SecM2003-0003 · January 2, 2003

FINANCIAL SECTOR ASSESSMENT SLOVAKIA

DECEMBER 2002

EUROPE & CENTRAL ASIA REGION VICE PRESIDENCY
FINANCIAL SECTOR VICE PRESIDENCY

BASED ON THE JOINT IMF-WORLD BANK FINANCIAL SECTOR ASSESSMENT PROGRAM

1. A joint IMF-World Bank Financial Sector Assessment Program (FSAP) mission visited Slovakia during February 14-March 1,2002 and April 8-19,2002 to undertake an assessment of the financial sector.[1] The principal objective of the missions was to assist the Slovak authorities in evaluating the potential vulnerabilities and key development priorities in the Slovak Financial System. This work was seen as being of particular importance in light of Slovakia's eventual accession to the European Union (planned for the beginning of 2004).

2. This report provides a summary of the main findings of the mission, and the policy priorities identified.

1 The FSAP mission team comprised Messrs./Mmes. Lalit Raina (World Bank, Mission Leader), Warren Coats (IMF, Deputy Leader);, Marie-Renée Bakker, Laura Ard, Michael Gascoyne, Gordon Johnson, Donald A. McIsaac, Angana Shah, Anne T. John (all World Bank); Alina Carare, Edward Frydl, Louis Kuijs, Maike Luedersen (all IMF); Euan Abernethy (former chairman of New Zealand Securities Commission), Herman Litman (Bank of Israel), Gudrun Mauerhofer (National Bank of Austria) and Krzysztof Senderowicz (National Bank of Poland). The mission was assisted in the field by Mmes. Ingrid Brockova and Petra Vehovska (World Bank Office, Bratislava) and by Mr. Costas Christou(IMF Resident Representative, Bratislava).

I. Overall Stability Assessment

1. **Since early 1999, the government has generally 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, the Financial Markets Authority, and other similar legislation. However, implementation of many of these laws is just in the beginning stages and the absorptive capacity of the government and the institutions involved is being stretched to the limit. Though there is a general consensus that most of the reforms are on an irreversible path, concerns remain about the speed and depth of the implementation of the necessary reforms.

2. **Slovakia is firmly committed to EU accession by the beginning of 2004**, is making considerable progress in adopting the *Acquis Communautaire*, and unless a major political change takes place in the coming elections, should remain on track. As soon as possible after EU accession, the authorities would like to join the Euro Zone. These facts have been taken into account in the team's recommendations.

3. **The high current account deficit, high unemployment, the increasing public debt, and remaining quasi-fiscal expenditures, need careful management.** Inflation has fallen to historic low levels of below 4 percent and core inflation is widely 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 low export levels due to slower growth in Europe during 2001 have 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. The external deficit increases vulnerability and the fiscal deficit could become inconsistent with the authorities' EU accession ambitions.

4. **The National Bank of Slovakia's (NBS) management of monetary policy operations and systemic liquidity has been sound and has contributed to stable interest rates and a reduction in liquidity risks and the related potential for destabilizing runs on the banking system.** Banks are currently very liquid, and can manage their liquidity efficiently and reliably with the NBS, even though the secondary money and securities markets remain underdeveloped.

5. **The banking system has undergone significant restructuring in recent years, and the system's soundness has increased substantially.** Stress tests suggest that the banking system would be negatively affected by interest rate shocks, due to large stocks of government securities on its books, although the large share of floating-rate government debt works to mitigate this exposure. The banking system may also be vulnerable indirectly to exchange rate shocks because of the significant foreign debt exposure of its corporate borrowers. However, neither of these exposures appears to approach the level of systemic risk. Credit risk is low as remaining NPLs in the system have also been more rigorously provisioned. Furthermore, new, strong, foreign bank owners are beginning to implement improved risk management systems**.**

6. **Financial sector supervision in general has been historically weak**; **strengthening of banking and non-banking financial sector supervision remains a priority.** Though 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, the newly developed momentum needs to be sustained in the coming months and years to anchor a fully reliable banking supervision function. The NBS banking supervision department's institutional capacity in terms of additional staffing and training, application of modern supervision techniques like risk based supervision, and enforcement track record, all still need to be built up. The Financial Markets Authority for non-banking supervision is a relatively new institution, and will need assistance to build institutional capacity and confidence in the safety and soundness of all non-banking markets and institutions.

