CHAPTER 4

SUPERVISION OF THE FINANCIAL MARKET

4

4 Supervision of the Financial Market[9]

4.1 FINANCIAL MARKET REGULATION IN SLOVAKIA

The general procedural rules followed by Národná banka Slovenska in supervising and regulating the financial market in the areas of banking, capital market, insurance and pension savings are laid down in Act No. 747/2004 Coll. on Supervision of the Financial Market and on amendments to certain laws, as amended.

The aim of financial market supervision is to contribute to the stability of the financial market as a whole, as well as to its secure and sound functioning.

The supervisory and regulatory powers defined in this law are exercised by the Financial Market Supervision Unit, which was in 2009 managed by a Deputy-Governor of Národná banka Slovenska. The Financial Market Supervision Unit is in charge of the following activities:

- rulemaking activities (it drafts generally binding legal regulations of Národná banka Slovenska, concerning the financial market, in particular prudential regulations, operational security rules and other requirements for the conduct of business by supervised entities; participates in the preparation of generally binding legal regulations issued by central government authorities; and issues methodological guidelines and recommendations for supervised entities of the financial market);
- licensing activities (it conducts proceedings, takes first-instance decisions, issues authorisations, approvals and prior approvals, and imposes penalties and remedial measures);
- supervisory activities (it supervises financial market supervised entities through on-site and off-site supervisions); and
- analytical activities (it prepares analyses of the financial market as a whole, as well as of its individual financial entities).

The Customer Protection Section, as part of the Financial Market Supervision Unit (tasked with customer protection under the NBS Act and the Supervision Act), handles petitions received from the customers of financial institutions supervised by Národná banka Slovenska on the basis of the above Acts and the organisational rules of Národná banka Slovenska.

The financial market comprises four sectors: the banking sector (represented mainly by banks and branches of foreign banks); the capital market (represented mainly by investment firms, asset management companies, the stock exchange, the central securities depository, securities issuers and investment service intermediaries); the insurance sector (represented mainly by insurance companies and branches of insurance companies from another Member State of the EU, insurance and reinsurance intermediaries); and the pension savings sector (represented mainly by pension fund management companies and supplementary pension asset management companies).

Slovakia's membership of the European Union means that foreign-regulated entities may operate in the country also without a licence from Národná banka Slovenska, provided they are authorised to conduct such activities in another EU Member State (the single passport concept).

4.2 RULEMAKING ACTIVITIES OF THE SUPERVISION UNIT

In the area of financial market regulation, numerous laws, regulations, methodological instructions and recommendations governing the legal environment of regulated entities were adopted in 2009. In this chapter, we do not provide a complete list of these measures, but rather point to those which have had the greatest impact on the activities of regulated entities in the individual financial market sectors of Slovakia.

One of the most significant preventive measures taken in response to the global financial and economic crisis was the adoption of the so-called 'anti-crisis law' (Act No. 276/2009 Coll.), which provides a legal framework for the granting of stabilisation aid to banks and amends numerous laws pertaining to the financial market. On the

9 *A detailed report on the activities of the Financial Market Supervision Unit for 2009 is published on the website of Národná banka Slovenska at http://www.nbs.sk/en/financial-market-supervision/analysis-reports-and-publications-in-the-field-of-financial-market/reports-on-the-activities-of-the-financial-market-supervision.*

Table 24 Number of supervised entities as at 31 December 2009

	Number of institutions as at 31 December 2009	Number of institutions as at 31 December 2008	Change
Banks in Slovakia	15	17	-2
Home savings banks	3	3	0
Mortgage banks	8	9	-1
Other banks	4	5	-1
Branches of foreign banks in Slovakia	13[1)]	11	2
of which: NBS-authorised	0	0	0
on the single European passport principle	13	11	2
of which: branches of foreign mortgage banks	0	0	0
Foreign banks contributing to the Deposit Protection Fund	1	0	1
Representative offices of foreign banks in Slovakia	4	7	-3
Branches (organisational units) of banks in Slovakia	1,042	857	185
Lower organisational units in Slovakia	188	401	-213
Branches of Slovak banks in other countries	2[2)]	1	1
Representative offices of Slovak banks in other countries	1	1	0
Foreign entities freely providing cross-border banking services	274	252	22
of which: banks	251	231	20
electronic money institutions	13	12	1
foreign financial institutions	7	7	0
credit cooperatives	3	2	1
Slovak banks freely providing cross-border banking services abroad	2	2	0
of which: electronic money institutions	0	0	0
Number of staff in banks and branches of foreign banks	18,750	20,598	-1,848
Insurance companies in Slovakia	20	23	-3
of which: insurance companies providing only life insurance	5	5	0
insurance companies providing only non-life insurance	3	4	-1
insurance companies providing life and non-life insurance	12	14	-2
Insurance companies based in Slovakia, providing services in another EU state	14	14	0
of which: without establishing a branch	11	11	0
through branches	3	3	0
Insurance companies from another Member State of EU providing services on a freedom to provide services basis	447	419	28
of which: without establishing a branch	433	406	27
through branches	14	13	1
Insurance companies in Slovakia providing compulsory third-party liability insurance for motor vehicles	9	9	0
Pension fund management companies	6	6	0
Supplementary pension asset management companies	5	5	0
Domestic asset management companies in Slovakia	8	10	-2
of which: companies with an extended licence under Section 3(3) of the Collective Investment Act	6	6	0
Domestic mutual funds	78	114	-36
of which: open-end mutual funds	73	68	5
closed-end mutual funds	0	41	-41
special mutual funds	5	5	0

