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The Expected Effects of the EU Accession on the Banking Sector in the Slovak Republic

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Introduction

The Slovak Republic became an independent state merely 10 years ago, due to the split up of Czecho-Slovak federation, effective since 1993. In the same year an association treaty between the Slovak Republic and the European Union was signed.

Eleven years later - after years of preparation and negotiations - Slovakia will join the European Union in May 2004. The historical event is expected to have far-reaching political, social and economic consequences. Despite the predominance of positive ones, some negative consequences are likely to occur. To prevent shocks it is important to provide fair and relevant information to businesses and public, in order to make their expectations realistic.

This paper should identify effects of the EU accession on the Slovak banking sector. However, it should be stated upfront that the accession will only have negligible effects on banking business. At the end of the long process of harmonizing the legal, regulatory and institutional framework the accession itself will be a formal event. Major changes have already taken place.

The consolidation and privatization of the Slovak banking sector has been completed in recent years. Consequently more than 90 % of bank assets in the country is now being dominated by banks from EU member states. The legal framework for a market economy has broadly been established. Although the enforcement of legal rules needs further upgrading, the banking sector is now much better prepared for expansion and the fulfillment of its intermediation role.

However banks will have to do a hard job to cope with the problem of underdeveloped active operations towards small businesses and households as well. Since the intermediation role of the non-bank financial sector remains minor – as explained in the first chapter – the role of banks in Slovak economy will remain decisive.

Following chapters of this paper respect the ICEG/AMCHAM format and describe the effects of the EU accession on growth of the sector, foreign trade, FDIs, labor market, regulatory framework and changes in market structure. In the last chapter several short and medium term policy recommendations are proposed.

1. Banking sector and its position in economy

Although the process of globalization brought many banks on local markets worldwide under the control of leading global players, the role of banking sectors in national economies still vary from country to country. Despite the fact that on the matter of knowledge and technology differences decreased significantly, it is important to realize huge differences based predominantly on tradition and on the size of the local market as well.

The position which banking sector has in certain economy is connected with an (under)development of capital market and with supply of non-banking financial services on the market.

1.1. Role of bank in Slovakia compared to western economies

There are many differences between Anglo-American and continental economies. One of the most important is a role what banks play in national economies. It is important everywhere, but much more on the east side of the Atlantic Ocean.

Although there is not a real ocean between Western Europe and Slovakia, when comparing a development of capital markets there is one. The Bratislava Stock Exchange (BSSE) has been operating for 10 years, but it has never seen any successful IPO (Initial Public Offering). There are very few liquid shares and corporate bonds – if any – on the Slovak market.

Merely one tenth of the BSSE overall turnover comprises from price-making transactions and even less than 2 % of those present trades with shares. Most of the BSSE turnover comprises from government bonds, mostly traded among banks.

More than 10 years after an ambitious voucher privatization in former Czecho-Slovakia, which produced millions of small layman shareholders, the capital market in Slovakia practically does not exist. Moreover there is very little chance to build it up. In this case, bad experience is worse than no experience.

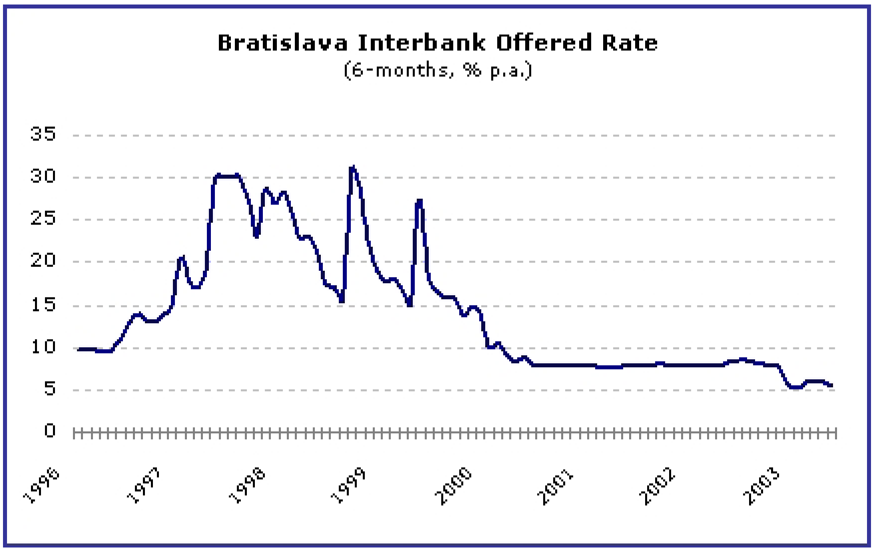
In United States - and not only there - banks are merely one of several alternative forms of capital intermediation. In most EU countries banks are the main and in Slovakia even the only real alternative - as far as speaking about intermediation between small investors and businesses.

1.2. Troubled performance of recent decade

Banking system in Slovak Republic is under deep financial pressures, said Standard&Poor´s in 1999. Due to the importance of banks in Slovakia, not just banking sector but overall national economy was in serious trouble.

Insolvency in Slovak corporate sector had grown gradually since early 1990s, as a result of dramatic turnover from centrally planned to market economy. Meanwhile traditional CEE markets – vitally important for big producers – collapsed. Insolvency, not penalized and healed by bankruptcy mechanisms (did not exist yet), spread among companies and affected banks too. Those under the state control dealt also with corruption and political pressures, resulted in new bad loans later on.

During the second half of the 1990s, especially between 1996 and 1998, non-performing loans mushroomed due to extremely high interest rates. Despite relatively low (single digit) inflation – the lowest in V4 countries at that time - an excessive central government spending lifted state bond coupons over 20 %, some 15 percentage points above inflation (CPI).



As a result of unpredictable environment the Bratislava Interbank Offered Rates became extremely volatile, the price of bank refinancing more than doubled. Consequently the price of credits to companies has doubled. It had a fatal impact on financial situation of indebted companies and a quality of bank portfolios as well. Vast amounts of money trapped by ailing companies brought to a halt providing new loans in dominating banks under the state control. Also sound subsidiaries of foreign banks reduced new lending to a minimum, while they were making profits on lucrative state bonds. Growth and market opportunities were thus limited, especially for small and medium-sized enterprises.

1.3. Successful revitalization

A breakthrough was of vital importance, and it came with the new government. An ambitious plan of consolidation and privatization of dominant banks was adopted by first cabinet of Mikuláš Dzurinda in 1999. The government restructured three largest state-owned banks (with a combined asset share of almost 50 %) by injecting capital (around 2 % of GDP) and carving out bad loans (around 12 % of GDP) in 1999 – 2000. After that dominant banks were successfully privatized to foreign direct investors.

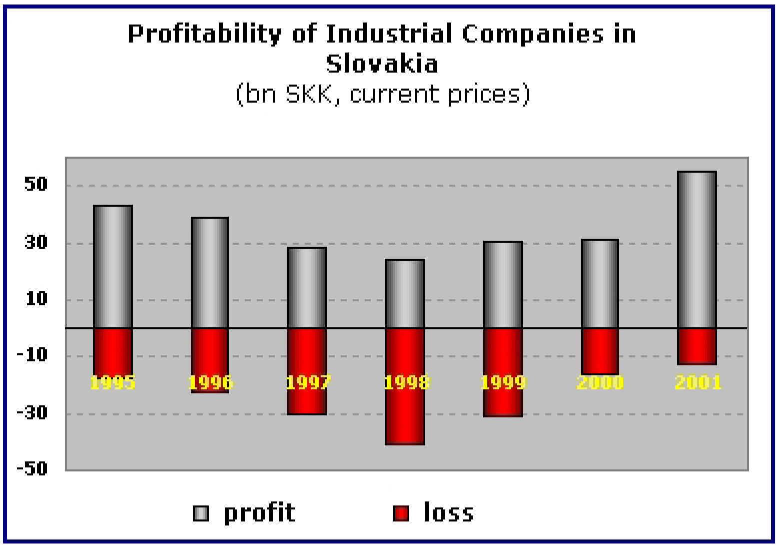
The state-owned consolidation institutions, to which the bad loans had been transferred, were merged in 2002, with the Slovak Consolidation Agency now being the only collection agency. The debt consolidation is being conducted through different market-based methods and the agency is currently looking for a foreign joint venture partner to bring in additional expertise. Due to delayed transfers of bad loans chances to get money back from debtors is very low, thus revenues will cover hardly one tenth of total costs paid for revitalization of former state banks. Consequently the total bill for their recovery has lifted the state debt up by more than 12 % of GDP.

