Macroprudential Commentary

December 2023

NÁRODNÁ BANKA SLOVENSKA
EUROSYSTÉM

Summary

- The financial cycle is in a cooling phase. The private sector debt-to-GDP ratio is falling. The slowdown is most evident in the financial sector, while the real economy and labour market show stable trends.
- The flow of new mortgages is no longer slowing. As for the consumer credit portfolio, it has increased in year-on-year terms.
- Growth in loans to non-financial corporations (NFCs) has stabilised since the summer and is one of the fastest rates in the EU. Corporate lending rates have increased only slowly.
- Housing prices have dropped by a tenth, year-on-year, with both prices of houses and prices of flats of all sizes having declined. The price downtrend is, however, already more moderate than at the turn of the year. Housing affordability remains low.
- The banking sector's aggregate profit has risen, year-on-year, with its growth largely attributed to an increase in net interest income. The sector's total capital ratio has climbed above 20%.

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No change in the CCyB rate

Loan demand remains moderate, but growth in loans to households is no longer slowing. High interest rates in particular are deterring people from taking on more debt. The lending slowdown has been due largely to falling demand for loans. Housing prices are therefore continuing to decline. At the same time, however, the uptrend in lending rates for both households and firms has slowed. The corporate loan portfolio has seen only a modest slowdown in its growth in recent months. Banks are reporting healthy profits and have strengthened their capital positions.

Hence, in this financial cycle downturn, there is no need for a further increase in the countercyclical capital buffer (CCyB) rate. Nor, on the other hand, are there any grounds for reducing the CCyB rate, since risks accumulated in banks' portfolios in previous years remain present. Meanwhile, non-performing loan ratios are largely unchanged and net provisioning remains at its pre-pandemic level.

Expectations for the CCyB rate in the next quarter

Národná banka Slovenska (NBS) does not, for now, see any need to adjust the countercyclical capital buffer rate in the next quarter.

The financial cycle is expected to remain in a cooling phase in the period ahead, as will be reflected in moderate loan growth and weaker demand for borrowing. Its slowing trend should not, however, be as pronounced is in previous quarters.

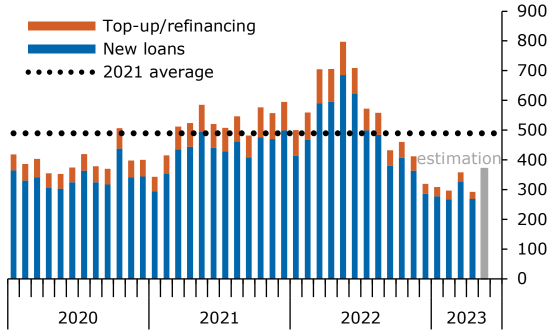
A reason to release the buffer would be if credit losses were to increase to the point that provisioning had to be stepped up beyond normal levels.

Household loan growth remains subdued

The amount of mortgage originations has been at a stable level for three successive quarters.[1] Compared with the average for 2021, it was lower by around one-third. The slowdown in mortgage lending continues to be caused by falling demand for loans rather than by banks' tightening of credit standards.

As a result of lower origination, annual growth in the mortgage portfolio has gradually declined, and as at October 2023 it stood at 4.3%. Among EU countries, Slovakia ranks in the top half for mortgage growth. Mortgage interest rates have increased only slightly.[2]

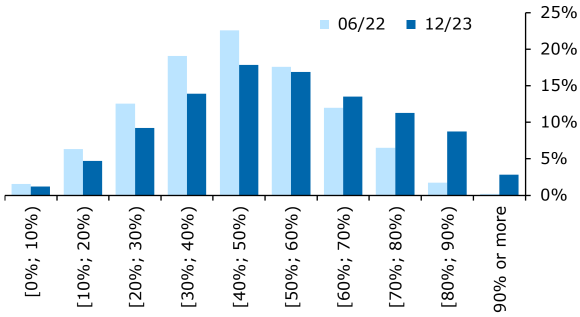
Chart 1 Mortgage demand stabilises
Pure new mortgages and top-ups/refinancing (EUR millions)



The share of mortgages with a high debt service-to-income (DSTI) ratio remained high in the third quarter of 2023.[3] At the same time, utilisation of the exemption under which loans may be granted with a DSTI ratio of between 60% and 70%[4] fell slightly during the period under review. As for non-performing loan ratios they remained at historically low levels.

