

Miscellaneous

MEASURE OF CORPORATE GOVERNANCE IN BANKING: A PERSPECTIVE OF FINANCIAL RATIO ANALYSIS

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Abstract

The international financial aspect is to establish a reregulation process to prevent potential crises and risks from the financial markets. So the potential target for the settlements is the banking organizations which are very likely to create crises and shocks. Banking International Settlements leading this way is trying to improve corporate governance practices in banking systems around the world and increase the efficiency and transparency of the financial system. Therefore, banks are working to meet the new guidelines with corporate governance initiatives that are so special and important for them. The purpose of this paper is to analyze Turkish Banks' performance which is reflected on their financial statements to provide evidence on the level of corporate governance in the banking sector. There are some financial ratios which are attained to interpret the level of corporate governance in banking (Gürbüz, Ergincan; 2004). The study consists of comparing the results of Turkish banks' ratios before corporate governance principles were implemented with the results of ratios after the implementation. It is carried by a comparative analysis of the total system's financial ratios with the foreign banks' ratios in Turkey. The financial analysis with the comparative analysis highlights the need and the importance to improve the corporate governance in the banking system in Turkey.

Keywords: corporate governance, banking, financial ratio analysis; performance

1. Introduction

In the wake of the recent corporate scandals, corporate governance practices have received heightened attention. Shareholders, creditors, regulators, and academics are examining the decision-making process in corporations and other organizations and are proposing changes in governance structures to enhance accountability and efficiency.¹ Corporate governance may be identified as a performance evaluation system which requires restructuring of firms and organizations with risk culture and management, transparency, responsibility and inferiority. It suggests that the firms should be high performers and competitive and provide their stakeholders with highest possible income.

Corporate governance looks at the institutional and policy framework for corporations from their very beginnings, in entrepreneurship, through their governance structures, company law, privatisation, to market exit and insolvency.²

There has been a great deal of attention given recently to the issue of corporate governance in various national and international fora. In particular, the OECD has issued a set of corporate governance standards and guidelines to help governments "in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries, and to provide guidance and suggestions for stock exchanges, investors, corporations, and other parties that have a role in the process of developing good corporate governance."³

Recent research suggests corporations that have better corporate governance signal better performance. It has been stated that major contributions of corporate governance to the company include enhancing performance (Boubakri, Cosset and Guedhami, 2003) and preventing fraud (Lee, Yeh, Ko, 2002). According to the research of Black, Jang and Kan (2002), companies with better corporate governance have better performance than companies with poor corporate governance. Although the subject of corporate governance in developing economies has recently received a lot of attention in the literature (Oman, 2001; Goswami, 2001; Lin, 2001; Malherbe and Segal, 2001), the corporate governance of banks in developing economies has been almost ignored by researchers (Capiro and Levine,

¹ Renée Adams; Hamid Mehran, "Is Corporate Governance Different For Bank Holding Companies", Federal Reserve Bank of New York Economic Policy Review, April 2003, p. 123.

² OECD, Corporate Governance, http://www.oecd.org/topic/0,2686,en_2649_37439_1_1_1_1_37439,00.html , 2005

³ OECD, Principles of Corporate Governance, 2004, www.oecd.org.tr

2002). Even in developed economies, the corporate governance of banks has only recently been discussed in the literature (Foerster and Huen, 2004; Macey and O'Hara, 2001). However, recent events, such as the Enron scandal and other corporate governance failures, have put corporate governance on the front.

Because of its unique nature, banking firm, whether in the developed or developing world, requires that a broad view of corporate governance, which encapsulates both shareholders and depositors, be adopted for banks.⁴ Banking system is a critical component of any economy. Banks provide financing for commercial enterprises, basic financial services to a broad segment of the population and access to payments systems. In addition, some banks are expected to make credit and liquidity available in difficult market conditions. The importance of banks to national economies is underscored by the fact that banking is virtually a regulated industry and that banks have access to government safety nets. It is of crucial importance therefore that banks have to have strong corporate governance.⁵ Sound corporate governance is an essential element of a strong risk-management process. Bankers and bank directors have specific responsibilities to manage the risks at their financial institutions and effectively oversee the systems of internal controls.⁶

Jensen and Meckling (1976) argue that board structure, ownership structure, and compensation structure are determined by one another as well as by a range of variables, such as risk, real and financial assets, cash flow, firm size, and regulation. They suggest that these variables also influence a firm's conduct and performance.⁷

In the case of local banks in Italy, Ferri, Masciandaro and Massori highlight three different forms of corporate governance testing the performance of them.⁸ Another study of corporate governance and

⁴ G. Capiro, R. Levine, "Corporate Governance of Banks: Concepts and International Observations", Global Corporate Governance Forum Research Network Meeting, April 5, 2002, p. 2

⁵ Basel Committee on Banking Supervision (BCBS), "Enhancing Corporate Governance for Banking Organisations", Bank for International Settlements, Switzerland, 1999, p. 6, www.bis.org/publ/bcbs56.pdf

⁶ Susan S. Bias, "Bank Performance and Corporate Governance", BIS Review, No: 55, September 28, 2002 <http://www.bis.org/review/r021009e.pdf>

⁷ M. Jensen; W. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure" *Journal of Financial Economics*, No. 3, 1976, pp. 305-360.

⁸ Giovanni Ferri; Donato Masciandaro; Marcello Massori, "Corporate Governance, Board Turnover, and Performance: The Case of Local Banks In Italy", *Università Bocconi*, No.146, November 2001,

performance was put to test using data of banks from Argentina in the 1990s including all types of bank ownership.⁹

This paper discusses the importance of corporate governance of banking institutions. This is an important issue given the essential role banks play in the financial systems of developing economies merely and the widespread banking reforms that these economies have implemented. Following the global crisis, banks all over the world had to go into critical change. Turkey, after two consecutive crises, still tries to reshape its financial system. Therefore, corporate governance principles were issued in the country. The analysis in this paper points that the Turkish Banking System showed progress through the implementation of corporate governance principles but still there is a need for further deliberate applications.

Accordingly, the paper is organized as follows: Section 2 gives information about corporate governance in banking. Section 3 and 4 are related with the Turkish banking sector and the corporate governance settlements. Section 5 provides the data and the methodology in detail. Section 6 discusses the results of the analysis, and Section 7 is devoted to the conclusions of the research.

2. Corporate Governance In Banking

Banking supervision cannot function as well if sound corporate governance is not in place and, consequently, banking supervisors have a strong interest in ensuring that there is effective corporate governance at every banking organization. Supervisory experience underscores the necessity of having the appropriate levels of accountability and checks and balances within each bank. Put plainly, sound corporate governance makes the work of supervisors infinitely easier. Sound corporate governance can contribute to a collaborative working relationship between bank management and bank supervisors.¹⁰

Recent sound practice papers issued by the Basel Committee underscore the need for banks to set strategies for their operations and establish accountability for executing these strategies. In addition, transparency of information related to existing conditions, decisions and

http://www.uni-bocconi.it/doc_mime_view.php?doc_id=11368&doc_seg_id=1

⁹ Allen Berger; George Clarke; Robert Cull; Leora Klapper; Gregory Udell, "Corporate Governance and Bank Performance: A Joint Analysis of the Static, Selection and Dynamic Effects of Domestic, Foreign and State Ownership", **World Bank Policy Research Working Paper**, No: 3632, 2005, p. 1.

¹⁰ BCBS, p. 4.

actions is integrally related to accountability in that it gives market participants sufficient information with which to judge the management of a bank. This guidance refers to a management structure composed of a board of directors and senior management. The Committee recognizes that there are significant differences in the legislative and regulatory frameworks across countries as regards the functions of the board of directors and senior management. In some cases, it is known as a supervisory board. This means that the board has no executive functions. In other countries, by contrast, the board has a broader competence in that it lays down the general framework for the management of the bank.¹¹

Basel Committee declared two accords (Basel I and II) to maintain requirement for the banking system all over the world. Basel II is a complex new standard that intends to promote safety and soundness in the financial system, align regulatory capital requirements more closely with underlying risks, provide incentives for institutions to pursue more sophisticated and effective risk management, and demonstrate robust governance, processes, and controls to shareholders and institutions. The final version of the accord was published in 4Q03, with parallel testing with the new and old accords (Basel I) from YE05 through 2006, and the new accord being in place by 2007 (though this date could slip further). Users must not only address Basel II independently, but also coordinate efforts to achieve its compliance with related parallel compliance efforts to both leverage efforts and support the development of more efficient enterprise wide governance programs.¹²

The corporate governance of banks especially in developing economies is important for several reasons. First, banks have an overwhelmingly dominant position in developing-economy financial systems, and are extremely important engines of economic growth (King and Levine 1993; Levine 1997). Second, as financial markets are usually underdeveloped, banks in developing economies are typically the most important source of finance for the majority of firms. Third, as well as providing a generally accepted means of payment, banks in developing countries are usually the main depository for the economy's savings. Fourth, many developing economies have recently liberalized their banking systems through privatization/disinvestments and reducing the role of economic

¹¹ *ibid*

¹² John Van Decker; Stan Lepeak, "Incorporating Basel II Requirements Into an IT Corporate Governance Framework: Part 2 The Services Dimension", April 28, 2004, pp. 1-2.

regulation. Consequently, managers of banks in these economies have obtained greater freedom in how they run their banks.¹³

The focus on corporate governance is particularly acute in financial services and, most of all, in the banking sector. The banking sector is already highly sensitized to public scrutiny and has learned to its cost the risk of attracting adverse publicity through failings in governance and stakeholder relationships. Banking is clearly a very special sub-set of corporate governance with much of its management obligations enshrined in law or regulatory codes.¹⁴

These factors put governance in banks as a considerably more complex issue than in other sectors. Banks will attempt to comply with the same codes of board governance as other companies but, in addition, factors like risk management, capital adequacy and funding, internal control and compliance all have an impact on their matrix of governance.

The board of directors is ultimately responsible for the operations and financial soundness of the bank. The board of directors must receive on timely basis sufficient information to judge the performance of management. An effective number of board members should be capable of exercising judgment, independent of the views of management, large shareholders or governments. Qualified external directors can also become significant sources of management expertise in times of corporate stress. The board of directors should periodically assess its own performance, determine where weaknesses exist and, where possible, take appropriate corrective actions.¹⁵

Corporate governance for a developing economy has an added dimension. After all, since the late 1980s/early 1990s, the financial sector of a number of developing countries has seen a wave of liberalization and deregulation. Greater deregulation in markets and in banks operations requires better governance as more responsibility rests with the Board and the management.¹⁶ Good corporate governance can help to ensure that the organization is fully prepared to manage potential threats, and to maximize the opportunities to be gained from business risk.¹⁷

¹³ T.G. Arun; J. D. Turner, "Corporate Governance of Banks in Developing Economies: Concepts and Issues", *Corporate Governance: An International Review*, Vol. 12, No. 3, July 2004, p. 3

¹⁴ Sang-Woo Nam, "Relationship Banking and Its Role in Corporate Governance", ADB Institute Research Paper Series, No. 56, April 2004, p. 3.

¹⁵ BCBS, p. 6.

¹⁶ Shyamala Gopinath, "Corporate Governance: Towards Best Practices", Bankers' Conference, New Delhi, November 10 2004, p. 1, www.abdi.org

¹⁷ Comment, "Emerging 21st Century Risks Emphasize Need for Good Corporate Governance", *Corporate Governance*, March 2000, pp. 6-8.

3. Turkish Banking Sector

The Turkish economy has been in a continuing progress after the economic program that was launched in 2001. In parallel with the aim of reinforcing the market mechanism, important steps for strengthening the regulatory and supervisory institutions have been taken. The stable growth environment had positive effect on the banking system. To ensure financial stability serious structural reforms have been introduced in the banking system. Thus, the structure of the banking system has become healthier. An independent agency was formed for increasing the effectiveness of banking supervision and control (the Banking Regulation and Supervision Agency-BRSA). The Banking Act and other banking regulations have been considerably harmonized with international best practices.

In the field of banking supervision serious steps have been taken toward the transition from rule-based approach to risk-based approach. Due to this, market discipline has started to have a greater importance in ensuring financial stability. With the aim of providing the public and market participants with the information necessary to make meaningful assessments of banks, the implementations on accounting standards, reporting and public disclosure have been strengthened.¹⁸

Table 1: Turkish Banking System (2000-2004)

Number of Banks	2000	2001	2002	2003	2004
Total	79	61	54	50	48
Commercial Banks	61	46	40	36	35
- <i>State-owned</i>	4	3	3	3	3
- <i>Privately owned</i>	28	22	20	18	18
- <i>Banks in the Fund</i>	11	6	2	2	1
- <i>Foreign Banks</i>	18	15	15	13	13
Non-depository Banks	18	15	14	14	14
- <i>State-owned</i>	3	3	3	3	3
- <i>Privately owned</i>	12	9	8	8	8
- <i>Foreign Banks</i>	3	3	3	3	2

Source: The Banks Association of Turkey (TBAT)

¹⁸ The Banks Association of Turkey (TBAT) (2005), Financial Sector and Banking System in Turkey- March 2005, p. 9, www.tbb.org.tr/english/TBBBrosur10032005englishi.pdf

In order to strengthen the capital structure of private banking system a special auditing process as a part of "banking restructuring program" was implemented. Assets of the banks were analyzed in detail, non-performing assets were determined, and necessary provisions were set aside for bad loans. Within the context of the restructuring program the balance sheet structure of state-owned banks was strengthened, and special importance has been attached to the increasing of the efficiency in these banks.

Shareholders' equity of the banking system has strengthened and free shareholders' equity has increased. Exchange rate risk has been considerably reduced. An improvement has been observed in the rates of return on assets and return on shareholders' equity. The practice of full insurance guarantee introduced to the saving deposits in 1994 and even to all liabilities of the commercial banks in 2001, was terminated in the second half of 2004. The insurance coverage over the saving deposits has been limited to 50 thousand YTL since July 2004. With the aim of full compliance with the EU Directives legislative work to amend the Banking Act continues. The amendments are mainly concentrated on improving risk-oriented supervision, strengthening the independent structure of the BRSA, and increasing the effectiveness of supervision in the banking system.¹⁹

4. Corporate Governance In The Turkish Banking Sector

In Turkey, Corporate Governance Principles are first issued by Capital Market Board. These Principles were issued to be implemented primarily by the listed companies in ISE. In the draft of new code on banking industry corporate governance principles are required for the financial institutions. Because corporate governance is a new concept for the Turkish companies and the compliance with the Principles is not compulsory, in order to understand the level of corporate governance, a survey among listed companies has been conducted. Although the main purpose of the survey is to understand the position of the companies in corporate governance context, there are other side effects of the survey such as increasing the awareness of corporate governance among listed companies and encouraging them.

