



SLOVAK BANKING SECTOR

NEW LOOK AND NEW CHALLENGES

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Part 2

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Legal Environment

Proper functioning and effectiveness of the legal framework is an essential step in guaranteeing a sound and stable operating environment for banks.

The 2001 EU Commission Report on convergence towards the EU, states that Slovakia already has a functioning market economy, which should be able to withstand pressures arising from the Common Market in the near term, provided further effort is placed in terms of implementation of the structural reform program. Concerning legal developments, the EU Commission notes that effective implementation of the legal framework needs to be strengthened, although the legal rules for a functioning market economy are largely in place and additional changes are already being prepared.

Strong revision of the legal framework is underway, in an effort to adapt quickly to best international standards. New Act on Banks and new Act on National Bank of Slovakia were adopted in 2001, Act on Bankruptcy was amended, and some fundamental amendments to Commercial Code were adopted in October 2001. Similar approach is expected also in case of right of lien and guarantee rights. Besides related measures and executive regulations, addressing the problem of proper functioning of the judicial system is a major priority.

Quality of Environment

All banks basically have equal conditions for functioning on the market, including taxation and regulatory and accounting standards. Banking activities are tied to a permit from the National Bank of Slovakia, while at the same time not every bank has to carry out all activities stated in the Banking Act. General tax regulations apply for legal entities.

The position of subjects conducting business in the fields of banking activities is unequal with regard to the protection of deposits, where construction savings banks pay a fee only half the amount compared to other banks. Such favorable conditions provided to construction savings banks will be, according to present legislation, reduced gradually, and fully removed starting from 2005.

Banks Regulatory Framework and Regulatory Practices

Banking regulation has been recently affected by major

changes in the banking legislation in 2001. The aim was to create environment that would be compatible with conditions in the EU. Major changes brought by the new acts concern introduction of supervision on a consolidated basis (on financial groups, instead of on single companies) and realignment to BIS requirements in terms of risk weighted capital adequacy requirements (including also set up of capital in terms of market risks).

Compatibility in terms of accounting, fiscal matters, other laws and regulations are further issues to be addressed.

Regulatory Framework

Regulation and supervision over the Slovak financial sector is carried out by means of specialised institutions rather than through one integrated body. Such an approach requires close cooperation of individual regulators, to ensure transparency and to avoid that regulators negatively influence the effectiveness of the activity of the group and subsequently also the financial market.

Institutional regulation and supervision over the Slovak financial sector is carried out as follows:

a) National Bank of Slovakia supervises the banking system. A partial regulatory function is performed also by the Ministry of Finance, which, together with the NBS, is responsible for the creation of legislation and accounting methodology,

b) Financial Market Agency is responsible for supervision of the insurance industry, collective investment and securities markets. It cooperates with the Ministry of Finance for regulation,

c) Ministry of Labour, Social Affairs and Family in cooperation with the Ministry of Finance regulate and provide supervision on additional pension insurance.

During 2000 the Financial Market Agency was created, which was intended to take over gradually the task of an institution of integrated supervision over the whole financial market. At present discussions are ongoing as to the advantages and disadvantages, as well as the prerequisites for the creation of an integrated supervisor over the financial sector given the conditions of the Slovak economy. Such an integrated supervisory agency has already been set up in the UK, while other EU countries, like Italy, continue to prefer a non-integrated approach, with strict cooperation between institutions.

Harmonisation of regulatory codes was assessed, in accordance with the Twenty-five Basle Core Principles for Banking Supervision, for the first time in 1998. In 2000, a second assessment was carried out, this time in close cooperation with the World Bank. Most of the recommendations of the World Bank are incorporated into the amendment to the Act on the National Bank of Slovakia (which came into effect in May 2001) and in the new Banking Act, which was approved by Parliament in autumn 2001. The Act on the National Bank of Slovakia and the new law on banks are basic legal standards, which create the legislative prerequisites for harmonisation of regulations with Council Directive 93/6/EEC of 15.III.93 on the capital adequacy of investment firms and credit institutions. In accordance with this law, as well as Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions, National Bank of Slovakia is preparing new Regulatory Rules that are to become effective already in 2002.

With regard to harmonisation works for accession to the European Union, Slovakia has preliminarily concluded all three related Acquis Chapters (3,4 and 11).

