NÁRODNÁ BANKA SLOVENSKA

Financial Stability Report
2003

NÁRODNÁ BANKA SLOVENSKA

Financial Stability Report

2003

Published by:

Imricha Karvaša 1
813 25 Bratislava

In cooperation with:

Financial Market Authority
Vazovova 2
813 18 Bratislava

and

Ministry of Labour, Social Affairs and Family of the Slovak Republic
Špitálska 4-6
816 43 Bratislava

Coordinator:
Governor's Office, NBS

Cooperators:
Institute of Monetary and Financial Studies, NBS
Banking Supervision Division, NBS
Banking Transactions and Foreign Exchange Division, Banking Transactions Department, NBS
Financial Management and Payments System Division, Payments System Department, NBS
Monetary Division, Monetary Policy Department, NBS
Capital Market Section, FMA
Insurance Section, FMA
Pension Savings Department, FMA
State Inspection Department, Ministry of Labour, Social Affairs and Family of the Slovak Republic

Contact:
Public Relations Department, NBS
Tel.: +421-2-5787 2142
Fax: +421-2-5787 1128
E-mail: webmaster@nbs.sk
The Financial Stability Report is available at http://www.nbs.sk

ISBN 80-8043-090-X

Contents

Foreword

The National Bank of Slovakia supports stability of the financial system, which belongs among its main objectives. Financial stability is defined as the situation when financial system and its varied elements – such as financial markets, financial institutions, systems for transfers of payments and securities, and settlement systems – function fluently and are prepared to settle potential difficulties. The analysis of situation and estimation of development trends in the economy help the National Bank of Slovakia in its efforts to identify future risks and factors leading to destabilisation of the financial system. The macroeconomic approach, which assesses the strengths and weaknesses of the financial system as a whole, and the microeconomic approach, which assesses the individual elements of this system and is supported by supervision of financial operations of individual financial institutions, are both important for the overall assessment of the stability of the financial system.

The *Financial Stability Report* is an output of such analysis. The National Bank of Slovakia has prepared its first edition, which reflects the situation in 2003, in cooperation with the Financial Market Authority, which is a supervisory authority in the area of capital market, insurance industry and old-age pension saving, and the Ministry of Labour, Social Affairs and Family of the Slovak Republic, which supervises the operation of the supplementary pension insurance companies.

The Financial Stability Report intends to assess the financial system in Slovakia and to bring the overview of potential risks with their implications on its financial stability. The Report consists of two parts, which complement each other. The first part provides the assessment of the international and national environment and focuses in particular on the weakening of financial stability, as the case may be, and risks for the national financial system arising thereof. Great emphasis is placed on the assessment of the situation and prevailing trends in the banking sector. The second part, containing Annexes, tackles those current issues which are closely connected with financial stability.

Executive Summary

For the Slovak Republic a high and steadily increasing degree of functional openness towards the euro area countries is characteristic. All in all, this openness contributes to the higher degree of the Slovak economy sensitivity to the development in these countries. However, owing to the growth effect of new investments, in particular foreign direct investment, which prevailed in 2003, the slowdown in the rate of growth in the euro area did not substantially influence the economic growth and stability of the Slovak financial system. The previously implemented structural reforms had also created the prerequisites for removing macroeconomic and microeconomic imbalances and for strengthening the overall economic and financial stability in Slovakia.

The positive development of the Slovak economy in 2003 has been documented by the relatively high rate of economic growth. The higher rate of inflation at 8.5% was a consequence of the implemented administrative price adjustments. When these adjustments are completed, the rate of inflation should substantially fall in the following years, this also in connection with the orientation toward the euro area. As at the end of 2003 the balance of payments current account deficit was 0.9% of GDP, representing the best result since 1995. It is expected that the development of the current account shall remain favourable also in the future, despite the growing import of technology and the forecast rapid economic growth. Although the unemployment rate fell in 2003, its high level, being at 17.4%, together with large regional differences, remained a serious problem for the Slovak economy. Significant progress was achieved in consolidating public finance. Here it was even managed to surpass the original budgetary target for 2003, where instead of the planned deficit of 5% of GDP, the public finance deficit was reduced to 3.5% of GDP. The government's reforms should create conditions for its further reduction.

The individual segments of the domestic financial market are not equally developed. The money market has been well prepared for ensuring inter-bank trading and has served a crucial function as a liquidity regulator. The important characteristic feature of its functioning in 2003 was a high volume of the excess liquidity sterilization by the National Bank of Slovakia. The interest of foreign investors in the Slovak koruna increased on the foreign exchange market mainly as a result of the lasting interest rate differential and the strengthening of the koruna exchange rate vis-à-vis the EUR and the USD. The central bank focussed on eliminating both the short-term effect of non-economic factors on the exchange rate development and its excessive volatility, thus preventing the adverse impact of the unstable exchange rate on the real economy and financial stability. Liquidity on the stock market remained low and non-financial corporations only rarely used securities issues to gain funds for their activities. The main financial sources for their activities were loans from commercial banks and external funds. The important segment on the long-term capital market remained debt securities, and mainly government bonds.

The important step of the NBS towards limiting systemic risks in the area of payment system was the take-over of the inter-bank payment system activities formerly conducted by the Slovak National Clearing Centre *[Bankové zúčtovacie centrum Slovenska]* by the NBS. Since 1 January 2003 the NBS has been operating a new, fully automated payment system (Slovak Interbank Payment System – SIPS), which is the only one in Slovakia providing domestic interbank transfers.

The banking sector as a whole can be currently considered stable as regards both finance and capital. However, attention should be paid to the factors, which have caused relative stagnation in some of its activities. In absolute terms its credit exposure increased, though in relative terms went down. Although banks had sufficient room for the further intermediation of loans without jeopardizing their financial stability, they did not exploit this potential. The growing liquidity surplus was invested prevailingly in government securities and loans to households, in particular mortgage and consumer loans, bearing low risk. Risk-free investing at a favourable rate was also present throughout the year in the form of the sterilisation of surplus liquidity in the banking sector by the NBS.

There also persisted a relatively high interest rate spread between the deposit and lending rates and the interest margin was a decisive source in overall profit. Throughout the year there subsequently occurred the accumulation of internal resources, by which the banks strengthened their stability and ensured their future competitiveness. In loan portfolios of banks short-term funds prevailed. This resulted from lower interest of banks in financing long-term investment projects of non-financial corporations, as well as from other possibilities for corporations to raise long-term funds, either via external long-term loans or increased foreign capital investments. In the coming period it is expected that, due to the fall in interest rates in the money market, banks will increase their credit exposure to corporations and households.

The most dynamic segment of the financial market from the viewpoint of other financial institutions was the developing collective investment, in particular mutual funds, where the amount of deposits was 3% of GDP at the end of 2003. In 2003 investments in the investment life assurance and supplementary pension insurance also increased.

Foreign capital represented a significant factor stabilising the banking sector, the insurance sector and the financial market in Slovakia. In the future, however, it will be necessary to monitor possible risks of transmission of external shocks also. In the event of an adverse cyclical development and disruptions in development abroad, the internationally integrated financial sector could be a potential source of financial instability for the domestic financial sector and the Slovak economy.

In 2003 the financial stability was not directly threatened in Slovakia. The expected positive development in the Slovak economy has created favourable starting point for maintaining stability of the whole financial system. In the long term it will be necessary to monitor in particular the risk arising from the quality of loans extended and their total amount; this in addition to the so-far insufficiently utilized growth potential of the banking and non-financial corporations sectors could cause the economy overheating and fast growth in prices of certain assets. Although the current trends do not confirm such development, it will be necessary to monitor further developments and avoid potential adverse trends by implementing adequate macroeconomic and microeconomic approaches.

1. The international environment

The international environment in 2003 was marked by an improvement in the cyclical position of the global economy, in particular thanks to the accelerated growth in the USA and the newly-industrialised Asian countries. The rate of growth in the euro area economy continued to slow on a year-on-year basis. In comparison with previous years the international trade grew and the financial markets recorded a rise. From the aspect of risks for the financial stability, the development over 2003 may be evaluated as positive, particularly in the context of its expected further improvement. However, certain risks persisted. These concerned primarily geopolitical risks and risks ensuing from existing global imbalances, where this concerned primarily the deepening problem of the United States' excessive current account deficit against the surpluses of export-oriented Asian economies.

The European Union acceding countries (including the V4 Group) maintained in 2003 a solid rate of economic growth, despite this adverse phase of the global economic cycle. However, the financial stability parameters of some countries worsened.

1.1 Main sources of imbalance in the external environment

After two years of problematic development in the global economy accompanied by geopolitical tensions, the outlook since the second half of 2003 has improved

Global output in 2003 grew by 3.9%, (3.0% in 2002). The acceleration of global growth was due in particular to a significant acceleration in economic growth in the USA and fast growth in the developing countries of Asia, especially China.

At the beginning of 2003 the outlook for acceleration in the economic growth was very unfavourable. The cause was the emergence of military conflict in Iraq, which at the end of 2002 induced negative expectations and led to a growth in oil prices. The situation was further dramatised by the outbreak of the SARS epidemic, which struck and negatively affected in particular the economies of East Asia and paralysed international tourism. As a result, recession in many parts of the world was deepened and a drop on stock markets recorded new lows in March.

Table 1.1 Global output **(annual percentage change)**

	2002	2003	2004[1/]	2005[1/]
Global output	3.0	3.9	4.6	4.4
Advanced economies	1.7	2.1	3.5	3.1
USA	2.2	3.1	4.6	3.9
Japan	-0.3	2.7	3.4	1.9
European Union (EU15)	1.1	0.8	2.0	2.4
Euro area	0.9	0.4	1.7	2.3
Newly-industrialised Asian countries	5.1	3.0	5.3	5.0
China	8.0	9.1	8.5	8.0
Central and Eastern Europe	4.4	4.5	4.5	4.4
EU acceding countries (ACC10)	2.4	3.6	4.0	4.2
Russia	4.7	7.3	6.0	5.3

[1/] Projection
Source: World Economic Outlook, April 2004; Economic Forecasts Spring 2004, European Economy No 2, 2004

Table 1.2 Volume of global trade (goods and services) **(annual percentage change)**

	2002	2003	2004[1/]	2005[1/]
Volume of global trade	3.1	4.5	6.8	6.6
Imports				
Advanced economies	2.3	3.5	5.7	5.4
Developing economies	6.2	8.9	10.2	9.4
Exports				
Advanced economies	1.9	2.7	6.3	6.1
Developing economies	6.5	8.7	8.1	8.7

[1/] Projection
Source: World Economic Outlook, April 2004

The end of the Iraq War at the start of May and the halting of SARS spread led to a global economic upturn. A recovery was recorded also in the global trade of goods and services, which in 2003 grew by 4.5% (as compared with 1.4 percentage points in 2002).

Global economic growth was supported by an expansionary setting of monetary and fiscal policies in many countries around the world. The interest rates of the major central banks dropped to historically low levels. The economic environment, however, did not stimulate a growth in prices, and inflation stood at favourably low values in general.

The growing global imbalance was becoming a crucial issue and a potential risk to the future development of the world economy

A source of global imbalances rested both in increased public finance deficits in several advanced and developing economies and in the high current account deficit of the USA contrasting with large current account surpluses of other countries. These imbalances were, inter alia, reflected in the development of exchange rates, most markedly in that of the US dollar.

In this context, the dollar's depreciation from its strongest level in February 2002 was favourable. The increase in the price competitiveness of the US products via a growth in foreign and domestic demand for these products worked as a balancing factor. However, the corresponding appreciation of other currencies concentrated in the currencies of advanced economies whose cyclical position was weak (the euro area, Japan). As domestic demand in the USA has been continually growing, forecasts predict only a slight improvement in the US current account deficit (to 4% of GDP by 2009). Therefore the pressures for freeing the fixed exchange rate regimes of countries with high trade surpluses (in particular the Chinese yuan and South-East Asian countries' currencies pegged to the US dollar) have become stronger. At present, these currencies are seen to be increasingly undervalued, and thereby artificially support the competitiveness of their countries' domestic production on global markets.

Economic development in the euro area in 2003 recorded a further slowdown in the rate of growth

GDP growth in the euro area reached 0.4%, which was half a percentage point less than in 2002 and the lowest growth since 1993. However, in the third and fourth quarter of 2003 the rate of growth on a year-on-year basis exceeded 1%, while the euro area economy stagnated in the preceding half-year. The main reasons for this development were a weak growth in private consumption (though almost 1 percentage point higher than in 2002), caused by a lack of consumer confidence in the economy's future development, and a negative growth in gross capital formation (however an improvement of 1.6 percentage points on 2002 was recorded) connected with uncertainties surrounding the future development of the euro exchange rate, as well as with the restructuring of balance sheets of banks and non-financial corporations. The contribution of net export to the real GDP growth was negative. Government consumption, conversely, grew relatively strongly (on average by 2%) and its contribution to the GDP growth reached almost half a percentage point. The largest euro area economy, Germany, in 2003 recorded a nega-

Table 1.3 Fiscal balance and current account position in selected economies (% of GDP)

	2002		2003		2004[1/]		2005[1/]	
	Fiscal balance	Current account	Fiscal balance	Current account	Fiscal balance	Current account	Fiscal balance	Current account
Advanced economies	-3.7	-0.7	-4.7	-0.8	-4.5	-0.6	-3.6	-0.6
USA	-3.3	-4.6	-4.9	-4.9	-4.8	-4.2	-3.5	-4.1
Euro area	-2.3	1.2	-2.8	0.6	-2.8	0.7	-2.4	0.8
Japan	-7.9	2.8	-8.2	3.2	-7.1	3.1	-6.6	3.2
United Kingdom	-1.5	-1.7	-3.0	-2.4	-3.0	-2.2	-3.0	-2.1
Canada	0.8	2.0	1.2	2.1	1.0	1.8	1.3	1.7
Hong Kong SAR	-4.9	8.5	-4.0	11.0	-4.9	10.3	-2.7	9.8
Korea	2.3	1.0	2.3	2.0	2.5	1.5	2.9	0.9
Singapore	4.0	21.4	1.8	30.9	1.1	28.0	1.2	26.7
Taiwan	-4.3	9.1	-4.0	10.0	-3.7	7.3	-2.9	6.2
China	-	2.8	-	2.1	-	1.6	-	1.9

[1/] Projection
Source: World Economic Outlook, April 2004; IMF WEO Database, April 2004

tive GDP growth (-0.1%), which was caused by a significant decline in domestic demand, as well as in net export.

The low growth in private consumption in the euro area also resulted from the adverse situation on the labour market and the low wage growth. Unemployment reached 8.8% of the workforce, representing a slight increase on 2002. The highest unemployment rate was recorded in Spain (11.3%), followed by France (9.4%) and Germany (9.3%).

The greatest risks to stability of the financial system in the euro area came from domestic financial imbalances, particularly in the non-financial corporations sector. These corporations in the euro area endeavoured to improve their balance sheets through reducing costs, scaling down investment activities and restructuring their debts. Although these efforts in general led to a growth in profitability, they did not manifest themselves in reducing the indebtedness of the sector as a whole. A satisfying fact in this context was that the level of debt of the sector in relation to GDP since the end of 2001 had not increased. However, differences have existed between individual sectors; the financial situation improved remarkably for instance in the telecommunications sector.

In 2003 the banking sector of the euro area withstood the third consecutive year of its weak economic performance. It managed to absorb the adverse effects of the economic environment thanks to reducing costs (reducing the number of employees and closing branches), reorganising its business (returning to "core" banking activities) and improving risk management. Large banks maintained, or even improved, their profitability and solvency. This was made possible by a relatively low creation of provisions for loan losses, cost savings through the rationalisation of business and an increase in earnings from activities on financial markets. As a result of this development, the monitored solvency indicators reported favourable values. Some banks, however, improved these indicators more through the sale of assets and the reduction of risk-weighted assets than through increasing the value of their equity capital. Changes in the ratings of European banks in comparison with 2002 were of a positive direction: a growth in the number of improved ratings was seen along with a fall in the number of rating downgrades. The overall balance, however, remained slightly negative.

1.2 Development in the V4 countries

The European Union acceding countries faced the task of implementing principal structural reforms supporting fast and sustainable nominal and real convergence to the euro area economy

Table 1.4 Economic growth, fiscal balance and current account of the V4 countries

	Real GDP (%)				Fiscal balance (% of GDP)				Current account (% of GDP)			
	2002	2003	2004[1/]	2005[1/]	2002	2003	2004[1/]	2005[1/]	2002	2003	2004[1/]	2005[1/]
Czech Republic	2.0	2.9	2.9	3.4	-6.4	-12.9	-5.9	-5.1	-5.8	-6.5	-6.8	-6.6
Hungary	3.5	2.9	3.2	3.4	-9.3	-5.9	-4.9	-4.3	-4.1	-5.7	-5.4	-5.1
Poland	1.4	3.7	4.6	4.8	-3.6	-4.1	-6.0	-4.5	-2.6	-2.0	-2.3	-2.8
Slovakia	4.4	4.2	4.0	4.1	-5.7	-3.6	-4.1	-3.9	-8.2	-0.9	-2.5	-4.0

[1/] Projection
Source: Economic Forecasts Spring 2004; European Economy No 2, 2004

Accession to the EU for new Member States also means a commitment to prepare their economies for the introduction of the euro. This means that macroeconomic policies must observe the set objectives (fulfilment of the Maastricht criteria), because changes in market expectations with regard to the success of economic convergence will represent a persistent source of pressure on exchange rates and interest rates.

The economies of Central Europe (V4 + Slovenia) grew on average relatively quickly (3.4%) in 2003. The fast growth of these economies, in the environment of subdued economic activity in the euro area, was maintained by a high level of domestic demand and export performance supported by new production capacities, and partially also by exchange rate developments. Major concerns of these countries were high fiscal deficits and in some countries also current account deficits. Moreover, as concerns Hungary and Poland, there also occurred a worsening in the perceived risk of the countries by foreign investors, which manifested itself in the exchange rate depreciation and in the case of Poland also in a growth in long-term interest rates. The higher risk perceived in relation to these countries was expressed also in their ratings. In June the Standard&Poor's agency changed the outlook for Poland to negative and in November downgraded the rating for government debt denominated in Polish zloty. In November, the Fitch Ratings agency changed to negative the rating outlook for the Hungarian debt denominated in Hungarian forint and in foreign currencies.

The significant growth in liquidity on the Slovak foreign exchange market and the increase in its transparency led to the fact that Slovakia was increasingly perceived as separate by foreign investors and not as a part of the region as a whole. Therefore, the impact of macroeconomic and monetary developments in neighbouring acceding countries on the Slovak economy was rather limited. The effects on the SKK exchange rate were very short-term and discernable only within the framework of one trading day.

The reforms supporting public finance consolidation, as well as the relatively stable monetary development, were reflected in the fact that the Fitch Ratings agency changed the rating outlook for the Slovak government debt denominated in foreign currencies to positive.

Table 1.5 V4 countries investment risk ratings as at the end of 2003

Country	Standard&Poor's	Moody's	Fitch Ratings
Czech Republic	A-	A1	A-
Hungary	A-	A1	A-
Poland	BBB+	A2	BBB+
Slovakia	BBB	A3	BBB

Source: Standard&Poor's; Moody's; Fitch Ratings

Transmission mechanism for shocks from the external environment

The standard scheme for the transmission of shocks for domestic financial stability is understood as follows: slowdown in the global economy → decline in the performance of the domestic economy → worsening in the financial situation of corporations and households in the domestic economy → pressure on the balance sheets of domestic banks → systemic risk for financial stability.

In the case of an adverse cyclical development the transmission channel could theoretically take the following form: slowdown in the global economy → worsening in the financial situation of corporations and households abroad → pressure on the balance sheets of foreign parent companies of banks operating in Slovakia → spread of instability via stakeholdings in domestic banks → systemic risk for domestic financial stability.

At present, we consider such a development in the Slovak Republic as unlikely. The risk of such a development could grow if domestic subsidiary banks changed their legal form from joint-stock companies with their own legal personality to branches of foreign banks, or if the number of branches of foreign banks operating in the Slovak financial market without their own legal personality increased.

1.3 Development on global financial markets

At the beginning of 2003 uncertainty prevailed on markets, ensuing from geopolitical risks and their impact on the world economy and international trade. The decline in risks in the course of the year significantly improved confidence on the markets.

Stock prices following a continued fall in the first quarter began to rise in the second quarter

The growing trend in stock prices on the major global stock exchanges continued throughout the year. The growth in stock prices was supported by a more favourable economic outlook, growing investor confidence, low inflation and low official interest rates, as well as a high volume of global liquidity. At the end of 2003 Standard & Poor's 500 stock price index grew on a year-on-year basis by 26% and the value of the Nasdaq composite index by approximately 45%. European indices also increased: the Euro STOXX 50 gained 16%, the German DAX went up by 37%, the British Financial Times SE 100 by 14%, and the Japanese Nikkei 225 by 24%.

The falling trend in yields from long-term government bonds stopped in June

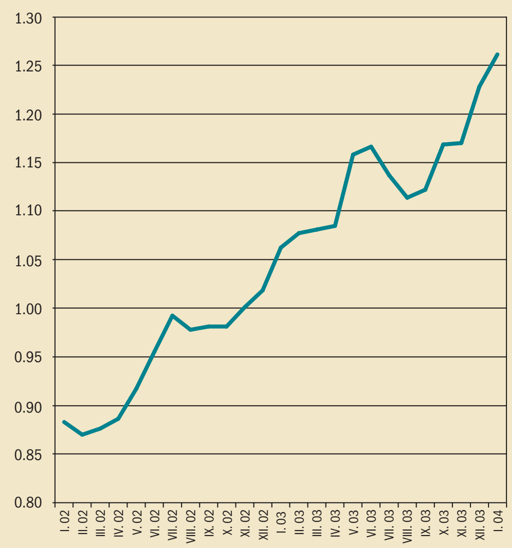
Until December yields had grown in the USA by approximately 0.9 percentage points to 4.26%, in the euro area by 0.6 percentage points to 4.36% and in Japan by 0.8 percentage points to 1.35%.

In the fourth quarter yields then stabilised in principle. This development signalled an improvement in the outlook for economic growth, supporting demand for stocks. However, with regard to the generally optimistic perception of the global economic growth, yields remained low. Low interest rates might generate a risk of a growth in stock prices regardless of fundamentals. A later growth in interest rates, in particular where it was sudden and unexpected, might induce a growth in volatility on the financial markets with a possible adverse influence on the economic recovery. While spreads between corporate bond yields issued by private corporations with the highest ratings and yields on government bonds decreased only slightly in the course of the year, spreads between corporate bonds with a high or low credit rating fell sharply (in the USA from 10 percentage points in February to 3 percentage points in December). The decline in risk premiums also signalled an economic recovery and a growth in investor confidence.

The US dollar weakened on international foreign exchange markets and the euro exchange rate continued to strengthen

The exchange rates on the international foreign exchange markets in 2003 recorded significant movements, brought about not least by growing imba-

Chart 1.1 Development of the EUR/USD exchange rate (monthly average)



Source: ECB Monthly Bulletin, February 2004

lance in the global structure of current accounts. The development of the US dollar, which depreciated against the euro (by 17%), the Canadian dollar (by 15.7%), the Swiss franc (by 12.1%), and against the yen (by 11.6%), was influenced by a lack of confidence among investors as to the sustainability of the US current account and the insignificant reaction of the US labour market to the economic recovery. The decline in the dollar's value was transmitted via interventions in the foreign exchange markets also to other currencies which were officially or unofficially pegged to the US dollar. For example, the dollar in the second half of the year strongly depreciated against the yen, but the extent of the dollar's depreciation, or the yen's appreciation, was limited owing to the large-scale interventions by the Bank of Japan. The (trade weighted) value of the yen over the year thus remained rather stable on average.

