NATIONAL BANK OF SLOVAKIA

DEVELOPMENT OF THE BANKING SECTOR IN SLOVAKIA

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Introduction

The beginning of the economic transformation in Slovakia relates to the former Czecho-Slovak Federation (CSFR). After the political break-down in 1989, the transformation developed under the "shock-therapy", since 1991. Simultaneously, as a constituent part of the transformation process, the two-tier banking system was created and new financial structures emerged. As of 1 January 1993, the Federation dissolved and the two successor States were established - the Czech Republic and the Slovak Republic. Despite of some populist rhetorics, the macro-economic policy of the Slovak government followed the stabilization program of the former Czecho-Slovak government. An independent development of the Slovak banking sector progressed rapidly, after the establishment of the central bank - the National Bank of Slovakia.

The aim of this paper is to present main development trends in the Slovak banking sector, during 1993-1997. Despite of a relatively short period of time, many important milestones were overcame in the way toward a standard market financial structures in the country. However, several issues remain to be solved, in order to complete successfully the process of financial restructuring in Slovakia.

The description of the Slovak banking sector development and issues of its restructuring are introduced with a short overview of the macro-economic development in Slovakia, over the period concerned. As the stabilization of the economy progressed rapidly and the economic growth, accompanied with a radical slow down in inflation, was restored since 1994, there may be stated that the macro-economic environment has been an important factor promoting the Slovak banking sector development. The second section of the paper is focused on the monetary policy of the National Bank of Slovakia with respect to its performance and use of related instruments, as well as from the point of view of feedbacks with the development of the real economy variables. A special attention is paid to the practice of monetary targeting and to the exchange rate regime in the current Slovak conditions.

Current landscape of the Slovak commercial banks is presented in the third section. Apart from the main data about the number of the banks, development of their activities and foreign capital participation, the issue of the banks privatization is discussed, as well. Finally, in the fourth section, main information on the progress in the process of financial restructuring is concentrated. A special attention is paid to the causes of "bad debts", or the loan portfolio problem. This topics discussed, the paper is closed with an overview of measures within the frame of the restructuring program of the Slovak banking sector. Important steps of the National Bank of Slovakia adopted in order to strengthen prudential regulations and to systemize claims classification, issues connected with their application in practice, as well as the current state in progressing the restructuring program are included in the discussion.

1 Main Macro-Economic Development Trends

Since the beginning of the national independence, economic development in Slovakia has changed its growth dynamics from the transformation recession of 1993, towards revival followed by high rates of economic growth, during 1994-1997. Stabilization of the economy progressed rapidly, as inflation decreased continuously. Some disturbing features in the macro-economic stability emerged since end of 1995 in the external sector, due to changes in export-import dynamics, resulting from domestic economic growth and decrease of demand abroad. An overview of the main macro-economic indicators development is given in Table 1.

Rise of the independent State called for an adjustment period in the economy. The economic development in 1993 was affected by both, economic and extra-economic factors, such a smaller domestic market, costly process of constituing the State infrastructure, as well as introduction of a new tax system (VAT base) and other reforms (as a new system of health and pension insurance). This, together with devaluation expectations after the break of the monetary union with the Czech Republic (8 February 1993) and the devaluation of the Slovak currency by 10 % (10 July), caused acceleration of inflation to the yearly rate of 23.2 %.

The economic revival began in 1994. The GDP growth reached 4.9 %, average inflation rate was cut to 13.4 %. The leading sector of economic growth was foreign trade, as the exports performance was favorable affected by growing external demand, as well as by the devaluation of the currency. On the other hand, imports were slowed down by the 10 % import surcharge, imposed in March 1994. As a result, the balance of foreign trade and services reached a moderate surplus. In 1995, economic revival accelerated with a 6.8 % growth in GDP. The average annual rate of inflation reached 9.9 %, Government spending resulted in a budget deficit of 1.6 % of GDP. An important feature of the 1995´s development was revival of consumer and investment demand in the domestic economy. However, the dynamics of gross fixed capital formation was not restored, and the economic growth was due primarily to the utilization of free capacity in production. Despite of the internal revival, the driving force of economic growth remained in the export sector.

Table 1 Main macro-economic indicators in Slovakia in 1990-1997

Indicator	1990	1991	1992	1993	1994	1995	1996	1997 [1]
GDP (%, constant prices 1993)	-2.5	-14.6	-6.5	-3.7	4.9	6,8	6,9	6,0 [2]
Industrial production (%, constant prices)	-4.8	-26.8	-13.7	-13.5	6.4	8.4	2.5	3.5
CPI (%, annual average)	10.4	61.2	10.0	23.2	13.4	9.9	5.8	6.1
Government budget deficit (%GDP)			-2.6	-7.3 [3]	-1.2 [3]	-1.6	-4.4	-4,3
Balance of trade and services (USD million)				- 619	762	570	- 2106	-999.1
Current account balance/GDP (%)				-5.0	4.8	2.3	-10.2	-10.9
Unemployment rate (%)	1.5	11.8	10.4	14.4	14.8	13.8	12.4	13.1

[1] 1-st half of the year; [2]Constant prices December; 1995; [3] Cleared from the clearing balance with the Czech Republic.
Sources: Statistical Office of the SR, National Bank of Slovakia

Another picture of economic development arose in 1996. The leading factor of a continued high increase in GDP that reached 6.9 % became exclusively domestic demand (among other, due to large government infrastructure projects), wherein namely the gross fixed capital formation recorded an important revival. Favorable as well, was further decrease in inflation rate that reached 5.8 %. On the other hand, serious imbalances occurred in the foreign trade sector. Rapid growth of the domestic demand, supported by a rapid growth of wages, caused a huge increase in imports, while the export dynamics slowed down. As a result, the deficit of the current account reached 11.1 % of GDP.

In the first half of 1997, the dynamics of the economic growth slowed moderately down to 6.0 %, while inflation growth accelerated to 6.1 %. As domestic demand has remained at the former high levels, the Slovak government adopted several measures in order to stop with dangerous developments in the external sector. Apart from re-introducing of the import surcharge at the level of 7 % and enlarging duties in certification of imports, regulation of wages will be imposed in the last quarter of the year. This, however, should serve as a means of slowing down the import growth dynamics, but does not resolve the issue of an unsatisfactory growth in Slovak exports. As a serious issues of the macro-economic stability remain growing amounts of government spending and of the government budget deficit.

During 1994-1997, the economic performance in Slovakia increased prevailingly by an extensive way of joining free productive capacity, without significant requirements in additional labor force. The rate of unemployment decreased only slowly, from 14.4 % in 1993, to 13.1 % in the 1-st half 1997. Some increase in the demand for labor was observed in 1996. This, however, was slowed down by gradual exhausting of the industrial capacity, as features of "overheating" emerged in some industrial branches, mainly of those with high shares of export orientated production.

For a small open economy as Slovakia, the development in the external sector represents one of the key factors of the overall macro-economic stability. Unfortunately, prevailing part of the Slovak exports is formed by semi-products and products with a low level of manufacturing, which - together with a backward in the technological recovery in general - causes a low competitiveness of the Slovak exports. On the other hand, import requirements of the Slovak economy are very high (closely to 70 % GDP) in general, and, moreover, there are many items (apart from energy and row materials, consumer goods as well), which provisioning is fully dependent on imports, because they have no substitutes at the domestic market.

As follows, the present Slovak foreign trade issues are closely related with the weakness of the domestic industrial structure. A rapid revival in exports dynamics is not expectable in the short run. Nor the resulting way of slowing down imports is simple in practice, while with restraining of consumer imports supporting of technological imports should be required. As an alternative source of new technologies are foreign direct investments (FDI). However, the FDI inflow to Slovakia is remaining at a very low level, and, moreover, prevailing part of them went to the trade and banking sector, or have not represented an inflow of strategic investments for economic restructuring.

Nevertheless, strengthening of the willingness to the recovery necessitates improvements in the management structures of the enterprise sector, which is primarily conditioned by closing the privatization process. Despite of the fact that by using official data the role of the private sector in the Slovak economy seems to be relatively high (in 1996, 76.8 % of GDP and 68.2 % of the industrial production were generated in the private sector), a process of restructuring within the new owners and with a larger participation of foreign investor is well expected.

2 Monetary Policy of the National Bank of Slovakia

The National Bank of Slovakia (NBS), established by the Act of the National Council No. 566/1992 as the central bank of the Slovak Republic, commenced operating on 1 January, 1993. The NBS is an independent central bank the main priority of which is maintaining of the stability of the Slovak currency and keeping inflation under control.[1] To meet this task, the Bank determines the monetary policy and instruments for achieving the monetary policy targets. Within the limits of the Act on the NBS, the Bank shall support the government economic policy. The second prior function of the NBS is to ensure a healthy development of the Slovak commercial banking sector.[2] The NBS represents the Slovak Republic in the international financial institutions and carries out activities in convertible currency on behalf of the State in international financial markets. The Bank has the right to issue legally binding rules and regulations that are of the same juridical power as those of the ministries and other executive bodies of the State.

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[1]The supreme bodies of the NBS are the Bank Board and the Directorate. The Bank Board is the highest management body of the NBS outlining Slovakia´s monetary policy and the instruments for its implementation, and making decisions on regulations to be imposed by the Bank in order to control the money supply and inflation. The members of the Bank Board are the Governor, two vice-governors and five other members. The Governor and vice-governors are appointed for a 6-year period by the President of the SR upon the proposal of the Government and endorsement by the Slovak National Council. Other members of Bank board are appointed for a four-year period by the Government upon the proposal of the Governor. During the membership in the Bank Board, members cannot perform functions of a Parliament deputy nor a member of the Government. The executive body of the NBS is the Directorate responsible for implementing the Bank Board decisions. (Within the amendment of the Act on the NBS, that was initiated by the Slovak government in summer 1997, but not yet approved in the Parliament, extension of the Bank Board by experts out of the Bank to a total amount of 10 members has been proposed. This, probably, will have an unfavourable impact on the independence of the NBS.)

