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Mortgage Bond System – Development in the Slovak Republic

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Summary of Mortgage Products Characteristics

In 1996 so called Mortgage Bonds System was implemented in Slovakia. The assets-side and liabilities-side of the mortgage business is defined as:

the provision of mortgage loans and the related issue of mortgage bonds

the provision of municipal loans and the related issue of municipal bonds by banks

Mortgage transactions can be carried out in Slovak crowns or **in a foreign currency. If they are carried out in a foreign currency, the exchange rate risk is borne by the bank or branch office of the foreign bank that carry out mortgage transactions (hereinafter referred to as mortgage bank). A mortgage bank is obligated to adopt measures to prevent exchange rate risk from coverage of mortgage bonds or municipal bonds claims from mortgage loans or municipal loans.**[1]

Mortgage Loans

Mortgage loan (ML), under new Banking Act, is defined as follows:

- long-term credit with maturity of at least **four years and maximum of thirty years**
- secured by a lien on domestic real estate, **it concerns also not finished real estate**
- provided by the banks, which have been granted by a licence, to legal and natural persons
- for the **acquiring** local real estate or its part, building or modifying existing buildings, maintenance of domestic real estate, or **repayment of a provided loan used as per above mentioned purposes, which is not a mortgage loans**
- financed (refinanced) mainly by the issues and sale of mortgage bonds
- loan-to-value ratio may not exceed **70 %**; 70 **%** limit only up to an amount not exceeding **10 %** of the total amount of provide ML (the second mortgage quality-ML are not allowed to serve for the coverage of the mortgage bonds)

Mortgage Bonds

Mortgage bond (MB), under Act on Bonds, is defined as follows:

- special type of bond, publicly negotiable, its name is protected by law
- the funds obtained by its sale are used for the refinancing of mortgage loans
- the total par value of issued mortgage bonds must be covered at least in the same amount and with at least the same yield as the par value of the provided mortgage loans, so called **ordinary** coverage. Maximum limit is set up to 70 % of real estate value.
- the **substitute** coverage may not exceed 10% of the total nominal value of issued MB's. For this purpose, only precisely defined in law - special assets shall be used.

the mortgage loans serving to cover mortgage bonds, or other items serving as substitute coverage, shall be registered by the bank in separate register-mortgage (coverage) one.

Within eighteen months of the date the permission to conduct mortgage transactions becomes effective, the bank may issue, on the basis of a decision passed at a general meeting of a shareholders, temporary mortgage bonds as publicly negotiable bearer securities with a total par value not exceed 50 % of the bank's equity capital, and which the bank is obliged to exchange for mortgage bonds covered according to relevant Articles, within two years of the date of issue. The application of the provisions of Article 17 of the Act on Bonds is one of the possible ways of commencing mortgage business.

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[1] The latiest Act on Banks amendments have abolished Article 36a (3): „Mortgage transactions may not be conducted by a branch of a foreign bank." Banking Act became effective on 11 October 1999.

The further principles

- the mortgage bank on the basis of an overall assessment of the real estate shall determine the value of real estate. In calculating the value, the mortgage bank may take into account only the factual value of the real estate and the long-term benefit to the owner, provided the real estate has been managed in proper manner. The mortgage bank shall be bound exclusively by its own valuation of the real estate,
- the right of lien of a mortgage bank on mortgage or municipal loans is effected upon registration of the same in the real estate register of the Slovak Republic, according to the proposal of the mortgage bank and the owner of the real estate. The mortgage bank has then the status of mortgagee,
- a mortgage loan or a municipal loan may not be secured by a lien on real estate on wich a lien already exist in favour of a third party, or a limitation on the transfer of real estate with exception of a lien established in accordance with separate legislation[2] and a lien established in favour of a building savings bank or the State Housing Development Fund,
- in enforcing a right of lien, a mortgage bank is entitled to sell real estate pledged as security (under Act on Execution), on the basis of an agreement made in the form of a notaries deed between the mortgage banks, its debtor, and the third person, provided the third person is not the debtor, defining the legal commitment; the entitled and obliged persons; the legal grounds; and the subject and time of fulfilment, if the parties involved agree in the said agreement.

A mortgage bank shall provide mortgage and municipal loans under the terms and conditions for granting of mortgage loans issued thereby that must in particular contain: the due form of application for a mortgage or municipal loan, a procedure for applying for a mortgage and municipal loan, the terms and conditions for granting mortgage and municipal loans, the manner in which a mortgage loan or municipal loan agreement may be recalled, a procedure to be followed by a mortgage bank in the event that a debtor defaults on the repayment of a mortgage or municipal loan or other due amounts payable therefrom, cases where as a result of a mortgagor´s changed situation a mortgage bank is entitled to call early repayment of a mortgage loan or municipal loan, the conditions for exercising a lien on real estate established to secure mortgage and municipal loans. A mortgage bank may not enforce early repayment of a mortgage or municipal loan for reasons caused by itself; this shall also apply where a mortgage bank is wound up.

Minimum Amount of Cash Contribution to Equity Capital

- The minimum amount of cash contribution to the bank's equity capital, which is a prerequisite for the granting of a licence to establish a bank, is SKK 500,000,000[3] or an equivalent amount in fully convertible foreign currency.
- If the subject of an application for a licence to establish a bank includes mortgage transactions, the minimum amount of cash contribution to the bank equity capital, is SKK 1,000,000,000, or an equivalent amount in fully convertible foreign currency.

The licence application contains:

- the methods of keeping a mortgage register
- the proposal for appointment of the mortgage controller (trustee) and his/her deputy
- the real estate assessment methods (valuation)
- the method of keeping a separate analytical record of mortgage activities within the bank's accounting system

Mortgage register. The purpose of a mortgage register is to keep a record of mortgage loans and municipal ones in separate way. Coverage register contains the data on ML maturity, ML volume, ML interest rate; data concerning to the property-type, cadastrial area, No. the ownership certificate, parcel

[2] Relating to the ownership of apartments and non-residential premises, with subsequent amendments.
[3] Foreign exchange rate, as of 29 October 2001 USD-48.930 SKK; EUR-43.697 SKK.

number, property value (mortgage lending value),..; data on coverage-ordinary and substitute as well, mainly ML's volume and the mortgage bonds issues.

The mortgage controller's task is to provide up-to-date information on the security and quality of MB´s coverage. He/she must ensure that the mortgage bonds are adequately covered and the assets used for their coverage are registered in the coverage register.

Mortgage business support

Direct incentives

From point of the housing affordability the so-called interest rate bonus from the State budget of Slovak Republic was introduced from 11 October last year as a part of the Banking Act. The government bonus is understood as a percentage by which the rate of interest set in a mortgage loan agreement is reduced by the Government. The amount of government bonus determined in percentage terms may not be changed over the entire repayment period of the mortgage loan set in the mortgage loan agreement. The amount of the government bonus for agreements concluded in individual calendar years shall be set out in the State Budget Act for the relevant fiscal year (for1999 fiscal year – 6 %; for 2000 fiscal year – 6 %; for 2001 - 5 %). A government bonus may be granted for a mortgage loan up to a maximum of SKK 2,500,000 per one real estate for housing, also in the case of married couple or (and) acquisition of such real estate into shared ownership. Only natural persons borrowing money under a mortgage loan agreement for housing purposes shall have a claim for this bonus.

Indirect incentives

From April 1999 mortgage bonds yields are tax-deductible (tax-free). Under the Decree of the NBS on the minimum reserve requirement the mortgage bonds and municipal bonds are excluded from the base for the minimum reserve calculation. The increasing the mortgage bonds attractiveness in comparison with others securities, primarly government bonds, and the supporting their tradability within capital market are the main reason for the such instruments implementation.

1. Financial Sector and Selected Aspects of the NBS´s Policy

In 2000, the NBS implemented its monetary policy in an environment marked by continuing macroeconomic stabilisation. Compared with 1999, the balance of payments on current account continued to improve, the ratio of fiscal deficit to GDP fell, the dynamics of prices slowed, and the rate of economic growth increased. This development encouraged a stabilisation of the money and foreign exchange markets, as well as a qualitative change in monetary policy.

With regard to methods and activities that can be influenced by the NBS through the exercise of monetary policy we consider 2000 as the breakthrough year – the change from quantitative to qualitative control with the aim of stabilising interbank interest rates and reducing the price of money in the economy. The first step in the implementation of qualitative control of monetary policy can be seen in the automatic approach of commercial banks to overnight refinancing and sterilisation sources for declared interest rates. At the end of May, the NBS started to declare a limit interest rate for a standard two-week REPO tender which, compared to the interest rate for overnight transactions, represents a stronger signal regarding the desired development of interbank interest rates and expected monetary and economic development.[4]

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[4] With effect from 1.2.2000, the Bank Board of the NBS decided to set rates for overnight sterilisation and refinancing operations at a level of 12 % p.a., or 8 % p.a.; in March and May the Bank Board reduced these rates to the level of 7 % p.a. for sterilisation and 10 % p.a. for refinancing operations. The interest rate for a two-week standard REPO tender was set at a level of 8.5 % p.a. Over the course of the year, these rates were further reduced. After the last reduction, which was implemented by the Bank Board of the NBS on 26 March 2001,

The new character of monetary policy – direct setting of rates for NBS transactions – was relatively quickly and very positively accepted by the market and this resulted in its stabilisation. The volatility of interbank market rates was significantly reduced, the trend for their reduction was gradually reflected in the reduction of interest rates on primary deposits and loans. The development of deposit interest rates was characterised by a falling trend which, compared with interest rates on loans, reacted more sensitively to changes in key NBS rates. Average deposit costs were reduced from 9.60 % p. a. to 5.57 % p. a. (in 1999 from 10.72 % p.a. to 9.85 %). 1999 was characterised by the stabilisation of primary bank resources and the acquiral of clients even at the cost of higher interest costs. The overall average interest rate on crown deposits in December 2000 was 4.28 percentage points below the level of December 1999, the average interest rate on time deposits was reduced from 6.55 % to 5.53 %, and for demand deposits it was reduced from 3.76 % to 3.08 %.

