NATIONAL BANK OF SLOVAKIA

RESTRUCTING OF THE BANKING SEKTOR OF SLOVAKIA

(Prepare for the OECD Seminar "Restructing of the Banking Sector in Trasition Countries" held at The Vienna Institute for Comparative Economic Studies)

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Table of contents

1. Overview of Sector Developments, 1990-1996

1.1 Summary overview

First steps in building the new banking system in Slovakia were made under the former CSFR, during 1990-1992. As of December 31, 1989, Government finance was separated from the State bank and the Czecho-Slovak State Bank (SBCS) was established as the central bank of the Czecho-Slovakia, with all standard functions of a central bank. Within the financial reform from 1990, the two-tier banking system was created and commercial banks emerged.

A dynamic expansion of the banking sector in Slovakia occured after the establishment of the National Bank of Slovakia (Act of the National Council of the SR No.566/1992 Zb.) and the split of the former common State, as of January 1, 1993. While on January 1, 1993, there were 23 commercial banks in Slovakia, 33 banks were granted licence, as of June 30, 1996.

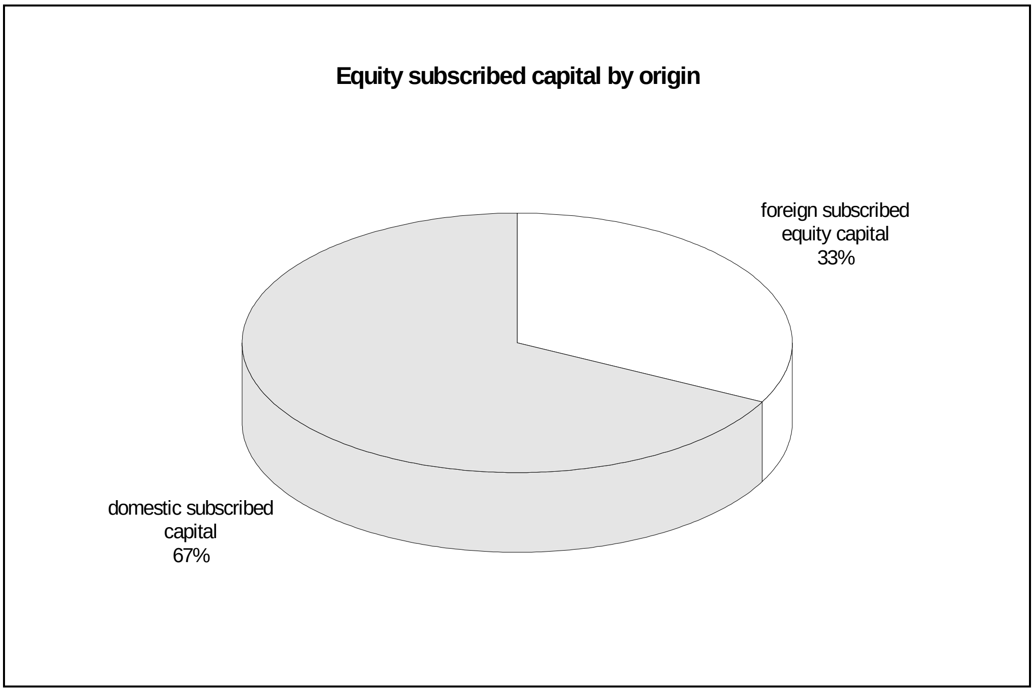
From the total number of the banks operating at present days in Slovakia, there are 24 domestic institutions and 9 branches of foreign banks. Apart of this, 12 representative offices of foreign banks are operating in Slovakia.

Prevailing legal form of the Slovak commercial banks are joint stock companies (22 banks). Two banks are public financial institutions, which fulfill special banking functions: the first one is the *Slovak Guarantee Bank* (*Slovenská záruèná banka*) and the second one is the *Consolidation Bank* (*Konsolidaèná banka Bratislava*) , which activities are concentrated primarily on servicing the pre-transformation credits and loans, and loan facilities for specific transformation purposes.

Of the total number of domestic banks (24), twenty banks have been granted a universal banking licence, and four are holders of specialized banking licence for specific activities (building savings banks, gaurantee and consolidation banks).

Sixteen commercial banks are licenced to conduct foreign exchange activities. The other banks have a limited licence in this field, according to requirements and conditions for trading in foreign exchange.

Chart 1.1 Equity subscribed capital by origin



The first data concerning amounts of equity capital of commercial banks were officially published as of 1 April 1993. The subscribed equity capital of commercial banks amounted from 9.7 bill. SKK (as of 1 April 1993) to 20.2 bill. SKK (as of 31 December 1995).

The participation of foreign investors in the Slovak banking sector represented 10.6 % of the total volume of subscribed equity capital, as of 31 December1993, and amounted to 32.7 %, as of 31 December 1995.

1.2 Creation of the two-tier banking system

1.2.1 Mono-bank system

Until 1989, the Czecho-Slovak banking system existed in a form that only marginally resembled current two-tier system. So called mono-banking system consisted of the banks as follows:

- ***The State Bank of the Czecho-Slovakia*** [***SBCS***] that fulfilled the function of the central bank of the State within the system of centrally planed economy, the function of the largest commercial bank that administered vast majority of financial resources and was the main creditor, as well as the function of organiser of the whole payment system in the country;

- ***The Czech State Savings Bank*** in Prague and the ***Slovak State Saving Bank*** in Bratislava that administered almost all saving deposits of individuals (the deposits were fully guaranteed by the State) and were the main suppliers of loans for individuals (in particular, special advantageous loans to newly weds and for housing construction projects and the purchase of household equipments);

- ***The Czecho-Slovak Commercial Bank [ÈSOB]*** that secured operations and transactions denominated in foreign currencies between domestic trading companies and foreign subjects and represented the State in international financial markets;

- ***The Entrepreneurial (Merchant) Bank [Živnostenská banka]*** that secured foreign exchange transactions for individuals.

1.2.2 Towards the two-tier banking system

Since January 1, 1990, within the framework of preparation of the transformation of the economy, the banking system experienced substantial movements. The State Bank of the Czecho-Slovakia was transformed in two parts: the SBCS seated in Prague as the central bank of the State that retained the functions of the issuing bank and, by separating the commercial functions of the former SBCS, three commercial banks were created, as follows:

1. ***Commercial Bank Prague*** *[Komerèní banka Praha]* that had assumed one part of deposits and credits, in particular those of entities with the seat in the Czech Republic. It assumed the respective technical equipment, premises and personnel from the SBCS.

2. ***General Credit Bank*** *[Všeobecná úverová banka]* that, in the Slovak Republic, did the same as the Komerèní banka in the Czech Republic.

3. ***Investment Bank*** *[Investièní banka Praha]* that assumed a part of long term credits, in particular those that were given to enterprises to finance large investment and housing projects in Czecho-Slovakia. On January 1, 1992, the Slovak organisation units had been disconnected on the grounds of which the ***Investment and Development Bank*** *[Investièná a rozvojová banka Bratislava]* was established.

The enactment of two laws, The Act on Banks (No. 21/1991) and The Act on the State Bank of the Czecho-Slovakia (No.22/1991) respectively, brought about more radical changes in the banking system [the powers of central bank, position against the government, monetary instruments, role and position of commercial banks, the framework of their activities in the banking sector were set]. Furthermore, a partial privatisation of four main domestic banks started (on the basis of the Act No. 92/1991 Zb. on the transfer of State property to other persons, the banks were transformed in joint-stock companies). Foreign banks were allowed to begin their banking activities.

1.2.3 Overview of the transformation of the Slovak banking system

As of January 1, 1993, the Czecho-Slovak Federation dissolved and the SBCS ceased to exist. On the grounds of the Act on National Bank of Slovakia (Law No. 566/1992), the Slovak central bank was established.

The National Bank of Slovakia *(NBS)* has the character of the juridical person, it is seated in Bratislava and it is not registered in the Commercial Register. The NBS has the right to issue legally binding rules and regulations that are of the same juridical power as those of the ministries and other executive bodies of the State. The NBS determines the monetary policy and instruments for achieving the monetary policy targets. The NBS represents the Slovak Republic in the international financial institutions and carries out activities in convertible currency on behalf of the State in international financial markets. The NBS is an independent central bank the main priority of which is maintaining of the stability of the Slovak currency and keeping inflation under control. The second prior function of the NBS is to ensure a healthy development of the Slovak commercial banking sector.

Commercial banking: size, structure and composition of the industry

Property classification. The commercial banks active in Slovakia, according to the property classification of banking institutions, are as follows: public financial institutions (2 banks), banks without foreign participation (8 banks), banks with foreign capital participation (14 banks), branch offices of foreign banks (8 banks).

Table 1.1 Banking institutions in Slovakia

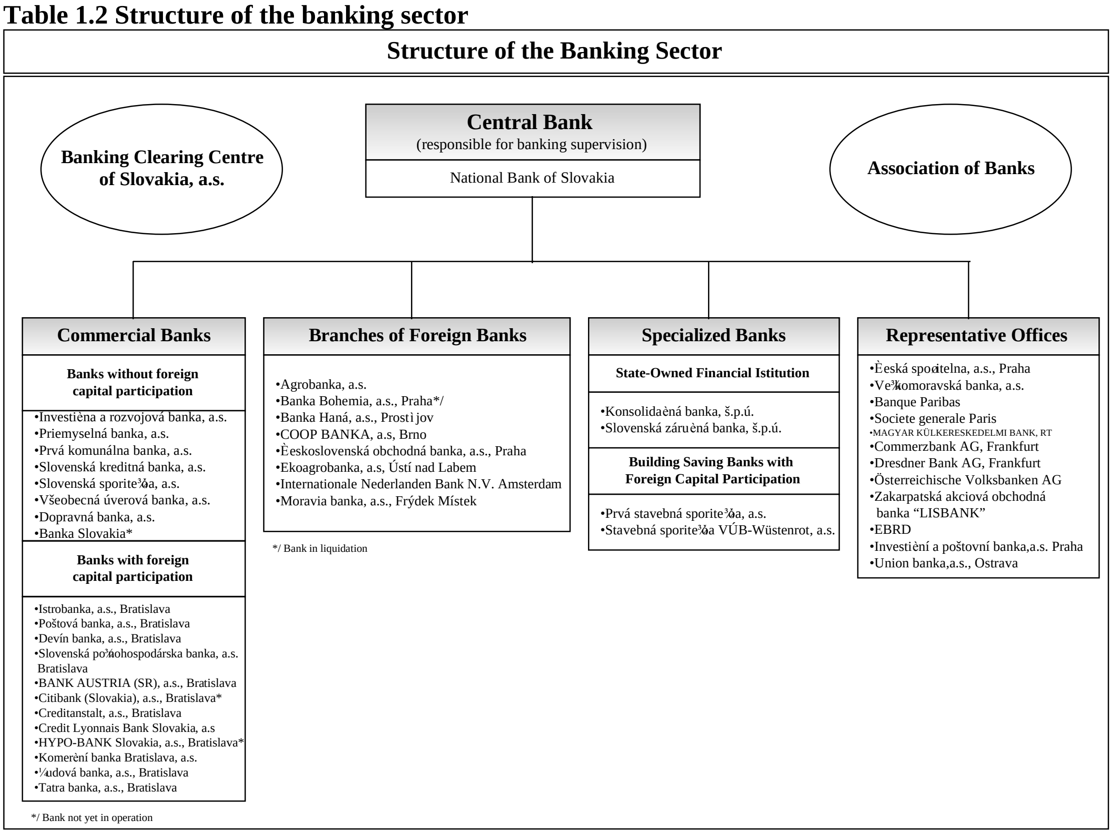
Type of institution	Number of banks and their organizational units

Public (state-owned) financial institutions	2 banking institutions 4 organizational units
Banks without foreign capital participation	6 banking institutions 1,032 organizational units
Banks with foreign capital participation	14 banking institutions 96 organizational units
Branches of foreign banks	8 banking institutions 38 organizational units

At 1 January 1996, there were 1,170 organizational units of banks registered in Slovakia, whereof 38 operated within the local branches of foreign banks. The character of their territorial distribution is influenced by the fact that the head offices of 16 banks are located in Bratislava, capital of the Slovak Republic.

Other institutions belonging to the banking sector. Apart from commercial banks there are the ***Banking Clearing Centre of Slovakia, a.s.,*** which is responsible for interbank payments and settlements and the operation of banking information systems, and the ***Association of Banks*** whose primary function is to deal with the current problems of the banking sector and to represent the members of the Association in relation to the bodies of State administration.

Table 1.2 Structure of the banking sector



Number of Employees in the Banking Sector. The total number of employees in the Slovak banking sector amounted to 21700, as of January 1, 1996, of which 20506 have been employed in the commercial banks and 1194 represented the staff of the National Bank of Slovakia. The number of bank employees per 1,000 inhabitants increased from 1.3 in 1990 to approximately 4.1 in 1995, including central bank employees.

Table 1.3 Employees in the banking sector

Type of bank	Total	of that in the SR	abroad
Banking sector in the SR - total	21,700	21,608	92
Central bank of the SR	1,194	1,194	-
Banks and branches of foreign banks - total	20,506	20,414	92
Commercial banks - total	19,135	19,043	92
Branches of foreign banks	1,371	1,371	-

Based on data at 1 January 1996

Banking education. Current institutional basis for banking education, of course, outside the state educational system, are the educational departments and centres belonging to individual banks and to the Institute of Banking Education of the National Bank of Slovakia. Course structure was focused on four basic types of educational events:

- preparation of new bank employees
- specialised preparation for selected banking activities and banking products
- preparation of middle and higher bank management
- language preparation

As far as participants' work experience in banking university graduates represent the share of 66% participants with 1-5 years of work experience, 24% less than 1 year and 10% more than 5 years. Comparable split is also in the group of high school graduates with more than 5 years work experience (18%). It is to be appreciated the assistance and co-operation with the American Agency for International Development, British Know-How Fund, important education institutions from Germany, as well as individual central and commercial banks all over the world etc. Special importance has the European Community programme PHARE.

1.3 Legal framework

In general, legal framework covering the functioning of the Slovak banking (or larger, financial) system was established under former CSFR, during 1990-1992. Especially in 1992, prevailing part of the basic legislation was approved: the National Bank of Slovakia Act (No. 566/1992 Zb.), Banking Act (No. 21/1992 Zb.), Building savings Act (No. 310/1992 Zb.), Act on Securities (No. 600/1992 Zb.), Act on Investment Funds and Investment Societies (No. 248/1992 Zb.), Stock Exchange Act (No. 214/1992 Zb.). In the years before, remaining important acts related to banking were approved, as the Foreign Exchange Act (No. 528/1990), Accounting Act (No.563/1991 Zb.).

However, since 1993, multiple amendments to individual acts were made reflecting the new constitutional set-up of the Slovak Republic as well as development of the financial environment in the country and, last but not least, systemic changes in foreign exchange relations with abroad. In such cases, new acts, including all the amendments assumed, were approved by the National Council of the SR. This concerns namely the new Foreign exchange Act (from 1995) and the Banking Act (from 1996). Apart from this, Act on Deposits Insurance was approved in 1996. In this section, the Banking Act will be discussed.

Act on Banks (No. 21/1992 Zb.) (Banking Act) with subsequent amendments (The full wording as published in Collection of Laws, No. 62/1996 Z.z.), effective on March 1, 1996.

For the purposes of this Act, banks are defined as legal entities permanently based in the Slovak Republic, established as joint stock companies or public (state-owned) financial institutions, which:a/ accept deposits and b/ offer loans, and perform activities specified in this Act on the basis of a licence to establish a bank and a licence to operate as a bank.

The due form of application, the minimum amount of equity capital -in the case of joint stock companies, the minimum amount of subscribed capital - (hereinafter called equity), which is a prerequisite for granting banking licence, shall be set forth by the National Bank of Slovakia (NBS) in a decree to be published in the Collection of Laws. At present the minimum amount of equity capital is 500,000 Sk. The decision to issue a licence to establish a bank shall be taken by the NBS in agreement with the Ministry of Finance of the Slovak Republic.

The decision to issue a licence shall be passed subsequent to assessment of:

- the origin, adequacy and composition of the bank's equity capital and other financial resources;
- the professional competence and civic integrity of the persons nominated to the bank's management;
- technical and organizational preconditions for performance of the bank's planned activities;
- feasibility study based on analysis of economic data;
- economic viability.

The decision to issue a licence to operate as a bank shall be taken by the NBS, subsequent to the assessment of the bank's readiness for performance of banking activities, upon agreement with the Ministry of Finance.

A foreign bank wishing to set up a branch office in the Slovak Republic is required to submit an application for a licence to establish a bank, to the NBS. The granting of a licence shall depend on assessment of:

- the amount of financial resources provided by a foreign bank to its branch office for an indefinite period of time;
- technical and organizational conditions for performance of the proposed activities;
- the professional competence and civic integrity of the persons nominated to the management of branch office;
- feasibility of business plan;
- economic viability.

