C. Banking Supervision

in 1997

1. DEVELOPMENT OF THE BANKING SECTOR

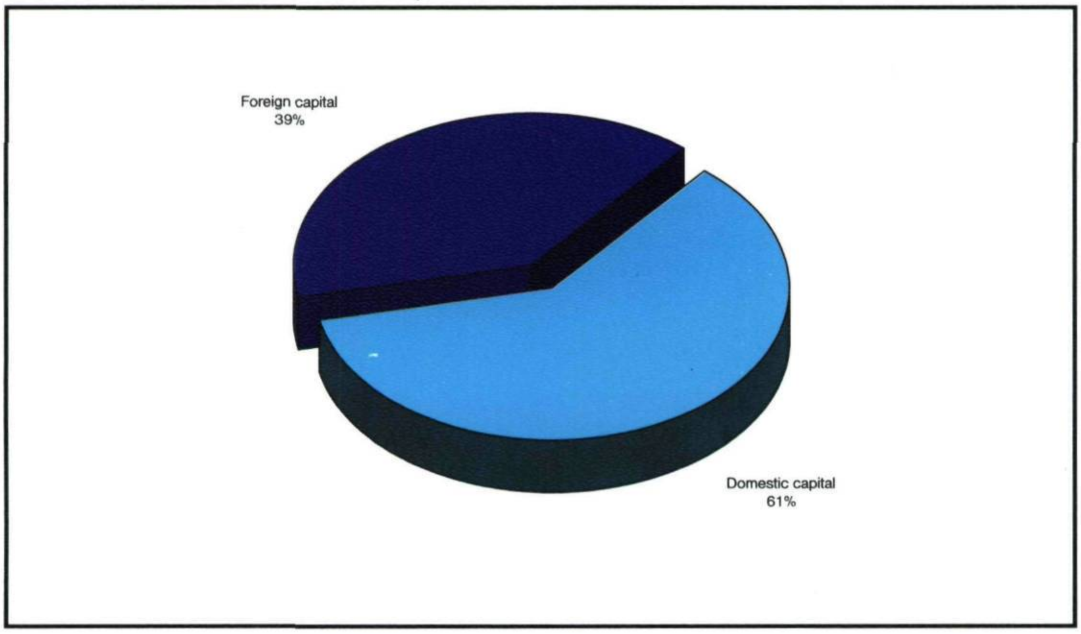
In 1997, Slovakia's banking sector consisted of 29 banking institutions, of which twenty-three were banks incorporated as joint-stock companies; two were state financial institutions, and four were branches of foreign banks.

The only new license to establish and operate a bank was granted to AG Banka, a.s., Banská Bystrica, which took over a branch of Agrobanka Praha, a.s. The number of representative offices of foreign banks decreased from ten to nine after the closure of Union banka, a.s. Ostrava, at its own request. Všeobecná úverová banka, a.s. Bratislava, HYPO-BANK Slovakia, a.s., Bratislava, and Slovenská sporiteľňa, a.s., Bratislava, were granted licences to conduct mortgage operations.

At the end of 1997, the National Bank of Slovakia imposed receivership upon Investičná a rozvojová banka, a.s. Bratislava, the first Slovak bank to experience this. The reason behind this decision was the deterioration in the bank's liquidity situation, caused mainly by unsolved problems in the structure of the loan portfolio, which is dominated by bank loans granted before delimitation. Another compelling reason was that the main shareholders of the bank had appointed management that was not capable of managing this situation on their own. The economic results were poor and the bank failed to meet the criteria of prudential banking, the deterioration continued; extraordinary general meetings of shareholders proved unsuccessful, and the leading shareholders were reluctant to raise the bank's capital.

The total subscribed capital of the Slovak banking sector, including funds permanently provided to branches of foreign banks, amounted to Sk 32.0 billion at the end of 1997, some Sk 2.0 billion more than a year ago. The share of foreign capital in the total subscribed capital of banks and funds permanently provided to branches of foreign banks ranged between 38.3% and 40.0% during the year.

