NATIONAL BANK OF SLOVAKIA

BANKING SYSTEM DEVELOPMENT IN THE 1990 - 1996

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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 22 commercial banks in Slovakia, 30 banks were granted licence, as of October 1, 1996.

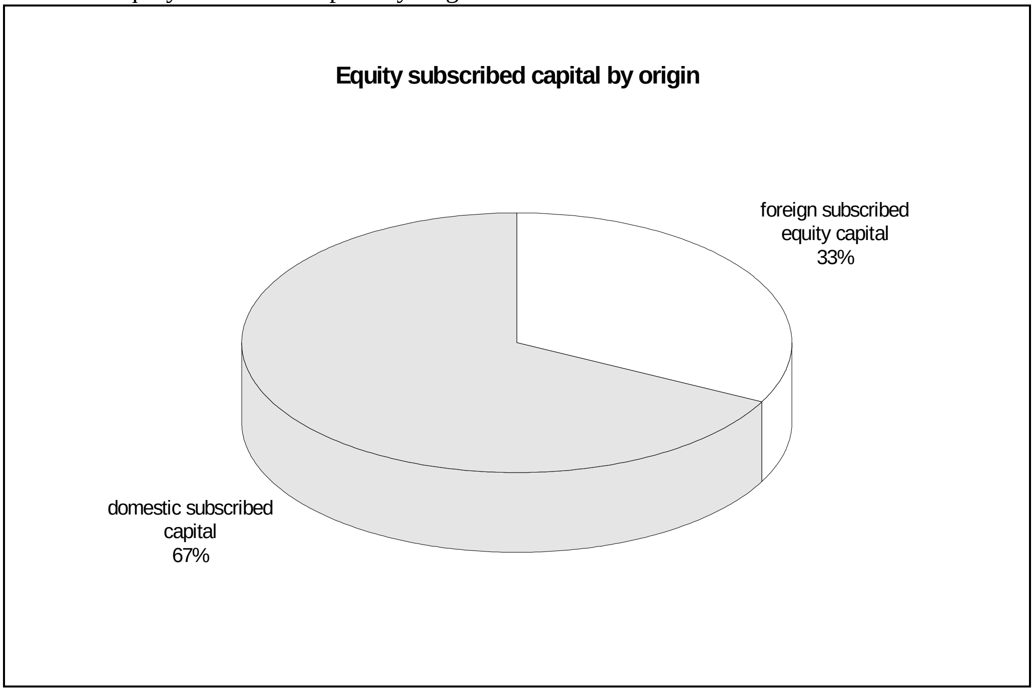
From the total number of the banks operating at present days in Slovakia, there are 24 domestic institutions and 6 branches of foreign banks. Apart of this, 12 representative offices of foreign banks are operating in Slovakia.

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 záručná banka*) and the second one is the *Consolidation Bank* (*Konsolidačná 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 [ČSOB]* 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 [Komerční 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 Komerční banka in the Czech Republic.

3. *Investment Bank [Investiční 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 [Investičná 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 (6 banks).

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.

For more details on the Slovak banking sector development over the period 1993-1996, see Table 1.1. As shown, the number of banks increased continuously, during 1993-1995. In 1996, three banks were deprived licence. All these banks were branch offices of the failed Czech banks.

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 1.1 Development of the Banking Sector in the Slovak Republic

Type of bank		1993				1994				1995				1996			
		1.1.	1.4.	1.7.	1.10.	1.1.	1.4.	1.7.	1.10.	1.1.	1.4.	1.7.	1.10.	1.1.	1.4.	1.7.	1.10.
Central Bank	a	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1
	b	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1
State-owned financial institutions	a	3	3	3	3	3	2	2	2	2	2	2	2	2	2	2	2
	b	3	3	3	3	3	2	2	2	2	2	2	2	2	2	2	2
Banks without foreign capital participation	a	8	8	6	6	7	7	7	7	7	7	7	8	8	6	6	6
	b	7	8	6	6	6	6	6	6	6	6	6	6	6	5	6	6
Banks with foreign capital participation	a	4	5	8	8	8	9	10	10	10	10	12	14	14	16	16	16
	b	4	4	7	7	7	8	9	9	10	10	10	11	13	15	16	16
Branch offices of foreing banks	a	7	9	9	9	10	10	10	10	10	10	9	9	9	8	7	6
	b	7	8	9	9	9	9	9	9	9	9	9	9	9	8	7	6
Banking Sector - Total	a	23	26	27	27	29	29	30	30	30	30	31	34	34	33	32	31
	b	22	24	26	26	26	26	27	27	28	28	28	29	31	31	32	31

