

# Financial Market Supervision





## 4 Financial Market Supervision

### 4.1 Regulation of the financial market in Slovakia

In exercising supervision of the financial market – in banking, the capital market, the insurance industry and pension saving – the Národná banka Slovenska follows general procedural rules laid down in Act No. 747/2004 Coll. on financial market supervision, as amended. This statute entered into force on 1 January 2006, the date that the Národná banka Slovenska assumed the competences of an integrated financial market supervisory authority, including the powers exercised by the Financial Market Authority until 31 December 2005.

The aim of financial market supervision (responsibility for which lies with a deputy governor of the Národná banka Slovenska) is to support both the stability of the financial market as a whole and its secure and sound operation. The financial market supervision department conducts financial market regulation, involving mainly:

- rulemaking activities – it produces draft generally binding legal regulations of the Národná banka Slovenska in the financial market field, in particular, draft prudential regulation, operational security rules and other requirements for the conduct of business by supervised entities;

Table 29 Number of financial institutions

	Number of institutions as at 31 December 2006	Number of institutions as at 31 December 2005	Change
Number of banks in Slovakia	17	18	-1
Home savings banks	3	3	0
Mortgage-lending banks	9	9	0
Other banks	5	6	-1
Number of branches of foreign banks in Slovakia	7	5	+2
of which: authorized by the NBS	1	1	0
on the single European passport principle	6	4	+2
of which: branches of foreign mortgage-lending banks	1	1	0
Number of foreign banks branches' contributing to the Deposit Protection Fund	2	2	0
Number of foreign banks' representative offices in Slovakia	10	9	+1
Number of branches (organizational units) of banks in Slovakia	715	692	+23
Number of lower organizational units in Slovakia	460	457	+3
Number of branches of Slovak banks in other countries	1	1	0
Number of representative offices of Slovak banks in other countries	1	1	0
Number of foreign entities freely providing cross-border banking services	131	104	+27
Banks	123	99	+24
Electronic money institutions	3	2	+1
Foreign financial institutions	3	3	0
Credit cooperatives	2	0	+2
Slovak banks providing free cross-border banking services abroad	1	1	0
of which: electronic money institutions	0	0	0

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**Table 29 Number of financial institutions (continued)**

	Number of institutions as at 31 December 2006	Number of institutions as at 31 December 2005	Change
Number of staff of banks and branches of foreign banks	19,525	19,850	-325
Number of insurance companies in Slovakia	24	25	-1
of which: insurance companies providing only life insurance	5	5	0
insurance companies providing only non-life insurance	5	4	+1
insurance companies providing life or non-life insurance	14	16	-2
Insurance companies providing services on a freedom to provide services basis	296	200	+96
of which: without establishing a branch	289	196	+93
of which: through branches	7	4	+3
Number of insurance companies in Slovakia providing compulsory contractual third-party liability insurance for motor vehicles	9	8	+1
Number of pension fund management companies	6	8	-2
Number of supplementary pension companies	3	0	+3
Number of supplementary pension insurance companies	1	5	-4
Number of domestic asset management companies in Slovakia	10	10	0
of which: asset management companies with an extended licence under Article 3(3) of the Collective Investment Act	7	7	0
Number of domestic mutual funds	109	100	+9
Open-end mutual funds	62	51	+11
Closed-end mutual funds	44	49	-5
Special mutual funds	3	0	+3
Number of foreign asset management companies and foreign collective investment undertakings operating in Slovakia on the basis of an authorisation issued under Article 75 of the Collective Investment Act	3	3	0
Through a branch in Slovakia	2	2	0
Without establishing a branch	1	1	0
Number of foreign asset management companies and foreign collective investment undertakings operating in Slovakia on the basis of a single European passport	21	14	+7
Foreign asset management companies	7	4	+3
Foreign investment companies	14	10	+4
within which: number of mutual funds and sub-funds of foreign investment companies	360	294	+66
Number of foreign asset management companies performing activities under Article 3(3) of the Collective Investment Act	6	3	+3
Number of securities dealers	33	36	-3
of which: banks and branches of foreign banks	18	18	0
Number of foreign entities operating in Slovakia as securities dealers	304	204	+100
Through a branch in Slovakia	2	2	0
Without establishing a branch	302	202	+100
Number of Slovak securities dealers providing services abroad	7 <sup>1)</sup>	5 <sup>2)</sup>	+2
Number of investment services intermediaries in Slovakia	888	756	132
Legal persons	55	37	18
Natural persons	833	719	114

Source: NBS.

1) In sixteen countries.

2) In nine countries.



- licensing activities – it conducts proceedings, takes first-instance decisions, issues authorisations, approvals and prior approvals, and imposes sanctions and corrective measures;
- supervision activities – it supervises financial market entities through on-site and off-site supervision;
- analytical activities – it produces analyses of the financial market as a whole, as well as of individual financial entities.

