banking supervisors for the implementation of the New Basel Capital Accord (also known as Basel II or the NBCA). The National Bank of Slovakia (NBS) is also aware of this fact and therefore has for a long time been preparing for its implementation. The regular communication with the banking sector is one of the forms of its preparation. At the time when concluding the definitive text of Basel II was approaching, the NBS organised a seminar aimed at familiarising the professional public with the latest knowledge and trends that were emerging in the process of preparing for implementation, both on the part of regulatory authorities and on the part of banks.

The seminar regarding the preparation for implementation of the NBCA was held on 21 June 2004 at the premises of the NBS headquarters under the patronage of the NBS Deputy Governor Ivan Šramko. The significance of the issue was highlighted by the presence of representatives of all the banks operating in the Slovak banking sector, members of the banks’ boards of directors, representatives of the Association of Banks and also various representatives of auditing and consultancy firms. The seminar’s agenda was divided into two parts, a “foreign” part which, following an introduction by the Deputy Governor of the NBS, comprised speeches of representatives of the European Commission, European Central Bank and foreign commercial bank, and a “domestic” part in which speeches were given by representatives of domestic commercial bank, consultancy firm and banking supervision staff of the NBS.

• The Deputy Governor of the National Bank of Slovakia Ivan Šramko in his opening speech summarised the basic facts about Basel II. He reminded the time schedule that the Basel Committee on Banking Supervision (BCBS) has set, and which presumes the implementation of new standardised and less advanced approaches to measurement of capital requirements (CR) for risks from the end of 2006 and the subsequent implementation of the most advanced approaches to measurement of capital requirements for risks from the end of 2007. With this is connected also the publication of the text of the new capital accord by the BCBS on 26 June 2004 and subsequent publication of the draft amended Directives of the European Union No 2000/12 and No 93/6, by the European Commission (EC) on 14 July 2004.

Ivan Šramko in the following part of his opening speech focused on the main principles of the NBCA. More and more it is becoming clear that Basel II does not mean only a change in the calculation of capital requirements towards more risk sensitive approaches, but also a continuing increase in the requirements for risk management in banks, or rather the requirements for processes carried out in a bank.

The content of the new accord consists of three parts, or “Pillars”. For a long time Pillar I was its most discussed part. For the first time it introduces a capital requirement also for the relatively little-researched operational risk and also extends the range of methods that a bank may use for calculating capital requirements for credit risk. Pillar III deals with the compulsory publication of information by the banks themselves and was equally criticised from the side of the banking community. The focus of discussions has however recently shifted to Pillar II, which sets out the principles for the process of banking supervision. This supervision has also an internal aspect: banks themselves would have to have the process of allocating economic capital for all risks, not only for those covered by Pillar I.

• Massimo Marchesi from the General Directorate for the Internal Market of the European Commission in his speech outlined the basic challenges connected with the implementation of Basel II in the
conditions of the European Union (EU). Following the adoption of Basel II, the European Commission also published its draft amended Directives No 2000/12 and No 93/6. Over the course of years 2004 – 2005 the legislative process of the directives’ adoption in the European Parliament and the Council of Europe and subsequently their implementation in years 2005 - 2006 by all the member states of the European Union will follow. As regards the BCBS, work has been continuing since July 2004 on selected areas of the NBCA. From October 2004 tests will be carried out in various fields in order to verify the calibration of the accord, in the second half of 2006 banks will carry out the parallel calculation of capital requirements according to both the Basel I capital accord in place today and according to Basel II. As for the date of the implementation of Basel II, the BCBS has opted for a phased transition, which means permission to use a standardised and FIRB approaches from the end of 2006 and the AIRB approach from the end of 2007.

Many answers to questions that had arisen in connection with implementation depend on the relation between the bank and the banking supervision. One of the problems is also the impact of Basel II on the respective banking sector. For verifying this impact various quantitative impact studies (QIS) have been performed, the results of which have helped to calibrate the document’s wording. Besides these quantitative impact studies, an overall macroeconomic study has also been carried out by PriceWaterhouse-Coopers on the impacts of the intended new regulatory framework on all sectors of the European economy, with a specific focus on small and medium-sized enterprises.

Basel II should be more flexible and adaptable than the original accord. For this reason the draft of the new rules has been divided into three levels, thereby shortening the protracted legislative process of adopting additional changes and achieving an appropriate balance between stability and flexibility. For this segregation there has been applied the so-called Lamfalussy principle, where articles of the directive may be changed only by a complete legislative procedure (level 1), annexes to the directive may be changed by a simplified legislative procedure, i.e. comitology (level 2) and level 3 is in the competence of the Committee of European Banking Supervisors (CEBS).

