Bank of Slovenia
Banking Supervision

REPORT ON BANKING SUPERVISION IN 2003 AND THE FIRST HALF OF 2004

October 2004

Pursuant to Article 26 of the Bank of Slovenia Act (Official Gazette of the Republic of Slovenia, no. 58/02, 85/02 - amend.), we submit this report on the supervision of banks, savings banks, and savings and loan undertakings in 2003 and the first half of 2004 to the National Assembly of the Republic of Slovenia.

The purpose of this report is to present the prudential supervision of credit institutions and development in banking in 2003 and the first half of 2004.

The report is also published and made available to the general public to safeguard the stability of the banking system and to promote transparency in the operations of banks, savings banks and savings and loan undertakings. The disclosure of data and information relating to banking supervision is in accordance with the provisions of the Banking Act (Article 59 of the Banking Act, which defines in detail what data are significant to the execution of the Bank of Slovenia's tasks and responsibilities, and those of the institutions to which it may submit that data).

MISSION STATEMENT

The Banking Supervision Department provides effective banking supervision to facilitate the secure and prudent operation of banks, savings banks and savings and loan undertakings.

OBJECTIVE

The most important objective of the Banking Supervision Department is to ensure depositor protection and thereby maintain the stability of the financial system. This objective underlies all the department's activities, and forms the basis for the sub-objectives for the whole department and its organisation units.

OPERATIONAL PRINCIPLES

The Banking Supervision Department is committed to ensuring the highest possible standards of operational safety and soundness in banking institutions in Slovenia. Our assumption in a market economy is that credit institutions are managed by professionals selected by owners who set out the standards that management must meet. Banking supervision does not mean decision-making on behalf of owners and we will not interfere in the responsibilities of credit institution management teams. The Banking Supervision Department role is to produce regulations and recommendations that contribute to greater competition and ethical business practice at every level of decision-making. Our department does this through regular open communication with the banks, savings banks and savings and loan undertakings.

THE ROLE OF MANAGEMENT AND INTERNAL AUDITORS

The primary responsibility of credit institution management teams is to their owners. But they are also responsible to the regulators, who work to ensure that banking operations are sound and effective through adequate supervision. The management teams have a duty to apply clearly defined rules to manage all forms of banking risk, which they do within a system of internal controls. Owners and regulators require the management teams to set out in writing the rules and mechanisms they use. Good business performance demands that credit institution managers also have long-term business strategies implemented through policies for each area of bank operation. Banking institutions are also required to have a well-developed internal auditing system that monitors the adequacy and appropriateness of banking operations and notifies the management of its findings and recommendations. It is vital that the bank management recognises the role and importance of the internal auditors and respects their findings and recommendations, because an internal audit department can only be assessed in terms of how the management implements its findings.

INTRODUCTION AND SUMMARY

The Bank of Slovenia supervises banks and savings banks, and since the Banking Act was passed in 1999, savings and loan institutions as well. The Bank of Slovenia's supervision includes licensing, the analysis of credit institution operations and the on-site examination of operations at an institution's registered office or business units. The Bank of Slovenia regularly monitors and checks whether institutions are operating in accordance with the law. This supervision takes place first of all via regular reports submitted to the Bank of Slovenia (daily, weekly, monthly, quarterly, etc.). When the Bank of Slovenia receives the reports, it analyses them and checks back for any irregularities or faults. The Bank of Slovenia takes action if any irregularities are discovered. Other forms of supervision include on-site examinations, which also cover true and fair reporting of operations to the regulator, i.e. the Bank of Slovenia. Banking operation examinations are scheduled a year in advance in the Bank of Slovenia's annual plan for the Banking Supervision Department. The relative merits of individual credit institutions operating on the market are taken into account when drawing up the Banking Supervision Department's annual plan. Larger credit institutions, and those with greater risks, are subject to greater scrutiny that others. In addition to the regular reviews of credit institutions that may take the form of a full-scope examination or just a specific department, there are also special examinations carried out in response to requirements on the Bank of Slovenia's own initiative (e.g. if it discovers a potential risk to the whole banking system, e.g. when reviewing card transaction support systems, transaction account operations, etc.) or in response to a request by another agency or person. The supervisor's task is not to verify every business decision a credit institution takes, as responsibility for ensuring credit institution operations are stable and secure lies with thee management itself.

The Bank of Slovenia's Banking Supervision Department carries out solo and consolidated supervision. Supervision includes the standard fields of capital, asset quality, management, profitability and liquidity, and also covers supervision of market and other forms of risk management, and monitoring of legal and natural persons when there is suspicion that banking services are being performed without Bank of Slovenia authorisation. Banking supervision includes tasks set out in the Consumer Credit Act, Prevention of Money Laundering Act and the Payment Transactions Act. There are also requirements for information systems, which must demonstrate high levels of reliability and security.

In addition to analysing the operations of banks, savings banks and savings and loan undertakings, and on-site examinations, the Banking Supervision Department of the Bank of Slovenia maintains regular contact with the management of banks and savings banks through channels including regular annual meetings held at the completion of full-scope or special examinations. These meetings are devoted primarily to assessing the operating results and financial position of the credit institution in question and learning about its strategy for future development. The exchange of views and information between supervisors and the management of banking institutions is also a prerequisite for timely and appropriate action in the event of operating difficulties. Meetings with outside auditors are also organised if required by specific problems in a credit institution or to address unresolved expert issues. Cooperation with internal auditors is an ongoing process.

Banking Supervision Department inspectors not only review banks in Slovenia, but also banks abroad that are partially or wholly owned by Slovenian banks. In 2003, the operations of Nova Ljubljanska Banka subsidiaries abroad were examined on the basis of a Memorandum of Understanding (MoU) with foreign supervisory authorities (LHB Internationale Handelsbank Aktiengesellschaft, Frankfurt am Main). In the first half of 2004, another two NLB subsidiaries were examined abroad, in cooperation with supervisors in Macedonia and Montenegro (Montenegro Banka in Montenegro and Tutunska Banka in Macedonia).

Over the last eighteen months, new MoUs have been signed with foreign banking supervision institutions: in August 2003 with Belgium's Commission Bancaire et Financiere, in October 2003 with

the Montenegrin Central Bank, in December 2003 with the Bulgarian National Bank and in June 2004 with the National Bank of Serbia.
MoUs were also signed with domestic supervisory bodies, the Securities Market Agency and the Agency for Insurance Supervision. In 2003 and 2004 the Bank of Slovenia continued to cooperate with these two supervisory agencies, primarily by exchanging information in accordance with the Rules on Reciprocal Cooperation between Supervisory Agencies and the signed memoranda. In most cases the supervisory agencies operated on a solo basis.

In 2004 the consolidation of the banking sector continued. Slovenska Investicijska Banka went into ordinary liquidation, and a number of savings and loan undertakings were amalgamated into the Association of Savings and Loan Undertakings or acquired by other credit institutions. After 1 May 2004, the Bank of Slovenia started to receive numerous notifications from foreign supervisory institutions regarding foreign banks wanting to provide banking and other financial services directly on the Slovenian market. Despite expectations to the contrary, entry into the European Union has not yet led to any of the five foreign subsidiary banks in Slovenia being transformed into a branch bank.

In 2003 the Bank of Slovenia received two international delegations, a group of European supervisors within the Peer Review mission (April 2003) and experts from the World Bank and International Monetary Fund for a Financial Sector Assessment Program Update (November 2003). The purpose of the visit by European supervisors in April 2003 was to determine whether Slovenia's supervisory institutions (including the Securities Market Agency and the Agency for Insurance Supervision) had implemented the recommendations they made on their first visit in 2001. The IMF/World Bank visit was not just to assess whether recommendations put forward by the IMF/World Bank delegation that visited in April 2001 had been implemented, but also to examine the practical implementation of changes and new practices in the Bank of Slovenia regulatory and supervisory work. The finalised Financial System Stability Assessment Update is already available on the IMF website, while the World Bank website has the Report on the Observance of Standards and Codes (ROSC) Corporate Governance Country Assessment. The publication of final reports on the financing of housing constructions, accounting and auditing and detailed assessments on the observance of basic banking supervision criteria and insurance principles is anticipated at the end of October 2004.

The IMF/World Bank mission's finding was that the Slovenian banking system was safe and sound, despite the challenges of EU entry and the ERM2 currency mechanism. Slovenian-based banks are facing increasing competition from European banks, while the risk of asset quality deterioration is increasing as due to lower real interest rates. The foreign experts assessed that the Banking Supervision Department has achieved a high level of core principle observance. Rapid changes and the complexity of the financial system demands high quality supervision. Members of the IMF/World Bank mission found that progress had been made in the supervision of associated companies and in consolidated supervision, but said further strengthening was needed in this field because of the growth of financial conglomerates. Based on the mission's findings the Banking Supervision Department prepared an action plan to improve observance of the core principles, which was approved by the Governing Board in February 2004. From June 2004 we will report twice annually to the World Bank and IMF on the implementation of the action plan.

Two amendments were made during 2003 and the first half of 2004 to the Banking Act (Official Gazette of the Republic of Slovenia, no. 7/99, 59/01, 55/03 in 42/04). The first amendments to the Banking Act (the second time it has been amended since first passed in 1999) came into force on 24 June 2003, while the second set came in on 8 May 2004. The amendments were needed to harmonise the Act with EU legislation, but there was also a need to harmonise it with two Slovenian laws (the Companies Act and Bank of Slovenia Act). Some of the Bank of Slovenia's recommendations for amendments to the Banking Act that came into force in May 2004 were not taken into account (e.g. that members of bank supervisory boards should obtain Bank of Slovenia authorisation before appointment), despite the fact that they were based on the IMF and World Bank's recommendations.

