SLOVAK BANKING SECTOR

NEW LOOK AND NEW CHALLENGES

(from the document White Book Slovakia 2001[1])

Part 1

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Development of economic, legal and ethic environment in transitive economies in Central and Eastern Europe can be also seen in attempts focusing on creating new standards for functioning of banking sectors in this region. Lack of historical experience, impact of external environment and personal interests especially in the past have made this process difficult. After making many mistakes, followed by reforms, it seems to us today that it is actually the banking sector, which could be used as an example showing how to reach desired goals. One of the new phenomena, so typical not only for Slovak banking sector, but for banking sectors in other developing countries as well, is the entry of foreign capital in local banks. Foreign bank groups are interested in and strive for making business terms and conditions standard, so that they reflect and approach as much as possible those of developed countries. With regard to this fact, foreign banks – in cooperation with their local banks – investigate local environments, compare them, and prepare their own analyses. Authors of this document have prepared such an analysis and, based on the outcome, they are trying to outline problematic areas or give certain recommendations. These suggestions, in many cases, are not unique, but in a certain way present opinions that correspond to opinions of other bankers in Slovakia. This document wants to investigate and focus on the current status of the banking sector; it also deals with legislation and regulatory and supervisory instruments and their impact on banking activities. It also briefly describes the influence of development within small- and medium-size companies, of the clearing system and other related areas on sound functioning of banks on our markets.

Characteristics of the Banking Sector

Despite being relatively small in the European scenario the Slovak banking system is a significant sector of the economy. Since 2000, following restructuring and privatisation of large banks and significant entry of foreign capital, the system has gradually begun to consolidate and to achieve stability. At the same time, all the prerequisites for the application of the standard methods and instruments of monetary policy, as well as of regulation and supervision, have been created.

Major opportunities for future development of the Slovak banking industry relate to EU convergence, to the still unexploited potential of retail banking and to a change in the scope of banking business, aiming at providing a comprehensive set of services to the client. A major issue to monitor is credit risk, in particular banks' ability to settle classified loans and to maintain the quality of assets with regard to the still relatively high risk environment.[3]

Aggressive growth of institutional investors (in particular foreign unit trust funds), shortcomings of the legal system and a possible slowdown of the reform process and of macroeconomic development after the 2002 elections would be further detrimental factors for banking sector growth.

Market Size and Market Penetration

With total assets of SKK 846 bln (€ 19 bln) at the end of 2000, the Slovak banking system is relatively small in the European scenario, accounting for 6.8% of the New Europe[4] market and only 0.1% of the EU market. Due to historical reasons[5], however, the level of banking intermediation is high compared to other New European countries. The assets to GDP ratio equalled 96% in 2000, the second highest level in New Europe, following the Czech Republic (139%). High growth potential emerges when one considers that in the EU the corresponding ratio is above 280%.

Since 1998 systemic restructuring has negatively influenced the size of the Slovak banking sector, resulting in a contraction in both total assets and loans. Major determinants of this transformation are the strict macroeconomic stabilisation program, a persisting credit crunch, the shift of a part of bad loans of state banks to the Slovak Consolidation Agency[6] and the transformation of Konsolidacna Banka Bratisla-

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[1] White Book is a document elaborated by UniCredito Italiano describing banking activities in Bulgaria, Poland and in Slovakia. It includes comparable data structure for 2000, and in some areas for 2001.

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[3] Environmental risk is influenced by the state of restructuring of the business sector, by the financial situations of firms, including small and medium sized, as well as by the legislative environment.

[4] Countries applying fro EU entry and Croatia

[5] In Czechoslovakia the role of intermediaries of banks at economic level was already extremely high before WWII.

[6] SKK 72.1 billion in 12/99 and SKK 32.4 billion in 6/2000, which is shown in a reduction of loans for the banking sector in the first quarter of the year 2001. On the whole, clean up operations in the system, plus withdrawal of the banking licence to Konsolidacna Banka Bratislava, implied a contraction in total banking assets of SKK 13 bln. and SKK133 bln. in loans. The difference is due to a partial substitution of loans with securities, as part of the recapitalisation of large banks.