Table 24 Number of supervised entities as at 31 December 2009 (continuation)

	Number of institutions as at 31 December 2009	Number of institutions as at 31 December 2008	Change
Foreign asset management companies and foreign collective investment undertakings operating in Slovakia and authorised under Section 75 of the Act	5	5	0
of which: through branches in Slovakia	2	2	0
without establishing a branch	3	3	0
Foreign asset management companies and foreign collective investment undertakings operating in Slovakia on the single European passport principle	57	0	57
of which: foreign asset management company branches established under Section 28 of the Collective Investment Act	2	0	2
Foreign asset management companies without a branch established under Section § 29 of the Collective Investment Act	13	0	13
European funds under Section 61 – foreign asset management companies	16	0	16
– foreign investment companies	26	0	26
within which: foreign mutual funds and sub-funds of foreign asset management and investment companies	874	0	874
Foreign asset management companies operating under Section 3(3) of the Collective Investment Act	13	0	13
Investment firms as defined by the Securities Act	18	18	0
Banks conducting business under the Securities Act and NBS-licensed	11	13	-2
Branches of foreign banks – investment firms licensed by their home authority	7	6	1
Foreign entities operating in Slovakia as investment firms	1,029	890	139
of which: through branches in Slovakia	4	5	-1
without establishing a branch	1,025	885	140
Slovak investment firms providing services abroad without establishing a branch	9	7	2
Investment service intermediaries in Slovakia	962	978	-16
of which: legal persons	85	73	12
natural persons	877	905	-28
Securities issuers whose securities are admitted to trading on a regulated market	125	144	-19
Other legal persons authorised by NBS only to issue electronic means of payment	2	1	1
Payment institutions	1	0	1
Electronic money institutions	1	0	1
Foreign payment institutions providing cross-border payment services in Slovakia	19	0	19

Source: NBS.
1) As at 31 December 2009, the following branches of foreign credit institutions had not commenced banking activities: AXA Bank Europe, a branch of a foreign bank, and UNIBON, a savings and credit cooperative (an organisational unit of a foreign entity).
2) As at 31 December 2009, Poštová banka had not commenced banking activities through a branch established abroad.

basis of this law, stabilisation aid to a bank can be granted in the form of a contribution of financial funds to the bank's registered capital for a countervalue in the form of equity or priority shares (recapitalisation), or a special guarantee for bonds issued by the bank or a loan provided to the bank. Further areas addressed by the 'anti-crisis law' are provisions relating to 'subordinated bonds' in the Commercial Code, the law on bankruptcy and restructuring, and the Securities Act; provisions of the Banking Act concerning reporting of large exposures vis-à-vis other persons or groups of persons; and provisions of the Insurance Act which now enable NBS to start proceedings against a responsible actuary for the breach of duties laid down in the Insurance Act and to suspend a natural person's authorisation to act as an actuary until the end of proceedings (the authorisation's suspension being recorded in the list of actuaries).

Another significant legal regulation prepared by the mutual working group of Financial Market Supervision Unit in collaboration with the Slovak Ministry of Finance was Act No. 186/2009 Coll. on Financial Intermediation and Financial Counselling and on amendments and supplements to certain laws. This Act was designed to regulate financial mediation and financial counselling throughout the financial market and to introduce the same rules for the conduct of intermediating and advisory activities in the insurance/reinsurance sectors, the capital market, the supplementary pension saving sector, and the market for loans and deposits. Národná banka Slovenska will supervise the providers of financial intermediation and financial counselling services on the basis of this law.

Národná banka Slovenska supported the measures taken to mitigate the effects of the global financial crisis also by amending other legal regulations, e.g. the Banking Act by the adoption of Act. 492/2009 Coll. With effect from 1 December 2009, the amended Banking Act prescribes credit risk calculation arisen from holding of assets by bank. The Banking Act was also amended in connection with the enactment of a law on payment services. The amendment contains important provisions concerning the register of bank loans and guarantees, which is kept by Národná banka Slovenska.

An important law governing pension savings was Act No. 137/2009 Coll., amending Act No. 43/2004 Coll. on Retirement Pension Saving. The amendment contains new provisions concerning fees that a pension fund management company is entitled to charge for asset management for savers. At the end of 2009, similar changes were made in the supplementary pension saving sector, through Act No. 557/2009 Coll., amending Act No. 650/2004 Coll. on supplementary pension saving.

At the level of by-laws, a major contribution to the implementation of anti-crisis measures on the part of Národná banka Slovenska in the banking sector was the issuance of NBS Decree No. 5/2009, amending Decree No. 18/2008 on the liquidity of banks and branches of foreign banks and on the process of liquidity risk management at banks and branches of foreign banks. Regarding cash flows in banks and branches of foreign banks in relation to the financial market situation, this decree was designed to strengthen the requirement to provide loans to enterprise entities, with the aim of mitigating the effects of the global financial crisis on the Slovak economy. Hence, the parameters of the indicator of liquid assets were reassessed.

