Macroprudential Commentary

June 2022

Summary

- Expansionary tendencies in the financial sector have gathered further momentum. Retail loan growth was already high, and now lending to non-financial corporations (NFCs) has started rise sharply. Firms' financing needs for fixed investment are greater than for working capital.
- Housing prices have increased by more than one-fifth in year-on-year terms, while housing affordability is deteriorating.
- Uncertainty about how the macroeconomic situation will evolve has not so far dampened growth trends in the credit and property markets. The outlook suggests that expansionary trends will continue but that their acceleration has already peaked.
- The war in Ukraine, as well as other factors, may have a negative impact on the financial position of firms.
- In view of the strong financial cycle upswing, Národná banka Slovenska (NBS) has decided to raise the countercyclical capital buffer (CCyB) rate from 1% to 1.5% with effect from 1 August 2023.

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The CCyB rate is raised

Current trends in the financial sector have continued and have gained momentum compared with the last quarter of 2021.

The annual growth rate of loans to households has long been among the highest in Europe and is now into double digits. Expectations of interest rate increases and the elevated inflation rate have added to the existing upward pressures on lending growth. Moreover, housing price growth is exceptionally high. At the same time, lending has accelerated to firms that have stepped up investment activity while also needing financing for their working capital. New risks related to an excessive financial cycle upswing are therefore gradually building up in banks' portfolios.

Meanwhile, there is great deal of uncertainty related to the war in Ukraine and its potential repercussions for Slovakia. So far, however, these factors are not expected to cause any significant slowdown in the credit or property markets in the short term. At the same time, the uncertainty about the impact of the war, particularly about its impact on firms, is stimulating vigilance and the need to prepare for worse-case scenarios.

Banks' profit-generating capacity is at a healthy level, and non-performing loan ratios remain low. Banks have sufficient capital headroom, and the CCyB rate increase will not adversely affect the credit market. The financial cycle's strong upswing implies the need for a relatively high CCyB rate. In view of the Ukraine war uncertainty, however, NBS has opted for a more moderate increase. The main purpose of increasing the buffer rate is to strengthen the banking sector's resilience.

Expectations for the CCyB rate in the next quarter

The outlook for future developments indicates that although the Ukraine war and rising input prices may weigh on Slovakia's economic growth, expansionary trends in the financial market should persist. As a result of elevated inflation, real interest rates on some loans will be negative, and people will remain incentivised to borrow at the expense of savings. Growth trends should, however, stop accelerating. At the same time, uncertainty stemming from the war and from rising prices is likely to persist.

NBS deems the newly adjusted setting of the CCyB rate (1.50% from 1 August 2023) to be appropriate and does not envisage having to raise it again in the next quarter.

At the same time, NBS is closely monitoring the evolution of risks to the Slovak banking sector. Should the situation deteriorate to the point that banks start making extraordinary losses, NBS stands ready to reduce the CCyB rate with immediate effect.

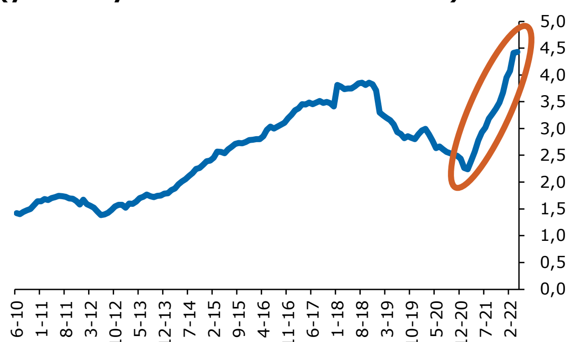
CCyB rate:
1.50%

After considering the risks and all available information, the NBS Bank Board has decided to raise the countercyclical capital buffer rate by 50 basis points, to 1.5%, with effect from 1 August 2023.

Household loan growth rates remain robust

Household loan growth has continued accelerating. This uptrend began in the spring of 2021 and has been gaining momentum. In April 2022 the annual growth rate was 10.2%. The acceleration has been driven mainly by the housing loan portfolio, where several factors are at play. With property prices rising, prospective buyers have been incentivised to hasten their purchase decisions and take out increasingly larger loans. This trend has been further supported by rising inflation and the search for ways to protect savings against inflation. A third key factor has been expectations of interest rate increases. Whether with new loans or at the resetting of interest rate fixation periods, borrowers have had a strong incentive to lock in favourable terms for longer periods. Housing loan growth acceleration is currently occurring across all central and eastern EU countries.

