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RESTRUCTURING OF THE BANKING SECTOR IN SLOVAKIA OVER THE LAST TWO DECADES

Abstract: *The paper analyses key changes in the structure and behaviour of the banking sector in Slovakia over the period of the last 20 years. Slovakia is a special case among CEE countries; it went through revolution under Czechoslovakia in 1989, splitting from the economically stronger part to become independent in 1993, transforming the economy including the banking sector, which resulted in the highest participation of foreign capital in it in the region. The country introduced the Euro and was able to cope successfully with the economic and financial crisis. In the first half of the 1990s, the Slovak banking system was inefficient, with a high share of bad loans. As a solution to these problems, the pre-privatization measures and the privatization itself at the turn of the millennium is briefly analysed in the paper. The main form of privatization was the acquisition of local banks by foreign banking institutions. Foreign investors brought new knowhow and made the system more flexible and competitive. Currently, due to high capital adequacy and cautious credit policy, the system is relatively stable and able to cope with increased risks in their environment.*

Keywords: *banking sector, monetary policy of the central bank, development of assets and equity of commercial banks, role of foreign capital, profitability of banks, capital adequacy ratio, euro adoption in Slovakia, impact of the global financial crisis*

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Introduction

Banking systems can play a pivotal role for growth and catching-up in all transitional economies and only after some more or less costly measures of banking sector transformation have been carried through, can the actual market-oriented economic expansion start. As the other segments (non-banking segments) of the financial sector in all post-communist countries have remained so far rather underdeveloped, the role of banks as the dominant form of financial intermediation is even larger.

Slovakia started the transformation process as a part of the former Czechoslovakia. The two-tier banking system had been created and commercial banks had emerged because of a financial reform in 1990. After the split of the former Czechoslovakia, starting from January 1993, the independent banking system in Slovakia was formed. The National Bank of Slovakia (NBS) was established and first commercial banks were granted licenses (in 1993 altogether 23 commercial banks).

The banking sector in Slovakia was formed based on a strategy to develop a relatively small, but economically effective net of commercial banks that gradually, would be able to provide all services and products required by the clients (Komínková and Múčková, 1996). Prevailingly, commercial banks in Slovakia have been established as universal banks, performing all basic banking activities.

Starting the Independent Monetary Policy in Slovakia

A new central bank – NBS – started to perform basic functions of monetary policy. Its main role was to ensure the stability of the Slovak currency (SKK). To meet this task, traditional central bank measures were applied: issuance of banknotes and coins, money supply management, coordination of payments and settlement operations between commercial banks, supervision of banking activities and prudential performance of the banking system. The NBS performed these tasks independently from the Government. However, within legally permitted limits, it supported Government economic policy. The NBS also represented Slovakia in international financial institutions.

During the first years, the NBS had to learn and adjust the basic know-how of the central banking policy within a market economy. Its relative disadvantage was that know-how acquired under Czechoslovakia after the revolution in 1989 and the qualified personnel was mainly concentrated in the Czech Republic. However, the NBS managed to cope with these problems and gradually became one of the basic pillars of the financial system stability in Slovakia.

Monetary policy measures applied during the early 1990s were rather unconventional in comparison with those in developed market economies. The minimum reserve requirement was relatively high (9%), and credit limits were used. Discount rates of the NBS were also high (12% in 1993, 8,8% in 1996 – the latter being used also as an interest paid to citizens from the so called privatization bonds under "the second wave of the privatization").

The exchange rate policy of the NBS was operating in a fixed exchange rate regime, the rate being defined towards a currency basket. After the split of the former Czechoslovakia and due to overall worsening of the macroeconomic situation, the Slovak crown was devalued by 10% in July 1993. Simultaneously, the fluctuation band of the SKK was defined as +/- 15%. In order to avoid foreign exchange outflows, the purchase of foreign exchange by the population was regulated to SKK 9.000 in 1994 and gradually increased during next years. After a favourable development of the main monetary indicators, in 1995 a significant liberalization of the current account (of the balance of payments) regulation occurred.

In the monetary policy, the strategy of NBS was to decrease the importance of direct instruments (mainly credit limits) and to increase the role of indirect instruments (preferably open market operations). Implementation of this strategy increased the manoeuvrability of commercial banks and their lending activity. However, new demands on banking supervision – mainly in connection with the high share of "bad loans" and high dependency of banks on "strategic clients" – came to the forefront. The share of non-performing loans in the total volume of crown loans increased from 21.8% in 1993 to almost 40% in 1996 [6, p.25]. Measures were applied regarding capital adequacy of banks, limiting large credit exposure to individual clients, liquidity regulation, etc.

In this period, a deposit protection scheme (for deposits of physical persons) was also introduced. A Deposit Protection Fund was established. All banks in Slovakia accepting deposits from physical persons are obliged to contribute to this fund. Regulations regarding the deposit protection scheme, of course, have been changing over time.

However, in the second half of the 1990s it became clear that a more radical restructuring of the banking sector is necessary, including new forms of privatization. NBS played an important role in planning and performing the pre-privatization measures [17].

Commercial Banking Sector in Slovakia during 1990s

From a quantitative point of view, the dynamics of the commercial banking sector was significant. The number of commercial banks increased continuously (although three banks were deprived of licence in 1996, new banks emerged), the number of employees, the volume and scope of operations increased as well. Before the start of the radical restructuring, leading to a dramatic increase in the foreign banks participation at the turn of millennium, there were 25 banks – residents in Slovakia (some of them with foreign ownership) and four branches of foreign banks.