The mortgage portfolio's riskiness has increased slightly in the recent period. This is because households' financial situation has deteriorated, owing to elevated inflation and rising interest rates, as well as to a decline in the prices of the properties serving as collateral for mortgages. Upward trends in basic living expenses and loan payments have over the past two years reduced household incomes by 6% on average.[5] The share of loans in the mortgage portfolio which have a loan-to-value (LTV) ratio of more than 70% increased from 8% in June 2022 (when housing prices peaked) to 23% in November 2023.

Chart 2 Mortgage portfolio riskiness increases
Decomposition of mortgage LTV ratios as at June 2022 and as at November 2023



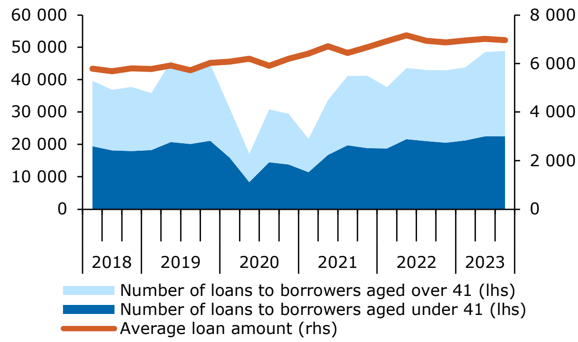
Source: NBS.

Consumer credit is recording stable growth. The month-on-month change in total consumer credit was positive in each of the first ten months of 2023.[6] As a result, the portfolio's annual growth rate rose to 6.3%.

Only in October 2023 did interest rates rise more sharply,[7] increasing to 10%. Slovakia ranks in the top half of EU countries both for consumer credit growth and in the interest rate level of consumer credit.

The higher growth in the consumer credit portfolio has been driven mainly by an increase in the number of loans granted to middle-aged and older customers. While the average amount of new consumer credit has remained roughly stable over the past year, the number of pure new consumer loans increased by approximately 14.[8] This increase was almost entirely accounted for by loans to borrowers aged 41 and over.[9]

Chart 3 Increasing number of consumer loans granted to middle-aged and older borrowers
Evolution of the number and average amount of new consumer loans (number; EUR)



Source: NBS.

Notes: The chart shows only pure new loans. 'Average loan amount' shows the moving average for a period of three quarters. The chart does not include data on consumer credit not exceeding €1,000.

Household deposits remains stable, while corporate deposits continue to grow moderately

Interest rates on new time deposits are also continuing to rise gradually. Time deposit rates for firms are among the highest in the euro area,[10] while those for households are at the euro area median. This is also related to the ongoing gradual

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[1] The amount of new mortgages originated during the first three quarters of 2023 was around one-third below the 2021 average.

[2] The month-on-month increase in interest rates on new mortgages averaged 0.02 pp in the third quarter of 2023. October saw a slightly higher increase of 0.07 pp, which represents one-third of the average month-on-month increase in 2022.

[3] A total of 38% of pure new mortgages and top-up/refinancing mortgages had a DSTI ratio of more than 55%.

[4] In the first quarter of 2023, the share of new mortgages exempted from the regulatory DSTI ratio limit was at the maximum level of 5%, while in the second quarter it was down to 3.7%, and in the third quarter, 2.9%.

[5] Loan payments and basic expenses as a ratio to income increased, on average, from 60% in September 2021 to 66% in September 2023.

[6] The volatility of month-on-month increases was largely consistent with typical seasonal trends.