[2]By the Act on the NBS, the banking supervision is institutionally merged within the NBS. During 1994-1995 the NBS passed a series of provisions, which made the rules for prudential behavior of the banks substantially stronger as compared with the past. The *NBS Provisions Nos.1-4/1994* concern the licensing requirements, capital adequacy, large credit exposure and the foreign exchange position of the bank. The prudential regulation parameters were set in accordance with the BIS standards. In 1995, an important step in progressing the process of financial restructuring of the Slovak banking sector was made by passing the *NBS Provision No 3/1995 "On rules of evaluating banks¢ claims and off-balance sheet liabilities according to the risk contained therein and of reserving funds in order to provide against those risks"*. By the provision, classification of the bank claims into five categories by the criterion of credit risk was introduced. Strengthening of the prudential regulations has had a favorable impact on all areas concerned.

2.1 Monetary policy performance

Target and intermediate targets. By the law, the monetary policy goal of the NBS is ensuring the internal and external stability of the Slovak currency. The main monetary policy target is to control the rate of inflation, which is performed throughout two intermediate targets: maintaining of the fixed exchange rate (within a defined fluctuation band) of the Slovak crown as a longer-term target and the yearly growth of the money supply expressed by the monetary aggregate M2[3]. The operational variable is the central bank money - the monetary base, defined as a sum of bank reserves with the NBS and the cash-currency in public and commercial banks holdings. The monetary base is regulated by means of discount and Lombard rates, open market operations, and minimum reserve requirements.

Development in using monetary policy instruments. Since the beginning of operating, the strategy of the NBS has been to reduce continuously using of direct instruments and to enlarge the use of the indirect ones. However, the importance of individual instruments developed in a close relation with the monetary development in Slovakia, which recorded some substantial changes, since 1993.

The monetary environment in 1993 was hardly marked by the establishment of the national independence and emerging Slovak financial market, given that firstly the single Government Budget Act of the Slovak Republic was introduced in this year. Due to the lack of liquidity in the banking sector, refinancing from the NBS by the way of auction refinance credits and rediscount credits reached high amounts. An important role played credit limits. After devaluation of the currency from July, in order to influence public expectations on a disinflationary monetary policy of the NBS the discount rate was increased to 12 % in December (as compared with the former rate of 9,5 %). Open market operations, after repurchase agreements were introduced, developed in this year rather slowly.

During 1994-1995 the monetary development stabilized and enabled a more systemic selection in using the monetary policy instruments. The importance of the credit limits slowed down, as their general use was cancelled and limits were set only for banks with credit activities exceeding SKK 20 billion, and finally, wholly abolished, as of 1 January, 1996. In March 1995, in order to support economic growth, the discount rate was slowed down to 11 %, and as the disinflation process continued all over the year, the discount rate was cut again to 9,75 % in October and to 8,8 % in January 1996. Changes were made in ratios of required minimum reserves (RMR) as well, in order to withdraw the excessive liquidity of the banking sector that became a serious issue, since the second half of 1994. The former 3 % and 9 % ratios on time and demand deposits respectively, were unified to a single higher level of 9 %, in August 1996. In October 1996, the RMR on building saving deposits were increased from 1 % to 3 % and to this date, the interest on the RMR paid by the NBS was introduced at the level of 1.5 %.

The importance of the open market operations (OMO-s) of the NBS in controlling the money market increased in 1996. Apart from REPO and re-REPO operations, a constituent part of the OMO-s became purchasing in own bills of the NBS. During 1996, issuing of the NBS-bills for sterilization purposes became regular, as in conditions of relatively favorable government budget performance, limited amounts of the T-bills issues were not able to swallow up the growing liquidity of the banking sector. In 1997, as the NBS has continued in a tighten monetary policy from the last months of the previous year, a quantitative management of the banks´ liquidity by intermediate of the OMO-s was introduced. The REPO rates for individual REPO-s were cancelled and REPO-tenders only became the means of the monetary policy performance, since the beginning of the year. Thus, banks were deprived from an automatic access to refinancing in the NBS.

Some comments on the NBS monetary targeting. The NBS adopted a two-target monetary policy orientation, that in theory are excluding each other (fixed exchange rate of the currency and growth of the money stock M2*)*. This was enabled due to the starting conditions of a limited (internal)

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[3]The aggregate M2 is defined as a sum of narrow money M1 and the quasi-money, or as a sum of notes and coins in circulation, demand deposits, time deposits (including deposit certificates and deposits by building societies) and foreign currency deposits.

convertibility of the Slovak currency, which put substantially lower requirements in foreign exchange reserves and interventions of the central bank. Furthermore, relatively high level of the monetary protection has been preserved after liberalization of the current account of the balance of payments (as of 1 October 1995), as well. Another supporting factor for continuing in this practice, has been gradual extension of the fluctuation band of the exchange rate of the Slovak crown (+/- 7 % against the basket parity, currently).

Table 2 Monetary targets of the NBS

	Monetary program		Actual values	
	M2 (in per cent)	inflation (CPI)[1]	M2 (in per cent)	inflation(CPI)[1]
1993	12	17.0	18.3	25.1
1994	13.2	10.0 - 13.2	18.9	11.7
1995	12.3	8.0	21.2	7.6
1996	11.6 +/-0.6	6.0 -7.5	15.7	5.6
1997	10.7	4.9 - 5.8	12.8[2]	6.2[2]

[1] Yearly indexes Dec./Dec. ; [2] September 1997/September 1996.
Source: National Bank of Slovakia

Nevertheless, a dynamic inflow of foreign exchange resources supported by favorable foreign trade development (during 1994-1995) and by enormous increase in foreign loans for financing large imports (since 1996), continuously resulted in an excessive growth of liquidity in the Slovak banking sector. This put permanent pressure on the growth of the money stock. In spite of sterilization activities of the NBS and regardless of other interdependencies (e.i. higher actual then expected growth of GDP, unconvincing level of stability of the money velocity), the targeted money stock growth was exceeded each year (see Table 2).

In fact, due to the fixed exchange rate, foreign exchange policy requirements in a safe level of the foreign exchange reserves of the NBS were, implicitly even in the period in consideration, the leading criterion in valuing the importance of fulfillment the external and/or internal intermediate monetary policy target. From this point of view, the monetary policy management was successful, since the 1993´devaluation. Foreign exchange reserves of the NBS have grown gradually: while at the end of 1993 they represented the value of 0.7-month Slovak average import of goods and services, the 1995 end-year level covered 4-month average imports. However, growing import requirements in the foreign exchange resources have caused some decrease in the reserves/imports ratio, resulting in 2.8 monthly average imports in June 1997.

It is obvious that the main issue of the NBS monetary targeting is to be found in actual possibilities of the NBS to control the money supply. That means the NBS ability to control the development of the resource (assets) side of the monetary base and/or the effectiveness of regulations undertaken towards the use of the monetary base, i.e. of the central bank money (bank reserves with the NBS and currency issued). Findings were made that the NBS´s possibility of controlling discretely the monetary base resources was in practice neglecting[4], as movements in the monetary base have been prevailingly (by over 90 %) influenced by the development of net foreign assets that are not directly controllable by the central bank. A rapid growth in net foreign assets has resulted in an excessive liquidity of the banking sector. Consequently, banks became independent of the NBS reserve money. Additionally, the banks were able and willing to keep in their portfolios safe government securities, but even these could not absorb the excessive liquidity. As a result, the NBS was put into a defensive position of a sterilization policy, which resulted in permanent issuing of its own NBS-bills. As a consequence of losing effective control over the banking sector was an enormous expansion of the banks´ lending activities against the private sector.

[4]Apart from the mentioned, there is a prerequisite of a stable (or predictable) value of the money multiplier between the monetary base and the targeted monetary aggregate (M2, in our case). The stability of the money multiplier has been found rather doubtful, as well. See for example: KOMÍNKOVÁ, Z.: Regulation of the Money Stock and Issues of Monetary Targeting in the Slovak Republic. Biatec, 4,1996, No.8, pp. 29-36.

Tightening of the monetary policy. Taking into account rapid economic growth and a continuous disinflationary trend in the economy, the NBS did not implement measures targeted to the reduction of the growth in the money stock, till summer 1996. Main factor in the final decision of tightening the monetary policy was an extreme dynamics in the M2 growth that indicated an increase close to 40 % to the end of 1996. In order to slow down the lending activities of banks that were the main factor of the money supply expansion, the NBS adopted in July 1996 a package of measures orientated against both, domestic and foreign currency credit expansion: the ratio of required minimum reserves was increased (unified) to 9 %, the Lombard rate was increased, as well, to 15 % (i.e. by 2 points).

Apart from this, an attempt to slow down huge foreign exchange lending activities of banks (and to avoid a potential risk of decrease in foreign exchange reserves of the NBS), a regulation called *bank foreign exchange position for monetary purposes* was introduced. The regulation (operating apart from the banking supervision foreign exchange position) imposes to banks a required foreign exchange assets/liabilities ratio, adjusted with regard to the resident and non-resident origins[5]. It came in force as of 31 December 1996. To this date banks were obliged to reach the position in the ratio of 0.65[6], at least. For 1997, the obligatory ratio was increased to 0.70 (as of 31 March) and to 0.80 (as of 30 June).[7]

Development of bank lending to personal and enterprise sectors. Increase in the banks lending to the enterprise and personal sectors was relatively low in 1993-1994, due to tight regulation by the way of credit limits. In 1995-1996, after a gradual releasing of the regulation, the growth in bank lending accelerated. Total credit to enterprises and households increased by 18.2 % in 1996 (although it is to be stressed that a considerable part of the increase in crown loans comprised interests on non-performing loans), wherein credits in foreign currency increased by 35.7 %. Apart from abolishment of credit limits (since the beginning of 1996), main factor causing for such a high increase in lending was growing domestic demand supported by a rapid wage growth. The almost twofold rise in credits denominated in foreign currency (as compared with the total credit to enterprises and households) was related with a huge increase in imports and, consequently, with the need of financing the current account deficit.

The leading tendencies in the enterprise and household sectors lending development are illustrated in Table 3. A continuos decrease in personal lending was followed by its dynamic increase, since 1996, while the expansion of enterprise lending slowed down, in 1997. However, in absolute values, the share of enterprise sector loans in the total crown enterprise and household loans has represented all over the period around 90-95 % (94.4 % in June 1997). Credits in foreign currency (extended exclusively to legal entities) have grown with the highest dynamics. Their share in the total lending reached 8.8 %, in June 1997 (as compared with 3 % in 1993). The impact of the monetary policy tightening from summer 1996 on the bank lending dynamics in 1997 is obvious.

