Restructuring banking sector - a first step of the economic reforms in Slovakia

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Several factors were behind a deterioration of the situation of the Slovak banking sector

- Politically motivated lending, especially privatisation transactions - soft budgetary constraints from state owned banks
- Missing structural reforms in the economy, including weak bank supervision
- Obsolete and unfit laws (e.g. Bankruptcy Law)
- Poor enforceability of laws, weak protection of creditor rights
- Lack of experience in banks with lending operations, undeveloped risk management
- Missing adequate management information systems
- Rent-seeking behaviour of many corporate managers leading to very poor corporate governance and serious economic problems
- **Result:** Large state banks were on the verge of bankruptcy in 1999, classified loans in their portfolio constituted 30% of GDP, their capital adequacy was deeply below the minimum of 8%

Banking sector reforms had to address all problems

- **<u>Strategic goal:</u>** Establish a viable, competitive and privatised Slovak banking sector
- Two key financial goals as prerequisites for privatisation:
  - *Restore capital adequacy above 8% via capital injections*
  - *Reduce the classified loans in portfolios below 20% of total loans - loans were carved-out from banks and placed in the non-bank work-out institution Slovenska Konsolidacna SKo*
- Privatisation of the state owned banks
- Resolution of the situation of small troubled banks - 4 bankruptcies and 1 acquisition, the rest - sale to strategic investors
- Restructuring of the corporate sector through sale of SKo assets and setting hard budgetary constraints by private banks
- Strengthening of regulation and supervision (NBS, creditor rights, corporate governance, collateral regime)

Lessons learnt from the Slovak banking sector reforms

- Co-operation with international institutions was very fruitful especially in the first stage
- Bail-out of banks has to precede their privatisation, bad loans have to be transferred out of banks
- Open privatisation tenders with no exclusivity lead to better results
- Ring-fencing should be minimised, as many “skeletons in cabinets” should be removed from banks as possible
- Bank restructuring and privatisation is a necessary condition of corporate restructuring
- Fair, efficient, independent and strong bank supervision with clearly defined powers and duties is of utmost importance
- Changes in legislation framework and law enforcement are inevitable (e.g. Bankruptcy law, collateral reform)

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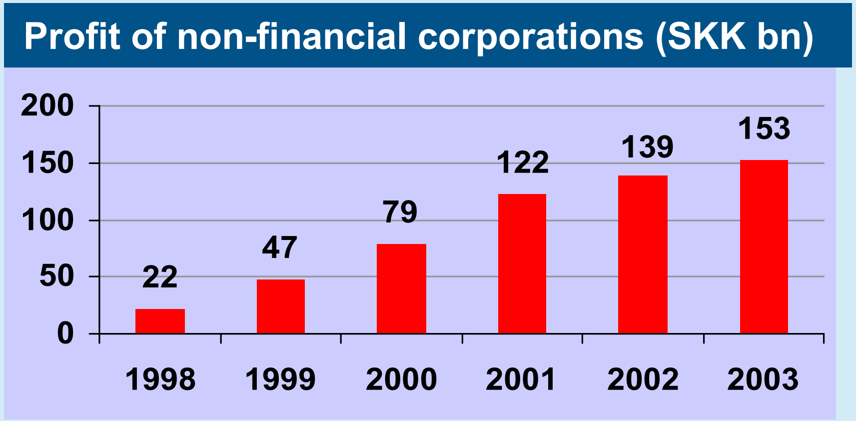
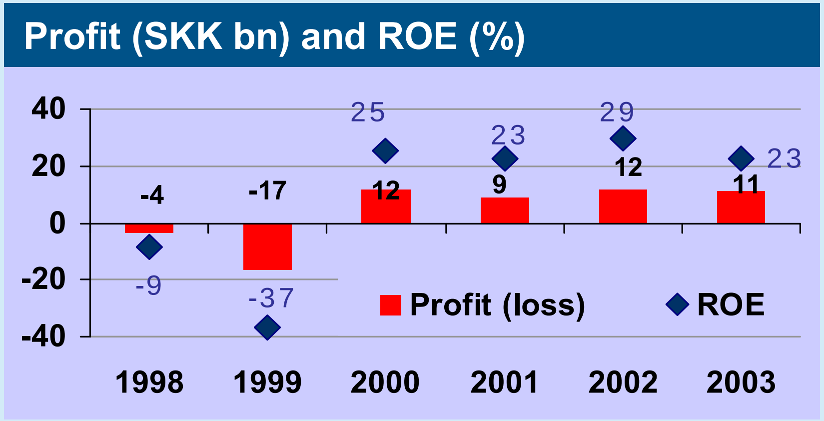
Banking sector reforms are reflected in profits of banks and corporates



Source: SLSP, Erste Bank Group



Source: SLSP

- Reformed and privatised banking sector plays a key role in restructuring of corporate sector
- Interest rates went down dramatically
- Loan quality is improving significantly *(classified loans are below 10% of total loans)* and banks in Slovakia have a potential to provide more loans
- Banks participated in several important work-out cases e.g. in metallurgy, textile industry
- Risk management in banks in significantly improved - pressure on corporate sector (controlling, reporting, corporate governance)

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