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This paper on the Financial System Stability Assessment on the **Slovak Republic** was prepared by a staff team of the International Monetary Fund and the World Bank as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on **August 7, 2002.** The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of the **Slovak Republic** or the Executive Board of the IMF.

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SLOVAK REPUBLIC

Financial System Stability Assessment

Prepared by the Monetary and Exchange Affairs and European I Departments

Approved by Stefan Ingves and Michael Deppler

August 7, 2002

This Financial System Stability Assessment is based on work under the joint IMF/World Bank Financial Sector Assessment Program (FSAP). A World Bank led mission visited Bratislava February 14-March 1, 2002 and April 8-19, 2002. The team met with Ivan Mikloš, Deputy Prime Minister for the Economy, Marian Jusko, Governor, Elena Kohútiková and Ivan Šramko, Vicegovernors, Executive Directors and staff of the National Bank of Slovakia (NBS); and Mr. Hajnovic, Minister of Finance (MoF) and staff of the MoF. In addition the team held extensive meetings with staff of the Ministry of Justice, Ministry of Labor, National Bank of Slovakia, Financial Markets Authority (FMA), Financial Police Administration, Slovak and Bratislava Stock Exchanges, Deposit Protection Fund, Slovak Consolidation Agency (SKA), and National Property Fund. The team also met with various industry associations, e.g., the Bankers Association, Insurance Industry Association, Association of Securities Dealers, Association of Investment Fund Managers, and the Leasing Industry Association. Intensive discussions were also held with various representatives of the financial and private industry including all the major banks, insurance companies, accounting and audit firms, and judicial trustees. The findings and analysis of the mission were discussed during the Article IV mission in May 2002. The FSSA report is presented in two parts: The *Staff Report on Financial Sector Issues* presents the main findings and overall assessment, and the *Report on the Observance of Financial System Standards* presents summary assessments of observance of standards in banking, insurance, and securities supervision and payment systems oversight.

The FSAP team was led by Lalit Raina (World Bank, Mission Chief), Warren Coats (IMF, Deputy Mission Chief), and comprised Marie-Renée Bakker, Laura Ard, Michael Gascoyne, Gordon Johnson, Donald A. McIsaac, Angana Shah (all World Bank); Alina Carare, Edward Frydl, Louis Kuijs, Maike Luedersen (all IMF); Euan Abernethy (Formerly Chairman of New Zealand Securities Commission), Herman Litman (Bank of Israel), Gudrun Mauerhofer (National Bank of Austria) and Krzysztof Senderowicz (National Bank of Poland), and Anne T. John (World Bank, Program Assistant).

Successful stabilization and an ambitious structural reform program since 1998 and the rehabilitation and privatization of the public banks has produced a banking and financial sector that appears to be robust to a range of macroeconomic or financial sector shocks, but political and implementation risks remain. Banking supervision is weak, but the NBS has launched a medium term program to strengthen it (with IMF and World Bank assistance). New, predominantly foreign, owners are also strengthening the risk management systems of their recently recapitalized banks and are expected to improve service and efficiency. However, with profits under pressure, banks have ventured into new areas, including household credit. The new forms of risk arising from these activities will challenge risk management systems, as well as supervisory capabilities in the years ahead.

The principal authors of this report are: Warren Coats, Edward Frydl, and Alina Carare. World Bank staff also contributed to both sections of the report.

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GLOSSARY

AML	Anti-Money Laundering
BSE	Bratislava Stock Exchange
CFT	Combating the Financing of Terrorism
DPF	Deposit Protection Fund
DDP	Supplementary Pension Insurance Companies (Slovak)
ECB	European Central Bank
EFSAL	Enterprise and Financial Sector Adjustment Loan
EU	European Union
FMA	Financial Market Authority
FSAP	Financial Sector Assessment Program
GDP	Gross Domestic Product
IAIS	International Association of Insurance Supervisors
IAS	International Accounting Standards
IMC	Investment Management Company
IOSCO	International Organization of Securities Commissions
IRB	Investicna a Rozvojova Banka
KBB	Konsolidacna Banka
MoF	Ministry of Finance
NBA	National Bank of Slovakia Act
NBNL	Nonbank Non-Licensed
NBS	National Bank of Slovakia
NPF	National Property Fund
NPLs	Nonperforming Loans
ROA	Return on Assets
RTGS	Real Time Gross Settlement
SDP	Supervisory Development Plan
SHDF	State Housing Development Fund
Sk	Slovak koruna
SKA	Slovak Consolidation Agency
SSE	Slovak Stock Exchange
SSP	Slovenska Sporitelna Banka
TPL	Third Party Liability
VUB	Vseobecna Uverova Banka

SECTION I—STAFF REPORT ON FINANCIAL SECTOR ISSUES

I. EXECUTIVE SUMMARY AND OVERALL STABILITY ASSESSMENT

1. **Following a late start with market reform, the Slovak Republic's banking sector is now reasonably sound, if not very profitable**. Since early 1999, the government has steadfastly embraced prudent fiscal and monetary policies and has undertaken a broad variety of structural reforms, including in the financial sector. It has passed a series of new laws—including laws on the central bank, banking, securities, insurance, and the Financial Markets Authority—which have contributed to enhancing progress on structural reforms. Four insolvent private banks were liquidated during 1999-2001 and their depositors paid off. Most of the state-owned banks have been restructured (at a direct cost of about 11 percent of GDP) and sold to foreign banks with relatively strong home country supervision. The sector is now more than 90 percent foreign owned (see Table 2). Nonbank financial sectors are underdeveloped and pose no serious systemic risks. Banks appear to be relatively robust to the range of likely macroeconomic shocks.

2. **Implementation of many of these reforms is just in the beginning stages, however**, and the absorptive capacity of the government and the institutions involved is limited and is being stretched thin. Also, parliamentary elections are due in September 2002, and there is a degree of uncertainty about the implications for economic policies. Though there is a general consensus that most of the reforms are on an irreversible path, concerns remain about the speed and depth of implementation going forward. Slovakia's firm commitment to early EU accession—possibly as early as 2004—provides considerable pressure to keep reform efforts on track.

3. **The macroeconomic situation remains stable, but the high current account deficit, increasing fiscal deficit and high unemployment need careful management.** Inflation has fallen to historically low levels of below 4 percent and core inflation is expected to continue on its downward trend in the medium term. Output growth remains strong despite a weak world economy. However, the increase in domestic demand, and weak export growth due to slower European demand during 2001 has brought the current account deficit to nearly 9 percent of GDP. Furthermore, on current trends, the 2002 fiscal deficit is likely to exceed the initial target of 3.5 percent of GDP by a large margin. While these deficits can be financed in 2002, they increase vulnerability to possible shocks.

4. **The most likely macroeconomic shocks to Slovakia would originate in its currently large external current account and government deficits.** These could result in a depreciation of the exchange rate and/or increases in interest rates. The economy's resilience to these shocks, and its ability to withstand the macroeconomic adjustments that might be needed, depends on the condition of the banking sector, its liquidity, and the credibility of its safety nets. As elaborated in the following paragraphs, **Slovakia's financial system appears sound enough to withstand relatively large interest rate and exchange rate shocks as well as relatively large increases in nonperforming loans.**

A. Financial System Soundness

5. **The banking system has undergone significant restructuring in recent years, and the system's soundness has increased substantially.** Stress tests suggest that the system is negatively affected by interest rate shocks due to the large stocks of government securities on its books, although the large share of floating-rate government debt works to mitigate this exposure.[1] The banking system is also negatively affected indirectly by exchange rate shocks because of the significant foreign debt exposure of its corporate borrowers. However, most banks are reasonably well positioned to withstand shocks of the magnitude that might be expected. Stress tests also show that credit risk has gone down, as remaining NPLs in the system have been more rigorously provisioned, though the impact of continued enterprise restructuring will need to be watched closely. New foreign bank owners are beginning to implement more effective risk management systems.

6. **Banking sector profitability remains under pressure, however, and the increased competition from larger, now foreign-owned, banks for good clients may lead to further consolidation in the sector.** There is a preponderance of government securities in the banking sector's assets, and the healthy loan book has shrunk in recent years. In order to increase profitability, the new private ownership is likely to introduce new services and increase competition for existing financial services in the sector. These efforts to improve profitability will change the risk environment and challenge internal risk management systems and supervisory skills, as well as create pressures for relatively weaker or unsuccessful banks to further consolidate, or exit the system.

7. **Banks are currently liquid, and can manage their liquidity efficiently and reliably with the NBS.** High liquidity is due to the NBS' sterilized purchases of capital inflows, the government's bailout of publicly owned banks, and banks' conservative management after the re-capitalization and privatization of the major banks. The NBS expects a continued abundance of liquid assets that must be held by financial institutions for at least the next few years.

8. **The NBS' monetary policy operations contribute to stable interest rates and sound and efficient liquidity management by banks.** These operations, especially the weekly repo auctions of the NBS to absorb excess liquidity from earlier purchases of foreign exchange, fully satisfy banks' liquidity management needs. The NBS liquidity projections (monthly and daily) are adequate. The alternative channels of liquidity management—money and securities markets—however, are still very shallow. The underdevelopment of money and financial markets, a potential weakness of the system, will become less relevant as

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[1] The banking system's capital adequacy ratio falls from 19.5 percent to 14.8 percent with the base line interst rate shock. Significant systemic distress emerges for a permanent interest rate shift of about 600 basis points.

Slovakia joins the EU and its financial markets become more integrated with European and international financial markets.

9. **The NBS has adequate powers to provide lender of last resort support to banks when appropriate and a strong commitment to do so.** Deposit insurance coverage is extensive and will rapidly rise to EU levels upon EU accession.

B. Supervision and Regulation

10. **Financial sector supervision in general has been historically weak and strengthening bank and nonbank financial sector supervision remains a priority.** Significant progress has been made in strengthening the legislative and regulatory framework for banking supervision, with the new banking law and the ongoing reorganization of the Banking Supervision Department. A fundamental change in the way supervision is conducted is being undertaken—consistent with the supervisory development plan under a World Bank EFSAL—moving to a more proactive and risk-based approach. This newly developed momentum needs to be sustained.

11. **Nonbank financial sector supervision, however, remains weak, in part because of inadequate regulations.** The Financial Market Authority (FMA) is a relatively new institution, which will need substantial institutional development, including outside technical assistance. The government should provide the necessary budgetary support and technical assistance to the FMA as necessary for its development into a mature independent entity. The FMA's effectiveness will also require to close certain gaps in the legal framework. The regulation and supervision of Supplementary Pension Insurance Companies (DDPs) is weak and fragmented between the Ministry of Labor, Ministry of Finance, and the Social Security Administration. The regulation of some entities that are taking funds from the public (deposits in all but name) by promising high returns is a high priority in light of the recent collapse of several of these operations.

12. **The government has opted to integrate regulation and supervision of all bank and nonbank financial markets under the jurisdiction of the NBS by 2005.** This appears to be a pragmatic solution, but the first priority should be to develop the separate supervisory capabilities of the NBS and the FMA. In this connection, the government should encourage: (i) close cooperation between the NBS and FMA through both formal and informal mechanisms prior to their merger; and (ii) development of an implementation strategy that leads to effective integrated financial market supervision after 2005.

13. **An assessment of anti-money laundering policies was undertaken**, based on the methodology developed by the IMF and the World Bank. This assessment found the legal and regulatory framework largely, or well on its way to being, in line with international standards. However, implementation (especially by nonbank financial institutions) lags behind. An active program is underway to develop procedures and training for effective implementation.

C. Issues and Recommendations

14. **The accomplishments of Slovakia's reform program are impressive but the program is incomplete.** The FSAP team urged the authorities to continue and to accelerate their reform agenda. While concluding that there are no indications of significant systemic risks, the report suggests prospective areas for strengthening the financial system and improving its resilience. During the discussion with the authorities, the mission emphasized the following broad themes:

- ***Strengthening supervision***, especially in light of new activities that foreign-owned banks are likely to develop; strengthening cross-border prudential supervision; and strengthening the supervision of the nonbank financial sector, which is modest in size but growing rapidly;

- ***Improving the insolvency and creditor rights framework***, by adopting as soon as possible new comprehensive insolvency legislation that improves efficiency, follows international best practice, and introduces a functional rehabilitation scheme;

- ***Bringing Slovak accounting standards and practices in line with International Accounting Standards and international best practice standards***, to allow investors and creditors to make meaningful use of financial statements. Accounting and disclosure policies should aim at improving the soundness and safety of banks, insurance companies, mutual funds, and pension funds;

- ***Strengthening exit policies for financial institutions***, by amending central bank, deposit protection, and banking legislation. Moreover, temporary administrators should be directed to use least cost failure resolution methods, and the DPF should not provide liquidity support to banks under temporary administration;

- ***Strengthening the Deposit Protection Fund (DPF).*** Too much of the financial burden of past bank failures falls on banks through large insurance premium payments. The Ministry of Finance should consider providing the DPF with a combination of equity and loan funds that will improve the financial condition of the DPF and allow a return to a more reasonable level of deposit insurance premiums for healthy banks and establishing, together with the NBS, a formal line of credit for the DPF;

- ***Applying same standards of disclosure and transparency used for financial institutions to the existing supplementary pension insurance fund management companies,*** and to companies that will manage the funds from the fully funded second pillar public pension arrangement (to be developed as part of pension reform). All these companies should be supervised by the FMA;

- ***Developing credit bureaus***, to facilitate the expansion in consumer finance, small sector lending, and leasing and housing finance;

- ***Developing the primary and secondary markets for government securities through strengthening public debt management***, by reducing the number of issues, bringing the issue policy in line with the overall objectives of debt management, and increasing the role of the ministry of finance in guiding the market through regular dialogue; and

- ***Rationalizing fiscal incentives to encourage housing finance***. Building socicties receive incentives for promoting longer term deposits, and mortgage banks receive incentives to promote longer term loans. However, this has led to creation of a fragmented banking sector with different types of licensing for different types of products. It would be preferable to bring all the various products and incentives under a single type of banking institution.

II. Overview of the Financial System

A. Institutions and Markets

15. **The Slovak financial sector consists of commercial banks, insurance companies, securities firms, investment funds, pension funds and leasing companies**. The sector is dominated by banks (Table 1). Overall, the financial sector, at 107 percent of GDP as of end-2001, is of a reasonable size compared with other EU1 accession countries. Monetization of the economy, as measured by the ratio of broad money to GDP, has remained fairly steady at about 60 percent reflecting a fairly high degree of confidence in the Slovak currency and the banking system (Figure 1).

16. **The banking system has undergone significant restructuring in recent years, and the system's soundness has increased substantially.** Four insolvent private banks were liquidated during 1999-2001 and their depositors paid off. Most of the state-owned banks have been restructured and sold to foreign banks, The sector is now more than 90 percent foreign owned (Table 2). Foreign ownership is expected to rise to 98 percent by year-end. The three largest of 20 banks hold 55 percent of the system's assets.

17. **The nonbanking financial sector is growing rather rapidly, but from such a low base that it has not had much impact on the size of the overall financial sector**. Total nonbank assets were 10 percent of total financial sector assets in 1997 and have grown to around 12 percent in 2001. Pension funds is the most rapidly growing segment but remains the smallest, while the more slowly growing insurance sector is the largest nonbank sector.

18. **The private insurance sector in Slovakia is one of the smaller, but faster developing, insurance markets in Central and Eastern Europe**. There are 27 companies operating in the market and together they collected close to US$600 million equivalent in premiums during 2000. Approximately 40 percent of premiums were for life insurance, and the balance for non-life insurance business.

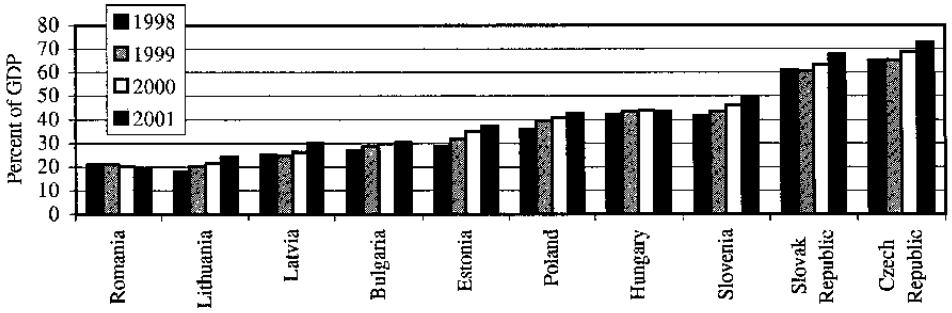
Table 1. Slovak Republic: Financial System Structure, 1997-2001

(In billions of Slovak koruna, unless indicated otherwise)

	1997	1998	1999	2000	2001
Assets of all financial institutions	**841.5**	**864.6**	**824.9**	**934.6**	**1061.9**
of which:					
Deposit money banks	757.3	777.4	738.7	834	931.3
Insurance companies	41.2	47.1	48.9	53.3	66.8
Voucher privatization funds	6.1	4.6	4.8	0	0
Investment funds	2.4	2.4	3.2	5.8	8.4
Pension funds	0	0.9	1.6	3.2	5.4
Leasing Companies	34.5	32.2	27.7	38.3	50
Memo items					
Gross domestic product	686	751	815	887	960
Customer deposits	441.5	457.4	499.8	588	654.8
Share of assets of financial sector	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
as a percentage, of which					
Deposit money banks	90.0	89.9	89.6	89.2	87.7
Insurance companies	4.9	5.4	5.9	5.7	6.3
Voucher privatization funds	0.7	0.5	0.6	0.0	0.0
Investment funds	0.3	0.3	0.4	0.6	0.8
Pension funds	0.0	0.1	0.2	0.3	0.5
Leasing Companies	4.1	3.7	3.4	4.1	4.7
Percentage of GDP					
All financial institutions	**118.7**	**111.6**	**98.7**	**102.8**	**107.4**
as a percentage of which					
Deposit money banks	106.8	100.3	88.4	91.8	94.2
Insurance companies	5.8	6.1	5.8	5.9	6.8
Investment funds	0.3	0.3	0.4	0.7	0.9
Pension funds	0.0	0.1	0.2	0.4	0.6
Leasing Companies	4.9	4.2	3.3	4.2	5.0
Number of financial institutions					
Dealer/brokers	132	148	154	141	130
Deposit money banks	29	27	26	23	21
Insurance companies	23	26	28	29	28
Investment management companies	12	18	19	6	9
Leasing companies	41	44	44	42	35
Pension funds	2	3	4	4	4

Sources: NBS, FMA, industry associations; and Fund staff estimates.

Figure 1. Broad Money in Eastern Europe, 1998-2001



Source: IFS.

19. **Equity markets are largely the outcome of the 1991 voucher privatization process** and the subsequent use of insider-oriented management buyouts. There are two stock exchanges, the Bratislava Stock Exchange (BSE) and the Slovak Stock Exchange (SSE), and an over-the-counter securities trading facility, the RM-System Slovakia (RM-S). Market capitalization of companies listed on the stock exchanges is low both in absolute terms and when compared with other economies relative to GDP. Of a total of 890 stocks listed or registered with the BSE, only 12 were quoted or registered in the Main and Parallel Markets. Market capitalization of listed securities has declined from 6.8 percent of GDP in 1996 to 2.6 percent in 2001. The market is extremely illiquid, with low turnover overall, and with the majority of stocks trading very rarely.

20. **The development of collective investment vehicles began with the creation of Coupon Privatization Funds in 1992.** Because of mismanagement and abuse, most of these funds have been closed down and liquidated. Since January 2000, only licensed Investment Management Companies (IMC) are permitted to offer closed-end or open-end mutual funds. There are at present 9 IMCs operating in Slovakia and the total Net Asset Value (NAV) of the funds under their management is approximately Sk 8.4 billion (see Table 1). The market remains highly concentrated, with the two largest companies controlling approximately 80 percent of all assets managed locally.

21. **The leasing industry has been a rather small but stable part of the financial sector.** Though it had a major setback during 1999, the industry has bounced back to approximately 5 percent of the financial sector in terms of assets and a similar percent of GDP.

Table 2. Slovak Republic: Banks as of May 2002

Name	Ownership	Assets (12/31/01) (In billion Sk)	Asset share	Capital ratio
Domestic banks (4)				
Banka Slovakia	State	4.8	0.5	29.2
Istro Banka	State	24.8	2.7	13.2
Postova Banka	State	25.1	2.7	14.2
Slovenska Zarucna a Rozvojova Banka	State	14.2	1.5	10.6
Foreign-owned banks (14)				
Citibank	American	25.7	2.8	10.7
Credit Lyonnais Bank Slovakia	French	22.3	2.4	20.1
CSOB Stavebna Sporitelna	Czech-Belgian (KBC)	2.0	0.2	
HVB Bank Slovakia	German-Austrian (HVB)	35.0	3.8	17.6
Investicna a Rozvojova Banka (IRB)	Hungarian (OTP)	23.9	2.6	53.0
Komercni Banka Bratislava	Czech-French (Societe Generale)	8.0	0.9	22.5
Ludova Banka	Austrian (Volksbank)	26.6	2.9	15.2
Polnobanka	Italian (Unicredito)	29.4	3.2	16.5
Prva Komunalna Banka	Belgian-French (Dexia, 51 percent)	27.1	2.9	12.8
Prva Stavebna Sporitelna	German-Austrian	42.7	4.6	19.5
Slovenska Sporitelna (SLSP)	Austrian (Erste)	216.8	23.4	21.1
Stavebna Sporitelna VUB-Wustenrot	VUB, 50 percent	10.9	1.2	15.1
Tatra Banka	Austrian (RZB)	112.1	12.1	14.2
Vseobecna Uverova Banka (VUB)	Italian (IntesaBci)	178.0	19.2	31.7
Foreign bank branches (2)				
CSOB	Belgian (KBC)			
ING Bank	Dutch			
System total		927.9		19.6

Note: Istro Banka has made an agreement on privatization that was not yet finalized as of May 2002.
Source: NBS, Slovak Banking Association.

B. Systemic Liquidity and Safety Nets

22. **Banks are currently very liquid, and can manage their liquidity efficiently and reliably with the NBS.** The NBS' monetary policy operations contribute to stable interest rates and sound and efficient liquidity management by banks. Banks' comfortable liquidity position is due to the NBS' sterilized purchases of capital inflows, the government's bank bailouts, and banks' conservative management after their recapitalization and privatization. The NBS expects these conditions to last for at least the next few years. The alternative channels of liquidity management, money and securities markets, however, are shallow. Although this shallowness of markets is a potential weakness, it is likely to become less relevant as Slovakia joins the EU, and its financial markets become more integrated with European and international financial markets.

Modalities of liquidity management

23. **Under its interest rate-based operational framework, the NBS' key monetary instrument is the interest rate on its weekly tender of two-week repos.**[2] After some adjustment to the system introduced in February 2000, the interest rate of the two-week repo tender[3] is now transmitted efficiently to the interbank money market. Standing overnight facilities—deposit, or "sterilization," and credit[4], or "refinancing"—are used to cap excessive changes in short-term interest rates. The NBS instruments and their use are quite transparent.

24. **As the NBS prepares for the Slovak Republic's accession to the EU, it intends to further refine its monetary policy instruments to more closely conform with ECB practice.** While the NBS plans to raise the rate of remuneration on required reserves to market levels in harmony with the ECB, it has no plans to change the structure of remuneration now in place. Currently the NBS remunerates reserve balances up to the required level each day rather than remunerating average reserve levels for the settlement period (up to the average required level). This practice lowers the remunerated average when reserves balances vary over the period, which discourages the desirable use of reserve averaging as a liquidity management instrument. **The FSAP team recommended that the average reserve holding over the settlement period (up to the average required level) be remunerated at market rates.**

25. **Currently the markets in which banks and others manage their liquidity are small, but growing**. The foreign exchange market registered the most growth in the past few years. The infrastructure of the markets is adequate, but would benefit from further technical

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[2] This framework is now very much in line with the assessment and recommendations of an IMF MAE mission on monetary policy that visited Bratislava in February 2000.

[3] On April 26, 2002 it was raised to 8¼ percent.

[4] The collateral used for the overnight credit facility consists of government securities.

improvements (e.g., tax distortions in the government securities market should be removed, and the structure and the transparency of the government's debt issue program should be further improved). The lack of depth in these markets may reflect in part the ease with which bank's can manage liquidity through the central bank.

26. **The payment system is generally efficient and largely observes the CPSS Core Principles.** The Slovak Interbank Payment System is owned, operated, and managed by the Slovak National Clearing Center. Only banks participate directly in the system. The legal uncertainties related to the payment system have been recognized and will be addressed by a new Payment System Law, which is expected to come in force in the second half of 2002. Also, in a few years a new RTGS system for large value payments will be introduced, replacing the current net settlement system. In the new system the NBS intends to implement intra-day credit facilities, as in the European Central Bank framework.

Safety nets

27. **Slovakia has made significant progress toward putting in place safety net schemes for banks, insurance companies and securities firms.** For banks, the NBS' lender of last resort function is explicitly stated in central and commercial bank legislation. Though the NBS has a good understanding of its appropriate use and the rules specified by its management are clear, it would be helpful to formalize in an internal NBS document the arrangements for lender of last resort support, so that they are easier to implement in difficult times in order to minimize pressures toward regulatory forbearance.

28. **Deposit insurance/investor protection is generally in place or planned. Deposit insurance is provided under the Bank Deposit Protection Act.** The Deposit Protection Fund (DPF) administers the coverage. The amount insured under the law is roughly equal to Euro 7,700 and is set to rapidly increase to Euro 20,000 to converge with the relevant EU directive immediately upon EU accession. For securities firms, an investor protection scheme is scheduled to become operational by mid 2002. In the insurance sector, a partial safety net exists in the form of a motor vehicle third party liability (TPL) fund created in September 2001, which will pay TPL claims in case of insurance company failure. All three schemes are modeled on applicable EU directives.

29. **Banking sector safety net arrangements have functioned effectively to date, although the cost of failure resolution has been fairly high.** During 1999-2001 four small/medium sized banks failed[5] and were put into liquidation under bankruptcy, and the

[5] The NBS did not provide lender of last resort financing to any of these banks, as they were deeply insolvent and their failure did not threaten overall banking system stability. In late 2001, the NBS provided lender of last resort financing to a solvent bank that was the subject of market rumors, and NBS liquidity support allowed the bank concerned to demonstrate its ability to honor large scale deposit withdrawals, effectively stabilizing the bank.

Deposit Protection Fund (DPF) in all four cases paid off the large majority of insured depositors within 3 months of the failure event, at a cost of approximately Sk 20 billion (equivalent to 2 percent of estimated 2001 GDP). As a result, the DPF's resources have been depleted, and it borrowed from the NBS to honor its legal obligations. This has also placed an undue burden on the solvent banks, which have been subject to high contributions to the DPF. A financial plan that addresses the DPF's insolvency position and future financial viability is needed.

C. Regulation and Supervision

Banking supervision

30. **Banking regulation has been significantly strengthened through the recent adoption of a new banking law.** The newly adopted banking law (effective January 2002) provides a stronger framework for corporate governance, risk management, enforcement, and consolidated supervision. The procedures for efficient resolution of problems in banks have also been substantially strengthened in the new law. The supervisor now possesses the explicit authority to require corrective action plans from banks, including requirements for a capital plan, plans for strengthening a bank's financial position, and other action the NBS determines necessary. Subsequent enforcement actions may be taken if NBS requirements are not met. Supporting regulations must now be drafted in order to further define selected aspects of the new SBA and to implement various provisions. In particular, regulations addressing classification of assets, market risk and risk management, capital adequacy, large exposures, and other areas must be updated or prepared. This process is currently scheduled to be completed by end September 2002.

