

A STRATEGY FOR PERFORMING BANKING SUPERVISION OF THE NATIONAL BANK OF SLOVAKIA

On 24 May 2002, the Bank Board of the National Bank of Slovakia approved its strategy for banking supervision, which details the manner in which the supervision over commercial banks is to be performed. The source, or base document concerning the NBS strategy in this area is the Banking Supervision Mission Statement, approved by the Bank Board of the NBS on 21 December 2001. This interview with Ing. Milan Horváth, the Chief Executive Director of the Banking Supervision Division of the National Bank of Slovakia, is to provide more detailed information on this issue.

- A re-evaluation of the past period has resulted in the need for comprehensive solution to organisation and personnel changes in the NBS banking supervision, aiming primarily to improve efficiency in performing banking supervision, increase the enforcement of legislation, improve communication between the banking supervision, foreign institutions and the public. The increased demands on operating banking supervision and its tasks are formulated in the Plan for the Development of Banking Supervision, approved at the end of the last year.

As Chief Executive Director, could you, in an introduction to our interview, specify the mission and aims of the NBS in banking supervision?

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The Banking Supervision of the National Bank of Slovakia had along with others to respond in the performance of its activities to the developments that have occurred in the banking sector of the Slovak Republic over recent years, these being characterised chiefly by restructuring and changes in ownership. By law, the banking supervision is to provide for the performance of supervision over banks and branches of foreign banks in the Slovak Republic.

The mission and primary aims of the banking supervision are formulated in the "Banking Supervision Mission Statement" approved by the NBS Bank Board on 21 December 2001. Primarily these comprise the following: promoting the stability of banks and the banking system, protecting depositors, promoting the transparent, safe and sound operation of banks and the banking system, and furthermore promoting the credibility of banks and the banking system for investors and depositors and promoting the development of the banking system.

The central bank is trying to achieve a state where banks



have capable and suitable owners and management, strategies elaborated and internal procedures to minimise and manage risks. Our activities are aimed at steering existing banks towards conducting their business prudently in compliance with the law and decrees, having adequate capital, liquidity, an appropriate asset structure and adequate resources to cover risks, and applying corporate governance, observing international standards of best practice in the management and conduct of activities so as not to put their customers at risk. We are doing all we can in order that the problems existing in banks are quickly and efficiently resolved in a manner that protects depositors to the greatest extent, minimises associated costs and potential disruptions to the banking system.

I believe that in addition to the above it is necessary to mention what does not constitute the role of the NBS banking supervision. In no case can the banking supervision be surrogate to the function of supervisory authorities, which represent shareholders in banks and their control mechanisms. In no case will it intervene in the executive powers of banks' management, and will judge individual operations exclusively on the basis of their compliance with laws and internal regulations of the respective banks.

At present a process of transformation is under way in the NBS Banking Supervision Division, which is to realise a systemic change in the approach to the banking supervision: from the so-called mandatory approach, where the compliance of a bank's operation with laws and subordinate legislation, such as decrees and individual operations were reviewed, to risk-oriented banking supervision. In the latter, the main emphasis is laid on auditing systems, such as those of risk management, internal controls, information processing, data security, etc. that the bank

has set up in order to function in accordance with law and subordinate decrees relating to prudent banking. In the long term, the goal is that the banking supervision, and firstly the banks themselves identify individual sources of risk, measure and manage individual risks resulting from their activities and be capitalised accordingly.

In order to provide for a smooth transition to such a performance of banking supervision, a great number of both substantive and organisational steps are to be taken as a part of the new strategy for banking supervision adopted by the Bank Board in May this year.

The strategy itself is divided into policies, which set particular objectives, as well as steps for achieving them in the individual activities of the banking supervision, starting from a system of education, through the methodology for the risk-oriented approach, the rating system, to the organisation of supervisory teams. This material is open, it is being and will continue to be supplemented as need be, and its implementation will naturally require the corresponding time.

• As you have stated, it is important for a developing banking sector that commercial banks have capable and suitable owners, management, strategy, internal procedure for the risk minimisation and management. How does banking supervision intervene in this process?

The answer to this question can be split into two parts. When it comes to ensuring that commercial banks have capable and suitable owners, banking supervision proceeds in accordance with the powers granted to it by law. The question of ownership has been to a considerable degree resolved through the entry of well-known foreign banks into the banking sector. Presently the share of foreign investors in the registered capital and permanently entrusted funds of banks exceeds 83%, with the volume of assets controlled by these investors exceeding 95% of the assets in the banking sector. Foreign investors bring with them advanced know-how, due to which the Slovak banking sector has attained a new level. This fact presents a challenge also for the banking sector, where development of the banking supervision should not lag behind development of the banking sector and the banking supervision must have a sufficient professional background, knowledge and capacity in order to keep abreast. At present, the privatisation of Banca Slovakia and Poštová banka is underway. Also in this case the NBS is carefully weighing the possible future ownership structure so that shareholders of these banks satisfy the exacting requirements that will ensure the maximum safety of personal deposits.

As for the existence of strategies, policies and internal procedures for risk management in banks, we are currently monitoring this area in detail. One of the parts of any comprehensive supervision, but also of the majority of thematic reviews is to check whether such risk management and internal control systems do exist. Besides this, the monito-

ring of interest risk management systems is currently underway in individual banks. In line with the strategy we are now preparing the banking supervision methodology for the identification, measurement and management of individual types of risks – from credit, through liquidity, market to operational risks. In so doing, we draw upon best practices, i.e., the best practices of developed countries, as well as the recommendations of the Basel Committee for Banking Supervision, which are summarised as 25 Core Principles for Effective Banking Supervision.