Chart 1 Household loan growth accelerated sharply last year
(year-on-year increase in EUR billions)



Source: NBS.

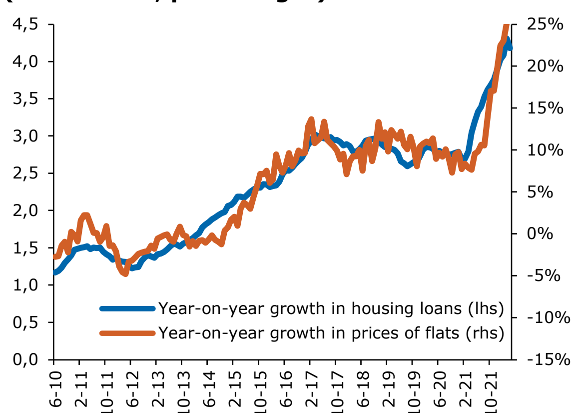
The average interest rate on housing loans has returned to its level of three years ago. In April 2022 the average rate was up to 1.3% – higher than at any time since August 2019 – and it continues to rise. A major reason for the increase has been growing demand for longer – and usually also costlier – interest rate fixation periods. In 2021 fixation periods longer than five years were quite unusual, whereas in April 2022 almost one in two housing loans were subject to such rate fixation.[1] In terms of the cost of housing loans, Slovakia continues to rank third lowest among euro area countries, since interest rates have been increasing in those countries too.

Consumer credit has to a lesser extent also been contributing to household credit growth. After three years of decline, the consumer credit portfolio has improved, with no significant month-on-month change since January 2022[2]. An important factor affecting the evolution of consumer credit has been the use of housing loans for consumption purposes. Both when borrowers consolidate their debts and when they increase their existing borrowing, the opportunity of a more favourable interest rate been a factor. Another positive development in the consumer credit portfolio is that the default rate has stopped increasing.[3]

Housing prices continue to accelerate

After starting to accelerate in the second half of 2021, growth in prices of flats and houses has shown no signs of slowing down in 2022. On the contrary, prices have increased by more than 20% year-on-year. Such growth rates have not been recorded since 2007–08, just before the global financial crisis. Prices of all types of residential real estate have been rising. Growth in prices of existing flats has been strong both in the capital city and in Slovakia's regional capitals, supported by purchases of property for investment purposes. The market in new-build flats has been greatly affected by rising prices of construction materials, which are pushing up the overall prices of property developments currently under construction. Annual growth in prices of new-build flats was approaching 23% in March 2022. In both Slovakia and other countries, housing price growth has been outpacing wage growth in the economy. Slovakia, however, has one of the highest rates of housing price growth in the European Union.

Chart 2 Strong housing price growth stoked by high credit availability
(EUR billions; percentages)



Source: NBS.

Amid strong growth in housing prices, housing affordability has deteriorated over the past year. In the light of current trends, housing affordability is expected to decline further. If housing prices and interest rates remain on their current upward trends, housing affordability at the end of 2022 will be at its lowest level in ten years. On the other hand, with inflation at elevated levels, housing loans are still being provided at negative real interest rates, thereby continuing to create conditions that support demand for housing loans.

[1] In the first half of 2021 the share of new housing loans with a rate fixation period of more than five years was 4%, while in April 2022 it was up to 41%.

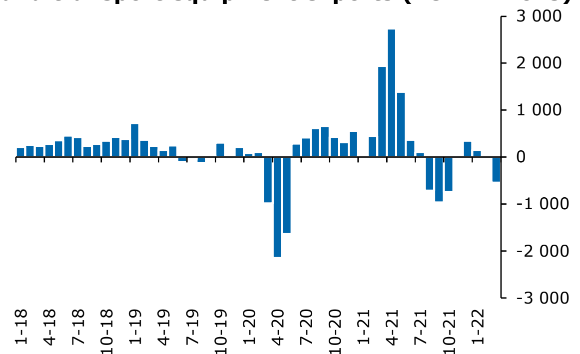
[2] The month-on-month changes in the consumer credit portfolio have been almost zero, and the year-on-year rate of decrease has moderated gradually, down to -2.7%.

[3] The net default rate of 1.7% is below the historical average.