Bank restructuring and privatization were accompanied by credit contraction in real terms, but recent developments suggest that lending activity to companies and households is picking up. The potential for expansion is large and will be encouraged by improvements in the legal operating environment. It will be based on the considerably enhanced stability of the sector.

The aggregate capital adequacy ratio based on Slovak accounting standards, for example, was almost 20 % at the end of 2001 in comparison with less than 1 % before bank restructuring (June 1999). Similarly, the ratio of non-performing loans to total loans dropped from almost 40 % before bank restructuring to roughly 13 %.

Such turnover in line with the higher transparency in fiscal policy revived credibility of the Slovak financial system. Reasonable government expenditures then pushed interest rates on state bonds rapidly down to single digit level in 2000 and even to approximately 5 % nowadays.

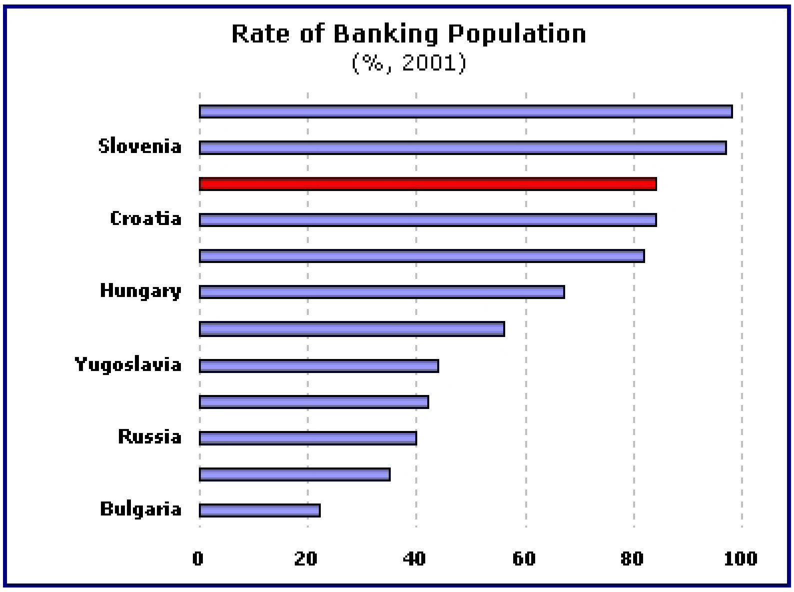
With the price of liabilities failing, the company´s financial performance improved significantly as well as their payment discipline. At the time when loans were costly, delayed payments to suppliers were a cheaper and oftentimes the only available way of financing for many companies. Presently, the majority of companies are no longer forced to deal with cash shortage and resort to such practices.



In 1999 S&P said, that restructuring of Slovak banking sector would have taken long time. Fortunately it has not. In less than three years the insolvent small banks went bankrupt, bigger ones were strengthened by new strategic investors or even by a government in advance. After a big wave of sales there remained only a couple of small banks dominated by domestic shareholders. From 2001 nearly all Slovak banks have been operating under the control of foreign financial institutions.

2. Growth potential

In spite of the mentioned problems connected with bad loans, Slovakia has a fairly developed banking sector. A market research made by GfK in 2001 has shown that 84 % of Slovak population (over 15 years of age) already use either personal account, passbook or another bank product. It is the highest rate in countries of V4.



Local banks have been implementing modern technologies in providing services. In some areas of banking Slovak customers use even higher comfort and more progressive communication channels than those in most EU member states. An aggressive changes in pricing policies force customers to prefer a phone banking or an internet banking with lower fees. Such policy reduce the need for new branches and staff. The density of the branch network would unlikely reach such level as in Austria or Germany as the Slovak banking sector – alike the Czech one – will jump over one step in its development directly towards greater reliance on electronic banking.

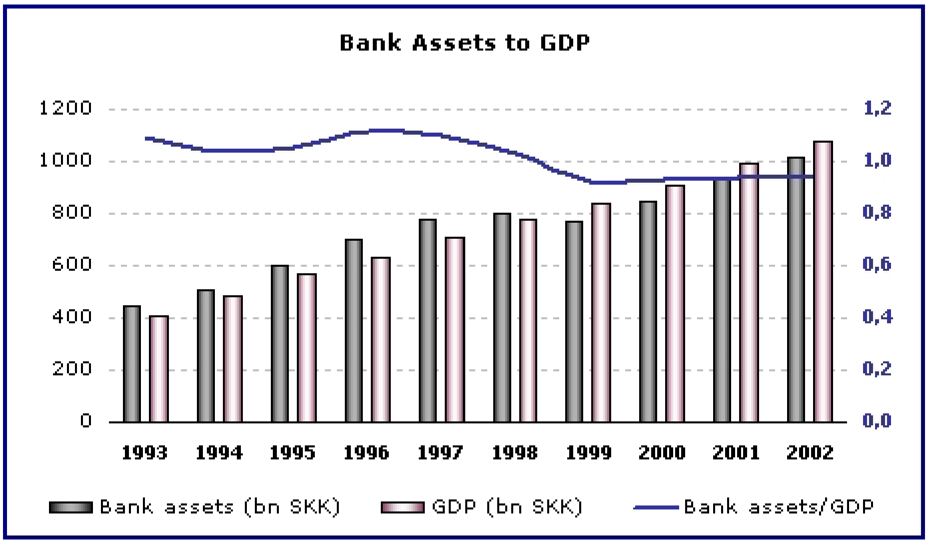
On the other hand active operations towards customers are still much less developed in Slovakia than in Western Europe and there is a huge potential for growth, hence they deserve more notice.

2.1. Active operations

One of the basic indicators of banking sector development is considered to be bank-assets-to-GDP ratio. The index for Slovakia is slightly below 1 – less than in EU current members but more than in most candidate/ EU new member states.

High volatility of this indicator for Slovakia has been reflecting some manipulation with total assets in late 1990s made by foreign subsidiaries in order to avoid the central bank regulation. In recent 2 years increasing amount of repo transactions with the central bank have been pushing total assets according to Slovak accounting standards above its real amount.

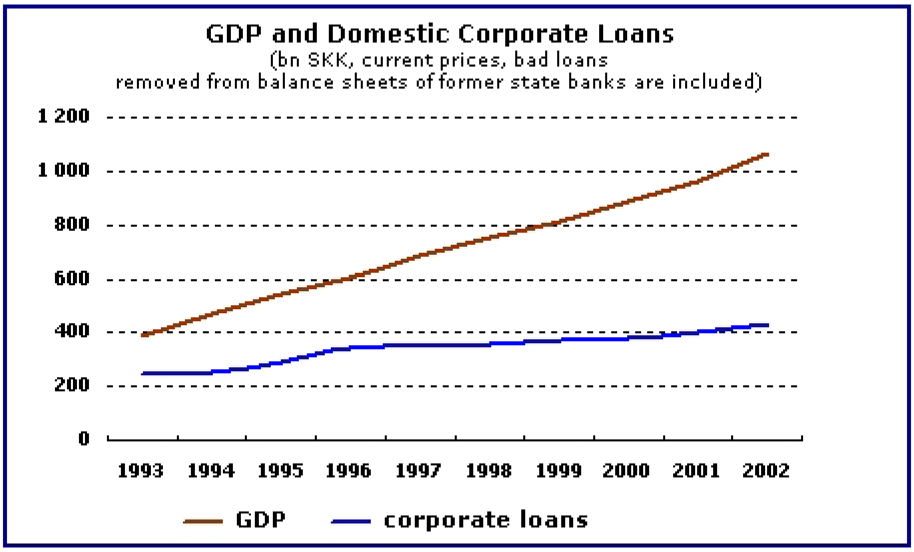
In fact since 1997 the growth of total assets in banking sector has stayed far behind nominal GDP growth in Slovakia. A change is likely to occur in coming years since massive restructuring and privatization within the sector is bringing a new drive especially to active banking operations. However, we do not expect that the total assets of banking sector could exceed annual gross domestic product in the following 5 years.



2.1.1. Unproductive composition of bank assets and its grounds

After a massive carve-out and replacement of bad loans by Government bonds, the balances of two leading domestic banks are almost free of bad loans and overcapitalized. The rest of their loan portfolios have been extremely little – less than a quarter of total assets (even less than 15 % in the biggest Slovak savings bank). On the other hand up to a half of their assets comprise from Government bonds.