Regulatory Practices

Regulation in the field of capital

Regulation in the field of capital is carried out by means of the capital adequacy ratio. The calculation of the capital adequacy ratio is approximated to BIS standards (1988), including a minimum capital adequacy requirement (8%). Reserves, the delimitation of their content as well as the amount included in capital, are a debatable item. According to national regulation, general reserves can be considered in the calculation of capital used for capital adequacy. This is not acceptable for some EU Central Banks such as the Bank of Italy, but it is still debatable whether this is in line with BIS requirements. Problems are linked also to the accounting definition of the content of reserves.

The quantification of risk-weighted assets, including risk weighting, is approximated to BIS regulations. The current calculation of the capital adequacy ratio does not take into account market risks, but new regulations are being prepared taking this also into account. All problems relating to price formation in an illiquid capital market will be considered in the objectivity of the calculation.

Risk regulation and practices

The current regulatory codes do not have special requirements in relation to the bank's system of risk management practices. The regulatory codes on exchange rate and liquidity risks approach most closely the best practices of risk management.

In terms of foreign exchange risks (part of market risks), measures of the National Bank of Slovakia stipulate limits for positions in FX currency and two limits for liquidity.

Other *market risks and the interest rate risk* are not regulated.

The regulation of the development of *credit risk* is performed through quantification of the development of the quality of loan assets through classification of loan receivables and their cover by adjusting items and reserves and the measurement of risk concentration in relation to a single client. An objective picture of the value of assets at each time (an accounting principle) is not applied, the obligation to create adjusting items is carried out on an annual basis in relation to accountancy.

The new Act on banks creates the legislative conditions for strict regulation in terms of risk management practices, in accordance with best international practices. Nevertheless, many banks, mainly those with foreign shareholders, have already created conditions for the implementation of the Act in this field.

Provisioning Requirements

The measure of the NBS creates a regulatory framework for the quantification of the need for own capital, in accordance with individual classification categories of receivables. Classification of receivables is set according to delay of repayment and evaluation of financial position of the creditor. Provisioning up to 2% of standard loans is created as a general reserve and is tax deductible up to this limit: 5% provisioning is required for watch loans, 20% for substandard, 50% for doubtful and 100% for loss loans. For categories of classified receivables, however, the linked collateral value is deducted from the nominal value of loan.

By deducting the value of collateral, individual banks use their own procedures to value the "real" value of the collateral. In view of the low recovery rate this could be a risk for the sector. In accordance with the latest amendment to the tax laws, it is possible to include most adjusting items in tax expenses.

Accounting criteria and differences from international standards (IAS)

Slovak accounting standards still differ from IAS, even if there has been an effort in terms of adaptation. Slovak banks are obliged to publish their balance sheet according to NAS only.

With regard to these differences between the domestic and international accounting and auditing standards (the field of capital accounting, valuation of collateral, accounting of interest on non-repayment of loans, leasing, fair value appraisal standards) Slovakia has joined the international project "Strengthening of the National Systems of Accountancy and Reporting". In 2002 an amendment to the Act on Accounting and an amendment to the Act on Auditors are to be prepared considering that in 2003, in the so-called transitional period, accounting procedures should follow both standards and 2004 should be the year of a definitive transition to IAS in the framework of the entire State. Thereby harmonisation of the legal standards of Slovakia in the field of accountancy with EU directives, as well as with International Accounting Standards will be ensured.



However, the World Bank and the IMF require two decisive changes in the accounting of banks, even prior to 2003 - before the transition to International Accounting Standards:

- to value securities on a quarterly basis in accordance with market value (to be ensured through the issuance of a respective measure by the NBS),
- with regard to the elimination of the accounting of interest on assets with a delay of 90 days or more, an amendment to the Act on accountancy and related regulations should be presented in Parliament.

Parameters of Operating Risks

So far in Slovakia operating risk has not been regulated, and as a result neither the creation of reserves nor adjusting items covering this type of risk have been regulated. Individual banks have their own policy of measuring operating risk and, as a consequence, of creating reserves and adjusting items in this field. Most often reserves are created for payment cards, as well as for other areas that external auditors have identified as problematic. The NBS requires that auditors' reports also provide information on the performance of IT audit, security, correctness and completeness of the work of the systems and adherence to prudent conduct of business, including economy in the operating field (banks, having foreign owners for a long time period, use IT back up as a component of their standard).

The New BIS Regulatory Framework

The existing and prepared bank legislation shall create a framework that provides the possibility of implementing BIS II in the Slovak banking system.

When implementing BIS II, great emphasis will be placed on credit risk, which is and also in the near future will be the most significant issue in the framework of Slovak banking. The NBS will consider single banks' approach to credit risk evaluation, distinguishing among those that can rely on internal models and those that should use external models.

