THE IMPLEMENTATION OF BASEL 2 IN SLOVAK LEGISLATION

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Regarding the implementation of the new regulatory framework known as Basel 2 in the Slovak legal environment, the process is now reaching a culmination and it is taking place at two levels. The first involves the transposition of the European Union directives 2006/48/EC and 2006/49/EC (jointly known as the Capital Requirement Directives or CRD) into the Banking Act,[1] which will be carried out through an extensive amendment that is now in the process of being approved by the National Council of the Slovak Republic. The second level consists of the preparation of new and amendment decrees of the National Bank of Slovakia.[2] This fundamental change in the regulation of the banking sector has been several years in preparation. At various stages it has involved a wide group of people drawn not only from the National Bank of Slovakia, but also from the Slovak Banking Association and the Ministry of Finance of the Slovak Republic.

The method selected for transposing the said directives is an amendment to the Banking Act. It is a particularly extensive amendment running to more than 75 pages, of which over 60 are directly concerned with implementing the CRD. The rest deals with the transposition of the Takeover Bids Directive[3] into Act no. 566/2001 Coll. on securities and investment services, as amended. This form of transposition was selected mainly for legislative technical reasons. The Act itself is slowly but surely becoming ripe for revision in the form of a new law on banks and credit institutions.

The substance of Basel 2 has already been the subject of many published documents, commentaries, and analyses, some of which have appeared in this journal. We will therefore focus here on describing the most important points of the Banking Amendment Act. The Securities Act will not be addressed in any detail – since the transposition of rules for securities dealers is analogous to the transposition into the Banking Act – and nor will the transposition of the Takeover Bids Directive be looked at.

The contents of the extensive Banking Amendment Act can be divided broadly into ten groups:

- the core mission of the NBS as the supervisory body, and the definition of a credit institution;
- definition changes for the terms dominant influence and power of control and the reasons for them;
- changes in the requirements for the business of credit institutions and their management employees;
- replacement of the term "capital adequacy" with the term "capital requirements";
- techniques for measuring and mitigating Pillar 1 risks;
- requirements for credit institutions under Pillar 2;
- prior approvals and remedial measures of the NBS;
- state subsidization of mortgage loans for selected household segments;
- provisions concerning security-technical measures in banks and information;
- transitional provisions.

It is clear just from this summary that amendments to the respective parts of the Banking Act have been extensive. We will now look at each of these groups in succession.

The core mission of the NBS as the supervisory body, and the definition of a credit institution[4]

This group includes three significant changes. The first is the replacement of the term "banking supervision" with the word "supervision" in regard to the NBS. This amendment results from the adoption of Act no. 747/2004 Coll. on financial market supervision (hereinafter "the Supervision Act") and the extension of the NBS's competences. The second amendment redefines the term credit institution in Section 5, so that it is understood to mean a bank or an electronic money institution. This amendment introduces into Slovak legislation a term which is regularly used in EU legislation governing regulation. The reason is to simplify the transformation relations between Slovak and European legislation. The third change – apparently minor, though in terms of consequences, substantial – is the new definition of how the National Bank of Slovakia is to exercise supervision, laid down in Section 6(2). In contrast to the current situation, it requires scrutiny not only in the sense of oversight, but also in regard to "the evaluation (...of introduced systems and procedures...and risks)" to which a bank may be exposed, and to the assessment

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[1] Act no. 483/2001 Coll. on banks, as amended.
[2] Decrees of the NBS no. 12/2004, 8/2002, 4/2004, 5/2004.
[3] Directive 2004/25/EC of the European Parliament and of the Council on takeover bids.
[3]4Mainly Section 4(1), Section 6(2), (13), (16), Section 13(2), Section 19(2), (3), (4), Section 47 in part, and Section 48.

of their capital adequacy. This new requirement reflects the current shift in understanding of how supervision is exercised – the supervisor does not simply view compliance with legal standards, but is also required to give its reasoned evaluation of a given matter. Naturally, this will also have a substantial effect on how the NBS exercises supervision and on the training and quality of its staff. To supervise in this way is, of course, substantially more demanding than the current method of supervision. This new paragraph also lays down, in regard to the exercise of supervision over the branch or subsidiary of an EU-based parent bank, a duty to communicate with the partner supervisory authority in the EU and the minimum information that is to be exchanged.