[7] In October 2023 interest rates on new consumer credit increased by almost 0.4 pp. The average increase for the previous months of 2023 was 0.02 pp.

[8] The number of refinancing consumer loans did not increase significantly.

[9] The older the age group of borrowers, the greater was the increase in the number of pure new loans.

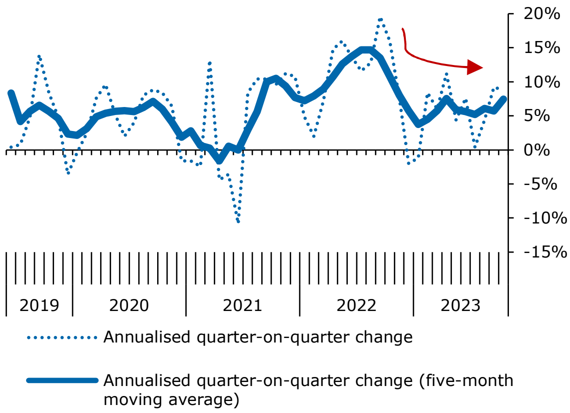
[10] In September 2023 interest rates on time deposits of firms were the third highest in the euro area (after France and Finland). By contrast, current account rates were below the euro area median, and that was the case for both corporate and household current accounts.

increase in the share of time deposits, which has so far been more pronounced in the NFC sector than in the household sector.[11] This is also a corollary of the evolution of time deposit rates, as the rates for firms have risen more sharply than the rates for households.

Lending to the NFC sector can be tentatively said to have stabilised

Weakened domestic and global demand has had an adverse impact on firms' revenues. Although total revenues increased year-on-year in each of the first six months of 2023, their growth was gradually decelerating.[12] In the third quarter, however, revenues were lower compared with a year earlier. This negative turn was seen in a number of sectors, while the main upward pressure on revenue growth came from telecommunication services and transport equipment manufacturing.

Chart 4 NFC loan growth is gradually stabilising
Annualised quarter-on-quarter change in total NFC loans (percentages)



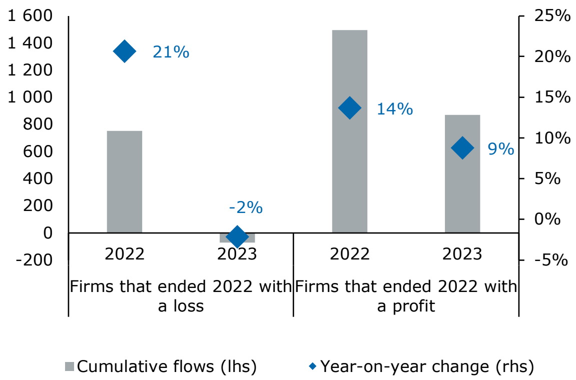
Sources: NBS, and Register of Bank Loans and Guarantees (RBUZ).

The corporate loan market may be tentatively said to have stabilised. Although quarterly credit flows were one-half lower in the third quarter of 2023 than in 2022, they were far higher compared with the 2019–21 period, even after adjusting for inflation. The size of the NFC portfolio was the same in October 2023 as in the previous month, so the annual growth rate slowed from 5.3% to 4.9%.[13] If monthly credit flows remained flat in the last two months of the year, the annual growth as at the year-end would stay at around 5%. Compared with NFC loan growth across central and eastern European EU countries, Slovakia's rate is at the median, while compared with all EU countries, it is in the upper quartile.

The NFC loan portfolio's evolution continues to show heterogeneity. Lending to micro firms is still maintaining stable growth,[14] and lending to small firms has picked up.[15] In the commercial real estate (CRE) portfolio, loan growth has slowed, while lending to the industry and trade sectors has gained some impetus after previously decelerating.