31. **The almost complete foreign ownership of Slovak banks (only two are branches of foreign banks) has implications for supervision.** With over 90 percent of banking business in Slovakia conducted by foreign-owned institutions, cooperation and exchange of information between the Slovak authorities and the home country supervisors of the banks are critical aspects of maintaining high-quality supervision. In addition, enhanced cooperation and exchange of information among supervisors in the region can be an effective way to develop capacity to monitor emerging risks in banking. Many of the new bank owners in Slovakia are also strategic investors in banking in neighboring countries, such as Austria, Hungary and the Czech Republic, where they are following similar business strategies. Since the risks from these strategies are likely to emerge at different times in different places, closer supervisory cooperation can give the Slovak authorities a strengthened ability to anticipate emerging problems. Progress has been made on this front; by end-June 2002 the NBS had signed bilateral cooperation agreements with foreign supervisors in the Czech Republic, Germany, and Hungary and was negotiating with 5 other countries.

32. **Implementing the new legal framework and achieving effective supervision will not be easy.** Overcoming past practices (reflected in the low level of compliance with the Basle Core Principles for Effective Banking Supervision) and achieving fundamental change in the way supervision is implemented will require years of effort. The authorities are

committed to such an effort. Early steps were the replacement of the management of the BSD and accepting an IMF-provided resident advisor on banking supervision to assist with the effort. To guide the reform, the NBS Board adopted an ambitious Supervisory Development Plan prepared with the assistance of the World Bank. In accordance with the plan, it adopted and published a new mission statement for banking supervision in December 2001 and a new supervisory strategy in May 2002. In addition to staff training and modernization of manuals, which are essential, prudential regulations will be strengthened and brought into conformity with the new law. With vigorous effort, supervision can be brought up to satisfactory levels in three to five years. The effort needed is considerable, however, and will require the continuous strong commitment of management and staff.

33. **Banks' financial statements, which are still prepared in accordance with inadequate Slovak accounting standards, do not present an accurate picture of their financial condition.** The discrepancies that most affect banks are that Slovak standards do not require fair valuation of assets or nonaccrual of interest on distressed assets. These faults may result in misrepresentation of bank income and capital. A principal concern is that these deficiencies overstate the true level of bank capital and correspondingly understate the system's exposure to risks. While such distortions introduce an unavoidable degree of uncertainty into vulnerability assessments, they do not appear to be so large as to invalidate the process.[6] One way to compensate for this uncertainty is to utilize relatively demanding shocks in stress tests, as this assessment sought to do. If the system does not then show widespread vulnerability, there can be some confidence that it will remain robust despite accounting errors at more reasonable levels of projected shocks. Nevertheless, adoption and implementation of International Accounting Standards are required to convey needed information to the users of the financial statements, including the supervisors.

Capital markets and insurance supervision

34. **The new securities law in force from January 1, 2002 and the new insurance law in force from March 1, 2002 have significantly enhanced the MoF's and FMA's authority to regulate and supervise capital markets and the insurance industry.** The split between regulatory responsibility of MOF and the supervisory responsibility of FMA imposes a coordination challenge. Since November 2000, capital markets and the insurance industry have been supervised by the FMA, and under the new laws passed in 2002, the FMA has specifically been given wide powers of supervision and can now impose a range of remedial measures and penalties to address violation of laws, regulations or terms and

[6] For example, the lack of a requirement for the fair valuation of assets does not necessarily result in an upward bias to accounted capital, since the institution may record appreciated assets at lower historical cost. The lack of nonaccrual of interest on distressed assets does create an upward bias to accounted capital but this bias is limited to the effect of such accrued interest on current earnings, which generally represents a small part of total capital.

conditions of its permits or licenses. However, the Ministry of Finance (MoF) continues to be responsible for legislation and regulations applicable to these segments of the financial system.

35. **The new securities law, as well as a recent amendment to the Commercial Code, have significantly improved shareholder rights.** However, there is still room for improvement. Specifically: (i) accounting and auditing standards are not in line with IAS/ISA; (ii) the definition of securities does not cover all products that should be subject to regulation; (iii) information required in issuer prospectus is insufficient; (iv) minority shareholder rights are not fully protected; (v) dealings by officers in the shares of the company, related party dealings, and total benefits received by way of remuneration from the company do not have to be disclosed; and (vi) there are inadequate rules about market manipulation.

36. **Regulation of securities firms has been tightened.** Before enactment of the new securities law on January 1, 2002 there were approximately 150 securities firms licensed in Slovakia. These firms were not required to limit their activity to trading in securities. Many firms were engaged in a mixture of securities trading, real sector trading and holding/investment company activity. All these firms have until the end of September 2002 to apply for a new license, but the actual re-licensing process is not expected to be completed until mid 2003. It is expected that of the 150 firms, not more than around 30 will be interested in, and able to meet the requirements for (including the minimum capital requirements), obtaining a new license as a securities broker/dealer (more narrowly defined). Of these 30 firms, approximately 20 are likely to be banks (thus, nearly all banks are expected to be also engaged in securities brokerage/dealing activity). Contrary to what was the case under the old securities law, the new securities law contains detailed provisions for the separation of securities firms' own assets from client assets.

37. **Under the new insurance law, external auditors are required to report to the supervisor factors that could impair the ability of the company to meet its obligations.** However, the new law does not protect these professionals with immunity from civil suits that might be launched against them as a result of their making reports of this nature. The new law also strengthens corporate governance but does not go far enough. It does not contain specifics regarding the duties of Directors with respect to setting investment policies and general risk management.

38. **While supervision and regulation of capital markets and insurance are quite transparent, the FMA's institutional capacity and enforcement track record still needs to be built up.** The FMA as a young agency still needs to develop its internal procedures, manuals and information systems, as well as provide input into the process of reissuing securities markets and insurance regulations to implement the new laws. Due to a lack of experienced supervisors, especially actuaries, the FMA relies heavily on external auditors. The FMA's independence, funding, and human resources all need to be strengthened.

39. **As a result of the above referenced weaknesses, Slovakia still falls short of observing the IOSCO Objectives and Principles of Securities Regulation.** Most but not all of the IAIS's Core Principles are observed. Areas of concern are: (i) the lack of instructions from the supervisor regarding the desired features in a system of internal controls (Boards of Directors should be made responsible for their implementation and monitoring); and (ii) the lack of a program by the supervisor for establishing disclosure standards and other consumer protection measures. The FMA will likely require additional resources if it is to fulfill its mandate.

Payment systems oversight

40. **The oversight of the payment system is given to the NBS in the central bank law.** Payment systems policy formulation and implementation by the NBS satisfies a very high standard of transparency. The system has functioned well, but the NBS has decided to design and implement a new RTGS under central bank operational control in order to meet the requirements of the EU. A detailed design is now under preparation.

III. Macroeconomic Environment and Risks

A. Environment

41. **Since the break-up of Czechoslovakia in 1993, rapid growth and restructuring of the Slovak economy was accompanied by large macroeconomic imbalances and structural weaknesses.** In 1994-98, average annual GDP growth was 5½ percent and inflation was low. However, growth was increasingly based on unsustainable fiscal policies and an investment boom that took place in an environment of soft budget constraints, weak corporate governance, and large scale extension of government guarantees. With the external current account deficit averaging about 9 percent of GDP in 1996-98 and the external debt to GDP ratio rising, exchange rate pressures culminated in late 1998 in the abandonment of the exchange rate peg and a depreciation of 8 percent against the deutsche mark (Table 3).

42. **In 1999-2000, macroeconomic balances were restored.** Fiscal consolidation, a hardening of budget constraints, and a strong export performance led to a substantial narrowing of the external current account deficit in 2000. The shift to a flexible exchange rate regime, with monetary policy oriented to lowering inflation, also contributed to reducing external vulnerabilities. However, as GDP growth slowed to around 2 percent per year in 1999-2000, the unemployment rate increased to 18-19 percent in 2000.

43. **In 2001, strong private domestic demand and an expansionary fiscal policy led to higher economic growth.** Fixed investment grew by 10 percent, boosted by increased profitability, enterprise restructuring, and reduced corporate income tax, and solid growth in private consumption was underpinned by rising real wages and employment, a personal

income tax reduction, and the redemption of National Property Fund (NPF) bonds.[7] The general government deficit widened by ½ percentage point to 4.0 percent of GDP, as fiscal policy was relaxed through the income tax cuts, the removal of the import surcharge, and higher government consumption. The combination of strong private sector activity and government expansion led to a pick up in GDP growth, which reached 3.3 percent in 2001.

44. **Surging imports and decelerating exports led to a widening of the current account deficit to almost 9 percent of GDP in 2001.** Strong domestic demand and the removal of the import surcharge in early 2001 led to a surge in imports of 11¾ percent. At the same time, the slowdown in European demand and Volkswagen Slovakia's temporary shut down to restructure its plant resulted in a slowdown of exports. The current account deficit does not appear related to competitiveness problems: the unit-labor-cost based REER has depreciated by more than 7 percent since 1998 because of structural-reform induced productivity gains and wage moderation. The current account deficit was financed mainly by FDI inflows (greenfield investment and privatization receipts) in the first half of the year, but increasingly by debt-creating inflows in the second half.

45. **The external current account deficit remains a concern, although privatization receipts have strengthened Slovakia's external position recently**. The current account deficit is likely to remain around 8 ½ percent of GDP in 2002. It is expected to be financed by a combination of greenfield investment, debt-creating inflows, and some usage of privatization receipts. The bulk of privatization receipts of about US$3.5 billion (17 percent of GDP) in 2002, of which US$2.7 billion was from the recently agreed sale of SPP, the gas company, are to be used to build up reserves—which are expected to increase to 210 percent of short-term debt. This will substantially reduce the key vulnerability indicators this year. However, this improvement may prove temporary if the current account deficit remains high in the years ahead.

46. **Despite the increasing fiscal deficit, the public sector's outstanding indebtedness is still relatively modest** at 43 percent of GDP (when including the cost of recapitalizing the state banks) and external debt relatively small. The risk premium on Slovak sovereign debt abroad has fallen to low levels, domestic interest rates are modestly positive in real terms, and the central banks foreign exchange reserves are at a comfortable three months of import (see Table 3). Foreign portfolio investment in Slovakia remains small.

B. Risks

47. **The key source of macroeconomic risk in Slovakia's open economy is the potential for sustained pressure toward depreciation in the foreign exchange market.** Possible causes of such pressures are: (i) current account pressures, due to domestic demand

[7] The NPF paid Sk 21.5 billion (2.2 percent of GDP), of which around three-fourths to households.

Table 3. Slovak Republic: Selected Macroeconomic Indicators, 1995-2001

Total population, in millions (end-2000)	5.4
GDP per capita, U.S. dollars (2000)	3,541

	1995	1996	1997	1998	1999	2000	Est. 2001
Real Sector							
GDP (percentage change)	6.5	5.8	5.6	4.0	1.3	2.2	3.3
GDP (in Sk billions)	569	626	709	775	836	909	989
Consumer price inflation (e.o.p.)	7.2	5.4	6.4	5.6	14.2	8.4	6.6
Household savings ratio (in percent of gross domestic income)	...	...	9.2	8.6	10.6	11.1	9.2
Monetary and credit data (change in annual averages)							
Monetary base	...	...	...	-5.5	29.0	-3.0	0.0
Money (M1)	15.1	17.2	-4.5	-11.4	4.6	21.6	22.0
Broad money (M2)	18.9	16.7	8.8	4.2	11.4	15.5	11.8
Domestic credit	...	...	8.8	16.1	5.7	6.0	9.3
Yield on government bills							
Yield on government bonds (period average)	10.2	8.6	18.9	23.2	17.0	9.0	7.8
Reference bank lending rate 1/			21.6	18.9	16.4	10.7	8.79
Spread of benchmark bonds (basis points, end of period) 2/	...	...	...	456	218	193	56
Stock market index (percent change, end of period)	-28.2	15.8	2.5	-48.5	-18.0	19.2	32.0
Public finances (in percent of GDP)							
Central government financial balance	-0.4	-1.8	-2.4	-2.1	-1.7	-1.6	-3.7
General government financial balance	0.3	-1.2	-4.8	-4.7	-3.3	-3.5	-4.0
General government gross debt 3/	21.9	26.4	28.8	28.8	40.1	44.1	43.0
External sector (levels, unless otherwise indicated)							
Sk per US$ (end of period)	29.6	31.9	34.8	36.9	42.3	47.4	48.5
Trade balance (billions of US$)	-0.2	-2.3	-2.0	-2.2	-1.1	-0.9	-2.1
Current account (in percent of GDP)	3.4	-8.8	-8.5	-9.2	-4.9	-3.6	-8.6
Foreign direct investment (billions of US$; net)	0.3	0.3	0.1	0.5	0.8	2.1	1.5
Portfolio investment (billions of US$; net)	0.2	0.0	0.0	0.8	0.6	0.8	-0.2
Gross official reserves (billions of US$, end period)	3.4	3.5	3.3	2.9	3.4	4.1	4.2
Reserve cover (months of imports) 4/	3.7	3.2	2.9	2.3	3.1	3.4	3
Reserve cover (short-term external debt)		1.2	0.8	0.6	1.3	1.7	1.4
Total external debt (billions of US$) 5/	5.7	7.7	9.8	11.9	10.5	10.8	11.4
of which: Public sector debt (government)	1.0	0.8	1.0	1.7	2.2	3.1	...
of which: Banking sector debt 5/	...	3.1	3.8	3.5	1.3	1.0	...
Central bank short-term foreign liabilities 6/ 7/	...	0.0	0.2	0.0	0.0	0.0	0.0
Central bank short-term foreign-currency liabilities 6/	...	0.0	0.2	0.0	0.0	0.0	0.0
External interest payments to exports (in percent) 4/	2.6	2.3	2.8	5.0	5.5	4.6	4.5

Sources: Slovak Statistical Office, National Bank of Slovakia, and Fund staff estimates.

1/ Rate on short-term loans.

2/ Eurobond; 5 yr, denominated in DEM, compared to German bund denominated in euros.

3/ For 1999 onwards, this includes 11 percent of GDP in bank recapitalization bonds.

4/ Exports of goods and services (excluding factor income).

5/ Debt data is inflated by US$2 billion in 1997 and 1998 (and US$1 billion in 1996) from offsetting claims and liabilities of two Slovak subsidiaries of foreign banks with their parent companies (due to tax incentives).

6/ Remaining maturities of 1 year or less.

7/ Includes short-term liabilities on behalf of government.

swings and/or expansionary fiscal policies; (ii) increased capital outflows, due to changes in confidence, ratings, changes in EU accession prospects or increases in political risk;[8] and (iii) delays, or halts, in greenfield FDI inflows. With elections in September 2002, increases in perception of political risk are also possible. This, and the other risks summarized below, determined the balance sheet stress tests conducted by the team.

48. **The results of severe foreign exchange market pressure depend on the response of the NBS.** A defense of the exchange rate could result in a sharp increase in interest rates, as in 1997-98 (one month rates peaked at 33 percent in June 1997 and 26 percent in September 1998). This, combined with turmoil-induced increases in market-based interest premiums, would adversely affect debtors, including the government, and banks' portfolio quality, particularly in the likely case that the interest rate hike depressed the domestic economy.

49. **In the case of severe, sustained foreign exchange pressure, however, the NBS might let the koruna depreciate.** A depreciation could affect adversely the corporate and financial sectors in a variety of ways both directly and indirectly. The banking sector's overall own exposure to FX risk seems moderate, judged by its net positive foreign exchange position, while the risk of excessive exposure of individual banks is limited by NBS regulation and monitoring. The exposure of the corporate sector, however, could reduce its ability to service its bank debts.

IV. Vulnerabilities and Soundness Issues

A. Banking System

Current condition

50. **Financial restructuring has diminished the NPL problem considerably (Table 4).** In the process of selling the state-owned banks to private foreign strategic investors, the government cleaned up bank balance sheets by removing about Sk 112 billion of NPLs (13 percent of GDP) and transferred them to consolidation agencies. New capital has been injected as Government bonds, and banks are now generally very well capitalized. NPLs not covered by provision (net NPLs) in the system have fallen from 25 percent of total loans in 1998 to 7-8 percent currently (stronger enforcement of loan loss provisioning rules may bring this figure up). This amount is much more manageable, particularly in light of the doubling in the banking system's capital ratio that has taken place over the same time period.

51. **However, bank profitability is under pressure (Table 5).** While net income has improved significantly in recent years, this gain is based in large part on non-recurring items, such as a reversal of funds previously committed to specific provisions or to the general risk

[8] Note, though, that the consequences of a portfolio outflow would not be as serious as in Hungary or the Czech Republic, as the stock of foreign portfolio capital is still relatively low.

Table 4. Slovak Republic: Financial Soundness Indicators for the Banking Sector, 1997-2001

(In percent, unless otherwise indicated)

	1997	1998	1999	2000	2001
			December		
Capital Adequacy					
Regulatory capital to risk-weighted assets 1/	8.0	6.6	12.7	13.1	19.7
Asset Quality					
Sectoral distribution of loans to total loans					
Individuals	5.2	6.5	8.7	10.7	15.3
Government	2.0	2.1	2.0	1.7	3.7
Agriculture	4.5	3.8	4.6	3.6	4.2
Mining	0.7	0.9	0.7	0.6	0.7
Manufacturing	29.5	28.7	20.7	18.6	19.7
Transportation	1.8	2.1	1.3	1.2	3.9
Financial services	5.0	2.3	2.7	2.5	3.8
Other services	51.2	53.6	59.3	61.2	48.6
FX loans to total loans	7.4	8.2	9.1	8.3	7.8
NPLs to gross loans 1/	27.2	31.6	23.7	15.3	14.0
NPLs net of provisions to capital	22.5	25.2	15.7	6.9	7.9
Earnings and Profitability					
ROA[2/]	0.09	-0.48	-2.27	1.41	1.07
ROE[3/]	2.81	-13.39	-36.53	25.16	25.26
Interest margin to gross income	68.6	56.6	50.8	72.0	72.2
Non-interest expenses to gross income	66.1	66.6	102.7	98.2	102.4
Personnel expenses to non-interest expenses	33.3	35.4	28.6	25.5	24.6
Trading and fee income to total income	29.7	39.5	46.1	27.8	28.9
Liquidity					
Liquid assets to total assets 2/	13.5	9.7	12.1	18.1	27.5
Liquid assets to short term liabilities 3/	47.8	38.6	59.7	90.7	61.4
Customer deposits to customer loans (ratio)	1.22	1.20	1.34	1.59	2.13
Customer FX deposits to total deposits	11.6	16.2	16.2	17.4	18.3
Sensitivity to market risk					
Net open positions in FX to capital	59.51	-0.25	11.07	-53.48	-23.03

Source: National Bank of Slovakia.

1/ Excluding KBB.
2/ Net income to total assets
3/ Net income to book equity
4/ Liquid assets include government securities of all types and maturities, cash and reserve balances at NBS.
5/ Defined as liquid assets to highly volatile liabilities in the NBS Supervisory Information System.

Table 5. Slovak Republic: Profitability and Cost Indicators in the Slovak Banking System, 1997-2001

(In percent, unless otherwise specified)

	1997	1998	1999	2000	2001
Profitability					
Operating profit (ROA)	1.40	1.37	-0.10	0.07	-0.09
Net income (ROA)	0.09	-0.48	-2.27	1.41	1.17
Net income (ROE)	2.81	-13.39	-36.53	25.16	25.26
Costs					
Earnings/employee (Sk thousands)	1,322	1,340	1,117	1,485	1,612
Employees (1,000s)	23.7	23.8	23.6	22.2	21.2
Operating expense/assets	2.73	2.73	3.67	3.88	3.20

Source: National Bank of Slovakia.

reserve. Looking at an operating profitability measure before provisioning, the rate of return on assets shows the system at near-zero profitability for the past three years.

52. **As banks reduce the overabundance of liquid assets in a seach for higher yields, they will need to venture into new and potentially risky business areas**. The new foreign owners are changing the direction of the banking business. Bank strategies now emphasize expanding into retail banking and mortgages. However, the underdeveloped Slovak banking markets, because of their small size, may not be able to generate sufficient profits for all entrants. Competitive pressures in an environment of low operating profitability can also be expected to drive a further round of consolidation. A new capital adequacy regulation, expected to be adopted in the fall of 2002, will introduce a capital charge for exchange rate and interest rate risks.

Stress tests

53. **In light of the macroeconomic risks faced by Slovakia, stress tests were administered to individual bank balance sheet data to estimate the result on capital of adverse interest rate, exchange rate, and credit quality shocks**. The stress tests carried out were calibrated to reflect various relatively severe macroeconomic shocks: a deterioration in loan quality corresponding to a moderate recession; a large permanent upward shift in the yield curve or a large currency depreciation; and a monetary policy defense against an exchange rate crisis with a corresponding 10 percentage point jump in interest rates that is expected to reverse fully within one year. Because of the large exposure of Slovak enterprises to foreign currency debt, the indirect credit risk effects of a depreciation were also taken into account in the exchange rate test. Scenarios that produce a combination of shocks,

e.g., simultaneous high interest rates and depreciation, could result in more severe vulnerabilities, but such scenarios were not explicitly tested because they are difficult to specify with a reasonable degree of likelihood. The sample used for stress tests included 17 banks, accounting for 90 percent of banking system assets. Stress tests indicate that the Slovak banking system can absorb shocks to credit risk, and high interest rate and foreign exchange shocks, without generating systemic distress, although vulnerabilities emerge in all cases (Table 6).

54. **Stress tests indicate that Slovak banks are now less vulnerable to credit risk.** The threat of existing loans turning bad is unlikely to be the focus of vulnerability going forward, because banks are now well-capitalized, borrowers are in an improved financial condition, and more conservative lending rules are being adopted. However, with exports amounting to 70 percent of GDP, a shock to foreign demand and exports, for example, could have significant real economy effects. The impact on the domestic banking system is mitigated because export-oriented firms have accumulated relatively little credit from the domestic banking system. However, the spill-over output losses in other sectors will impact on the quality of banks' portfolios. For a credit risk shock of a 65 percent increase in NPLs, only one bank drops (modestly) below the 8 percent Basel minimum capital ratio. A qualification to this outcome that was not formally incorporated into stress tests is that Slovak accounting standards, which do not require fair valuation of assets and allow the accrual of interest on distressed loans, may understate the true level of NPLs and overstate capital. Looking forward, improved credit management can be expected to slow the pace of generating any new NPLs.

55. **The banking system would be negatively affected, although not to the point of systemic risk, by a large and sustained increase in interest rates, with a few institutions being highly vulnerable.** Moreover, it is important to underline that emerging trends in bank behavior are likely to make market risk a greater concern in the future. For example, as the fixed-rate mortgage market grows, bank susceptibility to interest rate mismatches may also grow.[9] If the pressure of bank competition encourages banks to incorporate conditions friendly to the borrower, new elements of market risk will emerge. The banks' foreign owners should be relatively well equipped to handle such risks. However, supervisors will need to be vigilant.

56. **The banking system is not very sensitive to the direct effects of exchange rate shocks**. It is more sensitive to the indirect credit risk of depreciation worsening the balance sheets of its corporate clients whose external debt amounted to Sk 325 billion, or 34 percent of GDP at the end of 2001. Another Sk 53.5 billion, or 5.5 percent of GDP, was borrowed in foreign currency from the domestic banking system. Information on the extent of hedging is incomplete. Traditionally, external borrowing has been largely unhedged. However, after

[9] In Slovakia, this will depend in part on the extent to which mortgages are financed by long-term mortgage bonds and other features of financial sector development.

Table 6. Slovak Republic: Banking System Stress Tests

(Ratio of regulatory capital to risk-weighted assets)

	Interest rate shock		FX shock		
Pre-shock	Shift	Spike	Direct shock	With indirect credit shock	Credit shock
19.5	14.8	19.8	19.0	16.6	15.5

Sources: National Bank of Slovakia; and Fund staff estimates.

Note: Sample average is weighted by assets.

Interest rate shock: One shock applied was an upward shift in the yield curve equivalent to 3 standard deviations (which represents a 99 percent confidence level) for a 3-month change in the bank deposit rate over the period February 1993 to December 2001. This is equivalent to an upward shift of 248 basis points. Another shock was a severe inversion of the yield curve, given by a 1000 basis point immediate spike in rates expected to reverse completely in one year. This shock would be consistent with a successful monetary policy-based defense of exchange rate levels.

Exchange rate shock: Two tests were done for exchanges. The first was to apply to net foreign exchange positions a depreciation of 3 standard deviations (which represents a 99 percent confidence level) for a 3-month change in the exchange rate for the period February 1993 to December 2001. The shock is equivalent to a depreciation of 12.77 percent.

The second shock adds to the direct exchange rate shock an estimate of the indirect credit risk effect of the exchange rate change. This estimate was constructed by assuming, in the absence of full information on the distribution of company debt, that debt/asset ratios of firms were step-wise uniformly distributed across the interval [0, 1] and that all firms had the average share of foreign currency debt in total debt. For firms at the extreme debt/asset value of 1, the depreciation shock was applied to the value of foreign currency debt and the resulting percentage increase in the debt/asset ratio was taken as a measure of the percentage of firms that would be pushed into insolvency by the depreciation. This percentage was applied to the end-2001 stock of nonfinancial business loans from banks in Slovakia to obtain an estimate of new NPLs, which was combined with the direct effects of the exchange rate shock to get a total foreign exchange risk effect.

Credit risk shock: The Slovak economy has shown a relatively low degree of business cycle volatility. To estimate the credit risk consequences of a potential recession shock, the percentage point increase in the NPL ratio that occurred during the recession of 1997-99 in the Czech Republic (the economy most structurally similar to the Slovak economy) was used. This shock was equivalent to a 65 percent increase in total end-2001 NPLs, and is assumed to reflect a moderate recessionary shock (the Czech real GDP declined about 2.5 percent over the 3-year recession period), although one that would be relatively significant compared to the (limited) economic history of the Slovak Republic.

having been hit by the 1998-99 depreciations, there are indications that enterprises with most of their revenues in koruna have increasingly hedged their foreign currency debt. A significant share of external borrowing has been by state-owned enterprises (mainly utilities), which means that there would be fiscal consequences. For most of these state-owned enterprises, revenues are almost exclusively in koruna. Foreign banks have been prepared to lend to these enterprises despite their lack of foreign currency income, because they have been backed by government guarantees. The government's failure to sufficiently curtail such guarantees is one of the weak points in its fiscal policy.

Going forward

57. **NBS and government policies going forward will influence the development of the banking sector through the type of regulatory framework they create.** A more efficient banking system will contribute more to economic development and to minimizing vulnerabilities.

58. **Ownership restructuring undertaken since 1998 has improved the condition of the Slovak banking system in several ways but further improvements will be needed to eradicate the past weaknesses in credit management practices.** When the remaining smaller bank privatizations agreed and anticipated for 2002 are completed, the share of banking system assets controlled by foreigners will rise to over 98 percent. The entry of strong foreign owners is expected to strengthen the credit culture and governance in these banks, as well as bring in new, modern risk management systems, such as credit risk scoring (although this cannot be taken for granted and will need to be reassessed in future).

59. **Banks can be expected to respond to low profitability by reaching for yield, improving efficiency, expanding into retail lending, and/or consolidating further.** Although labor shedding in the banking sector in the wake of restructuring is apparent, other measures of cost, such as the ratio of operating expenses to assets have not yet shown sustained improvements (see Table 6). The banks –eager to improve returns—have ambitious business plans emphasizing potentially risky areas new to Slovakia like consumer banking, mortgage banking and lending to small and medium sized enterprises. To facilitate the realization of these potential new lines of business, some market infrastructure development and legislative fine tuning will also be required; e.g. support for the creation of credit bureaus and for the development of housing finance. Banks that do not succeed in expanding profitable product lines or reducing costs will merge or exit. Bank exit policies should facilitate such consolidation.

