NATIONAL BANK OF SLOVAKIA

SLOVAKIA'S FINANCIAL MARKET AND ITS POSSIBLE DEVELOPMENTS

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As the time I have for my address does not permit to elaborate on all aspects of the current condition of the financial market or to specify all factors affecting its development, I would like to focus on the latest tendencies in the size, structure and, perhaps, prices of the major categories of financial market assets.

Once more, the lending market played an important part in the domestic financial market in 1997. Although its volume has been constantly declining, its impact on qualitative parameters development, such as the liquidity and profitability, is heavier than before. That is why I am going to devote more space to loans.

As a simplification, we can say that the time structure of money market assets has moved in 1997 towards products with shorter maturity periods. In particular, this was the case in the short-term money market, largely because liquidity estimates have become more difficult to make. The daily volume of interbank transactions rose in 1997 by 11.8 billion Sk as compared with 1996, which is 2.5 times higher. Behind the upsurge was a slashing of the average maturity to below 5 days, less than one half of the previous year. The complexity of developments on the financial market is also reflected by a lower sensitivity in the relationship between short-term deposit rates (overnight and 7-day rates) and the rates charged for longer periods (1, 3 and 6 months), which were the decisive factor in the financial investments market in the previous period. In 1997, the links between the rates were very loose. To be more specific, on the basis of BRIBOR listings for the last quarter of the year, while the correlation between the overnight and 7-day rates was measured at 0.9, the correlation with 6-month rates was merely 0.4. The most recent results for the first weeks of this year show that the National Bank of Slovakia has managed to drive down interest rates in the money market.

Among other things, the time structure shift also had its impact on vital primary bank deposits. There may have been some growth in over 1 year time deposits, but it was clearly outstripped by 1-year-and-less deposits, with the average time period falling. It was especially in the second quarter of the year that the trend was manifested by slow growth in primary resources. A lower pace of primary deposits, coupled with their maturity structure, affected the developments in the loan portfolio. The current difference between average interest rates in the primary deposit market and the lending market may be regarded as an important potential for the stabilization of capital coverage. An adequate interest rate spread allows the compensation of losses incurred due to mediocre loan portfolios. However, both the developments in primary funds and a rising share of paralyzed loan flows increased the pressure on instant liquidity. As a result, the banking sector as a whole has developed yet stronger addiction to purchases of secondary funds, which in turn led to its dependence on the money market and the effects mentioned above.

In the primary capital market, rising interest rates made it harder to place new issues of securities. While lending transactions have watched their share in total banking assets erode for a long time now, there was little growth in other banking assets used in reproduction of corporate flows to make up for the decline. Issues of private bonds have suffered from a massive offer of state securities. By the end of 1997, total corporate bond issues added up to no more than 7.3 billion Sk, a 67.3-percent drop from the previous year. The slump is even more striking when divided into quarters. With as much as 72.6 percent of the year's total issues placed in the first three months of the year, the last quarter only brought out a scant 5.5 percent. In this case, too, we have to look at the relationship between this tendency and the loan portfolio, along with its impacts on liquidity, earning ratios and reproduction of banks' own capital. In an effort to achieve their capital adequacy limits, banks turned to purchases of state securities.

An enormous amount of bonds that the government needed to sell in 1997 was issued only at the expense of lavish yields and shorter redemption periods. Virtually all of the issues, worth a total of 27.9 billion Sk, are redeemable in one year, except for two 2-year issues floated to replenish the State Housing Development Fund with some 1.5 billion crowns. The jump of average yields on state bonds from 14.66 percent early in 1997 to 26.73 percent at the end of the year was much less a result of speculations to impose taxes on yields on state securities, than the real level of instant liquidity.

In 1997, the total turnover in the secondary capital market went on rising. With some 164.1 billion Sk traded, the volume was up 43.8 percent from the previous year. However, the increase was sparked by direct transactions, rather than the price-setting anonymous trades, which fell 62.7 percent. Apart from other reasons, this was a product of the aforementioned tendencies in the money market, causing high interest rates.

(CHART 1)

When we report that the SKK lost 9 percent against the U.S. dollar and gained 5 percent against the DEM (a better result than in other economies at a similar stage of transition), we also have to be fair enough to consider the influence of the aforementioned factors on interest rates in the national financial market. Similarly as the year before, foreign exchange fixing accounted for 5.7 percent of total interbank foreign exchange trading of USD 2,491.1 million. The number of transactions dropped from 835 in the previous year to 382, lifting the average transaction size from USD 3 to 6.5 million. Three leading banks were involved in 73 percent of forex fixing. Developments in the currency structure are shown in the following table:

%	1994	1995	1996	1997
USD	40.6	12.8	19.6	19.2
DEM	59.4	87.2	80.4	80.8

(CHART 2)

An overwhelming 93.8 percent of total transactions in the domestic interbank foreign exchange market (some USD 41,076.3 million), excluding transactions of the National Bank of Slovakia, were performed between Slovak banks. The U.S. dollar fared better than the year before (up from 59 percent in 1996 to 70.3 percent), while trading with German mark sank from 35.9 percent in 1996 to 23.7 percent. As a matter of fact, this means a swap of positions of these two currencies as compared to the foreign exchange fixing. The three most heavily trading banks took 76.2 percent of the interbank forex market.

