

# Bančni vestnik

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# Banking sector recapitalisation, corporate sector leverage and ways out in Slovenia

*Boštjan Jazbec\**

**T**he global financial crisis has hit Slovenia particularly hard and the country continues to face difficult times. The protracted decline in economic activity and a relatively weak recovery have their roots in the pre-crisis boom period. Economic growth during the pre-crisis period was fuelled by excessive borrowing and risk taking by banks and enterprises.

The onset of the crisis in 2008 soon drained away external financing. Slovenia was caught in a vicious cycle of reduced credit availability, deleveraging, a cutback in corporate investment and output, and soaring non-performing loans. The balance sheets of both banks and the corporate sector were impaired, causing a balance-sheet recession.

Balance sheet recessions usually fail to respond to traditional demand management measures. This is because the monetary policy transmission channel is impaired by the weak balance sheets of banks and the corporate sector, and credit demand is weighed down by corporate debt overhang. Thus, policies need to go beyond their traditional focus on the business cycle. Repairing the balance sheets of both the banking sector and corporate sector is a priority for unlocking credit growth and promoting output growth. The Bank of Slovenia, in cooperation with the government, has embarked on restructuring the banking sector with the objective of creating well-capitalised and profitable banks that perform financial intermediation efficiently, practice good governance and do not indulge in credit exuberance seen during the boom years.

Based on the findings of a comprehensive asset quality review and stress tests in late 2013, balance sheets of five banks have been repaired through recapitalisation and transferring non-performing loans to the Bank Asset Management Company. Five banks were also instructed to increase their capital from private sources within specific time periods in 2014. For the cases where private funding sources do not materialise, the commitment by the state to implement state aid measures will be realised. The rehabilitation strategy also involves bank resolution through liquidation, consolidation and privatisation.

Bank rehabilitation is only a necessary condition for unlocking credit growth to the Slovenian economy. Successful corporate restructuring is also essential to lay the foundation for productive investment and strong employment creation. Slovenian enterprises remain overleveraged, both when compared to their euro area peers and historical trends. Unless enterprise restructuring is undertaken decisively in a timely fashion, the capital buffer of banks created by the recent recapitalisation will erode and further injections will be needed once again. The enabling legislative framework for enterprise restructuring is in place, but systematic restructuring is yet to begin. This should be given priority by the new government. A decision must be made with regard to the most urgent restructuring cases.

A critical constraint that Slovenia faces is the availability of funding for corporate restructuring and increasing investment activities. The feasibility of using state resources for these purposes is limited because further increases in the size of the already large public debt would threaten debt sustainability. Therefore, privatisation and entry of private investors should be the key vehicles for the required non-debt capital infusion. An appropriate business environment has to be created to facilitate this. Steps should be taken to ease regulatory and other barriers that inhibit investment. To sum up, putting the economy back on track will require a coherent, integrated national strategy to restore the health of the financial sector, restructure the corporate sector, and sustainability of the public finances. The economic recovery must be based on equity-financed investment and not on debt-financed investment. Successful and timely policy implementation will require political determination and social consensus. Government agencies and stakeholders will have to coordinate their policies in order to adopt comprehensive implementing measures designed to reverse the downturn of the economy. In the absence of a determined follow-through on resolution policies, the fragile economic recovery will stall and problems will intensify.

\* Boštjan Jazbec, Governor of the Bank of Slovenia.

# Flow-of-funds perspective on unconventional monetary policy

*Bernhard Winkler\**

## FLOW-OF-FUNDS PERSPECTIVE ON UNCONVENTIONAL MONETARY POLICY

This paper looks at central banks' unconventional monetary policies via the use of their balance sheet capacity through the lens of the sectoral framework offered by the financial accounts (financial flows and balance sheets). Consistent with the traditional monetarist and portfolio balance channels of monetary transmission our approach suggests a taxonomy of standard and non-standard measures by issuing (debtor) sector as well as by counterpart (holding) sector, while distinguishing lending versus outright operations, the maturity and the degree of liquidity of instruments. The paper illustrates the impact of measures on bank lending and non-bank credit in the case of the euro area's bank-based financial system, including some comparison with the US. The relevance of a broad range of financing sources of corporates is recalled, including trade credit and intercompany loans.

JEL: E02, E40, E50, E58

Central banks around the world have employed a wide range of unconventional monetary policy measures in response to the financial crisis that erupted in 2007-2008. These measures resulted in large changes in their balance sheet size and composition and can be seen to serve two kinds of purposes: (1) imparting additional monetary stimulus once the standard tool of setting short term policy rates has reached the lower bound, (2) addressing impairments in the monetary transmission mechanism (such as disruptions in segments of financial markets or blockages in the bank lending channel). In both cases the central bank's balance sheet capacity is employed, either directly via size and composition or indirectly as a backstop, as set out in Cour-Thimann and Winkler (2014).

## I. Introduction

When the lower bound on the standard (short-term) policy rates is approached, the distinction between actions aimed at supporting monetary policy transmission of a given monetary policy stance vs. altering the stance, e.g. by activating additional transmission channels, becomes increasingly blurred. When standard monetary policy has reached its limits and/or turns to "balance sheet policies" when regular monetary transmission is impaired, financial markets are malfunctioning or segmented, there is a need to look at quantities over and above any information conveyed by market prices and interest rates.

\* Bernhard Winkler, Senior Adviser, Directorate Monetary Policy, European Central Bank. Views expressed are those of the author and should not be attributed to the European Central Bank. Valuable contributions and comments from Philippine Cour-Thimann, Philippe de Rougemont and Celestino Giron are gratefully acknowledged. The paper draws in part on Cour-Thimann and Winkler (2012, 2014)

Hence, the flow-of-funds framework, comprising both financial flows and balance sheets, seems well suited to help our understanding of unconventional monetary policies, as well as conventional policies, in such circumstances. This contrasts with most of the New-Keynesian literature and central bank practice in normal times, typically focusing analysis on the transmission via interest rates and rate expectations.

From a flow-of-funds perspective, central bank actions in crisis times can be broadly interpreted as mobilizing the economy's "balance sheet of last resort", comprising the classical lender of last resort (offering liquidity to solvent banks), the "intermediary of last resort" (substituting or backstopping intermediation between private borrowers and lenders) and the related function of the "market-maker of last resort" (in fostering activity and price formation in markets where private activity has dried up). These three functions relate to a "flow" perspective on the lender of last resort in bridging disrupted monetary transmission. From a "stock" perspective the central bank puts to use its balance sheet capacity as the "leverage-provider" of last resort and/or as "insurer" / "risk-taker" of last resort (in the case of contingent use of its balance sheet), where the central bank can counteract adverse developments by providing liquidity to support asset prices and pre-empt fire sales at times of crisis (Bindseil and Jabłeck, 2013).

While in operational terms the use of the central bank's balance sheet is confined to transactions with its counterparties in monetary policy operations, the ultimate impact of conventional and unconventional monetary policy depends on the interaction with assets and liabilities across all sectors of the economy, beyond the financial institutions as immediate counterparties.