Loan growth in 2023 was almost entirely driven by profitable firms. There was a significant slowdown in lending to firms that ended 2022 with a loss.[16] The shift in loan growth is seen mainly in the comparison with 2022, when there was growth in loans to both successful and less successful firms (as gauged by net profit). The outstanding amount of loans to loss-making firms did not increase over the first ten months of 2023, while lending to profitable firms continued to grow, albeit more moderately compared with 2022. This trend was not seen among large firms, as credit flows in this segment were strong also for loss-making firms. This is not to say, however, that banks were financing unviable firms, but rather that they were supporting large firms whose costs more than doubled in 2022.

Chart 5 For most firms, profitability had an upward impact on credit growth in 2023
Cumulative flows to loan portfolio (EUR millions) and annual rate of change in total loans (percentages)



Source: NBS.

Notes: The chart shows data for the NFC portfolio excluding large firms. The year-on-year change is expressed as an annualised average of the month-on-month changes for 2022 or for the first ten months of 2023.

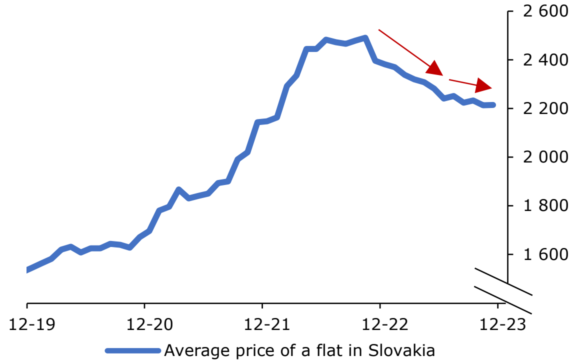
11 In the corporate deposit portfolio, the share of time deposits increased by 20 pp between June 2022 and October 2023, while in the household deposit portfolio it rose by just 4 pp. In recent months, however, the rate of growth in corporate time deposits has slowed.
12 Inflation-adjusted revenues declined throughout the period from January to September 2023.
13 The annual growth rate of NFC loans has in recent months been affected by the normalisation of loan flows and by a base effect.
14 Loans to micro firms are maintaining an annual growth rate of around 15%.
15 Growth in lending to small firms was already slowing in 2022, while in the second half of 2023 it was accelerating.
16 These included a number of firms that became loss-making as a result of sharp cost increases in 2022.

Housing demand dampened by higher interest rates

Housing market activity has slowed significantly compared with summer 2022; however, its cooling has been less pronounced in recent months than at the turn of the year. Housing prices are lower by one-tenth, year-on-year,[17] with most of that decline occurring in the late 2022/early 2023. Since then, housing prices have declined at a more gradual pace.

After experiencing a broad-based decline, housing prices are showing some divergent trends. Prices of both houses and flats have declined year-on-year, and flats of all sizes have decreased in price. In all regions of the country, flats listed for sale are cheaper than they were a year ago, but in some regions they are as much as 16% cheaper compared with summer 2022. The residential real estate markets of other euro area countries are in a similar situation, with housing prices experiencing a year-on-year decline.[18]

Chart 6 The decline in prices of flats has moderated
Average price of a flat (€ / m²)



Source: NBS.

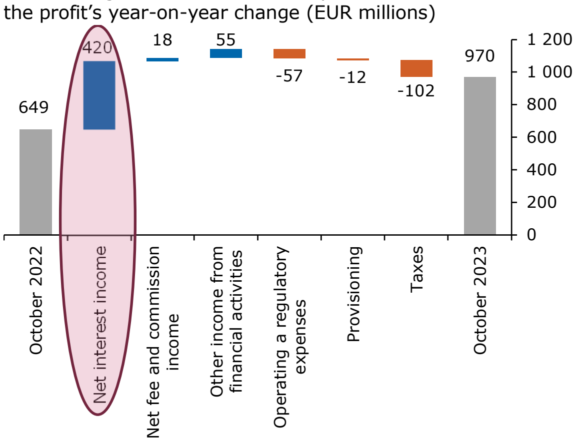
The housing market's cooling is due to reduced demand. High interest rates have made households less inclined to buy their own home and, together with elevated inflation, have made housing less affordable. At the same time, prospective buyers are not subject to the sort of strong demand-side competition that was present as recently as the summer of 2022. Another factor behind the lower demand is that the monthly rent for an average flat in Bratislava is currently lower than the monthly mortgage payment on such a property.