Table 1 – Market size and market penetration

	End of 2000	% NE	% EU	% GDP
GDP	887,200	5.0%	0.2%	–
Population (in million)	5.4	5.0%	1.4%	–
Total assets	846,955	6.8%	0.1%	96%
Total loans (all branches of industry)	502,696	10.6%	0.1%	57%
Total deposits (all branches of industry)	687,856	7.0%	0.1%	78%
Equity market capitalization	154,875	0.7%	0.0%	18%
Bond market relevance	117,383	–	–	13%

Source: NBS. In SKK million, if not stated otherwise. Exchange rate SKK/EUR 44.

Table 2 – Market structure and concentration (%)

	1996	1997	1998	1999	2000	2001*
3 largest banks, by total assets	56.3	52.81	47.75	49.85	52.21	54.61
3 largest banks. by loans net	56.2	49.70	44.42	48.85	51.13	40.04
3 largest banks. by deposits	56.7	52.91	48.84	51.72	52.81	60.06
Market share of banks with majority stake of the state*	61.3	54.14	48.75	51.21	49.27	3.28
Market share of foreign banks*	23.4	22.64	33.28	32.67	44.01	96.72

Source: NBS and estimates made by authors. * Adjusted variable (estimated share upon overtaking shareholder rights in Istrobanka and IRB).

va[7] at the end of 2001 and beginning of 2002. Despite this negative trend, the Slovak banking sector continues to perform a leading role as intermediary for the local economy, due to the underdevelopment of capital markets. The non-bank financial sector is marked by long term stagnation, low volume of market capitalisation, illiquidity and low turnover. Equity market capitalisation equals SKK 155 bln (€ 3.5 bln) at the end of 2000, representing 17.5% of GDP, with a considerable market decline since the first years of transition, when abnormal capital market growth was determined by the voucher scheme privatisation process. Bond market capitalisation equals SKK 117 bln (€ 2.7 bln), with a substantially stable share on GDP, equal to 13%. The vast majority of bonds are Government issues, while the corporate bond market is still negligible.

Opportunities for financial sector developments in the future are related to savings of the population and to income growth and distribution as a consequence of the EU convergence process. Development of gross household saving is cyclic, with absolute and relative growth in 2000, following two years of decline. Income distribution reveals a low disposable income of the population (80% of individuals have an annual income of less than 10,000 USD PPP, this group accounting for 56% of the country's total income).

Market Structure and Concentration

After 1999, upon restructuring and privatizing large banks, the structure of Slovak banking sector changed significantly. Slovak banks are almost exclusively owned by foreign banks, which actually have in their ownership 97% of assets (reviewed data[8]).

The three largest banks (Slovenská Sporiteľňa, VÚB and Tatra banka) cover more than 50% of assets and deposits and more than 40% of loans of the banking sector. The share of the two biggest ex-state banks has never fallen below 40% during the period under review. These banks are the only Slovak banks that enter the ranking of TOP 1000 World Banks[9] (In Tier One capital VÚB is at 697th place and Slovenská Sporiteľňa at 947th place). Among the TOP 25 in Central and Eastern Europe, they rank 15th and 22nd.

In 2001, the stake owned by the state decreased significantly. Due to the already completed transformation and privatization, the share of assets of banks with majority stake of the state dropped down to 3.28%; at the same time, total assets owned by foreign investors increased up to 96.72%. Privatisation of large banks and foreign ownership are increasing competition in the market. The fight to obtain the best clients, the transformation in lending portfolios, as well as the adoption of aggressive expansionary policies are major signals of an already ongoing process.

21 banks operated in Slovakia at the end of 2001 (two of them are branches of foreign banks). Three of them are construction savings banks[10]; one bank (Konsolidačná banka Bratislava) was administering classified debts and at the beginning of 2002 – within the restructuring process – this bank was transferred into a non-banking entity; one state bank focuses its activities on providing guarantees for selected clients and branches of industry to cover risks in commercial banks. The large number of small and medium sized banks, with a limited market share, suggests opportunities for further consolidation in the sector, to enhance stability and efficiency.

At the end of 2000 more than 11 million bank accounts, 1,202 bank branches, 1,084 ATM and 1,719,503 issued payment cards existed. Growth opportunities in terms of bank distribution channels emerge when comparing banking penetration in Slovakia and in the EU.

- In Slovakia, the average number of branches per 1 million inhabitants is 223, compared to 580 in the EU
- The average number of ATM per 1 million inhabitants is 200, compared to 620 in the EU

[7] The transformation of the restructuring banks is expected for the end of2001 and would imply its withdrawal from the banking sector.