During 2009, Národná banka Slovenska issued several decrees concerning collective investment in the capital market, including Decree No. 3/2009 providing a method for determining the value of mutual fund assets. Regarding the absence of adequate regulations, the aim of this decree was to regulate the valuation of securities, money market instruments, derivatives, current accounts and deposit accounts, receivables and liabilities, equity participations and precious metals held by mutual funds. The Supervision Unit also issued a methodological guideline (ÚDFT NBS No. 1/2009) for the conduct of activities in the area of collective investment on the basis of a single European licence. This methodological guideline was designed to implement the changes made in the Collective Investment Act in regard to the notification of European funds after its amendment by Act No. 552/2008 Coll., and to implement the provisions of the CESR guideline for the simplification of notification procedures for undertakings for collective investment in transferable securities (UCITS).

For the regulation of the insurance sector, Národná banka Slovenska issued two decrees over the course of 2009. NBS Decree No. 1/2009 concerning the activity reports and plans of internal audit units of insurance companies, branches of foreign insurance companies, reinsurance companies and branches of foreign reinsurance companies specifies the required form and contents of the activity reports of internal audit units and their plans for the next calendar year. NBS Decree No. 12/2009 is an amendment to Decree No. 25/2008 concerning the solvency and minimum guarantee funds of insurance and reinsurance companies, branches of foreign insurance and reinsurance companies, in connection to the revaluation of amounts for the calculation of solvency by the European Commission.

In the area of pension savings, the most important decrees approved in 2009 were NBS Regulation No. 74/2009 Coll. on the submission of reports on the exceeding of limits and compliance with limits concerning the assets of pension funds or supplementary pension funds, and NBS Regulation No. 75/2009 Coll. on the submission of information about the net asset values of supplementary pension funds, with the aim of obtaining and monitoring daily information on the net asset value in the individual supplementary pension saving funds created and managed by a supplementary asset management company. In June 2009, the Bank Board of NBS approved Regulation No. 267/2009 Coll. on the reference values of conservative pension funds and the composition of the reference values of balanced pension funds and growth pension funds. The aim of adopting this regulation was to set the minimum yield that a conservative pension fund is obliged to achieve over the period under review.

In the area of financial intermediation, NBS approved and issued Decree No. 11/2009, which specifies the due form of a proposal for registration, a change in registration or the cancellation of registration; the amounts of fees charged for a proposal for registration, a change in registration or the cancellation of registration; the specimen certificate; the structure of the registration number and other particulars of the register.

4.3 LICENSING ACTIVITIES OF THE SUPERVISION UNIT

In 2009, the Financial Market Supervision Unit of NBS issued 826 decisions concerning licences. Most of them related to the capital market and the banking sector. A breakdown by individual sector is presented in Table 25:

Decisions by Národná banka Slovenska related to the licensing of financial market supervised entities in 2009 include, for example, the following:

- granting prior approval to acquire a share in the registered capital and voting rights of Slovenská sporiteľňa, a.s., in the amount of 100%, and to become a subsidiary of EGB Ceps Holding GmbH;
- granting prior approval to Slovenská sporiteľňa, a.s., and UniCredit Bank Slovakia, a.s., to use an advanced measurement approach for operational risk model for calculating the capital requirement;
- granting prior approval for the merger of Československá obchodná banka, a.s., and ISTROBANKA, a.s.;
- granting licence to European Investment Centre, o.c.p., a.s., to provide investment services;
- granting prior approval to PORTFIN, o.c.p., a.s., to return its licence to provide investment services;
- granting prior approval for the transfer of administration of open-end mutual funds to another asset management company:
  - the transfer of 4 open-end mutual funds from ISTRO ASSET MANAGEMENT, správ. spol., a.s., to ČSOB Asset Management, správ. spol., a.s.;
  - the transfer of 2 open-end mutual funds from KD Investments, správ. spol., a.s., to IAD Investments, správ. spol., a.s., an asset management company;

Table 25 Number of decisions issued by the Financial Market Supervision Unit of Národná banka Slovenska in 2009

	Number of decisions
Banking sector and investment firms	163
Capital market	357
Insurance sector	155
Pension savings sector	124
Foreign exchange activities	24
Payment services	3
Total	826

Source: NBS.

- granting prior approval to ISTRO ASSET MANAGEMENT, správ. spol., a.s., to return its licence to operate as an asset management company;
- granting prior approval for the merger of KD Investments, správ. spol., a.s. and IAD Investments, správ. spol., a.s., asset management companies;
- granting prior approval for the merger of KOMUNÁLNA poisťovňa, a.s. Vienna Insurance Group and KONTINUITA poisťovňa, a.s., Vienna Insurance Group; KOMUNÁLNA poisťovňa, a.s. Vienna Insurance Group became through the merger the legal successor to company KONTINUITA poisťovňa, a.s., Vienna Insurance Group;
- granting prior approval to KOOPERATIVA poisťovňa, a.s. Vienna Insurance Group to conduct intermediation activities for a financial institution, Slovenská sporiteľňa, a.s.;
- granting prior approval for the sale of Q B E poisťovňa, a.s., including its branch in the Czech Republic, to QBE Insurance (Europe) Limited, United Kingdom of Great Britain and Northern Ireland;
- granting prior approval to Allianz Holding eins GmbH, Austria, to acquire a qualified share in Allianz - Slovenská poisťovňa, a.s.;
- granting prior approval to Doplnková dôchodková spoločnosť Tatra banky, a.s., to establish a new supplementary pension fund called Doplnková dôchodková spoločnosť Tatra banky, a.s., Konzervatívny príspevkový d.d.f.;
- granting prior approval to ING Continental Europe Holdings B.V., Netherlands, to increase its share in the registered capital of a supplementary pension asset management company, ING Tatry – Sympatia, d.d.s., a.s., to 66% in one operation directly;
- granting licence to Orange Slovensko, a.s., under Section 21(d) of Act No. 510/2002 Coll. on the Payment System and on amendments to certain laws, as amended; on the basis of this licence, the company is entitled to issue electronic money instruments;
- granting licence to Telefónica O2 Slovakia, s.r.o., under Section 81(b) of Act No. 492/2009 Coll. on payment services and on amendments to certain laws (the Payment Services Act); on the basis of this licence, the company is entitled to issue and manage electronic money instruments in a limited range pursuant to Section 87 of the Payment Services Act;
- granting licence to Trust Pay, a.s., under Section 64(1) of the Payment Services Act; on the basis of this licence, the company is entitled to provide payment services in accordance with Section 2(1)(c and g) of the Payment Services Act.