After two years of significant decline, housing affordability has stopped falling; nevertheless, it remains at a deteriorated level. On the one hand, housing affordability has been favourably affected by the decline in prices of flats; on the other hand, household incomes have been squeezed by inflation and by the upward impact of high interest rates on loan payments. As a result, housing affordability still remains below its long-run average.

Bank profits boosted by rising interest rates

Banks in Slovakia are having a good year in terms of profits. The banking sector's net profit has so far increased by one-half compared with 2022, and its full-year profit is expected to exceed €1 billion for the first time ever.[19] Banks are benefiting mainly from the uptrend in interest rates, which has resulted in their net interest income increasing by almost one-third.[20] The interest income growth stems largely from higher returns on corporate loans. Higher interest rates have also, however, had an impact on the cost side, with the sector's interest expenses having risen almost fivefold over the course of 2023.[21] In the wake of the increase in its profit, the Slovak banking sector has significantly improved its return on equity (ROE), which has rebounded back to its 2018 level.

Chart 7 Bank profits rose year-on-year owing mainly to higher interest income
The banking sector's net after-tax profit and contributions to the profit's year-on-year change (EUR millions)



Source: NBS.

Even so, the Slovak banking sector's ROE remains below the median for European banks.[22] This underperformance is due largely to a slower pass-through of policy rate increases to the retail loan portfolio. Given the planned introduction of a bank levy, the gap with European banks is likely to become more pronounced in the coming years. The amount of the levy, together with a tax on profits, is expected to equate to around 45% of the banking sector's profit, so it represents an exceptional burden on the sector. In the years ahead, however, the sector's profit is expected to remain above its 2022 level. Since banks' profits are a prerequisite for capital formation, it is positive that the bank levy as currently proposed is to be gradually reduced.

The banking sector's total capital ratio has risen above 20% for the first time since the end of 2021.[23] The good news is that the major contribution to this development came from significant banks.[24] The ratio increase reflected mainly a quarter-on-quarter decline of more than €600 million in the amount of risk-weighted assets (RWAs), with most banks reporting a drop in RWAs.

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17 The average asking price for residential real estate (RRE) was, on average, 10.1% lower in the third quarter of 2023 than in the same period of the previous year.
18 RRE prices in the euro area were 1.7% lower, year-on-year, in the second quarter of 2023.
19 The Slovak banking sector's net after-tax profit for the first ten months of 2023 was €970 million, up from €650 million for the same period in 2022.
20 Net interest income increased by €421 million (29.8%) year-on-year.
21 Total interest expenses rose by €1.1 billion (475%).
22 The factors explaining the current gap between the ROE of Slovak and European banks are addressed in more detail in Box 2 of NBS's November 2023 Financial Stability Report.
23 Capital adequacy on a standalone basis.
24 For the sector as a whole, the total capital ratio increased from 19.7% to 20%; for significant banks, from 19% to 19,4%.

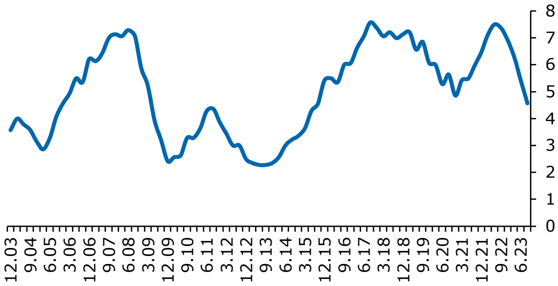
The financial cycle is in a cooling phase

The credit cycle has moderated significantly over the past year. This may be attributed to a shift in sentiment, as appetite for borrowing has greatly diminished. The private non-financial sector debt-to-GDP ratio has started to fall over the past year.[25] Hence the Cyclogram, NBS's composite indicator of the financial cycle, has decreased significantly during that period and is now below the levels it fell to during the pandemic crisis. Non-performing loans also had a downward impact on the Cyclogram in the third quarter of 2023, as their total was no longer falling and increased to its level of a year earlier. Th;e financial cycle's slowdown is therefore affected mainly by changing trends in the financial sector, and so far not significantly by macroeconomic developments.

