NÁRODNÁ BANKA SLOVENSKA
EUROSYSTÉM

MACRO-PRUDENTIAL ANALYSIS OF THE BANKING SECTOR

MARCH 2012

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FIRST QUARTER OF 2012

The aim of this macro-prudential analysis of the banking sector is to provide a comprehensive overview of risk and trend developments in the banking sector. The risks in banks are analysed in the context of developments in the external environment, i.e. the real economy, as well as with regard to trends in the banking sector itself. Given the increasing interconnection between developments in banks and trends in the real economy, the analysis aims to provide early identification of potential imbalances in the banking sector.

The analysis is not concerned with activities performed by the NBS Financial Market Supervision Unit as part of its exercise of supervision over individual banks and branches of foreign banks.

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1. ANALYSIS SUMMARY

The calming of financial markets at the beginning of the year was followed by increasing strains in euro area government bond markets

The first months of 2012 saw euro area financial markets become calmer in comparison with the last quarter of 2011. This development was to a large extent attributable to ECB non-standard measures, in particular three-year longer-term refinancing operations. Thus the euro banking sector became less uncertain, particularly in regard to its financing, and a severe tightening of bank lending to the real economy was largely avoided. The ECB's measure also had a positive effect on the euro area government bond market. Another significant risk that was to some extent mitigated in this period was the risk of a decline in economic growth. Nevertheless, the ECB action served only to address current problems; it did not represent a comprehensive solution.

The positive trends mentioned above were related to Slovakia as well. Yields on Slovak Government bonds fell steadily from February 2012 and by mid-May they were at one of their lowest levels in recent years. Similarly in the case of economic growth, the Slovak economy recorded one of the highest growth in EU.

By the end of March the situation in the government bond market was already beginning to deteriorate, as markets turned their attention to Spain, which is sensitive to the condition of its banking sector. This period also saw a marked rise in political risk, mainly associated with elections in certain countries. The most crucial developments in the short term were those taking place in Greece. In May, too, financial markets were heavily influenced by persisting fears that a country would leave the euro area. At the same there were concerns about the willingness of certain countries to press on with essential measures to consolidate public finances. Nevertheless, the negative developments in certain countries have not adversely affected the Slovak government bond market.

Slower growth in lending to Slovak households

The Slovak banking sector saw a continuation of the trends that originated during the second half of 2011. Households lending slowed, especially through housing loans. The increase in the outstanding stock of loans in the first quarter of 2012 was almost one-third lower than in the same period of the previous year. There were several reasons for this decline, principally the falling demand from households and further drop in residential property prices. Competition between banks remained strong and resulted in loan-to-value ratios being set as unsound. Such behaviour is risky for banks especially at a time of falling property prices.

Corporate sector financing maintained moderate growth, aided mainly by a decline in interest rates. Even so, both corporates and banks remain relatively cautious. Developments in the first quarter do not as yet indicate whether higher capital requirements in Slovakia and abroad, or the introduction of a bank levy, would have an adverse effect on the corporate lending market.

The quality of banks' credit portfolio remained largely unchanged during the first quarter of 2012. The NPL ratios to total household loans and corporate loans in the banking sector as a whole stayed as they were.

The exposure of banks to countries perceived to be at higher risk declined in the first quarter, from what was already a low level. The significance of Slovak government bonds increased.

Changes in the interbank market largely reflected the effects of non-standard measures applied by the ECB. Several banks participated in these measures, with the funds being used predominantly for redemption of interbank liabilities, re-depositing with the ECB, and, to a lesser extent, for buying government bonds.

The domestic banking sector's capital adequacy ratio increased, while its profitability declined.

The banking sector's total profit in the first quarter of 2012 was approximately one-fifth lower year-on-year. The main cause of this drop was the introduction of a new bank levy. Even without the bank levy, however, the banking sector's profit would have fallen by around 5%, largely due to rising credit risk costs. Interest income from households maintained its downward trend, as banks' interest rate margin in this segment has been falling since 2010. Interest income was further dampened by a slower growth in lending to households.

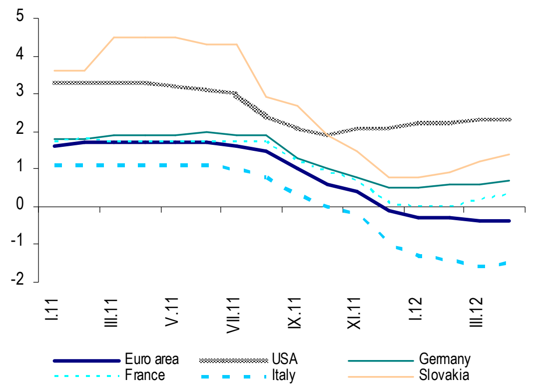
A key factor in regard to the banking sector's stability was the increase in its capital adequacy ratio, to 15% in the course of the first quarter of 2012, with the core Tier 1 ratio standing at 13.9%.

2. MACROECONOMIC DEVELOPMENTS AS THEY AFFECT BANKING SECTOR STABILITY

The beginning of the year was accompanied by improving sentiment in global financial markets and increasing risk appetite

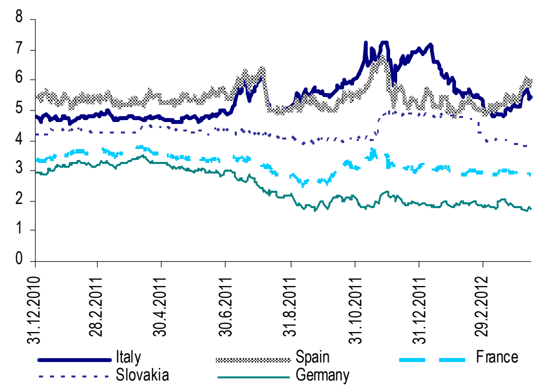
From the macroeconomic view, the key feature of the first quarter of 2012 was the averting of the threat of financial sector collapse in the euro area. The more optimistic sentiment in those first months was further supported by the situation in the United States, where the labour market in particular was reporting better than expected figures. Expectations for the health of the global economy and its growth were therefore moderately higher than at the end of 2011, which was reflected in, inter alia, upward revisions of IMF projections for 2012 and 2013. Even so, this does not change the fact that economic performance at both the global level and in most economic blocs will probably be lower than in the previous year and the balance of risks remains substantially on the downside. But looking at developments in recent weeks, with a new wave of nervousness in the euro area and a worse than expected showing from the US economy, it appears that a high degree of caution is warranted.

Chart 1 GDP forecasts for selected economies in 2012



Source: Consensus Forecast, London Economics.
The vertical scale shows consensus forecasts for GDP growth in percent (median of values given by forecasting institutions) made in the respective month.

Chart 2 Yields to maturity of 10-year government bonds of selected euro area countries

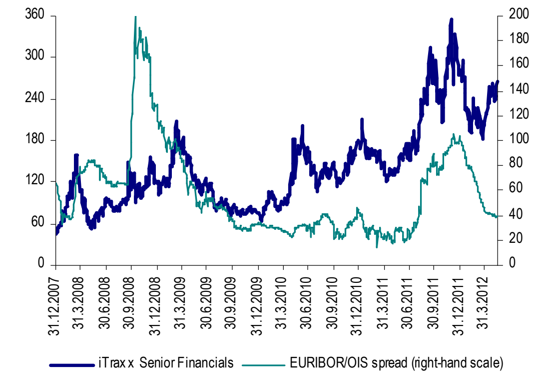


Source: Bloomberg,
Data are in percent.