Corporate lending has surged, but firms face several challenges

Corporate sale growth increased strongly in the first quarter of 2022, before slowing slightly in April.[4] In the evolution of sales, however, there is considerable heterogeneity across firms. The economy's reopening after the easing of the pandemic crisis has been most evident in the accommodation and food service sectors. But other services sectors have also being doing well. Sales growth has been strong among firms in the transportation and storage sector and selected market services sector. Rising energy prices have buoyed sales in the energy supply sector. In the transportation sector, too, sales have increased at the aggregate level. On the other hand, some sectors have seen sales growth lag far behind the increase in input prices. These include industry, construction, and information and communication, where sales growth has not even been above the inflation rate.

Chart 3 Total exports are being affected by complications in the automotive industry
(year-on-year change in the value of machinery and transport equipment exports (EUR millions)



Source: NBS.

The slowdown in industry sales growth is due to component shortages, particularly in the automotive industry but also in other manufacturing industries. Obstacles to the finishing of products have resulted in a drop in sales in the transport equipment manufacturing industry. Thus, we see a repeat of what happened in the second half of 2021, when supply chain disruptions dampened car sales and therefore revenues. The car industry has also been experiencing complications on the export front, with the value of its exported goods falling by more than €500 million year-on-year, notwithstanding an increase in input prices. Important in this respect will be the extent and duration of component shortages and firms' ability to substitute inputs.

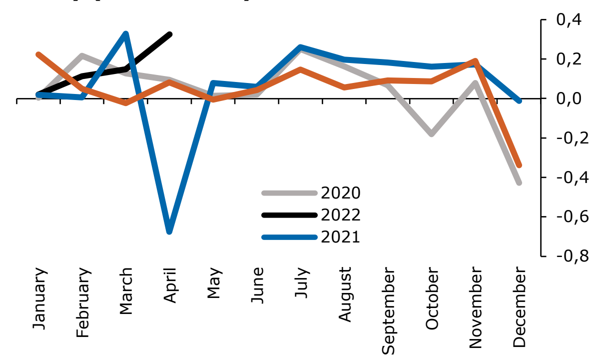
Lending to non-financial corporations (NFCs) accelerated at the start of the second quarter of 2022. Its growth rate was 8.8%, more than 5.3 percentage point higher than in March. This surge was accounted for by short and medium-term loans, whose rate of change was in line with growth in long-term loans. In terms of corporate loan growth, Slovakia moved to the median position among central and eastern European countries and to the level of the third quartile among EU countries. Lending activity accelerated in all of these countries, but to different degrees.

Loans of an investment nature with a maturity of more than five years were the most significant driver of annual loan growth in April. They accounted for one-half of the year-on-year increase, owing both to their strong growth[5] and to the sheer size of this corporate category.[6] Already in March, however, long-term loans accounted for a major part of corporate loan growth. Looking at its sectoral breakdown, the credit growth was supported by lending to most of the major sectors, including industry, transportation, commercial real estate, construction, and energy supply.

Medium-term lending contributed significantly to the acceleration of credit growth in April 2022. Annual growth in medium-term loans[7] was more than 4 percentage points higher in April than in the previous month, primarily due to growth in the commercial real estate (CRE) loan portfolio.

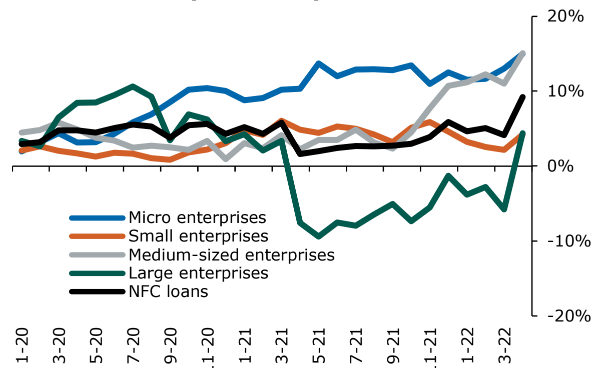
Short-term loans used for the financing of working capital recorded a substantial year-on-year increase in April 2022. This was caused by the sharp decline in the total volume of these loans in April of last year.[8] In absolute terms, however, the volume of these loans is at its end-2019

Chart 4 Corporate loan acceleration driven mainly by medium and long-term loans
(annual percentage change in volume of loans to NFCs) (EUR billions)



Source: NBS.

Chart 5 Loan growth accelerated across all firm size categories
(annual percentage change in corporate loans, broken down by firm size)



Source: NBS.

4 Annual nominal sales growth edged down from almost 25% in February and March 2022, to 22% in April.

5 The annual growth rate of NFC loans with a maturity of more than five years was almost 9%. These loans, however, were already recording strong year-on-year growth in the previous month, and their growth rate was around 1 percentage point higher in April than in March.