The financial market comprises four sectors – the banking sector (principally represented by banks and branches of foreign banks), the capital market (mainly securities dealers, asset management companies, the stock exchange and the central securities depository), insurance sector (mainly insurance companies and branches of foreign insurance companies) and the pension savings market (mainly pension fund management companies and supplementary pension companies/pension insurance companies).

Slovakia's membership of the European Union means that foreign banks, foreign financial institutions and electronic money institutions may operate in the country without an authorization from the Národná banka Slovenska, provided that they are authorized in another EU Member State (the single European passport principle). It is a similar situation with securities, which may be offered to the public or admitted to trading on a regulated market in Slovakia on the basis of a prospectus, and supplements thereto, approved by the competent supervisory authority of the issuer's home Member State. In the case that the NBS has been notified of this fact in the relevant manner the approval of the prospectus is not required.

## 4.2 Rulemaking activities of the supervisor

In the field of financial market regulation, several statutes, statutory instruments, methodological instructions and recommendations governing the legal environment of regulated institutions were adopted in 2006. The purpose of this part is not to enumerate these measures but rather to draw attention to those which have had the greatest effect on the activities of regulated entities in individual financial market sectors in Slovakia.<sup>9</sup>

Statutes and statutory instruments in the banking sector and capital market sector were adopted mainly in order to improve prudential regulation for banks and securities dealers operating on the single financial market of the European Union. As far as the banking and capital market sectors are concerned,

the most important of these pieces of legislation is Act No. 644/2006 Coll. amending the Banking Act and the Securities Act, which fully transposes the appertaining provisions of Directive 2006/48/EC of the European Parliament and of the Council relating to the taking up and pursuit of the business of credit institutions and Directive 2006/49/EC of the European Parliament and of the Council on the capital adequacy of investment firms and credit institutions. These directives, implementing the New Basel Capital Accord (Basel II), are aimed mainly at ensuring that the capital requirements of banks and securities dealers correspond to the actual risks to which banks and securities dealers are exposed and that groups providing financial services in more than one country are not unduly burdened by multiple levels of legal regulation and supervision. The amended prudential regulation are also focused on strengthening risk sensitivity, take into account the mitigation of risks related to the context in which individual exposures arise, and reflect the substantial progress in risk management and measurement procedures. For the same reasons, provisions regulating trading book keeping were bolstered and provisions on the treatment of credit derivatives and other financial instruments were introduced.

As regards the capital market, Act No. 213/2006 Coll. amending Act No. 594/2003 Coll. on collective investment and on amendments to certain laws, as amended, entered into force on 1 May 2006. This amendment allows for records of book-entry fund shares/units to be kept separately by an asset management company and depository and, in regard to market requirements, it provides for the creation of a new type of mutual fund – a real-estate special fund. This statute at the same time amended the Securities Act by, inter alia, introducing the holder's account. During 2006 a wide-ranging bill amending the Securities Act was being drafted with the aim of transposing several directives of the European Parliament and of the Council into Slovak law, e.g. Directive 2004/39/EC on markets in financial instruments (MiFID), as well as Commission implementing Directive 2006/73/EC and Directive 2004/109/EC on the harmonisation of transparency requirements. A bill amending Act No. 429/2002 Coll. on the stock exchange was also drafted for the purpose of implementing these directives. The amendment bill on the Securities Act includes an amendment to the Collective Investment Act which is designed to remove certain legislative barriers in the part concerning the real-estate special fund, in particular stipulations referring to real estate companies. On 20 December 2006, the NBS Bank Board approved NBS Decree No. 14/2006 on the submission of reports by asset management companies for the company and the mutual funds it manages, deposi-

<sup>9</sup> A summary of the legal norms which concern the remit of the NBS and were adopted in 2006 is given in Chapter 10.



tories of mutual funds, stock exchange and central depository of securities for the purpose of supervision of the financial market and for statistical purposes. The decree on the submission of reports is the first legal regulation concerning the capital market that provides for the collection of data required for off-site supervision and statistical purposes by means of the application software system STATUS DFT.

In the insurance sector, legislative activity included the adoption of Act No. 188/2006 Coll. amending Act No. 381/2001 Coll. on compulsory contractual motor vehicle third-party liability insurance and on amendments to certain laws, under which the policyholder is required to conclude an insurance contract with his existing insurer for the remainder of the insurance period where his original contract has been terminated owing to premium payment default. This law also changed the way members of the Slovak insurers' bureau pay their annual contributions. A number of adopted statutes included amendments to Act No. 95/2002 Coll. on the insurance industry and amending and supplementing certain acts, concerning, for example, reporting by supervised entities and the assessment of the credibility of entities for the purposes of that Act. In 2006 fundamental changes were made in regard to insurance intermediaries and reinsurance intermediaries, related to the entry into force on 1 September 2005 of Act No. 340/2005 on insurance mediation and reinsurance mediation and on amendments to certain laws, as amended, which required insurance intermediaries to be in compliance with this law by not later than 31 December 2006. The Register of Insurance Intermediaries and Reinsurance Intermediaries was also established. At the level of secondary legislation, there was the adoption of NBS Decree No. 8/2006 on the submission of reports by insurance companies and branches of foreign insurance companies, which provides for the collection of data required for off-site supervision and statistical purposes by means of the application software system STATUS DFT and which takes account of the need to adjust to the trend of risk-oriented supervision.