In 2009, on the basis of the terms and conditions set, the following credit institutions commenced operations through their local branches: Citibank Europe plc, branch of a foreign bank (from 1 January 2009), and Oberbank AG, branch of a foreign bank (from 1 April 2009).

In 2009, Národná banka Slovenska registered 22 credit institutions (including electronic money institutions and foreign financial institutions) and 140 investment firms, which informed NBS of their intention to provide cross-border banking and investment services in Slovakia.

Apart from issuing mentioned decisions, the Supervision Unit in 2009 received, from all sectors of the financial market, number of notifications from supervised entities, approved securities prospectuses and takeover bids, and issued other 24 decisions concerning foreign exchange activities.

The Financial Market Supervision Unit is the competent body of NBS to conduct proceedings and decide in the first instance. Within these activities, 45 proceedings against supervised financial market entities were conducted by the Supervision Unit in 2009. In the year under review, 33 of them were opened and 14 concluded (on the basis of the Supervision Unit's resolution in 2009). The proceedings related mainly to the insurance sector, the capital market and the foreign exchange sector.

4.4 CUSTOMER PROTECTION

The Financial Market Supervision Unit is also tasked, in accordance with the National Bank of Slovakia Act and the Financial Market Supervision Act, with protecting the customers of financial market entities and with handling petitions from the customers of financial institutions that are supervised by Národná banka Slovenska. In

2009, the Financial Market Supervision Unit received 933 petitions from the clients of financial market institutions (both natural and legal persons) who were dissatisfied with the practices of financial service providers. This represents an increase of petitions in more than 7% compared with 2008. Of the number received, the Supervision Unit managed to close 872 files, representing a 93.46% success factor in processing petitions. Most of the petitions received (463) concerned the insurance sector. The Customer Protection Section, in fulfilling the customer protection role assigned to Národná banka Slovenska by the NBS Act and the Financial Market Supervision Act and respecting the competence of Národná banka Slovenska in this area, guaranteed the dissatisfied clients of insurance companies, banks and other supervised financial market entities, so-called ‘remedy mediation’ without having to seek relief in the courts. As from the end of 2009, the Section is also responsible for processing petitions in accordance with the Payment Services Act. Financial market supervised entities cooperate with Národná banka Slovenska, supply NBS with information about their clients’ petitions, respect the opinions of NBS and are willing to reach a compromise, and, in some cases, to reconsider their decisions. Petitions from the clients of supervised entities are a source of information about the methods the supervised entities use in conducting their activities. This information is used by the Supervision Unit during on-site supervisions conducted at specific institutions.

4.5 SUPERVISORY ACTIVITIES OF THE SUPERVISION UNIT

One of the most important roles of the Financial Market Supervision Unit of Národná banka Slovenska is to supervise financial market entities through on-site and off-site supervision. When exercising supervision, NBS ascertains important facts about the entities under supervision and their activities, especially shortcomings, their causes and consequences, and the persons responsible for these shortcomings. Supervision is exercised on an individual or consolidated basis, as supervision of individual entities or consolidated groups of entities and special-purpose asset pools, including the entities under supervision, and supplementary supervision of financial conglomerates.

In 2009, the Supervision Unit conducted a total of 65 on-site supervisions at financial market supervised entities (Table 26).

On-site supervisions were conducted according to the annual plan of supervision, which includes a schedule of supervisions and their main aims.

In total, 19 on-site supervisions were conducted at banks and investment firms in 2009. They were predominantly thematic supervisions (11). Supervision conducted on-site at banks focused on, for example, evaluating the advanced measurement approach used for calculating the capital requirement for operational risk coverage (AMA); on evaluating the management systems used for market risk, liquidity risk, credit risk and operational risk; on evaluating banks’ internal control systems; on on-site inspections conducted in the scope necessary for the issue of prior approval for the use of an IRB approach for credit risk measurement; areas significant for the use of an advanced measurement approach for operational risk within the group at local level and its application under local conditions; on verifying banks’ anti-money laundering and anti-terrorist financing systems, information systems, selected prudential statements and reports, and the system used for evaluating banks’ internal capital adequacy ratios, accounting and reporting. In the case of investment firms, on-site supervisions focused on the following areas: compliance with the provisions of the law on securities and investment services in providing investment services; compliance with other laws and generally binding legal regulations; compliance with the terms and conditions laid down in the licence to provide investment services; compliance with the rules of internal control; verification of the company’s selected statistical statements and reports, organisation and management, internal control system, and trading system, business documentation, the system of anti-money laundering; adherence to professional standards in providing investment services; the objective accuracy of submitted statements and reports linked to the company’s accounting system; information system security, data protection and backup system.