Further chapters and articles of the this Act define requirements for banking operations, including some limits and prohibitions (for example, bank is not allowed to buy shares or acquire capital interests in legal entities which are not banks under this Act, exeeding 25% of the bank's capital and reserves; a bank may provide credit to persons having a special relationship to the bank, only if its statutory body decides to do so on the basis of an assessment of the banking transaction under consideration, and of the applicant's financial position); accounting and commercial documentation; remedial measures and penalties; conservatorship; revocation of a licence to operate as a bank.

If serious shortcomings in the activities of a bank or a branch office of a foreign banks persist, the NBS may, after consultation with the Ministry of Finance, revoke the licence to operate as bank; this step need not to be preceded by the imposition of conservatorship. A licence may also be revoked :

- if the bank's equity capital is reduced, due to loss, by more than 50% in single year, or more than 10% a year during three successive years;
- if the bank has not taken deposits for more than 18 months;
- if licence was acquired on the basis false information given in licence application;
- if bank in question is a branch office of foreign bank which has lost to operate as a bank in its home country;
- if bank failed to meet the conditions for commencement of banking operations, within the period of time set forth in the licence.

One of the new part of the Banking Act is part eight ***Mortgage Banking*** in which the basic principles of mortgage business are defined: mortgage loans purpose and maturity, the activities connected wih mortgages; loan-to-value ratio; coverage principle - ordinary and substitute coverage; valutation of the real estate; mortgage register; the position a the role of trustee (controller). The regulations for keeping the register of mortgages and information shall be determined by the NBS and the Ministry of Finance in generally binding legal regulations. (The process in this area is ended.)

Issuing of mortgage and municipal bonds, including all relevant conditions are regulated by *Act on Bonds* (No. 530/1990 Zb.) with subsequent amendments.

A very important article (44a) of the Act is following: Slovak savings bank, joint stock company, and other banks which granted loans prior to 1st January 1990, or banks which took over receivables resulting from such loans, which have been classified as high-risk bank receivables, will undergo a process of loan portfolio restructuring with participation of the State; the rules of loan portfolio restructuring will be set by government decree.

Banks specified above shall devise a method for restructuring their credit portfolios and shall provide the required data to the Ministry of Finance and the NBS. The prescribed form of the project of portfolio restructuring, its range, structure, and deadlines shall be set forth by the Ministry and the NBS in generally legal regulation.
Now the NBS is preparing a decree, the definitive version of which shall be finish in September 1996. In connection with the Banking Act, prudential behaviour rules will be innovated step by step.

1.4 Banking Services and Products

On may state that the Slovak banking sector has been formed on the basis of a strategy to create a regionally equable, however, economically effective net of commercial banks that, gradually, would be able to provide all services and products required by the clients. Prevailingly, commercial banks have been established on the principles of universal banks.

Slovak commercial banks provide basic banking services, i.e. the receipt of customer's deposits, granting of loans and advances, and other services. On the Slovak banking market, within the framework of deposit operations, various types of deposits are accepted (demand deposits, savings deposits, time deposits, certificates of deposits, bank obligations) from various depositors (corporate customers, households, central and local governments, other banks, etc.) as well as various kinds of borrowings from other banks. On the basis of concentrated resources, banks conduct business activities mainly by granting loans and making investments.

However, various banking institutions have different approaches to the provision of banking services. Differences arise mainly within the range and the quality of banking services provided. New offers of services are made by the banking sector mainly in this field. Among others, offers of services depend largely on the level of automation and computerisation within the banking sector.

On the Slovak financial market, banking institutions render financial services in both Slovak crowns and foreign currencies. First of all, they effect interbank payments and settlements. These are the largest operations carried out by banks, which involve practically all corporate entities. The opening of bank accounts, conditions of their administration and termination are governed by the Commercial Code (No. 513/1991 Zb.). At present, payment cards are in still in the process of development; presently they are used only in ATMs, and at filling stations in exceptional cases. The number of domestic payment cards increases, while the number of international cards is relatively low. With an increase in the number of such cards, the number and volume of transactions concluded through ATMs will also increase. The precondition for a widespread use of payment cards is the development of telecommunications and computer networks. Apart from this, the banks provide safe deposit services and foreign exchange operations - they keep accounts for customers, make international payments, conduct foreign exchange transactions, make loans to abroad, and deal in foreign securities. Most banks operate in Slovakia on the basis of a full or limited foreign exchange licence.

Large banking institutions render various services in the field of investment banking - capital market operations, products and services in the field of financial and investment consulting, services in the field of market research and analysis.

Other services rendered by Slovak banks are: safety deposit services, factoring, forfeiting, and financial leasing.

1.5 Foreign capital participation

Within the low amounts of foreign direct investment inflow to Slovakia, the banking sector (including financial sector) shared by the highest portions in 1993-1994, in 1995 the share of banking sector slowed down to the third place (behind the industry and trade sectors).

As concerns the foreign capital participation on the subscribed banking capital in Slovakia, it developed rapidly as compared with the very low starting amounts. While the participation of foreign investors in the Slovak banking sector represented 13.6 % of the total banking equity in Slovakia, as of June 30, 1993, their share amounted to 32.7 %, as of March 31, 1995. Prevailing part of this increase occurred during 1995, while in 1994, the growth in equity capital as a whole was rather moderate.

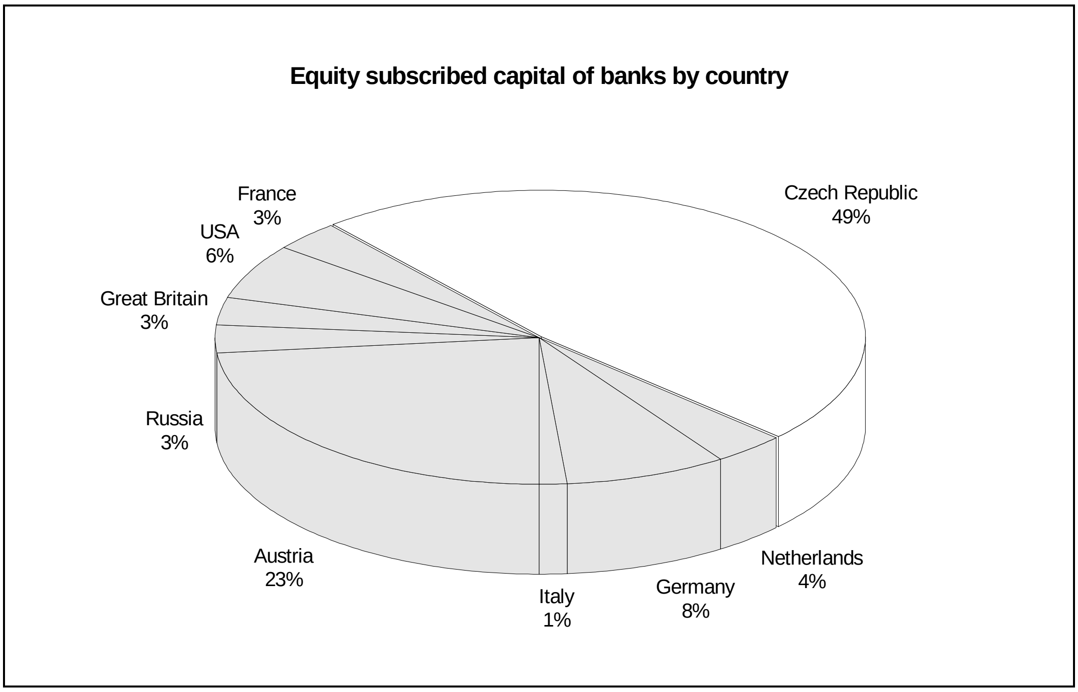
Table 1.4 Foreign capital investments

Country	Subscribed capital total in SKK million
Austria	1933.7
Czech Republic	3983.1
France	270.0
Russia	236.8
Great Britain	250.0
Germany	657.5
The Netherlands	305.8
Italy	113.8
USA	500.0

Foreign capital participation was reported in 13 domestic commercial banks, operating as of June 30, 1996. During first half of 1996, in accordance with the amended Banking Act, the NBS granted licence one bank with foreign capital participation to perform banking activities.

At the end of the first half of 1996, there were recorded 9 branches of foreign banks in the Slovak banking sector. Two branches of foreign banks were deprived licence to operate as a bank, in this period.

Chart 1.2



Banks with foreign capital participation are mainly of medium-sized entities, with equity capital between 0.3 billion SKK to 1 billion SKK. The equity participation ranges from 13.5 % to 100 %.

Foreign banking capital came primarily from Austria, in 1993-1994. As at the end of 1994 Austrian banking capital shared by 60.6 % on the total foreign banking investments in Slovakia, in 1995, the largest share (48 %) of foreign banking investments was of the Czech Republic origin, followed by Austria (24 %). To a smaller extent participations from Germany (8 %) , USA (6 %), The Netherlands (4 %), France, Great Britain, Russia (all 3 %) and Italy (1 %) on the total volume of foreign capital in the Slovak banking sector were recorded, at the end 1995.

Apart from the amounts invested, participation of the foreign capital in Slovak banks plays an important role in extending the required know-how in emerging specialized banking activities, such as are for example bulding savings or mortgage banking. With the Austrian and German capital participation were established the both Slovak building savings banks (Stavebná sporite¾òa VÚB-Wüstenrot, a.s., Bratislava , and Prvá stavebná sporite¾òa, a.s., Bratislava), and the licenced mortgage bank HYPO-BANK Slovakia, a.s., Bratislava, which would enter in operation in a near future, is fully controlled by the German capital.

The amounts and shares of foreign capital participation in the Slovak banking sector by the weight on the equity capital are given in following table.

Table 1.5 Foreign capital participation in the Slovak banking sector, as of January 1, 1996

	licence granted	**equity cap. subscribed (SKK mill.)**	**of which foreign in SKK mill.**	**in %**	**Origin**
Banks without important foreign capital participation (below 20 %)		***1600,00***			
Istrobanka,a.s.Bratislava	22.6.1992	1000,00	100,00	10,00	Austria
Poštová banka, a.s., Bratislava	15.12.1992	600,00	74,40	12,40	Austria
Banks with important foreign capital participation (20-50 %)		***2190,10***			
Devín banka, a.s., Bratislava	1.6.1992	640,0	236,80	37,00	Russia
Slovenská po¾nohospodárska banka, a.s., Bratislava	21.6.1990	1250,1	36,20 250,00	2,89 20,00	Czech R. G.Britain

Stavebná sporite¾òa VÚB-Wüstenrot, a.s., Bratislava	17.5.1993	300,0	90,00 60,00	30,00 20,00	Austria Germany
Banks with prevailing foreign capital participation (over 50 %)		***4065,7***			
BANK AUSTRIA (SR), a.s., Bratislava	21.4.1995	500,0	500,00	100,00	Austria
CITIBANK (SLOVAKIA), a.s., Bratislava	16.8.1995	500,0	500,00	100,00	USA
Creditanstalt, a.s., Bratislava	20.4.1994	515,5	500,00	100,00	Austria
Crédit Lyonnais Bank Slovakia, a.s.	22.2.1993	300,0	270,00	90,00	France
Komerèní banka Bratislava, a.s.	21.4.1995	500,0	500,00	100,00	Czech R.
¼udová banka, a.s., Bratislava	1.7.1991	448,0	304,20 113,20	67,90 25,40	Austria Italy
Prvá stavebná sporite¾òa, a.s., Bratislava	1.10.1992	300,0	97,50 97,50	32,50 32,50	Germany Austria
Tatra banka, a.s., Bratislava	1.10.1990	502,2	252,20	50,20	Austria
HYPO-BANK Slovakia, a.s., Bratislava	16.8.1995	500,0	500,00	100,00	Germany
Branches of foreign banks		***3752,80***	3752,80	100,00	

1.6 Impact of multilateral institutions

The Slovak banking sector has received important supports from multilateral institutions which impact has been manifested not only through the amounts of granted loans (both, for supporting the balance of payments in the first years of the transformation process, as well as for supporting the enterprise sector, including commercial banks). The second form of the offered multilateral assistance is technical assistance, which importance is growing with identifying the main issues of the banking sector development and crucial needs in managing and financing its restructuring.1

The main Slovakia´s relations with the international organizations, concerning their assistance in building and development of the Slovak banking sector are given in following overview.

World Bank (WB). The relative share of the Structural Adjustment Loan (SAL) granted by the WB to the former CSFR in order to offset short-term deficits of the balance of payments represented 150 mill. USD. The remaining third SAL tranche of USD 39.8 million was granted to Slovakia in 1993. In February 1994, the agreement on USD 80 million Economic Recovery Loan (ERL) to Slovakia was signed: USD 79.5 million was drawn by the end of the year, the remaining USD 0.5 million in January 1995. In 1995, negotiations for an Enterprise and Financial Adjustment Loan (EFSAL) for restructuring the enterprise and financial sector, were initiated. At present, neither the SAL nor the ERL are repaid. Principal repayments of SAL are scheduled within the period 1997-2006, the ERL will be repaid during 1999-2011. The interest rate on these loans are closely below 7 %, at present.

European Bank for Reconstruction and Development. The EBRD declared its interest in participation in the restructuring and privatization of banks provided the government has agreed its clear strategy. In the meantime the Bank will continue to support the development and institution building of private sector and possibly regional banks. The Bank also consider an equity investment in a major Slovak bank once privatized. The disbursement of credit lines is progressing well and under the co-financing facility increased utilization is expected.

1Last but not least, as an "invisible" source of the multilateral assistance may be concerned all experience in economic - including banking - diplomacy which gradually acquire Slovak banking and economic representations by the way of working in the integration process of Slovakia towards European and world economic and financial institutions.

OECD. Slovakia´s cooperation with the OECD began in 1993, with establishment of the Coordination Committee for cooperation with the OECD by the Slovak Ministry of Foreign Affairs in which the NBS is represented. Thereby, the interest in the offered cooperation within the program "Partners in the Process of Transformation" was declared. The Memorandum of Understanding between the OECD and the SR as a first step in the Slovakia´s interest in reaching the full OECD membership, was signed in December 1993. In February 1994, the SR applied for full membership in OECD. With regard to Slovakia´s integration into OECD, a matter of key importance for NBS is the application of the liberalization codes of OECD in the field of capital flow and current invisible transactions. The approved amendment to Banking Act (No. 21/1992 Zb., as amended in the full wording No. 62/1996 Z.z.) as well as the new Foreign Exchange Act (No. 202/1995, Z.z.) were elaborated in line with the OECD and EU requirements.

The European Union. Ratification of the Slovakia´s associated membership to the EU came into effect on February 1, 1995. The implementation of the Europe Agreement in the field of banking in line with the time schedule, i.e. during a period of roughly 10 years, forms the basis for creation of a legal and economic environment compatible with that of the EU. The material aspects of the process are specified in the "White Book - Preparation of Associated Countries in CEE for integration into the Internal Market of the EU", of which the National Bank of Slovakia is directly involved in regulations governing the free flow of capital (Chapter 1) and the internal market of financial services (Chapter 13). Groups of experts specially appointed for management of activities relating to individual chapters, were established. The NBS is represented in following groups: Free Flow of Capital, Financial Services, Protection of Personal Data, Accountancy, and Customs Union. Implementation of the White Book directives on banking and public finance is supported through the PHARE Program of technical assistance.

Program PHARE. The PHARE funds designed for the former CSFR were divided in the ratio 2:1. On January 4, 1993, an independent Project Management Unit (PMU) was established for the PHARE Program at the NBS. Since then, the PMU assumed responsibility for the coordination of PHARE assistance within the whole banking sector in Slovakia. Apart from supporting the development of both, the central and commercial banking, another aim of the assistance within the PHARE Program is approximation of the banking and finance legislation towards the EU legislation as a prerequisite of the future membership of Slovakia in the EU.

In 1993, the NBS obtained two foreign experts for long-term cooperation (special advisers to PMU and the Banking Supervision Department), and a number of experts specializing in solution of bad loans, training of bank employees, capital market operations, the activities of the Slovak Bank Association etc. For 1994, PMU prepared the Indicative Program which defined the priorities of the banking sector. The funds obtained for this program amounted to ECU 2 million.These funds may be drawn by July 31, 1998. In 1995, assistance was requested simultaneously by two financial resolutions, especially the financial resolution of 1993 and the remaining funds of GTAF 2, which were allocated to the PMU before 1995 and which were subject to special requirements. (Of the remaining funds, ECU 87,775 were granted to the FOREX dealers training program.)