Although these are extremes, high investments to state bonds are typical for most banks. In banking sector as a whole such investments still exceed total amount of money lent to customers. There are very few banks with at least 50 % share of loans to customers (either retail and corporate) on total assets.



Despite the fact that the condition of banks has improved significantly, loans are still unavailable to a large share of entrepreneurs. Several causes were identified in a research made by TREND Analyses in 2002 on side of legislature, business and banks as well.

Especially problematic are the banks´ overstated criteria on secured loans, unnecessarily lengthy paperwork with loan processing, and also little interest of banks to grant loans to small businesses. This is rooted in the negative experience of banks with bad loans. In the past, credit security was often fictitious. Oftentimes even standard security tools failed because of imperfect legislation, delayed decisions of courts, corruption, and a rather peculiar interpretation of the law by Slovak judges. Because of bad experience, banks act more cautiously. It seems, though, that they have gone from one extreme to another – from the benevolence of the early 1990s to excessive rigidity at present. A short time of the operation of the new bank owners contributes to this fact.

The elimination of subjective causes on the side of businesses will require not less time. Among the causes of a poor availability of loans is the under-capitalization of companies. Some apply for loans that are multiple of their equity, although more appropriate institutions to approach would be private equity or venture capital funds.

Unfortunately, in the first half of 1990s entrepreneurs faced a situation when banks extended loans to newly established companies with minimum capital. Oftentimes, bankers did not require more than a simple business plan, and this practice has resulted in potential entrepreneurs not being critical of their own projects. This phenomenon has not quite disappeared, partly due to the fact that corporate loans were marginalized by government borrowings in the latter half of the 1990s. During that period banks had problems with meeting the needs of the Government and big companies and loans to new customers were unavailable at all. Luck of experience on both sides now curbs providing loans especially to small and medium enterprises.

Presently, entrepreneurs are faced with a standard evaluation of loan applications. They have been learning their lesson that by hiding real profits - in order to avoid taxes - their chances to get a loan have been considerably limited, since banks do not trust unprofitable companies. Obviously it takes much time for such companies to achieve a profitable track record.

However, even those companies to which the above reasons do not apply, are not spared the difficulties. The strategies of many companies are in a crisis due to the unavailability of loans in the past period and at once due to a forced focus on the solution of short-term problems. Hence there is a deficiency of prepared solid projects for which loans are available.

2.1.2. Dealing with barriers in credit activity

Since there ceased to be a comfortable business built at high interest rates on Government bonds, banks have been forced to seek new investment opportunities. However, as explained above, after a long period of nonexistent or extremely low credit activity it takes much time.

The strengthening of the loan departments in the biggest banks in terms of guidance and human resources is a sign of keener competition on the loan market. In it, the willingness of banks to grant unsecured loans to companies with a stable cash flow is expected to play an important role.

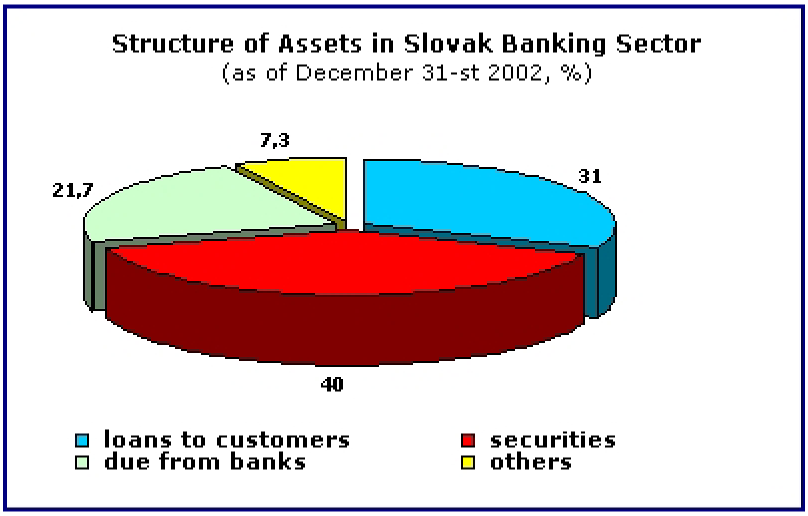
Although there has been a credit register for several years, it covers just corporate loans exceeding certain amount. A new credit register will soon start to operate covering also retail credits.

In legislation, a step forward is the enforcement of the bankruptcy law that has imposed limits on the priority claims of tax authorities towards companies in bankruptcy. A significant momentum for a more intense loan activity of banks could be the Civil Code amendment that has been operative from January 1, 2003. It sets forth charges on movable assets. Once the central charges registry was established, entrepreneurs have being entitled to use as security various equipment, technology and other movable assets.

First positive measures have been adopted recently to deal with delays in judicial proceedings. Nevertheless, much more has to be done to overtake unsatisfactory practices on Slovak courts. Professionalism of judges and taking improved legislature into practice seem to be crucial problems. More on legislature needed to adopt in the Chapter 8.

2.1.3. Growth potential in active operations

Despite existing problems the credit activity of banks in Slovakia has been speeding up. Last years´ increase in total volume of loans to customers was the highest since 1996, in the retail segment even the highest ever. However, these facts should not be over valuated because of very low starting point. We suppose a real expansion is only at the beginning.



Numbers speak for themselves clearly. Less than a third of total assets in Slovak banking sector is allocated in loans to customers (either corporate or retail), though an optimal share is considered to be a half.

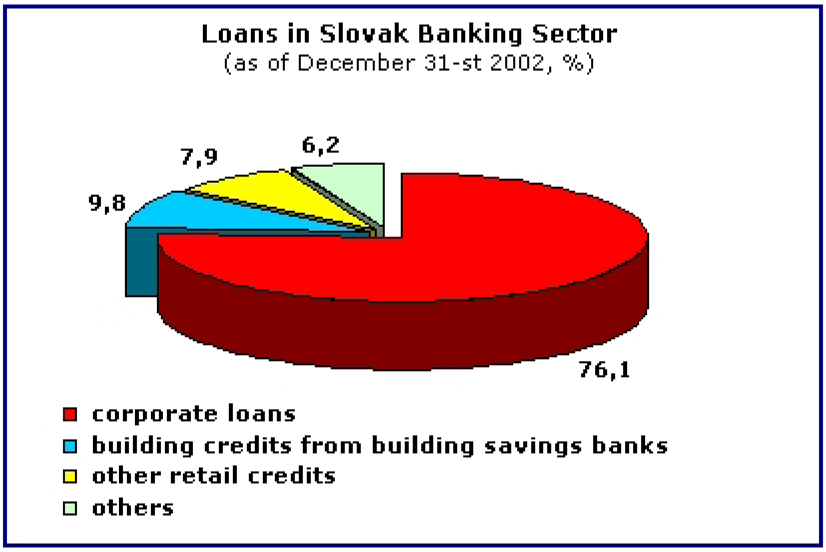
In contrast primary deposits of banks in the Slovak Republic cover two thirds of its´ assets, reflecting strong position of banking sector as almost exclusive collector of savings and free cash in the economy.

It is obvious, that on average banks in Slovakia have lent to customers merely a half of the volume of primary deposits. In a segment of retail customers total amount of credits represent only a fifth of their deposits. Such a gap is hard to find anywhere in the EU or even in the future member states. It shows a huge potential for growth, independent from the accession momentum.

Most existing portfolios represent corporate loans, especially to international and big domestic companies. There is extremely strong competition in this segment and very limited space for further growth, though the EU accession could lead some supranational corporations to come to Slovakia or to expand its´ existing activities in the country. There also could be certain space for growth of domestic loans to those companies, which refinanced their needs on international markets in recent years as it become cheaper now on Slovak market. On the other hand, in medium and especially long term horizon corporate bonds will start to play a role of real alternative to bank loans, as pension reform is likely to boost the demand for such assets.

Much greater space for growth represents an underfinanced segment of medium and small size businesses. Though with missing credit history for now and oftentimes with lack of transparency, it has a potential to be of vital importance for sustainable profitability in banking business after further cuts in interest rates.

