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ADOPTION OF THE EUROSISTEM'S ELIGIBILITY CRITERIA FOR COUNTERPARTIES

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Povzetek

Implementacija denarne politike v okviru Evrosistema mora upoštevati različnost finančnih sistemov in infrastruktur v državah članicah. Zato so tudi skupna pravila za izbiro strank pri izvajanju denarne politike splošna, pristojnost za določanje operativnih kriterijev pa je prenešana na nacionalne centralne banke. Z nadaljevanjem procesa konsolidacije bančnega sistema bo, po vstopu Slovenije v EMU, ta pravila možno uveljaviti v maksimalistični obliki, tako da bi vse kreditne institucije imele možnost dostopa do vseh instrumentov denarne politike. Po drugi strani pa bo zaradi presežka v strukturni poziciji povpraševanje po instrumentih financiranja pri Banki Slovenije majhno. Kot neto ponudnice sredstev bodo banke več uporabljale le instrumente za umik primarnega denarja.

Ključne besede: Evrosistem, Slovenija, banke, kreditne institucije, denarna politika

Abstract

Implementation of the monetary policy of the Eurosystem must take into account differences between financial systems and infrastructures of member countries. Common eligibility criteria for counterparties are general and let the NCBs to specify additional operational criteria. In the case of Slovenia, adoption of the eligibility criteria in a manner that will ensure access to all monetary policy instruments to all credit institutions is feasible, assuming further consolidation of the banking system. On the other hand, demand for central bank financing is expected to be weak due to structural surplus of the money market. Banks will be net provider of funds, frequently using recourse to the deposit facility.

Keywords: Eurosystem, Slovenia, banks, credit institutions, monetary policy

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1. INTRODUCTION

Counterparties to Eurosystem monetary policy operations must fulfil certain eligibility criteria. The General documentation on Eurosystem monetary policy instruments and procedures states following conditions:

- Only institutions subject to the Eurosystem's minimum reserve requirements are eligible to be counterparties.
- Counterparties must be financially sound, and must be subject to EU/EEA harmonised or comparable supervision.
- Counterparties must fulfil any operational criteria specified by the respective national central bank or the ECB.

In general, these criteria are set with an aim to provide access to monetary policy operations to a broad range of institutions, enhancing equal treatment of institutions across euro area and ensuring operational and goal-achieving efficiency of monetary policy measures.

Subset of counterparties should be chosen for fine-tuning reverse operations. Selection criteria should identify institutions which are the most active in the money market. Similarly, counterparties for foreign exchange swap transactions should be euro-area institutions which are capable to conduct efficiently large volume transactions under all market conditions. Finally, counterparties for foreign exchange interventions should be chosen from institutions located in euro area and other international financial centres that best fit additional prudential and efficiency criteria, ensuring flexibility and efficiency of intervention even in turbulent market conditions.

Adoption of the Eurosystem's eligibility criteria for counterparties is probably not the most urgent task that accession countries central banks should start with when preparing to enter the EMU. This judgement could be supported by at least three arguments. First, eligibility criteria applied by the Eurosystem are state-of-the-art and do not depart from best practices of other central banks and theoretical recommendations. Consequently, many major points/items of those criteria have already been implemented by accession countries' central banks as a result of natural evolution of monetary policy implementation. Second, Eurosystem's eligibility criteria let many details to be implemented by respective national central banks, in order to allow for different banking systems. And, third, implementation could be relatively fast and straightforward in most countries, in contrast to, for example, procedures and eligibility criteria for collateral framework. Nevertheless, timely taken actions with a clear view of targeted framework could help to avoid unnecessary changes and smooth the transition.

The remaining of the paper is structured along four chapters as follows. Chapter two contains short description of Slovenian banking system, focusing on issues that are relevant for selection of counterparties. Chapter three describes current practice of selecting counterparties at the Bank of Slovenia (hereafter: the BoS). Historical reasons are also presented. Generally, this practice is based on institutional criteria, supplemented by bank licensing and contractual arrangements. Chapter four describes a scenario for adopting the Eurosystem's eligibility criteria. Finally, chapter five concludes. The paper restricts its focus to the case of Slovenia.