Though the restructuring of the Slovak banking sector is still awaiting major decisions, the PHARE Program has allocated considerable amounts for projects of technical assistance, which will be available for banks as soon as the method of their restructuring has been approved. In May 1995, the NBS´s Foreign Department obtained a special advisor to PMU PHARE, who has prepared and coordinated technical assistance projects for Slovak commercial banks, and who also has prepared a so-called twinning program for the *General Credit Bank (VÚB*).

The most significant PHARE activity in 1995 was the implementation of a project for the *Investment and Development Bank, a.s.* A Consortium of AIB International Consultants of Ireland in a close cooperation with Gartside Miller Associates of Great Britain, and Grupo Espirito Santo of Portugal, worked on the project designed to strengthen the strategy and activity of this bank with the aim of ensuring its leading position among Slovak investment banks.

The PHARE Program also contributed to the training of banking professionals for the whole financial sector of the Slovak Republic. A large scale project in connection with the introduction of par-time banking study was funded in 1995. In accordance with results of a public tender, the implementation of the project will be coordinated by Instituto de Formacao Bancaria of Lisbon, a Portuguese-French-Austrian consortium.

In summary, as most important activities supported by the means of the PHARE Fund, following are to be mentioned:

- strengthening of the banking supervision;
- working of the team of experts, who elaborated an identification of loans and a proposal of a strategy for their improvement or off-writting (Mc Kinsey Report);
- assistance in restructuring and reorienting of the *Investment and Development Bank*.

Main tasks of the PHARE Program for 1995-1999 were set as follows:

- development of the legal system in the banking sector towards compatibility with the EU member states regulations;
- solving of the bad loans issue and release of funds for investments;
- technical assistance in maintaining the internal stability of the Slovak currency and supports for its transformation towards full convertibility;
- introduction of the par-time banking study;
- supporting of programs orientated on increasing the competitive environment in the Slovak banking sector.

2 National Bank of Slovakia: Development and Management of Monetary Policy

2.1 National Bank of Slovakia - overview

The National Bank of Slovakia (NBS), established by the Act of the National Council No. 566/1992 as the central bank of the Slovak Republic, commenced operating on January 1, 1993.

The major role of the NBS is to ensure the stability of the Slovak currency (Slovak crown, SKK). To meet this task, the following main activities fall under the Bank´s jurisdiction: monetary policy defining and main instruments of monetary regulation determining; issuance of banknotes and coins; money supply management; coordination of payments and settlement of accounts between commercial banks and ensuring efficiency of these operations; supervision on banking activities and prudential performance of the banking system. The Bank represents the SR in international monetary institutions and world financial markets, and coordinates the tasks arising from this representation.

The supreme bodies of the NBS are the Bank Board and the Directorate. The Bank Board is the highest management body of the NBS outlining Slovakia´s monetary policy and the instruments for its implementation, and making decisions on regulations to be imposed by the Bank in order to control the money supply and inflation. The members of the Bank Board are the Governor, two vice-governors and five other members.During the membership in the Bank Board, members cannot perform functions of a Parliament deputy nor a member of the Government. The executive body of the NBS is the Directorate, which is responsible for implementing the Bank Board decisions.

The NBS performs its main tasks independently of the Government. However, within the limits of the Act on the NBS, the Bank shall support the government economic policy. The Governor or an appointed Bank Board member shall inform the Government on approved decisions of Bank Board, and shall participate in meetings of the Government. The NBS shall serve advise the Government in the areas of monetary policy and banking. The NBS duty is to present half-year and annual reports on monetary development to the Parliament, and to publish information on quarterly monetary developments.

Jurisdiction in the NBS´s Foreign exchange management imposes to the NBS trading in gold and foreign exchange with domestic and foreign banks, establishment of conditions for regulation the balance of payments, and conditions for trading in gold and foreign exchange performed by banks and other persons, and issuance of securities denominated in foreign exchange.

The Bank enjoys legislative powers as well. It submits bills pertaining to currency and money supply to the Government, and, together with the Ministry of Finance, proposes bills pertaining to foreign exchange operations and banking.

A new Act on the NBS, which should further reinforce the NBS independence, is expected to be discussed in the Parliament in a near future.

2.2 Targets and intermediate targets of the monetary policy of the NBS

As expressed in the yearly monetary programs of the NBS, the monetary policy goal is ensuring the stability of the Slovak currency, in both, external and internal extent. The main monetary policy target is to control the rate of inflation, which is performed throughout two intermediate targets: maintaining of the fixed exchange rate of the Slovak crown (as a longer-term target) and the yearly growth of the money supply.

The intermediate target of the money supply growth is measured by broader monetary aggregate M2 (defined as a sum of narrow money M1 and the quasi-money, or as a sum of notes and coins in circulation, demand deposits, time deposits including deposit certificates and deposits by building societies, and foreign currency deposits).

The operational variable is the central bank money, or the monetary base, defined as a sum of bank reserves with the NBS and the cash-currency in public and commercial banks holdings. The monetary base is regulated by means of discount and Lombard rates, open market operations, and minimum reserve requirements.

2.3 Main instruments of the monetary policy

Development of operational details of the ***NBS interest rate policy instruments*** and the ***required minimum reserve ratios*** are summarized in the following tables.

Table 2.1 Discount rate of the NBS

January 1, 1993	December 20, 1993	March 17, 1995	October 6, 1995	January 13, 1996
9.5 %	12.0 %	11.0 %	9.75 %	8.8 %

Table 2.2 Lombard rate of the NBS

January 1, 1993	December 20, 1993	March 17, 1995	January 1, 1996	July 17, 1996
14.0 %	1 % over the last interest rate on auction refinancing loans	13.1 %	13 %	15 %

Table 2.3 Required minimum reserve ratios

	as of January 1, 1993	as of April 1, 1995	as of August 1, 1996
demand deposits	9 %	9 %	9 %
time deposits	3 %	3 %	9 %
building savings deposits	-	1 %	3 %
interest paid on RMR	-	-	1.5 %

Credit limits as a direct monetary policy instrument, temporarily were used in a following way:

Table 2.4 Credit limits

For the whole banking sector	March, 1993 - June, 1994
for banks with lending activities over 20 billion SKK (i.e. 5 Slovak banks)	July, 1994 - December, 1995

System of refinancing of the banking sector includes three forms:

- auction refinance loans (Dutch auction);
- Lombard loans;
- Bills of exchange rediscounted.

Bills of exchange rediscounting includes traditional commercial bills, exports and agriculture promoting bills of exchange (introduced in May 1993), and bills supporting privatization (used within the period of June 1993 up to the end 1994) .

Open market operations. The NBS trading with short term securities on the open market implies:

- REPO transactions (repurchase agreements)2**;**
- REPO tenders3 (auction form of the REPOs);
- secondary purchases and sales (direct purchases and sales);
- issues of the NBS-bills4.

The current REPO rates are announced by the NBS through the REUTERS system.

2.4 Exchange rate and foreign exchange policy

The exchange rate policy of the NBS is operating in a fixed exchange rate regime which is defined towards a currency basket. However, due to unfavorable development of the foreign exchange reserves of the NBS resulting from the overall deepening of the macro-economic disequilibrium in Slovakia after the split of the former CSFR, the NBS devaluated the Slovak crown by 10 %, as of July 10, 1993.

The currency basket of the Slovak crown, originally, was formed by 5 currencies (USD, DEM, ATS, CHF, FRF)5. As of July 14, 1994, the redefinition of the currency basket was made. Analyses of the currency structure of the foreign trade turnover of the Slovak Republic showed stable shares of both, the leading currencies DEM and USD and the currencies closely related to the DEM. Therefore, the currency basket was simplified to a two-currency basket, formed by DEM and USD as follows:

Table 2.5 Currency basket redefined, as of July 14, 1994

Currency	USD	DEM
Weight	40 %	60 %
SKK exchange rate	31.209	20.227

Simultaneously, the fixed exchange rate of the SKK was defined within a fluctuation band of +/- 1.5 % to the cross-exchange rate of DEM/USD. In order to harm a speculative foreign capital inflows and, more generally, to enlarge the NBS´s operational space for maintaining the fixed exchange rate of the Slovak currency after the liberalization of the current account, the fluctuation band was widened to +/- 3% (as of January 1, 1996), and further, to +/-5 % (as of July 17, 1996).

The flow of the foreign exchange between the NBS and Slovak banking sector is operating throughout the FX- fixing of the NBS. Trading on the NBS FX-fixing is realized in USD and DEM. Because of a drop in foreign exchange reserves of the NBS, the foreign exchange policy with respect to commercial banks was marked by a restriction of access to the NBS FX-fixing, in 1993. Apart, a "Directive" was enacted to define the procedure to be applied by commercial banks when making payments to foreign exchange non-residents (Decree of the NBS No.6, 30/93). The procedure was designed to restrict advance payments and to stabilize the foreign exchange reserves of both, commercial banks and the

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2***Conditions for REPO agreements.*** Minimum time for a REPO operation is one day. The agreement is closed for a definite time up to the end of a civil year. The whole time of the REPO since the moment of the security booking had not to exceed the maturity time of the security lowered by 2 working days. The interest on REPO is calculated on the basis of ACT/360.

3 REPO tender may be realized by the way of American auction, Dutch auction, auction with a fixed interest rate and otherwise (not specified).
4 The NBS-bills were introduced in 1995 for sterilization purposes, due to growing liquidity of the banking sector in conditions of a relatively favourable Government budget performance.

5The following were the weights of the currencies in the basket, as of July 10, 1993:

Currency	USD	DEM	ATS	CHF	FRF
Weight	49,06 %	36,16 %	8,07 %	3,79 %	3,79 %
SKK exchange rate	33.062	19.255	2.741	21.637	5.669

NBS. In December 1993, the "Directive" was cancelled, and new measures facilitating the banks´ access to the NBS´FX-fixing were adopted.

Foreign exchange policy towards the population. In order to avoid inadequate foreign exchange outflows, purchases of foreign exchange by the population were regulated to the amount of 9000 SKK up to 1994. In 1995, this limit increased to 16 000 SKK and since July 1, 1995 to 30 000 SKK (1000 USD) respectively. The regulation persists in 1996, the allowed amount increased to 60 000 SKK.

(The New) Foreign Exchange Act *(No. 202/1995 Z.z.)*. With regard to favorable development of the main monetary indicators and a dynamic growth of the foreign exchange reserves of the NBS during 1995-1996, a new foreign exchange act was passed, as of October 1, 1995. The contents of the Act is deregulation of the current account in the extent given by definition of the IMF Agreements´ Article VIII on the current account convertibility6.

However, in deciding on the acceptable extent of the current account liberalization, persisting weaknesses of the system environment in Slovakia provided the continued transformation process had been taken into account. Therefore, in the foreign exchange regime some securing levers have been kept, in order to protect the currency stability (Article 39, State of Emergency in the Foreign Exchange Economy).

Liberalization of the current account enables to residents and non-residents to perform transactions on the current account, and the Act licences circulation of the Slovak currency abroad.7

The Act deals only with those foreign exchange relations, which will be temporarily regulated or those ones that impose requirements. Direct regulation in the form of foreign exchange permission remains in trading in foreign securities and opening of accounts abroad. The hitherto regime of surrender requirement remains for legal persons, while for natural persons it was canceled. As limited remain also purchases and sales of foreign exchange in cash as well as its imports and exports. Acquisition of domestic real estates by non-residents is allowed only in cases mentioned by the Act, while as compared with the past, acquisition of real estates is allowed also for non-residents, who are citizens of the Slovak republic. The act includes also a reporting requirement, with which will be used as a means of information for balance of payments purposes.

On the capital account restrictions have been remained, which impose limitations on direct investment of residents abroad, with exception of direct investments to the European Union member states and to the states which have with the SR agreements on mutual support and protection of investments. Limitations are imposed also on operations with foreign securities and financial derivatives as well as credit withdrawing from abroad, with exception of credits that form part of foreign direct investments.

The whole philosophy of the Act is, to ensure a sufficiently large space for continuing of the liberalization process without the need of passing a new act on foreign exchange. This is supposed only as a final step, when the full convertibility of the Slovak currency will be reached.

Finally, as concerns the exchange rate policy, it is to be mentioned that passing from internal convertibility of the Slovak currency to the external one (in a limited extent of the current account liberalization), as of October 1, 1995, unification of the exchange rate in accordance with conditions of the Article VIII of the IMF Agreements was realized. This meant for Slovakia (as well as for the Czech Republic) elimination of inter-Republics advantageous payment conditions related with functioning of a mutual Payments agreement, since February 8, 1993 (after the split of the Czecho-Slovak Monetary union). The Agreement allowed to both Republics special exchange rate operations on their clearing account which could appreciate or depreciate the exchange rate of the both currencies towards the so called "clearing ECU" in the range of +/- 5 %. With adoption of a new Foreign exchange act (as of

6 Accordingly to the Article VIII, as a part of the process of preparing conditions for the current account liberalization was termination (to the date of passing the new foreign exchange Act) of the Payments agreement with the Czech Republic which included a clearing regime in mutual current transactions.
7 The international acceptability of the Slovak crown may be expected in a regional extent.

October 1, 1995), which has liberalized the current account of the balance of payments, the Payments agreement was dissolved.

2.5 Changes in using of the monetary policy instruments under changing monetary environment in Slovakia

The strategy of the NBS has been to decrease continuously the importance of direct instruments (namely credit limits) and to increase the use of indirect instruments with preferred orientation on growing role of the open market operations. However, the importance of individual instruments developed in a close relation with the monetary development in Slovakia, which recorded some substantial changes, since 1993.

The monetary environment in 1993 was quit instable, hardly marked by the establishment of a national independence of the country and emerging Slovak financial market in the year, when firstly the single Government Budget Act of the Slovak Republic was introduced.8 Due to the lack of liquidity in the banking sector, refinancing from the NBS by the way of auction refinance credits and rediscount credits reached relatively high amounts. Within the monetary policy instruments an important role played in this year credit limits (introduced in March 1993). The limits were set for the whole banking sector and in this form they were used up to the 1-st half of 1994. Minimum required reserves (3% rate on time deposits, 9 % rate on demand deposits) developed in 1993 unevenly, in this sense the effectiveness of this instrument was in this year not very convincing. With regard to forming a new monetary environment, changes of the discount rate were not been used in 1993 up to December 20, when the original rate of 9,5 per cent was increased to 12 per cent, in order to influence the public expectations on a disinflationnary monetary policy of the NBS. The development of open market operations, since repurchase agreements were introduced, was in this year rather slow.

During 1994-1995 the monetary development stabilized and obtained some durable features, which enabled more systematic selection in using the monetary policy instruments. In 1994, the importance of the credit limits lowered, in the sense that as of the 2-nd half of the year their general use has been abolished and limited only towards the banks with credit activities exceeding 20 bill. SKK. In such form credit limits were used up to the end of 1995. Since January 1, 1996, no credit limits for the banking sector are set.

More operative monetary policy management throughout changes in the indirect instrument parameters has been applied since 1995. In order to support economic growth, the discount rate was lowered by 1 percentage point (to 11 percent, as of March 17), and since the disinflation process continued all over the year, the second lowering of the discount rate to the level of 9,75 per cent occurred on October, 6, followed by further lowering to 8,8 per cent on January 13, 1996.

Due to stopping with the practice of auction refinance loans, there occurred redefinition of the Lombard rate towards a fixed rate at the level of 13,1 % (as of March 17, 1995), which changed to 13 % (from January 1, 1996). Within the packet of measures undertaken by the NBS on July 1996 which have been targeted on limitation of enormously growing credit activities of the banking sector, the Lombard rate was set at a two point higher level of 15 %, since July 17, 1996.

Several changes were made in ratios of minimum required reserves as well, in order to withdrawing the excessive liquidity of the banking sector. Apart from setting the RMR on building saving deposits with the 1 per cent ratio (from April 1, 1995), more important step represents unification of the former 3 per cent and 9 per cent ratios on time and demand deposits respectively, at the single higher 9 per cent level, as of August 1, 1996. The RMR on building saving deposits were increased to 3 %. Besides, the interest on the RMR paid by the NBS was introduced at the level of 1,5 per cent.

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8 In the years 1990-1992 there were three Government budgets in the former Czech and Slovak Federative republic - the Czech, the Slovak and the Federal one. Throughout the Federal budget was accomplished redistribution of resources between the both Republics. Balances from the Federal budget deficits were to be repaid by the successor States.

2.6 Some comments on the NBS monetary targeting

The fact, that the NBS adopted such a two-targets orientation which in theory are excluding each other (fixed exchange rate of the currency and growth of money stock *M2*), relates to the starting conditions of the regime of internal convertibility of the Slovak currency, which put substantially lower requirements on the foreign exchange reserves and interventions of the NBS.

Relatively high protected Slovak monetary environment has been preserved also in conditions of a liberalized current account of the balance of payments (since October 1,1995). Possibility for the monetary targeting has been further supported, in some extent, by widening of the exchange rate fluctuation band of the Slovak crown in 1996.