On-site supervisions at regulated capital market entities in 2009 concentrated on the activities of asset management companies and the mutual

Table 26 Number of on-site supervisions conducted at supervised financial market entities in 2009

	Comprehensive	Thematic	Follow-up	Total
Banks	0	11	2	13
Non-bank investment firms	6	0	0	6
Asset management companies	2	0	2	4
Pension funds management companies and supplementary pension asset management companies	5	1	1	7
Insurance companies	5	1	3	8[1)]
Insurance, reinsurance and investment service intermediaries	18	1	0	19
Entities subject to foreign exchange supervisions	8	0	0	8
Supervisions in total	44	14	8	65[1)]

Source: NBS.
1) One on-site supervision was a combination of comprehensive and follow-up supervision.

funds they manage; compliance with the laws on collective investment, securities and investment services, other laws and generally binding legal regulations, the terms and conditions laid down in the licences of asset management companies, and with the reporting requirement; the promotion of open-end mutual funds; the objective accuracy of selected statements and reports; the internal control system; the terms and conditions under which the companies were licensed to provide investment services under the law on collective investment; the procedure followed by the Central Securities Depository of Slovakia when making a change in the list of registered shareholders kept by the Central Securities Depository of Slovakia.

In the insurance sector, eight on-site supervisions were conducted at insurance companies during 2009, of which five were comprehensive, one thematic and three follow-up inspections. The supervisions focused on the valuation of technical provisions, accounting for technical provisions, and the supporting documents for valuation of technical provisions; the administration of insurance contracts, claims settlement/liquidation and claim payments; the verification of data and information presented by insurers to Národná banka Slovenska in the form of statements, surveys and reports; compliance with the provisions of Act No. 8/2008 Coll. on insurance and other generally binding legal regulations; compliance with the terms and conditions laid down in the licences of insurance companies; and the implementation of selected measures adopted to eliminate the shortcomings revealed during on-site supervision. On-site inspections were also conducted at insurance intermediaries, reinsurance intermediaries, and investment service intermediaries. These supervisions aimed at verifying compliance with the relevant generally binding legal regulations in force in Slovakia.

In the area of pension saving, seven on-site supervisions were concluded at pension fund management companies and supplementary pension asset management companies in 2009. The supervisions focused on the following activities: organisation and management; investment and risk management; valuation of pension fund assets, calculation of the net asset value and the current value of a pension unit; management of personal pension accounts for savers, pension fund fees; retirement pension saving contracts; complaints from savers, internal control; evaluation of the implementation of remedial measures; legal framework for operations; activities associated with the valuation of assets in pension funds, including the settlement of transactions; compliance with statutory limits concerning the composition of assets in pension funds; evaluating of assets in pension funds, accounting and reporting, advertising and promotion. In supplementary pension asset management companies, on-site supervisions concentrated on verifying the activities of supplementary pension asset management companies; compliance with the generally binding legal regulations, the statutes of supplementary pension funds, the by-laws of supplementary pension asset management companies, and the terms and conditions laid down in their licences; verifying the objective accuracy of selected statements and reports; organisation and management, investment management and risk management; the valuation of supplementary pension fund assets, including net asset value calculation; the management of personal accounts for participants, charges, participants contracts; the internal control system, complaints from participants; the personal accounts of participants and statements of the personal accounts of participants; activities associated with the valuation of assets in supplementary pension funds, including the settlement of transactions, the valuation of assets in supplementary pension funds, accounting and reporting, and the fees of supplementary pension funds.

Foreign exchange supervision focused on the verification of compliance with the reporting requirement by entities that are subject to supervision.

The aim of off-site supervision is to monitor and evaluate the financial situation and risk profile of supervised financial market entities according to information supplied on a regular basis, information obtained during on-site supervisions, information generally available to the public, and specific information provided on an irregular basis. For the needs of Supervision Department and management, the off-site supervisors prepare analyses of the individual banks on the basis of reports received from banks and the implementing outputs. Such analyses are normally prepared on a quarterly basis, or monthly if need be. They focus on developments in assets and liabilities, interbank transactions, loan portfolios, portfolios of financial instruments, customer deposits and foreign exchange positions. Special attention in analysis is paid to the economic results, liquidity, prudential ratios and the effects of stress scenarios. Data from these analyses are used in the process of internal capital adequacy assessment by supervision, during communication with banks and the competent domestic supervisory authorities in supervisory meetings in the case of banks that are subsidiaries of foreign banks. In 2009, increased attention was paid to changes in the strategies of banks, to credit risk, liquidity, concentrations and the ability of banks to cope with an unfavourable situation related to risks to which they are exposed. During 2009, the off-site supervisors provided additional information for the needs of on-site supervision before the commencement of on-site supervisions at individual financial market entities, as well as tips on the basis of information obtained and compiled about the banks. In validating IRB models, the off-site supervisors participated in the analysis of individual banks' loan portfolios and the calculation of risk-weighted assets for the purpose of capital requirement calculation. In accordance with the Banking Act, internal capital adequacy was evaluated in all banks, as well as the risk portfolios of banks. The supervisors subsequently analysed the results of internal capital adequacy assessment in the banking sector as a whole, and the results of analysis were presented to the representatives of banks at a working meeting in November.