The evidence indicates that the companies are eager to work on corporate governance and the number of companies having policies about social responsibility is growing. However, there many firms in Turkey both of the private and public sector that have to adopt corporate governance

¹⁹ *ibid*, p. 10.

principles. At the same time, Turkey's firm structure made up of family and group holding points to a lack of corporate governance to a great extent.²⁰

5. Data and Methodology

The methodology used in this paper is comparing the selected banks' financial ratios. For the purpose of comparative analysis of Turkish Banking Sector's performance, listed banks on the TBAT were selected. These selected banks were compared with the foreign banks in Turkey that fully apply the corporate governance principles. These pair-matched samples are used so that meaningful comparative analysis of performance may be made.

For those selected banks, the performance ratios are calculated from the set of data on TBAT's miscellaneous yearly reports concerning the last five years (2000-2004). The performance ratios are summarized for each year of the past five years in the form of the simple average ratio. These summarized data are presented with the attached tables. Several financial ratios indicate the results of banks' performance. The ratios for this study include those of capital adequacy, assets quality, profitability, liquidity, debt management.

²⁰ Doğan Cansızlar, "Capital Markets Board's Role in Shaping Corporate Governance", Roundtable on Corporate Governance United Nation's Economic Commission for Europe, Geneva, Switzerland, 9 February. 2005, p. 3, http://www.spk.gov.tr/yayinlar/seminerkonferans/IOSCO/files/RTS_opening_speak.pdf

Table 2: Financial Ratios Of Turkish Banking Sector

<i>CAPITAL ADEQUACY</i>	<i>2000</i>	<i>2001</i>	<i>2002</i>	<i>2003</i>	<i>2004</i>
Shareholders' Equity / Total Risk Weighted Assets‡	-	17,5	24,2	30,9	28,8
Shareholders' Equity / Total Assets	7	9,7	12,1	14,2	15
<i>ASSETS QUALITY</i>					
Total Loans / Total Assets	32,8	21,9	26,5	28	33,7
Loans Under Follow-up (net) / Total Loans	11,5	37,4	6,6	1,4	0,7
<i>PROFITABILITY</i>					
Return on Assets Net Profit(Losses) / Total Assets	-3,1	-6,6	1,1	2,2	2,1
Return on Equity Net Profit(Losses) / Total Shareholders' Equity	-72,8	-76,5	9,2	15,8	14
<i>LIQUIDITY</i>					
Liquid Assets / Total Assets	32,1	31	34,3	38,8	37,4
Liquid Assets / Short-term Liabilities	37,9	37,8	75,1	80,5	84,3
<i>DEBT MANAGEMENT</i>					
Net Interest Income / Total Assets	3,8	6,2	6	4,5	5,8
Total Interest Income / Total Interest Expenses	129,6	147,6	140,5	140,8	177,7

Source: Author's calculation (from TBAT's data)

‡ Risk weighted assets item has not been calculated in year 2000.

Table 3: Financial Ratios Of Foreign Banks* In Turkey

<i>CAPITAL ADEQUACY</i>	<i>2000</i>	<i>2001</i>	<i>2002</i>	<i>2003</i>	<i>2004</i>
Shareholders' Equity / Total Risk Weighted Assets ‡	-	44,2	32,6	36,2	26,9
Shareholders' Equity / Total Assets	10,3	22,2	21	24	20,1
<i>ASSETS QUALITY</i>					
Total Loans / Total Assets	17,1	26,3	33,9	23,3	24,4
Loans Under Follow-up (net) / Total Loans	2,9	1,4	1,1	1	0,8
<i>PROFITABILITY</i>					
Return on Assets Net Profit(Losses) / Total Assets	0,7	1,5	1,2	2,7	2,4
Return on Equity Net Profit(Losses) / Total Shareholders' Equity	11,1	6,9	5,9	11,2	11,9
<i>LIQUIDITY</i>					
Liquid Assets / Total Assets	63,7	41,5	43,4	43,3	42
Liquid Assets / Short-term Liabilities	79,3	77,2	80	83	67,4
<i>DEBT MANAGEMENT</i>					
Net Interest Income / Total Assets	9,4	12,2	11	9,1	6,5
Total Interest Income / Total Interest Expenses	158,1	193,9	233,5	269	215,1

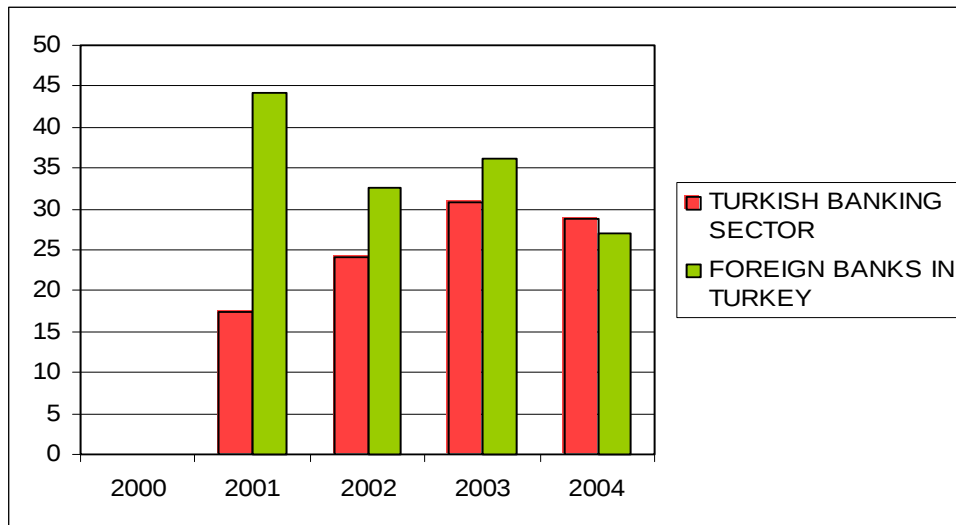
Source: Source: Author's calculation (from TBAT's data)

* Fully apply corporate governance principles and have a different management style beyond Turkish Banks

6. Results of Comparative Analysis

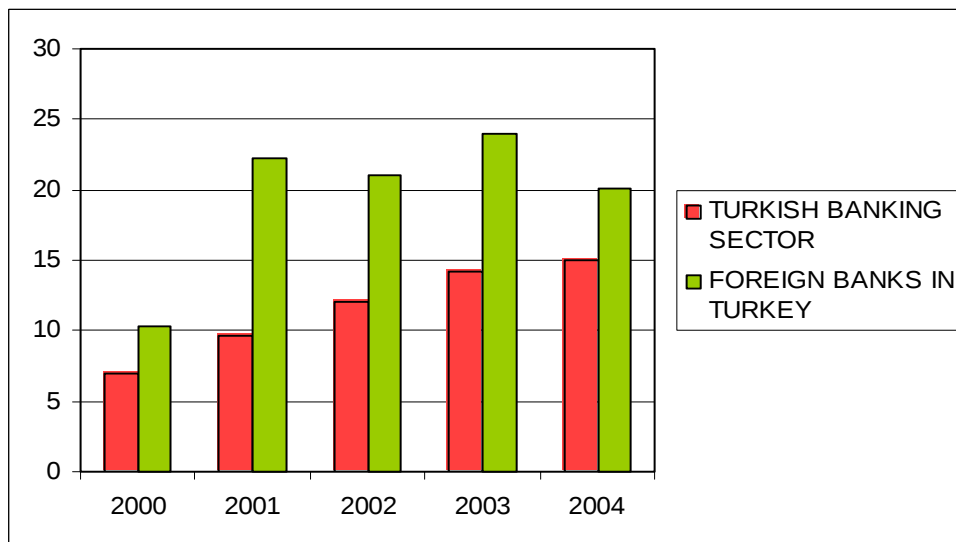
The capital adequacy ratio of Turkish banking sector lays small compared with the foreign banks' and it increases year by year as the corporate governance principles' implementation. The capital adequacy of foreign banks' showed a volatile trend but still higher than the sector's. Risk weighted assets of the sector reached and overtook the foreign banks' in 2004. That's one of the major exceptional results for the sector. At the same time, shareholders equity increases in the sector but remains low compared with the foreign banks'.

Figure 1: Shareholders Equity / Risk Weighted Assets



Source: Author's calculation (from TBAT's data)

Figure 2: Shareholders' Equity / Total Assets

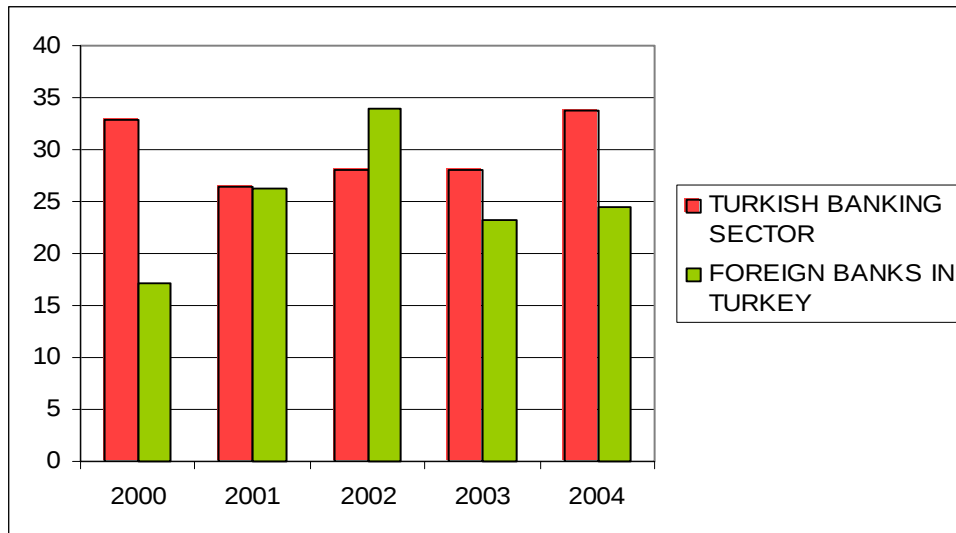


Source: Author's calculation (from TBAT's data)

According to assets quality, both the sector and the foreign banks had a volatile trend. The sector's loans grew bigger than foreign banks' thus the loans under follow-up flew high but slowed down in 2003 then catching the foreign banks' in 2004. That considerable change in the attitude towards the loans under follow-up is another important deviation from the result of the rest of the analysis. Just like the change in the risk weighted assets, the

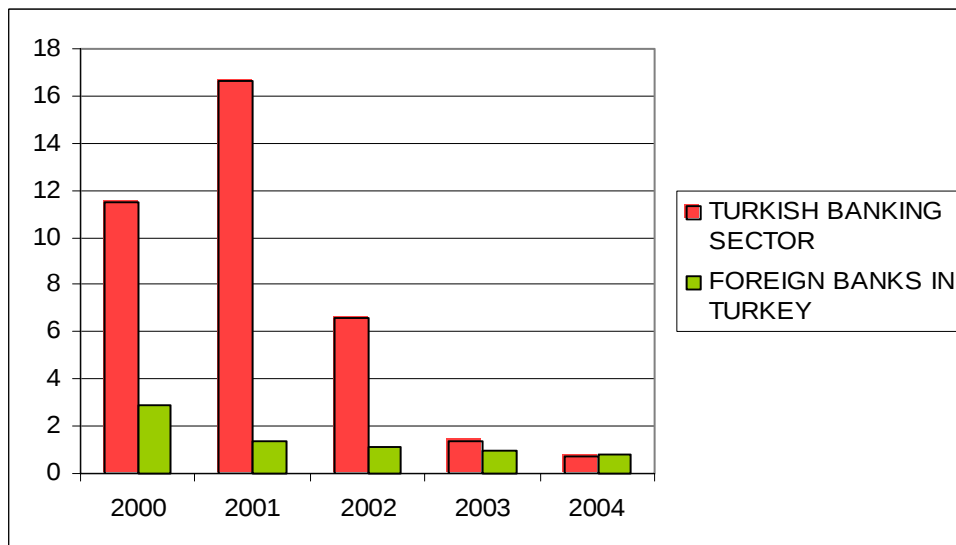
decrease in the loans under follow-up came through the settlement of risk management implementations that exist in corporate governance.

Figure 3: Total Loans / Total Assets



Source: Author's calculation (from TBAT's data)

Figure 4: Loans Under Follow-up (net) / Total Loans

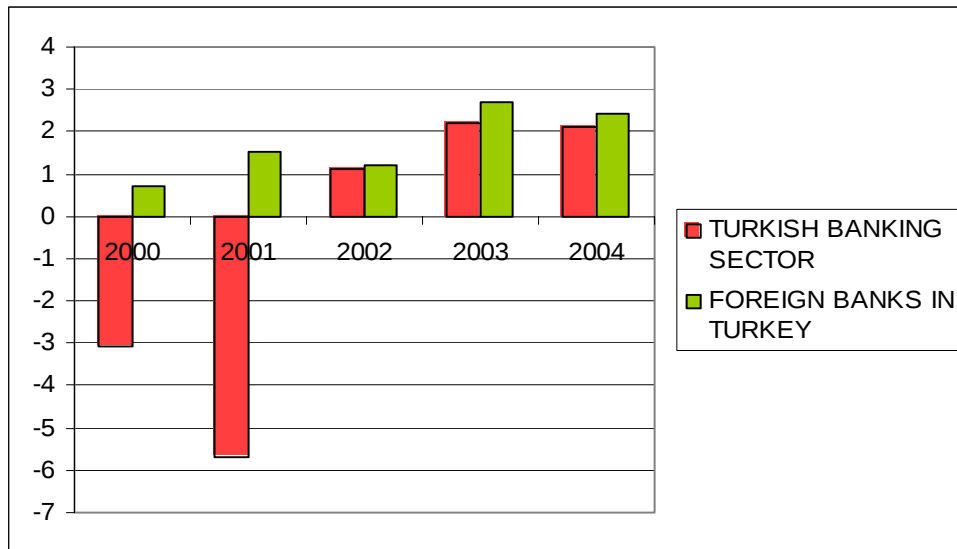


Source: Author's calculation (from TBAT's data)

Profitability of the sector showed considerable positive change especially in the return on equity. After 2001 a big jump started overtaking

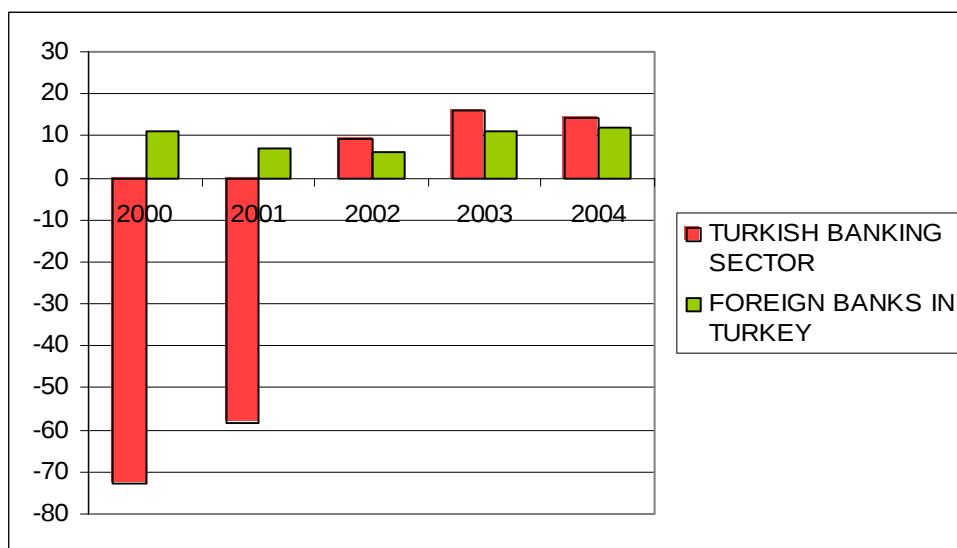
foreign banks' return on equity. On the other hand, rate of return on assets went slow reaching foreign banks' in 2003 and overtaking in 2004.