The euro, besides its high appreciation against the US dollar, appreciated in 2003 also against the yen and the British pound, though to a lesser extent than against the dollar. In the course of the year the euro strengthened significantly (measured on a weighted average by 11.5%) against the currencies of the euro area's 12 most important trading partners. The single European currency also significantly gained in real terms (i.e. after taking account of the inflation differential between the euro area and counterparty countries in the field of mutual trade). This development led, in particular at the end of 2003, to a worsening of the price competitiveness of exports from the euro area. Counter to this, however, there was the effect of a recovery in the global economic growth and global trade, representing an important stimulatory effect for the euro area production and exports.

2. Macroeconomic development, corporations and households

In the period since 1999 measures have gradually been implemented in the Slovak economy for resolving accumulated macroeconomic and microeconomic imbalances. These have been aimed at ameliorating the problem of the double deficit on the macro level and at the financial stabilisation of the banking and corporate sectors on the micro level. The current situation, although it is only an interim reflection of long-term endeavours, may be considered a significant advance towards the overall economic and financial stability.

Since the year 2000 a progressive reduction in the public deficit has been achieved. The process of consolidation was intensified after 2002 and its long-term aim was to achieve approximately balanced public finances. In 2003 the public finance deficit represented 3.5% of GDP[1]. The accelerated inflow of foreign direct investment (FDI) and the implemented reforms contributed to a significant reduction in the balance of payments current account deficit. It is forecast that the favourable development as to the external balance shall be sustained.

The restructuring of the banking sector contributed to the fact that today the sector reports very good parameters of efficiency and has the necessary preconditions for growth. Likewise, processes took place in the non-financial corporate sector, bringing a growth of efficiency and profitability, a decline in the share of loss-making corporations, and room for growth in their activities with the use of external funds also. Banks also began to take advantage of the opportunities provided by the household sector. This sector, so far, has had a low level of debt, and despite the fast growth in loans to households, lending to them has not represented any risk. Neither should the fast growth in mortgage loans represent any sizeable risk, since their volume has remained small and their provision is relatively prudent.

In the longer term it will be necessary to pay attention to the risks of overheating the economy and fast growth in asset prices[2], which is connected with the convergence of interest rates in Slovakia to the levels of interest rates in the euro area, and with the fact that banks and non-financial corporations are given room for faster growth. This risk may be avoided by adequate fiscal, structural and regional policy, and by banking supervision which will, in a greater extent, consider the possible future development in the economy, corporations and households.

2.1 The macroeconomic environment

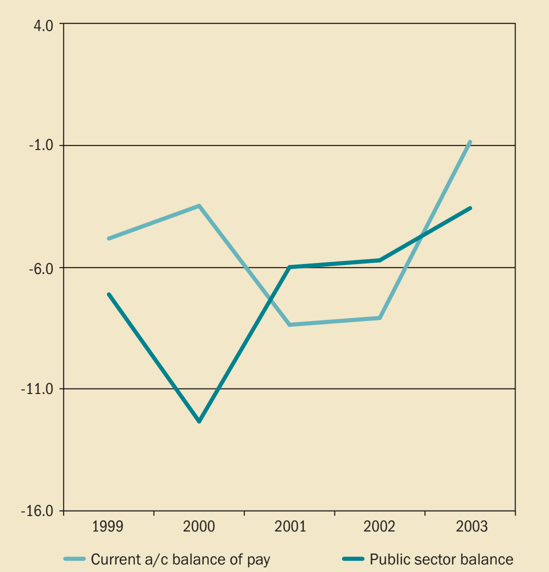
The acceleration of economic growth run concurrently with the reduction of the double deficit

A characteristic feature of the Slovak macroeconomic environment over the past years was that of accelerating growth in performance and increasing a degree of openness of the Slovak economy in the environment of double deficit (a balance of payments current account deficit and a public finance deficit). The rate of economic growth since 1999 had been smoothly accelerating and in 2003 for the second consecutive year exceeded the level of 4%. Economic growth did not directly depend on the economic boom in the EU. Its source lied more in new investment and production intended for export. Increased foreign investment directed towards Slovakia was motivated in particular by

[1] In the ESA 95 methodology.

[2] The so called “price bubble” in the assets market.

Chart 2.1 Double deficit development (percentage share in GDP)



Source: Statistical Office of the SR; NBS

lower wage costs, prospective EU membership and growing confidence in Slovakia's economic environment.

The economy's performance grew together with a growth in export performance. The latter increased from 61.4% in 1999 to 78% in 2003 and was strongly connected with the growth of import intensity, which went up from 65.7% in 1999 to 79.5% in 2003. More intensive foreign trade relations represented preconditions for structural changes and a growth in the economy's potential. At the same time, however, the economy's sensitivity to external shocks was increasing.

The external balance of the Slovak economy depended on export, which in turn relied on a greater penetration of foreign markets. As a result of the high import intensity of domestic demand, the adequacy of the growth in domestic demand also took on an important role. For example, in 2001 in consequence of the business cycle development on the EU markets, the sales of Slovak exporters were limited. Concurrently, domestic demand, driven by recovered private as well as public consumption, encountered an inflexibility in domestic supply. The disproportion between domestic supply and demand was solved by foreign supply. In the following year a partial turnaround was achieved thanks to significant export growth, and in 2003 the external imbalance was significantly ameliorated due to a continuing export growth and a decline in domestic demand. The current account deficit as a result of the significant improvement in the trade balance fell to 0.9% of GDP, which was the best value since 1995, when the current account ended in surplus.

Public sector finance from 2000, also in consequence of bank restructuring costs, was marked by high deficits and recovered only slowly. In 2003 it improved significantly in connection with widespread reforms aimed at consolidating public finance and achieving the sustainable fulfilment of the Maastricht criteria for deficit and debt.

The share of domestic savings in the financing of investment in 2003 increased (in 2003 more than 90 hellers of gross national economy savings pertained to one koruna of gross investment). This was in particular a consequence of the decline in the rate of gross investment. However, it is necessary to add that the efficiency of investment over the past years was growing.

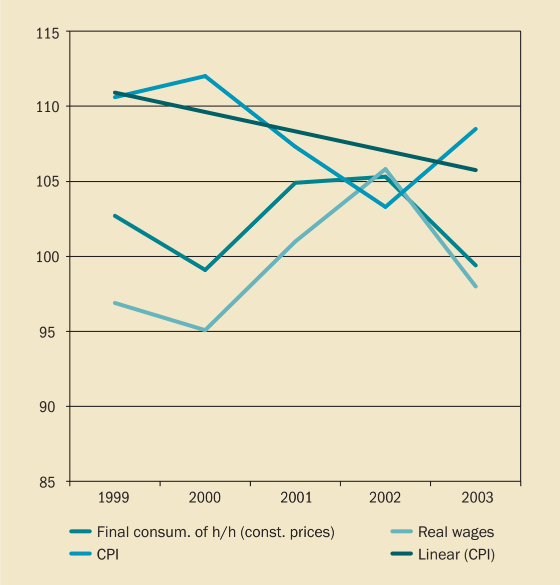
The cause of the decline in real wages was administrative price adjustments

Table 2.1 Development of investment and savings **(%, current prices)**

	1999	2000	2001	2002	2003
Gross savings rate[1]	23.2	23.7	21.8	22.3	23.3
Gross investment rate[2]	27.6	26.1	30.0	29.3	25.3
Coverage of investment by savings[3]	84.2	90.6	72.8	76.2	92.1

[1] *Share of gross domestic savings (GDP minus total final consumption) in GDP*
[2] *Share of gross capital formation in GDP*
[3] *Ratio of gross domestic savings to gross investment*
Source: *Statistical Office of the SR; NBS*

Chart 2.2 Development on the consumer market (year-on-year index)



Source: Statistical Office of the SR; NBS

Chart 2.3 Development of real labour productivity and real wages (year-on-year index)

Source: Statistical Office of the SR; NBS

The consumer market in Slovakia has for a long time now been marked by the gradual increasing of regulated prices (this concerns in particular gas, electricity, rent in state-owned and municipal apartments, water and sewerage fees) and by changes to indirect taxes (VAT, certain excise duties). These administrative adjustments also in 2003 substantially increased the level of inflation. To the average year-on-year level of inflation, which reached 8.4%, administrative measures contributed more than three quarters of the increase. For overall stability it was important that the high inflation did not feed through fully into wages. Real wages decreased, contributing to a decline in domestic demand.

The situation on the labour market has been characterised for a long time by a high rate of unemployment, though in 2003 this fell substantially from 18.5% to 17.4%[3]. This helped to maintain wage growth at a level lower than the growth in labour productivity and to achieve a favourable development in unit wage costs. An exception was 2002, when inflation fell in consequence of a slowdown in administrative price adjustments, while wages grew quickly, primarily in the public sector. However, consolidation measures in the field of public finance in the following year stabilised development also in the field of wages.

The exchange rate of the Slovak koruna has for a long time been appreciating against the reference euro

The improvement in the development of the current account of the balance of payments, public sector finance, the inflow of foreign direct investment, the upgraded ratings of Slovakia, as well as the continuing integration into international structures (the OECD and the EU), manifested themselves in the development of the Slovak koruna exchange rate against the reference currency, the euro. Overall, it may be said that the development of the exchange rate in the past years took on a trend of appreciation. This reflected the confidence of foreign investors in the macroeconomic stabilisation, as well as in favourable future development and a decline in the risk premium of Slovakia. On the other hand the persistent interest rate differential caused an inflow of short-term capital. The NBS tried to eliminate its effect on the exchange rate. The aim of the central bank was to act counter to both the short-term influence of non-economic factors on the development of the exchange

[3] *In the ILO (International Labour Organisation) methodology.*

rate and its excessive volatility, thereby preventing the negative influence of an unstable exchange rate on the development of the real economy and on financial stability. The stable development of the exchange rate in the context of a small open economy is a prerequisite for price stability also with regard to the role of exchange rate in the transmission of monetary policy.

In the context of consolidating the public sector, the continuing appreciation of the exchange rate and the decline in real wages and domestic demand, the National Bank of Slovakia in the course of 2002 and 2003 progressively reduced interest rates significantly so that the overall policy mix was not excessively restrictive.

The further acceleration of economic growth possible even without significant sources of disturbance to the macroeconomic balance

A significant factor that will influence economic development in Slovakia will be the inflow of foreign direct investment. In the medium term it should create the conditions for an acceleration in the process of real convergence, a growth in labour productivity and the Slovak economy's competitiveness. Economic growth could thus accelerate still further from its current level exceeding 4% without creating the basis for any significant sources of macroeconomic imbalance.

Price development, in accordance with the NBS's aim of fulfilling the Maastricht criteria for inflation by 2006, should be characterised by a gradual disinflationary trend supported by the continuing consolidation of public finance, as well as low imported inflation.

With regard to the expected recovery in the growth of real wages and a more significant recovery in investment demand, domestic demand should over the whole time scale operate to support the level of economic growth. In 2005 it is possible, in connection with fixed capital imports for the automobile industry, to expect a transitional worsening in the development of net export. In the following period, after launching the production in this sector, an improved development of the net export may then be expected, as well as a further gradual acceleration of economic growth.

The continuing consolidation of public finance will be a significant factor stabilising the macroeconomic environment. At the latest in 2007, the public deficit should be below the level of 3% of GDP. Together with an expected slight surplus on the current account of the balance of payments in 2007, the threats of the double deficit should be removed.

In the medium term, from the aspect of monetary policy, given the planned consolidation of the public sector continues (from the current 3.5% deficit of GDP to below 3% in 2007), it is possible to expect a gradual convergence of interest rates toward those of the euro area. As regards the exchange rate, the real appreciation may be expected to continue, where this should be connected in particular with the economy's development, primarily through the rate of growth in labour productivity exceeding that abroad.

2.2 Non-financial corporations

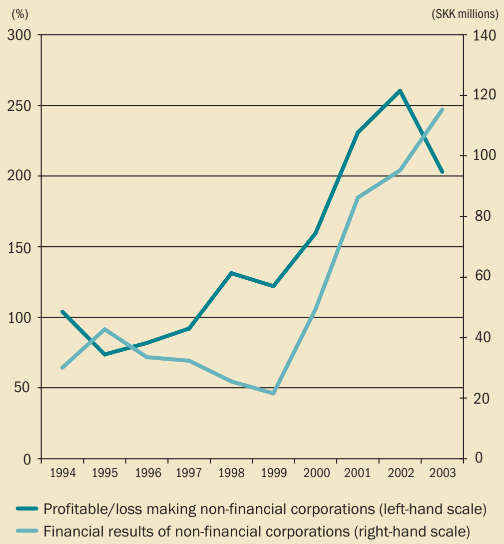
When assessing the tasks set for non-financial corporations in terms of creating preconditions for financial stability in the economy, it is necessary to consider how these corporations are financed and how their liabilities are formed. The domestic financial sector, in particular banks operating in Slovakia, has an important, albeit not decisive, role

Table 2.2 Share of loans and liabilities of non-financial corporations in total assets of the sector (in %)

	1999	2000	2001	2002	2003
Loans from banks in SR	17.40	14.82	10.58	10.03	9.92
Bank loans and assistance	21.52	17.65	16.89	16.37	16.19
Total liabilities	50.19	39.83	41.85	40.26	39.66

Source: Statistical Office of the SR, own calculations

Chart 2.4 Development of profitable & loss-making non-financial corporations



Source: Statistical Office of the SR, Aggregate financial results of financial & non-financial corporations

in their financing. Other elements, in particular financing by foreign banks and different forms of inter-company liabilities, are also important in terms of total amount of non-financial corporations liabilities. Moreover, growth in own funds, including funds from privatization and FDI, also participates.

The structure of non-financial corporations' liabilities has significantly changed since 1999 due to restructuring in the banking and corporate sectors. It is documented in Table 2.2. As shown, the share of loans granted by banks operating in Slovakia in the total assets of non-financial corporations sector has been gradually falling and currently is less than 10%. The important source of funding for non-financial corporations, in particular those supranational, also involves loans from banks operating abroad. These loans, when added to other forms of assistance, represent about additional 6% of the sector's total assets. Other funds, such as those created on the capital market and other liabilities of the sector, currently achieve about 24% of its total assets. Though the share of banks operating in Slovakia does not represent a large portion in the total assets of the non-financial corporations sector, their share is important in view of the structure of the sector's liabilities. They are also an important element in the earning assets of banks operating in Slovakia. Thus, the importance of non-financial corporations in terms of financial stability in Slovakia is also high. Chapter 4 brings the situational report of the banks operating in Slovakia.

The growth of overall efficiency of non-financial corporations

The basic features of the development in the non-financial corporate sector confirmed trends initiated in the restructuring process of the years 1999-2000. The share of corporations achieving profit was expanding, conversely the proportion of loss-making corporations was falling.

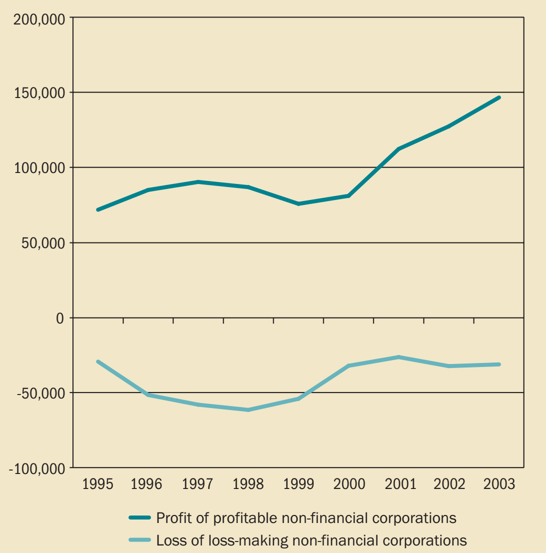
From the aspect of the reproduction of financial flows in the sector a positive feature was that the share of loss-making current assets in the sector was declining. This was confirmed by the development of selected indicators for the period 2000-2002[4]. While in 2000 the share of income of loss-making non-financial corporations in the total income of the sector was 21.27%, this figure declined in the following period and in 2002 reached 16.96%. Concurrently a decline in the share of loss-making non-financial corporations in the total added value of the sector was recorded, falling from 17.01% to 13.83% in 2002. This meant a reduction in the influence of loss-making corporations on the aggregate profitability of the sector and an increase in the health of financial flows.

The decline of the degree of credit risk

A significant role influencing this trend was played by the banking sector. The stricter lending policy of banks was reflected in reduced lending to loss-making non-financial corporations. This brought transparency to, and highlighted, differences in the development of basic performance parameters between the profitable and loss-making parts of the sector. From the aspect of future financial stability this was a very important factor. For potential shareholders, investors and trading partners it

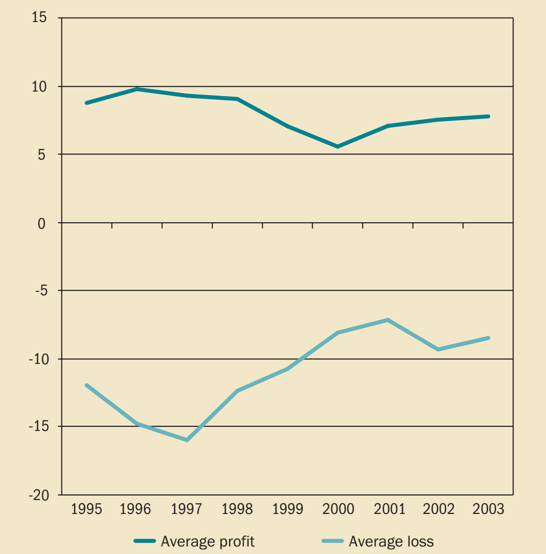
[4] *Based on data from the Statistical Office of the SR: At the time of concluding the Report, data were available only for until 2002. Partial data as to the development in 2003 confirmed these trends. Owing to certain specific features of the data, the development in 2003 is commented separately.*

Chart 2.5 Development in profitability and losses of non-financial corporations (in SKK millions)



Source: Statistical Office of the SR, Aggregate financial results of non-financial and financial corporations

Chart 2.6 Development in average profitability & losses of non-financial corporations (in hellers, on SKK 1 of income)



Source: Statistical Office of the SR, Aggregate financial results of non-financial and financial corporations

is important that they gain a more realistic view of the economic position of corporate entities and loss-making entities enter into financial flows in smaller extent.

The increase in the non-financial corporate sector's efficiency is also confirmed by Charts 2.5 – 2.6. These Charts document the growth in the volume and percentage of profit of profitable corporations and the decline in the volume and percentage of loss of loss-making corporations, as well as gradual polarisation of the profitable and loss-making parts of the sector. Furthermore, Chart 2.4 shows that in the long term (until 2002) the ratio of profitable to loss-making non-financial corporations more than doubled with regard to their number.

Through cutting off inefficient and loss-making credit flows the level of debt of corporate assets was reduced. This also resulted in a decline in the general level of credit risk. Such a development did not only result from the mentioned stricter lending policy of commercial banks operating in Slovakia, it was also based on the improving possiblities for corporations to exploit other sources of financing.

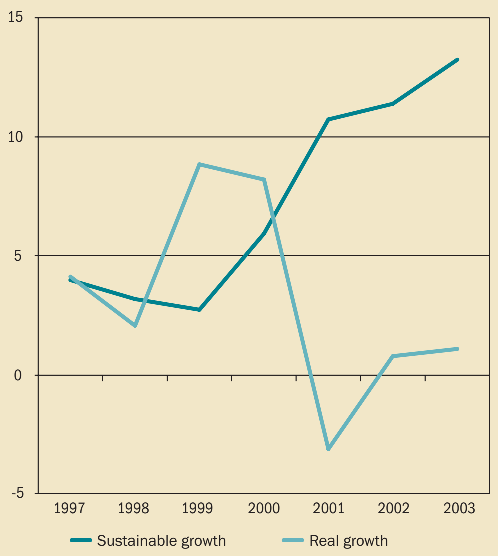
The conservative approach of banks in lending to non-financial corporations in Slovakia was also documented by a gradual decrease in total domestic and foreign bank loans provided to these corporations after 1999. In 2002 the volume of these loans in absolute terms stagnated. In relative terms however, the share of bank loans in the liabilities structure of non-financial corporatr sector was continually declining. The decline in the share of loss-making corporations allowed receivables to become a more realistic source of financing. There also occurred a reduction in the volume of inven-

Table 2.3 Development of non-financial corporations profitability indicators (in %)

	1999	2000	2001	2002	2003
ROA[1/]	1.23	2.59	4.69	5.15	6.18
ROE[2/]	2.67	5.60	9.70	10.22	11.71

[1/] *Return on assets*
[2/] *Return on equity*
Source: NBS

Chart 2.7 Comparison of sustainable and real growth of non-financial corporations (in %)



Source: NBS

tories and a significant decline in their share in corporate assets from 9.5% (1999) to 5.6% (2002).

Room for a growth in assets was characterised by a rate of sustainable growth. This room was expanding in the non-financial sector thanks to the favourable development of efficiency indicators.

The sustainable growth of corporate assets over the period 1997 – 2000 was on aggregate lower than real growth. The stabilisation of the economy and restructuring of banks and other corporations led to the fact that since 2001 sustainable growth has been higher than real growth. Non-financial corporations – neither those profitable – thus from 2001 did not fully exploit room for drawing domestic and foreign loans.

Since the year 2000 other parameters of sector's operations have also improved. The capital ratio and the ratio of earnings to assets have grown. While in 1999 for SKK 1 of assets there were reported SKK 0.9 of earnings, in 2002 the latter figure was SKK 1.1. The non-financial corporate sector has had the potential for further sustainable growth, room for greater encumbrance of current assets and greater return on investments. In the hitherto lesser importance of financing via the capital market and in the declining share of financing via loans, the role of own funds was also growing. The repeated reduction of corporate income taxes also contributed to their formation.

Despite the above, loans remained an important source of non-financial corporations financing. They were also important for domestic banks as their assets, although the weight of loans in the balance sheet of the banking sector was gradually decreasing. Table 2.4 contains selected indicators of the activity of the domestic banking sector as a whole. In particular, the values of potential growth indicate that the banking sector had the potential for a growth in lending, i.e. also to the non-financial corporations sector. This sector was able to absorb a higher volume of debt, which also included loans. The banking sector had room for higher leverage, and the non-financial sector had room for greater encumbrance of current assets with fixed capital. There thus existed room for banks to intermediate more funds for financing the non-financial corporate sector's development without threatening their own stability. While gradually using this space, the

Table 2.4 Selected indicators of banking sector activity (in %)

	1999	2000	2001	2002	2003
Sustainable growth	-40.13	10.00	15.15	18.00	14.56
Real growth	-3.78	9.90	9.79	9.17	-1.91
TABS/GDP	94.42	95.47	96.29	94.45	83.18
Loans/TABS	50.38	45.30	28.32	31.17	26.79
Loans to households/ Total loans	13.75	14.32	20.88	23.27	29.07
Deposits of households/ Total deposits	66.53	61.64	59.06	51.57	48.42

TABS = total assets of the banking sector, **GDP** = gross domestic product at current prices
Source: NBS

banks had to be careful not to threaten both their own and overall economic stability by the excessively fast growth in lending.

The ability of non-financial corporations to repay debts has since 1999 been gradually improving. The coverage of liabilities by equity improved, and the ratio of liabilities to capital fell from 1.0 (1999) to 0.8 (2002). The coverage of (short-term) liabilities by profit, claims or earnings similarly improved.