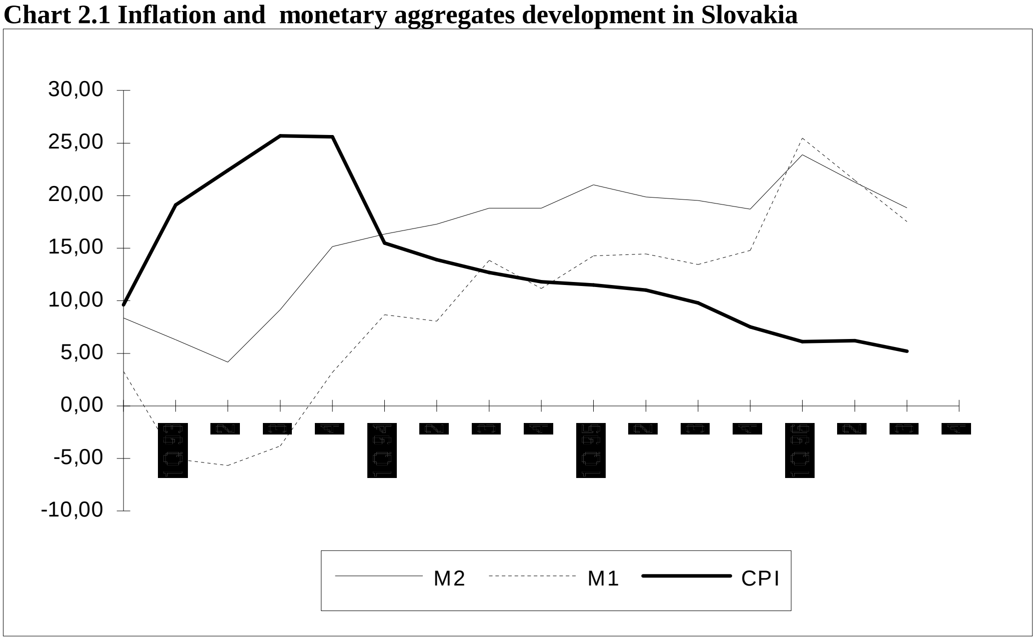
Table 2.6 Monetary targets of the NBS

	Monetary program		Actual values	
	M2	inflation (CPI)*	M2	inflation(CPI)*
1993	12 %	17,0	18,3 %	25,1
1994	13,2 %	10,0 - 13,2	18,9 %	11,7
1995	12,3 %	8,0	21,2 %	7,6
1996	11,6 % (+/-0,6%)**	6,0 -7,5	21,5 %***	6,2****

* Yearly indexes Dec./Dec.; ** Revisited value as of June 1996 (the original one was of 13,2 %); ***Yearly growth June 1996 / June 1995; **** June 1996/ June 1995.

Nevertheless, even in this period, a dynamic inflow of foreign exchange resources supported by favorable foreign trade development has continuously resulted in an excessive growth of liquidity in the Slovak banking sector, which put pressure on the growth of the money stock. In spite of enormous sterilization activities of the NBS and regardless of other interdependencies (expected and actual growth of *GDP*, level of stability of the money velocity), the money stock growth target was exceeded each year (see Table 2.6 and Chart 2.1).

Chart 2.1 Inflation and monetary aggregates development in Slovakia



An almost twofold growth in the *M2* aggregate against the targeted level for 1995 raises doubts as to the reasonability of announcing such a monetary policy intermediate target. If judging reasonable to maintain the practice of targeting the money stock growth, or, if to use it only as a supportive indicator of the monetary development, for both cases mentioned, it is necessary to improve its credibility by narrowing discrepancies between the targeted and actual values. Besides the fluctuation range widening, there might be useful the implementation of corridors for the money stock growth (as e.g., in the case of the German Bundesbank). The redefiniton of the M2 growth for 1996 in the value of 11,6 % (+/-0,6%) may be considered as a first step towards such a corridor targeting.

On the other hand, when taking into consideration the "twinning intermediate targets", eventually even in this period, due to the fixed exchange rate regime, the foreign exchange policy requirements in a safe level of the foreign exchange reserves of the NBS have been, implicitly, the leading criterion in valuing the importance of fulfilment the external and/or internal intermediate target. And the fact that the final disinflationary goal of the monetary policy of the NBS has been maintained all over the period of time without any serious relation between the growth of M2 and the development of inflation, confirms the crutial function of the fixed exchange rate as a nominal anchor.

From this point of view, one may state that the monetary policy management has been satisfactory succesfull, since the 1993 devaluation, and the foreign exchange reserves of the NBS have grown gradually: while at the end of 1993 the NBS´ FX-reserves exceeded moderately the starting January level and reached an amount which represented the value of 0,7-month Slovak average import of goods and services, the 1995 end-year level of the NBS´s FX-reserves covered 4-month average imports. However, growing import requirements in the FX-resources has reflection in a lower FX-reserves/import covering ratio, which fell down to 3.7 monthly average imports, in June 1996.

It is obvious that the main issue of the NBS monetary targeting is to be found in actual possibilities of the NBS to control the money supply. That means, first, the NBS ability to control the development of the resource (assets) side of the monetary base and/or the effectiveness of regulations undertaken towards the use of the monetary base, i.e. of the central bank money (bank reserves with the NBS and currency issued). Findings were made that the NBS possibility of controlling directly the monetary base resources has been in practice neglecting.[9] Second, there is a prerequisite of a stabile (or predictable) value of the money multiplier between the monetary base and the targeted broader aggregate M2, in the case of the NBS. The stability of the money multiplier has been found rather doubtful, as well.

To get clearer picture of the intervention space of the NBS used to regulate monetary base, the NBS has divided the monitoring of resources of monetary base into *autonomous factors* and *monetary policy factors*. The structure of *autonomous factors* includes net foreign assets , net credit to government, credit provided to the economy and other net assets. The *monetary policy factors* include credits to banks, and government securities.

The development of monetary base was influenced by resources that belong to the *autonomous factors* group, over the period. This trend has been strengthened since March 1994, when the share of *autonomous factors* in the resources of monetary base moved to a level of around 90% and it has grown to almost 100%, since the last quarter of 1995. This means that the NBS has not got any space for discreet interventions toward the monetary base.

The basic factor for the above development has been the rapid growth of net foreign assets, which has been reflected in the excessive liquidity of the banking sector. As consequence, the banking sector has become independent of the NBS reserve money. Additionally, the banking sector has been able and

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9 See for example: KOMÍNKOVÁ, Z.: Regulation of the Money Stock and Issues of Monetary Targeting in the Slovak Republic. Biatec, 4,1996, No.8, pp. 29-36.

willing to keep in its portfolio safe government securities, which, even could not absorb the excessive liquidity. As a result, the NBS has been put into a defensive position of a sterilization policy, which in 1995 resulted in permanent issuing of its own bills (NBS-bills).

The second consequence of losing effective control over the banking sector was an expansion of lending activities against the private sector.

2.7 Monetary policy performance in the light of bank lending to personal and enterprise sectors development

Increase in the bank lending to the enterprise and personal sectors was relatively low in 1993-1994, due to tight regulation of the credit activities of the whole banking sector within the credit limits imposed by the NBS in March 1993, which were used up to the first half of 1994. Thereafter, for the whole banking sector has been set credit space for lending activities, while credit limits were set only towards the banks with credit activities exceeding 20 bill. SKK (that means 5 biggest Slovak banks). Loans from foreign sources (EBRD, EIB, EXIM Bank of Japan, PHARE, National Agency for Supporting the Small- and Medium-Sized Businesses) were excluded from the limits in these banks. Functioning of the credit limit regulations was quit satisfying during 1993-1994, monthly fulfillments reached percentage values a bid-below the limit level (with exception of 3 monthly moderate overfulfillments).

Another development occurred in 1995, when the growth in bank lending accelerated and the overall credit activities toward enterprise and personal sectors exceeded regularly the level of the credit space by 0.2 % - 7.2 % (July and December, respectively), since March. The recorded overfulfillment of the given credit space was significantly influenced by growing lending activities in banks not subject to credit limits. High increase occurred primarily in crown loans, however, a considerable part of which comprised interests on non-performing loans. Simultaneously, considerable increase in the latter, or in standard receivables with reservations and classified receivables, was caused in a large extent due to the reclassification of loans in accordance with the NBS Decree No.3/1995 stipulating regulations for the valuation of receivables and off-balance sheet liabilities of banks according to risk incurred and for the creation of resources designed to cover the same.

The leading tendency within the enterprise and personal sectors lending may be characterized as a continuos decrease in the personal lending share and a growing share of enterprise lending in the total amounts of banks lending. General overview is shown in the table below. The rising share of enterprise sector loans in the crown enterprise and personal loans developed from 92.7 % in 1993, and 93.5 % in 1994, to 94.6% in 1995. Apart, credits in foreign currency have grown with the highest dynamics, however, their share in the total leading has remained relatively low.

Table 2.7 Enterprise and personal sectors crown-lendings : yearly percentage changes

	1993	1994	1995	1996, May
enterprise sector	+ 10.3	+1.3	+ 13.6	+ 7.6
personal sector	- 6.1	-9.8	-6.7	- 2.0

After the advantageous (due to very low lending rates10) loans to newly weds together with loans for housing construction projects and the purchase of household equipments were cancelled, the drop in credit to household sector occurred, resulting in decrease in the personal sector indebtedness vis-a-vis the banking system. Another reason of a continued decrease in personal credits has been persisting high level of interest rates on new loans.

Concerning the enterprise sector, a significant factor affecting unfavorably the development of crown credits has been a high volume of loans provided in the past with a very risky return as well as new high

10 The previous loans of this sort that by character have been long-term loans are still reflected in a low level of average lending rates on long-term loans to households, which move around 3 %, while the average rate on total concerned loans has moved around 10-12 %.

risky loans extended mostly to the private sector. The percentage share of doubtful, risky, and bad loans as well as temporarily non-liquid loans on the total volume of crown loans changed over the 1993-1996 (May) period in the following way:

Table 2.8 Non-performing loans development

	1993	1994	1995	1996, May
Non-performing loans (all categories), % in total crown loans	21.8	13.9	53.19*	39.57

* The extraordinary increase of the value between 1994 and 1995 is due to the reclassification of loans in accordance with the NBS Decree No. 3/1995 on rules of receivables and adjusting entries analysis by risk involved and creation of resources to cover such risks.

Another negative feature of the lending development in Slovakia was prevailing share of short-term loans, while the shares of medium and long-term loans dropped, in 1993 and 1994. In 1995, the dynamics in shares of short-term loans and the one hand and of medium and long-term loans on the other hand moderately changed: short-term loans decreased from 38.1 % in January to 37.6 % in December, while the share of medium and long-term loans increased from 61.9 % to 62.4 %.

Credits in foreign currency have been extended exclusively to legal entities. Their share in the total volume of enterprise and personal sectors credits increased from 1.5 % to 3 %, during 1993. In 1994, their shares reached 5.4 % and 7.4 % in 1995. In June 1996 the share increased to 10.2 %.

2.8 Issues and mid-term strategies

Taking into account rapid economic growth in 1995 and a continuous anti-inflationary trend in the Slovak economy, the NBS did not implement measures targeted at the reduction of the growth in the money stock. However, monetary development in 1995 can be considered as a warning signal, which brings about doubts as to the applicability of the money stock growth targeting in the future monetary policy of the NBS. Preservation of this approach is justified by a necessity to maintain its control functions. But, given the imperfect predictability of the Slovak monetary and economic development, implementation of a corridor form for setting monetary targets would allow for higher credibility space for meeting targets.

Nevertheless, the practice of the money stock targeting in the future may be disturbed with maintaining the fixed exchange rate regime of the Slovak crown. The fixed regime of exchange rate in conditions of a full convertibility of the national currency (i.e. of fully liberalized current and capital accounts of the balance of payments) will impose on the NBS obligations to intervene in the case of monetary disequilibrium (depreciation or appreciation of currency) on foreign exchange markets. In such conditions, maintenance of external stability of the currency will become the primary monetary policy target. On the other hand, this approach implies that achievement of the internal goal of monetary stability, defined, e.g., as the growth of a selected monetary aggregate, becomes residual, being limited by the intervention obligations of a central bank in the area of exchange rate policy.

From a systemic point of view, liberalization of the current account does not represent a step, which would result in dramatic changes of the foreign exchange flows between the Slovak Republic and abroad. After all, in the near future the inflow of foreign exchange resources created by the Slovak foreign trade sector will be reduced (or, as a result of a growing negative trade balance it may result in an outflow). Obviously, the pressure on the money stock will come from the development on the capital account, as the NBS anticipates from the expected inflow of foreign investment.

With respect to the expected development on the capital and financial account, the fact is to be considered that these two accounts are not yet liberalized in Slovakia. However, this has not got a clear, exclusively positive impact on the applicability of the money stock targeting. An asymmetric time schedule for the liberalization of these two accounts, which counts on a faster release of capital flows to Slovakia rather than from Slovakia, may represent an additional item hindering the applicability of the money stock regulation. From this point of view a symmetric time schedule of the liberalization would be more reasonable, although, on the other hand, it is more risky for maintaining the fixed exchange rate regime of the currency.

A further broadening of the fluctuation range for the exchange rate and the implementation of corridors for the money stock growth appears to be a certain satisfactory compromise for maintaining both intermediate targets, the fixed exchange rate of the Slovak crown and the money stock targeting, in the future monetary policy of the NBS.

Another way comes into consideration. It could be maybe useful to change the targeted monetary variable and to replace the intermediate target of the money growth M2 by direct inflation targeting. Apart, more flexible politics towards regulation of the amounts of ***reserve money of the NBS*** (use of the monetary base) would be perhaps more effective, regarding present conditions on the Slovak money market. The enormous credit activities of the banks since 1995, and on the other hand, costly sterilization policy of the NBS, called for implementing of such measures, as the NBS introduced in mid-July 1996: increasing in the ratio of required minimum reserves (or the unification of the former two ratios at the higher level of 9 %, respectively) and of the Lombard rate.

The expected effect of the RMR increase has been calculated in the amount of SKK 12 billion drawn by the NBS on the banks. However, in present days, the result of the measure in a whole is hardly to estimate, due to its relating impact on the banks as well as Government behaviors in the field of interest rate policy. While the immediate reaction of the banking sector was increase in the interbank interest rates11, increase in the lending interest rates which could slow down the credit activity dynamics is to be expected later, obviously, with further uncertain impact on the capital inflow dynamics. Moreover, the Government will also be under pressure to increase the interest rate on the issued Treasury-bills. Another question arises - what will be the impact of the interest rates increase on the inflation rate development.

With respect to probable impact of the increase in interest rates on the foreign capital inflow to Slovakia, as well as taking into account the unfavorable development of the current account since the beginning of the year, enlarging of the fluctuation band of the Slovak currency towards the money basket to +/-5 % introduced simultaneously with the above measure, should serve as an important instrument of ensuring the external stability of the currency.

3 Banking Regulation and Supervision

3.1 Legal framework for prudential regulations of banking activities

In Slovakia, the banking supervision is institutionally merged within the National Bank of Slovakia. The Banking Supervision Division consists of three departments: the On-Site Supervision and the Off-Site Supervision Departments and the Licensing Department.

Duties of the NBS in the field of banking supervision, subject, performance as well as sanctions in case of violation of conditions established by the banking supervision, are given in Part Nine (Section 36) of the Act on the National Bank of Slovakia. By the Law, the banking supervision consists of : (a) assessment of applications for granting a banking licence pursuant to statute of the Banking Act; (b) supervision of compliance with conditions established in the granted licences; (c) supervision of compliance with regulations issued by the NBS; (d) imposition of measures to correct or sanction non-compliance with the NBS Act and other relevant legislations. Penalties imposed by the NBS in the case of violation of established conditions shall constitute revenue of the State Budget of the SR.

11 In a July/June 1996 comparison, apart from 1-day deposit average interest rate, which decreased continuously and reached 11,47 % at the end of July (with a maximum of 13,31 % in the middle of the month), all inter bank average interest rates increased by around 1,5 percentage-points: average interest rate on 1-month deposits increased by 1,47 percentage points (to 13,43 %); on 3-month deposits by 1,57 percentage points (to 13,40 %); and on 6-month deposits by 1,87 percentage points (to 13,33 %).

Legal framework for prudential regulations of the banking sector activities is formed by:

- The Act on Banks, No. 21/1991, amendments (in effect of 1 March 1996);
- Provisions No.1 - 5/1994 of the NBS;
- Provision No. 3/1995 "On rules of evaluating banks′ claims and off-balance sheet liabilities according to the risk contained therein and of reserving funds in order to provide against those risks".
- Act on Protection of Bank Deposits, No. 118/1996 Z.z.