Table 3 Bank credit to enterprises and households: yearly percentage changes

	1993	1994	1995	1996	1997[1]
total credit to enterprises and households	10.8	0.4	14.7	18.2	7.9
- credits in SKK	9.1	-1.6	12.3	16.8	9.7
- enterprises	10.4	-0.8	13.6	16.9	8.9

[5]The position is constructed as a ratio, which nominator represents the bank´s total foreign exchange assets minus foreign exchange assets with residents and denominator represents the bank´s foreign exchange liabilities plus liabilities with non-resident banks denominated in Slovak crowns.

[6]In fact, banks reached the ratio of 0.663, as of 31 December 1996. The remained uncovered position should be penalised by the way of increasing the minimum reserve requirements.

[7]An inconvenient feature accompanying fulfilment of the ratio was that banks adjusted their positions just to the prescribed date (to the end of the month), by the way of trading in short-term foreign assets and liabilities, which caused a high volatility of them. Therefore, a daily data base for calculating the ratio was introduced, since July 1997 (as compared with the previous 10 days base). This lead, on the one hand, to a substantial moderation in the foreign liabilities (assets, as well) volatility, but, on the other hand, to an important increase in the short-term indebtedness of the Slovak banking system.

- households	- 6.1	-11.3	-6.7	16.3	25.3
- credit in foreign currency	118.9	77.8	57.6	35.7	-8.0

[1] June 1997/June 1996.

Source: Monetary Survey of the NBS 1993-1996; in current exchange rate

Interest rates development. Despite of a rapid progress in the disinflationary process and of a gradual decrease in the discount rate of the NBS, lending and deposit interest rates of commercial banks remain in Slovakia relatively high. While the yearly rate of inflation decreased from 25.1 % in 1993 to 6.2 % in mid 1997, the decrease in average interest rates was substantially smaller: the average deposit rate on deposits in domestic currency (together both, demand and time deposits) decreased from 8.67 % in December 1993 to 7.75 % in June 1997 ; the average lending rate decreased from 14.01 % in December 1993 to 13.22 % in December 1996 and increased again to 14.94 % in June 1997. Thus, it is obvious that the interest rate policies of the Slovak commercial banks have developed without any close connection to the inflation development and discount and Lombard rates of the NBS. They have been rather dominated by policies of the largest Slovak banks, namely because of the fact that in the balance sheet structure of these most powerful banks are concentrated the highest amounts of non-performing loans influencing the banks´ behavior in the sense of maintaining the interest rates on a safety high level.

However, primary causes of remaining the client interest rates at the high level have been in the development of interest rates in the interbank deposit market. The official BRIBOR[8] rates moved from 4.5 % to the discount rate level of 9.75 % (December 1995) and continued to rise, reaching the Lombard rate level of 15 % (December 1996). Main factors in the BRIBOR rates development in 1996 were high sterilization activity of the NBS by the way of issuing large amounts of the NBS-bills and, increase in the required minimum reserve ratio which resulted in an increase in the RMR volume with the NBS by 70 %, approximately. A dramatic development in the interbank rates occurred in 1997, due to a very unstable development in the banking sector liquidity. A general rise in the rates was characterized by their enormous volatility. Moreover, during the end-May period, a lack of liquidity - related with the critical development in the foreign exchange market in connection with the foreign attack against the Slovak currency - caused an outstanding limitation in the interbank market trading. For this reason, banks temporarily stopped with the BRIBOR rates quotation (that was substituted with an orientation monitoring of the interbank deposit market rates)[9]. Despite of a remarkable stabilization of the rates (to the levels of around 20 %, generally) in a short period of time after the situation in the foreign exchange market was cleared, quotation of the BRIBOR rates has not been renewed wholly, till present days.

2.2 Foreign exchange policy and exchange rate regime

A brief history. Main characteristics of the foreign exchange policy and the exchange rate regime of the National Bank of Slovakia have their origin in a foreign exchange experience within the former Czecho-Slovak Federation. During 1990, a series of devaluations resulting in depreciation of the currency (Czecho-Slovak crown, CSK) by 100 % (from 7.20 CSK/1USD to 28 CSK/1USD) was undertaken and the exchange rate was fixed toward a basket of five currencies (USD, DEM, ATS, CHF, FFR[10]). From a systemic point of view, the choice of the initial level of the exchange rate was criterially conditioned by declaring the internal convertibility of the currency (as of 1 January 1991) that defined the starting space for the external sector liberalization.

The fixed rate experience from the beginning of transformation proved to be successful mainly in two ways: first, the depreciation of the exchange rate created a large space for its working as a nominal monetary anchor, which resulted in a rapid slow down in inflation; second, the performance and

[8]BRIBOR = BRatislava InterBank Offering Rate. Since July 1995, BRIBOR on overnight, 1-month, and 3- month deposits are announced; since March 1996 a 6-month BRIBOR was introduced.

[9]During this period, highest interbank rates were reached: the overnight at the level of 185.00 %, 1-month 62.50 %, 6-month 45.00 %.

[10]USD - American Dollar, DEM- German Mark, ATS - Austrian Shilling, CHF - Swiss Franc, FFR - French Franc.

territorial restructuring of the export sector toward market economies was promoted, after the CMEA-market break-down. However, the adopted exchange rate (of 28 CSK/1 USD) ranged the Czecho-Slovak crown among the most depreciated currencies within the group of the central European transition countries. Thus, the same has been the position of the Slovak crown (SKK) as a successor currency (defined at the level 1 SKK = 1 CSK, former currency basket unchanged).

Maintaining of the internal convertibility of the currency. Since 1993, a precondition for following up with the former policies was to maintain the internal convertibility of the new Slovak currency. Only after the internal convertibility was saved, maintaining of the fixed rate was declared as an intermediate monetary policy target of the National Bank of Slovakia.

Sceptical expectations with regard to prospects of the Slovak economy generated strong fears of devaluation and a critical outflow of the foreign exchange reserves of the NBS at the beginning of 1993. The NBS was obliged to introduce some administrative regulations in the foreign exchange management and finally to accede to a 10% devaluation of the Slovak crown in the middle of 1993[11]. The devaluation proved sufficient to improve the situation. Behavior of economic entities became more stable and the outflow of foreign exchanges was stopped, so that administrative regulations were cancelled gradually. On the other hand, the stabilization effect of the devaluation was supported by additionally measures adopted to restrict imports[12].

Stabilization of the fixed rate. An important step regarding the Slovak crown exchange rate definition was applied in July 1994, when the currency basket was simplified from five to two - DEM and USD - currencies, in the 60:40 ratio[13]. In the same time the fluctuation band of the SKK exchange rate was enlarged from the former +/-0.5 % to +/- 1.5 % (with a maximum daily deviation of +/-1%) against the cross-exchange rate of DEM/USD. (The redefinition of the basket was based on the currency structure of foreign exchange receipts and payments within the previous period. Their actual development in a next period confirmed suitability of the choice.)

During 1994-1995, the balance of payments developed favorably and foreign exchange reserves of the NBS (and of commercial banks as well) grew with an increasing dynamics due to a rapid expansion of the export sector activities. Therefore, possibilities of the current account liberalization were discussed since the beginning of 1995. After the Czech Republic announced the intention of retiring from the Payments Agreement[14] with the Slovak Republic (motivated by the same liberalization aim and by related fulfillment of the non-discriminatory payment conditions of the IMF´s Article VIII), the decision

[11]After the devaluation, the weight ratios of individual currencies in the currency basket reached following values: USD 49.09 %, DEM 36.16 %, ATS 8.07 %, CHF 7.79 %, FFR 12.92 %.

[12]There were namely: obligatory consultations on payment conditions of imported goods, introduction of the import surcharge of 10 % in March 1994, obligation in certificates for foodstuffs in inter-republics Czecho-Slovak trading. On the other hand, regarding the protectionist measures, the Slovak economy has a very low level of customs protection (the average level of customs duties is around 4-5%). Apart, joint-venture companies were deliberated of the customs duty on technological imports, and the customs duty on imported cars up to 1,500 cu cm was cancelled, for 1995-1996.

[13] The absolute value of the currency basket has been defined by the way of an artificial unit 1 IDX = 0,012817 USD + 0,029663 DEM.

[14]In order to promote foreign trade relations between the Czech and Slovak enterprises, the payments agreement included clearing regime in current account payments between the both Republics. Other important agreements between the both Republics, concluded in order to avoid an undesirably unrestrained break-down in mutual Czecho-Slovak economic relations, were the currency union and the custom union. The currency union broke down as of 8 February 1993, i.e. practically one month after the CSFR split, the custom union is being in force till present days.

was made and a new foreign exchange act introducing convertibility[15] of the Slovak crown on the current account transactions entered in force, as of 1 October 1995.

Toward a more flexible exchange rate policy. Within the logics of the new foreign exchange Act, adjustments were made in foreign exchange management, in order to enable a more flexible performance of the exchange rate policy. As of 1 January 1996, the fluctuation band of the SKK was extended from +/-1.5% to +/-3%. Further extensions[16] to +/- 5 % and to +/- 7 % followed, as of 16 July 1996 and 1 January 1997. Thereby, the maneuvering space for the exchange rate policy was significantly enlarged. As expected, by this way the NBS should be allowed to react more flexibly on the balance of payments development, or to control short-term foreign capital inflows, especially.

Innovations in foreign exchange trading between the NBS and commercial banks at the foreign exchange fixing of the NBS[17] were adopted, as well. In order to support development of the interbank foreign exchange market, a currency band of +/- 0,25%[18] for commercial banks trading at the fixing was introduced, minimum required amounts traded at the fixing were increased (to USD 300,000, or DEM 500,000 respectively[19]) and some obligations of banks related with the NBS´s fixing performance were removed.

As some sortie of a safety fuse, regulation - in the form of limited amounts of foreign exchange that banks were allowed to sell for tourist purposes - remained in the foreign exchange policy with the population. The regulation was abolished in September 1997.

In summary, till 1996, the NBS was successful in maintaining the fixed exchange rate of the currency. The only instrument devoted to manage the exchange rate policy was flexible using of the fluctuation band. In determining the exchange rate of the SKK, main role played the commercial banks´ supply and demand for foreign exchanges at the foreign exchange fixing of the NBS, and development of the current account. Likewise, the attack against the Slovak crown initiated by foreign investors in May 1997 was successfully overcame and the fixed rate was maintained (however, at the price of around USD 200 million from the foreign exchange reserves of the NBS).