In the new accord each of the three pillars is implemented at a different level of consolidation in order to avoid the unnecessary duplication of requirements for individual banks and banking groups. Pillar I is applied at the solo level as well as at each consolidated and sub-consolidated level, Pillar II at a sub-consolidated level in a member state and Pillar III at the level of the EU parent company. A large number of national discretions can be still found in the draft directive, although their number has been reduced through negotiations.

- Christian Fehlker from the European Central Bank in his presentation spoke on general aspects and the broader consequences of the new accord. It is supposed that the amended EU directives will lead to reform of the financial sector. It is connected to the fact that banking supervision is not the only body responsible for maintaining financial stability. Any supervisory authority will always have less information than the management of a bank, which bears the main responsibility for it. The distance between a bank and the supervisory authority is gradually decreasing and the need for mutual co-operation is increasing.

- Basel II in the European perspective has various sub-levels and will apply for both large and small banks, all having their own interests. One of the international aspects of this accord will be competition. Pillar II, when compared with the other pillars, is more oriented on the process, i.e. the human factor will also intervene in an implied manner in decision making. Although the simplicity and objectivity of the accord is thus lost, on the other hand greater efficiency is gained. During several revisions of the text of the accord a large change was done in the minimum requirements placed on banks in their objective to use advanced approaches to measuring capital requirements. Banks should flexibly organize their strategies and it is generally expected that their behaviour will change.

- Monika Laušmanová from Česká spořitelna in her presentation spoke on the impacts of Basel II from the viewpoint of a commercial bank operating in the Czech Republic and belonging to a banking group operating in several Central and Eastern European countries. Such type of a bank is prevalent in the banking sectors of both the Czech and Slovak Republics, which results in the importance of solving relationships between the home and host regulators. Generally speaking this issue is important for almost all banks in Slovakia.

In the Czech Republic since September 2002 a joint project of the Czech National Bank, the Czech Association of Banks and the Czech Chamber of Auditors has been underway entitled “Basel II – Implementation of the New Concept of Capital Adequacy in the
Czech Republic”. Its aim is to set up an efficient communication platform and to bring together all interested parties to resolve tasks. The project incorporates broad education of the professional public, a definition of terms used in communication, a joint analysis of the documents of international institutions dealing with Basel II, commenting them and the subsequent implementation in the Czech Republic.

Despite the problems that such a broadly set project necessarily brings, many positive results were achieved. Dictionaries of terms and the problem areas that need to be solved, were gradually defined in the project (for example the relationship of default and the classification of claims, the issue of real estate collateral, the sharing of data, the relationship of portfolios according to Basel II and the actual portfolios of banks, the way of approving advanced methods of capital requirements calculation). The discussion has shifted over time from quantitative issues to more demanding issues connected with qualitative requirements for risk management.

Special attention was given in the presentation to operational risk. It has been shown that the advanced method of its measurement allows a bank to achieve, from the viewpoint of quantitative aspect, using an appropriate selection of parameters, very varying results, sometimes seemingly meaningless. Therefore the qualitative aspects of operational risk management are actually much more important than risk quantification. One of the principles that need to be complied with in measuring of operational risk is the consistency of the method of its measurement over time. It is also very important to monitor qualitative changes that may have a significant impact on the size of the operational risk undertaken by the bank, where this applies to both positive changes (for example the implementation of instruments for risk mitigation, the improvement of control mechanisms), as well as the negative ones (for example the implementation of new procedures, an increase in the volume of activities).

A further important topic covered by the presentation was the actual process of supervision over banks under the conditions of Basel II. The bank – regulator relationship is covered mainly in the Pillar II, which is not simply concerned with the possibility of prescribing additional capital requirements upon the bank by the regulator, as the issue of Pillar II is sometimes simplified. On the contrary, its basis is the internal capital adequacy assessment process (ICAAP) by the bank. According to one of the general principles issued by CEBS, the ICAAP is exclusively a matter of the bank and the regulator subsequently or simultaneously with ICAAP evaluates its quality, as well as the quality of the risk management system, its adequacy with regard to the bank’s activities and only then he possibly progresses to adopting measures.