There were also amendments to banking supervision regulations, such as the new Regulation on Reporting Effective Interest Rates and accompanying instructions (on the basis of requirements set out in the Consumer Credit Act), the Regulation on the Detailed Method of Calculation of Liabilities, Assets and Investments in Assessing Net Indebtedness or Net Exposure, the Regulation on the Harmonisation of the Amounts of the Minimum Initial Capital of Banks and Savings Banks, the Regulation on the Conditions to be Met by Credit Intermediaries, the Regulation on Submission of Bank and Savings Bank Information and some instructions.

Slovenia has started to prepare for the "capital changes" that will come in with the new Basel Capital Accord (Basel II) and EU capital directives. As the Slovenian bank regulator, one of the Bank of Slovenia's priorities up until 2006 is to inform banks of the new rules as regards Basel II and the new European capital arrangements, and how they will affect Slovenian laws and banking regulations. In 2003 in this area the Bank of Slovenia, in cooperation with the Bank Association of Slovenia, prepared the Slovenian Quantitative Impact Studies (SiQIS). The SiQIS analysis, which was finished in August 2004, produced the first quantitative assessments of the impact the new rules will have on calculating capital adequacy in the Slovenian banking system. In mid-2004 the Bank of Slovenia also prepared the First Consultation Document on the Introduction of Internal Ratings Systems. The answers banks supplied to questions in the survey were analysed to produce a preliminary assessment of readiness among Slovenian banks for the introduction of the stricter approaches to calculating credit risk capital requirements. The Bank is also preparing recommendations on operational risk management with the basic and standardised approaches, while using a range of surveys to closely monitor how Slovenian banks progress in developing their own operational risk management frameworks.

1. ASSESSMENTS OF THE FINANCIAL SECTOR IN SLOVENIA

In November 2003 the International Monetary Fund (IMF) conducted a Financial Sector Assessment Program Update (FSAP Update) in Slovenia together with the World Bank. Over the course of two weeks the IMF/World Bank mission assessed the financial sector in Slovenia and the observance by bank and insurance supervisors of the Core Principles for Effective Banking Supervision (Core Principles) and the principles of the International Association of Insurance Supervisors (IAIS). A new methodology meant that no assessment was made of compliance with the international principles for capital market supervisors (International Organization of Securities Commissions (IOSCO). This was the second independent assessment of Slovenian financial supervisors and the financial sector (the first assessment was in November 2000, by the IMF in cooperation with the World Bank). Four years ago assessments were also made on observance of the Core Principles for Systemically Important Payment Systems published by the Basel Committee on Payment and Settlement Systems. In November 2003 there were also assessments of accounting and auditing in Slovenia, an assessment of Corporate Governance and financing in the housing sector.

In April 2004 the IMF published the Financial System Stability Assessment Update on its website, and in May 2004 the World Bank website had the Report on the Observance of Standards and Codes (ROSC) Corporate Governance Country Assessment. The publication of final reports on the financing of housing construction, accounting and auditing and detailed assessments on the observance of basic banking supervision criteria and insurance principles is anticipated at the end of October 2004.

The assessment of the banking sector and the Bank of Slovenia's observance, as banking supervisor, of the Core Principles approved by the Basel Committee on Banking Supervision in September 1997 was conducted on the basis of a Bank of Slovenia self-assessment carried out in July 2003 (the Bank of Slovenia's third self-assessment since the Core Principles were adopted).

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The foreign experts assessed that the Banking Supervision Department had achieved a high level of core principle observance. Rapid changes and the complexity of the financial system demand high quality supervision. Members of the IMF/World Bank mission found that progress had been made in the supervision of associated companies and in consolidated supervision, but said further strengthening was needed in this field because of the growth of financial conglomerates.

The Banking Supervision Department prepared an action plan to improve Core Principle observance, based on the findings of the IMF/World Bank mission. The Action Plan to Improve Core Principle Observance was adopted by the Governing Board of the Bank of Slovenia in February 2004. From June 2004 onwards, we will report twice annually to the World Bank and IMF on the implementation of the action plan.

2. LICENSING

Banks and savings banks require a Bank of Slovenia licence in order to provide banking and other financial services. The Banking Act sets out the conditions for issuing a licence for the provision of banking and other financial services. The Bank of Slovenia only determines the staffing, organisational and technical conditions for the provision of banking and other financial services.

In addition to issuing licences for the provision of banking and other financial services, the Bank of Slovenia also grants authorisations for:

- acquisition of qualifying holding
- mergers and break-ups
- establishment of a branch abroad
- establishment of foreign bank branch in the Republic of Slovenia
- establishment of representative office for a foreign bank
- serving as member of a bank management board
- conclusion of a shareholders' agreement.

Table 1: *Number of licences and authorisations granted and refused to banks and savings banks in 2002, 2003 and the first half of 2004*

	Type of authorisation	**2002**		**2003**		**First half 2004**	
		No. issued	No. rejected	No. issued	No. rejected	No. issued	No. rejected
1	Authorisation to provide banking services	0	0	0	0	0	0
2	Authorisation to provide other financial services	4	2	13	0	4	0
3	Authorisation to establish a branch abroad	0	0	0	0	0	0
4	Authorisation to a foreign bank to establish a branch	0	0	0	0	0	0
5	Authorisation for a merger of banks or savings banks	1	0	0	0	0	0
6	Authorisation for a foreign bank to establish a representative office	0	0	0	1	0	0
7	Authorisation to acquire a qualifying holding	3	2	6	2	0	0*
8	Authorisation to serve as member of a management board	20	0	4	0	2	0
9	Authorisation to conclude a shareholders' agreement.					1	0
	Total	**28**	**4**	**23**	**3**	**7**	**0**

*One authorisation was rejected on 2 July 2004.

Source: Bank of Slovenia

Following Slovenia's entry to the European Union, a member state bank that is entitled to provide the banking and other financial services listed in Annex I in its home country (List of activities subject to mutual recognition) of Directive 2000/12/EC, can also provide these services in Slovenia, either via a branch *(in the case of permanent provision of services)*, or directly *(in the case of temporary provision without elements of permanent presence on the territory of the Republic of Slovenia)* without need for a Bank of Slovenia licence, but simply on the basis of a notification issued by the relevant supervisory body of the member state in question. A list of EU member state banks that had applied to their own supervisory body by 30 June 2004 to obtain a notification to perform banking and other financial services in Slovenia is given in Appendix14a. There are other arrangements in place for foreign banks from countries that are not EU members. These banks can only provide banking and other financial services in Slovenia via branches. In contrast to banks from the European Union, foreign banks from outside the EU still require Bank of Slovenia authorisation to establish a branch in Slovenia. The Bank of Slovenia is entitled to make licensing a foreign bank branch conditional on it depositing a specific sum or other appropriate assets or insurance as a guarantee for the settlement of liabilities arising from its transactions in Slovenia.

January 2004 also saw new minimum initial capital limits being set for banks and savings banks. The minimum initial capital for a bank is SIT 1.22 billion (EUR 5.1 billion according to the exchange rate on 30 June 2004) irrespective of the type of banking services provided, and SIT 245 million for savings banks (EUR 1.02 million according to the exchange rate on 30 June 2004).

3. EXAMINATIONS OF CREDIT INSTITUTIONS

Ongoing supervision of banks, savings banks and savings and loan undertakings is provided through the regular submission of reports submitted to the Bank of Slovenia for off-site verification and through on-site surveillance by our inspectors. Supervision is based on the "four-eyes" principle, whereby off-site analysts and on-site inspectors are jointly responsible for supervising each bank, savings bank and savings and loan undertaking.

On discovering an irregularity in the conduct of a credit institution, both analysts and inspectors take appropriate action and monitor the remedial steps taken.

A bank, savings bank or savings and loan undertaking can be examined more than once in a given year. The scope of an examination is determined on the basis of prior information and analysis of the institution's activities, initiated by the management of the Bank of Slovenia, other Bank of Slovenia departments, or by external bodies. The examinations permit an in-depth investigation of areas of heightened risk or areas in which the Bank of Slovenia lacks adequate information or verification.

In direct examinations of banks and savings banks during 2003 and the first half of 2004, inspectors from the Banking Supervision Department, in addition to the standard areas of examination, paid special attention to supervising capital and capital adequacy, the management of market risk and other forms of risk, compliance with the Consumer Loans Act, compliance with the Money Laundering Prevention Act, the execution of payments by legal persons, and information technology. In the first half of 2003 Bank of Slovenia inspectors also monitored bank readiness for the transfer of personal current accounts to transactions accounts.

In addition to 13 full-scope examinations (nine banks, one savings bank and three savings and loan undertakings), a further 50 partial examinations of banks, savings banks, savings and loan undertakings and other companies were undertaken in 2003 and the first half of 2004 in specific areas (not including examinations of IT systems).