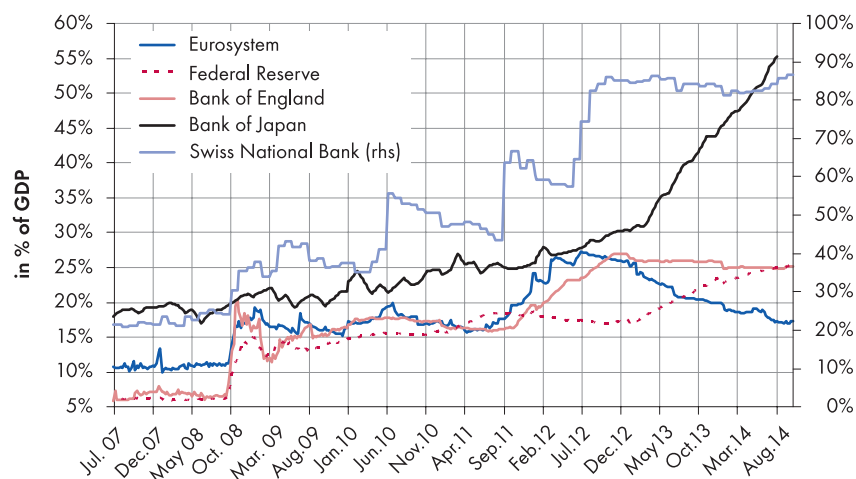
## II. The central bank balance sheet and financial structure

In the wake of the financial crisis the size and evolution of central bank balance sheets has come to be interpreted as an indicator of the monetary policy stance, in addition to the short term interest rate and related communication, such as forward guidance. Figure 1 shows the size of selected central banks as a share of GDP, where a different scale is applied in the case of the Swiss National Bank, whose balance sheet in relative terms has grown much more and become much larger than for the other central banks in recent years.

In interpreting this chart and hence balance sheet size as an indicator of the monetary policy stance, a number of caveats are in order. First, the starting levels of balance sheets differed significantly prior to the crisis in 2007 due to institutional factors. Second, a distinction needs to be made between active and passive (endogenous) evolution of balance sheet size. This depends on whether balance sheets are driven actively by central banks outright

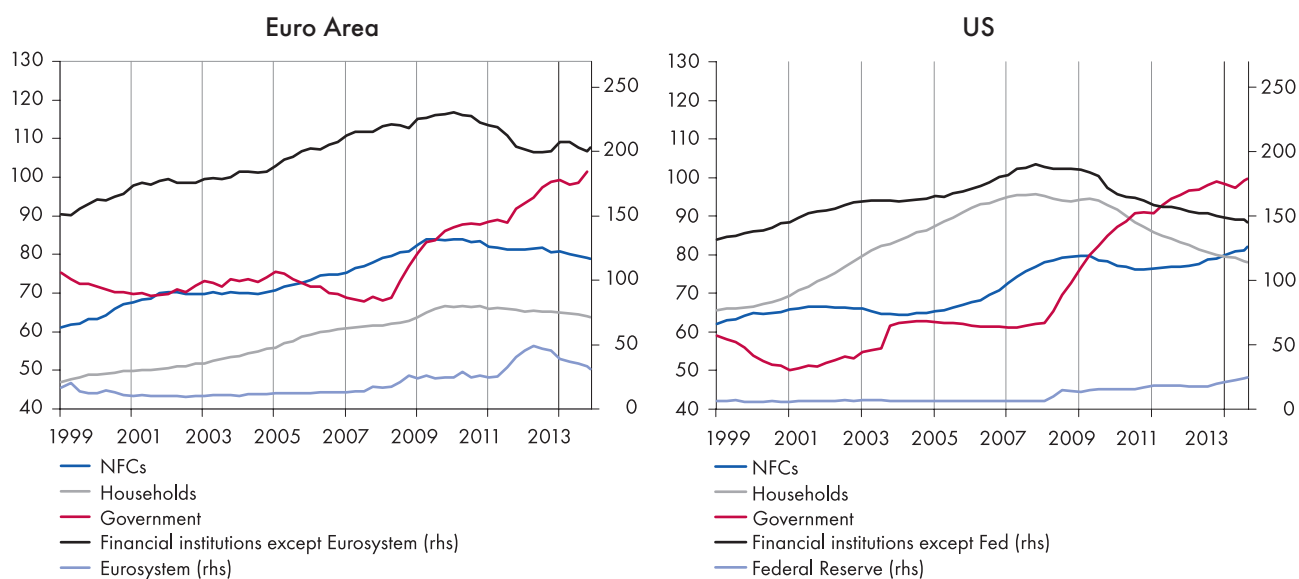
asset purchases or predominantly reflect lending operations, where the quantitative take up is a choice of counterparties. The ECB's non-standard actions to date focused mainly on collateralised lending while the Federal Reserve made larger use of outright operations (after a first phase of exceptional lending operations in late 2008-early 2009). From this perspective the Eurosystem's balance sheet contraction observed since mid-2012 was not necessarily signalling a less accommodative monetary policy stance but rather reflected an attenuation in funding market tensions and tail risks with diminishing demand by banks for holding pre-cautionary balances (Praet, Cour-Thimann and Heider, 2014). The ECB's decisions in September 2014 to embark on new outright purchases (of covered bonds and ABS) may, however, signal a more active use of balance sheet policies, while not establishing an additional target for monetary policy (Constancio 2014, Praet 2014). Third, the "contingent" use of the central bank's balance sheet capacity needs to be taken into account. In the SNB case, this pertains to

**Figure 1: Balance sheets of major Central Banks, total assets as % of GDP**



Source: ECB, Federal Reserve, Bank of England, Bank of Japan. Last observations: September 2014 (August 2014 for BoJ)

Figure 2: Sectoral debt ratios (as % of GDP)



Source: ECB and Eurostat, Federal Reserve. Last observation: 2014 Q1.

the overriding role of the exchange rate cap since September 2011. In the case of the ECB's non-standard measures of a contingent nature comprise the fixed rate full allotment regime in the ECB's refinancing operations after October 2008 (offering unlimited liquidity to counterparties against adequate collateral), which has been successively prolonged, and the announcement of Outright Monetary Transactions in 2012. Both measures provided insurance against certain adverse outcomes (respectively the risk of liquidity shortages faced by individual banks, and the risk of adverse self-fulfilling equilibria in sovereign bond markets). More broadly, from a flow-of-funds perspective, the evolution of central bank balance sheets needs to be interpreted jointly with the balance sheets of other sectors in the economy. (Winkler and de Rougemont, 2013) Figure 2 shows the evolution of sectoral debt ratios for the euro area and the US, showing the central banks separately from the remaining financial institutions sector. It can be observed that for the US deleveraging in the financial

sectors went hand-in-hand with rapid deleveraging in the household sector since 2009 (partly due to write-downs and repossessions), both more pronounced than in the euro area, while non-financial corporations have even started to increase their debt ratio in the recent period. At the same time US government debt went up more rapidly in the early stages of the crisis, compensating for private deleveraging, together with the expansion of the Fed's balance sheet. By contrast, in the euro area, while expanding until mid-2012 the balance sheet size of the Eurosystem has been declining since, as banks reduced recourse to central bank liquidity, which had temporarily boosted financial sector balance sheets. At the same time domestic private sectors continued deleveraging, especially the non-financial corporate sector, while the government debt ratio resumed its upward momentum. In this context, the prevalence of lending operations among the ECB's non-standard measures – as opposed to outright transactions – implied that private sector deleverag-

ing in the euro area was facilitated to a lesser extent than in the US, where the Federal Reserve's asset purchases allowed the private and public sectors to offload some of their debt onto the central bank's balance sheet (Cour-Thimann and Winkler, 2012).