Figure 5: Return on Assets



Source: Author's calculation (from TBAT's data)

Figure 6: Return on Equity

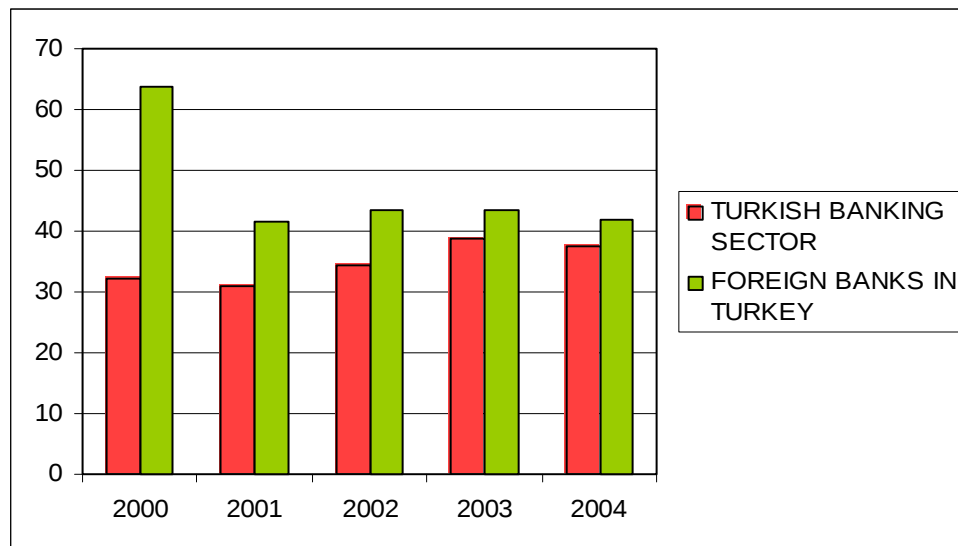


Source: Author's calculation (from TBAT's data)

Liquidity of the sector is strengthened and increased year by year. As for the ratio of liquid assets to total assets, sector remained lower than the

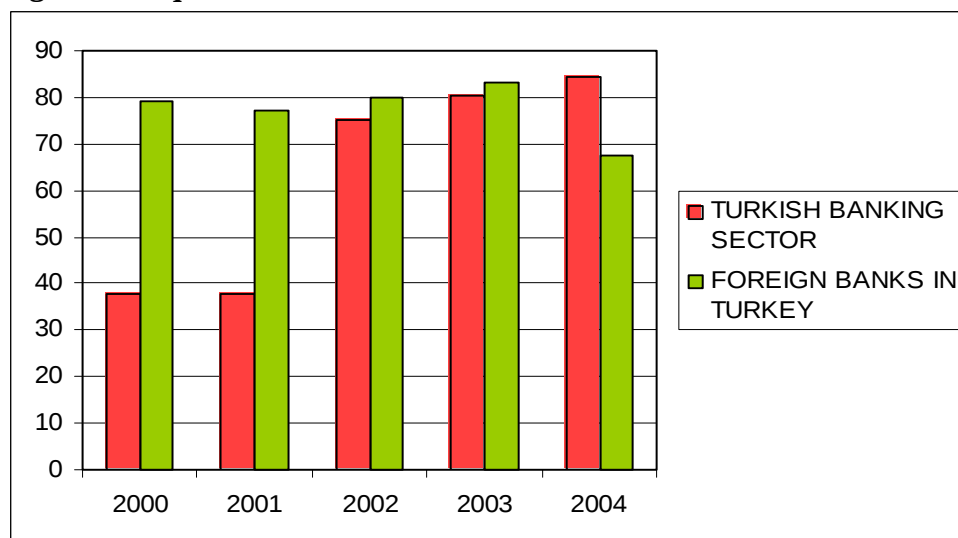
foreign banks at the end of 2004. But the ratio of liquid assets to short term liabilities showed a considerable change and went far than the foreign banks' in 2004.

Figure 7: Liquid Assets / Total Assets



Source: Author's calculation (from TBAT's data)

Figure 8: Liquid Assets / Short-term Liabilities

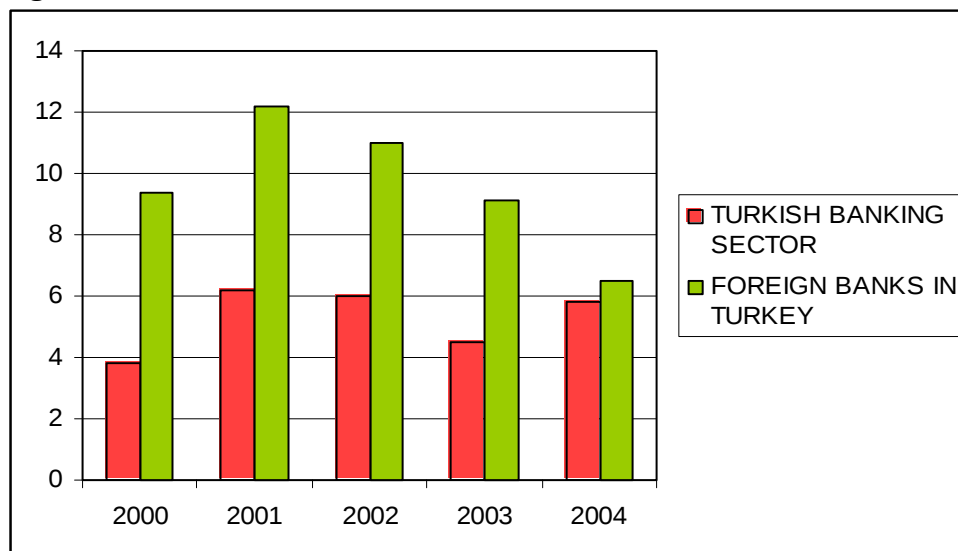


Source: Author's calculation (from TBAT's data)

As for the debt management, both the sector and the foreign banks showed a volatile trend in ratios. The ratio of net interest income to total

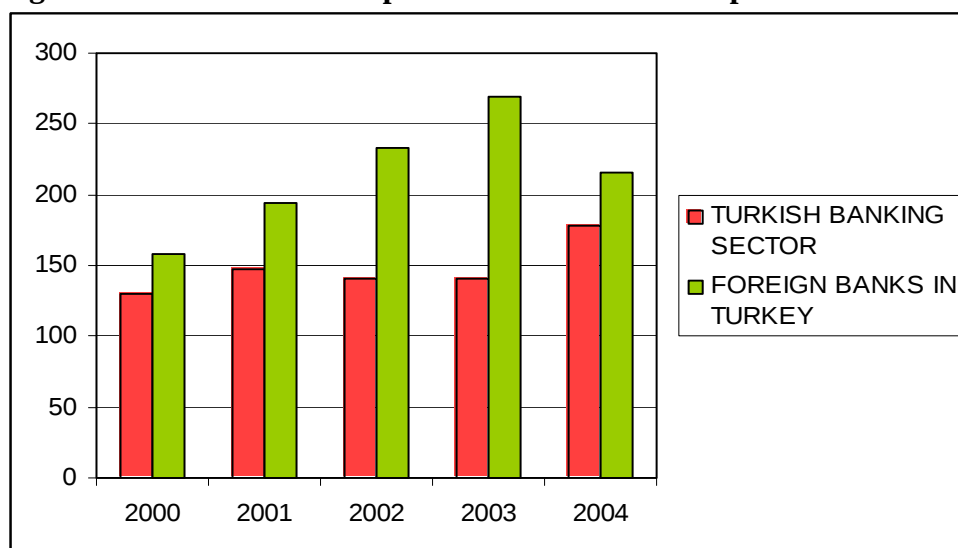
assets of the sector remained lower than the foreign banks'. The foreign banks' ratio slowed down whereas the sector's nearing a little closer in 2004 just like in the case of total interest income to total interest expenses.

Figure 9: Net Interest Income / Total Assets



Source: Author's calculation (from TBAT's data)

Figure 10: Total Interest Expenses / Total Interest Expenses



Source: Author's calculation (from TBAT's data)

The results totally show that foreign banks' management and performance in Turkey is much more adequate for the generally accepted corporate governance principles that had been set by OECD and especially BIS. Till 2004, generally ratios of the foreign banks went more adequate when compared with the sector's ratios. At the end of 2004, some of the ratios of the foreign banks started to fall below the sector's (shareholders' equity to total risk weighted assets; loans under follow up to total loans; return on equity, liquid assets to short-term liabilities) but others remained higher or more adequate.

It can be said that the Turkish banking sector showed a considerable change and reached to the level of foreign banks. The fact behind that change is the implementation of corporate governance in the sector and mainly the related issue of risk management. The ratios of the sector before the settlements were far beyond the foreign banks in Turkey. But after corporate governance principles, there happened a dramatic change in the financial management of banking system in Turkey. The sector reached a much more considerable level in ratios that reflect corporate governance. That shows the importance of corporate governance in banking as well as the need in the Turkish Banking System. But at the same time, it should be noted that the results still point to the need to attain stronger and sound corporate governance in the Turkish Banking Sector.

7. Conclusion

The empirical evidence presented above constitutes the level of corporate governance in the Turkish banking sector. In addition to casting serious doubts on some conventional notions on the background of Turkish banks and confirming some of my suspicions in various performance ratios, this paper also proposes extra evidence about the need for corporate governance that sector has and the importance of corporate governance overall for banking.

Of the four ratios tested, the sector performed better than the foreign banks in Turkey. This means Turkish banking sector showed considerable change and upgrading the level of corporate governance. Although policies are designed to strengthen the corporate governance of Turkish banks, the rest of the performance test results compared with the foreign banks operating in Turkey, point to the need in enhancing the efforts to progress stronger corporate governance level in the banking sector. Moreover, there is a need for the management of banks to be granted autonomy and be gradually introduced further corporate governance practices. Banking sector in Turkey is required to publish comprehensive financial and risk-related disclosures.

Corporate governance for Turkey, is the major transition issue as of EU, especially for the banking sector in the long-run.

In short, governance of banks is crucial for growth and development of a country's economy. At the same time, banks are subject to financial risks, highly leveraged as failure can lead to large output costs. Corporate governance affects banks' performance, valuation, and cost of capital, risk taking and the risks of financial crises.

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SOLUTION OF NON-VALUATION BANK ASSETS IN THE SLOVAK AND CZECH REPUBLIC¹

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Abstract

Transformation of the banking sector to a stable and efficient banking system which should be able to support the economic growth has been one of the most important problems by the transition to a market economy. In foreground was the question of inaccessible loans and the settlement of this question was the main assumption for the transformation and for the economic growth. The burden of inaccessible loans have namely blocked the restructuralisation not only with its existence, but above all with it's volume. Beside the need to build of new institutions for the move of inaccessible bank claims apeared the question of their valuation. This contribution is intended to theoretical aspectes of solving the problem of inaccessible assets in banks and also to concrete solution of the situation in this area in the banks in Slovakia and in the Czech Republic.

Key words: *banking sector, reclassification of banks, inaccessible claims, non- standing financial assets, risk loans, transformation institutions, valuation of claims, methods of valuation of claims, non-valuation assets*

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1. Banking Sector in the Slovak and Czech Republic

Demonopolization of banks in Czech-Slovak Federal Republic was accompanied through their strong undercapitalization, the capital appropriation has moved on the level 1,72 %. The disadvantage was also a very small number of qualified employees, lack of experience with managing of commercial banks, surroundings, absence of laws and other criterions in the area the central bank and the commercial banks. Banks were not equipped with modern technologies; branch -office net and know-how were absent. Despite that relatively a lot of banks came into being with home and foreign participation whereupon a lot of small banks have been founded mainly in the Czech Republic. New founded commercial banks have taken over a part of inaccessible loans from the Czech-Slovak National Bank, loans granted enterprises, loans for cooperative flat construction, how also loans for some big projects, for example power stations, water power stations and similar. Low experiences and political influences and insufficient legislature have contributed to the development of a other big parcel of not sufficient guaranteed loans and before long a lot of them was graded to the risk- or problem level.

The solution of the problem loans is dated from the Federal Czech-Slovak Republic when there were accepted measures for solving of the payment inability. The federal government placed at disposal 11 billion Czechoslovak crowns reclassification of potential viable enterprises and 4 billions Czechoslovak crowns for the capital strengthening of banks. Absence of experience with such projects has showed by us in a non system admission to solving of the payment inability. After dividing of the CSFR, the governments of the Czech and Slovak Republic have taken different steps to solve the situation in the banking sector. Both governments solved the state through consolidating institutions - moving of none financial standing assets to this institutions and at the same time through increasing of ground capital in this again healthy banks. The intention of both governments was also to sell the healthy banks to foreign investors.

Table 1: Owners Structure of Banks in SR and CR to the 31.12.1993

<i>Owner structure of Banks</i>	<i>Number of banks in Czech republic</i>	<i>Number of banks in Slovak republic</i>
<i>State Banks</i>	1	3
<i>Banks with major state participation</i>	3	4
<i>Banks with major private participation</i>	18	3
<i>Banks with foreign participation</i>	20	8
<i>Branches of foreign banks</i>	7	10
<i>Total</i>	49	28

Source: National Bank of Slovakia, Czech National Bank

1.1 Solution of problems in the Slovak banking sector after 1993

After dividing of the federation there have been the following main problems in the Slovak banking sector:

- prevailing state ownership in banks
- low capital adequacy
- quality of the credit portfolio- high stake of inaccessible credits
- lack of long term funds.

This state has had a negative impact not only on the liquidity of the banking sector, price policy and savings, but also on the whole economy of Slovakia, therefore in 1999 decline also in Slovakia to solution of unfavorable situation in the banking sector.