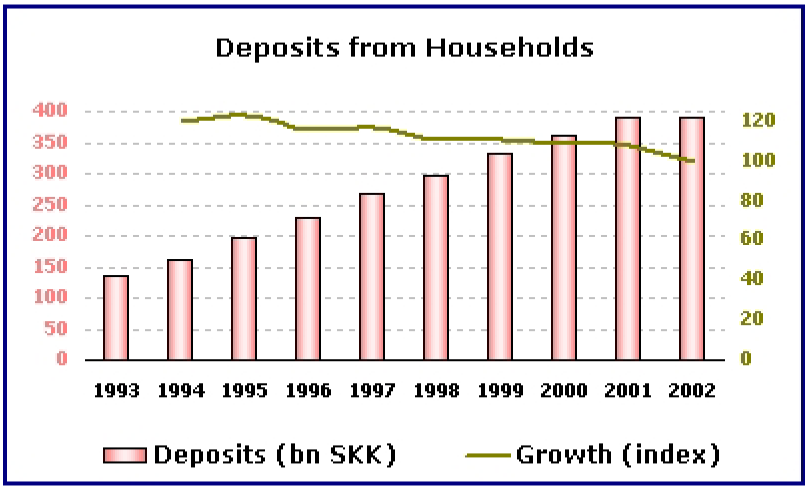
One more segment is of vital importance for the future market positions – retail business. After a decade of collecting deposits Slovak banks have discovered a potential in active operations towards retail customers. Mortgages, consumer credits, card credits and similar products had been marginal for long time or even had not existed. Recently just mortgages and consumer credits have been growing up with a potential for long lasting boom in further years.

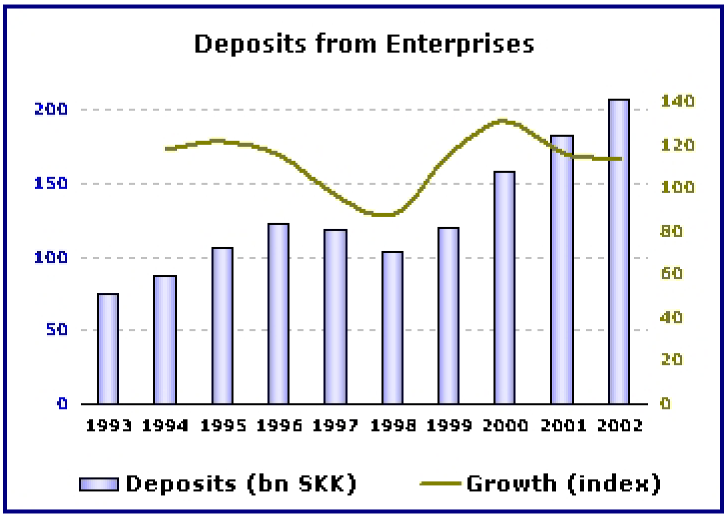


2.2. Deposits

On passive side of bank operations the dramatic decrease in interest rates in recent years brought a significant slowdown. While extremely high interests exceeded an inflation rate (CPI) 3-4 times, in late 1990s strongly mobilized deposits from households, on the other hand lack of liquidity in economy resulted in rapid decrease of deposits from enterprises.

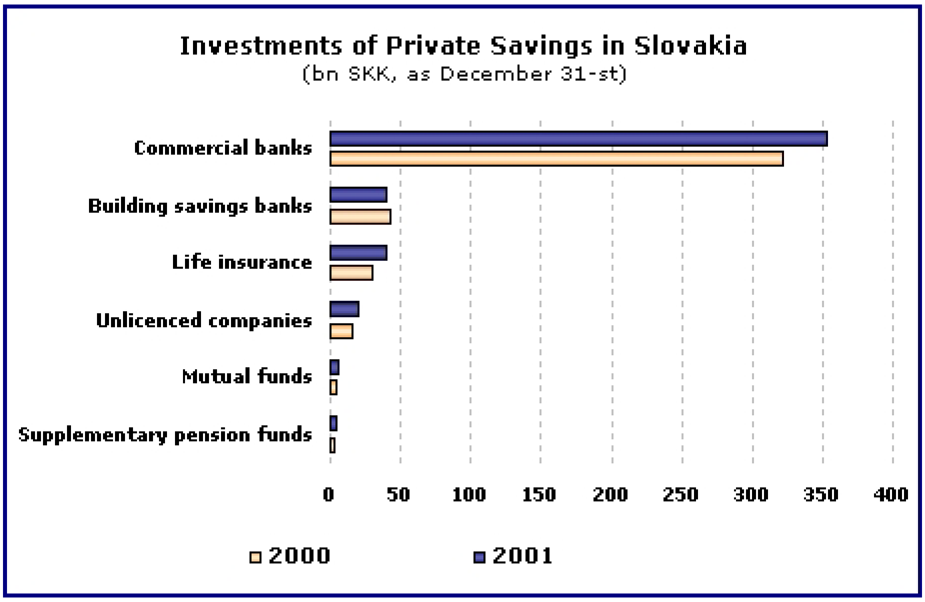
Conversely in recent years retail customers have been much less motivated to create new savings on bank accounts, consequently the total volume of households´ deposits stagnated for the first time. On the other hand rapidly improving access to liquidity resulted in significant increase of bank deposits from enterprises. In spite of the slowdown in total bank deposits, it still represents solid level of almost 63 % of GDP (by the end of 2002).





Much less satisfactory than the volume is the composition of bank deposits. It will be necessary to achieve a significant improvement in the time structure of deposits. Banks have been facing to a continuing decrease of medium- and long-term deposits already more than a decade. Nowadays there are almost no long term or at least medium term primary deposits in bank portfolios except specialized building saving banks.

An extreme shortage of deposits limits providing long-term loans, however banks have done a little to solve the problem. Nevertheless, a pension reform – that is just being prepared - could bring a breakthrough. Up to now non-bank investments of households savings remains marginal in Slovak economy.



2.3. Card business

At the end of 2002 there have been two and a half million payment cards in circulation in Slovakia – the country with the population of 5.38 million. Only 1.5 pro mile of them has been managed by non-banking issuers like Diners Club and American Express. Dozen domestic banks have issued the rest, mostly under brands of MasterCard (54.2 %) or Visa (42.7 %). Although the number of issuers seems to be high enough for the small Slovak market, the majority, more than 80 per cent of payment cards, is in portfolio of the one from the 3 biggest banks.

These "Big Three" banking companies dominate not only in issuing, but also in acquiring. In ATM business they (mainly Slovenska sporitelna of Austrian Erste Bank Group and Vseobecna uverova banka of Italian

BCI Group) control around 90 per cent of turnover, which overstepped 121 bn SKK last year. That number is pretty huge if compared to GDP or turnover in retail stores. Every third crown paid in retail was withdrawn out of ATM before spent as cash. That is more than eleven per cent of GDP produced in 2002.

The turnover of ATM business grew annually by one quarter last year. More intensively, by two fifths, jumped the output of POS industry, i.e. the turnover made on electronic point-of-sale (POS) machines, which accelerated up to 17.5 bn SKK. This segment of Slovak card business stays under the strongest competition struggle. The fight for merchants resulted in cutting fees under the level obvious in developed Europe. However, it is allowed also with lower fees for domestic issuers from domestic transactions.

The Big Three (mainly Tatra banka of Austrian Raiffeisen Group and VUB) control over 93 per cent of turnover on POS. Unofficial information indicates that market leaders think to increase the fees and make card business more profitable.

As for cards issuing and acquiring, the Slovak retail banking was completely blank twelve years ago. That is why banks jumped over the off-line era. They invested in technologies using magnetic stripe and decided to prefer on-line authorization with PIN to the off-line with signature. Therefore, more than 95 per cent of cards issued in Slovakia are electronic (mainly Visa Electron and Maestro brands).

Safer payment card system and less frauds are the result. That is one reason, why Slovak banks are so cautious about chip launch. Technologies for cards, ATMs and POS are developing very fast, prices go down, functionality of smart card is wider and wider every year. Small issuers wait for big acquirers to migrate their payment network, but those leave the migration to the latest term possible in order to maximize the final utility. The exception is Slovenska sporitelna, which started migration to chip in 1998. Nowadays VUB is transforming POS and ATM network to chip, while Tatra banka is amid of the preparation.