Strengthening banking supervision

60. **These and other new activities entail new risks and require new supervisory skills.** The current modest level of risks in the banking system give the NBS the time it needs to build a competent supervisory regime. However, a sense of complacency following the recent privatizations could lead to balance sheet problems in the future. Thus, in the years ahead, effective banking supervision will be crucial even more than now, and weak supervision would become a vulnerability of the financial system. Strengthening supervision

entails implementing the proactive approach to financial oversight embodied in the Supervisory Development Plan. In particular, the NBS should:

- ***Implement forcefully the new, risk based philosophy for banking supervision***. This requires that both NBS management and staff incorporate the basis of the recently adopted mission statement for banking supervision in all of its aspects of its supervisory practice. One of the most important steps in upgrading supervision is to evaluate current practice and revamp internal operating procedures consistent with the new, proactive approach to financial oversight. As enumerated in the Supervisory Development Plan, this requires preparing and adopting a new supervisory operating policy that specifies supervisory activities, supervisory cycles, risk ratings, and supervisory strategies for each bank. The supervision strategy adopted by the NBS Board in May provides a promising road map for the further strengthening of supervision. New staff need to be hired and rigorously trained. Training of staff (both old and new) is particularly needed on how to evaluate bank board oversight and management capacity, as well as how to effectively respond to governance deficiencies;

- ***Interpret and apply banking legislation more actively***. The application of the law has historically been very rigid and codified. While acknowledging the roots of the Slovak legal system, the current manner in which the law is interpreted and applied can hinder effective supervision. The law and supporting legislation should be viewed, in part, as tools to promote safe and sound banking;

- ***Enhance the accuracy of regulatory and accounting information***. The introduction of international accounting standards (IAS) should be expedited. Particularly, requirements for asset valuations are needed, including a rule for the nonaccrual of interest on distressed loans. The tax law should be adjusted immediately so as to avoid taxation of interest on loans that should be on nonaccrual or are no longer performing. Most foreign-owned banks (the majority of the system) are already required to submit IAS prepared statements to their head offices. Therefore, IAS requirements could be easily adopted and implemented, and the NBS should avail itself to this standard of reporting. Regulatory reporting requirements should be revised to reflect IAS standards and to include supplemental information as necessary for effective ongoing supervision; and

- ***Improve cross-border supervision.*** The predominant presence of foreign banks in the domestic banking system will require the implementation of effective cross-border prudential supervision as well as consolidated supervision and close and effective working relationships with foreign supervisors.

Resolution of problem financial institutions

61. **Bank failures in recent years have highlighted the difficulties with resolving failed banks under regular bankruptcy law and procedures.** Use of resolution techniques other than insured depositor payoff probably would have resulted in lower failure resolution

cost to the extent the failed banks still had good assets that could have been transferred together with deposit liabilities to another bank, and that are now wasting away in lengthy bankruptcy procedures. Thus, further strengthening of bank exit policies is needed.

62. **To further improve pre-failure resolution and exit policies for financial institutions,** financial sector legislation (banking, securities and insurance laws) has been overhauled to bring it in line with international best practice standards and the EU's *Acquis Communautaire*. For banks, insurance companies and securities firms, the new legislation contains prompt corrective action triggers for the appointment of temporary administrators, and for banks and securities firms, license revocation at pre-specified levels of capital is mandatory. For all three types of institutions, the laws seem to provide sufficient flexibility to the temporary administrator to use least cost resolution techniques.[10] These provisions have, however, not yet been tested in practice and it is conceivable that other legislation (Civil Code, Commercial Code) contain provisions that may limit the temporary administrators' flexibility in this regard. Liquidation of all three types of failed financial institutions must be done either under the Commercial Code (as long as the institution still has positive capital) or the Bankruptcy Law (in case of negative capital).

63. **Despite these achievements, several weaknesses in safety net design and funding and in pre-failure/exit mechanisms remain.** The most important of these are: (i) shortage of funds at, and lack of back-up funding arrangements for, the DPF, rendering it unable to either manage additional individual bank failures or an unexpected systemic bank failure event; (ii) inappropriate allowances for the DPF and the new Investor Guarantee Fund (IGF) to provide emergency liquidity support to banks and securities firms under temporary administration; (iii) inappropriate allowances for insurance companies to sell deposit insurance and investor protection coverage over and above the insurance/coverage provided by the DPF and the IGF; (iv) lack of detailed NBS and FMA guidelines instructing temporary administrators of intervened financial institutions on the use of least cost failure resolution methods; and (v) inconsistencies between financial sector and bankruptcy legislation, which preclude orderly resolution of failed financial institutions.[11] The authorities

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[10] E.g., insured deposit transfers, purchase and assumption transactions, insurance portfolio sale or transfer, sale to a third party of part or all of the entity under administration.

[11] The latter include: (a) lack of control by the NBS and the FMA over the initiation of liquidation proceedings, selection and appointment of liquidators, and the resolution methods used for resolving failed financial institutions; (b) lack of specific provisions in the bankruptcy law on the status of depositor/policy holder/client claims, including substitute claims held by the DPF, the motor vehicle TPL fund and the IGF as a result of depositor/policy holder/client payoff; (c) lack of allowance for set-off or netting of claims between a failed financial institution and other financial institutions for the sake of payments system stability; (d) ability of financial institutions to petition for reorganization under bankruptcy in contravention of NBS/FMA liquidation decisions; and (e) inconsistencies in the definition of insolvency for banks, insurance companies and securities firms as laid down

(continued)

should address the above issues through provision of appropriate financial support to the DPF, preparation of detailed failure resolution manuals for temporary administrators and amendment of applicable legislation.

B. Public Debt Management

64. **The thinness of the government securities market is a potential source of vulnerability.** Central government debt is modest. The nominal value outstanding at the end of 2001 was Sk 366 billion or a modest 37 percent of GDP. The government issues securities with maturities between nine months and ten years. Of this amount, the stock of t-bills and government bonds was Sk 271 billion. About one third of this amount matures within one year and roughly one half within two years. Secondary trading of these securities is negligible when taking into account that most trading is between foreign and domestic entities motivated by tax avoidance. As a result, the liquidity of government securities is much less than it might be and banks are forced to rely more heavily on the NBS for liquidity management and support. Given the large share of government securities in the banks assets, the market has yet to be tested as to how it will handle large sales from the whole banking system. However, NBS accepts all government securities as collateral in its open market operations.

65. **The MoF has improved its public debt management in the past couple of years, but it falls far short of best practices**. By strengthening the public debt management in several aspects the MoF could contribute to the further development of the primary and secondary markets for government securities. Possible improvements include: (i) Reducing the number of issues, increasing and homogenizing the amount issued per auction, including reopening previous issues, thereby stimulating the secondary market; (ii) bringing the issue policy in line with the overall objectives of debt management, making the issue schedule more transparent and reliable, and integrating the recapitalization bonds fully into the overall strategy; and (iii) increasing the role of the MoF in guiding the market through regular dialogue, clearly explaining its strategy and plans and listening to market needs and feedback.

C. Structural Reforms

66. **As impressive as Slovakia's recent achievements are, further reform efforts are still needed,** especially to enhance the ability of creditors to enforce loan contracts at a reasonable cost, and to improve the transparency and accuracy of financial statements. Furthermore, some likely future trends in financial sector development have implications for

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in banking, insurance and securities laws and regulations, and the insolvency definition of the bankruptcy law.

policy. This section examines the more important areas and, where appropriate, sets out the FSAP team's recommendations.

67. **Structural reforms implemented since 1999, though, have put the economy on a sounder footing, although substantial challenges remain.** Efforts to harden budget constraints have focused on restructuring and privatizing the major state-owned banks; strengthening insolvency and bankruptcy legislation and procedures; and curtailing quasi-fiscal activities. Controlling stakes in the telecommunications, oil, and gas sectors have been sold to strategic foreign investors, and significant progress has been made in the restructuring and preparation for privatization of enterprises in the electricity sector. Fiscal transparency and control have been strengthened, and a more proactive banking supervision team is being formed. However, more work is needed. The judicial system remains weak, delays have occurred in the reform of the pension system and the implementation of banking supervision enhancements (already discussed), and the stock of outstanding guaranteed debt has not been put on the envisaged downward trend.

Creditor rights

68. **As a general rule, creditor rights remain weak, collateral systems other than for the traditional mortgage are poorly developed, and enforcement procedures are slow and unreliable through the courts.** As a result, credit is largely inaccessible to all but the upper echelon of corporate borrowers. To offset the high regulatory risk, lenders have adopted a policy of requiring fully secured loans in nearly all corporate transactions. Similarly, the process of insolvency remains slow, inefficient, and poorly regulated, although recent changes in the law have led to improvements. Legal and regulatory weaknesses have fueled a growing business in lease finance, where ownership resides in the lender or creditor, making asset recovery more efficient and predictable.

69. **Court system weaknesses and inefficiencies are the most significant detriment to debt enforcement.** While the Foreclosure (Execution) Law has greatly enhanced the ability of creditors to foreclose on assets, mostly real estate, the creditor is unable to avoid court proceedings and continue enforcement without the cooperation of the debtor, which rarely occurs. Another notable deficiency in creditors' ability to secure their debts is the lack of a registry for pledges on movable property. Currently, possession is required to effect a pledge on movables. A new law and pledge registry for pledge of movables is being developed with assistance from the EBRD and should enhance significantly asset based lending. Bankruptcy presents the worst option for a creditor to recover debt. Though creditors' rights in a bankruptcy proceeding were strengthened by amendments adopted to the Bankruptcy Law as of August 1, 2000, creditors continue to find that participation in bankruptcy proceedings is not fruitful. Courts are weak as an institution in the Slovak Republic, and bankruptcy courts are no exception. The lack of professional development and regulation of trustees, important players in the bankruptcy process, represents another significant institutional weakness in the bankruptcy system.

Accounting and auditing standards

70. **Slovakia's legislative requirements on accounting and corporate financial reporting seem to be geared toward satisfying the information needs of the tax authorities only;** other users, including investors and creditors, have difficulty in making meaningful use of the financial statements for market-oriented decision making. There is a large gap between Slovak accounting requirements and IAS. Although listed companies are required to prepare financial statements in accordance with IAS, in addition to statutory annual financial statements, there is no mechanism to monitor and enforce this requirement. As a result, many of the statements presented as IAS financial statements do not fully comply with IAS.

71. **Slovak banks are required to follow Slovak Accounting Standards. International Accounting Standards (IAS) will not be adopted before 2003**. There are several differences between the two accounting systems that impact the usefulness of banks' reporting. For example, Slovak standards do not require fair valuation of assets or non-accrual of interest on distressed assets. These may result in misrepresentation of bank income and capital. Furthermore, the Slovak disclosure requirements fall short of IAS disclosure standards.

72. **In the auditing area, too, a number of problems indicate the need for a well-organized reform program:** auditors' failure to comply with internationally comparable independence and ethical requirements, inadequate capacity of the Slovak Chamber of Auditors to properly regulate the profession, shortcomings in educational and training arrangements with regard to the practical application of high-quality accounting and auditing standards and requirements, and absence of effective mechanisms for enforcing established rules and regulations.

73. **The authorities, with assistance from the World Bank, have agreed to design and implement a Country Action Plan (CAP) for bringing Slovak accounting and auditing standards and practices in line with IAS and international best practice standards.**

Pension funds development

74. **The expenditures for benefits and administration costs for the basic social security system or 1st pillar are already exceeding revenues, and a deficit has accumulated.** Parliament recently approved reforms to the first pillar aimed at easing the strains on the system, including changes to the benefit formula to link benefits more closely with contributions, the elimination of certain privileged pensions, and a gradual increase in the retirement age for women.

75. **The government is looking for alternatives to augment the 1st pillar pension by creating special privately managed 2nd pillar funds.** These funds would be financed by setting aside a portion of the mandatory contributions that are being collected to finance the 1st pillar. Such accounts to be established for participants would be invested in securities and other approved investments. One of the difficult questions is to establish the portion of the

current mandatory contribution that can be diverted to second pillar funds, and the overall funding pool is still limited. Sk 65 billion in privatization receipts have been set aside in an account at the NBS to finance pension reform, but the details of its use are still undecided.

76. **Special legislation was passed in 1996 authorizing the creation of "supplementary pension insurance companies (DDPs)"** under the supervision of Ministry of Labor as special purpose legal entities under the civil code to manage a 3rd Pillar. There are currently 4 DDPs and each one of them has the responsibility for the sales administration and asset management of their fund.

77. **Even though supplementary pension insurance companies are financial institutions and have the privilege of collecting contributions from the public, the operations of the DDP and their managed funds are rather non-transparent.** The legislation should make clear that the DDP is a pension fund management company with responsibilities for assets management and administration. They should be subject to the same standards of disclosure and transparency as any other type of financial institution. Accounting rules should be specified for them that indicate clearly to their members and to the general public how successful the management company has been in covering the operating expenses and in producing attractive investment returns for the benefit of participants. Since the pension funds could eventually become major players in domestic and regional capital markets, it would be advisable to transfer responsibility for supervision of the DDPs to the FMA.

Credit bureau

78. **A functional credit bureau, a necessity for development of consumer finance, does not yet exist.** While each bank knows the credit history of its own clients, this information is not shared. Five banks have recently formed an alliance to set up a credit bureau. Once operational, the alliance will be expanded to include all interested banks, and at a later stage other financial institutions as well.

79. **Legal changes are needed to overcome the banking law's secrecy requirements and restrictive provisions of the law on protection of personal data (Law no. 52/1998).** Both laws should be amended to allow a Credit Bureau to collect information on credit from banks and other financial institutions without prior client consent, and to allow meaningful bank access to this information, although provisions should be included to protect against the abuse of the personal and financial information collected. Additionally, banks need to agree on organization and technical aspects, such as consumer credit database design, the rules for its use and methods of integration with other information systems, such as collateral registries. Timely reporting to this database should be mandatory for all banks and later for all other types of lending institutions. Access should be open to all participating financial institutions.

Housing finance

80. **There are three separate housing finance schemes, all supported by Government subsidies.** The first scheme comprises specialized 'home savings banks'. Borrowers must save a pre-specified amount of money over a pre-specified period of time to become entitled to a housing loan. Savings are subsidized and both savings and loan interest rates are fixed at below market levels and earned interest is tax free. The second scheme comprises an interest rate subsidy for mortgage loans provided by selected commercial banks meeting a higher absolute minimum capital requirement, financed primarily through the issuance of mortgage bonds—tradable fixed income securities collateralized with mortgage loan receivables. Interest on these bonds is tax-exempt. The third scheme consists of an extra budgetary State Housing Development Fund (SHDF) which makes housing loans at subsidized interest rates to low-income individuals, and municipalities for the purchase of newly constructed housing for rental to low income families. These loans, although funded by the budget, are administered by commercial banks under agency contracts. Although the SHDF will cease to exist by end 2002, no decision has been taken on what to do with its existing loan portfolio. There are no linkages between the three schemes, thus individuals can tap into multiple schemes to maximize subsidy receipt.

81. **EU accession and the prospect of rapid integration of Slovakia's financial markets into EU financial markets may warrant adjustments to housing finance support policies**. In the short term thought should be given to: (i) linking the 'home savings bank' subsidy to taking up a housing loan; (ii) means-testing the 'home savings bank' savings subsidy and the mortgage loan interest rate subsidy; and (iii) introduction of a minimum mortgage bond funding ratio to preclude banks from taking on undue interest rate risk. In the medium term, once interest rates converge toward EU levels and per capita income grows, subsidies could be further reduced or abolishing altogether, the minimum absolute capital requirements for regular commercial banks and 'mortgage banks' could be unified and 'home savings banks' could be transformed into regular commercial banks. The latter two steps would allow a faster consolidation of the banking system and strengthen Slovak banks' ability to withstand strong cross border competition after EU accession.

D. Integrated Financial Markets Supervision

82. During the transition period to 2005 when all financial markets supervision is planned to be integrated under a single entity within NBS, the government should continue the current focus and momentum behind strengthening both NBS and FMA's independent regulatory and supervision functions. Leading up to 2005, the government should continue to pursue the ongoing initiatives for strengthening both NBS's banking supervision and FMA's nonbanking supervision. It should provide the necessary budgetary support and technical assistance to FMA as necessary for its development into a mature independent entity. At the same time, the government should encourage: (i) close cooperation between the NBS and FMA through both formal and informal mechanisms in the interim period; and (ii) development of an implementation strategy; in order to successfully achieve the transition eventually to a strong integrated financial markets supervision entity.

E. Anti-Money Laundering Issues

83. **The Slovak authorities significantly improved the legal framework for the prevention of money laundering with new legislation in force since 2001**, addressing issues such as client identification, record keeping and reporting requirements for a relatively broad range of reporting entities. The banking and securities supervisory laws establish more stringent obligations such as identification requirements for beneficial owners of funds. For the insurance sector, such obligation is established in the new insurance law in effect since March 2002. Regarding financial institutions, the supervisory laws contain provisions concerning fit and proper requirements for managers and shareholders holding a significant interest (for foreign exchange houses only very basic criteria are applied to managers, and such reviews should be expanded to also include owners).

84. Money laundering is addressed in the criminal law and efforts are underway to provide for effective mechanisms to combat terrorist financing. The legal provisions on seizure and forfeiture of property and assets, however, are not fully adequate and should be improved. The Slovak Republic has established channels for international cooperation, and the Palermo Convention and the International Convention for the Suppression of the Financing of Terrorism are expected to be ratified this year.

85. The main area of concern is whether the implementation of AML/CFT measures in the supervised financial sector has kept up with the improvements in the legal framework. In particular, regarding the securities and insurance sector, enhanced supervisory oversight should complement the role of the Financial Police (Slovak Financial Intelligence Unit). The regulatory authorities need to take steps to ensure the strengthening of internal controls in supervised institutions, including requiring the appointment in each institution of a senior officer responsible for AML/CFT activities.

SECTION II—OBSERVANCE OF FINANCIAL SYSTEM STANDARDS AND CODES: SUMMARY ASSESSMENTS

This section contains information for the Financial System Stability Assessment for the Slovak Republic on compliance and consistency with international standards and codes relevant for the financial sector. The assessment has helped to identify the extent to which the supervisory and regulatory framework have been adequate to address the potential risks in the financial system; and has also provided a source of good practices in financial regulation and supervision in various areas.

As part of the FSAP, the following detailed assessments of standards were undertaken: Basel Core Principles for Effective Banking Supervision: Laura Ard (World Bank) and Gudrun Mauerhofer (National Bank of Austria); the IMF's Code of Good Practices on Transparency in Monetary and Financial Policies: Warren Coats, Alina Carare, Louis Kuijs (all IMF) and Herman Litman (Bank of Israel); the International Organization of Securities Commission (IOSCO) Objectives and Principles of Securities Regulation: Euan Abernethy (Formerly of the New Zealand Securities Commission); the Committee on Payment and Settlement Systems (CPSS) Core Principles for Systemically Important Payment Systems (CPSIP): Krzysztof Senderowicz (National Bank of Poland); the International Association of Insurance Supervision (IAIS) Supervision Procedures: Don McIsaac (World Bank); and the World Bank *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems*: Gordon Johnson and Angana Shah (World Bank). These assessments were prepared by drawing on the authorities' self-assessments, answers to questionnaires, and field work during February 2002.

Slovakia has relatively weak financial sector supervision but has significantly strengthened relevant laws and is in the process of strengthening their implementation and training supervisors in modern risk based supervision. Slovakia's desire to join the EU in the near future is providing a strong incentive to improve supervision to the level of international best practice. Monetary policy and financial sector supervision are very transparent.

V. Introduction and Summary

86. **This section contains summaries of the team's assessments of Slovakia's observance of five financial sector supervision standards and codes and of good practice in creditor rights system.** The detailed assessments for each of these standards and codes formed an integral part of the FSAP and an input into the FSSA. An attachment summarizes Slovakia's efforts in the area of anti-money laundering and the combating of the financing of terrorism. An assessment of accounting and auditing standards was made independently of the FSAP and was drawn upon by the FSAP team.

87. **Financial sector supervision is weak in Slovakia, but a major program is well under way to develop effective, risk based financial sector supervision.** Many of the core principles of effective banking supervision are not observed or are only partially observed. The same is true for securities market supervision and to a somewhat lesser extend for insurance supervision. The modernization of payment system oversight on the other hand is more advanced and generally observant of the core principles for systemically important payment systems.

88. **The formation and implementation of monetary policy and financial sector supervision satisfy high standards of transparency.** The Slovak authorities have embraced the importance of transparency. NBS especially has put considerable effort into high quality disclosure of all relevant data and maintains a very useful website.

89. **To a large extent the legal foundations for effective supervision, especially in banking are now in place.** It will take longer, however, to align prudential regulations with the new laws and longer still to fully implement them. An ambitious program to modernize banking supervision, including staff training, is now underway at the NBS. The program has strong support from NBS management and is supported by a World Bank Financial Sector Adjustment Loan and an IMF supervised resident banking supervision advisor.

90. **Insurance companies and the capital market are supervised by the FMA and regulated by the MoF.** Due to a lack of experienced supervisors, especially actuaries, the FMA relies heavily on external auditors. Programs to strengthen supervision by the FMA are not yet as well developed as for banking supervision.

91. **The Government has opted to integrate regulation and supervision of all banking and nonbanking financial markets under the jurisdiction of the NBS by 2005.**

92. **As a general rule, creditor rights remain weak, collateral systems are poorly developed other than the traditional mortgage, and enforcement procedures are slow and unreliable through the courts.** As a result, credit is largely inaccessible to all but the upper echelon of corporate borrowers. To offset the high regulatory risk, lenders have adopted a policy of requiring fully secured loans in nearly all corporate transactions. Similarly, the process of insolvency remains slow, inefficient, and poorly regulated, although recent changes in the law have led to improvements. On the bright side, legal and regulatory weaknesses have fueled a growing business in lease finance, where ownership resides in the lender or creditor, making asset recovery more efficient and predictable.

93. **Court system weaknesses and inefficiencies are the most significant detriment to debt enforcement.** While the Foreclosure (Execution) Law has greatly enhanced the ability of creditors to foreclose on assets, mostly real estate, the creditor is unable to avoid court proceedings and continue enforcement without the cooperation of the debtor. Another notable deficiency in creditors' ability to secure their debts is the lack of a registry for pledges on movable property. Currently, possession is required to effect a pledge on movables. Bankruptcy has presented the worst option for a creditor to recover debt. Though creditors' rights in a bankruptcy proceeding have increased recently—notably, recent amendments were introduced to the Bankruptcy Law as of August 1, 2000—creditors continue to find that participation in bankruptcy proceedings is not fruitful. Courts are weak as an institution in the Slovak Republic, and bankruptcy courts are no exception. Trustees represent another institutional weakness in the bankruptcy system.

VI. Transparency of Monetary Policy

A. General

94. The assessment of the National Bank of Slovakia's observance with good transparency practices relating to monetary policy was carried out as part of the joint Fund-Bank Financial Sector Assessment Program (FSAP). The assessment was undertaken by Warren Coats and Alina Carare (both IMF) and was based on the *IMF Code of Good Practices on Transparency in Monetary and Financial Policies (MFP Transparency Code).* The assessment has taken into account the implementation issues mentioned in the *Supporting Document* to the Code.

95. The NBS is very eager to be transparent and sees the transparency as an important tool in public participation, in policy formulation, and in oversight of the NBS' operation.

96. The assessment was based on: (1) a pre-FSAP questionnaire response; (2) The National Bank of Slovakia Act (Act No. 566/1992), as revised and amended until February 2001; (3) information available on the NBS website, NBS publications; and (4) discussions with NBS officials and four commercial banks. The main NBS references used were the *Annual Report*, the *Monetary Survey*, the *National Bank of Slovakia 2001* and the NBS website: www.nbs.sk.

97. The Slovak authorities cooperated fully with the assessment and provided all the necessary information and clarification.

B. Main Findings—Summary

98. **Monetary policy formulation and implementation of the National Bank of Slovakia (NBS) satisfies a very high standard of transparency practices.** The compliance of transparency practices and the areas that deserve further strengthening are described below.

Clarity of roles, responsibilities and objectives of central bank for monetary policy

99. **The NBS is an independent central bank with the primary objective of maintaining price stability, as specified in the NBA.** The NBS's monetary policy has been predominantly geared to lowering inflation since 1998, without plans to move to a formal inflation targeting framework. The NBS's monetary policy decisions are taken mainly on the basis of inflation benchmarks set by the NBS. In a context of a floating exchange rate regime, the NBS has adopted a policy of only intervening on the foreign exchange market to avoid sharp oscillations of the exchange rate, and to smooth the assimilation of large, lumpy, and temporary foreign currency inflows resulting from privatization. The NBA assigns the institutional responsibility for foreign exchange to the NBS. In addition, the NBS is responsible for issuing banknotes and coins and controlling, coordinating and ensuring the circulation of money; the payment system and settlement between banks; ensuring the efficient and effective performance of these operations; and supervising the safe functioning of the banking system, as specified in NBA.

100. **In pursuance of its monetary policy objective, the NBS uses an operating framework very similar to that used by the ECB.** The main instrument used to signal its monetary policy stance is the weekly auction of repos and reverse repos with a maturity of two weeks. The NBS requires commercial banks to maintain minimum required reserves (defined as deposits with the NBS) of 4 percent, and building societies to maintain minimum required reserves of 3 percent. To limit the volatility in the cost of liquidity, the NBS introduced two overnight standing facilities in February 2000, the refinancing facility and the deposit ("sterilization") facility. The NBS also uses outright sales or purchases of three-month NBS bills with irregular issues.

101. **The Bank Board, the governing body of the NBS specified by the NBA, sets the interest rates** and the Auction Committee of the NBS decides the amount to be tendered in the weekly two-weeks repo tender. The procedures for appointment and terms of office for the Bank Board is specified in the NBA. The decisions to change the instruments are promptly made public, along with adequate explanations why the changes were necessary, and the NBA provides for instrument independence for the NBS.

102. **The government cannot override the NBS decisions, and the NBS is forbidden by law to give credits and overdrafts to the government.** There is a clearly defined institutional relationship between monetary and fiscal operations, as well as the procedures for central bank involvement in the rest of the economy (e.g., procurement or provision of services for a fee). The agency roles performed by the central bank for the government are clearly defined and made public. The NBS organizes the primary government securities market for the MoF. Currently the MoF issues mainly nine to twelve months Treasury bills and government bonds with maturities ranging from 1 to 10 years. The NBS also acts as the banker of the government, the manager of the foreign exchange reserves, fiscal agent to the government and advisor on economic and financial policies and in the field of international cooperation, as stipulated in the NBA.

103. **The NBS is accountable to the parliament (National Council), as stipulated by the NBA, and to the public.** The NBS has to submit to the National Council semi-annual reports on monetary developments, along with audited financial statements, according to international accounting standards. The NBS is required to inform the public of changes in monetary policy and to provide summary balance sheets.

Open process for formulating and reporting monetary policy decisions

104. **The NBS formulates and reports monetary policy decisions in an open process.** The framework, instruments and targets to pursue the objectives of monetary policy are publicly disclosed and explained, and the responsibility of the Bank Board to assess the underlying economic developments, monitor progress toward achieving the monetary policy objectives and formulate policy is publicly disclosed, as required by the NBA.

105. **Although the process in which the NBS formulates and reports monetary policy decisions is open, the NBS should formalize the framework in which advance consultations for technical changes, instructions and guidelines take place.** There is a formal requirement for all secondary laws (NBS Decrees) to be submitted to the affected industry for comment before they are adopted. The NBS already consults the public and the affected industry, and incorporates their comments prior to adopting major changes, like the ones included in the secondary laws (NBS Decrees). However, there is no formal procedure for or practice of submitting proposed changes to the industry in advance for comments for changes coming under a legal document lower than a Decree. The NBS sometimes consults informally with the Slovak Bankers' Association or others for proposed substantive technical changes in NBS rules and regulations. The team recommended that the NBS adopt a similar policy with regard to all operational and regulatory changes. More intensive and formal public consultations for proposed technical changes to the structure of monetary regulations give the public the opportunity to propose changes, including providing an opportunity to present reservations and expected problems in advance, and, therefore, to improve policies.

Public availability of information on monetary policy

106. **The NBS subscribes to Special Data Dissemination Standards and it complies with the standards.** The NBS publicly discloses a summary balance sheet each ten days within two weeks after the end of the reference period on the website. An advance release calendar, providing the precise release dates is disseminated on the NBS website. Complete and audited financial statements are prepared annually within three months of the end of the calendar year (Article 38 (3) of the NBA). An independent auditor prepares, the "Auditors' Report and Summarized Statutory Financial Statement" and the "Independent Auditors' Report and International Financial Statements" published in the *Annual Report*, according to International Accounting Standards and in accordance with Slovak legal regulations and in a format comparable with the format used for international purposes. A wide range of monetary data and all of the NBS' monetary operations are published monthly in its *Monetary Survey*, as well as foreign exchange assets and liabilities.