The Banking Act is presented in Chapter 1. The rest of the above will be discussed in this section.

3.1.1 Licensing requirements

Provision of National Bank of Slovakia (No.1/1994) establishing the prerequisites of the application for granting a licence to operate as a bank, as well as establishing the minimum amount of initial capital, being the condition for granting licence, and the requirements of the application form a licence to operate as a bank to a branch of a foreign bank as well as establishing the minimum amount of provided capital, being the condition for granting a licence.

The minimum amount of initial capital, in case of joint stock companies the amount of subscribed initial capital (hereinafter "initial capital"), representing the condition for being granted a licence for operating as a bank is 500 000 000 Sk (from 1 January 1994).

The application for a licence to operate as a bank must contain the following:

a) banks draft articles of incorporation;
b) information on the founders of the bank ;
c) the intended bank activities;
d) commercial plan of the bank for the first three years of its activities (1.the balance sheet; 2.the profit and loss account[12]);
e) intentions of the bank as to the development of the various banking activities indicating how these shall be reflected in the bank′s balance sheet and the profit and loss account;
f) information on the structure and organisation of the bank;
g) information on top management;
h) internal control guidelines, the position and duties of the internal control unit;
i) the decision-making process for extension of credits;
j) the decision-making process for forex operations.

The application of the foreign bank that intends to establish its branch on the territory of the SR for granting of a licence to operate as a bank must contain:

a) the decision of the statutory body of the bank to establish a branch in the SR and to provide the branch of the bank with the capital and other financial funds to secure its activities;
b) the approval of the authority responsible for banking supervision in the state the bank is seated in with the establishment of the bank′s branch in the SR, if in the respective state such a consent is required;
c) information on the founder;
d) the reasons that lead the bank to establish a branch in the SR;
e) the list of activities;
f) the commercial plan of the branch for the first three years of its activities;

12Minimum scope of information when publishing accounting records

g) the intentions of the bank as the development of the various banking activities indicating how these shall be reflected in the balance sheet and the profit and loss account;
h) the structure of the branch, the activities of individual departments and the number of employees, a detailed description of the relationship between the branch and the bank′s head office from the viewpoint of competencies and responsibilities in decision-making on banking transactions and their execution;
i) information on top management;
j) internal control guidelines applied within the framework of the bank and towards the branch of the bank;
k) the decision-making process for the extension of credits;
l) the decision-making process for forex operations.

Types of licences. A banking licence is granted for an indefinite period of time. The performance of certain banking activities may be excluded or restricted in the licence. There are two types of forex licences: a) a full forex licence; b)a partial licence, with types of operations explicitly stated.

3.1.2 Capital adequacy

The NBS passed *Provision No. 2/1994* to determine the capital-to-risk weighted asset ratio. This ratio is defined as capital adequacy. The limit of capital adequacy was set up at the international standard of 8 %. With respect to difficulties of the banking sector transformation, application of the limit for the whole banking sector shall enter into effect since January 1, 1997. During the period before, reaching of the 8 % limit will be regulated gradually with respect to the date of the individual banks establishment: banks established before December 31, 1992, the so-called banks undergoing transformation were excluded of the limit and special limits year by year were set for this group of the banks under transformation. For all other banks the limit represents 8 %. Limits set for the transforming banks for respective years are shown in Table 3.1.

Table 3.1 Capital adequacy limits for the transforming banks

From January 1 of a Year	Limit
1992	6.25 %
1993	6.25 %
1994	6.75 %
1995	7.25 %
1996	7.25 %
1997	8.00 %

3.1.3 Large credit exposure

The NBS passed *Provision No. 3/1994* in order to limit the magnitude of losses that could occur to a bank as a result of failure on the part of one or several debtors to meet their commitments. The amount of credit extended to a single debtor (and to 10 largest debtors) and/or economically associated group of debtors, does not exceed a predetermined percentage of its capital and reserves. Basically, the net credit risk exposure towards a client or economically linked group of clients had not to exceed 15% of the bank′s capital by the end of 1995. Until then, it can amount to 40% of a bank′s capital.

3.1.4 Liquidity ratio

The NBS passed *Provision No. 4/1994* to ensure a bank′s liquidity. In order to satisfy fully bank′s obligations to pay, a minimum level of liquid assets in relation to the bank′s assets or liabilities has to be kept. This obligation may also be met by depositing a predetermined portion of resources with the NBS.

3.1.5 Open foreign exchange position

The NBS passed *Provision No. 5/1994* following the legal requirement to restrict the open forex position. By this Provision the overnight overall forex position is limited to 25% of the bank′s capital.

3.1.6 Provision No. 3/1995 of NBS on rules of evaluating bank's claims and off-balance sheet liabilities according to the risk contained therein and of reserving funds in order to provide against those risks

The purpose of this provision is to set uniform rules of correct reporting and evaluating of banks' claims and off-balance sheet liabilities that would consider the risks of loss contained therein. The risk of unpayment (credit risk), contained in claims, is identified by analysing the client and the claim according to two main criteria:

• Results of a financial analysis of the client and assessment of his economic situation or moral standing. Financial analysis and assessment of client's economic situation is to be understood the calculation of various ratios as e.g. immediate and current liquidity, cash-flow determining and assessing, balance-sheet and profit and loss account analysis, client's capacity to repay his commercial obligations and liabilities towards other banks, assessment of client's position on the relevant market etc.
• Client's delays in repaying his obligation against the bank.

Claims are classified according to the significance of the risk contained therein into five categories.

***Standard claims** - have all the following characteristics:*
• the client is solvent, his economic situation and solvency do not provide any reason to assume that in the future the repayment of principal, interest and fees would be jeopardised
• delays in payments do not exceed 30 days
• the bank has granted to the client, regarding his requirements, the right type of loan
• the client has utilised the loan for the purpose that was agreed in the contract

***Special mention claims** - have at least one of following characteristics:*
• the client is in economic and financial difficulties which do not justify to assume that he would not be able to overcome them and that they would jeopardise the loan repayment
• delays in payment exceed 30 but not more than 90 days
• the client has failed to present to the bank the required financial statements and information within at least 30 but not more than 90 days
• the bank has granted to the client a wrong type of credit {if bank finances client's long-term activities by short-term loans}
• the client has utilised the credit for other purpose than was agreed in the loan contract

***Substandard claims** - have at least one of the following characteristics:*
• the borower's economic evolution is significantly negative and he is in financial and economic difficulties based on which it can be expected that in the near future he would become insolvent
• delays in payment exceed 90 but less than 180 days
• the borrower has failed to present the requested information within more than 90 but less than 180 days

***Doubtful and litigious claims** - have at least one of following characteristics:*
• the borrower is insolvent
• delays in payment exceed 180 but not 360 days

• the borrower has failed to present the required information within more than 180 days but less 360 days

***Loss claims** - have at least one of the following characteristics:*
• the client has not repaid his liabilities towards the bank for more than 360 days
• the client has failed to present to the bank the required information within more than 360 days
• the client is in bankruptcy or liquidation {regardless the amount of estimated loss)

In compliance with the rules of prudential banking the bank reserves funds for providing against contingent losses that could result from risks contained in claims or from off-balance sheet liabilities. These funds have a form of provisions or reserves, in exceptional cases the form of specific reserve funds in the minimal amount of: 5% of nominal value for special mention claims, 20% of the nominal value for substandard claims, 50% of nominal value for doubtful and litigious claims, 100% of nominal value for loss claims. When calculating the amount of necessary provision or reserve in order to cover the risks contained in the appropriate claim or balance sheet liability, the value of the collateral to claim or off-balance sheet liability in question is taken into account. The procedure is to deduct the value of the collateral from the nominal value of the claim or off-balance sheet liability. The difference is multiplied by a coefficient according to the category into which the claim or off-balance sheet liability was assigned and the result represents the amount of the needed provision or reserve.

3.1.7 Act on Protection of Bank Deposits (No. 118/1996, Z.z.)

The function of a deposit protection scheme is to pay compensation to depositors when a bank becomes incapable of repaying deposits due to its financial situation. Funds for covering an intervention are created with participation of all banks operating on the financial market. The scheme is based on the principle of mutual solidarity and common responsibility in the case of collapse of any one of banks.

The objective of the Act is to extend the protection of deposits scheme to all banks, including branch offices of foreign banks, without recourse to State guarantees, as well as to more precisely define the degree of existing protection and the necessary degree of protection.

A Deposit Protection Fund is to be established, for the accumulation and management of financial contributions from banks and branch offices of foreign banks for compensation for the banks deposits held on behalf of members of public. The Fund is an independent legal body. It is registered in the Corporate Register. The deposits under this Act are any type of fund deposited by a physical person in a bank and which represent an obligation of the bank towards the depositor to repay these the deposit with any interest accrued. Publicly non-tradable securities issued by the bank are also considered deposits. The act does not cover deposits of legal persons used for business activities.

Anonymous deposits are also unprotected. In order to ensure continuity with the period before enactment of the Act, whereby the state guarantees anonymous deposits in certain banks, the Act gives depositors time to transfer their anonymous deposits to non-anonymous deposits. During this period, deposits in anonymous account opened before the coming into effect of Act, will also be protected.

All banks in Slovakia accepting deposits from physical persons are obliged to participate in the deposit protection scheme. Branch offices of foreign banks are obliged to do so, only if their deposits are not insured or protected in the country where the bank has its head office, or are protected to a level that is lower than stipulated in the Act.

Article 5 defines the contributions banks are obliged to pay into the Fund: an initial contribution, an annual contribution and an extraordinary contribution. The initial contribution is a one-off contribution (is set at 1,000 000 Sk). Annual contributions are regular annual payments by participating banks to achieve the principal objective of Fund: payment of compensation for inaccessible deposits. The Fund sets the annual contribution in the range from 0.1% to 0.3% of the aggregate amount of deposits at a bank in the preceding quarter, and is to apply to all banks. The annual contribution of housing construction savings banks is 50 percent of the annual contribution set for other banks. The one-off entry contribution of the National Bank of Slovakia is 100,000,000 Sk. *By way of illustration:* with the level of savings deposits on December 31, 1995, the annual contribution to the Fund would be 148.1 million Sk at 0.1%, 296.2 million Sk at 0.2%, and 444.3 million Sk at 0.3%. The amount of an extraordinary contribution shall not exceed the amount of annual contribution.

If the NBS declares a bank unable to refund deposits, depositors are entitled to compensation from the Fund equivalent to thirty (sixty in the case of building savings deposits) average monthly salaries in the Slovak Republic for the previous calendar year, which currently amounts to approximately 200,000 Sk. Official data from the Statistical Office of the SR is to be used for the calculation. The compensation shall be calculated for each client of the bank irrespective of how many inaccessible deposits the client may have in the bank. The clients deposits are to be totalled, including deposit-share in joint accounts, and the compensation paid out in one pre-determined sum.

The money necessary for the Fund to carry out its functions is made up of contributions to the Fund, income from investments in state bonds, income in connection with completed bankruptcy proceedings. Should the Fund lack the necessary reserve, the Fund may borrow from the NBS or from other banks. Approval by the NBS is required in the case of a loan from foreign bank. The reserve of the Fund shall be deposited in a special account at the NBS. The NBS is authorized to supervise Fund activities with regard to compliance with provisions of the Act.

With regard to the restructuring of the banks named in the Act (Slovenská sporite¾òa, a.s., Všeobecná úverová banka, a.s., Investièná a rozvojová banka,a.s.) the State shall guarantee deposits in those banks, including anonymous deposits, in their full amount for 18 months from date the Act becomes law. During that period, depositors may transfer their anonymous deposits to named deposits. If they fail to do so, they shall cease to bear the full responsibility for their anonymous deposits, which shall cease to be protected after three years. The Act also introduces the obligation of aforementioned banks to transfer anonymous deposits to named deposits at the request of depositor, at his/her expense within a period of one year. Terms for depositors under which the anonymous deposit was originally established shall remain in force.

During the restructuring period of banks, however, for three years at most, the composition of the Funds' Board and its Supervisory Board may vary. The intention is to provide for equal representation of Ministry of Finance and the NBS in those bodies. The finance minister shall have the right to appoint and dismiss representatives of the Ministry from among the Ministry´s staff, and the Governor of the NBS from among the staff of bank. On the recommendation of the banks, the NBS Governor appoints and dismisses representatives of banks on the Fund's Board and Supervisory Board. The Act proposes the amendments of Income Tax Act, Act on banks, Act on the NBS, the Bankruptcy and Settlement Act.

3.2. Effectiveness of the banking supervision

Since January 31, 1994, the evaluation of results of the prudent conduct of commercial banks is based on new rules of conduct, which entered into effect to this date by the NBS´s Provision No.2/1994. Compared with the regulations used by the former SBSC, these are stricter and include monitoring of the activities of foreign bank branches and focus on revitalization of the banking sector.

3.2.1 Capital adequacy

Except the banks undergoing transformation (which are under special regulations, as mentioned in Section 3.1.2), the limit of capital adequacy was set up at the international standard of 8 %.

The development of the capital adequacy ratio was very different in the individual banks, during 1993-1994. It varied from 6.92 % to 160.62 %. In 1995, it obtained a less volatile figures, and presentation of the average capital adequacy ratio for banks operating in the SR (excluding branches of foreign banks) obtained reasonable sense: it was 7.9 %, for 1995. The 8 % ratio was achieved by all commercial banks with the exception of one bank undergoing transformation and one state financial institution, which credit portfolios are to be restructured with the participation of the State.

In the first half of 1996, achieving of the capital adequacy limits worsened, in the group of the banks undergoing transformation. Due to a high level of risk assets, these institutions are under-capitalized, or they require improvements of the credit portfolio in such an extent, which would not call for the capital shortening due to the uncovered potential losses from insufficient coverage of the value of the classified receivables.

The present 1996´s trend in the capital adequacy of banks (excluding the transforming banks), which capital adequacy was higher than 8 % in the previous period, has been decreasing, as a result of the process of enlarging the business activity of the new established banks.

3.2.2 Large credit exposure

a) Net credit exposure to non-banks clients. The international limit of credit exposure to non-bank clients is set to 25 % of the bank´s equity. By the NBS Decree No. 3/1994, this limit entered into effect from January 1, 1996. During 1993-1995, the limit for banks in Slovakia, in the case of one debtor or a group of debtors, was set at the level of 40 %. While in 1933, two banks exceeded the limit, in 1995, this limit was exceeded by 8 bank, and a similar development was recorded in the first half of 1996. The number of borrowers who exceeded limit did not recorded substantial changes, as well. As positive might be valued the shift of customers classified as high risk credit exposure to a lower category.

b) Net credit exposure to bank clients. Net credit exposure to bank clients may not exceed 80 % of the bank´s equity. In 1993, the limit was exceeded by 5 banks, the number of cases increased to 12 banks, in 1994. In 1995, seven banks exceeded the limit, and there were four banks, as of June 30, 1996.

c) Aggregate net credit exposure. The aggregated amount of net credit exposure of one bank was set at a level of 800 % of the capital adequacy reserve. While in 1995 the limit was not exceeded by any bank, five banks exceeded the 800 % limit of the aggregate level of the all net credit exposures, as of June 30, 1996.

3.2.3 Liquidity

The liquidity of the banks is analyzed with regard to the calculation of cumulative net balance position within respective due dates, as stated in NBS Decree No. 4/1994. The liquidity situation developed dynamically, over the period 1993-1995. In 1993-1994, it was complicated by the insufficient inflow of funds back to banks (credit payments), due to the clients´ failure to meet their loan repayment schedules. The analyses of liquidity had shown that namely the share of high liquid assets on the total assets of the banks was extraordinary low (in average 12.1 %, in 1994).

A serious issue of the liquidity management of the Slovak banking sector during 1993-1994 was insufficient and inadequate classification of bank receivables. Moreover, their amount was not balanced with the level of the credit risk exposure. In order to set a realistic classification of bank assets, the NBS approved the *Provision on rules of evaluating bank's claims and off-balance sheet liabilities according to the risk contained therein and of reserving funds in order to provide against those risks* which entered into effect in 1995.

In 1995, banks had not serious liquidity problems. They maintained the required level of liquidity, fulfilled the required minimum reserves, without any need to draw a stand-by loan from the NBS. During the first half of 1996, the situation in high liquid resources of the Slovak banks and of branches of foreign banks has implied a sufficient liquidity of the banking sector.

However, the issue of insufficient inflow of funds from the clients back to the banks persists, with respect to the situation in the classified receivables resulting from unsatisfied keeping of the loan repayment schedules.

3.2.4 Monetary positions

Considering the possible risk of losses due to the floating exchange and interest rates, NBS sold a limited amount of foreign exchange to the commercial banks via foreign exchange fixing set by special regulation of the NBS. Under this regulation (*Provision No. 5/1995*), sales are possible only in case of short position of the bank, when the coefficient of foreign exchange position has attained a value 1.05 (FX-assets/liabilities).