Resolution of the Government of SR No. 90/1999 and connecting resolution No. 908/1999 led to work out the procedure of restoring to health of banks under the name „Proposal of the program of reclassification of banks and reclassification of the private enterprise sector“. The objective was to displace a part of risky claims in such a way, that each bank will reach a part of max. 35 % of inaccessible claims and at the same time to increase the capital of banks and to reach a capital adequacy of 8 % according to the Basel criterions. On the basis of this documents, the reclassification was divided in two stages. The first stage of reclassification started in December 1999 and the second in June 2000.

Table 2: Classified credits in Slovak banks in 2000

<i>Year</i>	VUB, Ltd.	IRB, Ltd.	SlSp, Ltd.
2000	9707,3	174,7	1858,4

Source: Consolidating Bank, Ltd.

In the first stage of the recovery process have been joined the three biggest Slovak banks: General Credit Bank (VUB), Slovak Saving Bank (SlSp), and Investment and development bank (IRB). Entirely there have been displaced in the first stage credits in value about 82.2 billion Slovak crowns and in the second stage 34.2 billion Slovak crowns.

1.2 Solution of problems in the Czech banking sector after 1993

The Czech banking system at it's beginning had to occupy itself with a lot of financial liabilities, which occurred in none economic surroundings of central planed economy. To that have been added problems with temporary founding of new small banks, which have been strong undercapitalized, they didn't have an experienced management and operated in an unstable microeconomic environment. That all was the consequence for a strong increase of bad assets, especially credits, which was not ordinary paid back. The situation, which came into being, the government of the CR solved through a declaration of the consolidation program I., on which basis the credits for long terminated reserves, have been transformed to the consolidating bank. Because there began to appear problems of small, new founded banks, the government declared to their solution the consolidation program II and in the frame of it have been applied the following measures: there was initiated a forced management, finished the activity or the banks have been soled and at the same time increased the ground capital. From the entire 18 small banks have been in the frame of this program solved 15 and the amount of the raised funds was 33 billion Czech crowns. In 1997 began the stabilizing program which basis was the purchase of non-financial standing claims. To this program entered 6 banks from which 3 have been later excluded, 3 of them have changed the ownership and the program was prematurely finished.

By the end of the 90th the state began to solve the problems in the big banks, they received a lot financial help and this banks have been consequently sold to strategic investors.

Table 3: Classified assets in the banks of CR in 2000

Classification	Banks, total	KB	ČS
<i>Standard</i>	618 190	99 660	67 602
<i>Followed</i>	88 600	34 885	17 941
<i>substandard</i>	32 600	10 441	7 490
<i>doubtful</i>	31 500	4 263	1 920
<i>lossing</i>	91 800	9 032	19 550
<i>classified credits, total</i>	244 500	58 621	46 901
<i>classified credits total, in %</i>	28,3	37,0	41,0

Source: Czech National Bank

2. Admittances to the settlement of inaccessible credits

Searching of possibilities to settle the inaccessible credits have brought three admittances:

Decentralized admittance, when the state enter into the banks with capital and cover the loses from non-financial standing assets. The following step can be the privatization of such acquired stake. After it the banks are solving their non-financial standing assets in their own direction. This procedure has been used by the privatization of the banks in Poland. Certain modification is granting of state guarantee for non-financial standing assets. In the CR was the state guarantee partially used by privatization of the Czech saving bank and the Commercial bank, there have been issued guarantees to the new owners for risky assets.

Centralized admittance, by which non-financial standing assets purchase central institutions (AMC-Asset Management Company) and after it they manage this assets with the objective to reach a maximal yield or to reclassification them. The owner of these institutions can be the state, or a private person. We distinguish two types of these central institutions (AMC)

- restructuring institutions (Corporate Restructuring Vehicles), the objective of which is the restructuralization of banks and key enterprises
- rapid asset disposition vehicles , which objective is quickly sale of non-financial standing assets. This type of institutions doesn't pursue any reclassification of debtors.

The third way is the **combination** of the two a.m. admittances. Reclassified problematic credits, granted to big important enterprises will be moved to central institution and the rest of such credits remain to stay in commercial banks.

3. Reclassification instruments of non-financial standing bank assets

Transformation institutions structure the received non-financial standing assets according to determined criterions (for example according the debtors, the branches, regions, the financial situation of the debtor or according to the expected development of enterprising) in the portfolio and as follows they start the reclassification. The transformation institution has to decide which instrument it will use for the reclassification by consideration of the law- and tax aspects.

Emphasised is also the transparency of the reclassification process. By reclassification of non-financial standing assets in different countries will be used some of possible instruments, which are:

- capitalization of debts
- balancing, except the court balancing
- sells of portfolio assets, which can be realized:
 - . through individual sell
 - . through sell of fortune stakes
 - . auction through internet
- competitions
- securitization
- selling of guarantees

4. Transformation institutions in the Czech and Slovak Republic

4.1 Transformation institutions in the Slovak Republic

The need to solve the problematic credits has activated the founding of the Consolidating bank a state institution in 1990. This bank took over form the big commercial banks credits on value about 110 billion Czechoslovak crowns. As counter-value the banks received from the state 50 billion Czechoslovak crowns in government loans 12 billion Czechoslovak crowns for increasing of the own capital stock and 38 billion Czechoslovak crowns for the remission of credits for long term reserves. The consolidating bank has one-sided and formal changed the one year character of credits to a

long term credit with the assumption of repayment of this credits until 2000. The enterprises confirmed the regime of repayment decided through the Consolidating bank. The enterprises stopped to distinguish the separate types of credits with which of the one side has been solved the problem of credits from the view of banks, on the other side for the enterprises it was a load and for the state it meant a loading of the state debt and the public finance.

Reclassification of the Slovak banking sector was solved in August 1999 when the government of Slovak Republic issued the reclassification program for the chosen banks and of business sector which connected to the resolution of government No. 90/1999. To secure the transparence of the privatization process the government cooperated with foreign counseling firms. Project was prepared in cooperation with the European commission, the World Bank through the program PHARE. The objective of the project was, to create a mechanism which could secure to dismantle the whole loss from the whole process on the owners of debt enterprises (loss of fortune), creditors (partial satisfaction of claims) including banks (using of reserves and correcting items) and state (through the cover of the rest of uncovered loss). As an important step is to consider the legislative measures as the law about bankruptcy and settlement, laws about banks, tax laws and the actualization of the commercial and the civil code.

Partition of the federation meant also division of the Consolidating bank on two subjects. Consolidating bank as a state institution, founded in 01.01.1993 through the Ministry of Finance, took over nearly 2000 clients with credits about 30,4 billion Slovak crowns. The main objective was the liquidation or arrangement of claims and obligations connected with credits for long terminated reserves.

Admittance to the founding of the Consolidating bank in Slovakia was considerable different to the CR where the Consolidating bank received from the FNP (Fund of National Property) CR 15 billion Czech crowns. Separate solved the FNP the liquidation of the debts by state properties through what it helped to speed up the process of reclassification in CR. The Slovak Consolidating bank has fulfilled an important task in reclassification of banks and enterprises.

The Slovak Consolidating bank was practical founded without a basic capital stock. In the course of the first two years of existing the bank has been entrusted a capital stock about 2,357 billion Slovak crowns. But that was not sufficient in view of the volume of credits which the bank took over. The capital adequacy of the bank was by end of 1994 deep under 8 %. ² Volume of funds used for consolidation of the three biggest banks has been estimated

² Kovalčík, J.:Konsolidačná banka – pokus o centralizovaný prístup. In: TREND, 8. 11. 1995, s. 5A

on 105 billion Slovak crowns that is approximately 12 % of GDP.

Table 4: Moved claims from Slovak banks

	VUB	SLSP	IRB
Number of demands	3 035	2 646	104
Number of debtors	1 832	2 070	52
Nominal value in Slovak c	58 641 201 709	33 895 547 962	4 969 241 330

Source: Consolidating Bank, Ltd.

The Consolidating bank was managed through the bank law and therefore it was not possible to make activities aside the frame of law (for example selling of claims) and also the bank was not able to maintain the conditions of cautious undertaking of banks. With the resolution No. 908 of the Slovak government from 21.10.1999 therefore was founded a specialized finance institution the Slovak consolidated stock company (SKO) with stock capital about 1 billion Slovak crowns. It was a bank institution without bank license. The bank have arisen as stock company with following stakes: Ministry of finance-24 % , VUB, SSB, IDB and Consolidating bank each 19 %. The objective of the founding of the SKO was in a possible short time and effective realize the reclassification program of the government. The activities of the SKO are stated in the project of the agency for work with moved claims. For the SKO has been stated the conception of non banking institution. The mission of the SKO was to clear the classified claims, moved from the reclassified banks. An important task of the SKO was to create a secondary market with problematic claims and help to build a standard and transparent market in cooperation with IMF, World Bank, EU, foreign consolidated and consulting organizations.

The main objective of the company was a fast settlement of classified claims which has been moved to it's portfolio in the frame of the before privatizing reclassification in the past from the state owned banks, General Credit Bank VUB, Slovak Saving Bank SLSP and the Investment and Development Bank IRB.

After this stage, the SKO began its concrete activity with collecting of claims on the basis of mandate agreements with the banks in the first stage and after this stage the claims have been managed internal by SKO. By securing of return ability of claims the SKO used in the valued period non-court and also court forms of collecting. The company SKO has in the process of collecting of claims used the standard internal management and also part of claims has been collected through mandate agreements with reclassified banks, mandators, lawyer- or commercial offices. The intention of the administration of claims on the strength of mandate agreements and agreements about collecting of moved claims was to avoid

formation of damages and at the same time to save the continuity of the collecting process. Claims against subjects in CR and Russia have been transferred to chosen mandators. Collecting of most complicated juridical cases of claims the SKO has solved through lawyer- and commercial agencies. In area of court collecting of claims the SKO used all viable legal instruments, mainly proposals to issue of payment orders, to declare of crashes and to execute bailiftings. On the base of agreement between the SKO and the Fond of national property the company received assets from the Consolidating bank in value of 33,13 billion Slovak crowns. The SKO registered to 31.12.2004 in it's portfolio claims from reclassified banks about 49,23 Bi Slovak crowns. In comparison with the state at 31.12.2003 the nominal value of the portfolio dropped over 57,23 billion Slovak crowns. First and for most the drop was initiated through the progress of claims in the frame of the VVK project about the value 42 billion Slovak crowns and realization of the project VVK 2004 on the nominal value 12,6 Billion Slovak crowns. On decreasing of the portfolio in 2004 have participated except the named projects also individual moves of claims (0,156 billion Slovak crowns) and also reclassification of some debtors (0,842 billion Slovak crowns). In harmony with the accepted strategy of solving the claims of farm- and food firms have been realized the cession of claims from enterprises to the Slovak guaranty and development bank SZRB).

Reverse the increasing of the nominal value of the claims in portfolio of the SKO at the end of 2004 have activated a take over of claims from tax authorities in entire value about 24,6 Billion Slovak crowns. SKO maintained to the 31.12.2004 in management claims in an entire sum about 73,93 Billion. The value of the property represented to the 31.12.2004 a value about 22,949 Billion Slovak crowns. Creating of correcting items to the entire amount, which have been created from costs have influenced a negative result in 2004. On the other side, there has been created space for reaching of positive economics in the society in the following years. In the past the society reached negative results in economy as consequence of undervalued loss contained in managed claims. Insufficient volume of created correcting items was the consequence, the bigger volume of claims was moved to third subjects, and the bigger was the loss. In 2005 the SKO await a positive result. Individual attention the SKO granted the solution of opened questions with Slovak saving bank and General credit bank in connection with transfer of classified claims in frame of the reclassification of the banking sector. The result was the closing of conclusion protocols with both named banks. The company SKO finished the solution of the guaranty question of the Fond of national property in connection to the part of managed portfolio with the closing of an agreement about extinction of the guarantee. An important reality was in 2004 the implementation of a new management information

system which makes it possible to follow in details the process of bankruptcy proceedings, distains, voluntary auctions, court disputes or liquidations in real time.³

In legislature area on the basis of negative experiences in connection with the interpretation and application problems of the current valid law about bankruptcy proceeding by management and by collecting of claims prepared the SKO a proposal for the parliament to change the law about bankruptcy and settlement No. 328/1991. This proposal has been accepted by the Slovak parliament and is valid since 01.01.2005.

Table 5: Moving of classified credits to consolidating institutions in the SR

<i>Bank</i>	<i>Transfer of credits (thousand Sk)</i>		
	<i>Consolidating Bank, a.s.</i>	<i>Slovak consolidated stock company</i>	<i>Together</i>
<i>VUB, a.s.</i>	7 602,8	58 641,3	66244,1
<i>I. Stage</i>	7 602,8	37 642,2	44 945,0
<i>II. Stage</i>	0	21 299,1	21 299,1
<i>Slovenská sporiteľňa, a.s.</i>	2398,1	29 998,1	32 396,2
<i>I. Stage</i>	2398,1	20 398,8	22 796,6
<i>II. Stage</i>	0	9 599,3	9 599,3
<i>IRB, a.s.</i>	9 507,5	4 969,2	14 476,7
<i>I. Stage</i>	1 394,4	4 969,2	6 363,6
<i>Displacement of credits into DBV</i>	8 113,1	0	8 113,1
<i>II. Stage</i>	0	0	0
<i>Displacement of credits together in the 1st stage</i>	19 508,4	62 710,2	82 218,6
<i>Displacement of credits together in the 2nd stage</i>	0	30 898,4	30 898,4

Source: Ministry of Finance of Slovakia

In the period of its existence, the Slovak consolidated bank has solely managed and collected claims. At the present the institution is with its new professional management and personal equipment full prepared to manage further problematic claims from public finance sector.

³ *Consolidating Bank, a.s.*

4.2. Transformation institutions in the Czech Republic

Measures for relieving of the unfavorable situation in the banking sector solved the Czech government and the Central bank with measures which can be divided in three arrears:

- legislature and regulating measures (strengthening of competencies of the bank supervision and Commission for Securities, insolvency legislature and new bank laws)
- help the depositors, stricken through bankruptcy of banks
- direct help to banks or it's new owners.

By renovation of the banking sector in the CR there has been chosen a decentralized model, on which basis the Czech saving bank and Commercial bank received state guarantees for covering of risky assets.

By reclassification of the whole banking sector and also state enterprises has been chosen a centralized admittation by which the central state institution has bought non credible assets and was real reclassification institution. The task of these institutions was to remove the credits from the bank balances as result of the economy policy of the last regime and enable the banks and firms to do their business without burden from the past. Their next task was the taking over of non credible assets from the Czech banks and consequently to realize them. The reclassification institutions in CR fulfilled also an another task, they helped small banks which came to existence troubles and have been stabilized through the stabilizing programs I and II.