In 2009, NBS also verified, through off-site supervision, compliance with the reporting requirement by issuers whose securities were admitted to trading on a regulated market in accordance with Act No. 429/2002 Coll. on the Stock Exchange as amended and Act No. 566/2001 Coll. on securities and investment services (the Securities Act) as amended by regulations pertaining to the reporting requirement for entities inviting a tender for assets.

During 2009, the supervisors also verified the calculation of transfers from motor third-party liability insurance premiums (8%) to a special account of the Ministry of the Interior, which was realised by insurers providing such insurance services.

Another focus of off-site supervision was the independent valuation of correctness of valuation of financial instruments managed by pension funds and whether the acquisition of financial instruments by pension funds was in compliance with the law. In verifying the valuation of such instruments, the supervisors used not only reports from the supervised entities but also information from the Bloomberg and Reuters systems, information from stock exchange or other information disclosed during supervision. On the basis of the stress testing results, the supervisors analysed the scenarios under which the largest hypothetical losses were recorded in the different types of pension funds and compared their effects on the profits of these funds. Within the scope of information support, off-site supervisors put into operation a uniform information portal (Early Warning System) in 2009. This portal adds a new layer of presentation and visualisation to the original information system.

4.6 ANALYTICAL ACTIVITIES OF THE SUPERVISION UNIT

The Financial Market Supervision Unit conducts analytical activities at various levels of its organisational structure. A significant part of these analytical activities is focused on quantifying risks in the financial sector in connection with developments in the financial markets and in the domestic and foreign economies.

The analytical activities comprise activities related to the regular monitoring of trends in individual financial institutions and in the financial sector as a whole, the monitoring of developments in the real economy and in the financial markets. The aim of monitoring is to identify all the relevant trends that may significantly influence the stability of the financial sector as a whole.

In addition to monitoring the trends and risks in the domestic and foreign financial markets through selected indicators, a large part of the work is devoted to the Analysis of the Slovak Financial Sector. This report is submitted to the NBS Bank Board on a semi-annual basis and is published in a shortened form[10]. It is also used as a significant source material for the preparation of the Financial Stability Report. The Analysis includes a comprehensive and in-depth study of trends in the entire financial sector, risk identification, and a quantification of the ability of individual financial entities and the sector as a whole to cope with the risks to which they are exposed. Another regular analysis with the semi-annual periodicity is the Report on the State and the Development of the Slovak Financial Market, which is submitted under the Financial Market Supervision Act to the Government and the National Council of the SR. Another semi-annual report – the Macro-prudential Analysis of the Banking Sector[10] – was launched in 2009 (released in May and November), its purpose being to provide up-to-date information on developments of trends and risks in regard to banking sector stability.

10 *http://www.nbs.sk/en/publications-issued-by-the-nbs/nbs-publications/analysis-of-the-slovak-financial-sector.*

The analytical activities of the Supervision Unit were, to a large extent, utilised in the preparation of new regulations, particularly when the consequences of legislative changes were analysed. Thus, regulation should react to the potential risks in the financial sector well in advance.

Analytical activities in 2009 were influenced to a great degree by the ongoing financial and economic crisis. During 2009, when the financial crisis was changing into an economic crisis, the analytical activities focused on the evaluation of negative trends in the real economy and their effects on the banking sector's stability. Increased attention was paid to stress testing, the task of which is to quantify the sensitiveness of the financial sector to negative developments in the real economy and in the financial markets. During stress testing, numerous econometric models were used. Special efforts were made to improve the models and the risk assessment system. A new VaR model was introduced for market risk assessment.

The analytical activities included numerous meetings with banks of the Slovak banking sector. The main items on the agenda in 2009 were the exposure of banks to credit risk, and changes in the credit standards and lending policies of banks.

The analytical activities were extended with regard to the need for adequate input data. In 2009, new sources of data started to be used in the course of analytical activities. The emphasis was placed on the use of individual financial data from the corporate sector. These data were subsequently analysed together with data from the Register of Bank Loans and Guarantees. For analytical activities, data on households were also used from the banks' register of retail loans.

4.7 FINANCIAL MARKET DEVELOPMENTS IN 2009

In 2009, the Slovak financial market was influenced by the ongoing global crisis. While the first wave of the crisis in the second half of 2007 and the first half of 2008 affected the Slovak banking sector to a lesser extent than it did in the United States and in western European countries, the crisis gradually spilled over into the real economy in the second half of 2008. This led to a change in the behaviour of the financial institutions' customers, and the impact on Slovak financial institutions became more profound. Another one-off effect came from the euro changeover.