(CHART 3)

Whereas the volume of transactions between Slovak banks slipped about 1.3 percent, there was a major boom in trade between Slovak and foreign banks. With a total of USD 40,908.9 million, the latter have pulled nearly half of all Slovak crown transactions (which accounts for 48.4 percent of the forex market altogether). Compared to 1996, this was a 5.1-fold leap, driven mainly by purchases of foreign funds ending some USD 178.7 million in surplus. As far as the structure goes, USD was again the most popular trading item with 82.4 percent, followed by DEM with 14.7 percent. The average transaction amount rose from USD 2.1 to 3.3 million. The three most active foreign banks were involved in 32.92 percent of all transactions.

One problem shared by all analyzed assets, especially those of the money market, is a throwback from an advanced time-and-quality level down to shorter maturities. Indisputably, the loan portfolio is responsible for a large part of this setback.

In the long run, bank loans are bound to stay the most important form of financial ties between the banking sector and the corporate community. The quality of the general loan portfolio, described by its natural ability to reproduce, has a great influence on how the entire banking sector, as well as individual banks, behave in the money market. Prices in the lending market are in turn affected by the primary deposit market and the domestic financial market.

The position of bank loans in the financing of Slovakia's corporate sphere can be described by certain financial ratios:[1]

%	**1993**	**1994**	**1995**	**1996**	**1997**
TA/GDP	120.4	113.3	116.1	123.3	121.1
loans/TA	56.8	49.4	46.3	44.9	41.3
loans/GDP	68.6	55.9	53.7	55.4	50.0

TA - total assets in the banking sector
GDP - gross domestic product

[1] The loan portfolio does not include loans provided to the finance and insurance industries

As I have suggested earlier, the decline in loans has so far met with little compensation by other banking assets, which can be considered as alternative sources of corporate financial flows (corporate or municipal securities). That is why most analyses of the loan portfolio, of its position in the financial market and its impacts on the equity market, focus on the intensity of natural loan reproduction. The intensity of loan reproduction, determined as the rate of return, tells the bank how efficient its loan portfolio is and the price of loan for a debtor. From the macroeconomic point of view, even a modest loan portfolio can do wonders in the reproduction of corporate financial flows. Of course, provided that it spins fast enough and cuts classified loans, stuck in paralyzed financial flows of the business sphere, down to a minimum. If it is true when they say that the cheapest way to get a new loan is to pay off the old one, it should be a common interest of both the corporate and banking sectors to strive for a generally high rate of loan return. For now, it is clear that the average price of short-term loans, seen above 20.5 percent at the end of 1997, stems from a large part of frozen credit flows.

This can be documented by the following graph:

(CHART 4)

The **Credit Risk Coefficient (CRC)** is one of several parameters used to assess the general risk of lending.

$$CRC = \frac{\mathbf{x} \times 0 + \mathbf{y} \times 0.05 + \mathbf{z} \times 0.2 + \mathbf{q} \times 0.5 + \mathbf{w} \times 1}{\text{total loans}}$$

where x = standard loans

y = special mention standard loans

z = substandard loans

q = dubious and litigious loans

w = loss loans

The coefficient gives you a specific figure for the so-called gross need of creation of provisions for total loans. What it does not consider is the value of property pledged as collateral, since a substantial part of collateral cannot be used to restore financial flows without additional refinancing resources. At present, the value of collateral is a mere 40-45 percent of gross loan-related losses sustained by the bank sector. Plus, as much as 70 percent of the security is attached to loss loans. This situation in nonfinancial coverage has an adverse impact on the reproduction of loans. The operation leverage in the corporate sector, defined as a ratio of fixed expenses against sales, has been going up, which makes loans an even more risky choice in corporate finance. At the same time, the ratio of depreciation of movable and immovable collateral against fixed expenses has slipped from 5.40 percent to today's 4.39 percent. In corporate finance, cash flows have been losing ground as the source of loan repayment, in particular when it comes down to long-term investment loans. On top of that, the large portion of collateral tied to loss loans means that its value is off limits to financial flows that still "live."

The ratio defined above can be simplified as follows:

$$CRC = \frac{\text{gross loan-related losses}}{\text{total loans}}$$

It tells you how much you can expect to lose on each 1 Sk of unpaid loans. When you multiply the CRC with the sum of loans outstanding, what you get is the value of credit flows, which do not participate in the reproduction of the loan portfolio.