The assessment of development in the non-financial corporations sector in 2003 is only possible on grounds of preliminary data and incomplete estimates[5]. It is based on the unaudited data of the non-financial corporations which employ 20 and more people. These corporations stood for more that 80% of the sector's production. The data confirmed trends observed over the period of bank and corporate restructuring through 2002. Thus, the efficiency, profitability and profit volumes of profitable non-financial corporations increased. The adverse impact of loss-making corporations on the sector further decreased. These data confirmed that the sustainable growth in the non-financial corporate sector in 2003 accelerated and substantially exceeded the real growth. Thus, room for continued growth using external sources, including bank loans, has still existed in the sector of non-financial corporations. This room can be utilized by domestic banks through granting their loans in koruna, or in foreign currency, e.g. for the refinancing of loans which were formerly granted by foreign banks. In 2003 the volume of loans in foreign currency granted by domestic banks increased by 27% as compared with 2002[6].

The overall stability and risk of the non-financial corporate sector can be characterized by the birth and death rates and the ratings assigned by rating agencies. The establishment of new corporations since 1999 has gradually accelerated and their birth rate grew from 6% to 9% (2001), which is approximately at the level usual for EU countries. It significantly slowed in 2002, when it fell to 4%. The winding-up of businesses through liquidation (the death rate) was however unusually low (less than 1%) and did not allow credible conclusions to be drawn as to the overall stability of this sector.[7]

The rating of the Slovak corporate sector has as yet not been common practice. This is connected with the manner of financing, in which bank loans predominate, while own funds and the role of capital market in corporate financing are less significant. Only the largest corporations of international importance have ratings for domestic and foreign debt liabilities, the level of which is derived from the sovereign rating of Slovakia. This has improved substantially, where in 1999 it was at the level of BB+ (S&P, Fitch, R&I) or Ba1 (Moody's), and by 2003 increased to BBB or A3 respectively.

2.3 Households

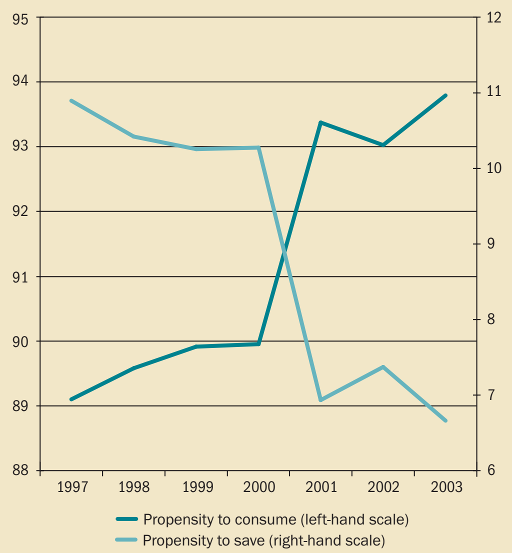
The increasing share of households in loan allocations

Over the period 2000 – 2003 the bank loan allocation structure between households[8] and the non-financial corporate sector changed significantly.
In the year 2000, 13.43% of the total volume of loans (calculated from the balance of bank lending) was allocated to households. In 2002 the share of loans to households increased to 24.85% and in 2003 reached 29.07%.

Households took advantage of the then current orientation of commercial banks in providing loans primarily as a source of financing their investments. Banks on the other hand responded to the fact that credit risk in relation to households was low. Although this risk has currently grown slightly, it does not threaten the financial stability of banks in the medium term. On aggregate then, the role of households in relation to banks has been changing, their position as debtor has grown and their position as creditor has declined. This can be seen also in the

5 *Statistical Office of the SR: Statistical report on the basic development trends in the Slovak economy in 2003.*
6 *See Table 4.5 Distribution of loans by sectors, p. 43.*
7 *An important role is clearly played here by different legislation and statistical methodology, as well as the extraordinarily long winding-up process of businesses drawn out by the court and bankruptcy proceedings.*
8 *Here, households include the sectors of inhabitants and sole traders, as defined in the national accounts methodology.*

Chart 2.8 Development of propensity to consume and to save (in %)



Source: Statistical Office of the SR; NBS

share of household deposits in total deposits, which fell from 66.53% (1999) to 48.42% (2003).

From the aspect of the structure of loans provided to households, loans for real estate continued to predominate, which was confirmed by the relatively high annual increases in mortgage lending. The provision of consumer lending increased slightly, and this also indirectly via the provision of funds for hire-purchase sales.

One of the factors influencing the change in the position of households (from creditor to debtor) was a decline in real deposit rates, in consequence of which there was also a decline in interest income. Hitherto, this created a decisive part of incomes from assets. On the other hand expenditures on assets increased due to a growth in fees for the administration of households' financial assets, in particular bank fees.

The retraction from saving and households' orientation towards consumption was also confirmed by the development of other indicators. In 2002 final consumption within the structure of the use of incomes in the household sector was 93%, in 2003 went up to 93.8%. Within the gross disposable income, the share of household savings fell by 4.05%, where this represents a long-term trend.

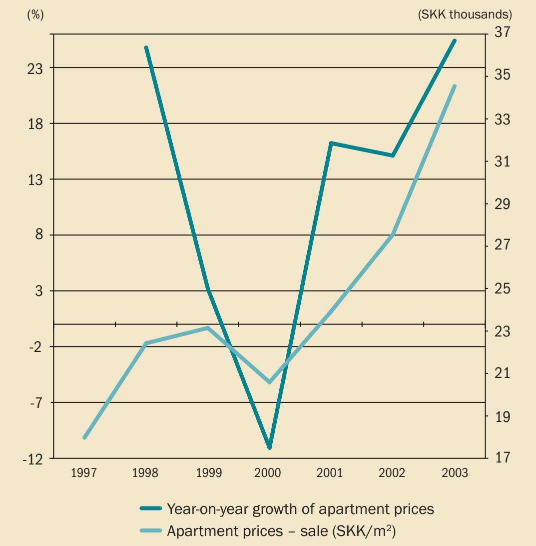
From the aspect of overall financial stability, these trends were not considered risky then. The banking sector had room for growth in credit exposure to the corporate sector and to households. Both the corporate sector and households had room for debt financing. The indebtedness of households was low, bank lending to households on aggregate represented less than 15% of their disposable incomes. However, it is necessary to add that in 2003 its growth represented approximately 5% of households' disposable incomes. The central bank has focused on this development, in particular in the light of the expected convergence of interest rates in Slovakia to those in the euro area and the risk of an excessive growth in loans and of overheating the economy.

Loans to households and real-estate prices

Real-estate prices can play a significant role in forming demand for loans and, conversely, also the supply of credit funds can have an impact on real-estate prices.

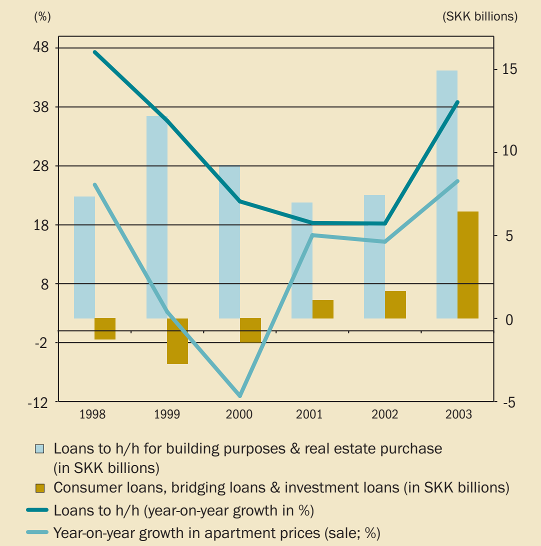
With regard to the fact that the physical volume of real-estate is fixed over the short term, the value of collateralised real estate is determined primarily by movements in its prices. A growth in real-estate prices, which can be brought about by a growth in aggregate demand, a fall in interest rates, or other rational or irrational factors, increases the value of households' assets and thus also their ability to obtain loans. The resulting growth in lending subsequently increases economic activity, which can induce a further growth in real-estate prices. Thus there can occur a self-accelerating process. However, there can also occur another situation, where an additional supply of loans (in the situation of surplus liquidity) increases demand for real estate, while its supply over the short-term is fixed. This then also leads to a growth in real-estate prices.

Chart A Development of apartment prices – sale



Source: Trend

Chart B Development of loans to h/h & apartment prices – sale



Source: Trend

On the basis of unofficial database of real-estate prices[9] (apartments – sale: price/m^2), their development was characterised by a growing tendency, mainly from 2001. A relatively significant growth in apartment prices also occurred in 1998, which was probably influenced by expectations of a depreciation of the Slovak koruna (under the influence of the Russian crisis), uncertainty surrounding parliamentary elections, as well as the abandonment of the fixed exchange rate regime and the subsequent depreciation of the koruna. Concurrently, this development was probably also affected by the launch of the building society lending (its volume increased in the course of 1998 from SKK 2.3 billion to SKK 9.6 billion). In the following year the growth in apartment prices slowed and in the year 2000 prices even declined, which was probably influenced by the implementation of the austerity package with a subsequent impact on decline in domestic demand, or its stagnation. The development of the credit market could also have a certain influence on real-estate prices, where the credit market was influenced by the process of restructuring the loan portfolios of selected banks and their preparation for privatisation, which was reflected in a reduced willingness of financial institutions to provide new loans. From 2001 there was a recovery in the growth of apartment prices, where this trend culminated in 2003 (reaching approximately 25% on a year-on-year basis).

Chart R 2.2 indicates a certain connection between the growth in apartment prices and the year-on-year growth in the lending to households. The slowdown in the growth, or decline in apartment prices in 1999 and 2000 was accompanied by a moderation in the year-on-year growth in lending. However, the acceleration in the development of apartment prices in 2001 and 2002 did not cause a change in the growth of lending to households. This was apparent only from 2003.

In absolute terms the growth in lending over the period 1998 – 2002 was essentially constant, varying in the range of SKK 8 billion through SKK 9.5 billion. From this aspect, 2003 represented a breakpoint in the development of lending to households (a growth of approximately SKK 24 billion).

In 2003 mainly, there can thus be seen a certain causal relation between the development of lending to households and real-estate prices. Besides purely economic influences, the situation in the credit market and the real-estate market was also influenced by new product development – the mortgage lending, significance of which began to increase from 2001, as well as by the system of state support for housing and changes to it (the

[9] *As there was no official statistics on real-estate prices available when this analysis was made (it is now being prepared by the Statistical Office of the Slovak Republic), this analysis was based on data provided by the TREND magazine.*

state contribution provided to cover the interest rate cost on such loans has, since 2003, been reduced firstly from 4.5% to 2.5% and since 2004 to 1%, and for credit contracts concluded since July 2003 the amount of the state contribution has ceased to be guaranteed for the whole period of loan repayment). An economic factor which contributed to the growth in the demand for loans, as well as in their supply, was the relatively significant liquidity surplus and the resultant interest among banks in longer-term lending, in particular to households. The relatively aggressive advertising campaign by commercial banks for mortgage lending, together with relatively low interest rates (below the level of interest rates on loans provided by building societies) equally contributed to a growth in the interest in this form of finance. The development of real-estate prices was influenced also by Slovakia's accession to the European Union and the related expectations of growing demand for real estate.

Thus, in 2003 the credit market was influenced by various economic and non-economic factors, which contributed to a significant interest in drawing primarily mortgage loans and concurrently to a growth in demand for real-estate. With regard to the fact that the supply of real-estate was fixed over the short term[10], this led to a growth in prices. At the same time the value of collateral increased (in this case real-estate prices), which collateral households could use as credit security (for example in the case of a mortgage loan for unspecified real estate; other real estate owned by the loan applicant served as collateral). The growth in credit sources caused an increased demand for real estate, thus posing additional pressures on real-estate prices.

Concurrently, higher real-estate prices could influence not only the drawing of mortgage loans, but also other forms of lending, primarily of a consumer nature (consumer loans, bridging loans to cover a temporary lack of funds), which can similarly be secured by real estate. The growth in real-estate prices and thus in household "wealth" could also stimulate demand for this form of lending. Loans drawn by households intended for the purchase of consumer goods partially compensated for the impact of both a growth in living costs (administrative price adjustments and changes to indirect taxes) and a decline in real wages on final consumption.

Though the loans provided to households are relatively well secured, a potential continuation of their dynamic growth could nonetheless generate a certain risk to the banking sector in the form of a worsening in the quality of the loan portfolio. With a growth in lending an increase in the interest rate costs for households is also connected. This could – in the event of a decline in economic activity, a growth in unemployment, etc. – result in the worsening of financial situation of households with a subsequent impact on their ability to repay loans. A certain risk may also be connected with a significant decline in real-estate prices with an impact on the decline of credit collateral value (in the case of mortgage loans, the loan is provided only up to 70% of the price of the real estate). Development on the credit and real-estate markets did not have any impact on the financial stability in 2003.

[10] On the basis of a statistical report by the Statistical Office of the Slovak Republic on basic development trends in the Slovak economy in 2003, the number of completed apartments was 13,980 (2002: 14,213), the number of newly-started apartments represented 14,065 (2002: 14,607) and the number of unfinished apartments reached 39,593 (2002: 46,271).

3. Financial markets

The domestic financial markets remained limited both in the extent of trades, and in the number of institutions. Despite this, primarily following the restructuring of the banking system, they became a stable component of the domestic financial system. Risks ensuing mainly from the limited capacity of the domestic financial markets can be significantly eliminated by means of an effective stabilisation policy and improved microeconomic basis.
The financial market of the Slovak Republic recorded a period of cardinal qualitative and quantitative growth over the past years. The essential elements involved the respect for the domestic economic environment's needs and the efforts to create the conditions, instruments and institutions enabling cooperation with systems in comparable countries and advanced economies.

A long-term problem was the cumbrous developing debt securities market, the limited extent of equity securities, with their minimal trading, and the relatively small range of products available. The domestic financial market expressed to a significant extent the existing possibilities of a small country in which a standard financial system and its institutions were gradually being created. It was thus natural that the most developed were those forms supported by central authorities, or which reflected systemic requirements. A principal segment of the long-term financial market comprised, as is often typical, debt securities with a principal dominance of government bonds. Despite a certain conservatism and stability, the development of new trades relating in particular to collective investment was also apparent. The domestic money market, besides ensuring interbank trading, served as the principal regulator of monetary liquidity with an influence on the development of inflation, where a trend in the use of derivatives, though not particularly dynamic, but certainly discernible, could be seen. Derivatives, though taking a special form of short-term swaps, also dominated the domestic foreign-exchange market. This market can serve as a long-term example of the significance of the mutual cooperation of domestic and foreign institutions in the ever increasing market turnover, including the execution of spot deals. It is participation, though limited, in international financial cooperation and trading that can be one of the decisive stimuli to the development of the domestic financial system.

The scope and volume of the stock market was for a long period insufficient, despite the created standard legislative, organizational and technical conditions. The price-formation trades continually showed low liquidity both on the free market and the listed market of the Bratislava Stock Exchange *[Burza cenných papierov Bratislava, a.s.]*. In order to support the further development of the stock market, it has been necessary to seek new impulses, which would make the trading on this market more attractive for investors as well as for issuers.

3.1 The money market

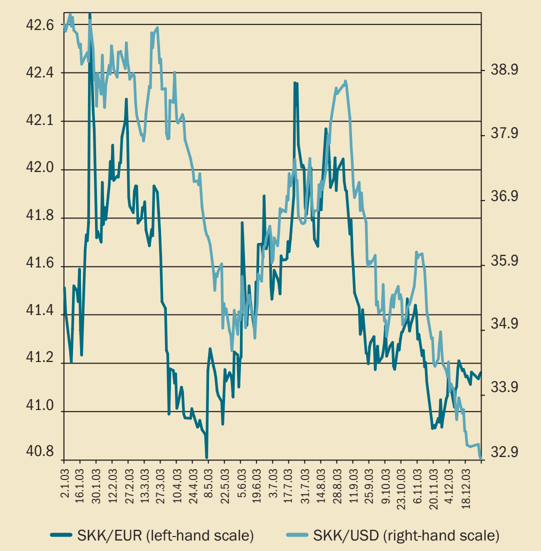
The interest of foreign investors in the Slovak koruna led to a decline in money market rates

The NBS key interest rates were reduced twice in 2003. The first reduction, by 25 basis points, in September did not greatly influence money market rates, as this decline was already included in deposit prices. The second reduction in the key rates of the NBS by 25 basis points in December had not been expected by the banks, which led to an appropriate decline in the whole BRIBOR (Bratislava Interbank Offered Rate) yield curve. Throughout the year money market interest rates were at the lower end of the corridor created by the NBS overnight rates for deposits and for repo trades. Their more significant changes in the first half of the year were mainly influenced by the activities

Chart 3.1 Development of monthly averages of BRIBOR and NBS rates (in % p.a.)

Source: NBS

Chart 3.2 Development of the SKK/EUR and SKK/USD exchange rates



Source: NBS

of foreign banks on the foreign exchange market. They, after purchasing the koruna on the foreign exchange market, deposited the purchased money directly or via swaps on the money market. In the second half of the year the spread between individual maturities of BRIBOR rates decreased and their stable development was essentially influenced by changes to the NBS key rates only. From the development of rates implied in the FRA (Forward Rate Agreement) prices it can be seen that banks expected a further decline in the NBS interest rates as early as in the first half of 2004.

The growth in sterilised funds at the NBS in 2003 did not influence the stability of money market interest rates. Merely an increase in individual forms of open market operations occurred on the money market. In the coming years, too, a gradual growth in liquidity surplus is expected. We do not predict that this factor will influence the stability of the money market.

Trades on the interbank market in 2003 grew by more than a third. The share of interbank repo trades in the total turnover was negligible due to their sporadic execution. The minimal interest in repo trades was connected with the significant surplus of interbank liquidity exceeding more than seven times the required minimum reserves. The interbank market in 2003 recorded a continuing decline in the significance of the deposit market in favour of the swap market, in which foreign banks achieved a majority share. A reason was the preference given to swaps for their lower credit risk. The stable development of the money market had a positive influence on the development of trading in money market derivatives, FRAs and IRSs (Interest Rate Swaps). In the coming period an increase in the volume of trades on the interbank market is expected, and in the structure of individual types of trades, continuing growth in the trading in swaps, FRAs and IRSs at the expense of trading in deposits.

The improving economic and political standing of Slovakia attracted interest among foreign investors and set a course for the strengthened Slovak koruna

The development of the Slovak koruna exchange rate against the euro at the beginning of 2003 was marked by the increased activity of foreign banks, where in January the koruna significantly weakened after London banks had closed their koruna positions (see Chart 3.2). The turnover on the domestic foreign exchange market at the start of the year was above average, while the Slovak koruna concurrently fell to its year-low (on 23 January 2003 to the level of 42.870 SKK/EUR). Subsequently, however, following a growth in confidence in the Slovak currency, the koruna began to strengthen and this trend persisted until May, when the NBS directly intervened the market. This step by the NBS subdued interest in the Slovak koruna over the short term on the market, though three months later the trend of its strengthening again began to continue and persisted until the end of the year. The SKK/USD exchange rate throughout 2003 developed in favour of the Slovak koruna. This was mainly owing to the euro's strengthening against the US dollar.

The NBS bought EUR 658 million in total on the foreign exchange market. Of this, purchases of foreign exchange funds – in the form of direct interventions aimed at weakening the Slovak koruna exchange rate – totalled EUR 250 million in 2003. Concurrently, throughout the year the NBS made use of offers from commercial banks and acquired EUR 408 million in outright transactions.

The basic characteristics of the foreign exchange market are summarised in Table 3.1. The gradual growth in liquidity on the foreign exchange market may be assessed as positive (the average daily turnover on the spot market represented USD 143.9 million), as may its reduced sensitivity to occurrences on the domestic political scene, as well as its reduced linkage to occurrences in neighbouring countries.

Slovakia's accession to international structures, the improvement in its rating, its positive economic outlook, and attractive interest rates, led ever more foreign investors to invest in koruna assets. The largest foreign banks, by the volume of their available funds, often cardinally influence the exchange rate levels and indirectly also interest rate levels. This may be considered as a risk factor for the NBS, since it impedes the conduct of monetary policy. The attractive interest rate differential[11] between the official rate for the SKK (4.5%) and main currencies such as the EUR (2%), or the USD (1.25%), increasingly attracts foreign investors, which usually brings about the strengthening of the currency with an influence on domestic exporters. Banks exploited such an interest rate differential between the official rates primarily via the official NBS open market instruments (i.e. intermediated participation in repo tenders), which were from their aspect risk-free. They thereby ensured a better return on assets, since the yield on one-month treasury bills in USD was even lower than the official rate (the so-called FED Funds) – approximately 1.10%, and the yield on treasury bills in EUR with a one-month maturity was approximately 2.3%. The gradual strengthening of the SKK made such a strategy even more advantageous, as besides the yield on depositing cash on the money market, they made a further profit also on the foreign exchange conversions. The differential between government bond yields with longer maturities (more than 1 – 2 years) was exploited less, since in the prices of these instruments

Table 3.1 Basic characteristics of the Slovak foreign exchange market in 2003

	SPOT			FORWARD			SWAP			Total	
	Volume (USD mil.)	(%)	Number of deals	Volume (USD mil.)	(%)	Number of deals	Volume (USD mil.)	(%)	Number of deals	Volume (USD mil.)	Number of deals
Deals of domestic banks without foreign banks	10,565.1	14	7,531	2.6	0.0	3	64,589.9	85.9	5,670	75,157.7	13,204
Deals of domestic banks with foreign banks	25,117.4	7.7	13,749	237.6	0.1	80	299,541.5	92.2	20,816	324,896.5	34,645
Foreign exchange market in the SR excl. the NBS	35,682.5	8.9	21,280	240.2	0.1	83	364,131.5	91.0	26,486	400,054.2	47,849

Source: NBS

[11] *Data as at 1 July 2004.*

there was already incorporated, to a significant extent, the future reduction in the NBS interest rates with regard to the convergence process.

The positive outlook for the development in Slovakia allows a presumption of the further strengthening of the Slovak koruna, which need not necessarily be completed even through a gradual convergence of interest rates to those of the ECB. The continuing inflow of foreign direct investment will be significant, as will the growth in exports following the launch of automobile production in 2006. The fast strengthening of the SKK exchange rate may be considered a risk to the Slovak economy.

3.2 The capital market in government bonds

The change in the state's issuing policy was directed at transparency, creation of preconditions for secondary market and reduction of issuer's costs

In 2003 the primary market in government bonds was historically significant from the aspect of the issuer's issuing policy. Besides an improvement in the quality of communication with the investor community, issues of government bonds were launched, outside the planned schedule of issues, with a zero coupon and without limiting the issue price. Their maturity was from 1 to 1.5 years. These issues were made in a period when demand for the planned issues was stagnating. This insufficient demand for the planned issues was influenced by the fact that the issuer had limited the issue price by the face value of the bond. Using a new market product with unlimited yields, as well as the short maturity of the issues, positively stimulated interest among investors. These government bonds helped to refinance almost a third of the state debt issued on the domestic market. A further important change was the diversification of maturities of other securities, which was connected with the needs of investors for creating a complete yield curve for government bonds. Of the total number of issues 5 were tap issues. Through them the issuer created a basis for an increase in liquidity on the secondary market. In 2003 the issuer placed on the market government bonds totalling SKK 98.5 billion, which in comparison with the previous year represented a growth of 31.2%. Such increased issuing activity was caused by the accumulation of the state debt repayments. The average amount of an issue grew against the previous period by 129% (to SKK 5.5 billion). The overall demand for government bonds grew against 2002 by 136.4%, which was connected with the higher number of auctions held, the introduction of new debt products and a lack of other low-risk assets, in particular in the first half of the year. In this period the most significant demand for government bonds was seen – reaching up to 90.5% of the total annual demand. This was also connected with the strategy of the issuer, which for a long period had already concentrated its issuing activity in the first half of the year.

For price reasons the issuer undertook an issue of two-year bonds on foreign markets. Thus, a two-year eurobond issue was made comprising two tranches (issued in May and November) in the total amount of EUR 750 million, which, even despite sufficient liquidity on the domestic market, allowed the issuer to refinance state debt at a level significantly below that on the domestic financial market, and eliminated pressure for a growth in government bond yields denominated in the domestic currency.

