a secure and accessible alternative to cash and cashless payments from their payment account (e.g. card payments, bank transfers, etc.).

While the digital euro promises many benefits for households, firms, and financial stability, its introduction could pose a challenge for banks. It is difficult at this stage to estimate how much and what part of the digital currency will originate from the conversion of existing cash and how much from bank deposits. The conversion of customer bank deposits into digital euro could actually affect the business model of domestic banks.[97] From a financial stability perspective, the key parameters appear to be the holding limit for the digital euro and the related functionalities of the payment system. The holding limit is not expected to restrict consumers' use of the digital euro, or to jeopardise banks' financial stability. Studies on this topic often consider a uniform, euro area–wide holding limit of €3,000,[98] but the actual level has yet to be set.

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[93] The starting point is a static balance sheet on the liabilities side as at 30 June 2024, i.e. without any additional deposits or capital, including profit generated on an ongoing basis. The capacity takes into account constraints on the total capital, leverage, MREL, LCR and NSFR ratios. Foreign bank branches in Slovakia are not included as they are not required to meet capital and liquidity ratios at the branch level, only as part of their parent bank.

[94] Average annual loan growth from June 2014 to June 2024 stood at 7.1%.

[95] This is due to the almost immediate limitation on capital following the LCR constraint, or certain banks' specific business model which would not allow credit demand to be covered efficiently. With deposit growth at the annual average for the last ten years (5.2%), banks' capacity for new lending would increase by only €0.2 billion.

[96] ECB, Progress on the preparation phase of a digital euro – First progress report.

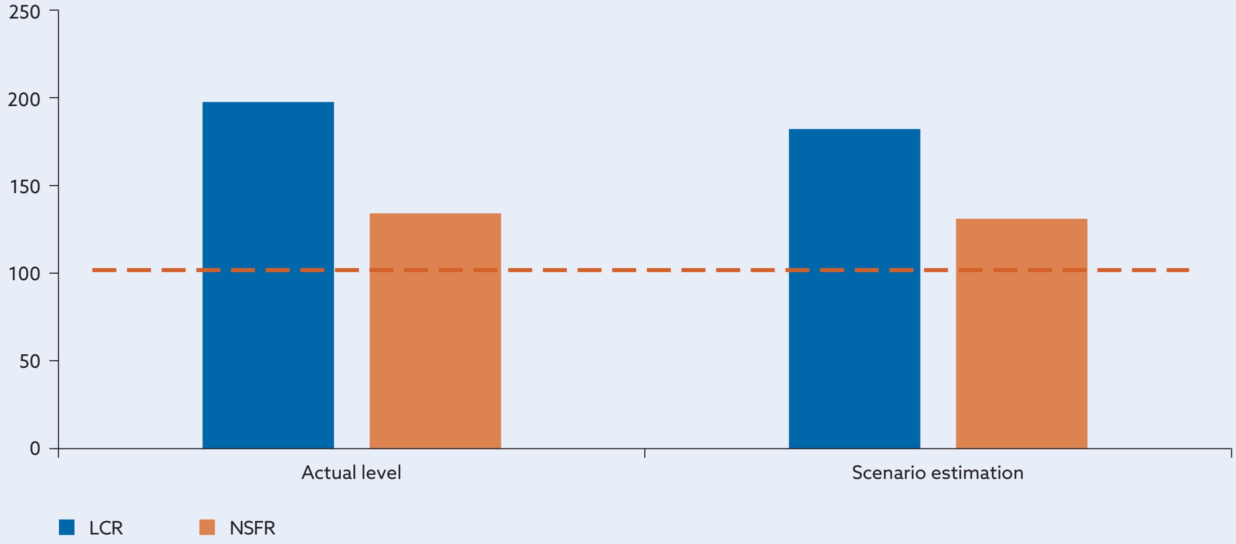
[97] For commercial banks, an outflow of deposits to the digital euro may have a number of implications: (1) a deteriorating liquidity profile; (2) an increase in funding costs; (3) higher sensitivity to interest rate movements; and (4) greater reliance on alternative sources of funding. These implications were discussed in more detail in Box 5 of the November 2023 Financial Stability Report.