The future course of the euro area sovereign debt crisis will have a major bearing on how the global economy progresses in the years ahead. It is therefore crucial that measures were taken to prevent a looming systemic event that could have had a severely adverse effect on the global financial sector. The primary credit for mitigating the critical situation that existed at the end of 2011 lies with the European Central Bank (ECB), since it provided unrestricted supply of three-year liquidity to the euro area banking sector. As a result, the balance sheets of several hundred banks in euro area were boosted by long-term funding totalling more than one billion euro. The benefits were two-fold. First of all, banks that had been finding themselves shut out of wholesale funding markets were now easily able to refinance their maturing debts. Secondly, the ECB measure acted as an indirect intervention in the sovereign debt markets of countries with higher risk, since many banks used the funds they obtained from the ECB for carry trades strategy, i.e. to buy primarily relatively high-yielding domestic government securities. This enabled several euro area countries (notably Spain and Italy) to get through the critical first-quarter period, when a significant proportion of their debt was maturing. Required yields to maturity on sovereign issues declined over the first three months in both the primary and secondary markets.

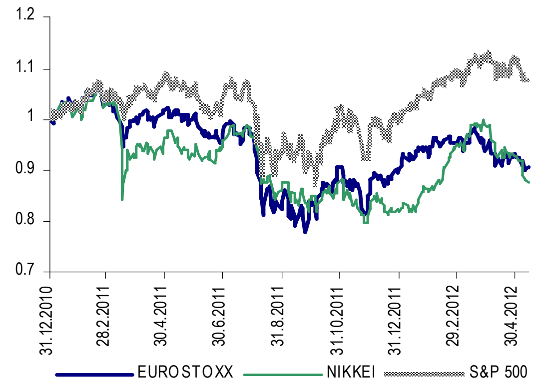
As fears of a collapse of certain banks abated, confidence to some extent returned to the euro area interbank market. This turnaround was evident in, for example, the EURIBOR/OIS spread, which narrowed quite significantly from the turn of the year. Another indicator of the lower probability of insolvency in the European banking sector was the iTraxx senior financials index, which tracks the spreads on CDS contracts of selected banks.

Chart 3 Indicators of uncertainty in the European banking sector



Source: Bloomberg.

Chart 4 Principal equity indices development



Source: Bloomberg.

The improvement in sentiment passed through to investors in other financial market segments and beyond the borders of Europe. All over the world, equities enjoyed one of their most successful first quarters ever, increasing in total by around 11%. In addition, the volatility of equity indices declined, and this was also a feature of other asset classes during the period under review. There was also rising demand for other more risky assets, such as corporate bonds (including those with a speculative grade), which along with diminished risk aversion was clearly the result of a search for higher yield at a time of long-term low interest rates.

By the end of the first quarter, the wave of optimism had already faded as investor attention turned once again to the strained fundamentals in the euro area periphery countries

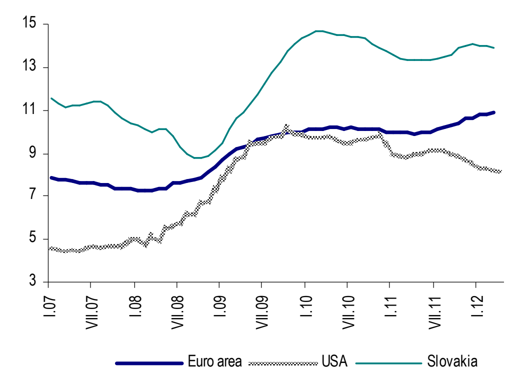
By the end of March, the liquidity-induced boost to sentiment in the euro area financial sector had weakened and market actors started to be concerned about reports from Spain that the country was at risk of breaching deficit limits and may make an official request for financial assistance. Credit spreads on Spanish and Italian sovereign debt began steadily to rise again, and although they fell short of the high recorded in November 2011, they approached the level at which the interest burden becomes unsustainable over the long term. According to certain indicators, risks in the euro area banking sector were perceived to have risen to some extent. Banks did not face an immediate risk given that their liquidity position is guaranteed by ECB operations, but as regards fundamentals the banking sector's resilience hardly changed from the previous year and markets again began to price this fact into certain financial instruments. Those banks which in the previous period had been most active in buying domestic government bonds even became more vulnerable to sovereign risk. The mounting uncertainty in the euro area was further exacerbated at the end of April and beginning of May by the political risk associated with elections in France and Greece and with the fall of the Dutch government. Tensions escalated in mid-May, as the post-election stalemate in Greece led to the most intense speculation to date about a Greek exit from the euro area. Mounting investor nervousness was further reflected in the European equity index, which by mid-May had lost the entire ten-percent gain it made in the first quarter, as well as in German government bond yields to maturity, which fell to an all-time low.

In addition to the ECB action, some other measures have been taken this year as part of the European Commission's strategic material "five-point strategy" for tackling the debt crisis. These include the restructuring of privately held Greek debt and an agreement to increase by €700 billion the overall ceiling for lending under the European Stability Mechanism and European Financial Stability Facility (ESM/EFSF) temporarilly operating in paralell. The market response to each measure was lukewarm.

The macroeconomic situation in the euro area remained difficult and subject to many risks, even though GDP stopped declining in the first quarter

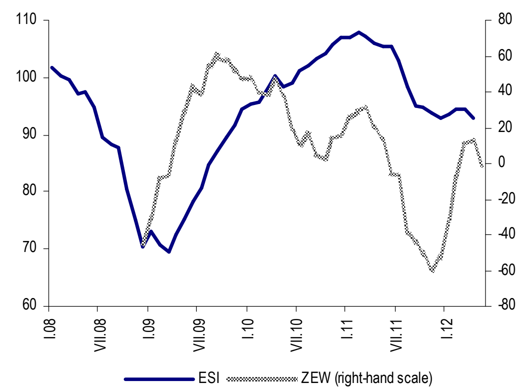
The improvement in financial market sentiment in the first quarter did not significantly curb negative tendencies in the euro area's real economy. Although aggregate GDP for the euro area managed to remain flat in the first quarter, after contracting in the previous three months, a number of individual euro area member countries slid further into recession. The weak performance of the economy led to upward pressure on the rate of unemployment, which during the period under review rose by three-tenths of a percentage, to 10.9%.

Chart 5 Unemployment rate in selected economies



Source: Eurostat, Bureau of Labor Statistics.

Chart 6 Indicators of confidence and sentiment in the euro area



Source: Bloomberg.
ESI – Economic Sentiment Index (European Commission);
ZEW – an indicator of economic sentiment compiled by Zentrum fur Eüropäische Wirtschaftsforschung, a private economic research institute based in Germany.

Developments in component indicators further indicate that the euro area is unlikely to experience an upturn in the near term. Industrial production stagnated from the beginning of 2012, and given that it declined in the previous period, production was, in absolute terms, only around the level observed in the second half of 2010. Another bad signal for euro area economy are data on retail sales which somewhat approximates household consumption. The volume of retail sales fell in recent months to a level last seen when the first wave of the recession peaked at the beginning of 2009.

Economic activity is also being held back by the restricted credit abvailability. According to the ECB's April 2012 bank lending survey, the tightening of credit standards for corporates and households eased in the first quarter, obviously as a consequence of the ECB's liquidity-providing operations, which mitigated the pressure on banks to deleverage. In the end, however, the credit restrictions were further tightened, thus adding to the substantial cumulative tightening that has taken place over recent periods. This is evident in the amount of loans provided to the private non-financial sector, which declined again in the first quarter albeit to a lesser extent than in the previous quarter. The effect of the declining amount of loans to corporates was mitigated only by a small rise in lending to households.

