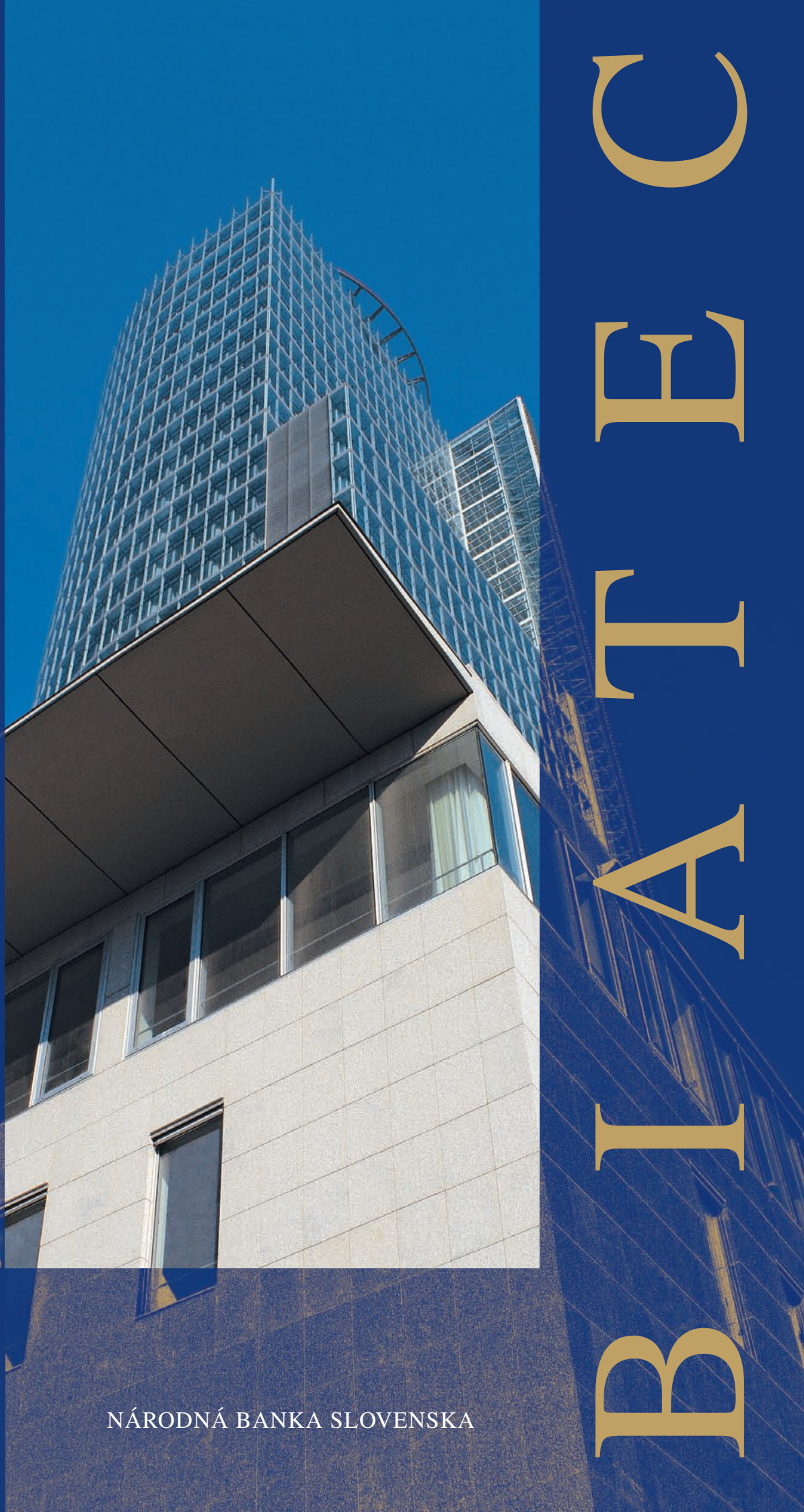


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The financial crisis brings new challenges for financial market supervision



*Ing. Martin Barto, CSc.
Deputy Governor of the NBS*

Dear readers,
I am very pleased that we have prepared for printing a special issue of the Biatic monthly devoted only to the issue of financial market supervision. Financial market supervision has undergone many important changes since 2005 and new changes, probably with an even larger impact, are forthcoming.

Until the end of 2005, the National Bank of Slovakia regulated and supervised only the banking sector of Slovakia. After experience from the years 1999 and 2001, it was possible to build up an effective and efficient institution, which started to contribute fundamentally to the maintaining of financial stability based on risk-oriented supervision. Good experience from the functioning of the supervision of banks, the continuing process of overlapping of the activities of individual segments of the financial market, as well as a general effort to render public administration more effective led to integration of the entire financial market supervision into the NBS, which thereby, in 2006, became the only supervisory authority as well as authority issuing secondary legislation for the whole market.

This step has turned out to be unambiguously positive. The actual process of merging the Financial Market Authority with the NBS was smooth and from 1 February 2007 the organizational structure of the Financial Market Supervision Unit has reflected its individual activities – licensing, proceedings, methodology and regulation and actual on-site and off-site supervision. Such a structure proves to be an appropriate choice for smaller countries with a relatively low number of supervised entities; after all, several months after us, the ČNB chose a very similar arrangement for

its integrated supervision unit. The new structure enabled to unite licensing in the whole market, as well the conduct of proceedings, which helps to create equal conditions for individual segments of the financial market. Similarly, secondary – but also primary – legislation is heading towards harmonization of the conditions for the pursuit of business on the financial market. Experience from forward looking risk-oriented supervision in the banking sector is transferred to the insurance sector, which is going to face the introduction of the new Solvency II rules for capital adequacy calculation. Likewise, this new experience has facilitated considerably the creation and modification of investment rules for pension funds of pillar II and pillar III. Because the NBS collects data from the whole financial market by means of the STATUS system, the NBS has a considerably larger database for the evaluation of financial stability, including stress testing, as well as crisis management.

There have been also important changes in the supervision of individual institutions. Supervision is exercised within whole financial groups, which enables a considerably better assessment of the risks, to which individual institutions as well as the whole group are exposed. Based on rich experience from regular monitoring of some banks, it has been possible to create a monitoring system for pillar II pension funds. Due to the special status of those funds, precise information on their condition at the beginning of the financial crisis has been of extraordinary importance. Moreover, information on the extent of exposure of all institutions to problematic assets has been available very quickly, which provided an exact picture of the direct impacts of the first stage of the financial

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Development of financial market supervision at the National Bank of Slovakia

RNDr. Pavel Ferienc, Ing. Miloš Švantner
National Bank of Slovakia

A new central bank – the National Bank of Slovakia – came into being following the dissolution of the Czechoslovak federation in 1993 by virtue of Act No. 566/1992 Coll. Within its activities, the central bank also performs supervision of banks and its competence includes the secure functioning and development of the banking system in Slovakia. Since the bank's foundation, the bank has also had a Banking Supervision Department, which consisted of two sections – the Licensing Section and the Supervision and Analyses Section. In October 1993, it was transformed to the Banking Supervision Division, which included three departments (the Licensing Department, On-site supervision Department and Off-site supervision Department). The building up and activities of the division were influenced not only by the development in the legislation area, but also by the implementation of the core principles of efficient banking supervision – the so-called Basel Core Principles.

Supervision activities were very complicated at that time. The reason was particularly a lack of experience, there were only few experts having an idea of how banking supervision is supposed to work; primary and secondary legislation was also insufficient. In fact, practices in both state and private domestic and foreign banks and foreign bank branches were not the best ones, and all these deficiencies were combined with the economic conditions brought about by a fast and often wild denationalization of the economy. Small-scale privatization and large-scale privatization entailed both political and economic pressure on lending, especially in state-owned banks; however, similar dubious practices were common in private banks and foreign bank branch offices.

NBS DECREES

In 1993, the Banking Supervision Division regulated prudential banking according to provisions issued by the Czechoslovak State Bank (ŠBCS). At the same time, in 1993, the NBS started to prepare new NBS decrees on prudential banking in cooperation with IMF advisors.

In 1994, the NBS cancelled the prudential banking decrees issued by the ŠBCS and issued its own decrees (on capital adequacy of banks, credit exposure of banks, liquidity rules for banks and regulation of monetary positions of banks). The new decrees of the NBS extended the scope of prudential rules from banks to foreign bank branches and some allowable items for the calculation of capital were rendered more precisely in the capital adequacy decree. Criteria for bank capi-

talization were rendered more precisely based on knowledge of the Banking Supervision Division and the development of risks in the banking sector and at the beginning of 1994 a NBS decree increased the required minimum share capital of a newly created bank or foreign bank branch from SKK 300 m. to SKK 500 m. In the same year, the Slovak Republic, as one of the first Central and Eastern European countries, issued an act regulating procedures to prevent money laundering (Act No. 249/1994 Coll.).

AMENDMENTS TO THE ACT ON BANKS

Substantial amendments to the Acts on Bank were carried out in 1996. The basic alteration for the activities of banks was the possibility to perform mortgage transactions. Further modifications related to the process of licensing new banks and foreign bank branches (the introduction of a two-stage licensing procedure). The amendment to the Act on Banks also reflected the effort of the central bank to achieve higher transparency in the monitoring of changes in shareholder structure of existing banks (banks can issue their shares only in the form of registered book entry securities and a time limit was set, within which banks had to change bearer shares to registered shares). The exercise of banking supervision was strengthened in the area of application of corrective measures. The amendment also imposed upon auditors the duty to inform the NBS on facts that can endanger the activities of a bank. Legal foundations for the establishment of a register of loans and guaranties were also laid.



Due to new authorization provisions in the Act on Banks, NBS decrees regulating the process of licensing new banks, foreign bank branches, but also the process of granting prior approval of the acquisition of shares of an existing bank, as well as the process of acquisition of non-bank equity by a bank and the process of foundation of the branch of a Slovak bank abroad were issued during the year for the first time since the dissolution of Czechoslovakia. The Act of the National Council of the Slovak Republic on deposit protection was issued at the beginning of the year and it completed the system of deposit protection in Slovakia.

The year 1998 brought an important amendment to the Act on Banks. The basic modifications took into account recommendations from pre-entry negotiations with the OECD. These were particularly:

- leaving out the economic purposefulness criterion in the assessment of an application for a banking license,
- simplification of the process of licensing new banks and foreign bank branches from a two-stage process to one procedure,
- adjustment of the limit for monitoring changes in shareholder structure of existing banks in accordance with the corresponding EU directives,
- a more precise definition of the term "concerted action" for a simplification of the monitoring thereof.

Based on the above mentioned alterations of the Act on Banks, the NBS issued new decrees regulating the process of licensing new banks, foreign bank branches, but also the process of granting prior approval to the acquisition of shares of an existing bank, as well as the process of acquisition of non-bank equity by a bank and the process of foundation of a branch of a Slovak bank abroad.

Another large amendment to the Act on Banks became effective in 1999; the amendment:

- extended the scope of banking activities that can be performed by banks,
- rendered more precisely the definition of activities that can be performed only by entities with a banking license,
- enabled the performance of mortgage transactions also to foreign bank branches,
- strengthened the exercise of banking supervision, for example by enabling the voting rights of bank shareholders to be suspended, and made the procedure of offsetting a loss against the share capital more strict,
- rendered more precisely and extended the authorization provisions related to the issue of prudential rules.

BANKING SECTOR REFORM

Within its conception of the development of the banking sector, the government of the Slovak Republic adopted a broadly conceived banking sector reform program on the basis of analyses

performed by the banking supervision of the National Bank of Slovakia in cooperation with the Ministry of Finance of the Slovak Republic. Certain positive results of the banking sector reform program started to become evident in the development of the banking sector of the Slovak Republic already in 2000:

- restructuring and privatization of the three largest state-owned banks,
- a program and strategy for the procedure against small and medium-size banks,
- strengthening of the regulation and exercise of banking supervision.

During the second half of 1999 and the first half of 2000, fundamental steps for the reinforcement of the capitalization (in the amount of SKK 18.9 bn.) and for the improvement of the quality of their credit portfolio (SKK 105 bn. of risky loans were transferred to special institutions) were taken in the largest state-owned banks. After those steps, the banks reached the standard capital adequacy limit and the percentage of classified loans decreased below 20%. This stabilized considerably some 45% of the banking sector assets.

Another step of the banking sector reform in parallel to the restructuring process was the process of ownership change – the privatization of banks. Conditions for the entry of several strategic partners were created during the year.

The strategy of procedure of the Banking Supervision of the National Bank of Slovakia against small and medium-sized banks was based on a financial analysis of the situation and developments in individual banks in 1999, the fulfillment of NBS decrees, as well as the approach of the investors of those banks in 2000. The strategy of procedure has quantified and proposed solutions to accumulating problems, particularly in the following substantial areas:

- a very high and growing amount of classified claims with inadequate coverage by provisions and reserves,
- the growth of loan losses decreasing the capitalization and performance of banks,
- assessment of guaranties and collaterals,
- the fulfillment of prudential rules and a deteriorating state of liquidity of some banks.

The pre-privatization restructuring of the banking sector was composed of two stages. The first stage was terminated in December 1999. The capital of banks was increased by a total of SKK 18.90 bn. within that stage.

Based on a Government decision, the second stage of restructuring of selected banks, based on which further risky loans of SKK 61.80 bn. had been transferred to special institutions, was terminated in June 2000.

The parliament adopted the Act on the Financial Market Authority in September 2000. The Financial Market Authority was accountable to the Government of the Slovak Republic for the conduct of its activities; it submitted to the Government activity reports for the previous calendar years along with an analysis of the current state of



the capital market and the insurance industry in the Slovak Republic.

The most important event in 2001 was the completion of the restructuring and privatization of banks with a crucial amount of assets in the banking sector of Slovakia. (Všeobecná úverová banka, Slovenská sporiteľňa, Investičná a rozvojová banka – 45% of assets in sum).

The restructuring of the banking sector was reflected in an improvement of the structure of assets, in an increased capital adequacy of the banking sector as a whole and in a decreased ratio of classified loans to total loans. The positive results of restructuring entailed a decrease in the price of financial resources. The decline of the price of financial resources was also reflected in a decrease in the level of average interest rates on deposits and loans. The transfer of loss loans to special institutions and their replacement by government bonds brought about the release of financial resources tied for the coverage of unprofitable assets. Together with a gradual restructuring of the business sphere, this creates room for the promotion of further economic growth of Slovakia.

Gradual privatization was reflected in the growth of foreign investors' share in the total subscribed capital of banks and funds provided permanently to foreign bank branches.

The supervisor was facing several problems in that period. The first one was insufficient support by primary and secondary legislation. The Act No. 21/1992 Coll. on Banks proved to be an insufficient instrument for supervision; secondary legislation was more dealing with issues of reporting or limits and it mentioned risks only marginally. The personal problem of supervision consisted in the fact that not all of its employees and managers had sufficient experience and knowledge on how to perform or not perform supervision. Insufficient communication and mutual links between off-site supervision and on-site supervision posed a problem. Both of these supervision methods existed in parallel and were developing, to a considerable extent, independently, which was, without doubt, also fostered by the organizational structure of supervision at that time. The result was that analytical documents of off-site supervision were only useful to a limited extent in the exercise of on-site supervision, where the risk approach to supervision was rather an exception at that time. In addition, due to many problems, on-site supervision was forced to solve acute problems, no systematic supervision, based for example on a supervisory cycle, was carried out.