Out of 25 institutions registered in Slovakia, 21 banks were granted a universal banking license, four were specialized for specific activities (building savings banks, a guarantee bank and a consolidation bank). The equity capital of commercial banks was 13,8bil. SKK in 1993 and grew to 30,6bil. SKK in 1997.The foreign investors' participation grew from 27% of the total volume of equity in 1993 to 52.2% in 1997. [7, p.14].

Privatisation of banks started under the former CSFR and three large state-owned banking institutions were included in the voucher privatization. New banks were established as private companies. After this first round of privatization, about 40% of Slovak banks' equity remained under the control of the state (mainly The Fund of National Property) and 60% was held by private owners.

However, there were significant problems in the Slovak banking sector (mainly concentrated in the three largest banks) that can be summarized as follows:
- Insufficient capital adequacy;
- Lack of long-term financial resources;
- High share of “bad loans”
- High share of state ownership often connected with loans to connected parties and corruption.

Lack of long-term resources is connected with the structure of deposits (low share of long/term deposits) and its comparison with the loan term structure. The propensity for long-term savings was relatively low in Slovakia, which was caused by internal and external socio-economic factors.

The most serious problem of Slovak commercial banking in the 1990s was an unfavourable loan portfolio, with a high share of bad loans. These bad loans were especially high in the three largest state-controlled banks (VÚB, Slovenská Sporiteľňa, Investičná a rozvojová banka). A portion of these bad loans was inherited from the centrally planned economy. However, new factors connected with the transformation process in the whole economy and some political decisions contributed to the increasing loan portfolio problem.

The first factor was the need to rapidly create a banking sector conforming to the needs of a transforming economy. The undersized banking sector was not able to handle the financing needs of many new business units.

The second factor could be a lack of personnel with the necessary skills and experience to evaluate the riskiness of business projects and perform the prudent bank procedures. The business environment was unstable; prices, exchange rates, reliability of customers and suppliers were changing frequently.

Another reason could be that it was very easy to enter the banking sector. It was possible to establish a bank with relatively little basic capital. The ability of the bank’s shareholders to secure the long-term success of the organization was not sufficiently examined.

In the very risky and uncertain situation of the early 1990s, guarantees on loans were very important. However, in reality their role was sometimes only formal. In many cases, collateral was not marketable at all; guarantee contracts had many shortcomings. Moreover, the existing legal environment and court procedures created conditions favourable for debtors and detrimental for creditors [7].

An even more important reason for increasing share of “bad loans” was the situation in the non-financial companies sector: insolvency of many companies just formally privatized during the voucher privatization, secondary inter-company indebtedness, and the general “debt-forgiveness” of enterprises [6].

Due to the reasons mentioned, a radical restructuring of the Slovak banking sector was inevitable. The restructuring process needed in the late 1990s should be aimed not only at the recovery of loan portfolio, but more generally at creating conditions for improving financial stability and forming a sound, effective, competitive and creditworthy banking system.

However, the restructuring implemented in the late 1990s was not complex enough and not based on a long-term vision. The first step in the pre-privatization restructuring was aimed at solving problems in the two large state-owned banks: VUB and Slovenská Sporiteľňa and later on in Investičná a rozvojová banka (IRB). Two basic issues were to be solved:

1. Improving capital adequacy in the mentioned banks to achieve the standard 8%;
2. Reducing the level of "classified claims" (which was higher than 1/3 of the total volume of loans).

Two measures to achieve these objectives were used:

– The basic capital of the aforementioned banks was increased. The government used almost 25B SKK to increase the basic capital of the mentioned banks.
– A significant proportion of bad loans (classified claims) was shifted to other state controlled institutions, mainly to a Consolidation bank. During the years 1999-2000 the 113,117B SKK of bad loans and guarantees were shifted from the three aforementioned banks to the Slovak Consolidation bank [17].

Due to these measures the credit portfolio of the largest Slovak banks was significantly improved, their capital adequacy increased and the banks were prepared for the next round of privatization. As a basic form of this privatization, an acquisition by foreign investors went underway. In 2001, Slovenská Sporiteľňa was acquired by the Austrian Erste Bank. The new owner of the Všeobecná úverová banka became an Italian group IntesaBci [17]. The name of the bank and a majority of the local management remained. In 2002 the largest Hungarian bank OTP Bank Rt. acquired 98.94% of the shares of the former IRB. These acquisitions led to a radical increase in the foreign capital share in the Slovak banking sector. The share of the foreign capital in the total equity of the Slovak banking sector increased from 31.6% in 1999 to more than 92% in 2003 [15]. These changes which occurred "at the turn of millennium" actually began a new era in the Slovak banking sector. Although the restructuring measures during the late 1990s, and especially the subsequent dramatic entry of foreign capital, significantly improved the "health" and competitiveness of the Slovak banking sector, one comment on the restructuring process is required.