The Czech consolidating agency (CKA) is the legal successor of the Consolidating bank, Prague. Till 2000 this bank has made financing in development projects in the areas infrastructure and ecology. In 2001 the bank vanished and was replaced through the Czech consolidating agency (CKA). CKA was founded on the basis of a special law No. 239/2001. This agency is a non banking finance institution which doesn't receive deposits and doesn't offer credits. The main task of the agency is to solve the problematic assets active, transparently and quickly with the objective to make a maximal yield for the state. Through the law the agency will vanish on 31.12.2011 without liquidation. The main influence in the agency has the supervision council, named through the parliament. Management of the agency is named by the government. Main activity of the agency is the management and realization of assets, reclassification of enterprises chosen by the government and solving of the managed assets through the court. If the clients properly made their payments, there are no difficulties by the liquidation of the assets. Not repaid credits will be solved by transfer of claims to third subjects, realization of the pawned law or sale by auction. In

the frame of solving the debts through the court there will be used the possibility of bankruptcy, liquidations and submitting of suits. In subsidiaries will be realized the block sale of credit claims. In companies, which are able to survive and to fulfill their obligations the CKA applies the strategy of reclassification eventually the strategy of installment-repayment. In case of enterprises, appointed through the government with the interest to sell them to a strategic investor, the CKA looks up a partner. The agency bought gradually non credible assets about 400 billion Czech crowns except the selling of the claims from the commercial banks, the CKA took over also claims from health insurances about 4 billion Czech crowns. The big increase of the balance sum has been compensated with an active solution of claims.

The main objective of CKA is to reach a max return ability of claims in shortest time with min. of costs. The processes have to be transparent and standard according to the actual segmentation in the surroundings of the new information system and each debtor have to be solved in harmony with in advance agreed strategy. KONOPO a limited company has been founded through the Commercial bank and all classified credits have the bank transferred to this company. Today the only owner of this company is the CKA. Subject of enterprising is purchase and sell of credit claims, management of claims, collecting of claims and real estate activity. In 2002 were purchased from the Commercial bank incredible claims for 60 Billion Czech crowns for reclassification takes KONOPO individual sale of claims and block sale. Entire have been sold claims for 4,12 billion Czech crowns. PRISKO stock company was founded in 1992 on the basis of the project SKODA with the objective to separate some claims out of the new privatized company. The CKA is here the only property owner. Revitalizing agency was founded in 1999 as special division for solving of some big and complex cases. From 2001 the company is inactive and in liquidation. Sanakon was founded by the Consolidated bank in 2000. The company offers administrative-technical services which support the business activities of banks.

Czech financial (C F) was founded by Czech central bank from 2000 a 100 % subsidiary of the KOB. CF is active in management of assets which took over in frame of programs for increasing of stability of the banking sector and consolidation of smaller banks, management of property stakes with effective using of property and shareholder rights. The main activity is especially the management of assets (credit claims, CPO, property stakes) which the company took over as contribution to strengthening the banking sector. The stabilizing program will be financed through the CKA and the Fund of national property on the basis of the resolution of the government No. 539/1996 and the agreement closed between the KOB and FNP on 04.02.1997.

Table 6: Block sale of incredible assets

Year	ČKA		SK	
	Total in billion CZK	Proceeds in%	Total in billion SKK	Proceeds in%
2001	19,10	7,10	13,30	3,30
2002	37,80	9,00	54,00	non realized solde
2003	62,00	non available	54,00	0,07
2004			15,06	

Source: Annual reports of ČKA a SK

Transformation institutions realize the reclassification through using of a lot of instruments from which the most used are the individual sales, blocked sales of incredible assets, capitalization of debts, sale of property stakes, bankruptcy and liquidation, realization of reinsurance. The condition for the correct using of the a.m. instruments is the right valuation of credit claims.

5. Valuation of credit claims

Value determination of credit claims has an impact to the economy, banks and state and at the same time important information from the view of the investor. For each of the named subjects has the credit claim an another economic value. Behind the claim we have to see a concrete enterprise, therefore the price is stated on the basis of ideas of the contract partners about the value and the price at the same time implicated the ideas about the structure of credit claims. The price of the credit claim is always created under assumption, that there exist an offer and demand. These markets are different from the markets on which people sell usual commodities. Each offered credit claim has it's own individuality and specifications. The individuality of each credit claim is leading to the assertion, that for claims markets not exist and each sale of portfolio is an individual case, which is not possible to compare with an another case. Therefore it can not exist an objective value and it is the task of the expert by creating the value of the claim to consider the specifications of the concrete seller and buyer. Each so created value is rather a subjective value in that sense that there is expressed a certain value in connection between the buyer and seller. Concrete claim has for different investors often different values. The optimum case would be, if there could be stated a real price which would correspond to estimates of the buyer and seller.

The valuation of credit claims have to assume from the principle of maximal use. By valuation of claims states the seller and potential new investors their objective of valuation and on that ground their state their own

strategy.

The valuation of the credit portfolio has to fulfill the following criteria:⁴

- creating the value of the claim in that way, that the assumed yield will be reached
- analyse the impact of risks in connection with the credit claim to the value of credit claim portfolio
- find the proper strategy for the solution of the credit claims.

The choice of the proper method of valuation the credit claim require a correct classification of claims and consider the real expectations regarding the behavior of the debtor. On this ground is possible to choose the following strategies:

- capitalization of claims and the following sale of claims or reclassification of the company and the transfer of the claim to the standard claims and it's gradual repayment. This strategy is possible to choose, if the debtor is cooperating and there is the assumption that the claim will be repaid.
- Strategy of involuntary auction or distraint of the property or bankruptcy in case that the debtor has property viable for sale,
- Sale of the claim on the basis of collected property of the debtor to a third subject.

The credit claims will be valued with the objective to drop the volume of loss and endangered assets and to reach a maximal yield with minimal costs of their management. The valuation of the claim follows before the decision about sale or keep the claim in the own portfolio. The importance of the evaluation of the credit claim is given through specific factors of their solving in the conditions of the economy in Slovak and Czech republic and mainly out of following reasons:

- Credit claims are mainly from risky debtors, who over long periods don't pay back the credits, not submit documents and information to the bank according to the credit agreement and don't communicate with the bank.
- The claims are not enough secured through possible instruments
- the market of credit claims is not enough developed
- In Slovak and Czech Republic not exist a uniform method for valuation of credit claims, which would respect the

⁴ Zmeškal, Z.: Finanční modely. Ostrava: VŠB-TU, Ekonomická fakulta, 2002. ISBN 80-284-0182-5

characteristics of big volumes of not repaid credits.

- The possibility that the credit claim will be repaid through the real debtor by means of a third person and legalized the obligation against the bank.

The valuation of the credit claims will be realized as follows:

- A. Establishing the nominal value of the claim incl. interest, costs and so on. In the same time is necessary on the basis of documents to state the credibility of the debtor and to judge if the value of the claim is zero.
- B. Judge the reinsurance of the credit claims and their sorting according to the manner of settlement
- C. Establishing a discount interest rate as addition of non risk yield and the risky surcharge.

By valuation of incredible assets there will be used a lot of methods in dependence from judging the situation on the basis of many points of view. There will be used four proceeds as follows:

- yield methods, by which the value of the claim will be stated as current value of future finance flows
- comparative methods, where for the statement of the value is to compare the given asset with the assets with similar qualities
- substantiating methods- the value of the given asset is stated on the basis of market valuation of the assets and the whole property
- optional method, if some consider the valuation of conditional claims, which can be asserted in some special cases.

Valuation of the portfolio of credit claims will be worked out on the basis of debtor analysis on the basis of bookkeeping statements - balance, statement profits and losses, cash flow and of public accessible information (business Journal, Annual reports of given firms and so on)

Objective of the valuation of claims is the determination of the value to a certain day. The value of the claims will be therefore stated from the valuable components which can be presented and quantified to the given day. The subject of valuation is always the unpaid value of the incredible asset to the given time where upon there will be considered also the expected development after the term of valuation. On the basis of given information and chosen strategy there will be judged the convenience of separate valuation methods, the most suitable will be chosen and on its basis will be stated the real value of the incredible asset.

System of valuation of incredible assets consists of following independent methods:⁵

- creation of value on the basis of payment ability of the debtor
- creation of value of the incredible asset through bankruptcy simulation
- creation of the claim value on the basis of value determination of pledging instruments
- credibility method
- comparison method
- combination of the named methods

Creation of value on the basis of payment ability of the debtor

By using of this method there can be expected, that the debtor is willing to cooperate with the bank, the bank will get all information about his entrepreneur activity and the debtor will continue in his activity. This procedure takes into consideration the cash flow which will be used for the settlement of the given claim. The base for the analysis are historical dates for the last two years and the finance calendar for the period of repayment of expected installments. The quality of valuation will depend from the quality of submitted documents from debtor. The claims are valued on the basis of current value for future installments.

Creation of the claim value through bankruptcy simulation

Statement of value of the claim on the basis of this method use the expected amount of received funds from the bankruptcy process which will be simulated. If a bankruptcy is not real, there have to be the valued the parts of property of the debtor separately for their sale and for their valuation have to be used the valuations in the case of bankruptcy. Starting point for the determination of bankruptcy value is the balance for the last period in the whole extension. The height of finance flows is stated through the asset volume. First there will be settled the claims from the bankruptcy virtue which occurred after declaration of the bankruptcy. All creditors have to be satisfied according to the statute of the bankruptcy.

⁵ Křístek, L.: Metody oceňování pohledávek. In: Bankovníctví č. 10, 2001, s. 12

Creation of the claim value on the basis of value determination of pledging instruments

On the basis of differentiation if there is material or immaterial property there will be used the cost (material) method or the yield and the comparison method. The cost method belongs to the oldest methods for creation of the market value of the enterprise. The objective of this method is how many funds are necessary for the renovation of the enterprise. Important is mainly the advantage value of separate parts of the property. This method will be used for example in the case of creating of the price of real estate property, for the valuation of the stake in finance companies and as complement statement by valuation of yields. The yield method is created on the time value of funds and relative risk of investments. The bases for the calculation are the annual earnings before taxation and will be used in business with real estates.

Credibility method

By this method the claims will be valued with a point valuation from 1 to 5. The coefficients of valuation have to be converted with weights of importance of each criterion. By creation for the value of credit claims have to be used all information from the debtor. More information from the debtor makes the method better. It's so a subjective method.

Comparison method

This method compares the buildings and ground with similar real estates on the market in the same period. The comparison will be executed on the place of real estates with the following valuation of offer and demand on the real estate market and with consideration of all criterions of real estates. This method can be used only limited and that mainly by valuation of plots and production halls.

Valuation of claims in case if there are not to disposal economical statements and the claims are not secured

In case that it is not possible to use any of the named methods then will be used an independent valuation of the claim. The main factor of the quality of the valuation is the volume of accessible information. In the case that the debtor doesn't communicate with the bank there will be used all reachable information about the property of the debtor with the objective at least to reach a partly settlement of the claim.

Conclusion

The solution of the problematic of inaccessible credits is a interdisciplinary problem. On the one side there are economic questions as valuation of inaccessible claims and determination of the settlement with inaccessible claims. On the other side there are legal questions- institutional covering of the credit moving, creation of laws and regulations. At the present is that also a political problem mainly from the view of creating of consolidating institutions and also of accepting of unpopular measures with the consequence of finance burdens for the state and the population.

The commercial banks have to eliminate the increase of new inaccessible credits what means the banks have to improve the system of risk management and consequent follow the problematic claims. The central banks have to increase the regulation and supervision in this area.

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THE WARRANTS – AN EVERYDAY PRODUCT

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Abstract

Warrants are considered structured investments; in their classic form, they are also known as plain vanilla warrants. The function of warrants can be derived from their name: Warrants securitize the right, but not the obligation, to buy or sell a predefined amount of a good at a predefined date. The good upon which the warrant is based is called the underlying. Shares and share indices serve as underlyings; so do branches and regions, interest rates, currencies or raw materials. The right to buy the underlying is called a call or a buy option; the right to sell is called a put or a sell option.

Keywords: *underlying assets, theta, omega, vega, rho, delta, index, sector baskets, leverage*

1. Introduction

Over the last few years, there is hardly a single financial instrument that has whetted investor appetites as much as the warrant. Warrants can be used to make substantial gains, yet they can also lead to considerable losses. Anyone wishing to invest in warrants needs to know exactly how they work and what risks they typically entail. Losses have all too often been the result of a lack of experience in dealing with these products. Only those who know what factors can influence the price of warrants and, above all, how these factors influence them, can trade successfully in these instruments in the long run.

2. The warrant

2.1 Option contract at a petrol station

The best way of explaining the origins and workings of warrants is to take an example from everyday life. Let us assume that you have just bought your dream set of wheels – a top-of-the range sports car with a powerful engine. Your initial enthusiasm is decidedly short-lived, however, when you arrive at the petrol station to fill-up your new car only to discover that a litre of premium petrol is going to set you back a whole euro. Suddenly remembering what has been written in the press over the past few weeks about rising crude oil prices in Rotterdam as well as the petrol tax, you are forced to reckon with the price for a litre of premium petrol hitting €1.50 or perhaps even €2 within the next two years. Your heart well and truly sinks as you realise that your dream car, depending on how fast it is driven, consumes between 15 and 20 litres per 100 kilometres.

You then have a flash of inspiration and enter into the following agreement with the owner of the petrol station. You acquire the right to buy 5,000 litres of premium petrol at €1 per litre over the next two years. This means you have purchased 5,000 petrol options, each entitling you to buy a litre of petrol under the agreed conditions. The rest of the deal with the owner of the petrol station works as follows. You pay an immediate €0.10 per litre for the agreed volume. The right to buy 5,000 litres of premium petrol at €1 per litre at any time within the next 24 months therefore costs you €500. You also agree with the other party to this agreement that you may sell your options, in part or in whole, to another car-owner at any time. At the end of the day, the petrol station owner is not really concerned who he sells the 5,000 litres to.

2.2 Limited risk – no further obligations

If the price of petrol were to rise to unexpectedly high levels over the agreed two years, you would be in a position to make a huge profit by buying 5,000 litres of premium petrol at well below the market price. If the price rose to €2 per litre, you could also consider selling your options, which, initially bought for €500, would then be worth €5,000. This would be a great deal all-round, and what is more, if the price of petrol were to fall, your risk would be limited to the sum needed to purchase the options. If the price per litre dropped to €0.80, for example, you would not be obliged to buy the 5,000 litres for €1. In this instance, the options would be worth nothing and expire worthless if the price of a litre of petrol remained below €1 for the term of the option contract. Let us now assume that during the agreed period of two years, the price of premium petrol for your dream car were to fall dramatically to rest at €0.70. In this instance, you would not make use of your right to buy 5,000 litres of petrol at €1 and would let the options expire. You would then have to assume the total loss of the sum paid for the options, i.e., €500. This loss would have been limited had you sold the options after a few months. If the petrol price were to shoot up to €2, you would have the following choice. Either you could continue to fill your sports car with petrol costing a mere €1 per litre or you could sell your options and make a large profit. Do not forget that as the buyer, you simply have rights, whereas the pump attendant, as the seller, has rights and obligations.