The average interest rate on loans had a falling trend which, with a certain time lag, copied the reduction of key interest rates. During the year, the interest level on disbursed loans steadily approached the overnight refinancing rate of the NBS. The development of interest rates was considerably affected by the transfer of loans in connection with the restructuring of the banking sector, which affected interest rates on both existing loans and disbursed loans.[5] Over the course of the year, mandatory minimum banking sector reserve rates were reduced from 8 % to 6.5 % and, as of 1.1.2001 to 5 %, with the aim of increasing the competitiveness of domestic banks toward foreign banks.

In other sections of the paper we will address aspects of the development of the banking sector, of which predominatingly mortgage loans market, capital market (incl. Mortgage bonds)and insurance sector. Each segment has its own particular development trends, activities, extent and quality of products and services provided, and current problems.

2. Banking Sector

The Banking Sector represents the most important and developed segment of the financial market in the SR. At present, available financial sources are mostly placed in the banking system (mainly savings of the population) and enter the economy via this system. Banking loans are still the key form of financial relationship between the enterprise and banking spheres.[6] At present 23 banking entities currently operate on the banking market (21 banks and two branches of foreign banks) and 10 foreign representations. As of 30. 6. 2001 the value of the subscribed equity of the sector was 60.1 bil. Sk (December 2000 54 bil. Sk). Foreign investors' share of the subscribed equity increased to 43.6 % from 28.1 % at the end of 2000. Overall bank assets in the monitored period recorded moderate growth (2.28 %) in the first half of 2001 to 866.3 bil. Sk. The asset structure is improving, the share of revenue assets increased by 1.36 % to 89.81 % compared to December 2000. The share of classified loans fell significantly, i.e. from 40 % in September 1999 to 17.56 % in June 2001. In the first half of 2001, the banking sector achieved a net profit of 9 bil. Sk (in June 2000 –0.6 bil. Sk) Capital adequacy (excluding Konsolidacná banka) stabilised at the level of 12.5 % at the end of 2000 and reached 19.65 % in June 2001. A minimum 8 % capital adequacy level was not achieved by two banking entities. The share of classified loans and the development of capital adequacy is shown in the following table.

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interest rates are at the following rates: refinancing 9 %, sterilisation 6 % and the limit rate for a two-week standard NBS REPO tender 7.75 %.

[5] More details in the Banking Sector section. See Annexes 2 – 4.

[6] See the Chart 1 and Annex 1.

Table 1

Classified loans and capital adequacy

Year	% Classified loans	% Capital adequacy
1997	27.2	8.1
1998	31.7	6.7
1999	23.7	12.6
2000	15.3	12.5
2001 (June)	17.6	19.7

Source: NBS

The restructuring and privatisation of three major banks contributed to the stabilisation of the whole sector. During the period 1999-2000 the restructuring process was completed (Všeobecná úverová banka, a.s. Slovenská sporitelna, a.s. and Investicná rozvojová banka, a.s.). Its objective was the strengthening of banking capital, the clearing of poor loan portfolios (transfer to specialised institutions) and the preparation of these entities for privatisation. The transferred loans were replaced with loans, the guarantee of which was assumed by the government.

A further measure directed at the support of privatisation was the conversion of banking loans guaranteed by the state, granted to Slovenská konsolidacná, a.s. and Konsolidacná banka, š.p.ú into government bonds in January and March 2001. These bonds were issued with a maturity period of 5, 7 and 10 years, with a combination of fixed and variable interest rates, with a disbursement of yield twice per annum, and with the first instalment fixed a year after the issue date of the Bills (for details see Table 2). It is expected that in addition to supporting privatisation these bonds will assist a better control of liquidity and other risks at the three banking institutions. The privatisation process is in its final phase. In January 2001, the sale of an 87.18 % controlling stake in the shares of Slovenská sporitelna was realised. The purchaser was a prestigious foreign strategic investor. In the case of VÚB, a.s. a so-called two-phase privatisation process was adopted. In February 2001, a 25 % package of shares was sold to institutional investors. This was immediately followed by a tender for the sale of a controlling package of shares to a strategic investor. Now the process is under the finalisation. With regard to IRB, a.s., bids for its purchase are currently being assessed, and the completion of its privatisation is expected by the end of this year. The current status of the privatisation process at Slovak banks is given in Table 3.

Table 2

Transfer of classified loans and issue of restructuring bonds, bil. Sk

Transfer of classified loans	Total	Date of issue	5-years bonds	7-years bonds	10-years bonds	Total
VÚB, a.s.	66.2	31.1.2001	22.5	11.4	11.0	44.9
		31.3.2001	9.1	4.7	7.5	21.3
Slovenská sporitelna, a.s.	32.4	31.1.2001	9.7	14.8	7.9	32.4
Investicná a rozvojová banka, a.s.	6.4	31.1.2001	3.2	1.6	1.6	6.4
Total	**105**		**44.5**	**32.5**	**28.0**	**105**

Source: NBS

Table 3

Status of the privatisation process

Slovenská sporitelna, a.s.	Erste purchased a package of 87.18 % shares, the contract was signed on 11.1.2001. Process is ended.
Všeobecná úverová banka, a.s.	Sale of 25 % shares – IFC and EBRD. Due diligence was carried out by two investors. Tender for the purchase of 68.58 % shares won by IntensaBci, S.p.A. At the end of June 2001 the NBS´s decision on 94.47 % stake shares purchase came into effect.
Investicná rozvojová banka, a.s.	Privatisation process incomplete; approval for due diligence was given by the NBS Banking Supervisory body to the Hungarian concern - OTP. The tender is currently being assessed by the Government of the SR. The process should be completed by the end of 2001
Banka Slovakia, a.s.	Privatisation process incomplete.

Source: NBS

We expect further positive developments with regard to the reform of the banking system, i.e. privatisation of state controlled banks, a program for dealing with minor problem banks,[7] a system of bank deposits insurance, reinforcement of regulation and banking supervision. The precondition for the restructuring of the corporate sector is a stable, properly controlled and regulated, competitive banking system, with a strong capital base. Overall it is possible to assess banking reform in a positive way, especially from the point of view of its stabilisation. The new Banking Law, which includes fundamental principles from Basel, will play an important role in the development of the banking system. This will include such areas as supervision on a consolidated basis; monitoring of market risks; reinforcement of the NBS's role by the preparation of banking accountancy rules; extension of co-operation with external auditors; and, last but not least, by the implementation of prompt corrective actions by the banking supervision body in the case of non-fulfilment of the criteria for prudent business.

These are the positive aspects of development in the sector. The negative aspects, in our opinion, include the long-term reduction of the loan activities of banks. Despite the distinct reduction of interest rates in the bank loan market for clients, the average annual amount of loans drawn in 2000 was 33.2 bil. Sk, which is 5.5 bil. Sk less than in 1999. The bank restructuring process mentioned above was not at that time reflected in increased lending to the business sector. In 2000, only 3.3 % of total loans were of a development nature and consumer loans drawn by the population comprised a negligible 0.2 %. In 2000, the trend of a reduction of average loan costs continued, i.e. from 12.59 % p.a. to 10.74 % p.a. (in 1999 they fell from 19.83 % p.a. to 16.40 % p.a.). The largest decrease in average loan costs was in the sector of businesses with majority state participation (by 47 %) and in the private business sector (by 19 %). The private sector had the highest average loan costs in December 2000, i.e. 13.11 % p.a.. The total value of loans to the private sector reached 35 % of total loans. This sector has the most classified loans. Last year, the highest amount of loans, at a stable level of 60 %, were granted to businesses with foreign control, Their average cost in December 2000 was 9.52 % p.a.. At the end of the year, the costs of loans to businesses with majority state participation was moderately higher than for businesses with foreign participation, i.e. 9.61 % p.a.. The overall share of these loans was 6 %.

The increase of interest margin is a negative tendency, which signals high risks within the business sector, i.e. loans costs are being adjusted to the money market. No qualitative changes have occurred at lending entities that would allow for a higher utilisation of loan resources. A major part of the financial resources of the economy is not development oriented, but is traded almost exclusively in the short-term money market with the aim of maintaining the price level, which may not be a reflection of the effective functioning of the economy and the use of loan resources for development.