General Legislation

With regard to the type of environment and banking activities, Act on Bankruptcy as well as legislation related to collateral and guarantees are considered to be the most important general legal standards in transforming economies.

Act on Bankruptcy and its efficiency

The Act on bankruptcy proceedings and settlement no. 328/1990 Coll. was passed by the Federal Assembly of the Czech and Slovak Federal Republic and came into effect on the 1st of October 1991 and, since then, it has been amended 14 times. The law is very complicated, due to the fact that various amendments over time, while introducing different legal treatments, also touched some of the proceedings that were already being applied. Average time of settlement of the bankruptcy process is high and ranges between 3 and 5 years.

Two recent amendments to Act on Bankruptcy (in 1998 and 2000) improved this Act significantly.

These amendments removed various delaying elements from the law and created the legal framework for the speeding up of bankruptcy proceedings. An increase in the effectiveness of regulation, following these last amendments, is shown by the fact that the number of entities under bankruptcy proceedings dropped slightly from 6,358 (at the end of 2000) to 6,263 (at the end of 2001).

Despite recent amendments, Slovak Act on Bankruptcy calls for certain improvements. One important area of intervention relates to limited power of creditors, especially as regards the judicial procedures. Enforcement of regulation, via strengthening of the judicial system, is a major priority to address. The 2001 EU Commission Report on Slovakia notes that staffing in Courts should be strengthened and training of judges intensified to make the new bankruptcy provisions fully applicable and effective.

Collateral and pledge law

The legal regulation of collateral is not covered by one single act or provision, due to the traditional system of legal regimentation in Slovakia. Collateral can be organised on both movables and real estate properties, however registers exist only for real estates (Cadastral Office) and securities (Security Centre), while no register is set for movable properties, with the obvious drawback in terms of risk of over-pledging and unclear lines of precedence.

Status of registers is as follows:

- The *Cadastral Office* is the register of real estates in Slovakia, specifying their owners, liens, etc. The office is undergoing a phase of institutional transformation, which should enhance its effectiveness. According to amended regulations, cadasters have become independent and specialized branches of public administration starting from January 2002; this created certain basis for correct functioning and it also improved changes for centralized data management. Cadaster itself is not equipped yet with sufficient number of PCs and is not operating in real-time (on-line). The process of reforms and modernization is actually running currently; cadasters have begun working on-line, however, searching in the system is still too complicated.

The major problems relating to the functioning of the cadastre regard the long time required for registration and provision of information. In order to register a new mortgage, a time period of between 1 and 30 months is required. In order to receive information from the system, a time period of 1 to 2 months should be required (following the law on cadastres), however a much longer period is standard..

- The *Security Centre* is the register of all securities, where also liens over securities are registered. The Security Centre creates its own regulations, often not in accordance with legal regulations or generally accepted legal opinions and principles. Its functioning is negatively affected by its monopoly status, multiplied by the fact that on the one hand its legal form is that of a joint stock company and on the ot-

her hand its only shareholder is the Ministry of Finance. Registration of pledges/mortgages at the Security Centre is mandatory

- At present, a functioning register for movables or other assets does not exist. A project is being developed and the Notaries Chamber of the Slovak Republic has been selected to run it. The introduction of a non-possessor right of lien is a further step which should be achieved soon.

In general practice, collateral does not operate properly in Slovakia. Major problems are:

- The poor functioning of existing registers and lack of a register for movables hinder certainty in terms of order of priority;
- The order of preference of creditors in the right of lien gives a priority to the State and its institutions, irrespective of effective precedence. This is a significant problem, especially when the relevance of tax and social security arrears in the country are considered;
- The third party guarantee is not effective. If the pledger is different from the debtor, it is practically impossible to achieve Court enforceability;
- The enforceability of law is limited by poor functioning of the judicial system.

Other Legal Issues

Corporate governance

The regulation controlling banks as commercial companies is legally embodied in general in the Commercial Code and some specifics of banks are embodied in the Banking Act as a *lex specialis*. Besides others, above mentioned act stipulates new conditions for members of statutory bodies, such as personal financial accountability when breaching set rules or states a prerequisite of university education and five years of banking practice (including three years in managerial position).

The management of other companies obeys the Commercial Code, newly approved in October 2001, which does in a significant way strike into the so-called laws of commercial companies. The new amendment besides the reduction of quorum necessary to convene the Extraordinary General Meeting, will increase the protection of minority shareholders. On the other hand, however, the new Act on securities by the elimination of duty of public covenant at the purchase of more than 30 percent of shares of the registered capital excludes the possibility of minority shareholders to realize their investments for the adequate prices. In addition the proposed amendments should also deepen the personal liability of the members of bodies of banks. Through these amendments there should occur harmonisation with European Union regulations.