CONSIDERABLE STRENGTHENING OF BANKING SUPERVISION

In 2001, fundamental changes, which considerably strengthened the status of banking supervision, were performed in Slovak legislation. On 23 February 2001, the National Council of the Slovak Republic adopted the constitutional Act No. 90 amending the Constitution of the Slovak Republic No. 460/1992 Coll. as amended. The

constitutional act amended the wording of Article 56 of the Constitution of the Slovak Republic, which provided for an independent status of the National Bank of Slovakia with an independent legislative initiative. On 6 April 2001, the National Bank of Slovakia adopted an act to amend the Act of the National Council of the Slovak Republic No. 566/1992 Coll. on the National Bank of Slovakia. In addition to rendering more precisely and adjusting the activities of the NBS, the act also strengthened the status of banking supervision. The amendment enabled banking supervision independent steps and decision-making in first instance proceedings in Art. 36 and 37. Individual activities of banking supervision were defined in a precise and unambiguous way. Another positive result of the amendment was harmonization of Slovak legislation with European Union law.

Another legal norm adopted in 2001 was the Act No. 483/2001 on banks and on amendments to certain acts of 5 October 2001, effective from 1 January 2002. The act provided for a strengthening of the status of the National Bank of Slovakia in the exercise of banking supervision, harmonization of Slovak banking legislation with the respective European Union directives, recommendations of the World Bank and International Monetary Fund. The act formulated the conditions for activities of banks and foreign bank branches, including prudential requirements. Moreover it contained the legislative framework for banking supervision on a consolidated basis and stressed the importance of corporate governance. It set the stage for a fast application of corrective measures and regulated in more detail issues related to official compulsory conservatorship. It set requirements for the cooperation of bank auditors with the National Bank of Slovakia.

Other legal norms adopted in 2001 also have an impact on banking supervision:

- Act No. 118/1996 Coll. on deposit protection, whose objective was to eliminate the risks of deterioration of the position of the Deposit Protection Fund as a creditor.
- Act No. 328/1991 Coll. on bankruptcy and composition and the related implementing piece of legislation No. 493/1991 Coll., which have inter alia strengthened the powers of meetings of creditors in bankruptcy.
- Act No. 566/2001 Coll. on securities and investment services.
- Act No. 513/1991 Coll. Commercial Code as amended, which provided for protection of creditors and other third parties in business relations, strengthened the protection of corporation shareholders from possible abuse of the position of statutory bodies (i.e. authorized representatives) and supervisory bodies of corporations.

In 2001, amended decrees of the NBS on limitations to unsecured foreign exchange positions of banks, on capital adequacy of banks, on rules for the liquidity of banks and foreign bank branches, on the publication of information by banks and



foreign bank branches, on rules for restrictions on concentration of bank property towards other entities, and on the submission of information by banks and foreign bank branches to the National Bank of Slovakia became effective.

By virtue of authorizing provisions of the new Act on Banks, in a first stage, the National Bank of Slovakia drew up six draft decrees and one regulation in cooperation with the Ministry of Finance of the Slovak Republic; they were approved by the Bank Board of the National Bank of Slovakia on 21 December 2001 and took effect on 1 January 2002.

NEW EFFECTIVE DECREES OF THE NBS

1 January 2002 was the effective date of the licensing decrees (on the granting of a banking license, on the granting of a banking license to a foreign bank for the pursuit of banking activities by means of its branch in Slovakia, on the registration of a representation of a foreign bank or a similar foreign financial institution pursuing banking activities, on prior approval to establish a branch abroad, on the granting of a prior approval under Art. 28 sec. 1 of the Act on Banks, on the requisites for reports necessary to identify other persons having a special relationship to a bank or a branch of a foreign bank due to their relationship with the reporting person, decree of the NBS and MF SR on the mortgage register and on the details of the status and activities of the mortgage controller and his representative). Furthermore, a new decree stipulating the lay-out of the extended audit report for the audit of banks and foreign bank branches became effective on 1 January 2002.

Based on the adopted new decrees, which issue from Act No. 483/2001 Coll. on Banks, the EU Directive 2000/12/EC relating to the taking up and pursuit of the business of credit institutions, which indicates the basic framework for the setting of regulatory instruments of banking supervisions of EU member states, and EU Directive 93/6/EEC on the capital adequacy of investments firms and credit institutions, rules for a safe operation of banks in selected types of banking activities were introduced and the provision of information to the general public was regulated more strictly.

In 2002, decrees for prudential banking were approved and became effective gradually.

Based on a recommendation of the World Bank, the Bank Board of the National Bank of Slovakia adopted, in December 2001, a long-term plan for the development of banking supervision (LPDBS). An overview of how the plan is being fulfilled was consulted with the World Bank, because the monitoring of the implementation of the LPDBS was connected with the assessment of meeting the conditions for the release of tranches of the EFSAL (*Enterprise and Financial Sector Adjustment Loan*) in 2003.

In February and in March 2002, representatives of the International Monetary Fund and the World Bank in Slovakia evaluated the fulfillment of the

FSAP (*Financial Sector Assessment Program*). The summary report was published in September 2002 and pointed to the deficiencies that the NBS had in banking supervision.

An analysis of the level of implementation of 25 Basel Core Principles for effective banking supervision in Slovakia was elaborated within the evaluation of the FSAP.

A program, prepared and supervised by the International Monetary Fund (the *Staff Monitoring Program*), was terminated in May 2002 in Slovakia. Tasks resulting from the program were fulfilled by the Banking Supervision Division. These were:

- the application of a proactive and risk-based approach to the exercise of banking supervision,
- an increase in the number of employees of the Banking Supervision Division,
- the application of a new evaluation of banks (based on the CAMEL system) during on-site inspections from the beginning of 2002,
- the adoption of a new Act on Banks, which became effective on 1 January 2002 (Act No. 483/2001 on Banks),
- the introduction of a new organizational structure of the Banking Supervision Division.

At the end of May 2002, the European Commission performed a Peer Review evaluation in Slovakia (at that time an EU candidate country). The report drawn up based on this evaluation was, to a large extent, identical with the conclusions of the FSAP evaluation. Based on these recommendations, the Banking Supervision Division adopted a plan for working in the recommendations (the *Action Plan*) at the end of 2002. An analysis of the level of implementation of 25 Basel Core Principles for Effective Banking Supervision in Slovakia was drawn up within the Peer Review.

AN EFFECTIVE SUPERVISION INSTRUMENT

At the beginning of 2002, a new organizational structure of the Banking Supervision Division (BSD) of the National Bank of Slovakia came into force. The necessity to modify the organizational structure resulted mainly from a change in the approach of the BSD to the supervisory process. It was necessary to base the supervisory processes on a risk-oriented pro-active approach to supervision on a consolidated basis. These principles, as well as new policies of banking supervision, were elaborated in the document Banking Supervision Strategy adopted by the NBS Bank Board in May 2002.

The tasks resulting from the strategy entailed many conceptual, organizational and personal changes for the exercise of actual supervision. Their main objective was above all the ability to perform risk-oriented on-site supervision in all banks and branches of foreign banks during a two year supervisory cycle, the drawing up of a manual for the procedures in the exercise of supervision and evaluation of banks and branches, a strengthening of on-site supervision, rendering off-site supervision more effective, and the elaboration of a system of their cooperation and mutual interconnections. An important part of supervision was



also the introduction of a system of cooperation with the methodology unit so as to enable a very fast transfer of the requirements of everyday life to primary and secondary legislation.

A positive example of such cooperation was the drawing up of Decree No. 12/2004 on the risks and risk management system. The decree specifies the qualitative requirements on risk management in such a way that they meet the conditions for the transition to a new qualitative level as represented in the Basel II rules. On the other hand, the decree provided supervision with an effective instrument for the exercise of supervision.

Basel II is not only a new way of calculating capital requirements, but it also represents a complex system including the identification, measurement and management of all significant risks, to which a bank is exposed; and bank management systems must be adapted to this. The capital requirement for credit and market risk had been already included in Basel I. The three-pillar Basel II brings more sophisticated calculation methods for the capital requirements for these risks, and it also deals with the capital requirements for operational risk in its first pillar. In the second pillar, the bank's calculation of capital must also take into account other important risks, to which it is exposed. The third pillar sets the framework for the publication of data on the risks of a bank in such a way that the customer has as much information as possible in his decision-making. There is also a new way of exercising supervision, and the demands on the quality as well as personal and technological resources of supervision are much higher. In addition, it introduces continuing international cooperation with the supervisions of other countries, from a very detailed technological level up to the harmonization of legal procedures when approving advanced calculation methods for capital requirements.

The supervision performed 68 on-site inspections and carried out 2 complete supervisory cycles between the beginning of 2002 and the end of 2006. A manual for supervisory procedures was drawn up; supervision employees were retrained and an education system was introduced at the same time.

At the end of 2006, the FSAP performed another evaluation mission, which evaluated the fulfillment of 25 Basel conditions for effective supervision, already adjusted to the conditions of Basel II. The results of the evaluation showed fundamental progress in the exercise of banking supervision in Slovakia and confirmed that NBS banking supervision fulfills all the criteria at a high level.

A NEW APPROACH TO SUPERVISION

The year 2006 was important for financial market supervision also because the former Financial Market Authority (hereinafter referred to as the FMA) became affiliated to the NBS. The FMA had been founded in 2000 by spinning off from the Ministry of Finance of the Slovak Republic into an independent supervisory unit, which had been

created as a body for the supervision of licensed financial market entities other than banks. The reason for the integration was an attempt to take advantage of the experience of banking supervision and to apply its methods to the whole financial market. In February 2007, the actual integration of supervision took place and organizational changes were carried out, whose aim was to ensure functional integration. In this connection, as well as due to the implementation of risk-oriented supervision to the whole financial market and the necessity to respond to the new situation, a new approach to the exercise of supervision was chosen. Above all, the supervision focuses on a group of market entities that are interconnected by relationships of ownership. If the leading element of such a group is a bank, then its subsidiaries or sister companies, for example the pension fund management company, supplementary pension insurance company, the securities dealer, asset management company or another licensed financial market entity, are also subject to supervision in the same section. Such an approach enables a natural view of the consolidated group and enables to gain an overview of the financial developments and movements within the group, which is extraordinarily useful. Due to considerably higher demands on mathematical procedures and methods as well as analytical source documents needed for the exercise of supervision, the classical off-site supervision was modified and split in such a way that one part became part of the activities of on-site supervision and the actual quantitative methods, including electronic data processing up to analytical source documents, are processed separately.

Experience shows that the group supervision principle has proved to be very effective in several respects. In addition to an overview of the financial situation and movements of funds within the group, it also enables to identify risks more quickly and saves both financial and personal capacities of supervision to a considerable extent.

As a reaction to the financial and economic crisis, a report of the de Larosière Group expert group has been drawn up within the EU. The report has proposed the architecture of future European supervision. Discussions are currently under progress on how this vision is to be implemented and what competences it will have. Slovakia also joined the discussions. Our attitude can be characterized by the motto "balance of responsibilities and powers". What ever the result might be, for NBS supervision it will mean operation in a substantially more complex international environment. Cooperation and communication with the European supervisory agency will not be a substitute for bilateral and multilateral cooperation as exercised by the supervisor today. The European supervision can be certainly expected to bring new demands on both human and financial capacities. For that reason, the structure of integrated financial supervision at the NBS is likely to be extended and modified in the medium run.



The ICAAP and its implementation in Slovakia

Ing. Mária Pročková
National Bank of Slovakia

The New Basel Accord, also known as Basel II, has laid the foundations for more precise approaches to the measurement of capital requirements of banks; the approach is known as Pillar I. At the same time, the process has been extended by adding two other areas: the supervisory review process (the so-called Pillar II) and disclosure (the so-called Pillar III). This paper is dealing with the implementation of Pillar II in Slovakia.

Both the implementation of the New Basel Accord in the CRD (Capital Requirements Directive, 2006/48/EC relating to the taking up and pursuit of the business of credit institutions) and subsequently in national legislations, as well as the establishment of supervision of the process have one general objective in common – to contribute to the stability of the international financial system. Its primary purpose is to ensure that banks have an adequately sufficient capital to support all of their business and development-related risks to motivate them to use better risk management techniques in risk monitoring and management. In general, capital must not be regarded as a substitute for insufficient oversight or an inadequate risk management process.

THE CAPITAL ADEQUACY ASSESSMENT PROCESS

The *Internal Capital Adequacy Assessment Process* is not an absolute innovation. The process of capital optimization and capital allocation inside the bank has formed the basis of bank management for their stockholders since the establishment of banks. The Internal Capital Adequacy Assessment Process was implemented into our legislation by Act No. 483/2001 Coll. on Banks, which set out obligations for banks as well as for the supervision unit. Banks are obliged to have their own internal capital adequacy assessment process that they consider to be adequate to cover the current or potential risks they are exposed to. Banks should “possess”, develop and manage their risk management processes; the Internal Capital Adequacy Assessment Process (ICAAP) belongs to the banks. The supervisor’s duty is to examine and evaluate the ICAAP the reliability of the internal systems of risk management, within which it is used.

The basic aim of the processes within Pillar II is to reinforce the connection between the bank’s risk profile, its management and risk mitigation systems and its capital. The banks themselves should develop reliable risk management systems able to determine, measure, group and monitor their risks in an appropriate manner. It is assumed that banks have an appropriate assessment process

encompassing all of the key elements of capital planning and management and generating an adequate amount of capital to compensate those risks.

APPLICATION OF THE SUPERVISORY REVIEW PROCESS

The Committee of European Banking Supervisors (CEBS) issued a guideline on the Application of the Supervisory Review Process under Pillar II in 2006, also known as CP03. The guideline is designed to support the convergence of supervisory procedures and approach consistency, taking account of market trends and national procedures to accomplish a sound and effective market. The NBS supervision unit subsequently issued the Methodological Guideline No. 1/2007 of 5 February 2007 on the Internal Capital Adequacy Assessment Process of banks, which in full conformity with CP03 requirements.

According to the CRD directive, the ICAAP was related to a transitional period until the end of 2007, during which banks were not obliged to prove the inclusion of the clause in their internal regulations and the maintaining of the ICAAP provided that certain conditions had been met. The supervision performed introductory meetings with all banks at the end of 2006 as a preparation for the implementation of ICAAP processes. Expectations about the ICAAP processes were presented to the banks by the NBS supervision unit at those meetings. At the same time, the banks were notified of the fact that the first “practice” ICAAP assessment was going to take place in 2007.

The banks were asked for the first documentation and their first own calculations in the second half of 2007. The NBS supervision unit evaluated all the obtained information and then re-conducted the individual meetings with the bank managements. The idea of the implementation of ICAAP processes was not clear at that moment both in banks and in the NBS. The NBS supervision unit summarized the information and several conclusions resulted from the evaluation of that information; the conclusions were presented to bank representatives by representatives of the unit at a



joint meeting in February 2008. The supervision observed mainly deficiencies in the submitted documentation: the banks have not adopted any strategies, the senior management of banks was not actively involved in the process, and in most cases the ICAAP process was not perceived as an integrated part of the management with links to business decisions.

In this context, it has to be remarked that the ICAAP was not a self-evident part of management processes of bank groups. We have found, on international meetings of regulators, that the NBS Supervisory Department got involved in ICAAP process for the first time under the terms of several groups.