2.3 Market value of the options

Three months later, during a routine trip to your local petrol station, you notice that a litre of petrol now costs €1.20. The value of your options has therefore risen and, contrary to the other car drivers you meet at the pumps, you are happy at how things have turned out. Of course, all attention turns to you when they realise that you only have to pay €1 per litre. You tell them about the deal with the petrol station and a number of the higher-price payers then offer to buy some of your options. Something along the lines of a market then materialises. As most people fear that petrol prices are going to increase further, you could sell your options immediately for €0.30 per litre. The prevailing market value of each option, which you purchased for €0.10, is therefore €0.30.

2.4 Maturity of the options

The higher the petrol price per litre rises above €1.10 – i.e., above your profit threshold – the more your options are worth and the more profit you will make. Given that you may exercise your options at any time and actually receive delivery of the petrol, and that there are parties interested in

buying your options from you, you are free to choose between purchasing the 5,000 litres of petrol over the two years at a significant discount to the prevailing market price or selling your options at the prevailing market price. The price the other car drivers are willing to pay will, of course, be higher the more expensive a tank of petrol becomes. If the price of petrol were to rise to €1.20, you would save €0.20 by exercising your options. However, the “market value”, i.e., what others would be prepared to pay for these options, is €0.30. There is a good reason for this, namely that three months ago you entered into an agreement with a two-year term, i.e., the options are still valid for another 21 months. During this period of time, the price of petrol could rise to unexpectedly high levels. It therefore follows that the right to buy petrol at €1 per litre for another 21 months is worth more than the right to do this only for another two days, for example.

Another feature of your petrol options is that you and the pump attendant have agreed to physical delivery. This means that upon exercising the options, you actually receive physical delivery of the underlying, in this instance, the premium petrol.

2.5 Future expectations

Enjoying your role as a warrant owner, you take your pride and joy for a spin one morning and need to refuel again. On the display board at the petrol station you notice that the price of premium petrol has gone up overnight from €1.10 to €1.30. This price rise is due to the Organisation of Petrol Exporting Countries (OPEC) making a surprise decision to reduce crude oil production, thereby sending prices on the crude oil market in Rotterdam through the roof and causing oil companies to react as they always do in these circumstances, i.e., by hiking petrol prices. Groups of drivers can be seen standing around the pumps embroiled in heated discussions. An air of panic abounds as everyone fears that petrol prices will continue to rise even higher.

Now well known among local car drivers, you step onto the forecourt and become immediately surrounded by a group of them wanting to buy your options for 60, even 70, cents per litre. A particularly worried driver offers to buy 2,000 options for as much as €0.80. A few days later and the situation is different. Premium petrol has indeed risen to €1.35 a litre, yet no one expects prices to rise any further. The government has announced that, if necessary, it will lower petrol tax in order to keep prices stable. When you ask car drivers what they would be willing to pay for your options, the highest bid you receive is €0.50. It therefore goes without saying that expectations of future price trends for the underlying affect the value of an option. Hopefully, at the height of the panic, you will have accepted the highest bid and sold some of

your options, leaving your angst-ridden buyers to curse the planned petrol tax cuts and bemoan their unlucky investment decision.

2.6 Playing the stock exchange

Since acquiring your petrol options, you have developed a keener interest in petrol price trends and their influences. One day, you read an interesting newspaper article about Deutsche Automobil AG. The carmaker is about to bring out an attractive, high-performance car that only consumes 2 litres per 100 kilometres. The model looks set to be a roaring success – especially given the further rise in petrol prices over the past weeks.

In view of your positive experience of petrol options, you decide to try your luck with warrants traded on the stock exchange. The problem here is that there are a whole host of warrants available on Deutsche Automobil AG shares. All you have to do now is choose the right one. With the carmakers' shares currently trading at €43, you follow a hunch that they will significantly appreciate in value and therefore opt for a call warrant. However, before you part with your cash, you want to know which warrants are lucrative. This involves looking at various key data on the risk/return profile of these financial instruments. These indicators can give you an idea of not only how much more expensive a warrant on Deutsche Automobil AG shares is than buying the shares directly but also how much the price of your warrant can fluctuate over time. These decisive details are outlined in the following sections. Departing from our petrol station scenario, we would now like to introduce you to the intriguing world of warrant trading on the stock exchange.

3. The basics

3.1 The right warrant for the right investor. The choice is wide and the indicators varied.

It is a well-known fact that investors can make a lot of money with warrants, yet can also suffer considerable losses. Before you venture into this market, you should familiarise yourself with the basics. Warrants are categorised as derivative financial instruments. This means that every warrant is linked to an underlying financial asset. The underlying asset performance is reflected in the price of the warrant according to a given ratio. It is generally only worth buying a warrant if you think the price of the underlying asset is going to move considerably. On the German exchanges, warrants are issued on a variety of underlying assets, such as German and international equities, German and international equity baskets, German and international bonds, bond and share indices, as well as commodities, such as oil or

precious metals. Index warrants, followed by equity warrants, comprise the largest segments with the highest trading volumes. Warrants on European and US equities, in particular, can be found in large supply. Those who want to speculate on the price movements of blue chips listed on say the DAX, the Dow Jones EuroSTOXX 50SM or the Dow Jones Industrial AverageSM, will not be disappointed with a lack of choice. In fact, the maturities as well as strike prices of these instruments are so varied that investors are likely to find exactly what they are looking for.

The direction in which investors expect the price to move will determine whether they buy a call or a put warrant. This is because the owner of a warrant has the right to either buy or sell the underlying (also referred to as the underlying asset) at a certain price (strike price) from or to the issuer within a specified period of time (maturity) according to a certain ratio (exercise ratio) on the capital market, or else receive an equivalent monetary amount (further explanations below). Investors therefore have to decide whether to purchase call warrants (calls) or put warrants (puts). Calls are bought when the price of the underlying is expected to rise, while puts are opted for when the price is expected to fall. The right to sell this underlying at a specified price therefore becomes more valuable the lower its price.

Those in possession of an option have the following three choices: they can either let it expire, sell it or exercise it. Should you decide in favour of exercising your option, you must not forget that there is an important difference between American and European options, namely that you may exercise the former at any time prior to expiration and the latter only on the expiration date. With otherwise identical indicators, European options often sell for less than their American counterparts as the right to exercise at any time presents an unquestionable advantage.

Many warrants are settled nowadays by means of cash settlement rather than physical delivery. Cash settlement was first introduced because physical delivery was not possible for certain warrants, e.g. index warrants – you cannot physically deliver the DAX. Now, however, with the streamlining of settlement procedures, even warrants where physical delivery is possible have a cash settlement feature.

3.2 The value of a warrant

Warrants can have various features in order to accommodate investors' expectations. Below are a number of terms used for these features. The price of a warrant is comprised of the intrinsic value and the time value. The latter is the difference between the warrant price and its intrinsic value. The time value is the consideration payable for the "lifetime" of the option. The longer the time to maturity of the option, the more valuable it is. This is

based on the belief that a change in price of the underlying will lead to an increase in the differential amount achieved up to the expiration date. As the time to maturity of an option decreases, its time value will thus decay at an accelerating rate, ultimately towards zero. The price of the warrant upon expiration will be no more than its intrinsic value. A warrant always has an intrinsic value – also known as parity – if it can be exercised at a profit. This is determined by whether the spot price of the underlying is above or below the strike price. In this instance, a difference is made between options that are in the money, at the money or out of the money.

In the case of out-of-the-money warrants, i.e., with no intrinsic value, the price simply equals the time value. If the option remains out of the money until maturity, the time value will shrink to zero and the option will expire worthless. Out-of-the-money warrants are ultimately a far riskier purchase than warrants with intrinsic value. Warrants that are extremely out of the money and soon due to expire are therefore highly speculative as they carry the highest risk of total loss. These warrants will only yield a profit if the price of the underlying makes a swift and sharp move in the desired direction. The probability of this happening has to be assessed in each individual case.

3.3 The effects of price fluctuations

Price fluctuations are one of the major factors influencing warrant pricing and should therefore be monitored constantly. One of the key premises of modern option pricing theory is that an option will be more valuable the greater the range of price fluctuations or volatility. The reason for this is that the probability of the warrant appreciating in intrinsic value increases the more intensely the price of the underlying fluctuates. As it is possible to make an exact calculation of historical volatility, this is an important indicator for assessing expected volatility and implied volatility, which are both priced into options. Past fluctuations can only ever serve as a guide, however, as the rate of volatility can change very rapidly. All traders have experienced this at some point or another. For example, a surprise profit warning that strips 30 percent off an otherwise conservative or even dull stock has a major impact on the price of calls and puts it underlies.

The nature of these events is that they come as a surprise. All warrant traders look at the historical volatility of options traded at a particular time on the market and draw their own conclusions as to their implied volatility. The latter has a considerable impact on option pricing. Conclusions on the interdependency between the price of a warrant and that of its underlying – expressed in dynamic indicators – can therefore only be applied as long as the market view of implied volatility stays the same.

Buying warrants just before a sharp rise in volatility can prove very lucrative. Let us assume, for example, that you acquire a put on an automotive stock just before the company releases a surprise profit warning. Previously classed as a relative non-mover, the stock then sheds 25 percent overnight. As the owner of that put, you stand to gain not only from the expected fall in the price of the underlying but also from a sharp rise in volatility.

3.4 VDAX – the volatility index

Following the same reasoning, you can also suffer significant losses by buying warrants on financial assets that are extraordinarily volatile. Let us now assume that the price of a share climbs from €100 to €200. You now decide to buy because you expect this strong rally to persist. Instead, the share price remains at the same level for weeks. Although the underlying has not fallen in price, calls on this stock will lose value due to the return to a lower level of volatility. In the worst case scenario, the share price could rise slightly while the calls continue to lose value because of the lower implied volatility. This scenario, of course, is also affected by the loss of time value.

As the level of volatility during bear markets tends to rise faster than in bull markets, the above also applies, and perhaps even to a greater extent, to markets following a crash. The reason for this is that downside trends are often faster and more furious than upside trends. The recognised volatility index VDAX measures the implicit volatility of options trading at the money and due to expire in 45 days. This index is predominantly influenced by the level of volatility expected by market participants.

The volatility of the underlying tends to vary greatly. The implied volatility of the DAX® is therefore always a lot lower than the implied volatility of its individual constituents; one share price goes up, one goes down, ultimately having a balancing effect on the overall volatility of the index.

4. Expensive or not?

4.1 From the wide range of warrants on offer, you now have to select the most suitable and least expensive

What happens if ...? Indicators are important, especially given the fast pace of option trading. You not only have to know what they are, you also have to be able to interpret them. Static indicators facilitate a qualitative price assessment of similar warrants at a given point in time. These indicators should only be used to compare warrants with similar features.

One of the most important indicators when valuing options is the premium. The major advantage of this indicator is that it can be easily calculated, thus providing a quick overview of which warrants are worth investing in. When buying options, the aim is to invest a small amount and then make a proportionally larger gain from any price movements of the underlying. The premium shows (in the case of calls) how much more it would cost to acquire the underlying by exercising the option rather than buying it directly.

Ultimately, however, an option is more valuable the longer its time to maturity and so this indicator, which fails to take this time aspect into account, does not say much at all. A more sensible way of comparing warrants would therefore be to calculate the premium per time unit, usually per year of time to maturity.

But even this annual premium does not quite hit the mark, the reason being that it is not seen in relation to the warrant. It is obvious, for example, that a premium of €1 has to be treated completely differently according to whether the warrant costs €5, €10 or €100. The best way to compare warrants using this indicator is therefore to calculate the percentage premium. This premium shows how much more (in percent) it would cost to acquire the underlying by exercising the option rather than buying it directly, thereby serving as a useful criterion for comparing options.

Asserting that an option is cheaper the lower the premium would nevertheless be too simple. A comparison of warrants is only worthwhile if they have similar maturities and intrinsic values. Generally speaking, warrants with a high intrinsic value have low premiums and warrants with a low or no intrinsic value will only have a premium. A comparison based on the percentage premium serves two main functions. First, it provides investors with a quick and clear overview of which warrants are suitable. Secondly, if they have decided on a particular underlying, it enables them to compare the premiums of warrants with similar maturities and strike prices and then opt for the least expensive.

4.2 Leverage

Arguably the most widely known options indicator is leverage, which shows the extent to which a warrant moves in line with its underlying. Current or simple leverage can be calculated by dividing the price of the underlying by the price of the option. If this ratio deviates from 1.0 or the underlying assets are denominated in a foreign currency (foreign equities), these factors are also priced into the warrants.

Simple leverage is based on the assumption that price movements in the currency units of both the underlying and the option will be equivalent. This assumption, however, does not hold any weight. Let us take the example of a warrant granting the right to buy a share that is trading at €100. The strike price is say €200, and the option is set to expire in two months. The warrant costs €1, producing a simple leverage ratio of $100 \div 1 = 100$. According to this ratio, a 10 percent rise in the price of the share to €110 would lead to a 1,000 percent rise in the price of the warrant to €11. In practice, however, this would never happen as the share price would still be a long way off the strike price of €200. If the share fails to move “into the money” within the space of two months, i.e., rises above €200, the option will expire worthless. This ratio is therefore only ever applicable to options with a high intrinsic value and not at all for those without any. It is for this reason that elasticity – also referred to as the omega – is mainly used nowadays.

Another key indicator is the break-even point, which shows the price level of the underlying at which the owner of the warrant will make a profit. Taking the example of a warrant costing €1, a strike price of €200 and an exercise ratio of 100:1, the share price would have to exceed €300 in order for the investor to make a profit.

5. Dynamic indicators

5.1 Alongside static indicators, dynamic indicators also provide key information on warrants.

Dynamic indicators reflect changes in the price of an option relative to changes in the price, maturity or volatility of the underlying. As opposed to their static counterparts, they allow investors to make a forecast of the future price movements of warrants from a specific point in time and are generally determined using option valuation models. They are only valid for a short period of time and must be recalculated every time any key influential factor changes.

5.2 Delta

One of these indicators is the delta, which belongs to the family of modern valuation indicators otherwise known as the “Greeks” because they are named after letters of the Greek alphabet. In modern option pricing theory, this indicator represents the sensitivity of the price of a warrant to the price movements of the underlying. The delta is calculated exactly using option valuation models derived from financial theory. The delta of a call warrant may lie between 0 and 1, and for a put warrant between –1 and 0. A

delta of 0.70 means that, at an exercise ratio of 1:10, a €1 rise/fall in the price of the underlying would lead to a €0.07 rise/fall in the price of the warrant. It can also be used as a rough guide to whether the option will have intrinsic value upon maturity and therefore not expire worthless. The probability that the above warrant will not expire worthless is therefore 70 percent. In mathematical terms, the delta is the first derivative of the warrant price with respect to the price of the underlying.

5.3 *Omega*

Elasticity, which shows the percentage change in the price of the warrant relative to the percentage change in the price of the underlying, has also been represented by a Greek letter, namely omega. It is obtained by multiplying the delta by the leverage ratio. The omega serves as a useful indicator yet, due to the fact that the delta changes with time, can only provide investors with a snapshot view.