7. **Continued GDP growth in future is expected to lead to not only further growth of banks, but also insurance companies, mutual funds and pension funds; and effective corporate governance, accounting and disclosure policies will be key for the safety and soundness of such institutions**. With the current household savings rate at about 11 percent of disposable income, and growing GDP and per capita income in the coming years, the pool of savings will grow significantly in the future. Though a large part of the savings is likely to flow into fixed investment like housing, the balance will primarily be deposited or invested in contractual savings institutions. However, present Slovak corporate governance, accounting, disclosure and auditing standards and practices still lag behind the level required for increasing public confidence in the safety and profitable operations of such institutions, and supervision of these areas remains very weak. Slovakia's adoption of international accounting and auditing standards is essential for improving financial transparency, disclosure and meaningful use of financial statements.

II. Financial System Overview

A. Institutions and Markets

8. **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, which constitute nearly 88 percent of the sector's assets, followed by insurance companies at around 6 percent and leasing companies at almost 5 percent. Overall the financial sector at 110 percent of GDP as of end 2001 is of a reasonable size compared with other EU accession countries. Total assets in the financial sector have grown in absolute terms from (Slovak crown?) Sk 841 billion in 1997 to Sk 1,061 billion in 2001. Monetization of the economy as measured by the ratio of broad money to GDP has remained fairly steady at 60 percent reflecting a fairly high degree of confidence in the Slovak Crown and the banking system.

9. **The non-banking 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 non-bank assets were 10 percent of total financial sector assets in 1997 and have grown to around 12 percent in 2001. As a percentage of GDP they have grown from 11 percent to 13 percent. Pension funds are the most rapidly growing segment but remain the smallest, while the relatively slower growing insurance sector is the largest non-bank sector. This trend is likely to continue in the foreseeable future.

10. **The private insurance sector in Slovakia is one of the smaller but faster developing insurance sub-sector 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. The total level of insurance premiums written has gone up from Sk 14.0 billion in 1996 to Sk 32.0 billion in 2001. Approximately 40 percent of premia were for life insurance, and the balance for non-life insurance business. Insurance penetration, measured in terms of premium income as a percent of GDP was 3.1 percent for the year 2000, virtually the same as the Czech Republic (3.6), Poland (3.0) and Hungary (2.9). Insurance density, expressed as total premia in US$ per capita, was reported as US$ 45.50 for life insurance and US$ 64.00 for non-life insurance. These figures rank Slovakia ahead of Turkey but below the Czech Republic, Hungary and Poland.

11. **Equity markets are largely the outcome of the 1991 voucher privatization process and the subsequent use of insider-oriented management buyouts, rather than the result of a constructive capital mobilization process.** 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 exchange is low both in absolute terms and when compared with other economies relative to GDP. Market cap of listed securities (much lower than market cap of post privatization registered securities) has declined from nearly 7 percent of GDP in 1996 to just below 3 percent in 2001. The market is extremely illiquid with low turnover overall and with the majority of stocks trading very rarely.

12. **The leasing industry has been a 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. The fortunes of the leasing industry in Slovakia are tied closely to the automotive industry . A strong driver of the leasing industry is the ability to claim accelerated depreciation allowances on leased assets; this allows leasing companies to price their lease finance products competitively compared with bank term loans. This advantage has somewhat eroded since the government set upper limits for the depreciable value of cars in 1998-99.

B. Systemic Liquidity, Payments System and Safety Nets

13. **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. Slovak banks have substantial holdings of liquid assets, due to the NBS' sterilized purchases of capital inflows, the government's bank bailouts, and 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 the financial sector for at least the next few years.