• It is in the interest of the NBS that existing banks pursue their business prudently, in accordance with the law and decrees, that they have adequate capital, liquidity, appropriate asset structure and adequate funds to cover risks, that they apply corporate governance, and that in the management and conduct of their activities they comply with international standards so as not to put their customers and the public at large at risk. What is the banking supervision able to do in order to meet this goal?

First and foremost the banking supervision consistently requires compliance with the Banking Act and other laws and subordinate legislation, especially the provisions on prudent banking and limits resulting from these. The violation of these laws or non-compliance with these norms and limits is sanctioned by the banking supervision within the possibilities laid down by law, such as proceedings on the imposition of a penalty. Our aim is to proceed in a so-called pro-active approach, where the likely problems of banks are identified early enough to allow for their avoidance through preventive measures, and, on the other hand, the banks themselves are interested in close co-operation with a regulatory authority owing to the fact that stability of the banking sector is in the common interest of responsible shareholders, the central bank, as well as society as a whole.

• Problems in banks should be addressed so as to protect depositors to the greatest possible extent, to minimise costs and possible disruptions to the stability of the banking system...

I agree. The protection of depositors is one of the primary goals of the central bank with regard to the performance of banking supervision. This is also mentioned in the Banking Supervision Mission Statement referred to above. By law, the banking supervision has sufficient powers to be able to effectively exert a preventive influence upon banks, and, in the case of necessity to also protect the personal deposits through the imposition of forced administration. However, it needs to be kept in mind that the main responsibility for the handling of deposits rests with the shareholders, and through them, with the management of banks. In the event that the management of a bank mismanages the funds obtained from individuals or legal en-



ties, whether due to their own incompetence or with the intention to enrich themselves, and, moreover conceal such activities by the misstatement of accounts, it is not always possible to prevent the bank from collapse. The situation becomes even more complicated when this also ends up in a "run" on the bank, since no bank can survive where all of its depositors wish to withdraw their funds.

Any bank and the banking business as such are based on trust. It is the role of the banking supervision to promote this trust and to prove to the public, by taking the aforementioned proactive approach in concurrence with the banking sector, that the banking system is worthy of such trust.

• How will the changes in international standards, set by the Basel Committee for Banking Supervision, be reflected in the operation of the banking supervision, especially in connection with the expected accession of the Slovak Republic to the international organisations?

One of the basic principles of the Basel Committee is that they set recommendations which become standards when accepted by other institutions – for example, by the European Union, which translates them into binding directives. At present, the entire financial sector is getting ready for principal changes that will follow from the submission and expected subsequent adoption of the definitive draft of the New Basel Capital Accord. Since it is envisaged that hand in hand with its adoption, also the EU directive to implement the Accord within the EU will be passed, many obligatory tasks will also ensue from it for the NBS banking supervision. Not any more at the level of recommendations, but as an obligation to implement them, whether from the position of a regular or associated member of the EU.

The newly proposed rules represent an extensive and comprehensive system that should improve the manner in which the risk of banking business is managed. They are distinguished by a more sensitive approach to measuring and managing the credit risk and for the first time they deal with operational risk. In our conditions, also the regulation of market risks will be something new. The new aspects include, among other things, the use of ratings from rating agencies for the purposes of assigning risk weights to claims, the possibility of an individualised approach by regulatory authorities to individual banks, determining capital adequacy on consolidated basis for the whole bank group and raised requirements on disclosures to be made by individual banks. Needless to say, these new rules place substantially higher demands on the quality and performance of the banking supervision and concurrently on the quality of all employees conducting it. The application of the said new approaches should however not only bring the banking regulation to a higher level of efficiency, but should especially strengthen the stability of the banking sector.

• Do you expect that the implementation of these changes will influence the performance of the banking supervision in terms of changing ownership structure of banks in Slovakia?

Certainly. The ownership structure is already now influencing the performance of banking supervision. One of the consequences of the changes in this structure is also a need for close cooperation with bank supervisory authorities of those EU countries where the parent bank is seated. Since these are eminent and internationally active banks, the Basel Committee's recommendations are binding on these banks. One of the roles of the banking supervision is to minimise the possibility of the occurrence of regulatory arbitration and to prevent the creation of a competitive environment putting domestic banks at disadvantage – for example in relation to the EU. On the other hand, the change in the ownership structure increased the likelihood of an inflow of new banking and financial business technologies and procedures. It is envisaged that new, more complex products will appear, which, on the one hand will better suit the requirements of an individual customer, but on the other hand will bring about new and more complicated risks. All this certainly places also greater demands on the banking supervision, on the quality of its performance, capabilities and knowledge of its employees..

• How is the banking supervision getting engaged in international activities within the financial sector?

Let us mention at least the two most recent ones of the range of international activities. Under the auspices of the NBS, the 15th annual conference of countries of regional association Group of Banking Supervisors from Central and Eastern Europe (BSCEE) will be held in Bratislava on 6 – 9 October 2002. This organisation consists of eighteen countries of Central and Eastern Europe and republics of the former Soviet Union. The main topics on the agenda of this conference will be internal ratings of banks and their application in the operation of banking supervision and the topical role of supervisory bodies in taking measures against money laundering.

A second important activity, in which the banking supervision has recently been involved, is the preparation of an impact study (entitled QIS 3), aimed at developing a definitive version of the New Basel Capital Accord. The NBS Banking Supervision Division coordinates this preparatory work within the SR and has called upon banks to get actively involved in it in the broadest possible scope. On the one hand this is a way how to actively intervene in the definitive wording of the Accord and on the other it will make it possible for the banks involved to prepare themselves in time for implementation of the respective EU directive.

**Thank you for your interview
Soňa Babincová**