2. BANKING SYSTEM IN SLOVENIA

The financial system in Slovenia is dominated by monetary institutions, namely only one quarter of financial intermediation is performed by the non-monetary financial institutions. Despite rapid growth of intermediation during transition the intermediation of savings through banking system still remains low in comparison to the EMU countries standard. Measured by the ratio of total assets to GDP it amounted to 90% in 2001. Slightly lower, around 65%, but rapidly and steadily increasing, is the ratio of broad money to GDP.

The Slovenian banking system is an universal banking system. As in most continental European countries, there is no statutory requirement to separate commercial banking from investment banking. However, universal banking system does not exclude the possibility that individual credit institutions may have restricted licenses or specialise in particular lines of business.

There are three types of credit institutions in Slovenia: banks, savings banks, and savings and loan unions. Institutional aspects of savings and loan unions are regulated by a special law. Despite that banks are outnumbered by other credit institutions, they still do most of business, namely 98% of assets are held by banks.

The current legal framework was established in 1999 with a passing of a new Banking Law, that was introduced to bring Slovenian laws in line with the EU directives. The law was amended in 2001 in the area of supervision on consolidated basis, connected lending, etc.

Supervision of the banking system is the responsibility of the BoS. Supervisors are organised as a department within the BoS. They focus on early detection of risks and implementation of appropriate corrective measures. Supervisory process for individual institution range from bank's duty to submit various regular and occasional reports to the on-site inspection. Beside that, the department issues banking licences and deals with various systemic regulatory issues.

2.1. Banks

There are 21 banks currently operating in Slovenia, including one branch of a bank incorporated outside Slovenia. Number of banks has been declining over years – in 1994 there were 33 banks – mostly due to mergers and acquisitions. Further four acquisitions have already been announced. On the other hand, there have been only two new credit institutions established since 1994.

The banking system could be characterised as highly concentrated, taking into consideration independent currency area. The market share of largest bank was 35% at year-end 2001, its combined share with three subsidiaries even reached 39%. The market share of three and seven largest bank, measured by balance sheet total, rose to 56% and 80%, respectively. As all banks operate most of banking activities, the concentration in the market for deposits, credits, and other banking services is similar. The banking system is considered rather competitive, despite high concentration. Domestic competition is further enhanced by competition from abroad, as borrowing and investing abroad are free (some inefficient restrictions on transactions of households remain in power till 2003).

Beside one branch, there are four subsidiaries of euro area banks, additional nine are minority owned by nonresidents. Presence of domestic banks in the euro area is limited. There are two entities included in the ECB database of eligible counterparties – a subsidiary bank in Germany and a branch in Italy, both are owned by the largest bank (NLB).

2.2. Savings banks

Savings banks are credit institutions established in accordance with the same banking act, but with narrower scope of business and lower initial capital requirement (one fifth of initial capital for banks, namely EUR 1 million). They are not allowed to manage investment funds. Beside that, they are restricted to domestic currency operations. As a consequence of those limitations, their ownership, and some other historical reasons, they are limited to collect deposits from households, non-profit institutions serving households, and small unincorporated enterprises. Funds are mostly channelled to credits to households and deposits at banks. Currently, there are only two savings banks in Slovenia, having total market share of meagre 0.4%.

2.3. Savings and loan unions

There are two sub-types of savings and loan unions; most of them are established by agricultural co-operatives to collect savings from member farmers and finance their investment projects. Most of agricultural unions are organised as two-tier institutions with umbrella institution (established as union as well). The remaining institutions are established by tradesman's co-operative societies. Their operations are considered more risky from the systemic point of view due to the fact that they collect deposits from broader public and have considerably higher concentration of credit exposure.

Terms and conditions for setting up and running a savings and loan union in Slovenia were are down in a special law on savings and loan unions promulgated back in 1969, and superseded by the effective law in 1990. The law does not prescribe minimum capital base (initial capital) and leaves to the founders to set out terms and conditions governing its operating activities. Under the effective law, founders are jointly and severally liable for savings deposits and all liabilities incurred by the respective savings and loan unions¹.