### III. A flow-of-funds taxonomy of balance sheet measures

#### Transmission channels

From a quantity (and quantity theory) perspective the first traditional transmission channel to consider is the loan-deposit channel. The simple textbook "money-multiplier" characterization often starts from central bank (outside) money translating into broad (inside) money created in the banking system, which needs to be underpinned by the banks capacity to supply credit and the demand for loans by the private sector (in turn creating deposits). From the monetarist perspective non-standard measures aim at boosting narrow and ultimately broad monetary aggregates. This can be achieved

via liquidity provision increasing bank reserves and via the bank lending channel or, alternatively, by placing money directly in the hands of the non-bank private sector, e.g. via asset purchases from non-bank investors. From this perspective the holding sector (not the issuing sector) of assets would seem to matter in the first place and how holding sectors rebalance their portfolios with the money received for the assets purchased by the central bank (Cloyne et al. 2014).<sup>1</sup>

From a monetarist perspective increases in the size of central bank balance sheet work via changing the quantity (rather than the price) of money, which in turn affects the balance sheets of the counterpart sectors involved in asset purchases. However, whether an increase in central bank money (reserves held by at the central bank) leads to boost to broad monetary aggregates ultimately depends on the behaviour of banks and of the money holding sectors. In the case of banks, broad money will rise only if the extra reserves alter banks' propensity to

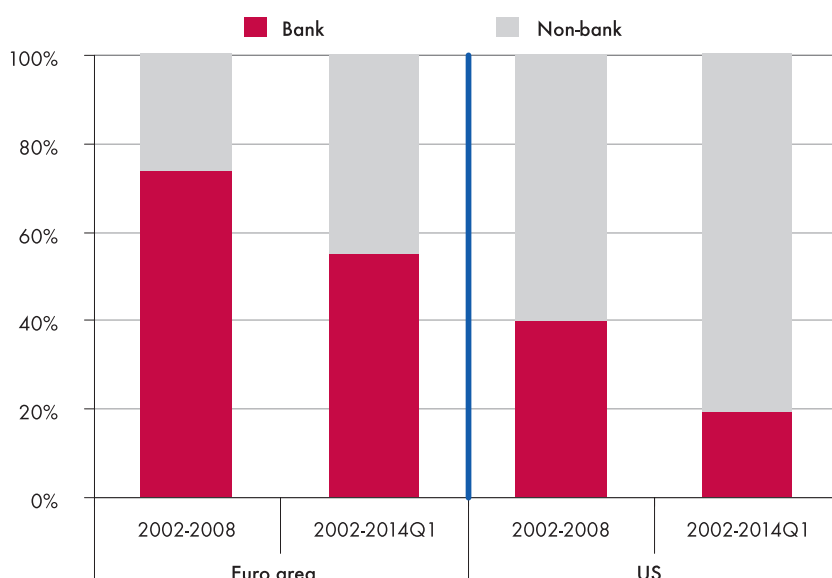
lend to the private sector and new deposits are created. If the ultimate seller is the non-bank private sector deposits will, by contrast, indeed go up in the first instance and can lead to portfolio rebalancing. Whether the private sectors will be willing to hold extra money balances will depend on their use of the additional money and substitution across the spectrum of alternative assets (Winkler, 2010). Whether the loan-deposit channel or the portfolio balance channel is most pertinent for monetary transmission clearly depends on the

financial structure of the economy, namely the relative weight of bank and market financing on the liability side of the private sectors and, similarly, on the relevance of money/deposits vs. market instruments in investors' and ultimately household portfolios. In turn this has a bearing on central banks operating more via collateralised lending with (bank) counterparties or resorting to outright purchases in the markets. Figure 3 shows that debt financing of firms in the euro area is more bank-based than for the US, but reliance on bank financing has been declining in both areas.

Differences in financial structure help explain the preponderance of bank-focused lending measures in the case of the ECB compared to the Federal Reserve's focus on outright purchases of debt issued by the non-bank sectors: government bonds, government-guaranteed mortgaged backed securities, commercial paper, portfolios of long-term bonds or securitised loans, thus to large extent bypassing the banking system. In contrast, the ECB has mainly provided liquidity support to Monetary financial institutions (MFIs), relying on financing intermediated via the banking sector.

*ECB's non-standard actions to date focused mainly on collateralised lending.*

**Figure 3: Funding of the non-financial corporate sector in the euro area and the US (shares in cumulated debt transactions)**



Source: Eurostat, ECB, US Federal Reserve.

**A sectoral taxonomy of non-standard monetary policies in the euro area**

For the narrow and broad money channel of transmission, what matters is the creation of reserves (base money) and whether assets are ultimately purchased from money holding sectors thus increasing money holdings. From a flow-of-funds

<sup>1</sup> For a flow-of-funds based assessment of the Fed's asset purchases see Carpenter et al. (2013), Thornton (2012) for a sceptical view on the portfolio balance channel in the case of government bonds. Bertaut et al. (2011) estimate asset demand equations for bank deposits, treasury securities and corporate debt in a portfolio balance model.



perspective, in addition the issuing sector of assets and the characteristics of instruments matters as relevant for the demand and supply of assets and ultimately for financing conditions across sectors and instruments. Figure 4 proposes three key fundamental characteristics affecting credit and market risk of conventional and unconventional monetary policy operations of relevance for the ECB:

- (1) the sector of the issuer of the debt acquired: banks, government or non-financial corporations (NFC)
- (2) the presence or absence of collateral
- (3) the maturity/duration of the instrument

Another important characteristic is whether the instrument acquired is tradable/marketable or an illiquid claim (such as individual bank loans). Standard monetary policy relies on

short-term lending to banks against collateral, the least risky of all operation, as in the ECB's regular main refinancing operations (**MRO**) at weekly frequency. A first type of non-standard measures has thus been to take more risk vis-à-vis the same counterpart sector (banks) by accepting a wider range of eligible collateral, by lending longer term or by purchasing bonds issued by banks but benefiting from additional securities. This applies to the several rounds of longer-term refinancing operations (**LTRO**), specifically the two VLTROs conducted in December 2011 and February 2012 as well as the targeted lending scheme (TLTRO) decided in June 2014. A second extension of non-standard measure involved moving away from the focus on banks to purchasing liabilities from non-bank issuers, namely government debt, on secondary markets