Definition changes for the terms oversight and control and the reasons for them[5]

This field includes several amendments not directly related to the implementation of the CRD, but instead concerning the elimination of certain shortcomings. First, the text of the Banking Act has been harmonized with the text of Directive 2006/48/EC in regard to the definition of a qualifying holding, with the threshold increased from the original 5% laid down in Section 7(11) to 10%. Since the respective article of the Directive is not mentioned in Recital no. 13 (on super equivalence), which allows a Member State to legislate more strictly than the Directive, this provision must be implemented as it is. Section 44 with its complicated and superfluous typology of "consolidated groups" and "for the purpose of exercising supervision on a consolidated basis" (over branches and subsidiary credit institutions of EU-based parent companies) has been repealed and replaced with definitions laid down by Directive 2006/48/EC. The term "decisive influence" has also been repealed. The result is not ideal and there will surely be efforts to simplify and clarify the terminology as far as possible in the interests of having an unambiguous interpretation.

Changes in the requirements for the business of credit institutions and their management employees[6]

The draft text of Section 23 of the Banking Act is intended first of all to implement Article 22 of Directive 2006/48/EC, which lays down the organizational requirements and the basic "arrangements, processes and mechanisms" which a bank must comply with when performing its activities. It also defines certain basic terms, including so-called regulatory risks, that is, those for whose coverage the NBS may require a certain volume of own funds. For the exercise of supervision, mainly Paragraph 4 is significant, since it sets out the method, objective and framework of supervision. As in the definition of the NBS's supervisory remit under the Financial Market Supervision Act, the supervisor's obligation is being enacted so as to include evaluation and not only review. Moreover, Section 24(3) lays down for senior management the basic principles of their responsibilities for the bank's business. In this regard, the term "soundness and security (of the bank)" has been replaced with the term "economic stability". The previous term was quite problematic, since as an almost literal translation of the English term, it sounded relatively odd in Slovak.

Replacement of the term "capital adequacy" with the term "capital requirements"[7]

The expansion of the types of regulatory risks, and particularly the enacting of the option to increase the minimum capital requirements by the use of Pillar 2 principles, has made it necessary to change the term "adequacy", which is essentially linked with the ratio of own funds to risk-weighted assets. By expanding the scope to stipulate additional capital requirements for risks other than only credit risk, the said ratio has lost its logical legitimacy. In fact, it was already causing problems in regard to the setting of capital requirements for market risk. The term "capital requirements" was therefore defined, and allows also for the inclusion of an individual capital requirement depending on the evaluation of the credit institution's risk profile by the National Bank of Slovakia.

Techniques for measuring and mitigating Pillar 1 risks[8]

This part represents the core of the CRD' transposition into Slovak legislation. The first stage involved identifying in the text of the CRD – not just in the directives themselves, but also in their extensive technical annexes – every place where an obligation is imposed, whether on credit institutions, supervisory authorities, or EU Member States. In legal English, this is often expressed by the word "shall" and more than 300 such cases were identified. This fact itself gives some idea about the demands of the whole transposition. In the

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[5] Mainly Section 6(4), (5), (6) (repeal of the term), Section 7(11), (19c), Section 44, Section 45, Section 46, Section 48 and Section 49b.

[6] Mainly Section 4(1), Section 5(o to r), Section 8c, Section 23 (measure on risks), Section 24(2), and Section 27.

[7] Mainly Section 7(7), Section 8(7), Section 24(3), Section 49e(13), (14a), Section 49f(1)(c).