Yields were mainly influenced by rates on the money market and situation on the domestic political scene

Government bond yields over the first half of the year recorded significant volatility and were mainly influenced by the development on the primary market for government bonds. Essentially however, (with the exception of the shortest maturities) the yields remained in the band of 4.5% – 5%. In the second half of the year a long-term increase in all maturities was seen (again with the exception of the shortest maturities, which responded more to the situation on the money market). This was mainly due to the situation on the domestic political scene (the coalition crisis). In November and December yields again reported marked volatility caused by two conflicting factors – on one hand a repeated reduction in the NBS interest rates and on the other hand a sharp growth in interest rates in Hungary.

The achievement of transparency in the yield curve

In connection with the requirement of banks for transparent trading and pricing of government securities, in 2003 the most active banks on the government bonds market decided to cooperate on a system of benchmarking government bonds and publishing their yield curves with a maturity of 1 to 10 years. As to the rules, 8 contributors applied, and in the course of December quoted on a trial basis prices of selected government securities. With effect from 1 January 2004 the system was made completely functional, with the possibility of expanding the number of participants. The benchmarked yield curve, mainly following the official confirmation of its use for pricing bonds held by banks, can significantly increase the liquidity of government bonds, including the interest in these assets on the primary market.

The continued interest of foreign investors in government bonds trading

In 2003 investors gave preference particularly to investments with short maturities. A change occurred in the composition of investors on the government bonds market, mainly as regards a growth in the share of foreign entities. The increased interest of foreign investors was influenced in particular by a change in Slovakia's foreign policy standing, its improved credit rating and the prospects of foreign investment inflows. Their interest was, moreover, conditional upon the interest rate spread, especially as regards the shorter maturities. The share of foreign investors on the primary market for government bonds grew to 11.2%. Their share in the overall turnover on the Bratislava Stock Exchange reached 48.1%, although a significant part of this turnover was of a speculative nature connected with tax optimisation.

Government bond trades most significantly influenced the secondary securities market from the aspect of the volume of conducted trades and formed a substantial part of this market. This fact was confirmed by the 95.8% share of trades in these securities in the total volume of trades effected on the Bratislava Stock Exchange in 2003, representing a volume of SKK 1,050.7 billion and a growth on the preceding year of 77.4%. The SDX component for government bonds as at the end of the last trading day on the Bratislava Stock Exchange in 2003 reached the value 217.25, representing an overall strengthening by 4.2% in the course of 2003.

3.3 Corporate shares and bonds

Trading in non-government securities on the organised market saw the continued trend of the falling number of issues and volume of liquidity

The stock market was long marked by low liquidity, and the majority of trades concluded in 2003 (up to 93.37%) were outrights. As at the end of 2003 it was possible to conclude deals in 395 share issues, of which 14 issues on the listed market and 381 issues on the open market. Shares issued on the open market were mostly traded only sporadically, while such stock issues were common where no anonymous trade was concluded over the year. The Bratislava Stock Exchange thus did not fulfil one of its tasks, which is setting the real price of shares on the basis of price-forming trades, in spite of the fact that a number of issues held by relatively many shareholders were accepted on the organized securities market as a result of the "coupon privatisation". Low liquidity of the market resulted from the gradually reached intense concentration of shareholder structures of issuers, while those majority shareholders, who exercised the real influence on their companies development, were not interested in gaining financial resources for their further activities on capital markets. This may lead to closing all trades in their shares on the stock market. However, this also causes the gradual depleting of the market. Investor confidence and so a potential increase in market liquidity in 2003 were also undermined by the suspicion of securities price manipulation on the Bratislava Stock Exchange, though the following investigations did not prove it.

In the course of the year, 51 new issues of shares and units in the nominal value of SKK 3.6 billion were accepted for trading. These were mostly issues, which after the winding-up of the Slovak Stock Exchange *[Slovenská burza cenných papier-*

ov, a.s.], on 31 December 2002, were accepted on the Bratislava Stock Exchange market. The market capitalisation of all the tradable issues of equity securities registered on the markets of the Bratislava Stock Exchange throughout the year grew by 4.7%, representing a total of SKK 109.9 billion. Listed shares achieved a 15.3% growth in capitalisation to SKK 42.3 billion, despite the fact that the trading in shares of large companies such as VSŽ, a.s., and Allianz – Slovenská poisťovňa, a.s., was terminated on the listed market. The total volume of shares traded reached SKK 24.3 billion, of which price-forming deals represented only SKK 1.6 billion, and finished deeply below the levels of the bond market. This increase in capitalisation, despite the abolished trading in certain issues, was due to the higher share prices. Most traded were the shares of the company Slovnaft, a.s. (SKK 13.6 billion), which during the year had the greatest influence on the SAX index. This achieved one of the most sucessful years in its history, strengthening over the year by 26.9%, from 139.97 to 177.62 points. The market reaction to the strengthening of the capital entry of the Hungarian oil refinery MOL into Slovnaft and the subsequent declared compulsory takeover bid were responsible for the positive influence of Slovnaft's shares on the SAX index development. The development of stock trading on the capital market in the course of 2003 was also influenced by declared compulsory takeover bids in the case of 41 issuers, which at least temporarily increased the liquidity in the given issues.

In the case of issued non-government bonds from the non-financial corporate sector it can be stated that companies only to a limited extent utilised this instrument as a source of gaining more efficient funds for their corporate activity over credit facilities from commercial banks. In total 35 issues of non-government bonds were traded on the Bratislava Stock Exchange in 2003, of which 20 issues were from commercial companies (of which 5 were bank issues), 10 issues were of mortgage bonds and 5 of municipal bonds. Of the above non-government bonds 24 issues were accepted on the listed market and 11 issues on the open market of the Bratislava Stock Exchange.

In the period to come new issues of mortgage bonds can be expected as a result of a boom in mortgage banking, as well as their launch on the capital market. This should lead to a further growth of already dominant trading in bonds (97.8% in 2003) on the capital market.

The Slovak capital market neither in 2003 could be considered a place were interesting business capital could be obtained, owing to its low liquidity. Due to this services of commercial banks were used by investors for depositing their free funds and by corporations for raising new funds.

Gradual integration into international structures, expected accession of Slovakia to the EU and investments allocated by important global producers in Slovakia created preconditions for new investments in companies traded on the Bratislava Stock Exchange. This, together with a possible strengthening of the position of majority shareholders in companies, will influence the take-over bids announcements and possibly the resulting close of trading in relevant issues on the Bratislava Stock Exchange. This may adversely influence the Bratislava Stock Exchange capitalization and lead to its decrease.

As the Slovak Central Securities Depository *[Centrálny depozitár cenných papierov SR, a.s.]* shall start its operations securities accepted on the Bratislava Stock Exchange may also be traded on the over-the-counter market in accordance with the Act on securities. It is expected that a great part of trades previously traded on the stock exchange as outrights will be executed in the form of direct transfers of securities via a member of the central depository. Owing to this a need for increased activities of the Bratislava Stock Exchange is stressed to introduce new issues on its market directly or via either a merger with a foreign stock exchange or integration of the Bratislava Stock Exchange with stock exchanges in the neighbouring countries. Liquidity on capital markets, in particular stock market, could be increased through a launch of new extensive issues of attractive energy or telecommunication issuers.

Central Securities Depository

Despite the fact that the new Act on securities entered into force on 1 January 2002, the changes and obligations ensuing from it, in particular for the Securities Centre *[Stredisko cenných papierov SR, a.s.]* and securities dealers, were manifested mainly in 2003.

The Act on securities introduced the institute of a central securities depository. Through its decision, which came into effect on 19 September 2003, the Financial Market Authority issued the first licence for establishing and operating a central depository. It was granted to the Securities Centre which performed its activity pursuant to Act No 600/1992 Coll. until 19 March 2004, when the central depository began its activity. With the establishment of the central depository there were created the prerequisites for implementing a two-stage registration operated by the central depository on a membership principle, as well as for implementing a new system of clearing and settlement of securities trades. The central depository, with regard to its activity, has a key position in the capital market, influencing investors confidence.

The system of registering and settling securities within the central depository

The system of registering, clearing and settling securities (the new system) operated by the central depository through the application of the relevant provisions of the Act on securities cardinally differs from the system of registering securities administered by the Securities Centre under Act No 600/1992 Coll.

The new system introduces a two-stage registration of securities and is founded on a membership principle. The central depository shall administer the accounts of securities holders, who are members of the central depository. On these accounts the securities in the ownership of central depository members shall be registered. At the same time the central depository shall administer client security accounts for its members. On these accounts securities of clients of central depository members shall be registered. Securities of individual clients shall be also registered on client accounts administered directly at a central depository member. In this way the separation will be ensured of clients' assets from the own assets of a central depository member.

The Act on securities through establishing the central depository enables the over-the-counter trading in securities accepted for trading on the Bratislava Stock Exchange, the so-called OTC market. On this market transfers of securities are realised between individual securities holders directly, without the use of the stock exchange trading system. In this case this is not a standard securities market, since the central depository does not organise the securities market on the basis of an anonymous offer and bid, rather there simply occurs the direct transfer of securities on the basis of an agreement of two contracting parties.

The central depository shall, in the framework of the new system, ensure also the clearing and settlement of stock exchange trades and the clearing and settlement of trades in investment instruments at a client's request, i.e. it will also ensure the activities which in the case of stock exchange trades were provided by the stock exchange. The central depository financially clears them and at the same time settles the assets on the respective security accounts, which it will administer.

The central depository will maintain a register of rights of lien on securities, which will enable the better orientation of potential investors and the elimination of risk ensuing from the ownership of securities.

Impacts of the central depository's establishment on the financial market

The implementation of the two-stage registration performed by the central depository on a membership principle is a principal consequence of legislative changes connected with the establishment of the central depository. The Act on securities has in this way directly removed the original monopoly position of the Securities Centre in the field of registering securities. Investors, or securities holders, shall have the possibility to choose a member of the central depository which will administer their account for them, while taking account of the convenience of the services provided and the financial cost of these services.

The Act on securities at the same time also enables the concurrent process of financial clearing and asset settlement of concluded securities trades. It is this positive change that follows from the legislative amendment to the Act on securities, removing the time difference between the mentioned operations of stock exchange deals and enabling the clearing and settlement of a trade to be carried out in the real time.

The liberalisation of the system of registration, clearing and settlement of the central depository does not mean simply the possibility of choice of members of one central depository on the basis of the convenience of the services provided and their prices, rather the act enables the establishment of multiple central depositories. In reality this option is significantly limited by the possibilities and needs of the capital market in relation to the efficient functioning of a central depository.

The task of the central depository in the period between the approval granting and the start of its activities was to provide a smooth transition to the new system, particularly as concerns the organization and technical aspects. The shortcomings in the system of registration and clearing of securities at the beginning of the central depository's activity in March 2004 caused a lack of confidence among the capital market participants, which in turn led to a significant decline in securities trading activity. Continuance in shortcomings of this kind can result in paralysing the capital market and causing a permanent disinterest among investors in securities. The reliable provision of activities by the central depository will have a substantial influence on the development on the capital market and is important for maintaining its stability.

3.4 Financial infrastructure

The payment system and securities settlement system

On 1 January 2003 Act No 510/2002 Coll. on the payment system and on amendments and supplements to certain laws (the Act on the payment system) became effective. This Act implemented the formerly lacking complex regulation of payment system and harmonized the Slovak law with the legal acts of the European Union which relate to the payment system area.

This act, inter alia, regulates in particular the area of domestic and cross-border transfers of funds; the issue and use of electronic means of payment; the establishment, operation and oversight of payment systems; as well as claims and out-of-court settlement of disputes which have arisen in relation to the payment system.

Moreover, with effect from 1 January 2003, the National Bank of Slovakia took over from the Slovak National Clearing Centre the activities connected with the interbank payment systems and started to operate, in accordance with the Act on the payment system, a new, fully automated interbank payment system – the Slovak Interbank Payment System (SIPS). (See Annex 2 for a basic description of the SIPS system).

Oversight of the payment system

The primary task of the National Bank of Slovakia in the area of payment systems is their oversight. The National Bank of Slovakia, in conducting oversight of the payment system[12], fulfils the tasks of a central bank and follows the international standards, the so-called Core Principles for Systemically Important Payment Systems (the Core Principles) issued in January 2001 by the Committee on Payment and Settlement Systems of the Bank for International Settlements (see the Box below).

The National Bank of Slovakia set the following three basic objectives in its framework of payment system oversight:

1. *Maintain payment system stability* – identify potential risks, to which the payment system is

[12] *The objectives and instruments of the National Bank of Slovakia when overseeing the SIPS interbank payment system were involved in the paper "The payment system oversight in Slovak Republic" posted on the NBS's website.*

exposed, and undertake measures for their elimination and regaining control over them;
2. *Ensure the safe and smooth functioning* of the payment and securities settlement systems;
3. *Ensure the public's confidence in payment instruments* used.

The basic objective of payment system oversight is, in general, the limitation of systemic risk. It is important that all risks (credit, liquidity, operational, legal), which may lead to a systemic risk, are known, quantified and understood by the system operator, its participants and the public. The danger and impacts of these risks increase proportionally with the number and mainly the value of transactions processed by the specific payment system.

The National Bank of Slovakia oversees the SIPS. The SIPS is the systemically important payment system of Slovakia and the key component of the country's financial system, and its smooth functioning is essential for maintaining financial stability.

The stability of the SIPS system is important for several reasons:
– The payment system processes large-value payments, i.e. payments of extraordinary economic importance, therefore, in the event of failure significant losses could incur;
– Failures in the payment system do not affect only its participants, but also the clients of these participants whose payments it processes;
– The payment system settles monetary policy operations of the central bank, deficiencies in the system could threaten their performance;
– The payment system provides financial settlement of operations of the money and capital markets, a deficiency, or disruption of the settlement could threaten the stability of the respective market.

With regard to the above, from the viewpoint of maintaining the financial stability of the country, it is important that the securities settlement systems were overseen in the same way as the payment systems. The financial aspect of securities trading (the so-called "cash leg") is settled via payment systems, therefore, the linking of securities settlement systems with payment systems should be ensured so that no risks arose which would threaten the payment system participants or the processing and settlement within the payment system, and that the financial settlement of securities trading ran smoothly and safely.
This is why the securities settlement system fall within the country's payment system oversight framework.

Responsibilities of the central bank

A. The central bank should define clearly its payment system objectives and should disclose publicly its role and major policies with respect to systemically important payment systems[13].

B. The central bank should ensure that the systems it operates comply with the Core Principles.

The National Bank of Slovakia started to operate the Slovak Interbank Payment System – SIPS in 2003. As the central bank, which operates a systemically important payment system, it has to ensure that this system is in line with Core Principles. In 2003 the SIPS was operated in line with the Core Principles; and preconditions were created for further changes to the SIPS in 2004.

Core Principle I covers the legal basis. When assessing the quality level of the legal basis for the payment system, it is necessary to determine the legal framework related to the payment system and its operation.

The National Bank of Slovakia, as the payment system operator, has concluded a contract for the SIPS with each participant in this interbank payment system. This contract specifies the rights and duties of counterparties. The Act on the payment system represents a legislative basis for the establishment and operation of payment systems. In addition to the Act on the payment system, the basic legal framework for the payment systems is further created by the Commercial Code and Civil Code.

[13] See the paper "The payment system oversight in Slovak Republic".

Core Principles for Systemically Important Payment Systems

I. The system should have a well-founded legal basis under all relevant jurisdictions.
II. The system's rules and procedures should enable participants to have a clear understanding of the system's impact on each of the financial risks they incur through participation in it.
III. The system should have clearly defined procedures for the management of credit risks and liquidity risks, which specify the respective responsibilities of the system operator and participants and which provide appropriate incentives to manage and contain those risks.
IV. The system should provide prompt final settlement on the day of value, preferably during the day and at a minimum at the end of the day.*
V. A system in which multilateral netting takes place should, at a minimum, be capable of ensuring the timely completion of daily settlements in the event of an inability to settle by the participant with the largest single settlement obligation.*
VI. Assets used for settlement should preferably be a claim on the central bank; where other assets are used, they should carry little or no credit risk and little or no liquidity risk.
VII. The system should ensure a high degree of security and operational reliability and should have contingency arrangements for timely completion of daily processing.
VIII. The system should provide a means of making payments which is practical for its users and efficient for the economy.
IX. The system should have objective and publicly disclosed criteria for participation, which permit fair and open access.
X. The system's governance arrangements should be effective, accountable and transparent.

Responsibilities of the central bank in applying the Core Principles

A. The central bank should define clearly its payment system objectives and should disclose publicly its role and major policies with respect to systemically important payment systems.
B. The central bank should ensure that the systems it operates comply with the Core Principles.
C. The central bank should oversee compliance with the Core Principles by systems it does not operate and it should have the ability to carry out this oversight.
D. The central bank, in promoting payment system safety and efficiency through the Core Principles, should cooperate with other central banks and with any other relevant domestic or foreign authorities.

** The systems should seek to exceed the level of the minimum requirements stated in these two Core Principles.*

Core Principles II and III are closely linked. They focus on the fact that the risks, which participants incur through their participation in payment systems, have to be clearly understood by them. Rights and duties of the involved parties shall be clearly defined in the rules and procedures.

The National Bank of Slovakia, following these principles, stresses the need of comprehensive, transparent and properly documented rules and procedures of the payment system. The NBS issues and updates the rules and working procedures for the system and the access criteria for its participants, daily monitors technical and operational functions of the system, and compiles and analyses statistical data from the system. In this regard, the National Bank of Slovakia issued the access criteria for the SIPS, which were posted on the NBS's website. These access criteria also involve contracts for evaluation testing, for the SIPS system, and their supplements. The NBS also issued the Code of Conduct, which provide the organizational, operational and methodological procedures for the system operation. At their working meetings, the NBS discusses with participants of the system each change to the SIPS payment system.

Core Principle IV relates to another important feature of payment systems, which is the settlement finality. Participants may be exposed to the credit *and liquidity risks in the period between accepting payment orders by the system and finally executing the payments. Thus, the minimum requirement is that the system should provide final settlement at the latest at the end of the value day.*

The SIPS system executes the final settlement within one day. The rules of the system, as well as the Act on the payment system, guarantee the irrevocable character of each payment order entering the system and the final settlement for each participant of the system.

In 2004, the principle of real-time gross settlement shall be introduced in the SIPS. This principle should substantially limit any possible systemic risk arising in the interbank payment system, as the received payments to be settled in the real time shall be individually processed and settled on the accounts with the central bank, if these accounts are sufficiently credited, or up to the amount of the allowed intraday credit.

Core Principle V does not relate to the SIPS, as the National Bank of Slovakia does not operate the netting payment system.

Core Principle VI focuses on the assets used for settlement. In order to minimize the credit and liquidity risks, claims on the central bank should be used as financial assets.

The SIPS uses the participants' accounts with the National Bank of Slovakia for settlement, which minimizes the credit and liquidity risks connected with the used financial assets.

Core Principle VII involves the operational risk. The credit and liquidity risks for the payment system participants may result from operational failure of the payment system, late or erroneous processing, or inaccessibility of the system due to the unexpected events and lacking back-up arrangements.

The SIPS system involves the back-up facilities used in the event of failure, which ensure the functioning of the system if the main work centre is inaccessible.

Core Principle VIII stresses the efficiency of the payment system. The payment system must meet functional and quality requirements of its operator and users as to the provided services, as well as requirements for safe and smooth operation in view of its cost efficiency.

The National Bank of Slovakia created the SIPS system using its own funds, while the cost effectiveness was achieved. A reason for the taking over of the payment system operation by the National Bank of Slovakia was also improving the safety and efficiency of the system utilizing state-of-the-art information technologies.

Core Principle IX involves fair and open access to the payment system. The criteria for participation in the system should support both the safety and efficiency of payment services. These criteria should also ensure protection of the system and its participants against such a participation, which might expose them to excessive legal, financial and operational risks.

The access criteria for the SIPS were posted on the NBS's website. In this area, a possible systemic risk is eliminated by the requirement that each participant in the SIPS must meet technical preconditions to be allowed to participate in the system. If the NBS observes that any participant in the payment system has ceased to meet technical preconditions for the participation in the system, it may exclude the participant from the payment system. Each new participant is duly tested before they are allowed to enter the system, which ensures protection for other participants against any potential risk.

The National Bank of Slovakia, through the unified access criteria for the payment system participants, ensures the principle of "fair and open access" to the SIPS system.

Core Principle X introduces a principle of effective, accountable and transparent governance arrangements for the payment system.

This principle is ensured by the National Bank of Slovakia as the operator of the SIPS. The NBS concludes with each participant in the SIPS system the same contract for the SIPS system. The SIPS access requirements are posted on the NBS's website, i.e. they are available to each applicant for the system.

C. The central bank should oversee compliance with the Core Principles by systems it does not operate and it should have the ability to carry out this oversight.

The SIPS system is the only payment system operated in Slovakia.

D. The central bank, in promoting payment system safety and efficiency through the Core Principles, should cooperate with other central banks and with any other relevant domestic or foreign authorities.

Infrastructural assessments of the payment system and the securities settlement system before Slovakia's accession to the European Union

In 2002, based on the questionnaire from the European Central Bank, the National Bank of Slovakia assessed the infrastructure of the payment system and the infrastructure of the securities settlement system (i.e. the clearing and settlement system for investment instruments operations). This assessment was targeted on reviewing the given infrastructure of Slovakia before its accession to the European Union.

This assessment involved the use of payment instruments, level of automation and standardization, eligibility of market infrastructure, central bank roles and supervisory powers, and the assessment of systemically important payment systems and securities settlement systems.

In this regard, the European Central Bank stated that the infrastructure of the Slovak payment and securities settlement systems was sufficient for the smooth access of Slovakia to the European Union.

Assessment of the securities settlement system vis-à-vis the securities standards

In 2003, based on the questionnaire from the European Central Bank, the National Bank of Slovakia assessed its securities settlement systems. This assessment was aimed at reviewing the securities settlement systems as to the Economic and Monetary Union requirements for linking them with the TARGET payment system. In order to fully ensure all credit operations of the Eurosystem, including intraday credit for the purposes of payment system, the securities settlement system must comply with the European Monetary Institute standards[14] set for the securities settlement systems.

The National Bank of Slovakia assessed the following securities settlement systems:

1. Central Register of Short-term Securities of the NBS;
2. Securities Centre of the Slovak Republic, a.s. (since 19 January 2004 renamed as Central Securities Depository of the Slovak Republic, a.s.);
3. Bratislava Stock Exchange, a.s.

The assessment made by the NBS was targeted on the legislation regulating the given area; whether and how settlement on accounts with the NBS was made; whether excessive risks arose from securities safekeeping; the institutional background for the management and regulation of securities settlement systems, including oversight of the systems; risk management procedures; system's ability to achieve settlement finality within one day; compatibility of the operation hours and days of the system and the TARGET; operational reliability of technical systems; and the availability of sufficient back-up equipment.

The assessment by the NBS led to a conclusion that all reviewed securities settlement systems in Slovakia were sufficient for the Eurosystem's credit operations, however, certain areas must be further developed. The National Bank of Slovakia sent this assessment to the European Central Bank. The European Central Bank prepared recommendations for each securities settlement system, which must be met before linking with the TARGET.

[14] *Standards for the use of EU SSSs in ESCB Credit Operations; January 1998.*

Cooperation between the National Bank of Slovakia and other relevant institutions

The National Bank of Slovakia, in order to cooperate with relevant institutions in the area of oversight, signed in December 2002 the Agreement on cooperation between the National Bank of Slovakia and the Financial Market Authority in the area of banking, payment systems and foreign exchange supervision and financial market supervision in the area of capital market and insurance business. The Agreement is aimed at the mutual cooperation in the area of supervision of banks, payment systems, capital market, insurance business and foreign exchange area, in order to ensure the high-quality and efficient conduct of financial market supervision.