[98] Meller, B. and Soons, O., "Know your (holding) limits: CBDC, financial stability and central bank reliance", *Occasional Paper Series,* No 326, ECB, Frankfurt am Main, August 2023.

Chart 21

The introduction of the digital euro will not have a significant impact on liquidity ratios

Estimated evolution of the LCR and NSFR after the introduction of the digital euro (percentages)



Source: NBS.
Notes: Data are as at 31 December 2023. LCR – liquidity coverage ratio; NSFR – net stable funding ratio. The scenario assumes a holding limit of €3,000 or up to the amount of the customer's balance in their transaction account, at an affinity rate of 42%.

The introduction of the digital euro raises questions about the potential outflow of household deposits from banks. In an April 2024 survey of residents in Slovakia,[99] around 34% of respondents were aware of the digital euro, while only 42% expressed no objections to using it. By analysing the demographic characteristics of the survey respondents and customer deposits,[100] it was possible to estimate the volume of household deposits that might be transferred to the digital euro.[101] Taking into account the assumed holding limit for the digital euro, the level of interest in the digital euro, and the structure of household deposits in banks, the outflow is estimated to be around 5% of total household deposits.

Based on currently available information on preferences for using the digital euro, the estimated outflow of household deposits does not pose a threat to the financial stability of domestic banks. If banks covered the deposit outflows from their liquid reserves, the aggregate liquidity coverage ratio would decline by 15 pp and the net stable funding ratio by 3 pp.

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[99] Cupák, A., Gertler, P., Hajdiak, D., Klacso, J. and Rychtárik, Š., "Survey of Potential Users of the Digital Euro: New Evidence from Slovakia, *NBS Occasional Paper*, No 2/2024, Národná banka Slovenska, Bratislava, 12 October 2024.

[100] The estimate includes only current account balances as at December 2023 which the selected banks identified as transactional (so balances in, for example, associated savings accounts were not considered).

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

If banks refinanced these outflows through operations with the central bank, their profits would fall by 5%. A separate issue is the behaviour of bank customers at times of banking crises, when the digital euro could lead to significantly faster and higher outflows of bank deposits.[102]

4.2 No changes in the calibration of macroprudential policy instruments

In 2024 there have been no reasons to adjust the level of the countercyclical capital buffer (CCyB). The financial cycle has contracted significantly in recent years, and current credit market developments are not generating excessive new risks that would warrant a change in the CCyB rate. It is now more than two years since the financial cycle was in a strong expansionary phase, marked by double-digit annual credit growth and by housing price growth of more than 20% per year. Since then, bank customers have had to face a sharp rise in consumer prices and, in most cases, a decline in their real incomes and a rise in interest rates due to monetary policy tightening. These pressures have severely tested the solvency of firms and households, curbing their demand for loans. On the positive side, the financial cycle downturn has not been accompanied by such an increase in non-performing loans or deterioration in loan portfolio quality that would necessitate a CCyB release.

Current developments in the mortgage and housing markets imply that the financial cycle has bottomed out, with signs of recovery evident in some segments. The outlook for economic growth in 2025 and for further monetary policy easing, as well as the gradual rise in real incomes, indicates that lending activity and the financial cycle could be turning slowly upward. If the assumptions of a gradual economic recovery and a steady reduction in interest rates materialise, the improving financial condition of the private sector would simultaneously reduce loan portfolios' sensitivity to potential shocks.

The level at which the CCyB rate is set will depend on the extent of the risks accumulated in banks' portfolios. In both the corporate and household loan portfolios, risks are currently at elevated levels (see Chapter 3).

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[102] Bidder, R., Jackson, T. and Rottner, M., "Will the digital euro strengthen financial stability? Yes, within certain limits", *Research Briefs*, No 66, Deutsche Bundesbank, Frankfurt am Main, June 2024.

There is, moreover, the new uncertainty about the potential impact of the fiscal consolidation package on firms and households (Box 1). If, however, as expected, the credit risk in banks' portfolios eases in 2025, there would be scope for reducing the CCyB rate. The question of whether that scope exists will be answered by the outcome of next year's stress testing of the banking sector and by the evolution of riskiness indicators for banks' loan portfolios.