COOPERATION OF REGULATORS – THE COLLEGES

Regarding the process of ICAAP implementation, the year 2008 has been also specific in that cooperation of home-host regulators by means of what is called colleges was fully launched in that year. Meetings of bank groups were organized by means of regulators; the group-based approach to solving the ICAAP to the regulators of entire bank group was presented at the meetings. Within the distribution of competences between home and host regulators, a common understanding of the CRD directive, which imposes the primary power to assess Pillar II on the regulator having local responsibility, was necessary. ICAAP at the consolidated level, by contrast, is carried out by the group responsible for the consolidated group and the ICAAP assessment is carried out by the regulator responsible for the consolidated group. It has been agreed at the meetings of regulators that the assessment on the individual basis will be independent and will be guaranteed by the regulator having local responsibility and that regulators will accept the deadlines and additional requirements of the consolidated group regulator. The harmonization of deadlines, the common form of assessment and the assessment methodology keep being open problems frequently discussed at meetings of regulators. However, a rare concurrence of views occurred in one point: the ICAAP process has to be possessed by each single bank on a solo basis, the group methodology can be used, the methodology must be very applied to the local environment and the conditions of the particular bank in a very targeted way. The bank management must understand the methodology and must be able to explain all the applied calculations and numbers. Any black box-like calculation of the economic capital, without its detailed explanation by the bank management, is unacceptable for any regulator.

The supervision has been carrying out regular annual assessments of the banks according to the Act on Banks for a quite long period of time.

These assessments were extended by adding the assessment of ICAAP process and results for the year 2008. Individual banks will be informed of the results of these assessments and in case of foreign banking groups home regulators, who have requested the assessment to set up an overall assessment of the banking group for the so-called consolidated assessment level, will be informed as well. Although the assessments are not fully completed, it is possible to state that the level of documentation is of better quality and more banks with foreign capital participation apply the group methodology compared to the 2007. Its correct application to the local environment and the conditions of the particular bank is still a problem. The senior management actively participated in the ICAAP implementation process in a number of banks, but in many cases the application test remained at the introductory calculation stage and its link to business activities is rather an exception. The management of banks will have to keep on dealing with improving the risk measurement methods, data quality as well as with the implementation of economic capital into management and decision-making processes.

ICAAP AS AN EFFECTIVE BANK MANAGEMENT INSTRUMENT

Based on the acquired knowledge from international activities, as well as results from cooperation with banks doing business in Slovakia, it can be said that both the regulators and the banks are gradually starting to perceive the need of capital management as useful and able to point to possible non-covered risks in due time or to a shortage of own resources. Early identification of possible problems is always the basis of prevention. Within a dialogue the supervisor can point out uncovered risks to the bank, and within international activities the supervisor can ask the home regulator for cooperation in the solution of problems, for which a bank based in Slovakia is not directly responsible. The ICAAP may gradually become an effective instrument for managing the bank, as well as an effective instrument for regulators, be it on the individual or on the consolidated level. Finally it can be said that in Slovakia the ICAAP process has been initiated in the right direction and in compliance with international requirements and practices.

However, it has to be noted that we are at the beginning and ICAAP's full implementation will require further capacities both on the banks' side and on the regulators' side, the amendment to the CRD directive being a clear evidence of this. The changes should reinforce the competences of regulators in the capital adequacy assessment process and further requirements will be imposed on banks also in this field.



Methodology of risk-based supervision

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The methodology of risk-based supervision for the supervision of banks started to be implemented at the Supervisory Department of the NBS in 2002 after organizational changes at the Supervision Division and after the NBS Strategy for banking supervision has been approved by the Bank Board of the NBS. The basic characteristics of the methodology of risk-based supervision is the evaluation of a bank's risk profile, from which the planning, focus and frequency of the performed supervision is derived.

The methodology used by the Supervisory Department uses two basic evaluations of the bank's risk profile – a risk evaluation using a risk matrix and a CAMEL rating evaluation.

THE RISK MATRIX

The risk matrix contains six main risks. The evaluation of each risk includes an evaluation of the level of risk and of the risk management system. The risks under evaluation are the:

- credit risk,
- market risk,
- liquidity risk,
- operational risk,
- strategic risk,
- reputation risk.

A numerical evaluation from 1 to 5 is allocated to each risk for the degree of risk and, separately, for risk management system of the given risk. An expected development trend (negative, positive, stable) is also allocated to each risk. The broader framework for the evaluation of each institution is the evaluation of the implemented organization and management, as well as internal management and control system of the bank. A complex evaluation of the risk profile of a bank is drawn up once a year within the annual evaluation of the bank.

CAMEL RATING

The CAMEL rating evaluation includes the evaluation of capital, assets, management, earnings, liquidity and sensitivity of a bank. A resulting numerical evaluation from 1 to 5 and the expected development trend (negative, positive, stable) is allocated to each area under evaluation. Numerical indicators have been set for each area under evaluation, except management. The management is evaluated particularly based on knowledge from on-site supervision, but communication and cooperation with the bank within off-site supervision and knowledge from discussions with the bank management during the period under evaluation are also taken into account. As a rule, a full CAMEL rating evaluation is performed once a

year within the annual evaluation of the bank and it is based on knowledge from off-site supervision and on-site supervision.

THE SUPERVISORY CYCLE

Based on the results of annual bank evaluation and the allocated rating, a supervisory cycle – i.e. the period, during which on-site supervision has to be conducted at the bank – is set for each bank. The standard length of a supervisory cycle is 24 months. This period of time is reduced to 12 months in the case of a rating evaluation of 3 and to 6 months in the case of a rating evaluation of 4. A rating evaluation of 5 means a special regime for the bank.

This risk-based approach also includes the application of the proportionality principle, i.e. the size of the bank, the extent and complexity of the activities performed and the importance of the bank for the stability of the financial sector are taken into account in the focus and frequency of the exercise of supervision.

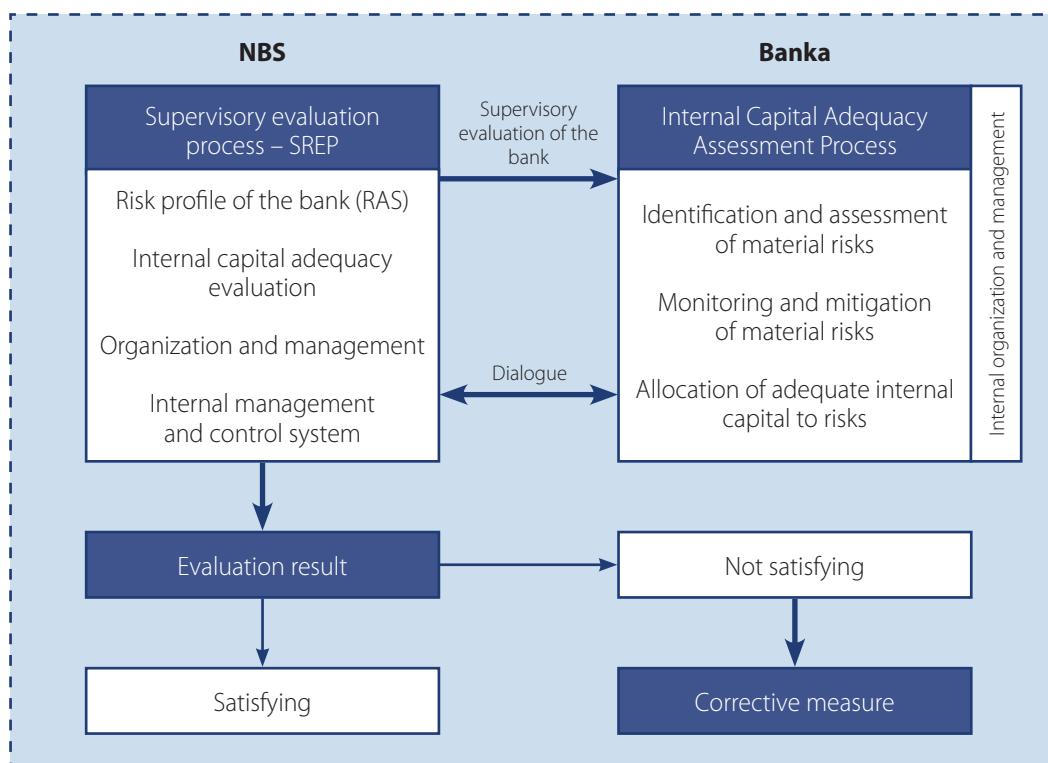
OFF-SITE SUPERVISION AND ON-SITE SUPERVISION

The rating evaluation and risk matrix are only the top of a pyramid composed of the performed supervisory activities. Basic components of supervision are off-site supervision and on-site supervision. Another layer is cooperation with the auditor of the bank and cooperation with the internal audit unit of the bank.

Off-site supervision is responsible for the collection and processing of data on banks (statements, reports, audit reports and internal audit reports, correspondence with the bank, other available data) and their analysis in such a way that it is possible to evaluate the financial situation of the bank and respond to a negative development in time. Off-site supervision provides information on the bank to on-site supervision and provides impulses for verification based on the gained and processed information on the bank. The basis for the financial analysis and analysis of significant changes is a set of observed values and observed



Diagram 1 The supervisory evaluation process



Source: NBS

indicators. Outputs for the evaluation of the bank are defined based on this set of observed values.

On-site supervision is the verification of the activities and processes directly in the entity under supervision. A supervision plan is drawn up for on-site supervision based on the evaluation of the risk profile of the individual banks, other available information and according to the set supervisory cycle for the individual banks.

Three basic types of inspections are performed at banks:

- Comprehensive inspection
- Thematic inspection
- Follow-up inspection.

The comprehensive inspection includes the evaluation of all main activities of the bank and after this supervision it is possible to evaluate the bank's risk profile.

The thematic inspection focuses on selected activities of the bank or the evaluation of a selected risk.

The follow-up inspection focuses on the evaluation of the fulfillment of measures adopted by the bank based on comprehensive or thematic supervision. Based on the nature and materiality of the findings, the on-site supervision proposes further steps to be taken against the bank, especially proceedings against the bank concerning the elimination of detected deficiencies or a change of the supervisory cycle.

PROCEDURES FOR THE EXERCISE OF SUPERVISION

The Supervisory Department has also compiled internal procedures for off-site and on-site supervisory evaluation of a bank, which describe the rules and procedures of supervision for the evaluation of individual activities and risks of banks. As a rule, the procedures contain a textual part and an evaluation check list for the area under review, which contain the settings of the evaluation criteria for the evaluation of the degree of risk or risk management system. The procedures are an tool for the exercise of supervision; they enable to standardize the exercise of supervision, as well as technological support for the processing of the final evaluation of the bank's risk profile. The compilation of the procedures in parallel to the exercise of supervision was a difficult process and represents more than 500 pages today.

METHODOLOGY OF SUPERVISION AFTER THE INTRODUCTION OF BASEL II RULES

The new capital adequacy regulation framework based on the New Basel Accord from 2004 consists of three parts known as pillars. The first pillar regulates the minimum capital requirements for covering credit risk, market risk and operational risk. The second pillar focuses on the verification and monitoring of capital adequacy by supervisors. The third pillar deals with the issue of market discipline and publication of information on a bank to enable a comparison of capital adequacy between individual institutions.



Requirements resulting from the first and third pillar are elaborated in more detail in the legislative framework made up of the Act on Banks and related decrees of the National Bank of Slovakia.

The second pillar focuses on the process of exercise of supervision. The aim of the second pillar is to ensure that banks apply the correct process of risk management and the pillar introduces a new view of the assessment of a bank's capital adequacy. A bank is obliged to assess continuously and to maintain internal capital that it considers adequate to cover risks, to which it is or could be exposed. The basic aim of the processes in the second pillar is to improve the connection between the risk profile of a bank, the management system of the bank, risk mitigation of the bank and the bank's capital.

The methodology of risk-based supervision (introduced gradually from 2002 to 2006) has proved to be fully compatible with requirements on the supervision process resulting from the new capital adequacy regulation framework. Thus, in 2007, the methodology for the exercise of supervision was

supplemented only with additional activities related to the implementation of the second pillar.

The supervisory evaluation process as described by the Basel II rules is shown in Diagram 1 (on the preceding page).

AN EFFECTIVE INSTRUMENT FOR SUPERVISION

The design and introduction of the new methodology for the exercise of supervision, including the preparation of procedures for the evaluation of banks, has been a long and difficult process. However, the methodology of risk-based supervision and its implementation into the process of bank supervision turned out to be an effective instrument for the exercise of supervision, which helps to identify problems at banks in time and to react to the identified problems in time. Risk-based supervision also means the introduction of systematic supervision. After the full integration of supervision in 2007 in NBS, the conception of risk-based supervision is gradually being introduced in other financial market sectors.



Colleges of supervisors for banks in the European Union

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The colleges of supervisors are permanent structures for cooperation and coordination between supervisory institutions responsible for the supervision of cross-border groups (groups of banks, insurance companies; financial conglomerates), particularly large groups.

1 www.c-ebs.org.

CREATION AND OBJECTIVE OF COLLEGES OF SUPERVISORS

The basis for the creation of colleges of supervisors for the supervision of cross-border banks in the EU was provided by Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions (also known as the Capital Requirements Directive - CRD), which set the competences and the framework for cooperation of supervisors of EU member states, particularly by means of Article 129, 131 and 132.

Two models of the division of competences in the supervision of banks in EU countries are possible according to the currently valid wording of the CRD:

1. A bank based in an EU member state has a branch in another member state:

- supervision of branches of banks is exercised by the supervisor of the member state, in which the bank has its residence (home supervision),
- supervision of liquidity of the branch is exercised by the supervisor of the member state, in which the branch is operating (host supervision),
- supervisors of individual member states are obliged to cooperate and exchange information for the exercise of supervision.

2. A bank based in an EU member state (a so-called foreign parent company) has a subsidiary – bank in another member state:

- exercise of supervision of the parent company on an individual basis is exercised by the supervisor of the member state, in which the parent company has its residence, and supervision of the subsidiaries is exercised by the supervisors of those member states, in which the subsidiaries have their residence,
- consolidated supervision is exercised by the supervisor, in which the foreign parent company has its residence (home supervision),
- the supervisors of involved member states are obliged to cooperate and exchange information needed for the exercise of supervision,
- the supervisor responsible for the exercise of consolidated supervision should ensure planning and coordination of activities of supervisors of other member states responsible for

the supervision of subsidiaries (host supervision).

In 2006, the Committee of European Banking Supervisors (CEBS) issued a Guideline for the co-operation between consolidating supervisors (home supervision) and host supervisors¹, as a more detailed framework for the cooperation of supervisions according to the articles 129, 131 and 132 of the CRD. The CEBS has been actively promoting the creation of colleges of supervisors for all cross-border banking groups in the EU since 2006. In this connection, the CEBS has prepared several documents, three of which have been published so far:

- Colleges of Supervisors – 10 Common Principles (published on 27 January 2009)¹
- Template for a Multilateral Cooperation and Coordination Agreement on the Supervision of XY Group (published on 27 January 2009)¹
- Good Practices for the Functioning of Colleges of Supervisors for Cross-border Banking Groups (published on 2 April 2009).¹

According to these documents, the main objective of colleges of supervisors is:

- to assist in the exchange of information, opinions and evaluations between supervisors in order to achieve a more efficient and effective exercise of supervision both on a consolidated and on an individual basis and timely response of the supervisors
- to enable supervisors to reach a common understanding of the risk profile of the given banking group as a basis for risk-based supervision both on a consolidated and on an individual basis.
- to achieve coordination of the process of supervision and evaluation of the risk profile, creation of supervision plans, the ensuring of a division of supervisory tasks and joint examinations to avoid duplication of the work of supervisors and thereby reduce the burden on the supervised entity.
- to coordinate the decisions adopted by the individual supervisors, and efforts to achieve a consensus in decisions.

The composition of a college of supervisors depends on the structure of the individual banking



groups, but the basis of a college should always be constituted by home supervisor and those host supervisions, in which country the banking group is doing business as a subsidiary. In the case of pursuing business by means of a branch in another member state an invitation to the college depends on the size and systemic importance of the branch in the respective member state. European banking groups also pursue business in countries, which are not EU member states. In the case of such countries, an invitation to a college primarily depends on home supervisor, but also on the interest of the supervisor of the non-member state in cooperation and exchange of information on the respective bank.