107. **The information on monetary policy is publicly available in a timely manner and of high quality, in various publications and on the website.** This is not the case with the emergency credit information, however. Emergency financial support by the NBS has been rare and its details, which on each occasion would involve a single bank, were not published as such. However, on each occasion the fact of the assistance was publicly acknowledged. The results of such credits are reflected, in the aggregate financial statements of the NBS. In addition, the extension of credit by the NBS to the Deposit Insurance Fund was publicly disclosed. The team recommended improving the disclosure of emergency credits. While giving due recognition to concerns relating to stability of the financial markets, confidentiality and moral hazard, the NBS should disclose aggregate information on the emergency credit facilities, exercising judgment on the timing and on the nature of the information disclosed. Such disclosure enhances policy efficiency and accountability of the use of public funds. Information reported could include amounts, terms, follow-up developments, amount outstanding and repayments made, press releases, press communiqués, or other communication vehicles.

108. **The public information services of the NBS are carried out by the Public Relations Department**. The Department disseminates the publications cited above and also publishes monetary policy decisions and policy announcements in Slovak on the website. Starting with the first half of 2002, it is planning to post them in English as well. Moreover, the NBS operates a website (http://www.nbs.sk), which contains information on the structure, role and organization of the NBS, legislation, data, and research by NBS staff. The English website provides mostly data and legislation governing NBS, as well as a summary of the objectives of the NBS and the Bank Board appointment rules. The website is structured also by function to take account of the multiple functions of the NBS (monetary policy, banking supervision, payment system oversight). The Department also maintains contact with media representatives. All texts of regulations by the NBS are published in *Vestnik* and on the NBS website in Slovak. The publication is mailed to the commercial banks and can be available by subscription.

109. **The NBS issues the *Annual Report* and the monthly *Monetary Survey***. They are both posted on the website in Slovak and English and available in hardcopies. In addition, the *Annual Report on Monetary Developments in the Slovak Republic* that is submitted to the National Council by the NBS is a part of the *Annual Report* of the NBS and it is available in Slovak and English on the website and in hardcopy.

110. **Moreover, the NBS submits to the National Council the *Semiannual Report on Monetary Developments in the Slovak Republic***. This report, required by the NBA (Article 3), is available only in the Slovak version of the website. The NBS banking journal *Biatec* was issued in print until January 2002 in both languages and its contents were published on the NBS website (for the English version). Currently only the Slovak version is issued in print, and the English version is on the website. All publications are distributed by mail to interested parties, and are available on the website and as hardcopy at the NBS headquarters. NBS also publishes research working papers on the website in English and Slovak. The NBS has also published information brochures on the *Slovak Interbank Payment System, Market for Government Securities* and *National Bank of Slovakia* (publication, 1999,

2000, 2001; as well as multimedia CD-ROM, 2000). They are both posted on the website in Slovak and English and available in hardcopies. The NBS has also published *Documents in the Archives of the NBS* and *Branch Offices of the NBS*, along with promotional leaflets on money issue and other specific activities. In addition, legislation documents (the NBA and the Foreign Exchange Act) are printed in volumes that include both Slovak and English versions, along with explanations. The NBS publications are free of charge, unless otherwise stated above.

Accountability and assurances of integrity by the central bank

111. **The NBS Governor appears before the National Council twice annually** and upon request. In addition, The Monetary Programme is presented by the Governor to the press and commercial banks in December each year. Moreover, the NBS Governor and or one of her/his Deputies may attend meetings of the National Council and the Government and present the NBS's views with regard to economic or financial issues. Senior NBS officials also attend meetings of the Committee on European Integration and the Meeting of Economic Ministers (PEM). NBS senior officials very often appear before National Council commissions to present the NBS's position during legislation work. NBS senior officials give interviews, appear on television, and give speeches on monetary policy and financial sector issues as well as the state of the economy. The NBS Governor and other NBS senior officials regularly give interviews, appear on television, give speeches, attend meetings of the Slovak Bankers' Association and appear in front of the National Council at request. The speeches of the Governor and other NBS senior officials will be published on the NBS website also in English in the first half of 2002 (so far they have been available only in Slovak).

112. **The NBS has very thorough principles and arrangements of internal audit and control in place**. An NBS Internal Code of Conduct containing internal rules and regulations with regard to standards for the conduct of personal affairs of officials and staff of the central bank, "Code of Ethics of NBS Employees," is listed on the Slovak version of the NBS website and it is available upon request. This Code is similar to standards for the conduct of central government employees, but it includes also specific features given by the nature of the NBS work.

113. **The information on expenses and revenues is presented in disaggregated form in the audited financial statement** in the *Annual Report*, "Auditors' Report and Summarized Statutory Financial Statements" and "Independent Auditors' Report and International Financial Statements."

114. **The NBS intends to improve its transparency further**. Currently the efforts of the NBS are concentrated on improving the communication with the public by further developing its website. Both the Slovak and English version have been modified to include more information in a more user friendly format, starting with April 2002. The Public Relations Department efforts will be concentrated during 2002 in this direction.

C. Recommended Actions and Authorities' Response to the Assessment

Recommended actions

Table 7. Slovak Republic: Recommended Plan of Actions to Improve Transparancy of Monetary Policy

Reference Practice	Recommended Action
I. Clarity of Roles, Responsibilities and Objectives of Central Banks for Monetary Policy	
II. Open Process for Formulating and Reporting Monetary Policy Decisions	Advance consultation for technical changes, instructions and guidelines should be formalized.
III. Public Availability of Information on Monetary Policy	Disclosure of emergency credits should be improved.
IV. Accountability and Assurances of Integrity by the Central Bank	

Authorities' response

115. The NBS generally agreed with the assessment.

VII. BANKING SUPERVISION

A. Basel Core Principles for Effective Banking Supervision

General

116. The Basel Core Principle assessment was performed as a part of the Slovak Financial Sector Assessment Program (FSAP) with the objective of determining the country's compliance with international best practices in banking supervision as prescribed by the Basle Committee for Effective Banking. A two-member team[12] assessed compliance with the Principles during a visit in late February 2002. Banks in the Slovak Republic are supervised by the Banking Supervision Department (SD) of the National Bank of Slovakia. The documents used for the assessment included relevant laws and regulations, including the Slovak Banking Act, the Act on the Slovak National Bank, Anti-Money Laundering Act, Commercial Code, Act on Auditors, Civil Code, Slovak Accounting Standards, and Decrees of the National Bank of Slovakia. Many aspects of Slovak legislation are undergoing

[12] Laura Ard (World Bank) and Gudrun Mauerhofer (Austrian National Bank).

substantial change. However, the assessment is based on those laws, regulations and practices that were in effect at the time of the assessment. Extensive discussions were held with the Chief Executive Director of the NBS Supervision Department (SD), managers, and staff. Visits were made to several commercial banks, major auditing firms, the Chamber of Commerce, and to the Financial Police. The assessment also benefited from information collected by other FSAP team members who assessed compliance with the IAIS Core Principles, IOSCO Core Principles, the IMF MFP Transparency Code and Anti-Money Laundering experts.

117. The team had full access to all information and individuals needed to complete the assessment. The country counterparts were very cooperative, and no impediments to the process were encountered.

118. The assessment was based on the Basel Committee Methodology for assessing the Basel Core Principles. The Slovak Republic's compliance with the Core Principles (CPs) was assessed against both "essential" criteria and "additional" criteria. This implies that the Slovak Republic, in addition to seeking to fulfil the minimum standard, also strives to apply international best practice.

Institutional and macroprudential setting, market structure—Overview

119. Banking supervision was set up in 1992 as a separate department of the Slovak branch of SBCS, the former central bank of Czechoslovakia. When Slovakia became independent in 1993, it became a part of the National Bank of Slovakia. Today, the SD is responsible for oversight of the banking sector and benefits from the independence of the NBS that is provided under the Constitution. The Financial Market Authority (FMA) oversees the insurance and capital market sectors.

120. Presently, the banking sector in the Slovakia consists of 20 licensed banks. Of these, 5 are currently domestically (state) owned. Fifteen are foreign-affiliated: thirteen are foreign subsidiaries, and 2 are branches. The three largest banks held 55 percent of the market at the end of 2001.

121. The banking sector in the Slovak Republic has undergone a significant change in ownership as a result of the government's reform efforts and in response to a severely distressed banking sector. As a key part of their restructuring strategy, the authorities pursued rapid privatization of state-owned banks. The strategic investors making direct, controlling investments have been uniformly from outside the country. As a result, the Slovak banking sector is on the threshold of becoming nearly 100 percent foreign-owned.

122. The restructuring of the system involved a carve out of bad assets in selected banks totalling approximately 13 percent of GDP. This, together with privatisation, resulted in a decline of problem assets and a marked increase in the capital ratio. Banks' restructured balance sheets are now largely deployed in highly liquid assets (cash, central bank accounts, or Treasury bills). As a result of the investment in lower yielding assets, interest rate spreads are relatively tight. No relief in this current yield configuration is immediately apparent due

to the existing competitive environment and the perceived lack of quality loan demand. In order to bolster profitability, banks may begin reaching for yield through new products and fee generated business that could, in turn, introduce new risks to the balance sheet.

General preconditions for effective banking supervision

123. While the public infrastructure that supports financial sector oversight is gradually improving, it still presents challenges to effective banking supervision. Recently, a number of changes have been made to the legal framework. However, the legal framework in the area of general court procedures needs strengthening in order to provide increased enforceability of contracts, collateral, and creditor rights (see the assessment of observance of the World Bank's Principles and Guidelines for Effective Insolvency and Creditor Rights Systems). More specifically, the banking legal framework has been considerably changed in the last two years. The newly adopted Slovak Banking Act (SBA) (effective January, 2002) provides a stronger framework for, in part, bank governance, risk management, enforcement, and corrective actions, particularly in the area of problem bank resolution.

124. The exit policies used to remove a bank from the system should be improved. The experience with the resolution of the four banks that were closed in 2000/2001 highlighted weaknesses in the bankruptcy law and procedures when applied to banks. Amendment of selected provisions in banking, deposit protection and bankruptcy legislation to address these issues is desirable. Additionally, the NBS should consider developing detailed guidelines for temporary administrators directing them to use least cost failure resolution methods rather than as a matter of first choice opting for full insured depositor payoff.

125. Deposit insurance is provided under the Act on Protection of Bank Deposits (BDP Act). The Deposit Protection Fund (DPF) administers the coverage. The amount insured under the law is roughly equal to Euro 7,700 and is set to rapidly converge with the relevant EU directive. The cumulative effect of the four previous bank failures rendered the DPF insolvent. The BDP Act was recently amended to address many of the issues that contributed to this situation. A financial plan that addresses the DPF's insolvency position and future financial viability is needed.

126. Slovak banks are required to follow Slovak Accounting Standards (SAS). International Accounting Standards (IAS) will not be adopted until 2004. There are several differences between the two accounting systems that impact the usefulness of banks' reporting. Overall, SAS does not go far enough to present a fully comprehensive picture of banks' and enterprises' true economic positions. Banks are audited according to SAS, however, increasingly foreign owned banks are receiving dual audits according to both SAS and IAS. The SBA authorizes the NBS to require additional audit steps in the form of a "long form" report. Upon notification by banks of the appointed external auditor, the SD has the right to veto the selection if certain credible concerns exist.

127. Market discipline is generally weak as the tools used to apply such discipline are not adequate. Corporate governance, accounting and disclosure practices, and auditing standards still lag behind international best practices and hinder the ability of the users of financial

information from drawing well-informed opinions on the safety and soundness of the sector. This consequently impacts the level of confidence with which the domestic and international public view the condition and status of the Slovak financial system. Slovakia's move toward International Accounting and Auditing standards and stronger disclosure practices is essential for improving financial transparency and meaningful use of financial statements.

128. The key source of macroeconomic risk in Slovakia's open economy is the potential for sustained pressure in the foreign exchange market. With elections in September 2002, increases in perception of political risk are also possible.

Main findings

129. Banking supervision in Slovakia must be further strengthened, both in its practice and its application of the law, in order to ensure that the safety and soundness of the system is safeguarded. Fundamental change in the way supervision is implemented must still be accomplished to be effective and consistent with international best practices. However, the authorities recently have taken significant, meaningful steps to begin a comprehensive development process. Supervisory objectives have been crystallized in the form of a mission statement that has been publicly disclosed. The supervisor's legal authority has been significantly enhanced through the new Slovak Banking Act (SBA), effective January, 2002. The SBA places stronger governance responsibilities on supervisory boards and management and provides the supervisor with increased authority to require remedial action by these parties. Enforcement capacity has been further enhanced through the provisions of prompt corrective action and through other expanded remedial capacities. However, effective implementation of law must still be accomplished. The supervisory process is still more compliance based, and there is a continuing need to conduct more qualitative assessments on bank safety and soundness, management practice, systems, and risk management. As the supervisor's capacity to conduct a more proactive supervisory approach develops, its willingness and confidence to carry out its mandate as expressed in its mission statement and operating policy should likewise be enhanced and demonstrated.

130. **Objectives, autonomy, powers, and resources (CP 1):** Banking supervision enjoys the independence of the central bank provided by the Constitution. The legal framework for banking supervision is also suitable and provides supervisory independence. While the SD enjoys the benefits of this structure, the lack of adequate financial resources and trained personnel inhibits its ability to respond effectively and on a timely basis, thereby de facto, compromising its independence. Recent changes to the SBA have enhanced the supervisor's authority and ability to act, in part based on certain safety and soundness provisions. However, the ability of the supervisor to address safety and soundness issues in banks is significantly encumbered by its institutional capacity and its reluctance, and restrictions by its legal counsel, to apply qualitative judgement. Now that the SBA allows freer exchange of information among supervisors, an operating mechanism to facilitate the needed communication should be established.

131. **Bank licensing and structure (CPs 2–5)**: The SBA limits the use of the term "bank" and clearly defines permissible activities. However, it does not explicitly provide the NBS

with the authority to act against any entity which is, de facto, conducting the business of banking. Due to this and the issue cited above regarding the NBS' hesitance in interpreting banking legislation, the supervisor has not taken action with entities suspected of deposit gathering activities. The licensing process, as stipulated by law, addresses the key elements critical to prudent authorization. The supervisor has full authority to reject any proposal for ownership, in a de novo bank or in a change of control, if they do not meet the specified criteria. The law conforms to the EU directive, which requires strict investment limits and requires notification of such investments.

132. **Prudential regulations and requirements (CPs 6–15):** Banks are required to maintain a level of capital adequacy, individually and on a consolidated basis, consistent with international standards. However, the supervisor has not yet introduced a regulation allowing it to require capital based on a bank's individual risk profile, and there is no capital charge for market risk. The experience in many countries (including Slovakia) is that the integrity of reported financial information is often poor, and therefore, the accuracy of the capital adequacy levels is unreliable (CP6). Banks are required to have internal policies, controls, and monitoring over the credit granting process. However, legislation and guidelines do not specifically cite the importance of bank internal policy to the effective oversight and governance of a bank's statutory and supervisory boards (CP7). Banks are required to risk rate and classify their loan portfolios, but classification of investments and other assets is not captured. The current regulation requires further implementation (CP8). The SBA limits exposures to large and groups of borrowers. However, the definition of borrower groups is subject to rules for consolidated accounting that hinders effective combination of indebtedness for risk concentration purposes. The rule governing large exposures requires more emphasis on strong governance and the responsibilities of the bank authorities to ensure prudent control over concentrations of risk. It also requires further implementation (CP9). The SBA provides a sufficiently broad definition of "persons having special relationship" to a bank and provides adequate provisions governing such (CP10). The SBA does not specifically address country and transfer risks (CP11), and no market risk management provisions have been provided (CP12). While the SBA requires, generally, that individual banks have appropriate risk management processes, the supervisor's ability to assess banks' risk management processes requires strengthening (CP13). The SBA describes the responsibilities of the members of statutory and supervisory boards in the area of safety and soundness, qualifications of internal auditor and head of internal control. More specific definition of what constitutes sound internal controls is needed (CP14). Significant effort in the area of anti-money laundering has been made and legislation is in substantial compliance with international standards. The new legislation and procedures must now be implemented (CP 15).

133. **Methods of Ongoing Supervision (CP 16-20)**: The delivery of supervision to the banking sector is currently weak. The supervisory system consists of both on and offsite supervision. However, at the time of the assessment the objectives and methodology of supervision were ambiguous. The department had just been reorganized and the strategy and approach to examining and conducting off-site monitoring was undefined. Staff continue to need training (CP 16). The off site process does have a means of collecting needed information, but does not yet collect consolidated information (CP 18). Supervisory contact

with bank management is not sufficient to establish a regular, fluid exchange of information and convey supervisory concerns. Routine evaluation of the quality of management has not been conducted. (CP 17). The supervisor has a means of independent validation of the supervisory information it receives, through both on-site examinations and external auditors. However, those means are not used in an optimal manner. In the past, material misstatements of financial condition by banks have not been addressed in a timely manner. (CP 19). The supervisor, through the SBA, has the authority to conduct supervision of consolidated entities, however, these provisions must now be implemented (CP 20).

134. **Information Requirements (CP 21)**: The supervisor requires that banks maintain records according to Slovak Accounting Standards (SAS) and NBS regulatory reporting requirements. Implementation of the provisions in the SBA providing the supervisor with substantially improved authorities to ensure accurate regulatory reporting and financial statements is needed. Certain aspects of SAS significantly hinder accurate reporting of banks' true economic positions, and the supervisor is reluctant to require more conservative regulatory accounting.

135. **Formal Powers of Supervisors (CP 22)**: The SBA provides a range of remedial actions to the supervisor, which, if interpreted properly and effectively applied, offer the supervisor sufficient leverage and actions to oversee the banking sector. In order to accomplish this, the overall practice of supervision must continue to be strengthened. The willingness and capacity of the supervisor to identify issues and to take timely and effective actions must still be demonstrated.

136. **Cross-Border Banking (CPs 23–25)**: The SBA gives the authority to the supervisor to conduct supervision over consolidated entities, both domestically and internationally. Guidelines and processes must be developed in order to implement the requirement (CP 23). The legal framework allows information sharing with other domestic and international supervisors. However, the supervisor must continue to build its operational capacity to allow foreign supervisors to place reasonable confidence in its oversight abilities (CP 24). The SBA allows the supervisor to share information with foreign supervisors once a formal MoU is in place. At the time of assessment, only one MOU was in place for a system that is now 90 percent foreign owned. The supervisor is actively pursuing MOU arrangements with a number of foreign supervisors (CP 25).

Efforts underway to improve compliance

137. Overall compliance with the Core Principles needs improvement. While compliance *on a legal basis* has substantially improved with the adoption of the SBA (effective January, 2002), the implementation of the law and the application of sound supervisory practices by the supervisor still need improvement. In December, 2001, the NBS Bank Board adopted a Supervisory Development Plan (SDP) that provides time bound objectives for further strengthening bank supervision. This Plan, if fully implemented both through regulation and through practice, should serve to address a number of the issues cited in Core Principles Assessment. Effective implementation of the core elements of the Plan will require at least a 2-3 year time horizon.

138. **Objectives, autonomy, powers, and resources (CP1)**: Supervisory independence would be clearly enhanced if financial and human resources were improved, and increased qualitative judgement was used in interpreting law and regulation. If effectively implemented, the objectives listed in the SDP should help achieve fuller compliance with this section and should enable the supervisor to build its reputation and garner increased respect from the domestic and international public. Within the context of the public infrastructure, the adoption of IAS and the strengthening of governance standards and bank exit procedures will further enhance the NBS' ability to effectively oversee the banking sector. Compliance with elements CP 1(2) (operational independence and adequate resources), CP 1(3) (suitable legal framework—authorization of banks), CP 1(4) (suitable legal framework – powers to address compliance with laws and safety and soundness), and CP 1(6) (arrangements for information sharing) are in the process of being addressed.

139. **Licensing and Bank Structure (CP 2-5)**: The recent adoption of the SBA has contributed to substantial legal compliance in this area. However, due to the lack of explicit enforcement provisions to take action against institutions conducting de facto banking activities, such institutions, in the past, have been allowed to continue in business. Compliance with CP 2 (defining and enforcing permissible activities) is being addressed through the SDP and through developing more cooperative efforts between the NBS and Financial Markets Authority. Compliance with CP 6 (capital adequacy) will be addressed when the regulation requiring and defining a capital charge for market risk and consolidated capital adequacy calculations is finalized and implemented. As steps are taken to ensure the integrity of reported numbers through financial statements and regulatory reporting, in part accomplished through the eventual adoption of IAS, reliance upon reported capital adequacy ratios should improve.

140. **Prudential Regulations and Requirements (CP 6-15)**: Compliance with these principles is generally adequate, however some strengthening and further implementation are required. The supervisor is in the process of finalizing new prudential regulations in certain specific areas (capital adequacy (CP6), asset classification (CP 8), large exposures (CP 9), persons with "special relationships" to the bank (CP 10), risk management (CP 11, 12, 13), and internal controls (CP 14) as required by the adoption of the SBA. This should improve compliance in many of the cited areas. In particular, increased emphasis on the role of strong governance and the responsibilities of boards and management in these prudential areas is specifically needed. It is through the prudential regulations that the new governance provisions provided in the SBA should be, in part, required. While finalization of these new (or revised) regulations represents a step toward fuller compliance with the respective principles, full compliance cannot be achieved until effective implementation is achieved.

141. **Methods of Ongoing Supervision (CP 16-20)** is the area of weakest compliance and the area requiring the most attention and work by the authorities. Under the terms of the SDP, the supervisor has begun to make the first changes necessary in order to build banking supervision into an effective process. The goals and objectives of supervision will be clarified and the appropriate mix of on and offsite supervision (CP16), including the extent and nature of management contact (CP 17) and the ability to conduct supervision of consolidated entities (CP 18, 20), will be more fully developed. Compliance with CP 19—

validation of supervisory information—should also be improved as the supervisor develops its capacity and willingness to take remedial action against banks who are not reporting financial and regulatory information in an accurate and truthful manner. While the responsibility to strengthen supervisory process rests with the NBS management itself, improving the accounting environment through the adoption of IAS and harnessing market discipline through strengthened governance and disclosure rules will further support the efforts of the supervisor.

142. Compliance with **Information Requirements (CP 21)** needs improvement. The supervisor has achieved additional authority in requiring accurate accounting records and reporting through the SBA. However, the Slovak accounting law continues to set the standards and procedures. The supervisor should expend further effort to establish regulatory accounting process through which more conservative information is reported and disclosed, better conveying the true economic position of the bank. Fuller compliance with this principle will be achieved when IAS is finally adopted and the supervisor more actively exercises its new authority under the SBA.

143. The **Formal Powers of the Supervisor (CP22)** have been substantially strengthened, on a legal basis, through the SBA. The capacity of the supervisor must now be strengthened in order for these particular provisions to be properly implemented. The efforts underway to prepare (and implement) a corrective action policy that would guide when and how remedial measures will be taken (as directed by the SDP) will contribute significantly to fuller compliance with this Principle.

144. Compliance with **Cross-Border Banking (CP 23-25)** has substantially improved as the supervisor has gained the authority, through the SBA, to enter into cooperative agreements with domestic and foreign supervisors (CP 24, 25). The banking sector is now approximately 90 percent foreign-owned, which adds to the importance of dialogue with other supervisors. The supervisor is aggressively pursuing MOU with all pertinent regulators. Following the completion of such agreements and cooperative work relationships established, compliance will be substantially strengthened.

Medium-term challenges

145. The main challenge facing the supervisor is to fundamentally change its supervisory philosophy and its operating practice through evolving the attitudes of and retooling NBS management and staff. The SDP adopted by the NBS Bank Board provides a road map through which to start initiating this change. A new supervisory policy is in the process of preparation that will provide a new standard for conducting supervision on a more risk based approach. This first step in implementing change, if accomplished effectively, will help trigger change at all levels of supervision. This, in turn, will build capacity, improve the willingness of the supervisor to make more qualitative judgements about risk, and take more risk itself in executing its duties. As this occurs, many of the cited concerns in the Core Principle Assessment will be addressed. Specifically, interpretation of legislation, improvement in personnel and financial resources, the method and role of onsite supervision within the overall supervisory process, the manner and timing of effective remedial actions,

and stronger governance and accounting standards are all critical components for improving banking supervision within the next 2-5 years. The NBS Bank Supervision Department has recently employed an IMF provided advisor to help with the change and implementation process.

Table 8. Slovak Republic: Recommended Action Plan to Improve Compliance of the Basel Core Principles

Reference Principle	Recommended Action
Principle 1 1(2) Independence and Resources	Consistent with the SDP, there is a clear need to evaluate and improve both the financial and personnel resources within the SD.
1(3) Legal Framework and Ability to Issue Supporting Legislation	The NBS' ability to issue prudential rules in the form of decrees that both interpret the SBA and set the standards for safe and sound banking practice is still encumbered through the legislative review process. The ability of the supervisor to provide guidance to the banking industry through rules and decrees must be established.
1(4) Enforcement Powers	Steps must be taken by the NBS', its supervisors, and its legal department to develop and use the qualitative judgment necessary to effectively interpret and apply the law and to oversee the safety and soundness of the system.
Principle 2 Permissible Activities	The SBA does not provide the explicit authority for the NBS to act when an entity in the market is conducting, de facto, the business of banking without a proper license. While the Act should explicitly provide this power, the NBS must use its authority and its position to responsibly act in such cases, particularly when the interests of the public are at stake.
Principle 3 Licensing	The SBA should be amended to provide a "grandfather" clause that allows a graduated introduction of the university education requirements for bank management. Newly licensed banks should be examined more frequently during their initial years of operations. All supervisory personnel opinions (including onsite examiners) should be elicited when evaluating proposals for licenses, management changes, ownership changes, and changes to the corporate structure of a banking organization.
Principle 6 Capital Adequacy	Decree No. 2/2000, supporting legislation for capital adequacy ratios, should be carefully revised. The impact of a market risk charge should be evaluated through a banking industry survey. The rules for applying capital adequacy on a consolidated basis should be methodically evaluated.
Principle 7 Credit Policies	The supporting Decree No. 3/1995 should be amended to address all forms of borrowers' exposure, including direct credit extensions, securities, and off-balance sheet exposures. The governance aspect of the Decree should be strengthened to ensure proper emphasis on bank boards' oversight, internal risk management systems, and responses.

Reference Principle	Recommended Action
Principle 8 Loan Evaluation and Loan Loss Provisioning	Accurate classification of credit exposures and subsequent provisioning requirements, as specified in Decree No. 3/1995, must be more effectively implemented by the industry and tested by the supervisor. More emphasis on banks' governance over proper credit granting, monitoring, and classification is required. Changes to the basis for classification of exposures away from the current creditworthiness and paying capacity of the borrower toward a more backward looking approach (based solely on past due status) is inappropriate.
Principle 9 Large Exposures	The definition of "economically linked" borrowers is dependent upon the consolidation rules set by the MOF in accounting standards. This is inadequate for purposes of identifying and managing concentrations of risk and potential unsafe banking practices. The application of "economically linked" borrowers should be expanded to include various scenarios, including legal linkages, common sources of repayment, etc. The supervisor must be provided (or assume) the authority to apply the large exposures limit on a case-by-case basis as situations are so identifie, particularly during on-site examinations.
Principle 11 Country Risk	The supervisor should require that banks' risk management systems address all sources of risk, including country exposure. It should be provided the authority to address weaknesses in risk management as required by law and as they threaten the safety and soundness of the institution.
Principle 12 Market Risk	See CP 6, 11. Supporting legislation for market risk capital charges should be relative to the level and complexity of such risk taken by the subject bank. Supporting legislation should be issued that describes the requirements for a sound risk management system and management and board oversight.
Principle 13 Other Risks	See CP 11, 12.
Principle 14 Internal Control and Audit	The legal provisions require strong internal control and audit oversight. However, there is a need to effectively implement these provisions and to increasingly emphasize the board and management responsibility in the oversight process (governance). The supervisor should issue guidelines on what constitute adequate and effective internal control and internal audit processes.
Principle 15 Money Laundering	Enhanced legislation and examination procedures have been introduced in recent years. These could be expanded to require that banks appoint a senior officer specifically responsible for AML/CFT activities. Also, the law should explicitly protect bank staff who report suspicious activities in good faith (in addition to the existing confidentiality waiver). Focus on implementation is now necessary.
Principle 16 On-site and Off-site Supervision	Substantial change in this area is required. The purpose and role of the on and off-site supervisory process must be clarified. Strategic policy and procedures must be prepared and adopted by the NBS Bank Board. The organizational structure in the supervisory area should be re-evaluated and revamped in order to effectively deliver supervision. Personnel must be further trained. Progress in implementing the SDP must be demonstrated.
Principle 17 Bank Management Contact	Consistent with the SDP, the supervisor should establish minimum requirements for contact with bank management and supervisory boards. This contact should be increased as the significance of the issues grows and the condition of the bank deteriorates.