Approved changes in banking regulation will increase the sector's stability

The new EU banking package – CRR3/CRD6 – implements the finalised Basel III rules in the EU and will start to apply from 2025. These latest amendments to the Capital Requirements Regulation and Directive are primarily aimed at limiting unwarranted cross-bank variability in own funds requirements and increasing banks' resilience. The changes to the standardised approach for credit risk are intended to establish a more risk-sensitive treatment of exposures, particularly in relation to exposures secured by real estate up to a specified LTV ratio. As regards the internal ratings–based (IRB) approach, the key change is the introduction or adjustment of probability of default (PD) and loss given default (LGD) floors. Another key element of the package is the introduction of an output floor, whose purpose is to limit unwarranted variability in own funds requirements produced by internal models and excessive capital reduction.[103]

Changes in the regulation of other risks will not have a material impact on capital adequacy for domestic banks. While banks in Slovakia do not face high capital requirements for market risk, they will be challenged by the increasing demands of the new regulation, in particular concerning the management and reporting of market risk. Another significant change will be the replacement of all existing approaches for measuring operational risk with a new standardised approach. The relative capital requirements for this risk will increase with the size of the bank. The provisions on macroprudential buffers have been significantly revised only in regard to the new output floor, aimed at preventing an unwarranted increase in capital requirements following its introduction.

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[103] The lower limit on the own funds requirements produced by banks' internal models will be set at 72.5% of the own funds requirements that would apply if standardised approaches were used.

5 Other sectors

5.1 Insurers remain profitable and solvent[104]

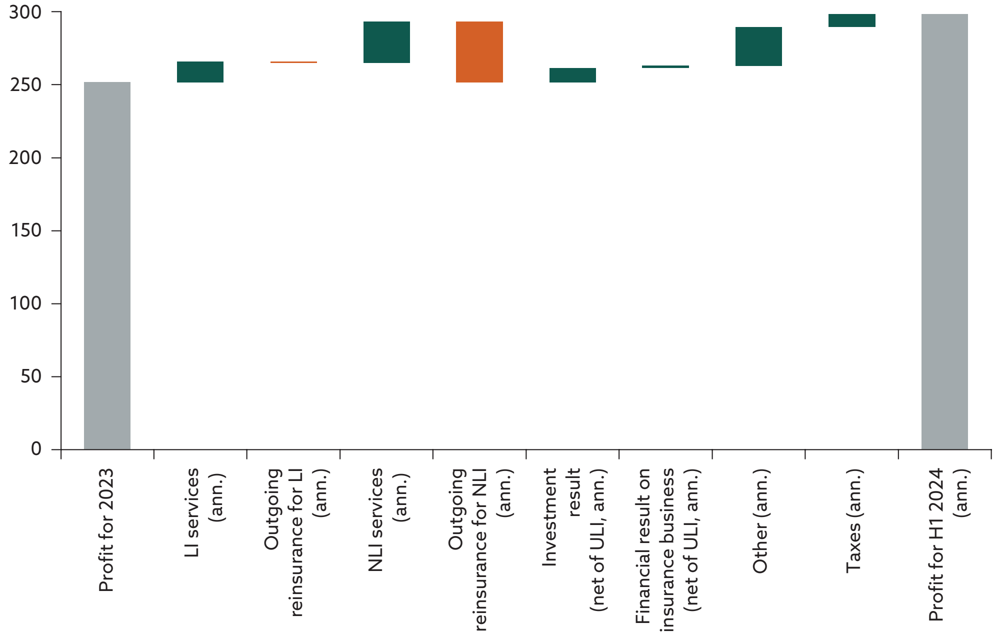
Sector profitability increased

The insurance sector's aggregate profit for the first half of 2024 reached €149 million. Annualised, this represents an 18.4% increase compared with 2023.[105] Nearly all major profit components contributed to this growth, except for non-life business. While current revenues in this segment rose, the overall profit declined year-on-year due to the reinsurance result.