14. **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 couple of years. The infrastructure of the markets is adequate, but would benefit from further technical improvements (e.g., tax distortions in the government securities market should be removed, and the structure and transparency of the government's debt issue program should be further improved). The lack of depth in these markets, resulting in a preponderance of very short-dated and relatively unsophisticated instruments being traded, and thus very heavy reliance on the

central bank for liquidity management vehicles, will become less important with Slovakia's integration into the EU.

15. **Under its interest rate-based operational framework, the NBS' key monetary instrument is the interest rate on its weekly tender of two-week repos. As the NBS prepares for accession to the EU, it intends to further refine its monetary policy instruments to conform more closely with ECB practice.** While the rate of remuneration on required reserves will be raised to market levels in harmony with the ECB, the system of remuneration now in place will not be changed. 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 reserve balances vary over the period, which discourages the desirable use of reserve averaging as a liquidity management instrument. It is recommended that the average reserve holding over the settlement period (up to the average required level) be remunerated at market risk free rates of comparable maturity.

16. **The payment system is generally efficient and largely observes the CPSS Core Principles.** The Slovak Inter-bank 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 by the National Bank of Slovakia and will be addressed by a new Payment System Law, which is expected to come in force in the second half of 2002. Also, a new RTGS system for large value payments will be introduced in future, 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.

17. **Slovakia has made significant progress towards 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. The NBS has demonstrated a good understanding of the appropriate use of the lender of last resort function and the rules specified by its management are clear. It would, however, be helpful to formalize internal written arrangements for lender of last resort support, so that they are easier to implement in difficult times.

18. **Deposit insurance and investor protection are 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 increase rapidly to Euro 20,000 to converge with the relevant EU directive immediately upon EU accession. Banking sector safety net arrangements have functioned effectively to date, although the cost of failure resolution has been fairly high. As a result, the funding of the DPF has been depleted and should urgently be replenished. A financial plan that addresses the DPF's insolvency position and future financial viability is needed. For securities firms, an investor protection scheme that will compensate investors up to 90 percent of their unavailable assets subject to a maximum payout of Euro 20,000 is scheduled to become operational by mid/late 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.

19. **Several weaknesses in overall financial sector safety net design also need to be addressed**. The most important of these are: (i) inappropriate legal authority for the DPF and the new Investor Guarantee Fund (IGF) to provide emergency liquidity support to banks and securities firms under temporary administration; and (ii) inappropriate legal authority for insurance companies to sell deposit insurance and investor protection coverage over and above the insurance/coverage provided by the DPF and the IGF.

C. Regulation and Supervision

20. **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 and obligation to require corrective action plans from banks for strengthening a bank's financial position , and other action the NBS determines necessary.

21. **Implementing the new legal framework and achieving effective supervision will not be easy but NBS is committed.** . Early steps were the replacement of the management of the BSD (Banking Supervision Department) 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. 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.

22. **Banks' financial statements, which are still prepared in accordance with inadequate Slovak accounting standards, do not always present an accurate picture of their financial condition**. 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. Nevertheless, adoption and implementation of International Accounting Standards are required to convey needed information to the users of the financial statements, including the supervisors.

23. **The new securities law and the new insurance law in force in 2002 have significantly enhanced the MOF's and FMA's (Financial Markets Authority) authority to regulate and supervise capital markets and the insurance industry**. While supervision and regulation of capital markets and insurance are quite transparent, the FMA's institutional capacity and enforcement track record 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 (as a new agency it has been dependent on MOF's past legacy), funding, and human resources all need to be strengthened.

24. **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**. The new securities law, as well as a recent amendment to the Commercial Code, has significantly improved shareholder rights. However, there is still room for improvement. Specifically: (i) the definition of securities does not cover all products that should be subject to regulation; (ii) information required in issuer prospectus' is insufficient; (iii) minority shareholder rights are not fully protected; (iv) 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 (v) there are inadequate rules about market manipulation

25. **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 satisfy a very high standard of transparency. The system has functioned reasonably well, but the NBS has decided to upgrade it further and implement a new RTGS under central bank operational control in order to meet the requirements of the EU. A detailed RTGS design is now under preparation.