In the field of pension savings, there were alternations to primary legislation with the adoption of two acts that amended the law on retirement pension saving and the law on supplementary pension saving. The more comprehensive amendment, effective as of 1 August 2006, was Act No. 310/2006 Coll., amending Act No. 461/2003 Coll. on social insurance and on amendments to certain laws, as amended. This piece of legislation changed certain provisions on personal scope in retirement pension saving in relation to amendments contained in Act No. 461/2003 Coll. on social insurance, as amended; it elaborated the provision on the protection of savers' personal data and on retirement pension saving contracts, introduced the return of retirement pension saving contributions

from the pension fund to the Social Insurance Agency, and changed the rules under which certain activities of a pension fund management company may be delegated to another entity. This law also abolished the position of the intermediary of retirement pension saving with effect from 1 January 2007. In the area of supplementary pension saving, this law transposed Directive 2003/41/EC of the European Parliament and of the Council on the activities and supervision of institutions for occupational retirement provision. Within secondary legislation concerning retirement pension saving, a decree was issued in regard to the implementation of STATUS DFT, a system that will provide for the collection, processing and storing of statistical data reported by financial market entities.

### 4.3 Licensing activities of the supervisor

Table 30 shows the number and breakdown of licensing-related decisions taken by the NBS in 2006 which concern financial market entities.

Table 30 Number of decisions issued by the NBS in 2006

Financial sector	
Banking sector and securities dealers	151
Capital market	299
Insurance sector	370
Pension saving	7,209

Source: NBS.

In 2006 the principal licensing-related decisions taken by the Národná banka Slovenska in respect of entities in the Slovak financial market included the following:

- On 1 March 2006, J & T BANKA, a.s., a branch of a foreign bank, commenced operation on the basis of a single European passport. Deposits of the branch are insured in the Deposit Protection Fund, Prague, the Czech Republic.
- Under an NBS Decision of 17 March 2006, Slovenská sporiteľňa, a.s. received prior approval to use an internal model for the calculation of market risk.
- By its Decision of 15 May 2006, the Národná banka Slovenska issued prior approval for the winding up of CALYON BANK SLOVAKIA, a.s. as a result of a bank enterprise's sale, it having been purchased by the foreign bank CALYON S. A., France. The said company had decided to change the operation of CALYON BANK SLOVAKIA, a.s., controlled by it, in the SR, and transfer all its activities to the newly established branch of CALYON S. A. At the same