The negative contraction and/or zero growth of GDP in the last two quarters was largely attributable to stepping-up of government austerity measures during this period. The consolidation of public finances represents one of the main pillars of the European strategy for tackling the sovereign debt crisis. If spending cuts and tax hikes continued to be implemented in full, the current plans for deficit reduction would be met, but these measures would of course, by dampening demand, make a negative contribution to economic growth in the years ahead. In the medium-term horizon, however, these direct effects could be outweighed by the indirect positive repercussions resulting from the reduction in general government debt and a return of confidence to the sovereign debt market. On the other hand, the public and political debate on whether austerity should not at least to some extent be counterbalanced by government measures aimed at boosting growth has been intensifying in recent months. Even if government investment in a suitable form and scope could support the recovery of economies, such a marked deviation away from the current strategy and towards an increase in public spending, as several countries are calling for, may ultimately lead, on the one hand, to a short-term improvement in the situation, but, eventually to an even greater crisis.

Falling demand in the euro area periphery countries dragged the economies of that region even further into recession, while the performance of the German economy in the first quarter was surprising positive

The economic situation in the euro area remained most acute in the periphery countries. In all of the periphery countries except Ireland, GDP for 2012 is expected to be negative by more than one and a half percent, which is considerably worse than the average projected for the euro area as a whole. It is these countries that are undertaking the most stringent programmes of public finance consolidation, but since they are consistently failing to perform up to the original projections, they are having to adopt further austerity measures in order to meet consolidation objectives and this in turn is exacerbating their downward spiral. The restrictive fiscal policy is to be compensated by structural measures designed to support growth, but these will require a longer period before the benefits are seen. Recent instances of such dynamics can be found, for example, in Spain where the government deficit for 2011 was more than 2 percentage points higher than projected. The disclosure of this figure was one of the key factors behind the reversal of the improving sentiment in financial markets (stemming from liquidity injections) and the return of economic fundamentals to the centre of attention. Soon afterwards S&P downgraded Spain's credit rating by two notches, to BBB+, as a response to the persisting stress in the domestic banking sector.

Germany is pulling up the euro area average in all respects. Although the German economy contracted moderately in the fourth quarter of 2011, it rebounded with relatively strong growth in the first quarter of 2012. The preliminary forecast for annualised GDP growth in Germany during the first three months is around 2%, which is far higher than expected. Germany is managing to improve performance not only through its traditionally strong exports, but also through domestic demand. And although the optimism among enterprises and households is no longer at the levels observed in summer 2011, the indicator of economic sentiment and confidence remains relatively high in comparison with its long-term average.

The US economy maintained solid growth, but signs of an acceleration at the beginning of the year proved unfounded

Reports on the state of the US economy at the beginning of 2012 aroused moderate optimism. This stemmed mainly from the unexpectedly positive figures for job creation in the United States and from certain other property market indicators. In March and April, however, the pace of employment growth slowed to a level more in keeping with developments in other macroeconomic variables.

First-quarter GDP growth in the United States stood at 2.2% on an annualised basis. On the one hand, this indicated that the US economy was in relatively sound condition despite the problems in the euro area; on the other hand, it served to temper the overly optimistic view that the economy was on an upward trajectory.

According to the Case-Shiller index, residential property prices in the United States rose month-on-month in February, which following a long downward trend indicates that their cyclical trough may have passed. The stabilisation of these property prices is viewed as a key precondition for more dynamic economic growth.

While there are no significant indications at present that the United States faces a threat of recession, it should be noted that the fiscal consolidation package arranged in autumn 2011 is due to be implemented from 2013.

Economic activity in Slovakia is maintaining strong growth above expectations, driven by expanding industrial production

The Slovak economy was generally projected to grow at a slower pace in 2012 than in the previous year, but the positive figures for the first quarter did not support these expectations. The manufacture of goods and services in Slovakia maintained linear growth, in annualised terms, of just over three percent, again one of the highest rates reported by any countries in the euro area or EU.

As for the output measure of GDP, the main driver of growth was the industry sector. The volume of industrial production in the months from January to March showed a further considerable improvement and reached a new historical high. Industrial new orders, too, are gradually reaching new highs, which, looking ahead, indicates that the positive trend will last at least into the next quarter.

The favourable fundamentals of the domestic economy may to some extent sway investor demand for Slovak government bonds. In January, yields to maturity on five-year issues government bonds remained at the level to which they rose in November 2011, but from the beginning of February they began falling quite sharply and by May they were approaching an all-time low. The conditions for Slovakia in the primary market have also been favourable so far this year. The Debt and Liquidity Management Agency (ARDAL) had by mid-May managed to secure a majority of the funding that it plans to raise over the whole of 2012. This included placing a significant dollar bond issue.

While the macroeconomic situation in Slovakia is largely positive at present, its development in the longer term horizon will be closely linked to how the rest of the euro area fares. Thus there remains the risk of a slowdown or even recession, and it should also be noted that domestic consolidation measures are due to be implemented in full from 2013.

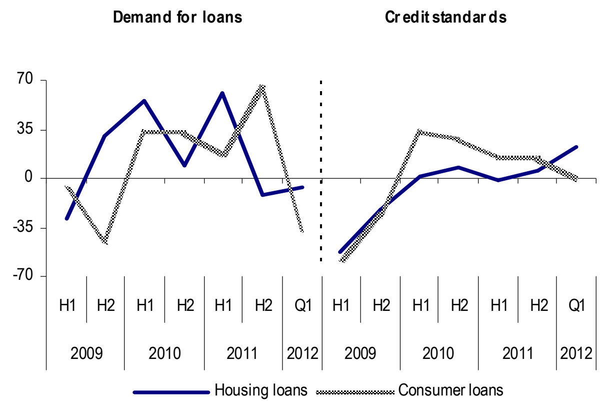
3. TRENDS AND RISKS IN THE SLOVAK BANKING SECTOR

Housing loan growth continued to slow due to weak demand

The rate of lending to households for house purchase continued to decline in the first quarter of 2012. The absolute increase in the outstanding amount of these loans in that period was more than one-third lower than in the first quarter of 2011, meaning that for the first time since 2009 lending growth had slowed in year-on-year terms.

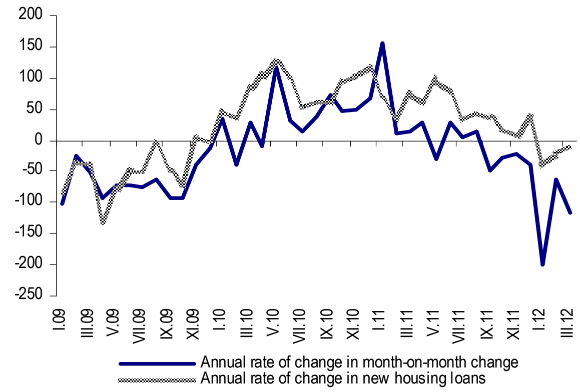
In the first quarter of 2012 there were two factors in particular that shaped the stock of housing loans: household borrowing demand and property prices (including expectations for their future movement). The continuing decline in household demand for loans can be largely attributed to low confidence in the household sector and a moderate rise in interest rates on housing loans back in 2011. Consumer confidence was eroded through several channels by the dampening of economic activity, and it indicates that the overall financial situation of households has deteriorated. Most indicators are back to the levels last observed in the crisis year of 2009.

Chart 7 Borrowing demand and credit standards for new loans to households



Source: NBS.
Data are in percent.
Data for Q1 2012 are based on a survey of selected banks.

Chart 8 Annual percentage changes in amount of new loans to households



Source: NBS.
Data are in EUR millions.