Chart 22

Profit increased mainly due to taxes and additional impacts

Decomposition of profit change (EUR millions)



Source: NBS.
Note: LI – life insurance; NLI – non-life insurance; ULI – unit-linked insurance; ann. – annualised.

The sector's return on assets (ROA) and return on equity (ROE) increased during the period under review. The annualised ROA rose by 0.7 pp, to

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[104] This edition of the Financial Stability Report covers all nine domestic insurance undertakings, but also, unlike previous editions, 16 branches of insurers from other EU Member States and one branch of a reinsurer from another Member State. These 26 undertakings account for almost all of the premiums written in Slovakia.
Profitability data for the branches have been fully available since December 2023. The conclusions of this chapter therefore focus on comparing the annualised figures for the first half of 2024 with the full-year figures for 2023. Where appropriate, figures for domestic insurers – for which a longer data history is available – are presented separately.

[105] Among the nine domestic insurers – the only undertakings for which a year-on-year comparison is available – the aggregate profit increased by 13.2%.

4.0%, and the annualised ROE by 2.2 pp, to 15.1%. In both cases, the increase was accompanied by a slight decline in the denominator.

The overall capital adequacy of domestic insurers as at end-June 2024 was virtually unchanged year-on-year.[106] On the positive side, the insurers whose solvency ratio fell were mainly those with a higher ratio to begin with, while the lowest ratio in the sector increased. Compared with other EEA countries as at the end of 2023, Slovakia ranked just below the median on this measure.

Life insurance lines show continuation of long-term trends

Life insurance production across domestic insurers (for which historical data are available) increased by 5.3% year-on-year in the first half of 2024. Long-term trends in the evolution of premium volumes continued (Chart 23, left-hand panel). While endowment insurance is experiencing a prolonged decline in premium volume, other key lines of life insurance business – including unit-linked insurance, health-related insurance, and term insurance – are recording premium growth.

Data on year-on-year growth in premium volumes at insurers' branches are available only for the first half of 2024. Except in regard to unit-linked insurance, the production trends among domestic insurers and among branches differ only in terms of the degree of the year-on-year change (Chart 23, right-hand panel).

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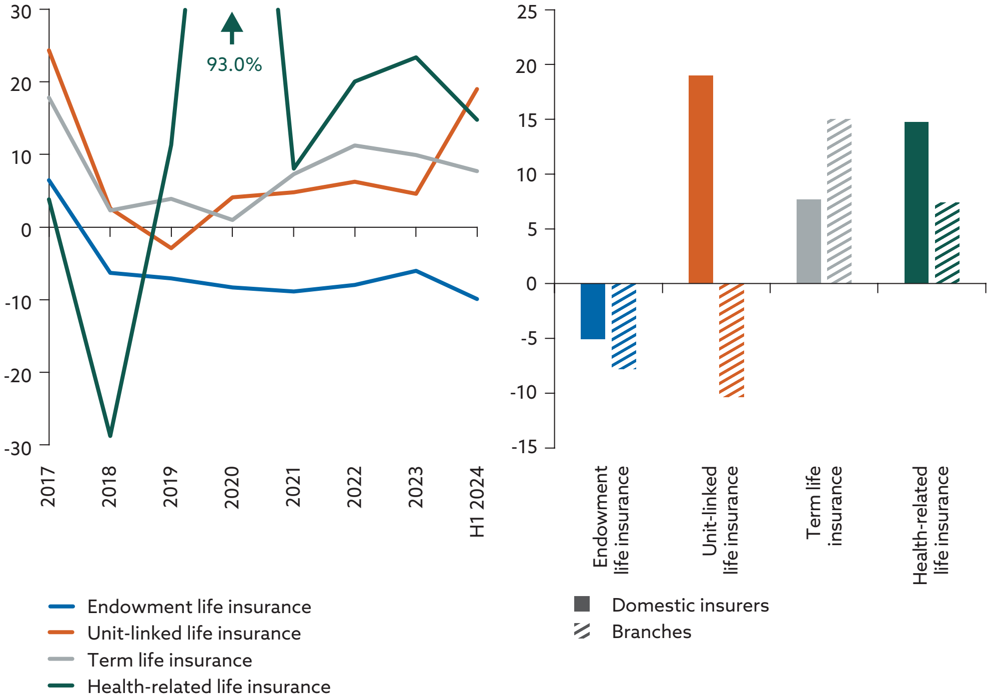
[106] The aggregate solvency ratio climbed from 191% in June 2023 to 205% in December 2023, before falling back to 192% by the end of June 2024.
As the reporting frequency for expected profits included in future premiums (EPIFP) has been reduced from quarterly to annual, it is not considered in the capital adequacy assessment for the first half of 2024 According to end-2023 data (the most recent available), the share of EPIFP in available own funds amounted to 64%, representing an increased level of stability.