The most frequently identified irregularities in banks and savings banks were:

- inadequate control of credit risk (classification of counterparties and required provisioning)
- incorrect calculation of capital and capital adequacy
- inadequate control of foreign exchange or market risk
- inadequate and incomplete compliance with the Money Laundering Prevention Act
- operations inconsistent with internal regulations
- ineffective internal auditing
- inadequate internal controls
- failure to maintain integral data on outstanding claims and liabilities towards an individual customer
- inappropriate maintenance of accounts

- deficiencies in IT support for banking transactions (these are presented in detail in Chapter 3 on information technology examinations in credit institutions)
- organisational deficiencies with regard to security and control of business operations
- operational risks etc.

The most frequently identified irregularities in savings and loan undertakings were the following:

- failure to observe capital requirements and principles of safe and sound banking
- inappropriate classification of counterparties and provisioning
- inappropriate accounting procedures
- inadequate IT support for business operations with regard to security etc.
- excessive (concentrated) exposure to particular counterparties and savings and loan undertaking founders.

In 2003, the Bank of Slovenia used its legal powers to issue 24 orders for the correction of operating irregularities, 12 of which related to information technology. In the first half of 2004, 10 orders were issued, two of which concerned information technology.

In 2003 the Bank of Slovenia filed an indictment against a savings and loan undertaking for fraud and wilfully causing bankruptcy and issued an order to one savings and loan undertaking to adopt a programme for financial rehabilitation.

In the first half of 2003 Bank of Slovenia inspectors paid considerable attention to the then smallest bank in Slovenia – Slovenska Investicijska Banka d.d. At the request of both parliamentary chambers (the National Assembly and the National Council) the Bank of Slovenia issued a detailed report on the issue of the Slovenska Investicijska Banka, and in 2003 and 2004 prepared materials and replies to questions raised that included a chronological overview of the bank's position, supervised activities and action taken by the Bank of Slovenia. The material was studied several times by working bodies in parliament and at regular and special sittings of the National Assembly and the National Council, which are therefore not listed again here.

On 29 December 2003, the Slovenska Investicijska Banka d.d. went into voluntary liquidation.[1] The bank was then issued with a decision restricting its licence to perform banking and other financial services. The Bank of Slovenia is monitoring the voluntary liquidation procedure, which is still underway.

The Bank of Slovenia's supervisory powers also extend to other entities if there is reasonable suspicion they are performing banking services without authorisation from the Bank of Slovenia. In 2003, on the basis of referrals from relevant government institutions (principally the Ministry of the Economy and the Market Inspectorate of the Republic of Slovenia) or at the instigation of members of the Governing Board of the Bank of Slovenia, Bank of Slovenia inspectors carried out nine examinations of companies suspected of engaging in unauthorised business activities. In the first half of 2004 there were six such investigations. The Bank of Slovenia referred one company to the misdemeanours court in 2003, and one company in the first half of 2004.

In line with the Core Principles for Effective Banking Supervision, the Banking Supervision Department of the Bank of Slovenia maintains regular contact with the management of banks and savings banks, through channels including regular annual meetings held at the completion of full-scope examinations and other specially arranged meetings. These meetings focus on assessing the operating results and financial position of the banks or savings banks in question and learning about their strategy for future development. The exchange of views and information between supervisors and

[1] On 5 January 2004 the resolution on commencement of the ordinary liquidation of the Slovenska Investicijska Banka was filed with the Register of Companies.

the management of banking institutions is also a prerequisite for timely and appropriate action in the event of operating difficulties.

In 2003 and 2004 the Bank of Slovenia continued to cooperate with the two domestic supervisory agencies – the Securities Market Agency and the Agency for Insurance Supervision – primarily by exchanging data and information in accordance with the Rules on Reciprocal Cooperation between Supervisory Agencies and the signed MoUs. In most cases the supervisory agencies operated on a solo basis. The exception was the joint supervision by the Bank of Slovenia and the Securities Market Agency over the Nova KBM bank and the stockbroking firm, Mariborska Borzno Posredniška Hiša.

In 2003, Bank of Slovenia inspectors examined the operations of the Nova Ljubljanska Banka subsidiary abroad (LHB Internationale Handelsbank Aktiengesellschaft, Frankfurt am Main) on the basis of MoUs with foreign supervisory authorities. In the first half of 2004, another two NLB subsidiaries were examined abroad, in cooperation with supervisors in Macedonia and Montenegro (Montenegro Banka in Montenegro and Tutunska Banka in Macedonia).

The examination of the LHB bank primarily involved the management and supervision mechanisms between Nova Ljubljanska Banka (NLB) and the subsidiary bank, and between the subsidiary bank and its connected companies, the subsidiary's system for reporting to NLB for reports in accordance with the Regulation on the Consolidated Supervision of Banks and Savings Banks, lending, provisioning and success in recovering problematic investments, and other areas such as capital, internal auditing, profitability and treasury activities.

The examination of Tutunska Banka was carried out in collaboration with supervisors from the National Bank of the Republic of Macedonia and included a review of strategy, internal auditing, profitability, liquidity, operational risk and information technology. The examination of Montenegro Banka covered the same areas (excluding liquidity) and was carried out in cooperation with the Central Bank of Montenegro.

3.1. Information technology examinations of credit institutions

In 2003 and the first half of 2004 the Banking Supervision Department continued to assess the bank capacity in managing operational and projected risks from the acquisition, maintenance, hiring and use of information technology.

The examination of the level of observance and direct implementation of the conditions prescribed in Article 38 of the Banking Act primarily involved the following tasks:

- ensuring security and reliability of information systems
- ensuring a high degree of systems availability
- ensuring uninterrupted business activity
- updating information systems
- outsourcing implementation to external providers (total or partial outsourcing)
- sourcing software from external providers (quality and timescale)
- change management and quality assurance
- establishing procedures for checks on business processes and conducting reviews of banks' internal audits
- development of information technology and keeping up-to-date with information science.

The Bank of Slovenia checked for possible deviations from current primary and secondary banking legislation, European Commission recommendations and generally accepted best practice by carrying out information technology examinations in banks and savings banks.

In one case in July 2003 the Bank of Slovenia ordered the permanent supervision of a bank, due to increased operational risks arising from the introduction of personal transaction accounts. Special attention was paid in 2003 and the first half of 2004 to the permanent monitoring of banks that were overexposed to risk arising from the updating of information systems.

Most banks have gradually improved how they ensure the security and reliability of information systems, although it was found that most banks do not yet fully satisfy the recommendations of the prescribed ISO17799/BS7799 standard.

Our findings indicate problems in defining responsibility for information security in bank systems have been reduced. The banks recognise that security planning and implementing is only possible with the inclusion and cooperation of all their employees.

There has been progress in the capacity of banks to draw up plans and allocate resources for continued operation in an emergency, and prepared a joint agreement on the preparation of a suitable basis for efficient resolution of such problems. Banks also have to test the effectiveness of these methodologies in practice and periodically test solutions that reduce risk exposure.

The introduction of new market channels and new services (e.g. custody accounts) is also forcing banks to implement more systematic and effective solutions in the area of high information system availability. Banks have improved their security infrastructure and ensured more secure operations by providing higher levels of authorisation, authentication, integrity and non-rejection of transmitted messages via modern market channels.

The results of work by banks to update their systems does however point to inadequate project management. We have found that bank project work does not ensure an adequate improvement in operational efficiency. The complex changes that banks are involved in due to updating their information systems do not yet receive enough support or supervision from bank managements. The most important factor in risk mitigation is the commitment and support of the bank's management, but in some banks the management is still not providing the right support for these activities.

We have found that outsourcing is increasing so there is a need for banks to pay more attention to outsourcing management and to be more systematic in ensuring that the solutions delivered are high in quality and on time.

Banks too frequently disregard the proper design and monitoring of internal control systemswhen focusing on achieving optimal business process automation. Poor analysis and documentation of business processes is a further reason for the below standard quality of internal checks. Banks are too slow in adapting support for a system that demands high-quality data generation for business decision-making and reporting to external supervisory authorities (data integrity).

Following on-site examinations of banks, the Bank of Slovenia issued a series of recommendations for managing the risks described above. More effective risk management requires banks to make more detailed analyses of their needs and to measure their exposure to operational risks related to banking information technology.

Various forms of card fraud and abuse of cash dispensers represent a growing problem, so banks will have to monitor the area with greater care and improve the management of risks relating to card transactions. However, the failure to manage these risks properly has not as yet led to major abuses of the system or protracted non-availability of banking services. Brief interruptions in processing and errors have occurred in individual cases, but banks have generally responded well to these problems.

The Banking Supervision Department also carried out a number of sample examinations of issues the Bank of Slovenia considers relevant in terms of increased risk (transformation of consumer accounts and payments, reporting to the Bank of Slovenia, the state of information system updates, adequacy of external implementation of the card and ATM transactions, e-commerce etc.).

The sample examinations of a selection of banks did not reveal major risks that might seriously jeopardise banking service provision, although the Bank of Slovenia did issue some additional actions and recommendations.

We plan to spend more time in the future checking whether the security provisions and reliability of information systems meet the recommended standards.

We assess that following the overhaul of the personal bank account system, the risk attached to the updating of the banking information system has been partially reduced. Banks are gradually facing up to new challenges in the implementation of additional control mechanisms to prevent money laundering, although the importance of this type of monitoring has not yet been fully understood and accepted. Activities are underway to integrate information systems to support decision-making and planning, as is the construction of data warehouses. Banks must gradually prepare for the introduction of the euro and build systematic models to monitor operational risk.