- time the NBS granted prior approval for the sale of the bank enterprise and the sale of the securities dealer enterprise to the seller, CALYON BANK SLOVAKIA, a.s., and the purchaser, CALYON S. A. France.
- On 22 August 2006, Slovenská sporiteľňa, a.s. received an NBS Decision under which the prior approval for the use of an internal model for the calculation of market risk is expanded.
  - Under an NBS Decision of 19 October 2006, UniBanka, a.s. was granted prior approval to become a subsidiary of Bank Austria Creditanstalt AG (Vienna). Another NBS Decision, of 24 October 2006, gave Bank Austria Creditanstalt AG (Vienna) prior approval for the acquisition of a share of 97.11% in the share capital of UniBanka, a.s. and the attached voting rates.
  - A licence for the provision of investment services was issued to Money Market Brokers, o. c. p., a. s., Bratislava under an NBS Decision of 31 May 2006.
  - In 2006 the NBS issued decisions under which the following companies received prior approval to return their licences for the provision of investment services: Stredoeurópsky makléřský dom, o.c.p., a.s. (decision dated 29 June 2006), EURÓPSKA KAPITÁLOVÁ o.c.p., a.s. (16 August 2006) and Capital Partners, o.c.p., a.s. (16 October 2006).
  - On 14 August 2006, the NBS issued decisions allowing the following securities dealers to change their business names: Across Investment Services, o.c.p., a.s. became Across Wealth Management, o.c.p., a.s., and AFS, o.c.p., a.s. became SALVE INVESTMENTS, o.c.p., a.s.
  - A licence for the provision of investment services was issued to ACTIVE FINANCE o.c.p., a.s. Košice under an NBS Decision of 12 October 2006.
  - In connection with the possibility to create a new type of mutual fund, the NBS issued four licences for the creation of a real-estate special fund to the following asset management companies:
    - Investičná a dôchodková, správ. spol., a. s.,
    - Asset Management Slovenskej sporiteľne, správ. spol., a. s.,
    - Tatra Asset Management, správ. spol., a. s.,
    - PRVÁ PENZIJNÁ správ. spol., a. s.
  - Also in 2006, the Národná banka Slovenska issued:
    - one licence for the creation of a higher-risk special fund to Asset Management Slovenskej sporiteľne, správ. spol., a.s.
    - sixteen licences for the creation of an open-end mutual fund to ČSOB Asset Management, správ. spol., a.s., Tatra Asset Management, správ. spol., a.s., ISTRO Asset Management, správ. spol., a.s., VÚB Asset Management, správ. spol., a.s., AIG Funds Central Europe správ. spol., a.s., Asset Management Slovenskej sporiteľne, správ. spol., a.s.,
    - one prior approval for the merger of closed-end mutual funds, and, subsequently, prior approval for the conversion of a closed-end fund into an open-end fund, to PRVÁ PENZIJNÁ správ. spol., a.s. (this concerns the only asset management company operating closed-end funds; it intends to convert these funds, at the end of their period of appreciation, into open-end funds, and then to merge these funds so that the net value of the assets therein does not decline after the funds are made open-end);
    - two prior approvals for the merger of open-end mutual funds to VÚB Asset Management, správ. spol., a.s. (of the original ten open-end funds managed by this asset management company, six remained);
    - one prior approval for the delegation of an activity mentioned in Article 3(2)(a) of the Collective Investment Act to Tatra Asset Management, správ. spol., a.s. (this concerned prior approval for the delegation of an activity to Raiffeisen Kapitalanlage-Gesellschaft m.b.H. in regard to five mutual funds).
  - As part of its licensing activities in 2006, the Národná banka Slovenska issued three decisions that approved changes in the Operating Rules of the Central Securities Depository, based largely on the need to harmonize the Operating Rules with the amended text of the Securities Act.
  - In 2006 the NBS also approved a change to the licence for the establishment and operation of the Central Securities Depository. This was related to an extension of the scope of the CSD's activities to include the setting up and maintenance of holders accounts for members.
  - In 2006 the NBS issued prior approval for the acquisition of 100% of the share capital of the Central Securities Depository of the Slovak Republic held by the National Property Fund of the Slovak Republic. The NBS subsequently issued prior approval for the acquisition by the Bratislava Stock Exchange of 100% of the CSD's share capital. The acquisition by BSSE of 100% of the CSD's share capital was made in order to implement the Government's decision on the privatization of state-owned stocks and their sale to the BSSE. The purpose of this acquisition was to standardize relations in the Slovak capital market by means of changing the shareholder structure of the CSD in favour of capital market entities using its services. This decision was preceded by the prior approval to increase its 66% share in the BSSE's capital granted by the NBS for the National Property Fund of the Slovak Republic.
  - In 2006 the Národná banka Slovenska examined 29 mandatory takeover bids. These bids were made either because the statutory percentage of the voting rights attached to the shares of a single issuer had been reached or exceeded (nine such



- bids were approved), or because the issuer's general meeting of shareholders had decided to delist the company's shares from the BSSE or to suspend trading in its shares on this stock exchange (18 such bids were approved and two were rejected).
- In 2006 the NBS issued 34 decisions in connection with the approval of prospectuses for 24 issues of securities (16 mortgage bond issues, 7 bond issues and 1 share issue).
  - On 30 January 2006, an NBS Decision on the return of the authorisation to perform insurance business issued to Vzájomná životná poisťovňa Sympatia, a.s. entered into force.
  - On 8 February 2006, AEGON Životná poisťovňa, a.s. was issued an authorisation to perform life insurance business in the insurance classes A1, A4 and A6.
  - On 26 May 2006, an NBS Decision on the return of the authorisation to perform insurance business issued to Winterthur poisťovňa, a.s. entered into force.
  - On 20 October 2006, on the basis of an application by OTP Garancia poisťovňa, a.s., the NBS extended company's authorisation to perform non-life insurance business to cover class B10a.
  - On 20 December 2006, on the basis of an application by KOOPERATIVA poisťovňa, a.s., the NBS extended company's authorisation to perform non-life insurance business to cover class B17.
  - On 10 May 2006, on the basis of an application by QBE poisťovňa, a.s., the NBS restricted the coverage of company's authorisation to perform life insurance business.
  - Under an NBS Decision of 13 January 2006, Buffalo Springfield Holding SA (Luxembourg) and natural persons Peter Struhár and Ladislav Reháč jointly acquired a share of 10.23% in the capital of Winterthur d.s.s., a.s.
  - Prvá dôchodková sporiteľňa, d.s.s., a.s. was dissolved on 1 March 2006 after the NBS had approved its merger with Allianz–Slovenská dôchodková správcovská spoločnosť, a.s.
  - In 2006 the NBS issued each of the following companies with a licence for the incorporation and operation of a supplementary pension company:
    - ING Tatrý–Sympatia, d.d.s., a.s.,
    - Winterthur d.d.s., a.s.,
    - Doplnková dôchodková spoločnosť Tatra banky, a.s.,
    - Stabilita, d.d.s., a.s. (the company had not been incorporated by the end of 2006 and was not entered in the Companies Register of the Slovak Republic).