Chart 23

Life insurance trends among domestic insurers continue (left-hand panel); **new data allow branches' results to be tracked as well** (right-hand panel)

Left-hand panel: Annual growth in life premium volumes among domestic insurers (percentages)
Right-hand panel: Annualised year-on-year growth in life premium volumes in the first half of 2024 (percentages)



Source: NBS.
Notes: The acceleration in unit-linked insurance in the first half of 2024 is related to single-premium policies offered by a small number of domestic insurers. Excluding them, the growth rate would be slightly positive. In a change from previous Financial Stability Reports, traditional life insurance is divided into two categories, as follows:

- **endowment life insurance**, which pays out a lump sum either on maturity of the policy or death of the policyholder (this class accounts for 55% of the premiums written in traditional life insurance as previously reported);
- **term life insurance**, which pays out if the policyholder dies during the term of the policy (excluding insurance with a survival benefit) or suffers permanent disability from an accident (45% of the premiums written in traditional life insurance as previously reported).

Historical data have been adjusted to account for expert-estimated reclassifications between insurance classes. Purchases of annuities under the second pension pillar, which are single-premium in nature, have also been adjusted.

Non-life premium volumes surge as a result of inflation[107]

Reflecting the impact of inflation, premiums written in non-life insurance increased by 10.5% in the first half of 2024 – the highest growth in several years. The growth was observed in comprehensive motor insurance, motor third party liability (MTPL) insurance, and property insurance.[108] In all three classes, premium growth reached its highest level since the current

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[107] Non-life insurance also includes active reinsurance business.

[108] In comprehensive motor insurance, premiums written increased by 14.5%; in MTPL insurance, by 9.5%; and in property insurance, by 14.3%.

insurance classification system was introduced in 2016.[109] In contrast to life business, trends in non-life insurance can be compared across both domestic insurers' and branches, allowing developments in the entire market to be analysed collectively.

The primary driver of premium volume growth was the increasing average cost of premiums in response to rising claims cost inflation. According to data from the Slovak Insurance Association (SLASPO) on the number of insurance policies,[110] annual growth in the number of policies (1.1%) was far more modest than the increase in the volume of premiums written.

While reinsurance previously helped insurers manage the sudden rise in claims costs, it has since returned to normal levels. The share of premiums ceded to reinsurers has not changed significantly in recent years,[111] but the same has not been true for claims costs. In 2022, when claims costs rose sharply, the share of claims ceded to reinsurers also rose significantly. Virtually all of the increase in claims costs was covered by reinsurers. The share of claims ceded to reinsurers has subsequently returned to previous levels.[112]

The combined ratio for comprehensive motor insurance edged down to 90.5% in the first half of 2024, after increasing in 2022 and 2023[113] The combined ratio for MTPL insurance, including the contribution to the Slovak Insurers' Bureau, increased to approximately 117%.[114] For most insurers, this ratio has consistently been above 100%, indicating the loss-making nature of this insurance class. Uninsured vehicles are a pressing issue in the MTPL business, as their share in Slovakia is high compared with other countries.

As for property insurance, some insurers reported a sharp rise in premium volume between September and December 2023. By June 2024, the combined ratio for property insurance had reached 87.0%.

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[109] Historical comparisons are only possible for the group of domestic insurers. However, the main trends are the same for both domestic insurers and the sector as a whole.

[110] Data on the number of policies come from SLASPO members. As the sources of these data and the premium volume data are different, their comparison is only indicative.