Cashless payment instruments

The scope of services provided in the area of payments is broad and directly influences bank clients, who use cashless payment instruments – mainly bank payment cards. The exact operation of the system directly affects the clients' confidence in functionality and safety of the used cashless payment instruments.

The company *Transacty Slovakia, a.s.* (former Authorization Centre of Slovakia, a.s.) has a specific position on the Slovak market as to the processing of payment operations (mainly payment card transactions) and related support services, in particular:

– In the area of clearing and settlement of domestic card transactions, it functions as a participant in the SIPS system;
– In the area of support services connected with the payment cards issue, it arranges direct authorisation of card transactions, or redirects the authorisation of card transactions to card issuers;
– In the area of support services connected with the acceptance of payment cards, it administers acceptance devices (e.g., ATM and EFT POS).

Its market share moves between 50 % and 60 %, in relation to the type of services provided.

In the area of support services connected with the payment cards issue – particularly the authorisation of card transactions – a potential systemic risk was minimized, as in 2003 the issuers of bank payment cards continued or started with the authorisation of card transactions executed via those bank payment cards they had issued (The *Transacty Slovakia* company redirected the authorisation of card transactions to card issuers). Thus, the authorisation of card transactions was made at more places, not one only.

In the area of support services connected with accepting payment cards a possible systemic risk was reduced through improving the quality of technical aspects in particular. This involved, for example, the connection of ATMs via GPRS data service, which was alternative to the communication protocol X.25. The technical support could also solve any possible technical failures of the system, which reduced a risk of a possible payment transaction failure.

As concerns other cashless payment instruments, the applications of electronic banking played an important role, which were alternative to traditional payment instruments, such as a credit transfer submitted in the paper form. These payment instruments were mainly issued by banks, thus the legal environment was created for this area of activities. Here any possible systemic risk was almost eliminated, as banks guaranteed safety of their own systems for accepting and processing payment orders submitted in the electronic form.

After passing the amendment to the Act on the payment system, which should be effective from 1 January 2004, legal framework for the business of the so-called electronic money institutions (i.e. non-banks) will be created. These institutions, based on a licence issued by the National Bank of Slovakia, may operate in the area of issue and administration of electronic money. This should reduce a legal risk connected with unauthorised issue and administration of electronic money, as well as any possible systemic risk arising from weakened clients' confidence in electronic money payment instruments.

4. Financial institutions

Despite the fact that the banking sector could, on the basis of the reported parameters of its economic position, be considered as stabilised in terms of capital and finance, it was, however, necessary to pay attention to the factors of profit generation causing its relative stagnation.

Following its restructuring, the position of the Slovak banking sector was balanced. In terms of basic parameters of its performance and degree of balance, it achieved the values ensuring a relatively high sustainable growth and, as concerned achieved profitability, there was room for the credit-exposure growth. The general degree of credit risk was reported to be at a sustainable level. These positive values were, nonetheless, partially affected by the relative (and, at the end of 2003, also absolute) reduction in banking sector assets, i.e. in these assets to GDP ratio. The logical consequence of this was high capital adequacy, growth in capitalisation and ability to cover identified credit risk. The structure of interest-bearing assets (government securities, loans to households) was reflected in the growth of interest yields, which was affected by a more intensive decline in interest expense than interest income. The banking sector thus did not benefit from the potential of sustainable growth. In relation to the amount and year-on-year accruals of flows of revenues in the Slovak economy, this potential could be characterised as small. One of the consequences was a decline in interest income on fixed assets of the banking sector as a whole. It may be expected that, with a fall in the mentioned factors of the current profit formation, the banks will be forced into a higher degree of credit exposure towards the non-financial corporations sector. The effort to sustain the currently low rate of credit risk may trigger the faster decline in lending rates.

In the monitored period better preconditions were also created for the development and effective functioning of the financial market, where changes in legislation, the investments made by foreign corporations and a higher degree of competition had a decisive impact. In comparison with other financial institutions, collective investment still remained this market's most dynamic segment, while the insurance sector with its growth in mandatory insurance premium (especially in the compulsory motor third-party liability insurance) also showed a trend of steady growth. The sector of investment services provided by security dealers was stabilized. The revival of the Slovak financial market may be expected as a result of the implementation of the old-age pension savings scheme, as in the long run the assets in the value exceeding 50% of the annual GDP should be deposited in pension funds.

4.1 Banks

The stabilisation in the banking sector in 2003 resulted from figures achieved by banks in 2002, when, *inter alia*, asset productivity improved, competition on the market in banking products increased, and compliance with prudential ratios developed favourably. In the latter area there was a qualitative shift during 2003 in terms of calculation of adequacy of own funds where, following the effectiveness of the Decree on adequacy of bank's own funds of financing, as from 1 January 2003, in addition to credit risk, market risks also started to be considered.

As at the end of 2003 there were eighteen banks and three branch offices of foreign banks operating in the Slovak banking sector; where the branch office of COMMERZBANK Aktiengesellschaft first reported its financial results only as at 31 December 2003.

The amount of subscribed equity capital of the eighteen banking entities represented SKK 40.4 billion and financial resources provided by foreign

Table 4.1 Development of profitability indicators of the banking sector as at 31 Dec. (in %)

	2002	2003
ROE[1/]	29.43	27.15
ROA[2/]	1.17	1.17

[1/] Return on equity
[2/] Return on assets
Source: NBS

banks to their branch offices were SKK 2.8 billion. With the entry of foreign investors into the banking sector, they now hold almost 90% of the subscribed equity capital.

The assets of banks in the Slovak banking sector in 2003 were SKK 985.4 billion, where more than a half of this value was controlled by the three largest banking entities. These three banks had a 70% share in the total financial results of the banking sector, which was SKK 11.3 billion. Net interest income was the greatest component of the financial results, forming a 75% share in total net income from financial operations. Income from fees was almost 19.5%, and net non-interest income formed the remainder.

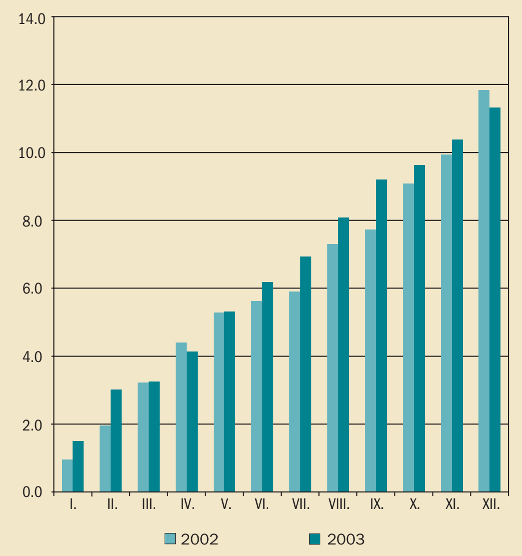
4.1.1 Profitability analysis and financial strength

The change in accounting standards in 2003 hindered any real comparison of banks' performance with the previous year. Despite this, it can however be said that banks undertook structural changes in their income and expense. In the major banks restructuring was completed following the entry of new investors (writing off bad loans and doubtful assets), which was reflected in the stabilisation of income items. A gradual increase in lending to consumers began although the volume of loans provided still lagged behind that of the euro area countries. Sterilisation of excess liquidity in the sector, carried out by the National Bank of Slovakia, remained for the banks a risk-free investment at an advantageous rate. Moreover, profitability was strengthened by the growth in incomes from fees and commissions. In the future, the strengthening of incomes from stabilised revenues from banking activities, primarily from the expanding retail segment and partially also from derivative trades, may be expected, in particular owing to the restructuring of loan portfolios. In the expenditure items further growth is likely in the outsourced services. It is expected that the mentioned will help to maintain the achieved level of stabilised asset productivity.

The banking sector reported stabilised development despite a slight fall in the total financial result figure

As at 31 December 2003 the banks reported net profit in the amount of SKK 11.3 billion, but in a year-on-year comparison of the sector's financial results (see Chart 4.1) it decreased by a negligible amount of SKK 0.5 billion (i.e. 4.43%). This decrease was influenced by the higher year-on-year growth in expense for financial operations as compared with income from financial operations. The financial result development was also negatively influenced by the year-on-year growth of general operational costs of SKK 1.2 billion.

Chart 4.1 Development of current financial results in a year-on-year comparison (in SKK billions)



Source: NBS

Financial results of the banking sector in the assessed period as at the end 2003 and their year-on-year development are characterized by profitability indicators calculated on the profit and loss compensation, average assets and equity capital.

The aggregated indicator of asset productivity for the sector fell slightly on a year-on-year basis, while its achieved value was comparable to the value it achieved as at the end of 2002. This development affected the decline in net income from banking operations, which was moderately more significant in percentage terms than the fall in the average volume of assets. The decline in net incomes from banking activity was influenced by several factors. One of these in particular was the higher year-on-year growth in expense for financial operations as compared with income from financial operations.

The restructuring of assets was shown in both the expense and income items, primarily in the higher volume of dissolved provisions and reserves. The net impact of these last on the growth of financial result figures in 2003 was SKK 5.0 billion, and compared to the previous year it was higher by SKK 0.8 billion. As compared to 2002 net expenses on depreciation of claims fell significantly, while the influence of extraordinary income and expense on the financial result was almost negligible.

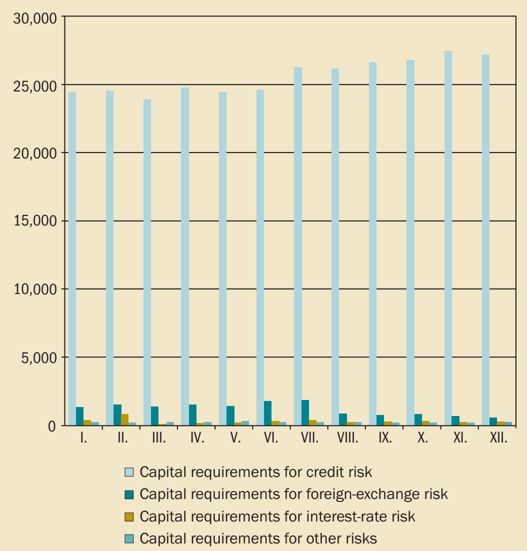
The development of retail operations was reflected in the growth of net interest margin

Net interest margin of interbank operations, operations with clients and securities operations increased slightly on a year-on-year basis, and its slight increase, as compared with the end of 2002, influenced the increase in net interest income with the concurrent decline in the average volume of assets. The development of net interest income was positively influenced especially by a significant year-on-year growth in net yield from operations with clients, with a concurrent fall in the volume of securities operations and interbank operations.

4.1.2 Credit risk in the banking sector

With regard to the development of risk in the sector, positive factors were the effort of banks to improve the level of risk management and the

Chart 4.2 Amount of capital requirements (in SKK millions)



Source: NBS

adoption of certain measures that created preconditions for risk monitoring and assessment. The new Act on accounting entered into force on 1 January 2003, implementing the larger part of the international accounting standards IAS 37 and IAS 39. In the banks' financial statements the following were manifested most: valuation at real values of securities for trading, securities for sale and derivatives. In 2003 banks also reduced the amount of reserves for general banking risks, as their maximum amount was limited by an NBS Decree.

Credit risk had the greatest impact on the capital requirements. From the aspect of capital need, market risks were less significant.

In the course of 2003 the weightings of individual risks and the overall value of capital requirements in the banking sector did not basically change. A slight increase in the value of the total capital requirements throughout the year corresponded to the development of credit risk. This fact is illustrated in Chart 4.2.

The dominant impact of the credit risk weighting on capital requirements

In the course of 2003 the relative weighting and the absolute amount of capital requirements for

Table 4.2 Development of standard loans

	December 2002 (in SKK millions)	December 2003 (in SKK millions)	Index
SKK residents	178,907.3	210,123.9	1.17
SKK non-residents	460.4	1,103.5	2.40
FC residents	40,826.2	47,605.3	1.17
FC non-residents	2,794.8	8,929.2	3.19

Source: NBS

credit risk increased in the banking sector. This trend was caused primarily by the development of client lending operations. The amount of standard loans (excluding loans provided to banks, government authorities, funds, local self-governments, and insurance companies) during the whole of 2003 grew. In December 2003 it reached 27% of the aggregate net value of assets. The year-on-year growth of 20% against December 2002 represents a rather significant change.

The gross value of classified claims[15] formed, at the end of 2003, 10% of loans provided by banks to households and corporations. In the course of the year the gross value of classified claims fell, expressed in absolute terms, and the volume of provided loans grew. The coverage of classified claims by provisions equalling three quarters of their value was relatively high. On the basis of simulations performed, it may be assumed that the share of classified claims should not exceed 14% of the value of gross loans by the end of 2004.

In the case of standard loans, koruna loans provided to resident persons or non-financial corporations incorporated in Slovakia prevailed. The share of loans in foreign currencies in standard loans provided to residents was practically unchanged, when compared on a year-on-year basis. However, residents and non-residents recorded different rate of growth in terms of year-on-year accruals. This rate was higher, by more than double, in the non-resident group. This fact is shown in Table 4.2.

The analysis of loans by their purpose showed a significant dominance of business activities. In the total aggregate of standard loans, corporate loans for investment purposes formed more than 35% and loans for current assets 27%. Mortgage loans formed more than 10%. Consumer loans were less than 4%. The rate of growth in consumer and mortgage loans was high – mortgage loans doubled compared with 2002 and consumer loans grew by almost a third. This development affected the overall structure of loans by purpose. The share of loans provided to households increased, and the structural changes, in terms of the risk development, were manifested positively.

Table 4.3 Concentration of loans in the banking sector **(in %)**

	Standard loans	Special mention loans	Classified loans	Assets
First 3 banks	41.04	55.79	49.69	54.27
First 6 banks	67.76	57.85	58.76	67.49
First 9 banks	82.00	65.72	66.95	82.80
First 12 banks	90.37	72.49	82.89	89.15

Source: NBS

[15] *Sub-standard, doubtful and litigious, and loss claims from corporate and retail loans.*

Table 4.4 Concentration of risk-weighted assets in the banking sector (in %)

	RWA	Assets[1/] (excl. branch offices of foreign banks)	Assets[1/] (the whole sector)
First 3 banks	53.01	62.08	54.27
First 6 banks	74.22	77.20	67.49
First 9 banks	85.05	86.42	75.55
First 12 banks	93.91	93.72	81.93

[1/] Excluding provisions.
Source: NBS

The analysis of concentration of standard and other loans in the sector[16], performed by the size of banks, showed a better composition of loan portfolios in medium-sized banks. This is documented in Table 4.3 showing the share of groups by size and individual categories of loans in the total values reported by the banking sector.

The concentration of special mention loans and classified loans did not wholly correspond, within the individual groups by size, to the concentration of standard loans provided to clients. Other than standard claims were mainly concentrated in the first three largest and in the eight smallest banks.

Though the value of risk-weighted assets (RWA) during 2003 grew, the proportion of basic own funds to risk-weighted assets fluctuated at a stable level, reaching 21.5% at the end of the year.

RWA formed in all the banks at least 87% of the sum of RWA, and market risk exposure[17] volume, in 14 banks this share exceeded 95% and its share for the whole sector represented 95.7%. The RWA concentration in the sector and the comparison with the share of assets of the respective banks in the sector's assets is shown in Table 4.4.

It is clear from the Table that the RWA concentration in medium-sized banks was higher than could be expected with regard to their weighting in the sector's assets. Despite a better composition of corporate and retail loan portfolio, the medium-sized banks allocated their total funds in higher risk assets.

Credit risk was covered by the change in the structure of provided loans

Banks through their business policy reacted to the then current level of industrial and sector risk. A consequence of such changes in their business orientation was a partial change in the structure of loans provided.

Table 4.5 Distribution of loans by sectors (in SKK millions)

	SKK			Foreign currency		
ECONOMIC SECTORS	Dec 2002	Dec 2003	Index	Dec 2002	Dec 2003	Index
Total non-financial corporations	185,418.0	184,944.9	0.99	49,599.0	62,988.8	1.27
Other fin. intermediaries, insurance corp. and pension funds	16,959.3	23,265.4	1.37	4,491.6	5,093.2	1.13
Public authorities	19,691.8	16,355.3	0.83	1,326.4	2,982.5	2.25
Households (personal accounts)	61,319.2	85,113.6	1.39	95.9	354.5	3.69
Other	8,066.7	10,696.2	1.33	4,491.5	10,300.6	2.29
Total	291,455.2	320,375.7	1.10	60,004.7	81,719.7	1.36

Source: NBS

[16] Banks and branch offices of foreign banks.
[17] Market risk exposure means a 12.5 multiple of the capital requirement to cover market risk.

Table 4.6 Distribution of loans by industrial structure			(in SKK millions)
INDUSTRIES	Dec 2002	Dec 2003	Index
Agriculture, forestry and raw material extraction	7,582.0	7,918.7	1.04
Industrial production	53,425.2	49,073.4	0.92
Electricity, gas and water generation and distribution	42,396.3	33,796.5	0.80
Construction	4,855.7	5,456.9	1.12
Trade and services	39,166.1	41,041.4	1.05
Transport, warehousing, postal services & telecoms	21,722.6	29,770.6	1.37
Financial intermediation	16,976.3	23,165.1	1.36
Other activities total (including households)	105,330.7	130,152.7	1.24

Source: NBS

Gross value of loans in Slovak koruna increased in December 2003, representing an increase on the preceding year of 10%. The volume of loans provided in foreign currency as at the end of 2003 grew by 36%.

The provision of loans in domestic currency in terms of individual economic sectors changed partially as compared with the previous year. The year-on-year growth in loans was caused in particular by an increase in loans to households), as well as to financial intermediaries and insurance companies. On the other hand, a fall in loans to the public authorities and stagnation of loans to non-financial corporations confirmed the changing structure of loan portfolio. Despite the mentioned decline, non-financial corporations constituted the largest part (57%) of loan debtors, followed by households (26%).

Non-financial corporations had the largest share in the growth of loans denominated in foreign currencies. Similarly to the case of loans in Slovak koruna, the largest growth was recorded in foreign-exchange loans to households. These loans continued to be of minor significance in terms of their weight on the total loans in foreign currencies. Loans in foreign currencies provided to public authorities recorded a relatively high growth as well. Non-financial corporations reduced their share in total loans in foreign currencies by 6%, despite the year-on-year growth in foreign-exchange loans by 27%. However, they still represented more than three quarters of loans in foreign currencies. These facts are illustrated in Table 4.5.

The structure of loan provision also changed from the aspect of the industrial sector: the most important items – industry and energy – gradually decreased. Conversely, the less important items grew, such as transport, warehousing, posts, telecommunications, and financial intermediation, as illustrated in Table 4.6.

The analysis of sectors with regard to the share of special mention loans and classified loans in total loans provided in the relevant sector showed a higher share of these loans in the non-financial corporations and sole traders sectors. In this regard consumers, financial intermediaries and public administration appeared to be less risky, where the share of problematic loans fluctuated between 1.4% and 4.5%.

Industrial sector risks of loan-repayment default were concentrated in agriculture, sole traders, industrial production, construction, trade and services. This is documented in Table 4.7.

Higher estimated new capital requirements for covering credit risk (NBCA) when compared with the capital requirements under the original Basel Capital Accord (BCA)

All Slovak banks involved in the quantitative impact study QIS 3[18] used a standardised approach to

[18] Quantitative Impact Study 3, organized by the Basel Committee on Banking Supervision.

Table 4.7 Share of special mention loans and classified loans in total loans by sectors and industries (in %)

	Share of SML and CL[1/]	Share of CL[2/]
TOTAL	22.19	9.37
ECONOMIC SECTORS		
Total non-financial corporations	33.65	13.50
Other financial intermediaries, insurance corp. and pension funds	1.38	0.93
Public administration	3.21	0.23
Sole traders	37.20	24.68
Private individuals	4.45	2.79
Other	46.14	16.69
INDUSTRIES		
Agriculture, forestry and raw material extraction	43.89	32.85
Industrial production	32.15	22.42
Electricity, gas and water generation and distribution	63.95	0.18
Construction	34.98	23.70
Trade and services	34.90	23.25
Transport, warehousing, posts & telecoms	9.15	1.10
Financial intermediation	1.39	0.93
Other activities total (including households)	8.41	3.83

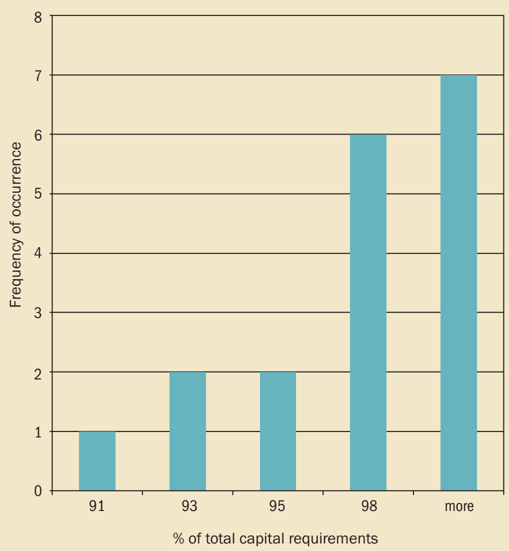
[1/] Share of special mention loans (SML) and classified loans (CL) in the amount of loans in the given sector or industry.
[2/] Share of classified loans in the amount of loans in the given sector or industry.
Source: NBS

credit risk. The average estimated increase in the capital requirement for the credit risk was 9.6%.

In the field of credit risk, the increase in capital requirements was mainly showed by the bank and sovereign (countries and central banks) portfolios, owing to the change in risk weightings in these segments as compared with the recently effective regulation of Basel I. This was caused by an increase in the risk weighting from 20%, or 0%, to risk weightings given by external ratings of the counterparties of banks. This, however, in the case of lower penetration by ratings or of weaker ratings in the banking segment, means an increase in the risk weighting to 50% or even 100%. In the sovereigns segment the reason for the expected increase in capital requirements was the existence of receivables towards states denominated in currencies other than the national currencies of these states (Eurobonds).

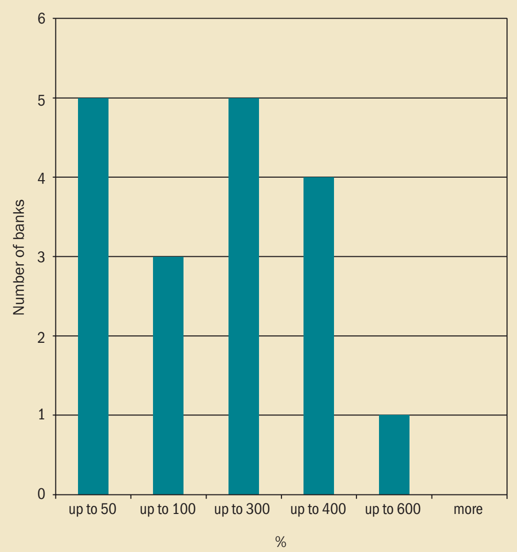
Conversely, the most significant decrease in capital requirements following implementation could be expected in the retail segment. This influence would not however be significantly shown in the total capital requirements in the case of a low share of this segment in banks. The significance of the credit risk weighting in the case of new capital requirements, by the number of banks with this level of significance, is shown in Chart 4.3.