[8] Mainly Section 30, Section 31, Section 32, Section 33, Section 33a(1) to (5), Section 33b(1) and Section 33e.

second stage, the requirements were analysed to see which could be brought in under decrees and which had to be stated in the statute. Clearly, this was not at all an easy matter. The implementation of Pillar 1 alone has resulted in several new sections in the draft Banking Amendment Act, beginning at Section 30 and continuing up to Section 33e. The first of them sets out how the minimum capital requirements are to be calculated. It should be noted that this is not exhaustive – the NBS may, under remedial measures, set an increase in the requirement by means of Pillar 2 powers. Banks are obliged both to calculate and systemically to monitor the value of their own funds. This means that a bank is required to ensure monitoring of its own funds in such a way that their volume is kept above the stipulated minimum level. This does not of course mean that it would have to check the exact size of its risk exposure. However, it must provide for an effective system of controls by means of, for example, limits on exposure, risk capital, etc., so that this requirement is met. It is clear that particularly in the case of large and complex banks, a requirement to know at all times the exact risk exposure would be practically unfulfillable; on the other hand, the minimum required by the regulator is that it is not so large that the bank does not have sufficient of the prescribed own funds. To ensure such a system is already within the power of every bank, whether larger or small.

Section 31 defines some basic terms which will be needed to set out the regulatory methods for measuring credit risk. Allow us to make a general point in this regard. The whole law, even in its present wording, is quite difficult to read partly because the definitions are not in one place, as they are in the CRD, but are scattered among various sections. Despite the efforts of specialist departments and the Slovak Banking Association, it has not, for various reasons, been possible to clarify this. Section 32 is devoted to definitions and basic characteristics of the so-called standardized approach to credit risk and to the definition of the regulatory segmentation that is to be used in this approach. Among other things, it provides for the use of external ratings assigned by recognized rating agencies to individual borrowers, and for the conditions of their recognition. It should be noted that this approach, resulting mostly in lower capital requirements, will probably be used mainly for the sovereign segment (the government and borrowers of an equal standing), banks and significant corporate entities. In Slovakia, it is not expected that these ratings will become particularly more widespread, given that the conditions for recognition by rating agencies are quite strict. The NBS will generally not accept so-called unrequested ratings, in other words those which are carried out using only publicly available information and not on the basis of an order for cooperation with the evaluated entity. The reason is clear.

The amendment act continues with a section on the "internal ratings-based approach". The following two alternatives have been selected for the definition in Section 33: a "foundation"[9] and "advanced"[10] internal ratings-based (IRB) approach, which is included in the Basel Accord,[11] but which in the final stage of preparation was not incorporated into the CRD. It is mainly for technical reasons that this terminology has been accepted for the Banking Act. This section stipulates the conditions under which the NBS will allow a reverse from the advanced to the foundation approach, the key point being that a bank which applies for this does not do so simply in order to lower its capital requirements. In addition, as part of the approval process for the use of the IRB approach for a banking group with a parent company in another EU country, the NBS is placed under an obligation to cooperate with the relevant supervisors in the EU.

The principles and applicable techniques for the mitigation of credit risk are the focus of Section 33a. Here are defined the basic requirements for assets and entities in regard to the recognition of funded and non-funded credit protection,[12] assuming that the particulars will be laid down in an NBS decree. The subsequent section concerns securitization. Given that this technique has so far had limited, albeit steadily growing, significance in banking business, the formulations in the CRD are adopted practically word for word, and the CRD annex will constitute the decree on particulars that is to be issued by the NBS. It is likely, however, that practice will show the necessity of supplementing this section in the near future.

Section 33d states the basic principles for the calculation of capital requirements for operational risk. This concerns a new type of regulatory risk which the law does not so far recognize. The section defines three basic methods of measurement: the basic indicator approach, the standardized approach, and the advanced measurement approach to operational risk. Of these, only the advance measurement approach requires prior approval from the NBS. It should be noted in this regard

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[9] The foundation approach refers to where, within the rating system, the credit institution itself determines the probability of default (PD) of a borrower. This approach is not possible with a retail borrower.