Some comments on the fixed exchange rate sustainability: balance of payments development trends (1993-1997). Since 1993, the policy of the NBS with the balance of payments aimed to secure creation of a sufficient amount of foreign exchange reserves required for securing the fixed rate of the national currency (under a criterion of minimizing the increase in foreign indebtedness). Two issues should be discussed in this connection: *1) how the fixed rate influenced the current account*

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[15]The construction of the act enables a gradual liberalisation of the capital account transactions as well, within the act (excluding the final stage of transition toward a full convertibility).

[16] Based on the recent development analyse, the NBS by intermediate of the "Auction Committee" weekly determines in what part of the fluctuation band the exchange rate of the SKK should move during the next week. No limitation for daily fluctuations against the basket parity are set at present (as compared with the +/-0.1 %, used till July 1996).

[17]The foreign exchange fixing of the NBS represents a constituent part of the Slovak foreign-exchange market. At the fixing, Slovak crown/foreign exchange transactions between commercial banks and the NBS are performed. By intermediate of the fixing, banks are able to regulate partly their liquidity position. For the NBS, purchases at the fixing represent an important source of required level of foreign exchange reserves. The current share of the NBS´s fixing in the Slovak interbank foreign exchange market has represented around 5-7 % (1996-1997). Before, due to under-developed interbank foreign exchange market, the share of the fixing in the total amount of domestic foreign exchange operations was prevailing (close to 70 %, in 1995). Trading at the fixing is being performed only in two currencies - USD and DEM.

[18]This means that he NBS sells foreign exchanges to banks for an exchange rate increased by 0.25 % and buys for a rate lower by 0.25 %, as compared with the exchange rate value that was set at the NBS´s fixing.

[19] Before, the minimum required traded amount was 100 000 currency units in USD or DEM.

development and, followingly, how the current account influenced the financial and capital account development; 2) whether the recent development trends in the balance of payments allow to expect that the adopted level of the exchange rate will be sustainable in a longer term.

Table 4 Balance of Payments of the Slovak Republic in 1993 - 1997 (in USD million) [20]

	1993	**1994**	**1995**	**1996**	**1997** [1]
Balance of trade	-1038.0	105.2	24.1	-2105.8	-986.0
Balance of services	417.1	657.0	546.2	7.4	-13.0
Current account	***-559.0***	***712.0***	***648.8***	***-1940.8***	***-1006.3***
Net medium and long-term fin. account	272.0	958.9	772.7	1103.9	244.5
Direct investments	134.0	169.5	134.0	177.5	-28.5
Portfolio investment	-266.5	271.7	246.1	11.8	-135.5
Net short-term financial account	-125.5	-916.7	170.1	1010.2	160.2
Capital and financial account	***675.9***	***129.3***	***988.6***	***2143.8***	***404.7***
Overall balance	***58.5***	***1289.9***	***1578.8***	***237.1***	***-252.7***

[1] Cumulative January- June 1997
Source: National Bank of Slovakia

All over the period concerned, the development on the ***current account*** has been extremely influenced by results of the trade balance (apart from, the balance of services functioned as a stabilizing factor of the current account, over 1993-1995). A significant shift from the 1993´ deficit to the 1994´ surplus was mainly due to increased export growth dynamics, supported, in general, by the exchange rate measures of the NBS (devaluation from the mid 1993) and by exchange rate operations on the clearing account with the Czech Republic. The net export results were increased by anti-import measures (import surcharge, obligation in certificates on the agricultural products trading between the Czech and Slovak Republics). Since 1995, the trade balance development was influenced primarily by a huge increase in imports, while the export dynamics slowed down. The latter was due to worsening of the business cycle conditions abroad, as well as to a gradual exhausting of the devaluation effect on export prices of domestic producers. As a result, a moderate surplus from 1995 dropped to a sizeable deficits of USD 2.1 billion in 1996 and USD 1 billion in June 1997. In summary, the recent development trends of the current account have not been able to create sufficient amounts of foreign exchanges required for maintaining the fixed exchange rate of the currency: the 1996´s deficit on this account reached 11,1 % of GDP, the 1997´ half year result has been similar at the level of 10,9 % GDP. Moreover, financing of transactions on the current account by using long-term resources from the capital account became current.

Development on the ***capital and financial account*** balanced, in general, the results on the current account so that the overall balance of payments resulted in surpluses, till 1996. In half 1997, a deficit of the overall balance was recorded (USD 253 million), which indicates growing imbalances in the whole external sector of Slovak economy. As concerns the short-term financial account, a huge increase in the net short-term funds was recorded in 1996: the share of short-term funds in the capital and financial account reached approximately 50 % (the increase in speculative short-term liabilities of the banking sector shared by 30 % in the total yearly net capital inflow). The short-term capital inflow was regulated by the way of a gradual extending of the fluctuation band of the SKK´s exchange rate and by introducing the regulation "foreign exchange position for monetary purposes" (July 1996). A remarkable effect of the both regulations has been reflected since the second trimester 1997, so that the dynamics in the short-term funds inflow was slowed down. Simultaneously, an increased inflow of the long-term funds, namely in the form of financial credits to enterprises, has been recorded in 1997. Followingly, the long-term capital inflow reached a dominant share of 60.4 % within the capital and financial account.

[20] Exchange rate applied: 1993:1USD=30.790 SKK; 1994:1USD=32.039 SKK; 1995:USD=29.735 SKK; 1996:USD= 30.647 SKK; 1997:USD=33.035 SKK. The balance is simplified, only main items are recorded.

Within the medium and long-term financial account, one of the most unfavorable factors has been a decreasing trend in the direct and portfolio investments´ foreign capital inflow. While direct investments remained at a relatively stable - and, undesirably low - level, portfolio investments decreased considerably to a symbolical level, in 1996. The negative values in 1997 have been caused by faster growth in the Slovak FDI abroad, as compared with the FDI in Slovakia. The importance of the FDI inflow for both, the foreign exchange reserve funds creation and the technological restructuring of the economy (and thereby for foreign exchange creation in the future) will require to pay special policy attention namely to this issue of the recent balance of payments development.

External debt development. The starting foreign debt position of Slovakia was relatively favorable: as of 1 January 1993, the gross external debt represented an amount of USD 2.9 billion[21], of which USD1.6 billion was the official debt (of the NBS and Government) and USD 1.3 billion the debt of the commercial sector (enterprises and banks). During 1993-1997 the indebtedness increased, reaching USD 9 billion, at the end of June 1997. The Slovakia´s total gross debt per capita increased from USD 695 (end 1993) to USD 1 473 (end 1996) and reached USD 1705, at the end of June 1997.

The debt of the official sector increased namely at the beginning of the period, due to withdrawing loans for supporting the balance of payments and the NBS bond issues on the international capital markets. Later, accordingly to the schedule of repayments it has slowed down to an amount of USD 1.6 billion, as of end June 1997, which means that its absolute value has been the same as at the beginning of 1993. On the other hand, the indebtedness of the commercial sector increased continuously to USD 7.2 billion, as of half 1997. As follows, ratios of the official and commercial debts changed remarkably, over the period: while at the beginning of 1993, prevailing part of the total gross debt (55 %) was the official debt, in the half of 1997, 80 % of the total debt was the debt of banks and enterprises. However, a large part of the Slovak commercial debt is being guaranteed by the State, which, indirectly, increases the current official debt.

Continuing in the foreign exchange liberalization process. With the approval of the new Foreign Exchange Act (as of 1 October 1995) the current account transactions were liberalized. Capital flows have been liberalized in the extent of non-resident investments in Slovakia, including capital transfers and earnings from these investments.

Following the association process of Slovakia toward the OECD, a schedule for the capital account liberalization was elaborated, approved with the Slovak government in June 1996. The time and subject schedules of the capital movements liberalization were arranged with regard to the need of the Slovak economy restructuring. The principle of preferring capital inflow to the capital outflow, of long-term transactions to the short-term ones, and of direct investments to long-term financial loans was accepted. The necessity of remaining the short-term capital flows under temporary control relates to the need in protection of the currency against strong "hot-money" fluctuations, or to avoid undesirable pressures on the exchange rate.

In accordance with the liberalization codes of the OECD, measures were introduced in December 1996, concerning namely liberalization of acceptance medium and long-term financial loans; acceptance and granting of international commercial credits by the way of financial intermediators in relation to the OECD; purchasing of real estates by Slovak residents and foreign direct investment in the OECD countries. A whole liberalization of the balance of payments, excluding purchasing of real estates by non-residents in Slovakia, should be terminated in the year 2000.

Outlook. The fluctuation band of the exchange rate of the Slovak crown at the level of +/-7 % against the basket parity theoretically enables a large scope of 14 % for the exchange rate fluctuations. However, the recent development has been characterized by a close exchange rate movements around

[21]Accordingly to principles passed by the constitutional "Act on dividing the property of the CSFR", property, receivables and liabilities of the former CSFR were divided between the successor states in the ratio 2:1 (in favor of the Czech Republic), except the commitments with the IMF, which determined by the IMF were divided in the ratio 2,29:1. Liabilities and receivables of the business sector were divided according to their domicile (regional principle).

the central parity, which, in practice, reduces the band for a half 7 % scope. This, perhaps, might be enough for stopping undesirable speculative capital inflows attracted by high interest rates in Slovakia. Nevertheless, a pressure to appreciation of the exchange rate and eventually to devaluation expectations has emerged and remains for the future. In the same direction to devaluation is being working the recent development on the current account.

From a longer-term of view, maintaining of the fixed rate will be dependent on the speed of overcoming the current "unproductive" development of the balance of payments. This mean, how fast the imports that are the leading factor of the present current account deficit will be reflected in a technological recovery of the economy and thereby, in a higher performance of the Slovak exports. Changes in the capital flows structure in favor of increasing the foreign direct investment to Slovakia swill be required, as well. Apart from improvements in legislation that are in the process, their faster inflow is likely to be expected in connection with a new wave of the ownership restructuring in a direction of selling the new private enterprises (cheaply acquired from the State) abroad.

Under conditions of the Slovak economy, the experience of a fixed nominal exchange rate pegged to a basket of currencies, extended by the fluctuation band, proved to be successful, in general. Nevertheless, maintaining of the current level of the fixed rate should never be seen as an ultimate final policy goal.