The amount of loans was also affected to a significant extent by developments in the residential property market. The continuing decline in property prices reduced to some extent the incentive to invest in owner-occupied housing and stoked expectations of a further drop in prices. A separate factor is the level of property prices, which are around 20% lower than they were before the crisis. It may be inferred from this that if housing market dynamics and LTV ratios had remained stable, the nominal amount of housing loans would be around 20% lower than in 2008. On the other hand, the slowdown in housing loan growth in the first quarter of 2012 was not accompanied by any marked drop in property prices. Thus the nominal decrease in housing loan growth during the period under review cannot be explained by falling prices, but rather by subdued overall dynamics in the apartment market.

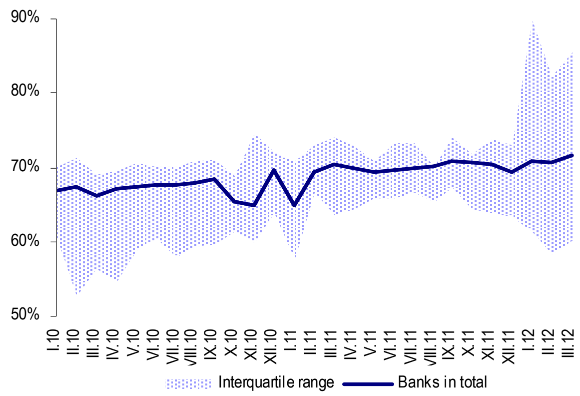
The decline in the annual rate of growth in lending was to some extent caused by the base effect of household behaviour in previous periods, when the spread between interest rates on new and outstanding loans in 2010 and 2011 stimulated borrowing demand by incentivising people to refinance their old loans with new ones. This difference ceased to exist in the first quarter of 2012.

In contrast to housing loans, consumer loans recorded year-on-year relative growth. Although that growth was slightly lower, the outstanding amount of consumer loans remains at a comparatively high level. Only certain banks reported higher than average growth in consumer lending.

Certain banks eased loan collateral requirements quite significantly

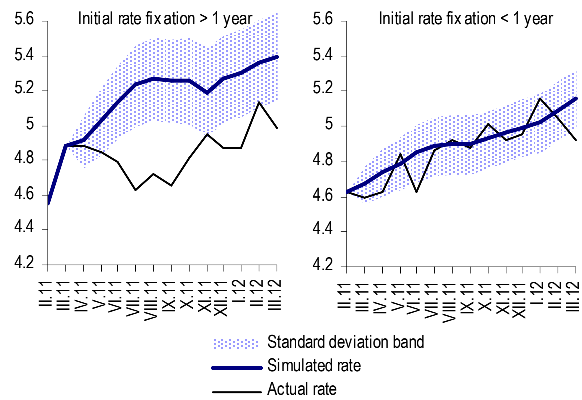
Amid continuing strong competition in the first quarter of 2012, banks remained under pressure to ease credit standards. They did so mainly by lowering loan collateral requirements, which was reflected in the loan-to-value (LTV) ratio for new loans. The LTV ratio rose only slightly in the first quarter of 2012, but within the sector there were substantial differences in the LTV ratios reported by different banks. On the one hand there was one group of banks that markedly raised the average LTV ratio, while on the other hand some banks reduced the average LTV ratio. Those banks that relaxed LTV conditions gained market share in the first quarter. Whereas reducing LTV ratios at a time of falling property prices can be seen as prudent and correct in regard to credit risk, increasing LTV ratios in this situation indicates that the bank is taking on greater risk in order to grow its loan portfolio and increase market share. From the view of the sector's stability such behaviour is associated with several risks, mainly in regard to the credit risk of banks, but also the adverse effect on the setting of credit standards in other banks.

Chart 9 Loan-to-value ratio



Source: NBS.

Chart 10 Simulated and actual interest rate on housing loans



Source: NBS.
Data are in percent.

Interest rates rose moderately in comparison with the end of 2011

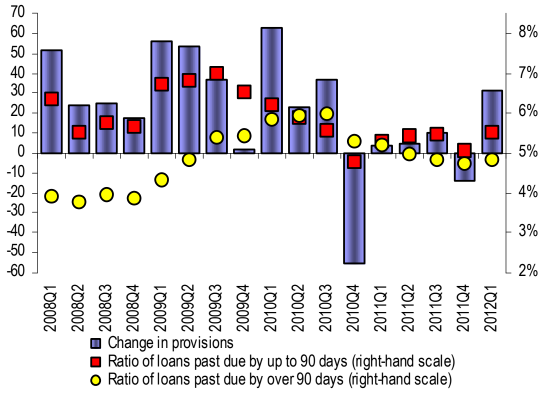
Interest rates, a key factor in the housing market development, fluctuated in the first quarter of 2012. After remaining flat in the last quarter of 2011, the average interest rate increased sharply in January 2012 and then declined. Nevertheless, interest rates on housing loans increased from their level at the end of 2011, due in large part to an increase in credit risk in the household sector. In March 2012 interest rates came down in the wake of falling yields on domestic government bonds. The average interest rate remains lower than the simulated rate, which takes into account market factors and therefore captures the continuing strong competition in the housing loan market.

Repayment behaviour of households deteriorated slightly

In most banks the amount of non-performing loans (NPLs) did not increase significantly in the first quarter of 2012. In almost all loan categories the NPL ratio is stable, and overall it is below 5%.

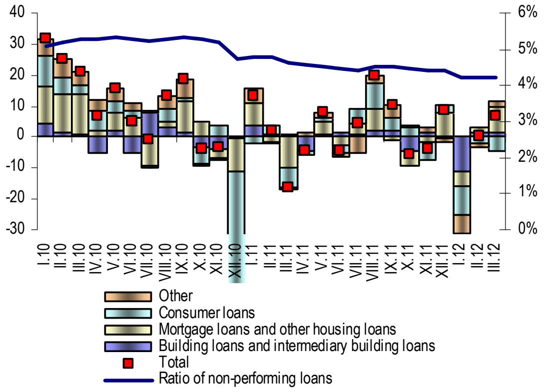
A sign of negative developments in the first quarter of 2012 was the increase in the ratio of loans which instalments are past due, meaning mainly loans past due by up to 30 days. A further indication of deteriorating repayment behaviour was the moderate increase in the ratio of loans on which penalty interest rate is paid. Should this trend continue, it could lead to an increase in non-performing loans. The first quarter also saw a marked rise in provisions for household loans.

Chart 11 Household loans by period past due and amount of provisions



Figures on the left-hand scale are in EUR millions.

Chart 12 Changes in amount of non-performing household loans



Figures on the left-hand scale are in EUR millions.

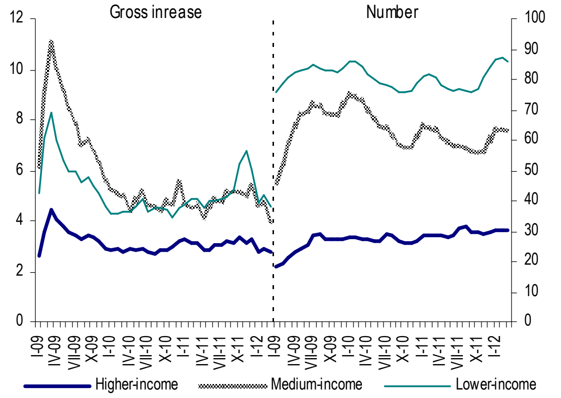
Unemployment implies increased credit risk

The unemployment rate, as one of the factors affecting the ability of customers to service their debts, has since the beginning of the second half of 2011 been indicating an increase in credit risk. The annual increase in registered unemployment was more pronounced in higher-income job categories, to which the majority of banks' borrowers belong. On the positive side, unemployment in this job category rose at a slower pace in the first quarter of 2012.

The employment index has been trending downwards, with all sectors except for manufacturing and services reporting a contraction in employment. Expectations for the future employment situation remain unchanged, implying that there will not be any significant rise in employment in the period ahead.