Over the past decades, dynamic indicators have been used to develop a series of option price valuation models. Along with the binomial model, the fair value model, devised by the American mathematicians Fisher Black and Myron Scholes, has drawn particular attention. Using the Black-Scholes Model, which was named after its originators and later further developed, it is possible to calculate the “fair value” of an option. This value refers to the theoretically justified value at which there is an equal probability of making a profit or a loss. Unfortunately, valuation models such as these are founded upon basic assumptions that do not often hold true in real options markets. These assumptions include a constant interest rate, which is the same for credit and debit interest, and no constraints on short selling. Despite its flaws, however, the Black-Scholes Model has opened up a new perspective on the valuation of options. As a detailed discussion of this model is beyond the scope of this brochure, we have included a list of recommended literature in the appendix that addresses this subject in great detail.

5.4 *Theta*

We have already mentioned that the price of an option is comprised of its intrinsic and its time value, and that the closer the expiration date, the faster the time value erodes. The theta measures the loss of time value per unit of time, e.g. per day or week, assuming that the price of the underlying, along with all other parameters, remain the same until expiration. This indicator is usually shown as a percentage. A weekly theta of 1.5 percent means that, providing the underlying price moves sideways, i.e., the intrinsic value remains constant, the option will lose 1.5 percent of its value every week. The theta is very much dependent on whether the option is in the

money, at the money or out of the money. A warrant with a high intrinsic value will have the lowest theta. At-the-money options will experience the fastest loss of time value as they move towards their expiration date. Generally speaking, the time value of a warrant will erode the most during the last three months until maturity.

Investors must be constantly aware of this loss of value, which is solely attributable to the decreasing time to maturity. The closer a warrant gets to its expiration date, the greater the price movement in the direction predicted by the investor must be in order both to offset the ever growing loss of value and ultimately generate a profit. In mathematical terms, the theta is the derivative of the warrant price with respect to time.

5.5 Gamma

Another key indicator is the gamma, which defines the sensitivity of the delta to changes in the price of the underlying. The higher the gamma, the greater the reaction of the delta to such price movements. A gamma of 0.02 means that if the price of the underlying rises or falls by €1, the delta will change by 0.02 units. Options trading at the money have the highest gammas. Furthermore, the gamma is higher the shorter the time to maturity of the option. Mathematically speaking, the gamma is the first derivative of the delta with respect to the price of the underlying and therefore the second derivative of the price trend of the option in relation to the price movements of the underlying.

5.6 Vega

The vega shows the influence of fluctuations in volatility of the underlying on the price of the warrant. You will remember that volatility is the range of fluctuations in the price of the underlying within a given period of time. Along with the price of the underlying, the vega is the most important factor that can influence the value of an option. This indicator measures the degree to which the price of the warrant moves when the implied volatility rises or falls by one percent. A vega of 0.25 means that if the volatility of the underlying changes by one percent, the value of the option will rise or fall by 0.25 currency units, adjusted for the exercise ratio. As is the case with the gamma, options trading at the money have the highest vegas. In contrast to the gamma, however, the vega is higher the longer the time to maturity of the option. From a mathematical perspective, the vega is the first derivative of the warrant price with respect to volatility.

5.7 Rho

The rho is the indicator used to measure the influence of interest rate changes on the value of options. When pricing options, the forward rather than the spot price is used. The forward price is comprised of the spot price plus a factor known as the costs of carry. This factor can be defined as the total costs of financing the underlying until the agreed expiration date of the option. These costs are affected mainly by the interest rate level. A rho of 0.50 means that the option price – adjusted for the exercise ratio – will change by €0.50 if the domestic interest rate rises or falls by one percentage point. When trading in currency options, the foreign interest rate must also be factored in. Euro/US dollar warrants, for example, have two rho indicators – one for the euro interest rate and one for the dollar rate. As extreme short-term interest rate fluctuations are very rare, however, the rho can often be disregarded for most other options. In mathematical terms, the rho is the derivative of the warrant price with respect to the interest rate.

6. Types of warrants

6.1 Underlying assets come in all shapes and sizes

Warrants can be acquired on various types of underlying and investors can use these derivatives to speculate on indices, equities, baskets, currencies, interest rates and commodities.

6.2 Index warrants

Index warrants are based on the performance of share or bond indices. In the case of bond indices, the German REX bond index plays a key role. The most popular underlying in this market segment, however, is the DAX, i.e., the German share index containing the top 30 German stocks. Warrants on the American S&P 500, the Nasdaq 100, the Euro STOXXSM as well as the Japanese Nikkei 225 indices also attract investor interest, as do a small number of warrants based on other major foreign indices, such as the Austrian ATX, the UK's FTSE 100, France's CAC-40 or the China/Hong Kongbased Hang Seng.

6.3 Equity warrants

The lion's share of these warrants is based on single stocks. Calls and puts can be acquired on national and international equities with various strike prices and maturities, although liquid stocks are always a favourite.

6.4 Basket warrants

Warrants on sector indices, such as the sub-indices of the DAX or the Dow Jones Euro STOXXSM, also have their appeal. These warrants show parallels to index warrants in that they offer investors the opportunity to speculate on the performance of a sector as a whole. Their underlying consists of an equity basket. This basket is, of course, not put together at random; the stocks all have a common denominator in that they may all belong to the same sector or originate from the same country, or both. A suitable example would be a German automotive basket containing BMW, DaimlerChrysler, VW and perhaps even Porsche stocks. Basket warrants therefore give investors the chance to speculate on sector trends or the performance of a particular equity market rather than on single stocks. Investors who forecast a flourishing automotive industry and yet are unsure which stocks are going to fare best can buy a basket warrant and benefit from upside across the whole sector. The same applies to the downside, as basket warrants also come in the put variety.

6.5 Currency warrants

A further market segment consists of currency warrants. These derivatives enable investors to speculate on the performance of the euro in relation to foreign currencies. The US dollar is by far the most important currency in this segment, although warrants do exist on the Swiss franc, the Swedish krona, the British pound, the Japanese yen and the Canadian and Australian dollars. In addition, warrants can be bought for exchange rate changes between two foreign currencies, such as the US dollar and the Japanese yen. It goes without saying that there are also a large number of puts on offer that can be used to speculate on the weakness of a particular currency or to hedge against currency losses. This can prove vital if you own foreign stocks or are owed a sum of money in a foreign currency. Note: you would buy a euro/US dollar call if you predicted that the euro was going to strengthen against the US-dollar and a euro/US dollar put for the reverse scenario.

6.6 Warrants for global markets

The smallest segment of the options market consists of commodity warrants. The most popular and virtually exclusive underlying assets are gold and silver, measured in troy ounces (31.1035 grams). Investors who predict that the price of gold will shoot up quickly can achieve a far higher return on commodity warrants than gold coins or mine stocks. Warrants with bonds as their underlying are known as bond warrants. These derivatives can be used to speculate on the downside or upside potential of fixed-income securities

and thus also on a change in the general level of interest rates on the capital markets. The German term Zinsoptionsschein (interest warrant), however, is a little misleading as when you buy an equity call, you predict that the share prices are going to rise, whereas when you buy a bond call, you believe that the price of bonds is going to rise and are therefore speculating on a fall and not a rise in interest rates. As bonds are more sensitive to interest rate changes the longer their time to maturity, bond warrant buyers must not only consider the maturity of the warrant but also that of the underlying. This problem does not exist for equity warrants, whose underlying assets do not have a limited lifespan. The principal underlying assets of bond warrants traded in Germany are Bunds and US Treasury Bonds.

7. Conclusion

Warrants are placed by issuers, i.e., banks, financial services providers, savings and loans and financial institutions. The purchase of an option creates a debt obligation between the investor and issuer, similar to the situation with bonds. Warrants have a limited, predetermined maturity, usually between six months and two years. The majority of warrants traded on the market forgo the delivery or acceptance of the underlying at the end of the maturity in lieu of a cash settlement. When the warrant can be exercised at any point during the entire maturity period, it is known as the American variation; if this is possible only at the end of the maturation period, then it is known as the European variation.

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IMPACT OF EUROPEAN STRUCTURAL FUNDS FOR THE FUTURE DEVELOPMENT OF ROMANIA

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Abstract

European structural funds are important resources for the development within the countries of European Union. The EU funds are serving main goals that are oriented to the general economic develop at local, regional and national level. The major priority of the European Structural Funds and of the political cohesion promoted the UE is applying a balanced development and its purpose is decreasing the differences between various areas. The second priority has as purpose to revitalize all the areas with deficient structure (industrial, rural, urban). The activity of the European Structural Funds is based on 4 principals: focusing on the priorities; the implementation steps which is the result of several years lasting programs; the partnership which implies a close collaboration between Commission and the corresponding authorities at the national, regional and local level, in every member state from the preparing steep to the rules implementation; the subsidiary which means that it is up to the management authorities named by member States, to select the project which will get the finance and to supervise their implementation. Romania institutions are hardly working in order to prioritize the direction of strategic development. The process is very complex one and will assure the proper use of the funds after the well and long expected integration in EU.

Keywords: *structural funds, strategic development, EU integration process*

1. Introduction

The Structural Funds are 4 financial instruments at countries disposal addressed to specific sectors that have been considered relevant for the social and economic development of European Union. They are: European Regional Development Fund(EDRF)- mainly finances infrastructure, job-creating investments, local development so measures, Small and Medium Enterprises development; European Social Fund(ESF) – is oriented to co-finance training and capacity building measures and systems fostering recruitment and employment; Financial Instrument for Fisheries Guidance(FIFG) – it includes measures financing the modernization of fishing industry especially in region where this sector is affected by recession; European Agricultural Guidance and Guarantee Fund(EAGGF) – the guidance section of this Fund finances rural development measures.

2. The European Social Fund and the Cohesion Fund

2.1. The European Social Fund

The European Social Fund (ESF) contributes to the economic and social cohesion objective set in article 158 of the EC Treaty, by supporting policies and priorities aimed to achieve progress towards full employment, improve quality and productivity at work, and promote social inclusion and cohesion, in line with the guidelines and recommendations under the European Employment Strategy (EES).

In order to achieve this objective, the ESF needs to address three major challenges: addressing the considerable employment disparities, social inequalities, skills gaps and labour shortages in an enlarged Union; an increasing pace of economic and social restructuring due to globalization and the development of the knowledge-based economy; and demographic changes, which have resulted in shrinking and ageing workforce.

The mission on the European Social Found

The ESF shall strengthen economic and social cohesion by supporting Member States' policies aiming to achieve full employment, improve quality and productivity at work and promote social inclusion and the reduction of regional employment disparities. In particular, the ESF shall support action in line with the guidelines and recommendations adopted under the European Employment Strategy.

In carrying out the tasks referred to in paragraph 1, the ESF shall support the priorities of the Community as regards the need to reinforce social cohesion, strengthen competitiveness and promote environmentally

sound economic growth. In particular, it shall take into account the objectives of the Community in the fields of social inclusion, education and training and equality between women and men.

Scope of assistance

1. Within the framework of the convergence and the regional competitiveness and employment objectives, the ESF shall support action under the following priorities:

- a) increasing adaptability of workers and enterprises, in particular by promoting:
 - increased investment in human resources by enterprises, especially SMEs, and workers, through the development and implementation of lifelong learning systems and strategies which ensure improved access to training of low skilled and older workers, transparency of qualifications and competences, dissemination of ICT and management skills and the promotion of entrepreneurship and innovation;
 - the anticipation and positive management of economic change, notably through the design and dissemination of innovative and more productive forms of work organization, including better health and safety, the identification of future occupational and skills requirements, and the development of specific employment, training and support services to workers in the context of company and sector restructuring.
- b) enhancing access to employment of job seekers and inactive people, preventing unemployment, prolonging working lives and increasing participation in the labour market of women and migrants, in particular by promoting:
 - the modernization and strengthening of labour market institutions, in particular employment services;
 - the implementation of active and preventive measures ensuring early identification of needs and personalised support, job search and mobility, self-employment and business creation;
 - specific action to increase sustainable participation and progress of women in employment, to reduce gender-based segregation in the labour market including by addressing the roots of the gender pay gaps, and to reconcile work and private life including by facilitating access to childcare and care for dependent persons;
 - specific action to strengthen the social integration of migrants and increase their participation in employment, including guidance and language training and validation of competences acquired abroad.
- c) reinforcing social inclusion of people at a disadvantage and combating discrimination, in particular by promoting:
 - pathways to integration in employment for disadvantaged people, people experiencing social exclusion, early school leavers, minorities and people

- with disabilities, through employability measures, including in the field of the social economy, accompanying actions and relevant social support and care services;
- diversity in the workplace and the combat against discrimination in accessing the labour market through awareness-raising and the involvement of local communities and enterprises.
- d) mobilizing for reforms in the fields of employment and inclusion, in particular by promoting the development of partnerships and pacts through networking of relevant stakeholders at national, regional and local level.
2. Within the framework of the convergence objective the ESF shall also support action under the following priorities:
- a) Expanding and improving investment in human capital, in particular by promoting:
- the implementation of reforms in education and training systems, especially with a view to raising their responsiveness to the needs of a knowledge-based society, improving the labour market relevance of initial education and training and continually updating of skills of teaching and other personnel;
 - increased participation in education and training throughout the lifecycle, including through action to achieve a significant decline in early school leaving and increased access to initial vocational and tertiary education;
 - the development of human potential in research and innovation, notably through post-graduate studies and training of researchers and related networking activities between universities, research centres and enterprises.
- b) Strengthening institutional capacity and the efficiency of public administrations and public services at national, regional and local level to embrace reforms and good governance especially in the economic, employment, social, environmental and judicial fields, in particular by promoting:
- good policy and program design, monitoring and evaluation, through studies, statistics and expertise, support to interdepartmental coordination and dialogue between relevant public and private bodies;
 - capacity building in the delivery of policies and programs, including with regard to the enforcement of legislation, especially through managerial and staff training and specific support to key services, inspectorates and socio-economic actors including social partners and relevant non-governmental organizations.
3. In implementing the objectives and priorities, the ESF shall support the promotion and mainstreaming of innovative activities as well as trans-national and inter-regional cooperation in particular through sharing of

information, experiences, results and good practices, and through developing complementary approaches and coordinated or joint action.

4. In implementing the social inclusion priority, the financing by the ESF of actions within the scope of the Regulation (EC) may amount to a maximum of 10% of the priority axis concerned.

The Member States and managing authorities shall ensure that the action supported by the ESF is consistent with and underpins the implementation of the European Employment Strategy. In particular, they shall ensure that the action set out in the strategic frame of reference and in the operational programs promote the objectives, priorities and targets of the Strategy in each Member State and concentrate support in particular on the implementation of the employment recommendations made under Article 128 of the Treaty as well as of the relevant objectives of the Community in the field of social inclusion.