Just as in the case of banks and savings banks authorised under the banking law, savings and loan unions will have to be in line with the provisions of EU directives, which govern credit institutions, with exception of articles that govern their institutional aspects. Since the alignment with capital and other requirements call for a major overhaul, they need a longer transitional period; hence a five-year period has been envisaged for them to become fully compliant. They have been given time until 31 December 2004 within the framework of negotiations with the European Union to transpose capital and other requirements necessary for safe and sound operations in line with the banking law.

Save in the case of savings and loan unions, which had by the end of January 2001 passed a decision to begin activities leading to winding-up of business, all unions shall comply with the provisions of the banking law, in line with the conditions and milestones laid down in the special regulation on their compliance which elaborated transition period to full compliance. The requirements also apply to those institutions, which opted for a merger with another institution later on.

¹ See Annual Report 2000, Bank of Slovenia, 2001.

As for the future of savings and loan unions, eighteen of them initially declared interest in aligning with the requirements set out in the banking law, thirty will merge with the Association of Savings and Loan Unions (umbrella institution of unions established by agricultural co-operatives), thirteen will join banks and savings banks, while the remaining unions have been wound-up. Many of institutions that initially intended to align have later on withdrawn from the intention. Exact number of institutions that will be able to align is difficult to predict.

Number of savings and loan unions is decreasing, from 68 in 1999 down to 31 at the end of October 2002. Their combined market share measured by total assets is 1.6%.

3. CURRENT ELIGIBILITY CRITERIA FOR COUNTERPARTIES

Determination of the set of counterparties could be more straightforward in a case of a single country, in comparison to the monetary union including countries with differences in the legal system or in the structure of financial system. On the other hand, that could lead to a higher degree of pragmatism and inconsistency of the framework.

Eligibility criteria for counterparties in the case of Slovenia are primarily influenced by the structure of the financial system: (a) the prevailing role of credit institutions, and (b) the absence of financial institutions that are very similar to credit institutions, e.g. money market funds. From the legal point of view, these characteristics are reflected in a simple legal framework and its strict enforcement. Credit institutions are defined as institutions having exclusive right to perform banking services, i.e. reception of deposits from legal and natural persons and granting credits from these resources on its own account. Exclusivity is enforced by the BoS in cooperation with other supervisory institutions, including tax and market inspectorat. Despite that provision is not restricted to them, credit institutions need explicit licence for providing other financial services (e.g. factoring, performing payment transactions and issuing means of payments, trading with securities and derivatives, ...).

3.1. *Monetary policy instruments*

Beside general principles, that is equal treatment and operational efficiency, there are additional issues considered when choosing counterparties:

- The structural position of the money market in Slovenia has been in surplus for quite a long time. Consequently, the BoS does not need to systematically inject liquidity. On the demand side, there are no credit institutions that consistently rely on the financing from the central bank.
- As arises from the principle of prudence, small credit institutions are net provider of funds for the banking sector. Those institutions can easily manage liquidity by changing their net lender position towards larger banks. Considering that and the structural position, access to the central bank instruments is not an important advantage for those institutions.
- Many of savings and loan unions would not pass criteria of transparency due to weak disclosure practice. Moreover, financial soundness of some of them is also questionable. They could be excluded following the principle of prudence, until considerable alignment with the banking law is achieved.
- In addition, number of savings and loan unions is large. It would be operationally inefficient to accept all of them as counterparties. And, there are no explicit legal provisions for two-tier system with an umbrella institution.

- Unusual payment system framework that had been in place until July 2002 had generated additional risks for banks. Risk had arisen from uncontrollability of deposits from enterprises that had accounts at the Payment Agency (only banks had had such deposits). The BoS tried to compensate this risk by offering additional instruments for liquidity management.
- The BoS is restrictive at eligibility criteria for collateral, accepting only the BoS and government securities. Many of savings and loan unions do not have these securities in their portfolio.
- Restrictions on the access could also be considered as a stimulus to consolidation of the banking system.

The BoS has imposed reserve requirement on all credit institutions. Access to other instruments is restricted to banks and savings banks. Savings and loan unions will automatically have access to the same instruments as savings banks when they fully comply with the banking law. There are additional restrictions at instruments offered by auctions, namely only banks are allowed to submit bids.