The Banking Supervision Department will pay more attention to examining the organisation and documentation of structures and working processes supporting the acquisition, maintenance, hiring and use of information technology, and the effectiveness of internal controls. In the future the banks themselves will have to focus more on checking their own internal control systems. For this reason our examinations will include a greater focus on the efficiency and effectiveness of internal audit departments.

The Bank of Slovenia will also check whether system updates have enabled banks to reduce development and operating costs relating to information technology. We will continue supervision based on detailed monitoring of security policy planning and implementation and banking information system strategy with an emphasis on verifying compliance with the recommended standard.

3.2. Prevention of Money Laundering

The prevention of money laundering is an important part of the supervision of banks, savings banks and savings and loan undertakings. The Bank of Slovenia undertakes two kinds of examination relating to anti-money laundering measures:

- examinations as part of the scope of regular bank examinations undertaken according to an annual plan
- specific examinations of anti-money laundering issues alone.

In 2004 Bank of Slovenia inspectors carried out anti-money laundering checks to discover the capacity of Slovenian banks and savings banks to manage risks in this area. The examinations were carried out from February to July 2004 and included seven banks and one savings bank. The examinations covered organisational and staffing conditions, service implementation, information support and the functioning of internal audit departments.

On the basis of the examinations carried out in seven banks and the one savings bank, we drew the overall conclusion that, in general, banks do have a system in place to implement the legal provisions. They have appointed contact persons to communicate with the Office for Money Laundering Prevention, and implementing the legally prescribed checks on cash transactions over SIT 3 million and reporting transactions over SIT 5 million to the Office for Money Laundering Prevention.

However, banks still treat the issue of money laundering prevention as a legal obligation alone, with too little recognition that it is a form of operational risk. Bank of Slovenia assessments indicate that the Slovenian banking industry, employees and management, still displays a lack of awareness and an erroneous belief that there is little likelihood of money laundering occurring in Slovenian banks.

In most cases the money laundering prevention system only covers cash transactions, while the higher risk field of transactions with foreign banks and foreign legal persons still warrants little attention from banks, which has been seen in deficiencies detected in how they identify money laundering. The Bank of Slovenia took appropriate action in these cases.

A key deficiency at every level of the banking system is the inability to perceive unusual or suspicious activities, which is the consequences of inadequate information support that are not properly organised and do not include the right control mechanisms.

Where money laundering is suspected of a transaction, a person or entity, the Bank of Slovenia must submit a written referral with reasons to the Office for Money Laundering Prevention, in addition to making inspections. The Bank of Slovenia must then decide on the appropriate supervisory measures and notify the Office of the Republic of Slovenia for Money Laundering Prevention in writing of any offences discovered under Articles 45, 46 or 47 of the Money Laundering Prevention Act.

The Bank of Slovenia must work together with other supervisory authorities to draw up a list of indicators for identifying suspicious transactions within the institutions they supervise (the latest list of indicators was produced in June 2004). In 2004 the Bank of Slovenia further strengthened cooperation with the Office for Money Laundering Prevention, ensuring the rapid and effective information exchange and resolution of unresolved issues.

Bank of Slovenia representatives participated in the Bank Association of Slovenia's money laundering prevention committee in 2004, while Banking Supervision Department collaborators shared their experience in money laundering prevention work at seminars organised by the Bank Association education centre.

3.3. Oversight of payment systems

On the basis of the Bank of Slovenia Act and the Payment Transactions Act (hereinafter: the ZPlaP), the Bank of Slovenia is in charge of payment system oversight. The Bank of Slovenia Act gives the Bank general authority for oversight of the legality and correctness of the country's payment systems, while the Payment Transactions Act sets out its specific powers.

The objective of the payment system oversight is to protect the financial system from possible systemic consequences if one or more payment system participants has financial difficulties, and to ensure the operational security and effective functioning of payment systems. Payment system oversight focuses on the system rather than on individual members of the system.

In most countries, central banks (including the European central bank system) carry out payment system oversight, using the standards known as the Core Principles for Systemically Important Payment Systems (hereinafter: Core Principles) prepared by a working group of the Bank for International Settlements. The Core Principles set out minimum requirements that all systemically important payment systems must meet in a country where the central bank decides on (systemically) important individual payment systems. The Core Principles form the basis for payment system oversight. In addition to the requirements on payment system security and effectiveness, the Core Principles also set out the responsibility of central banks to implement the principles themselves.

In May 2003, the Governing Board of the Bank of Slovenia passed a regulation confirming the Core Principles as the basis for the Bank of Slovenia's expert services involved in payment system oversight. It also passed a regulation that the only systemically important payment system in Slovenia is the RTGS system, which must meet all the Core Principles, while the Bank of Slovenia as system administrator of the Giro Clearing system will be responsible for system meeting all the principles. The Bank of Slovenia will also ensure that the remaining inter-bank payment systems are in line with Core Principles guidelines, with the requirements regarding fulfilment of Core Principles being adapted to the characteristics and importance of the individual payment systems.

3.4. Cash operations

In accordance with its legal powers and contractual agreements, the Bank of Slovenia ensured the uninterrupted supply of tolar currency notes and coins to the government in 2003 and the first half of 2004. The supply was organised via the Bank of Slovenia banknote depots (hereinafter: depots) and coin stores.

In 2003 and the first half of 2004 eight depots were in operation at five commercial banks acting as depositaries. Their role is to deal with surpluses or shortages of cash arising from commercial bank operations. The Bank of Slovenia sets the depositary banks a treasury maximum each quarter and monitors their commercial activity on a daily basis. Under the terms of the contract between the Bank of Slovenia and each individual depositary, the Bank of Slovenia carries out regular comprehensive inspections of the depositaries' operations. It inspected three depots in the first half of 2004. All depositaries observed the approved maximum and no irregularities were uncovered in the course of the inspections.

On the basis of the new Payment Transactions Act, the Regulation on the Criteria to be Met by a Payment Service Provider for Authorisation to Conduct Payment Services, the Bank of Slovenia continued its review of cash operations at banks with the aim of ensuring their effectiveness and security (particularly with respect to operational risk management, and conducting operations in line with business excellence and good banking practice). In the first half of 2004 the Bank of Slovenia inspected one commercial banks and 11 organisational units of commercial banks. No irregularities were discovered.

The Bank of Slovenia examined cash dispenser transactions in four commercial banks and nine of their organisational units. There was also an examination of the compliance of cash dispenser transactions with the Regulation on the Criteria to be Met by a Payment Service Provider for the Authorisation to Conduct Payment Services, and the related risk management, the structure of management, the fulfilment of organisational, staff and technical conditions for operation and compliance with internal acts of the bank. The Bank of Slovenia provided information in an attempt to eliminate deficiencies discovered that were connected to the banks' lack of proactive attitude in cash dispenser operations.

4. SAVINGS AND LOAN UNDERTAKINGS

With the entry into force of the Banking Act in February 1999, the Bank of Slovenia assumed responsibility for supervising savings and loan undertakings. On 20 February 2004 the five-year transition period for savings and loan undertakings to comply fully with the provisions of the Banking Act or cease operations ended. This means that savings and loan undertakings that comply with Banking Act must now fulfil the creditworthiness regulations that have applied to savings banks for many years. The only article from the 1990 Savings and Loan Undertaking Act that remains valid sets out the definition of their status.

The National Assembly set a five-year transition period for savings and loan undertakings to enable a smooth transition to operating in line with the credit ratings restrictions (the Bank of Slovenia proposed a one-year transition period). Despite the lengthy transition period a vast majority of savings and loan undertakings recognised they would not be capable of meeting even the minimum standards on safe and sound banking. Until the Banking Act was passed, savings and loan undertakings operating on the basis of the Savings and Loan Undertakings Act, which had practically none of the credit ratings standards that have applied to banks and savings banks since the Banking Act of 1991. This led to them joining up with other credit institutions. As 83 per cent of savings and loan undertakings were established by agricultural cooperatives, the logical step was to bring the undertakings together in an umbrella undertaking, the Association of Savings and Loan Undertakings (Zveza HKS). At first the Maribor Zveza HKS joined the Association of Savings and Loan Undertakings at the end of January 2001, while the last to join was the ZHKS Ljutomer Križevci at the start of April 2004. A total of forty different local associations joined the Association of Savings and Loan Undertakings at regular intervals over that time. The Association of Savings and Loan Undertakings planned to bring its operations into line with the Banking Act, obtain a licence to perform banking and other financial services and to operate independently, specialising in the agro-food industry. There have been numerous attempts to obtain special status and credit ratings regulations for savings and loan undertakings. Savings and loan undertakings wanted on the one hand to be granted special status as a credit association, as well as less stringent credit ratings requirements than apply to savings banks (a special law). Special arrangements of this nature would be in contravention of the EU banking directive, which does not allow for any exceptions to the credit ratings rules for credit institutions.

Over the last two years operating conditions for savings and loan undertakings have seriously deteriorated, due to greater competition from banks offering cheaper and more complex services. In response to this the Association of Savings and Loan Undertakings decided to link up with another credit institution, the Slovenska Zadružna Kmetijska Banka (Slovenian Associated Agricultural Bank), which is the best solution in the long term. The merger could have significant synergistic effects, especially as the institutions cover the same sector. The merger process lasted from the middle of 2003, until its completion at the start of July 2004 (on the day the bank took over the operations of the Association of Savings and Loan Undertakings, it changed its name to Deželna Banka Slovenije - Slovenian Rural Bank). The status of the Association of Savings and Loan Undertakings "shell" will be transformed within in a year to manage capital investments in the Deželna Banka Slovenije.