[7] The Program for the Solution of Problems in Small (Medium-sized) Banks was based on the analysis of the situation and trends at individual banks in 1999, these results in accordance with the regulation activities of the NBS, and on the attitude of investors in 2000. During 2000, the adverse situation was addressed (quality of assets and the ability to pay) at some banks. One banking institution, on the basis of a decision of shareholders, was sold at the end of 1999; one bank had its license revoked by the NBS in May 2000; two banking institutions finally went bankrupt following enforced administration (July 2000). In two cases measures were approved for the rescue of entities, above all by increasing the basic capital, and selling a part of the capital participation to a foreign investor in one case (November 2000). Now Devín banka, a. s. is under solution.

2.1. Mortgage banks

Number. Up to now six banks have been granted by licence for mortgage transactions.

Table 4

Banks with Mortgage License

Banks	Date of license	Commenced operation
Všeobecná úverová banka	June 1997	October 1997
HypoVereinsbank Slovakia	December 1997	November 2000
Slovenská sporitelna	December 1997	July 1999
Istrobanka	November 1998	Q3 1999
Tatrabanka	January 2000	October 2000
Bank Austria Creditanstal	October 2000	Preparing phase

Table 5

Equity capital in Sk million, capital structure in %, as of December 2000

Banks	Equity capital	SR	Foreign
VÚB	12,978.1	99.588	0.412
HypoVereinsbank	1,560.8	-	100 Germany
Slovenská sporitelna	6,374.2	100.00	
Istrobanka	1,300.0	90.00	10 Austria
Tatrabanka	1,044.3	16.17	83.83 Austria
BankAustria Creditans.	1,015.5	-	100 Austria

Notes: banks with foreign capital participation under 10 % are classified as bank with no foreign participation. The legal form of the banks is joint stock company (corporation). All banks above are universal ones with foreign exchange license and with license to conduct mortgage business.
Recourse: NBS statistics.

Table 6

Balance Sheet Volume of the Banks with Mortgage Transactions License, June 2001

Bank	Balance Sheet Volume (in billion SKK)	Share on the total Banking Sector Balance Sheet Volume, %
CABV	52.9	6.1
Hypo	12.1	2.5
ISTR	34.1	3.9
SLSP	205.9	23.8
SUBA	176.5	20.4
TATR	90.6	10.5

CABV - Bank Austria Creditanstalt Slovakia, a. s.; Hypo – HypoVereinsbank Slovakia, a. s.; Istro – Istrobanka, a. s.; SLSP - Slovenská sporitelna, a. s.; SUBA – Všeobecná úverová banka, a. s.; TATR – Tatra banka, a. s.. The Merge of the HypoVereinsbank Slovakia, a. s. and the Bank Austria Creditanstalt Slovakia was realised in October 2001. Now HVB Bank Slovakia, a. s. is active on the banking market, capital of the new entity is 2,576.3 mn. Sk.

2. 2. Mortgage business development

As of 31 December 1999 there were four banking institutions licensed to carry out mortgage transactions, while three of them are providing mortgage loans for housing construction and one bank is providing mortgage loans for the implementation of business plans in the area of economy. In spite of the established legislation and licenses for providing mortgage transactions, this funding system does not meet the role as awaited from it. In the years 1997 and 1998, only Všeobecná úverová banka, a.s. Bratislava provided mortgage loans in a non-significant extent. Since Q2 1999 two other banks - Slovenská sporitelna, a.s. Bratislava and Istrobanka, a.s. Bratislava – have commenced to provide mortgage loans. Table 7 gives an overview on implemented mortgage loans.

Table 7

Mortgage Loans Development in 1997 – 1999

	Všeobecná úverová banka, a.s.	**Slovenská sporitelna, a.s.**	**Istrobanka, a.s.**	**Total**
Number of loans in total	***420***	***12***	***1***	***433***
- of it for natural persons	335	12	1	348
legal entities	85	0	0	85
Sum of loans in total (SKK million)	***402.7***	***8.0***	***2.5***	***413.2***
- of it for natural persons	208.0	8.0	2.5	223
legal entities	194.7	0	0	194.7

Source: Pursuant to data of banks

The reasons of providing so low extent through mortgage loans is vested in the economic position of individuals who cannot meet the conditions for providing mortgage loans (proving their capability of repaying the applied loan plus pledging through a real estate item). For natural persons the interest rates were about 13.25 to 13.5 % p.a., and the average maturity period was 11.3 years, what results into the non- availability of such funding, and that an average amount of such mortgage loans was only about SKK 580 thousands in this period. Non-existence of stimulation instruments, non-adjusted legislation, under-developed capital markets and standard forms of accumulation of long-term resources, all this comprises the reasons of hampering the development of mortgage transactions/loans. Since 11 October1999, it is introduced the provision on state contributions reducing interest rate on mortgage loans aimed at housing construction. With regards to the fact that the contributions for reducing interest rates on mortgage loans are utilised only a short time, the total sum spent for this purpose is only SKK 0.8 million in this period. As of 30 June 2000 the number of mortgage loans approved was 1244, of which 77 % for physical persons. Total mortgage loans outstanding volume has been more than doubled – 909 mil. SKK (at the end of September – around 1.2 bill. SKK). From 1 September 2000 the interest rates were about 11,75 % (for individuals, for housing purposes); with 6 % state bonus 5,75 %.

Table 8

Mortgage Loans Volume as of December 2000, September 2001

Bank	**Mortgage Loans**		**Market share %**
	2000	**Sept. 2001**	**2000**
VÚB	900	2,268	62.13
SLSP	332	974	22.92
Istrobanka	127	602	8.21
Tatrabanka	90	1.327	6.21
HypoVereinsbank		13	
Total volume (mil. Sk)	**1,449**	**5.184**	

At the beginning of 2001 (February) the mortgage banks cut mortgage interest rates - SLSP - 10 % p.a., VÚB - 9.9 % p.a., Istrobanka - 10.2 % p.a, Tatrabanka - 9.95- 10.70 % p.a. (5 year fixed mortgage interest rates), 10.25-11 % p.a. (10 year fixed mortgage interest rates). From this period mortgage loans dynamic is rather higher, average volume is by about 700 000 Sk and the average maturity period under 12 year.

3. Capital Market

The domestic capital market is, from the long-term point of view, considered as a problem segment of the financial market. Except for one part of the capital market – the Government Bonds market – other markets (share market and the non-government bonds market) can be seen as stagnating: The **causes and problems of stagnation** are generally known, therefore we shall state the most important, e.g. the overall lower level of the Slovak economy compared to advanced countries, traditional banking funding, decisions taken on privatisation methods (voucher privatisation and direct sales at a symbolic price; sale via the exchange, one of the purest privatisation methods and a major tool for investment support, was not used), multiple, purpose-oriented and non-systematic changes to capital market legislation, and the delay in creation of an advanced regulation framework. This situation was not removed by the establishment of the institution responsible for Capital Market Supervision (ÚFT – Financial Market Authority), which lacks the required competence. Newly emerging elements, particularly the establishment of a system of market makers for government bonds and shares[8] can be considered to be a positive trend to some degree. The foreign capital market has acquired a major role for several domestic entities in recent years, because of its capacity to accept the placing of bonds denominated in Slovak crowns. This market became an important source for financial funds required for the state budget – for the provision of funding of public requirements, it provides a suitable opportunity, to a limited degree, for several domestic investors.

The stable and predictable interest rate development in the money market creates positive conditions for the development of capital market products. The reaction of capital market entities (market subsystems) to NBS interest and money market rate signals can be indirectly deduced from a brief assessment of the development in the capital market.

3.1. Primary Market

3.1.1.Government bonds (GB)

In 2000, 20 government bond issues were floated on the domestic market with a total value of 69.5 bil. Sk (representing a 13.5 % total increase and an 89.3% increase in investor demand in comparison with 1999). The increased demand of investors, primarily banks, was dependent on liquidity excess and the limitation of loan activities. Issuers were able to obtain cheaper financing. A reduction in the number of issues and an increase in the average issued amount (no issue was below 1 bil. Sk) are a major condition for the establishment of a secondary market with a potential influence on increased demand by foreign investors. While in 1999 only one-, two-, and three-year bonds were issued, in 2000 these were supplemented by bonds with a longer maturity (5-, 7- and 10-year), thus reducing the refinancing risk. *For 2000, a reduction of accepted yields was characteristic for all comparable maturity periods and, in comparison with 1999, the average yield for all maturity periods was substantially reduced.* As of the beginning of 2000, a new market order came into effect, which facilitated access to the primary market, accelerated individual procedures and extended the circle of investors in government bonds to include non-residential legal entities. In this period, 12 foreign investors were registered on the primary market. The increase of the share of government bonds held by this investor group to 9.39 %, compared to 1.3 % in 1999, is indicative of the interest of foreign investors. On the other hand, their share of government bond deals is still adversely affected by the slow-paced process of opening property accounts at the Stredisko cenných papierov SR (Securities Centre of the Slovak Republic).