[8] Data has been modified in the way as specified in Table 2.
[9] The Banker.
[10] Special commercial banking institutions aimed at fund raising and lending for real estates acquiring and furnishing only

• The average number of issued cards per 1 million inhabitants is 318,000, compared to 862,000 in the EU.

Banking Activities [11]

Restructuring of state banks, a high-risk environment and overall macroeconomic reforms are reflected in the dynamics of banking assets and in their structural changes. Restructuring of state banks and transformation of Konsolidačná banka Bratislava during 1999 – 2001 have resulted in decreasing loans and reducing assets significantly.

Bank lending policies have also started to change, with a decline of the share of total loans to assets, a gradual contraction of the share of loans of business clientele and an increase in loans to the public sector and to households.

Loans and deposits denominated in local currency account respectively for 82.8% of total lending activity and 83.7% of total bank deposits. Compared to other transition economies, the relevance of foreign denominated products is limited in Slovakia, as a consequence of substantial stability of the currency and general trust in the system. In future, a slight increase in importance of activities denominated in foreign currency can be expected, as a consequence of increasing use of the euro on an international basis.

Customer segmentation – By distinguishing among different segments of the market, the relevance of the corporate sector is prevalent on the lending side, while on the liability side households prevail.

At the end of 2001, corporate sector accounted for 84.6% of total loans provided to private sector, and loans provided to inhabitants accounted for some 15.4% of the market, despite rapid growth. Following restructuring of banks, a reshaping of banking portfolios in search of higher diversification, thus reducing exposure towards the corporate sector and increasing penetration in retail markets, is in place. Restructuring policies for existing portfolios also supports this trend in terms of new loans, due to the fact that the largest share of write-offs concerns loans in the corporate sector in particular.

Table 4: Loans in SKK, by market segments

	Share in %, in 2001	In billion SKK, in 2001
Total loans		**338.4**
SKK loans	***82.77 %***	**280.1**
Out of it		
Corporate sector	*76.47 %*	214.2
Government sector	*4.53 %*	12.7
Households	*18.53 %*	51.9
Other	*0.46 %*	1.3
FC loans	***17.23 %***	**58.3**

Source: NBS, preliminary data from monetary review.

In 2000, mortgage loans accounted for 2.5% of loans to households (0.3% of total SKK loans); however, in 2001 mortgage loans accounted for 9.1% of loans to households (1.7% of total SKK loans). Further expansion of mortgage loans can be expected in the close future mainly due to government programs subsidising interest rates charged on mortgage loans. However, strong development of the market is still constrained by deficiencies in the legal environment and in particular by ineffective collateral law. A new proposal of law is under discussion and its implementation should be an essential precondition in achieving a developed mortgage market in the country.

Segmentation of clients on the liability side reveals a predominance of the retail sector, which accounts for almost 60% of total deposits in both domestic and foreign currency. Slovak banks rely highly on traditional fundraising for their financing and competition is increasing. This is already reflected in the low level of the mark down (the difference between market rates and rates on bank deposits), which is peculiar to the country, when compared to other transition economies.

Table 3 – Banking activities towards the non-financial sector

	1997	1998	1999	2000	2001
Total assets	776,853	799,993	769,764	846,955	931,324
Total loans (gross)	389,874	405,158	411,357	408,230	339,001
Total loans (net)	355,159	369,124	360,696	338,799	278,507
Total deposits	447,729	462,281	506,989	596,301	674,400
Total assets %, y/y	8.4 %	3.0 %	-3.8 %	10.0 %	9.9 %
Total loans (bgross) %, y/y	3.5 %	3.9 %	1.5 %	-0.8 %	-17.1 %
Total loans (net) %, y/y	3.1 %	3.9 %	-2.3 %	-6.1 %	-17.7 %
Total deposits %, y/y	6.7 %	3.3 %	9.7 %	17.6 %	13.1 %

Source: NBS, calculations made by authors. In SKK million, if not stated otherwise.

In terms of maturities[12], 28.2% of deposits are payable immediately (deposits without period of maturity); deposits with a certain period of maturity represent a 43.6% share; and savings deposits represent some 28%.

Influence of legislation, macroeconomic environment and taxes, and influence of other incentive factors in relation to deposits and loan products can be seen especially in the following areas:

• Specific subsidies granted to agricultural sector (subsidies of 9%–10% to interest rates); this has a positive influence on development of borrowings and loans in the given segment.