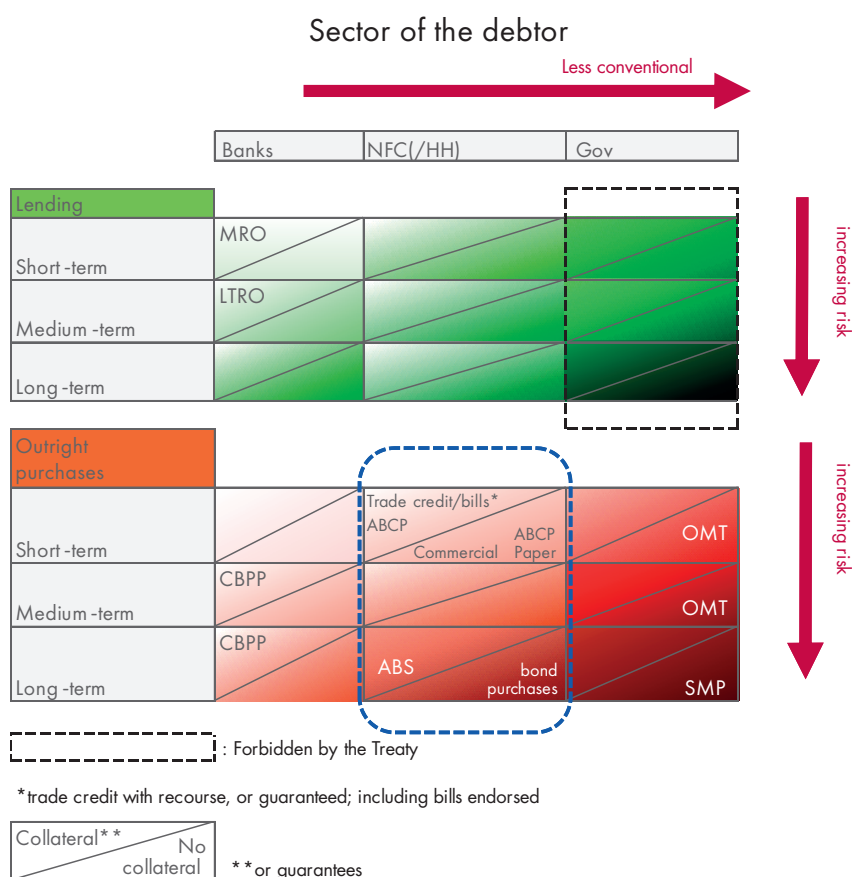
(with direct lending ruled out by the prohibition of monetary financing by the Treaty), namely the securities market program (**SMP**) launched in 2010 and the outright monetary transactions (**OMT**) decided in 2012.

A third type of non-standard measures involves liabilities of the private sector, circled in blue in Figure 4, such as commercial paper or corporate bond purchase programmes that had been launched by the Fed and the Bank of England in the early phase of the financial crisis. Commercial paper is a traded short-term instrument issued by very large companies usually benefiting from well-established external ratings. For the risk characteristics and the borderline of central banks engaging in short-term liquidity provision as opposed to intervening in longer term allocation of savings and capital (as might be the case for longer dated corporate bonds or loan markets), what matters is the maturity of assets purchased, whether they are traded in liquid secondary markets and whether they benefit from guarantees.

Accordingly, the ECB's main non-standard measures have been mainly directed towards facilitating and extending collateralised lending to banks, by providing on incrementally generous terms: (a) full allotment, (b) increasing the list of collateral, (c) extending maturity to 3-month, then 1-year, then 3-year (VLTROs) and up to 4 years under the new targeted lending scheme (TLTROs).

In some sense, one could also classify the ECB's **Covered bond purchase programmes (CBPP)** in this category, as covered bonds are a major bank funding instrument and in some ways similar to collateralised lending, although with the two differences: (1) in the regular lending operations the collateral is generally liquid, while the covered bonds,

Figure 4: A sectoral perspective on the ECB's non-standard measures





which themselves are liquid, contain illiquid pledges (also originated by the borrower), and (2) the maturity is very different. However, when (a) the collateral list for lending operations is extended such as to encompass many loans, and (b) the LTRO goes up to 3 years or more, the strong distinction between these two types of operations diminishes.

In contrast, the **Securities Markets Programme (SMP)**, active during 2010-2011, as in the case of the Fed's LSAPs, involved purchasing debt issued by non-banks. It should be noted that the ECB's motivation was related to countering dysfunctional markets and intervene in several national government bond markets, which were regarded as important for the even transmission of the single monetary policy across the area. This motivation also applied to the **Outright Monetary Transactions (OMT)** launched in 2012 to address unwarranted redenomination risk premia that had appeared in bond markets. Unlike the SMP, while ex ante unlimited in scope, the OMT was limited to maturities of up to 3 years and was made conditional

on countries entering an adjustment programme prior to any purchases in order to guarantee solvency.

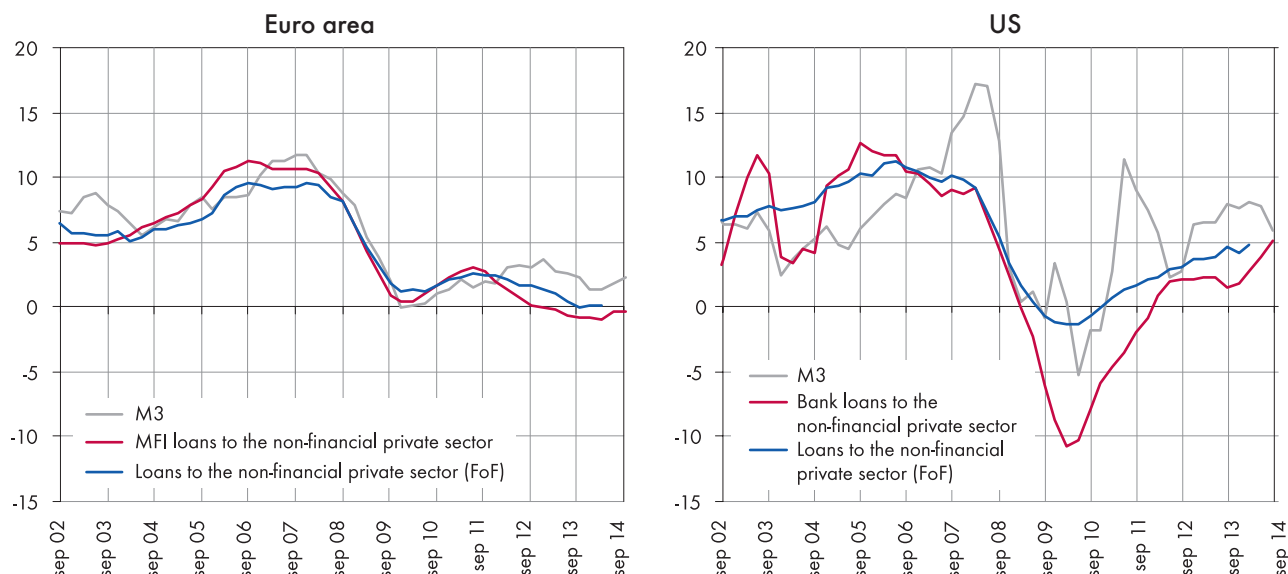
Figure 4 also includes asset backed securities (**ABS**) and asset backed commercial paper (**ABCP**), which package loans or other claims (credit card, leasing, trade receivables), where the underlying claim is on the non-financial private sector (NFCs or households). ABS vehicles are often sponsored by banks or other financial intermediaries, but unlike covered bonds they do not remain on balance sheet and do not benefit from double recourse protection (ie. with claim on issuer and on the collateral). Trade credit is also included as a short-term NFC liability in Figure 4. Indeed, trade credit, "securitised" in the form of trade bills (or bills of exchange), which were typically endorsed/guaranteed by multiple signatures (from both seller and buyer), discounted and underwritten by banks and rediscounted by central banks were the most traditional instrument for liquidity provision by central banks over centuries (before the onset of repo securities operations in Europe and before the