Some of the more powerful savings and loan undertakings decided not to amalgamate with the Association of Savings and Loan Undertakings and either amalgamated directly with the Slovenska Zadružna Kmetijska Banka or other banks in the form of a takeover. The first takeover was in May 2001, the last at the start of July 2004, with 14 in total.

Just two of the former 77 savings and loan undertaking now function independently (HKS Vipava and HKS Tolmin). Both submitted an audited report on compliance and an application for a licence to perform banking and other services to the Bank of Slovenia within the set deadline. Both are currently in the process of obtaining a licence.

Three of the larger craft related savings and loan undertakings (of the 15 registered, although some ceased trading before the Banking Act came into force) had serious problems meeting the credit ratings rules during the transition period (HKS Slovenska Hranilnica in Posojilnica, HKS Sicura and HKS Soča). It was characteristic of these savings and loan undertakings that they took deposits from personal investors at attractive interest rates and concentrated these assets with borrowers that were unable to pay back their loans regularly and in full. This led, despite action by the Bank of Slovenia, to the savings and loan undertakings having liquidity and solvency problems. In response the Bank of Slovenia proposed bankruptcy proceedings. Bankruptcy proceedings are still underway, but the first division of a bankruptcy estate was of HKS Slovenska Hranilnica in Posojilnica Kranj totalling 46%. Actions are underway against the founders of this savings and loan undertaking to pay the difference for savers, as they have joint and unlimited liability for the savings and loan undertakings liabilities in the case of bankruptcy.

After the entry into force of the Banking Act (February 1999), savings and loan undertakings came under the supervision of the Bank of Slovenia. During the five-year transition period, supervision had been focused on applying a special Bank of Slovenia regulation bringing the savings and loan undertakings into line with the Banking Act. The Bank of Slovenia's supervisory powers include the power or duty to take action if a savings and loan undertaking does not meet the prescribed credit ratings restrictions. This duty was already in force during the transition period, which some of the savings and loan undertakings did not agree with. In 2001 one took its case to the Supreme Court to challenge these powers. In May 2002 the Constitutional Court ruled that the Bank of Slovenia had acted correctly, and in February 2004 the Supreme Court did the same. Another two savings and loan undertakings, which are now in bankruptcy proceedings, contested the Bank of Slovenia's supervisory measures and appealed for judicial protection by filing an action with the Supreme Court, while one also challenged the constitutionality of provisions in the Banking Act. In one case, the Supreme Court ruled that the Bank of Slovenia had acted correctly, while the Constitutional Court ruled that the Banking Act provisions that were challenged were in accordance with the constitution.

In line with its duties, in response to suspicion of a crime, the Bank of Slovenia indicted a savings and loan undertaking and its responsible persons. All the procedures are still open.

Table 2: *Overview of savings and loan undertaking transformations*

	Number of savings and loan undertakings				
	2001	2002	2003	2004	Total
Amalgamated	14	12	12	2	40
Taken over	4	3	4	3	14
Ordinary liquidation	1	-	1	2	4
Compulsory liquidation	1	-	-	8	9
Bankruptcy	1	2	1	-	4
Deleted under Fin. Ops. of Companies Act (ZFPP)	-	4	-	-	4
Total	21	21	18	15	75

Source: Bank of Slovenia

5. COOPERATION WITH AUDITORS

The Banking Supervision Department's analysts and inspectors cooperate with internal and external auditors in monitoring banks and savings banks. The following auditing companies carried out external audits of banks for the 2003 financial year: PriceWaterhouseCoopers (11 banks), Deloitte & Touche Revizija (5 banks and 1 savings bank), Ernst & Young (2 banks), KPMG (1 bank), Constantia UHY (1 savings bank). Compared to 2002 the number of banks audited by PriceWaterhouseCoopers and Deloitte & Touche Revizija increased, while the number of banks audited by Ernst & Young and KPMG fell.

Auditors assessed all the financial statements positively, i.e. in the opinion of the auditors the financial statements of banks and savings banks in Slovenia presented a true and fair picture of their financial position, income statement and changes in financial position in the preceding year. The auditors' responsibility is to express an opinion of the balance sheet, income statement and statement of changes in financial position, which are the responsibility of the governing board of each bank or savings bank.

Auditors also reviewed the report on compliance with Banking Act provisions produced for the two savings and loan undertakings that decided to operate independently under Banking Act rules. The report contains their financial statements with clarifications and annex in accordance with the Regulation on the Minimum Scope and Content of Audits and Auditors' Reports and an auditor's report on the financial statements.

To enhance cooperation with auditors, in mid-2002 we signed an MoU with all auditors that had banks or savings banks as clients. The amended Banking Act which came into force in June 2003 included an amendment to Article 59, which permits the Bank of Slovenia to send information to companies auditing the annual reports of banks or performing the auditing tasks set out in Article 205[2], if required to complete this work. Article 119 of the Act obliges auditors to send at the Bank of Slovenia's request information that the Bank of Slovenia requires to carry out the supervision of a bank. The duty to keep information confidential does not apply to auditors in this specific case.

We organised meetings with auditors as necessary in the case of major deficiencies or difficulties with particular banks or savings banks or to address unresolved expert issues.

6. COOPERATION WITH SUPERVISORY AUTHORITIES

6.1. Cooperation with Domestic Supervisory Authorities

As stated in the chapter on credit institution examinations, Slovenia's financial sector regulators – the Bank of Slovenia, Securities Market Agency, and the Agency for Insurance Supervision – cooperate, primarily through exchanging information. Mutual cooperation between the institutions is regulated by the Rules on Reciprocal Cooperation between Supervisory Agencies from 1999 and the signed MoUs.

The Rules on Reciprocal Cooperation between Supervisory Agencies determine the form and content of cooperation between the Bank of Slovenia, the Securities Market Agency and the Agency for Insurance Supervision. The Coordinating Body was founded on the basis of the rules, presided over by the minister for finance, with cooperation from the Governor of the Bank of Slovenia, the presidents of the councils of experts at the Securities Market Agency and Agency for Insurance Supervision. As the rules anticipate cooperative agreements between the supervisory bodies, in 1999 and 2000 the Bank of Slovenia signed memoranda with the Securities Market Agency and Agency for Insurance Supervision respectively. The security market and insurance agencies signed an agreement between themselves in 2001. In December 2003 a new agreement was signed between the Bank of Slovenia and the Securities Market Agency, while the agreement with the Agency for Insurance Supervision was updated in June 2004.

The agreements set out the form and content of reciprocal cooperation and information exchange in more detail. There is also the Committee for Reciprocal Cooperation between Supervisory Bodies (hereinafter: the Committee), which sits at least once every three months, and is in charge of implementing the agreements and tasks passed by the Coordinating Body. The Committee comprises the Deputy Governor of the Bank of Slovenia, the Director of the Securities Market Agency and the Director of the Agency for Insurance Supervision. The Committee first sat in February 2000. The chairmanship is currently held by the Deputy Governor of the Bank of Slovenia, and will pass to the Director of the Securities Market Agency in December.

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[2] When the Bank of Slovenia finds violations in the keeping of business books, or administrative and other evidence which the bank is required to keep, or more comprehensive violations in the operations of the bank, it may order the bank also to submit a report on the elimination of the violations, containing a positive opinion of the authorised auditor that the violations establish have been eliminated.

The Committee monitors any problems in the implementation of new regulations and informs the Coordinating Body if any occur. It focuses on coverage levels (do regulations adequately cover the work of financial intermediaries), and issues proposals for amendments to regulations.

The main issues dealt with by the Committee in 2003 and the first half of 2004 were:

1. reporting authorisations issued to financial institutions (including for board members) and on any financial institutions that cease operations
2. agreement on joint on-site examinations and reporting examinations carried out by supervisory authorities solo (including examinations carried out by Bank of Slovenia inspectors abroad and examinations of savings and loan undertakings)
3. reporting measures against institutions under the supervision of the Bank of Slovenia, the Securities Market Agency or the Agency for Insurance Supervision
4. determining the need for supervision of holding companies and financial conglomerates and reporting the creation of new holding companies
5. creating working groups to identify conglomerates
6. discussing possibilities for a joint financial supervisory authority in connection with the Financial Market Development Strategy drawn up by the Ministry of Finance
7. preparing a joint report for all three financial supervisory authorities
8. reporting on the work of the conglomerates group
9. reporting proposed amendments to financial sector legislation and new financial sector regulations
10. reporting on foreign cooperation, including the FSAP Update programme, on MoUs signed with foreign supervisory authorities, and on participation in various international committees and working groups.
11. agreeing on new MoUs between the Bank of Slovenia and the Securities Market Agency and Agency for Insurance Supervision to unify procedures for granting authorisations to banks for services and operations under the auspices of the Securities Market Agency and Agency for Insurance Supervision
12. discussing misleading advertising of financial products
13. discussing the use of inside information and fictitious transactions
14. exchanging views on the introduction of the International Standards on Auditing
15. exchanging views and experience on the supervision of entities engaged in the unauthorised provision of financial services.

6.2. International cooperation

The Bank of Slovenia has signed a number of Memoranda of Understanding with foreign banking supervisors that enable cooperation in supervising branches and subsidiary banks abroad and in Slovenia. The supervisory bodies must preserve the confidentiality of all information acquired through information-sharing with parties to the agreement and use it solely for the purposes for which it was supplied.