Next stress the Slovak banks give in their strategies are credit cards. Till the middle of year 2000 all the card biz was about debit cards, whether electronic or embossed. In August 2000 Tatra banka jumped into the segment (Visa), followed by VUB (ECMC and MCE) and small Istrobanka (MCE) in autumn 2001. Today only two banking houses issue worldwide accepted credit cards. They have focused on clients with higher bonity while the mass market of low wage potential debtors was filled with non-banking companies issuing cards, which need not be really "credit" from the partner bank point of view.

Still there exists a market opportunity which could be used by e.g. Citibank, the credit card leader in Czech republic. Some potential lies in MasterCard Electronic (MCE), formerly domestic credit brand, which is being spread to worldwide use. As a result of lower risk the brand is cheaper and therefore more appropriate for lower income clients of banking industry.

3. Foreign trade

Banking sector has a very low direct impact on foreign trade. Conversely the quality and accessibility of banking services affect other sectors to some extent since both exporters and importers need to use bank financing or another bank services.

Conditions have improved significantly for serviced companies in recent years in line with the decline of interest rates. Although in short-term period it can push imports up due to higher investments, an increase of export potential should later help to balance foreign trade.

In the coming years interest rates are expected to fall down closer to the euro ones. An additional savings in companies´ financial cost should come from early euro adoption. All this promises further reduction of disparities in financing between domestic and foreign competitors with a positive implication on export capability of domestic companies.

In the matter of free funds transfer it is evident, that presently Slovak banks mobilize more funds then they can allocate domestically. However, considerable exports of excess liquidity are unlikely hence more than 80 % of deposits are denominated in SKK. Banks thus have very limited space for investments abroad without currency risk. Moreover interests paid on SKK assets are still higher than dollar or euro ones. An excessive liquidity in the Slovak currency is still being sterilized by the National Bank of Slovakia, which offers its own papers with an interest of 6.5 % p.a.

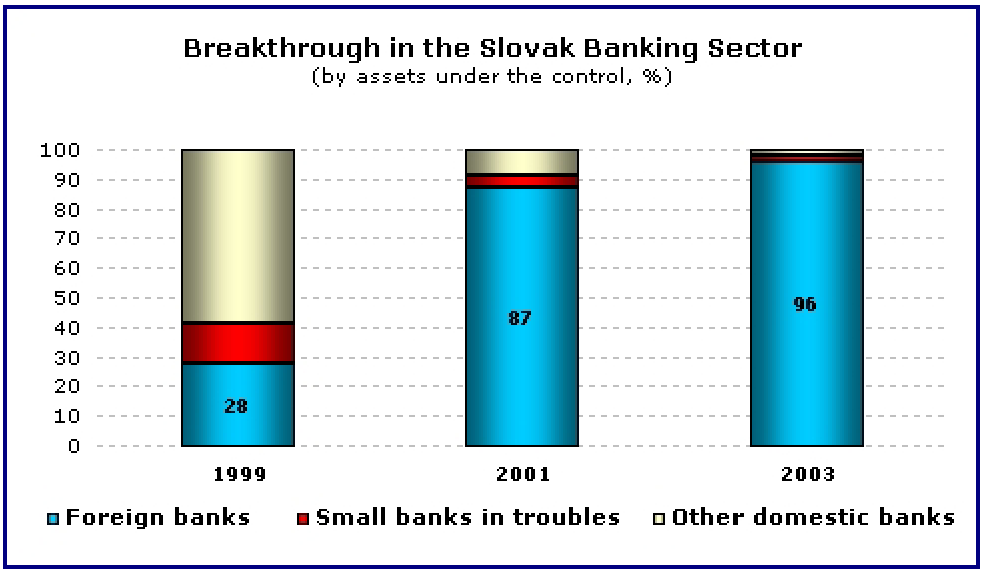
Although interest rates are expected to decline, significant increase in free funds export is not likely either after the accession to the EU. The situation may change by the euro adoption later, nevertheless by that time we expect an amount of money lent to customers on local market would by much more balanced with amount of deposits than nowadays.

4. Foreign direct investments

Slovakia had not been a favorite country to invest for many years. Despite very low FDI inflow to the economy in 1990s, there were not only few foreign direct investments in Slovak banking sector. Since mid 1990s almost a half of banks in the country had had majority, or at least minority foreign shareholder.

Nevertheless dominant banking houses had stayed under the state control and FDIs had been limited to greenfields. That is why an influence of foreign capital in the sector had grown gradually for 10 years and reached merely 30 % at the beginning of 2000, measured by share of banking assets under the foreign control.

The situation changed rapidly in further 2 years, when the share tripled to almost 90 % at the end of 2001. A breakthrough was being made by a privatization of two dominant institutions, but also several medium sized banks were sold to foreign investors simultaneously and a few small banks went bankrupt in 2000 and 2001. Two more banks have attracted FDIs last year. After that 96 % of banking assets in Slovakia are already under the control of foreign, mostly European banks.



Due to recent changes in ownership a situation has been changing significantly in the individual banks and overall banking sector at all. A standard practices have spread among most banks and brought a higher quality of credit risk management as well as other essentials for sustainable profitability.

Undercapitalized banks have being strengthened and at the moment there is almost no need for FDIs increase in the sector (except 1 or 2 small banks). On the contrary dominant banks are being overcapitalized, having a space for several years of expansion without new capital.

Further development is fairly predictable in banking sector as for FDIs. Considering the existing ownership (almost exclusively foreign banks) it is obvious that there could hardly be any outward investments from Slovak banking sector - either before or after the EU enlargement. Conversely an assessment of inward investments is not so simple.

The accession to the EU will let all banks from EU to provide services in Slovakia without a permission of national regulatory authority. Meanwhile, National Bank of Slovakia has been barely providing licenses to foreign branches, preferring subsidiaries with separate share capital allocated in Slovak Republic.

Therefore the EU accession will open the door for branches of supranational banks which have decided not to establish a subsidiary in Slovakia. Some of them will likely open a branch in the country in following years, since it will have almost no need for capital. In view of the fact that Slovak market is fairly competitive at the moment, we do not expect many new foreign branches. They will probably focus on serving the biggest corporate and international clients.

On the other hand we expect that some existing subsidiaries, which have been providing just corporate banking, will transform to foreign branches in Slovakia. Consequently the EU accession will likely have a negative impact on the volume of FDIs in Slovak banking sector. In spite of the expected decrease in registered capital it will not have a real negative impact on banking sector.

5. Labor market

An employment in Slovak banking sector had been growing gradually in previous decade in line with increasing number of market players and a development of branch networks of either new or old banks. Total number of employees in the sector culminated between 1996 and 1998 when it exceeded 24 thousand (excluding central bank).

Dominant institutions at that time started to deal with the problem of overemployment while attracting a state support. They cut their staff significantly – some even by more than one third - in the last 5 years. Approximately 5 thousand people have lost their job in three former state banks, mostly during pre-privatization period. That could not been fully compensated by an increase in staff of foreign subsidiaries, particularly after almost two thousands people lost their jobs in five small bankrupted banks in 2000 and 2001. Therefore a total number of employees in Slovak banking sector has declined by more than 4 thousand below 20 thousand (less than a half of state railways staff) at the end of last year.

It is obvious that most unpopular measures have been done in recent years. Since the level of qualification and technical skills of bank staff is sufficient, an accent will be put on improving the communication and management skills, especially in recently privatized banks. They have to enhance predominantly customer friendly and sales oriented behavior, therefore a lot of training is being made for staff.

A new generation of young managers had grown up in the last decade in foreign subsidiaries. In recent years many of them were hired by new investors and have been helping to change climate and redefine culture in dominant, former state banks.

Nevertheless, in top managements of many banks ex-patriots are still predominate. Unfortunately, not every parent bank nominates good ones. In addition the poor knowledge of the local market conditions sometimes leads them to wrong decisions. However deficiency of experienced domestic bankers is noticeable.

The EU accession could help to achieve an improvement on this field. Up to now administrative barriers limit a rotation of young managers from non-member states in the structures of international banking groups. Only few of them have such an opportunity to gain skills and experience essential for their professional growth.

The EU accession will certainly raise the perspectives of qualified labor force assert in affiliated financial institutions abroad. Nevertheless, we do not expect a massive migration into Euro zone in short-term horizon, because of deficiency of experienced bankers on domestic market, implied to above-standard wages.