practice of using Treasuries for open market operations in the US, Jobst and Ugolini, 2014).

### Transmission impact

Liquidity provision to the banking sector is only one element, but not a sufficient condition for supporting bank lending and broad money. The balance sheet situation of financial and non-financial sectors has to be taken into account and the bank lending channel may be impaired in the presence of deleveraging pressures, debt overhang and capital constraints. On the asset side, there are alternative uses of funds for liquidity provided by central banks via lending or outright purchases. Figure 5 shows the development of broad money and loans (banks loans and broader flow of funds definition) for the euro area and the US. It can be seen that in the first phase of the financial crisis bank lending contracted much more sharply in the US with much more rapid deleveraging (namely related to mortgage defaults and reposessions) in the household and banking sectors,

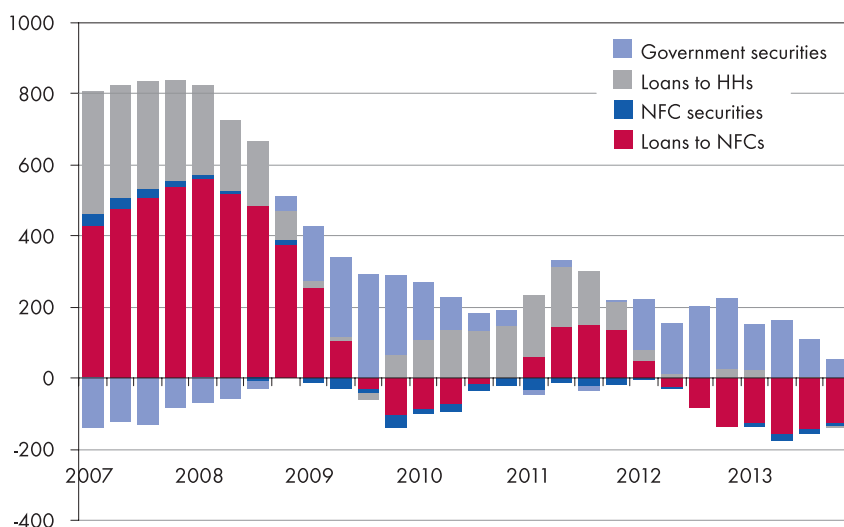
Figure 5: Money and credit growth



Last observation: 2014 Q3 (2014 Q1 for FoF)

Notes: Annual percentage changes. FoF = flow of funds / financial accounts

**Figure 6: Net acquisitions of loans and debt securities of the non-financial sector by MFIs (4-quarter sums, bn euro)**



Last observation: 2013 Q4.

Source: ECB

with subsequent gradual recovery in money and lending growth. In the euro area a double-dip profile can be seen, with a renewed decline in money and lending after the intensification of the sovereign debt crisis in 2011.

This suggests that liquidity support

via the LTROs amounting to nearly EUR 1 trn – fundamental for stabilizing the banking system – and the SMP, CBPP and OMT programmes – essential for addressing tail risk and supporting impaired bank and government funding markets – have nonetheless not translated into a

durable recovery in bank lending to date, even if surely preventing disorderly bank deleveraging and much more adverse counterfactual scenarios. This raises the question what use have banks made of the funds provided to them via the longer term refinancing operations.

Figure 6 shows that banks have invested heavily in government securities during the period of one-year LTROs in 2009-10 and again at the time of the two three-year LTROs in 2012-2013, coinciding with weak or negative loan flows to households and non-financial corporations.

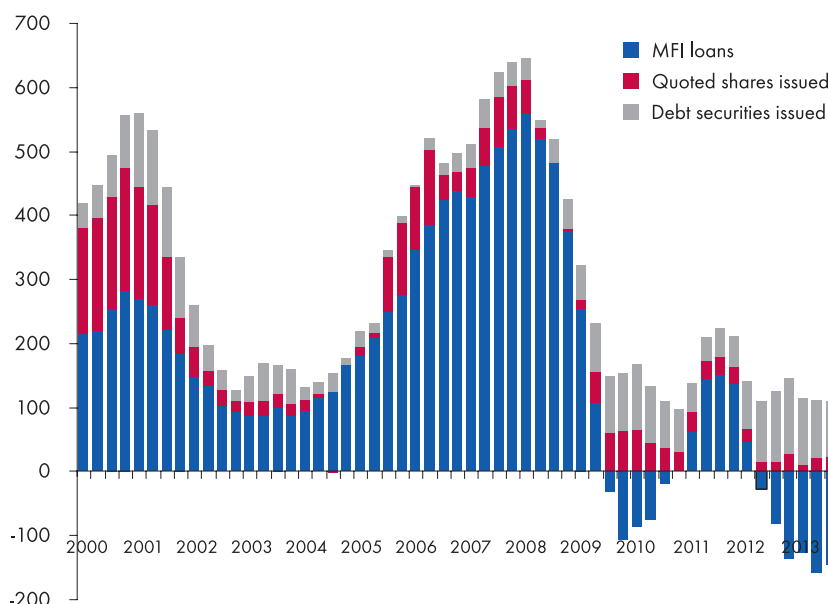
Hence, from a flow of funds perspective it can be argued that the two longer-term lending operations launched in December 2011 and February 2012 VLTRO also appeared more effective in supporting bond markets than in supporting bank lending. This all the more so, if we take into account that central bank funding displaced previous bond investors, who might also have substituted bank bonds in their portfolios with adjacent asset classes, likely benefitting government and corporate bonds.

To some extent, the VLTROs could hence be seen as an indirect channeling of funds in support of bond markets under stress, also working to compress government bond yields and supporting private bond markets as a side effect. However, only the more direct, if conditional, commitment of the OMT from 2012 brought about a lasting reduction in risk premia and a return of domestic and foreign long-term investors.