[10] The advanced approach refers to where, within the rating system, the credit institution itself determines not only the PD, but also the loss given default (LGD) and the exposure at default (EAD) of a borrower, and possibly credit conversion factors.

[11] Basel II: International Convergence of Capital Measurement and Capital Standards: a Revised Framework, www.bis.org.

[12] Section 23(6)(g) and (h).

that the existing NBS decree on risks,[13] in the part concerning operational risk, adopted most of the qualitative requirements for the standardized measurement approach to operational risk, and therefore all banks in Slovakia should already have in place at minimum a database of operational risk events and losses. The NBS took such an approach because of a core emphasis on the fulfilment of quality requirements, this being because own measurement, even in the case of advanced measurement, is still more of an indicator than a real measure of the size of the operational risk undertaken. This issue is in a state of turbulent development and we may continue to expect a real measurement of this risk.

The last section in this series is Section 33e on large exposures. It contains only one substantive change in that the NBS has decided to exercise the option laid down in the CRD to temporarily exceed the limits for large exposures in the trading book. This will make it easier for banks to meet the limits (in, for example, the settlement of transactions) and it will reflect the daily reality on the market without having a substantial impact on banks' financial stability.

It is necessary to note that the said sections of the Banking Amendment Act include only the most essential obligations and definitions. Most of the so-called technical details will be laid down in NBS measures, especially in the new decree on own funds.[14]

Requirements for credit institutions under Pillar 2[15]

Pillar 2 represents for most EU Member States a more or less new issue in the exercise of supervision, not only for the supervisory authorities but also for banks. It is not that some elements have not already turned up in practice, but that the comprehensiveness and taxonomy of its principles is new. Banks are at present focusing mainly of meeting the Pillar 1 requirements, though these are to be amended in the near future. The actual text of the legislative regulation is relatively simple. In Section 23(6), the term internal capital is defined as a bank's capital which, on the basis of its own risk definition and assessment, are maintained internally for risk coverage. In the EU, there is not a single approach to this definition. Some Member States require that it relates exclusively to Tier 1 capital,[16] while others, such as Slovakia, do not prescribe anything. In that case, it is possible to use any funds which have the appropriate long-term maturity and are similar in nature to regulatory own funds. The actual definition from that part of Pillar 2 which imposes an obligation on banks is contained in Section 27(3), which defines the internal capital adequacy assessment process (ICAAP).[17] One of the key principles is that the bank itself is the owner of this process, meaning that the NBS neither determines how the process is carried out, nor approves methods and procedures used in it. The same section defines what the implementation of this process should answer:

- what is the strategy for managing the level of internal capital;
- what is the procedure for determining the adequate level of internal capital, the components thereof, and for assigning it to individual risks;
- what system is used to keep the internal capital at the level required by the bank.

It is the second of the required outputs that poses most of the questions and problems for a bank. A frequent question is whether in fact every bank must have a sophisticated model for determining "economic capital".[18] The answer is, of course not. The existing simple but consistent identification of significant and insignificant risks, together with well-founded consideration of the acceptable collateral and its correlation with exposure risk, may overall be a good model of economic capital. Given that banks have the option to remain within the current regulatory regime for the duration of 2007, it should be expected that both the banks and NBS will carry out necessary specification in that year. It is necessary to stress in this regard that the basic assumption for the successful implementation and exercise of supervision under Pillar 2 is a constructive dialogue between the NBS and the supervised institutions.

The only specific requirement is mentioned in Section 33f(1), namely, that a bank's economic value[19] may not fall to below more than 20% of the value of its own funds in the event of a sudden change in interest rates. The NBS will stipulate what constitutes "a sudden change in market interest rates". For the Slovak koruna, it currently represents a parallel shift in the yield curve of 200 basis points. Should it happen in regard to exposures recorded in the banking book, the NBS may stipulate additional capital requirements.