The following MoUs have been signed to date:

- in January 2000 with the State of New York Banking Department (since LBS is no longer a subsidiary of Slovenia's largest bank, the agreement is now superfluous)
- in January 2001 with the Austrian Federal Ministry of Finance, which merged with other financial sector supervisory authorities to form the Austrian Financial Market Authority as of 1 April 2002
- in April 2001 with the Federal Banking Supervisory Office in Germany, which merged with other financial sector supervisory authorities to form the German Financial Supervisory Authority as of 1 May 2002
- in June 2001 with the National Bank of the Republic of Macedonia

- in November 2001 with the Banking Agency of the Federation of Bosnia and Herzegovina and the Republika Srpska, and the Central Bank of Bosnia and Herzegovina
- in November 2001 with the Bank of Italy
- in October 2002 with the French Banking Commission
- in October 2003 with Belgium's Banking and Finance Commission
- in October 2003 with the Central Bank of Montenegro
- In December 2003 with the Bulgarian National Bank
- in June 2004 with the National Bank of Serbia.

While Slovenia was an associate member of the European Union, representatives of the Bank of Slovenia attended sessions of the Subcommittee on Internal Market of the European Commission and the Subcommittee on Economic and Monetary Issues, Capital Movements and Statistics with observer status.

Since joining the European Union, we have now become full members of those committees and working groups.

We participate in the following committees and working groups of the European Commission:

- Committee of European Banking Supervisors
- Groupe de Contact
- Expert Group on the Risk-based Capital Directive
- Working Party on Financial Services (Capital Requirements)
- Working Group on the Validation of IRB – and AMA Approaches
- Working Group on External Credit Assessment Institutions
- Working Group on EU Common Reporting
- Supervisory Disclosure Task Force
- Sub-Mixed Technical Group of Supervisors
- Committee on prevention of the use of the financial system for the purpose of money laundering
- Select Committee of Experts on the Evaluation of Anti-Money Laundering.

Bank of Slovenia representatives from the banking supervision and financial stability department cooperate at the European Central Bank in the Banking Supervision Committee and two working bodies:

- Working Group on Developments in Banking
- Working Group on Macro-Prudential Analysis.

As a supervisory authority the Bank of Slovenia is a member of the Group of Banking Supervisors of Central and Eastern Europe. Staff from the Banking Supervision Department therefore regularly attend meetings, seminars, workshops and conferences of member countries.

The Banking Supervision Department joined the FSAP Update programme in November 2003, and takes part every year in consultations under Article 4 of the IMF's Articles of Agreement. Banking Supervision Department collaborators were also involved in numerous meetings with representatives of rating organisations, foreign commercial banks and other international guests.

7. AMENDMENTS TO BANKING SUPERVISION LEGISLATION

In 2004 the Banking Act was amended for the third time, since originally passed in February 1999. Officially titled the "Act amending the Banking Act – ZBan-C" it was published in the Official Gazette of the Republic of Slovenia, no. 42/04 on 23 April 2004 and has been in force since 8 May 2004. The amendments to the Banking Act necessitated amendments to other Bank of Slovenia regulations. The main amendments to Bank of Slovenia regulations between January 2003 and the end of June 2004 relating to banking supervision are set out below.

a) Regulation on the Financial Reports and Accounts of Banks and Savings Banks with instructions on the implementation thereof in the section on the Methodology for Preparing Balance Sheets and Income Statements and the Methodology on Calculating Indicators

In February 2004 amendments were made to the chart of accounts for banks and savings banks, which came into effect on 1 April 2004. The purpose of these changes prescribed in the Regulation on the Financial Reports and Accounts of Banks and Savings Banks – which also affected the methodology for preparing balance sheets, income statements and calculating indicators – was to obtain the additional bookkeeping information (off-balance sheet items, leasing, night deposits, transaction accounts, etc.) needed to monitor new services and new methods of bank operation.

b) Regulation on Reporting Effective Interest Rates in accordance with the Consumer Credit Act

The entry into force of the amended Consumer Credit Act in May 2004 completely revised the Bank of Slovenia's obligations in the area of consumer credit. The Act states that twice a year the Bank of Slovenia must publish the average effective interest rates for specific amounts of credit over set periods, which banks and savings banks implement in accordance with the Banking Act. The Bank of Slovenia passed this regulation in May 2004 in response to these legal obligations.

c) Regulation on Reports by Branches of Member State Banks

The Regulation on Reports by Branches of Member State Banks, which entered into force on April 2004, governs the method of reporting by the branches of member state banks that perform banking and other financial services in the territory of the Republic of Slovenia. Its aim is to facilitate the exercise of the Bank of Slovenia's powers and its performance of tasks on monetary policy, monitoring liquidity risks, statistics and the realisation of deposit guarantee schemes. In accordance with the principle of home state supervision the Bank of Slovenia no longer carries out the prudential supervision of bank branches from other EU member states, which are supervised by the relevant body in the country in which they have their headquarters. The amendment of the regulation in May 2004 meant that the obligation to report on effective interest rates based on the Consumer Credit Act, and to report in accordance with the Regulation on the Conditions to be Met by Credit Intermediaries were extended to the branches of member state banks.

d) Regulation on the Detailed Method of Calculation of Liabilities, Assets and Investments in Assessing Net Indebtedness or Net Exposure

In September 2003 the regulation was revised to increase transparency following changes in Banking Act provisions on the definition of people holding the position of supervisory board member of a bank. The methodology for calculations and exemptions remains unchanged, while some changes were made to the allowance for a certain net exposure by banks to legal entities connected to members of the supervisory board.

e) Regulation on More Detailed Content of Reports set out in Article 127 of the Banking Act

This regulation was amended in September 2003, to bring it into line with changes in the Banking Act relating to the prior written notification of the acquisition or alienation of shares, commercial stakes and members' rights in legal persons and other changes to such investments. This ensures the Bank of Slovenia is informed of banks' intentions regarding the acquisition and alienation of shares in the capital of other persons (other banks and financial organisations at home and abroad), and that it obtains advance information on the strategy of banks and savings banks with regard to the capital of other persons.

f) Regulation on the Deposit Guarantee Scheme

The value of guaranteed deposit was increased by the amendments to the Banking Act to SIT 5,100,000, which then had to be brought into the Regulation on the Deposit Guarantee Scheme. The regulation was also changed with regard to liquid investments for payment of guaranteed deposits, as the possibility of investing liquid bank assets from domestic securities has been extended to high quality foreign debt and equity securities. Changes to the chart of accounts for banks and savings banks in February 2004 meant changes also have to be made to the Instructions on Preparing Guaranteed Deposit Reports.

g) Regulation on Large Exposure of Banks and Savings Banks

The amendment to this regulation in March 2003 supplemented the selection of written reports on large exposures for banks, which, pursuant to the Regulation on the Capital Adequacy of Banks and Savings Banks, are obliged to calculate and fulfil capital requirements for market risks. A minor additional amendment followed in July 2003 regarding changes to the restrictions on bank exposure to persons in special relationship with the bank, which arose from the amended Banking Act. Another change was made to equalisation of exposure to other banks on the basis of transactions in derivative instruments with different exposure. The amendment to the regulation in April 2004 introduced reporting on exposure to certain persons (legal persons whose supervisory board members are also members of the management board, supervisory board, or authorised agents of that bank, and legal persons that are not banks and that are direct or indirect owners of shares in the bank on the basis of which they hold at least 5% and at most 9.99% of the voting rights or shares in the bank's capital), which means that the prescribed restriction of 20 per cent or 200 per cent of bank capital does not apply to exposure to these persons. The purpose of these amendments was to keep the amount of information at the same level as before the Banking Act was amended, and to establish a system of systematic monitoring for these forms of exposure.

h) Regulation on the Capital Adequacy of Banks and Savings Banks

The March 2003 amendments to this regulation expanded reporting on capital and capital adequacy for banks that, pursuant to the Regulation on the Capital Adequacy of Banks and Savings Banks, are obliged to calculate and fulfil capital requirements for market risks. In April 2004, the regulation's provisions were changed slightly to bring them into line with the basic banking directive with regard to weighting of balance sheet items. Other changes to off-balance items and items from trading or capital requirements for market risks were made to improve the transparency of reporting. The text of the regulation on subordinate debt instruments was reviewed by legal experts, and a provision was expressly written that when a bank accepts a subordinate debt instrument issued by a bank to insure its claims, the subordinate debt instrument cannot be considered as capital. This change is in line with the replacement of the institute of Bank of Slovenia consent with the institute of prior notification in cases in which a bank intends early repayment of subordinate debt in order to replace it with a higher quality form of capital or with subordinate debt with a more favourable interest rate. In June 2004, Annex 2 to the regulation was amended, as a new agency was added to the list of multilateral development banks (Multilateral Investment Guarantee Agency – MIGA) in accordance with Directive 2004/69/EC.

8. PREPARATIONS FOR BASEL II IN SLOVENIA

In 2003 and in the first half of 2004 the work of the implementation group for Basel II, the new European capital arrangements,[3] within the Banking Supervision Department continued at a relentless pace, with further activities to prepare for the new banking standards that will come into force at the end of 2006.