6 Loans with a maturity of more than five years make up half of the corporate credit portfolio.

7 Loans with a maturity of one to five years.

8 In particular through prepayments of short-term loans by large enterprises' prepayments, which amounted to almost €400 million and significantly reduced the comparison base. The annual growth rate of short-term loans was 9% in April 2022, representing an increase of 13 pp compared with the previous month.

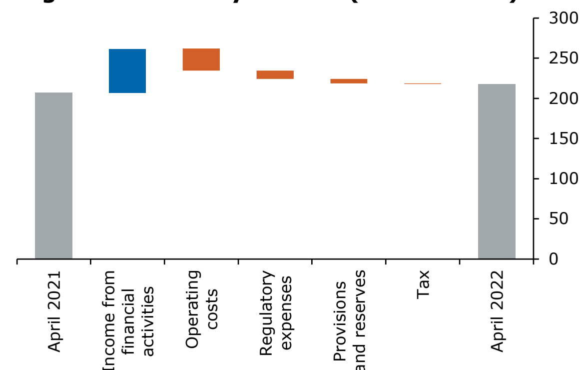
level and below the levels recorded during the pandemic crisis.[9] We are therefore not yet seeing any broad increase in working capital financing in response to rising input prices. There is, however, stronger growth in such loans in the sectors of trade, construction, and energy supply.

In the breakdown of the corporate credit portfolio by firm size category, all categories recorded year-on-year growth. Like the growth in short-term loans, the annual growth in loans to large enterprises was caused largely by a base effect, and the total stock of these loans was at its 2019 level. The situation is different in other size categories, where the outstanding amount of loans is far higher than the pre-pandemic level.[10] However, the strong growth in loans to micro enterprises is heavily affected by the CRE sector.[11]

Banks are doing well this year too

The growth trend in banks' profits has continued in 2022, but in year-on-year terms it is not so strong as it was last year. The banking sector's net after-tax profit for the first four months of 2022 was €218 million, representing a year-on-year increase of 5.1%.[12] Interest income turned positive after a trend of stagnation and decline in previous years. Its year-on-year growth reflected a gradual upturn in interest rates and strong credit growth.[13] At the same time, banks have seen their fee and commission income rising on the back of growth in new production. As for their loan loss provisioning, banks have reduced it in response to the easing of the pandemic crisis, but it still remains higher than its pre-pandemic level.[14] As regards approaches to credit cost allocation, there remains considerable heterogeneity across banks. Rising prices are also increasing banks' costs. These include operating expenses, which rose after decreasing in the previous two years. The sector's profitability as measured by return on equity is already back to its pre-crisis level. Compared, however, with other national banking sectors in the EU, the Slovak sector is below the median, close to the level of the first quartile.

Chart 6 The banking sector's profit is continuing to grow moderately in 2022 (EUR millions)



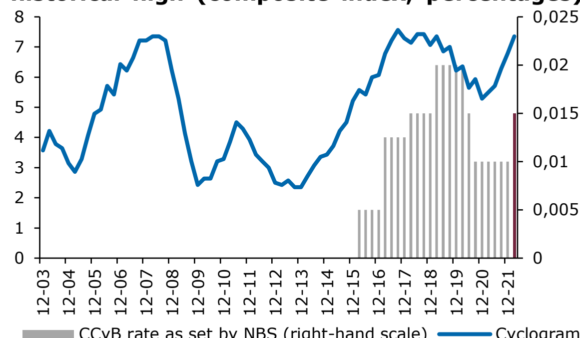
Source: NBS.

Banks remain well capitalised. Although the banking sector's total capital ratio declined slightly in the early part of this year, it remains above its pre-pandemic level.[15] At the end of the first quarter of 2022, the aggregate total capital ratio stood at 19.6%.[16] The decline in solvency was the about the same for systemically important banks as it was for systemically important banks and less systemically important banks.[17] The capital ratio decline was largely due to the impact of loan growth (-0.7 pp), which was partially offset by capital increases (+0.2 pp), in particular a capital increase carried out by one significant bank. Total capital ratio levels across banks remain relatively heterogeneous.