Depending on the character of the banking group, a college of supervisors can be active at one or two levels. In the case of a one-level structure, the college is a general college, in which all relevant supervisors cooperate equally. In the case of a two-level structure, a so-called core college is created in addition to the general college; part of the core college are supervisors responsible for the supervision of a substantial part of the banking group, so that their closer and more frequent cooperation is necessary.

As part of the implementation of the new banking directive CRD by individual member states, as early as in 2006 and 2007 the aim of the first meetings of regulators was the gradual building up of an efficient structure for the exchange of information. Full cooperation of supervisors in colleges started in 2008, when multilateral meetings of supervisors of most banking groups active in the EU were organized.

COLLEGES OF SUPERVISORS FOR BANKS ACTIVE IN SLOVAKIA

As at 1 August 2009, 15 banks and 10 foreign bank branches pursued business in Slovakia. Out of these banks, for 10 banks and 10 foreign bank branches NBS supervision is in the position of a host supervisor, the NBS having full responsibility for supervision on an individual basis in the case of supervision of the banks and responsibility for liquidity supervision in the case of supervision of the foreign bank branches.

NBS supervision works actively in eleven colleges of supervisors, of which 9 are for banks based in Slovakia and 2 for foreign bank branches.

Activities of the existing colleges of supervisors and requirements of home supervisors on providing information recently started to influence the exercise of supervision and brought new tasks for NSB as supervisor.

The main topics of meetings of colleges of supervisors in 2008 and 2009 were:

- Mutual exchange of information between regulators concerning the respective banking group (also in the context of the financial crisis).
- The results of the evaluation of the risk profile of individual entities, as well as the whole banking group (so-called risk assessment).

- The methodology and approach of the banking group in Pillar 2 (the ICAAP – Internal Capital Adequacy Assessment Process).
- Requirements of home supervisor on reports and other information, particularly for evaluation according to Pillar 2 (SREP – Supervisory Review and Evaluation Process).
- Exchange of information and reaching a common decision for the approval of regulatory models for the calculation of capital requirements (IRB, AMA).
- The text of a written cooperation agreement between supervisors for the respective banking group.
- Coordination of supervision plans.

Within the setting up of the structures of the colleges, it was important to put through that our significant and systemically important banks were included in basic structures of the colleges (core college). In our case, these are not only large banks, but also medium-size banks, in which the percentage of protected deposits is significant. It was also important that significant foreign bank branches be included in general structures of the college (general college).

For each banking group, for which a college of supervisors was created, written cooperation agreements will be signed in 2009. The agreements will enable us to learn confidential information on the group, but they will also oblige us to engage in close cooperation with the regulator responsible for consolidating supervision.

Work in the colleges means at least the following list of activities for NBS supervision:

- Regular and irregular information providing for home supervisor, particularly:
 - annual risk profile evaluation,
 - annual ICAAP evaluation,
 - providing of information on the results of examinations,
 - specific information and reports according to requirements of home supervision.
- Regular meetings of colleges of supervisors (frequency 1 to 4 times a year).
- Joint SREP (supervisory review and evaluation process) evaluation of the banking group.
- Participation in joint on-site inspections in the parent company in the case of invitation.
- Organization of common on-site-supervisions in the case of a request of home supervision or based on a decision of NBS supervision.
- Cooperation within validation of regulatory models for the calculation of capital requirements.
- Cooperation in crisis situations.

CONCLUSION

The activity of colleges of supervisors becomes an active part of the work of NBS supervision, it helps to recognize systemic risks of the group more easily and it is indispensable primarily because all our systematically important banks belong to cross-border banking groups in the EU.

The first experience from meetings of supervisors have shown their undisputed usefulness



and have brought closer together supervisory approaches, and have brought about a better exchange of information as well as more trust between the supervisors. Meetings of colleges and joint supervisions also lead to common exchange of professional knowledge of supervision employees, which helps to increase the quality of their work.

Information acquired in the colleges has enabled a better assessment of the risk profile of banking groups active in our territory and a subsequent response using adequate supervisory activities, potentially by means of a suitable adaptation of regulation in our financial market.

EUROPEAN
CENTRAL
BANK



International cooperation in financial market supervision

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Bilateral agreements between supervisors of individual countries, the so called Memoranda of Understanding, are a precondition for effective banking supervision of foreign banks branches, their subsidiaries and their cross-border facilities. The agreement on mutual cooperation expresses the will and willingness of supervisors to cooperate on basis of mutual confidence and understanding in the area of banking supervision within one's jurisdiction. These agreements enable a purposeful, effective and proactive exchange of information needed for proper supervision based on willingness, confidence and reciprocity.

Cooperation by virtue of these agreements gained importance particularly in the area of supervision on a consolidated basis, where indispensable information exchange and working meetings of employees of supervisors are parts of supervision. The entering into such agreements also results from the Core Principles for Effective Banking Supervision issued by the Basel Committee on Banking Supervision at the BIS (Bank for International Settlements), more exactly from principles 23 through 25, which relate to cross-border banking and determine the duties of home and host banking supervision. The basic elements of the agreement on cooperation between banking supervisors were set by the Basel Committee on Banking Supervision in 2001, yet they leave enough leeway for own solutions and variations depending on the jurisdiction of the counterparties.

The need to establish mutual cooperation with foreign supervisors in the field of banking supervision has resulted also from the shareholder structure of banking entities that pursue business in the territory of Slovakia.

COOPERATION AND FIRST AGREEMENTS

The National Bank of Slovakia started to prepare the first agreements in 2002 in line with a modification of the strategy for banking supervision development putting greater emphasis on international cooperation. During two years, agreements on cooperation in supervision have been signed with the Bundesaufsichtsamt für das Kreditwesen, Germany, The Hungarian Financial Supervision Authority, Hungary, Česká národní banka, Banca d'Italia, Italy, Commission Bancaire, France, De Nederlandsche Bank, the Netherlands, the Central Bank of Cyprus, the Malta Financial Services Authority, Malta, the Federal Ministry of Finance and Austrian Financial Market Authority, Austria. Some of them were signed from the perspective of the possible future path of the development

the banking sector, other agreements were initiated by the entry of capital into the Slovak banking sector, for example the entry of Italian capital by means of the UniCredito Italiano and Intesa BCI groups.

Another form of cooperation is cooperation with the American supervisor Office of the Comptroller of the Currency. The Office of the Comptroller of the Currency has proposed cooperation by means of a letter of understanding, in which both parties pledged to mutual cooperation and information exchange.

Since 1 January 2006, when supervisors of the Slovak financial market were integrated, the NBS took over all obligations resulting from international agreements concluded by the former Financial Market Authority. As regards securities market supervision, these were agreements of understanding entered into with the Hellenic Capital Market Authority, Greece, Commission de Surveillance du Secteur Financier, Luxembourg, Bundesanstalt für Finanzdienstleistungsaufsicht, Germany, Commissione Nazionale per le Società e la Borsa, Italy, as well as with the Securities Market Commission, Portugal. In the area of insurance, cooperation with the Swiss Federal Office of Privat Insurance, Switzerland has been taken up again.

Agreements on mutual cooperation with the Central Bank of the Russian Federation and the Federal Service for Financial Markets of the Russian Federation are currently being prepared. Due to the declared interest of two Russian banks to set up a branch or subsidiary in Slovakia, a framework for mutual communication and information exchange with the supervisor of Russia had to be prepared. The Federal Service for Financial Markets of the Russian Federation has expressed interest in cooperation with the National bank of Slovakia in financial market supervision. Both of the agreements under preparation are at the stage of exchange of the last comments of both



parties. Moreover, a new, updated version of a the cooperation agreement with the supervisor of Mata is being prepared these days.

MULTILATERAL MEMORANDA OF UNDERSTANDING

Apart from bilateral agreements of understanding in the field of banking supervision, the National bank of Slovakia has signed the multilateral Memorandum of Understanding on cooperation between financial supervisors, central banks and ministries of finance within the European Union in the situation of a financial crisis. This agreement, signed in 2005 and amended in 2008, sets the fundamental principles and procedures of cross-border cooperation in a crisis situation. The Memorandum of Understanding on the principles of high-level cooperation in crisis management situations between banking supervisors and central banks of the European Union is similar. It sets the principles and procedures set by the authorities responsible for crisis management, information flows between participating authorities and the practical conditions of cross-border level information exchange. This Memorandum was signed in 2004. In the same year, a Memorandum of Understanding between payment system supervisors and banking supervisors at the third stage of the Economic and Monetary Union was signed; its aim is to ensure soundness and stability of payment systems. Due to these multilateral memoranda of understanding, the need of bilateral agreements within European Union countries decreases, but their importance increases when establishing cooperation with third countries.

In terms of supervision of securities dealers, the National bank of Slovakia as an IOSCO member (International Organization of Securities Commissions) has signed a multilateral memorandum of understanding related on cooperation and information exchange. It has also become a signatory of a multilateral Memorandum of Understanding on cooperation, information exchange and supervision of activities in the area of securities signed by member institutions of the CESR (The Committee of European Securities Regulators). This Memorandum has created the basic framework for cooperation of supervisors in the fulfillment of their supervisory functions in the area of investment activities and services provided by branches in the territory of another European Union member. Its supplementary Protocol on the supervision of branches under the Directive of the European Parliament and Council of financial instrument markets enables the two basic models of cooperation between two or more competent supervisors – in the form of a **Common Oversight Request** or a **Standing Request for Assistance**. The Common Request is a model based upon common and coordinated supervision; the **Standing Request for Assistance** is a model, in which the competent supervisor asks another competent supervisor for assistance in supervision. The National Bank of Slovakia cooperates with Česká národní banka, Czech Republic, the Bundesanstalt für das Finanzdienstleistungsaufsicht, Germany and the Financial Market Authority, United Kingdom of Great Britain and Southern Ireland by means of a Standing Request for Assistance.

The new system of financial market supervision and regulation according to the de Larosière Group.



The new system of financial market supervision and regulation according to the de Larosière Group

Financial Market Supervision Unit
National Bank of Slovakia

Selected and partially updated parts of the document Opinion of the National Bank of Slovakia on proposals for a new architecture of the supervision and regulation of financial institutions based on recommendations of the de Larosière Group, which was discussed and noted by the Bank Board of the National Bank of Slovakia on 25 May 2009.

On 25 February 2009, the expert group "de Larosière Group" submitted the report *On Financial Supervision in the EU* to the European Commission. The aim of the report was to propose an expert view of the system of functioning of processes on financial markets and to eliminate shortcomings of the regulatory system as perceived by them. Recommendations of the de Larosière Group report initiated a process of assessment and evaluation of the system of functioning of regulation and supervision of the financial market.

Discussions take place at the level of 3L3 committees (3L3 committees are third level committees of the so-called Lamfalussy process, = CEBS – Committee of European Banking Supervisors, CESR – Committee of European Securities Regulators and CEIOPS – Committee of European Insurance and Occupational Pensions Supervisors) within financial committees of the European Commission as well as within the European Central Bank. At the same time, a public consultation, organized by the European Commission, has taken place under accelerated proceedings. European Commission's aim has been to present a new architecture concept of European supervision and regulation of financial institutions, the so-called *European financial supervision package*. The June meeting of the European Council, preceded by an ECONFIN meeting, dealt with the new conception.

One of the main objectives of the de Larosière Group was to propose a possible model of supervision of European financial institutions and markets with the aim of ensuring their proper and sound functioning. The areas contained in the report are worked up at the national, European and global level.

In addition to recommendations on a new arrangement of the functioning of supervision in the European Union, the Report also contains technological recommendations aimed at changes in the regulation of individual financial market sectors.

Many recommendations can be considered useful, if they are implemented in a way that ensures stability of financial markets in the European context, but has no negative impact on the stability of regulated entities and the financial market in Slovakia.

At the same time, it has to be stated that due to the need to cope with the financial crisis and the relatively short period of time during which the Lamfalussy framework for regulation has been used, it has not been possible for its full efficiency to manifest itself and in our opinion the quickly proposed new solution might not meet expectations.

INTRODUCTION

On 25 February 2009, the European Commission published the report *On Financial Supervision in the EU* (the Report), which had been drawn up by a group chaired by Jacques de Larosière¹ upon a mandate granted by the European Commission. One of the main objectives of this initiative was to designate a possible model for the exercise of supervision of European financial institutions and markets to ensure their proper and sound functioning. Areas contained in the Report are worked up at the national, European and global level.

On 4 March 2009, the European Commission (hereinafter referred to as the Commission) published its opinion to the Report together with the annex "Communication for the spring European Council-Driving European recovery"² (opinion of the European Commission). This opinion of the European Commission implies its aim to present a European financial supervision package, which should help to eliminate shortcomings of the current regulatory framework in the European Union and to increase the quality of the exercise of supervision of European financial institutions and markets. In this connection, the European Commission published an invitation for public consultation³ on 10 March 2009; within the con-

- 1 http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf
- 2 http://ec.europa.eu/commission_barroso/president/pdf/press_20090304_annx_en.pdf
- 3 http://ec.europa.eu/internal_market/finances/committees/index_en.htm



4 <http://www.cesr.eu/popup2.php?id=5709>

5 *Analysis of the Slovak financial sector in 2008, Table A.2.1, p. 103*
– http://www.nbs.sk/_img/Documents/_Dohlád/ORM/Analýzy/analyza_2008_4.pdf

sultation interested entities had the opportunity to express their opinion on the conclusions published in the Report and opinions of the European Commission.

The invitation was responded to by the CEBS, CESR and CEIOPS committees (3L3 committees) by a common opinion published on 23 April 2009⁴. In general, it can be stated that the 3L3 committees welcome the initiative, by which a system of macro-prudential supervision would be created and the position of national supervisors at the micro-prudential level would be strengthened. At the same time, the opinion of the 3L3 committees is well-disposed to the issues of establishing an obligatory mediation mechanism and to the issues of adopting obligatory decisions and documents for the exercise of supervision. In their opinion, the introduction of such mechanisms will also represent a challenge for their implementation.

On 23 March 2009, the report *Consideration of the Report by the de Larosière Group – FSC Note with a view to preliminary assessment by the Council of the European Commission's Financial Services Committee* was drawn up. It summarized preliminary evaluations of recommendations of the Report. The Report was designed to serve as a source document for meetings of the European Commission's Economic and Financial Committee. It results from the document that there is general support among the member states particularly regarding the issues of macro-prudential supervision and strengthening the position of national supervisors at the micro-prudential level. There is currently no common opinion of the member states regarding the issues of transformation of the current 3L3 committees to authorities (probably European agencies) of the European Union.

On 31 March 2009, the Economic and Financial Committee document entitled *Draft Issues note for Ministers and Governors on the proposals related to supervision of the de Larosière Group* was worked out; it was supposed to serve as a source document for an informal meeting of the ECOFIN (3 April and 4 April 2009 in Prague). The document is a brief proposal for a Financial Services Committee report, in which questions for the ministers of finance and central bank governors of the member states were supposed to channel the discussion at the informal ECOFIN meeting. The NBS received a report from that Economic and Financial Committee (EFC) meeting – by means of the Ministry of Finance of the Slovak Republic.

Based on the above mentioned initiatives, the European Commission planned to present the above mentioned "European financial supervision package" in May 2009, which is supposed to be subject to discussion at the June meeting of the European Council, which should be preceded by an ECOFIN meeting.

The European Central Bank (ECB) also actively deals with the recommendations of the Report.