6. Regulatory framework

In the last two or three years, the Slovak banking legislation changed significantly as a result of a gradual adoption of the EU legislation before the decisive Copenhagen summit in December 2002. The Parliament approved or amended several laws that regulate or influence banking activities. The most important among them are:

- New banking law which considerably strengthened the position of the Banking Supervision and made changes in provisions regarding capital adequacy where now market risks are also included
- Act on Payments harmonized the Slovak legislation for domestic and foreign payments with EU
- Act on the Protection of Bank Deposits will guarantee the same compensations for unavailable deposits as in the EU after the accession
- Act on Protection against the Legalization of Proceeds from Crime abolishes anonymous bearer passbooks
- Accountancy Law ensures the full compliance with respective EU directives

Law on Protection of Bank Deposits

The amendment to the Act on Protection of Bank Deposits now covers by a deposit protection scheme private persons and also legal persons of non-profit and non-business nature. The compensation amount for unavailable deposits has started to rise from the present 90% of the 45 multiple of an average wage (approximately EUR 14,300) to reach 90% of EUR 20,000 upon the accession. Membership in the scheme is compulsory for all banks and the contribution may vary from 0.1% to 0.75% of the volume of covered deposits plus extraordinary contribution up to 1% of protected deposits.

Laws regulating other financial services

Since banks are now providing a full range of financial services, it is worth to mention that the Insurance Law, Act on Securities and Investment Services, Act on the Stock Exchange and amendment to the Collective Investment Act were adopted. The Act on Securities and Investment Services transposes rules on capital adequacy of investment firms into the Slovak legislation. It also establishes a compensation fund for investors. The Act on the Stock Exchange aligns with acquis the regulation of the listing and trading securities on the stock exchange. The insurance sector and the investment services are now regulated partially in line with EU directives, however the full compliance will have to be achieved by the time of accession.

Two regulators of the financial sector

The new Act on Financial Market Supervision has established a new Financial Market Supervision Office (FMSO) that is no longer financed from the state budget but from contributions of market participants. At present, thus there are two bodies, the National Bank of Slovakia (NBS) for credit institutions and FMSO, overseeing insurance sector and capital markets. Banks are regulated by both of them. The two institutions have different positions against market participants, since their position is defined by different pieces of legislation. The central bank and its position are defined by the Constitution and it has a power to issue the secondary legislation. An ordinary law established FMSO; therefore this institution does not have the power to issue any secondary legislation independently. The Slovak government already adopted the concept of integrated financial market supervision, which sets a framework for a gradual integration of both regulatory institutions under one roof. In the first phase their co-operation will strengthen. Legislation changes will be adopted by 2004 and the end of 2005 expects the final merger of both institutions.

Other laws

An amendment to the Foreign Exchange Act has liberalized operations with financial derivatives and also has abolished a possibility to set limits on imports and exports of coins and banknotes. The amendment will authorize Slovak residents to open accounts abroad and will remove their obligation to transfer financial means acquired abroad into the country. This will have an impact on banking sector since domestic banks will compete with banks abroad. Insurance companies will be allowed to invest their reserves also into foreign securities.

Act on Payment Systems has fully transposed the Directive on cross-border credit transfers and on settlement finality and ensures to compliance with acquis on electronic payment instruments.

The new Accountancy Law has achieved a full compliance with EU Directive 4 and 7 and International Financial Reporting Standards.

6.1. Assessment of the Slovak progress by the regular EC report

The recent regular report on Slovakia's progress towards EU accession published in October 2002 assessed that the Slovak legislation is in line with the relevant banking acquis. The National Bank of Slovakia (NBS), as a regulator of the banking industry, has issued rules and is implementing policies and practices which are similar to the Recommendations of the Basle Committee on Banking Supervision and in line with EC directives. Nevertheless, although NBS has already started on-site examinations in all existing banks, states the report, it has to increase their frequency and has to continue in upgrading the training and number of prudential supervisors.

In the field of general right of establishment and freedom to provide services Slovakia has achieved a considerable progress, however there are some ambiguities and potential restriction the current Slovak legislation, which need to be identified and removed before the accession.

Capital movements are almost fully liberalized in line with acquis. The only restriction concerns the acquisition of real estate by non-residents, which will be partially abolished by the accession. Transition period concerns agricultural and forest land acquisition (7 years). The Slovak payment system after the adoption of the new law on Payments is broadly in line with acquis, however some amendments should be still introduced.

Very important subject of money laundering legal framework has improved significantly but the report states that further steps are necessary, especially in implementation of new rules.

Slovakia has already included provisions of the Directive for capital adequacy where market risks are covered by the banks´capital. Slovakia will also gradually increase a volume of compensation for unavailable deposits and abolish anonymous bearer passbooks. Some improvements have to be made in the field of protection of personal data and data movement that is an important issue for banks, which have to share the credit data via credit register. In payment systems should be established a body which will solve complaints following from cross-border payment transactions and real time settlement system for inter-bank payments.

6.2. Further steps in legislation and improvement of regulation

Slovakia will amend the Insurance Law and the Law on Collective Investment which both will fill gaps between current Slovak legislation and acquis and EU directive (UCITS).

The Banking Supervision of the central bank will have to be strengthened – it needs more enforcement powers. It also needs a possibility to take an early enforcement action against unlicensed non-banking institutions (this a lesson learnt from the past when these subjects embezzled approximately 2% of GDP). This would require a significant improvement in quality of NBS personnel, which has also to reflect a growing competition in the banking sector. FMSO and NBS Bank Supervision Department will have to enhance their co-ordination and co-operation. The concept of the merger of these two regulators was approved by the government in 2002 and should take place in 2005. The Slovak regulatory bodies will need to increase their co-operation with foreign regulators.

6.3. Other factors influencing regulation

The Slovak banking sector will be influenced by other significant changes in the economic policy especially by tax and pension reforms. The contemplated tax reform brings about a concept of flat tax for individuals and significant drop in the corporate tax rate (which should be less or equal to 20%). However, this is accompanied by abolishing various tax-deductible items, from which the most critical is provisioning that should become a non-deductible item. This would influence credit policies of banks and would make credits more expensive. Simultaneously, the Slovak banks will become less competitive on the EU market.

Regulatory framework will be fully compliant with acquis and EU directives after the accession (with the minor exceptions where transition periods were negotiated). The Slovak banking market will be fully liberalized and Slovak subjects (private persons but mainly corporates) will have an option to seek for banking services, especially financing abroad. We expect a strongly increased competition in the corporate banking sector where increased number of Western European banks will try to penetrate the segment of the largest Slovak corporates (approximately 200 units), especially exporters and daughter companies of the their Western European clients. We believe that the small and medium enterprises (SME) and retail segments will be less interesting since risk management requires relatively expensive local presence through branches although the branch establishment will be much easier than nowadays. With improvements of law enforcement and creditor rights protection we can expect an increasing competition in the SME segment as well. We also expect that freedom of providing banking services will lead to mergers or acquisitions of existing Slovak banks (at present mostly daughter companies of Western banks) in the way that the most important European banks will have a subsidiary or branch in Slovakia which will intensify a competition on the Slovak market.

There are several general legal issues with a strong impact on the banking sector activities. Legal courts that are expected to guarantee the justice are overloaded, and their work is inappropriate. Too long court process does not motivate market participants to behave according to law. Therefore, generally, protection of creditors´ rights is low and banks have to be cautious in providing loans. This increases the price of loans as well as transaction costs.

The Bankruptcy Law has been amended several times but still does not represent fully a tool for creditors for collecting unpaid payables. Debtors have many option how to use a court and thus to delay repayment. Overloaded courts are unable to resolve issues quickly and thus the value of remaining debtor's assets is declining. Moreover, the law is inclined towards bankrupted company liquidations rather than their restructuring. Therefore it is difficult to keep an operation of a bankrupted company and restructure it with its debts. Usually results of a bankruptcy procedure are write-offs of claims as tax-deductible costs.

Banks are also negatively influenced by often changes in legislation (for example Income Tax Law), late law and rulings publishing with no explanation part. General instability of the law gives only small space for long-term tax planning and optimization.

Sub-optimal situation with law enforcement and imperfections in legal system will represent a comparative disadvantage for Slovak banks on the unified EU market. They will generally contribute to higher prices of their products and services compared to other EU banks and their lower competitiveness.