These effects were mainly reflected in the banking sector, where the amount of assets decreased as a result of the euro adoption and the related cessation of sterilisation operations with NBS. Although deposit withdrawals of foreign banks were moderated by an increase in household deposits, the result was a decrease of €9.9 billion (16%). Regarding the inflow of foreign bank deposits over the last few years, this change should be viewed as inevitable. The decrease in the share of interbank activities also contributed to the lower volatility in the banking sector's balance sheet. Another sector in the Slovak financial market in which assets decreased in year-on-year terms was the investment firms sector. As a result of weakening confidence in financial markets in the first quarter of 2009, collective investment funds also recorded a decline. The amount of assets decreased mainly as a result of redemptions and, to a lesser extent, a fall in asset prices. In the remaining part of the year, however, the situation in the sector improved as financial markets turned around, and collective investment funds recorded positive net sales of units in aggregate terms. Together with the positive performance, this ensured an increase of 9% in the amount of managed assets during the year. The highest growth in terms of the amount of assets was recorded in both pillars of the pension system. As a result of regular contributions, assets managed in pension fund management companies increased by 30% and those in supplementary pension asset management companies by 12%. Compared with the previous year, the rate of growth in the insurance sector accelerated to 8% in 2009. In terms of the sum of assets and managed assets in all regulated entities, the Slovak financial sector contracted by almost 11% in 2009.

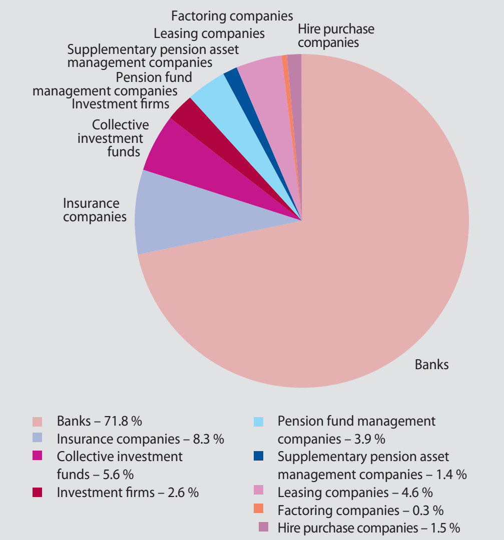
The relatively weaker activity of financial market entities in 2009 was also reflected in their profits. Most severely hit was the banking sector, where return on equity fell substantially. The fall in profits was to a large extent due to the country's entry into the euro area. Higher profits were achieved by insurance companies and supplementary pension asset management companies, while pension fund management companies remained in loss. The decrease in profits of collective investment management companies can be attributed to their strong correlation with the amount of managed assets.

The year 2009 saw significant changes in the balance sheet of banks. While the previous years had seen dynamic growth, the year 2009 can be characterised as one of disappointment. Primarily the economic crisis hit Slovakia with full force. Its adverse effects were also felt in sectors to which domestic banks have significant credit exposures. Banks reacted by restricting their investment activities in sectors with a worsening financial position, while investing more in conservative assets.

Lending to the corporate sector was restricted to a relatively significant extent. Reduced financing was observed in almost all of the sectors. Banks changed their views of what could be yet considered as recoverable loan. Credit standards were tightened throughout 2009, mainly because of the worsening economic development and its negative outlook. On the other hand, the economic crisis also squeezed demand in the corporate sector, mainly for investment loans.

In contrast to the corporate sector, lending to households was affected by the financial and

Chart 42 Distribution of assets and managed assets in the financial sector



Source: NBS.

economic crisis with a certain lag. Household loans, unlike corporate loans, still showed relatively strong growth in 2009. The supply of and demand for loans in this sector was influenced by several factors. The most crucial were uncertainty in the labour market, the rising unemployment, the tightening of credit standards accompanied by a fall in interest rates, the declining property prices and, to some extent, the adoption of the single currency. The strong growth in loans continued in some of the banks only, while other banks were more cautious in their lending activities.

The more prudent approach of banks to lending led to a marked increase in investment in government bonds, on a year-on-year basis. Compared with the previous periods, numerous banks made increased investments in foreign government bonds, mainly from neighbouring countries. In the case of certain banks, the growth in refinancing operations was directly connected with investment in securities.

In the interbank market, banks' activities underwent a marked change in comparison with 2008. In 2008, banks mostly received deposits from foreign banks and then conducted sterilisation operations with NBS. In 2009, however, after the euro changeover, these operations lost their relevance. Developments in 2009 were influenced first and foremost by refinancing operations between the ECB and NBS. Several banks borrowed mainly at one-year maturities. The funds borrowed were invested predominantly in government bonds, and, in some cases, in the interbank market, mainly in transactions with parent banks.

In 2009, the crisis was also reflected in the decreasing amount of mortgage bond issues. This was due to the lower amount of new mortgage loans and to the unfavourable situation in financial markets at the beginning of 2009.

Banks strengthened their capital positions over the course of 2009. This was relatively general trend, and reflected banks' efforts to make them better prepared for a potential increase in losses. This was supported on the one hand by an increase in own funds, mainly in Tier I capital, and on the other hand the amount of risk-weighted assets decreased.

The situation in the insurance sector in 2009 characterized for two key developments: firstly, the largest drop in premiums in monitored history, caused mainly by the unfavourable economic conditions, and, secondly, the sharp rise in profits compared with 2008, which stemmed from increased gains on financial operations. More significant decrease in premiums was recorded in life insurance, where premiums for unit-linked insurance policies, long the fastest growing of all insurance lines, fell significantly. In non-life insurance, prolonged contracts increased its share on all insurance contracts, indicating a stabilisation of insurance portfolios in almost all lines of business. In the motor insurance segment, premiums for motor vehicle insurance exceeded premiums for motor third-party liability insurance for the first time since 2002. The profits of insurance companies amounted to €136.1 million in total, representing a rise of 26.5%. As for the investment structure of technical provisions, the share of government bonds increased at the expense of bank bonds and term deposits.