The objective of the European Commission is to publish, in the fall of this year, proposals for

particular pieces of legislation, by which the new architecture concept of European supervision and financial institutions regulation should be adopted.

OPINION OF THE NBS

As to the proposals for the supervision and regulation of financial institutions based on recommendations of the de Larosière Group report, the NBS appreciates the initiative of the European Commission to pay appropriate attention to the issues of the impact of the current global financial crisis on the economy in the member states.

I. GENERAL PART

One of the basic starting points that have to be taken into account when analyzing the impacts of the de Larosière Group report on future European architecture of supervision and regulation is the specificity of the ownership structure of banks and insurance companies in Slovakia. The share of owners based in Slovakia in the share capital of bank is 6.69% and of insurance companies 8.16%⁵. This implies that Slovakia is predominantly a host member state and the powers of the National Bank of Slovakia as the supervisor and regulator of regulated financial institutions corresponds to this fact.

As a result of the financial crisis, whose main origin cannot be identified in the European continent, but whose consequences have adversely affected all economies of the world, the European Commission has launched an initiative, the aim of which is to reinforce financial stability within European Community member states.

The aim of reinforcing general financial stability within European Community member states, which is supposed to be reached by implementing recommendations set out in the Report, should not be based on principles that would prefer general financial stability within the European Community to financial stability of its member states.

Despite significant integration shifts in the area of regulation and supervision of the regulated entities of the financial market, the integration efforts have not led to the creation of a single financial market. The historical development of the legal systems of the member states and within them of specific legal institutes, language barriers and a low percentage of natural person mobility within the space of the common internal market cause the clients of regulated financial institutions to use financial services particularly in their member states. These factors also imply the need to ensure such an extent of authorization for national regulators that they can actively contribute to maintaining the stability of financial markets of the member states, which will contribute positively to general financial stability within the European Community.

A proposal for the future architecture of supervision and regulation of financial market participants, which would leave a major part of respon-



sibility for contributing to and ensuring financial stability to the national supervisors without the corresponding powers could directly negate these efforts.

1.1 The regulatory framework

Central to the proposed measures is the distinction between the exercise of macro-prudential supervision and micro-prudential supervision, and the related competences of the national regulators and supervisors and the proposed European system of financial supervision. Although the NBS supports, in general, a distinction between macro-prudential supervision and micro-prudential supervision, we point out that in practice such a distinction can lead to problems of overlapping competences, both between national regulators and supervisors and between national and European regulators and supervisors. Therefore it will be necessary that within the setting up of new structures in setting the regulatory framework:

- a) the competences of (current and newly created) authorized authorities be clearly specified with a clear allocation of their responsibility to the exercise of their powers,
- b) within the division of competences at the micro-prudential and macro-prudential level in favor of the authorized authorities, no situation arises, in which no authority is responsible for a certain area.

It has to be pointed out that the aim of the new initiatives of the European Commission is to reach so-called full harmonization in the area of financial institutions regulation, i.e. the member states will be allowed to a minimal extent only that their own financial market regulation deviates from European financial market regulation and national financial market laws will only reflect the adopted text of community law.

The system of full harmonization enables the member states to adopt more strict measures in a particular area of regulation only to a very limited extent – only depending on the extent of authorizing provisions expressed in the legally binding text of a particular legal act of European law.

1.2 The supervision system

The main reasons why recommendations expressed in the Report can be seen as positive:

- the creation of a new system of macro-prudential supervision, whose main aim is to collect and evaluate macroeconomic data in order to point to the existence and impact of systemic risks on the financial stability of member states of the European Community,
- the ensuring of higher coordination and cooperation between individual supervisors of the member states. At the same time it has to be stated that the existing directive in the area of financial regulation regulate the duty of mutual cooperation between national supervisors and there are no mechanisms to ensure its practical application.

In terms of Slovakia's interests, it is important that the future system of supervision in the EU does not weaken the powers of the NBS in the exercise of supervision, ensures independence and all necessary instruments for ensuring financial stability to the NBS, which is a precondition for the protection of clients of regulated entities on the financial market, because without adequate instruments and powers the NBS will not be able to fulfill this task properly (see also Resolution of the Government of the Slovak Republic No. 758 of 22 October 2008).

As for the adoption of measures in the area of supervision, we also consider it necessary that the possibility to adopt more strict measures be kept, under the condition that objective facts justify such a procedure due to protection of the stability of the national financial sector (e.g. measures in the area of liquidity, capital adequacy, etc.).

Some proposals of the Report can be considered positive, if they are implemented in a way that ensures financial market stability in the European context, but they will have no negative impact on the stability of regulated entities and of the financial market in Slovakia.

The idea of establishing a college for supranational institutions as a means of improving the information flow and of ensuring coordination between national supervisors has our support. In regard to the functioning of the colleges at supranational regulated entities, it will be necessary to resolve the issue of the legally binding effect of opinions and recommendations of colleges with respect to activities of national supervisors. In our opinion, opinions of the colleges can be of non-binding nature only and they cannot legally bind the acts of national supervision institutions, because only these institutions are responsible for the fulfillment of the tasks.

II. SPECIAL PART

The subject-matter of the special part is not a detailed analysis of the individual recommendations of the Report. The aim is to point out some topics contained in the recommendations that will require enhanced attention on the part of the Slovak Republic during discussion about the proposals, by which recommendations of the Report are supposed to be implemented, taking into account the opinions expressed in the European Commission's working document European financial supervision of 15 May 2009.

II.1 The supervision system – European System of Financial Supervision

Within the system of supervision and regulation, the recommendations of the Report issue from the above mentioned distinction between a macro-prudential and a micro-prudential supervision level.

For the micro-prudential supervision level, the Report proposes to create a European System of Financial Supervision (ESFS), by transforming the current 3L3 committees to European authorities

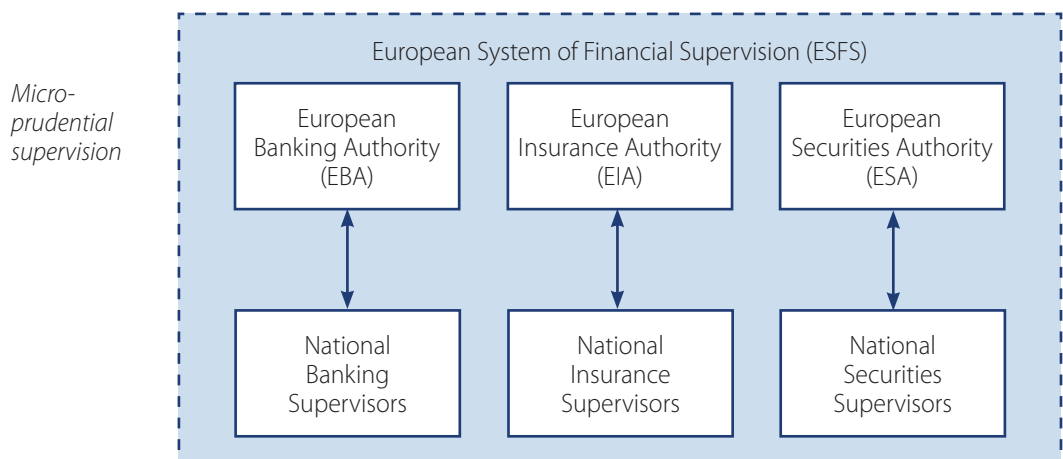


with legal personality – the *European Banking Authority*, *European Insurance Authority*, and the *European Securities Authority* (European Supervisory Authorities). The main area of competences, which are proposed in the Report, is shown in Diagram 1.

According to the European Commission working document European financial supervision of 15 May 2009, the aim of the proposed structure is supposed to be as follows:

- a) to reach greater harmonization of the rules applied to national supervisors – European Supervisory Authorities are supposed to have the power
 - to create binding technical standards specified in the legislation of the European Communities (e.g. supervisory standards for colleges of supervisors, standards for internal model validation), which will be issued by means of the Commission;
 - to draw up binding interpretative guidelines, which the supervisors of member states are supposed to apply in taking individual decisions in the pursuit of their activities.
- b) to ensure consistent application of EU rules – the proposed European Supervisory Authorities are supposed to
 - have, in specified cases, the funds to ensure consistent application of legal acts of the European Community;
 - resolve conflicts of opinion between national regulators in the form of a mediation mechanism, in which – if there is no settlement regarding the disputed issue – the European Supervisory Authority having sectoral responsibility will have the power to issue a binding decision;
 - have the power to examine the legality of procedures of national supervisors based on instigations of other national supervisors or the European Commission and to adopt a recommendation for the national regulator. If national regulators do not comply with
- instructions of the European Supervisory Authorities, is supposed to be involved in the processed; the Commission can commence proceedings against the member state due to violation of European legislation (infringement proceeding). In urgent cases, the European Supervisory Authorities are also supposed to have the power to adopt decisions, which will be directly binding upon financial institutions of the member states;
- c) to ensure a common supervisory culture and consistent supervisory practices – common training programmes, promotion of delegation of task and responsibility from one national supervisor to another national supervisor;
- d) to give the European Supervisory Authorities the exclusive power to exercise supervision of specific financial market entities – for example rating agencies and counterparty clearing houses. At the same, it is allowed that the European Supervisory Authorities take part in the assessment of the processes of mergers of financial institutions and acquisitions of capital participations in financial institutions;
- e) to ensure coordinated response in crisis situations – the European Supervisory Authorities are supposed to have a coordinating role in crisis situations and to help the national supervisors to prepare and implement decisions that are correct from their point of view; in extraordinary situations, European Supervisory Authorities are supposed to have the power to adopt emergency decisions (e.g. to prevent **short selling**) – the scope of the power to adopt emergency decisions is supposed to be defined in community legislation;
- f) to collect micro-prudential data – the European Supervisory Authorities are supposed to be responsible for:
 - aggregating micro-prudential data emanating from national supervisors;
 - establishing and managing a centralized database;

Diagram 1 European System of Financial Supervision (ESFS)



Source: The High-Level Group on Financial Supervision in the EU, Chaired by Jacques de Larosière, Report, Brussels, 25 February 2009.



- the aggregate data is supposed to be available for colleges composed of the respective national supervisors and may be provided in both an aggregated and non-aggregated form, while maintaining anonymity, to the European Systemic Risk Council (see item II.2 of this document);
- g) to represent at the international level – European Supervisory Authorities will be allowed to enter into international agreements of technical nature with international organizations and executive authorities of third countries corresponding to European Supervisory Authorities in terms of their status. At the same time, European Supervisory Authorities should assist the European Commission in adopting decisions related to equivalence of legal norms in the area of supervision.

The European Commission proposes the following solution to the issue of the organizational structure of European bodies:

The European Commission proposes to keep the sectoral breakdown in the structure of the exercise of supervision, which is also reflected in the proposal to transform 3L3 committees to 3 separate European Supervisory Authorities.

To ensure mutual understanding, cooperation and a consistent approach to supervisory issues the *Steering Committee* is supposed to form a part of the structure of European Supervisory Authorities. To fulfill the mission of the Steering Committee, which is supposed to be the overcoming of unjustified intersectoral differences, it would be appropriate to provide the Steering Committee with the necessary instruments, so that it is not only a formal body without the possibility to influence the reaching of tasks assigned to it. For this reason, we would welcome a more detailed specification of the institutional framework of the proposed Steering Committee. The method of election of representatives of individual European Supervisory Authorities and the way of the functioning of the Steering Committee are not obvious from the document of the European Commission.

At the same time, the European Commission proposes that each of the European Supervisory Authorities be allowed to participate in meetings of the remaining European Supervisory Authorities as an observer.

Each European Supervisory Authority is supposed to establish a Board of Supervisors, which is supposed to be composed of senior representatives of national supervisors. The Board of Supervisors is supposed to be chaired by the chairperson of the appropriate European Supervisory Authority. Representatives of the European Commission, the European Systemic Risk Council (ESRC, see item II.2 of this document), the competent supervisors from member states of the European Free Trade Association (EFTA) and the competent supervisors from member states of the European Economic Area (EEA) are supposed to participate

in the meetings of the Supervisory Council with an observer status. The observers should not have the possibility to participate in meetings of the Council for Supervision related to individual supervised entities. Decisions of the Board of Supervisors related to technical rules are proposed to be adopted by qualified majority and the votes of the individual member states have to be weighted in accordance with the Treaty. The proposal of the European Commission does not specify the mechanism of vote weighting and does not refer to the voting mechanism regulated in some of the founding treaties. Decisions related to the application of existing European legislation are supposed to be adopted by simple majority, using the “one person – one vote” principle.

In addition to the Council for Supervision, each European Supervisory authority is supposed to establish a Management Board, whose task would be to ensure the operating tasks. The Management Board would be composed of representatives of national supervisors and of the European Commission. The board is supposed to be chaired by a chairperson, whose nomination is supposed to be preceded by a competitive hiring procedure and he should be an independent expert. The election of the Management Board chairperson should be confirmed by the European Parliament and the chairperson's term of office should be 5 years. The European Commission document does not specify the composition of and nomination to the Management Board, who will propose persons for the position of the chairperson of the European Supervisory Authorities Management Board, who will carry out the competitive hiring procedure for the Management Board chairperson, how decision related to the functioning of a European Supervisory Authority and of the selection of the Management Board chairperson will be adopted, what criteria will be decisive for his election, what role will be played by the European Commission in this process.

As regards the preparation of budgets of the European Supervisory Authorities, the European Commission's proposal is not unambiguous. The budget of European Supervisory Authorities is supposed to be composed of contributions from the budget of the European Union, as well as contributions of national supervisors and/or contributions of supervised entities. The budget of European Supervisory Authorities is supposed to be separated from the budget of the European Union.

European Supervisory Authorities should keep the highest independence possible and should be accountable to political bodies – the Council, the European Parliament and the European Commission.

Recommendations of the Report related to the ESFS, as well as the said working document of the European Commission, give rise to the following questions:

- the extent of the degree of responsibility regarding the assigned powers at the European



Supervisory Authorities, which are supposed to be newly created, has not been set. In this context, there is obvious asymmetry between the powers of European Supervisory Authorities to determine the activities and the regulatory framework of national supervisions and the full responsibility of national supervisors for supervision and for ensuring financial stability at the national level,

- the extent of independence of national regulators and supervisors in their activities and the degree of restriction of independence by means of decisions by the European Supervisory Authorities and the mediation mechanism, whose result will be binding on national supervisors,
- the extent of independence of the European Supervisory Authorities from political bodies – the Council, the European Commission and the European Parliament, as well as from entities, which will set up the budget of these bodies,
- the scope of powers, which are supposed to be transferred to the newly created European Supervisory Authorities. In our opinion, the competences that they should gain require detailed analyses (for example of the legally binding effect of mediation between national supervisors versus independence),
- the definition of the micro-prudential and macro-prudential regulation and supervision of supranational regulated entities,
- the settings of the voting mechanism and adoption of legally binding documents and decisions (the veto privilege, the weight of the votes of individual members of authorities, qualified majorities etc.),
- the possibility to apply more strict measures by the national regulator and supervisor (the Report contradicts itself in part in this point – e.g. when comparing recommendation 10 and 20, even though recommendation 10 has to be interpreted with respect to requirements on the internal market)
- regarding the vesting of the transformed 3L3 committees with competences, the Report has not taken into account the existing legal issues of feasibility of the recommendation contained

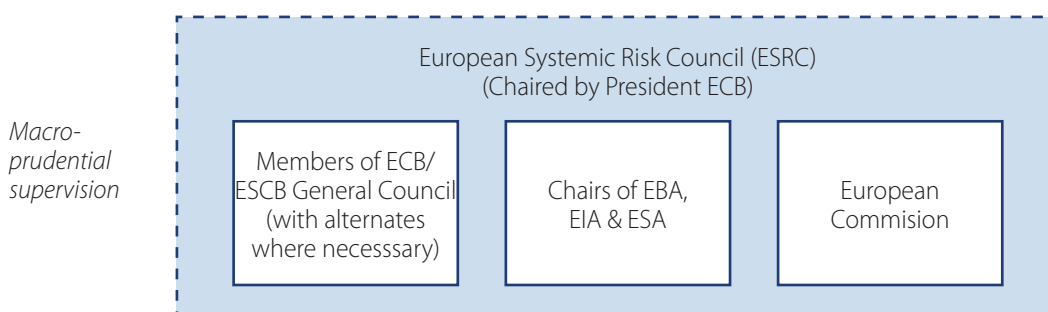
therein, therefore as an introduction to the discussion it is first necessary to perform extensive legal analyses, because in our opinion they can demonstrate the need of changes of the EC Treaty or of the Treaty of Lisbon, if it becomes valid and effective. In this connection, we perceive the following proposed powers of European Supervisory Authorities as extraordinarily problematic:

- the power to interpret legally binding acts of Community Law in the area of regulation of financial market entities. Not even the European Commission itself is currently authorized to provide legal interpretations of legal acts, but only to publish its opinion about the application of legal acts, because is the only body having the power to interpret binding legal norms of Community law is the European Court of Justice.
- the power to adopt legally binding decisions, despite the fact that these decisions will be subject to examination by the European Court of Justice. In this connection, in discussions of legal acts that should enable such a power, we consider it necessary to define clearly the responsibility of European Supervisory Authorities for the harm caused by maladministration or by an illegal decision.
- we are of the opinion that discussions of the proposed extent cannot be carried out within the currently proposed short period of time, if they are supposed to serve as the basis for the adoption of qualified decisions.