The Národná banka Slovenska fulfil the tasks of a foreign exchange authority ensuing from Act of the National Council of the Slovak Republic No. 202/1995 Coll., the Foreign Exchange Act, as well as the tasks ensuing from Act of the National Council of the Slovak

Republic No. 566/1992 Coll. on the National Bank of Slovakia.

Following the completion of the foreign exchange regime liberalisation process and abolishing of the regulation of individual transactions on the current and capital accounts of the balance of payments by means of foreign exchange authorisations, certain entrepreneurial activities conducted on cash or cashless basis and related to funds in the Slovak currency and in other currencies (trade in foreign exchange assets and foreign currency services) remained subject to foreign exchange regulations.

In relation to these entrepreneurial activities, the Národná banka Slovenska, on the basis of factual assessment of the filed requests and annexed documents, granted foreign exchange licences as follows:

- 46 licences to provide currency exchange activities
  - to purchase and sell foreign currencies for Slovak koruna in cash (27 of which were granted to legal persons and 19 to natural persons),
- 18 licences to provide currency exchange activities
  - to sell foreign currencies for Slovak koruna in cash (8 of which were granted to legal persons and 10 to natural persons),
- 1 licence to trade in currencies on a cashless basis.

#### 4.4 Supervision activities of the supervisor

In total during 2006, 15 on-site supervisions, comprising 11 thematic supervisions and 4 follow-up supervisions, were conducted in banks, branches of foreign banks, and securities dealers. The follow-ups to on-site supervision were made in order to review the measures that the Národná banka Slovenska had imposed on the banks concerned. The thematic on-site supervision centred on the management of credit risk, market risk, operational risk and liquidity risk, on banks' preparedness for using internal models to calculate market and credit risk capital requirements, on reviewing selected reports, and on the operation of securities dealers. Selected securities dealers were subjected not only to on-site supervision, but also to visits focusing on their organization and management activities, how they closed transactions, and their processes for accounting and reporting. In addition to the standard activities carried out within the scope of off-site supervision – i.e. verifying that reporting to the NBS is complete and correct and evaluating the fulfilment of plans adopted following on-site supervision – other tasks were performed: e.g. an analysis of reports on the estimated maturity of assets and liabilities was carried out, and, as part of the evaluation of auditor's reports, the conclusions of the supervisor's internal evaluation of the auditor's reports were discussed with



**Table 31 Number of on-site supervisions conducted in banks, branches of foreign banks, and securities dealers in 2006**

	Quarter I		Quarter II		Quarter III		Quarter IV		Quarters I-IV	
	Started	Completed	Started	Completed	Started	Completed	Started	Completed	Planned	Actually
On-site supervision:										
- comprehensive	-	-	-	-	-	-	-	-	-	-
- follow-up	3	3	-	-	-	-	1	1	4	4
- thematic	1	1	5	2	-	3	5	5	10	11
<b>Total</b>	<b>4</b>	<b>4</b>	<b>5</b>	<b>2</b>	<b>0</b>	<b>3</b>	<b>6</b>	<b>6</b>	<b>14</b>	<b>15</b>

Source: NBS.

the auditing companies (with the responsible auditors and partners) in the presence of the representatives of the respective commercial banks.

In the capital market, the on-site supervision of collective investment focused on compliance with the provisions of generally binding legal regulations governing collective investment by asset management companies, in particular, the management of mutual fund assets. In 2006 on-site supervision was conducted in two asset management companies and in one legal entity that procures the issuance and redemption of securities of foreign collective investment undertakings. Also in 2006, off-site supervision was carried out on 10 asset management companies (altogether managing 110 mutual funds) and 7 banking entities performing the role of depository as defined in the Collective Investment Act. The main aim of the off-site supervision was to monitor compliance with disclosure and reporting obligations as set out in the Collective Investment Act and the Securities Act, and to validate statements and reports concerning risk diversification. Among foreign collective investment undertakings, off-site supervision was exercised over 2 foreign asset management companies authorized by the NBS to perform activities in the territory of Slovakia. The supervision exercised over the BSSE's activities during 2006 consisted mainly of the ongoing monitoring of executed transactions in securities admitted to trading on its markets within its business system modules. The monitoring of trading was aimed especially at possible violation of insider dealing prohibition and market manipulation, particularly in regard to trading with issuers' shares which were subject to a mandatory takeover bid, and at whether BSSE members conducted their activities in accordance with the honest business relationship principle and with professional care. The exercise of supervision over the CSD in 2006 was focused on the reliability of the securities registration modules and the clearing and settlement modules operated by the CSD. In 2006 the Národná banka Slovenska also exercised off-site supervision in regard to the fulfilment of the disclosure obligation by securities issuers. As for investment

services intermediaries, two on-site supervisions and 37 off-site supervisions were carried out at legal entities in 2006. The main aim of the supervision was to comprehensively review the state of compliance with provisions of Act No. 566/2001 Coll. on securities and investment services, in regard to the performance of licensed activities in the Slovak financial market.