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[8] In December 2000, trading began with shares via market makers. The first issues included via market makers were the shares of the companies Slovnaft and Slovakofarma, From January 2001, the shares of Železiarne Podbrezová were also sold in this fashion.

In the first half of 2001, 28 issues of government bonds were floated with a total value of 160.72 bil. Sk. Government bonds for the restructuring of selected banks comprised 105 bil. Sk of this total. The volume of issues and the maturity period of government bonds for the restructuring of selected banks (5-, 7- and 10-year) influenced the situation on the primary market. The NBS expects that some investors will, in all probability, prefer shorter issues, i.e. with a maturity of up to 3 years. Current developments on the primary market partially confirms this expectation. The current value of the coupon of three January issues up to the due date of the first payment of yield on 30.1.2002 is 7.88 % p.a. In February, a new type of sale appeared on the primary market which allows, after a certain time, the reopening of an already existing issue, i.e. to sell it gradually. The reduction of overall demand in April started to signal changes in the market situation – a degree of saturation due to the restructuring bonds issued and the frequent alternation of the opening of two identical issues. In May, the decrease of overall investor demand continued further. In order to ensure sufficient demand issuers were obliged to increase the offered yield (from 7.60 % p.a. to 7.75 % p.a. for one-year bonds), and additionally reduce maturites. This trend – reduced investor demand and increased requirements regarding the amount of yield up to maturity, also continued in June. The overall reduction of demand can be ascribed to the large volume of government bonds issued in 2001 and the reduced capacity for a reduction of interest rates in the following period, which attenuated investor interest in the yields offered by issuers.

3.1.2. Non-government bonds

In 2000, the primary market saw a revival: the total value of non-government bonds issued (according to data reported to the NBS) reached 8.7 bil. Sk at the end of the year (1.9 bil. Sk in 1999), 54.8 % of this amount represented publicly negotiable non-government bonds. For the first time, 4 publicly negotiable non-government bonds denominated in foreign currencies were issued (two issues in EUR – with a total value of 59 mil. EUR, two issues in USD – total value of 8.3 mil. USD). The revival of the primary market for non-government bonds can be ascribed mainly to the reduction of yields in the primary market and to a liberalisation of the issuing process.

In the first half of the year, publicly negotiable non-government bonds with a total value of 500 mil. Sk were issued. This represents an increase of 150 % compared with the same period of the preceding year.

*3.1.3. **Mortgage Bonds Issues***

Only one credit institution (VUB) has the first experiences with the liabilities-side of mortgage transactions. Overview of all mortgage bonds issues in 1999 and 2000 is as following.

Table 9

Issues of Mortgage Bonds

Securities type	Total NV (mil. Sk)	NV (Sk)	Securities pieces	Int. rate (p.a.)	Issuing date	Maturity	Maturity date	Coupon payout
HZL*	100	1 000 000	100	10 %	15/01/1999	5 years	15/01/2004	half yearly
HZL	100	1 000 000	100	10 %	15/11/1999	5 years	15/11/2004	half yearly
HZL	100	1 000 000	100	9 %	15/05/2000	5 years	15/05/2005	half yearly
HZL	250	1 000 000	100	8,5 %	15/08/2000	5 years	15/08/2005	half yearly
HZL	250	1 000 000	100	7,8 %	15/12/2000	5 years	15/12/2005	half yearly

* HZL – hypotekárny záložný list (mortgage bond). Up to now only VUB has issued mortgage bonds.
NV – nominal value

The second banking institution – Tatrabanka, a. s. is preparing the mortgage bonds issue, the expected volume will be probably 500 (600) million Sk with 5 year maturity, with interest rates 7.0 – 7.5 % p. a.

3.2 Secondary Market

3.2.1. Bonds and Shares

In 2000, the total value of stock trading[9] reached 255.5 bil. Sk and thus recorded a 35.6 % increase compared to 1999. Trading in government bonds and bonds of the Fond národného majetku (FNM) SR comprised 90 % of the overall trading volume. The volume of price-setting transactions saw a reduction from 14.7 % in 1999 to 11 % in 2000.[10] Government bonds were the most traded amongst price-setting and direct transactions. The market capitalisation of bonds increased year-on-year by 3.2 % to 117 bil. Sk, of this amount 107.1 bil. was in listed bonds. The share market registered a moderate revival. The total volume of trading reached 25.1 bil. Sk (1999 – 20.2 bil. Sk) and the absolute value of price-setting transactions also increased (1.9 bil. Sk), but their share recorded a reduction from 9.9 % in 1999 to 7.57 %. In 2000, the most traded shares at the BCPB were those of Slovnaft, Nafta Gbely, VÚB and registered VSŽ shares. The market capitalisation of all property securities increased from the end of 1999 by 2.7 % to 154.9 bil. Sk.

Foreign investors' share of trading at the BCPB, compared to 1999, increased substantially but the share of natural persons was almost unchanged.

Table 10

Shares of Foreign Investors and Natural Persons of the Total Trading Volume at the BCPB during 1999 and 2000

1999	**Sale**	**Purchase**	**Turnover**
Foreign investors	20 %	36 %	28 %
Natural persons	18 %	18 %	18 %
2000	**Sale**	**Purchase**	**Turnover**
Foreign investors	26 %	50 %	38 %
Natural persons	19 %	18 %	18 %

Source: BCP, annual reports; ÚFT (Financial Market Authority „Analýza aktuálneho stavu kapitálového trhu v SR" (Analysis of the Current Situation of the Capital Market in the SR), June 2001

In the secondary market (stock trading) trends are also visible from preceding years in the first half of 2001. In June 2001, the total trading volume (21 trading days) reached 6.7 bil. Sk. The shares of the individual markets of the total were as follows: listed bonds had a dominant share of 89 %, bonds from the registered securities market - 4 %, shares on the free market - 3 %, listed shares - 2 % and shares on the registered securities market - 2 %. The bond market in June was dominated by government bonds (95 % share), average yield up to maturity – 7.96 % p.a. with an average duration of 1.9 years. On the shares market, the largest volume of trading (294.4 mil. Sk) was recorded by registered shares of Doprastav. The market capitalisation of all tradable shares at the end of June reached 166.5 bil. Sk.
Despite the positive developments in the bond and share markets we can state that the development from previous years has been confirmed on the capital market:

- a high share of bond trading, mainly government bonds, thus continuing the suppression of the private sector by the public sector,
- reduction of the share of price-setting (anonymous) trading of the total (bonds and shares) is indicative of the low market liquidity and the related low validity level of prices,

[9] The share of the BCPB (Bratislava Stock Exchange) of total stock trading on the Slovak capital market in 2000 was 87.4 %, its share of total bond trading was 100 %, its share of FNM (National Property Fund) SR bond trading was 43.1 % and its share of the overall volume of share trading was 86.4 %.
[10] The reduction of the price-setting function of the BCPB was reflected in both main types of traded securities, shares and bonds.

- the stock exchange as an alternative method for the raising of financial sources was practically used only by issuers of bonds (these being mainly the government and municipalities),
- a low level of investments by natural persons via capital market products.

3.3. Collective Investment

The Law on Collective Investments undoubtedly "renewed" the trust of investors in collective investment, which was predominantly expressed during 2000 by a significant increase in the value of property accumulated in open share funds – in 1999 their value was 2 bil. Sk. By the end of 2000, this figure was almost 4.5 bil. Sk. Behind this positive development it is necessary to recognise the stabilisation and gradual decrease of interest rates on the money and banking markets. The transition to qualitative control of currency policy – the interest channel (interest signals) of the NBS "came" via the banking system to the collective investment sector. The interest rate reduction on deposits at commercial banks triggered a search for alternative investment opportunities for the placing of savings, predominantly the population's. In 2000, the share of funds invested in open-end trusts (3.6 bil. Sk) of the increase of deposits by the population at banks for the same period (increase by 33.5 bil. Sk) reached a record of 10 %. The share of the overall value of deposits by the population is still low, it marginally exceeded 1%. The trend for an increase of this share will depend on the further reduction of bank interest rates and also on the investment decisions of the population (willingness to invest in trust funds with regard to the amount of yield of shares, and trust), but also on the quality of the management of administration companies.