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[13] NBS Decree no. 12/2004 on risks and a system of risk management.

[14] The Decree on own funds is under preparation and will substitute the Decree No. 8/2002 on large exposure of banks, the Decree No. 4/2004 on adequacy of banks' own funds of financing and the Decree No. 17/2004 laying down particulars of an application of a bank or a branch of a foreign bank for a prior approval for use of internal models for market risk calculation.

[15] Section 27(1) to (7), especially subsection (3).

[16] The highest-quality and most liquid financial capital, especially paid-up share capital and agio funds.

[17] Tnternal Capital Adequancy Assessment Prosess.

[18] Economic capital refers to the minimum amount of internal capital that a bank assigns for the coverage of its risks.

[19] The economic value of a bank is understood to mean the net present value of interest-rate sensitive exposures in the banking book.

Prior approvals and remedial measures of the National Bank of Slovakia[20]

As has already been mentioned, there are several points in the CRD where the supervisory authority is required to express an opinion on some option, procedure or method. Of course, not everything will take the form of a prior approval, but there will still be substantial expansion of matters requiring an NBS opinion. It is not necessary to state individual cases – the reader may find them in the sections of the Act cited below. This is one of the reasons for the repeal of Decree no. 17/2004 – which lays down the particulars of an application of a bank or the branch of a foreign bank for a prior approval of the NBS for the use of internal models in market risk calculation – and its inclusion in the new decree on capital requirements. If we wished to generally describe the instances where NBS approval is required, it would be those in which the use of a certain specific procedure or method may result in a lowering of the standard capital requirements.

As scope has expanded for measuring risks and the obligations of banks and their managements, so it has become necessary to amend Section 50 and Section 53. In Section 50(1), for example, the new paragraphs (m), (n) and (o) have been insert, which lay down the option of setting capital requirements on a case by case basis (paragraph (m)), the option of requiring that the provisions created for own funds be supplemented where the bank's method does not sufficiently take account of the credit risk exposure (diversification risk – paragraph (n)), and the option to require a reduction in risk exposure (paragraph (o)). In addition, the replacement of the term "capital adequacy" with "capital requirements" has required a reformulation of the conditions in Section 50(5), Section 53(3), and Section 63(1)(b).

Section 49 includes an obligation to consult with the "home supervisor" where an NBS decision concerns the basic characteristics of a subsidiary (a change in the shareholder structure, the imposition of binding remedial measures and fines). This provision reflects the principle of consolidated supervision in the EU.

State subsidization of mortgage loans for selected household segments[21]

This part of the amendment is not directly concerned with the duty to implement the CRD. It applies to Section 85a and Section 85b, which stipulate the conditions under which the state will subsidize mortgage lending to a selected segment of households. The most important of these conditions are probably the obligation of banks to allow the repayment of both interest and the principal to be deferred for a period of 5 years, the fixing of the state subsidy on an annual basis, and the fact that a mortgage bank is not liable for the correctness of the criteria for providing this type of mortgage loan.

Provisions concerning security-technical measures in banks and information[22]

This part, too, only partially concerns Slovakia's obligation to implement the CRD. First of all, the period for which a bank may, under Section 93a(7), keep audio and video recordings from the surveillance of its premises is extended from 30 days to 12 months. It should be noted, however, that this question has been the subject of dispute proceedings with the Office for Personal Data Protection. The purpose of recordings made under this section is expanded to include "the identification and detection of criminal offenders".