In the insurance sector, five thematic supervisions had been launched in insurance companies by the end of 2005, the focus of which included the level and method of setting technical reserves for claims outstanding provided under compulsory contractual motor vehicle third-party liability insurance, and the claims settlement within this type of insurance. Four on-site supervisions were conducted in the first quarter of 2006 and one in the third quarter. The off-site supervision included review of the insurance companies' standard statements and reports prepared as at the end of 2005 (audited) and for each quarter of 2006 (interim), as well as reports forwarded on an ad hoc basis, and the handling of 145 complaints on the insurance companies activities. The off-site supervision of insurance intermediaries and reinsurance intermediaries included review of the statements and reports submitted by these intermediaries for the end of 2005, as well as review of notifications of any changes in the facts presented by these intermediaries when they applied for the licence to perform intermediary activities, and the handling of 15 complaints on the insurance intermediaries activities. As part of the review of entities' reporting obligations, 80 insurance intermediaries were examined. Under the off-site supervision of insurance brokers of legal and natural persons, the NBS reviewed the validity of indemnity insurance contracts for insurance mediation that were concluded for an indefinite period.

As regards pension savings, the on-site supervision carried in the sector of retirement pension saving and supplementary pension saving focused on compliance with the provisions of generally binding legal regulations, in particular, with the provisions of Act No. 43/2004 Coll. on retirement pensions saving,



as amended, and Act No. 650/2004 Coll. on supplementary pension saving, as amended. During 2006 a total of nine on-site supervisions were made. The Národná banka Slovenska carried out continuous daily monitoring and evaluation of all transactions in pension fund assets and the total amount of pension fund assets, on the basis of information which pension fund management companies and their depositors provided on a daily basis in accordance with Article 110(3) of the Act on retirement pension saving. There was also review of the fulfilment of disclosure obligation of asset management companies as laid down by Decree of the Ministry of Labour, Social Affairs and Family of the Slovak Republic No. 75/2005 Coll. Under Article 114(1)(h) of the Act on retirement pension saving, the activities of the Social Insurance Agency are subject to NBS supervision in regard to the transfer of retirement pension saving contributions to pension fund management companies under a separate regulation. Within that remit, the NBS examined over the course of the year 2006 112 submissions from savers and seven initiatives from pension fund management companies.

## 4.5 Analytical activities of the supervisor

One of the purposes of financial market supervision is to contribute both to the stability of the financial market as a whole, and to the secure and sound functioning of the financial market. In addition to rule-making, licensing and supervision activities, analytical activities are also performed in this regard.

In 2006 the Financial Market Supervision Division produced the Report on the Results of the Slovak Financial Sector Analysis for the first half of 2006 and for the whole of 2006. This report is submitted to the NBS Bank Board and published in an abridged version.<sup>10</sup> The other regular analysis carried out on a semi-annual basis is the Report on the Status and Development of the Slovak Financial Market, which in accordance with the Financial Market Supervision Act is submitted to the Government and the National Council of the Slovak Republic. This report consists mainly of a description of key trends and an evaluation of the risks inherent in them. The analysis covers each type of financial institution separately, as well as the financial market as a whole.

In the context of improving how the effects of various risks are monitored, especially in the banking sector, the supervision division has been working on the further development of economic-mathematical models, mainly in the following areas:

- the incorporation of correlations in the stress-testing of market risks;
- a panel regression model for evaluating the credit risk of particular economic sectors;
- a model that simulates the impact of changes in unemployment and interest rates and of a decline in real estate prices on retail loans portfolio, by using data on a sample of households;
- a model of the impact of interest rate shocks on banks' financial results, taking account of how changes in the NBS base rate are gradually translated into other interest rates (modelled using a so-called error correction model). This model complements the existing model based on an assessment of changes in net economic value;
- a model for estimating probability of default by means of learning systems that utilize fuzzy logic. A learning systems-based model for the evaluation of banks has been used by the supervisor for a relatively long period of time.

In regard to pension saving and collective investment undertakings, new statistical reports have been drafted which will allow for risk measurement and stress testing to be extended to these institutions in 2007.

Besides regular analyses for the NBS Bank Board, the analytical activities of supervision in 2006 was largely devoted to evaluating the increase in household lending and the related risk, both at the macrolevel and at the level of individual households.

On the subject of entry into the euro area, an analysis was conducted on the possible effects of the euro changeover on the performance and activities of the banking sector in Slovakia.