Chart 4.3 Share of credit risk in total capital requirements



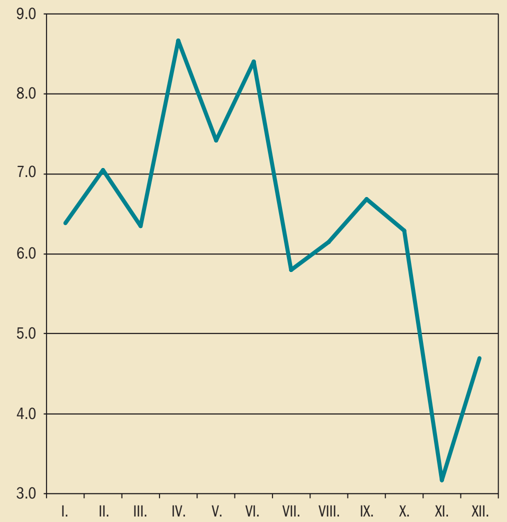
Source: NBS

Chart 4.4 Total exposure



Source: NBS

Chart 4.5 Share of the net open position in banking sector total assets (in %)



Source: NBS

The proportion of bank's own funds to the risks of counterparty, one group of counterparties and to the accumulated value of all extensive risks was limited by an NBS Decree. Throughout the year the banks complied with the limit, according to which the total large exposures could not exceed 800% of own funds. In December 2003 total large exposures did not exceed the limit of 600% of own funds in any of the banks; the highest value reached as at the end of 2003 was 568.9%. In the development of large exposure no such threats were recorded that would have serious impacts on financial stability.

Concentration of large exposure by number of banks with a comparable level of large exposures is illustrated in Chart 4.4.

4.1.3 Market risks in the banking sector

The foreign exchange risk measured by capital requirements for its coverage did not represent any great risk for most of the banks in 2003

The size of foreign exchange risk relates mainly to the net position of balance-sheet and off-balance-sheet items in individual currencies and the exposure of open positions in foreign currencies to the foreign exchange rates fluctuations.

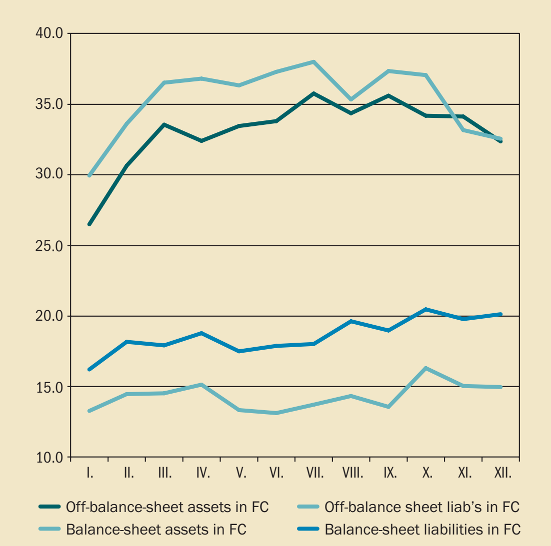
The total open foreign exchange position is defined as the sum of net balance-sheet position and net off-balance-sheet position in all currencies. In 2003 the total open foreign exchange position of the banking sector was short, i.e. operations on the liability side exceeded the operations on the asset side. With regard to the appreciation of the Slovak koruna against most of the main currencies during 2003, the total short open position of the banking sector had a positive impact on the banking sector.

The share of the total open foreign exchange position in the total assets of the banking sector was falling at the end of 2003. This development was caused mainly by a fall in liability items in the off-balance sheet.

The annual development of the share of the total open foreign exchange position in total assets of the banking sector is indicated in Chart 4.5.

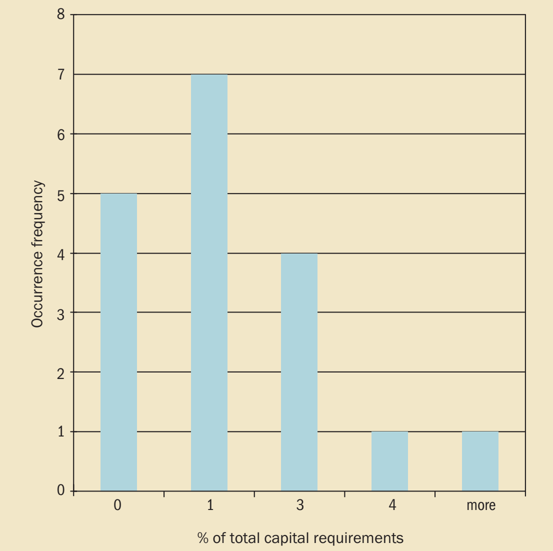
In 2003 the banking sector recorded a slight increase in the share of off-balance sheet assets and liabilities in foreign currency in total assets. While liability operations were prevailingly of a short-term nature in the form of deposits from physical persons and legal entities (in particular residents), asset operations in foreign currencies were equally distributed in short-term and long-term assets

Chart 4.6 Share of balance-sheet and off-balance-sheet positions in banking sector total assets (in %)



Source: NBS

Chart 4.7 Share of foreign exchange risk in total capital requirements



Source: NBS

and were prevailingly loans to legal and physical persons (mainly residents), securities (mainly residents), and deposits and loans provided to other banks (in particular to non-residents) in foreign currency.

The off-balance-sheet positions had, like the balance-sheet positions, an open short position, where they were primarily fixed-term operations. The development of balance-sheet and off-balance-sheet positions in 2003 is shown in Chart 4.6.

The share of capital for covering foreign-exchange risk in the trading book and the banking book as at the end of 2003 in the total regulatory capital was approximately 1.5%. The distribution of this share is shown in Chart 4.7.

The persistent and growing liquidity surplus characteristic for the Slovak banking sector

The highly liquid interbank market affected the behaviour of the majority of banks in the liquidity risk management. In the course of the year the share of quick assets in total assets mostly decreased. This indicated that the banks, which renewed their liquidity mainly on the interbank market, relied on an easy replenishment of their resources in the case of need.

The average daily amount of sterilised financial resources in the NBS in 2003 reached SKK 162.7 billion which, compared with 2002, was an increase of SKK 77.4% (SKK 71 billion).

The reasons for the relatively high liquidity in the banking sector also included lower interest of the Slovak banks in financing of long-term investment projects due to their higher level of risk. On the part of financial resources the short-term liabilities prevailed with a significant influence of revolving term deposits.

The banks endeavoured to use the excess liquidity in the form of providing a large number of small consumer loans to physical persons, since loans to small non-financial corporations were still considered too risky.

The interest rate risk in the banking sector closely connected with the development of interest rates

In 2003 a continuing decline in interest rates was recorded in banks both within the asset and liability operations. Banks, however, had expected this trend and adapted accordingly the time structure of asset and liability items.

Chart 4.8 Share of cumulative gap in banking sector total assets (in %)

Source: NBS

Over the course of the year banks continued to acquire mainly short-term funds, which was reflected in the deepening of negative cumulative gap up to 1 year. On the other hand, the cumulative gap above 5 years was positive and during 2003 stable. Such a time structure of balance-sheet and off-balance-sheet items has a positive impact on the interest income of banks when decreasing interest rates, and implies a vulnerability of banks when increasing interest rates (Chart 4.8). The results of stress testing for 2003 (parallel shifts in revenue curve) also confirmed the positive impact on interest income of banks when decreasing interest rates and the vulnerability of banks when increasing interest rates.

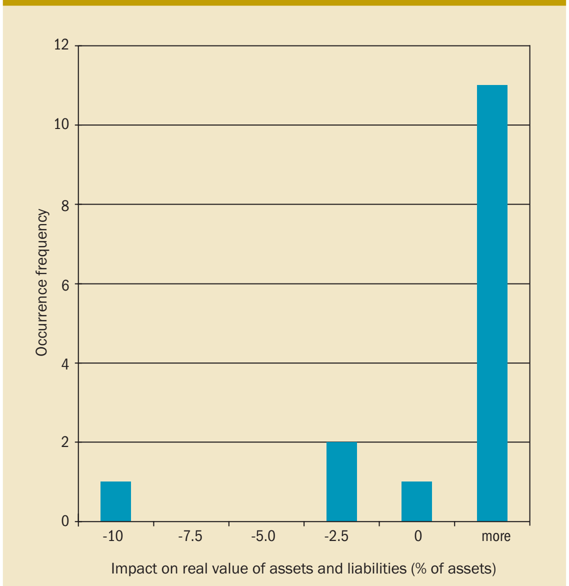
The positive distribution of impacts on the real value of assets and liabilities in the banking sector in the case of a reduction in interest rates by two percent (a percentage of assets) is illustrated in Chart 4.9.

Interest rate risk in the trading book from the aspect of the total risk of banks was relatively low. The capital necessary for covering interest rate risk was worth, for the banking sector as a whole as at the end of 2003, only 1.6% of the total regulatory capital. The distribution of the capital for interest rate risk for all banks in the sector is shown in Chart 4.10.

No capital requirements yet set for covering operational risk of banks

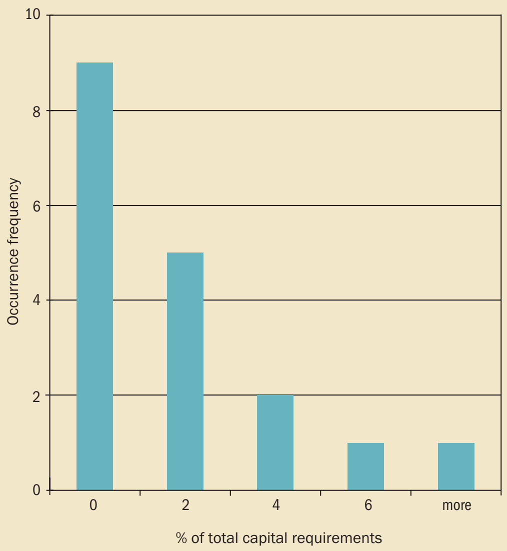
The importance of outsourcing, forming a part of operational risk, has been growing among other operational risks. The management of risks related to outsourcing is based on a contractual relationship with the service provider. The risk evaluation itself is carried out prior to signing the contract. Banks use mainly the Slovak legal entities, members of their own banking groups, building societies, and physical persons – sole traders – as outsourced services providers. Such outsourcing of activities that are directly related to banking activities has been used by 4 banks, activities related to the personification of payment cards and clearing of transactions have also been outsourced. Other activities that banks carry out via outsourcing include in particular legal and personnel consulting, services for information systems and information technologies, debt recovery, intermediation, operation of ATMs, and marketing services. In ancillary activities banks use outsourcing mainly for the administration of real estate, administration of written documents and their archiving, store management, document and mail operation, security services, cleaning services, and transport of cash.

Chart 4.9 Distribution of impact on the real value of assets and liabilities in the banking sector in the case of a reduction in interest rates by 2%



Source: NBS

Chart 4.10 Share of interest rate risk in total capital requirements



Source: NBS

An important factor, currently affecting the size of operational risk, has also been the increasing dependence on electronic banking, expanding network of ATMs and EFT POS and efforts to simplify procedures that users must learn to manage. There exists a discrepancy between the need to reduce operating costs and to protect new, more risk-sensitive, technological solutions against their potential abuse.

4.2 Other financial institutions

Growth in assets in collective investment funds in consequence of a fall in interest rates and strengthening of the exchange rate

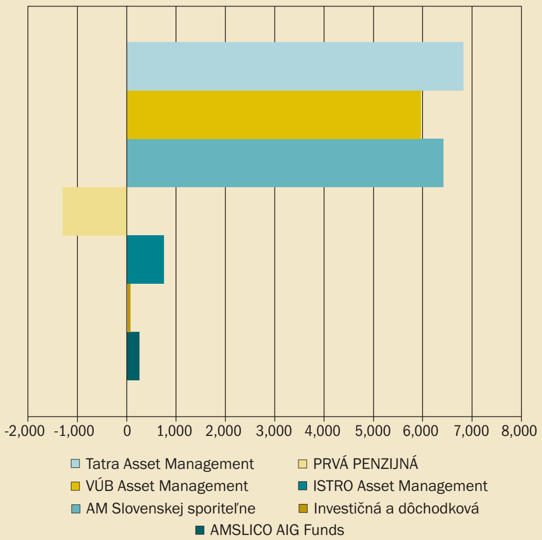
Growth in the assets in collective investment funds in Slovakia was affected in particular by the

Changes to Act No 118/1996 Coll. on the protection of bank deposits and amending certain other laws as amended (hereinafter referred to as the “Act on deposit protection”)

The previous wording of the Act on deposit protection did not address the issue of the provision of information to and protection of depositors, nor other matters in the case of termination of the participation of a bank or a branch office of a foreign bank in the deposit protection scheme in Slovakia and their transfer to a deposit protection scheme in another state. The occurrence of such a situation had been almost impossible, but since May 2004, when Slovakia became a member of the European Union, it has been possible with regard to the principle of validity and advantages of a single banking licence (“single passport”) under the European Union law. Such a situation could occur for example if a domestic bank sold a part of its enterprise (some of its branch offices) to a foreign bank, clients of the domestic bank would thereby automatically become clients of this foreign bank.

On the date of entering into force of the Treaty of Accession to the European Union with Slovakia, the Act No 186/2004 Coll. amending the Act on deposit protection also entered into force. Through the amendment to this Act it was above all necessary to ensure the provision of information to, and protection of, depositors so that there would not arise any risk to the protection of deposits belonging to depositors or its deterioration, and so that depositors would have the possibility to react, within the contractual relationships between the bank and its depositors, to such situation (time deposits are normally not deposited for a period longer than 12 months). At the same time, a bank leaving the deposit protection scheme in Slovakia is obliged, under the amendment to the Act on deposit protection, to pay to the Deposit Protection Fund the hitherto unsettled annual contribution or the hitherto unsettled part of the bank’s annual contribution for the respective calendar year. If the Deposit Protection Fund at the time of the bank leaving it is in an adverse financial situation which has arisen during the bank’s participation in the deposit protection scheme in Slovakia, then the bank is also obliged to pay an extraordinary contribution to the Deposit Protection Fund. This is based on the principles of the European directive on deposit protection schemes, which leaves the methods of financing deposit protection schemes entirely to the national legislation, where the system of deposit protection must be based on the principle of solidarity among all financial institutions in the given financial market and that the costs of financing deposit protection schemes must basically be borne by credit institutions themselves, i.e. by banks.

Chart 4.11 Net sales of domestic asset management companies in 2003 (in SKK millions)



Source: Association of Asset Management Companies

strengthening of the exchange rate of the Slovak koruna against other currencies and the concurrent decline in interest rates on money deposited with banks. Another reason for the growth was the stable and high-quality legislative framework harmonised with the European legislation. Growth in the asset value in collective investment funds in Slovakia was primarily covered by the increase in net sales of mutual fund shares. In the domestic mutual funds this was a cumulative value of SKK 19.65 billion, which in comparison with 2002 represented a growth of 270.75%, where the substantial part was directed into bond funds (SKK 10.2 billion) and money funds (SKK 8.5 billion). The proportion of net sales of mutual fund shares of domestic mutual funds on the Slovak market was 86.21%, the remaining part was formed by the sales of foreign funds. Chart 4.11 indicates the net sales of the largest domestic asset management companies.

Asset management companies founded by banks used the strong market positions of these banks and their already established wide distribution network and strong positions in the retail market. The collective investment market was practically dominated by subsidiaries of the asset management companies of these banks. Indeed, these leading banks caused the dominant part of investments to be invested in the safer funds of the money market and bond funds. Another reason for this was the fact that, in view of the then current yields in bond markets and from investments in money, and particularly koruna, funds, (owing to the constant strengthening of the Slovak koruna and decreasing of the current deposit rates these funds became attractive), it was not even necessary to enter into higher risk represented by equity funds.

The amount of assets managed in 93 mutual funds in the administration of 10 asset management companies in Slovakia reached at the end of 2003 the value of SKK 35.7 billion, representing an increase against 2002 of 120.74%, where the net asset value of these funds was SKK 16.2 billion. A substantial part of the financial resources (SKK 33.8 billion) invested into mutual funds in Slovakia concerned 39 open-end funds (their growth against 2002 represented 136.78%). Closed-end funds (53 mutual funds) and one special mutual fund made up the number of mutual funds administered by the Slovak asset management companies. As at 31 December 2003 the net asset value of mutual funds in Slovakia was as follows: bond funds SKK 15.06 billion (42.18%), money funds SKK 12.34 billion (34.55%), mixed funds SKK 4.56 billion (12.77%), equity funds SKK 1.88 billion (5.29%), and the net asset value of closed-end funds was SKK 1.86 billion (5.21%). With regard to the amendment to the Collective Investment Act that entered into force on 1 January 2003, the number of foreign asset management companies operating in Slovakia via a branch office was reduced. Conversely, the number of securities dealers who became authorised to sell securities issued by foreign asset management companies increased. In total, foreign securities of 249 funds and sub-funds were traded.

The amount invested in collective investment funds per capita in Slovakia was the lowest within the V4 countries (EUR 161). In the period to come it may therefore be expected that the growing trend of the interest in investing in these entities and of the further outflow of financial resources from banks will continue. As a consequence of liberalising this segment, an increased activity of foreign

Non-banking institutions without licence

At the beginning of 2002 the problems with non-banking financial institutions without licence peaked, having an impact on the whole society. These entities operated outside the framework of regulated financial market areas, in the form of trade corporations established in accordance with the Commercial Code. Imperfect legislation allowed them, contrary to the scope of their activities, to accept funds from physical persons (clients) in most cases in the form of a contract for a sleeping partnership, or else, for safe-keeping of funds, fund administration, or loan contracts, via application for a membership in a cooperative, or via inominal contracts. Using massive misleading advertising, which created an image of creditworthiness especially for retail investors, these institutions promised unrealistically high appreciation of deposits, normally at the level of 30% – 40% per annum. From 1997 to 2002 the number of concluded contracts exceeded 250 thousand. In view of the fact that the own assets of non-banking corporations without licence were not separated from their clients' funds, the assets were treated in a non-transparent manner, they were embezzled, and yields were paid from the earlier accepted funds. According to the preliminary data of the law enforcement authorities*, a loss exceeding SKK 22 billion accumulated within five years. The side effect of the operation of these institutions without licence was the outflow of funds, in particular of retail investors, from the regulated financial market.

Owing to the extent of operations of the non-banking financial institutions without licence, the low degree of awareness of their method of operation, as well as insufficient reaction on the part of the law-enforcement authorities, this kind of mock-undertaking became a nationwide phenomenon. In early 2002 the largest entities became insolvent and the individuals – clients of these companies – demanded that the state took over responsibility and paid the indemnities for the losses worth billions caused by non-banking financial institutions without licence. The funds accepted by non-licensed entities were not covered by the Act on deposit protection, and therefore the law did not allow their mitigation. Consequently, the situation was transferred to the political area and so threatened the weakening of political stability in the country.

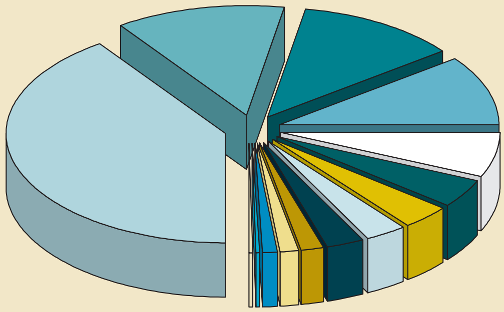
The law-enforcement authorities addressed the situation via investigation, followed by bringing against statutory representatives of these non-banking institutions without licence charges of fraud, illegal business activities and breach of binding rules in the economic operations. Also, in the period from 1999 to 2001 the amendments to Act No 483/2001 Coll. on banks and to the Commercial Code, and also the new Act No 385/1999 Coll. on collective investment were adopted. They unambiguously set limits for business activities in the financial market area. The turning point was, however, the adoption of Act No 566/2001 Coll. on securities and investment services, laying down rules for the public offer of large assets, which in the context of this Act meant a regulation to the possible taking of funds from the public and their utilization for commercial purposes. The purpose of this legal provision was to introduce the elements of transparency into the methods of acquiring funds from the public. A number of non-banking financial institutions without licence were not able to accommodate themselves to the new regulations, this being one of the basic reasons that caused their operations to wind up.

The steps of the law-enforcement authorities and new regulations, having made unlawful the operations of those non-banking financial institutions without licence which did not comply with the new regulations, were the decisive factors which contributed to stifling their operations. In view of the fact that no activities of this kind were recorded** in 2003, it may be concluded that this issue has been mastered and it does not currently pose any risk in terms of threatening the financial stability of the country.

* *Source: The complex information of the Slovak government on the situation in non-banking financial institutions and the measures taken by the government, 2002.*

** *Source: Information on the results of examination of all property transfers, as well as other contractual relations and financial operations, of non-banking financial institutions to political parties and political movements within the criminal proceedings related to the investigation of criminal activities in the non-banking institutions, 2004.*

Chart 4.12 Share of individual brokers in total client deals in 2003



1/ Calyon Bank Slovakia, a.s., from 1 May 2004
Source: Financial Market Authority

collective investment entities in Slovakia and a related outflow of funds into such foreign entities are forecast.

Banks – securities dealers dominant in the field of providing investment services

In 2003 the share of client deals completed by securities dealers – banks in the Bratislava Stock Exchange was 93%. The stabilisation of the market was also helped by the increased level of supervision, the process of pre-licensing securities dealers, the implementation information obligations, including the monitoring of own funds and their adequacy, and the establishment of the Investment Guarantee Fund.

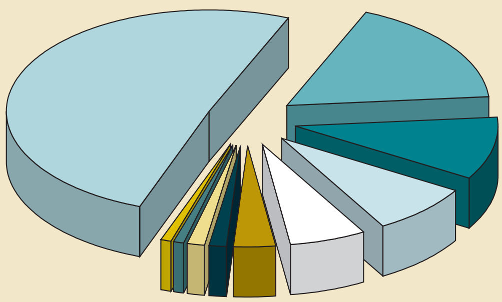
As at the end of 2003, 44 entities in total holding a valid licence to operate as a securities dealer operated in Slovakia, (38 of which holding a licence to provide investment services and 6 holding a licence pursuant to Act No 600/1992 Coll.). Of this number 13 were banks and 2 foreign banks operating via their branch offices in Slovakia. From the aspect of the amount of equity capital, or the value of funds entrusted, 18 entities had equity capital above SKK 100 million, 13 entities had equity capital from SKK 20 million to SKK 100 million, and 13 securities dealers had equity capital of less than SKK 20 million.

Chart 4.12 shows the share of individual securities dealers holding a licence to provide investment services in the total volume of client deals on the Bratislava Stock Exchange at the end of 2003.

The dominant position held by banks in this segment was also positively manifested in the own funds and the adequacy of own funds of securities dealers, where the largest amount of own funds as at 31 December 2003 was reported by Všeobecná úverová banka, a.s., in the amount of SKK 15,056 million (equity capital of SKK 12,978 million). The adequacy of own funds of banks as securities dealers was stable in 2003; their average adequacy of own funds as at the end of the year was at the level of 23.89% (compared with the average of 29.05% in the first six months of 2003). Securities dealers – non-banks recorded significant differences in capital adequacy over 2003; it did not, however, fall below the set minimum of 8%.

Slovakia's accession to the EU and the gradual transition to the European currency, as well as the expected entry of foreign entities, will create pressure for increasing competition on the market in

Chart 4.13 Structure of foreign shareholders in insurance companies as at 31 Dec. 2003



Source: Financial Market Authority

investment services. This development will positively influence the quality, professionalism and complexity of the provided investment services, and contribute to the growth and development of capital markets.