3 Banking Sector Development in the 1990'S

Pretransformation period. Until 1989, the Czecho-Slovak banking system existed in a form that only marginally resembled current two-tier system. The so called mono-banking system consisted of a limited number of banks with exactly defined functions that performance was not related to the market principles. There were banks as follows: the ***State Bank of the Czecho-Slovakia*** (*SBCS)* that fulfilled the function of the central bank of the State within the system of centrally planed economy, i. e. the function of the largest commercial bank that administered vast majority of financial resources and was the main creditor, as well as the function of organiser of the whole payment system in the country; the ***Czech State Savings Bank*** and the ***Slovak State Saving Bank*** that administered almost all saving deposits of individuals (the deposits were fully guaranteed by the State) and were the main suppliers of loans for individuals (in particular, special advantageous loans to newly weds and for housing construction projects and the purchase of household equipments); the ***Czecho-Slovak Commercial Bank*** *(CSOB)* that secured operations and transactions denominated in foreign currencies between domestic trading companies and foreign subjects and represented the State in international financial markets; the ***Merchant Bank*** that secured foreign exchange transactions for individuals.

Since 1990, within the framework of preparation of the transformation of the economy, the banking system experienced substantial movements. The State Bank of the Czecho-Slovakia was transformed in two parts: the SBCS as the central bank of the State that retained functions of the issuing bank and, by separating the commercial functions of the former SBCS, three commercial banks were created: ***Commercial Bank Prague*** that had assumed deposits and credits of entities with the seat in the Czech Republic. It assumed the respective technical equipment, premises and personnel from the SBCS; ***General Credit Bank*** that, in the Slovak Republic, did the same as the Commercial bank in the Czech Republic; ***Investment Bank*** that assumed a part of long term credits, in particular those that were given to enterprises to finance large investment and housing projects in Czecho-Slovakia. On 1 January 1992, the Slovak organisation units had been disconnected on the grounds of which the ***Investment and Development Bank*** was established in Slovakia.

The enactment of two laws, The Act on Banks (No. 21/1991) and The Act on the State Bank of the Czecho-Slovakia (No.22/1991) respectively, brought about more radical changes in the banking system (the powers of central bank, position against the government, monetary instruments, role and position of commercial banks, the framework of their activities in the banking sector were set). Furthermore, a partial privatisation of four main domestic banks started (on the basis of the Act No. 92/1991 Zb. on the transfer of State property to other persons, the banks were transformed in joint-stock companies). Foreign banks were allowed to begin their banking activities.

Current landscape of the banking system. As of 1 January 1993, the Czecho-Slovak Federation dissolved and the SBCS ceased to exist. On the grounds of the Act on National Bank of Slovakia (Law No. 566/1992), the Slovak central bank was established. Since then Slovak commercial banking developed independently. The number of banks increased continuously, during 1993-1995. In 1996, three banks were deprived licence. All these banks were branch offices of the failed Czech banks. From the total number of 29 banks operating at present days in Slovakia, there are 25 domestic institutions (without and with foreign capital participation) and 4 branches of foreign banks; apart from this, 10 representative offices of foreign banks. At 1 July 1997, there were 1,186 organizational units of banks registered in Slovakia, whereof 17 operated within the local branches of foreign banks. The character of their territorial distribution is influenced by the fact that the head offices of 20 banks are located in Bratislava, capital of the Slovak Republic.

The prevailing legal form of the Slovak commercial banks is that of joint-stock companies (23 banks). Two banks are public financial institutions, which fulfill special banking functions - *Slovak Guarantee Bank* and the *Consolidated Bank*, whose activities are concentrated primarily on servicing pre-transformation credits and loans, and loan facilities for specific purposes of the transfromation.

Twenty- one domestic banks have been granted a universal banking licence, and four are holders of specialized banking licence for specific activities (building savings banks, gaurantee and consolidation banks). Fifteen banks are licenced to conduct full foreign exchange activities. The other banks (10) have a limited licence in this field.

The total number of employees in the Slovak banking sector amounted to 25,464, as of end June 1997, of which 24,172 have been employed in the commercial banks and 1,292 represented the staff of the National Bank of Slovakia. The number of bank employees per 1,000 inhabitants increased from 1.3 in 1990 to approximately 5 in Q2/1997, including central bank employees.

First data concerning amounts of equity capital of commercial banks were officially published at end-April 1993. From this date, the subscribed equity capital of commercial banks amounted from 13.8 bill. SKK to 30.6 bill. SKK at 1 July, 1997. The participation of foreign investors in the Slovak banking sector amounted from 10.6 % of the total volume of subscribed equity capital, to 38.3 %, within this period. Currently, foreign capital participation has been recorded in 14 domestic banks.

In general, legal framework covering the functioning of the Slovak banking (or larger, financial) system was established under the former CSFR, during 1990-1992. Namely in 1992, prevailing part of the basic legislation was approved: the National Bank of Slovakia Act (No. 566/1992 Zb.), Banking Act (No. 21/1992 Zb.), Building savings Act (No. 310/1992 Zb.), Act on Securities (No. 600/1992 Zb.), Act on Investment Funds and Investment Societies (No. 248/1992 Zb.), Stock Exchange Act (No. 214/1992 Zb.). In the years before, remaining important acts related to banking were approved, as the Foreign Exchange Act (No. 528/1990), Accounting Act (No.563/1991 Zb.). However, since 1993, multiple amendments to individual acts were made reflecting the new constitutional set-up of the Slovak Republic as well as development of the financial environment in the country and, last but not least, systemic changes in foreign exchange relations with abroad. In such cases, new acts, including all the amendments assumed, were approved by the National Council of the SR. This concerns namely the new Foreign exchange Act (from 1995) and the Banking Act (from 1996). Apart from this, Act on Deposits Insurance was approved in 1996. An amendment of the Act on the National Bank of Slovakia is being in preparation accompagnied by a sharp discussion on the topic of the central bank independence *de jure* against *de facto*, between the National Bank and the Slovak government.

Banking Services and Products. The Slovak banking sector has been formed on the basis of a strategy to create a regionally equable, however, economically effective net of commercial banks that, gradually, would be able to provide all services and products required by the clients. Prevailingly, commercial banks have been established on the principles of universal banks.

Slovak commercial banks provide basic banking services, i.e. the receipt of customer's deposits, granting of loans and advances, and other services. On the Slovak banking market, within the framework of deposit operations, various types of deposits are accepted (demand deposits, savings deposits, time deposits, certificates of deposits, bank obligations) from various depositors (corporate customers, households, central and local governments, other banks, etc.) as well as various kinds of borrowings from other banks. On the basis of concentrated resources, banks conduct business activities mainly by granting loans and making investments. However, various banking institutions have different approaches to the provision of banking services. Differences arise mainly within the range and the quality of services provided. Among other, offers of services depend largely on the level of automation and computerisation within the banking sector.

On the Slovak financial market, banking institutions render financial services in both Slovak crowns and foreign currencies. First of all, they effect interbank payments and settlements. These are the largest operations carried out by banks, which involve practically all corporate entities. The opening of bank accounts, conditions of their administration and termination are governed by the Commercial Code (No. 513/1991 Zb.). At present, payment cards are in still in the process of development; presently they are used only in ATMs, and at filling stations in exceptional cases. The number of domestic payment cards increases, while the number of international cards is relatively low. With an increase in the number of such cards, the number and volume of transactions concluded through ATMs will also increase. The precondition for a widespread use of payment cards is the development of telecommunications and computer networks. Apart from this, the banks provide safe deposit services and foreign exchange operations - they keep accounts for customers, make international payments, conduct foreign exchange transactions, make loans to abroad, and deal in foreign securities. Most banks operate in Slovakia on the basis of a full or limited foreign exchange licence.

Large banking institutions render various services in the field of investment banking - capital market operations, products and services in the field of financial and investment consulting, services in the field of market research and analysis. Other services rendered by Slovak banks are: safety deposit services, factoring, forfeiting, and financial leasing.

Privatization of banks. Privatization of banks started under the former CSFR, enacted by the Large Privatization Act (No. 190/1995 Z.z. and Act No. 92/1991 Zb. on the transfer of State property to other persons). By the Act, the banks (in the same way as large State non-financial enterprises) were transformed in joint-stock companies.[22] The issue of the financial sector privatization in Slovakia has concerned a limited (nevertheless, powerful) group of four State financial institutions (Slovak State Savings Bank, General Credit Bank, Investment and Development Bank, and the Slovak State Insurance Company) that were created within the first stage of forming the two-tier banking system, during 1991-1992. Every other new commercial banks (excluding the two specialized public financial institutions - the gaurantee and consolidation banks) were established exclusively as private companies. Therefore, the following relates to the three mentioned banks.

After the first wave of privatization, the ownership structure in concerned banks changed as follows: more than 50 % of equity of the *General Credit Bank* and more than 65 % of the equity of the *Investment and Development Bank* were transferred to the private sector. The third bank, *Slovak Savings Bank*, changed its legal form to the joint-stock company on April 1994, but its ownership structure has not been changed yet - share of subscribed equity capital held by the National Property Fund and Restitutional Investment Fund[23] represents 100 %, up to now. The current share of bank′s subscribed equity capital (excluding NBS) held by the National Property Fund and by the State is shown in Table 5 (data as of end 1996). One may see that over 40 % of the Slovak banks´equity capital still remains under a direct control of the State, or closely 60 % of the total banks´equity capital is held by privat owners.

Table 5 State ownership share on the banks´ equity capital

	SKK million	**%**

[22] The shares of the joint-stock companies became the ownership of a established public institution, the National Property Fund. (NPF). As the companies gradually privatized (or, sold by the NPF to the new privat owners), the NPF has collected earnings from the sales and the share of the NPF in the capital ownership of individual companies has slowed down.

[23]The Restitutional Investment Fund, joint- stock company, founder-the National Propety Fund. The RIF was established in connection with large-scale privatization process for the purpose to finish and settle up the restituents propety claims. The RIF received 3% of the shares of the privatized enterprises, in which restitutional settlement was not finished.

Subscribed equity capital	**23,459**	**100.0%**
share		
The State (ministries)	**3,021**	**12.9%**
The National Property Fund	**4,772.0**	**20.0%**
State-owned businesses	**1,800**	**7.7%**

Source: National Bank of Slovakia
1/ Excluding branch offices of foreign banks

The third Meèiar´s Government in its Program Declaration from January 1995, expressed that in order to stabilize the development in the Slovak society, the Government will specify the interests of the State in privatization of the strategic enterprises, including (among other) the banking sector. Enactment of related legislation was a constituent part o of package of new important legislative powers in the field of regulating the privatization process, from 1995.