An important aspect of the restructuring process in the banking sector is the relation "bank–client (debtor)". The final success of the whole process depends also on restructuring of the enterprise sector, making it more efficient and competitive. The restructuring of the banking sector in the 1990s was oriented just on the "bank side" of the process. At that time large, either state-owned or just formally privatized companies prevailed in the Slovak economy. The problem of their insolvency was not solved and even after further changes in the ownership structure, it did not disappear. However, the improvement of the quality of loan portfolios and the restructuring of banks, created conditions for the employment of financial resources in a new, effective way, which can significantly improve the cooperation between banks and their clients.

The restructuring process in the banking sector led to improvement in all primary banking indicators. The total assets of the banking sector increased, credit risk was lower and did not endanger the capital stability of the sector. Conditions for the long-term sustainable growth of the sector were established [15].

The Impact of Foreign investors and EU Membership on the Slovak Banking Sector

Two basic interrelated factors influenced the structure and behaviour of Slovakia's banking sector during the last decade:
- The dominant position of foreign investors in the banking sector
- Slovakia's membership in the European Union

We can say that Slovakia's banking sector has been from the turn of millennium dominated by foreign banks. This can be made clear from all basic indicators: the share of foreign owned banks in the total number of banks in Slovakia, the share of foreign capital in the total banking sector equity, etc. Starting from 2002 the share of foreign capital in the total equity of the banking sector in Slovakia has always been above 90% – although fluctuating a little. According to the recent data, in 2014 the total amount of equity of commercial banks in Slovakia was €3,445,4M. Out of this just €153,9M was the capital of banks without foreign ownership. The rest was the capital of foreign banks that are residents in Slovakia or of the branches of foreign banks doing business in Slovakia (NBS, 2014).

From 16 banks registered in Slovakia (residents) in 2014 just two small banks were domestically owned, all other were foreign controlled. Additionally, there were 13 branches of foreign banks doing banking business in Slovakia. Probably, the dominant position of foreign banks is in Slovakia is the most evident in comparison with other CEEs [12].

The positive effects of foreign banks on the modernization of the banking business, improving credit policy, introducing new products and services and generally improving the international competitiveness of the banking sector are well-known from all post-communist countries. Amendments to the Banking Act, which came into force in 2002, moved the legal framework of Slovak banking closer to EU standards.

The fact that the commercial banking sector in Slovakia has actually been controlled by foreign capital brought many benefits to Slovakia's financial sector by improving the stability of this sector and has also benefitted whole economy. Foreign investors introduced new banking products and services (e.g. asset management schemes), new types of loans and especially new know-how and ethics which contributed to increasing the quality of personnel and improvements in bank-client relations.

In theoretical literature, we find various motives for foreign banks to go to CE countries [19, 3, 8]. Among factors supporting foreign banks entry into CEE countries we can mention: the previous development of the financial system (and especially the banking sector), the legal system and financial and political stability in a country, differentials in the rate of economic growth between the home and host country, and the distance between the bank group headquarters and host country. Similar factors also influence the form of foreign banks entry into Slovakia–although these forms also depend highly on a particular bank's global strategy.

For Slovakia, the most important motivating factors were: Slovakia inherited a relatively developed banking system from the former Czechoslovakia, political conditions were favourable – government supported this form of privatization, geographical position of the county was favourable and although the level of non-financial corporations FDI in Slovakia was lower at that time than in other V-4 countries, the foreign banks expected a significant increase in FDI (in manufacturing, services, etc.) in the future. Their entry into the Slovak financial sector was also a way to prepare for these changes. In general, we can say that the development of the banking sector during the first decade of the 21st century (with the dominant position of foreign banks) formed one of the comparative advantages of the country considered in FDI decisions by nonfinancial companies.

On May 1st, 2004 the EU experienced the largest enlargement since its creation. Slovakia entered the European Union as one of the 10 new member states. It had to adjust to the legislation of the EU, including the norms regulating the financial sector. Slovakia's financial system strategy should be formed in harmonization with the EU financial system development. For banks in Slovakia such an orientation was quite natural because most foreign owners of banks in the SR were from EU countries.

The financial system of the EU is often described in the literature as a bank-based system, owing to the prominent role traditionally played by banks in the major economies in the EU [1]. In the years 1995–2004 the banking sector of the EU grew rapidly reflecting the financial deepening and integration of the EU financial system. In the same period the average growth of banks' assets outpaced GDP growth. The ratio of banks' assets as a percentage of GDP was in the EU15 more than 400%. In the new member states the role of financial intermediation was significantly lower and the ratio of bank's assets as a percentage of GDP was under 100%. However, in Slovakia this ratio was relatively higher and in 2004 it was 88%. Slovakia actually used to be (and still is) a country with bank dominated financial system.

The development of the banking sector in Slovakia during the years 2005–2007 (after EU entry) was positive. EU membership was one of the factors that created a favourable environment for successful development of the Slovak financial sector. Internal factors were also important. Strong economic growth and an improving financial situation in certain economic sectors resulted in a greater volume of client loans. The positive trends were apparent in the increase in lending in almost all sectors. Although funds from foreign banks continued to increase, it was important for the stability of the system that the majority of banks had funds from domestic clients which were sufficient to finance the growth of loans at their disposal (NBS 2005, 2006, 2007).The profitability of banks grew, mainly in large banks.