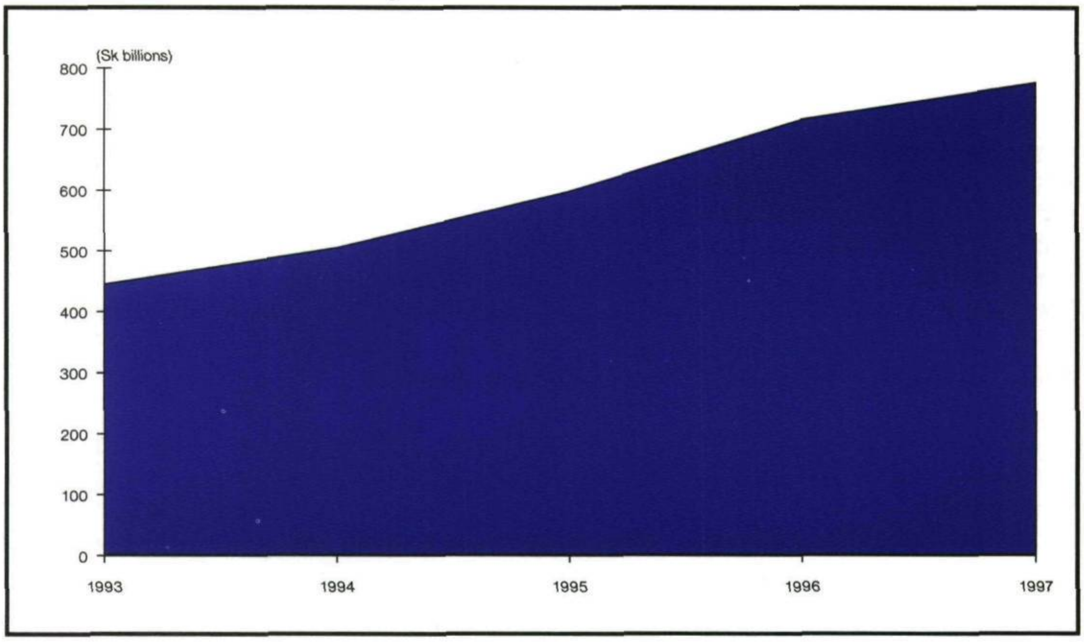
Structure of capital and permanently provided funds of banks and branches of foreign banks in Slovakia (as at 31 December 1997)



2. CHARACTERISTICS OF THE BANKING SECTOR

For the banking sector as a whole, 1997 took a positive course bringing fair economic results. Total assets of banks operating in the Slovak money market expanded by 10.5% to Sk 776.8 billion, with banks undergoing transformation process accounting for 50.7% of the amount on 31 December 1997; some 5.7% less than year ago. The entire banking sector raised Sk 27.6 billion in primary resources (up 7.8%), to reach Sk 447.7 billion. The volume of secondary resources increased by Sk 32.8 billion (18.2%), to Sk 212.8 billion.

Total assets of the Slovak banking sector



The total volume of claims arising from credits granted to clients grew by Sk 38.9 billion (7.4%, reaching Sk 568.3 billion. Of this amount, classified claims increased year-on-year by Sk 8.1 billion (7.2%) to Sk 120.1 billion, with special-mention claims growing by Sk 15.3 billion (26.6%) to reach Sk 72.7 billion.

Sector-wide, banks reported an aggregate financial loss of Sk 1.3 billion as at 31 December 1997, a clear turn for the better, considering that this entailed a Sk 1.5 billion improvement in comparison with the previous year's figure, i.e. a 52 per cent reduction.