Reference Principle	Recommended Action
Principle 18 Off-site Supervision	The regulatory reporting process and off-site analysis should address the consolidated position of bank institutions.
Principle 19 Validation of Supervisory Information	The rigor with which the supervisor addresses inaccuracies and untruthful financial reporting by both the banks and external auditors should increase. Communication and reliance on external auditors should likewise improve.
Principle 20 Consolidated Supervision	The new SBA now provides the authority to conduct consolidated supervision. The supporting legislation and supervisory procedures should now be upgraded to implement the process.
Principle 21 Accounting Standards	The introduction of international accounting standards (IAS) for banks should be expedited. Particularly, requirements for asset valuations and non-accrual of interest on distressed assets are needed. The supervisor should rigorously enforce the requirements for accurate accounting and reporting to both the NBS and the public. Lines of communication with external auditors should be improved.
Principle 22 Remedial Measures	The effectiveness and timeliness of supervisory responses must improve in order to proactively address developing problems before they become costly to the system and to protect the depositor. Enforcement procedures to prevent the misuse of the word "bank" and to prevent de facto banking activities such as deposit taking should be established, in practice and through law. Measures (such as extra judicial actions, purchase and assumption of assets and liabilities, etc.) should be developed to address banks in administration to avoid, to the extent possible, costly liquidation procedures.
Principle 24 Host Country Supervision	The SD must continue to build its operational capacity to supervise overseas activities of domestic banks and to allow foreign supervisors to place reasonable confidence in its oversight capabilities.
Principle 25 Supervision Over Foreign Banks' Establishments	The NBS should continue the process it is currently pursuing to establish MOU's with each pertinent foreign supervisor of banks that conduct business in the Slovak Republic.

Authorities' response

146. The authorities did not agree with the assessment for CP 22 (Materially Noncompliant—MNC). They agreed with the assessment that the legal framework in this area is now satisfactory. But they noted that: "it is true that none of the remedial measures have been applied since the new Banking Act has entered into force, but as this is really a too short period of time our position is that to assess this particular principle as MNC is not adequate."

147. The authorities did not agree with the MNC assessment for CP 16 and 17 (Onsite and Off-site supervision, and Contact with Bank Management). They pointed to the long term Supervisory Development Plan (out to year 2004) that details current and future action steps designed to address the issues cited in the Core Principles Methodology and the Assessment itself.

148. The authorities did not agree with the MNC assessment for CP 2 (Permissible Activities). They cite that the NBS is not explicitly authorized to take remedial action in

cases where entities are conducting non-licensed activities. They also point out that the newly adopted Securities and Investment Services Act provides room for interpretation and possible action against such activities. Otherwise, the law enforcement authorities are responsible for taking action under the Criminal Code.

B. IMF's Transparency Code—Transparency of Banking Supervision

General

149. Banking supervision policy formulation and implementation by the National Bank of Slovakia (NBS) satisfies a very high standard of transparency practices. The main transparency practices and the areas that deserve further strengthening are described below.

150. The NBS is very eager to be transparent and sees the transparency as an important tool in public participation, in policy formulation, and in oversight of the NBS' operation.

151. The Slovak authorities cooperated fully with the assessment and provided all the necessary information and clarification.

Main findings

152. **Clarity of roles, responsibilities, and objectives of the banking supervisory agency.** The objective of the Banking Supervision Division (BSD) is clearly formulated in the NBA and, especially, in the Mission Statement. The NBA, SBA and the Mission Statement are published on the NBS website. A part of the NBS' Annual Report, which is widely available in hard copy and on the NBS website, is dedicated to its supervisory function conduct. Procedures for appointment and removal of the head of the BSD are not publicly disclosed. Because the MOU between the NBS and the FMA is still to be signed, the scope and the procedures of the cooperation between them is not publicly disclosed.

153. **Open process for formulating and reporting of banking supervisory policies.** Primary and secondary legislation (which is very detailed) and the overview of the issued supervisory decisions are on the NBS website. That part of supervisory policies which is contained in the secondary legislation (decrees of the NBS) is always discussed within the preparatory period with the banking industry. Significant changes in financial policies are put for discussion to the Board and, after the Board meeting, the NBS issues a press release. The banking supervision development plan is published on the NBS website, allowing the public to comment. The NBS has only one signed MOU with the Czech National Bank and its essential elements are on the NBS website. The annual and semi-annual reports contain a part on Banking Supervision which describes also how the BSD`s overall policy objectives are being pursued.

154. **Public availability of information on banking supervision**. Quarterly reports on the banking sector performance are published on NBS website. Emergency financial support by the NBS has been rare and its details, which on each occasion would involve a single bank, were not published as such. However, on each occasion the fact of the assistance was

publicly acknowledged. The results of such credits are reflected, in the aggregate financial statements of the NBS. The team recommended improving the disclosure of emergency credits. While giving due recognition to concerns relating to stability of the financial markets, confidentiality and moral hazard, the NBS should disclose aggregate information on the emergency credit facilities, exercising judgment on the timing and on the nature of the information disclosed. The NBS has its own Public Information Department and also own speakers. The Department issues information concerning banking supervision. The NBS conducts quarterly meetings, chaired by the Governor with the Vice-Governor responsible for the BSD and the Chief Executive Director of the BSD, with the representatives of all banks. Beyond these regular meetings the Governor and other members of the Bank Board commonly comment on banking sector developments in the media and also publish articles in press. According to the SBA, the banks are obliged to publish on their premises information about the deposit protection system in line with the BDP Act. Moreover, banks must inform depositors about the extent to which each deposit-related product is covered by the deposit protection scheme. The BSD ensures compliance with this requirement.

155. **Accountability and assurances of integrity by the banking supervisory agency.** The Governor and vice-governors appear in the Parliament to present an Annual Report and Monetary Policy Report (three times a year). They are also very often invited by the Parliament to appear and to answer different questions concerning the banking system. They, and staff of BSD, take part in discussions in parliamentary committees when they are dealing with new banking legislation. The NBS is obliged to present its audited financial statements once a year to the Slovak Parliament. The NBS has very thorough principles and arrangements of internal audit and control in place and they are posted on the NBS website. The Code of Ethics which deals with standards of conduct of the BSD staff (and is separate from the Code of Ethics for other NBS staff) is not publicly disclosed. The SBA states legal protection of BSD staff.

Table 9. Slovak Republic: Recommended Action Plan to Improve Observance of IMF's MFP Transparency Code Practices—Banking Supervision

Reference Principle	Recommended Action
V. Clarity of Roles, Responsibilities, and Objectives of Financial Agencies Responsible for Financial Policies	The procedures for appointment and removal of the CED of the BSD should be publicly disclosed. The MOU with FMA should be publicly disclosed when signed.
VII. Public Availability of Information on Financial Policies	The disclosure of emergency credits should be improved.
VIII. Accountability and Assurance of Integrity by Financial Agencies	The BSD Code of Ethics should be publicly disclosed.

Authorities' response

156. No comments provided.

VIII. Insurance Regulation

A. IAIS Insurance Core Principles

General

157. The assessment of the Slovak Insurance Sector was performed as part of the Financial Sector Assessment Program (FSAP) for the Slovak Republic in February 2002. The main objectives of this assessment are to determine the levels of observance with the International Association of Insurance Supervisor (IAIS) principles, and to suggest areas where further development may be appropriate. The assessment was prepared by Donald McIsaac, Lead Insurance Specialist, Financial Sector Department of the World Bank and was based on a review of the legal framework, and extensive discussions with the supervisory authorities and market participants.

158. The principal counter party for the assessment process is the Insurance Section of the Financial Market Authority. Regulation of the insurance market is based on the Insurance Act of 1991 with amendments in 1992, 1995, 1997 and 2000. This Act is supported by Decree 136, issued in 1996 (with important amendments in 1999 and 2000) and by various supporting memoranda issued under the authority of the Ministry of Finance, including the Order that establishes the means of determining the required minimum solvency margin. The supervisor has also issued specific instructions to licensed companies in order to clarify the application and interpretation of the legal framework. In addition, "Head 15" of the Civil Code that deals with insurance contracts is relevant for the operations of insurance companies. As is the case for all general purpose corporations, insurance companies must be in conformity with the Commercial Code. Financial reporting practices for insurance companies are governed by the Act on Accounting.

159. As of March 1, 2002, a new "Act on Insurance Industry and Amending Some Laws" goes into effect. It will replace the existing insurance legislation. Companies will be given a transition period of one year in order to conform their operations to the requirements of the new law. Some of the provisions in the new law are designed to come into force only at the time of the EU accession for the Slovak Republic.

160. This assessment was performed on the basis of the regulatory system in place prior to the effective date of the new legislation. Supervisory procedures in place are those that support the previous legislation and supporting regulations. At the time of the assessment, necessary decrees to support and make effective the new law were still in the drafting stage. It will take some time before the impact of the new legislation will be felt in the insurance market and in supervisory practices. Where relevant, the assessment identifies those changes

that will come from the new legislation that will assist the supervisory system in the Slovak Republic to become more observant of the Core Principles.

161. In making this assessment the FSAP team made use of the Core Principles Methodology Document that was adopted by the IAIS at its annual meeting in October 2000.

Institutional and macroprudential setting—Overview

162. There are 28 licensed insurance companies operating in Slovak Republic, all incorporated locally. As at the end of the year 2000, the majority of the voting shares of 18 companies were foreign owned while the rest are controlled by domestic investors. Four of the companies do only life insurance business, 6 do only non-life business, while there are 18 composite companies. There are no domestic professional reinsurance companies.

163. There are no strategic shareholdings between insurance companies and banks and the only affiliations tend to be of a loose nature. For example, some insurance companies have arrangements to offer mortgage-related insurance products through a bank's network. However, in general, sale of business through banks is not yet a major part of the operations of insurance companies. ING group has established both a life insurance and a non-life insurance subsidiary in the country. It will be interesting to see whether that leads to significant marketing through the banking arm of the group.

164. As an indicator of the relevance of the insurance industry to the financial sector, it is helpful to compare the total liabilities of insurance companies in respect of their policyholder obligations with the total amount of deposits held by banks. For the year 2000, total liabilities arising under insurance policies issued by Slovak insurance companies amounted to SK 39.0 billion and that amount is approximately 6.4 percent of total bank deposits at the end of 2000. The comparable figures for 1999 were SK 34.7 billion or 6.8 percent of total bank deposits at the end of 1999.

165. Total premiums received by insurance companies operating in the Slovak Republic during 2000 amounted to SK 27.5 billion, of which SK 11.2 billion was for life insurance and SK 16.3 billion for non-life insurance. Total premium income is estimated to represent 3.1 percent of GDP. This level of penetration ranks ahead of that in Poland, Hungary and Croatia , but behind the comparable value for Czech Republic (3.6 percent).

166. The market is somewhat concentrated, since Slovenska Poistovna, a state-owned company, has a 46 percent market share and the top 5 companies collect over 75 percent of premiums written (estimates for 2001 obtained from the Slovak Insurance Association.)

General preconditions for effective insurance supervision

167. The legal system in the Slovak Republic is similar to that prevailing in Germany. Companies, including insurance companies, are incorporated according to the Commercial Code. The Code is to be amended shortly and changes will have an effect on the corporate governance of general purpose corporations. However, the provisions do not go far enough in

protecting the interests of policyholders and account-holders in financial institutions. For this reason, laws such as the Insurance Act should include special provisions outlining the responsibilities of Directors and identifying certain key roles they must play. A new Insurance Act has been adopted and will become effective March 1, 2002. This law does give some consideration to the roles and responsibilities of Directors. However, it does not contain specifics regarding their duties with respect to setting investment policies and general risk management. There is no Law on Insurance Contracts in the Slovak Republic although there are relevant provisions contained in Head 15 of the Civil Code. This Code has become outdated.

168. Accounting for all domestic corporations is governed by the Act on Accounting. By virtue of a special supplement to the Act, prepared at the direction of the Ministry of Finance, unique rules prescribe accounting and financial reporting requirements for insurance companies. The rules have the effect of ensuring that Slovak insurance companies prepare their accounts in accordance with the rules established by the EU Insurance Directives for its member countries. Financial returns are to be accompanied by reports and opinions issued by an auditor and an actuary.

169. An important new feature of the new insurance legislation to become effective March 1, 2002 is the requirement for derivative reports. When the actuary or the auditor becomes aware during the course of a regular review that a situation is developing that could impair the ability of the company to meet its obligations, the professional is obliged to make the situation known to the authorities. This provision may cause some difficulties because the law does not appear to provide these professionals with immunity from civil suits that might be launched against them as a result of their making reports of this nature.

170. While an actuary's opinion is required, and in fact is collected with each annual return, the situation requires some clarification since the Society of Actuaries does not yet have the status of a professional body. In order to deal with this situation, the new legislation will authorize FMA to organize and conduct special qualifying examinations. Persons who have accepted academic credentials in actuarial science and mathematics, will be given the opportunity to attempt a special examination and those who complete it successfully will be registered as "actuaries" by FMA.

Main findings

171. **Organization of supervisor**: At present, FMA has only 13 persons dedicated to the supervision of insurance companies. This number may be increased in the near future provided the revised plans for funding of FMA are adopted and provided this results in an increase in revenues for the authority. The supervisory team has adopted a reliance approach to their work and look to the external auditor and the actuary to assist with the work of monitoring the financial strength of companies. Unfortunately, none of the supervisory staff has much experience in the insurance field. Efforts have been made to provide training and a commendable job was done by the German supervisory authority that provided technical assistance with financing from the EU PHARE program. However, there is no substitute for experience.

172. The regulation and supervision of the Slovak Insurance sector has been strengthened with the integration of the supervision within FMA. The new legislation just adopted is more closely harmonized with EU legislation, including EU solvency criteria.

173. **Licensing and changes in control**: In practice, each company must file a business plan when it obtains a license. It must inform the supervisor of any changes to the plan. In the process of inspection and supervision, FMA officials monitor the appropriateness of the elements of the plan and ensure that the company management is adhering to the plan. This process enables the supervisor to ensure, among other things, that Directors and senior managers are always "fit and proper" persons. Since the business plan includes details on the products the company proposes to offer for sale as well as the actuarial and other assumptions upon which prices and technical provisions are based, the supervisor who carefully monitors developments in the plan should be in a position to identify problems at an early date.

174. **Corporate governance and internal controls**: Corporate governance of insurance companies relies on general provisions of the Commercial Code. Although these provisions have been recently strengthened, they are still insufficient to ensure sound governance of insurance companies. Directors should be made responsible for the establishment of such internal policies as the investment policy, policy on risk retention, policy on transactions with related parties, internal control systems, etc. and for the monitoring of compliance with these policies.

175. The insurance legislation does not impose any particular requirements with respect to internal controls. While company practices in this respect are reviewed at the time of onsite inspections, such inspections are not sufficiently frequent. The supervisor should issue instructions regarding the desired features in a system of internal controls and Boards of Directors should be made responsible for their implementation and monitoring.

176. **Prudential rules**: The primary focus of insurance supervisory efforts is the monitoring of solvency and capital adequacy. When a company's net worth falls below the amount that would be required through application of the solvency margin formula, the supervisor makes a formal request for prompt remedial action and the legislation provides considerable powers for intervention in such cases. There have been two insurance company failures in recent years and FMA has advised that there are at present 4 companies that do not meet the minimum solvency requirements and where plans for remedial action formulated by the companies are under consideration.

177. The supervisor should have the authority to order an insurance company to amend its reinsurance program. It would also be desirable if the supervisor collected information on the reinsurance companies with whom the direct writer has made contracts. Additional reserves could then be required if the reinsurers are not highly rated.

178. **Market conduct**: The existing insurance legislation does not deal directly with issues of consumer protection. There is no Law on Insurance Contracts in the Slovak Republic although there is some reference to insurance contracts under Head 15 of the Civil Code.

This code is outdated and it is not apparent that there are any plans for revision. No rules have been set regarding the requirement for codes of conduct for intermediaries and for companies in respect of their relationships with their clients. However, the local associations of companies and of brokers established such codes. The insurance section does not have a program for establishing disclosure standards and other consumer protection measures. It will likely require additional resources if it is to take steps in that direction.

Recommended actions and authorities' response

Recommended actions

Table 10. Slovak Republic: Recommended Action Plan to Improve Observance of IAIS Insurance Core Principles

Reference Principle	Recommended Action
Organization of an Insurance Supervisor	
CP 1	Supervisor requires additional human resources in order to perform its functions adequately. Perhaps this will come with new method of funding for FMA. Care should be taken to ensure optimal coordination between supervisory work at FMA and regulatory functions of MOF
Licensing and Changes in Control	
CPs 2–3	Establish requirements and adopt procedures for "fit and proper" testing of all major shareholders of insurance companies
Corporate Governance and Internal Controls	
CPs 4–5	Responsibilities for Directors should be defined. The legislation should include the specifics – such as responsibility to establish and monitor investment policy; responsibility to set risk retention limits; responsibility for identifying, limiting and resolving transactions with related parties. Internal control procedures should also receive the scrutiny of the Directors
Prudential Rules	
CPs 6–10	Qualification of actuaries should be strengthened. Annual review of adequacy of technical provisions should include a determination whether guarantees promised at the point of sale continue to be sustainable. A practice of collecting comprehensive statistical data should be introduced in order to facilitate the verification of technical provisions. Supervisor should have the authority to review reinsurance arrangements and set minimum standards for retention, and should also have the authority to order changes in the reinsurance program.

Market Conduct	
CP 11	Consumer protection responsibilities of the supervisor should be made clear through the legislation. There should be control over disclosure requirements, conflicts of interest, use of misleading information. It would also be wise to provide for some forms of alternate dispute resolution
Monitoring, Inspection, and Sanctions	
CPs 12–14	On-site inspections should be conducted at a minimum frequency for all companies. There should be regular communication between the inspectors and the external auditor
Cross-Border Operations, Supervisory Coordination and Cooperation, and Confidentiality	
CPs 15–17	No comments

Authorities' response

179. The authorities noted that the new law coming into force April 1, 2002 will introduce a number of changes that will address current deficiencies. They specifically cited provisions that would correct the current non-observance of Principles 1, 2, 5, 7, 14, and 15.

180. The authorities did not agree with the team's assessment that the FMA did not have sufficiently specific requirements in its regulations and enforcement procedures to ensure adequate corporate governance (CP 4). They argued that the governance provisions of the Commercial Code adequately provided for the membership and duties of the board of directors, supervisory board and other boards.

181. The authorities did not agree with the team's assessment that because insurance companies in Slovakia are not using derivative investments, CP 9 is "not applicable." They argued that because an insurance company can invest technical provision resources only in the assets specified in the article 29 of the act on insurance, which do not include financial derivatives, the restriction called for in the principle is observed.

B. IMF's Transparency Code—Transparency of Insurance Regulation

General

182. Insurance supervision policy formulation and implementation of the Financial Markets Authority (FMA) and the Ministry of Finance (MoF) are quite transparent. The main transparency practices and the areas that deserve further strengthening are described below.

183. The FMA and the MoF are very eager to be transparent and see the transparency as an important tool in public participation in policy formulation and in oversight of their operation.

184. The Slovak authorities cooperated fully with the assessment and provided all the necessary information and clarification.

Main findings

185. **Clarity of roles, responsibilities, and objectives of the insurance supervisory agencies.** The objectives of the FMA are clearly formulated in the ICA. The ICA and the statement of the FMA's objectives of supervision are publicly disclosed on the MoF website. The FMA Act states that the FMA has the authority to supervise the insurance industry, while according to the Constitution the MoF has the authority to regulate (to issue secondary legislation regarding) the industry. The FMA issues a bulletin that includes reports about its operation, decisions legally in force, professional positions and other important announcements. Under the FMA Act, the FMA may publish an announcement about imposed penalty or a measure to correct found shortcomings in the national daily press. The information is easily available on the FMA website. The procedures for appointment, terms of office, and any general criteria for removal of the Chairman and the members of the council of the FMA are stated in the FMA Act, which is posted on the FMA web. The FMA cooperates with the MoF in formulating financial policy for the insurance industry. On both websites there is information about this cooperation. Because the MOU between the NBS and the FMA is still to be signed, the scope and procedures of the cooperation between them are not publicly disclosed.

186. **Open process for formulating and reporting of insurance supervisory policies.** Relevant laws and by-laws and the regulatory framework of primary and secondary legislation are posted on the FMA website and on the MoF website. All administration fees of the Slovak Republic, including those charged by the FMA, are set according to the Administration Fee Law and are published in the note to the law, which is posted on the FMA website. Cooperation between the FMA and the MoF, and the NBS is stated in the FMA Act. Under the FMA Act, the FMA can conclude agreements on mutual cooperation with foreign supervisory authorities of the insurance industry. MOUs were signed with the German and Austrian Supervisory Authorities, and its main elements were put on the FMA website. Significant changes in financial policy, which can only be changed through primary and secondary legislation are publicly disclosed on the MoF website. All drafts of new regulations are put on MoF website and the public can comment. The FMA's Annual Report and an Analysis of Insurance Industry adequately explain how its activities contribute to the overall objectives of supervision, but do not adequately evaluate how the MoF regulations of insurance contribute to those objectives.

187. **Public availability of information on insurance supervision.** The FMA issues an Annual Report and an Analysis of Insurance Industry. The reports are available on the FMA website. Summaries of quarterly reports of insurance companies sent to the FMA are published on the website of the FMA continuously. The Annual Report includes FMA financial data, balance sheet and income statements. The FMA has a Public Relations Department. The FMA`s chairman and vice chairman appear in public. They give interviews, attend conferences, make speeches and publish articles. The texts of public statements and speeches are released as a matter of course to the public. There is one policyholder guarantee

established by law—the Insurance Guarantee Fund—for the case of compulsory contractual insurance of motor vehicles against civil liability (MTPL). Information on the nature and form of the Fund, on the operating procedures, on how the Fund is financed, and on the performance of the arrangement, is contained in the MTPL Law.

188. **Accountability and assurances of integrity by the insurance supervisory agency.** Standards of accountability differ between the regulatory (the MoF) and supervisory (the FMA) authorities: the Report of the FMA is sent to the Cabinet and the officials of FMA may be requested to attend the meeting of the Cabinet, while under general rules of accountability of Cabinet, the Minister of Finance can be summoned by the Parliament to report on policies in the area of insurance and answer questions. The FMA financial statements are not audited. According to the new FMA Law, the FMA will be required to prepare financial statements that are audited by an external auditor. They will be publicly disclosed. Internal governance procedures are not publicly disclosed. The FMA Act establishes a requirement for the chairman, council and staff of FMA to prevent conflicts of interest, including submitting yearly statements about compliance with legal restrictions.

Table 11. Slovak Republic: Recommended Action Plan to Improve Transparency of Insurance Supervision

Reference Practice	Recommended Action
V. Clarity of Roles, Responsibilities, and Objectives of Financial Agencies Responsible for Financial Policies	The MOU with NBS should be signed and publicly disclosed.
VI. Open Process for Formulating and Reporting of Financial Policies	One of the reports issued by the FMA should include a section contributed by the MoF explaining how MoF activities contribute to the overall objectives of oversight of insurance industry.
VII. Public Availability of Information on Financial Policies	
VIII. Accountability and Assurance of Integrity by Financial Agencies	Officials of the FMA should be available to appear before the Parliament to answer questions on its Annual Report.

Authorities' response

189. No response provided.

IX. Securities Regulation

A. IOSCO Objectives and Principles of Securities Regulation

General

190. The assessment of the Slovak securities market was performed during the period February 18–March 1, 2002 as part of the Financial Sector Assessment Program (FSAP) for the Republic of Slovakia. The main objective of the assessment was to determine the effectiveness of securities regulation, soundness of market intermediaries, and development prospects for the capital markets, including observance of the IOSCO Objectives and Principles of Securities Regulation. The assessment was prepared by Euan Abernethy, consultant under the supervision of Lalit Raina, World Bank.

191. The assessment was based on the Objectives and Principles of Securities Regulation, issued September 1998, by the International Organization of Securities Commissions (IOSCO) and the accompanying Methodology. The information used for the assessment included: (i) answers by the Financial Market Authority of the Republic of Slovakia (FMA) to the IOSCO "Questionnaire and Methodologies for Self-Assessment;" (ii) English translation of the Act on Financial Market Authority and the Securities Act No. 566/2001; (iii) English translation of regulations issued by the FMA, and rules issued by the Bratislava Stock Exchange and the Slovak Stock Exchange; (iv) material available on the website for the Financial Market Authority and the Bratislava Stock Exchange; and (v) interviews with the Ministry of Finance and FMA officials and various market representatives, the Bratislava Stock Exchange, the Slovak Stock Exchange, accountants, lawyer and leading market participants.

192. In regard to auditing and accounting standards, the assessment used the research and references in the Report on the Observance of Standards and Codes (Accounting and Auditing) dated November 27, 2001 prepared by a staff team from the World Bank on the basis of information provided by the authorities of the Slovak Republic pursuant to an initiative of the Ministry of Finance and the Slovak Chamber of Auditors.

Information and methodology used for assessment

193. Until November 2000 the regulation and supervision of the capital markets in Slovakia was carried out by the Ministry of Finance (MOF). The FMA was established on November 1, 2000 as the body of state administration responsible for the supervision of the capital markets and insurance sector, which it took over from the MOF. The MOF retains the authority of making regulations.

194. Act the time of the assessment, there are one stock exchange quoting listed shares, the Bratislava Stock Exchange (BSE). The BSE has market segments for shares on the Listed Market and the Free Market. Of a total of 887 stocks listed or registered only 11 were quoted or registered in the Listed Market and the balance (876) on the Free Market. Trading is concentrated in five companies. Even here the volumes are very low. Market capitalization of

bonds in the Listed Market on January 31, 2002 was SK 250 billion and on the Free Market was SK 51 billion.

195. It would appear that the efficiency of the capital markets requires significant strengthening to aggregate capital for use in productive enterprises or to provide an efficient platform for trading in securities. Market capitalization of companies listed on the stock exchange is low both in absolute terms (Euro 3.3 billions in year 2000) and when compared with other economies by reference to GDP (17.5 percent in the year 2000). The market is extremely illiquid with low turnover overall and with the majority of stocks trading very rarely.

General preconditions for effective securities regulation

196. The securities market in Slovakia is open to any firm meeting the regulatory requirements. The accounting standards under which the market functions, however, are not adequate. The accounting and financial reporting standards now in place provide accounts relevant for taxation purposes but are not geared to the requirements of capital markets and investors. There are significant differences between Slovakia's statutory accounting standards and IAS. These include limited disclosure requirements, limited segment reporting, lack of detail on related party transactions, different treatment on recognition, measurement and disclosure of financial instruments and deferred taxation differences. Shortfalls in auditing practice (other than in the international accounting firms) include lack of appreciation of auditors independence, quality control for audit work, lack of strict application of related party transactions and lack of implementation of a going concern standard.