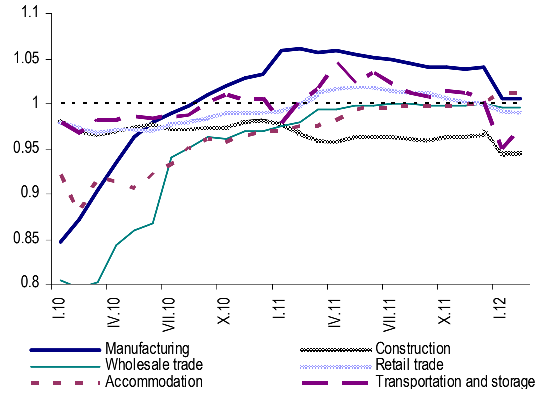
Another source of credit risk in the next quarter could be the still high inflation rate, which in the first quarter stood at 4%. High inflation erodes the real income of households, and in conjunction with a negative interest rate shock (a rise in interbank rates or in yields on Slovak government bonds) it could escalate credit risk.

Chart 13 Gross increase in unemployment by income category



Source: Central Office of Labour Social Affairs and Family.
Data are in thousands of people.

Chart 14 Index of employment in selected sectors



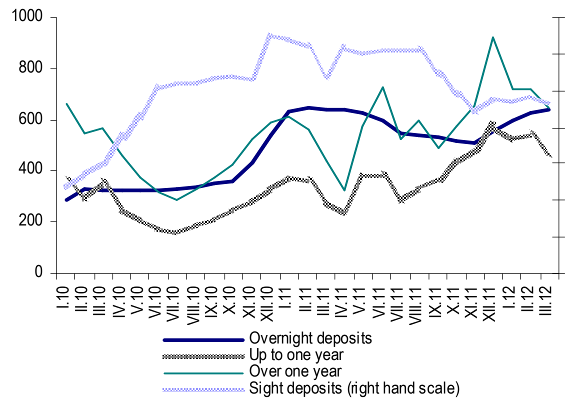
Source: Statistical Office of the Slovak Republic.

Growth in shorter-term time deposits

Deposits from households continued to increase in the first quarter of 2012, and their amount was 55% higher than in the same period of the previous year. Medium-sized banks recorded the largest increase in these deposits.

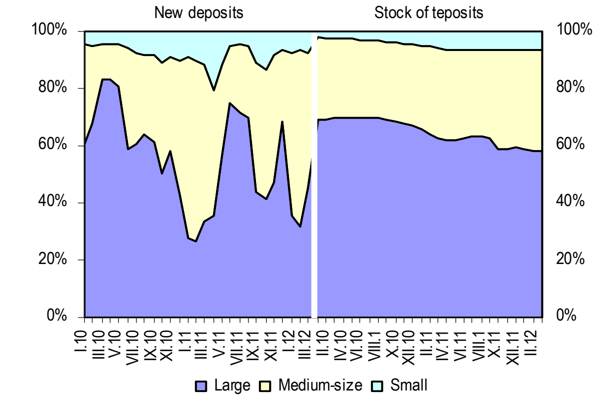
Competition between banks remaining strong not only in long-term deposits, but also in term deposits with maturity of up to one year. The average interest rate on time deposits remains higher than the simulated rate, which takes into account market factors. There was, however, a change in interest rates on longer-term time deposits, which started to be reduced systematically in the first quarter of 2012 after rising for almost two years.

Chart 15 New deposits of households by maturity



Source: NBS.
Data on the left-hand scale are in EUR millions; data on the right-hand scale are EUR billions.

Chart 16 Bank categories by share of long-term deposits



Source: NBS.

Deposit business saw a continuation of the trend observed in the last quarter of 2011, with households shifting funds from longer-term time deposits and non-time deposits to time deposits with an agreed maturity of up to one year. This was evident to a greater extent in January 2012, when customers of one bank transferred a total of €65 million in this way. Probably a key factor behind this development is the narrowing difference between interest rates on long-term and short-term time deposits, meaning that the long-term are becoming less attractive to customers.

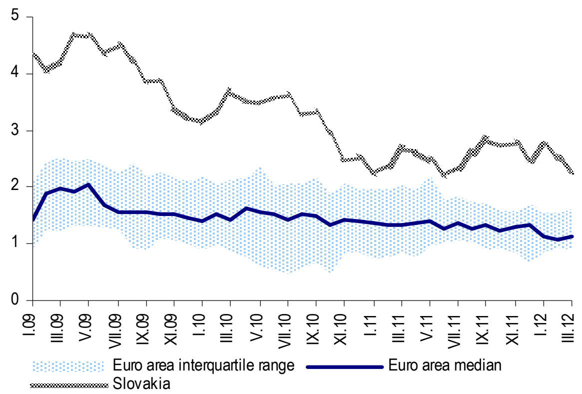
Comparison of household sector developments in Slovakia and the euro area

Households in Slovakia benefited more from the movement of housing loan interest rates in the first quarter of 2012 than did households in other euro area countries. In the last quarter of 2011 interest rates on new loans were significantly different from the euro area, but by the end of the first quarter of 2012 the situation got better. In a sign, however, of the increasing disparities between individual euro area countries in terms of economic performance, interest rates across the bloc remain divergent.

In both Slovakia and other euro area countries, the outstanding amount of bank loans for house purchase recorded a slower annual increase in the banking sector in the first quarter. Lending increased in absolute terms in most euro area countries, except for those stressed by the sovereign debt crisis. Slovakia, however, recorded highest lending growth in the euro area, while the biggest surprise was the slump in lending growth in the Netherlands and Belgium.

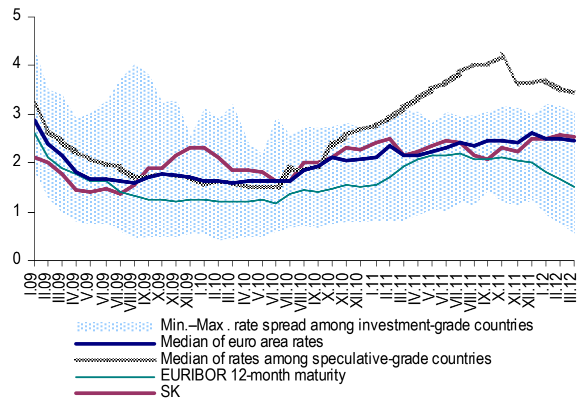
Another changing trend was observed in interest rates on new time deposits. While interest rates in the euro area had a downward tendency in the first quarter, the average rate in Slovakia remained at one of the highest levels in any investment-grade country. Although the speculative-grade countries of Italy, Portugal and Ireland reported positive developments, time deposit interest rates in these countries had a more or less falling tendency. With confidence in the interbank market recovering to some extent, banks became less reliant on retail deposits for their financing. In Greece, on the other hand, as well as in Cyprus (a speculative-grade country closely linked to Greece), interest rates continued to rise.

Chart 17 Interest rates on new housings loan in Slovakia and in the euro area



Source: ECB.
Data are in percent.

Chart 18 Interest rates on new time deposits in Slovakia (SK) and in the euro area



Source: ECB.
Data are in percent.

The impact of interest rate movements on time deposits was not reflected to the same extent in the year-on-year rate of deposit growth in all Member States. Particularly strong year-on-year growth in interest rates was recorded by banks in the Netherlands and, even more so, in Italy (almost 150% year-on-year); this is even more pronounced when compared with the year-on-year deposit growth in Slovakia, which at around 17% is among the highest in the in the euro area. On the other hand, Greek banks, offering the highest time deposit interest rates, continue to report a decline in household deposits, which is further exacerbating their unfavourable situation.