Monetary positions of the banking sector was reviewed only in banks which were granted the foreign exchange licences, in 1994. The regulation of certain currencies position, as well as the overall currency and crown position, is set by limits included in the NBS Decree No. 5/1995. On the basis of the reports on the daily currency position, one may state that banks observe the set limits and only exceeded the limits (USD, DEM) in a few cases and for short periods of time, during 1994-1995. Subsequently banks adopted measures to remedy these differences within time limits agreed with the banking supervision authority.

In connection with the liberalization of the Foreign Exchange Act and the subsequent transition to a standard method of payments and settlements with the Czech Republic, the Banking Supervision Division of the NBS modified the limit for the individual overnight monetary position of the Czech crown, from 2% to 10 % of the bank´s capital as defined by the NBS´s Provision on capital adequacy.

Due to uncovered expected losses, lowering of the capital level for the capital adequacy calculation (to 25 %, as of January 1, 1996) affected in certain banks also the valuation of the monetary position limits. The NBS initiated discussions with the representations of concerned banks and adequate corrective measure was agreed.

4 Restructuring of the Banking Sector

4.1 Dynamics of the banking activities

General overview of the assets, liabilities and structure of the profit and loss accounts of banks developments is given in following tables. Balance-sheet items and ratios, including selected financial ratios of banks in Slovakia are shown in Annexes I-III.

Table 4.1 Assets (in SKK million)

	Domestic Banks						**Branch Offices of Foreign Banks**					
	12/1993	**%**	**6/1994**	**%**	**12/1994**	**%**	**12/1993**	**%**	**6/1994**	**%**	**12/1994**	**%**
Total Assets	403291		413327		456.313		42154		39219		49.016	
1. Loans	237387	58.9	227994	55.2	223.866	49.1	22936	54.4	25058	63.9	28.209	57.6
2. Interbank Assets	100827	25.0	106712	25.8	115.337	25.3	7966	18.9	7058	18.0	7.036	14.4
3. Securities	27949	6.9	35819	8.7	53.412	11.7	779	1.8	546	1.4	4.561	9.3
- T-bills	7183	1.8	10127	2.5	23.105	5.1	499	1.2	231	0.6	2.919	6.0

Table 4.1 - continued

	Domestic Banks						Branch Offices of Foreign Banks					
	6/1995	**%**	**12/1995**	**%**	**6/1996**	**%**	**6/1995**	**%**	**12/1995**	**%**	**6/1996**	**%**
Total Assets	474832		536470		581183		54831		61463		62373	
1. Loans	237363	50.0	241638	45.0	260982	44.9	27958	51.0	32528	52.9	35510	56.9
2. Interbank Assets	110010	23.2	117601	21.9	110443	19.0	8032	14.6	11223	18.3	9934	15.9
3. Securities	66486	14.0	90459	16.9	101283	17.4	6732	12.3	6523	10.6	5115	8.2
- T-bills	24764	5.2	14800	2.8	15635	2.7	4335	7.9	30	0.1	130	0.2

Methodological remarks:

1. The balance sheet statement figures represent the whole banking system including the specialized banks. Since their proportion on the whole banking system as measured by total assets is equal only 8.2%, their inclusion does not distort the assets composition considerably. Moreover, the composition of their consolidated balance sheet resembles the one of the whole banking sector.

2. On the profit and loss account specialized banks are included until the end of 1994, as their proportion on total assets was even lower as it is nowadays. In order to take into account the fact that the extraordinary asset composition of the specialized banks influences the aggregated profitability of the whole banking system, specialized banks were excluded and, accordingly, all income and expenses figures have been adjusted with respect to this fact, since 1995.

3. General issues of a correct presentation of the banking activities are gradual changes in the methodology of the banking statistics, which reflect growing experience and needs of the individual departments of the NBS. Therefore, the structure of individual statements has changed year-by-year. For this reason, tables presenting the banking activities for 1993-1994 were adjusted to the present methodics.

Table 4.2 Liabilities (in SKK millions)

	Domestic Banks						Branch Offices of Foreign Banks					
	12/1993	**%**	**6/1994**	**%**	**12/1994**	**%**	**12/1993**	**%**	**6/1994**	**%**	**12/1994**	**%**
Total Liabilities	403291	100	413327	100	456313	100	42154	100	39219	100	49016	100
1. Interbank Liabilities	77648	19.3	77331	18.7	81725	17.9	12680	30.1	13682	34.9	16098	32.8
2. Deposits	213442	52.9	209212	50.6	245116	53.7	14818	35.2	13747	35.1	19135	39.0
3. Securities	1414	0.4	1759	0.4	2766	0.6	147	0. 3	210	0.5	1152	2.4
4. Central bank accounts	39403	9.8	43211	10.4	34702	7.6	1800	4. 3	558	1.4	64	0.1
5. Equity	43084	10.7	48635	11.8	54078	11.9	5638	13.4	7055	18.0	9206	18.8
Equity composition												
1. Common and Other Stock	12650	29.4	13607	28.0	16886	31.2	571	10.1	742	10.5	787	8.5
2. Reserves + Reserve Funds	28235	65.5	31645	65.1	34695	64.2	4959	88.0	5337	75.6	6870	74.6
3. Other Funds Created from Profit	0	0.0	0	0.0	0	0.0	0	0.0	0	0.0	0	0.0
4. Capital Funds	0	0.0	0	0.0	0	0.0	0	0.0	0	0.0	0	0.0
5. Retained Earnings	2199	5.1	3383	7.0	2497	4.6	108	1.9	976	13.8	1549	16.8

Table 4.2 - continued

	Domestic Banks						Branch Offices of Foreign Banks					
	6/1995	**%**	**12/1995**	**%**	**6/1996**	**%**	**6/1995**	**%**	**12/1995**	**%**	**6/1996**	**%**
Total Liabilities	474832	100	536470		581183		54831		61463		62373	
1. Interbank Liabilities	77897	16.4	89711	16.7	94446	16.3	18013	32.9	18738	30.5	21561	34.6
2. Deposits	249598	52.6	292365	54.5	300956	51.8	20381	37.2	26082	42.4	22357	35.8
3. Securities	3738	0.8	5278	1.0	10348	1.8	1677	3.1	4380	7.1	3797	6.1
4. Central bank accounts	32766	6.9	33441	6.2	33197	5.7	2	0.0	0	0.0	0	0.0
5. Equity	55183	11.6	59479	11.1	63225	10.9	9421	17.2	7417	12.1	8041	12.9
Equity Composition												
1. Common and Other Stock	17043	30.9	20231	34.0	21636	34.2	2761	29.3	3805	51.3	4905	61.0
2. Reserves + Reserve Funds	20677	37.5	21791	36.6	22519	35.6	5660	60.1	2592	34.9	2594	32.3
3. Other Funds Created from Profit	12565	22.8	12282	20.6	13289	21.0	21	0.2	25	0.3	22	0.3
4. Capital Funds	1512	2.7	1620	2.7	1645	2.6	0	0.0	0	0.0	0	0.0
5. Retained Earnings	3386	6.1	3555	6.0	4136	6.5	979	10.4	995	13.4	520	6.5

Table 4.3 Profit and Loss Accounts (in SKK million)

	Banks in SR (exluding specialized banks)											
	12/1993	**%**	**6/1994**	**%**	**12/1994**	**%**	**6/1995**	**%**	**12/1995**	**%**	**6/1996**	**%**
Income												
Interest Income	52427	72.6	24652	71.5	57653	72.2	27412	82.7	58307	64.3	30364	75.6
Fees and Commissions	2113	2.9	1302	3.8	1844	2.3	1191	3.6	2266	2.5	1475	3.7
Usage of Reserves and Provisions	615	0.9	197	0.6	1895	2.4	397	1.2	9236	10.2	3028	7.5
Other Income	17041	23.6	8337	24.2	18503	23.2	4157	12.5	20820	23.0	5295	13.2
Total	72196	100	34488	100	79895	100	33157	100	90629	100	40162	100
Expenses												
Interest Expenses	33380	47.5	16080	54.5	35772	46.7	17816	62.1	36860	42.7	21142	55.6
Operating Expenses	6051	8.6	3294	11.2	8402	11.0	4708	16.4	12144	14.1	6396	16.8
Reserves Creation and Gross Provisioning	13751	19.6	2956	10.0	12871	16.8	3547	12.4	18210	21.1	6520	17.2
Other Expenses	17085	24.3	7161	24.3	19514	25.5	2628	9.2	19227	22.1	3959	10.4
Total	70267	200	29491	200	76559	200	28699	100	86411	100	38017	100

Table 4.4 Balance Sheet (in SKK million)

	12/1994	%	6/1995	%	12/1995	%	6/1996	%
Total Assets	505.239		529.663		599042		643556	
Loans	260.738	51,6	276.458	52,2	285074	47,6	307130	47,7
Securities	57.998	11,5	73.186	13,8	97556	16,3	94492	14,7
Inter-bank Market Assets	122.373	24,2	118.043	22,3	128870	21,5	120376	18,7
Equity Capital	62.860	12,4	61523	11,6	67563	11,3	62769	9,8
Common Stock	19.335	3,8	19.904	3,8	24036	4,0	18179	2,8
Reserves and Reserve Funds	25.218	5,0	26.337	5,0	24383	4,1	23250	3,6
Other Funds Created From Profit	13.981	2,8	12.586	2,4	12298	2,1	13310	2,1
Capital Funds	640	0,1	1.512	0,3	1.629	0,3	800	0,1

Table 4.5 Loans and deposits composition (in SKK million)

	12/1994	%	6/1995	%	12/1995	%	6/1996	%
Loan composition								
- short-term	95920	36.8	108770	39.3	105776	37.1	117500	38.3
- medium term	46912	18.0	52644	19.0	57589	20.2	60743	19.8
- long-term	117906	45.2	115044	41.6	121709	42.7	128887	41.9
Deposit composition								
- short-term	178776	73.6	177033	71.2	225968	71.9	231813	69.2
- medium term	55714	22.9	56073	22.6	67598	21.6	72628	21.7
- long-term	8387	3.5	15431	6.2	20568	6.5	304441	9.1

Table 4.6 Earnings and expenses (in SKK million)

	As of 31.12.1995	**%**	**As of 30.6.1996**	**%**		**As of 31.12.1995**	**%**	**As of 30.6.1996**	**%**
Total income	90629		40162		**Total expenses**	86411		38017	
including					**including**				
Interest income	58307	64,3	30364	75,6	**Interest expenses**	36860	42,7	21142	55,6
Fees and commission	2266	2,5	1475	3,7	**Operating expenses**	12144	14,1	6396	16,8
Reserves usage	9236	10,2	3028	7,5	**Reserves creation**	18210	21,1	6520	17,2
Other income	20820	23,0	5295	13,2	**Other expenses**	19227	22,1	3959	10,4

The figures in tables implicate a couple of trends that can be summarized as follows:

- The development of assets composition between 1993 and 1995 was primarily influenced by banks' efforts to maintain some standard level of liquidity. A low starting amount of capital hand in hand with a higher general level of credit risk provided banks with an incentive to change the composition of risk weighted assets. Reckognizing the relatively stable proportion of inter-bank assets (24.4% as of Dec. 93 and 21.5% as of Dec. 95) we realize that the drop in proportion of loans (58.4% as Dec. 93 and 47.6% as Dec. 95) was compensated by a sharp rise of the proportion of securities held by banks (6.4% as of Dec. 93 and 16.3% as Dec. 95). The securities portfolio is dominated by government securities.

- Looking at the development of equity we realize that the proportion of common stock on equity has been growing. Again this growth is compensated by a decline of reserves and reserve funds. These funds are being transformed to provisions. The liquidity increase has been achieved mainly by changes in earning assets composition.

- When looking at the term structure of assets and liabilities we can note that the starting position was not favourable, as short term liabilities exceeded short term assets by SKK 77,881 mil. A gradual decline in this gap mainly caused by an increase in short-term loans and treasury bills on the assets side as well as in time deposits (of which the most important is the growth of deposits with longer maturity) on the liabilities side of the balance can be regarded as an positive fact. The result is that the difference now amounts only SKK 47,155 mil.

- In terms of liquidity development a positive achievement can be recorded with the changes in the liquidity gap. The initial amount SKK 80,180 million of the gap declined to SKK 58,430 million. This decline is even better visible when demonstrated in percentage terms. The proportion of the gap on the total assets lowered from 17.94% to 9.08% today. It is important to stress that while before only 60.77% of the gap was by equity today this ratio reached 107.43%.

- When looking at the composition of income and expenses dominant items are both interest income and interest expenses. Thus the preposition that the net interest margin is the factor influencing the profitability at the most holds steady. Nevertheless, more than 80% of the interest spread is being absorbed by net non-interest expenses with net provisioning as their most important component. Their proportion on the total assets represents 2.72%. This means that net provisioning binds 68% of the operating margin.

- When comparing the development achieved during the first 6 months of 1996 with the previous period we observe some changes in assets composition. The short-term loan expansion was reflected by a halt in the trend of declining proportion of loans on earning assets. At the same time the earning base (earning assets /total assets) declined from 89% to 86.4%.

- The profitability, as well as amounts of income and expenses is steadily being distorted by seasonal factors as visible in quarterly changes in ROA and the amount of profit. With this respect sharpest changes are recorded with other income and other expenses items. On the contrary to the previous development we can assume that net provisioning is loosing its seasonal nature. While in previous years the highest rise in provisions was always recorded in the last quarter what caused the whole year profit to equal to about 150% of its first quarter level, provisioning has a steadier nature, in 1996.

4.2 Process of financial restructuring

4.2.1 Needs for restructuring : solving the "bad loans" problem

The problem of ‘bad loans’ does not only relate to Slovak banks. It is a common problem in all transition economies. Despite numerous methodological changes in the rules of categorising bank receivables by risk, requirements on the creation of loan loss provisions, differences in the degree of government involvement, the legal framework, and in the approach to the solution of this problem, there are some common aspects of this problem: high-risk loans represent a large share in total bank lending.

The bad loan problem is known in advanced economies as well: at the turn of the 90ies, the Scandinavian banking system was in crisis; in 1994, Japanese and Italian banks got into trouble. Causes of the problem are associated with the cyclic development of these economies: they have a different base, but a common feature is their dynamism, rapid growth, and methods of solution with extensive government support. Direct and indirect support from the government (direct: capital injections, indirect: bank investment funds and bank insurance funds guaranteed by the government) led to an increase in the government's interest in the three largest Norwegian banks - from 68% to 98%. These banks are prepared to be gradually re-privatised through new issues of shares (state participation is to be reduced in the course of three years, i.e. from 1994 to 1997).

The restructuring of the banking sector, which is currently a basic condition for the recovery of financial flows between commercial banks and their economic environment, must take place in two areas. On the one hand, banks must strengthen their internal resources for the coverage of loan losses, on the other hand, it is necessary to establish standard relations in the financial flows of enterprises. These relations are expressed in terms of indicators defined in the previous part. The cleaning up of the banking sector of long-term loss-making entities will lower the risk involved in lending operations. The recovery of the banks' loan portfolios solely by writing off loss-making loans to the detriment of bank reserves represents only a short-term solution which could solve consequences but not causes of the bad loan problem. Thus, the worsening trend in the quality of loan portfolios and the related problem of high interest rates would persist. Therefore, by means of the financial restructuring it is necessary to solve the causes of the generally high rate of credit risk and the frequent failures in inter-firm financial flows.

The development of the restructuring process in the Slovak banking sector will be analyzed with special attention paid to following groups of issues:

- methodological approach to restructuring;
- causes of the loan portfolio problem in Slovakia;
- measures adopted and prepared, respectively;
- restructuring programme.

4.2.2 Methodological approach to restructuring

Generally, there are three possible approaches to the banking sector restructuring: centralised, decentralised, and combined.

Centralised approach. The aim of the approach is to clean up the bank's balance sheet of bad loans and to transfer them to a bank restructuring agency (consolidation bank, or a corporation for asset management). A part of these non-performing loans may be restructured in co-operation with enterprises, another part may be written off to the detriment of reserves and provisions.

Advantages: clear separation of the banks' recapitalisation from the restructuring of enterprises, improved financial discipline, accelerated privatisation. In addition, this approach may reduce the conflict of interests, because the decisions of commercial banks on new loans would not be influenced by past relations with the company management, but would be based on commercial principles. Restructuring of enterprises by using this method could make a contribution to the effective utilisation of government resources.

Disadvantages: strong political pressure (political risk), mainly in case when the mandate of such an institution is not clearly defined. Moreover, relatively high costs of the establishment, requirements in highly qualified staff, etc.