III. SECTORAL AND INFRASTRUCTURAL ISSUES

26. **The Slovak banking sector has gone through major restructuring in recent years (1999-2001).** A series of bank failures in 1999-2001, and the resulting banking resolution, have mostly eliminated the distressed banks in the system. The total number of banks in the system has gone down from 29 in 1997 to 20 in early 2002. The balance sheets of all of the larger state owned banks were cleaned up in 2000-2001 by provisioning non-performing loans (NPLs), or removing them to the Konsolidacna Banka (KBB) and the Slovak Consolidation Agency (SKA) and replacing them with government bonds. All of the larger state-owned banks – Slovenska Sporitelna (SSP), Vseobecna Uverova Banka (VUB) and Investicna a Rozvojova Banka (IRB) – have been sold to much larger, well supervised foreign banks from Europe that should bring in more sophisticated management and services. The banking sector is now more than 90 percent foreign-owned.

27. **The restructuring has left the banking sector with high liquidity and a reduced loan book. The banking system's profitability remains under pressure, and the increased competition from the larger, now foreign-owned, banks for good clients will likely lead to further consolidation in the sector.** There is a preponderance of government securities in the banking sector assets, and the healthy loan book has been severely depleted in recent years The clean up of non-performing loans over the last couple of years has produced a clearer picture of the real loan portfolio of the banks. The loans-to-total assets ratio has gone down from 47 percent to 31 percent between 1997 and 2001, while liquidity (including government securities) has gone up substantially. This implies an increased earning challenge and competition within the banking sector in the coming years. In order to increase profitability, the new private owners are likely to introduce new services and increase competition for existing financial services in the sector, which will change the risk environment and create pressures for relatively weaker or unsuccessful banks to further consolidate, or exit the system.

28. **As a result of the above factors, and coupled with increasing cross border banking, banking sector growth will likely be fueled in the future by expansion in consumer finance, small business sector lending, leasing and housing finance.** The corporate sector ownership is rapidly changing in Slovakia; larger entities are being privatized and are increasingly foreign owned. Though there will be regular growth in credit facilities to these larger private corporations, a significant part of such funding will be provided through cross-border credit facilities and foreign direct investment (FDI). Most of the additional domestic asset growth will come from growth in new consumer, small business, leasing and housing finance services. Since these loans are usually backed by the personal credit of borrowers, there is an urgent need to set up functioning credit bureaus in Slovakia to facilitate this growth.

29. **However, Slovakia does not have a functional credit bureau, one of the key elements for developing consumer finance.** While each bank knows the credit history of its own clients, this information is not shared. Legal changes are needed to overcome the banking law's secrecy requirements and restrictive provisions of the law on protection of personal data. Both laws should be amended to allow a credit bureau to collect information on customers' credit from banks and other financial institutions without prior client consent, and to allow meaningful bank access to this information. A balance should be struck between enabling the existence of a credit bureau that will help the development of the banking system and one that will provide personal privacy protection; a regulatory body may be created to oversee its operations. Additionally, banks need to agree on organization and technical aspects, such as the design of a consumer credit database, 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 immediately for all banks and over time for all other types of lending institutions. Access should be open to all participating financial institutions. The government can play an important part in facilitating the creation of a credit bureau.

30. **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 practice, housing related subsidies are given according to the type of institution rather than type of products, and institutions are accordingly narrowly licensed. Building societies (home savings banks) 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 institutions providing different types of products. It would be more efficient to bring all the various products and incentives under a single type of commercial banking institutional structure, which could specialize in a specific product category, as it and the market desired. In the short term, thought should be given to: (i) linking the 'home savings bank' subsidy to taking up a housing loan (which is not essential at this time) ; (ii) means-testing the 'home savings bank' savings subsidy and the mortgage loan interest rate subsidy; and (iii) introducing a minimum mortgage bond funding ratio to preclude banks from taking on undue interest rate risk. In the medium term, once interest rates converge towards EU levels and per capita income grows, subsidies could be further reduced or abolished 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.