II.1.1 Proposed opinions of the supervision unit on the European System of Financial Supervision

1. The NBS has carefully analyzed the presented proposals related to a new architecture of micro-prudential supervision in the European Union. Integration of financial markets entails tasks, whose solution requires a more effective cooperation between national supervisors. The structure of supervision architecture proposed by the European Commission could constitute a shift in the organization of supervision, provided the scope of rights and the corresponding duties are clearly defined and the scope of responsibilities of the

Diagram 2 European Systemic Risk Council



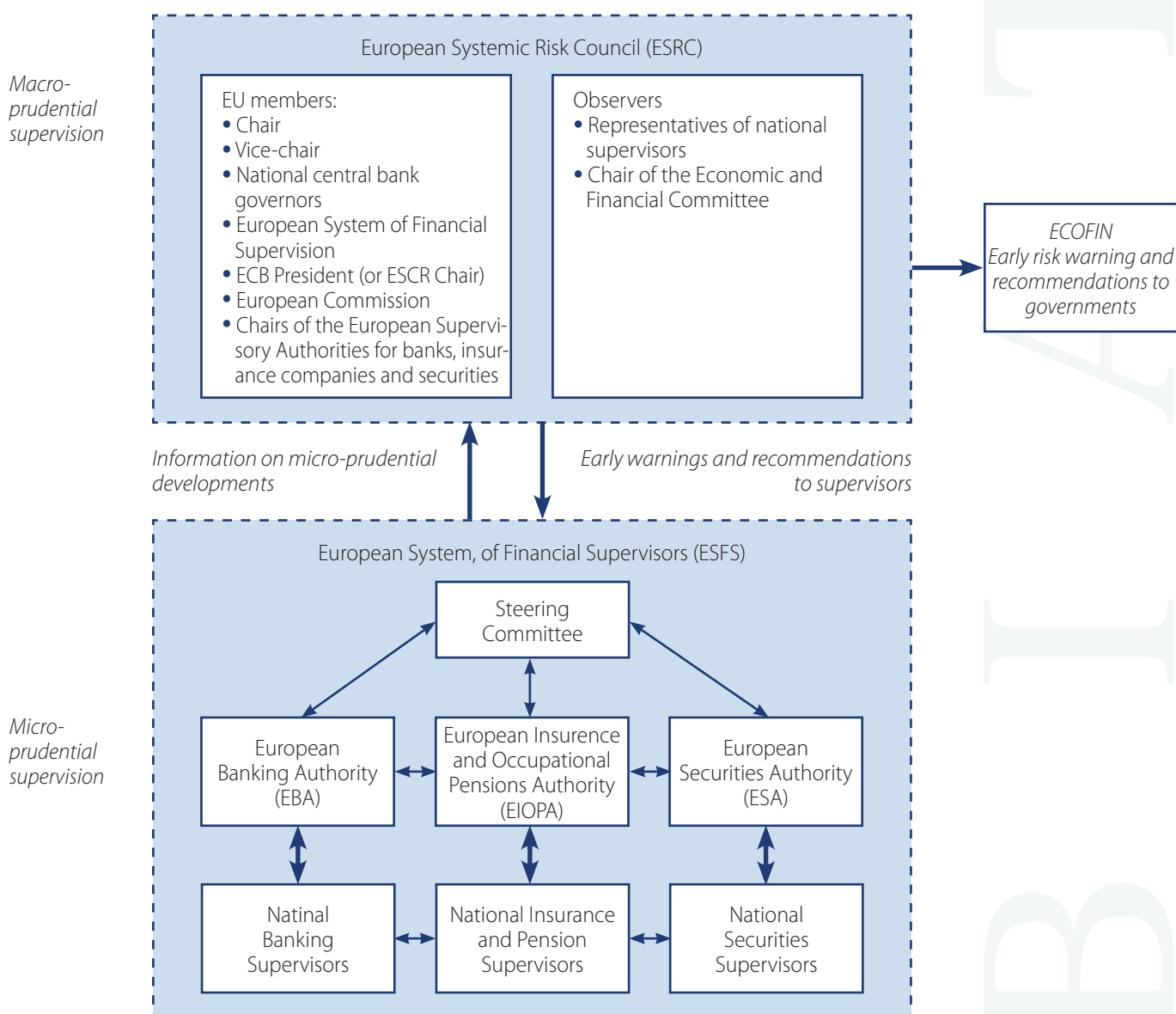
Source: The High-Level Group on Financial Supervision in the EU, Chaired by Jacques de Larosière, Report, Brussels, 25 February 2009.



authorities, which the European Commission proposes to create, is defined. For this purpose, it will be necessary to provide European Union member states with detailed answers to questions, some of which are outlined in part II.1 of this document. The working document of the European Commission also implies relatively weak efforts to get over the existing sectoral breakdown in the arrangement of supervision and regulation within the European Union, which means that it does not take into account the fact that there are strong cross-sectoral interconnections of activities and structures of financial institutions, especially financial conglomerates. For this reason, the NBS would welcome – if the changes in the architecture of supervision and regulation take place – that due attention be paid to the issue of interconnection of the exercise of supervision of individual financial market segments.

2. The Report, as well as the working document of the European Commission, recommend that the proposed European supervisory and regulatory authorities have the power to adopt weighty decisions in the case of disputes between national supervisors within the so-called mediation proceedings. In principle, the NBS does not rule out the application of such a mechanism. However, neither the Report nor the working document of the European Commission provide answers as to the legal basis for the adoption of the proposed mechanism. Despite the possibility to examine a legally binding decision adopted by a European Supervisory Authority within mediation proceedings at the European Court of Justice, the NBS is of the opinion that, due to the possible extent of the impact of such decisions on the functioning of the exercise of supervision and financial stability in the member states, enforceability of such deci-

Diagram 3 A new European framework for safeguarding financial stability



Source: Commission Services Working Document; European financial supervision, Brussels, 15 May 2009



sions must be postponed until the decision of the European Court of Justice becomes legally valid, if one of the parties to the dispute exercises its right to examine the decision issued in mediation proceedings by a European Supervisory Authority.

3. If European Supervisory Authorities are established in accordance with the European Commission Report, the NBS is of the opinion that, due to their fundamental impact on the exercise of activities of supervision, decisions should be adopted without weighting of votes, but with equal weights of the votes of representatives of the member states. The NBS considers this way of voting to be justified for the adoption of decisions on issues that are subject to mediation between national supervisors, as well as in the light of the possible weightiness of the impact of possible decisions, for which the European Commission Report proposes that the proposed European Supervisory Authorities be vested with in the area of adopting weighty technical rules in the area of regulation and supervision, which are supposed to set concrete activities of national supervisors.

4. In the field of harmonization deepening in the regulation of financial institutions, the NBS supports the preservation of the system of a needed and justified level of minimum harmonization and does not support the promotion of the principle of full harmonization or harmonization only in partial issues. The NBS considers it necessary to preserve the possibility of national options and discretions, which would enable the member states and their bodies, which are supposed to be responsible for ensuring financial stability, to adopt more strict measures as compared to those being to be the content of Community law, due to taking into account national specificities.

5. The NBS supports the reinforcement of the convergence of common supervisory culture.

II.2. European Systemic Risk Council

For macro-prudential supervision, the Report proposes the establishment of a so-called European Systemic Risk Council (ESRC) by a transformation of the current BSC (Banking Supervision Committee established within the ECB).

The proposed ESRC system should be responsible for the exercise of supervision of financial stability by performing supervision at the macro level. Within the fulfillment of its task, the ESRC should have the power to:

- collect and analyze all data relevant for assessing potential threats to financial stability that arise from macroeconomic developments and developments within the financial system as a whole;
- identify and designate such risks;
- issue non-binding warnings where risks are significant;
- give non-binding recommendations on measures in reaction to the risks identified and subsequently monitor the fulfillment of warnings and recommendations.

In fulfilling its tasks, the ESRC is supposed to cooperate actively with the IMF, the FSB and other relevant institutions.

Despite the fact that warnings and recommendations are not supposed to be of binding nature, their fulfillment is supposed to be subject to a subsequent checking mechanism, which should work under the "act or explain" principle. At the same time, the mechanism of exerting pressure by means of a flow of information on the proposed measures and their implementation through the ECOFIN. According to the proposal of the European Commission, the recommendations should be subject to publishing because of their non-binding effect to enhance their effectiveness. The ESRC is supposed to account to the Council and the European Parliament and this accountability is supposed to be performed in the form of issuing regular reports, at least twice a year.

The ESRC is supposed to be made up of central bank governors of EU member states. The central bank governors should be accompanied by a representative of the national supervisor, who would have observer status (the 1+1 principle). Further members of the ESRC should be the president of the ECB, the chairpersons of three European Supervisory Authorities and a member of the European Commission. The chairman of the Economic and Financial Committee (EFC) would participate in meetings as an observer, which would ensure the flow of information for finance ministers of the member states.

Decisions should be taken by a simple majority without using the mechanism of vote weighting and the voting right would be granted to the central bank governors of the member states, the chairpersons of the European Supervisory Authorities and a representative of the Commission.

Recommendations of the Report, related to the ESRC, as well as the above mentioned working document of the European Commission give rise to the following open question:

- neither the Report nor the Commission specify, what the financial stability, for which the ECB will be responsible, is supposed to mean, and what emphasis will be put on financial stability of the EU as a whole and what part is going to be played by financial stability of individual member states in this context,
- the unclear definition of the terms macro-prudential supervision and micro-prudential supervision can have a fundamental impact on the coordination of activities and the flow of information between the entities concerned,
- the way of participation of ESRC members in the adoption of recommendations and warnings as well as the possibility of ESRC members to influence the text of the recommendations and warnings, against which they will provide justified and pragmatic comments,
- the way of ensuring early implementation of ESRC recommendations and warnings,
- the form and way of publishing recommendations and warnings of the ESRC, as well as the



fact, whether such warnings and recommendations are supposed to be published,

- responsibility for the consequences of wrong opinions contained in recommendations and warnings, which can cause harm to the member states,
- the way of implementation of the act or explain mechanism,
- permissibility of political pressure in issues regarding preservation of financial stability by means of finance ministries of the member states on their regulators and central banks and conformity of these measures with the principle of independence of central banks,
- how and whether the scheme for the bearing of cost of a possible crisis or default (including the deposit protection fund scheme) should be adjusted

II.2.1. Proposed opinions on the ESRC

1. The NBS supports the creation of a system, which can – by its activities (analyses at the macro level) – contribute to an early identification of

global and European systemic risks, which can affect adversely financial stability of European Union member states and thereby help achieve the adoption of measures to go to pains to prevent instability on financial markets within European Union member states.

2. The NBS is of the opinion that the key role in such a system is supposed to be played by national central banks, which would actively contribute to the process of creating analyses at the macro level as well as in the formulation of recommendations and warnings, which should be adopted based on such analyses.

3. It will be beneficial to the success of the process of creating a system supposed to contribute to macro-prudential supervision, if the rights and obligations of the individual authorities in the process of preparations are clearly defined, the macro and micro level is defined and if, in the process of designing the institutional framework, the European Commission takes into account opinions formulated by the member states in this context.



Off-site supervision in the retirement pension saving market

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In the area of retirement pension saving, six pension fund management companies managing 18 pension funds and 4 banking entities performing depositary activity according to Act No. 43/2004 Coll. on Retirement Pension Saving are currently subject to off-site supervision.

Inspections of the meeting of the daily duty of pension fund management companies and pension fund depositories to inform the NBS of transactions made with property of pension funds and the state of property at pension funds are among the standardly performed off-site supervisory activities. Daily reports are the basic information source for off-site supervision. The riskiness of performed transactions and their influence on the riskiness of pension fund portfolios is then evaluated based on the daily reports.

VERIFYING THE CORRECTNESS OF FINANCIAL INSTRUMENT VALUATION

Off-site supervision emphasizes independent verification of the correctness of the valuation of financial instruments included in pension fund assets, and the conformity of the acquisition of financial instruments to become part of the assets of individual pension funds with provisions of the law. In addition to the daily reports, the Bloomberg and Reuters systems, information from the stock exchange and other information acquired in the supervision process are used to check the correctness of valuation. Subsequently, possible detected discrepancies are first consulted with the relevant pension fund management companies and if the situation requires it the company is then asked to take corrective measures.

A regular output of off-site supervision are quarterly reports, whose primary aim is the monitoring of market risk in pension funds, mainly their sensitivity to changes in interest rates, share prices and exchange rates based on the relative method of historical simulation for the calculation of the value at risk (VaR). The VaR is calculated both for the whole market risk (all types of market factors are taken into account simultaneously) and separately for the interest risk (only interest and discount rates are taken into account), the currency risk (only exchange rates are taken into account) and the share risk (only share prices are taken into account). When the calculation has been finished, the ratio of the calculated VaR values to the total

portfolio value is determined. The ratio represents the basis for market risk evaluation.

STRESS TESTING

An integral part of the report are the results of stress testing. The aim of stress testing is to draw attention to unexpected losses that could occur in the case of an extraordinary – but also in the case of a possible – development of market factors. Due to an intensification of the financial crisis during 2008, the standardly used set of stress scenarios was supplemented with new scenarios that take into account the existing situation, so that 15 stress scenarios are currently being used. Based on the obtained outputs, it is evaluated, in which scenarios the individual pension fund types incurred the greatest hypothetical losses, and the funds are compared as to the impact on their profitability.

THE EARLY WARNING SYSTEM

In the first half of 2007, the Supervisory Department internally developed the information system Pillar II Pension Limits System (IS ISDL2). The main objective of the system is to evaluate on a daily basis in an automated way whether pension funds are handling assets in accordance with the investment limits prescribed by law. The IS ISDL2 is an early warning system. It is capable of immediate signalization of a discrepancy in the investment of assets in pension funds and provides a basic analysis of the reason for failing to meet the investment limit. It is a sophisticated analytic instrument of the National Bank of Slovakia, which provides management outputs for the sector of retirement pension saving.