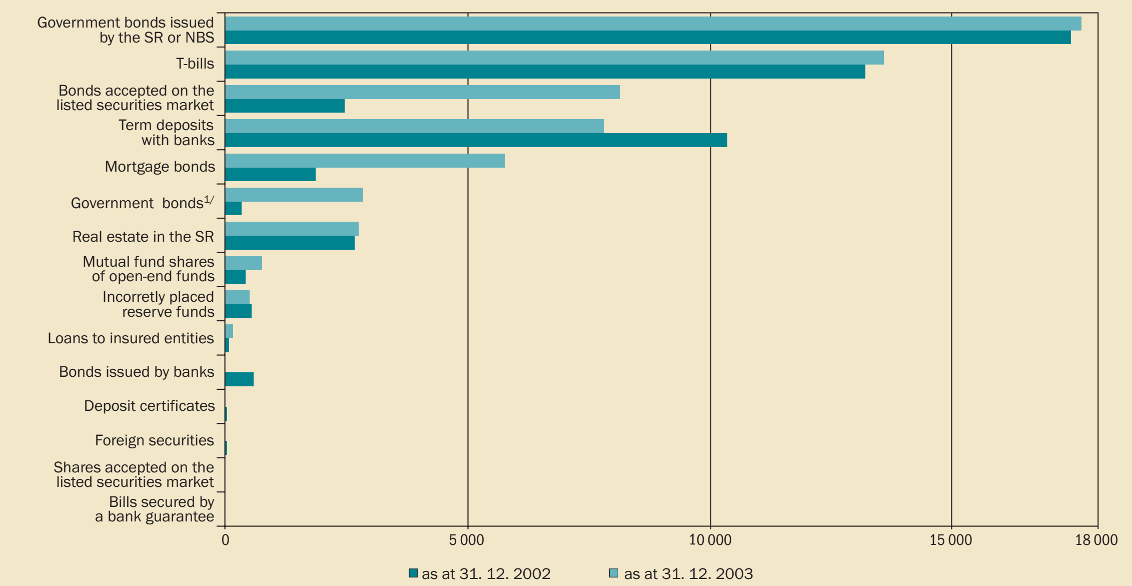
The insurance market in Slovakia, influenced by a high proportion of foreign capital, became largely concentrated

In 2003 the financial result of the insurance industry ended in a profit of SKK 1,384,968 000. The level of the total profit was influenced by the financial result of Allianz – Slovenská poisťovňa, a.s., which company due to the merger between Slovenská poisťovňa, a.s. and Allianz poisťovňa, a.s., performed on 1 January 2003, reached a dominant position in the insurance market with a 44% share.

The volume of foreign capital invested in the Slovak insurance industry increased on a year-on-year basis by 22.17% and in 2003 represented a 89.64% share in the total paid-in capital of insurance companies. After the change in the shareholder structure of Slovenská poisťovňa, a.s., where a share of the German shareholder Allianz Holding AG reached 84.52% of the paid-in capital of Allianz – Slovenská poisťovňa, a.s., the situation continued in 2003, when the highest share in the total foreign capital in Slovakia was held by German shareholders, in particular the financial group Allianz Holding AG. An important share of foreign capital was also reported by investors from Austria, these being in particular the large financial groups Wiener Städtische Allgemeine Versicherung AG, Generali Holding Vienna AG and UNIQA International Versicherungs-Holding GmbH. From these circumstances it is apparent that stability, development and vulnerability of the insurance industry in Slovakia directly depended on the stability and development of financial markets in the above-mentioned countries. Chart 4.13 depicts the share of individual countries in the foreign capital of insurance companies in Slovakia.

Total written premiums in 2003 grew on a year-on-year basis by 15.83%. The year-on-year increase was recorded in non-life insurance, which was brought about in particular by an increase in rates, on average of 50%, in the compulsory motor third-party liability insurance, representing up to a 36.59% share in the non-life insurance. Excluding the impact of the mentioned class of insurance industry, non-life insurance reported lower year-on-year growth than life

Chart 4.14 Allocation of technical reserves **(in SKK millions)**



1/ Government bonds issued by Member States or NCBs of such states and bonds issued by EIB, EBRD or IBRD
Source: Financial Market Authority

assurance, whereas the increase in life assurance was affected and caused mainly by the growth in unit-link assurance. Due to the majority share of motor vehicle insurance in the insurance market it may be expected that the development of the share in non-life insurance will depend on the development of this class of insurance.

In connection with the concentration of the insurance market it is necessary to say that in 2003 more than 61% of insurance market was dominated by two insurance companies, while each of them had a greater than 10% share in this market. Thus, it may be said that the insurance market in Slovakia is to a great extent concentrated, which positively affects the financial stability in the insurance industry sector. This development should also persist in the following year.

Assets representing the coverage of technical reserves of insurance companies formed 66.33% of the total assets of insurance companies. In 2003 insurance companies invested technical reserves mainly in domestic government bonds (30.55%), treasury bills (23.44%) and bonds accepted on the listed securities market (14.08%). When compared with 2002, insurance companies reduced their investment of technical reserves in stocks, certificates of deposit, bills and foreign securities, and conversely increased investment in mortgage bonds, corporate bonds and government bonds, the issuers of which were EU Member States or the central banks of such states. Assuming that no significant, in particular legislative, changes occur, it may be expected that this trend will also continue in 2004. Technical reserves of insurance companies were allocated in the structure shown in Chart 4.14.

In 2003 all insurance companies fulfilled the minimum solvency ratio. The actual solvency ratio of these insurance companies fluctuated within the range of 1.08 to 82.62-times the minimum solvency ratio; in some cases it exceeded the minimum solvency ratio multiplied by 100. It may be expected that insurance companies will comply with the strict solvency criteria also in the following year.

In connection with Slovakia's accession to the EU there exists a presumption that in the second half of 2004 the provision of insurance services by insurance companies of other Member States will begin on the basis of the free provision of services, which should not however cause any significant changes, but may increase competition in the insurance sector.

The share of assets managed by supplementary pension insurance companies in gross domestic product was 0.95%

The system of supplementary pension insurance, which is based on both the employer-employee and the individual principle, forms a significant part of the pension systems in Europe. The reason for the implementation of supplementary pension system in the pension system was to enable employees to acquire a supplementary pension income in old age or a supplementary pension income in the event of ending the working activities, which are classified as category 3 or 4 based on the decision of a health authority.

There were 550 000 persons participating in the supplementary pension system in the period between its introduction and 31 December 2003, and it became a vital part of the pension system.

The supplementary pension insurance, carried out by supplementary pension insurance companies, is based on contributions, and its financing is made by means of their capitalisation. The system benefits from tax allowances on both the employees' and employers' contributions. The state subsidizes the system of supplementary insurance by means of tax relieves limited up to 10% of annual income, though not exceeding SKK 24,000 per annum. Another benefit is the contribution of an employer which makes the supplementary pension insurance an important integral part of the employers' social policy.

As at 31 December 2003, there were 5 supplementary pension insurance companies (hereinafter "SPIC") operating in the Slovak Republic. However, in the supplementary pension insurance market there were only four entities: P DDP Tatry – Sympatia, DDP Stabilita, Pokoj DDP, DDP Credit Suisse Life & Pensions, actually operating. Since 2004, when DDP ING started its operations on the supplementary pension insurance market, six

Table 4.8 Development of basic indicators of operation of supplementary pension insurance companies

	2001	2002	2003
Financial result (in SKK thousands)	175,030	96,850	319,527
Assets (in SKK millions)	4,966	7,907	11,369
Assets/GDP ratio (in %)	0.49	0.72	0.95
Contributions to SPICs (in SKK millions)	1,956	3,065	4,291
Share of contributions to SPICsin gross savings (in %)	4.56	6.21	9.05

Source: Ministry of Labour, Social Affairs and Family of the SR

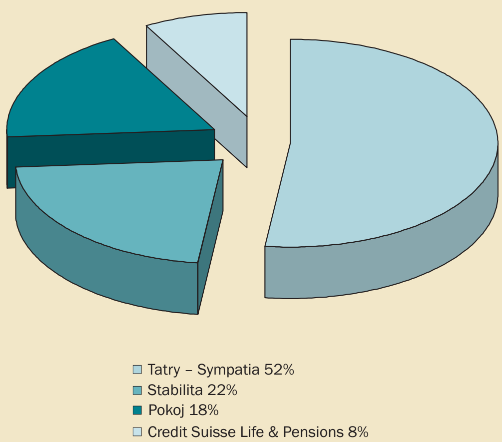
entities have been operating as supplementary pension insurance companies.

The importance of supplementary pension insurance is also expressed by the share of assets managed by supplementary pension insurance companies in gross domestic product. Since 1997, this ratio increased from 0.02% to 0.95% in 2003 (see Table 4.8). The supplementary pension insurance sector achieved in 2003 the profit of SKK 319,527 thousand. However, the rate of growth was not the same in all SPICs. The DDP Stabilita recorded the highest increase in profit, which was SKK 13,553 thousand in absolute terms. The DDP Credit Suisse Life & Pensions recorded the most dynamic rate of growth. On one hand, it was due to the dynamic growth in the number of insured persons, and on the other hand a relatively low financial result for the previous period.

The SPICs' assets recorded a growth of 43.27% in 2003, this providing supplementary pension insurance, along with collective investment, to be among the most dynamically growing segments of the Slovak financial market. The continued appreciation of assets managed by SPICs is supported in particular by tax allowances provided to this form of saving.

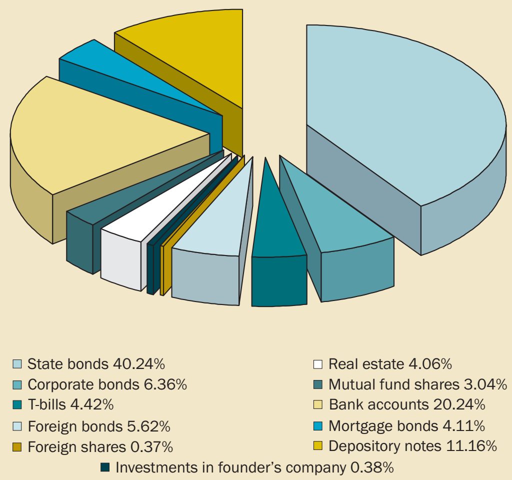
The growing importance of supplementary pension insurance is also evidenced in its increasing share in total savings of households. Since 2001, this ratio has doubled and currently it amounts to almost one tenths of growth in physical persons' savings. As at the end of 2003, the assets man-

Chart 4.15 Share of individual assets of supplementary pension insurance companies in sector's total assets as at 31 December 2003



Source: Ministry of Labour, Social Affairs and Family of the SR

Chart 4.16 Overall structure of financial assets of SPICs as at 31 December 2003



Source: Ministry of Labour, Social Affairs and Family of the SR aged by the four SPICs amounted to SKK 11,369 billion; this was an increase of SKK 3,462 billion when compared to 2002.

Over the assessed period, the supplementary pension insurance market reported a constantly high level of concentration, where the largest DDP Tatry – Sympatia managed more than 50% of total assets of the supplementary pension insurance companies. Chart 4.15 shows shares of individual SPICs in total assets of the supplementary pension insurance sector as at 31 December 2003.

In comparison with 2002, there occurred more changes in the SPICs' financial assets structure in 2003. As to the volume, in particular investments in government securities, mortgage bonds, funds in bank accounts and depository notes grew.

The share of the safest investments in total financial assets has continued to grow. Government securities and funds in bank accounts made almost 65% of the total financial investments value. The investments in the group covering corporate bonds, foreign bonds, mortgage bonds and depository notes represented more than 27% of the SPICs' total investments. Mutual fund shares, foreign shares and real estate represented the remaining 8% of financial assets.

The shown structure of financial investments undoubtedly indicates that the supplementary pension insurance companies have preferred conservative investments.

The supplementary pension insurance companies have allocated most of their investments in securities. In 2003 their share in total investments slightly decreased in favour of investments in real estate. Securities, however, still represent more than three quarters of total financial assets of SPICs. Share of funds in bank accounts remained almost unchanged when compared with 2002.

With the aim to eliminate the weaknesses contained in the current regulation of supplementary

Pension management companies

In 2003 the legislative and institutional framework was created in Slovakia for introducing a system of retirement pension savings and for the activity of new financial institutions – pension management companies, which should allocate a large amount of accumulated funds to various investment instruments on the financial market with the view of their appreciation to pay out retirement pension benefits. Working inhabitants of Slovakia will make contributions worth 9% of their tax assessment base into this system of retirement pension savings, which has the nature of a compulsory defined-contribution system. The pension management companies will allocate these financial resources accumulated in pension funds in the investment instruments on financial markets.

The introduction of the retirement pension savings system in Slovakia will probably cause a beneficial effect in the form of a recovery on the Slovak capital market. This should primarily be supported by regulatory obligation to place 30% of assets accumulated in pension funds in the issues of issuers registered in Slovakia. It is first expected that these will mainly be bonds and mortgage bonds. Later, however, as assets in pension funds increase, fund administrators should also seek alternative investment opportunities on domestic markets, in particular Slovak blue-chips.

Only those administrators of inhabitants' pension assets, which fulfil the conditions provided by Act No 43/2004 of the Coll. on retirement pension savings, will be able to enter the market in retirement pension savings. This Act and the licensing process performed on its basis by the Financial Market Authority are considered by domestic and foreign experts to be one of the strictest regulations in the field of retirement pension savings in the world. This degree of supervision should contribute to the elimination of risk and its further impact on the financial market stability.

pension insurance, to improve its transparency and to transform supplementary pension insurance companies in standard entities of financial market, the Slovak government approved a draft law on supplementary pension insurance.

The law proposes transformation of the current supplementary pension insurance companies in supplementary pension companies, these would carry out supplementary pension saving in accordance with the licence authorising their establishment and operation, granted by the Financial Market Authority. The law also assumes that a supplementary pension company shall create and manage at least two supplementary pension funds.

On the adoption of the Act on supplementary pension savings, the oversight of new system of supplementary pension saving will be taken from the Ministry of Labour, Social Affairs and Family of the Slovak Republic and the Ministry of Finance of the Slovak Republic, and will be assigned to the Financial Market Authority.

5. Current issues / Special topics

Annex 1

The New Basel Capital Accord – Basel II

All in all, in 2003 the Slovak banking sector was in the state of full preparation for the implementation of the amendment to Directives 93/6 and 2000/12, which are based on the New Basel Capital Accord (NBCA). This was a result of the activity of the NBS Banking Supervision, as well as foreign parent banks owning the majority of Slovak banks and branches. The first major impulse for this preparation was the involvement of the Slovak banking sector in the Quantitative Impact Study 3 (QIS 3), organised by the Basel Committee on Banking Supervision during the second half of 2002 and the first half of 2003. Certain important findings follow that have resulted from the QIS 3 and which provide a picture on the impact of the standardised methods of the NBCA on the Slovak banking sector.

The result of the QIS 3 was the publication of the Third Consultative Paper (CP3) by the Basel Committee. The paper contained certain serious changes differing from the rules under which the QIS 3 was carried out. The CP3 became the basis for the draft amendment to European Union Directive 2000/12/EC. This Directive will bind all banks in the European Union to observe the NBCA rules. It shall also be binding for the business activities of the Slovak banking sector.

The QIS 3

Of the 20 commercial banks that formed the Slovak banking sector (specifically 3 domestic banks, 2 branches of foreign banks, 3 building societies, and 12 subsidiaries of foreign banks) 17 participated in QIS 3. The preparation of the Slovak banking sector for QIS 3 consisted of a series of expert seminars and of the collection of preliminary data for the Basel Committee. 15 banks representing 74% of the sector's assets provided their data. Individual and aggregated data taken from a sample formed by 9 banks (67% of the sector's assets) were sent by the NBS banking supervision to the Basel Committee and in January 2003 an assessment report for the Slovak banking sector was made.

On the basis of preliminary results of QIS 3 certain changes in the draft NBCA were made. For the purpose of verifying their impact, during the first three months of 2003 additional information was acquired from the commercial banks involved in QIS 3.

All Slovak banks used the standardised approach to credit risk and also to operational risk. When compared with the capital requirement under the original Basel Capital Accord (BCA), the new capital requirement is higher on average by 19.5%. It has minimally increased by 7% and at maximum by 31%. By and large it may be said that the NBCA's impact which can be expected on the Slovak banking market, at least so far as it concerns capital requirements, is fully manageable by the banks in the framework of the currently high level of the capital ratio.

Table 5.1 includes share of individual portfolios in the estimated average increase in capital requirements for credit risk of 9.6%.

The further development in the implementation of RBCD[19] Directives in Slovakia

The NBCA does not constitute only capital requirements under standardised approaches. It can be

[19] *Risk Based Capital Directive.*

Table 5.1 Share of individual portfolios in the estimated average increase in capital requirement

Segment	% of exposure	% of current RWA	% of change in RWAs	Share in the total change
Corporates	16.7	35.7	0.0	0.2
Sovereigns	36.6	0.6	x	2.9
Banks	11.9	6.3	67.0	5.3
Retail	2.7	5.8	-25.5	-1.5
– of which mortgage	1.4	2.4	-25.3	-0.7
SMEs	14.7	29.4	1.7	0.7
Specialised financing	0.5	1.1	0.0	0.0
Equities	0.1	0.2	0.0	0.0
Trading book	16.9	7.4	-3.1	-0.1
Investments in affiliated companies (transfer to risk-weighted assets)		13.5	7.5	2.1
Total credit risk			9.6	9.6
Operational risk				9.8
Total change			19.5	19.5

Source: NBS

said that majority of banks count on – either from the moment of implementation or at least in the medium-term horizon – more progressive approaches to the measuring of credit risk. This will require the creation of suitable internal rating systems, the implementation of suitable processes and the collection of necessary data. The advanced approaches must fulfil the demanding qualification preconditions that will be set in the amended Directive 2000/12/EC.

On the basis of consultations made and ongoing with the banking sector and on the basis of information that the banking supervision has available from negotiations in working groups of the Basel Committee, the European Commission and the European Central Bank, the following summary may be made:

- Changes made in the Act on banks, relating to the preparation for the implementation of the amended Directive (e.g., preparation for the segmentation of the banking book, for the option allowing a bank to use a more advanced method of calculating capital requirements on a solo basis following the fulfilment of qualification requirements, etc.) do not cover all current requirements. It will be necessary to make other changes relating to the second pillar of the NBCA, i.e. to the process of examinations made by supervisory authorities and to the assessment of risks posed to a bank (in particular in connection with the option of individual capital requirements under the risk profile of a particular bank);
- Most Slovak banks which are subsidiaries of foreign banks expect that they will use the same approaches to individual types of risks which their parent banks will use;
- For all banks that may want to use more advanced approaches, it will be very demanding to ensure the sufficient quality, amount, detail, and length of time series of the data necessary for the calibration and verification of the approaches;
- The NBS Banking Supervision is convinced that in the Slovak environment it is not possible to use data of other banks without mutual convergence of processes and environments where such data were obtained. This concerns the estimate of PD (Probability Of Default), LGD (Loss Given Default) and EAD (Exposure At Default) risk parameters as to the credit risk and the estimate of the size of the operational risk in terms of the AMA (Advanced Measurement Approaches) approach. Unless this condition is met, all estimates could be significantly inaccurate.

The new form of the relationship between the home regulator (regulator of the parent bank within the EU) and the host regulator (regulator of subsidiary within the EU), as well as their powers and responsibilities, have not yet been clarified. The NBS Banking Supervision is currently exclusively in the position of a host regulator; subsidiaries of foreign banks and branches of foreign banks in Slovakia count for more than 95% of the sector's assets.

Annex 2

The new Interbank Payment System SIPS

SIPS (the acronym of the Slovak Interbank Payment System) is a single interbank payment system in Slovakia that serves for executing domestic transfers. The National Bank of Slovakia became the operator of the system of Slovakia on 1 January 2003, when on the basis of the decision of shareholders took over the performance of activities related to the interbank payments system of the Slovak National Clearing Centre. For this purpose the National Bank of Slovakia prepared and implemented a new, fully automated interbank payment system SIPS, which it has operated from January 2003 in accordance with Act No 510/2002 Coll. on the payment system and on amendments and supplements to certain laws as amended by Act No 604/2003 Coll. (hereinafter referred to as the "Act on the payment system"). As at 31 December 2003, SIPS had 25 participants (including the National Bank of Slovakia). The National Bank of Slovakia has concluded with each SIPS participant the identical SIPS contract, the content of which is laid down by the Act on the payment system.

The National Bank of Slovakia has created the SIPS interbank payment system using its own resources. Since putting the SIPS into operation the NBS has upgraded its software several times with a view of increasing its efficiency and the safety of the payment system taking advantage of the state-of-the-art information technologies as the basis for establishing a real-time gross settlement system (RTGS) in the conditions of Slovakia. The RTGS system was created and introduced into operation on 1 April 2004.

Basic features of SIPS

The processing and settlement of payments

The processing and settlement of payments are fully automated, the data transfer between the National Bank of Slovakia and the SIPS participants is made exclusively in the electronic form – by means of the communication system BIPS (Basic Interface for Payment System), using the private data network of the National Bank of Slovakia – UNIVERZAL-NET®. In data transmission the integrity and authenticity of data are verified by means of a digital signature.

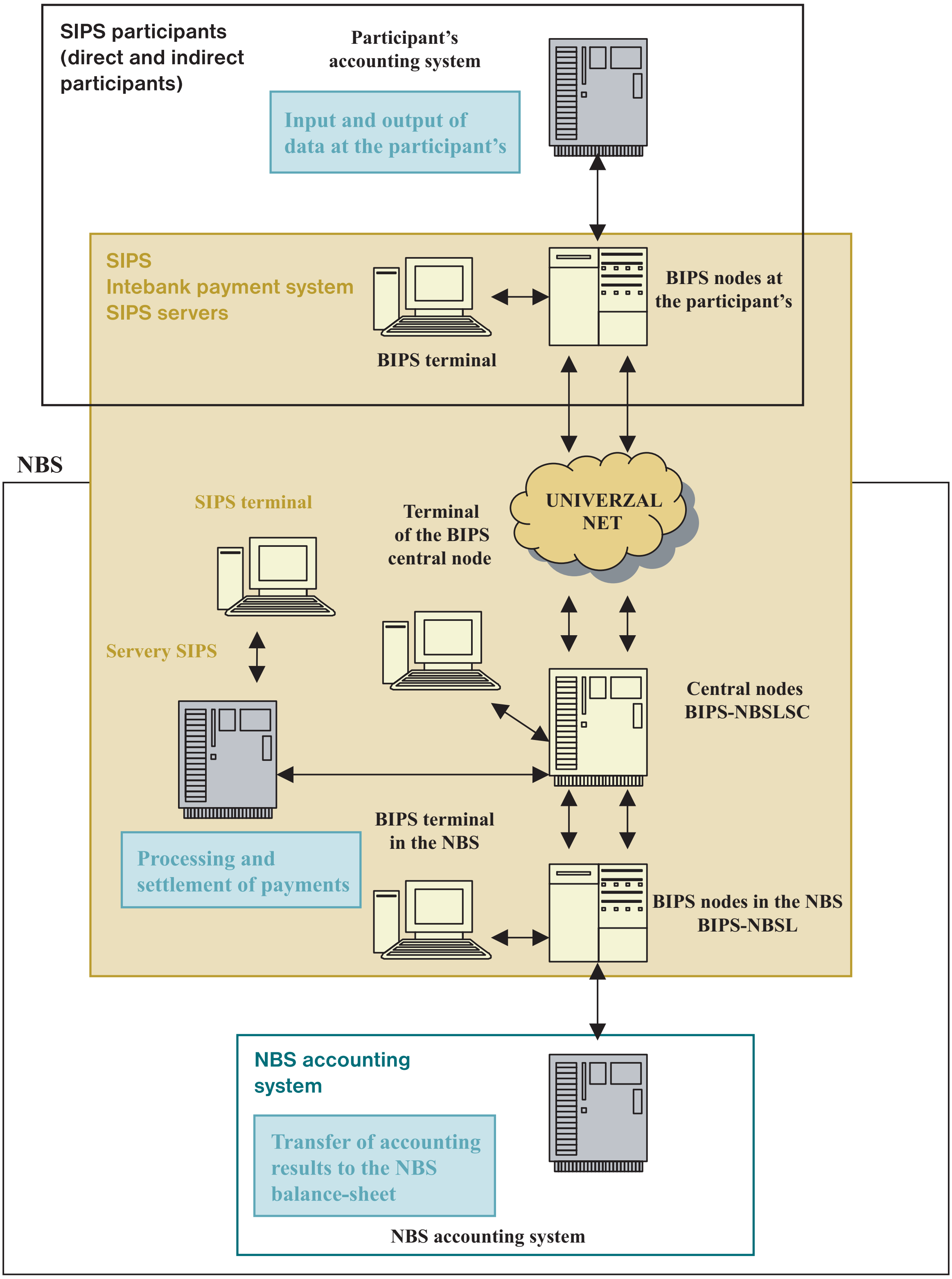
Payments enter and leave the processing in the form of clearing files created in a local standard – called a clearing sentence. In processing, SIPS does not distinguish a payment's value. Payments are processed on FIFO (first in first out) principles, and based on priorities set in advance. Each payment must be covered by financial resources on participants' accounts which are kept with the National Bank of Slovakia. Payments, for the coverage of which the participant's account with the NBS does not have sufficient funds at the end of the clearing day, are returned to the participant as unprocessed due to insufficient liquidity.