The analytical activities of supervision include the validation of banks' internal risk measurement models in accordance with the Banking Act. In 2006, two market risk models were assessed, and several unfinished credit risk models were the subject of pre-validation consultations.

## 4.6 Financial market developments in 2006<sup>11</sup>

The financial market entities analysed in 2006 comprised banks, branches of foreign banks, insurance companies, branches of foreign insurance companies, asset management companies, pension fund management companies, supplementary pension (insurance) companies, and securities dealers.

<sup>10</sup> <http://www.nbs.sk/DFT/BD/ANALYZY/INDEXA.HTM>

<sup>11</sup> Based on preliminary data, with the exemption of the banking sector and the insurance sector.

As at 31 December 2006, the assets managed by these institutions amounted to almost SKK 1 759 billion, representing just under 107% of GDP in current prices. Year-on-year, the volume of assets and managed assets increased by SKK 62.5 billion, or 3.7%. That represented a slowdown in comparison with the 12 months of 2005, when the financial market grew by SKK 318 billion, or 23%. The slowdown in the growth rate reflects mainly banks' balance sheet total, which increased by only SKK 4 billion (representing minimal growth in the context of a total amount of SKK 1 409 billion).

The financial market experienced another year of positive trends in 2006. The environment of strong economic growth and the improving financial position of the main sectors of the real economy was reflected in the growth of almost all financial market sectors.

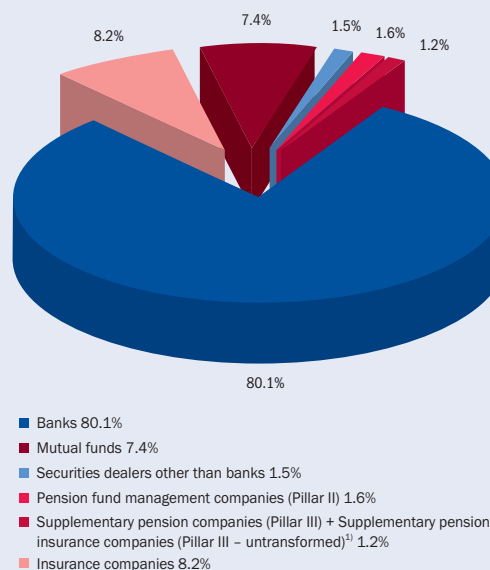
The positive economic development was most substantial in the banking sector. This was largely due to customer lending, which increased by 20% year-on-year and accounted for 46% of total assets in December 2006. Most of the lending growth was driven by household and enterprises loans. The main pillar of funds continues to be household deposits, which in 2006 increased both in amount and as a share of the balance sheet total.

Almost one third of banks' balance sheet total comprises funds deposited with the NBS or invested in NBS bills. These funds are largely financed with short-term funds from foreign banks. However, their volume fell after the NBS intervened in the foreign exchange market in June and July 2006 in favour of the Slovak koruna. An important fact in regard to the financing of banks' activities is that, for the time being, most domestic banks and the Slovak banking sector as a whole have a sufficient amount of stable domestic funds at their disposal.

As lending continued to rise sharply and the amount of own funds remained more or less stable, the capital adequacy ratio declined. This was observable in most banks, and the average capital adequacy ratio, weighted by the amount of own funds, fell year-on-year from 14.8% to 13%. All banks, however, maintained the ratio above the minimum threshold of 8%.

The banking sector reported a net profit of SKK 17.8 billion for 2006 and a return on equity (ROE) of 21.2%. Net interest income, in particular, rose substantially in comparison with 2005, which was related to continuing growth in lending and in banks' interest margins. Income from trading declined year-on-year. Operational efficiency in banking sector increased, with a decline in the ratio of operating costs to gross income from banking activities.

**Chart 69 Financial institutions by share of assets and managed assets of the financial market in December 2006**



Source: NBS.

Note: For banks and insurance companies, the share is evaluated by net assets, and for other sectors, by value of managed assets.

1) The figures for SPICs are estimates.

The risk profile of the banking sector did not change significantly in 2006 – it was largely related to the previously mentioned higher increase in banks' credit exposure to households and enterprises. Although, at present, non-performing loans account for a relatively small percentage of banks' credit portfolios, there is a potential risk in the close dependence of banks on the domestic business cycle. As regards the structure of customer lending, real estate prices have an increasingly significant position. The risk relates in particular to the financing of commercial real estate, where the returns on property developments are closely connected with real estate price movements. On the other hand, the economy's positive development has improved the financial position of borrowers. Household income has risen and unemployment has fallen. The financial condition of enterprises has also improved, especially the profitability of small and medium-sized enterprises.

The structural changes in banks' balance sheets can be expected to impact liquidity risk in terms of banks' ability to repay their liabilities in the event of a run on deposits, notwithstanding the maturity mismatch between the actual contractual maturity of assets and liabilities. In this regard, it is important that a sufficient holdings of customer deposits are covered by relatively liquid assets, for example, NBS bills, government bonds or other assets, which banks may sell, where necessary, without suffering



a substantial loss because of the quick sell. Largely due to the increase in customer deposits, the ratio of liquid assets to customer deposits and other volatile funds declined in 2006. It should be noted, however, that time deposits, which are relatively less volatile, recorded the largest growth.