The IS ISDL2 informs of the distribution of pension fund investments by asset types, geographical breakdown and by monetary exposure. In addition, it identifies the 10 share, bond and money investments that are the most important ones in terms of volume.

It ensures the supervision of the meeting of the conditions of comparing the performance of



pension funds, set by the law, by means of automated monitoring and evaluation of all quantitative conditions.

In March 2008, when it was possible to determine the performance of pension funds for the first time, off-site supervision started to check the observance of these provisions of the law. Information on the average yield of pension funds and an average yield of market competition were regularly published on the NBS website. Since a law amendment abolished these provisions in July 2008, the data ceased to be published.

The IS SDL2 generates a daily overview of the value of all direct exposures of an issuer (or entities belonging to the group) against the sector, the pension funds group, the pension fund management company and the pension fund. It quantifies the amount of the consideration, to which the pension fund management company is entitled.

In connection with legislative changes effective from 7 July 2009, the IS SDL2 currently meets the requirements of the valid act in its provisions related to the setting up of a guarantee account and to the consideration for valorization of assets in the pension fund.

ON-SITE SUPERVISION

Off-site supervision has one more important role – to support on-site supervision during both the preparation process and the actual exercise of

supervision. This support consists mainly in the checking of the valuation of portfolios of the supervised entities. In this case, information requested within on-site supervision, particularly a more detailed description of the procedures of market valuation and theoretical valuation used by the supervised entity and data that extend the information contained in daily statements is also a source of necessary information. When controlling the valuation of financial instruments, the Bloomberg system is used as the primary source of the market prices of securities. The Reuters system is the main source of yield curve rates used in theoretical valuation of financial instruments. In the case of a check of the theoretical prices indicated in statements, off-site supervision focuses on the way of their calculation, which must be in line with the relevant legislation.

Off-site supervision participates regularly and actively in adjustments to and corrections of primary and secondary legislation in the area of pension saving.

The financial crisis had an impact on the pension saving market as well. Off-site supervision has monitored to a greater extent the adverse impact of events like the bankruptcy of Lehman Brothers, of banks on Island, as well as the developments in surrounding countries (particularly in Hungary and Poland) on the real rate of return of funds. At the same time, the amount of exposure to other companies marked as risky has been monitored.



New Community legislation on collective investment

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National Bank of Slovakia

During more than 20 years of the existence of collective investment, the UCITS IV directive has been only the second large alteration of Community legislation on collective investment. It is an extensive supplement to the existing regulation accompanied by a recodification of the original UCITS directive (85/611/EEC). Alterations of Community legislation on collective investment are not finished by the adoption of the new directive. The adoption of another directive – a directive on managers of alternative investment funds – is forthcoming.

7 The Directives 2001/107/EC and 2001/108/EC.

The original UCITS (*Undertakings for Collective Investment in Transferable Securities*) Directive was adopted as early as in 1985. Its aim was to create a single legal framework for the functioning of open-ended investment funds focusing on investments in transferable securities. This harmonized legal regulation enables to sell harmonized (UCITS) funds freely in the common internal market of the EU without the necessity to obtain a license in each member state. This feature differentiates UCITS funds from non-harmonized investment funds – the so-called non-UCITS funds.

THE NEW CONCEPT

The first attempts to alter the directive occurred already in the early 1990's, but lack of political unanimity among the member states caused these first initiatives, unofficially called UCITS II, to fail. That led to a later submission of two separate substitution proposals for an alteration of the UCITS directive – one part related to the fund manager, the second part to the legal regulation of the "product" – the actual UCITS fund. Two amending directives, known as UCITS III⁷, came to being. They were adopted in 2001 and were the first large alteration of Community legislation on collective investment. Extended possibilities for investing fund assets and a broader scope of the authorization for management companies are considered to be the greatest changes within UCITS III. They were supposed to be given the possibility – in addition to the possibility to provide some investment services – to also use a special type of a single European license (passport). For this reason, the UCITS distinguishes two types of a single European license – the first type is the Management Company Passport – relating to the activities and services of the management company, and the second type is the Product Passport – enabling the public offering (sale) of funds in other EU member states. In addition, the UCITS III directives have also introduced other changes

– for example basic rules for the activities of management companies or rules for the publishing of information on management companies. In this connection, the new concept of a so-called simplified prospectus was introduced. The concept's objective was to introduce a simple harmonized summary of basic information on the fund, based on which a usual investor could assess a planned investment.

During the existence of Community legislation, the UCITS funds have become a reputable world brand. UCITS are currently being sold in many countries outside the European Union (EU), particularly in Southeastern Asia. Community legislation has assisted in this expansion outside the EU, because for a UCITS fund there is a clear set of rules stipulating particularly:

- how these funds are to be managed,
- what the obligatory portfolio diversification is,
- and licensing procedures for foreign regulators have been simplified considerably.

SOME BARRIERS

Nevertheless, the UCITS III directives regulation is often considered a failure. Many of the ambitions of the 2001 directives have not materialized. The single EU market – the main objective of the Community legislation – still faces some barriers in the area of collective investment. There are various reasons, but the main reason is the actual nature of the UCITS directive – the concept of minimum harmonization, supplemented by national implementations in individual member states. This causes the fact that while regulation is similar in the member states, there are some important differences. As a result, regulatory arbitrage and possible discrepancies between the regulators of individual member states can arise. The work of the Committee of European Securities Regulators (CESR) is very important in this area; the committee has contributed to the unification of the interpretation and application of the UCITS directive over the last years. Another shortcoming of the



existing directive is the failure of some of its regulatory instruments – in some countries, product passport notification is still a quite lengthy procedure, the functioning of the passport for the management companies is considerably restrained and the simplified prospectus is a document as useful to the investors as expected.

The European Commission decided to respond to the shortcomings of the current legal regulation by preparing possible alterations to it. The first work started already in 2004⁸. The original objectives of the European Commission were published in a green paper⁹ and a white paper¹⁰ and there have been long and extensive discussions on both of them. Based on this, the expected amendments of the legal regulation by adding further parts focusing on the elimination of the remaining barriers on the single market resulted in the preparation of a legislative proposal of a recodification of the existing directive – the so-called UCITS IV directive. The draft of the new directive has been already approved and it should be published in the Official Journal of the EU soon. The deadline for its implementation in the legal system of the member states is mid-2011.

DRAFT OF THE NEW DIRECTIVE

In addition to taking over old parts, the new directive also contains new issues. Apart from the transformation of the simplified prospectus to a so-called Key Information Document, the new issues are in parts primarily focusing on the cross-border pursuit of business in the collective investment sector. The new directive will, for example, enable cross-border mergers of UCITS funds, irrespective of their legal form. Moreover, the product passport notification procedure will be simplified. At present, the UCITS fund itself or the management company managing it is the notification entity. The new notification procedure is supposed to take the form of communication between the home and the host supervisor. The two-month time limit for the assessment of notification documents will cease to exist as well. The check, which has been applied by the host regulator on an ex-ante basis, will have to be applied ex-post to a greater extent. Another new feature in the Slovak legal system resulting from the directive is the provision for what is called “master-feeder” structures. It is a system, in which funds are collected in a main (master) fund by means of several feeder funds. The existence of such structures has not been possible so far due to portfolio diversification rules. The advantage of such structures is that while portfolio management and fund administration are centralized at the level of the master fund, marketing and the sale of feeder fund shares can be adapted in a flexible way to the various conditions in various member states.

However, the most important element of the UCITS IV directive is probably the introduction of a “full” passport for management companies – the

new directive will enable that the management company from one member state gets a license to found a fund in another member state. This part of the proposal for the new directive was subject to a variety of discussions at the EU Council. The reason was that this change has many subsequent implications, particularly as regards supervision. In this case there are two supervisory authorities: the first one is responsible for the supervision of the activities of the management company, the second one for the supervision of the creation and administration of the fund. It is mainly important to ensure a sufficient level of communication and cooperation between them. In addition, competence conflicts of competences or a “competence vacuum” can occur especially in the case of UCIT funds without legal personality. Therefore the proposed new directive sets out a precise list of areas, for the supervision of which the home or host supervisor of the management company is supposed to be responsible.

Another consequence of the introduction of a “full” passport for the management companies is the need to increase harmonization of the legal regulation. Because the directive has a so-called Lamfalussy format, important parts of the legal regulation will fall within the second (implementing piece of legislations of the European Commission) or third level (guidelines of the CESR, Committee of European Securities Regulators). The range of implementing piece of legislations is considerable – from organizational requirements, conflict of interest and rules for activities of management companies, implementing piece of legislations related to the measurement and management of risks and applying to UCITS fund portfolios, the content of depositary agreements in the case of cross-border administration, to the area of mutual communication and cooperation in the exercise of supervision. In addition, the directive also provides for the existence of further implementing piece of legislations, which are not directly associated with the introduction of the “full passport” for management companies – these are regulations related to the Key Information Document, cross-border mergers of UCITS funds, “master-feeder” structures and notifications within the product passport. Implementing piece of legislations of the European Commission are currently being prepared and the National Bank of Slovakia is involved actively in the process by means of the CESR. The definitive content is not clear so far, because proposals can be adjusted following a public consultation¹¹ and subsequently at the European Securities Committee – ESC. It is sure that they can take the form of both implementing directives of the European Commission, which will have to be implemented in the legal systems of the member states, and implementing regulations of the European Commission, which will be effective right after their publication in the Official Journal of the EU. Obligatory implementing pieces of legislation should be issued on 30 June 2010.

⁸ Report of an European Commission expert group, http://ec.europa.eu/internal_market/investment/docs/consultations/ameg-report_en.pdf.

⁹ Green Paper on the enhancement of the EU framework for investment funds, Brussels, 12 July 2005, COM(2005) 314 final.

¹⁰ White Paper on enhancing the single market framework for investment funds, Brussels, 15 November 2006, COM(2006) 686 final.

¹¹ Two public consultations on CESR's technical advice take place, <http://www.cesr.eu/index.php?page=consultation&mac=0&id=>



¹² http://ex.europa.eu/internal_market/investment/alternative_investments_en.htm.

¹³ The aim is to achieve that all financial market participants are subject to adequate regulation and supervision.

¹⁴ See e.g. *Investment trusts opposed on size fits all legislation*, Ruth Sullivan, *Financial Times*, 12 July 2009.

OTHER REGULATORY INITIATIVES

In addition to a set of work activities and projects under the heading of UCITS IV, another regulatory initiative is being prepared at the Community level. In this year's spring, the European published a proposal for the *Alternative Investment Funds Managers Directive* – AIFM¹². The aim is to introduce harmonization to the segment of funds that did not fall within the UCITS Directive (non-UCITS funds). The primary source of this initiative are the conclusions adopted because of the current crisis on the financial markets¹³, but it was preceded by some consultation and examination work at the European Commission level. Due to the current process of discussion of the proposal at the EU Council, it is too early to evaluate the result of this initiative, but its proposed scope – the directive is supposed to apply to any investment funds not falling within the UCITS directive – can be considered to be its most controversial part. Initially, this fact was surprising, because it was expected that the new legal regulation will apply only to hedge funds and private equity funds. However, according to the proposal, in Slovakia, the regulation will also apply to closed-end funds, as well as special mutual funds, including special real estate mutual funds. The regulation is supposed to be applied only at the level of the fund manager, not at the level of the product, i.e. the actual fund. Other parts of the directive's content are controversial as well. On the one hand, the directive tries to introduce a common regulation of the administration of very different products, such as various hedge funds, private equity funds, commodity or real estate funds, on the other hand it is quite extensive and includes regulatory mechanisms, which are not even in the UCITS directive. Because the UCITS directive is an example of regulation of retail funds, it would be justified to expect that the AIFM directive would be less strict and harmonized. The proposal for the AIFM directive

has been accepted the most negatively by the market participants, who justifiedly argue that the European Commission cannot apply single regulation to this heterogeneous group of funds¹⁴.

The impact of the new regulatory initiatives of the EU on the Slovak collective investment sector is hard to estimate. The market itself went through a crisis in 2008 and the volume of managed assets decreased considerably after a long period time. The new UCITS and AIFM directives can bring a trend towards asset management centralization in financial centers of the EU. However, the localization of asset management is not influenced only by existing regulation, but also by other attributes of the member countries, such as the business environment and particularly the tax regime, both with respect to the tax imposed on the manager and with respect to the tax on income and increase in the value of assets in the funds. Proofs are the examples Luxembourg and Ireland – countries that historically have been occupying the first two ranks in collective investment – where both the income on assets in the fund and the increase in asset value are exempt from taxes. However, what can be expected from the new directives is an impact on the activities of the National Bank of Slovakia as the supervisory authority. In addition to the need of cooperation regarding the implementation of directives of the Ministry of Finance of the Slovak Republic, as for supervision of management companies, regulation based on principles will be extended, similarly to the situation in the Act on Securities. As regards the supervision of the management of mutual funds, the main result will be challenges related to cross-border supervision of the management of funds, which will require a high level of communication and cooperation with other supervisory authorities of the EU. However, the following two to three years will show what the precise actual development will be.



Act on Financial Intermediation and Financial Counselling – a new legal regulation

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On 13 May 2009, Slovakia's President Ivan Gašparovič signed the Act on Financial Intermediation and Financial Counselling, which had been prepared as a part of the Conception of consumer protection in the area of financial services, ensuring of financial education and regulation of intermediation activities and counseling activities in the financial market. The conception was approved by Resolution of the Government of the Slovak Republic No. 624/2007 of 1 August 2007; at the same time the Government of the Slovak Republic charged the Minister of Finance of the Slovak Republic – with a recommendation to cooperate with the governor of the National Bank of Slovakia – with submitting, until 30 June 2008, for the meeting of the Government of the Slovak Republic a draft bill, whose subject-matter will be a uniform legal regulation of financial intermediation and financial counseling.

Another – equally completely new – act is being prepared in parallel – an act on the consumer protection on the financial market, which will define the institutional system of consumer protection on the financial market as a complex set of institutions for the protection of the rights and justified interests of consumers, who entered or can enter into relations with financial institutions providing their services on the financial market. In addition to the already existing guarantee schemes, new institutes – the Financial Consumer Protection Authority and the National Academy of Financial Education are supposed to be parts of this system. This piece of legislation will be part of the above mentioned conception and will supplement the enforcement rules of the act on financial intermediation and financial counseling.

The new legal regulation, becoming effective on 1 January 2010, wants to be above all uniform and common for financial intermediation and financial counseling in any financial market sector. Hence it takes the form of an umbrella law with impact on the whole financial market. The act's aim is to eliminate the fragmentation resulting from differing legal regulations of financial intermediation and financial counseling existing in separate acts for individual sectors of the financial market, with regard to elements of a special legal regulation where it is justified by the specific conditions of a particular financial market sector or the existence of a legal regulation harmonized with the Community law.

The act visibly attempts to ensure adequate consumer protection (in all financial market areas – insurance and reinsurance, capital market, sup-

plementary pension saving, acceptance of deposits and granting of loans), particularly suggestible and vulnerable consumers and consumers whose knowledge and information of the functioning of the financial market are not sufficient to take qualified, rational and independent decisions. Thus, the regulation will also apply to companies, which have provided financial services so far, but have not been regulated by the National Bank of Slovakia. These are particularly companies providing leasing services, hire purchases etc.

WHAT DOES THE NEW LEGAL REGULATION BRING?

The new rules will also include a separation of the activities of financial counseling from financial intermediation. Despite the fact that the content of these activities overlaps in many respects, the purpose, for which these activities are performed differs considerably. Financial intermediation is supposed to ensure the distribution of financial services to the customers, including the provision of information, analyses, expert opinions and recommendations related to the offered financial services.