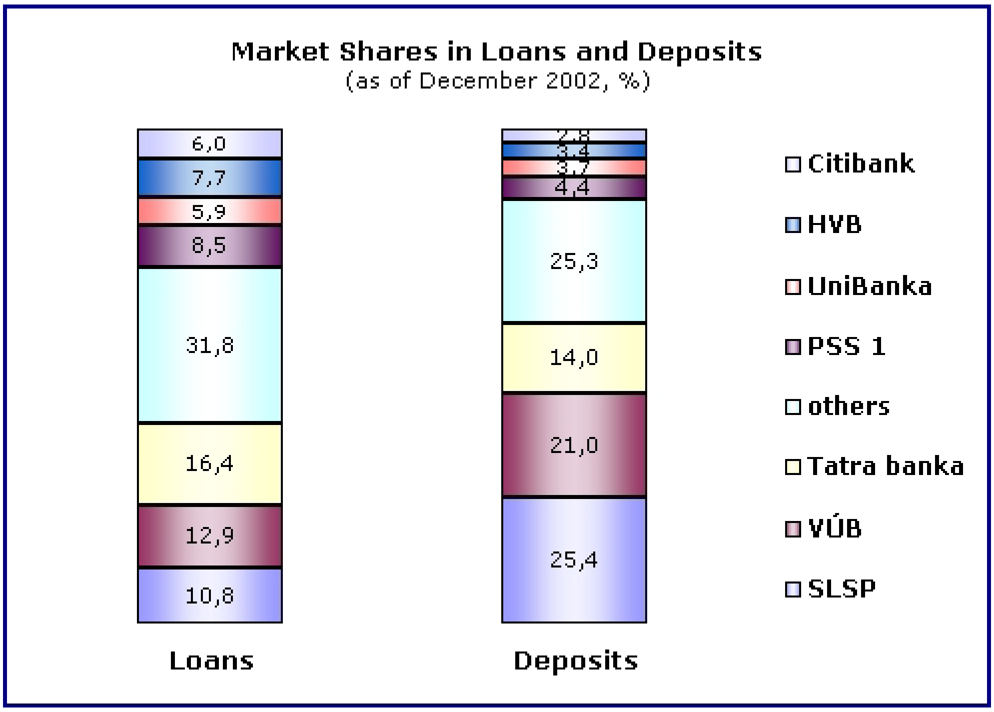
7. Changes in the market structure

Number of banks active on the Slovak market has declined by a third since 1996 when it culminated at 31. Currently 19 banks (incl. 2 foreign branches and 3 building saving banks) and two specialized state financial institutions operate on the market.

Big three still dominate

Approximately 55 % of total assets in the sector is under the control of the biggest 3 players: Slovenska sporitelna of Austrian Erste Bank Group, Vseobecna uverova banka of Italian Gruppo Intesa and Tatra banka of Austrian RZB.

The "big three" already collected more than 60 % of primary deposits, hence their networks comprise together from almost seven hundred branches – two thirds of total number for the banking sector (excluding 1620 counters at the post offices). On the contrary, after bad loans carve-out the position of leading three players is weaker in active operations towards customers with the 40 % market share, which is likely to increase soon.



Some medium-sized banks – as HVB, Citibank and Unibanka of UniCredito – compete successfully especially in providing loans to enterprises, since networks do not play such an important role as on deposits side. With the new drive of the two biggest banks especially in providing mortgages and other credits to households we expect the big three will remain dominant in every important segment of banking business.

New foreign branches after the accession

As mentioned earlier, the EU accession will likely lead to higher presence of leading global banks on the Slovak market, since it will be easier to open branch offices in the country. They are expected to focus on the biggest corporate and international clients, eventually the richest private customers.

On the other hand we suppose that some existing subsidiaries would transform to foreign branches. As a result their credit limits for individual clients, so far related to the equity capital of Slovak subsidiary, would rise significantly hence will be related to the capital of parent banks.

Another factor could play in favor of branches – an absence of medium and long-term deposits on local market. Due to that fact the local banks have a limited space for long-term lending which indicates an opportunity for competitors from the EU countries.

All these factors will strengthen the competition in the segment of big corporate and international clients, though it already is quite strong. There is a danger that local, especially medium sized banks (foreign subsidiaries) could be marginalized in this segment.

In contrast, an increase in number of banks active in retail business and SME´s segment is unlikely. It underlines vital importance of servicing these segments for local banks, mentioned already in the Chapter 2.

Looking for synergies within groups

Since most local banks are owned by internationally active banks, we expect them looking for synergies within their networks. Some activities would be centralized, like IT centers, treasury operations or call centers.

Management of certain divisions and for example nearly all treasury operations are expected to be centralized in headquarters with sales remaining in subsidiaries. However, looking for synergies will not mean a relocation of certain activities abroad in all cases. In contrast, for example IT and call centers could be more effective in countries like Slovakia with educated labor force available for less money.

Nevertheless, in most cases centralization will mean relocation of certain operations (or at least its management) outside of the country. Especially relatively small subsidiaries up to now servicing just corporate clients would degrade to branches operating as a sales centers.

Cross-selling potential

Decreasing interest margins will thus more affect universal banks with costly branch networks. As expected, they have already been increasing fees and provisions to compensate lower net interest income. Because of very low starting level, we expect the process will continue in following years.

In this process a cross selling will play an extremely important role. Leading local banks currently own leading building savings banks, asset management or leasing companies. Some of them are also interconnected to insurance companies or another businesses related to financial services. Despite this, the potential for synergy has not yet been exploited satisfactorily. Therefore we expect an increasing cross-selling activity within Slovak financial sector.

Limited space for mergers

A progress made on this field together with an ability to develop an active operations to SME´s and retail customers will decide, which of current medium-sized universal banks will survive on the market in the long run. We expect the final selection will not be made next to the EU accession but closer to momentum of the accession to euro-zone, since it will bring further decrease in bank incomes.

Due to the fact that nearly all banks in Slovakia already have a strategic owner, it will not be easy to arrange mergers on local market. Moreover branch networks of small and medium-sized banks are very similar with limited space for synergies. Therefore mergers of medium-sized players will rather follow a merger or acquisitions of its parent banks in the EU.

8. Policy measures and legislation

The Slovak government published the list of its priorities based on the Regular report by EC on the progress towards EU accession. The list addresses topics mentioned by the report and its main tasks were mentioned in the chapter 6 of this report. Nevertheless, successful and effective banking sector requires further measures:

Laws and rules observance

General situation of the Slovak business environment should be enhanced. Observance of written and unwritten rules is poor. The level of trust among business partners is low and this limits a willingness of banks to provide credits and simultaneously pushes up risk margins. Credit procedures are then often complicated (especially for new clients) and time-consuming. There are only very limited chances to finance a starting company or a new project (without bank or credit history).

We believe that Slovakia has to improve law enforcement system. Judicial courts should adopt decisions faster than now and the decisions should be more rooted in the country's legislation. More weight should be also given to extra-court procedures of cause solution.

Bankruptcy legislation

Although new bankruptcy legislation has been in effect for 3 years, the experience from several recent significant bankruptcies shows that creditor rights are not protected sufficiently as was already mentioned in the Chapter 6. Creditor rights, especially during bankruptcy process, should be further strengthened. It is important to mitigate various possibilities for speculations.

Separated record for property will has to be used for separated compensation, more precise definition of deadlines, when the property, on which is a collateral becomes a property belonging to a creditor, should be in the amendment. This also should reduce a possibility to register new (often artificial) claims (in so called second hearing) and strengthen the position of collateral creditors (banks).

Creditors should have approach to all information, at present creditors often are not able to find out who submitted a proposal for a bankruptcy which is an important information. System of voting on creditor meetings has to change. We have to underline the fact that on the unified European market will this situation if it is not changed automatically means a competitive disadvantage for the Slovak banks.

Deposit Protection Fund

There is a special issue of the Deposit Protection Fund in Slovakia. In the past the Fund repaid compensation for protected deposits in 4 banks, totalling approximately SKK 20bn. The Fund had to take a loan from the central bank and the outstanding amount that has to be repaid from contributions of all banks, still exceeds SKK 10bn.

In the situation when there is a surplus of liquidity and interest rates are declining a relative weight of the contribution to the Fund grows. Besides regular contribution that is now at its maximum of 0.75 % of the protected deposits volume (approximately SKK 350bn), the Fund may ask for extra payment up to 1 % of this volume. Thus annual contribution can exceed SKK 6bn that is a half of the 2002 net profit of the whole banking sector (SKK 12.5bn). This would significantly deteriorate banking sector economic performance and on the other hand such situation poses a moral hazard since the regulator is not punished for a sub-optimal supervision. Regulated subjects pay the whole bill.