a) number of commercial banks and branch offices of foreign banks licensed in the Slovak Republic
b) number of commercial banks and branch offices of foreign banks operating in the Slovak Republic

Table 1.2 Structure of the banking sector

Structure of the Banking Sector

Central Bank
(responsible for banking supervision)

National Bank of Slovakia

Commercial Banks

Banks without foreign capital participation

- Priemyselná banka, a.s.
- Prvá komunálna banka, a.s.
- Slovenská kreditná banka, a.s.
- Slovenská sporite¾òa, a.s.
- Dopravná banka, a.s.
- Banka Slovakia, a.s.

Banks with foreign capital participation

- Investièná a rozvojová banka, a.s.*
- Istrobanka, a.s.*
- Poštová banka, a.s*
- Všeobecná úverová banka, a.s.*
- Devín Banka,a.s.**
- Po¾nobanka, a.s.**
- BANK AUSTRIA, a.s.***
- CITIBANK (SLOVAKIA, a.s.***
- Creditanstalt, a.s.***
- Credit Lyonnais Bank Slovakia, a.s.***
- HYPO-BANK Slovakia, a.s.***
- Komerèní banka Bratislava, a.s.***
- ¼udová banka, a.s.***
- Tatra banka, a.s.***

Branches of Foreign Banks

- Banka Haná, a.s., Prostìjov
- COOP BANKA, a.s, Brno[x]
- Èeskoslovenská obchodná banka, a.s., Praha
- Ekoagrobanka, a.s, Ústí nad Labem[x]
- Internationale Nederlanden Bank N.V. Amsterdam
- Moravia banka, a.s., Frýdek Místek

Specialized Banks

State-Owned Financial Istitution

- Konsolidaèná banka, š.p.ú.
- Slovenská záruèná banka, š.p.ú.

Building Saving Banks with Foreign Capital Participation

- Prvá stavebná sporite¾òa, a.s.
- Stavebná sporite¾òa VÚB-Wüstenrot, a.s.

Representative Offices

- Èeská spoøitelna, a.s., Praha
- Investièní a poštovní banka, a.s., Praha
- Union banka,a.s., Ostrava
- Ve¾komoravská banka, a.s., Hodonín
- Živnostenská banka, a.s., Praha
- Banque Paribas
- Societe Generale
- Magyar Külkereskedelmi Bank RT Budapest
- Commmerzbank AG, Frankfurt
- Dresdener Bnak AG, Frankfurt
- Österreicische Volksbanken AG
- EBRD

* Banks with Minor Foreign Capital Participation (less than 20 %)
** Banks with Significant Foreign Capital Participation (20 to 50 %)
*** Banks with Majority Foreign Capital Participation (more than 50 %)
[x] The Branches have been sold to Dopravná Banka.
[x] The Sales agreement came into effect the 1th of November 1996

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 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.

1.4 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.

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 sporiteľňa VÚB-Wüstenrot, a.s., Bratislava , and Prvá stavebná sporiteľňa, 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.