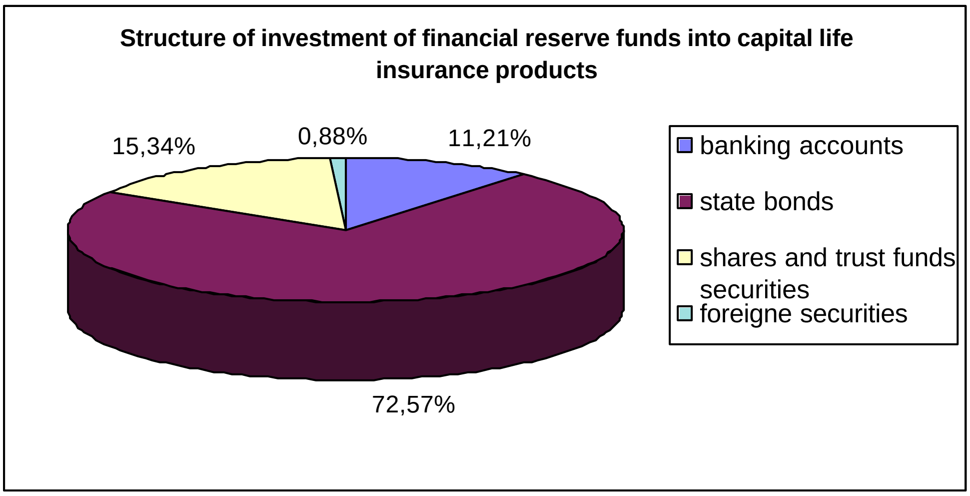
4. Insurance

With regard to the accumulation of long-term financial sources and the formation of strong institutional investors, insurance companies have now, and will have in the future, an irreplaceable position in the economy of the SR. They are included among the so-called contractual financial institutions which, as opposed to banking entities, acquire free financial sources by the offer of legal contracts for protection against risk. At present, there are 29 insurance companies established on the market, of which 21 have a foreign property participation (19 reported a dominant or 100 % share of foreign shareholders). The overall share of foreign shareholders of the basic equity of insurance companies is 42.3 %. The territorial structure of foreign capital is very close to the territorial structure in the banking sector. The highest share of basic equity is reported for Austria, Germany, Holland, the Czech Republic and the US. This information indicates that the interest of foreign insurance companies in the acquisition of business licenses in Slovakia is ongoing. The activities of insurance companies as regards the introduction of new insurance products and services in response to client requirements is positive. For example, the offer and development of life insurance products will allow the development of a higher degree of activity on the capital market. The future development of this, in advanced countries relatively widespread product, will depend on the willingness of the population to "go" for a higher risk, i.e. a higher yield on invested funds and, naturally, on the investment policy of specific insurance companies and their responsibility. The insurance business is assessed in the same way as the banking system or the capital market, i.e. by indicators characteristic for the business. The indicator prescribed premium/GDP is considered to be one of the basic indicators. It measures the importance (weight) of insurance deals in the economy. In 2000, this figure reached 3.10 %, as shown by analyses[11]. It is steadily increasing (1993 - 2.27 %; 1997 - 2.81 %; 1999 – 3.03 %). In EU countries this figure was 7.51 % and in OECD countries it was 8.41 %. As positive are considered the increased dynamics within the life insurance sector, the increased share of prescribed life insurance of the overall prescribed premium (slightly above 40 % in 2000), and the reduction of the share of non-life insurance. This development represents a movement towards an equilibrium of the ratio of both types

[11] Annual reports of the Association of Insurance Companies, Financial Market Authority, comments of public professionals.

of insurance (50:50), which is in accordance with world-wide trends. At the same time life insurance products will create the capacity for the accumulation of long-term financial resources in the economy and for the position of insurance companies as strong institutional investors. In this context, insurance companies reserves (creation and structure), their use and placement with regard to the diversification of risks are an extraordinarily important area. Insurance companies have, in this direction, defined the rules of the game – reserves are used for the payment of obligations of the insurance company towards the insured. The insurance company can place them in banks or use them for the procurement of domestic and foreign securities. By the placement of reserve funds, the insurance company obeys (complies with) the principles of safety, profitability (revenue creation or growth of these funds), liquidity (part of the funds placed in such a way that they are readily available for the payment of the premium), a reasonable spread of placement of reserves (risk spread by the use of various methods of placement) and the dispersion of the placement (only a limited portion of reserve funds placed in a single entity). The structure of investment of financial reserve funds into investment (capital) life insurance products is given in diagram 1. Naturally, we have not considered the insurance sector in detail. From the position of a central banker it is rather an analysis of the position of the sector within the economy, and especially within the financial system. Signals from the NBS and the money market are also reaching the insurance companies and their customers. At the beginning we mentioned that the central bank directly or indirectly influences the behaviour of all market players by its monetary political decisions, including the insurance business. A stable economic and currency environment is vital for the development of the insurance business. Insurance entities develop their commercial business activities within the overall economic and monetary orientation of the government and the central bank. The NBS and the banking system cannot in the long-term replace an effectively functioning capital and insurance market, even under the conditions of advanced market economies. The stabilisation of interest rates and the trend to their reduction especially within the banking market may help change the attitude of investors and increase interest in other financial products, including insurance products.

We consider the insurance business and the insurance market to be a dynamically developing segment. Despite its relatively small size, it represents one of the most promising forms of deposit of the population’s savings. The development of life insurance, the dynamics of its development and the expansion of the product range of this type of insurance, and last but not least, the preparation of conditions for business in the insurance sector and regulation are confirmation of this fact.



Closing Remarks

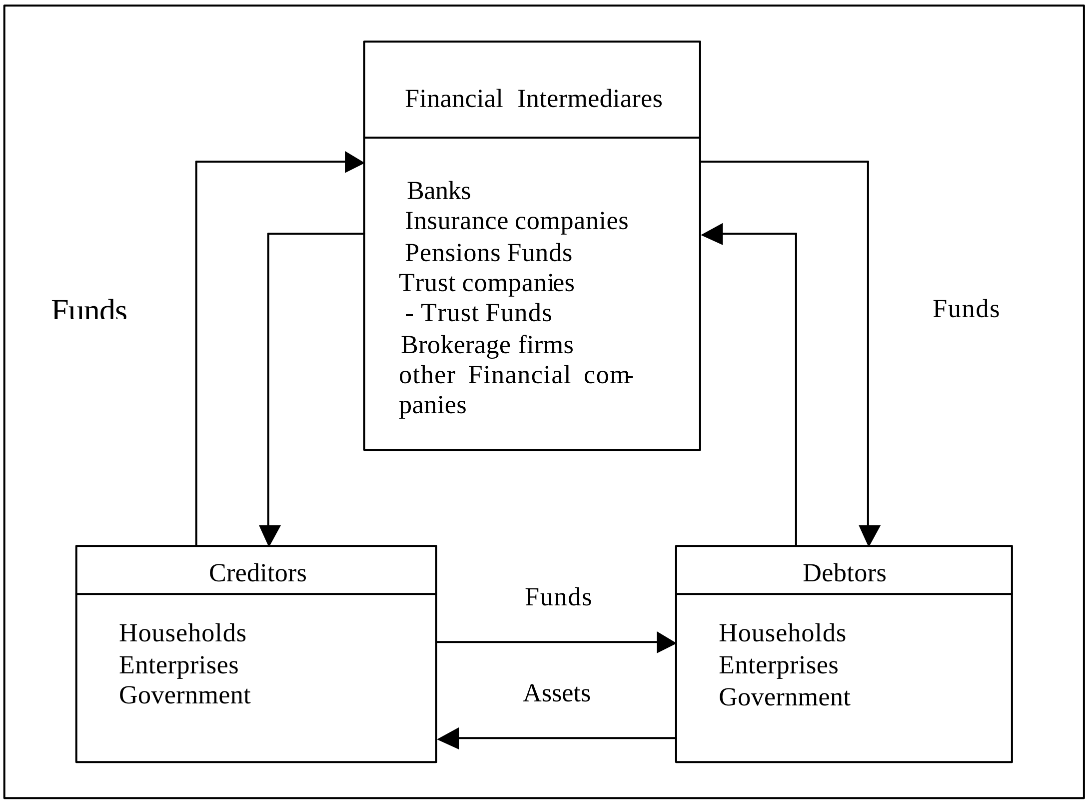
A significant aspect to be taken into account during the valuation of mortgage bond system is the formation of a market for mortgage products with respect to the specific conditions under which banks offer of these products. Indeed mortgages have extended banking activities on the one hand; on the other hand they contribute to the revival of investment activities. A generally valid and empirically confirmed fact is that the effective development of the market for mortgage loans and mortgage bonds is conditional upon the existence of an adequately functioning capital market, the removal of legislative barriers, and equally important role is paid by economic factor, such as GDP growth, inflation and unemployment rates; market interest rates stabilisation and their structure; the size and structure of financial sector for the placement and saturation of mortgage bonds.

Although a lot of problems we have overcame (relevant acts amendments; mortgage interest rates decrease and their stabilisation; the implementation of direct, indirect incentives) one of the crucial aspects are conditions on the Slovak capital market. In this field financial authorities are preparing a new legal framework in the course of EU legislation (e. g. Act on Securities, Act on Insurance, Act on Collective Investment – amendments, and so on). Several obstacles concerning mortgage bonds are in the existence, very closely connected with capital market chronicle identified problems, of which especially non-transparency, low market liquidity and the related low validity level of prices; the stock exchange as an alternative method for the raising of financial sources is practically used only by issuers of bonds – mainly by government.