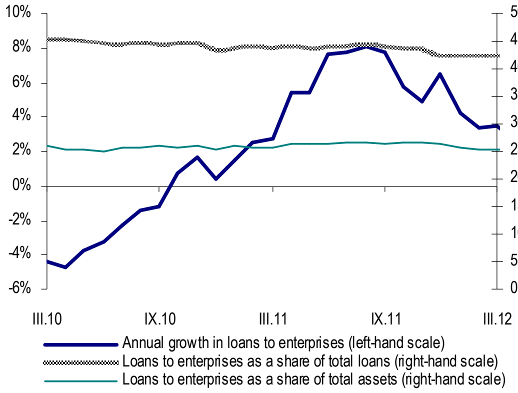
Loans to non-financial corporations continued to grow moderately

Loans to non-financial corporations continued to grow in the first quarter of 2012, rising year-on-year increase by 3.5%. Although the growth rate was lower than in the summer months (around 8%), it was still relatively solid. Furthermore, overall lending to the corporate sector was not provided by just a small number of banks, nor focused on certain segments (as, for example, in 2010). The growth was relatively balanced, and the shares of individual banks and business segments in the outstanding amount of loans was largely in line with the respective market share. Another positive aspect is that the decline in lending to traditional segments continued to ease, mainly due to growth in lending to retail trade.

Even though credit standards remained relatively tight and borrowing demand had still not rebounded significantly, total positive flow of loans to enterprises continued to rise in the first quarter of 2012. In addition, interbank interest rates continued to decline during the first three months, which resulted in downward pressure on lending rates for enterprises. At the beginning of the year there was an isolated drop in the interest-rate margin on loans of more than €1 million, which can be partly explained by banks' long-term refinancing operations with the ECB.

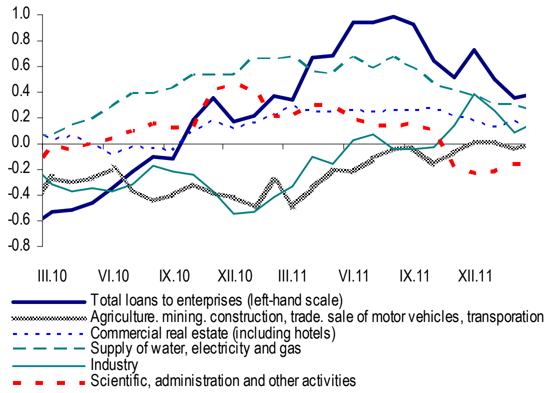
It is of importance in this regard that the ratios of loans to enterprises to both total loans and banks' assets continued to increase. Thus the fears of deleveraging that pertained mainly to banks in the euro area did not materialise in Slovakia during this period. Lending activity in the first quarter of 2012 does not yet indicate whether preparations for the new Basel III regulatory standards, or the introduction of the bank levy, would have an adverse effect on the corporate lending market.

Chart 19 Loans to enterprises



Source: NBS.
Data on the left-hand scale are in EUR billions.

Chart 20 Year-on-Year changes in the amount of loans to enterprises by segment

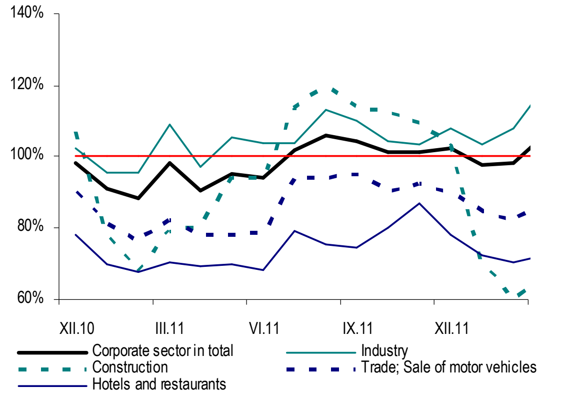


Source: NBS.
Data are in EUR billions.

Activity in the corporate sector improved moderately, but in many segments it still remains below pre-crisis levels

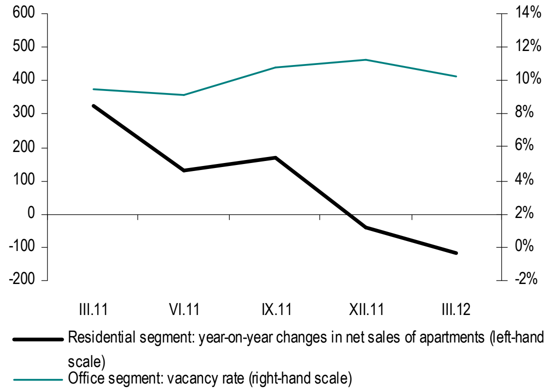
After slowing towards the end of 2011, economic activity in the corporate sector improved and there was even a moderate increase in firms' sales growth during the first two months (in February it was even higher than export growth). On the other hand, the preliminary foreign trade figures indicate that export growth slowed to 5.3% year-on-year.

Chart 21 Sales in the corporate sector – comparison with the pre-crisis level



Source: Statistical Office of the Slovak Republic.
For the purposes of this chart, "pre-crisis level" covers the period from the first-half of 2007 to the first-half of 2008.

Chart 22 Commercial real estate market



Source: CBRE, Lexxus.

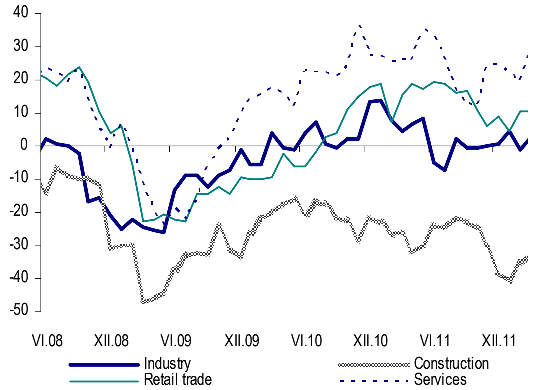
The main exception to the growth in activity is in the construction sector, which in both January and February reported a year-on-year decline of 11% in both sales and production. In line with the slump in activity, the construction confidence indicator declined as well. It remains a problem that sales in many sectors have still not rebounded to their 2007–2008 levels. Any sales growth in these sectors should be treated with caution, since it may be largely a case of recovering the ground lost in 2009. The most buoyant sector is export-oriented industry, where sales have for some time surpassed pre-crisis levels. On the other hand, under-utilisation of production capacity is a persisting problem that has become even more pronounced in recent months, with the result that Slovakia has fallen even further below the EU average in this respect. In such circumstances there is subdued demand among firms for new investment activity or for financing of current operations.

The commercial real estate sector warrants special attention, given the size of banks' exposures to this sector and the market concentration. On the positive side, office vacancy rates remained relatively stable and therefore did not make pressure on prices. Furthermore, the vacancy rates of around 10% are quite low in comparison with those in Prague or Budapest. In the residential segment the trends are somewhat negative: new apartment sales recorded a year-on-year drop for a second successive quarter, despite the continuing decline in prices.