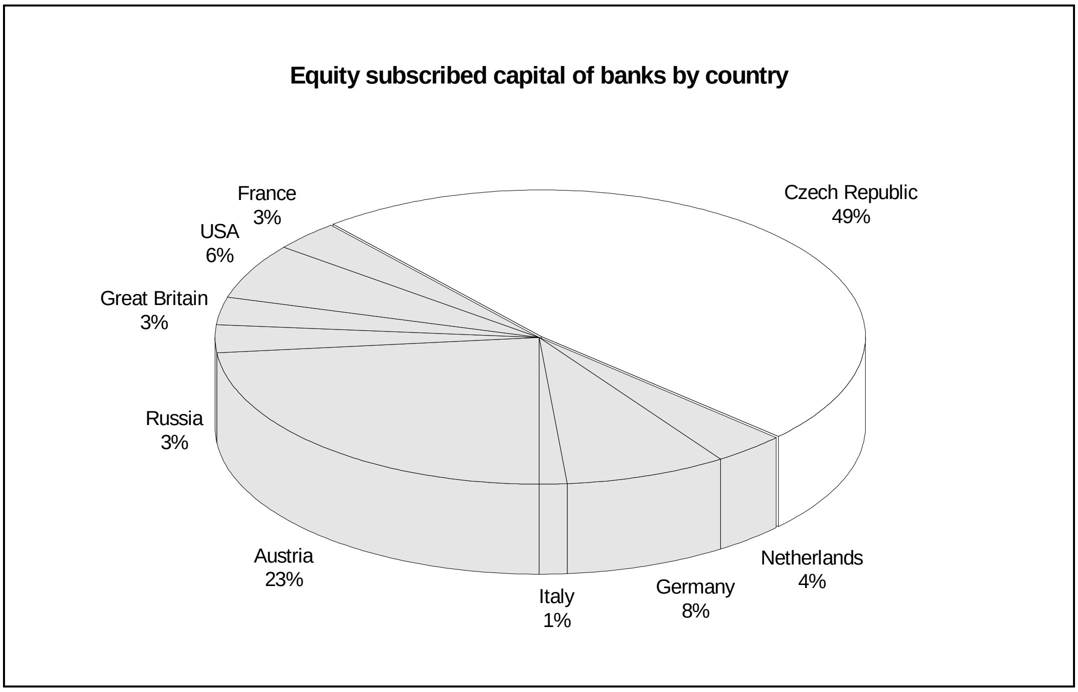
The amounts and shares of foreign capital participation in the Slovak banking sector by the weight on the equity capital are given in following table.

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 poľnohospodárska banka, a.s., Bratislava	21.6.1990	1250,1	36,20 250,00	2,89 20,00	Czech R. G.Britain
Stavebná sporiteľňa 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
Komerční banka Bratislava, a.s.	21.4.1995	500,0	500,00	100,00	Czech R.
Ľudová banka, a.s., Bratislava	1.7.1991	448,0	304,20 113,20	67,90 25,40	Austria Italy
Prvá stavebná sporiteľňa, 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	

Chart 1.2



1.5 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.

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.

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 sporiteľňa, a.s., Všeobecná úverová banka, a.s., Investičná 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.

2. Characteristics of economic development of the banking system

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 2.1 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 2.1 - 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 2.2 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.	48635	11.	54078	11.	5638	13.	7055	18.	9206	18.
Equity compositi												
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 2.2 – continued

	Domestic Banks						Branch Offices of Foreign Banks					
	6/1995	%	12/1995	%	6/1996	%	6/1995	%	12/1995	%	6/1996	%
<u>Total Liabilities</u>	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.	59479	11.	63225	10.	9421	17.	7417	12.	8041	12.
<u>Equity Compositi</u>												
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 2.3 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 2.4 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 2.5 Loans and deposits composition (in SKK million)

	12/1994	%	6/1995	%	12/1995	%	6/1996	%
<u>Loan composition</u>								
- 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
<u>Deposit composition</u>								
- 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 2.6 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.

- The change in earning assets composition as witnessed by the shift towards assets with a lower risk weight was reflected also in a relative decline of the amount of risk-weighted assets. During the relevant period this figure rose from SKK 308,167 mil to SKK 324,603 mil. Aforementioned relative drop in the volume of risk-weighted assets as calculated with the use of the following ratio "risk weighted assets / total assets" reached the level of SKK 83,637 mil, since this ratio fell from 0.681 to 0.541. This facilitated a more intensive provisioning, which was not fully reflected in the decline of capital adequacy ratio. The reason for this lies in the fact that an increase in provisions which are deductible from the amount of equity for the purposes of calculating the capital adequacy ratio was accommodated by a decline in the amount of risk-weighted assets.