Going forward, the financial cycle is expected to remain in a contractionary phase. Its cooling should not, however, be as pronounced as at the turn of the year, since loan growth is no longer decelerating and several components of the Cyclogram are now at lower levels.

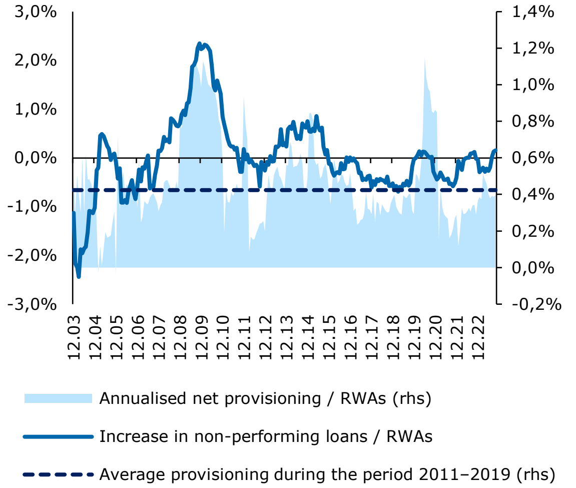
Despite the credit market slowdown, the financial cycle's cooling does not warrant any release of the countercyclical capital buffer (CCyB). The risks that built up in banks' portfolios during the strong expansionary phase of previous years remain present. Holding capital to cover any excessive losses arising from these risks is therefore justified in this situation. The question remains as to how banks' customers will cope with the rising cost of servicing their existing debt. At present, the situation is stable and non-performing loan ratios remain at relatively low levels, both for household loans and NFC loans. Although net provisioning has increased, it is for now back to the levels of non-crisis years.[26] Banks do not as yet need to release capital because of excessive provisioning. If in future the situation changes and banks are compelled to step up their provisioning owing to an increase in loan defaults, Národná banka Slovenska stands ready to support them by reducing the CCyB rate.

Chart 8 The financial cycle indicator is now below its lowest level during the pandemic crisis
(composite index; percentages of risk-weighted assets)



Source: NBS.
Note: Higher Cyclogram values imply a stronger build-up of imbalances.

Chart 9 Net provisioning is approaching its pre-pandemic average
(percentages of risk-weighted assets; percentages of risk-weighted assets)



Source: NBS.
Poznámka: RWA: risk-weighted assets.

25 As at the third quarter of 2023, the private non-financial sector debt-to-GDP ratio was 3.7% of GDP lower year-on-year, at 63.5% of GDP.
26 The pre-pandemic years of 2011 to 2019, when there were no significant crises in Slovakia.

What´s new in the world of macroprudential policy

Risks to euro area financial stability remain elevated

According to a recent publication of the European Central Bank (ECB),[27] risks to euro area financial stability remain elevated. Uncertainty about how the tightening of credit standards and the weak economic outlook will affect borrowers' debt servicing capacity is a cause for concern. Although the tightening of financing conditions is helping bring inflation back towards target, it may result in overindebted borrowers becoming financially stressed and distressed. Concerns surround overindebted firms, households and governments. There are also risks related to a possible correction of real estate prices and its impact on banks and non-bank entities. Banks have so far benefited from rising interest rates, which have resulted in higher interest margins. Going forward, however, banks will be adversely affected by decelerating credit growth, as borrowing demand in certain countries is cooling extremely rapidly. Another factor that may weigh on banks' profits is credit losses, which are now starting to increase, albeit from low levels. These trends could be exacerbated by ongoing price correction in both commercial and residential real estate markets. According to the ECB, targeted macroprudential policy action, regulatory reform and faithful implementation of Basel III can help to ensure the durable resilience of the euro area banking sector.