3. EVALUATION OF PRUDENTIAL BANKING

Prudential banking behaviour was regulated during 1997 by five National Bank of Slovakia decrees, all based on international standards and the recommendations of the Basle Committee on Banking Supervision. In evaluating compliance with the prudential decrees, the Banking Supervision Division of the NBS has relied on accounting data and disclosures provided in banks' regular prudential reports on capital adequacy, credit exposure, liquidity, regulation of foreign exchange positions, rules for the evaluation of claims and off-balance sheet liabilities of banks according to the risks contained therein and for the creation of provisions to cover such risks (classification of claims and off-balance sheet liabilities). As long as banks comply with the prescribed limits and regulations, they may take on adequate risks vis-á-vis their capital adequacy according to international standards. The Supervision Division utilises a banking information system in evaluating developments and trends in individual banks, groups of banks and the entire banking sector of the Slovak Republic, for which a set of financial ratios is applied. Prudential behaviour assessment of banks is conducted systematically during on-site inspections carried out by the Banking Supervision Division.

3.1 Amendments to Prudential Banking Decrees

As an amendment, the National Bank of Slovakia issued Decree No. 5, of 16 May 1997, on the capital adequacy of banks, which came into force on 30 June 1997. The amendment concerns especially deductible equity shares that banks hold in non-bank entities and subsidiaries, risk weights to assets, and sets out guidelines for the addition of subordinated debts.

An earlier decree on liquidity management issued in 1994, was replaced with Decree No. 7 of 23 June 1997, on bank liquidity regulations, taking effect on August 31, 1997. Stricter liquidity regulations, expected to improve the liquidity of banks and the banking sector as a whole, require banks and branches of foreign banks to conduct business in a way that allows them to achieve and maintain increasingly severe limits on ratios of assets to liabilities with maturity within one month (until 30 September 1997, the ratio is set at no less than 70%, followed by at least 85% until 31 December 1997, and 100% from 31 March 1998). Another amendment reduces the interval for liquidity reports from three to one month.

In Decree No. 11 of 28 November 1997, imposing restrictions on open foreign exchange positions of banks (effective from 1 January 1998), the National Bank of Slovakia specifies the provisions of Decree No. 5/1994, being in force up to the end of 1997. This decree applies strictness to regulations for the safe operation of banks and branches of foreign banks dealing with values denominated in foreign currencies. The decree puts limits on exchange differentials of assets and liabilities in specific foreign currencies when calculated in Slovak crowns of 10%, and 25% for the total open foreign exchange position, when measured against bank capital.

3.2 Capital Adequacy

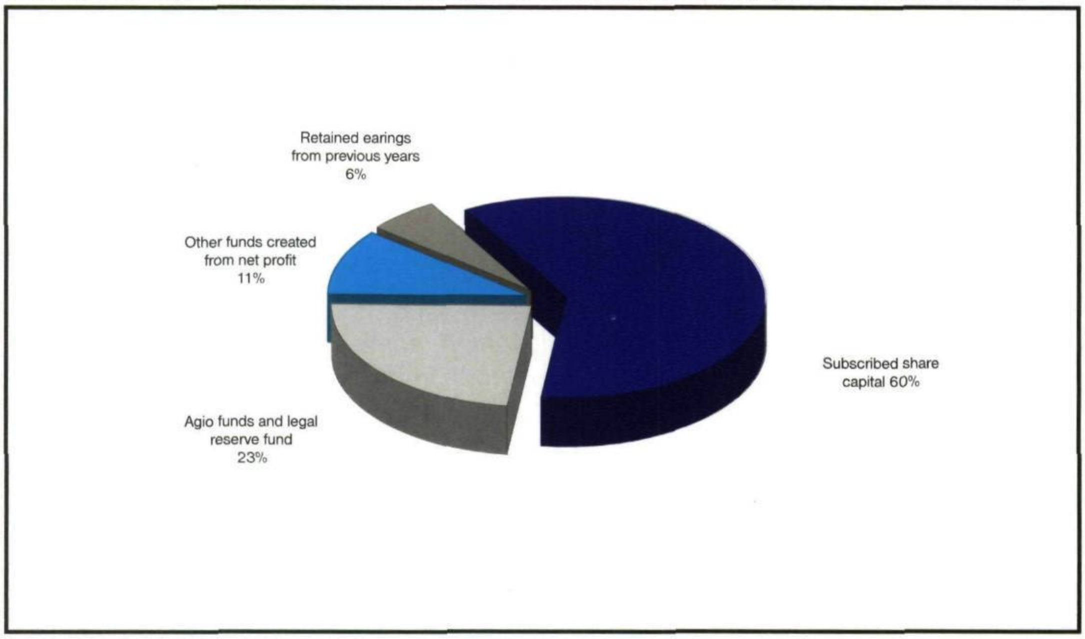
The NBS Decree No. 5/1997 on capital adequacy requires banks to maintain a minimum level of capital adequacy of 8%. On March 21, 1997, the NBS Bank Board prescribed special individual capital adequacy targets for each quarter of 1997 for banks undergoing transformation. As at 31 December 1997, deductible items exceeded capital in one commercial bank and one state financial institution, which is the reason why these two institutions were excluded from the evaluation of capital adequacy in the banking sector as a whole. As at 31 December 1997, four banks were found not to have complied with the binding capital adequacy limits.