Bank Secrecy

Bank secrecy exists and is regulated in a relatively conservative way, which provides protection to clients and creates

confidence in banks, but can cause difficulties in terms of time and procedures for banks in the assertion of their interests. The subject of banking secrecy is formed, in accordance with § 89 - 93 of the new Act on banks, by all data and information on banking trades, products and other matters concerning clients, which are not publicly available. Any notification of data, information and reports relating to banking secrecy is possible only with the consent of the client with an exception concerning, in particular, notifications of data for the purposes of various legal proceedings (criminal, civil including bankruptcy proceedings, tax, customs, executorial), for the purpose of protection against the legalising of incomes from criminal activity (money laundering), for financial control and audit.

Privacy Protection

Protection of privacy is also governed by conservative regulations. Personal data is strictly protected in IT-systems based on Civil Code, Act on Personal Data Protection, and by Penal Code. Some of this data cannot be collected at all and processed, if not stipulated by a specific act on specialized bureau, for a purpose strictly defined by law (e.g. Statistical Office of the Slovak Republic at population census, Slovak Information Service and National Security Bureau, or bodies responsible for penal proceedings upon consent from public prosecutor or court). Consent of the respective person is not sufficient for obtaining this data; in order to obtain such data all additional terms and conditions resulting from law and enabling the respective body to obtain and process such data must be observed to. Other personal data can be retrieved and processed only upon consent of the respective person.

Money Laundering

Money laundering has been strictly regulated by Act No. 367/2000 on Restraining of income from money laundering, which covers not only banks but among others also asset management companies, securities' dealers, post offices, even casinos and shall protect against possible money laundering by means of reporting any suspicious financial operations exceeding SKK 100,000.

By way of amendment of the Civil Code as well as the new Act on banks, anonymous bank deposits are no longer permitted in Slovakia.

Deposit Insurance

In Deposits insurance was a subject of change in November 2001. Starting from December 1, 2001, deposits of citizens and of certain legal entities are protected against possible bankruptcy of banks up to 30 times the average salary in Slovakia during the last 9 months of the year. Starting from July 2002, this limit will increase to 40 times the average salary. This protection thus applies to a limit, which now represents around SKK 370,000. By the time of accession of Slovakia into EU the limit of € 20,000 will apply.



The Deposits insurance fund, which is responsible for re-payment of lost deposits, is funded by commercial banks by means of regular and special transfers. Regular annual transfers represent 0.1% to 0.75% of the insured amount of deposits. Special transfers range between 0.1 and 1.0% of insured amount of deposits.

Areas related to bank activities

Financial, Foreign Currency and Equity markets

The Slovak koruna money market has become standard, liquid, and stabilised due to the change in monetary policy, as well as through the restructuring of market. In 2000, the National Bank of Slovakia introduced a limit to interest rates in repo offers, thereby creating a system of interest rates. Thanks to the liquidity and relative stability of the money market, this resulted in a significant lowering of interest rates and the new system began to be used to a greater extent in the framework of interest rate policy of market participants. As to products, deposit products prevail, followed by FRA.

The size of trades on the primary market for short-term government securities (Treasury Bills) has been positively influenced by tax benefits. As a consequence of the agreement on the limitation of double taxation, foreign revenues from Treasury Bills purchased on the primary market were in fact not subject to taxation. This helped to reduce prices. Despite formal abolishment of these allowances, there still exists a possibility for arbitration.

The secondary market for Treasury Bills has been negatively influenced by the non-resolution of methodological problems regarding the taxation of Treasury Bills, and therefore their trading by domestic financial institutions has been carried out only in isolated cases.

From mid 2000 it is possible to say, that there is a complete yield curve of the financial market, even if only for the shortest maturities. Even if BRIBOR interest rates are quoted in the full range (overnight, 7, 14-day, 1M, 3M, 6M, 9M, 12M) the most liquid are maturities of up to one month. The same can be said of the yield curve of government bonds, which was completed in the year 2000 through the issue of government bonds with maturities of 5 years or longer. Low liquidity of certain products, however, hinders reliability.

The foreign currency market is significantly influenced by the rating of the country, as well as of individual banks. Foreign banks prevail in the foreign currency market, accounting for 84% of total turnover, due to various factors: a bank rating reflecting low independence and individuality, a freeing from RRR in swap trades as well as the significant participation of foreign banks in these trades. In the framework of domestic banks in 2000 there was a decline of as much as 20%, with swaps being prevalent (more than 70%), spot trades only 27.3% and forward trades 1.1%. This trend was al-

so continuing in 2001. The average daily turnover in the year 2000 was USD 42 million.