Financial counseling, by contrast, is performed to provide information, expert opinions or similar recommendations to the consumer, sufficient for him to take a responsible decision on his entry into a contractual relationship with a financial institution. These information, analyses, expert opinions or personal recommendations do not issue from the limited offer of financial services.

That implies that persons who – for example based on an analysis of personal finance – submit



offers to customers and enter into contracts on the provision of a financial services, for which a particular financial institution pays a reward – a commission – to them, will not be allowed to call themselves a financial counsel, but will have to call themselves financial intermediaries. If a customer will want to use the services of a “financial counsel” under the new system, he will have to pay for his services.

By creating a single register of financial agents (intermediaries) administered by the National Bank of Slovakia, the customers, for example, will be given the opportunity to verify in a simple way, whether the respective person has the required license.

The criteria that providers of services in the area of financial counseling and intermediation must meet change, as well. A financial counsel will have to meet requirements regarding education, including professional exams, integrity, as well as professional experience. The provisions are also tighter for financial agents selling several financial products from several financial sectors (e.g. insurance and loans). They will have to meet weaker requirements than financial counsels, but compared to the situation today the requirements on them will be stricter. Professionalism of financial counsels and agents is supposed to be achieved by the introduction of special and permanent financial education. Their quality will be verified by means of obligatory professional exams they will have to pass.

Another innovation will be the duty to disclose the commission. Before intermediation, the customer must be unambiguously and in an

exhaustive manner informed of the existence of any monetary or non-monetary performance accepted by the agent for financial intermediation from a person different from the customer.

To ensure that the new regulation has effective influence on the exercise of financial counseling and financial intermediation, it is necessary to ensure a system of efficient supervision. This issue is closely related both to the determination of responsibility and to a rational definition of the number of entities supervised by the National Bank of Slovakia (supervision of only persons with an independent status, i.e. an own NBS license, is expected). Towards such persons, the new legal regulation also determines the extent of information and reporting duties in order to render the exercise of supervision more effective and at the same time to increase consumer protection.

The act's aim is not to cause sudden changes in the regulation of financial intermediation and financial counseling to an extent that would cause an inadequate increase of costs in this area. Therefore there are plans for ensuring a continuous transition to the new legal regulation by providing sufficient time for an adaptation to the new legal regulation. The National Bank of Slovakia want to assist this aim by an objective endeavor to ensure the broadest communication possible of open questions with representatives of companies providing the financial services in question, and by the resulting preparations and subsequent publication of answers to the most frequently asked question and by methodological guiding of the companies concerned to achieve the most smooth transition possible to the new rules.



Slovak anticrisis law for the banking sector

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The Act No. 276/2009 Coll. on measures to mitigate the effects of the global financial crisis on the banking sector and on amendments to certain laws (hereinafter referred to as "the Act") became valid and effective on 10 July 2009 by its publication in the Collection of Acts of the Slovak Republic.

The Act is a piece of legislation adopted in response to the financial crisis that started to manifest itself more markedly in the financial sector of European Union member states in 2008. It must be emphasized that the adoption of the Act in Slovakia is merely a precautionary step, which is supposed to create a legal framework for a flexible approach of central government bodies and the National Bank of Slovakia in case of potential threat to some of the banks having their seat in Slovakia. Last but not least, the Act is an instrument for reinforcing the legal certainty of banks, which, in a transparent way and in advance, lays down rules, procedures and conditions for the provision of state aid to them. Because the Act has been prepared with the collaboration of the National Bank of Slovakia, the aim of this article is to present it to the public from the point of view of its co-author and to point to some of the important elements in its philosophy. The article does not have ambition to provide an in-depth analysis of the Act or other measures adopted in connection with the financial crisis besides the Act.

Mandate for preparation of the Act can be found in resolutions of the Government of the Slovak Republic adopted at the end of 2008¹ and above all the in Report on crisis scenarios and possible instruments for their resolution, approved by the Government of the Slovak Republic on 14 January 2009. The draft outline of the Act constituted the annex to the Report. Based on this mandate, works on preparation of the draft law began in January 2009.

In conceiving the philosophy of the act, the starting point was the fact that rescue "anticrisis" measures implemented in the financial sector of European Union member states shortly after the breakout of the crisis have mostly taken the form of individual state aid² or a state aid scheme. The provision of individual aid is subject to examination by the European Commission; therefore in each individual case a member state must notify the state aid to the European Commission and ask for its assessment. Individual aid was provided at the start of the crisis in Europe when some of the Western European banks faced serious troubles as a consequence of the drop in the value of their assets. From October 2008, most countries

have been gradually switching to a more systematic and transparent solution that provides higher legal certainty to the aid provider and beneficiary – they have started to draw up state aid schemes, mostly in the form of an "anti-crisis laws" and possible related statutory instruments.

The provider of state aid can provide individual aid within the scheme without its prior notification to the European Commission. The actual state aid scheme must be notified by the state. This procedure ultimately enables to provide aid with minimum interference by the European Commission, which reduces the administrative burden and enables to state to act more swiftly, which is essential in times of crisis when an individual bank can get into serious troubles in a matter of days. Conformity with the European union state aid rules was one of the top priorities in the drafting process. The Act has been drafted fully in line with the respective Commission communications for the area of state aid adopted in connection with the financial crisis.³

The Act's aim was to create conditions for preservation of national financial stability and for mitigating the pass-through of the crisis from the financial sector to the real economy. In the text of the Act, these objectives are incorporated in Article 2 sec. 2, which defines the purpose of the provision of aid. In Slovakia, where claims from granted loans and not securities⁴ are the dominant part of bank assets, the former aim (financial stability) is of greater importance; it has the potential to enable provision of aid to a bank, whose stability would be endangered due to serious problems in real economy. Both aims are in line with obligations resulting for Slovakia from the Paris Declaration of the heads of states and governments of the euro area.⁵ Other member states have adopted similar measures with the same aim⁶. A legal basis of these provisions is Article 87 (3) b) of the EC Treaty, which – as an exception from the general ban on the provision of state aid – provides for aid to remedy a serious disturbance in the economy of a member state.

An instrument to meet the objective of the Act is the actual stabilization aid (a term used in the Act instead of "state aid") that can be provided under Article 2 sec. 1 of the Act in the form of guarantee

¹ For example Resolution of the Government of the Slovak Republic 758 of 22 October 2008 on the analysis of the economic and legislative environment, in which subsidiaries of foreign financial institutions are active to deepen the protection of customers, domestic financial entities and preserve stability of the financial system of the Slovak Republic, Resolution of the Government of the Slovak Republic 829 of 12 November 2008 on the proposal of alternative possibilities of state action in the commercial banking sector of the Slovak Republic in connection with the ongoing global financial crisis.

² In the context of the financial crisis, individual state aid has been provided in their home countries, for example to the following financial market entities pursuing business in the Central European region by means of their subsidiaries: Fortis, Dexia, KBC, ING and Aegon.

³ They are the following non-binding regulations explaining the procedure of the European Commission for the evaluation of state aid provided in the context of the financial crisis for the financial sector: Communication from the Commission — The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition (OJ C10, 15 January 2009, p.2), Communication from the Commission on the treatment of impaired assets in the Community banking sector (OJ C72, 26 March 2009, p.2). The following European Central Bank documents were used as auxiliary instruments: recommendation of the Governing Council of the European Central Bank on the pricing of recapitalisations and recommendation of the Governing Council of the European Central Bank on government guarantees for bank debts.

⁴ See e.g. the 2008 analysis of the Slovak financial sector, http://www.nbs.sk/_img/Documents/_Dohlad%5CORM%5CAnalyzy%5Canalyza_2008_4.pdf, retrieved on 22 August 2009.

⁵ Declaration on a concerted European Action Plan of the euro area countries, approved at the meeting of heads of states and governments of the euro area in Paris on 12 October 2008, available at http://ec.europa.eu/economy_finance/publications/publication13260_en.pdf.



⁶ See "DG Competition's review of guarantee and recapitalisation schemes in the financial sector in the current crisis" p.3, available at http://ec.europa.eu/competition/state_aid/legislation/review_of_schemes_en.pdf, retrieved on 18 August 2009.

⁷ Recommendation of the Governing Council of the European Central Bank of 20 November 2008 on the pricing of recapitalisations, http://www.ecb.int/pub/pdf/other/recommendations_on_pricing_for_recapitalisationsen.pdf and Recommendation of the Governing Council of the European Central Bank of 20 October 2008 on government guarantees for bank debts, http://www.ecb.int/pub/pdf/other/recommendations_on_guarantees-en.pdf, 24 August 2009.

for bonds issued by a bank or a loan granted to a bank. The second form of the state aid recognized by the Act is a contribution in cash to the share capital of beneficiary bank (recapitalization). The "parameters" of assets, for which guarantee can be provided, is in line with the respective communications from the European Commission.

The stabilization aid must be provided in line with the provisions of the Act that can be summarised as follows: non-violation of basis principles of European continental private law, flexibility, temporarity, non-claimability and nongratiuous nature of the aid. In some foreign legal regulations adopted in response to the financial crisis, there have been serious interventions to the settled rules of commercial law (especially to rules on protection of minority shareholders) and competition law (e.g. in the area of mergers), especially in connection with the context of nationalisation of banking institutions. The Slovak anti-crisis act does not contain any such provisions, on the contrary, it assumes that potential applicants for the provision of state aid will prepare for the process themselves in a preventive way. In other words under the Act the state has not assumed any special intervention powers vis-à-vis potential beneficiaries of the state aid. Article 8 sec. 1 of the Act stipulates that the bank's general meeting of shareholders should ensure in advance by adopting a resolution that the shareholders' preemptive rights to subscribe shares are suspended in case of an increase of share capital as a result of recapitalisation, as envisaged by Art. 204a sec. 5 of the Commercial Code. Under normal circumstances, this process takes at least 5 days from the day of the general meeting, which can be too restrictive in a crisis situation. Although the Act does not stipulate it explicitly, it is obvious from the nature of the thing that the preventive preparations of a potential applicant for aid should also include the adoption of a general meeting resolution, by which the managing board is charged with a power to issue a decision on an increase of share capital, in accordance with Art. 210 sec. 1 of the Commercial Code (under normal circumstances this power is given to shareholders meeting). Should this not happen, a general meeting will have to be convened to approve the recapitalization.

As for flexibility, aid is provided based on application of the bank. The administrative proc-

ess of application submission is very flexible, the only requisite is to submit the application and several accompanying documents (e.g. the current financial statements) to Ministry of finance. The National Bank of Slovakia is obliged to provide comments on the application, particularly in terms of an evaluation of the financial situation of the bank and necessity to provide help. The time limit for handling the application by state institutions is very short – under the law it must not exceed 6 days. The aid is provided on a contractual basis. To prevent distortions to competition when providing the state aid, the Act contains several behavioural safeguards the beneficiary is required to adopt. Advertising of information within beneficiary's marketing activities will be prohibited, beneficiary will have to adopt restrictions on the remuneration of the management and some other measures set out in Art. 5 sec. 6. These measures are all in line with the corresponding communications from the European Commission.

Regarding the nongratiuous nature of the aid, the actual situation of the bank must be thoroughly assessed in order to classify bank into one of the two categories: fundamentally sound or distressed. For the former category, a lower remuneration for the provided aid should be set, because the debtor is less risky for the aid provider. The Act lays down this principle by means of tying the level of the consideration to the bank's risk profile set by the National Bank of Slovakia (Art. 5 sec. 3b) point 3 and Art. 5 sec. 3b)). Under Art. 5 sec. 5, the details on the determination of the level of remuneration are supposed to be regulated in a statutory instrument to be issued by the Ministry of finance. This piece of legislation will have to be based on the corresponding recommendations of the European Central Bank⁷. For this reason, it can be expected that for example the level of the remuneration for the provision of recapitalization will be around 10% p.a.

Finally, it can be noted that the adopted legal regulation enables to enter into a contract on the provision of stabilisation aid until the end of 2010. If the currently improving trend in the development of European economy does not reverse, it can be expected that the respective provision of the Act will not be altered by a possible amendment and the whole Anticrisis Act will become obsolete after that date, thereby fulfilling its primary function of a precautionary instrument.



The financial crisis brings new challenges for financial market supervision

Completion from page 2 of the cover

crisis (fall 2009) on the Slovak financial sector.

Long-term practice of on-site supervision in banks has also provided a new impulse to local inspections in other financial institutions and has led to a better and safer operation of those institutions.

Overall, the integration of financial market supervision can be evaluated as a very successful step that has contributed to an increased stability of supervision as well as to the capability of taking the necessary steps for further strengthening of stability. Evidence of this is also the fact that the domestic financial system was affected by the first phase of the financial crisis only minimally and its ability to resist an adverse development in further phases is high. The financial system thus constitutes a stabilizing element of Slovak economy. During the first phase of the crisis, the Government of the Slovak Republic evaluated the steps of the NBS (and the Ministry of Finance of the Slovak Republic) and stated that efficient measures had been taken to ensure financial stability and customer protection.

The financial crisis has brought new challenges for financial market supervision. Competent persons are looking for a regulation and arrangement of supervision that would prevent or at least mitigate possible future crises in a globally interconnected world. The European Union charged an expert group, called the de Larosière Group, with proposing solutions. The group brought solutions, which can help to cope with the crisis, if it starts to spread, but in my opinion they are not useful as regards the actual breakout of the crisis. The current crisis has basically two reasons – incorrect political decisions and weak supervision at the local level, which has been unable to force financial institutions to detect and recognize all risks to which they expose themselves. The proposed solutions can correct some wrong political decisions, albeit in the form of a recommendation, but they do not contribute to a significant improvement of supervision activities at the local level. In addition, no integration that would lead to better knowledge of the risks in the financial system is being proposed – but here one of the reasons are past political decisions, which have decided that the insurance sector will not be subject to ECB supervision.

I believe that a strong supervision at the local level is the key for maintaining global financial

stability. Such supervision must have such powers and conditions, which enable it to contribute to the maintaining of financial stability in the respective jurisdiction. The Government of the Slovak Republic has borne this in mind and charged the Minister of Finance in cooperation with the governor of the National Bank of Slovakia with ensuring that such European legislation is being put through during discussions at European Union bodies, which does not weaken the powers of national financial market supervision. The financial sector in the European Union is currently quite heterogeneous, particularly in the area of services to households and small and medium-size enterprises. There are various barriers – from the language barrier, through the definition of security interest, Cadastres, bankruptcy legislation, to various definitions of insurance contracts. Hence, the environment differs in the individual member states, and local level supervision must take that into account and has to have appropriate instruments to cope with the problems. Precocious full harmonization of the environment can be therefore counterproductive, because under certain circumstances it could lead to a situation where local supervision fails to stop adverse trends. Similarly, leaving the decision-making on disputes between home and host supervision to the representatives of all supervisors will not necessarily bring about optimum decisions, particularly because the decision makers will not bear any responsibility, so that their decisions might have various motivations, not only the concrete substance of the dispute.

The Financial Market Supervision Unit has gained a good position within European supervisory structures. Despite the above mentioned objections and doubts, it is indisputable that its importance will increase in the future. Therefore, a great challenge will be to ensure a representation of the NBS that will enable it to influence decisions of those structures based on the strength of the argument. However, small host states have no other possibility to put through their own needs in the fulfillment of their tasks in the area of maintaining financial stability vis-à-vis the interests of supranational financial groups and home states. Of course, a solution for the future is a fiscal union and responsibility for financial stability in the whole European Union resting on the shoulders of single European supervision. But for the present that is only a vision...