### The transmission to non-financial corporations

Even though most of the ECB's non-standard measures were motivated by supporting the monetary transmission mechanism and namely and ultimately credit to the real economy,

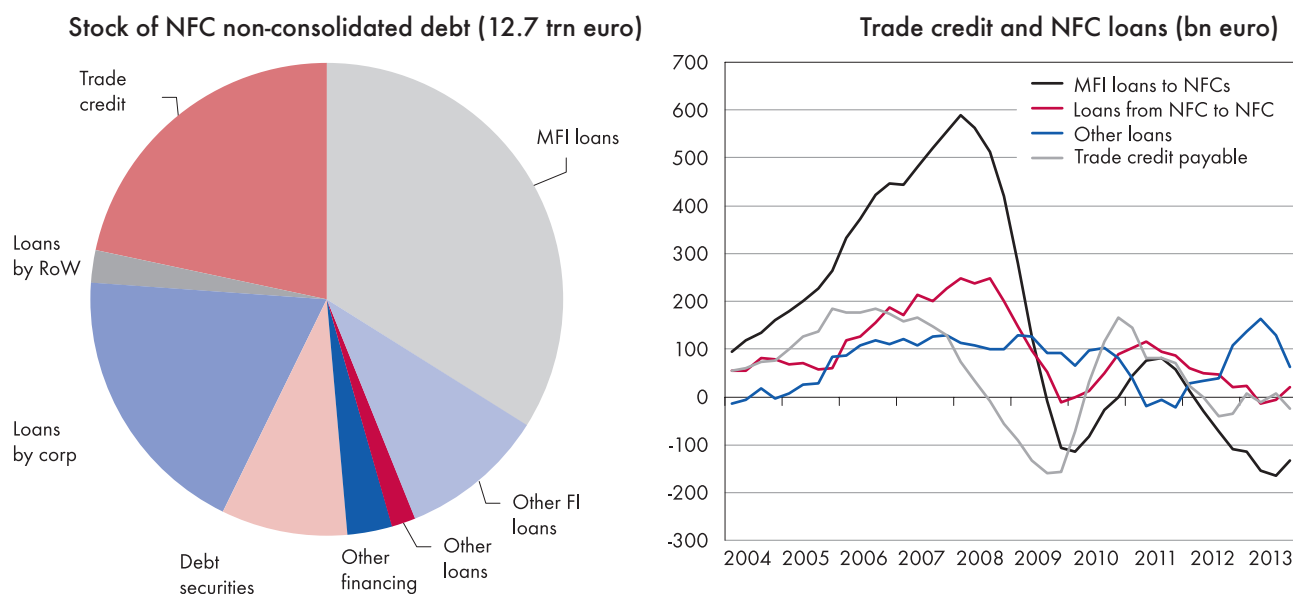
**Figure 7: NFC financing: MFI loan borrowing, net issuance of debt securities and quoted shares (4-quarter flows, bn euro)**



Last observation: 2013 Q4.

Source: ECB

**Figure 8: Corporate debt finance (including inter-company claims)**



Sources: Eurostat, ECB (internal estimates for trade credit). Last observation: 2013 Q4.

bank lending to the private sector and non-financial corporations, in particular, has continued to contract, against the background of continued deleveraging needs and increased regulatory demands. The same disintermediation pattern from bank to market financing, attributable in part to the need for bank balance sheet repair, and in part to the extent that ECB liquidity provision to banks mostly “spilled out” into the bond markets (rather than being used for bank lending) can also be seen by looking at the sources of external financing of non-financial corporations in Figure 7.

Market based funding (from stock markets and corporate bonds) substituted to a significant extent for shrinking bank loans both in the wake of the Lehman shock 2009-2010 and again after 2011-12 after an intermittent period of normalization, where bank lending had seen a tentative recovery. However, it needs to be recognized that most SME do not have access to bond or equity markets and remain heavily bank-dependent. Hence attention has recently turned to unlocking alternative

*Standard  
monetary policy  
relies on short-  
term lending to  
banks against  
collateral.*

sources of funding, tapping/reviving securitisation markets with relevance for SMEs as part of the ABS purchase programme, or making liquidity provision to banks conditional on on-lending to the private sector in the targeted lending operation (TLTROs), similar to the Bank of England’s “funding for lending” scheme. The flow of funds data can be used to show a more complete picture of the corporate funding sources, in particular exploiting the non-consolidated presentation, which also includes intra-sector claims. Figure 8, on the left-hand side, looks

at debt instruments (ie. abstracting from quoted shares and unquoted equity) in non-consolidated presentation. It emerges that MFI loans only make up for 1/3 of external debt financing (outstanding amounts), which is significantly more than debt securities. At the same time, other sizeable sources of financing relate to inter-company claims, namely trade credit and inter-company loans, both important elements in the financial supply chains and inter-linkages in the corporate ecosystem. The right-hand side shows that NFC loans to other NFCs and trade credit have fulfilled a stabilising role in the financial crisis by contracting much less than bank lending and also less than activity and value added. Loans from non-bank financial intermediaries (special purpose vehicles often issuing debt securities on behalf of NFCs in other jurisdictions) have risen in recent quarters. Carbó-Valverde et al. (2014) show on the basis of firm-level Spanish data that credit constrained SMEs depend more on trade credit, in place of bank loans, and that the intensity of this dependence increased during



the financial crisis. Unconstrained firms, in contrast, rely more on bank loans and less on trade credit. This underlines the critical role of trade credit (among corporates) offering relationship based financial buffers at times when the bank lending channel is impaired and SMEs can rely less on relationship lending from banks. There is a widespread perception that SMEs in many countries remain liquidity and credit constrained, with low cash flow, with banks cutting lending and credit lines. At the same time ample provision of central bank liquidity seems not to have filtered through to SMEs, nor have buoyant asset markets, while large corporates continue to hoard cash.

This has been one motivation to opening or supporting additional channels for monetary transmission, in particular the ECB's ABS purchase programme in conjunction with regulatory initiatives to support "simple, transparent and real" securitisation activity. In addition, the TLTROs aims to strengthen incentives for banks to use liquidity received under the programme for additional lending. Finally, the CBPP 3, while directed at a bank funding instrument, involves an asset class also widely held by non-bank investors and hence might open up a transmission channel that puts money directly into the hands of investors, with possible portfolio

balance effects, rather than relying on the bank lending channel. Among the portfolio of non-standard measures implemented or considered by central banks around the globe it remains somewhat of a puzzle that attention has not turned to rediscover or re-engineer instruments like the trade bill, as the most standard and traditional means of refinancing the real economy used in Europe as recently as 1999, until the onset of monetary union and as successfully and very swiftly revived by the Bank of England during the 1980s (Allen, 2014).

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# Reviving credit growth for strong and sustainable recovery

*Engin Dalgic, Davide Lombardo and Daria Zakharova\**

## REVIVING CREDIT GROWTH FOR STRONG AND SUSTAINABLE RECOVERY

The Slovenian economy is finally recovering from a deep and protracted recession. But credit is still contracting. A creditless recovery would be a poor prospect. Such recoveries tend to be weak and are likely to be followed by subpar growth. Reviving credit is thus essential to achieving a more vigorous and durable economic expansion. This paper analyzes the supply- and the demand-side constraints to credit growth in Slovenia and proposes measures to address them.