Within operational programs, resources shall be directed towards the most important needs and focus on those policy areas to which ESF support can bring about a significant effect in view of the attainment of the objectives of the program. To maximize the efficiency of ESF support, operational programs shall take particular account of the regions and localities facing most serious problems, including deprived urban and declining rural and fisheries dependent areas.

The relevant elements of the Member States' annual report referred to in Article 19 of regulation (EC), shall be integrated respectively in the corresponding national action plans for employment and national action plans for social inclusion.

The quantified objectives and indicators selected to monitor the implementation of the national strategic frame of reference, shall be those used in the implementation of the European Employment Strategy and in the context of the agreed objectives of the Community in the fields of social inclusion and education and training. The monitoring indicators of operational programs should be coherent with these quantified objectives.

Evaluations undertaken in relation to the action of the ESF shall also assess the contribution of the action supported by the ESF to the implementation of the European Employment Strategy and to the objectives of the Community in the fields of social inclusion and education and training in the Member State concerned.

The ESF shall promote good governance and partnership. Its support shall be designed and implemented at the appropriate territorial level, with particular attention to the regional and local level, according to the institutional arrangements specific to each Member State.

The Member States and the managing authority of each operational program shall ensure the involvement of the social partners and adequate

consultation of nongovernmental stakeholders, at the appropriate territorial level, in the programming, implementation and monitoring of ESF support.

The managing authorities of each operational program shall encourage adequate participation and access of social partners to the activities funded under Article 2 of this Regulation. Under the "Convergence" Objective, at least 2% of the ESF resources shall be allocated to capacity-building and activities jointly undertaken by the social partners, in particular as regards adaptability of workers and enterprises.

The managing authority of each operational program shall encourage adequate participation and access of non-governmental organizations to the funded activities, notably in the domain of social inclusion and equality between women and men. When responsibility for implementation is delegated, support in the framework of a program may be provided through global grants.

The Member States and the managing authorities shall ensure that operational programs include a description on how gender equality is promoted in the programming, implementation and monitoring including any specific indicators, and in the evaluation.

In the framework of each operational program, Member States and managing authorities shall pay particular attention to the promotion and mainstreaming of innovative activities. After consulting the Monitoring, the managing authority shall choose the themes for the funding of innovation and shall define the appropriate modalities of implementation. The Member States and managing authorities shall ensure that programming of transnational and inter-regional co-operation activities takes the form of a specific priority axis within an operational program or a specific operational program. The Member States shall ensure coherence and complementarity between the action of the Fund and actions supported through other Community trans-national programs, in particular in the field of education and training, through appropriate co-ordination mechanisms, to optimise the use of Community resources in support of education and life-long learning.

The Commission shall promote in particular exchanges of experiences, awareness raising activities, seminars, networking and peer reviews to identify and disseminate good practices and encourage mutual learning with the aim of enhancing the policy dimension and contribution of the ESF to the objectives of the Community in relation to employment and social inclusion. The annual and final implementation reports shall contain a synthesis of the implementation of:

- gender mainstreaming as well as of any gender specific action;
- action to strengthen social integration and employment of migrants;
- action to strengthen social integration and employment of minorities;

- innovative activities, including a justification of the themes selected for innovation, a presentation of their results and of their dissemination and mainstreaming;
- trans-national and inter-regional co-operation activities.

The ESF shall provide support towards public expenditure which takes the form of non-reimbursable individual or global grants, reimbursable grants, loan interest rebates and micro-credits and the purchase of goods and services through public tenders.

The following expenditure shall not be eligible for ESF support:

- (a) Reimbursable VAT;
- (b) Interests on debt;
- (c) Purchase of infrastructure, depreciable movables, real estate and land.

Notwithstanding national eligibility rules, the expenditure declared under the operational programs co-financed by the ESF can include:

- the allowances or salaries disbursed by a third party to the benefit of them participants in an operation and certified to the beneficiary, on condition that such disbursements constitute the national public co-financing to the operation, in conformity with national rules in force.
- the indirect costs of an operation fixed on a flat-rate basis, up to 20 % of the direct costs declared for this operation, according to the type of operation, the context in which it is implemented and its location.

The links between the Community financial instrument and the Union's policy framework need to be reinforced in the future programming period to better contribute to the employment objectives and targets of the Lisbon strategy. To this end, the ESF should support the policies of Member States which are closely in line with the guidelines and recommendations made under the European Employment Strategy and the agreed objectives of the Union in relation to social inclusion and education and training.

The draft ESF Regulation for 2007-2013 provides a focussed framework for ESF interventions throughout the Union. Under both the 'Convergence' and the 'Regional Competitiveness and Employment' objectives, the ESF will provide support with a view to anticipating and managing economic and social change. Its intervention will focus on four key areas for action endorsed by the European Council: increasing adaptability of workers and enterprises; enhancing access to employment, preventing unemployment, prolonging working lives and increasing participation in the labour market; reinforcing social inclusion by promoting the integration in work of disadvantaged people and combating discrimination; and promoting partnership for reform in the fields of employment and inclusion.

In the least prosperous regions and Member States, the Funds will concentrate on promoting structural adjustment, growth and job creation. To this end, under the Convergence objective, in addition to the above-

mentioned priorities, the ESF will also support action to expand and improve investment in human capital, in particular by improving education and training systems, and action aimed at developing institutional capacity and the efficiency of public administrations, at national, regional and local level.

Furthermore, the proposal gives a greater emphasis to the Union's commitment towards the elimination of inequalities between women and men: specific actions addressed to women are combined with a robust gender mainstreaming approach, to increase participation and progress of women in employment.

Equally, the promotion of innovative activities and trans-national co-operation will be fully integrated in the scope of the ESF, and mainstreamed within the national and regional operational programs. Under both the 'Convergence' and the 'Regional Competitiveness and Employment' objectives, the ESF will give priority to funding trans-national cooperation, including exchanges of experiences and best practices across the Union and joint actions, ensuring where appropriate, coherence and complementarity with other trans-national Community programs.

Finally, the proposal attaches a particular importance to the promotion of good governance. The involvement of the social partners is of particular importance in the programming and implementation of the Fund priorities and operations. To this end, under the new Convergence objective, social partners will be encouraged to actively participate in capacity building actions and to undertake joint activities in the policy areas where they play a decisive role.

2.2. *The Cohesion Fund*

The Cohesion Fund is enshrined in article 161, paragraph 2, of the treaty, with the objective of contributing financially to interventions in the field of the environment and the trans-European networks. Regulation (EC) No 1164/94 established the Cohesion Fund, and, for the first time, provided a framework for its implementation. This regulation was subsequently complemented by Regulations (EC) No 1264/99 and (EC) No 1265/99. Following the Union's enlargement on May 1st 2004, the Cohesion Fund applies to the 10 new Member States until the end of 2006, as well as to the three Member States eligible at the end of the 2000-2006 period (Greece, Portugal and Spain).

Creation and purpose of the Cohesion Fund:

- A Cohesion Fund (hereinafter: the Fund) is hereby set up for the purpose of strengthening the economic, social and territorial cohesion of the Community in the interests of promoting sustainable development.

- The Fund shall contribute to the financing of programs, which support the objectives set out in the Treaty.
- The Fund is governed by the provisions of Regulation (EC) and by the provisions of this Regulation

Regulation (EC) lays down the general provisions for the functioning of the structural funds and the Cohesion Fund for the programming period 2007-2013. It envisages that the Cohesion Fund contributes to the convergence of less developed Member States and regions through financial participation in the operational programs of this convergence objective.

Under the reform of the implementation system of cohesion policy, Cohesion Fund interventions are integrated into the multi-annual programming of the structural funds, including major projects. The reform was announced in the third cohesion report, which was adopted by the Commission in February 2004. While maintaining the fundamental principles which underlie the value of the policy (multi-annual programming, partnership, evaluation, shared management), this reform provides a balance between an increased strategic component, and a simplification of the implementation system. Simplification notably occurs through the reduction in the number of funds, simplified programming, a clarification of the roles of the Commission and the Member States in terms of financial management and control, and by adapting the implementation modalities to reflect the intensity of the community contribution.

In the field of trans-European transport networks, actions financed by the Cohesion Fund must follow the guidelines for these networks, which were adopted by the Council in revised decision (EC) 1692/96. In the environmental field, the Cohesion Fund contributes to achieving the Union's policy objectives envisaged under article 174 of the treaty.

An extension of the domains of intervention is justified by the accession of new Member States on May 1 2004, all of which are eligible to the Cohesion Fund, and which face new and important financing needs. Thus the Cohesion Fund can also finance actions in support of sustainable development, where these have a clear environmental dimension, such as energy efficiency or renewable energy. Beyond the trans-European transport networks, this also allows for financing of rail, navigable maritime and river waterways, multi-modal transport actions and their inter-operability, road and air traffic management, clean urban transport, and communal transport. This extension of the domain of interventions is in accordance with the corresponding provisions in the treaty, and is in line with the priorities decided by the European Council in Lisbon (March 2000) and Gothenburg (June 2001).

The aim of this regulation is to specify the tasks of the Cohesion Fund, and its specific application, in particular regarding the conditionality of assistance and the fields of intervention of the Fund.

Member States benefiting from the Cohesion Fund must conform to the conditions set out in the treaty regarding convergence programs and those regarding excessive deficits for the Member States participating in economic and monetary union. Assistance under the Cohesion Fund is conditional upon the satisfaction of these conditions. If the Council decides, on the basis of a Commission proposal, that an excessive deficit exists and that the Member State concerned has not taken effective action, the payment will be suspended, effective from January 1 of the following year. The suspension ceases, when the Council decides, on the same basis, that the Member State concerned has taken the measures necessary to allow a return to a situation that is in accordance with the Treaty and with the Council decisions.

3. Impact of European Structural Funds for the future development of Romania

For Romania the regulations for the implementation of structural funds are:

- The Regulation of the Commission (CE) No. 438/2001 from 2nd of March 2001 which establishes detailed rules for the implementation of the Regulation of the Council (CE) No. 1260/1999 concerning the administration and check systems within the framework of the Structural Funds [Official Journal L63 from 03.03.2001].
- The Regulation of the Commission (CE) No. 448/2001 from 2nd of March 2001 which establishes detailed rules for the implementation of the Regulation of the Council (CE) No. 1260/1999 concerning the procedure for the realization of the financial corrections for the assistance within the framework of the Structural Funds [Official Journal L64 from 03.06.2001].
- Regulation (CE) No. 1059/2003 of the European Parliament from 26th of May 2003 concerning the establishment of a common classification of the Territorial Units for Statistics (NUTS) [Official Journal L154 from 06.21.2003]

The Operational National Program (ONP) 2007-2013 in Romania based on:

- National Strategy for the Regional Development and Sectorial Strategies of PND 2007-2013 (at national level)
- Regional Documents for Programming and Implementation (DRPI, at regional level)

The structures of the ONP are:

- Analysis of the existing situation and strategy

- Priorities and Measures
- Coherence and concordance of the strategy
- Financial programming
- Implementation

For Romania as areas of stipulated interventions are:

- Development of the regional and local infrastructure: transport infrastructure, environment infrastructure, power infrastructure, social infrastructure, urban rehabilitation
- Business support: the support of the micro-enterprises and SMEs development (start-ups), business infrastructure development (industrial, technological, scientific parks, etc.), consulting and formation for SMEs
- Tourism support : tourism infrastructure, tourist services improvement, tourist marketing development
- Rural development support: diversification of the economic activities in rural environment, development of the rural infrastructure
- Support of the research, development, innovation and information society: support of the technological transfer to SMEs, development of the innovation capacity of the SMEs, development of the communication between the university environment and SMEs

Financial package proposal for Romania for 2007- 2013 is:

- Agriculture
 - Market measures – 732 millions euro
 - Direct payment – 881 millions euro
 - Rural development – 2 424 millions euro
- Structural and cohesion funds – 5 973
- Internal politics - 765,8 millions euro
- Administrative expenses - 242,2
- Total of engagements: about 11 millions euro
- Total of payments: about 6,3 millions euro

At European level for the cohesion fund is allocated a sum of 344 billions euro, representing about 0,41% community GIP. For Romania between 2007 and 2009 will be allocated about 6 billions euro, and for the same period 2010 and 2013 are anticipated maxim 4% from the Romanian GIP on a year.

Should be considered that the structural and cohesion funds:

- Are co-financed from the national budget
- The sums allocated in the year n should be spent gradually till n+2
- The sums afferent to the structural funds are financed from the EU budget until maxim 75% from the project's value
- The sums afferent to the cohesion funds are financed from the EU budget until 85% from the project's value

For 2007-2013 Romania proposes as eligibility on those two objectives as follows:

- ❑ Convergence objective: Romania will be eligible with the whole territory (eight development regions NUTS II) for the cohesion policies 2007-2013:
 - Regional GDP per capita under 75% from community GDP average;
 - FC (GIR under 90% from community GIR average);
- ❑ European Territorial Cooperation Objective:
 - Trans-frontier cooperation (regions NUTS III longway the external and internal frontier)
 - Trans-national cooperation
 - Inter-regional cooperation

4. Conclusion

Development Fund, the European Social Fund and the Cohesion Fund, establishes the framework for the action of the Structural Funds and the Cohesion Fund. It fixes, in particular, the objectives, the principles and the rules concerning partnership, programming, evaluation and management. It is therefore necessary to specify the mission of the Cohesion Fund in relation to this new framework and to the purpose assigned to it in the Treaty and to repeal, for the sake of clarity, Council Regulation (EC) No 1164/94 of 16 May 1994 establishing the Cohesion Fund.

Trans-European network projects financed from the Cohesion Fund must fit the guidelines for these networks adopted by the Council and the European Parliament. The Community may, through the Cohesion Fund, contribute to action in pursuit of the Community's environmental policy objectives specified in Article 174 of the Treaty. Under Article 175 of the Treaty and without prejudice to the principle that the polluter should pay, the Council can decide, in the case of measures on the basis of paragraph 1 of that Article which are deemed to involve disproportionate costs for the public authorities of a Member State, that the measure is to be aided from the Cohesion Fund.

Granting of assistance from the Cohesion Fund must take due account of the priorities of the enlarged Union, in particular those set by the Göteborg European Council on the environment in the interests of sustainable development. Regulation (EC) provides that eligibility of expenditure is to be established at national level, with certain exceptions, for which it is necessary to lay down specific provisions. The exceptions concerning the Cohesion Fund should therefore be laid down.

Conditionality provisions in the granting of financial assistance will continue to apply in conjunction with the fulfilment of the conditions of economic convergence as set out in article 104 of the Treaty and the need for

sound government finances. In this respect, Member States participating in the Economic and Monetary Union are to implement stability programs and non participating Member States convergence programs.

Romania institutions are hardly working in order to prioritize the direction of strategic development. The process is very complex one and will assure the proper use of the funds after the well and long expected integration in EU.

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