During the years mentioned, Slovakia (and its financial institutions) were preparing for the introduction of the euro-currency. Different Slovak authorities and different financial institutions (mainly the central bank) were involved in this process. During the period analyzed, in cooperation with the European Commission, the European Parliament and the European Central Bank published several reports on the practical preparation for the enlargement of the euro-area. In the eighth report (2008) the European Commission concluded that Slovakia's preparation was well advanced and the introduction of the euro could be smooth. The National Bank of Slovakia started to distribute euro coins and banknotes to commercial banks in September 2008. In order to address consumers' fears of price increases around the changeover, Slovakia implemented a whole set of measures (double prices immediately before and after the change; ethical code of businesses declaring that prices will not be increased just due to a currency change, etc).

The majority of the Slovak population accepted euro positively and for banks, it was very advantageous that before the currency reform a massive increase in bank deposits occurred (people invested their money in bank accounts to minimize technical problems with the currency change). Paradoxically enough, at the time when western banks were facing serious liquidity problems, liquidity of Slovak banks was higher than before.

The Impact of the Single European Currency Adoption on the Banking Sector in Slovakia

From January 1, 2009, adopting the euro currency in Slovakia became a reality. Slovakia was the first V–4 country that joined the Euro-area. The process of transition to the single European currency was smooth and actually without problems. Positive evaluation of the euro adoption prevail, mainly in the business sector (foreign investors regard the common currency as an important comparative advantage of Slovakia as a location for investment), and positive evaluations prevailed in political institutions and among the population. During the first months of the global financial crisis, the common currency helped to soften the impact of the crisis and supported financial stability. The euro as a stronger and more stable currency could protect the Slovak economy against financial risks. However, it is difficult to separate the impact of the euro's introduction from the impact of the start of the global financial crisis and recession. Both processes occurred almost simultaneously.

From the point of view of the banking sector, the transition to a new currency is a more complex process. On the one hand, the central bank (NBS) played the leading role in the preparation process and mastered this task successfully. Commercial banks were involved in the preparation process as well and some measures were rather costly. On the other hand, from a deeper analysis of the causes of the crisis, some lessons for the financial system in general and banking sector as the key component of the financial system in Slovakia especially can be learnt.

For Slovakia, as a country with high bank-real sector interdependency, developments in the real economy are of crucial importance for the future of the banking sector. Some of these tendencies are more general, relevant also for countries that are not euro area members. Some of them are more connected with euro introduction.

Due to some measures in the preparation process that were costly and due to a decline in revenues from exchange operations, profitability of commercial banks in 2009 declined by more than 50%. In this decline, of course, the development in the real economy and insolvency of many clients is also reflected. Banks had to create higher reserves to cover losses from defaulted loans.

Membership in the euro area also radically changed the monetary policy. The Basic tasks of the monetary policy were transferred to the European Central Bank (ECB). Up to the end of 2008 there was a separate interbank market in Slovakia (rather well functioning) with the basic rate BRIBOR. After the euro area entry, this market ceased to exist and Slovak banks have to raise short-term interbank loans at the European interbank market with EURIBOR as the basic rate.

As a negative impact of the euro adoption in the context of the global financial crisis, a decline in the banks' profitability can be mentioned as well as lower interest revenues from the inter-bank operations. Revenues of Slovak banks from exchange operations declined in 2009 (in comparison with the previous year) by 77 % [5].

The Impact of the Global Financial Crisis on the Banking Sector in Slovakia

The world-wide financial crisis that broke out at the outset of the second half of 2007 was causing major global turbulences during the whole of 2008 and became so severe at the turn of the year that it began to threaten the very existence of the global financial system. Compared to other developed countries, the impact of this phase of the financial crisis on the Slovak banking sector was relatively low. One of the reasons to this relatively moderate impact on the Slovak banking sector was that the Slovak banking sector was predominantly linked with the domestic economy and the share of banks' activities related to foreign financial markets was negligible. Slovak banks minimized their exposure against many innovative instruments of the present-day world of finance that have proven to be the main cause of the crisis spread (NBS, 2008).

However, the next year, when the global financial crisis also led to a global recession, with a heavy impact on Slovakia, the situation was different. As mentioned above, the banking sector in Slovakia was (and still is) intensively linked with the domestic real economy. A recession in the Slovak economy was a serious problem for the banking sector. Slovakia is a highly open economy and the decline in demand from Germany and surrounding countries led to a deterioration of the economic situation in Slovakia as well. Economic growth fell by 4.9%; exports shrunk by 15.9%.The unemployment rate grew and risk that mortgage loans will not be paid on time increased.

To cover potential credit losses, several banks during the year 2009 increased their own funds. This measure led to a higher capital adequacy, but on the other hand, dividends were not paid or were lower. The behaviour of banks became more conservative and this was particularly true in the asset-side operations. Lending activities of banks focused mainly on loans with high repayment probability. In the area of corporate financing, banks concentrated on less risky sectors and enterprises. Another important factor in the restriction of corporate lending was the decline in demand from enterprises, due to the declining number of investment opportunities.

On the other hand, banks invested more in relatively safer assets, e.g. government bonds. Loans to households were also regarded as less risky than corporate lending and these loans grew in 2009.

During the crisis, differences in effectiveness of individual banks became more apparent than in the past. These differences could be seen, for example, in the quality of loan portfolios or the differences in the financial condition of large vs. small banks. Although most banks recorded a drop of interest income from the corporate sector, large banks maintained their interest income from the household sector. Overall, the banking sector profits in 2009 included sizeable differences between individual banks. Differences in financial condition were typical not only for subsidiaries or branches of foreign banks in Slovakia, but also for foreign parent companies of the banks.