Increasing build-up of imbalances in the financial sector

The financial cycle is in a strong expansionary phase, which is particularly evident in the credit and property markets. There is credit growth in the economy which can be deemed excessive. Appetite for borrowing is high, especially among households, which are being incentivised to take on debt by the continuing uptrend in property prices (implying a cost in delaying property purchase decisions) and by ongoing increases in interest rates (implying a reduction in purchasing power going forward). At the same time, the inflation rate is even higher than the level of newly raised interest rates, which means that a swathe of loans are still being provided at negative real interest rates. As a result, households are preferring borrowing over saving. Although economic growth is being adversely affected by the war in Ukraine and rising input prices, the labour market situation remains relatively favourable and non-performing loan ratios are low. On the other hand, in a financial cycle upswing, it is typical for households to underestimate risk related to debt repayment.

Chart 7 The financial cycle is already close to its historical high (composite index; percentages)



Source: NBS.

Note: Higher index values imply a stronger build-up of imbalances.

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9 Following the onset of the pandemic, firms stepped up their short-term borrowing as a precautionary measure. In April 2021, following the fading of the pandemic's second wave, much of that borrowing was repaid.

10 The largest increase has been in total loans to micro enterprises, which were 28% higher in April that at end-2019. There were smaller increases in the loans to medium-sized enterprises (almost 18%) and loans to small enterprises (8%).

11 Several property development projects are financed through special-purpose vehicles (SPVs), which are often categorised as micro enterprises. Not including these SPVs, the growth in loans to micro enterprises would be lower by more than one-third.

12 The sector's profit for the same period in 2021 was €207 million.

13 In April 2022 aggregate interest income increased by €18 million (3.1%).

14 Banks' net provisioning for the first four months of 2022 amounted to €48 million, compared to an average of €42 million for the same periods in 2017, 2018 and 2019.

15 The sector's total capital ratio hovered around 18.2% over the period 2017 to 2019.

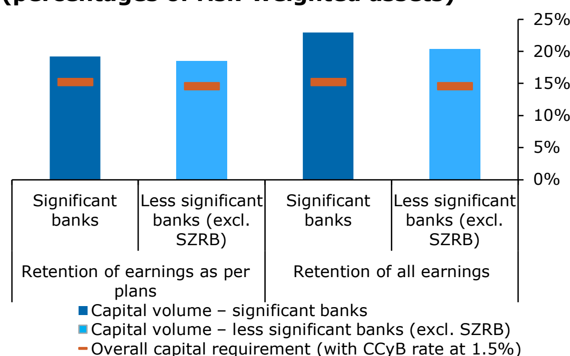
16 Representing a decrease of 0.4 pp compared with the end of 2021.

17 For significant banks, the aggregate total capital ratio fell by 0.5 pp; for less significant banks, it fell by 0.4 pp.

The Cyclogram, an NBS-designed composite indicator of the financial cycle in Slovakia, is already close to the historical highs it reached in 2008 (on the eve of the financial crisis) and in 2017 (a couple of years before the pandemic crisis). The Cyclogram's current level implies that the countercyclical capital buffer (CCyB) rate needs to be higher than its current configuration, in fact as high as 2.5%. At the same time, the outlook indicates that expansionary tendencies in the financial sector will continue in coming quarters, albeit to a lesser degree. On the other hand, there is ongoing uncertainty about the war in Ukraine and about rising prices. In view of the imbalances associated with current developments in the credit market., and taking all circumstances into account, NBS has opted to increase the CCyB rate by 50 basis points, to 1.5%.[18]

The CCyB rate increase is not expected to present any problems for banks as regards their fulfilment of capital requirements. During the pandemic crisis, and in line with ECB and NBS recommendations, banks refrained from paying dividends, with the result that the sector's total capital ratio is now close to 20% of risk-weighted assets and therefore comfortably above regulatory limits. If the CCyB rate is increased, not one bank will have any difficulty in meeting the higher capital requirement.[19] NBS therefore does not expect that the latest CCyB rate increase will have any impact on the banking sector's lending activity.

Chart 8 Banks should not have difficulty in meeting their overall capital requirement even under the higher CCyB rate (percentages of risk-weighted assets)



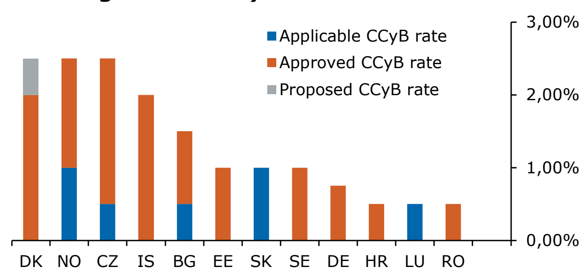
Source: NBS.

Note: SZRB - Slovenská záručná a rozvojová banka (Slovak Guarantee and Development Bank).