Slovenian Quantitative Impact Studies - SiQIS

In 2003 the main feature of our cooperation with banks within the framework of the bank Association of Slovenia's Basel II committee was the Slovenian Quantitative Impact Studies (SiQIS),[4] which was used to obtain the first quantitative assessments of the impact the new rules will have on the capital adequacy of the Slovenian banking system[5]. The study assessed the impact of changes in the standardised approach to the calculation of capital requirements for credit risk and the impact of the new capital requirements for operational risk, calculated using the basic or standardised approach.

The SiQIS results will provide banks with information that will help in making a strategy to prepare effectively for the new European capital arrangements. It will make it easier to assess their minimum capital requirements,[6] if they decide against using one of the more advanced and hence more complicated methods for capital requirement calculation. Even applying the most basic new approach will nevertheless require banks to make some changes, both in terms of creating the necessary data support in terms of risk monitoring and management.

SiQIS is also intended to identify unresolved issues and data and other needs that can contribute to making it easier for banks to find the best solutions. The SIQIS results will prove of use to the Bank of Slovenia, as the Slovenia bank regulator, in the discretionary decisions at the national level that tailor the universal approach to the specific needs of each country.

Two working groups worked on SiQIS preparations within the Basel II committee, the ratings group and the operational risk group:

- The aim of the *working group on ratings*, in accordance with the main task of the committee, was to draw up credit rating approximations comparable with those of internationally recognised ratings agencies. These served as an input to the SiQIS tables. To this end the group defined a set of the indicators that were believed to be most representative for rating Slovenian firms. Based on scores for these indicators and their relative importance, the banks classified their customers into nine ratings SiQIS categories, similar in methodology and meaning to those of internationally recognised ratings agencies. This reflects the essence of the new standardised approach to the calculation of capital requirements for credit risk, which is the use of credit ratings by recognised external ratings agencies as a basis for weighting a bank's claims against its debtors.

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[3] Two EU directives, defining the capital arrangements for credit institutions (banks and savings banks) and for stockbroking companies: the Banking Consolidation Directive (2000/12/EC) and the Capital Adequacy Directive (93/6/EC).

[4] The SiQIS package comprises the SiQIS tables, the Instructions on Preparation of the SiQIS tables and the Bank of Slovenia questionnaire on the preparation of the new capital agreement and a standardised approach to determining capital requirements for credit risk (the SiQIS questionnaire).

[5] The system only includes banks with registered office in the Republic of Slovenia as from 1 May 2004 only these banks will be under the direct supervision of the Bank of Slovenia. The system does not include any foreign bank branches, and for specific reasons neither the two savings banks nor the Slovenian Export Corporation are included. Banks in liquidation are also excluded.

[6] It should be pointed out that with the proposal for a revised consolidating banking directive (2000/12/EC) of 14 July 2004, which would be binding on Slovenia as an EU member, capital adequacy will no longer be calculated, but instead there will just be a check on whether or not a bank has enough capital to cover its minimum capital requirements or all forms of risk to which it is exposed.

- The *working group on operational risk*, also charged with evaluating the impact of the new capital requirements for operational risk on the capital adequacy of Slovenian banks, began to map out the banks' business activities on the list of standard business areas drawn up by the Basel Committee on Banking Supervision. It produced an accountancy supported definition of gross income, which is an indicator of operational risk. Banks calculated capital requirements for operational risk using the basic and/or standardised approach, based on gross income assessments by individual operating areas.

The SiQIS questionnaire, which addressed qualitative issues, included important questions that could have an impact on the accuracy of results and determining the level of national discretion.

Main findings of the Slovenian Quantitative Impact Study

In designing the SiQIS tables we attempted to strike a balance between simplicity and precision, so they were designed using assumptions or simplifications that would still ensure that the SiQIS results were satisfactory indicators of the impact the new capital rules will have on bank capital adequacy. Despite this, the banks experienced considerable difficulty in obtaining the necessary information on their position as on 30 September 2003, which meant the quality of the SiQIS data itself had to be assessed before the systemic analysis of the impact of the new capital rules could begin. The Banking Supervision Department then carried out the analysis. The net value of balance sheet and traditionally off-balance sheet items, and replacement values of derivative financial instruments were compared with values submitted by banks as part of the normal reporting capital adequacy reporting process for their position on 30 September 2003. Significant discrepancies at individual banks led us to correct or adapt the SiQIS data ourselves in reference to the regular reports, and we did not want to additionally burden the banks and require them to redo the SiQIS tables. We used, within this very time-consuming process of harmonising SiQIS data, the same credit ratings classification for individual items as the banks had used in their original SiQIS tables. After harmonising the data for each bank, we used the new risk weightings, to weight the net values and replacement values. Only then did we aggregate the risk adjusted balance sheet and off-balance sheet items and the calculation of capital adequacy for the credit risk of the system according to the new capital rules, using the standardised approach for credit risk.

The SiQIS tables for calculating credit risk capital requirement were option-based due to the national discretion for certain areas of the banking portfolio, but it should be emphasised that banks were required to enter data and provide calculations for every option. This led to a systemic impact analysis of the new capital rules across 128 scenarios or combinations of discretion decisions, within which we identified the following:

- optimistic scenario: i.e. the one best adapted to the system, which within the scenario or group of discretion decisions would realise the lowest credit risk capital requirements
- pessimistic scenario: i.e. the one least well adapted to the system, which within the scenario or group of discretion decisions would realise the highest credit risk capital requirements.

On the basis of our analysis of the SiQIS questionnaire, we also selected "realistic scenarios" from the 128 possible that provided a best fit for the current state of Slovenian banking, with regard to the selection of the national discretionary choices.

Based on these results and taking into account SiQIS' limitations, we find that using the simplest approaches to credit and operational risk (i.e. the standardised approach for credit risk and the basic approach for operational risk), the impact of the new European capital arrangements on the level of capital adequacy in the Slovenian banking system for the three most important scenarios would be as follows:

- **Optimistic scenario:** the capital requirements for system credit risk would fall by 13.92 per cent, while total capital requirements would fall by just 0.6 per cent, due to the impact of the new capital requirements on operational risk.
- **Pessimistic scenario:** the capital requirements for system credit risk would increase by 9.8 per cent, and total capital requirements would increase 19.98 per cent.
- **Realistic scenario:** the capital requirements for system credit risk would fall by 0.53 per cent, while total capital requirements would increase, due to the impact of the new capital requirements on operational risk, by 11.02 per cent.

We also found that only one bank out of nine would have lower capital requirements for operational risk using the standardised approach rather than the basic approach. In this case, the capital requirements for operational risk would be 1.31 per cent lower when applying the standardised approach than when applying the basic approach.

All the institutions that took part in the SiQIS (banks, branches of foreign banks, the savings banks and the Slovenian Export Corporation), were informed of the results of the analysis of the SiQIS tables and SiQIS questionnaire. The results were also presented to the Governing Board of the Bank of Slovenia.

First Consultation Document on the Introduction of Internal Ratings Systems

Approaches based on internal ratings assessments are among the important significant innovations in approaches to calculating capital requirements. Known as IRB approaches, some banks have already expressed an interest in them, though their complexity means it is vital for banks to prepare their implementation very quickly. If they intend to use the basic IRB approach as soon as Basel II comes into effect at the end of 2006, they should have already activated internal project work to implement the new provisions. The Bank of Slovenia has therefore already started offering consultation to banks regarding readiness to apply IRB approaches, as this is the only way to identify all unresolved issues.

To this end we decided to make preliminary assessments of banks' general activities and readiness to introduce the new approaches in areas such as management oversight, compliance with minimum requirements, data quality and implementation plans.

The First Consultation Document on the Introduction of Internal Ratings Systems covers a wide range of objectives relating to IRB approaches. The aim of this Bank of Slovenia document is to:

- consult Slovenian banks about their plans and methods to achieve compliance with standards and minimum requirements, which is needed to obtain consent to use the IRB approaches
- assess banks' current readiness to meet the priority qualification criteria for IRB approach use
- define the range and relative significance of individual portfolios, as defined in the IRB approach framework, which will be of use in decisions on a number of unresolved issues relating to Basel II and the introduction of the IRB approaches, especially in terms of using national discretion
- identify priorities in bank support when introducing the IRB approaches and plan the Bank of Slovenia's internal preparation on areas of most importance to the Slovenian banking sector.

Recommendations for Operational Risk Management in the Basic and Standardised Approach

The New Capital Accord Implementation Group also prepared guidelines for banks on the development of a framework for operational risk management under the simpler approaches. The new Basel Principles on operational risk management place considerable demands on banks, relating to four elements of operational risk management: identifying, assessing, monitoring and mitigating operational risk. The Basel Committee on Banking Supervision therefore issued a special document on sound principles of operational risk management, containing basic principles for banks and regulators in this area. The Bank of Slovenia decided to develop the Basel Principles into precisely interpreted recommendations to motivate banks to timely and comprehensive prepare for the Basel method of operational risk management.

A special feature of the Basel Principles on operational risk management is that the first step requires banks to internally identify and assess the operational risks they themselves are exposed to. This is a financially and organisationally demanding process that banks must implement at every level of their organisation, and which requires very careful planning of activities and resources. It is also important that banks monitor their own operational risk, which means collecting data on losses in an internal database and setting up a reporting system at all management levels. This is another potentially very expensive area of operational risk management, demanding the development of internal operational risk databases and training for the employees that will be inputting data. The last part of the operational risk management system involves banks setting up internal control systems and process to identify their own operational risks and attempt to mitigate them using these systems. Even a brief description of individual sections of the operational risk management framework indicates the complexity of the whole project, which has to be based on strategic policies from the bank's management and properly organised development.