- Liabilities and earning assets equal 89% and 88%, respectively, of total assets of the whole banking system. The spread between other income and other expenses enables an adequate profit creation. In order to create internal sources of funds that can be used to cover loan-related losses, such an average yield on loans has to be achieved which will enable the creation of provisions without incurring a loss. It can be seen from above that interest bearing liabilities and earning assets have been balanced. Interest income makes up 75.6% of total income and combined with other income stemming from interest earning transactions (fees etc.) it fully covers interest expenses, operational expenses and a standard level of profit margin. However, current level of interest income does not cover loan-related losses in their full extent, but corresponds only to a standard level of loan-portfolio quality, what would be a 2% share of loss loans on total assets. This implies that a higher level of general loan risk is reflected in relatively high average interest rates.

3 Description of the economic position of the banking sector and its basic trends

In the period of transition to a two-tier banking system, the initial economic position of the banking sector was characterized by the following basic features:

- Shortage of capital and inadequate structure of equity capital.
- Inadequate relationship between earning assets and sources of funds. This inadequacy was expressed in two ways. The first is the inadequate maturity structure of bank loans. Secondly, the discrepancy in terms of liquidity, which was reflected in a wide liquidity gap of negative value
- Unusually high rate of credit quality risk.

These three basic features were reflected, and the consequences of their gradual elimination are still reflected in the low level of profitability within the banking sector. This situation hinders the accumulation of internal resources necessary for the recovery of assets portfolios.

One of the most important requirements was, and is still the achievement of a standard level of liquidity expressed in terms of capital adequacy. Quite understandably, this requirement most affects banks with a majority share in the market for bank assets. Thus banks had to deal with two contradictory problems. On the one hand, the inevitable need to increase the amount of equity capital affected the index of year-on-year growth for 1994/1993 (148%). At the same time, however, it caused a decrease in the ratio of foreign resources to equity capital, from Sk 9.69 to Sk 7.13. In percentage terms, this decrease represents 26% with a direct impact on the aggregate ratio of profitability.

The aforementioned year-on-year growth in equity capital in 1994/1993 resulted in a 18% increase (Sk 75 billion) in foreign resources in 1995/1994. Economically vital need for an increase in the balance-sheet value of the banking sector posed the question where the required increase in foreign resources should be placed.

Banks used these funds to increase their capital adequacy ratios; as a result, the structure of their risk-weighted assets changed considerably. The decrease in the share of loans within the structure of earning assets, from 68% to 56%, was accompanied by an increase in the share of securities to 18%, from 6%. Government securities accounted for 95% of the total volume of securities in portfolio.

As a result, the converted value of risk-weighted assets fell by Sk 83 billion. The proportion of risk-weighted assets to total assets fell to 0.541, from 0.681. Thus the change in the structure of risk-weighted assets made it possible to increase the ratio of capital adequacy by 1.06 points. (Later we shall deal with the problem how this trend affected the development of profitability.)

The time discrepancy culminated at the end of 1993, when it reached a level of Sk 78 billion, representing 17% of the balance sheet value. This development was due mainly to the increased involvement of the banking sector in the process of covering the financial needs of small- and large-scale privatization projects. These projects were predominantly financed through medium- and long-term credits. The banking sector gradually reduced this discrepancy to Sk 47 billion, representing 7% of the balance-sheet value. However, the downward trend in the value of time discrepancy resulted in a fall in the level of profitability. On the one hand, the share of time deposits as resorces bearing a higher interest increases; on the other, the percentage of short-term deposits (assets earning less interest) grows. If such time deposits are placed in Treasury bills, the above influence on the degree of final efficiency will be stronger.

The banking sector is gradually learning to cope with the problem of liquid assets. While in 1993, the volume of unstable liabilities was Sk 80 billion larger than that of liquid assets, this difference currently amounts to Sk 53 billion. In maintaining the required level of liquidity, however, a decisive factor is the coverage of such discrepancy by equity in percentage terms. In 1993, the negative liquidity gap was covered by equity capital up to 60%. In 1994, the liquidity gap was, for the first time, covered up to 102%; this value currently stands at 107%.