Total number of counterparties is declining, regardless of instrument concerned. In September 2002 there were 73 institutions subject to reserve requirement, access to most other instruments was restricted to 23 banks and savings banks, while 21 banks were allowed to participate at auctions.

3.2. Exchange rate management instruments

The BoS executes exchange rate management operations according to rules that are extended from rules applied to monetary policy instruments. The BoS manages the exchange rate by purchasing and selling foreign exchange, both outright and as a swap arrangement, and determine the corridor where market rates could fluctuate. Participating banks have permanent access to instruments by which they exchange foreign currency to domestic (and vice versa), regardless of current market liquidity.

The framework is legally formalised as a contract between the BoS and banks. Counterparties are restricted to banks, since only they are allowed to do banking business in foreign currencies. Out of 21 banks 20 entered the contract.

3.3. Market makers for short term government securities

In 2001 the BoS and the Ministry of finance started activities to promote functioning of the money market. Initial set of activities has been devoted to the development of the short term government securities market. The BoS and the Ministry of finance signed an agreement with five banks that had been most active in the primary market for government securities, and in the other segments of money market. Implicit criteria to choose market makers only among banks was that only large banks have a capacity to hold sufficient amount of securities and adequate cash position, to be able to continuously quote competitive buy and sell prices. Additionally, larger banks had been invited to discuss their vision of acting as a market maker, and, finally, customer base of individual banks had been taken into account in order to promote direct financial instruments, over the border of the banking system.

3.4. Counterparties for special liquidity loan with participation of banks

Special liquidity loan with participation of banks is a prudential arrangement aiming at reduction of liquidity risk. Basically, it is a special purpose last resort loan, that enables the

BoS to manage credit risk despite the lack of appropriate collateral. In addition to that, there are also mechanisms implicitly built in to facilitate reorganisations, acquisitions, or other winding-up procedure of troubled institutions. The loan is available to banks facing liquidity problems, which are unexpectedly not able to attract new depositors or borrow in the interbank market, and are not eligible for the BoS's loans due to non-availability of appropriate collateral. Any such bank can obtain liquidity loan from the BoS with one or more banks intermediating the loan. The participating bank is obliged to pledge to the BoS securities issued by the BoS or the Republic of Slovenia; the beneficiary bank pledges other securities or claims to participating bank in return².

On a yearly basis, the BoS invites banks to participate in the agreement. Banks express their interest by stating maximum amount of intermediation. The participating banks are obliged to hold an appropriate securities portfolio against compensation of a certain percentage of the amount made available. The BoS determines the beneficiary bank, the interest rate and maturity of such loan, and the claims to be pledged by the beneficiary bank to the participating bank in return. The special agreement limits the difference between the interest rate on the BoS's loan to the participating bank and the loan of participating bank to the beneficiary bank. The arrangement has not been used yet in practice; it only has signalling effect.

The BoS selects counterparties, i.e. intermediary banks, among banks, according to their interest. Implicitly, the stand-by collateral requirement favours banks that have abundance of first class collateral.

4. ADOPTION OF THE EUROSISTEM'S CRITERIA

From the current perspective, it seems that Slovenia, after joining the EMU, could be a case where all credit institutions will be potential counterparty for most of regular instruments. There are a few supporting arguments for such an arrangement: (a) small number of credit institutions, probably not exceeding 20, after ongoing consolidation process will be finished, (b) flat structure of credit institutions, i.e. absence of any multi-tier banking structures, (c) eligible counterparties criteria for instruments and operations that will evolve into monetary policy instruments of the Eurosystem is already nearly accomplished, and, (d) counterparties' eligibility criteria for special arrangements mentioned in previous paragraphs (exchange rate management operations, special liquidity loan) will not be relevant any more, because those arrangements per se will be abolished when joining the EMU, or even before. Nevertheless, assessment of criteria for counterparties should balance costs and benefits of implementation of those criteria, in the framework of general criteria set by the ECB.

It is highly probable that the Slovenian banking system will continue to have surplus vis-à-vis the central bank before joining the EMU. Consequently, banks will obtain large amount of liquidity soon after joining the EMU with the maturing of the BoS' securities issued to absorb liquidity. Slovenian banks will be, at least on average, on the lending side in transactions with other euro-area credit institutions. Recourse to the Eurosystem financing will be limited to extreme liquidity situations, and due to surplus of liquidity it will be asymmetric, in favour of deposit side.