197. The legal foundation of the capital market (corporate governance and securities regulation) is broadly satisfactory but needs to be strengthened in a number of areas. The duties of company directors and managers to the company they manage and to the shareholders of that company need to be clarified and disclosure improved in the areas of dealings by officers in the shares of the company, related party dealings and of total benefits received by way of remuneration from the company. The rights of shareholders, and minority shareholders in particular, are not clearly defined or are non-existent.

Main findings—Summary

198. The securities laws and the constitution of the FMA as a supervisory authority are recent developments in Slovakia and the terms of those laws and the powers and authorities of the FMA generally conform to the good regulatory codes as set out in the IOSCO Objectives and Principles. The powers and authorities of the FMA will be further clarified and improved with new legislation in effect on April 1, 2002 and the new securities laws now in force will apply with more certainty to brokers as they become licensed by the FMA before September 30, 2002.

199. The new securities laws and recent amendments to the Commercial Code have improved shareholder rights but there are still areas where improvements can be made. In

particular accounting and auditing standards are not in line with IAS/ISA, the definition of securities does not cover all products that should be covered by securities laws, information required in issuers prospectus' is insufficient, minority shareholder rights are not fully protected and directors duties and disclosure requirements are not adequate.

200. The FMA is a young agency and is developing its procedures and supervision and enforcement regimes. It will have to ensure that it can offer competitive remuneration and working conditions to attract and retain the skills and experience required to effectively supervise the markets and enforce the laws.

Regulator (Principles 1-5)

201. These Principles are generally implemented. However the FMA is limited in its operational effectiveness in being unable to initiate secondary legislation. The FMA is subject to government salary and employment and working conditions and must compete with the private sector for staff. The effective exercise of the FMA's powers depends on its ability to engage and retain suitable staff.

Self-regulatory organization (Principles 6-7)

202. These Principles are implemented.

Enforcement (Principles 8-10)

203. There are comprehensive inspection, investigation and surveillance powers granted to the FMA. Some entities, however, are not subject to securities market legislative requirements notwithstanding previous offers of assets to the public. The application of the law to brokers is unclear and they will not become subject to the new laws until they are relicensed by the FMA. This is required by 30 September 2002.

Cooperation (Principles 11-13)

204. These Principles are generally implemented. There could be more use of MOU's but some are now being negotiated. In the meantime the lack of these is not seen as a limitation in cooperation in practice. The FMA intends to become party to the multilateral IOSCO MOU, at which time Principle 12 will be fully implemented.

Issuers (Principles 14-16)

205. Accounting and auditing standards are not of a high or internationally acceptable standard. There are significant differences between the Slovak accounting standards and IAS and there are gaps in the auditing standards. Prospectuses do not contain mandated information that a well informed investor requires and the securities laws do not extend to some asset and financial products issued to the public. Minority shareholder rights are not adequately protected by the Commercial Code or the Securities Act.

Collective investment schemes (Principles 17-20)

206. These Principles are implemented. It would be preferable for the annual report or a summary report to be sent to each unit holder in a unit trust.

Market intermediaries (Principles 21-24)

207. These Principles will be implemented as brokers become licensed by the FMA under the Securities Act. This must occur before end September 2002. In the meantime, there is doubt about the powers of the FMA in respect of brokers who are not licensed under the Securities Act.

Secondary market (Principles 25-30)

208. These Principles are generally implemented. However the provisions prohibiting market manipulation are weak and difficult to enforce.

Recommended actions and authorities' response to the assessment

Recommended actions

Table 12. Slovak Republic: Recommended Plan of Actions to Improve Securities Regulation

Reference Principle	Recommended Action
Principle 2	Legislation should grant the FMA the ability to initiate secondary legislation under the Securities Act. The FMA would be more financially independent if it could obtain revenues from market participants.
Principle 3	The FMA should be independent of government salary scales and conditions of employment.
Principle 8	The legislation should clarify the application of the Securities Act to all entities that have offered assets or financial instruments to the public.
Principle 9	Legislation should clarify the application of the powers of the FMA to brokers in the period to September 30, 2002.
Principle 12	There could be more extensive use of MOU's with foreign regulators.
Principle 14	The legislation or secondary legislation should provide more mandated information in prospectuses.
Principle 15	The Commercial Code should provide more effective protection for minority shareholders. There are inadequate provisions for the duties of directors to the company and shareholders.
Principle 16	Slovakia should adopt accounting and auditing standards which are the same as or equate to international standards.
Principle 22 and 23	Legislation should clarify the application of the Securities Act to those brokers who have not been licensed by the FMA under that Act pending September 30, 2002.
Principle 24	The Securities Act should be amended to clarify the powers of the FMA over brokers pending licensing of all brokers by September 30, 2002.

Reference Principle	Recommended Action
Principle 27	Important company announcements should be made to the exchange and to members immediately instead of at the end of the days trading.
Principle 28	The laws on market manipulation should be strengthened.

Authorities' Response

209. The authorities did not agree with the "Partially Implemented" assessment for Principle 14." In their opinion, in addition to the public offer prospectus, the listing prospectus should also be considered for the assessment. The authorities believe that the listing prospectus is more detailed in terms of information disclosure according to Article 130 of the Act on securities and investment services.

210. The authorities did not agree with the "Partially Implemented" assessment for Principle 15. In their view, appropriate provisions of commercial code (Articles 12, 123, 176, 179,189 and 194) and securities law (Article 73) satisfies these standards.

211. The authorities partly disagree with the "Non-Implemented" assessment for Principle 16. According to the authorities, IAS financial statements are required by Ministry of Finance and Bratislava Stock Exchange for listed companies. Also, according to Article 144 of the law on securities Financial Market Authority is authorized to require additional information disclosures from issuers

212. The authorities do not agree with the "Partially Implemented" assessment for Principle 19 because in their view, according to Article 53, paragraph 1 of the Act No. 385/1999 Coll. on collective investment annual reports are also published and submitted to Financial Market Authority.

B. IMF's Transparency Code—Transparency of Securities Regulation

General

213. Capital markets supervision policy formulation and implementation of the Financial Markets Authority (FMA) and the Ministry of Finance (MoF) are quite transparent. The main transparency practices and the areas that deserve further strengthening are described below.

214. The FMA and the MoF are very eager to be transparent and see the transparency as an important tool in public participation in policy formulation and in oversight of their operation.

215. The Slovak authorities cooperated fully with the assessment and provided all the necessary information and clarification.

Main findings

216. **Clarity of roles, responsibilities, and objectives of the supervisory agencies over capital markets.** The broad objective of supervision over capital markets, to achieve market efficiency, is not publicly disclosed. Responsibilities and the authority of the FMA to supervise the capital markets is clearly stated in the SIS Act and the SEA. These Acts are on the FMA website. The responsibilities of the MoF as regulator (issues secondary legislation) are stated in the Slovak Constitution. The FMA issues a bulletin, which includes reports about its operation, decisions legally in force, professional positions and other important announcements, and information about economic performance of issuers of publicly tradable securities and asset management companies. The bulletin and other information are easily available on the FMA website. The procedures for appointment, terms of office, and any general criteria for removal of the Chairman and the members of the council of the FMA are stated in the FMA Act, which is posted on the FMA website. The FMA cooperates with the MoF in formulating financial policy for capital markets. On both websites there is information about this cooperation. Because the MOU between the NBS and the FMA is still to be signed, the scope and the procedures of the cooperation between them are not publicly disclosed. Stock exchanges are governed by provisions of the SEA and the Articles of Association (available on their websites).

217. **Open process for formulating and reporting of supervisory policies over capital markets.** Relevant laws and by-laws and the regulatory framework of primary and secondary legislation are posted on the FMA website and on the MoF website. All administration fees of the Slovak Republic, including those charged by the FMA, are set according to the Administration Fee Law and are published in the note to the law, which is posted on the FMA website. Cooperation among the FMA, the MoF, and the NBS is stated in the FMA Act. Under that Act, FMA can conclude agreements on mutual cooperation with foreign supervisory authorities over capital markets. MOUs were signed with the Czech Supervisory Authority, and their main elements were put on FMA website. Significant changes in financial policy, which can only be changed through primary and secondary legislation, are publicly disclosed on the MoF website. All drafts of new regulations are put on the MoF website and the public can comment. The FMA's Annual Report and an Analysis of Capital Markets, which are available on the FMA website adequately explain how the FMA's activities contribute to the overall objectives of supervision, but do not adequately evaluate how the MoF regulations of capital markets contribute to those objectives.

218. **Public availability of information on supervision over capital markets.** The FMA collects data quarterly and it is published in the Analysis of Capital Markets. The Annual Report includes FMA financial data, balance sheet and income statements. The FMA has a Public Relations Department. The FMA`s chairman and vice chairman appear in public. They give interviews, attend conferences, make speeches and publish articles. The texts of public statements and speeches are released as a matter of course to the public. Under the SIS Act, the Investment Guarantee Fund is established. The Act specifies the nature and form of the protection, how the guarantee shall be financed, and how the arrangement shall be performed.

219. **Accountability and assurances of integrity by the supervisory agency over capital markets.** Standards of accountability differ between the regulatory (the MoF) and supervisory (the FMA) authorities. The Report of the FMA is sent to the Cabinet and the officials of FMA may be requested to attend the meeting of the Cabinet, while under general rules of accountability of the Cabinet, the Minister of Finance can be summoned by the Parliament to report on policies in the area of capital markets and answer questions. The FMA financial statements are not audited. According to the new FMA Law, the FMA will be required to prepare financial statements that are audited by an external auditor. They will be publicly disclosed. Internal governance procedures are not publicly disclosed. The FMA Act establishes a requirement for the chairman, council and staff of the FMA to prevent conflicts of interest, including submitting yearly statements about compliance with legal restrictions.

Table 13. Slovak Republic: Recommended Plan of Actions to Improve Transparency in Securities Regulation

Reference Practice	Recommended Action
V. Clarity of Roles, Responsibilities, and Objectives of Financial Agencies Responsible for Financial Policies	The broad objective to achieve market efficiency should be publicly disclosed by a Mission Statement. The MOU with the NBS should be signed and publicly disclosed.
VI. Open Process for Formulating and Reporting of Financial Policies	A report issued by the FMA should include a section contributed by the MoF explaining how MoF activities contribute to the overall objectives of oversight of capital markets.
VIII. Accountability and Assurance of Integrity by Financial Agencies	Officials of the FMA should be available to appear before the Parliament to answer questions on its Annual Report.

Authorities' response

220. No comments received.

X. Systemically Important Payment Systems Oversight

A. The CPSS Core Principles

General

221. **The assessment of the Slovak payment and settlement system was performed during the period February 18–March 1, 2002 as part of the Financial Sector Assessment Program (FSAP) for the Republic of Slovakia.** The main objective of the assessment was to determine the level of observance with the Basle Committee on Payment

and Settlement Systems (CPSS) Core Principles for Systemically Important Payment Systems, and to suggest areas where further development may be appropriate.

222. **The assessment was prepared by Krzysztof Senderowicz**, Deputy Director, Payment Systems Department of the National Bank of Poland under the supervision of Warren Coats, International Monetary Fund.

Information and methodology used for assessment

223. **The assessment was based on** the legislation applying to payment activities including: the National Bank of Slovakia Law, Bankruptcy and Arrangement with Creditors Act, Notice of the National Bank of Slovakia on principles of payment transfers among banks and relevant agreements with banks and operational guidelines for operators and payment systems participants. The assessment also drew on discussions with the representatives of the National Bank of Slovakia (NBS), the Slovak National Clearing Center (SNCC), the Slovak Central Securities Depository, the Bratislava Stock Exchange, the Slovak Stock Exchange and commercial banks, and answers to the IMF questionnaire with regard to payment systems. The staff of the NBS and other institutions cooperated fully with the mission and provided all the necessary clarifications and documents.

224. **The assessment was focused on the Slovak Interbank Payment System (SIPS) operated by the Slovak National Clearing Center.** The SIPS has been identified as a systemically important payment system as it is the only payment system in the country. The SIPS handles all interbank payments in Slovakia regardless of the value of transaction. The SIPS is used for the settlement of capital market transactions and payment cards transactions.

Institutional and market structure—Overview

225. **The banking sector in the Slovak Republic consists of 20 banks.** While banks provide most of the payment services to the general public, the NBS plays the principal role in establishing principles and basic rules governing the functioning of the interbank clearing and settlement system. According to Slovak law the National Bank of Slovakia controls, coordinates and ensures the circulation of money, and settlement of the payments within the scope established by the Act on the NBS, and ensures their efficient and economic performance. From operational point of view payments are cleared and settled by the SIPS, which is owned, managed and operated by the Slovak National Clearing Center Inc. established in 1992 in connection with the division of Czechoslovakia into two independent states. The SNCC commenced operations on 8 February 1993 (i.e. the day on which the Slovak currency was introduced) as the sole clearing center for all domestic interbank payments. The SNCC is owned by the NBS (about 40 percent of shares), commercial banks and the Ministry of Finance (one share).

226. **Foreign exchange transactions are based on correspondent relations.** The Slovak Interbank Payment System operates only in domestic currency.

Payment systems infrastructure

227. **According to the Slovak regulations all domestic interbank payments must be carried out through the SNCC.** Currently, there are 23 active participants in the system: 21 direct participants (the NBS and 20 commercial banks) and two so called "third parties" (the Bratislava Stock Exchange and the Authorization Center of Slovakia).

228. **Direct participants of the SIPS are obliged to hold reserve accounts with the central bank.** These accounts are used for final settlement of interbank payments at the end of the clearing day. The SNCC holds technical accounts for all its participants. The initial balances of the banks' technical accounts in the SNCC equal the initial balances of the reserve balances at the NBS. During the clearing day the SNCC executes all payments on banks' technical accounts in real time on a gross basis. At the end of the clearing day the SNCC sends the information to the NBS about the balances of technical accounts and the NBS makes final settlement on banks' reserve accounts.

229. **Indirect participants of the SIPS do not keep reserve accounts with the NBS** and do not conduct payment transactions "in their own name." They are authorized to debit or credit the accounts of direct participants. The Bratislava Stock Exchange delivers to the SNCC the results of securities trading and receives the information about financial transfers carried out on banks' technical accounts. The Authorization Center of Slovakia delivers to the SNCC the net positions of banks arising from processing of card transactions and receives the information about financial transfers carried out on banks' technical accounts.[13] The BSE and the ACS have access to the SIPS on the basis of a permit issued by the NBS.

230. The BSE co-ordinates the clearing and settlement of trades concluded by stock exchange members. The transfer of ownership of securities is effected according to the individual trades concluded on BSE. At the end of the trading day, the BSE calculates the net position for each broker. The result can be either a debit or a credit. The obligations are due to be paid on T+2, and the receivables are due to be paid on T+3. Payments to settle trades are made via the SIPS where the BSE assumes a third party role. On T+2 the BSE debits the accounts of debtors and collects the funds on its account at the settlement bank. On T+3 the BSE credits the accounts of creditors. All payments are irrevocable. In order to achieve delivery versus payment, it is necessary to compare the number of securities blocked in favor of the BSE at the Securities Depository and the funds transferred via the SIPS on T+2. If the numbers of securities on the broker's or its customer's account at the Securities Depository differ, the BSE will not initiate the respective funds transfer.

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[13] The role of the ACS is not big enough to have significant influence on the payment system and the level of risk does not seem to be material, since the number of payments by cards and the value is relatively small.

231. The BSE settles on multilateral net basis. There are not special risk management solutions in the SNCC to guarantee the settlement. Some inefficiencies in intraday liquidity management and the lack of real time processing in the books of the central bank are the main shortcomings of the system. Therefore, one of the main recommendations for the payment systems is to establish intra-day credit facilities to improve risk management, especially in the context of a new RTGS system.

232. **Cash is still the major payment instrument in Slovakia** (particularly among individuals) but in recent years, banks have introduced advanced payment instruments. Electronic banking, internet banking and payment cards are widely used. Credit transfers are the major payment instruments particularly among legal entities.

233. **The predominance of credit transfers is a distinguishing feature of the payment system in Slovakia.** The SIPS also processes direct debits and transactions coming from checks and payment card transactions.

234. **The SNCC works on the basis of a 24-hour cycle called "a clearing day."** The data exchange between banks and the SNCC takes place at time intervals set according to a timetable for submitting and processing data at the clearing center. Banks may deliver payment transaction data for processing on a given clearing day from 5:00 p.m. at the previous day to 11:30 a.m. at the clearing day and they are processed in real time on gross basis. The period from 11:30 a.m. to 1:00 p.m. on the clearing day is reserved for large-value interbank funds transfers aimed at balancing the liquidity. From 1:00 p.m. to 4:00 p.m. the final positions of all banks are calculated and the system maintenance is carried out. At 4:00 p.m. books are closed for the current clearing date, daily reports are generated and distributed to all participants and the information about balances of banks' accounts is sent to the NBS for final settlement. The processing and settlement of credit transfers, from debiting the payer's account at one bank to crediting the beneficiary's account at the other bank, takes no more than three days.

235. **Banks monitor their current balance on the technical account at the SNCC during the day,** either electronically or by telephone. The NBS is authorized to monitor the technical accounts of all banks with the aim to oversee and supervise liquidity in the banking sector.

236. **As regards card transactions, the Authorization Center of Slovakia (ACS),** a joint stock company, supplies banks (which issue and accept payment cards) with clearing files containing the data on the use of payment cards on a daily basis. At the same time, the ACS prepares data for mutual settlement between banks and submits them to the SNCC for processing on the basis of a third-party order.

237. The settlement of transactions for banks is based on the principle of net settlement. Table 14 shows the number and value of transactions processed in the SIPS in comparison to GDP.

Table 14. Slovak Republic: The SIPS Transactions

Year	Number of processed transactions (millions)	Value of transactions (SK billions)	Ratio Value/GDP
1997	54.5	12,727	18.5
1998	61.1	11,767	15.7
1999	65.4	9,999	12.3
2000	70.9	12,860	14.5
2001	79.1	15,815	16.5

1/ Source: National Bank of Slovakia (1997-1999); and SNCC (2000-2001).

Main findings—Summary

238. Payment system in Slovakia is generally efficient, and the SIPS largely observes the CPSS Core Principles. However, there are a few areas that could be addressed to bring Slovakia with full observance of the CPSS Core Principles.

Legal foundation (CPI)

239. **The existing law and regulations do not clearly establish when settlements are final.** The existing law does not exclude collateral security provided in connection with participation in the system or in the framework of operations with the central bank from insolvency procedures. Thus there is legal uncertainty concerning the rights of the pledgee in the case of the bankruptcy of the pledgor. Furthermore, the effects of insolvency rules and procedures governing collateral in the case of bankruptcy could create potential problems for the payment system. In addition, current Slovak law does not contain provisions ensuring that transfer orders are protected from insolvency law provisions from the moment they enter a designated system. The retroactive effects of insolvency rules on rights and obligations in systems are not prohibited clearly enough. However, the payment system department cooperates very closely with the banking supervision (there are formal procedures in place that are followed). In practice the system operator is informed about any bankruptcy by the central bank before the beginning of the new clearing day. This means that there is not a possibility to send any payments to the system by the bank that was declared insolvent. According to the law, all the banks in the system should participate in the SIPS. Therefore, new entry is not deterred by other banks in the system. However, before joining the system, technical capabilities to send, receive and process payments are checked by NBS.

240. To solve these shortcomings, the NBS (in cooperation with other institutions) has prepared a draft Payment System Law. The draft transposes the European Union legislation for the payment system area (settlement finality, cross-border credit transfers, electronic payment instruments). It is expected that these amendments will be approved by the Parliament in the first half of the year 2002.

Understanding and management of risks (CPs II-III)

241. **Mandatory direct participation in the system without providing an intraday facility, other than the interbank money market, is a deficiency of the system.**

242. According to Article 2 of the Notice No. 275 of the NBS on principles of payment transfers among banks, banks carry out interbank payments through the Slovak National Clearing Center. As a result of that regulation all banks have to be a direct participants in the SIPS.

243. Detailed rules and procedures on how to carry out payments, standards governing payment instruments, detail relationships between SNCC and each participant, the timetable of operations, responsibilities and obligations of the parties, procedures for handling abnormal situations are governed by the agreement concluded between SNCC and each participant of the payment system.

244. The NBS does not provide an overdraft or intra-day facility. A debit balance on the bank's technical account with SNCC is not allowed. If any bank does not have sufficient funds on its technical account with SNCC to cover its payment orders, the system puts them into the hold queue until the bank has enough funds. If there are payment instructions in the hold queue at the end of the day and banks still do not have sufficient funds to cover them, SNCC returns such payment orders to the senders. The primary source of additional liquidity for a bank with insufficient balance on the settlement account is the interbank money market. Since all domestic payments (high-value and retail) are sent through the SNCC and executed on a gross basis, the system requires relatively large amounts of intra-day liquidity.

Settlement (CPs IV-VI)

245. **The system seems to provide prompt final settlement at the end of the day.** Banks' reserve accounts are kept by the NBS. However, during the day all interbank transactions are processed on banks' technical accounts kept by the SNCC. At the beginning of every day the initial balances of the banks' technical accounts in the SNCC equal the initial balances of the reserve accounts at the NBS. At the end of the clearing day the SNCC sends the results of processing of banks' payment instructions to the central bank. In the event of a system breakdown, the SNCC has the possibility to restart the system within short period of time and therefore complete settlement on the same day.

Security and operational reliability, and contingency arrangements (CP VII)

246. **The SIPS has a high degree of security and seems to be operationally reliable.** There has not been any security incident since the SIPS was introduced (February 8,1993). The processing of transactions is organizationally and technically separated within the SIPS.

247. The system is constructed from two separate hardware and software systems. They are the production system and backup system. Both of them are working in parallel. The backup system is located at another place than the productive system. It is connected to the

same transfer channels through which processing data are transferred to the productive system.

Efficiency and practicality of the system (CP VIII)

248. **From an operational point of view SIPS seems to be efficient.** It provides low risk payment facilities for banks and indirectly for all users of payment system. SIPS can be used for transfers of funds arising from banks' and clients' payments. The fees for customers' and banks' payments are the same.

Criteria for participation (CP IX)

249. **The lack of publicly disclosed access and exit criteria is the main shortcoming of the SIPS**. All banks have to be a direct participant in the SIPS. Before joining the system, technical capabilities to send, receive and process payments are checked. A potential participant has to demonstrate its technical capability during the tests executed by SNCC. These **criteria are defined in the internal working instruction** of the NBS that stipulates procedures on authorizing and dismissing participants' identification codes into/from register of identification codes for domestic payments.

250. Currently there are only access criteria ("license criteria") applied when an institution makes an initial application. There are no exit criteria other than related to insolvency procedures.

Governance of the payment system (CP X)

251. The SIPS system is owned, managed and operated by the Slovak National Clearing Center—a joint stock company owned by banks, the NBS and the Ministry of Finance. The major shareholder is the NBS. The chairman of the supervisory council of the SNCC is chief executive director of the NBS. All the system's governance is based on the Commercial Code 513/91 Coll. as amended by subsequent regulations. All changes concerning the payment system and relevant regulations are discussed with banks.

Central bank responsibilities in applying the CPs

252. With regard to the responsibility of the central bank in applying the Core Principles, **the NBS has publicly disclosed its clearly defined oversight role over the payment system and the major policies it will follow to achieve its objectives for systemically important payment systems.**

253. The main objectives and competencies (role of the NBS) are supported by the National Bank of Slovakia Act No. 566/1992 Coll., which states the objective of the NBS regarding the oversight and coordination of payment systems (Article 2 and 31). The mentioned Articles refer to control, coordination and ensuring the smooth operation of the payment system and settlement between banks and other legal persons that carry out certain banking activities and ensuring the efficient and economic performance of these operations. In order to direct and ensure a standardized payment and settlement system and clearing of

data from the payment and settlement system between banks and selected legal persons, the NBS is competent to issue appropriate regulations.

254. Since Slovakia is actively preparing itself for European Union membership, work is currently underway to fulfill legal and infrastructure requirements in order to implement EU directives concerning payment systems and to be able to join the TARGET system.

255. **Important changes are currently underway in the payment system.** These include the implementation of an RTGS system. This will be one of the biggest changes in the domestic payment system since the banking reform of 1990 and the introduction of the new clearing system in 1992. The establishment of the new system will allow the separation of large-value payments from other payments. According to the proposal the new RTGS system will be owned and operated by the NBS. The liquidity management in the payment system will be improved by the introduction of intra-day credit facilities that do not exist in the current system.

256. **The NBS has already finished its detailed design of the new RTGS,** which has been discussed with all the payment system participants via working group for payment system established in June 1998. Its members are selected experts from the NBS, commercial banks and other institutions actively involved in interbank payments and clearing. The design is to be approved in the first half of the year 2002 by the governing body of the NBS. The SIPS will stay in operation for small value payments. Together with the RTGS system, a new technical platform for both systems called the Basic Interface for Payment Systems (BIPS) is being developed. The processing and settlement transactions will be conducted according to the principle of gross settlement. All transactions will be carried out in real time and recorded directly in the books of the NBS as final and irrevocable. In the case of insufficient funds on bank's account the payment will be put in a hold queue. Payments will be put in the queue according to the code of priority. There will be two degrees of priority and the FIFO principle in place. Each participant will have a chance to change the order of items in the queue. To improve the liquidity management, the NBS decided to supply liquidity in the form of intraday credit. The credit will be fully covered by securities.

Recommended actions and authorities' response to the assessment

Recommended actions

Table 15. Slovak Republic: Recommended Actions to Improve the Slovak Interbank Payment System

Reference Principle	Recommended Action
Legal foundation—CP 1	Legislation should protect transfer orders from insolvency law provisions from the moment they enter a designated system, insure that the rights and obligations with the system are protected from retroactive application of insolvency provisions, and insulate collateral from the effect of insolvency proceedings.

Understanding and management of risk—CP 3	Intra-day credit facilities should be established in the context of a new RTGS system.
Criteria for participation—CP 9	These criteria should be applied continuously, not only when an institution makes an initial application. Access and exit criteria should be disclosed.

Authorities' response

257. The authorities had no comments on the payment system assessment.

B. IMF's Transparency Code—Transparency of Payment System Oversight

General

258. Payment System policy formulation and implementation by the National Bank of Slovakia (NBS) satisfies a very high standard of transparency practices. The main transparency practices and the areas that deserve further strengthening are described below.

259. The NBS is very eager to be transparent and sees the transparency as an important tool in public participation in policy formulation and in oversight of its operation.

260. The Slovak authorities cooperated fully with the assessment and provided all the necessary information and clarification.

Main findings

261. **Clarity of roles, responsibilities, and objectives of the payment system oversight.** The objective of the payment system oversight, the means to pursue this objective and the responsibilities of the NBS to direct, coordinate and to secure the payment and settlement system, are all clearly stated in the NBA. The NBA is published on the NBS website. The NBS issues an Annual Report but no part of this report is dedicated to the payment system. The NBS website includes the legislative framework (primary and secondary legislation). The governing body of the NBS is the Bank Board. Procedures for members of the Board appointment, terms of office, and any general criteria for removal and all members by name are available on the NBS website. General policy principles are publicly disclosed in the NBS bulletins and on the NBS website.

262. **Open process for formulating and reporting of the payment system oversight.** Legislative support for the payment system is provided by the SBA. In the NBA there are also some operating procedures. The operating procedures are described in great detail in the Decrees, which are on the NBS website. Access criteria to the payment system are described in the internal instructions which are not publicly disclosed. Recently, the draft of the Act on payment systems was published on the website of the NBS for comments. Description and explanation of each paragraph was an important part of the draft. Through this the NBS explained its policy. The drafts of substantial technical changes are put on the NBS website for public information and comments. Significant changes in financial policies are placed on

the Board's agenda, and after the Board's decision, the NBS issues a press release. The NBS overall policy objectives for the payment system are reported in the banking publication BIATEC and on the website of the NBS.