31. **The insolvency and creditor rights framework remains very weak in Slovakia, and is one of the areas where significant reform still remains to be achieved.** The government should adopt as soon as possible the needed new comprehensive insolvency legislation that would improve efficiency, reflect modern features based on international best practice, and introduce a functional rehabilitation scheme. The government should also adopt a comprehensive regulatory framework governing qualification and conduct of trustees to assure integrity and maintain public confidence in the system. Efforts should be made to improve debt recovery and enforcement mechanisms, including *inter alia,* greater efficiency in judicial enforcement, non-judicial executions/sale, and auction procedures. The move to adopt a new pledge law and centralized registry will enhance asset-based lending and should proceed urgently.

32. **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 International Accounting Standards (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 comply fully with IAS.

33. **In the auditing area, too, a number of problems indicate the need for a well-organized reform program.** These include**:** 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 the absence of effective mechanisms for enforcing established rules and regulations. 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 international standards.

34. **Currently, the two Slovak securities exchanges, BSE and the SEE, have a low level of activity that is likely to continue. Slovakia's imminent admission to the EU and freer access to Europe's exchanges are likely to bring the viability of a separate Slovak exchange, much less two of them, into question**. Out of 890 listed stocks in BSE (market cap of about Sk 126 billion), only 9 are quoted regularly with very light trading. The SEE is new and not yet operational. Most of the trading on the BSE (over 90 percent) is in government bonds**.** Corporate bonds also trade modestly but are insignificant in amount. Slovakia's larger companies – those most likely to raise funds in the market – are increasingly foreign-owned, and can obtain financing externally on better terms than in the local market. From the demand side, as household income and corporate wealth grow in Slovakia, the demand for stocks and bonds will also grow, but the desire for portfolio diversification and the ready access to regional, European, and world markets is likely to limit significantly the demand for specifically Slovak instruments. Slovakia's entry into the Euro zone, by removing exchange rate risk within the EU, will compound these effects. High trading costs will further reduce the demand for Slovak instruments relative to foreign instruments. Similar conditions and factors throughout the region are encouraging the merger of major European exchanges and development of regional exchanges.

35. **Supplementary pension fund management companies (DDPs) have been created since 1996 under the supervision of Ministry of Labor as special purpose legal entities under the civil code to manage a third pillar—however the regulation and supervision of DDPs is weak and fragmented among the Ministries of Labor, Finance and the social security administration.** Supplementary pension insurance companies are financial institutions and have the privilege of collecting contributions from the public. They should be subject to the same standards of disclosure and transparency as any other type of financial institution. Currently, however, the operations of the DDPs and their managed funds are rather non-transparent. The accounting and disclosure rules are deficient. Clear separation between the pension fund assets and those of the DDPs is not always ensured. The DDPs need to be supervised the same way all other investment management companies are.

36. **Exit policies for financial institutions need to be strengthened further.** The experience with the resolution of the four banks that failed to date has brought to light that regular bankruptcy law and procedures are ill-suited for the handling of bank failures. Selective amendment of banking, deposit protection and bankruptcy legislation would go a long way towards addressing this issue. 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. Other important issues that should be addressed are: (i) the inappropriateness of allowing the DPF to provide emergency liquidity support to banks under temporary administration; and (ii) the inappropriateness for insurance companies to sell deposit insurance over and above the insurance/coverage provided by the DPF.

37. **The restructuring and privatization of state-owned banks has left a long tail of NPLs still to be resolved.** As noted in paragraph 2, above, NPLs were transferred from the state banks to KBB and the Slovak Consolidation Agency (SKA). But KBB was ineffective and in early 2002, was merged into SKA. SKA is a joint stock company owned by the state, but an investment board staffed with independent domestic and foreign experts must endorse all NPL resolution actions proposed by management. SKA is receiving donor funding for outside legal and financial expertise to assist with NPL recovery. SKA has adopted a three-pronged strategy for NPL recovery comprising sales of claims to third parties, recovery using third party solicitors, and in-house action. The government could take several steps to further accelerate SKA's NPL resolution efforts, including: (i) further upgrading of insolvency legislation and procedures; (ii) ensuring the availability of sufficient budget resources; and (iii) ensuring the continued effective functioning of the investment board and the continued presence of professional management, staff and outside expertise.