4.1. *Expected relevant future changes in the structure of the banking system*

² See Annual Report 1999, Bank of Slovenia, 2000.

There are two major driving forces that will influence the structure of the banking system in Slovenia in the short and medium term. The first one arises from the implementation of banking law that imposes higher standard of conducting banking business, especially higher capital requirement. The banking law exclusively governs operations of credit institutions, but allows their establishment by a special law (institutional set-up only). In the absence of a new law governing establishment of savings and loan unions, that would regulate two-tier structure, the number of those institutions will further decline.

The process of consolidation is also driven by market forces. Three medium size banks are expected to unite with the largest Slovenian bank. Further mergers are expected, involving the second largest bank (state owned), the fourth largest, the postal bank.

Fundamental market forces will probably converge the structure of Slovenian banking system closer to that of other transition countries. In the context of counterparty policy the ownership structure should be mentioned. Foreign ownership is increasing but is still lower than in most of transition countries. Further take-overs of domestic banks by non-residents could be expected, reducing, consequently, number of banks that will perform treasury activities in Slovenia after joining the EMU. This will reduce the need of recourse to the central bank.

Another particularity of Slovenian banking system that will probably converge to banking system of other transition and EMU countries is a low share of interbank claims. This deteriorates the capacity to transform funds, by restricting intermediation to one cascade. It is sub-optimal also due to diseconomy of scale, inability to disperse risk, etc³ ("Autarky" at the level of a single institution is also manifested in the foreign exchange market, resulting in a very low share of interdealer transactions). Simple, single-layer intermediation rises the need of liquidity management through central bank. Therefore, normalisation of the structure of intermediation will further decrease the demand for access to the central bank.

4.2. Operational steps and outcome

The process of selecting the eligible counterparties should, as a rule, be neutral regarding the existing market structure, this is to say, that the list of eligible counterparties should change as the market structure evolves, and not vice versa.

In Slovenia, the list of counterparties is currently based on institutional rather than qualitative criteria. The legal documentation in force defines banks and, albeit not to the full extent, saving banks and saving and loan unions as the counterparties that can directly approach the instruments of monetary policy.

Membership in the EMU calls for a consistent set of criteria that, apart from fulfilling the general eligibility criteria set by the Eurosystem, also takes full account of distinct features of the Slovenia's market and institutional structure. In ensuring operational efficiency, three principles shall therefore be observed when selecting the eligible counterparties. First, an institution deemed eligible to participate in central bank's operations must be subject to the maintenance of the minimum reserve system. Second, it shall maintain its reserve holdings directly, not by means of an intermediary. And finally, it should be a member of, or at least has access to, the RTGS system. Regarding counterparties for fine tuning operations, application of criteria would identify up to three banks most active in the money and foreign exchange market. But application of special criteria is currently not necessary, due to small

³ Thinness of interbank wholesale market could partly explain relatively high interest rate spreads and also the size of the banking system in comparison to the GDP (90%).

total number of institutions. Criteria for foreign exchange intervention operations counterparties are, even further, probably not relevant for small accession countries, due to expected change of these operations (centralisation within the ECB).

Turning to individual monetary policy instruments, the type of institutions subject to minimum reserve system will not change substantially till the EMU accession. Institutions issuing electronic money currently do not exist outside the banking sector, but should they emerge, they also would be treated as part of the minimum reserve system. Substantial progress has been made enabling all credit institutions to access open market operation and standing facilities, thus assuring equal treatment. The same holds for the intraday credit facility, which has just become operational. There is an intention to provide access to the Euro intraday credit to the same group of institutions, providing that such a credit will still be available to EU member states outside the EMU by the time of accession.

5. CONCLUSION

The criteria for choosing counterparties that have access to the instruments of the central bank depend mainly on the structure of the banking system. Assuming that current consolidation process will continue, small number of credit institutions will allow the BoS not to restrict access to the Eurosystem's instruments. On the other hand, demand for central bank financing will be weak due to expected structural surplus of the money market. Banks from current tolar area will be net provider of funds, frequently using recourse to the deposit facilities, similar to current situation.