Types of payments

The basic types of payments the system works with are credit transfer and direct debit. Payments are further divided into standard and high priority payments. Standard payments may be described as standard interbank and client payments that have a low priority from the aspect of their processing. High priority payments may be characterised as payments of extraordinary economic importance and urgent payments: as a rule these are payments of the interbank money market. High priority payments have the highest priority from the aspect of their processing, which means that they are prioritised when being processed in the SIPS interbank payment system. In designing the RTGS system the National Bank of Slovakia has especially focused on high priority payments, which meet all the requirements placed on the real time gross settlement.

The transmission of a high priority payment from a participant to the National Bank of Slovakia takes approximately 3 to 5 minutes. If the participant's account with the National Bank of Slovakia has sufficient funds to cover the high priority payment, it is processed and settled within the following few minutes, depending on the number of payments that are at the given moment prepared for processing in the SIPS interbank payment system. After processing of each high priority payment a binding confirmation containing all the data necessary

SIPS operation scheme



to identify the priority payment is sent via the BIPS both to the sending and receiving participant.

Main economic indicators

In 2003 the SIPS system daily processed and settled on average 400,000 payments in the total value of more than SKK 130,000 million, and on busy days the number of processed payments exceeded 1 million. By means of the current technical equipment it is, however, possible to process and settle up to 2 million payments per hour. By means of the BIPS communication system it is possible to transfer between an individual participant and the National Bank of Slovakia approximately 230,000 payments per hour.

For the whole 2003, 99 million transactions were processed, which was a growth of 11% against the preceding year. The total value of transactions was SKK 32,248,756 million, which was a 44% increase on the preceding year. Of the total number of transactions processed, high priority payments represented 0.02 to 0.03% and more than 25% of the total value. The average value of one high priority payment was SKK 460 million. Standard payments represented more than 99% of the total number and approximately 74% of the total value of transactions processed. The average value of one standard payment was SKK 250,000.

Conclusion

With regard to the fact that each payment system for transference of payments is a key component of the financial system, the importance of the SIPS is even greater from the aspect of financial stability, due to the absence of any other interbank payment system in Slovakia. The National Bank of Slovakia therefore designed and developed SIPS so that the smooth and safe functioning of transfers of funds was ensured with the least possible degree of the occurrence of the risk of failure of the whole system or its parts. Within each software update, an effort is made to further upgrade the security level of individual system components.

Despite the fact that the SIPS has been functioning reliably since the beginning of its operation, the National Bank of Slovakia has been preparing several changes over the course of 2004 and further in 2005 which should contribute to development in terms of smoothness and efficiency of fund transfers in Slovakia. Since 1 January 2004 the participants of the regime of minimum reserves have had the option of bridging temporary insufficient liquidity on their accounts during a day through drawing an intraday credit. In addition, in the course of 2004 the real-time gross settlement system will be launched.

Annex 3

The credit boom and its impact on financial stability

The banking sector's restructuring process and a new conduct of monetary policy led to the increased availability of credit resources

In 2002 and 2003 the year-on-year growth in lending activities accelerated, where particularly in 2003 credits to households recorded relatively high growth.

The development of credits to households and enterprises[20] over the past years was influenced not only by a change in the conduct of monetary policy, but also by several changes of a structural nature. At the end of 1998 the fixed exchange rate regime (with a fluctuation band) was replaced by managed floating. The development of the exchange rate, as well as expectations of its development in the future, thus began to play a more important role in the decision-making of economic entities in drawing loans. Concurrently, in 2000 a change in the conduct of monetary policy took place from the quantitative to qualitative management by means of setting the key interest rates of the NBS.

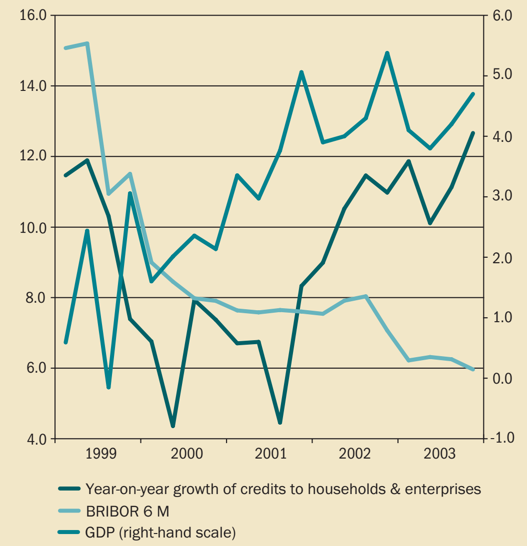
The new form of the monetary policy conduct significantly contributed to the stabilisation of the money market rates with a subsequent impact on primary interest rates. Thus, the key rates of the NBS have currently represented an anchor in carrying out the interest rate policy of banks.

The lending policy of banks, however, was to a considerable extent influenced also by the banking sector reform, bringing restructuring of loan portfolios of selected banks and privatisation of banks. Structural reforms together with the change in the performance of monetary policy contributed importantly to the standardisation of the environment, and created room for a substantial increase in the effect of market factors on the lending policy of banks and decision-making of non-banking institutions.

Reforms in the banking sector were reflected in a slowdown in the year-on-year growth of credits to households and enterprises over the years 1999-2001. Recovery of the banking sector, together with a decline in interest rates, showed itself in the progressive increase in the year-on-year growth of loans in the subsequent period. The reduction in interest rates and the growing trend of loans were partially affected also by reducing the minimum reserves rate. The acceleration of the growth in lending activities probably also partially reflected the need to finance a faster economic growth.

After the situation when following 1999 growth in foreign currency loans began to slacken, in 2003 a significant growth in their volume could be observed. In particular due to the trend of the Slovak koruna appreciation and forecasts of its continuation, there occurred a substitution of koruna loans by foreign currency loans in loans drawn by corporations (almost 100% of the volume of credits to households and enterprises in foreign currencies was represented by loans to corporations). A chan-

Chart 5.1 Year-on-year growth in credits to households and enterprises (average quarterly data; at the current exchange rate), development of 6M BRIBOR and the growth of real GDP (in %)



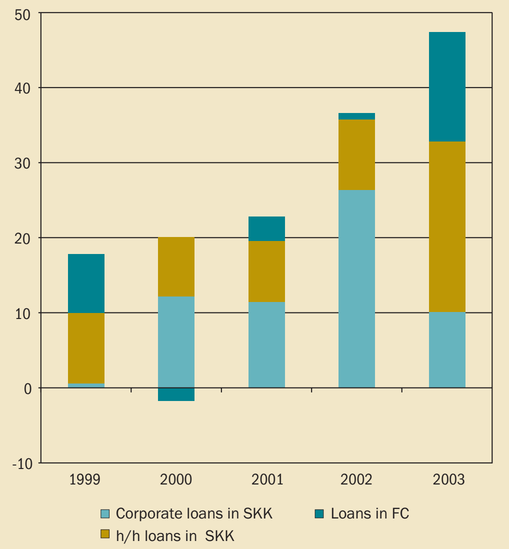
Source: Statistical Yearbooks of the SR

[20] *In accordance with the Monetary Survey methodology (i.e., Special Data Dissemination Standards – SDDS, Analytical accounts of the banking sector).*

ge in preferences in favour of drawing loans in foreign currency was affected by the exchange rate, as well as by the persistent interest rate differential.

Development in the volume of loans, in addition to a change in the credit growth structure, indicated certain changes in the behaviour of individual economic entities. Whereas in 1999-2002 a growth in loans to households was almost constant, in 2003 they increased significantly. This was influenced, besides lower interest rates, also by the development of mortgage financing and the state support scheme for this type of loans[21].

Chart 5.2 Year-on-year change in credits to households and enterprises (in SKK billions)



Source: NBS

The further cheapening of credit resources currently prevented mainly by the interest spread maintained by banks

In the period following the restructuring aimed at the recovery of loan portfolios the share of loans in GDP fell. In 2001 it fell to the level of 28.31%, in 2002 of 27.15%, and in 2003 it decreased to 26.79%.[22] Besides the mentioned indicators of the economic position, from which resulted room for sustainable growth and higher credit exposure, an important factor was represented by the positive trend in the degree of coverage of expected loan losses by own funds. As at the end of 2003 the expected loan losses were covered in full. A positive fact was that total profit was not affected, in terms of accounting, by a difference between created and used provisions, which distorted the real level of the return on assets and return on equity in the banking sector.

The total assets of the Slovak banking sector were relatively low, especially in relation to the GDP development. 2003 also saw an absolute fall in banking assets. In absolute terms credit exposure increased, but in terms of relative ratios (loans to total assets, loans to GDP) a decline was recorded. One of possible explanations of the banking sector's behaviour reflected in such credit-exposure stagnation, as well as in overall activity, could be the effort to accumulate internal resources for ensuring future competitiveness. This is an effort to prepare capital for possible changes in the cash-flow structure and be able to eliminate a possible lack of the currently stable resources of profitability.

Despite a significant decline in average lending rates, which over the period 1999-2003 fell from 16.89% to 8.60%, the rate of their reduction was lower than a decrease in deposits rates. Average interest rates on loans provided to the public sector reached 7.57%. Interest rates on loans allocated to the private sector averaged 8.47%. For an important part of corporate entities, these have not yet provided sufficient leverage. Average lending rates for households as at the end of 2003 reached the even higher level of 9.72%, and when compared with the private sector recorded a significantly lower year-on-year decline. With total average deposit rates, which stood at 3.35%, this represented an aggregated lending – deposit rate spread of

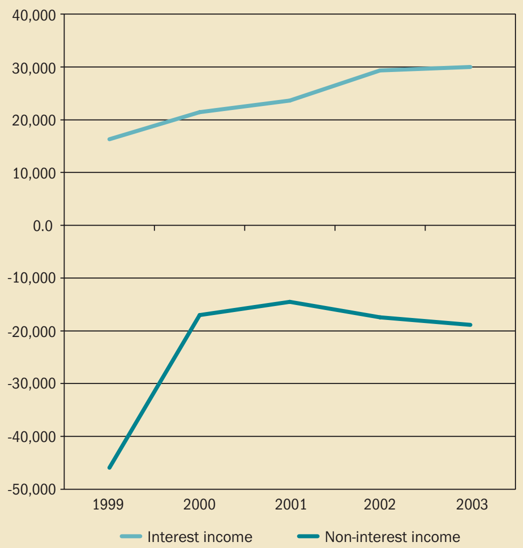
[21] The development of loans in 1999-2003 was affected by the restructuring of loan portfolios of selected banks, by the winding-up of certain banks, or by other factors, which influenced the statistically reported volume of loans. Credits to households and enterprises in the Monetary Survey also comprised an increase as a result of a credit transferred from the Slovak branch of ČSOB to its Prague headquarters and replaced in the balance sheet by assets towards non-residents in SKK.

[22] In the euro area the ratio of bank loans to GDP in 2000 represented 87.20%, in 2001 it was 88.45% and in 2002 this share increased to the level of 89.11% (source:ECB Monthly Bulletin, 2001-2002).

5.25%. When compared with the average deposit and lending rates for households, the interest spread was significantly higher, reaching 6.84%. Interest income, due to the mentioned interest rate spread, recorded an increase in the period following restructuring (in 2003 much moderated), however, a non-interest loss was concurrently increasing, even though its year-on-year growth was decelerated (2002/2001 growth index = 120.30% and the index for 2003/2002 = 107.92%).

Interest income continued to constitute a decisive source of the total profit. The room for a fall in interest rates on deposits (in particular those of households) was small. The interest rate spread could induce households to be prone to consumption, or to place their savings outside the banking sector, bringing an impact on further increasing the operating leverage of the banking sector as a whole. It was expected that the banks would prepare capital potential for a reduction in lending rates, though the dominant position in the interest income structure was held by households. Interest yield as at the end of the year reached the value of SKK 58,607 million and the interest income totalled SKK 29,984 million. If we accept that one of the important factors of a bank's cash flow is the lending-deposit rate spread, then households have had a decisive impact on this item in the profit structure. In the overall deposits in the banking sectors households had a 48.42% share, but in interest on deposits only 39.98%. Conversely, households had a 29.07% share in the total volume of provided loans and a 32.85% share in the interest on provided loans. Considerable growth (especially in 2003) in credit exposure, and in its framework in mortgage loans allocated to households, has been an important potential source of profitability for the banking sector. It may, however, be expected that this interest potential will be reduced in the future.

Chart 5.3 Development of the banking sector profit structure (in SKK millions)



Source: NBS

Sharp increase in provided mortgage loans, though stable development maintained

The most important fact of the development of the Slovak banking sector in the course of 2003 was undoubtedly the substantial growth in the volume of mortgage loans provided. This expansion, the scope of which by far exceeded the expectations of the NBS as well as those of market analysts, was caused by the behaviour of retail clients connected with the amendment to the Act on banks (effective as from 1 July 2003) which, *inter alia*, cancelled the fixed state contribution, i.e. the percentage by which the state reduced the amount of the interest rate set in the mortgage loan contract.

The growing dynamics of the mortgage market became apparent throughout the whole of 2003. As at 31 December 2003 the total number of mortgage loans contracts concluded (including promises) totalled SKK 35.3 billion, of which banks actually provided to clients loans in the amount of SKK 27.2 billion, representing a 77.3% share. However, the prevailing part of the mortgage loan contracts concluded in the second quarter was of the nature of a loan commitment, i.e. the loans were not actually provided and disbursed. This fact was documented by the substantially lower rate of increase in the item of mortgage loans provided, which as at 31 December 2003 totalled SKK 27.2 billion and compared with the initial volume of the first half-year of 2003 increased by SKK 9.4 billion, i.e. by 34.6%. Owing to the mentioned development, 2003 saw a significant decline to 77.3% of the share of mortgage loans actually provided in the sum of mortgage loans contracts concluded. In view of the fact that the unilateral withdrawal by a client from the contract, i.e. not using the loan commitment, is relatively costly and this even despite the forecast of a substantial growth in real estate prices, the second half of 2003 did not suffer any decline in the total volume of the mortgage loan contracts concluded. The total value of issued and sold mortgage bonds increased and as at 31 December 2003 reached the value of SKK 14.8 billion.

Annex 4

New prudential rules for banks and banking supervision

In 2003 the following laws were adopted that had an important influence on the development of financial stability of banks on the market.

• **Act No 165/2003 amending**
Act No 310/1992 Coll. on building society saving as amended: The change concerns the reduction in the state premium from 20% to 15% of the annual deposit; and
Act No 483/2001 Coll. on banks and on the changes and supplements to certain other laws as amended: The change concerns the setting of the percentage amount of the state contribution which is no longer guaranteed for the whole period of the mortgage loan, but set each year by the Act on the state budget for the respective calendar year in which it applies to all mortgage loan contracts.

• **Act No 603/2003 amending** Act No 483/2001 Coll. on banks: The aim of the amendment was to take into account the incentives of the World Bank (presented in the preparation of the second and third tranche of the EFSAL loan), which concern requirements for undertakings of banks and branches of foreign banks (including the related increase in effectiveness and efficiency of banking supervision), and which are compatible with directives applicable for banking in the European Union.

• **Act No 602/2003 amending**
Foreign Exchange Act (Act of the National Council of the Slovak Republic No 202/1995 Coll. as amended): laying down the rules for executing and mediating the remaining foreign-exchange regulated business activities (in deals with foreign exchange assets and in foreign-exchange money services) which are related to funds in the Slovak or foreign currencies in cash or non-cash form (purchase, sale and exchange of funds, and cross-border cash transfers of funds in the Slovak or foreign currencies); and
Act No 566/1992 Coll. on the National Bank of Slovakia as amended: The most important amendment is that the National Bank of Slovakia is authorised to acquire (to request) and further process personal and other data for the purposes of performing its statutory competences (e.g., in monetary policy, statistics, banking deals and supervision carried out by the National Bank of Slovakia).

• **Act No 594/2003 Coll. on collective investment** amending and supplementing certain acts (hereinafter referred to as the "Collective Investment Act"), which at the same time amended Act No 530/1990 Coll. on bonds as amended, Act No 566/2001 Coll. on securities and investment services and on the amendments and supplements to certain acts as amended, and Act No 429/2002 Coll. on securities stock exchange:
The amendment to the Collective Investment Act enabled an extension in the scope of activities of fund management companies to include certain additional investment services in the management of investment portfolios for individual clients, and implemented additional rules of prudent business conduct for asset management companies, including capital adequacy rules.

• **Act No 604/2003 Coll. amending** Act No 510/2002 Coll. on the payment system and on amendments and supplements to certain laws: The amendment provides the basic rules and conditions for granting licence for the electronic-money activity of e-money institutions, the minimum amount of cash deposit in the equity capital for an e-money institution in the amount of EUR 1 000 000 or its equivalent value in another currency when converted to the SKK, and the basic conditions and requirements for the business conduct of an e-money institution.

Conduct of banking supervision carried out also by means of secondary regulations, licensing decrees and decrees on prudential banking

In 2003 the following decrees were issued:

No 1/2003 of 28 February 2003 amending the National Bank of Slovakia's Decree No 3/2002 covering the rules governing prudent conduct of banking business and associated reports: The aim of the amendment was to change the limit from 40% to 25% for the ratio of bank's large exposure and bank's own funds, where the large exposure is to a person with a special relationship to the bank, if such person is a bank with the registered office in an OECD Member State. This Decree entered into force on 20 March 2003.

No 2/2003 of 30 May 2003 concerning the register of credits and guarantees: This Decree increases the quality and efficiency of the system of the credits and guarantees register established within the NBS for providing information from this system to banks and branches of foreign banks concerning the total credit exposure of a client. It also stipulates the details of what is understood by the technical protection of disclosed and provided data. This Decree entered into force on 1 June 2004.

No 4/2003 of 29 July 2003 amending NBS Decree No 2/2002 on liquidity of banks and liquidity of branches of foreign banks and associated rules of safe operations and reports: This Decree cancelled the obligation for banks to present reports on seven-day liquidity, and laid down the definition of the date of financial settlement. This Decree entered into force on 20 August 2003.

No 5/2003 of 11 September 2003 on reporting submitted to the National Bank of Slovakia by a bank controlling a bank consolidated group or a bank sub-consolidated group, which entered into force on 1 September 2003: The aim of this Decree of the National Bank of Slovakia was to ensure the monitoring of the current position of the existing bank consolidated groups or bank sub-consolidated groups, particularly on the basis of reports submitted by banks for the purposes of the banking supervision conduct.

Over the period in question the Banking Supervision Division issued, as a part of the pro-active approach to the conduct of banking supervision, ten methodological instructions concerning the Act and secondary regulations, and three recommendations.

Methodological Instructions

No 1/2003 to the Decree of the National Bank of Slovakia No 6 of 12 December 2002 on the adequacy of banks' own funds, regulates in more detail the manner of calculating the theoretical prices of financial instruments, and contains explanations for completing reports on own funds and their adequacy.

No 2/2003 for compiling interim financial statements of banks and branches of foreign banks, reacts to changes in the Act on accounting and in the regulations for compiling and presenting financial statements.

No 3/2003 to NBS Decree No 7/2002 on classification of assets and liabilities of banks and branches of foreign banks, on their re-valuation, formation and dissolution of reserves and related reports, clarifies in conceptual terms the areas which were problematic for banks.

No 4/2003 to the provision of Article 40 (3) and (4) of the Act on banks, was issued in the interests of transparency in cooperation with external auditors. The Banking Supervision has an interest in sustaining the stability of the banking system and supporting the security and health of individual banks for the purpose of protecting depositors' interests.

No 5/2003 on best practices of banks and branch offices of foreign banks in cases of discrepancies found in the Register of Credits and Guaranties: This instruction was issued for the purpose of defining the procedure in the case of finding a discrepancy between the actual state and the factual content of the extract of summary data on a client from the Register of Credits and Guarantees.

No 6/2003 on how to classify individual debtors into a group of economically connected persons for defining members of a group of economically connected persons pursuant to Article 31 (7)(b) of the Act on banks: This instruction was issued with the aim of defining members of a group of economically connected persons, in which group the mutual economic relations are of such a nature that it is clear from all circumstances that financial difficulties of one entity will cause the inability of other entities to repay their liabilities in time.

No 7/2003 on the country risk management: This methodological instruction for banks and branches of foreign banks on the country risk management was issued with regard to the fact that the National Bank of Slovakia had not set limits of large exposure in relation to countries or geographical areas. However, in accordance with the law, an obligation to manage risk resulting from such exposures arises to the banks.

No 8/2003 on the drawing-up and submitting of interim consolidated financial statements of banks: The Banking Supervision Division issued the instruction for banks as to how to prepare interim consolidated financial statements.

No 9/2003 to Decree of the National Bank of Slovakia No 6 of 12 December 2002 on the adequacy of banks' own funds of financing: This instruction lays down in more detail the scope of positions in the trading book which arise in connection with individual financial instruments and their trading. It serves as a supplementary document to the Decree, particularly to those parts which lay down the calculation of market risks pursuant to Articles 11 to 13 and Articles 16 to 29 of the Decree.

No 10/2003 on the completion of a report on overdue of claims and a report on the classification of assets and liabilities: This methodological instruction was issued on the basis of the valid and effective Decree of the NBS No 7/2002 on classification of assets and liabilities of banks and branches of foreign banks, their re-valuation, formation and dissolution of reserves, and related reporting, and with regard to the fact that the mentioned reports did not contain explanations prepared in such a form that would describe the content of individual lines and columns according to the accounting procedures valid and effective from January 2003.

Recommendations

No 1/2003 to the FATF Guideline concerning the list of non-cooperating countries: The National Bank of Slovakia drew attention by means of this recommendation to the existence of the list of non-cooperating countries, issued by the FATF in February 2003. In making business transactions with the given countries it is necessary to pay special attention to the identification of the client and the actual beneficiary.

No 2/2003 on the method of reporting the bank's own funds under the Basel Capital Accord (hereinafter referred to as the "BCA"): This recommendation reflects the variety existing in the interpretation of the scope and structure of the concept of "own funds" for the purposes of calculating the adequacy ratio of own funds, or the calculation of capital adequacy in general. The Banking Supervision Division issued this recommendation explaining the differences in the structure and content of "own funds" for the purpose of unifying terminology.

No 3/2003 to banks and branch offices of foreign banks for the implementation of the anti-money laundering procedures: The Banking Supervision Division issued this recommendation based on recognised standards issued by international institutions in view of the risk of abuse of a bank or a branch office of a foreign bank for legalisation of illegally acquired funds.

List of charts

List of tables

List of boxes