In 2010, some positive trends in the financial market developments and economic growth in Slovakia and abroad appeared and these trends had a significant impact on the situation in the Slovakia's banking sector. The global economy recorded a moderate recovery boosted by monetary and fiscal policies, and international trade grew, but significant differences between countries remained. Emerging countries of Asia and Latin America became the drivers of global economic growth.

For Slovakia, 2010 was a positive year. Economic growth recovered (GDP growth was 4.4%), manufacturing grew by 13.3%, mainly due to the rapid growth in the production of automobiles, electronics and machinery. For the Slovak financial sector, this year was also relatively positive. Most sectors of the financial system recorded increased profitability.

Banks provided more funding for the real economy, mainly through housing loans. Banks in Slovakia strengthened their financial position. The profitability of the banking sector as a whole doubled in comparison with the previous year (NBS 2010). The profitability growth was driven mainly by increasing income from retail operations. Banks also increased the volume of their own funds to cover unexpected losses. In general, risk management systems improved significantly in the majority of banks. Although it seemed that the worst of the crisis was over, businesses, including banks, regarded the recovery as a fragile one and were very cautious. The amount of corporate financing provided by the domestic banking sector remained relatively flat in 2010 and only to a small degree reflected the economic recovery.

Over the past two years, domestic financial institutions have seen their share of total corporate lending decline, and at the same time the financing of corporations from abroad increased (which can be reflected also in increasing the intra-company lending).

For the stability of the banking sector it is important that the amount of households' financial assets deposited in banks continues to exceed the amount of loans that banks extend to households. Banks tried to support a shift towards deposits with longer-term maturity by means of interest rates changes or by introducing new financial products, connecting traditional deposit operations with financial investment (NBS, 2010).

One can say that during the crisis a special modification of the banks' strategy has been developed, with some features common to all banks (and most countries) and some bank specific and country specific features. The basic objective of this strategy modification has been to take into account the new dynamics of the financial world development and global economy development as a whole, to cope with increasing uncertainty in their environment and to improve (or sustain) their global competitiveness under present conditions. Common features, applied by all banks, include mainly:

– Cost reduction measures.
– Improving risk management methods and involving them in the core of the strategy.
– Keeping the position of a "global player" and adjusting organizational and regional structures to changing environment.

Headquarters of different banks active in Slovakia can choose different orientations to achieve the synergic effect within the whole bank group. There can be differences in relations to host country governments, in a degree of supporting a positive macroeconomic and social development in host countries, in the orientation on different types of clients, etc. There can be also differences in the degree to which "cross-financing" within the bank group is regarded as acceptable.

Recently, an interesting paper has been published by three Czech and Slovak authors [16]. The paper analyses the behaviour of foreign controlled banks under conditions of the financial crisis in two countries – the Czech Republic and Slovakia. The behaviour of subsidiaries of four multinational banking groups (Raiffeisen Bank International, Erste Group, Volksbank International and UniCredit) in both countries is examined. The question to be answered is whether the multinational banks pursue a coherent strategy for the whole region, to cope with the risks connected with the crisis, or focus on finding local solutions. The authors conclude that all banks followed the strategic directives of their parent companies. For Slovakia, this means:

– Tatra Banka (belonging to the Raiffeisen group) implemented a prudent, non-expansionary risk strategy, focused on stabilization, even at the cost of a moderate decrease in some profitability indicators;
– Slovenská Sporiteľňa (Erste Group) focused on SMEs within corporate banking and regarded retail as important as well. Its aim was to maintain and strengthen good customer relations;
– Volksbank Slovakia emphasized relations with small business, but was careful in granting loans to newly established companies;

– UniCredit Bank Slovakia attempted to achieve stability by focusing on anti-cyclic industries.

However, even if the same basic strategy of the banks within a group was applied, the financial indicators were different for subsidiaries in different countries. Local conditions probably significantly influenced the results. Another specific factor is the financial position of the parent company. If there are serious problems at the headquarter level, the parent company can decide to sell the subsidiary (to other foreign investor). The case study supporting this analysis started exactly in this way.

Recent Situation

The economic environment of the banking sector remained uncertain also during the years 2011–2012. Although financial markets calmed, they did so mainly in response to measures taken by the ECB, rather than due to expectations of an improvement in the macroeconomic situation. The risks associated with euro area periphery economies were acute mainly in 2011, but, on the other hand, economic growth was weak due to low competitiveness.

Slovakia's rate of growth declined. A positive phenomenon can be that the Slovak government bond prices completed their recovery from the turbulent autumn of 2011, thus providing a boost to the domestic financial sector. The drivers of the growth of the Slovak financial sector were also favourable developments in the household sector, as households increased both their borrowing and their investments in the financial sector. Increase in lending to the households sector was most marked in housing loans, but consumer credit also rose. On the other hand, a different situation was observed in the corporate sector. As a result of weakening demand for loans and tight credit standards, the outstanding amount of corporate loans initially recorded lower growth and then, began to decrease. The pace of their decline in the second half of the year 2012 was similar to the levels seen at the end of 2009 (NBS, 2012).