As follows from the Chart 4, developments in the risk structure of loans have been influenced more by the dynamics in new loans rather than by a natural change in the general level of the risk of lending. This is also proved by figures in the table below:

growth index 1997/1995 (%)		loss loans / gross loan-related losses (%)	
total loans	116.19	1995	87.18
gross loan-related losses	113.21	1996	90.71
loss loans	119.22	1997	91.81

The total amount of loss loans has been growing more rapidly than the sum of loans and gross loan-related losses. For the long haul, this is reducing the ability of the banking sector to refinance its loan portfolio.

In 1997, we registered a 2.9-percent annual growth in loans to businesses, a rise of Sk 6.4 billion. Simultaneously, gross loan-related losses posted an increase of 8,951 million Sk on loss loans rising by 9,329 million Sk. Hence, it seems safe to conclude that new loanable funds have been used to refinance older loans.

The graph below compares the rate of risk for loans with different repayment periods to the average rate of risk of the loan portfolio:

(CHART 4)

Looking at the time structure of financial assets, we find a continuing shift to short-term assets as banks try to avoid taking the risk of loaning their money over longer periods of time. With short-term primary funds prevailing, certain volatility in volumes and prices in the domestic financial market, and especially loans becoming more hazardous, which it turn hampers the circulation of financial resources, it was impossible to provide adequate credit refinancing.

Meanwhile, it would not be right to think that a fairly steady share of long-term loans in the loan portfolio is the result of their perpetual reproduction. The truth is that the long-term loans have the worst rate of return of all. And, in order to maintain a standard liquidity level, the banking sector must attune the time structure of its liabilities to its assets. Not an easy task, with almost 46 billion of unpaid long-term loans today deemed to be irrecoverable. That is a considerable chunk of long-term loanable funds buried in stalled corporate financial flows. Therefore, it is understandable that its adverse impact on operating liquidity of the banking sector has forced banks to turn to short-term funds to refinance their liabilities and to favor short-term loans. In the meantime, long-term funds lay "conserved" in corporate financial flows.

According to analyses of major economic variables for the monetary program for 1998, new corporate loans are projected to grow by around 26.5 billion Sk, an increase of 7.2 percent. However, the real amount of bank assets used to bolster corporate financial flows will depend on their price. The price, or in other words the average lending rate, will in turn depend on economic standings of the entire banking sector. And although, in the long run, loans are losing weight as a source of profits, their negative impact on profitability in the banking sector is ever greater.

The table below has the evidence:

	1993	1994	1995	1996	June 30, 1997
earning assets (in mil. Sk)	374,463	417,511	474,775	608,691	657,725
earning assets/assets (%)	90.95	90.27	87.25	84.94	86.05
gross loan-related losses (%) earning assets	5.22	12.44	20.44	16.58	16.35
loss loans/earning assets (%)	1.95	8.70	17.82	15.04	14.81

With this data, it is possible to make out several apparent tendencies which have been affecting interest rates:

- Despite recent reports of a slight turn for the better in parameters listed in the table, which have an impact on profitability, the ratio of profitable assets against total assets still falls short of the standard 90 percent deemed necessary to generate enough profits to reproduce own capital.

- The ratio of gross loan-related losses and loss loans against earning assets has been declining. On the other hand, the total amount of gross loan-related losses and loss loans has been rising and, since 1995, the amount of loans that do not reproduce remains higher than the aggregate equity capital. That means the improvements registered in these parameters are just a result of redistribution of earning assets. A large amount of government securities issued at the market, together with their high yields, has logically exhausted resources that could otherwise be used to reproduce the loan portfolio.

- Gross loan-related losses have been growing faster than internal reserves set aside for their coverage. The aforementioned blockage of credit flows, in particular in case of long-term loans, was reflected in the growth of the portion of liabilities which was not used for earning assets. The figure we are talking about is somewhere near 27 billion Sk these days, which drains disposable profits from the banking sector.

- In 1997, issues of private bonds amounted to 7.3 billion Sk, down 67.3 percent from year ago. Out of that bulk, however, a full 5.3 billion were issued in the first quarter alone. That means the sum of credit flows in motion has been declining, which in turn leads to a greater share of irredeemable loans in total assets, now at 13.2 percent. Meanwhile, a strong credit position represents their share of 2 percent.

Thus, with all this in mind, it is uncertain whether the projections of 26.5 billion Sk in new loans in 1998 will really materialize. All the factors mentioned above, which reduce the real yield on lending, are exerting pressure to stabilize high interest rates. Therefore, it is quite likely that expectations of any major shifts in the price of money have no economic grounds. If this theory is right for money in general, it is even more realistic for the price of loans.

I have outlined only a few basic tendencies in the latest development of Slovakia's financial market. Their analysis, despite the fact that the market has yet to complete its transformation, which explains its relative imperfection, has shown the functioning of several economic relationships and connections between markets (money market - deposit market, money market - loan market). This in turn supports considerations about the efficiency of the alternative steps implemented by the NBS.