38. **The government's proposal to gradually incorporate both banking and non-banking financial sector regulation and supervision within the NBS by 2005 is a pragmatic approach towards creation of an integrated financial markets supervision entity** The government should, however, continue to focus on strengthening both NBS's banking supervision and FMA's non-banking supervision and encourage close cooperation between the two entities in the interim period, in order to successfully achieve the eventual transition to a strong integrated financial markets supervision entity.

39. **The legal and regulatory framework for anti-money laundering is well on its way to being in line with international standards, but specific provisions to combat the financing of terrorism have to be put into place, and implementation needs to be strengthened**. An active program is underway to develop procedures and training for effective implementation, which is lagging significantly behind especially with respect to non-bank financial institutions.

IV. KEY FSAP RECOMMENDATIONS

40. **Strengthen Financial Markets (Banking and Non-Banking) Supervision**.

- In order to strengthen banking supervision, implement the Supervisory Development Plan under EFSAL (Enterprise and Financial Sector Adjustment Loan—WB) and move to a more pro-active and risk-based approach;
- Implement effective cross-border prudential supervision and consolidated supervision and complete bilateral cooperation agreements with all relevant foreign bank supervisors;
- Improve supervision of market risk, including collection of data on the duration of asset/liability exposures;
- Initiate reforms to unify regulatory treatment for banks thereby absorbing mortgage banking and housing finance activities into main stream banking institutions, harmonizing incentives and avoiding a fragmented banking sector with specialized housing finance multi-tiered institutions;
- Strengthen the institutional capacity of the relatively new Financial Markets Authority (FMA) in order for it to become an effective insurance and capital markets participants supervisor;
- Encourage close cooperation between the two supervisory entities NBS and FMA in the interim period, in order to successfully achieve eventual transition to a strong integrated financial markets supervision entity as per the government's target date of 2005.

41. **Emphasize Least-Cost based Bank Exit Policies**.

- Develop detailed guidelines for temporary administrators/liquidators of banks, mandating the use of least-cost failure resolution methods rather than the past preferred method of fully insured depositor payoffs.

42. **Put the Deposit Protection Fund (DPF) on a Sound Financial Base and Eliminate Inappropriate Safety Nets**.

- Provide the DPF with: (i) an initial injection of 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 (ii) establish through the NBS or the MOF, a formal line of credit for the DPF to draw upon during emergencies.
- Eliminate the inappropriate current practice for the DPF to provide emergency liquidity support to banks under temporary administration;
- Remove the legal permission for insurance companies to sell deposit insurance over and above the insurance/coverage provided by the DPF.

43. **Improve Quality, Breadth and Depth of Financial Intermediation.**

- Reform the insolvency and creditor rights legislative and regulatory framework in line with international practices in order to: (i) improve efficiency of judicial enforcement, non-judicial executions/sale, and auction procedures; (ii) introduce a functional rehabilitation scheme; and (iii) ensure the qualification and conduct of bankruptcy trustees;
- Improve corporate governance by improving disclosure of prospectus information and strengthening minority shareholder rights, insider trading rules, disclosure of insiders remuneration, and market manipulation rules;
- Improve transparency and disclosure of financial information by introducing full International Accounting Standards for all financial markets participants and public companies, and introduce International Auditing Standards for audits of financial statements;
- Facilitate the establishment of a credit bureau, including drawing up relevant amendments to the banking law's secrecy requirements and restrictive provisions on protection of personal data to encourage prudent growth and risk management in consumer finance, small business sector lending, leasing and housing finance;
- Adopt a new pledge law and centralized registry to enhance asset based lending.

44. **Strengthen Pension Fund Management**.

- Subject supplementary pension insurance companies (DDPs) to the same standards of disclosure and transparency as any other type of financial institution.
- Ensure clear separation between the pension fund assets and of the DDPs.

46. **Improve the AML/CFT Legal and Enforcement Framework.**

- Strengthen the legal and institutional framework to detect and prevent money laundering and to combat the financing of terrorism, particularly by establishing clear provisions addressing terrorism and terrorist financing. The implementation of AML/CFT measures in the financial sector should keep up with the improvements in the legal framework