The Bank of Slovenia is therefore closely monitoring the development of the operational risk management framework in banks. In 2003 and in the first half of 2004 we sent banks two questionnaires, one of which the banks are still completing. The questionnaire contains specifically targeted questions requiring straightforward replies that will indicate to banks what actual progress they have made towards meeting the Basel recommendations on operational risk management. The results of the questionnaire will help the Bank of Slovenia plan individual meetings and practical reviews in the banks, as one of the main ways of motivating banks and practically assessing their progress.

Communication with banks and the industry as whole

The Bank of Slovenia has been involved in a high level of communication with banks on the subject of Basel II, via the Basel II Committee, numerous lectures on credit and operational risk at the Bank Association of Slovenia, as well as through presentations at individual banks. Members of the Basel II group have also been publishing professional articles in the *Bančni Vestnik* review and other professional publications.

All the current publications and documents relating to Basel II are also regularly made available on the Bank of Slovenia website at the following address: http://www.bsi.si/html/basel2/default.htm .

9. PAYMENT SYSTEMS

Adapting existing low-value payment systems in Slovenia and examinations of payment system administrators

Payment system administrators were required to bring their systems into compliance with the Payment Transactions Act (ZPlaP) and the Regulation on Settlements between Payment Service Providers (settlements regulation) by the end of March 2004.

The settlements regulation included some interim deadlines, such as the requirement for payment system administrators to submit documentation on existing settlement methods by the end of March 2003, and documentation complying with the requirements of the ZPlaP and settlement regulation by June 2003. Supported by fact-finding visits to payment system administrators, by the end of October 2003 the Bank of Slovenia had issued the providers with requirements for organisational and technical adjustments to payment systems involving formal documentation changes and payment systems rules. The adjustments also affected the management of financial and operational risks in settlements between payment service providers.

Bankart d.o.o. (system administrator for a cash dispenser settlement system and card settlement system), Banka Koper d.d. (administrator of the Activa system), Nova Ljubljanska Banka d.d. (administrator of the NLB clearing system), and Abanka Vipa d.d. (administrator of the Visa clearing system) must fully comply with Bank of Slovenia requirements and report regularly on progress towards implementing individual recommendations.

In April and June 2004, the Bank of Slovenia also carried out regular examinations of two payment system administrators, Bankart and Banka Koper.

The aim of the payment system examinations was to gauge compliance with the requirements of the ZPlaP, the settlements regulation, and the Bank of Slovenia recommendations on organisational and technical adjustments issued in October 2003. The examinations measured reliability, security and efficiency of the payment system operations administered by Bankart and Banka Koper.

The examination was carried out in line with the Bank of Slovenia's own methodology for examining payment systems, which incorporates the Core Principles. A number of basic criteria and a questionnaire are used to evaluate system compliance with the Core Principles.

When the administrators notify the bank that they are fully compliant, the Bank of Slovenia will re-evaluate to check for discrepancies, and if it confirms full compliance will issue the payment system administrator with a payment system authorisation.

Pan-European payment systems

In 2003 as part of preparations for European Union accession, the Bank of Slovenia created guidelines for Slovenia's entry into the TARGET and STEP2 systems. The final phase of preparations for November 2004 entry into the STEP2 system started in the first half of 2004.

The TARGET system (Trans-European Automated Real-Time Gross Settlement Express Transfer System) is an interbank settlement system for cross-border payments in euros in real time within the European Union. The TARGET system comprises 15 national RTGS systems and the European Central Bank system, which are connected to create a single cross-border payment platform. The aim of the system is to provide support for the implementation of the euro monetary system and to ensure secure, reliable and effective payments as a contribution to the integration and stability of the euro currency market.

Now Slovenia has become an EU member, it is also eligible to join the TARGET system. It should be emphasised that countries that have joined the EU in the past have had the right, as well as the obligation to cooperate in the system, while on joining the Economic and Monetary Union (EMU) they must also become members of the TARGET system. The European system of central banks has also started to introduce the next generation of the TARGET system (TARGET2), which should enable the new EU members to join without any problem.

Adoption of the Regulation on Cross-Border Payments in Euro (2560/2001/EC), according to which the same prices must apply to domestic and cross-border low-value payments (at present payments up to EUR 12,500 - set to rise to EUR 50,000), also mean changes had to be made to the pan-European low-value payment infrastructure.

Anticipating this issue, the Euro Banking Association (EBA) which has been gradually developing and administering euro payment systems since 1999 (EURO1 for high-value payments, STEP1 for low-value), has being working towards the creation of the STEP2 system. This system which also represents the first step towards a pan-European clearing system, enables the automatic processing of mass low-value payments in euro and a reduction in the cost of cross-border payments in euros, enabling prices to be set the same as for domestic payments.

The system is also of interest to banks in Slovenia, particularly given the ECB requirement that by the end of 2004 all banks in the new member states should accept payments and be on-line in this system. This subject was addressed in December 2003 by the Payment Services Committee, which is responsible for strategic decision-making on payment systems. Given the low number of payments anticipated and the relatively high costs of direct participation in the system, banks supported the concept of a single entry point providing all banks with equal access to the system. In response, the Bank of Slovenia started preparations for STEP2 entry, which is planned to take place in November 2004.

Integrated low-value payments system

The Payment Services Committee, established in October 2002, on the basis of the interbank agreement on cooperation in low-value payments, continued its work throughout 2003 focusing on the integration of low-value payment systems.

In June the idea of creating a clearing house was raised, either by upgrading the existing system (Bankart) or by establishing a new legal entity. The Bank of Slovenia issued a public tender for a detailed study on the two proposals in terms of timescale and cost of implementation.

Attention then focused on analysing the option of upgrading the existing payment methods in the Bankart collection centre, into payment systems. The subject was addressed at the December 2003 meeting of the Payment System Committee, while these activities will continue throughout 2004, partially in relation to harmonising existing payment systems with the settlements regulation.

In 2003 the Payment Services Committee also studied events related to the creation of the Single Euro Payment Area (SEPA), and joining the pan-European payment systems, TARGET (high-value payments) in STEP2 (low-values).

10. ORGANISATION AND TASKS OF THE BANKING SUPERVISION DEPARTMENT

The Banking Supervision Department is divided into three sections:

- Licensing
- Off-site Analysis
- On-site Inspection.

The Department had a staff of 17 at its creation, which had risen to 54 by 30 June 2004 (there were 52 on 31 December 03).

The Off-site Analysis section has five analysts who monitor individual banks, savings banks and savings and loan undertakings, one accounting specialist, nine members of staff responsible for drafting secondary regulations, and monitoring EU banking-related directives, and Basel Committee recommendations and similar, two legal specialists, three support staff and a section head.

The On-site Inspection section has 21 employees, four of which are specialised in market risk, and four in information technology.

Following the entry into force of the Banking Act in 1999 the Banking Supervision Department assumed new tasks (consolidated supervision, supervision of legal and natural persons suspected of performing unlicensed banking activities, supervision of savings and loan undertakings etc.). The Consumer Loans Act, Money Laundering Prevention Act and Payment Transactions Act also conferred new responsibilities on the Department.

In addition to a careful recruitment policy for Banking Supervision staff, over 80 per cent of staff having a university level education, considerable attention is also given to training. Practical experience is interspersed with short training and educational events such as seminars, workshops and study visits and/or supplemented by theoretical studies, mainly at postgraduate level.

The main tasks performed by the individual sections are:

Licensing

- processing applications and preparing reports on licence issue/granting of authorisation
- preparing and providing grounds for decisions on licence issue
- checking implementation of issued decisions
- preparing secondary legislation on licensing
- offering advice on implementing licensing regulations.

Off-site Analysis

- analysing the operations of banks, savings banks and savings and loan undertakings
- checking the operations of banks, savings banks and savings and loan undertakings on the basis of reports and other documentation they submit
- announcing measures to eliminate deficiencies in the operations of banks, savings banks and savings and loan undertakings and monitoring their elimination
- cooperating in the preparation of checks on banks, savings banks and savings and loan undertakings
- designing the systemic basis for supervision
- monitoring EU directives, Basel and other recommendations on banking supervision

- providing advice on implementing banking legislation
- implementing instructions on the use of accounting standards and accounting consulting
- cooperating with domestic and foreign supervisory and other institutions
- legal consultancy
- data processing.

On-site Inspection

- preparing checks on banks, savings banks and savings and loan undertakings
- checking the operations of banks, savings banks and savings and loan undertakings, producing reports and proposing measures to be taken
- taking action to eliminate deficiencies in the operations of banks, savings banks and savings and loan undertakings
- supervising the implementation of measures taken against banks, savings banks and savings and loan undertakings
- advising banks, savings banks and savings and loan undertakings on operational improvements during examinations
- preparing measures to be taken against banks, savings banks and savings and loan undertakings to prevent deterioration
- cooperating in detecting circumstances requiring special administration of a bank or savings bank
- cooperating in detecting circumstances requiring the forced liquidation of a bank or savings bank
- cooperating in detecting circumstances requiring bankruptcy proceedings against a bank or savings bank
- in exceptional circumstances administering and managing banks and savings banks
- cooperating with domestic and foreign supervisory institutions.

Encl.:

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