Capital adequacy of evaluated banks, operating in the banking sector of the Slovak Republic, was increased by 2.3 points from the end of 1996 to reach 10.0%. This positive improvement was influenced by the fact, that the capital applied for the calculation of capital adequacy was growing more dynamically than the volume of risk-weighted assets.

While capital applied for the calculation of capital adequacy grew year-on-year by about Sk 9 billion to Sk 35.4 billion in the year to 31 December 1997 (by 33.8%), the risk-weighted assets of banks in the Slovak banking sector increased by Sk 10.6 billion (by 3.1%), to reach Sk 352.7 billion.

The growth of capital used for the calculation of capital adequacy in the banking sector as a whole was influenced for the most part by a Sk 2.7 billion increase in equity capital (8.2%), to Sk 35 billion, together with some Sk 2.6 billion (36.4%) of statutory reserves set aside to cover bank losses resulting from banking activities, and subordinated debts, which took these statutory reserves to Sk 9.9 billion, and a decrease in deductible items by Sk 3.6 billion (27.9%) to Sk 9.4 billion.

Structure of capital applied for the calculation of capital adequacy (at 31 December 1997)



3.3 Credit Exposure

Under the NBS Decree No. 3/1994, banks are required to carry out a monthly monitoring of their credit exposure to potential losses which could potentially have been caused by high credit exposure to a single borrower, or an economically linked group of borrowers. At any time, net credit exposure to non-banking clients must not exceed 25% of a bank's capital, or 80% to banks, and the total amount of individual net credit exposures, which in each case exceed 15% of the bank's capital, must not exceed 800% of the bank's capital.

During 1997, eighteen banks were found to have overstepped the net credit exposure limits applied to non-banking borrowers, while twelve had broken the limit set on banks. The limit on the aggregate amount of reported loans was exceeded by eleven banks. The main reasons behind the infringements were capital position of banks, inheritance of bad debts from the past, excessive lending, as well as a methodical change in the capital adequacy decree. That notwithstanding, the trend was favourable and, towards the end of 1997, the number of infringements decreased.