• The State contribution to interest on mortgage loans of 5% has a positive influence on the development of loans in the case of private clientele

• Expansion of deposit products influenced especially by preferential state contributions to construc-

[11] Consolidated data for the banking sector.

Table 5: Primary deposits in banking sector, by market segments

	Share in %, in 2001	In SKK billion, in 2001
Domestic currency (SKK)	**83.6%**	**563.7**
Entrepreneurial sector	*28.2%*	*159.0*
Public administration	*12.4%*	*69.9*
Non-profit organizations	*57.4%*	*323.4*
Other	*2.0%*	*11.4*
FC currency	**16.4%**	**110.7**
Total deposits	**100%**	**674.4**
Corporate	40.0%	–
Households	60.0%	–

Source: NBS, preliminary data from monetary review.

tion savings banks and tax relief. Treasury bills and securities issued by NBS denominated in foreign currency, and interest rates on mortgage deposit certificates are not subject to taxes. Besides others, yields of an interest nature from municipal bonds (10%), yields of an interest nature from deposit products and debt securities (15%) and income from dividends are taxed at a special rate.

Asset quality – Risk loans are considered to be one of the biggest problems in Slovak banking sector. Gross classified loans account for 21% of loans provided to non-financial sector. This figure is one of the highest in the region. Credit quality is however mainly a consequence of the heritage of the behaviour of banks in previous years. Prudent lending policies adopted by banks and restructuring intervention should limit the relevance of a new considerable flow of bad debts.

Non-traditional banking operations

Similarly as in other economies in transition, revenues generated by banks include a relatively high percentage of interest revenues, due to relatively high profits from traditional bank operations and lack of modern bank products. One would assume that the proportion of non-interest revenues would grow due to creation of financial groups or strategic alliances with financial institutions focusing on financial services.

Growth of asset management and investments in unit trust funds (domestic and foreign) may be considered the most dynamic in recent periods. At the beginning of 2002, some SKK 9 bln. was invested in Slovakia in domestic as well as foreign unit trust funds, with further growth expected. This positive development has been influenced by the following factors: a significant decline in interest rates on the banking market, a growth of confidence among citizens in domestic unit trust companies, (their founders being reputable banks), the penetration of foreign unit trust funds into the domestic market (their share represents approx. 25%), the tax advantages of investing in unit trust funds[13].

Table 7 – Profitability of the banking sector

	1999	2000	% change
Net interest margin	-265	-4,062	n.s.
Other operating income (gross)	22,440	24,505	9 %
Net operating income	2,247	8,031	257 %
ROA (%)	-4.0	0.5	n.s.
ROE (%)	-61.2	8.9	n.s.
CTI (%)	89.9	71.9	-20 %
Equity/ Total Assets (%)	6.27	5.81	n.s.
Equity/ Net Loans (%)	11.79	12.04	n.s.

Source: NBS. In SKK million, if not stated otherwise. This data includes also Konsolidačná banka.

To be continued in issue 5/2002

Table 6 – Credit quality in the Slovak banking sector

In non-financial sector	1996	1997	1998	1999	2000	2001
NPL ratio*, gross %	31,2	32.6	37.0	30.9	21.6	21.2
NPL ratio, net %	24.8	26.0	30.9	21.2	5.5	4.0
Substandard (mln. SKK)	15,070	15,611	22,256	21,131	6,840	5,555
Doubtful (mln. SKK)	10,371	9,780	10,536	13,247	8,978	4,096
Loss (mln. SKK)	92,128	101,514	117,140	92,750	71,949	61,389
Total non-performing (mln SKK)	117,569	126,905	149,932	127,129	87,768	71,040
Provisions over NPLs %	29.1	29.0	25.4	42.6	78.7	84.3
Provisions over gross loans %	8.7	8.9	8.9	12.3	16.9	17.7

Source: NBS. In SKK million, if not stated otherwise.

[12] This break-down exists only for SKK deposits.

[13] E.g. the capital gain of a private individual from a unit trust fund with tax domicile in the SR is, up to the amount of SKK 50,000 per year, tax-free. Following three years retention, it is tax free up to an unlimited amount, similarly, after three years, capital gain flowing from abroad is also tax-free.