The aggregate net profit of the banking sector in 2012, according to data reported by banks, declined by almost one-third year-over-year. This can be largely explained, on the one hand, by the imposition of an extraordinary banking levy and, on the other hand, by an increase in credit risk costs. Bank profits were further squeezed by the continuing decline in interest rate margins.

The banking sector's capital adequacy ratio (CAR) increased in 2012 to its highest level since 2005.It was 16.2% in 2012 (NBS 2013). This was largely because a significant share of the sector's 2011 profit was retained, and also due to a direct increase in own funds.

In 2013 the euro area economy, a major part of the external environment of the Slovak financial system, emerged from recession, with a majority of euro area countries reporting moderate growth. This positive tendency was reflected also in the Slovak banking system development.

The profits of Slovak banks increased in comparison with the previous year. The banking sector's profit growth was largely attributable to lending growth and lower credit risk costs; nevertheless, its return on equity was still lower than it was in 2010 and 2011 and it is significantly below pre-crisis levels.

A positive trend in the Slovak banking sector is the continuing increase in its capital adequacy ratio, which rose to 17.2% in 2013. That is higher than the euro area average and matches the average of other banking sectors in central and east European EU Member States.

The increase in the capital adequacy ratio is a positive tendency from the point-of-view of the financial sector stability. The banking sector stability of Slovakia was rather positively evaluated by international ratings. According to the 2012 Financial Development Report (WEF, 2012) Slovakia is in 23rd place (out of 62 evaluated countries) based on the financial stability criterion and based on the banking system stability criterion in 17th place. High ratings were also given for retail access to loans (19th place) and Central bank transparency (5th place).

As the banking sector in Slovakia is significantly dominated by foreign banks and the space for national banks supervision is rather limited, the project of *The European Banking Union* is very important for Slovakia. Actually, this project is important for all Central and East European countries, where banks headquartered in Western Europe play a central role. Banks generally support the banking union project and argue for it to be as comprehensive as possible. However, there are differences in views of different countries regarding the allocation of tasks between local (national) supervisors and the ECB and some procedural rules.

As for Slovakia, the interplay between ECB and local authority in the area of macro-prudential policy is important. Local bodies better understand the real economy and sometimes are able to more effectively assess the risk. For Slovakia as well, it is important that the approval of intra-group (within the bank group) financial support should be in the competence of national supervisors. As the governor of the NBS pointed out [11] "European Stabilization Mechanism has been established primarily to provide support to Member states and not banks, the contribution key should be re-designed so that the contributions by Member States are linked to the risks embodied in their financial systems…. It also has to be ensured that in the setting-up of a European Resolution Scheme, the use of any European funds do not raise issues of moral hazard and/or unjustified mutualisation of losses stemming from the past."

Conclusion

During the last two decades banking sector in Slovakia transformed from a rigid, inefficient system into a modern, flexible network of banks (although still with a dominant position of a few large banks), able to practically apply up-to-date banking techniques and skills and provide up-to-date services to their clients. The banking sector has always been the dominant part of the financial intermediaries system in Slovakia and this role of commercial banks is true today.

Foreign investors have played the key role in the modernization of the sector and improving its competitiveness. Some foreign owned banks existed in Slovakia even at the beginning of the transformation process. However, the most intensive entry of foreign banks into Slovakia's banking sector occurred at the turn of millennium when foreign investors acquired the largest, state controlled banks. We can say that Slovakia's banking sector is actually foreign capital controlled. The share of foreign capital in the total equity of commercial banks is 94.4% (as for July 2013).

Foreign capital dominance and Slovakia's EU membership are interrelated. Foreign owners of banks in Slovakia are interested in EU membership (and euro-area membership) of the country and, on the other hand, integration into the European Union provides impulses for further growth of banks and globalization of their activities.

Almost simultaneously with the euro adoption in Slovakia, the global financial crisis started. The immediate impact of the crisis on Slovakia's banking sector was not so profound as in other countries. The basic reason is that banks in Slovakia are financed mainly from domestic resources (deposits of local clients), their liquidity in 2008 was high and their dependence on international financial markets transactions was relatively low. However, the recession in Slovakia (culminating in 2009) had a significant impact on the banking sector. The high openness of Slovakia's economy makes the country very vulnerable to downturns in Western Europe.

The banking sector in Slovakia has had very close links with domestic enterprises. This was a disadvantage for banks during the downturn in Slovakia's economy. The profits of banks in 2009 declined by more than 50%. In their lending activities, banks began to behave more conservatively. They paid more attention to the actual repayment of loans, new loans were concentrated on less risky sectors and organizations, and financing conditions were tightened. Despite some recovery in the real economy during the next years, basic features of the "conservative approach" in lending strategy are relevant also today. Future development of the banking sector will depend primarily on the real economy development in Slovakia and Europe in general. Most banks in Slovakia have a relatively high loss-absorption capacity due to their high capital ratio and solvency. This can be the basis for the banking sector stability.