The problems of cross-border supervision in the Czech Republic and in Slovakia are an especially hot topic, felt also by banks, since they must concurrently meet the requirements of their parent banks, or said otherwise implicitly the requirements of the home regulator responsible for supervision on a consolidated basis, and also the requirements of the host regulator that licensed them. The European approach to this dilemma gives an ever-growing role to the home regulator. This brings about both many advantages (for example limiting the duplication of many activities and saving the resources of all parties involved), as well as disadvantages (for example cross-border projects are more demanding, cultural barriers arise, threatening a reduction of professionalism in the subsidiary banks).

- Jonathan Locke from Všeobecná úverová banka (VÚB) in his presentation spoke about the state of the implementation of Basel II in a commercial bank in the Slovak banking sector. Although VÚB is the second largest bank in Slovakia, in the European context the bank is a small one.

As regards approaches to the measurement of capital adequacy, the bank has decided to implement them gradually; it plans to move over to the most advanced approaches to measuring risks in the medium term. Several projects have been established in the bank, concerning the central planning and coordination of activities connected with Basel II. These activities however require considerable investment by the bank in particular in credit risk management. The cooperation with its parent company is very important for VÚB. If possible, a model for credit risk will be developed locally and adequately calibrated by the parent company for the reason of the required reporting and portfolio management under the group. In the case of operational risk the bank plans to implement an advanced model of quantifying operational losses, in accordance with the strategy of the parent company.

Basel II requires banks to improve their risk management, which in turn leads to the need for improving the quality of data. The implementation project in the bank is phased; the bank at its outset selected a main coordinator, set up working groups and performed an initial gap analysis. All levels of management were informed about the main principles of Basel II and the bank’s expectations. Work still remains for the bank in creating a domestic database for specific activities and in assessing the methodology of the parent com-
pany from the aspect of both all particulars and the regulator.

The further steps to follow in the future are for example those of identifying responsibility for Basel II, both at the level of the whole bank, as well as at the level of individual subprojects, the compilation of a Basel II project plan, determining the main fields, defining the subjects of individual fields and defining approaches. VÚB therefore needs to create at least a general knowledge of the Basel II issue throughout the whole bank. Possible ways of achieving this are, for example, training of relevant levels of management, the circulation of various materials and setting up a virtual help desk.

- **Alfonso Asaro from Deloitte & Touche** in his presentation dealt, from the broader perspective, with the situation of a bank having its parent bank located abroad. It seems that no general instruction for any banking group, or local bank which is a part of it, exists on how to successfully cope with the demands of Basel II. It may however be said that the local bank should thoroughly require from its parent bank timely communication concerning any requirements that need to be fulfilled for a successful solution at the consolidated level. This will enable to adapt its own approach both to the group-wide aims, as well as to the local market and regulator. Taking the initiative in any field may bring the local bank an even better position in the group, if the group solution is proposed according to its local solution.

The aims and advantages of Basel II by far do not end in Pillar I through reduced demands on own funds, on the contrary Pillar II is an area in which banks may, in comparison with the current state, profit significantly. The result of the thorough application of the principles of Pillar II may, for example, be the introduction of the use of new quantitative instruments into common operations, the simplification of operations in the whole bank or banking group, the creation of quality control systems and an overall improvement in management. All this cannot be done without financial support, but in the case of the necessary investments for the needs of Basel II, a quick rate of return on these costs involved is possible.

- **Juraj Lörinc from the Banking Supervision Division of the National Bank of Slovakia** in his presentation spoke on the activities of the NBS directed towards implementation of Basel II. The first major activity of the NBS was the quantitative impact study QIS 3⁴, undertaken in years 2002 – 2003. The Banking Supervision Division then, besides assessing the impacts of Basel II on the banking sector, also prepared a cycle of seminars for banks, where the technical part of Basel II – Pillar I was explained, as well as the individual consultations. At these meetings the majority of banks declared their intention to use advanced risk measurement methods in the future. A further issue which banking supervision dealt with was the preparation of NBCA itself, which began for the NBS in 2001 and continues to the present day. Various versions of Basel II were subjected to study and comment, as were other additional documents issued by the Basel Committee on Banking Supervision. The document concerning the cross-border implementation of NBCA⁵, which divides up the tasks between the home and host regulators was of special importance.