263. **Public availability of information on the payment system oversight**. The NBS publishes BIATEC (a journal on banking industry), part of which is devoted to major developments of the payment system. BIATEC is also on the NBS website. Aggregate data on payment system are available on the NBS website. The NBS publishes its audited financial accounts in the Annual Report. Emergency financial support by the NBS has been rare and its details, which on each occasion would involve a single bank, were not published as such. However, on each occasion the fact of the assistance was publicly acknowledged. The results of such credits are reflected, in the aggregate financial statements of the NBS. The team recommended improving the disclosure of emergency credits. While giving due recognition to concerns relating to stability of the financial markets, confidentiality and moral hazard, the NBS should disclose aggregate information on the emergency credit facilities, exercising judgment on the timing and on the nature of the information disclosed. The NBS has its own Public Information Department and also own speakers. The Department issues information concerning the payment system. The NBS conducts quarterly meetings, chaired by the Governor with the representatives of all banks. Beyond these regular meetings the Governor and other members of the Bank Board commonly comment on payment system developments in the media and also publish articles in the press.

264. **Accountability and assurances of integrity by the NBS.** The Governor and vice-governors appear in the Parliament to present an Annual Report and Monetary Policy Report (three times a year). They are also very often invited by the Parliament to appear and to answer different questions concerning the payment system. They and staff of the NBS take part in discussions in parliamentary committees dealing with new banking legislation. The NBS is obliged to present its audited financial statements once a year to the Slovak Parliament. The NBS has very thorough principles and arrangements of internal audit and control in place and they are posted on the NBS website. An NBS Internal Code of Conduct containing internal rules and regulations with regard to standards for the conduct of personal affairs of officials and staff of the central bank, "Code of Ethics of NBS Employees," is listed on the NBS website. NBS officials and staff have satisfactory legal protection under the Labor and the Civil Code, which are applicable for all employees.

Table 16. Slovak Republic: Recommended Action Plan to Improve Transparency of Payment Systems Oversight

Reference Principle	Recommended Action
V. Clarity of Roles, Responsibilities, and Objectives of Financial Agencies Responsible for Financial Policies	A part of an Annual Report should be dedicated to the payment system.
VI. Open Process for Formulating and Reporting of Financial Policies	Access criteria to the payment system should be publicly disclosed.
VII. Public Availability of Information on Financial Policies	The disclosure of emergency credits should be improved.

Authorities' response

265. No comments provided.

INSOLVENCY AND CREDITOR RIGHTS SYSTEMS

A. Introduction

1. The FSAP team assessed the Slovak creditor rights and corporate insolvency systems pursuant to a joint IMF-World Bank initiative on observance of standards and codes ("ROSC"). A two person team[14] carried out the review from February 17-28, 2002, using the World Bank *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems* ("Principles") adopted by the World Bank Board at its meeting in April 2001.[15]

2. The assessment team interviewed a cross section of country stakeholders regarding the effectiveness of the legal infrastructure and its implementation supporting debtor-creditor relationships, corporate insolvency and credit risk management and resolution practices, including among others, with: (a) senior officials and staff members of the Ministries of Economy, Finance (Tax Department) and Justice (Bankruptcy and Executions Department); (b) bankruptcy and district court judges in Bratislava and Banska Bystrica; (c) debt recovery teams in the SKA and 5 commercial banks; (d) representatives of the registry (Cadastre) office; (e) members of the Inter-Agency Commission for the preparation of a new insolvency law, and members of the drafting team for the new collateral law; and (f) various professionals serving as trustees, executors, lawyers and accountants. Excellent cooperation was received.

3. The conclusions in this assessment are based largely on the above interviews, a review of applicable legislation,[16] data and information, various reports prepared by the World Bank between 1999-2001 and other reports or analyses pertaining to the areas assessed, including the project on the new collateral legislation and registration system for pledges (charges).[17] Some laws unavailable in English at the time of the mission were

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[14] Gordon Johnson and Angana Shah (World Bank).

[15] World Bank, *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems* (April 2001) <http://wbln0018.worldbank.org/Legal/GILD/csadmin.nsf/wblaunchtext?readform&Best+Practices>.

[16] Primary legislation reviewed in relevant part includes: Bankruptcy and Composition Act, Act No.328/1991 (as amended through and Act 397/2001Coll.); Commercial Code, Act No. 513/1991 Coll. (as amended through Act 263/99 Coll.); Civil Procedure Code, Act No. 99/1963 Coll. (as amended Act No. 223/1999 Coll.); Civil Code, Act No. 40/1964 Coll. (as amended). Laws unavailable in English but discussed with practitioners and specialists included the Execution (Foreclosure) Law, Act No. 233/1995 (as amended); Income Taxes Act, Act 366/1999; and other tax related legislation.

[17] These included reports prepared by a World Bank EFSAL team in connection with various missions from 1999-2001, and a Foreign Investment Advisory Service report on barriers to investment in the Slovak Republic. *See* FIAS, *Slovak Republic: Administrative Barriers to*

(continued)

discussed in a number of meetings with institutions and professionals in the public and private sectors, and translations have been requested for follow-up. In addition, at least three commercial banks provided responses to a questionnaire pertaining to credit risk management and corporate recovery practices with respect to distressed assets. The mission met with each of the three responding banks, and two non-responding commercial banks, to discuss their responses, practices and experience in resolving and collecting non-performing loans. The mission also reviewed statistics and data on the numbers and dispositions of insolvency and execution proceedings over a period of years, and obtained and reviewed tax statistics on tax arrears and experience of the tax authorities as a creditor.

B. Description of Country Practice

Creditor rights and enforcement

4. **The commercial and financial community agree that the legal framework supporting credit and creditor rights remains highly fragmented, inadequate and inefficient, rendering credit largely inaccessible to all but the upper echelon of corporate borrowers**. As a general rule, creditor rights remain weak, plagued by poorly developed collateral mechanisms (other than the traditional mortgage) and slow and unreliable enforcement procedures through the courts. Legal and regulatory weaknesses have fueled a growing business in lease finance and receivables factoring, where ownership resides in the lender or creditor, making asset recovery more efficient and predictable. Perhaps the most significant development is the recent adoption of a new security law that comes into effect in January 2003, coupled with a national centralized pledge registry that boasts to be among the more progressive in the region. Other recent improvements in enforcement procedures have strengthened creditors' rights somewhat, but the system has yet to embrace these reforms in a predictable manner.

5. **To offset the high regulatory risk, lenders routinely insist that loans be fully secured in nearly all corporate transactions and have relied on other financing techniques designed to avoid the need for enforcement (e.g., lease and receivables finance)**. Loans are generally secured by a mortgage on real estate. To date, security in movable property has proven ineffective and unreliable, as the present regime requires possession to perfect the security interest, which is not feasible for businesses. This should change when the new pledge law and registry become effective next year. In practice, obligations are often secured by an assignment of a right, including a right of title. There is very little legislation regarding this security mechanism. The transfer generally occurs as a conditional transfer of title, subject to a condition precedent, or an outright transfer of title, subject to retransfer to the debtor upon satisfaction of the secured obligation. Accounts receivable are most often secured through assignment, or factoring. In a receivables assignment, the lender typically authorizes the borrower to collect the receivables until such time as the lender notifies the account debtors that it has taken an assignment and directs

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Investment (August 2001) (specifically, Ch. VI deals with securing transactions). The final report was updated to reflect the adoption of the new collateral law in June 2002.

payment to itself. Leasing companies use the assignment of title method to provide lease financing of equipment and vehicles. Most assignments are reasonably predictable and constitute a preferred form of security, even though little legal regulation exists for this method of security.[18] Third party guarantees are also commonly used as security.[19] Other forms of security allowed under the Slovak system are transfers of present or future rights or claims against third parties and stock pledges.[20]

6. **The land registry has functioned relatively inefficiently due to large backlogs of cases in the land registry (cadastral) offices.** Recent automation has improved the situation somewhat. A continuing problem is that the law fails to provide adequate guidance on the sufficiency of documentation to be recorded at the land registry. As the cadastral office is responsible for approving the documents, and tends to be conservative, the absence of clear criteria often leads to refusal to register transfers of property, leading to delays, and sometimes rendering sales difficult.

7. **The government recently adopted a new modern security law for movable property that should strengthen creditor rights and foster a new wave of asset based lending secured by movable assets.** The inability to effectively pledge movable property has been a significant hindrance to asset-based lending and credit protection. The problem has been further exacerbated by the lack of a pledge registry system for giving notice to third parties of rights that have been pledged or alienated. A new collateral law, developed with assistance of the European Bank for Reconstruction and Development (EBRD), was recently adopted and will come into effect in January 2003. The new law affords the widest potential for taking security in movable property. Consistent with international best practice in this field; it adopts and complies with both the World Bank's Principles and the EBRD's core principles for a secured transactions law. The new law provides for non-possessory pledges, establishment of a registry for movables, non-judicial procedures for enforcement of collateral rights, including the Public Auction Law, and subordinates the priority previously afforded to tax claims making them subject to the first-in-time rule for registration filings. The new law also provides for a lien on a fluctuating stock of assets.

8. **Court system weaknesses and inefficiencies are the most significant detriment to debt enforcement.** Whenever the court system is involved, whether in execution of a lien or enforcement of a debt, or through a bankruptcy, delays are the rule rather than the exception and serve to diminish the value of assets and reduce recovery based on time value of money. Enforcement of unsecured debt must go through the courts, as the creditor requires a payment order to collect on a debtor's assets. In Slovakia, a first but non-final, non-appealable judgment is not sufficient for execution. Unsecured lenders can avail themselves of expedited proceedings that allow for execution/payment orders to be issued by a court and become final within 15 days for commercial claims under SK 1,000,000, and within three

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[18] Sections 524 to 528, Civil Code Act No. 40/1964 Coll. (as amended).
[19] Section 546, Civil Code Act No. 40/1964 Coll. (as amended), Sections 303-312, Commercial Code, Act No. 513/1991 Coll. (as amended through Act 263/99 Coll.)
[20] Section 132, Civil Code Act No. 40/1964 Coll. (as amended).

days for bills of exchange and checks. The latter encompasses any sort of payment agreement.[21] Though the Slovak Republic has instituted expedited proceedings and non-judicial enforcement procedures, if a debtor objects to the enforcement, the action is referred to regular court proceedings. The debtor can and often does easily interfere with expediency in creditors' actions.

9. **The introduction of a system of private professional bailiffs (executors)[22] establishes non-judicial procedures for execution and foreclosure that greatly enhance the prospects for secured creditors to foreclose on their collateral.** When the security documents are in the form of a notarial deed, the creditor is able to avoid court proceedings and recover the collateral with the debtor's cooperation through expedited proceedings. Expedited proceedings and special procedures apply to both secured and unsecured lending. Still, secured creditors face substantial obstacles to efficient enforcement and foreclosure. A debtor's objection at any stage of the process can convert a non-judicial executory proceeding to a full-fledged court proceeding. Consequently, even with the use of executors, realization on collateral ranges from a low of 3 months for movable property (uncontested) to 2-4 years for execution on real estate, if contested.

10. **Cumbersome valuation procedures, market value minimum bids, and other deficiencies in the auctioning process contribute to delays.** Both inside and outside bankruptcy, procedures for auctioning assets are obstacles to maximizing asset value. Valuation procedures can be long, and a debtor's objection routinely requires a second valuation. Minimum bids are generally fixed at unrealistic estimations of market values and can be lowered only with court approval in successive auctions. The need for court approval, and unrealistic minimum bids can result in substantial delays, which in many cases serve to devalue the asset and hence a creditor's recovery on its claim.

C. Legal Framework for Corporate Insolvency

11. **The Bankruptcy and Composition Act ("Bankruptcy Law") governs liquidation and rehabilitation proceedings. In August 2000, the law was amended to improve efficiency, strengthen creditor rights, and promote going concern sales.** The law has been amended 14 times in 10 years, most recently to increase efficiency with time-bound procedures, strengthen creditors' rights, increase management accountability, and salvage of viable businesses. As Table 1 below reveal, between 1993 and 2000, when the law was amended, the stock of bankruptcy cases steadily increased, exacerbating the delays in the opening and processing of cases. For example, in 1999, over half of the total cases filed remained unprocessed, while cases in the systems averaged 3-7 years (or longer) to process.[23] Unsecured creditors realize little or nothing, while secured creditors report dismal returns of

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[21] Civil Procedure Code §§ 172-174, Act No. 99/1963 Coll. (as amended through Act No. 223/1999 Coll.).

[22] Foreclosure (Execution) Law in 1995, Act No. 233/1995 (as amended).

[23] The percentage of non-processed cases to total pending cases in 1999 (e.g., after subtracting previously dismissed and terminated cases) is actually closer to 70 percent.

5-10 percent, after administration costs. These results have led lenders to view bankruptcy as a last resort to write off bad debts.[24] The mere opening of a case used to take 9-12 months, during which time the debtor is entitled to continue operating its business to the detriment of creditors. The new amendments require a decision on declaration within 30 days of the filing of the petition, and completion of the liquidation within 18 months of declaration, unless the court in its discretion extends this period based on the circumstances of the case.

Table 17. Slovak Republic: Bankruptcy Statistics, Cases on File

Disposition of Cases	1993	1994	1995	1996	1997	1998	1999	2000	2001
Annual bankruptcy filings (cumulative filings all years)	538 (538)	1115 (1653)	1530 (3183)	1321 (4504)	1755 (6259)	1831 (8090)	2161 (10251)	2008 (12059)	2351 (14410)
Annual declarations	11	43	117	315	742	1396	2061	N/A	1042
Cumul. dismissed/terminated	158	592	1109	1583	1644	1692	2316	N/A	894
Non-processed cases (year- end)	369	649	939	2663	3896	5025	5897	N/A	N/A
Control line (tot unprocessed)	369	1018	1957	2606	3873	5002	5874	N/A	N/A

Source: Slovak Republic Ministry of Justice.

12. **Although the bankruptcy amendments were designed to strengthen creditors' rights, creditor participation and creditor-imposed discipline remain low**, partly due to a general lack of appreciation by creditors of their new found rights and in part due to inconsistent recognition and enforcement by courts. Creditors are entitled to participate in a creditors' committee, be consulted on decisions regarding the bankruptcy, and approve the final distribution plan. If creditors are dissatisfied with the progress of the case or performance of the trustee, they may even vote to replace the trustee. These rights do not necessarily protect the rights of creditors. Notwithstanding the quicker declaration requirement (30 days), the court is not required to convene a meeting of the creditors' committee until 80 days after the bankruptcy declaration. By this time, significant decisions may be made by an interim trustee, or even ignored pending the creditors meeting, with detrimental affect to the rights of creditors and the value of the assets. While creditors report increased participation, on the whole they are largely inactive.

13. **Secured creditors are entitled to separate settlement of their claims through execution on their collateral, but may only collect 70 percent of the amount realized if**

[24] Notably, this practice may become unnecessary as more flexible and permissive provisioning and write-off rules allow for full write-off without commencing and bankruptcy case.

the bankruptcy estate is short on cash for administrative expenses. Secured creditors complain of their collateral being sold only to maintain a bankruptcy proceeding's administrative costs. Set offs are also prohibited, upsetting arrangements where setoffs were the security, and especially undermining the potential for well established swaps and derivative type contracts. In addition, the law prescribes too many exceptional preferential categories, and unnecessarily interferes with pre-bankruptcy arrangements and understandings.

14. **Auction procedures inhibit maximum return on assets in liquidation**. The initial price is set at the official appraisal price. Official appraisals, based on book value or other outdated valuation methods, tend to inflate the minimum price for assets. Judges often stand in the way of lower prices at auctions, due to past abuses and collusion between trustees and buyers. Bid-rigging or collusive arrangements are commonly reported.

15. **Enterprise rehabilitation is elusive in practice, due to the lack of a corporate rescue culture and outmoded provisions in the law**. Debtors may pursue a formal rehabilitation through a compulsory arrangement with creditors in court, or may seek approval of an arrangement with creditors without bankruptcy. Both proceedings invoke similar protections for creditors and have threshold requirements for approval and distribution. The arrangement with creditors invokes a 6 months stay on creditors, and the arrangement must be approved within 3 months of the declaration by the court authorizing the procedure. This procedure is almost never used.

16. **Reorganization provisions within bankruptcy have been enhanced, but to date the process is rarely attempted with success.**[25] The law lacks the requisite criteria and detail to make rehabilitation feasible. Without the provisions necessary to facilitate reorganization, it is unlikely to increase in frequency. For example, during the time between filing and declaration of bankruptcy the debtor remains unprotected by a stay on creditor action. During this period (9-12 months), secured creditors may succeed in executing on collateral before the case is formally declared, leaving few or inconsequential assets for a restructuring. There is no full discharge of debts for the reorganized enterprise, nor are there provisions to encourage priority financing of the debtor entity to sustain business operations. Despite these shortcoming, the 2002 amendments introduced more flexible provisions for disposing of assets that have in fact enabled some viable businesses to be saved through "creative liquidations." The new provision authorize the sale of the entire business or its productive units as a going concern, free of liabilities.

17. **An Interagency Commission was established in February 2001 with the aim of modernizing the framework for bankruptcy.** The Commission has analyzed the effectiveness of recent amendments and identified weaknesses in the current framework. The

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[25] In one successful case, creditors worked to allow the major employer in a region to remain operational (through a strategic sale). The banks decried the two-year long procedure as having been time-consuming and complex, even though the company continues to operate one year after the restructuring.

Commission also concluded that the defects in the current system are so significant that comprehensive reform is required. To that end, the Commission plans to oversee the development of new comprehensive legislation. Fundamental guidelines include a modern law that is properly integrated with and suited to the broader commercial and legal framework in Slovakia, consistent with EU regulations, and that complies with the basic principles identified in the World Bank *Principles on Effective Insolvency and Creditor Rights System*, including new effective procedures for rehabilitation.

D. Regulatory Framework for Insolvency

Institutional framework

18. **Judicial and administrative inefficiency is widely cited as the most significant and intractable problem facing the system.** There are a total of 1172 district and regional court judges in Slovakia, of which 21 are specialized bankruptcy judges, who deal exclusively with bankruptcy and composition proceedings. The bankruptcy judges are situated in three district courts (Bratislava, Banska Bystrica, and Kosice). The recent changes to the law drastically reduced a judges' role in bankruptcy proceedings. Much of the power to direct bankruptcy liquidations and other proceedings shifted to creditors and trustees. Now, the judge is responsible to open a case, appoint a trustee (though creditors may replace him), approve trustee actions, and administer, but not direct, the case. Though it should lighten their caseloads, some judges have had difficulty relinquishing certain decision-making powers.

19. **Courts have been overburdened due to inefficient rules of procedure and ineffective constraints on abusive filings.** Debtor's have numerous legally sanctioned opportunities to resort to the courts, which is used as a calling card for delay by debtors intent on avoiding their obligations. The sheer overload means that proceedings are sometimes delayed to the extent that assets may be rendered valueless by the time the court can reach decisions. While the 2000 amendments introduced an 18 month deadline within which cases are to be finished, the time limit is permissive (not mandatory) and may be extended by the court. It is too early to determine whether court practice complies with the new time limit. Trustee incompetence is also considered a factor contributing to delay.

20. **Lack of automation and transparency has also constrained the courts' ability to process an increasing number of cases.** Recent automation through an IDF grant has improved case management in the bankruptcy courts, but backlog remains a substantial problem. Each court maintains computerized records identifying the debtor, creditors, assets and actions taken in the case. These systems, although computerized, and not connected between courts. Judges do not yet have personal computers and email access, though the IDF grant contemplates further hardware to accommodate the courts. Computerized access for the public, currently unavailable, is also being considered. Moreover, court practices are not standardized, transparent, or predictable and vary from court to court. Decisions in similar situations can be widely divergent in different bankruptcy courts, or even among judges in the same court, as decisions are not widely published, or shared between courts. The Supreme Court does publish decisions in cases where it deems guidance is required for lower

courts, but lower courts are not bound by these guidelines. Public access to records is difficult, and financial data regarding the debtor is not available even to creditors.

21. **Judges have not received adequate training in commercial law generally, nor in bankruptcy law in particular.** Beyond the apprenticeship period of three years, no training or continuing education is mandated for judges. They are therefore not well-equipped to handle bankruptcies, and particularly reorganizations, and may hinder them by resisting allowing creditors, as the true stakeholders, to direct the course of the proceedings. There is a government-run facility for judge training at Trencianske Teplice, but it is considered inadequate. Court case overload is also cited by judges and trainers as leaving judges little time for training. Time and lack of sufficient training programs are obstacles to adequate education of judges.

22. **Judicial corruption has been a problem throughout the region, and the Slovak courts are no exception.** The bankruptcy law in various places provides for the consequences of fraud, such as in dealing with fraudulent transfers, insider transactions, and repeal of the plan if it was procured by fraud. However, guidance on what constitutes fraudulent conduct is inadequate. Under the law, the court has sufficient authority to act on fraud when it has determined that it exists and prejudiced the estate and creditors. However, the courts are currently too weak an institution to do this effectively, especially given the lack of specific guidance and procedures. Directives that are to be issued by the Ministry of Justice to govern certain aspects of the bankruptcy procedure await development and issuance. Some areas of recognized abuse of judicial discretion have been addressed through reforms to limit discretion or shift the decision-making authority to creditors. While there is some benefit to these changes, they suggest a systemic problem that can be improved only with wider regulation of the system.

Regulatory framework

23. **The lack of professional development of trustees as an association is cited as one of the pivotal weaknesses in the insolvency system.** Creditors, debtors and judges are uniform in complaining about trustees. There is a widespread perception that the profession is corrupt and incompetent, although to be sure such an indictment cannot be leveled at all practitioners, many of whom are capable and conscientious. The main criticisms have to do with collusion between judges and debtors (or creditors), tunneling of assets back to owners at a fraction of their value through collusive sales. The power to have a trustee of choice appointed is perceived as the power to control the proceeding, rather than as a way to ensure fairness. To date, trustees have not been accountable to any governing body. The Ministry of Justice has oversight, but has not enacted legislation or regulations to properly ensure that trustee's are held to a high standard and to provide for monitoring, investigation and discipline for misconduct or incompetence. Requirements in the Bankruptcy Law for appointment are minimal and general, i.e. no criminal record, "appropriate professional qualifications" (undefined), and unbiased individuals. Once appointed, trustees enjoy life tenure. There is no procedure for challenging or revoking a trustee's right to practice.

24. **There is no formal education process or mandatory training for trustees.** There are currently over 1000 licensed trustees. They may be lawyers who do not have business/economics training, or non-lawyers who do not have legal training. Further, only individuals may be appointed as trustees, which precludes the appointment of a legal entity, such as a firm engaging in trustee work that may bring specialized services of different professionals to a case. In practice, such legal entities have sometimes produced better results than individual trustees, though they may not officially be appointed as an entity. The Slovak Insolvency Administrators' Association, a newly formed trustees' association, is seeking to introduce qualifications, an entrance exam, continuing education, and legal regulation of trustees. The World Bank has provided an IDF Grant to the authorities that aims, among other things, to strengthen the regulatory framework.[26]

E. Credit Risk Management/Informal Corporate Workouts

25. **The law remains inflexible as to the mechanisms for resolution of debts, inhibiting workouts of debt.** Cash payments are generally required, and within bankruptcy, debt-equity swaps are not allowed. A lender cannot write off a debt without paying taxes on the full amount until the debtor has been declared bankrupt, though a bank lender may do so once the credit has been fully provisioned under existing banking regulations. Genuine debt forgiveness and restructuring are limited. In particular, tax creditors insist on full payment of tax liabilities, and place themselves at the front of the creditor queue. As tax liabilities in 1998 represented 10 percent of GDP in Slovakia, and are a large portion of claims in individual bankruptcies, sometimes leaving the tax authorities as the largest creditor, this limits the scope for genuine restructuring of the enterprise. There are some signs that when rehabilitation appears possible, the government is lenient and even cooperative in rehabilitation efforts, and does not insist on liquidating companies to collect tax arrears. The government has amended banking laws regarding provisions for write-offs, and is currently working on new legislation concerning criteria for write-offs by corporations or businesses and corresponding tax treatment rules.

26. **As a general rule, commercial banks in the Slovak Republic are adopting reasonable internal policies and procedures to manage credit risk and resolve distressed loans**. Credit institutions in the Slovak Republic have internal guidelines for monitoring debt. Banking regulation requires review of debts once a year or four times a year, depending on size. Debts are then classified as to their collectability, based on debtor's financial

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[26] Specific goals of the IDF grant include: (1) development of bankruptcy educational program for bankruptcy trustees, liquidators, administrators and enterprise restructuring experts; (2) establishment of professional criteria for bankruptcy trustees and liquidators; (3) designing the procedures for trustee/liquidator compensation; (4) preparation of a handbook for trustees, liquidators and enterprise restructuring experts; and (5) provision of assistance to establish a private, voluntary, self-regulatory organization which can certify professional trustee/liquidators. The Slovak Insolvency Administrators' Association is moving to develop professional criteria, and develop into a self-regulatory organization to oversee trustees

information and collateral. Banks must then provision between 5 and 100 percent of the nominal value of a loan based on the classification.[27] As for resolving distressed loans, the preferred methods in order of preference are: (i) debt rescheduling, including time and payment extensions or adjustments; (ii) executing via executor on a notarial deed that has been the basis of the secured loan; (iii) execution through courts; (iv) selling the receivable; and (v) bankruptcy. One method may be more suitable than another depending on the debt and the collateral. Where the cost of collecting a debt outweigh the recovery and even the tax penalties, a debt may be written off. Different banks may also have slightly different practices.

27. **Informal workouts are a practice among bank lenders, but they face legal obstacles.** When implemented in appropriate situations, where the bank assesses that the default is temporary, and resulting from a temporary condition, rescheduling is attempted, and according to one bank, when tried, is effective approximately half the time in resolving the problem. Such rescheduling is generally an extension of time or payment terms. More complex workouts, such as forgiveness of debt, or any arrangement that impairs the lender, is more difficult. Tax laws may severely penalize the creditor for forgiving debt unless the debtor is in bankruptcy, a bankruptcy has been declared, and the creditor has submitted a claim, though recently banks have been able to write off the debt after provisioning for it. Tax laws also make transfer of debt between a parent and subsidiary difficult, inhibiting transfer and sale of receivables. Genuine debt forgiveness is difficult. Debt-equity swaps face obstacles as well. Though lenders do not generally find debt-equity swaps appealing, even when allowed, due to the low value of the equity, some pursue it. There are problems, however, with tax treatment and restrictions on affiliate transactions when a bank takes equity, leaving the bank unable to make loans to the entity in which it has taken a share. The bank is also conflicted out of participation in management, without which it may not wish to take equity in a company with bad management.

28. **To restructure and privatize the largest Slovak banks, the government supported the transfer of bad assets to the Slovak Consolidation Agency (SKA).** In December 1999 and June 2000, SK 105 billion in bad assets were carved out and transferred to SKA and Konsolidacna Banka (KBB), and replaced by State-guaranteed loans, from the restructured banks, to SKA and KBB. Bonds were sold to fund the loans.[28] Further amounts have been transferred since then. The transfer of further bad debts, including some tax debt, is contemplated. These operations have restored the profitability of the banks and increased their Capital Adequacy Rations (CARs) to above 12 percent, according to International Accounting Standards (IAS). The performance of the banking sector prior to the consolidation is reflected in Table 2. The SKA's has two major sections, the business and

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[27] Decree No. 3 of the National Bank of Slovakia of 3rd March 1995 on Rules for Evaluating Bank Claims and Off-balance Sheet Liabilities in Terms of Risk Exposure and for Reserving Funds as Provision against such Risks.

[28] Bond payments have been timely made through February 2002, according to officials in the government.

portfolio management divisions. The portfolio management departments analyze acquired assets, monitor payments and executions, and package assets to sell. The business management division runs SKA's operations.

Table 18. Slovak Republic: Size and Performance of Banking Sector Before the Reforms, June 1999[29]

(In percent)

Bank Assets/GDP	Bank Loans/GDP	Classified Loans (2 to 5)/Total Loans	Classified Loans (3 to 5)/Total Loans	Capital Adequacy Ratio	Return on Equity
83.0	50.3	54.7	39.3	0.7	-13.1

Source: National Bank of Slovakia.