No significant change in business confidence indicators

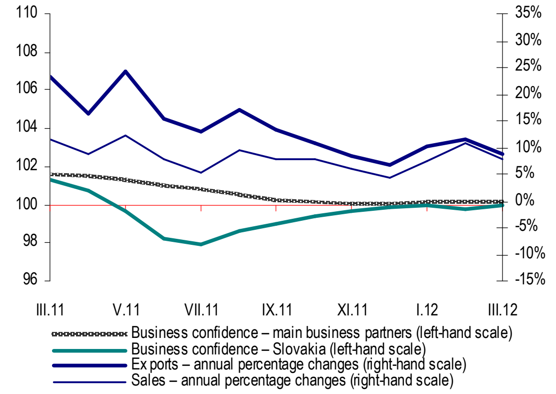
Sentiment was moderately more optimistic in the first quarter of 2012 than towards the end of 2011, when there was a prevailing negative mood caused largely by the sovereign debt crisis. A key reason for the upturn was the ECB's introduction of long-term refinancing measures. Business confidence indicators in Slovakia's main trading partners and in Slovakia itself did not, however, change significantly, and they remain at the levels recorded at the beginning of 2011. According to preliminary data, export growth slowed moderately again in the first quarter of 2012, as the year-on-year growth rate of exports fell from 6.9% in December 2011 to 5.3% in March 2012.

Chart 23 Confidence indicators in selected sectors



Source: Statistical Office of the Slovak Republic.

Chart 24 Sales, exports and business confidence



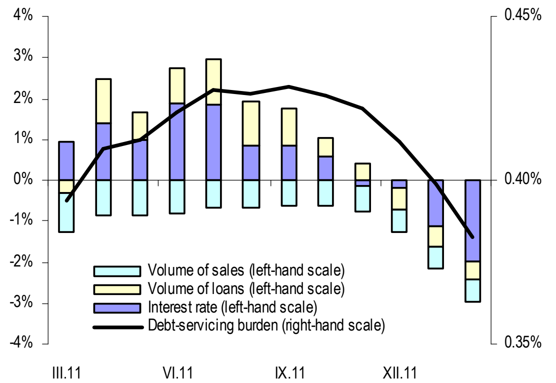
Source: Statistical Office of the Slovak Republic, OECD.

Growth rate of non-performing loans increased, while portfolio quality remained stable

From the view of credit risk, the reduction of interest rates in the first quarter contributed significantly to easing the debt-servicing burden on enterprises. It should be noted, however, that even with interest rates at historically low levels, the amounts of non-performing loans saw significant changes, primarilly in the wholesale and services sectors. In addition, the NPL ratio for corporate loans came to the end of a downward trend (related to the number of loans) and in March it even increased slightly.

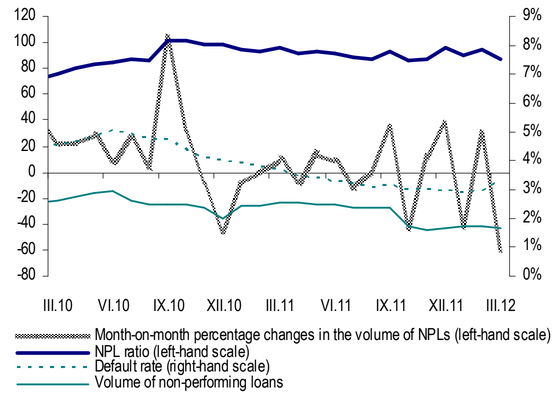
Disregarding relatively large movements related to non-performing loans and subsequent cleansing of the portfolio, the overall quality of the corporate credit portfolio remained relatively stable in the first quarter of 2012. It is positive from the view of overall losses on unpaid loans that NPL provisioning did not decline during the period under review; on the other hand, it remains slightly below pre-crisis levels.

Chart 25 Debt-servicing burden on the corporate sector



Source: NBS, Statistical Office of the Slovak Republic.

Chart 26 Non-performing loans and default rates in the corporate sector

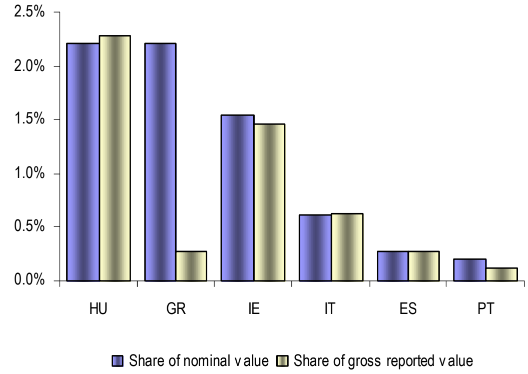


Source: NBS.

Investments in bonds issued by non-residents declined

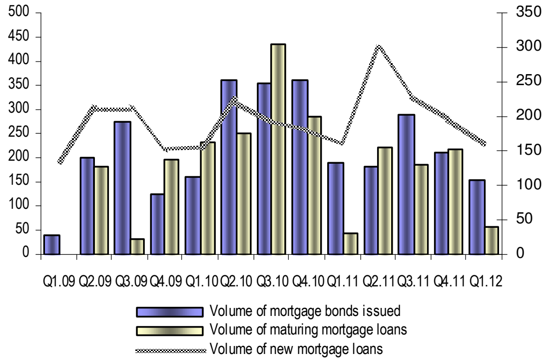
The volume of foreign government bonds held by Slovak banks declined in the first quarter of 2012, while the volume banks' invested in other types of bond remained largely unchanged. This development only further strengthens the importance of Slovak government bonds and Slovak Treasury bills in overal banks' bond portfolios, and by the end of March they constituted more than 85% of the sector's bond portfolio.

Chart 27 Bonds issued by selected countries as a share of the banking sector's overall bond portfolio



Source: NBS.
So-called GDP-linked warrants constitute 50% of the total nominal value of Greek government bonds. Since with such warrants there is no redemption of the nominal value, the nominal share of Greek government bonds in the overall portfolio is in fact lower, at 1.1%.

Chart 28 Volume of mortgage bonds issued



Source: NBS.
Data are in EUR millions.

Issuance of bonds by domestic banks did not change significantly

The securities issued by Slovak banks in the first quarter of 2012 were mainly mortgage bonds. Mortgage bonds were issued by three banks in total nominal value of €155 million, while bonds other than mortgage bonds were issued by only one bank and their total nominal value was €10 million.

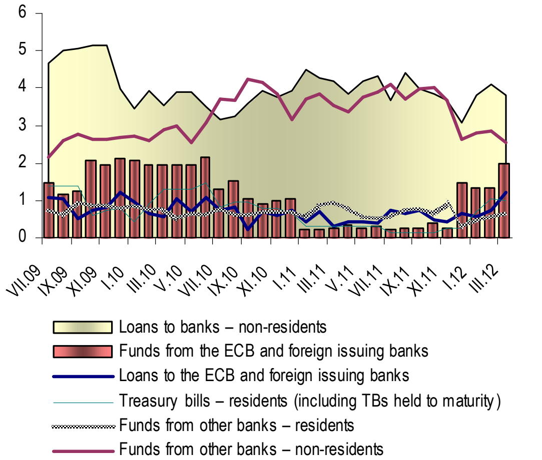
It is worth noting that all the mortgage bonds issued by banks during the first three months were fixed-coupon bonds. The decision to go exclusively for fixed-coupon bonds was probably influenced in part by the fact that a large proportion of the bonds (more than 50%) were offered to retail investors or no qualified investors, respectively. Another factor was the current low levels of EURIBOR interbank rates (under downward pressure from the ECB's non-standard operations) and the consequent likelihood that these rates will rise during the lifetime of the bonds (maturity of issues between 2 and 6 years). By fixing the coupon of the bond it is possible to prevent a future rise in the bond interest expenses. In addition, these bond issues were probably also affected by demand-side factors.

Unlike in the last quarter of 2011, both the average maturity and average coupon rate of the banks' bond issues were back to levels in line with the longer-term behaviour of banks.