A n n e x e s

Chart 1

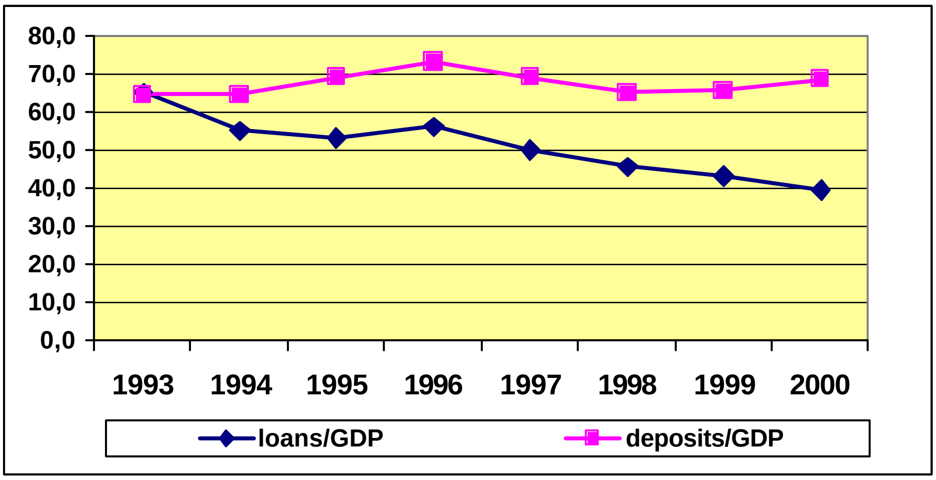
Financial System Institutional Structure in the Slovak Republic



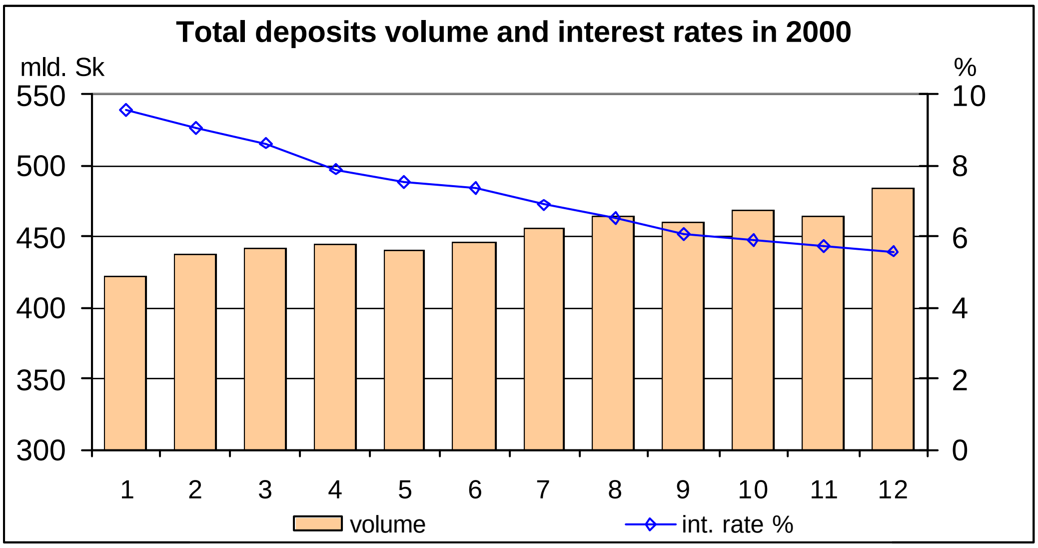
ANNEX 1

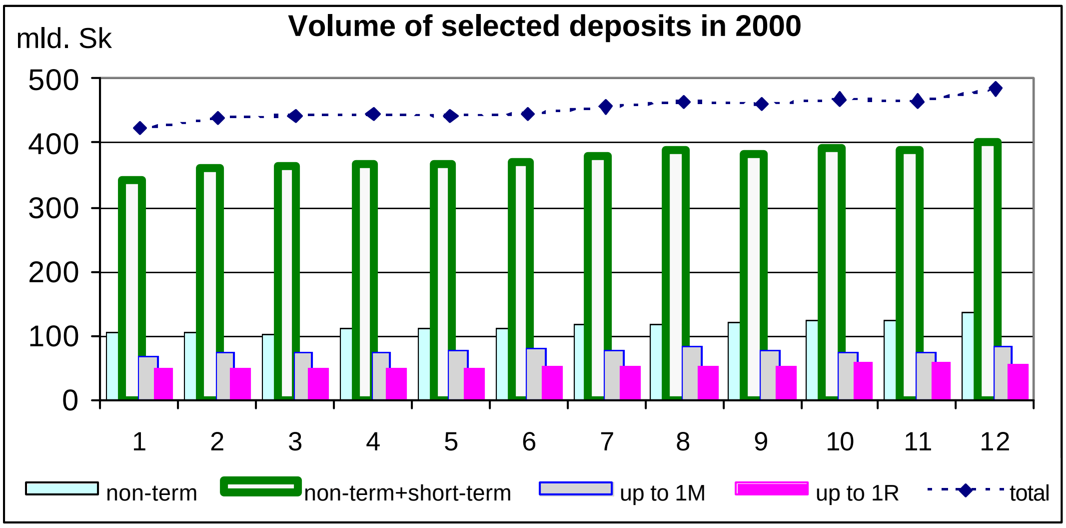
Banking Sector Macroeconomic Position

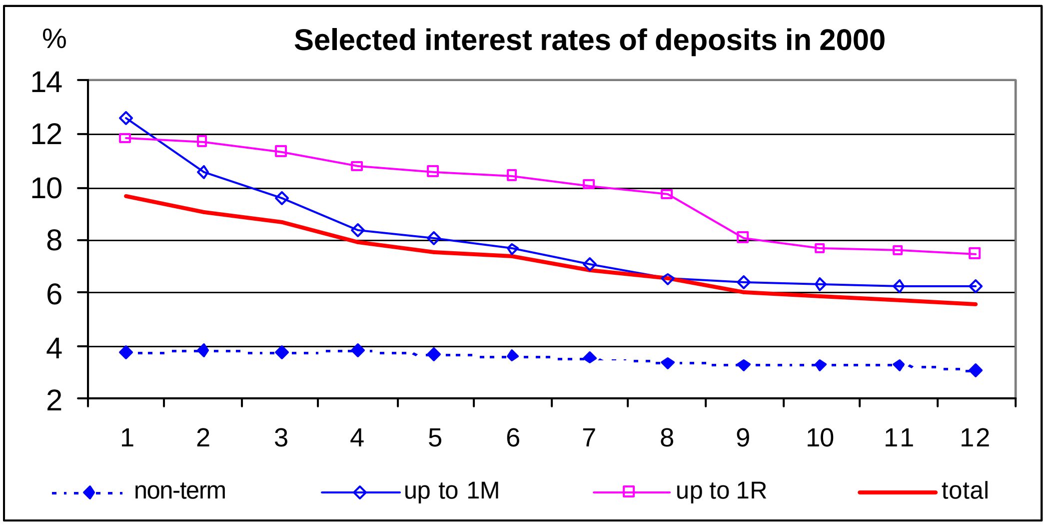
indicator/year	1993	1994	1995	1996	1997	1998	1999	2000
loans / GDP	64,8	55,2	52,8	55,9	49,9	45,3	43,0	39,7
deposits / GDP	64,7	64,4	69,1	72,9	68,9	64,8	65,5	68,7
GDP in current prices								