29. **SKA's performance to date in resolving bad debts has been lackluster.** One package of SK 13 billion in bad debt was sold for roughly 3.5 to 4 percent of the nominal value. An additional SK 6 billion has been resolved, with a recovery rate of about 23 percent. Overall, the recovery rate is estimated at about 10 percent. However, the amount of debt resolved debt is small relative to the remaining levels of distressed assets at SKA. The vast majority of the SKA portfolio relates to companies that are in bankruptcy proceedings.[30] Given the historical performance and recoveries in bankruptcy, it is unreasonable to expect a high recovery on bankruptcy related claims. Moreover, SKA must incur a cost with respect to protecting and monitoring its claim in bankruptcy, which in some instances may require active participation. To date, active participation has been limited to those companies where the entity is viable or has substantial assets. To increase its effectiveness, SKA is seeking a strategic joint venture partner for SK 50 to 60 billion in debt. Bids from interested parties were to be submitted in March 2002. It is too early to determine the value to be added by a joint venture partner.

F. Summary of Assessment Findings and Conclusions

30. The creditors' rights enforcement framework remains weak and inefficient. Though there have been some improvements, many more are needed. There are a number of

[29] Loan classifications are as follows: Category 1—standard; category 2—watch; categories 3-5 include doubtful, substandard and nonperforming loans.

[30] Approximately 77.5 percent of SKA's debts are with debtors in bankruptcy.

deviations from the World Bank Insolvency and Creditor Rights Principles (CP) both in the letter of the law, and due to weaknesses in institutions:

- ***The ability of tax creditors to exercise priming liens, along with weak creditors' rights in general, leads to low incentive for creditor-imposed discipline.*** The coordination of legislation in different areas that affect creditors' rights is poor, and cannot satisfy CP 1. Tax creditors ability to exercise priming liens at any time during enforcement, considering that most companies have large accumulated tax debts, can reduce creditors' already low recoveries to nothing. Such a right, combined with the other weaknesses in creditors' rights, discourage creditors from engaging in the expense and committing the time involved in enforcing their rights;

- ***Auction Procedures.*** A main problem in achieving observance of CP 2 and 5 is that auction procedures are inefficient with respect to execution and enforcement proceedings and foreclosure. The rules allows multiple frivolous objections by the debtor and establish overly strict requirements on minimum bids and multiple auctions, with no real value added;

- ***Land registry is functioning but recording rules need to be clarified.*** The land registry is generally functional, but fails to operate efficiently, due to lack of resources to manage the backlog. Further, unclear rules on sufficiency of documentation needed for land transfer leads to a high level of rejected documents. The lack of clarity in the law, and varying practice at different district land registry offices, hinder transactions, and make the time and cost unpredictable;

- ***Pledges on movables inhibited due to lack of a pledge registry.*** The inability to effectively secure movable assets has been a significant obstacle to development of a modern credit system. Pledges generally require possession for perfection. To date, there has been no pledge registry where creditors could publish their interests in movables and thus adequately determine their relative rights and priorities. This is expected to change with the adoption of the new secured transactions law and the creation of a centralized registry, recently adopted by the Parliament; and

- ***Debtors have inordinate power to object and cause delay during enforcement proceedings, out of proportion to the need to protect their rights.*** (CP 2 and 5) Debtors' extraordinary power to interfere with and delay sale of assets leads to many of the inefficiencies and delays in the system that are bemoaned by creditors. The law does not provide for enforcement of first but not final judgment, nor are summary proceedings sufficiently available to prevent unnecessary, unproductive debtor delay. Once a debtor objects, resolution must be made through the cumbersome, overloaded, and inefficient court system, resulting in realization times of up to 2 to 3 years, and sometimes longer.

31. **The bankruptcy law, despite recent amendments, continues to conflict with other legal systems, and remains inadequate to protect companies and creditors and promote**

rehabilitation. The mission is informed that a new insolvency law and regulations will be developed.

- ***Management accountability.*** Though the letter of the law mostly complies with CP 7, and management has become liable to shareholders and creditors through amendments to the Bankruptcy Law and Commercial Code, enforcement of the provisions remains difficult due to lack of definitions of due care and fraud, and low initiative on the part of those who have the right to pursue such actions. Resources to watchdog and investigate abuses are also lacking. This has led to excessive levels of asset stripping and insider collusion to defraud creditors.

- ***Governance: creditors and the creditors' committee.*** New changes in the law substantially comply with CP 12, although certain provisions undercut their effectiveness. Creditors' committee meetings are called much too late into the process, months after the declaration of bankruptcy, which may be many months after filing, when their participation may have become moot through dissipation of the estate. Creditors do not have sufficient access to debtors' financial information. Their right to supervise dealings of the trustee are not sufficiently developed in the language of the law, and regulations or directives are conspicuously lacking.

- ***Auction procedures.*** As described in the discussion on auction procedures related to execution on collateral, auction procedures inhibit greater return on assets due to inflated minimum bids, provisions allowing debtor objection and delay, and required court approval for price reduction, interfering with compliance with CP 13. Judges also often stand in the way of successful auctions by interfering with prices they consider too low, in response to the extensive bid-rigging that has occurred in the past, and continues. Any benefits or protection conferred by the procedure are far outweighed by the devaluation of assets that occurs due to the substantial time delay involved in auctions. Corruption in auction procedures that lead to bid-rigging are also a substantial problem. Few provisions address corruption directly, and regulations or directives prescribing anti-corruption procedures are conspicuously lacking.

- ***Fraudulent and preferential transactions.*** The letter of the law has moved toward compliance with CP 15, but is not quite compliant. Actions are avoidable, but may face enforcement problems unless fraud is better defined. Preferential transactions, which favor one creditor over another and thus upset priority, are not addressed in the Bankruptcy law, therefore denying creditors recourse when their rights are violated.

- ***Treatment of stakeholder rights and priorities.*** The proliferation of exceptional preferential categories nullifies the "pari passu" rule and help to prevent compliance with CP 16. The imposition of such priorities changes the legitimate commercial expectations and erodes confidence in the sanctity of the contract, without compelling reason.

- ***Rehabilitation.*** The Bankruptcy Law has numerous deficiencies that demonstrate either a lack of understanding of the process of reorganization, or a lack of belief in it. The process is still heavily geared toward liquidation. Practical provisions to help sustain business operations, and a full discharge of debts for a reorganized debtor emerging from bankruptcy, are missing (CP 17-23).

32. **The regulatory framework represents the weakest part of the system**. Some recent automation through the IDF grant has improved court case management, but the courts have a long way to go before they are efficient and effective.

- ***Institutional capacity.*** Principles relating to the institutional framework (CP 28-33) received the lowest rating on compliance. The bankruptcy court system is overloaded with cases. Further resources are needed to deal with the backlog and incoming cases. Judges are also in great need of training in commercial and bankruptcy matters, in particular in the area of rehabilitation. Donors conducted some training, but should not be relied upon for what should be institutionalized to maintain an effective bankruptcy judiciary. The IDF grant includes funds to develop such training.

- ***Regulatory framework.*** The regulatory framework is considered to be another area where there has been little progress. Accordingly the rating on CP 34 and 35 is considered to be materially non-observed. Trustees are effectively subject to no oversight or regulation. There is no formal qualification procedure, and no avenue for discipline or removal from the trustee's list. The lack of regulation and oversight feeds the public perception that trustees are incompetent and corrupt. Lack of public confidence undermines the entire bankruptcy system. The newly formed Slovak Insolvency Administrators' Association is working to enact legal regulation and promote the professional development of the trustees. Given trustees' central role in bankruptcy proceedings, the importance of their professional development and regulation cannot be understated.

33. The tax treatment of debt write offs, and other legislation inhibiting workout mechanisms, such as the absolute priority of tax debt over other debt, interferes with the incentives and abilities of debtors and creditors to engage in informal workouts. The disincentives in the law to debt forgiveness and workouts lead to almost complete noncompliance with CP 25, Enabling Legislative Framework. The recent adoption of the new secured transactions law will improve priorities and certainty as between pledge holders under the new system and tax claims, but there are still many other uncertainties in regard to tax claims and the write off of such claims that should be addressed.

G. Policy Recommendations

34. Creditors' rights and enforcement procedures need development as follows:

- Rules or legislation on sufficiency of security/transfer/ownership documents should be promulgated to remove the discretion of the land registry and prevent delay of transactions due to refusals of district land registry offices to register documents;

- Auction procedures should be refined to allow for more realistic minimum bids, more transparent and corruption-resistant procedures, and less court involvement;

- Debtor mechanisms for delaying enforcement of their creditors' rights should be reduced, and in many cases eliminated. Debtor's rights can be protected through summary proceedings, in a different forum dedicated to routine debt enforcement; and

- Enforcement of first but not final judgments should be allowed subject to posting of appropriate bond.

35. The Bankruptcy Law and related provisions in other laws requires comprehensive, coordinated, and well-planned revision to modernize the system to be integrated with the broader commercial and legal framework in Slovakia, consistent with EU regulations, and to comply with the basic principles identified in the World Bank *Principles and Guidelines on Effective Insolvency and Creditor Rights Systems*, including new effective procedures for rehabilitation. The Interagency Commission's work should be pursued aggressively.

36. The Bankruptcy Law should be further amended to include mandatory deadlines, with time-bound procedures, to avoid the decimation of asset value over time.

- The moratorium on creditor action should be effective from the time of filing the petition, and the stay on secured creditors counter-balanced by safeguards to protect and preserve the value of a separate creditors' interest in collateral from deteriorating in value.

- Creditors' committee meetings should be convened within 30 days of petition filing, and creditors' powers to supervise dealings of the trustee, should be better defined. Creditors should have the right to propose, and not just approve, liquidation or reorganization plans.

- The Bankruptcy Law, combined with regulations or directives, should provide for greater creditor access to the debtor's financial information, including provision for special investigation or examination of the debtor by creditors. The creditors' committee should also be convened much earlier, at the outset of the case, rather than the current substantial period after declaration of bankruptcy.

- The Bankruptcy Law should incorporate more provisions promoting reorganization, rather than only liquidation, of enterprises when viable. The process of separating viable businesses during liquidations from other assets is commendable. The trend should be extended toward true reorganization of viable businesses, with full discharge upon successful rehabilitation, and provisions that allow the business to operate during the bankruptcy period while the reorganization plan is being developed. Greater creditor participation in the reorganization process should also be incorporated into the law.

- Creditor priorities should be reduced significantly and conformed, as near as possible, to priorities created under applicable non-bankruptcy law to uphold commercial expectations.

- Secured creditors' interest should be safeguarded by adoption of rules that protect collateral against erosion in value. Payout within a specified time period after collateral is sold should also be mandatory to prevent trustees' bankrolling administration costs at the expense of secured creditors.

37. The institutional framework for bankruptcy requires resources in order to be developed into an effective, functioning implementer of the bankruptcy and creditors' rights system, and to create public confidence in the system.

- More resources should be dedicated to courts to eliminate backlog and help them run efficiently. The IDF grant funds many such activities, and should be implemented to assist in this area. However, a more long term commitment to funding and development of the courts will be required in order to sustain improvements over time.

- Judges require substantial education and training in commercial law, and particularly, bankruptcy issues. Training should be provided regularly to bankruptcy judges.

- Trustees require regulatory oversight, either through a private or governmental body, and training. The IDF grant provides for the development of the trustees as a profession, and should be implemented. The development of trustees is central to improving the functioning of the bankruptcy system.

38. Informal workout procedures have begun to develop, but legislative and other institutional impediments to informal workouts should be addressed.

- Tax rules on debt forgiveness should be amended to allow debt forgiveness when debts become bad and to promote effective financial restructurings and workouts.

39. The SKA is an important institution as a major creditor in the Slovak economy, and as a continuing repository for an increasing amount of distressed debt. Its performance must be improved, both on past-acquired, and on to-be-acquired debt.

ANTI-MONEY LAUNDERING ISSUES

1. The Slovak system to detect and prevent money laundering and to combat the financing of terrorism (AML/CFT) was assessed in late February 2002 for observance of the criteria described in the draft Fund and Bank Methodology for Assessing Legal, Institutional and Supervisory Aspects of Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT Methodology).[31] The review of the legal framework extended to the financial supervisory system, foreign exchange houses and money remittance/transfer companies, and the implementation in the financial supervisory system was assessed for the banking, insurance, and securities sectors.

2. In 1994, the Slovak authorities adopted legislation concerning the prevention of laundering of the proceeds of most serious crimes, in particular of organized crime. This law established obligations to report suspicious transactions for banks, but not for insurance companies or securities firms. The Ministry of Interior issued a regulation detailing what constitutes a suspicious banking transaction in 1997. In 2000, the legal framework was significantly enhanced with the adoption of Act No. 367/2000 Coll. on Protection Against Legalization of Incomes from Illegal Activities and on Amendment of some Acts (AML Act), which was enacted on October 5, 2000 and entered into force January 1, 2001.

3. Under the Slovak legal system, the term legalization of incomes from illegal action is equivalent to money laundering. The scope of the AML Act covers a broad range of entities such as banks, branches of foreign banks, insurance companies, securities firms, securities market organizers, management companies of collective investment schemes, exchange offices, money remittance/transfer companies, auditors, tax advisors, leasing companies, real estate agents and casinos. It is envisaged that lawyers will be brought under the scope of the AML Act, as well.

4. For the banking sector, more detailed provisions are set out in the new banking law in force since January 1, 2002. For the insurance sector, a more detailed new insurance law entered into force on March 1, 2002. The securities sector is governed by the Securities Act, the powers of the Financial Market Authority (FMA) are laid out in the FMA Act. Foreign exchange houses and money remittance/transfer companies are governed by the Foreign Exchange Act and subject to licensing by the National Bank of Slovakia (NBS) and the Small Business Office within the Ministry of Interior.

5. The Slovak Republic is a member of the Council of Europe, including its Select Committee of Experts on the Evaluation of Anti-Money Laundering Measures (PC-R-EV), but not a member of the Financial Action Task Force. The Slovak anti-money laundering regime has twice been reviewed by the PC-R-EV. The first such mutual evaluation took

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[31] SM/02/40, 02/08/02.

place in 1998 and the second round was conducted in 2001. Staff obtained a summary of the 1998 evaluation report and requested copies of the full 1998 report as well as the 2001 draft report. However, the Slovak authorities did not make these reports available, stating that the 1998 report was outdated and the 2001 report was still a draft.

6. Several official organizations play a role in the AML/CFT effort. The Ministry of Finance is responsible for financial legislation. The Ministry of Interior is responsible for addressing money-laundering issues and prepared draft amendments to the AML Act in April 2002. The Ministry of Justice is responsible for the Penal Code and the Code of Criminal Procedure, including criminalization of AML and CFT, as well as international legal cooperation. The Ministry of Justice has prepared draft amendments to the Penal Code as well as to the Code of Criminal Procedure. The Ministry of Justice is also working on a substantial revision of the Penal Code, expected to take effect at the beginning of 2003. The NBS is responsible for supervising the implementation of laws and regulations by banks and the licensing of foreign exchange houses and money transfer/remittance companies. The FMA is responsible for supervising the implementation of laws and regulations concerning insurance companies and securities firms. The Slovak financial intelligence unit (FIU) is established within the Financial Police (FP) and receives and analyzes unusual transaction reports from the reporting entities designated in the AML Act. The FP forms part of the police corps under the auspices of the Ministry of Interior. The customs office is part of the Ministry of Finance and investigates tax violations and cross-border crimes.

7. With the enactment of the AML Act, the Slovak authorities significantly improved the legal framework for the prevention of money laundering. The AML Act establishes a number of obligations such as client identification, record keeping and reporting requirements for a relatively broad range of entities (banks, branches of foreign banks, insurance companies, securities firms, securities market organizers, management companies of collective investment schemes, exchange offices, money remittance/transfer companies, auditors, tax advisors, leasing companies, real estate agents and casinos), but does not require the identification of the beneficial owner of funds. Although such requirement is contained in the supervisory laws for the banking and securities sector (and the insurance sector during March 2002), it should be incorporated into the AML Act. The provisions on client identification are generally appropriate, but should be strengthened regarding legal entities. Client identification records and transaction records must be kept for a period of ten years.

8. Regarding financial institutions, the supervisory laws contain provisions concerning fit and proper requirements for managers and shareholders holding a significant interest (for foreign exchange houses only very basic criteria are applied to managers, and such reviews should be expanded to also include owners).

9. Money laundering is criminalized in Article 252 Penal Code, and efforts are underway to provide for effective mechanisms to combat terrorist financing. The legal provisions on seizure and forfeiture of property and assets are not fully adequate. The Slovak FIU, established in 1996 as part of the FP, is a member of the Egmont Group and exchanges

information with other financial intelligence units. Institutional independence and autonomy could be strengthened, for example in the budgetary area.

10. The authorities have signed and ratified the Vienna and Strasbourg Conventions. They have also signed, but not yet ratified, the Palermo Convention and the International Convention for the Suppression of the Financing of Terrorism. The Slovak Republic is party to the European Convention on Mutual Legal Assistance and various other multilateral and bilateral agreements on mutual legal assistance. The extradition of a Slovak national is possible. The FP as well as the supervisory authorities exchange information with domestic and international counterparts on the basis of memoranda of understanding, a number of which are currently being negotiated. The FP is prepared to share information also in the absence of a formal arrangement.

11. For the banking sector, the legal framework complies substantially with the required criteria for AML/CFT measures and according to Basle Core Principle 15. Some areas for further clarification include: special legal protection for individuals referring unusual activity to the bank's internal compliance officer or to the authorities (in addition to the existing confidentiality waiver); explicit requirement to appoint a senior officer for oversight of a bank's internal AML/CFT program; obligation for banks to conduct focused internal reviews of those customers considered "high risk," and requirement for banks to maintain a register of all inquires made to it under the law.

12. The authorities have made significant progress with the steps they have taken thus far concerning the banking sector. However, the true test of compliance will become evident as the banking supervisor implements its own program of examination and monitoring, and administers any enforcement actions necessary. Notably, the NBS is preparing itself to monitor the implementation in the banking sector and to hold training sessions for selected staff during February 2002, both on an internal basis and with the FP. Examination procedures for AML activities of banks are in preparation, and the first examination of a bank's AML program are to be conducted by the NBS in March 2002. Communication with the banks on supervisory expectations in this area is of the utmost importance in protecting the banking system from potential criminal abuse.

13. The insurance market in the Slovak Republic is highly concentrated. Approximately 80 percent of all insurance premiums collected are received by the top five insurance companies in the marketplace. Each of these major players has taken the initiative to establish a program for dealing with the risks of money laundering and prepared training programs and printed materials to guide their staff. Typically, a compliance officer has been appointed, usually in relation with the internal controls group, and that person is charged with preparing reports for the FP as necessary. The Slovak Insurance Association has arranged training programs whereby executives of member companies have come together to meet with representatives of the FP. Considerable efforts are made to provide guidance on what type of transaction might constitute an "unusual" transaction for a life insurance company.

14. The insurance supervisor has been given no particular responsibilities in the campaign against money laundering and terrorist financing. As part of on-site inspection work, FMA staff will review compliance with internal control requirements established by the companies, when there are such systems in place. In recent training assignments FMA staff gained more experience, and recent FMA inspections included a more active approach regarding AML issues. The new Insurance Act, in effect since March 1, 2002, sets out the AML responsibilities of companies much clearer, however, it would have been preferable if the new legislation also specified the responsibilities of the insurance supervisor in this regard, but it has not done so.

15. The securities markets in the Slovak Republic are small and underdeveloped both in terms of market capitalization and liquidity. Transactions on the stock exchanges are concentrated on a small number of listed companies and the volumes of trade are low. Stock brokers only may carry out trades on the exchanges and all stock brokers must be licensed by the FMA. There are a number of collective investment schemes (31 open-ended funds and 54 closed-end funds). All management companies of collective investment schemes, of which there are nine, must be licensed by the FMA. The FMA does not actively supervise compliance with specific anti-money laundering provisions in the AML Act. It does, as part of its supervision of the securities markets, require compliance with those provisions of the Securities Act and the Act on Collective Investment that stipulate know-your-client and record keeping obligations but regards the FP as the appropriate authority to supervise anti-money laundering obligations.

16. Stock brokers must include in their articles of association the allocation of responsibilities and powers within the firm for prevention of money laundering, however, the provisions of the Securities Act, Stock Exchange Act and Act on Collective Investment do not include requirements for stock brokers, stock exchanges and management companies of collective investment schemes to have in place policies and procedures to deter money laundering and to provide specific authority for the FMA to supervise the implementation of those policies and procedures as part of its supervisory function. The Act on Collective Investment does not contain specific record keeping, audit and anti-money laundering rules for management companies of collective investment schemes, including client identification requirements. There are doubts about the application of the provisions of the Securities Act to stock brokers during a transitional period from January 1 through June 30, 2002.

Recommendations and action plan

17. The following actions are recommended to improve the legal and institutional framework and to strengthen the implementation of AML/CFT measures in the areas of banking, insurance and securities.

18. Unusual transaction reports must currently be submitted to the FIU within three days. Article 7, para. 1 AML Act should be amended to require that reports must be submitted to the FP without delay in all cases, the three day limit should be abolished to avoid any notion

that this limit be considered the norm rather than the limit. Article 7, para. 2(a) AML Act should be amended to require that oral reports are always followed up by a written report.

19. The AML Act should indicate the circumstances in which a reported unusual transaction must be delayed on a mandatory basis. The amendments addressing this issue proposed by the Ministry of Interior should be adopted. The AML Act should further be amended to provide for legal protection from civil actions for financial intermediaries carrying out their reporting obligations under the AML Act in good faith.

20. Payments made through the SNCC must include originator information, but a mandatory originator information requirement for transfers on behalf of clients effected by money remittance/transfer companies as bulk transfers (combined transfers made on behalf of several clients) should be introduced. The AML Act should be amended to require the identification of beneficial owners of funds.

21. The scope of Article 6, para. 1(a) AML Act, which requires internal procedures to prevent an institution from being used to launder money, should be expanded to require that internal guidance should address combating the financing of terrorism, as well. In certain sectors, the legal provisions on fit and proper requirements should be expanded to also apply to shareholders holding a significant interest.

22. The AML Act should be amended to authorize the FP to issue guidelines on the identification of unusual transactions or formalize the involvement of the FP regarding guidelines issued by the NBS or FMA on this matter.

23. The Penal Code adequately addresses money laundering in general. However, the authorities should establish clear provisions addressing terrorism, terrorist organizations and the financing of terrorism in the Penal Code.

24. The authorities have identified a number of shortcomings such as the need for provisions permitting forfeiture of property on a value-based approach, and have prepared amendments to the Penal Code and Code of Criminal Procedure to address them. These amendments should be adopted. As a matter of transparency, it is advisable to explicitly set out in the law the mandatory forfeiture of proceeds of crime and of assets used to finance terrorism as well as instrumentalities used to commit predicate crimes to money laundering, for money laundering itself, or for terrorism.

25. The authorities should take the necessary steps to ratify the Palermo Convention and the International Convention for the Suppression of the Financing of Terrorism.

26. For the banking sector, the supervisor should formulate supervisory expectations and focus on reviews and examinations of banks' AML/CFT compliance, internal controls and training programs. Supervisory guidelines should include client verification requirements and address "high-risk" clients, correspondent banking relationships and new technological developments. Supervisory guidelines should stipulate the appointment of a senior bank officer for AML/CFT compliance.

27. The insurance legislation should specifically require the supervisor to take an active role in monitoring company compliance with obligations in accordance with the anti-money laundering effort. The legislation should also provide the supervisor with all the authority it requires to enforce compliance. The supervisor, perhaps in collaboration with the trade association, should issue guidelines to assist company officials with the identification of unusual transactions.

28. The provisions of the Securities Act, Stock Exchange Act and Act on Collective Investment should be extended to include requirements for stock brokers, stock exchanges and management companies of collective investment schemes to have in place policies and procedures to deter money laundering and to provide specific authority for the FMA to supervise the implementation of those policies and procedures as part of its supervisory function. Specific record keeping, audit and AML/CFT rules for management companies of collective investment schemes, including client identification requirements, should be established in the Act on Collective Investment. Supervision by the FMA on AML/CFT issues would be exercised in cooperation with the FP. The application of the provisions of the Securities Act to stock brokers during a transitional period before the new Securities Act applies should be clarified by legislation.

AML/CFT Requirements	Recommended Action
Part 1: AML/CFT in the legal and institutional framework	
Suggested actions for the legal and institutional arrangements	
Client due diligence	- A requirement to identify the beneficial owner of funds under the AML Act should be introduced; - The three-day period for unusual transaction reports should be eliminated and the mandatory delay of transactions clarified in the AML Act; - Money remittance/transfer companies should be mandated to include originator information in bulk transfers; - internal guidelines should extend to combating the financing of terrorism; - fit and proper requirements regarding shareholders should be strengthened.
Criminalization of money laundering and terrorist financing	- Clear provisions criminalizing terrorism, terrorist organizations and the financing of terrorism should be introduced that provide for adequate sanctions.
Confiscation of proceeds of crime or assets	- The Penal Code should be amended to allow for the forfeiture of property on a value-based approach.
Financial intelligence unit	- The AML Act should be amended to authorize the FP to issue guidelines on AML/CFT issues or provide for other formalized involvement of the FP.

International cooperation in AML/CFT matters	- The Palermo Convention and the International Convention for the Suppression of the Financing of Terrorism should be ratified.
Part 2: AML/CFT in prudentially-regulated sectors	
Suggested actions for AML/CFT measures in the banking sector	
Organizational and administrative arrangements	- Supervisory guidelines on AML/CFT expectations should be prepared and implemented in the supervisory review and examination procedures of banks' AML/CFT programs (compliance, internal controls and training).
Customer identification and due diligence	- Supervisory guidelines should include client verification requirements and focus on "high-risk" clients, correspondent banking relationships and new technological developments.
Record keeping, compliance and audit	- The appointment of a dedicated senior bank official responsible for AML/CFT compliance should be required.
Suggested actions for AML/CFT measures in the insurance sector	
Organizational and administrative arrangements	- The supervisor should have responsibility to establish guidelines for company practices regarding AML/CFT measures and should monitor compliance with those guidelines.
Suggested actions for AML/CFT measures in capital markets regulation	
Organizational and administrative arrangements	- The Securities Act, Stock Exchange Act and Act on Collective Investment should be amended to include requirements to have in place policies and procedures to deter money laundering and to require the FMA to supervise implementation; - the application of the provisions of the Securities Act to stock brokers during a transitional period before the new Securities Act applies should be clarified by legislation.
Customer identification and due diligence	- Specific AML/CFT rules for management companies of collective investment schemes, including client identification requirements, should be established in the Act on Collective Investment.
Monitoring and reporting of suspicious activities	- The Securities Act and the Act on Collective Investment should be amended to require formal procedures to recognize and report unusual transactions and to have the FMA monitor the implementation of such requirements.
Record keeping, compliance and audit	- The Act on Collective Investment should be amended to require record keeping and audit procedures.

Recent developments

29. Some of the weaknesses in the Slovak AML/CFT system had already been identified by the authorities and taken up in reform proposals. In April 2002, the authorities prepared amendments to the AML Act that require the identification of beneficial owners in certain

circumstances. The scope of the AML Act is to be expanded to include lawyers when performing specified functions, and the definition of unusual business activity would extend to terrorist financing. The record keeping requirements are reduced from ten to five years. A reporting obligation for supervisory authorities is introduced, and it would be clarified in the law that unusual transaction reports must always be submitted without undue delay. The amendments have been adopted by the National Assembly and are expected to come into force September 1, 2002.

30. The authorities also prepared amendments to the Penal Code and to the Code of Criminal Procedure adopted by the National Assembly in June 2002. Specific provisions criminalizing terrorism, terrorist organizations and the financing of terrorism are incorporated in the Penal Code. Further, the amendments will clarify the forfeiture of interest and other gains and permit the forfeiture of substitute assets and of assets of corresponding value. The amendments to the Penal Code will take effect September 1, 2002.