The capital market, following the introduction of elements that should contribute to its revival, is gradually becoming an alternative to the exclusive financing of public needs, while for other (private) needs it is non-functioning. Increases in trades, in particular in equities, are mostly linked to privatisation transactions and the realisation of public covenants in connection to these. However, the inability to institutionalise one single stock exchange (two currently exist: the Bratislava Securities Exchange and Slovak Stock Exchange) continues to hinder its development. Future reform of pensions system will be of key importance for further development of capital markets by means of introducing obligatory capitalization principle.

Payment System

The inter-bank payment system in Slovakia is based on the existence of a single clearing centre (for retail and large transactions), with all banks being obliged by law to execute domestic payments by means of this clearing centre (BZCS, a.s. – Bank Clearing Centre of Slovakia, a.s.). The majority shareholder of BZCS, a.s. is the National Bank of Slovakia which is responsible for the coordination, integration and effectiveness of the domestic inter-bank system of payments, as well as the management and coordination of the system of payments abroad.

Other shareholders are commercial banks and the Ministry of Finance. Transactions in foreign currencies in the domestic payment system are cleared similarly to payments to abroad, through the classic bilateral relationships using a system of nostro accounts.

The existing system has various advantages: with regard to the management of liquidity and with regard to the fact that one clearing account exists, data is processed consistently, non-bank subjects have access to the system, the system works 24 hours a day, with data being sent over 21 hours (3 hours for processing and maintenance). Two major disadvantages however exist: closing time at 13.00 hours daily, as well as the non-existence of clearing of large payments in real time (RTGS).

In relation to preparation for EU entry, as well as in connection with the multinational payment system TARGET, the NBS is preparing a new Act on the system of payments in the Slovak Republic, the main element of which will be the hiving off of the processing of large volume inter bank payments to the RTGS system.

Securities Clearing System

In compliance with the Act on Securities and Investment Services, securities can be issued based on a public offering, or without it. Transfer of securities issued based on a public offering and property clearing of the transaction in SCS SR

can be done only via public markets. Transfer and property clearing of the transaction with publicly traded securities can be done only at SCS SR.

Small and Medium Sized Enterprises

The segment of small- and medium-size companies (SME) plays an important role in the economy of Slovakia (a 65% share in employment and a 52% share of GDP). SME is to play even more important role for functioning of the banking sector. However there are some critical obstacles restricting development of this segment in Slovakia. They include especially:

- Complicated legislation and rules, excessive administrative burden Significant financial burden (mainly in the scope of taxes and social contributions)
- Limited access to sources of financing, especially due to undercapitalization and high risk. Moreover, limited access to external funds is also a consequence of the non-fulfilment of certain standard prerequisites requested by banks the unavailability of micro-loans from banks as a consequence of their inefficiency, the non-existence of an independent “credit bureau”, an insufficiency of seed and venture capital.

Credit Register

In accordance with the Act on banks, banks are obliged to inform the NBS (through the Credit register) of all credits and guarantees provided to clients (corporate customers). The non-fulfilment of this duty is however not penalised and this fact highly hinders proper functioning of the system. Data in the register are updated once a month. Banks can obtain data from the bureau on the basis of an individual written

request. The system is now at the end of a three-year phase of testing, which should be completed in 2002.

Once fully implemented, the system will work on-line and banks will have to pay for connection to and use of the service.

The shortcomings connected with the functioning of the register - the indefinite identification of the client and definition of the credit products of the banks and of the quality, scope and structure of the information provided, significantly limit its usefulness.

Retail Client Register is being worked on at present (similarly as in the Czech Republic). This is a register conceived on a wider basis with parameters comparable to those of the registers in the EU, which should remove the problems surrounding the existing credit register.

Conclusion

After restructuring and privatizing former state owned banks, banking sector in Slovakia bears certain signs demonstrating sound functioning. Besides transferring bad debts to the ownership of the state and replacing them with government bonds, sound functioning of banks can be attributed also to know-how brought in by foreign investors. Further improvement of efficiency, profitability and rentability of bank activities will be closely linked to quality and readiness in which banks will be able to accept and implement crucial decisions facing both domestic and global competition. Growing quality of legal and legislative environment, strict enforcement of adopted legislation and determined implementation of ethic standards in business activities – all these factors will be crucial for completing the ongoing process begun.