The most important of these laws was the amendment to the Large Privatization Act, which closed the ongoing discussion about legal aspects of privatization in favor of standard methods. The second wave of the voucher privatization in Slovakia was replaced by the so-called bond method.[24] The amendment increased the powers of the NPF, and considerably accelerated the process of privatization in the form of direct sale, as well as public tender and sale of shares on the capital market. Subsequent to this legislation, a law was passed to secure the interests of the Government in the privatization of strategically important State enterprises and corporations. This law (NC SR No. 192/1995 Z..z.) defined which companies could only be privatized with government approval.

By the way, the need of restructuring the banking sector and solving the bad debts problem, expressed in the Government Program Declaration as well, initiated discussion on the topics "what step is to be made first: privatization or restructuring?". After an intermediate period of declarations that banks will be privatized until end February 1996, the present legislation enabled to conserve the existing ownership structure in the banks till end March 1997. In general, conclusion was made: before the large three Slovak banks (and the Slovak Insurance Company) will be privatized, they are to pass the restructuring process.

As a result, the expected fast process of the banks privatization has been slowed down. However, signals emerged in the last months that existing status quo does not satisfy large industrial companies that are interested in closer linkages with the banking sector. An example is the case of the VSZ (the largest Slovak metallurgical company), which wanted to increase its shares in the Investment and Development Bank over the ratio of 15 % allowed by the Banking Act, but the National Bank of Slovakia did not gave the permission for this operation. It may be stated that the NBS´s approach to such or similar cases has been very prudential because of recent unfavorable experience of the Czech banks.

Foreign capital participation. As compared with the very low starting amounts, the foreign capital participation on the subscribed banking capital in Slovakia developed rapidly. While the participation of foreign investors in the Slovak banking sector represented 13.6 % of the total banking equity in Slovakia, at the end 1993, their share amounted to 38.3 %, at the end Q2/1997. Prevailing part of this increase occurred during 1995, while in 1994, the growth in equity capital as a whole was rather moderate. Foreign capital participation was reported in 14 domestic commercial banks, as of 30 June 1997. To this date, four branches of foreign banks operated in Slovakia. By 30 June 1997 data, the largest share (37 %) has the Czech Republic, followed by Austria (21 %), Netherlands (19 %), Germany (7 %), USA and France (4 % each), Great Britain and Italy (3 % each) and Russia (2%).

[24] According to this, each individual registered in the second wave of the voucher privatization is entitled to a bond issued by the National Property Fund (NPF) at a par value of SKK 10 000, with maturity at 31 December 2000, which may be used for specified purposes. Shortening of the maturity date to 31 December 1997 was made for pensioners by an amendment to the Act (from October 1996). Trading in the bonds started in August 1996. High supply has been faced with a low demand, in general. Until present days, **... %** of the bonds were redeemed from the total. **Doplním ja.**

Banks with foreign capital participation (banks with participation under 10% are classified as bank with no foreign participation) are mainly of medium-sized entities, with equity capital between SKK 0.5 billion to SKK1.85 billion. The equity participation ranges from 10 % to 100 %.

Apart from the amounts invested, participation of the foreign capital in Slovak banks plays an important role in extending the required know-how in emerging specialized banking activities, such as are for example bulding savings or mortgage banking. With the Austrian and German capital participation were established the both Slovak building savings banks, and the licenced mortgage bank (*HYPO-BANK Slovakia)*, which entered in operation in July 1996, is fully controlled by the German capital.

Development of banking activities. The size of banking sector in the SR is rather small. Although in the years 1993-1996 the balance sheet total of the sector (including specialized banks) increased faster than GDP at current prices (balance sheet/GDP ratios - Dec. 1993-120,41; Dec.1994-114,50; Dec. 1995-116,09; Dec. 1996-123,28), the banking sector growth is still low in comparison with the developed countries. This is predominantly influenced by the largest banks restructuring, by low capital starting position and by lower activities against abroad. On the other hand, the gradual, slow banking industry growth is sustainable from economic point of view. One of the positive growth feature is the banks number stabilization, a continual tendency toward banking activities deconcentration caused by emerging of new banks, occurred during 1993-1995 and their relatively good economic position, namely banks with foreign capital participation. The financial power of Slovak banks is still concentrated in the three largest banks. At the end of 1996 their share in the total balance sheet represented 60,78% (75,58% in 1993, 70,60% in 1994, 66,34% in 1995), in the total loans 62,39% (75,59% in 1993, 68,32% in 1994, 66,38% in 1995) and in the total deposits 69,95% (86,93% in 1993, 81,82% in 1994, 76,18% in 1995). A general overview of the total bank assets, liabilities, equity developments and their composition is given in Tables 6, 7. The figures implicate a couple of trends that can be summarized as follows:

- The development of assets composition between 1993 and the first half of 1997 was primarily influenced by banks' efforts to maintain some standard level of liquidity. A low amount of capital hand in hand with a higher level of credit risk provided banks with an incentive to change the composition of risk weighted assets. Reckognizing the relatively stable proportion of inter-bank assets (24.4% as of Dec. 93 and 26.6% as of June 1997) we realize that the drop in proportion of loans (58.4% as of Dec. 1993 and 42.3% as of June 1997) was compensated by a sharp rise of the proportion of securities held by banks (6.4% as of Dec.93, 16.6% as of Dec. 1995, 15.8% as of Dec. 1996 and 13.3% as of June 1997). The securities portfolio is dominated by government securities.

- Looking at the development of equity we realize that the proportion of commom stock on equity has been growing (27.1% as of Dec. 1993 and 45.4% as of June 1997). Again this growth is compensated by decline of reserves and reserve funds (68.1% as of Dec. 93 and 42.9% as of June 97). These funds are being transformed to provisions. The liquidity increase has been achieved mainly by changes in earning assets composition.

Table 6 Assets, Liabilities and Equity of Banks in the Slovak Republic

	Total Banks									
	12-93	**%**	**12-94**	**%**	**12-95**	**%**	**12-96**	**%**	**06-97**	**%**
Total Assets	445.445		505.329		597.933		716.596		711.004	
1. Loans	260.323	58,4	252.075	49,9	274.166	45,9	314.520	43,9	300.683	42,3
2. Interbank Assets	108.793	24,4	122.573	24,3	128.824	21,5	149.060	20,8	188.809	26,6
3. Securities	28.728	6,4	57.973	11,5	96.982	16,2	113.419	15,8	94.436	13,3
incl. T-bills	7.682	1,7	26.024	5,1	14.830	2,5	29.255	4,1	22.079	3,1
	0		0		0		0		0	
Total Liabilities and Equity	445.445		505.329		597.933		716.596		711.004	
1. Interbank Liabilities	90.328	20,3	97.823	19,4	108.449	18,1	139.797	19,5	176.728	24,9
2. Deposits	228.260	51,2	264.251	52,3	318.447	53,3	367.186	51,2	361.557	50,9
3. Securities	1.561	0,4	3.918	0,8	9.658	1,6	18.662	2,6	19.874	2,8
4. Central Bank Accounts	40.843	9,2	34.766	6,9	33.441	5,6	35.041	4,9	58.031	8,2
5. Equity	48.722	10,9	63.284	12,5	66.896	11,2	76.350	10,7	67.388	9,5
Equity Composition										
1. Common and other stock	13.221	27,1	17.673	27,9	24.036	35,9	30.040	39,3	30.605	45,4
2. Reserves and Reserve Funds	33.194	68,1	41.565	65,7	24.383	36,4	27.046	35,4	28.902	42,9
3. Other Funds Created from Profit	0	0,0	0	0,0	12.307	18,4	13.004	17,0	12.496	18,5
4. Capital Funds	0	0,0	0	0,0	1.620	2,4	1.962	2,6	1.105	1,6
5. Retained Earnings	4.398	9,0	4.046	6,4	4.550	6,8	4.298	5,6	-9.124	-13,5

- In terms of liquidity development a positive achievement can be recorded with the changes in the liquidity gap (short-term assets - short-term liabilities). The initial amount SKK -80,180 million of the gap (as of Dec. 1993) declined to SKK -53,230 (as of Dec. 1995) and slightly rose to SKK -61,624 (as of Dec. 1996, the liquidity gap growth is covered by own capital). This decline is even better visible when demonstrated in percentage terms. The proportion of the gap on the total assets lowered from 17.94% in 1993 to 11.6% in 1996. At the same time the ratios short-terms assets/short-terms liabilities were developed favourably - 61.85% as of Dec. 93, 75.46% as of Dec. 94, 77.40% as of Dec. 95, 80.3% as of Dec. 96. The gradual decline in this gap was mainly caused by an increase in short-term loans and treasury bills on the assets side as well as in time deposits (of which the most important is the growth of deposits with longer maturity) on the liabilities side of the balance sheet, a fact can be regarded as positive one.

- The above mentioned trends are confirmed by loans and deposits term structure composition. The proportion of the short-term loans in the total loans has been growing step by step, from 36.8% in 1994 to 41.55% today (30 June 1997); the similar development we can reckognize on the medium term composition loans side, from 18% in 1994 to 21.53% up to the first half of 1997. Although long-term deposits share in total increased from 3.5% as of Dec. 94 to 8.43% as of 30 June 97, the share is not favourable from the long-term perspective point of view. In generaly, the propensity to long-term savings is not convenient which is influenced by internal and external social-economic factors (some of them are defined below).

As far as concerning the banking sector profitability development, in terms of return on assets and net interest margin data, we can summarize the following. Net interest margin is relatively high, a positive feature is its gradual decrease, from 4.69% in 1993, to 4.52% in 1995, to 3.22% in 1996, to 3.05% as of 30 June 1997. In spite of, the ROA is low (0.67 in 93, 0.67 in 94, 0.87 in 95, -0.02 in 96, all as of Dec.). This is connected with the high general level of the loans risk, the result of which is the net interest income usage for the loans losses coverage, there fore the orientation toward intensive restructuring recources creation is rather understandable as we can see below.