What impact may central bank digital currencies have on financial stability?

This question is addressed in a paper published by the US Federal Reserve,[28] in which the authors provide an overview of the literature in this area. The introduction of a central bank digital currency (CBDC) may induce more competitive behaviour in deposit-taking and may thereby also affect lending. If designed well, a CBDC could improve terms for depositors without large-scale disintermediation of credit. Crucial in this regard will be what mandate the central bank has and how the central bank will be able to respond to any reduction in bank lending as a result of accumulations of CBDC on its balance sheet. It will depend on alterative sources of funding for banks, and for the economy more generally, as well as on the extent to which the central bank has a mandate to conduct open market operations and assets sales. This is because alternative sources of central bank financing can, on the one hand, mitigate the effects of disintermediation and reduce banks' reliance on short-term funding, and, on the other hand, if the CBDC is highly popular, increase the likelihood of bank runs. It depends on how large and how active a role the central bank is prepared to play in the financial sector. And it depends on how a CBDC might catalyse, or hinder, the development of complementary fintech technologies, as these all entail a certain degree of risk. At times of stress and bank runs, there may also be a risk of deposits outflows to a CBDC. On the other hand, a CBDC can be a safe alternative to cryptocurrencies and non-bank financial intermediaries, such as money market funds.

Can macroprudential policy be successful in strengthening financial stability?

In a paper published by the IMF,[29] the authors use a dataset of 53 countries to analyse the macroprudential measures and capital controls typically adopted during times of financial cycle expansion. This is because many financial cycle upswings are accompanied by credit growth and rising asset prices, and by a deterioration of the balance of payments current account due to a surge of capital inflow. The authors focused their attention on expansionary periods, examining whether the use of macroprudential measures and capital controls reduces the probability of the credit boom ending in a bust. According to their findings, macroprudential policy can be an effective tool in mitigating credit contractions. The authors identify capital-based tools, borrower-based tools such as LTV and DSTI caps, and reserve requirements as having a significant effect in this regard. Although countries may not always be successful in taming credit booms, they can, with these tools, build up buffers and minimise risks, thereby making the financial sector more resilient.

The impact of monetary policy on financial stability

According to the findings of a paper published by the ECB,[30] surging financial stress has a strong short-term impact on economic growth. Applying a quantile vector autoregressive model, the authors find that a build-up of financial vulnerabilities tends to be accompanied initially by subdued financial stress, but risks and economic vulnerability surges over the medium term due to the tightening of financial conditions. Tightening conventional monetary policy, especially when unexpected, reduces inflationary pressures at the cost of slower real GDP growth and surging financial stress. By contrast, changes in long-term interest rates induced by unconventional monetary policy are similarly effective in reducing inflation, but have a smaller impact on growth and financial stress.

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27 *Financial Stability Review*, European Central Bank, Frankfurt am Main, November 2023.

28 Infante, S., Kyungmin, K., Orlik, A., Silva, A.F. and Tetlow, R. J., "The Macroeconomic Implications of CBDC: A Review of the Literature", *Finance and Economics Discussion Series*, No 2022-076, Board of Governors of the Federal Reserve System, Washington DC, October 2022.

29 Arakelyan, M., Gersl, A. and Schindler, M., "Macroprudential Policies and Capital Controls Over Financial Cycles", *IMF Working Papers*, No 2023/171, International Monetary Fund, Washington DC, August 2023.

30 Bochmann, P., Dieckelmann, D., Fahr, S. and Ruzicka, J., "Financial stability considerations in the conduct of monetary policy", *Working Paper Series*, No 2870, European Central Bank, Frankfurt am Main, November 2023.