Interbank operations influenced mainly by the second auction of three-year LTROs

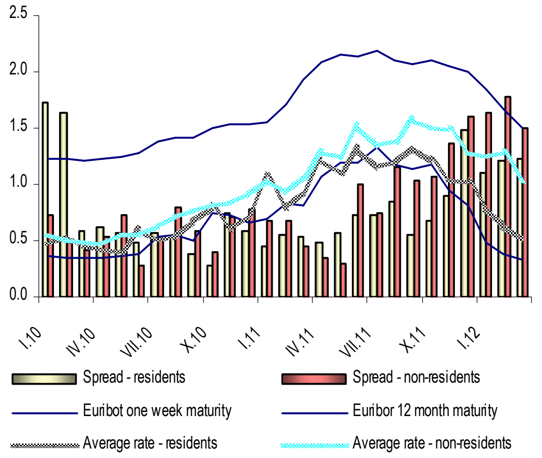
After the volume of interbank transactions declined at the end of 2011, owing to the ECB's three-year LTRO, it rose again in the first two months of 2012 largely as a result of asset-side transactions with non-resident banks. The number of banks behind this increase was smaller and the transactions were conducted within individual bank groups.

Chart 29 Selected items of interbank assets and liabilities



Source: NBS.
Data are in EUR billions.
The chart shows month-end amounts reported by banks in the individual categories.

Chart 30 Interest rates in the domestic interbank market



Source: NBS.
Average rate for non-residents – average interest rate on interbank deposits taken from non-resident banks.
Average rate for residents – average interest rate on interbank deposits taken from resident banks.
The interest rates were calculated on the basis of the stock of euro-denominated short-term (up to 1 year) loans and deposits reported as at the end of each month.
The rates were calculated as an average weighted by the volume of individual transactions.
Data on interest rates are in percentages.
The spreads were calculated as the difference in interest rates between the bank with the highest average rate and the bank with the lowest average rate.
In the case of non-residents, the spread calculations omitted rates for J&T, since their average has long been higher than the sectoral level.

As a result of the ECB's second auction of three-year LTROs, in which certain Slovak banks and branches of foreign banks in Slovakia took part, the amount of funding from the ECB increased further in March. The overall volume of ECB funding thus reached levels last observed in the second half of 2009 and first half of 2010, when banks took advantage of favourable ECB terms for 12-month borrowing. As with the auction of annual LTROs and the first three-year LTROs, however, the funds obtained did not translate into financing for the domestic economy in the form of loans to households and enterprises. On the whole, the funds were used to settle interbank liabilities, transferred in intra-group transactions, re-deposited with the ECB, and, to a relatively small extent, used for buying securities.

The movement of implied interest rates in the domestic interbank market remains in line with the movement of EURIBOR rates. The higher level of interest rates and higher spread on transactions with non-resident banks reflects more their slightly longer maturity than a higher credit risk premium. The majority of these transactions continue to be intra-group transactions.

4. FINANCIAL POSITION OF THE BANKING SECTOR

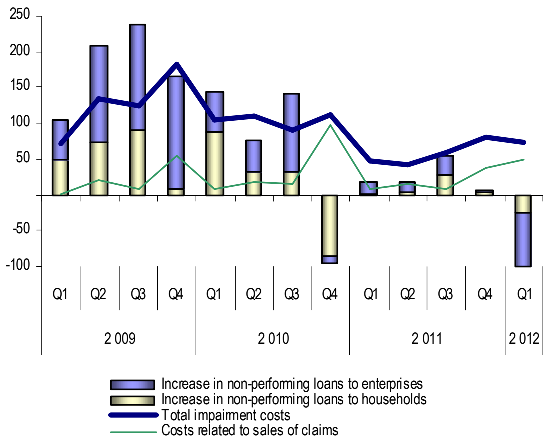
The year-on-year growth in the sector's total profit was lower in the first quarter of 2012 than in the previous quarter, although no significantly negative changes were recorded

The net profit for the first quarter of 2012 was €142 million, representing a year-on-year decline of 19%. If the new bank levy had not been in force, the drop in profit would have been substantially more moderate, at around 5%. A total of two banks and eight branches of foreign banks reported a loss, and the segment of large banks reported a decline in profit.

The main cause of the lower year-on-year profitability was rising credit risk costs and a decline in net non-interest income. On the other hand there was an increase in net interest income from the corporate sector.

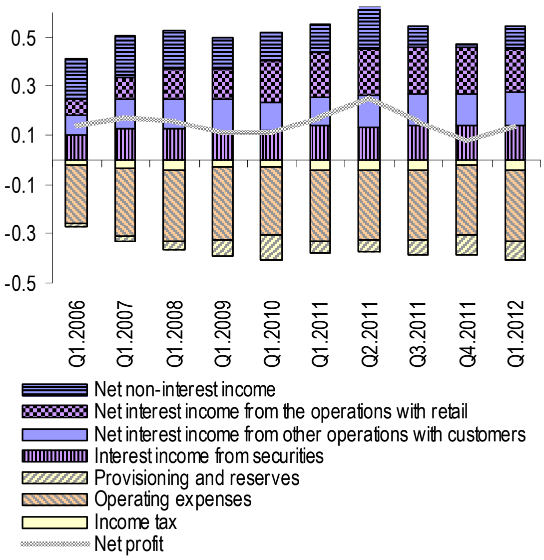
The fall in interest income from the household sector was mainly attributable to a change in the net interest margin in this sector, which has been steadily narrowing since the beginning of 2010 (it stood at 5.8% in the fourth quarter of 2009 and at just 4.9% in the first quarter of 2012). This in turn reflected mounting deposit costs and lower returns on loans. Furthermore, in the past two quarters the growth in household loans has been lower than the increase in household deposits, resulting in downward pressure on the total volume of net interest income from this sector.

Chart 31 Credit risk costs and the volume of NPLs in the banking sector



Source: NBS.
Data are in EUR millions.

Chart 32 Changes in the composition of the banking sector's profit



Source: NBS.
Data are in EUR billions.

The year-on-year increase in net interest income from enterprises stemmed largely from developments back in the fourth quarter of 2010, when a combination of continuing growth in returns on corporate loans and declining costs of corporate deposits widened the interest spread between the lending and deposit rates for enterprises, from 3.3% to 3.5%. The returns and costs of corporate loans and deposits remained stable in the first quarter of 2012, nor was there any significant change in the total net interest income from the corporate sector.

As the macroeconomic situation deteriorated again and the risk of a decline in economic activity in the euro area increased, the credit risk costs related to operations with customers remained at the elevated level in the first quarter of 2012 to which they had risen during the second half of 2011 and therefore recorded a further marked rise (of 56%) in year-on-year terms. Nevertheless, these costs were moderately lower in the first quarter than in the fourth quarter of 2011 and did not reach the levels observed in the 2009-2010 crisis period. Overall, credit risk costs in the first quarter stood at around 0.2% of the total amount of claims on customers, and up to 0.3% in all large banks.

The increase in the sector's capital adequacy ratio was mostly due to a positive revaluation of bonds available for sale and to preliminary decisions on the retention of a part of profit

The sector's capital adequacy ratio (CAR) increased over the first quarter of 2012, from 13.3% to 15.0%, with lowest ratio at 12.0%. The average core Tier 1 ratio was 13.9%, with the lowest ratio at 9.9%. Therefore all banks were compliant with the *Recommendation on maintaining the stability of the Slovak banking sector* issued by the Financial Market Supervision Unit of Národná banka Slovenska on 16 January 2012, which advised banks to maintain a core Tier 1 capital ratio of least 9%.

The rise in the CAR was largely attributable to own funds, which increased (by 9.3%) as certain banks retained as equity a proportion of their profit from previous years. The equity of the Slovak banking sector was further boosted by a net increase in revaluation gains, which resulted from a further rise in bond prices and amounted to 3% of own funds. A lesser factor in the CAR increase was that own funds requirements were reduced (by 2.2%).