Decentralised approach. In this case the responsibility for solution of the bad loan problem is assumed by banks. Banks may be recapitalised by using a combination of retained earnings and debt issuance with the aim of increasing the bank's capital to a level sufficient for restructuring of the bad loans of enterprises or their writing off.

Alternatives:

** Contract with the management - in case the bank is not able to recapitalise itself by using its own resources, the government may provide an additional capital injection (in the form of subordinate debt, increase of equity), which will empower it to perform some supervisory function at the bank according to the amount of funds provided.*

In practice, it concerns a two-stage contract: the first stage (a six-month contract) is devoted to preparation of the strategy for revitalisation, the stage of implementation follows after the strategy is approved.

** Participation of the central bank - strengthens its position as guarantor of the restructuring project, in case the bank is evidently 'not able' to meet the defined criteria, the central bank requires the introduction of a rehabilitation programme. In case of failure to comply with the rules, the central bank may impose penalties according to law. The advantage of the participation of the central bank, which is an institution independent from government control, is the elimination of political risk.*

Combined approach. It is regarded as the most advantageous solution. If a suitable financial environment is created, banks are able to recapitalise themselves from their own resources so that a part of bad loans are transferred to the Consolidation Bank. During the process of restructuring, banks work in close co-operation with their clients. The effectiveness of bank restructuring is closely connected with the restructuring of enterprises and the process of privatisation.

On may state that the restructuring process in Slovakia is managed with using the combined approach.

4.2.3 Causes of the loan portfolio problem

The transformation process of the Slovak Republic towards a market oriented economy that is characterised by changes in relative prices, the collapse of former CMEA export markets, sudden tightening of import competition, reduced state subsidies, inappropriate industrial structure with only marginal share of value added products resulted in the large number of enterprises that had become unprofitable and burdened with high volumes of debt. Many enterprises were capable of covering their operating costs, but servicing their debts is inherited volume of "out-of-market long term credits" extended to enterprises between 1967 the late 80-ies. Certain amount of bad loans, especially those given in the recent period, turned classified due to insufficient experience of credit officers and unprudent credit policies of commercial banks. The ratio of Slovak banks'capital to total assets was low (it ranged from 0.84 to 1.22 %) compared with banks in advanced market economies. The capital adequacy ratio which may not fall below 8 % according to the Basle capital adequacy standards, reached an average of 1.72 % in the banking sector. Banks operating on foreign markets (ÈSOB and Živnostenská banka) reached a 4 to 5 % ratio of capital to risk-weighted assets, representing an exception.

The reasons of such a development may be divided into several groups:

**** The intensive need to rapidly create a banking sector, conform with the needs of a transforming economy***

This intensive need had an objective, and therefore also a program character. Many new business entities have been established in the economy, which the undersized banking sector, undergoing a slow reform at the end of the eighties, was unable to handle. One of the fundamental reasons of today's problems may therefore be seen in a undeveloped banking sector, or its adaptation to needs of centrally managed economy.

**** Absence of personnel prerequisites for a rapid expansion of the banking sector***

Qualified staff of already existing banks could not satisfy the needs of newly established banking entities. Additionally, these qualified specialists of the former State Bank of Czechoslovakia and saving banks were confronted with entirely new tasks: this was no longer a simple redistribution of loan resources in accordance with planned goals, but their distribution on a purely commercial basis, with the need to observe criteria of prudent banking procedures, and on the basis of an evaluation of the business plan of an applicant for a loan. Experience required to properly evaluate a business plan was scarce, and many important characteristics that would help create a picture about a client were not available. The majority of clients were newly established business entities, without a corporate history, where an opportunity of examining their property situation, economic results, etc., was absent. This caused considerable difficulties in determining the reliability of a client, as well as feasibility of the purpose of a loan. The business environment was unstable; all determining parameters were in a relatively dynamic motion - prices, currency exchange rate, reliability of customers and suppliers. It took time to gradually acquire necessary experience, and the price of mistakes that have been made now often has a form of large unpaid receivables.

**** Necessity to support the process of privatization, the development of small and medium-sized enterprises, and other activities called for by the society, and which were among the priorities of the economic policy pursuing economic transformation***

Banks were under political pressure and pressure from the society. A common denominator of these pressures was criticism, that banks are not flexible enough in supporting business activities.

**** It was relatively easy to enter the banking sector (this is particularly evident in comparison with the current situation, when entry into this sector for new entities is very complicated, and is subject to very demanding licensing procedures.)***

It was possible to establish a bank with relatively little basic capital[13], and in the licensing procedures, the ability of the bank's shareholders to ensure a long-term success on the banking market was not sufficiently examined. The economic strength of shareholders, their strategy, and ability to raise the bank's capital in the future remained unexamined, or prerequisites for such examination were missing. In a number of cases the establishment of a bank served a predetermined purpose: to open the way to its founders for acquiring loans. Additionally, assumptions about high yields from capital invested into the banking sector were either exaggerated or unjustified. Hints of success ensued from relatively easy available resources: at the beginning of the nineties, basically all loan resources were at the disposal of two entities - Vseobecna uverova banka (the General Credit Bank), and Slovenska sporitelna (the Slovak Savings Bank). In the new situation, the Slovak Savings Bank (not sufficiently equipped for providing loans) had an opportunity to deposit its resources not just in one bank, as in the past, but allocate them favorably into other, newly established banks. This possibility caused, that already at the beginning of their activity, new banks were capable of achieving relatively high volume and growth rate of loan transactions. At the time when the loans were granted, their quality could not be measured, and therefore the initial period of functioning of each bank was seemingly successful and without problems.

***** Complicated implementation of guarantees on provided and non-performing loans**

High importance was attributed to guarantees on loans. This was partly a reaction to the insufficient possibility to reliably evaluate the quality of business plans. In a number of cases, experience with recovering collateral has shown that accepted guarantees on loans were only formal. Guarantees had the form of collateral very difficult to repossess for various reasons. These included formal shortcomings (faults in guarantee contracts, which proved an insurmountable obstacle to implement collateral right), conditioning the execution of a guarantee (collateral) on consent of the debtor; such consent is generally only achieved in court, which extremely prolongs recovery of claims. In many cases, collateral is not marketable at all, or can only be sold with a loss. Increasingly strict audit requirements (as well as criteria set by the central bank) have led to reassessing the real value of guarantees, which resulted in a growth of the volume of uncovered risks. This causes the necessity to create additional reserves and provisions.

An essential factor arises in the whole issue of loan guarantees and their resolute implementation, which, however, is frequently a reason for only a formal role of guarantees in the loan relationship: the existing legal environment and court procedures are creating a situation which is in favor of a debtor and detrimental for a creditor. The positions of debtors and banks are uneven. Banks did not anticipate this development. They trusted the premise that the state, in order to provide for the functioning of society and economy, would create conditions that would defend the interests of creditors.

***** In some cases, the lack of experience resulted in unclarified concepts of the bank's development, as well as shortcomings in assets and liabilities management.**

This is one of the reasons why several banks have a high volume of non-performing assets. Among other causes, this is the consequence of extremely rapid expansion at the onset

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13 While at present the minimum required capital (initial capital) represents an amount of 500 000 million SKK and, given the NBS Provision from December 1993, the whole amount must be deposited in a monetary forme, the 1990 starting required level represented only 50 000 million CZK (i.e. 1/10 of the present one). However, the starting level was increased and up to the end 1992 it reached 250-280 million CZK. Then, by the SBCS Provision from 1992 it was augmented to 300 million CZK.

of bank's development. A certain role in this was played by the rapid establishment of bank branch offices and affiliations, an extensive banking network was created during a historically short period of time (five years), capable of meeting the needs of clients. A relative decline of demand for new loans, narrowing profit margin, and a generally tougher competition on the banking market caused that in a number of cases, the ratio of expenditures and revenues is becoming tense. This situation will require the reduction of a number of expenditure items, in order to compensate for declining bank revenue from financial operations.

***** Insufficient experience with trading on the capital market caused that banks, trading on their own behalf and into their own portfolio, purchased shares at times when their prices culminated. This caused losses, which further aggravated the negative consequences of bad loan transactions.***

4.2.4 Measures adopted in the period 1990 - 1994

- ***General "Debt Forgiveness" of Enterprises***

The first attempt to undertake the problem dates back to times of the former Czecho-Slovak federation. In order to assess the financial strength of enterprises, all of them were broken down by three categories:

1. viable enterprises with the sufficient capability of servicing their indebtedness,
2. potentially viable enterprises with positive operating cash-flow but heavily burdened, with debt that is not being repaid,
3. loss making enterprises.

The government had put aside approximately 15 billion crowns to solve the problem. One part of these funds (11 bil.) were mainly dedicated to the potentially viable companies. The National Property Fund swapped its bonds for credits of viable enterprises with commercial banks. The remainder of funds (4 bil.) had been utilised for the capital strengthening of banks.

These measures, however, did not result in an expected effect. The primary and secondary inter-company indebtedness hat not dropped substantially. One of the main weaknesses of this project was that it was not prepared as a systemic conceptual project but as the one-step event. Mistakes also occurred when having assigned the enterprises into respective categories. Such a solution did not resolved the crucial problem of the insufficiency of long term financial sources that would finance new feasible project, especially those for the conversion of the armament production.

- ***Establishment of the Consolidation Bank***

This bank, as a special purpose bank developed its sole activity in the field of the administering of the indebtedness of the former military production oriented enterprises that are currently being restructured under the program of conversion. Another part of bad loans are the loans for the "perpetuating stock and inventory"("TOZ" in the Slovak abbreviation). It is expected that a proportion of these loans shall be repaid in the future. These loans were restructured and current portion that is being repaid amounts to two thirds of their nominal value.

In March 1991, some CZK 110 billion worth of outstanding TOZ credits - permanently revolving working capital credits (TOZ) - were transferred to the Consolidation Bank, which was specially established for this purpose. In return, the banks received CZK 50 billion in government bonds, CZK 12 billion worth of loans for the increase of their capital base, and the remaining amount for the writing off of these loans. This transaction solved only the problem of the TOZ credits; that of other non-performing loans remained unsolved.

The NBS, in close collaboration with the government, has been systematically dealing with the problem of bad debt since its establishment. New regulations of the NBS on capital adequacy, liquidity, credit exposure and foreign exchange position were introduced, effective since January 31, 1994. This issue has often been discussed with the representatives of various international financial institutions, such as the International Monetary Fund and the World bank.

In September 1993, the international consulting company McKinsey prepared an analysis of the scope of bad debts in the four selected commercial banks. This study was financial by EC PHARE. Results of the analyse, in which the figures provided by the NBS, auditors and commercial banks were assessed proved necessity to introduce new measures to prevent further deterioration of the credit portfolios. On the basis of the results, the NBS in a close collaboration with the Ministry of Finance and the Government will decide on the scenario on the revitalisation of the banking system within the context of enterprise restructuring.

- ***The clean up of the CSOB´s Balance-sheet***

On December 29, 1993, the Slovak Collect Company (*Slovenská inkasná spoloènos•*) was established by the Ministry of Finance of the Slovak Republic. Claims of the export companies were transferred to the SCC in the amount of SKK 10,7 billion. The claims are financed by the CSOB redistributing loan with the State gaurantees. Agreement of the loan repayment is being in the process.

4.2.5 Restructuring programme

The process of restructuring is to be divided into several stages which could be characterized as follows.

**** Preparatory stage.*** Introduction of the new rules of classifying bank receivables and off-balance sheet liabilities by the risk involved and the creation of resources for risk coverage (NBS Decree No. 3, March 1995). The goal is to improve the existing conditions, create adequate resources for risk coverage, improved the quality of risk analysis and risk management. The basic criteria for the grouping of receivables and off-balance sheet liabilities into one of the five categories (1.standard; 2.special mention claims; 3.sub-standard; 4.doubtful; 5.loss) are the assessment of the client’s financial position (financial credibility, e.g. level of liquidity, economic performance, reserves, profitability, capital adequacy), and the financial discipline in accordance with the terms and conditions stipulated in the credit agreement (application of the borrowed funds for a predetermined purpose, repayment accounting to the agreed schedule).

**** Creation of resources for loss coverage.*** After the categorisation of receivables, provisions are created for loan loss coverage in the amount of 5%, 20%, 50%, 100% of the nominal value of the loan in the groups No. 2,3,4 and No. 5. In calculation, we take into account the value of collateral (guarantees, right of lien). The guarantee is excluded, if the guarantor is in a bad financial situation, if the guarantee is doubtful, or the collateral is illiquid. The assessment of the real value of the collateral remains a problem (methodology of assessment, unstable market).

The process of creating resources for loss coverage and restructuring is spread over a period of three years. The burden of and the responsibility for the process of restructuring is concentrated in the banks concerned. In this stage, the preparation of restructuring projects is of great importance.

The banks in connection with this provision of the NBS were obliged to submit the internal by-law to the banking supervision within three months from the day when the provision had become effective {up to 30 June 1995}. A newly established bank will submit such by-law within three months from its establishment.

Although above mentioned main legal and regulatory framework has been prepared (with application of the EU standards), it is necessary to identify some problems in this area.

1. Provision No.3/1995 on categorization of the claims against risk and the creation of reserving funds for the risks coverage facilitated to give an actual picture and size of the banks loans portfolio - loans in the amount of SKK 125 billion are considered classified (substandard, doubtful, loss) and their repayment is in question. According the banks quantification SKK 90 billion are loss claims. These strong new rules have been implemented in the period when the government had declared to participate in banks rehabilitation by the preparation and implementation of the Act on reserves and provisions creation for calculating income tax base. The main idea of a so long time expected Act is following: the reserve funds and provisions against clasified claims (principal) - their creation will not be part of the income tax base. Because the Act has not passed through Slovak Parliament yet , the problems continue and in some cases the capital adequacy ratios falled down in 1995 (e.g. in VUB - 4.78%).

2. The banks have an obligation to include unpaid interest into their earnings which are not actual (fictive profit - its taxation deteriorates the banks' economic position). The volume of unpaid interest is slightly higher than 1/3 of the clasified claims.

3. The Bankruptcy and Settlement Act does not work well - the procedure is connected with time and expensive consuming. On the one hand the obligation to participate in negociation (pre-phase period) is considered the main obstacle, on the other hand the bankruptcy is not used in practice (only 150 bankruptcies have been declared, one only was finished).

Table 4.7 Claims classification

	30.6.1995		31.12.1995		30.6.1996	
	SKK mil	%	SKK mil	%	SKK mil	%
a) standard	160.305	59,14	129.827	45,06	145.117	47,25
b) special mention	10.208	3,77	37.844	13,13	40.959	13,34
c) substandard	22.601	8,34	22.140	7,68	19.904	6,48
d) doubtful and litigious	13.628	5,03	12.574	4,36	9.282	3,02
e) loss	64.308	23,72	85.756	29,77	91.868	29,91
Total classified (c + d+ e)	100.537	37,09	120.470	41,81	121.054	39,41
Total (a + b + c + d + e)	271.050	100,00	288.141	100,00	307.130	100,00

The new methodology influence on the claims classification: 81,2 %.

Although the creation of classified claims provision did in fact begun in 1993, the substantial rise in its volume was observed in 1995, when NBS's Provision no. 3/1995 came into force.

Until then the creation of provision according to Tenets of ŠBÈS was not mandatory, but only recommended. Therefore during that period banks did mainly create reserves for covering losses, including loan losses. As for the taxation, these reserves were recognised as legitimate costs, while provisions are not tax-deductible yet. The finance ministry is working on amending the Act on Reserves and provision, which should include also their tax-deductibility. The overall numbers are included in the Table 4.2.8.

Table 4.8 Creation and use of classified claims provisions (in SKK million)

	1993	**1994**	**1995**
Creation	2451,3	6343,4	20445,6
Use	0,0	265,4	6002,4

**** Restructuring projects.*** Based on a loan portfolio analysis according to the new rules of loan classification, the actual level of loan loss provisions, the evaluation of the client's financial position and capital strength, the banks make proposals in their projects for methods and possibilities of their own revitalisation (cleaning up of loan portfolios, recapitalisation).

In preparing the banks´restructuring projects special attention must be paid to measures within the bank (elaboration of demanding criteria for assessment of the credibility of clients) and, on the basis of an analysis, to judgements of the clients' ability to repay their financial obligations. An important step is evaluation of the 'credit history' of the client, i.e. amount and nature of liabilities to banks, debt repayments - compliance with the schedule of repayments, frequency of changes in the schedule, etc. Intrabank measures must focus on the re-valuation of expenses, including overheads, investment plans, and the placement of financial resources (reduction of investment risk), ways and possibilities of additional increase in share capital, utilisation of the profit, distribution of dividends, etc.

After the projects are prepared by the banks, they will be approved by the National Bank of Slovakia and carried out. In case the compliance with prudential regulations (capital for the calculation of capital adequacy) is threatened, exemptions may be given in justified cases.