JEL G01 G21 G28

Slovenia was hit hard by the global financial crisis. The crisis caused a sudden stop in the externally funded construction and investment boom. The combination of an overly indebted corporate sector, weak banks, and limited financing precipitated a vicious cycle of deepening recession, mounting bankruptcies, rising nonperforming loans (NPLs), and further deleveraging. All in all, real GDP dropped by 11¼ from its 2008:Q2 peak to its 2012:Q4 trough—the largest output loss among euro area members after Greece.

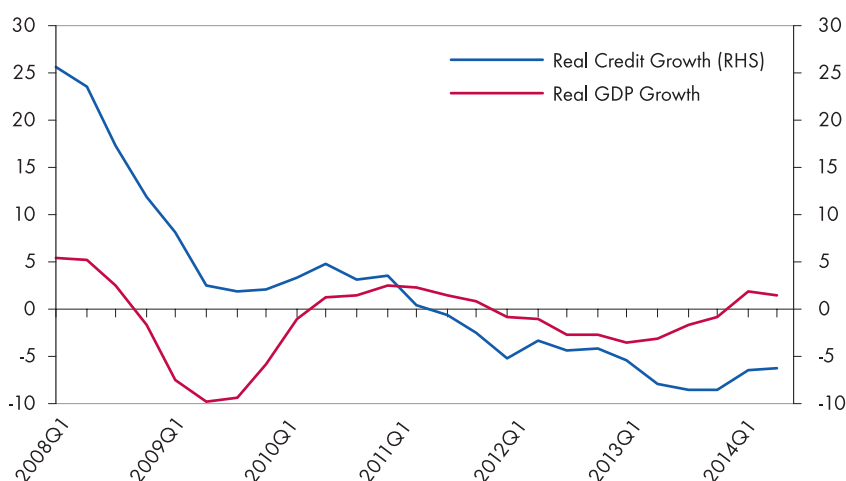
### I. Introduction

The economy is now starting to recover. Quarterly growth turned positive in 2013:Q2, helped by recovering euro area demand. A small positive growth is projected this year, largely driven by the ongoing strength of exports. At the same time, domestic demand is expected to remain subdued, with investment weighed down by the balance sheet problems in banks and corporates.

Meanwhile, credit is still contracting. Firms appear to be largely relying on their own resources to support the recovery, including using the excess capacity resulting from the deep recession (see chart on next page).

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**Slovenia: Output and Real Credit Growth (y-o-y percent change)**



Source: Haver Analytics.

Slovenia could thus be facing a “creditless recovery”—arguably a poor prospect. Recent studies find that the risk of creditless recoveries is especially high in situations, like Slovenia’s, where an economic downturn follows a foreign-financed credit boom and banking crisis. They also document that creditless recoveries tend to be weaker (by as much as a half) than those supported by stronger lending—because eventually capacity constraints start to bind—and are more likely to be followed by mediocre growth, reflecting the long-term adverse effects of lower

investment and weaker productivity.<sup>1</sup> Enabling a resumption of credit growth is therefore essential to achieving more vigorous and durable output growth. Unlocking credit supply requires completing the repair of banks’ balance sheets. The recent recapitalization of the largest banks is an important step in this direction. But further efforts are needed to restore banks’ financial viability, including through a further meaningful reduction in NPLs. Moreover, weaknesses in Slovenia’s banking system in large part reflect continued financial stress in its overleveraged

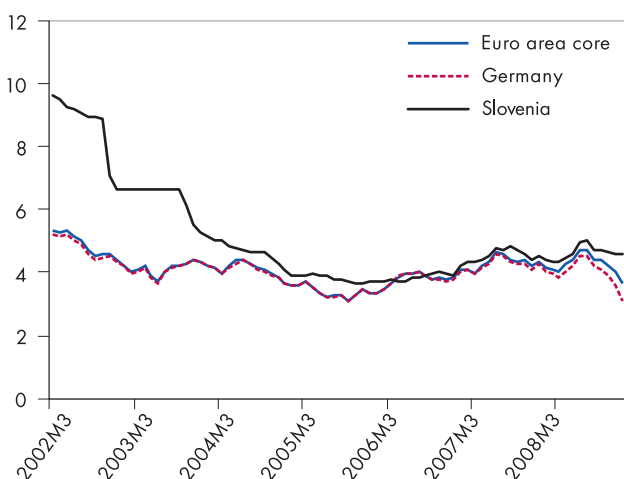
corporate sector. Thus, credit (and robust economic growth) cannot be restarted without addressing the demand side of the equation. This calls for a comprehensive strategy to facilitate the restructuring of corporate debt. But before we discuss how these demand and supply constraints could be tackled, it is important to understand how these constraints developed in the first place.

**II. The build-up of vulnerabilities in the pre-crisis period**

EU accession (2004) and euro adoption (2007) triggered a reduction of Slovenia’s borrowing costs towards those of the euro area core. As a result, and in the context of abundant global liquidity, the country significantly increased its external borrowing. Most of the external borrowing was done by banks, while the corporate and—at least through 2006—the official sectors kept their exposure broadly unchanged. Cheap external funding fuelled a rapid expansion

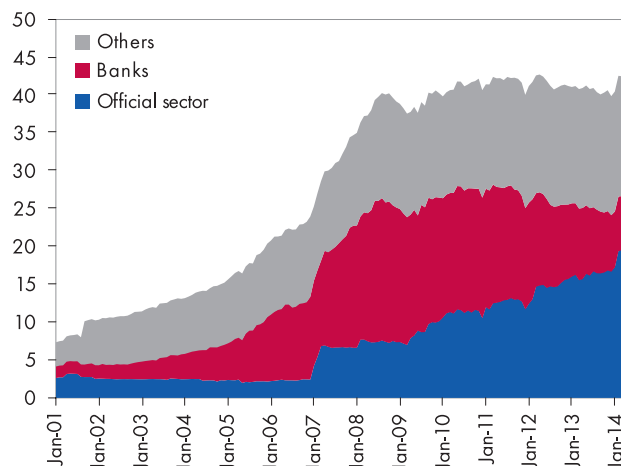
<sup>1</sup> See Abiad et al. (2011); Bijsterbosch and Dahlhaus (2011); IMF Global Financial Stability Report (2013); and Barkbu et al. (2014).