[111] The share premiums ceded by domestic insurers and branches to reinsurers stood at 27.3%. Among domestic insurers, the share was 19.7%, consistent with recent years. It exhibits some seasonality.

[112] This share climbed to 28.9% in 2022, before returning to 15.6% in 2023 and remaining at a similar level (16.8%) in the first half of 2024. The return to previous levels represented a relative increase in insurers' reinsurance costs.

[113] The level of the combined indicator before the COVID-19 pandemic was 98–99%. During the pandemic, it dropped to 84%, and even after subsequently increasing, it remained below the pre-pandemic level. Its highest post-pandemic level came in 2023, at 92.1%.

[114] Owing to extraordinary reversals of provisions at certain insurers, their combined ratio was replaced with an expert estimate.

Renewed growth in the government bond component of insurers' portfolios

In insurers' investment portfolios, the past growth in the corporate bond component has reversed, while the share of government bonds is back to a rising trend. The government bond component has been rising since late 2022/early 2023, following a period of decline when the low interest rate environment typically resulted in negative yields on government bonds. By contrast, insurers' debt exposure to the non-financial corporation sector has been falling.[115] The share of bonds issued by the financial sector remains stable.[116]

5.2 Asset management sectors continue growth trend

The pension and investment fund sectors have seen strong asset growth, particularly in equity-oriented funds

Across the second and third pillars of the Slovak pension system and the domestic investment fund sector, the aggregate net asset value (NAV) of funds recorded historically high growth in the first nine months of 2024. The total volume increased by €3.7 billion to more than €30 billion, with almost two-thirds of the growth accounted for by funds' positive performance amid upward trends in financial markets. In sectoral terms, growth was highest in the second pension pillar (€2.1 billion), followed by the investment fund sector (€1.1 billion) and the third pension pillar (€0.5 billion).[117]

From the perspective of fund types, the growth was driven by equity-oriented funds and index funds (a special type of equity fund). There were three reasons for this. The first was high returns on existing assets under management (AUM) during a period marked by optimism and expansion in global equity markets. Over the first nine months of 2024, the average nominal return on equity and index funds in all sectors was 15%. The second reason was customer demand, which has for some time gravitated towards funds with a high equity component. Thirdly, the growth trend in the second pension pillar was further amplified by a recent law change

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[115] It fell from 18.0% as at June 2021 to 14.7% as at June 2024.

[116] The share of financial sector bonds in the sector's investment portfolio has consistently been around 19%.

[117] The relative growth rate in both the second and third pension pillars was 15%, while the rate in the investment fund sector was a slightly lower 12%.

mandating the switching of some savers' assets from bond pension funds to index pension funds.[118]

The domestic investment fund sector experienced an upturn in the period under review, after almost two years of subdued demand. Cumulative net issuances from January to September amounted to around €440 million. However, compared with past episodes of peak demand for investment funds, such as in 2021, the recent pick-up in issuances has been relatively gradual. Consistent with their trend over the past four years,[119] equity investment funds have attracted the highest customer demand so far this year, with inflows amounting to approximately €300 million. The even longer positive trend in demand for real estate investment funds has basically maintained a steady pace.[120] Bond fund issuances have continued the strong growth trend that began in the second half 2023, probably driven by declining inflation and expectations of falling interest rates. Total net inflows into investment funds during the period under review were diminished by net redemptions across mixed funds, which remain the most significant type of investment fund in terms of both number and NAV.[121] While the investment fund sector has experienced phases of decline, stagnation and recovery over the past three years, all of these phases have been marked by increasing concentration within the sector. [122]

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[118] Under the ongoing transition to what is known as the default investment strategy system, index funds have assumed a dominant position in the sector, with their aggregate net asset value (NAV) now approaching €10 billion. In the third pension pillar, the NAV of equity-oriented pension funds has grown organically, without external intervention, to nearly match that of the historically dominant mixed pension funds.

[119] The steady flows into equity investment funds contrasts with the trend across the broader euro area, where net redemptions have been the norm for such funds since 2022.

[120] Demand for real estate investment funds has not been significantly dented either by the unusual brief period of negative returns on these funds in late 2023/early 2024, or by the overall still fragile situation in the domestic real estate market.