As regards the implementation of the CRD, a substantial further change is contained in the new subsection (8) of Section 93a, which stipulates that a bank may collect personal data on customers and other persons within the scope of the NBS decision on prior approval, in accordance with Section 33 (when using the internal ratings-based approach). It legitimizes the hitherto controversial (especially in regard to the Personal Data Protection Act[23]) collection of personal data necessary for the creation of rating and scoring systems in the retail segment. Another area is the disclosure of information about the bank under Section 37. Although this obligation is already established in the current text of the Banking Act, the amendment substantially expands the scope of the disclosed information. The particulars are again stipulated by decree, and an institution need not disclose the requested information where it is classified as immaterial, internal or confidential information. In that case, however, it is obliged to notify the NBS of the information which it does not disclose for this reason. As the supervisory authority, the NBS will examine whether the undisclosed information in fact has character defined by law. It should be noted in this regard that to what extent the scope of disclosed information is increased will depend on the sophistication of the approaches used by the bank for measuring regulatory risks, and on whether

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[20] Section 33a(6), Section 33b(3–8), Decree Article 9, Section 33c(2) to (5), Decree Article (6), Section 33d, Decree Article 10, Section 33f – Economic Value, Section 50(1)(a) to (o), (2) to (5), and (11), Section 51(1) and Section 63(1b).

[21] Mainly Section 85a, Section 85b and Section 89(4).

[22] Mainly Section 6(13), (16), Section 13(2), Section 37, Section 48, Section 92(1) and (8), Section 93a (7) and (8).

[23] Act no. 428/2002 Coll. on personal data protection, as amended.

or not it is a parent bank. For most Slovak banks, it will not mean a substantial expansion of disclosed information; the exception will be systemically significant (i.e. the largest) banks. We mention out of interest that among the items of newly required information are total earnings from exercising the office of a member of the statutory body or the supervisory board (subsection 8(d)) a bank has to pay.

The information obligation attaches not only to banks, but also to the National Bank of Slovakia as the supervisory authority. In Section 6, under the new subsection (16) there is laid down the obligation to disclose:

a) generally binding legal regulations, methodological instructions and recommendations related to financial market supervision;

b) how national decision-making is applied in relation to the adoption of EU legal acts and the choices which banks have under this Act;

c) general evaluation criteria and the methodology which the National Bank of Slovakia uses when exercising supervision over banks and the branches of foreign banks;

d) a summary of the statistical data on the relevant indicators related to changes in banking sector regulation;

e) the process of recognizing rating agencies and list of the recognized rating agencies in accordance with Section 32;

f) a list of the regional governments and municipalities which are assigned the same risk weight as are countries, for the purpose of calculating risk-weighted exposures by the standardized approach to credit risk.

This requirement, on the one hand, arises from the application of the transparency principle in the exercise of supervision and regulation, and, on the other hand, reflects the reality of the "host banking sectors" in the EU and the requirement for the creation of a barrier-free market in the EU.

Transitional provisions[24]

The substance of this part, focused on one section, is clear from the name. Its most important provisions are the option to use the existing framework and regulatory method up to 31 December 2007, which will probably be taken by a majority of Slovak banks, and the option to shorten the required length of time series data during the transitional period (especially subsection 12). The reason for this relief is that lawmakers want banks to switch as soon as possible to more advanced methods for the measurement of credit and operational risk while maintaining necessary prudence (subsection (2) – the upper limit on capital savings for the years 2007 to 2009, or subsection 13 for home loans). The formulation and contents were taken directly from the CRD.

From what has been said here, it is clear that this amendment to the Banking Act represents the largest and most radical revision in the Act's history. The overall effect of these changes – not only on the banking sector but also on its regulation and the supervision exercised by the NBS – will be huge and its shape can for the time being only be guessed at. It is no secret that the banking sector, in cooperation with the NBS, has already been preparing for this amendment for three years. Nevertheless, it is likely that only the implementation itself will show up any weaknesses or a need to rework the Act. That is also why, more than before, it needs to be viewed together with the relevant NBS measures. The total sum of documents runs to several hundred pages, which in turn reflects the huge development that the banking sector has undergone since 1993.

[24] Mainly Section 122f.