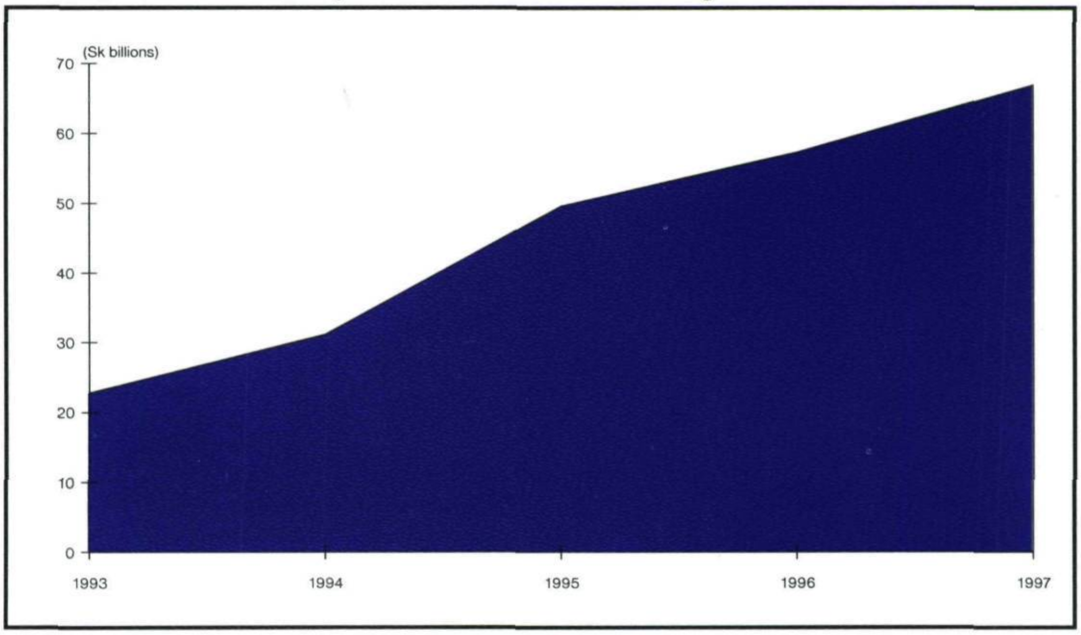
3.4 Liquidity

On account of previous developments in the banking sector, and the growth in monetary aggregates, the NBS anticipated liquidity problems. Already in 1996, the central bank tightened refinancing conditions for the banking sector; set a foreign exchange position for monetary purposes, increased the minimum required reserves limits, and reduced intervals between the checks on these limits from one month to fifteen days. Apart from these instruments, liquidity was also influenced by the actual situation and developments on the money market. In particular, those factors included an on-going lack of especially long-term and, to a certain degree, medium-term funds, lingering capital market problems and a lack of powerful investors, combined with tax regulations and, at the end of May, an attack on the Slovak crown by several investors.

All these factors combined were reflected in the lack of liquid funds, and the subsequent failure of certain banks to maintain the level of required reserves, in the difference in maturities of resources and their use, resulting in a significant increase in interest rates on the interbank money market. The most serious problems with liquidity and, subsequently, with meeting their minimum reserves requirements were seen in transforming banks. In November and December 1997, the NBS supplied liquidity to the banking sector.

Amended Decree No. 7/1997, setting the rules of liquidity management for the banking sector, required banks and branches of foreign banks to achieve a 70% ratio of assets against liabilities with maturity within one month (by September 30, 1997), and to increase the coverage to 85% by 31 December 1997. Five banks and two branches of foreign banks failed to meet the targets in the period under review.

Growth in total reserves and provisions for risk asset coverage



3.5 Foreign Exchange Positions

The purpose of NBS Decree No. 5/1994, on the regulation of foreign exchange positions of banks, is to curb potential losses sustained due to exchange rate fluctuations (exchange rate risks), depending on the openness of the foreign exchange position. The Decree regulates open positions in individual foreign currencies - 10% compared to the bank's capital, and 25% for its overnight crown and overall foreign exchange position. The risks taken in foreign exchange exposures during the year were mostly short-term, except for banks undergoing transformation and one commercial bank, where this seems to be a persistent problem.

3.6 Classification of Claims

Decree No. 3/1995 sets out uniform requirements for reporting and evaluating the claims and off-balance sheet liabilities of banks and branches of foreign banks with respect to the risks contained therein, and for reserving funds in order to provide against those risks.

As a result of a moderate deterioration in the development of classified assets, banks created a larger amounts of provisions in 1997.

Compared with the previous year, the total of uncovered estimated losses of bank claims and off-balance sheet liabilities was reduced by approx. Sk 1 billion (7.5%), to Sk 12.1 billion. The total volume of uncovered, estimated losses in the Slovak banking sector is concentrated in banks undergoing transformation (Sk 9.9 billion, i.e. 81.4%) and one state financial institution (Sk 2.2 billion, i.e. 18.6%).

The reduction in uncovered estimated losses in the Slovak banking sector was due to a Sk 9.5 billion (16.7%) increase in the volume of reserves and provisions to cover risk assets to Sk 66.8 billion, and slower growth in the share of classified loans in total loans.