Table 7 Loans and deposits composition (in SKK million)

	12/1994	%	12/1995	%	12/1996	%	30.6.1997	%
Loan composition								
- short-term	95920	36.8	105776	37.1	137.491	40.59	141932	41.55
- medium term	46912	18.0	57589	20.2	70909	20.93	73550	21.53
- long-term	117906	45.2	121709	42.7	130370	38.48	126092	36.91
Deposit composition								
- short-term	178776	73.6	225968	71.9	271199	72.44	261231	71.51
- medium term	55714	22.9	67598	21.6	74410	19.88	73251	20.06
- long-term	8387	3.5	20568	6.5	28768	7.68	30819	8.43

4 Procces of financial restructuring

There is obvious that restructuring of the banking sector, which is currently a basic condition for the recovery of financial flows between commercial banks and their economic environment, must take place in two areas. On the one hand, banks must strengthen their internal resources for the coverage of loan losses, on the other hand, it is necessary to establish standard relations in the financial flows of enterprises. These relations are expressed in terms of indicators defined in the previous part. The cleaning up of the banking sector of long-term loss-making entities will lower the risk involved in lending operations. The recovery of the banks' loan portfolios solely by writing off loss-making loans to the detriment of bank reserves represents only a short-term solution which could solve consequences but not causes of the bad loan problem. Thus, the worsening trend in the quality of loan portfolios and the related problem of high interest rates would persist. Therefore, by means of the financial restructuring it is necessary to solve the causes of the generally high rate of credit risk and the frequent failures in inter-firm financial flows.

In analyzing the development of the restructuring process in the Slovak banking sector, special attention should be paid to three groups of issues: (1) causes of the loan portfolio problem in Slovakia; (2) preliminary measures adopted; (3) restructuring programme.

(1) Causes of the loan portfolio problem. The transformation process of the Slovak Republic towards a market oriented economy that is characterised by changes in relative prices, the collapse of former CMEA export markets, sudden tightening of import competition, reduced subsidies from the State, inappropriate industrial structure with only marginal share of value added products resulted in the large number of enterprises that had become unprofitable and burdened with high volumes of debt. Many enterprises were capable of covering their operating costs, but servicing their debts is inherited volume of “out-of-market long term credits” extended to enterprises between 60-ies and the late 80-ies. Certain amount of bad loans, especially those given in the recent period, turned classified due to insufficient experience of credit officers and unprudent credit policies of commercial banks. The ratio of Slovak banks’capital to total assets was low (it ranged from 0.84 to 1.22 %) compared with banks in advanced market economies. The capital adequacy ratio which may not fall below 8 % according to the Basle capital adequacy standards, reached an average of 1.72 % in the banking sector. Banks operating on foreign markets (*ČSOB* and *Merchant Bank*) reached a 4 to 5 % ratio of capital to risk-weighted assets, representing an exception. The reasons of such a development may be divided into several groups:

- An intensive need to create rapidly a banking sector, conform with the needs of a transforming economy. This need had an objective, and therefore also a program character. Many new business entities have been established in the economy, which the undersized banking sector, undergoing a slow reform at the end of the eighties, was unable to handle. One of the fundamental reasons of today's problems may therefore be seen in an undeveloped banking sector, or its adaptation to needs of centrally managed economy.

- Absence of personnel prerequisites for a rapid expansion of the banking sector. Qualified staff of already existing banks could not satisfy the needs of newly established banking entities. Additionally, these qualified specialists of the former State Bank of Czechoslovakia and saving banks were confronted with entirely new tasks: this was no longer a simple redistribution of loan resources in accordance with planned goals, but their distribution on a purely commercial basis, with the need to observe criteria of prudent banking procedures, and on the basis of an evaluation of the business plan of an applicant for a loan. Experience required to properly evaluate a business plan was scarce, and many important characteristics that would help create a picture about a client were not available. The majority of clients were newly established business entities, without a corporate history, where an opportunity of examining their property situation, economic results, etc., was absent. This caused considerable difficulties in determining the reliability of a client, as well as feasibility of the purpose of a loan. The business environment was unstable; all determining parameters were in a relatively dynamic motion - prices, currency exchange rate, reliability of customers and suppliers. It took time to gradually acquire necessary experience, and the price of mistakes that have been made now often has a form of large unpaid receivables.

- Necessity to support the process of privatization, the development of small and medium-sized enterprises, and other activities called for by the society, and which were among the priorities of the economic policy pursuing economic transformation. Banks were under political pressure and pressure from the society. A common denominator of these pressures was criticism, that banks are not flexible enough in supporting business activities.

- There was relatively easy to enter the banking sector - this is particularly evident in comparison with the current situation, when entry into this sector for new entities is very complicated, and is subject to very demanding licensing procedures. It was possible to establish a bank with relatively little basic capital[25], and in the licensing procedures, the ability of the bank's shareholders to ensure a long-term success on the banking market was not sufficiently examined. The economic strength of shareholders,

[25] While at present the minimum required capital (initial capital) represents an amount of SKK 500 million and, given the NBS Provision from December 1993, the whole amount must be deposited in a monetary forme, the 1990 starting required level represented only CSK 50 million (i.e. 1/10 of the present level). However, the starting level had been gradually increased and by the SBCS Provision from 1992 it was augmented to CSK 300 million.

their strategy, and ability to raise the bank's capital in the future remained unexamined, or prerequisites for such examination were missing. In a number of cases the establishment of a bank served a predetermined purpose: to open the way to its founders for acquiring loans. Additionally, assumptions about high yields from capital invested into the banking sector were either exaggerated or unjustified. Hints of success ensued from relatively easy available resources: at the beginning of the nineties, basically all loan resources were at the disposal of two entities - the *General Credit Bank*, and the *Slovak Savings Bank*. In the new situation, the *Slovak Savings Bank* (not sufficiently equipped for providing loans) had an opportunity to deposit its resources not just in one bank, as in the past, but allocate them favorably into other, newly established banks. This possibility caused, that already at the beginning of their activity, new banks were capable of achieving relatively high volume and growth rate of loan transactions. At the time when the loans were granted, their quality could not be measured, and therefore the initial period of functioning of each bank was seemingly successful and without problems.

- Complicated implementation of guarantees on provided and non-performing loans. High importance was attributed to guarantees on loans. This was partly a reaction to the insufficient possibility to reliably evaluate the quality of business plans. In a number of cases, experience with recovering collateral has shown that accepted guarantees on loans were only formal. Guarantees had the form of collateral very difficult to repossess for various reasons. These included formal shortcomings (faults in guarantee contracts, which proved an insurmountable obstacle to implement collateral right), conditioning the execution of a guarantee (collateral) on consent of the debtor; such consent is generally only achieved in court, which extremely prolongs recovery of claims. In many cases, collateral is not marketable at all, or can only be sold with a loss. Increasingly strict audit requirements (as well as criteria set by the central bank) have led to reassessing the real value of guarantees, which resulted in a growth of the volume of uncovered risks. This causes the necessity to create additional reserves and provisions.

An essential factor arises in the whole issue of loan guarantees and their resolute implementation, which, however, is frequently a reason for only a formal role of guarantees in the loan relationship: the existing legal environment and court procedures are creating a situation which is in favor of a debtor and detrimental for a creditor. The positions of debtors and banks are uneven. Banks did not anticipate this development. They trusted the premise that the state, in order to provide for the functioning of society and economy, would create conditions that would defend the interests of creditors.

- In some cases, the lack of experience resulted in unclarified concepts of the bank's development, as well as shortcomings in assets and liabilities management. This is one of the reasons why several banks have a high volume of non-performing assets. Among other causes, this is the consequence of extremely rapid expansion at the onset of bank's development. A certain role in this was played by the rapid establishment of bank branch offices and affiliations, an extensive banking network was created during a historically short period of time (five years), capable of meeting the needs of clients. A relative decline of demand for new loans, narrowing profit margin, and a generally tougher competition on the banking market caused that in a number of cases, the ratio of expenditures and revenues is becoming tense. This situation will require the reduction of a number of expenditure items, in order to compensate for declining bank revenue from financial operations.

- Insufficient experience with trading on the capital market caused that banks, trading on their own behalf and into their own portfolio, purchased shares at times when their prices culminated. This caused losses, which further aggravated the negative consequences of bad loan transactions.

(2) Preliminary measures adopted in the period 1990 - 1994. First attempt to undertake the problem of bad loans, which dates back to times of the former Czecho-Slovak federation, was based on a g*eneral "debt forgiveness" of enterprises.* In order to assess the financial strength of enterprises, all of them were broken down by three categories: (1) viable enterprises with the sufficient capability of servicing their indebtedness; (2) potentially viable enterprises with positive operating cash-flow but heavily burdened, with debt that is not being repaid; (3) loss making enterprises.

The government had put aside approximately 15 billion crowns to solve the problem. One part of these funds (11 billion) were mainly dedicated to the potentially viable companies. The National Property Fund swapped its bonds for credits of viable enterprises with commercial banks. The remainder of funds (4 billion) were utilised for the capital strengthening of banks. These measures, however, did not result in an expected effect. The primary and secondary inter-company indebtedness hat not dropped substantially. One of the main weaknesses of this project was that it was not prepared as a systemic conceptual project but as the one-step event. Mistakes also occurred when having assigned the enterprises into respective categories. Such a solution did not resolved the crucial problem of the insufficiency of long term financial sources that would finance new feasible project, especially those for the conversion of the armament production.

Another partial incentive of solving the issue was establishment of the *Consolidation Bank.* This bank, as a special purpose bank developed its sole activity in the field of administering the indebtedness of enterprises that, in the past,were orientated to military production and are currently being restructured under the program of conversion. Apart from this, by intermediate of this bank another part of bad loans - namely of those for financing inventories - has been solved. These loans were restructured and transferred to the *Consolidation Bank.* In return, the banks received partly government bonds, partly loans for increasing their capital base, and the remaining amount for the writing off of these loans. However, this transaction solved only the problem of bad credits for inventories, but the issue of bad loans remained unsolved, in general.

In order to clean up the balance sheet of *Czecho-Slovak Commercial Bank (CSOB)* that, in the past, operated as the exclusive agent in foreign trade transactions for the whole Czecho-Slovakia, the *Slovak Collect Company (SCC)* was established by the Ministry of Finance of the Slovak Republic, in December 1993. Claims of the export companies were transferred to the SCC in the amount of SKK 10,7 billion. The claims are financed by the *CSOB* redistributing loan with the State gaurantees. Agreement of the loan repayment is being in the process.