The banking sector's exposure to market risk in 2006 involved mainly the interest rate risk of instruments held to maturity, meaning the risk of a gradual decrease in net interest income in the event of a rise in interest rates. The interest rate risk of instruments measured at fair value, foreign exchange risk, and equity risk did not have a particularly significant effect on banks (except for foreign exchange risk among branches of foreign banks). Banks are, however, exposed indirectly to interest rate risk in view of the fact that a significant portion of customer loans is provided at short-term fixed interest rates. A relatively significant increase in rates could raise repayments, and therefore increase the credit risk on these loans as borrowers find themselves in a worse financial position.

Gross written premium according to IAS/IFRS international standards was in total SKK 51.3 billion as at 31 December 2006, which represented 3.1% of GDP (insurance penetration). Gross written premium in life insurance was SKK 23 billion and in non-life insurance SKK 28.3 billion. Because written premium had been reported in accordance with Slovak accounting standards until the end of 2005, the NBS adopted an analysis of technical premium, which may be defined as the price agreed in individual insurance contracts without regard to the method of their financial reporting. The same approach was taken to the analysis of claim expenses. In 2006 technical premium amounted to SKK 53.6 billion, including SKK 25.3 billion in life insurance and SKK 28.3 billion in non-life insurance.

Technical premium in life insurance rose by 15.6% in 2006, confirming the trend of higher growth in technical premium in this field. In non-life insurance, technical premium fell by 5%. The gradual trend decline in market concentration continued. Technical expenses for claims increased by 25% year-on-year, to stand at SKK 21.2 billion. The earnings recorded by insurance companies in 2006 increased to SKK 4.5 billion. That increase occurred despite a sharp rise in operating costs (20% in life insurance and fully 41% in non-life) which was largely due to the creation of fewer technical provisions in life insurance. The allocation of technical provisions saw no changes, and they continued to be invested in low-risk assets.

Within the services provided by securities dealers, the amount of customer transactions totalled SKK 1 810 billion in 2006, representing a year-on-year

increase of 10%. Fully 95% of these transactions were made through banks. Transactions concluded on the account of customers increased significantly in comparison with 2005. The most traded instruments were bonds and forward contracts.

The amount of funds invested through mutual funds in 2006 increased far more slowly in comparison with the previous few years. This reflected the level of interest rates which, after a long downward trend, began to move up in 2005, and this rise continued in 2006. This change adversely affected the performance of, in particular, bond funds and mixed funds. Besides that, the performance of funds was influenced by the substantial appreciation of the Slovak currency, as instruments denominated in foreign currencies fell in value. As a result, the net asset value of open-end mutual funds increased during 2006 by only 4%. In 2005, the total net sales of funds represented SKK 38.7 billion, but in 2006 the figure was negative – sales by investors exceeded purchases by SKK 2.6 billion. The redemptions were highest among bond funds and money market funds. The funds acquired in this way were transferred mainly into funds of funds, equity funds, and time deposits in banks. The riskier groups of funds, especially, equity funds, profited from European stock markets, which rose in 2006, albeit less quickly as in 2005.

The new pension system had its first year of practical operation in 2006, as the last deadline for voluntary entry into the second pillar of pension insurance passed on 30 June 2006. As at the end of December 2006, the number of savers registered with pension fund management companies stood at 1.54 million, and the assets in their pension accounts amounted to SKK 28 billion. Nevertheless, individual pension fund management companies reported little change in their market share. The three largest of these companies were managing 73% of total pension fund assets.

Pension fund assets are mostly concentrated in growth funds, where the risk is significantly greater and the predicted returns over the long run are highest. They are followed by balanced funds and then conservative funds. Although most assets are managed in growth funds, the structure of investments is still fairly conservative. Fully 86% of the assets are invested in bank accounts and bonds. The annual yield on pension funds as at 31 December 2006 carried spreads of 2.8% to 3.7% for conservative funds, 3.2% to 4.8% for balanced funds, and 3.1% to 5.2% for growth funds. At the same time, simulations using historical data of interest rates, share prices and exchange rates show that in the event of market difficulties, conservative funds should not decline by more than 0.5%, and balanced and growth funds by not more than 1.5%, over a period of 10 days with a



probability of 99%. Equity risk and foreign exchange risk should be the most significant, while the foreign exchange risk should be negligible.

The number of Slovak citizens participating in three supplementary pension companies and one untrans-

formed supplementary pension insurance company involved in the third pension pillar came to 856,000 and their savings in this pillar amounted to SKK 21.3 billion. These assets are invested in a similar way as pension fund assets, mostly in bank accounts and bonds.