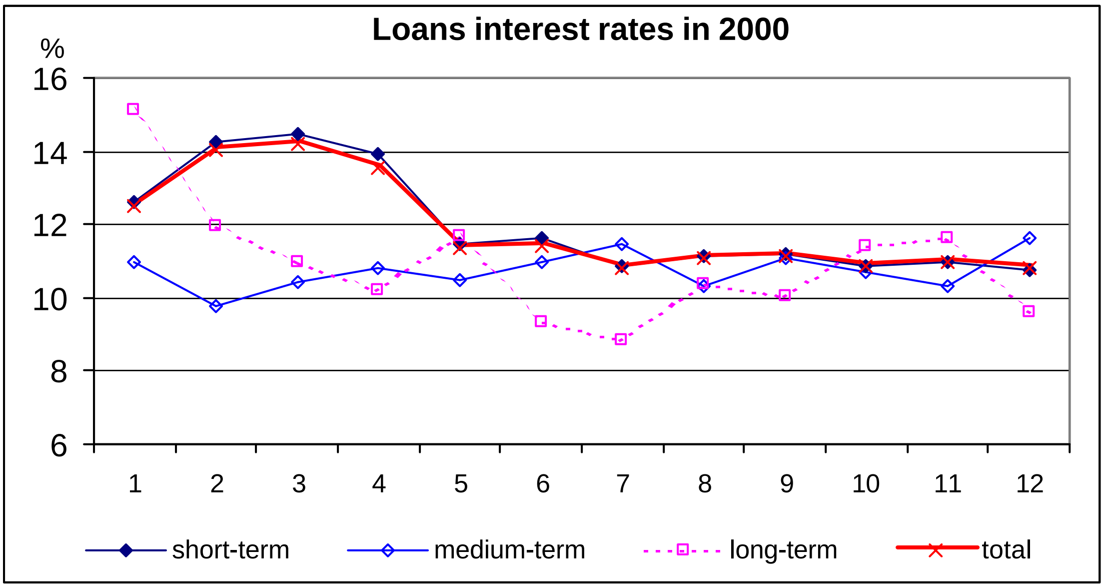
ANNEX 2

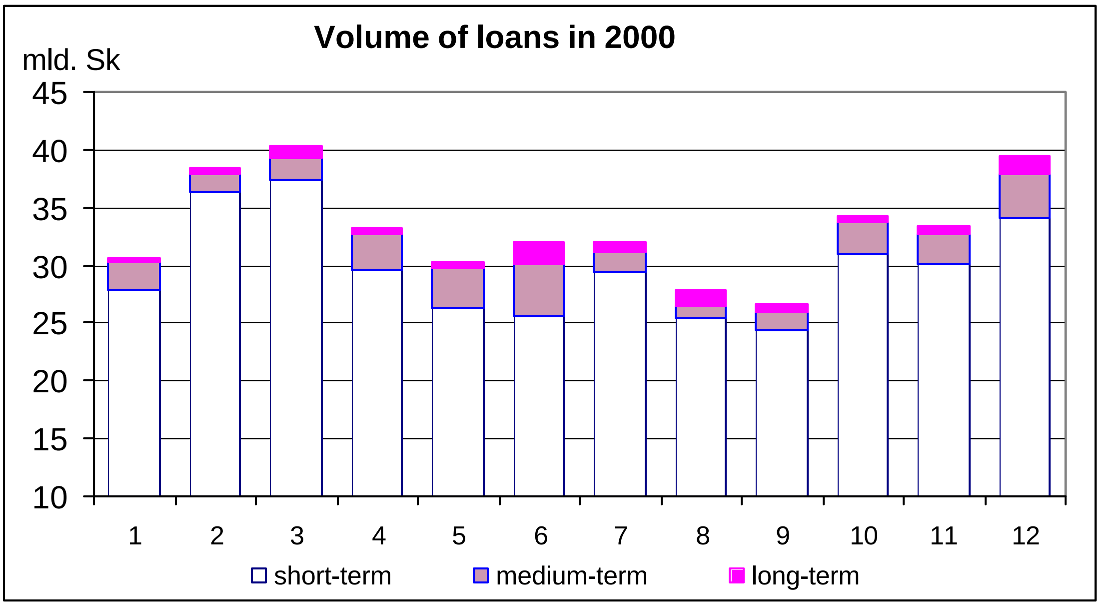

Total deposits volume and interest rates in 2000
mld. Sk
%
550
500
450
400
350
300
10
8
6
4
2
0
1
2
3
4
5
6
7
8
9
10
11
12
volume
int. rate %


Volume of selected deposits in 2000
mld. Sk
500
400
300
200
100
0
1
2
3
4
5
6
7
8
9
10
11
12
non-term
non-term+short-term
up to 1M
up to 1R
total


%
Selected interest rates of deposits in 2000
14
12
10
8
6
4
2
1
2
3
4
5
6
7
8
9
10
11
12
non-term
up to 1M
up to 1R
total

ANNEX 3


Loans interest rates in 2000
%
16
14
12
10
8
6
1
2
3
4
5
6
7
8
9
10
11
12
short-term
medium-term
long-term
total

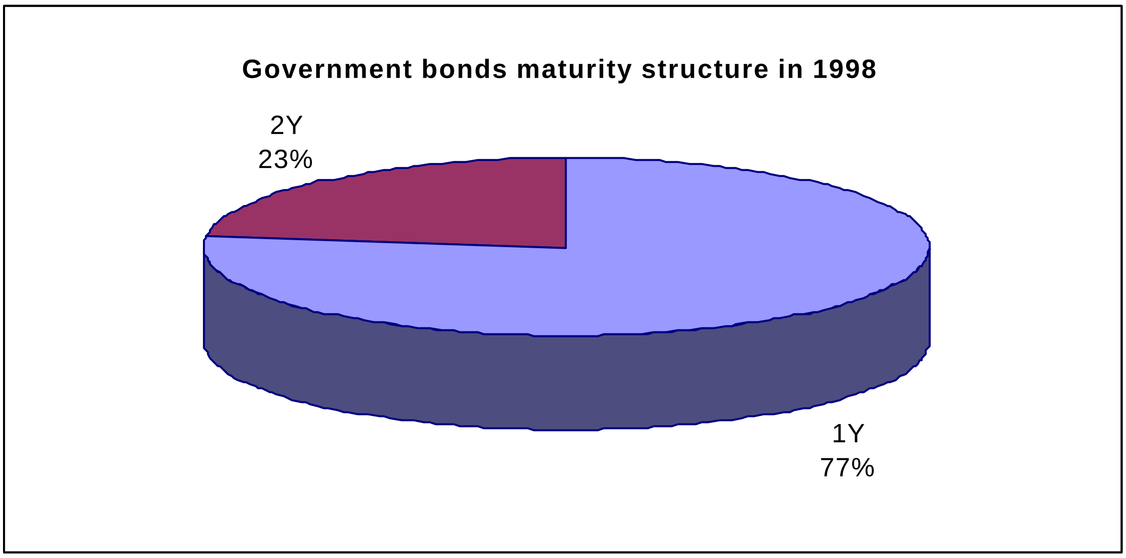

Volume of loans in 2000
mld. Sk
45
40
35
30
25
20
15
10
1
2
3
4
5
6
7
8
9
10
11
12
short-term
medium-term
long-term

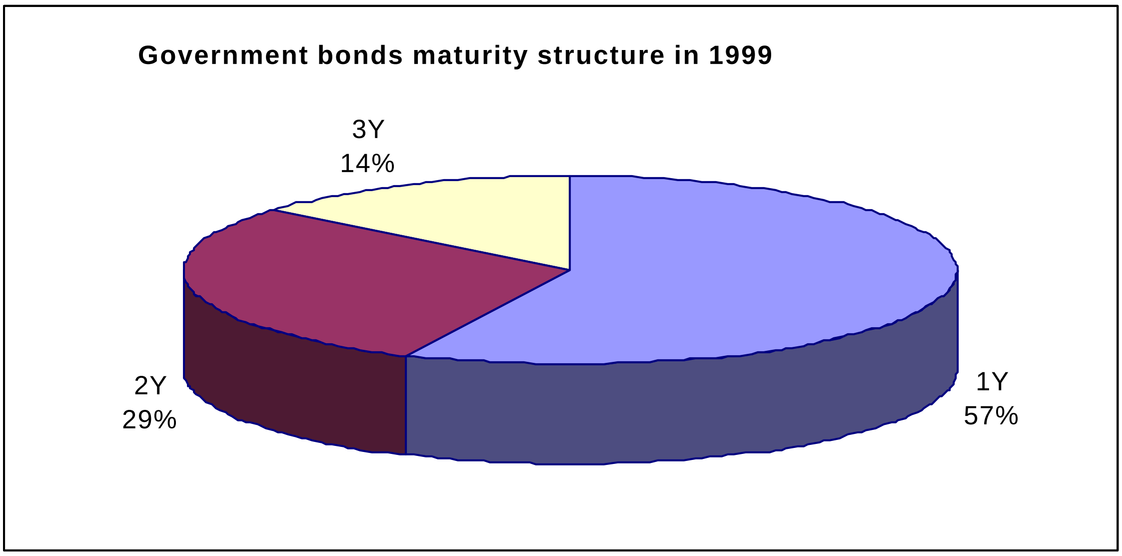
ANNEX 4

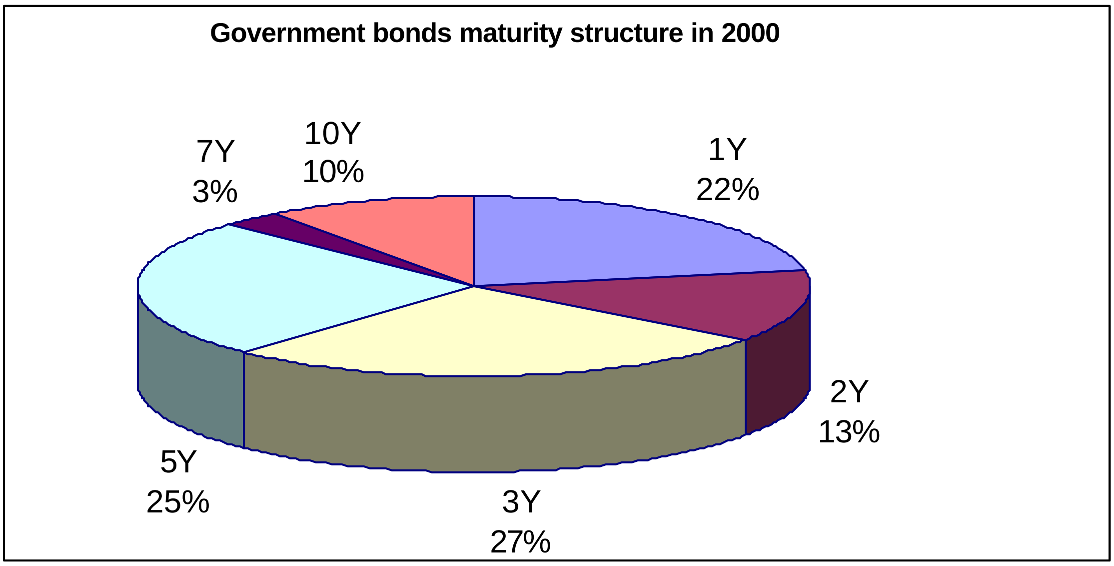
		Credit Market					Bank Deposits Market			
2001/Month	CA - Deb.	C/cont.	to 1Y	to 5Y	over 5R	BDep CA	BDep 1M	BDep 1Y	Bdep NT and ST	BDep Average
January	15,75	15,01	10,20	9,58	9,39	2,93	6,16	7,19	5,40	5,52
February	18,26	12,47	9,32	11,69	10,94	2,62	5,86	7,04	5,16	5,34
March	14,76	13,40	9,82	10,78	8,75	2,61	5,81	6,84	5,20	5,36
April	15,16	11,45	9,62	9,57	10,06	2,57	5,95	6,73	5,10	5,26
May	15,66	12,09	9,26	10,71	9,98	2,53	5,95	6,68	5,04	5,20
June	15,01	11,49	9,09	10,22	9,29	2,57	5,95	6,63	5,00	5,16
July	13,64	11,83	8,77	10,27	9,33	2,49	5,85	6,55	4,92	5,09
August	13,83	12,32	8,95	10,13	9,57	2,47	5,88	6,46	4,94	5,09
September										
October										
November										
December										