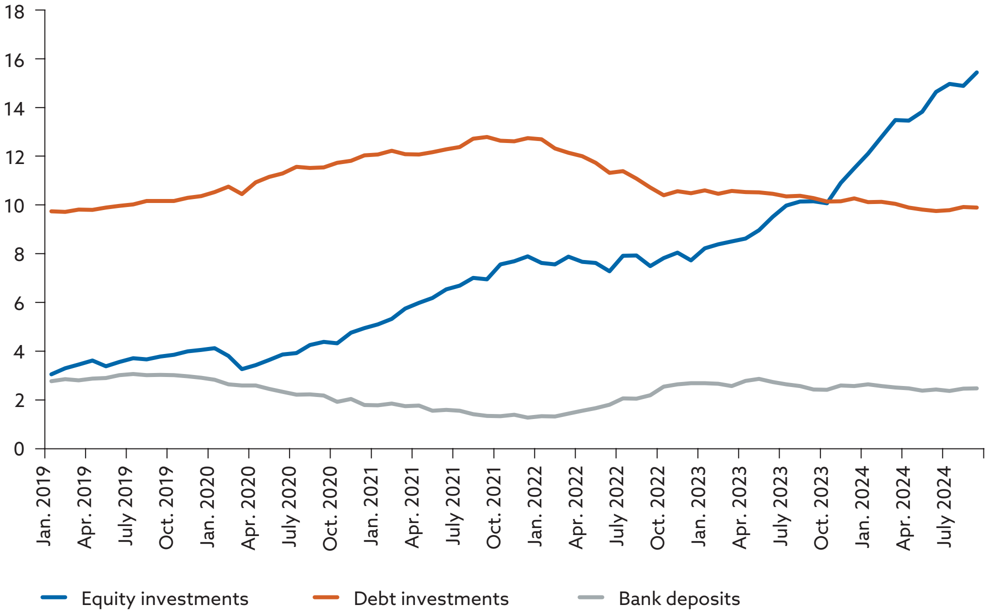
[121] However, the intensity of their redemptions has gradually eased during the year, and owing to their performance, the overall NAV of these funds has decreased only slightly.

[122] The ten largest investment funds accounted for 45% of the aggregate NAV as at 31 December 2021; this share has now risen to 52%.

Chart 24

Equity exposures now predominate in funds' total assets

Volume of underlying assets (EUR billions)



Source: NBS.

Looking at the aggregate portfolio of all three sectors, there remains a strong bias towards equity investments.[123] The equity component of the total assets under management has increased from 20% in 2020 to the current level of 50%. At the same time, the share of debt securities has almost halved, from a level of 60% in 2020. This realignment was still notably ongoing in the first half of 2024, but recent months have seen signs of stabilisation. As for the share of bank deposits in the aggregate portfolio, it has been slowly falling since late 2023.

Given the nature of its portfolios, the non-bank sector should not pose a systemic risk to financial stability

International institutions such as the ECB, the ESRB and the IMF have long been highlighting the risks posed by the burgeoning sector of non-bank financial institutions. They have pointed to the gradual build-up of structural imbalances in certain non-bank portfolios, including in particular liquidity mismatches between assets and liabilities, excessive leverage, concentration of exposures, and interconnectedness. Such characteristics have the potential to amplify and spread even initially limited shocks throughout the financial system. In this context, it must be emphasised that while the Slovak non-bank sector is not immune from turbulence (for

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[123] This view of asset structure essentially combines the portfolio composition of different sectors/types of funds and the preferences of customers (almost exclusively households) for particular investment alternatives.

example, originating in foreign financial markets or the commercial real estate sector), its characteristics should largely contain the risk of systemically destabilising developments. This is because the aforementioned imbalances are either virtually absent in domestic non-banks (leverage), present in only a small part of the sector (liquidity mismatch),[124] or generally low (interconnectedness).

Additionally, the already low interconnectedness between domestic non-banks has further declined in the recent period. The most significant channel of exposure to domestic banks has stabilised in terms of volume, and thus slightly declined relative to the size of the two sectors. Cross-investments between investment funds have remained steady, and third-pillar pension funds have redeemed part of their holdings of shares/units issued by domestic investment funds.