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Appendix

KBC Group – BAWAG P.S.K.: A Case Study of a Cross-Border Acquisition in the Banking Industry
Soňa Ferenčíková

Buyer and seller description at the time of acquisition

KBC Group

The beginnings of KBC Group could be traced back to 1998, when two Belgian banks, Kredietbank and CERA bank as well as the Belgian insurance company ABB, merged to create KBC Group and Insurance Holding Company. In 2008, the KBC Group is represented across over 30 countries; it employs 55,000 employees, almost 30,000 thereof acting in Central and Eastern Europe. The KBC Group offers their services to over 12 million clients, with 8 million of those in Central and Eastern Europe. The KBC Group NV is involved in the NYSE, EURONEXT and Luxembourg Stock Exchange. The group has headquarters in Brussels.

KBC is a multi-channel banking and insurance company active in Europe and it provides services primarily to retail and private clients, as well as small and medium-sized companies. In addition to their banking insurance activities (through banking subsidiaries, insurance agency and the Internet), KBC is also engaged in asset management, private equity, corporate banking, leasing, factoring, brokerage services as well as project- and real estate finance.

In the last decade before 2008, KBC established themselves across a majority of countries that became EU members as of May 1st, 2004 such as Poland, Hungary, the Czech Republic and the Slovak Republic. Recently, KBC have accomplished a number of acquisitions and in 2008 it was present in Bulgaria (DZI Insurance, DZI Invest and EIBANK), Romania (KBC Securities Romania, Romstal Leasing and INK Insurance Broker), Russia (Absolut Bank) and Serbia (KBC Banka and Senzal, renamed to KBC Securities AD Beograd, Hipobroker, actually KBC Broker a Bastion, renamed to KBC Securities Corporate Finance). Their acquisitions reflect the criteria of KBC expansion to the Central and Eastern European markets, making good use of the regional economic proximity to Europe for further penetration of their banking and insurance products.

Československá obchodná banka, a.s. (ČSOB, a.s)

Československá obchodní banka, a.s. (Czechoslovak Commercial Bank, a.s.) was set up in 1964 as the only one bank offering services in the areas of international trade, finance and currency exchange operations in the former Czechoslovakia. Following 1989, the bank expanded into providing services for both physical and legal entities.

After the division of Czechoslovakia into two independent states, the bank was active in both markets, and was headquartered in Prague. The bank functioned in the Slovak market as a subsidiary of the foreign bank. In 1999, a majority of its shares was bought by KBC Group and on January 1st, 2008, a joint stock company, Československá obchodná banka, a.s. (ČSOB, a.s.) was established in Slovakia.

In 2008, the company's main business covers services for all segments of clients: physical entities (retail clients), small and medium-sized enterprises, financial markets and private banking business. The services were provided through the network of over 100 branches. The company ČSOB, a.s., is a universal bank focusing, above all, on funding housing and investments. It offers by far the widest range of financial services on the market, pursuing the successful distribution model (KBC) for banking insurance and asset management. The ČSOB Financial Group comprised of ČSOB Bank (ČSOB Banka), ČSOB Insurance (ČSOB Poisťovňa), ČSOB Asset Management, ČSOB Pension Fund Management Company (ČSOB Dôchodcovská správcovská spoločnosť), ČSOB Leasing, ČSOB Building Savings Bank (ČSOB Stavebná Sporiteľňa) and ČSOB Factoring.

BAWAG P.S.K.Group

The BAWAG P.S.K Group (Bank fürArbeit und Wirtschaft und Österreichische Postsparkasse Aktiengesellschaft) was established as the merger of BAWAG and P.S.K. in the year 2000. The acquisition sought a successful expansion of both banks with their total volume of assets amounting to 44.8 billion euro. In 2008, BAWAG P.S.K. ranked as the fifth largest banking subject in Austria and the leading retail bank for medium income clientele. The Group views becoming a provider of universal financial services based on good knowledge of the market, with complex individual care for clients and pursued of product innovation as its objective goal. With its 160 BAWAG branches across over 1,300 post-offices, BAWAG P.S.K. has at their disposal the largest centrally controlled distribution network in Austria. The Group is also the market leader in the area of payments clearing services in Austria. It employs 6,300 employees altogether.

In 2007, BAWAG P.S.K was sold to a consortium led by US hedge Fund Cerberus. The bank was put up for sale after dubious credits and failed currency speculations severely damaged both bank and union finances.

Istrobanka, a.s.

The BAWAG P.S.K.Group entered the Slovak market via acquiring Istrobanka in 2002 (becoming its sole owner) from the former Slovenská poisťovňa and the Bratislava municipality. Istrobanka, a.s. had provided services and products primarily in the areas of mortgages and consumer credits, credit card issuance as well as the promotion of electronic banking and Internet banking for physical entities. Istrobanka, a.s. had also been known for offering services to small-and medium-sized enterprises

(SME). What set the bank aside from other banks active then in the territory of the Slovak Republic was that it also provided services for the communities. The targets in this case were city councils, local authorities, or spin-offs of city and local councils. At the time, Istrobanka, a.s. saw as its goal or strategy, offering attractively priced products to the widest possible segment of clients. Given such ambitions, in 2007 Istrobanka ranked as the eighth largest credit provider in Slovakia, controlling a 2.2 percent of the market share in the area of deposits and a 3.2 percent market share in the area of credits. With its 750 employees, the bank services were able to cover 125,000 retail, SME, and corporate clients via 60 branches, 9 thereof within the BILLA chain of shops. Through its affiliations, the bank also provided services in asset management. By the end of 2007, the banks' total assets stood at roughly 1.22 billion euro, with its equity reaching 100.5 million euro (ČSOB, 2008). However, according to Slovak bankers' community the quality of their portfolio was mixed and their main product was saving book to the retail customers with attractive yields to attract liquidity.