The principles of Basel II have also been taken over into draft directives of the European Union. Already as an acceding country to the EU the Slovak Republic was invited to comment on the draft text of Directives No 2000/12 and No 93/6. Active participation is occurring at various levels – participation in the Committee of European Banking Supervisors and Groupe de Contact, the main working group of the CEBS, in which the NBS is represented by its Deputy Governor Ivan Šramko and the Chief Executive Director of the Banking Supervision Division Milan Horváth, in the working group of the EC (later the Council of the EU), which is in charge of preparing the text for the new wording of the directives and in which the NBS is represented by Lúbor Malina, and the adoption of a joint position for the new member states of the EU.

Through adopting Basel II, new tasks await the NBS. First of all, it will be necessary to change the professional public’s understanding of the philosophy of capital adequacy, since ever-greater emphasis is now placed on the qualitative aspects rather than numerical evaluation. Further, it will be necessary to create new terminology, to incorporate EU directives into the Banking Act and other acts and subsequently into decrees and methodological instructions of the NBS. The Banking Supervision Division plans to hold regular meetings with banks on a quarterly basis, the first round of which was held at the end of June 2004. Technical questions and definitions necessary for regulation will be drawn up in cooperation with the Association of Banks. Besides the CEBS and the Groupe de Contact, the NBS is also cooperating with foreign banking supervisors with which it has signed

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⁵[http://www.bis.org/publ/bcbs100.htm](http://www.bis.org/publ/bcbs100.htm): High-level principles for the cross-border implementation of the New Accord, Bank for International Settlements, Basel Committee on Banking Supervision, August 2003.
Memorandum of Understanding. The aim of the National Bank of Slovakia in the implementation of Basel II is to create a sound financial system, comprised of well-functioning banks providing a good quality services to clients.

- Ľubor Malina from the Banking Supervision Division of the National Bank of Slovakia in his short speech at the conclusion of the seminar addressed issues of future cooperation between the Banking Supervision Division and the banking sector in the implementation of EU directives. Banking supervision is currently in the first stage of implementation and is aware of the scale of problems that still lie before it. Its most pressing task will therefore be to raise awareness of Basel II in the banking sector. A limitation may however be the position of the Slovak banking sector in the whole EU financial sector. Through the fact that banking supervision of the NBS is almost exclusively in the position of a host regulator, it is the recipient of decisions of parent banks, while the subsidiary banks play the key role in the Slovak banking sector. The Banking Supervision Division plans to focus on three main fields. The first field comprises local data, where necessary information will be required for approval of the advanced methods of measuring capital requirements. In this regard it counts on strong support from the side of the Association of Banks. Working groups set up by the Association of Banks will focus on specific content of segmentation and business lines to allow the collection of comparable data from the side of banks. The second field will be the targeting of banking supervision on substantial increase of the quality of risk management processes in banks, while the issue of quantity will represent a secondary field. The third field will be the handling of retail, corporate and SME portfolios (a portfolio of small- and medium-sized enterprises). The Banking Supervision Division in the coming period also plans to increase the frequency of contacts with the banking sector, where it is counting also on support from the top management of banks.

- In the discussion bank representatives asked about the role of the CEBS and how this committee will influence the decision making of the NBS. The CEBS plays a key role in harmonising national legislations, harmonising national positions at its meetings, whereby a unified approach to the issue emerges.

A further question put by banking sector representatives was whether the NBS will prepare a decree in accordance with the implementation of Basel II, considering that the decree about risk management, which is now under preparation, precedes the publication of the NBCA. The response of the Banking Supervision Division was aimed at the protracted legislative process of adopting European directives and their implementation into national legislation. The Banking Supervision Division wishes to achieve full harmonisation with European legislation, to apply the maximum of the already existing provisions of the directives, and to achieve the timely preparation of the banking sector for the coming change in regulation so that all banks have sufficient time to change their systems. In this field significant cooperation is again expected from the side of the Association of Banks.

The third question concerned the NBS’ cooperation with regulators responsible for supervision over the parent banks of Slovak banks. Cooperation of the NBS Banking Supervision Division with other banking supervisors is of a varied level. It has signed a Memorandum of Understanding with all the supervisors involved. Following the publication of the definitive draft text of the directives the NBS Banking Supervision Division plans to hold meetings with banking supervisors of member states who have their banks represented in the Slovak banking sector.

It has been shown that the whole of Basel II places high demands both on commercial banks, as well as on the regulator. For this reason the long-term preparation of all parties involved is necessary. Although amended Directives of the European Union No 2000/12 and No 93/6, which will reflect the content of Basel II in the conditions of the European Union, are to be implemented not before 1 January 2007, very little time remains for the preparation.