The National Bank of Slovakia, in a close collaboration with the Slovak government, has been systematically dealing with the problem of bad debt, since its establishment. The issue was often discussed with representatives of various international financial institutions (International Monetary Fund, World Bank), as well. In autumn 1993, an international consulting company McKinsey prepared an analysis of the scope of bad debts in the four selected commercial banks. This study was financial by EC PHARE. Results of the analyse, in which the figures provided by the NBS, auditors and commercial banks were assessed proved necessity to introduce new measures to prevent further deterioration of the credit portfolios. New regulations of the NBS on capital adequacy, liquidity, credit exposure and foreign exchange position were introduced, effective since January 1994. Finally, a scenario on the revitalisation of the banking system has been elaborated in the NBS in a close collaboration with the Ministry of Finance and the Slovak government. A decision has been gradually accepted that solving the banking system issue will be performed within the context of enterprise restructuring.

(3) Restructuring program. The process of the Slovak banking sector restructuring is to be divided into several stages which could be characterized as follows.

Preparatory stage. Introduction of new rules of classifying bank receivables and off-balance sheet liabilities by the risk involved and creation of resources for risk coverage (NBS Provision No. 3/1995). The goal has been to improve the existing conditions, create adequate resources for risk coverage, improved the quality of risk analysis and risk management. The basic criteria for grouping of receivables and off-balance sheet liabilities into one of the five categories (1.standard; 2.special mention claims; 3.sub-standard; 4.doubtful; 5.loss) are the assessment of the client's financial position (financial credibility, e.g. level of liquidity, economic performance, reserves, profitability, capital adequacy), and the financial discipline in accordance with the terms and conditions stipulated in the credit agreement (application of the borrowed funds for a predetermined purpose, repayment accounting to the agreed schedule). For development of the structure of classified claims see Table 8. (The calculated impact of the new methodology on the claims classification represents their increase by 81,2 %.)

Creation of resources for loss coverage. After the categorisation of receivables, provisions are created for loan loss coverage in the amount of 5%, 20%, 50%, 100% of the nominal value of the loan in the groups No. 2,3,4 and No. 5. (For yearly amounts in creation and use of reserves and classified claims provisions see Table 9) In calculation, the value of collateral (guarantees, right of lien) is taken into account. The guarantee is excluded, if the guarantor is in a bad financial situation, if the guarantee is doubtful, or the collateral is illiquid. However, the assessment of the real value of the collateral remains as an unsatisfactory solved issue (methodology of assessment, unstable market). The process of creating resources for loss coverage and restructuring has been spread over a period of three years. The burden of and the responsibility for the process of restructuring has been concentrated in the banks concerned. Namely, the preparation of restructuring projects was of great importance, in this stage.

Table 8 Claims classification

	31.12.1995		30.6.1996		31.12.1996		30.6.1997	
	SKK mil	**%**	**SKK mil**	**%**	**SKK mil**	**%**	**SKK mil**	**%**
a) standard	129.827	45,06	145.117	47,25	178.515	51,66	163.859	50,83
b) special mention	37.844	13,13	40.959	13,34	56.800	16,44	42.712	13,25
c) substandard	22.140	7,68	19.904	6,48	7.760	2,25	8.165	2,53
d) doubtful and litigious	12.574	4,36	9.282	3,02	10.371	3,00	10.209	3,17
e) loss	85.756	29,77	91.868	29,91	92.126	26,66	97.445	30,23
Total classified (c + d+ e)	120.470	41,81	121.054	39,41	110.257	31,91	115.819	35,93
Total (a + b + c + d + e)	288.141	100,00	307.130	100,00	345.572	100,00	322.390	100,00

Source: National Bank of Slovakia

The banks in connection with this NBS´s provision were obliged to submit the internal by-law to the banking supervision within three months from the day the provision had become effective {up to 30 June 1995}. A newly established bank will submit such by-law within three months from its establishment. The above main legal and regulatory framework has been prepared with application of the EU standards. Nevertheless, there is necessary to identify some problems in this area.

Table 9 Creation and use of reserves and classified claims provisions (in SKK million)

	1993	1994	1995	1996	Q2 / 1997
Creation	12. 523	12.023	18.210	19.522	6.949
Use	4.356	1.697	9.236	13.473	3.718

Source: National Bank of Slovakia

First, the NBS Provision on categorization of claims against risk and creation of reserving funds for the risks coverage facilitated to give an actual picture on the banks loan portfolio: loans of SKK 125 billion have been considered as classified (substandard, doubtful, loss) and their repayment will be in question. According to the banks´ quantifications, SKK 90 billion have been loss claims. These strong new rules have been implemented in the period when the government had declared to participate in banks rehabilitation by the preparation and implementation of the Act on reserves and provisions creation for calculating income tax base. The main idea of the Act, approval of which was being expected for a long time, is that creation of the reserve funds and provisions against clasified claims (principal) will not be a constituent part of the income tax base, in contrast to the present practice. Because the Act has not passed through Slovak Parliament yet, the problems continue and in some cases they have resulted in falling down the bank capital adequacy ratios.

Second, the banks have an obligation to include unpaid interest into their earnings which are not actual (fictive profit - its taxation deteriorates the banks' economic position). The volume of unpaid interest (SKK 32810 million) is being by about 1/3 of the clasified claims.

Third, the Bankruptcy and Settlement Act does not work well - the procedure is connected with time and expensive consuming. On the one hand the obligation to participate in negociation (pre-phase period) is considered as the main obstacle, on the other hand the bankruptcy is not used in practice (only 150 bankruptcies have been declared, one only was finished).

There is to be mentioned that the creation of classified claims provisions did in fact begun in 1993, using the rules of the former SBCS. However, according to the Provision of the SBCS, the creation of provision was not mandatory, but only recommended. Therefore during that period banks did mainly create reserves for covering losses, including loan losses. As for the taxation, these reserves were recognised as legitimate costs, while provisions are not tax-deductible yet. A substantial rise in the volume of classified claims provision occurred in 1995, as the concerned NBS Provision (No. 3/1995) came into force. The Ministry of finance is working on amending the Act on Reserves and provisions, which , among other, should include also their tax-deductibility.

Restructuring projects. Based on a loan portfolio analysis according to the new rules of loan classification, to actual level of loan loss provisions, as well as with respect to the client's financial position and capital strength, the banks make proposals in their projects for methods and possibilities of their own revitalisation (cleaning up of loan portfolios, recapitalisation).

In preparing the banks´ restructuring projects special attention must be paid to measures within the individual bank (elaboration of criteria for assessment of the credibility of clients) and, on the analytical basis, to judgements of the clients' ability to repay their financial obligations. An important step represents evaluation of the "credit history" of the client, i.e. amount and nature of liabilities to banks, and debt repayments (compliance with the repayment schedule, frequency of changes in the schedule, etc.). Intrabank measures must focus on the re-valuation of expenses, including overheads, investment plans, and the placement of financial resources (reduction of investment risk), ways and possibilities of additional increase in share capital, use of the profit, distribution of dividends, etc.

After the projects prepared by the banks, they will be approved by the National Bank of Slovakia and carried out. In case the compliance with prudential regulations (capital for the calculation of capital adequacy) is threatened, exemptions may be given in justified cases.

It follows from the above that a significant aspect of the restructuring process in the banking sector is being the relation "bank - client (debtor)". Eventually, the success of the whole process will depend from a principal solving of the "chronic" debtors (state-owned companies, some of them already privatised within the small or large-scale privatisation) issue within restructuring of the enterprise sector. The issue of insolvency is growing at a fast rate (estimate of SKK 180 billion) and its non-solution or stagnation in solution will be reflected in an increase in the banks' bad loan portfolios and in a reduction of resources for the provision of new loans.

On the other hand, the significance of restructuring for bank clients is being obvious in several directions. Among the most important, creation of conditions for employment of financial resources in new effective lending operations, redslting from the improvement of the quality of loan portfolios and of banks restructuring, shoulbd be mentioned. The banks as entrepreneurial entities - intermediators, on the basis of their policies of assets/liabilities management and risk analysis, may meet the standard criteria (performance indicators, ratios, creation of reserves and provisions, etc.) and fulfil tasks required by customers (collecting deposits, providing loans and a wide range of banking and consulting services, which contribute significantly to the quality of the relation between the bank and the client). Moreover, the extension of the restructuring process to bank clients will make a significant contribution to the improvement of co-operation between the bank and its clients, the strengthening of its position in the process of revitalisation programmes (e.g. changes in the schedule of repayments, proposals for the inclusion of individual clients in categories according to their abilities to meet liabilities, or to make proposals for bankruptcy proceedings, which also contributes to the reduction of credit risk). Last but not least, an effective allocation of financial resources, based on the agreed rules, may contribute to the recovery of financial flows within the whole economy, which will have a favourable influence on the position of the banking system, mainly from the point of view of creditworthiness.

Present state of restructuring. Since the process of the financial restructuring of the Slovak banking sector was iniciated, a relatively large package of measures and relevant activities has been (and are to be) introduced into practice (i. e. namely, rules of assessing bank receivables and off-balance sheet liabilities according to the risk involved and the creation of resources for risk coverage from March 1995; evaluation of the actual situation in accordance with the new rules, during March to September 1995; elaboration of restructuring projects by banks, included in the process, within the period of September 1995 to November 1996; evaluation of the projects by the banking supervision authority, which is being in process; preparation of related legal regulations, in process, as well).

The restructuring projects submited to NBS in 1996 included limits of capital adequacy which became binding for the banks in 1997 after having been approved by the Bank Board of NBS. We note that 3 transforming banks and 1 public financial institution did not meet the required 8% limit, however all of them were by the decision of the Bank Board of NBS excepted from fullfiling this requirement. As a result, the Banking Supervision Division has recommended that these did not distribute dividends to the shareholders in 1996. In concern to the restructuring process, these banks were recapitalised via subordinated debts of foreign banks in the amount of SKK 5 billion.

In summary, the process that started in 1994-1995 has not been completed, until now. Its performance is stagnating, which may prolong the estimated time necessary for the recovery of banks with unfavourable consequences on the financing of promising projects in the future.

The Act on Entreprises Revitalisation became effective on 30 July 1997. All basic elements, i.e. conditions, forms, procedure and decision-making process, projects features, limits,... are contained in this Act. The main idea is to solve the economic recovery of the Slovak entreprises in bad situation and to solve the borrowers-creditors relations in more effective way (the members of the decision-making commission are, for example, the representatives of 3 transforming-restructuring banks). Up to now no project of revitalisation has been approved. The short-term future will show the approach correctness.

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