These trends work as communicating vessels, they influence one another, and determine the profitability of the banking sector. The Institute of Monetary and Financial Studies is currently preparing a methodology for evaluating the economic positions of commercial banks. We have selected nine key balance-sheet ratios measuring a bank’s financial conditions. We know, on the basis of a regression analysis, that the level of profitability is influenced by these ratios, up to 88%. At the same time, we can also analyze the mutual relationships between them by means correlation matrices.

With regard to liquidity, the basic trends described above open up possibilities for the accumulation of internal resources within the banking sector in the form of earnings. Banks’ effort to increase the capital adequacy ratio through the shift towards assets with lower risk caused a decline in gross average yield of their assets. Net interest margin thus lowered from 5.28 to 4.73. Despite the decline in the average yield on assets and consequently also in the net interest margin the resulting profitability increased. Return on assets of the whole banking system rose from 0.67 as of 1993 to 0.87 as of 1995.

At the first glance this might seem controversial. Interest yield has lowered together with the net interest margin, as the interest income declines faster than interest expenses. At the same time the overhead efficiency which describes the relation between other income and other expenses of the banks has been stable. On the other hand the profitability increased. The common denominator of these two controversial features is the impact of banks’ loan portfolio on their economic position.

The average yield on loans has been steady for a long time and it reaches around 14.8%. This rate amounts to 141% of the average rate on interbank assets and 214% of the average rate on securities. Despite this fact banks have been incurring a loss on loans. It is influenced by an extremely long period of loan turnover caused by a high proportion of non-current loans. Gross provisioning represents 19.4% of overall expenses, while the use of provisions amounts only to 5.6% of total income. Net provisioning thus have a crucial impact on the net non-interest margin, which is therefore negative. The net non-interest loss absorbs roughly 85% of the net interest income. The amount of net provisioning corresponding to Sk 1 of assets equals Hal 1.85, what amounts to 68% of the operational margin of Hal 2.72 to Sk 1 of assets.

These figures which make up the resulting profitability are related to the loan profitability. It can be evidenced by the development of correlation coefficient explaining the relation between the some assets composition ratios and the profitability as expressed by return-on-assets. The correlation coefficient of the proportion of loans to ROA decreased from -0.194 to -0.418. This means that despite their high yield loans exhaust the profit. This effect is becoming increasingly visible. On the contrary, the positive impact of interbank assets on ROA is gaining importance, since their correlation coefficient increased from 0.184 to 0.350. Securities play a specific role in this context. Their average yield is not sufficient for a creation of profit, but compared to loans securities do not exhaust so intensively and moreover they bring liquidity.

In terms of the need of restructuring the loan portfolio what enables to accomplish the overall assets recovery the shifts in the assets composition can be regarded as a positive feature.

It influences the possibilities of restructuring the loan portfolio in two ways:

- Provisioning partially absorbs previously created general reserves which are included in equity. The decrease in equity caused by this fact is being compensated by the drop in the amount of the risk-weighted assets. Thus the creation of reserves aimed to cover loan losses is not fully reflected in the decline of the capital adequacy ratio.
- Aforementioned impact of the change in assets composition enables to generate a higher amount of profit which acts as the vital source of provisioning. This is important, because the required provisioning should not result in incurring a loss. Otherwise provisioning is linked to the need of use of the liabilities. Then the discrepancy between earning assets and interest-bearing liabilities widens, what lowers the interest spread.

It can be understood that the influence of economic ratios upon the development of the level of banks’ liquidity and profitability is specific. It results from the environment surrounding banking systems in transition economies. Meanwhile, banking systems themselves experience the period of internal transition. That is why we regularly monitor the development of particular ratios, their mutual relations as well as their impact on the stability of the banking system. This short time assigned to our presentation did not allow us to define all the economic relations in their complexity. Our effort was to pinpoint the most important tendencies, which from the basis for the development of the economic position of the banking system.