The Expectations

What were, then, the expectations of acquiring Istrobanka, a.s. According to André Bergen, CEO of KBC, taking over Istrobanka was a "logical and significant step towards KBC expansion in Central and Eastern Europe", initiated ten years ago. The acquisition of Istrobanka was expected to render ČSOB the fourth largest player in the Slovak banking business. To quote André Bergen again, the acquisition of Istrobanka is going to "enforce KBC's position within an attractive and ever more stabilized Slovak market that is offering major opportunities for further penetration of banking and insurance products." He is equally enthusiastic about making use of the cross-selling potential in retail and corporate banking, which he believed, were to bring KBC's savings stemming from the bigger size and ensuing growth in share value (ČSOB, 2008).

The ČSOB General Manager and Country Manager ČSOB Financial Group Daniel Kollár says that "the acquisition of Istrobanka is going to considerably strengthen KBC and its position in the Slovak market as well as promote ČSOB market share with immediate effect, from 7.6 percent to 10.5 percent in credits, from 6.5 percent to 8.5 percent in deposits. For KBC Group, the acquisition of Istrobanka means fulfilling half of its goals, namely reaching, by 2010, a 10 percent market share in Slovakia" (ČSOB, 2008).

Jan Vanhevel, CEO of the KBC operation in Central and Eastern Europe also sounded equally optimistic: "KBC believed that the know-how and rich experience in the area of asset management and insurance will result in a successful introduction of the banking insurance model. We are convinced that both employees and clients of the banks, ČSOB and Istrobanka, will closely co-operate and benefit from the upcoming merger of the two companies" (ČSOB, 2008). "Without Istrobanka, we would not have 10% of the market which is critical mass for sustainable profitability" (Evert Vandenbussche, Bratislava, 26.10.2012).

The optimism in CSOB was also fuelled by the analysis of the JP Morgan who was advising on this deal. However, it must be recognised that during the preparation of the JP Morgan business case in the first quarter of 2008, there was no awareness of the crisis that would hit the financial world and global economy in autumn 2008, three months after closing the transaction. JP Morgan calculated the synergies based on following assumption of the GDP growth rates in Slovakia: 8.5% in 2009, 8.2% in 2010, 7.8% in 2011 and 7.5% in 2012 (Internal CSOB documents, 2010). [1]

Such an expression of over-optimism begs the question, why did BAWAG P.S.K. subsequently sell Istrobanka? As for David Roberts, General Manager of the BAWAG P.S.K., "BAWAG P.S.K. made a decision to concentrate on activities in the Austrian market last year. At the same time, in our international activities we wish to make use of the product leader principle. Selling Slovakia's subsidiary was then, the best path to follow for Istrobanka's future evolution" (ČSOB, 2008).

In this context, it might be of interest to know the opinion of Istrobanka's General Manager, Volker Pichler. He perceived the events as follows: "Istrobanka's management have welcomed the decision and are looking forward to the close co-operation with ČSOB, appreciating the promise to support the expansion of our banking and insurance business with a clearer orientation towards the retail segments." He also added that they were convinced that "both employees and clients of the banks will be considerably benefiting from belonging to one of the leading bank and insurance group in Europe" (ČSOB, 2008).

Given the information above, it would be not unwise to suggest that the real reasons for disposing of Istrobanka, which used to be a part of BAWAG P.S.K., were the change to the ownership structure of BAWAG P.S.K., or that the failure to meet the goals set for Istrobanka within the Slovak banking business. In fact, Istrobanka was supposed to significantly grow its market share in Slovakia, which it did not.

Major milestones

August 2007 – Beginning of the financial crisis in the USA
1 January, 2008 – CSOB Slovakia established as an independent subsidiary of KBC Belgium (Not a CSOB Czech Republic subsidiary any longer)
20 March, 2008 – KBC Belgium announced that KBC Belgium and BAWAG Austria agreed on sale of Istrobanka Slovakia
1 July, 2008 – KBC received all the approvals necessary from the Antimonopoly Office of the Slovak Republic and from National Bank of Slovakia to acquire full ownership (100%) of Istrobanka and Istro Asset Management. KBC acquired them for 350 million EUR (10.54 billion Slovak crowns) which was 3.5 higher than the

[1] However, due to the financial crisis the reality was completely different: according to the Eurostat, the real GDP growth in 2009 was – 4.9%, in 2010 4.2% and in 2011 3.4%.

book value (the book value was 100 million EUR). It was also the date of closing of SPA (share purchase agreement).
1 September, 2008 – A new leading team for CSOB and Istrobanka (Country Team) had been created. Miroslav Paulen, chairman of the board, and CEO of Istrobanka had become a member of it.
September 2008 – Collapse of Lehmann Brothers, worldwide financial crisis (JP Morgan, advisor of KBC on acquisition of Istrobanka was strongly hit by the crisis, as was KBC itself in Belgium).
1 October, 2008 – CSOB and Istrobanka has started to sell their products together.
1 January, 2009 – Euro introduction in Slovakia
1 April, 2009 – CSOB Asset Management took over the funds of Istro Asset Management
1 July, 2009 – Istrobanka and CSOB Slovakia legally merged

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