During 2009, trading in financial derivatives suffered a sharp year-on-year decline (by 76%), owing to the financial crisis. Trading in bonds, shares and other financial instruments increased by 40%. The amount of customer assets managed by companies with authorization to manage a customer portfolio remained virtually unchanged in year-on-year terms. Investment firms met the statutory capital requirement by a large margin.

The collective investment sector in the first quarter of 2009 was still reeling from the negative developments in 2008 that were driven mainly by the financial and economic crisis. The crisis was reflected in the plunging prices of certain assets managed by domestic and foreign collective investment undertakings, and it thus fuelled investor fears and led to a wave of redemptions. The main equity indexes bottomed out at the beginning of March 2009. In the period that followed, stock markets began to rebound (offering the first signs of improvement in expected economic developments) and the prices of other assets stabilised, and it was in this context that investor demand for collective investment products gradually picked up and thus brought stability back to the collective investment sector. From the second quarter of 2009, the sector was reporting positive net sales, and their growth was supported also by the low level of interest rates on bank deposits, which are the principal alternative for investors in collective investment undertakings. Overall, in 2009, the prices of assets managed by collective investment undertakings and the total net asset value in the sector rose in comparison with the end of 2008, but the figures still fell short of the levels recorded before the wave of mutual fund redemptions began in September 2008.

In the pension saving sector, the portfolio composition of all pension funds underwent a radical change in 2009. Pension fund management companies sold practically the entire equity component of their fund portfolios and substantially reduced the volume and share of the bond component. The funds released in this way were reinvested in Treasury bills, which reached a year-end share of 35.3%, and thus became the largest asset class in the portfolio of Pillar II of the pension saving system. Within the portfolio of debt securities, the share of government debt securities increased to 80% at the end of the year, and companies purchased debt securities with shorter residual maturities. Unlike in Pillar II of the pension saving system, supplementary pension funds invested most of their assets in bonds, predominantly in government bonds. The share of the portfolio's equity component increased to 4.7% in Pillar III of the pension system. It can be seen as positive that the year-on-year performance of balanced and growth funds entered positive territory for the first time since the outbreak of the global financial crisis. Once again, though, savers with conservative funds enjoyed the highest yields. Improved performance was also recorded in the case of supplementary pension funds.

The economic downturn in 2009 relatively quickly resulted in increased risks in the domestic banking sector. The crisis had a severe impact on the corporate sector in particular. Almost all sectors recorded negative effects on their financial positions, which reduced their ability to repay liabilities to banks. After a noticeable downturn in the first half of 2009, a moderate revival occurred, mainly in export-oriented sectors. Statistics point to a certain revival, but the absolute increases indicate that production and capacity utilisation are still at a very low level. An important confidence indicator in the corporate sector is willingness to employ staff. This indicator was very low at the end of 2009.

Similar developments were also recorded in the household sector, where the effects of the economic downturn were less serious. After a steep rise during the first two quarters of 2009, the unemployment rise rate stabilised. However, households remained exposed to a relatively high degree of uncertainty, which is related to the state of the recovery in the corporate sector. Hardest hit by the crisis were the lower-income groups. Exposures to these groups are concentrated in the lending segments of consumer loans and current account overdrafts. The largest increase in non-performing loans was also recorded in these segments. Share of lower-income groups on house purchase loans is smaller, albeit their share has been rising in recent years.

Regarding the exposure of banks to risks, in particular to credit risk, a very important factor will be the pace of economic recovery and primarily its sustainability.

In terms of liquidity, the banking sector maintained its stability throughout 2009. It is important that, in the long term, the majority of banks still cover lending from stable customer funds. The situation in the area of short-term liquidity remained unchanged, with almost all banks meeting the prescribed short-term liquidity ratio. Nonetheless, there were differences between banks within the sector.

In addition to the positive trends in the real economy, signs of improvement were also observed in the financial markets. Regarding the risks to which Slovak financial institutions are exposed, an important trend in the second half of 2009 was the decrease in the volatility of share price indices, interest rates and credit spreads.

In most sectors, risk exposures remained virtually unchanged throughout 2009. The most significant change was a decrease in the risk exposure of portfolios of pension fund management companies over the second quarter of 2009, including a change in the structure of these risks. The retirement pension sector was exposed mostly to the risk posed by countries with a high degree of public finance debt, albeit only through bonds with short residual maturities. In addition, the equity component's share in the portfolios of mutual funds increased, as a result of the rising share prices and the positive net sales of equity and mixed funds at the end of 2009.

The highest risk was recorded in the asset portfolios of insurance companies invested on behalf of the insured (unit-linked insurance). These portfolios had a large proportion of shares and mutual fund unit certificates, as well as long-duration bonds.

As for market risks, banks were exposed to interest rate risk in particular. Parallel interest rate increases would have a negative impact on banks. At present, however, interest rates are expected to rise for shorter maturities only, while rates for longer maturities will probably remain stagnant. Such interest rate changes should have no significant impact upon banks. The level of interest rate exposures remained virtually unchanged in 2009. Banks offset the rise in longer-term retail deposits recorded in the last quarter of 2009 by extending the duration of the bond portfolio.