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It follows from the above that a significant aspect of the restructuring process in the banking sector is the relation 'bank - client (debtor)'. Eventually, the success of the whole process will depend on the restructuring of the enterprise sector - 'chronic' debtors (state-owned companies, some of them already privatised within the small or large-scale privatisation). The problem of insolvency is growing at a fast rate (estimate: Sk 180 billion) and its non-solution or stagnation in solution is reflected in an increase in the banks' bad loan portfolios and a reduction of resources for the provision of new loans.

On the other hand, the significance of restructuring for bank clients may be summarised as follows:

* The improvement of the quality of loan portfolios and the restructuring of banks will create conditions for the employment of financial resources in new effective lending operations. The bank as an entrepreneurial entity - intermediator, on the basis of its policy of asset/liability management, risk analysis, may meet the standard criteria (performance indicators, ratios, creation of reserves and provisions, etc.) and fulfil tasks required by customers (collecting deposits, providing loans and a wide range of banking and consulting

services, which contribute significantly to the quality of the relation between the bank and the client).

* The extension of the process of restructuring to bank clients will make a significant contribution to the improvement of co-operation between the bank and its clients, the strengthening of its position in the process of revitalisation programmes (e.g. changes in the schedule of repayments, proposals for the inclusion of individual clients in categories according to their abilities to meet liabilities, or to make proposals for bankruptcy proceedings, which also contributes to the reduction of credit risk).

* The effective allocation of financial resources, based on the agreed rules, may contribute to the recovery of financial flows within the whole economy, which will have a favourable influence on the position of the banking system, mainly from the point of view of creditworthiness.

Summary: present state of restructuring

Since the process of the financial restructuring of the Slovak banking sector was iniciated, following measures and relevant activities have been (and are to be) introduced into practice:

* Rules of assessing bank receivables and off-balance sheet liabilities according to the risk involved and the creation of resources for risk coverage (March 1995);

* Evaluation of the actual situation in accordance with the new rules (March 1995 - September 1995);

* Elaboration of restructuring projects by banks, included in the process (September 1995 to November 1996);

* Evaluation of the projects by the banking supervision authority (in process);

* Preparation of related legal regulations.

The process started in 1994-1995 has not been completed; it is stagnating, which may postpone the beginning of the process and prolong the estimated time necessary for the recovery of banks with unfavourable consequences on the financing of promising projects in the future.

Conclusions

1. Commercial Banking

While during the first years of the transformation process within the CSFR Slovak banking system developed rather slowly, it begun to expand with a high dynamics after the establishment of the National Bank of Slovakia and the split of the former common State, since 1993. The present number of 33 commercial banks (of which 9 branch offices of foreign banks) operating in Slovakia might be considered as satisfying for ensuring the required banking services in the country. Banks in Slovakia have been established prevailingly as universal institutions, however, there are also banks with closely specialized functions (as consolidation bank, guarantee bank and building savings banks).

Despite, the financial power of Slovak banks remains concentrated within a close circle of the largest banks, which took over the powers of the former State banks and, at present, as joint-stock-companies with a large State participation they are being in the process of transformation.

The banking legal framework includes the whole main banking law necessary for favorable and safe development of the banking sector. Among other, there are also legally covered such areas as mortgages banking or protection of deposits. However, introduction of a large amount of new banking laws into practice is often slower then would be desirable.

It is to be stressed that forming of the legal framework as well as general establishment of the commercial banking into practice is being put into life with a fruitful assistance of numerous international institutions and the special aid of the EU PHARE Program.

2. Monetary Policy of the National Bank of Slovakia

The National Bank of Slovakia (NBS) is established as an independent institution, which performs all standard functions of the central bank. The banking supervision is institutionally merged within the NBS as well. Despite14, the NBS is being very successful in performing its disinflationary monetary policy strategy: within the period 1993-1996 the rate of inflation in Slovakia gradually decreased and by estimates it will reach around 6 % at the end 1996, as compared with the 23,2 % level in 1993.

The control of the inflation represents the internal part of the main - currency stability goal of the NBS. The external one is defined by maintaining the fixed exchange rate of the Slovak crown toward a currency basket, consisting of DEM and USD in the ratio 60:40.

Performing of the final disinflationary target of the NBS´s monetary policy is operated through the intermediate target of money supply growth measured by broad money aggregate M2. However, monetary targeting of the NBS, inspired by long successful experience of the German Bundesbank, does not bring in Slovak conditions any convincing results. Apart from unstable developing economic environment, which is being reflected in large differences between predicted and actual values of economic growth (in terms of the GDP growth) as well as from short a methodically changing time series necessary for applying the monetary targeting practice, there is a systemic limitation given by simultaneous adoption of the fixed exchange rate regime. Although, in conditions of a limited convertibility (after the liberalization of the current account as well) of the currency the controversy between these "twinning-targets" has been in a large extent damped, the issue of a primarily external influence on the monetary development in Slovakia arose during the past years as well. It was reflected in a dynamic inflow of foreign exchange resources into the Slovak banking sector which put strong pressure on the money supply growth in the economy. Followingly, the intermediate target of the money supply growth has been overfulfiled all over the period.

Resulting from growing liquidity of the banking sector, banks expanded rapidly their lending activities toward the personal and enterprise sectors. This tendency is clearly being observed since 1995, despite limitations given for large banks and with elimination of the credit limits it persists in 1996. Despite, the NBS up to the summer 1996 did not adopted any measures to slow down the money supply growth. Since the inflation decreased continuously, the central bank decided to continue in maintaining a policy supporting the economic growth, although for the NBS it became more and more costly, due to growing amounts of the own bills issued in order to sterilize the excessive liquidity of the banks.

Finally, as the current account deteriorates continuously since the beginning of 1996 (due to huge growth in imports and a substantial slow down in the export dynamics), in July-August 1996 the NBS adopted a packet of measures devoted to stop (or to slow down) the excessive money stock growth and to get the banking liquidity, and eventually the lending activities, under stronger control. Measures

14 See for example: BRUNI, F.: Central Bank Independence in the European Union. Paper presented on the Conference Toward More Effective Monetary Policy. Bank of Japan, October 26-27, 1995. By means of analytical comparisons of the central banking in the EU members countries, the author argues that central banks relieved of the banking supervision are more sucessfull in their anti-inflationary policies.

adopted concern domestic lending sources (increase in the required minimum reserve ratio) as well as foreign credits (foreign exchange position for monetary purposes).

However, the main issue of the Slovak monetary targeting controversy remains in the fixed exchange rate regime - although in an enlarged fluctuation band of +/-5 %. And, it is obvious that from the mid-term point of view, maintaining of the given exchange rate regime (or the external aspects of the currency stability in general) will play more important role in the monetary policy of the NBS then unconvincing results of the monetary targeting. Nevertheless, regular monitoring of the money stock growth (defined by M2 or another monetary aggregate) could serve - as in developed countries - as an indicator of the money stock development in the economy.

3. Prudential regulation of banking activities

As concerns the prudential regulation of banking activities the banking supervision of the NBS has at disposal a sufficient packet of instruments enabling an effective control. During 1994-1995 the NBS passed a serie of provisions, which made the rules for prudential behavior of the banks substantially stronger as compared with the past. Tightening concerns as the licensing requirements, as the ratios of capital adequacy, large credit exposure, liquidity and foreign exchange position. However, even the setting up of the prudential regulation parameters is being orientated towards reaching the international standards, they were set gradually and with differences regarding especially the group of the transforming banks, during the period.

From the point of view of a necessity of solving the famous "bad debts" problem, crucial is the Provision No. 3/1995 *"On rules of evaluating banks¢ claims and off-balance sheet liabilities according to the risk contained therein and of reserving funds in order to provide against those risks"* . Identifying of five bank claims categories by the criterion of credit risk would serve as an important instrument (or step, respectively) in the process of the financial restructuring of the Slovak banking sector.

When valuing the effectiveness of the NBS´s banking supervision one may state that due to strengthening the rules of prudential regulation a favorable trends are observed in all concerned areas. On the other hand, however, selection of partial problems in banking activities obtained more distinct character, which, eventually might be considered as a positive accompanying feature of the restructuring process in the Slovak banking sector.

4. Banking sector restructuring

The transformation and restructuring of the banking sector is aimed at achieving internationally acceptable parameters of banking business, which can be characterised by the following attributes: capital adequacy, low credit risk, adequate collateral, reserves and provisions for the credit. In final consequences, the aim of transformation and restructuring is to establish a sound, effective, competitive and creditworthy banking system.

At present one of the most important role in commercial banking is the correct risk valuation and the adequate creation of the recourses against risk. On the other hand it is not a simple nor unambiguous task to determine the weights of the individual factors which ‘caused’ the problems in the Slovak Banks (especially large domestic banks). The efforts to report on the actual state of loan portfolios led to the setting of new rules of categorising the banks’ receivable and off-balance sheet liabilities by the risk involved and the creation of loss provisions. These rules lay increased demand on the harmonisation of legal regulations: laws on reserves, income tax, accounting, bankruptcy, settlement out of court, commercial code, etc.) and on the active participation of the government, banks, and enterprises in the preparation and implementation of restructuring projects.

Concerning the restructuring process it necessary to emphasize again:

- the realization of the 3 years restructuring programme suggested by the NBS is already delayed for 2 years

- in connection with Banking Act, amendments (§ 44a) the Ministry of Finance and the NBS are obliged to work out the legal regulation (prescription) in which the main aspects of restructuring projects will be determined (draft is worked out)
- it is not decided yet the State participation concerning the forms, size and conditions
- the related legal regulations have not passed through the Slovak Parliament yet.

SUPPLEMENT

General Economic Overview

During the three and half years of the national independence, economic development in Slovakia has changed its growth dynamics from the transformation recession of 1993, towards revival followed by high rates of economic growth, during 1994-1995. Stabilization of the macro-economic environment progressed rapidly, as inflation decreased continuously and the external stability of the Slovak currency has been reinforced by growing foreign exchange reserves of the National Bank of Slovakia (NBS). Some disturbing features in the macro-economic stability emerged in the 1-st half of 1996 in the external sector, due to changes in export-import dynamics development, resulting from domestic economic growth and decrease of demand abroad. An overview of the main macro-economic indicators development is given in the following table.

Main macro-economic indicators in Slovakia in 1990-1996

Indicator	1990	1991	1992	1993	1994	1995	1996**
GDP (%, constant prices 1993)	-2.5	-14.6	-6.5	-3.7	4.9	7.4	7.1
Industrial production (%, constant prices)	-4.8	-26.8	-13.7	-13.5	6.4	8.4	3.4
CPI (%, annual average)	10.4	61.2	10.0	23.2	13.4	9.9	6.2
Government budget deficit (%GDP)*			-2.6	-7.3	-1.2	-1.6	-2.2
Fiscal deficit (sufficit) (% GDP)				7.1	2.6	(0.5)	(2.0)
Balance of trade and services (USD million)				- 619	762	570	- 828
Unemployment rate	1.5	11.8	10.4	14.4	14.8	13.8	12.4

** Cleared from the clearing balance with the Czech Republic; ** Half-year data.*

Rise of the independent State called for certain adjustment period in the economy. Therefore, the economic recession deepened and GDP decreased by 3.7 %, in 1993. The economic development in this year was affected by various, both, economic and extra-economic factors, such as a smaller domestic market and costly process of constituting the State infrastructure.

Introduction of a new tax system (VAT base) and other reforms, as a new system of health and pension insurance, together with effects of devaluation expectations after the break of the monetary union with the Czech Republic (as of February 8) and of the devaluation of the Slovak currency by 10 % (July 10), affected acceleration of inflation dynamics, but the annual average rate of inflation (CPI measure) remained at a relatively low level of 23.2 %, in 1993.

Due to extraordinary conditions of the year, the Government budget deficit reached 7.3 % of GDP. Unsatisfactory development was also in the external sector, where namely a huge slow down in trading with the Czech Republic contributed to a deficit of the balance of trade and services in the amount of 619 mil. USD. The deficit of the current account was 559 mil. USD.

The economic revival began in 1994. The GDP growth reached 4.9 %, average inflation rate was cut almost by a half to 13.4 %, Government budget deficit slowed down to 1.2 % GDP. The leading sector of economic growth was foreign trade, as the exports performance was favorable affected by growing external demand, as well as by effects of the Slovak crown devaluation. On the other hand, imports were slowed down by the 10 % import surcharge, imposed in March 1994. As a result, the balance of foreign trade and services reached a surplus of 762 mil. USD, and the current account a surplus of 712 mil. USD.

In 1995, economic revival accelerated with a 7.4 % growth in GDP. The average annual rate of inflation reached 9.9 %, Government spending resulted in a budget deficit of 1.6 % of GDP. The balance of foreign trade and services generated a surplus of 570.2 mil. USD and the current account a surplus of 649.5 mil. USD.

An important feature of the 1995´s development was revival of consumer and investment demand in the domestic economy. However, the dynamics of gross fixed capital formation was not restored, and the economic growth was due primarily to the utilization of free capacity in production. Despite the internal revival, the driving force of economic growth remained in the export sector.

Another picture of economic development gives rise in the first half of 1996. While the dynamics of GDP growth remained at the level of around 7 % (7.1 % for the 1-st half 1996) and the yearly rate of inflation decreased to 6.2 % in June (5.2 % in September), serious imbalances occurred in the foreign trade sector. Rapid acceleration of the domestic consumer as well as investment demand dynamics has caused a huge increase in imports. Simultaneously, export dynamics slowed down due to worsening of international trade conditions and withdrawing the effects of devaluation from spring 1993. As a result, deficit of the trade and services balance reached around USD 1 billion, in August.

Observing the last three-year economic development in Slovakia, one may state that due to appropriate economic (or budgetary, respectively) and monetary policy, the macro-economic environment has been stabilized and by this way, favorable conditions for economic growth were created. However, the economic performance still increased by an extensive way of joining free productive capacity and, without significant requirements in additional labor force. This is well illustrated by the fact that in spite of a rapid economic growth, unemployment has remained over the whole period at a relatively high level, and the rate of unemployment has decreased only slowly, from 14.4 % in 1993, to 13.8 % in 1995. Some increase in the demand dynamics for labor has been observed in the 1-st half 1996, resulting ine a decrease of the unemployment rate to 12.4 %.

On the other hand, as a result of a backward in the technological recovery, the competitiveness of the Slovak exports slowed down, affected by lower dynamics of the business cycle abroad. In other words, the main issue of the present Slovak foreign trade development, which could be dangerous for maintaining of the macro-economic stability in the future, is closely related with the weakness of the domestic industrial structure. It is obvious that searching for increasing the foreign trade performance by intermediate of an export supporting devaluation strategy is not acceptable once again, while technological recovery by the way of supporting technological imports and restraining consumer imports should be required.

An alternative source of new technologies which could moderate the import requirements in an important extent, are foreign direct investments (FDI). The FDI inflow to Slovakia remains at an unsatisfying level, although its dynamics has accelerated since second half 1995. The amount of foreign capital invested in the Slovak economy reached around USD 1400 million, in the 1-st half 1996.However, prevailing part of the FDI went to the trade and banking sector, whereby follows that it is hardly to speak about an inflow of strategic investments for economic restructuring.

Nevertheless, strengthening of the willingness to the recovery necessitates improvements in the management structures of the enterprise sector, which is conditioned by closing the privatization process.

Main data on the private sector in the Slovak economy are as follows: in 1995, 64.9 % of the GDP and 64.6 % of the total annual volume of industrial production, were generated by the private sector (including co-operatives), which employed 56.5 % of the total labor force. The share of profit based organizations in private ownership (partial or whole) in the total number represented 96.4 %.

In 1995, new important legislations in the field of regulating the privatization process were enacted. The most important of this laws was the amendment to the Large Privatization Act (No. 190/1995 Z.z. and Act No. 92/1991 Zb. on the transfer of State property to other persons) which closed the ongoing discussion about legal aspects of privatization in favor of standard methods. The second wave of the voucher privatization in Slovakia was replaced by the so-called bond method.[15] The amendment increased the powers of the NPF, and considerably accelerated the process of privatization in the form of direct sale, as well as public tender and sale of shares on the capital market. Subsequent to this legislation, a law was passed to secure the interests of the Government in the privatization of strategically important State enterprises and corporations. This law (NC SR No. 192/1995 Z..z.) defined which companies could only be privatized with government approval.

15 According to this, each individual registered in the second wave of the voucher privatization is entitled to a bond issued by the National Property Fund (NPF) at a par value of SKK 10 000, with maturity at 31 December 2000, which may be used for specified purposes. Shortening of the maturity date to 31 December 1997 was made for pensioners by an amendment to the Act (from October 1996). Trading in the bonds started in August 1996. High supply has been faced with a low demand in the firsts weeks, extending of purchases is expected with the announced entry of some large banks in the bonds trading.

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