The responsibility of the regulator (NBS and the state) cannot be avoided. Since in the past usually low quality of the bank supervision and political interests led to falls of banks, the state has to pay its share as well.

Capital market

The Slovak capital market also needs a significant change. At present, its role in financing private sector is negligible and banks are by far the only source of financing for the corporate sector. Slovakia also prepares the reform of its pension system, where a new obligatory fund system will be likely introduced.

The pension funds will need to invest partially into domestic assets providing higher yields than state securities. This fact only underlines the necessity to revive the Slovak equity market where rights of minority investors will be protected and the governance of companies will be watched and regulated by an independent body with strong powers, especially to issue the secondary legislation (this is for now vested through the Ministry of Finance, whereas a political influence cannot be fully excluded).

Quality of regulation

The problem of the Slovak capital market is therefore closely linked to a problem of a regulation of the whole Slovak financial market. The single authority to supervise the whole market is planned for 2006. By that time, NBS and FMSO should improve their co-operation and co-ordination.

The quality of supervisors should be improved significantly. Current reporting system requires from banks to produce more than 1000 various reports annually. With such a number of reports it is obvious that many of them are very similar and thus point out that level of co-operation among various institutions is low. We believe that this could be unified and simplified in order to reduce banks' costs.

The question of the secondary legislation issuance by FMSO should be resolved soon. The independence of FMSO on political subjects, as well as market participants, should be significantly strengthened. The quality and effectiveness of regulators will be also an important factor of the competitiveness of the local banks on the unified European market.

Adoption of IFRS

We also believe that a general adoption of International Financial Reporting Standards (IFRS, former IAS) will bring more transparency about the economic situation in banks and companies. This will positively affect the corporate governance and give a clearer picture about the banks and companies to all its stakeholders.

General use of IFRS by their corporate clients will help banks to identify better corporate potential and risks. This will simplify credit procedures and decrease risk margins, i.e. the use of IFRS should bring companies cheaper financing. The use of IFRS will also make easier for banks to adjust to the New Basle Capital Accord (Basle II) requirements.

Basle II adoption

Adoption to Basle II rules will be a challenge for banks and for the regulator, as well. NBS collected data for a quantitative impact study 3 (QIS 3) of Basle II on the Slovak banking sector in 2002. Banks should start to fill in historical databases for example, for internal ratings, loss and default cases and collaterals this year. We believe that although, the final and full version of the Basle II accord and corresponding EC directive do not exist yet, the central bank and banks should start as soon as possible with personal, technical, methodical and other steps for implementation of the new measures.

Study on the impact of EMU accession

The Slovak entry into the EU will be followed sooner or later by a adoption of Euro and the monetary policy of the ECB. This is predominantly an economic and political decision, but the adoption of Euro will have impact on the Slovak banking sector. The Euro adoption will likely lead to a termination of some bank activities in Slovakia (especially treasury) connected to foreign exchange. Lower transaction costs for companies simultaneously mean lower revenues for banks.

The adoption of Euro will have, however, more serious impact on the whole country. We believe that an early accession to the EMU could cause that Slovakia has negative real interest rates during several years. This might weaken savings rate and could endanger prepared pension system reform.

Slovakia and the rest of EMU will not likely form an ideal monetary zone during next several years as, for example, there will not be a free movement of a labour force between Slovakia and some members of EMU (7 year transition period). The Slovak prices and wages are at 40 % of the EU average at present; therefore any price and wage flexibility is missing, since Slovakia will slowly adjust to the EU level.

We strongly recommend preparing several impact studies of the EMU accession for various segments of the Slovak economy. Focus should also be given on setting of economic parameters values (e.g. price level, wage level, GDP, ERDI etc.), which should be reached before the Euro adoption.

Executive summary

After severe difficulties with large proportion of non-performing loans in the last decade the Slovak banking sector is currently in good condition. Although bank restructuring and privatization were accompanied by credit contraction in real terms, recent developments suggest that lending activity to companies and households is picking up. The potential for expansion is large and will be encouraged by improvements in the legal operating environment. The banking sector is now much better positioned for the fulfillment of its intermediation role.

At the end of the long process of preparation the EU accession momentum will have very limited impact on Slovak banking sector. Expected growth is based on factors what are mostly independent from EU enlargement. Nevertheless, some additional benefits and costs as well are likely to occur.

The EU accession could help to deal with a deficiency of experienced domestic bankers. Up to now administrative barriers limit a rotation of young managers from non-member states in the structures of international banking groups. Only few of them have such an opportunity to gain skills and experience essential for their professional growth. The EU accession will certainly raise the perspectives of qualified labor force assert in affiliated financial institutions abroad. Nevertheless, we do not expect a massive migration into Euro zone in short-term horizon.

The EU accession will likely lead to higher presence of leading global banks on the Slovak market, since it will be easier to open branch offices in the country. They are expected to focus on the biggest corporate and international clients.

On the other hand we suppose that some existing subsidiaries would transform to foreign branches. As a result their credit limits for individual clients, so far related to the equity capital of Slovak subsidiary, would rise significantly since it will be related to the capital of parent banks. Another factor could play in favor of branches – an absence of medium and long-term deposits on local market. It indicates an opportunity for competitors from the EU.

All these factors will strengthen the competition in the segment of big corporate and international clients, though it already is quite strong. There is a danger that local, especially medium sized banks (foreign subsidiaries) could be marginalized in this segment. In contrast, an increase in number of banks active in retail business and SME´s segment is unlikely. It underlines vital importance of servicing these segments for local banks.

Since most local banks are already owned by internationally active banks (mostly from the EU), we expect them looking for synergies within their networks. Management of certain divisions and for example nearly all treasury operations are expected to be centralized in headquarters with sales remaining in subsidiaries. In contrast, for example IT and call centers could be more effective in countries like Slovakia with educated labor force available for less money.

Relatively small subsidiaries up to now servicing just corporate clients would degrade to branches operating as sales centers. Decreasing interest margins will thus more affect universal banks with costly branch networks. They have already been increasing fees and provisions to compensate lower net interest income. Because of very low starting level, we expect the process to continue in following years.

In this process a cross-selling will play an extremely important role. Leading local banks currently own leading building savings banks, asset management or leasing companies. Some of them are also interconnected to insurance companies or another businesses related to financial services. Despite this, the potential for synergy has not yet been exploited satisfactorily and we expect an increasing cross-selling activity within Slovak financial sector.

A progress made on this field together with an ability to develop an active operations to SME´s and retail customers will decide which of current medium-sized universal banks will survive on the market in the long run. Since nearly all banks in the SR already have a strategic owner, local mergers will rather follow mergers or acquisitions of its parent banks in the EU.

Slovakia successfully adopted most of acquis dealing with the banking system; only minor amendments to existing laws have to be approved by the time of accession. The freedom to provide banking services without limitations will trigger an increasing competition from the EU, especially in a field of large corporate banking.

Law implementation and enforcement together with poor bankruptcy legislation, however, remain a weak point and can become a main competitive disadvantage for Slovak banks in the single EU market.

Banks are regulated by two regulators at present: National Bank of Slovakia and Financial Market Supervision Office. The position of these institutions is different. Both regulators need to strengthen their personal capacities and they have to enhance mutual co-operation and co-ordination. Both regulators will merge into a single regulator by 2006.

Concerning policy measures and legislation there are two main areas for recommendations. The first one relates to the fact that the Slovak banking sector will operate on the single EU market. We strongly believe that the quality and effectiveness of the Slovak judicial system, protection of creditor rights and generally law enforcement will decisively influence the competitiveness of the Slovak banks on the unified EU market. Quick and significant changes are necessary.

Bank supervision is the next factor that will have an important impact on the competitiveness of the banking sector. We recommend that the quality of the personnel in NBS bank supervision department is strengthened by means of significantly increased salaries. Powers of the Bank supervision should be enhanced and co-operation and co-ordination of NBS and FMSO has to improve dramatically. The state has to take its responsibility for quality of bank supervision decisions also through co-financing the Deposit Protection Fund.

Accession to the EU represents only the first step in the European integration. European Monetary Union is the further step. We advise to begin with extensive studies about the consequences of Slovakia's EMU accession on various industrial and service sectors as well as about necessary reform measures that should be adopted prior to eventual EMU entry.