EU countries continue to raise CCyB rates

Although the outbreak of the Ukraine war caused uncertainty and some hesitation, several European countries have continued raising their CCyB rate. In March 2022 the Czech Republic, Croatia and Norway decided to raise the CCyB rate. There are now 12 countries that have an approved non-zero CCyB, which is similar to the number that did so before the onset of the pandemic.[20] Of these countries, seven apply a CCyB rate that is the same as, or higher than, the rate applied in Slovakia. Since the outbreak of the war in Ukraine, no country has reduced the CCyB rate.

Chart 9 The number of countries that now have a non-zero CCyB rate is similar to the number that did so before the pandemic (percentages of risk-weighted assets)



Sources: ESRB, Det Systemiske Risikoråd, and NBS.

[18] With effect from 1 August 2023.

[19] This bank-level analysis assumes that profits will be at the levels assumed in the baseline stress test scenario presented in NBS's May 2022 Financial Stability Report.

[20] At that time there were thirteen countries.

What´s new in the world of macroprudential policy

What affects banks' willingness to draw down their capital buffers?

An IMF[21] paper from earlier this year sought to answer this question. Even during the pandemic crisis, regulators were encouraging banks to make active use of their capital buffers, yet banks showed considerable hesitancy to do so. In their analysis based on data from 71 banks across 23 countries, whose market capitalisation corresponds to around 60% of the global banking system, the authors of the study attempted to identify the main factors behind banks' willingness/unwillingness to use the funds freed up by relaxed capital requirements. Banks typically fear market stigma, uncertainty around potential future credit losses, and uncertainty around supervisory decisions regarding the restoration of any buffer draw-down. Provided the market expects a bank to rebuild its buffers, any draw-down will open up a capital shortfall that will weigh on its share price, according to the authors. Therefore, bank CEOs will only decide to use their banks' buffers if the value creation from lending activity offsets the costs associated with a capital shortfall. According to the authors, however, this rarely happens, occurring in around 5% of all the cases analysed. The authors propose overcoming these hurdles by means of an enhanced CCyB framework and a public guarantee scheme that banks in this situation would have access to.

The interlinkages between monetary policy and macroprudential policy from a financial stability perspective

This topic is addressed in a study published by the ECB,[22] which maps the findings of the literature in this area. According to the authors, the prevailing view is that macroprudential measures have the potential to mitigate recessions and, hence, have a positive impact on long-term GDP, but that they can also reduce the length of economic expansions by restricting the flow of credit growth. On the other hand, accommodative monetary policy induces banks to take greater risks. The authors take the view that coordination of monetary policy and macroprudential policy is not necessary, since each can be focused on addressing its own objectives and risks in a non-mutually exclusive way (Tinbergen principle). The tightening of monetary policy during an expansion has a downward impact on lending and borrowing in the economy, thereby also reducing the probability of crises. By contrast, the loosing of monetary policy during a recession supports the recovery of equilibrium. From a macroprudential policy perspective, however, monetary policy often has a belated impact.

How are financial openness and income inequality linked?

This is the question addressed by authors of paper published by the BIS.[23] Based on an empirical analysis using data for 48 countries between 1991 and 2013, the authors concluded that the impact of increasing financial openness (understood as a country's openness to the external environment) on inequality varies considerably over time. An increase in external liabilities is usually associated with an initial rise in inequality (lasting several years), followed by a decline in inequality, usually five years after the initial increase in external liabilities. It depends greatly, however, on the nature of financial openness, according to the authors. The relationship between portfolio equity and inequality in the economy is insignificant, whereas the relationship is relatively strong where financial openness is generated by foreign direct investment and cross-border bank lending. The link between financial openness and inequality tends to be substantially weaker in advanced economies than in emerging market economies.

The June 2022 Macroprudential Commentary was discussed by the NBS Bank Board on 20 June 2022. The publication has not been copyedited. Reproduction is permitted provided that the source is acknowledged.

[21] Abad, J. and Pascual, A. G., "Usability of Bank Capital Buffers: The Role of Market Expectations", *IMF Working Papers*, No 22/21, International Monetary Fund, January 2022.

[22] Laeven, L., Maddaloni, A. and Mendicino, C., "Monetary policy, macroprudential policy and financial stability", *Working Paper Series*, No 2647, European Central Bank, Frankfurt am Main, February 2022.

[23] Avdjiev, S. and Spasova, T, "Financial openness and inequality", *BIS Working Papers*, No 1010, Bank for International Settlements, March 2022.