Among the more notable trends during 2024 has been the increase in the residual maturity of the debt securities portfolio.[125] The increase per se is not what stands out (it is only a few months), but rather the shift in direction after previous declines or stagnation. This reversal has been seen across bond funds in the second and third pension pillars and the investment fund sector. A common trend, not only in recent months but also over a longer period, has been a reduction in the share of Slovak government bonds in funds' portfolios and their replacement with bonds issued by domestic banks or by other EU countries, especially from the CEE region. The share of Slovak government debt held across asset management sectors stands at just over one per cent.

Investment firm sector also seeing growth trends

Activity in the investment firm sector is showing an upward trend. The volume of securities included in an investment service provided to domestic non-financial customers increased from €13.4 billion to €15.9 billion over the first nine months of 2024, which represented a faster pace of growth compared with 2023. The main contribution to that increase, as well as to the total amount, came from foreign ETF products, shares/units issued by domestic investment funds, and shares in domestic corporates. Holdings of debt securities also increased, but only gradually. These comprise mainly bonds issued by domestic non-financial corporations or by Aus-

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[124] Real estate investment funds are characterised by a more pronounced liquidity mismatch, but in recent months, the proportion of liquid assets in these funds has increased. And although real estate investment funds remain, in general, relatively more vulnerable, the outlook for this segment is at least improving as a result of overall economic developments (including the trajectory of interest rates) and the stabilisation of the housing market.

[125] One potential explanation is that fund managers wanted to lock in higher interest rates for a longer period before rates started to fall.

trian banks. Households account for a large majority of investment firms' domestic customers. Of the above-mentioned total volume of securities as at end-September 2024, €2 billion were included in portfolio management services. The total value of transactions carried out by investment firms in the first half of the year amounted to around €32 billion, representing an activity level comparable (within the normal volatility) to previous years. Derivatives were by far the most traded type of instruments.

Abbreviations

APRC	annual percentage rate of charge
AUM	assets under management
bp	basis point(s)
CCyB	countercyclical capital buffer
CEE	central and eastern Europe(an)
CET1	Common Equity Tier 1 (capital)
CRE	commercial real estate
CRR3/CRD6	EU banking package amending the Capital Requirements Regulation and Directive
DSTI	debt service-to-income (ratio)
DTI	debt-to-income (ratio)
DTV	debt-to-value (ratio)
ECB	European Central Bank
EEA	European Economic Area
EPIFP	expected profits included in future premiums
ESRB	European Systemic Risk Board
ETF	exchange-traded fund
EU	European Union
EURIBOR	euro interbank offered rate
FTT	financial transaction tax
GDP	gross domestic product
HGV	heavy goods vehicle
HICP	Harmonised Index of Consumer Prices
ICR	interest coverage ratio
IMF	International Monetary Fund
IRB	internal ratings–based (approach)
LCR	liquidity coverage ratio
LGD	loss given default
LI	life insurance
LTD	loan-to-deposit (ratio)
LTV	loan-to-value (ratio)
MF SR	Ministry of Finance of the Slovak Republic
MREL	minimum requirement for own funds and eligible liabilities
MTF	medium-term forecast
MTPL	motor third party liability (insurance)
NAV	net asset value
NBS	Národná banka Slovenska
NFC	non-financial corporation

NLI	non-life insurance
NPL	non-performing loan
NSFR	net stable funding ratio
P2G	Pillar 2 guidance
P2R	Pillar 2 requirement
PD	probability of default
pp	percentage point(s)
RBUZ	Register of Bank Loans and Guarantees / Register bankových úverov a záruk
rhs	right-hand scale
ROA	return on assets
ROE	return on equity
RWA	risk-weighted asset
SLASPO	Slovak Insurance Association / Slovenská asociácia poisťovní
SMEs	small and medium-sized enterprises
SO SR	Statistical Office of the Slovak Republic
TLTRO	targeted longer-term refinancing operation
US	United States
ULI	unit-linked insurance
VAT	value-added tax