Average Money Market Interest Rates

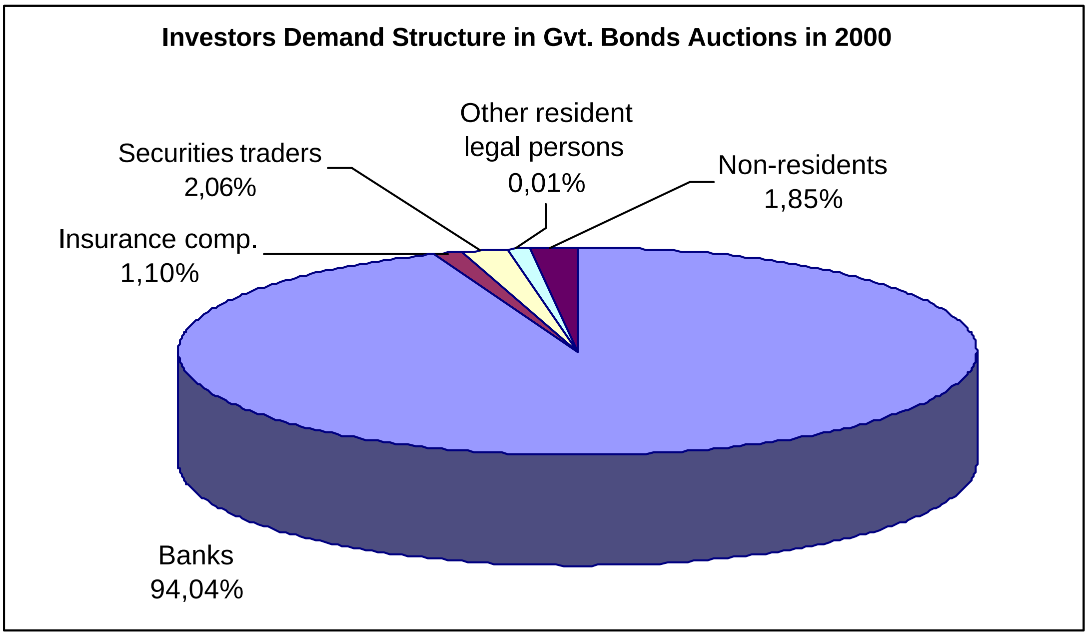
2001/Month	O/N	1W	2W	1M	2M	3M	6M	9M	12M
January	6,88	7,62	7,71	7,76	7,71	7,69	7,68	7,65	7,65
February	7,14	7,72	7,75	7,72	7,68	7,64	7,61	7,57	7,56
March	8,04	7,89	7,88	7,83	7,75	7,71	7,66	7,61	7,61
April	7,39	7,74	7,75	7,74	7,72	7,69	7,66	7,61	7,60
May	7,16	7,68	7,72	7,72	7,72	7,72	7,71	7,69	7,68
June	7,16	7,68	7,71	7,73	7,75	7,75	7,77	7,77	7,78
July	7,42	7,75	7,77	7,78	7,79	7,81	7,82	7,82	7,83
August	7,52	7,73	7,77	7,79	7,84	7,86	7,90	7,91	7,92
September	7,82	7,80	7,81	7,83	7,88	7,89	7,94	7,97	8,00
October (to 15)	6,77	7,65	7,75	7,82	7,86	7,89	7,92	7,95	8,00
November									
December									

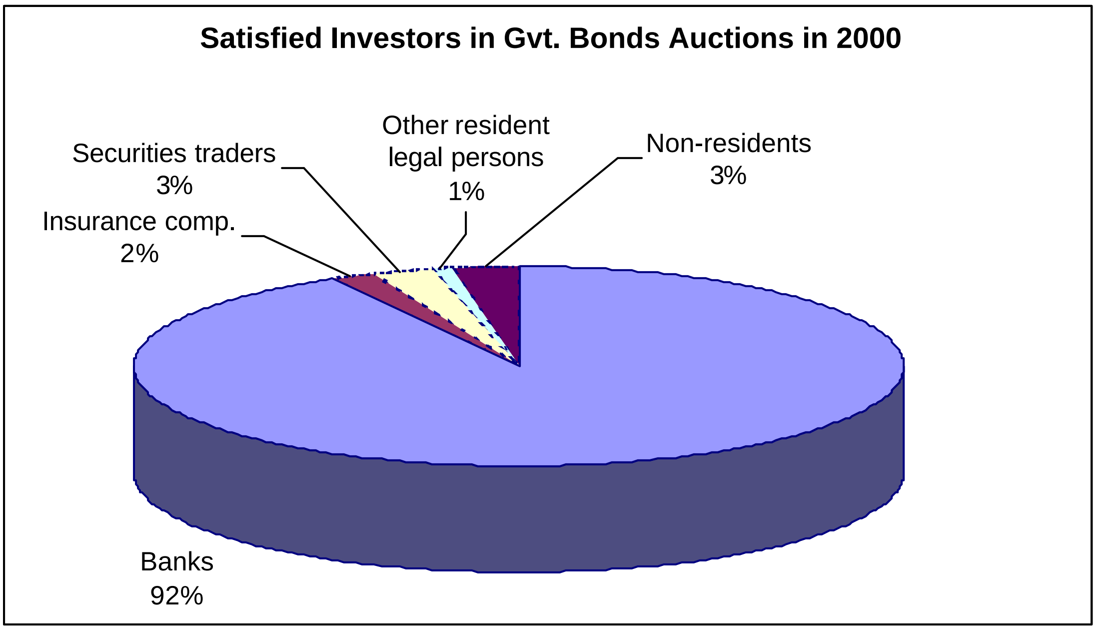

Government bonds maturity structure in 1998
2Y
23%
1Y
77%


Government bonds maturity structure in 1999
3Y
14%
2Y
29%
1Y
57%


Government bonds maturity structure in 2000
7Y
3%
10Y
10%
1Y
22%
2Y
13%
5Y
25%
3Y
27%

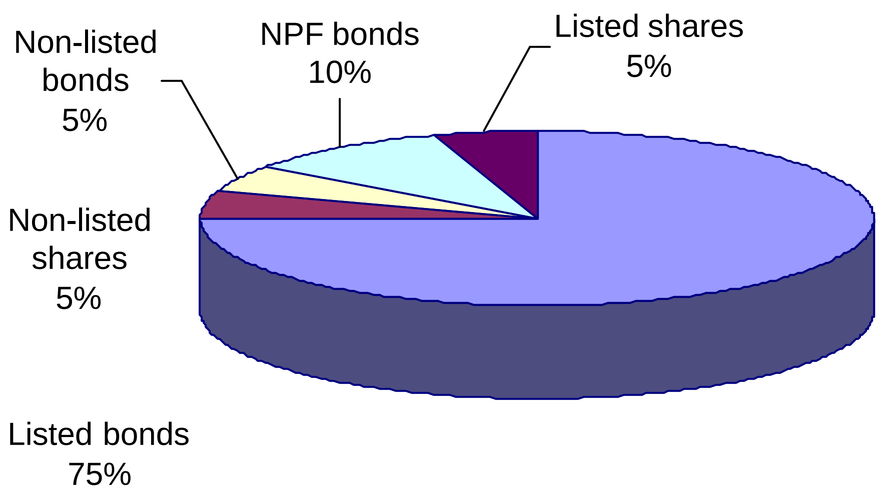
ANNEX 6


Investors Demand Structure in Gvt. Bonds Auctions in 2000
Other resident legal persons 0,01%
Securities traders 2,06%
Non-residents 1,85%
Insurance comp. 1,10%
Banks 94,04%


Satisfied Investors in Gvt. Bonds Auctions in 2000
Other resident legal persons 1%
Securities traders 3%
Non-residents 3%
Insurance comp. 2%
Banks 92%

ANNEX 7

Share of the relevant mkts. on total trading volume in 2000



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