**Interest rate convergence (percent)**



Sources: Bloomberg, Haver Analytics and IMF staff calculation

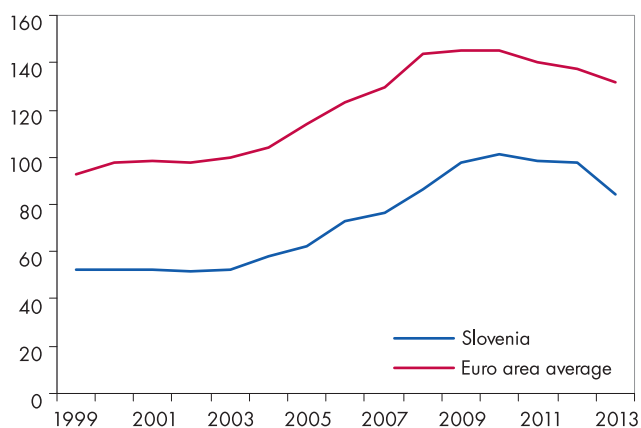
**External borrowing (EUR, Billions)**



Source: Haver Analytics.

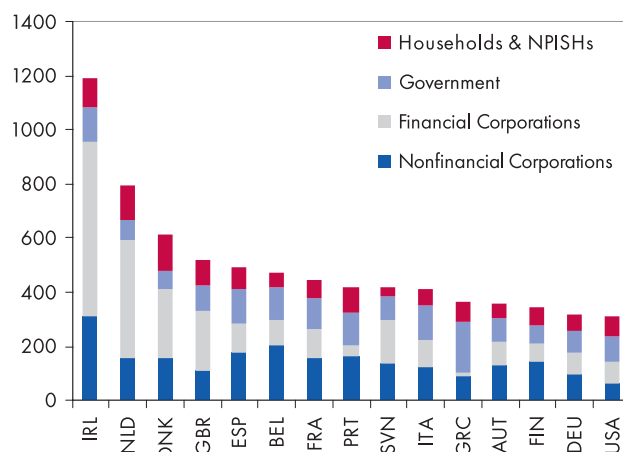


Credit-to-GDP Ratio



Sources: Bank of Slovenia, IMF IFS and WEO.

Total Debt as a Percent of GDP



Source: Haver Analytics.

Note: NPISHs = non-profit institutions serving households.

in bank credit. The ratio of bank assets to GDP increased from about 78 percent in 2000 to a peak of 146 percent in 2009, despite the concomitant growth in nominal GDP. On a macroeconomic level, the credit boom was reflected in rising current account deficits and external debt. Slovenia's current account deficit reached 5.5 percent of GDP in 2008, and its external debt doubled to 105 percent of GDP between 2003 and 2008.

**Bank lending was largely channeled to corporates in the non-tradable sector.** Domestic bank credit to the non-financial corporate sector grew by 25 percent per year during 2005–08, and 35 percent at its peak in 2008. Fixed investment increased from 24.3 percent of GDP during 1997–2004 to 27.1 percent during 2005–08, almost entirely on account of the increase in non-tradable investment, of which half went into real estate and construction.

**Credit became the primary funding source for investment and corporate takeovers.** The ratio of new bank loans to investment spiked during 2007–08 as firms increasingly relied on credit, rather than retained earnings, to finance investment. Loans were also used for non-invest-

ment financial operations, including funding corporate mergers and buy-outs. In many cases, the seller of the companies was the state itself, which, guided by the notion of 'national interest', preferred domestic owners over foreign candidates. In practical terms, this led to giving a secondary role not only to prices fetched, but also to key qualifications for ownership, such as financial strength<sup>2</sup>. Financial holding companies, where a diverse set of companies are brought under an umbrella ownership, proliferated in this environment.

**The result was a significant increase in corporate leverage, which put bank lending at risk.** While the rapid credit expansion was not unique to Slovenia (see left chart above), and Slovenia's private sector debt remained relatively low (right chart above), it did take place against very limited equity capital, resulting in one of the largest corporate debt-to-equity ratios (see charts below). This makes bank debt more exposed to a downturn, because companies have limited equity buffers to absorb losses. In part, the relative scarcity of equity capital reflected Slovenia's reluctance to embrace foreign direct investment (FDI), a key source of potential equity: FDI into Slovenia has

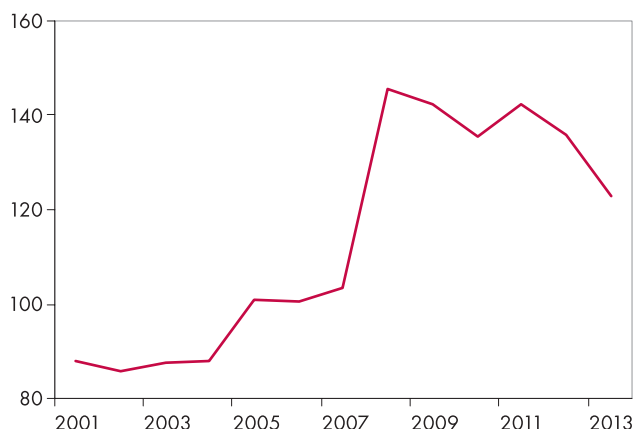
averaged 1.6 percent of GDP per year since euro adoption, against an average for the euro area of 29.4 percent of GDP.

**Slovenian banks also took significant liquidity risks.** On the eve of the crisis (2008), wholesale funding represented 30 percent of their liabilities (against 7 percent in the average euro area bank), and liquid instruments accounted for only 10 percent of their assets (versus 30 percent in the average euro area bank).

**The 2008–09 global crisis exposed these vulnerabilities.** The global loss of confidence crippled interbank markets. Despite sovereign guarantees, Slovenian banks effectively lost access to external markets, and were thus forced to repay their large external debts as these came due. Between August 2008 and end-2013, the net reduction in external liabilities of the banking system reached 11.8 billion euros, roughly a quarter of the aggregate balance sheet as of end-2008. The (longer-term) liquidity support from the European Central Bank (ECB) provided a breather, in that banks used it to help pay off

<sup>2</sup> For an interesting political economy take on the privatization and the notion of national interest in this period, see Lindstrom and Piroška (2007).

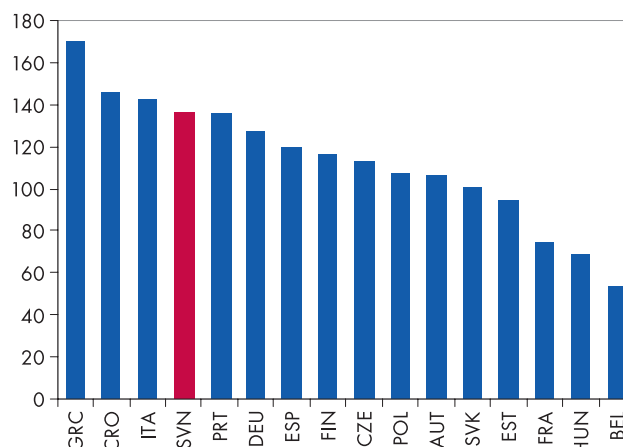
**Corporate Debt-to-Equity Ratio in Slovenia, 2001-2013 (Percent)**



Sources: ECB and Eurostat.

1/ Defined as total liabilities minus equity over equity in non-financial corporates.

**Corporate Leverage, 2012 1/ (Percent)**



Source: Haver Analytics.

Note: NPISHs = non-profit institutions serving households.

their maturing external liabilities, but did not turn the fundamental dynamics around.

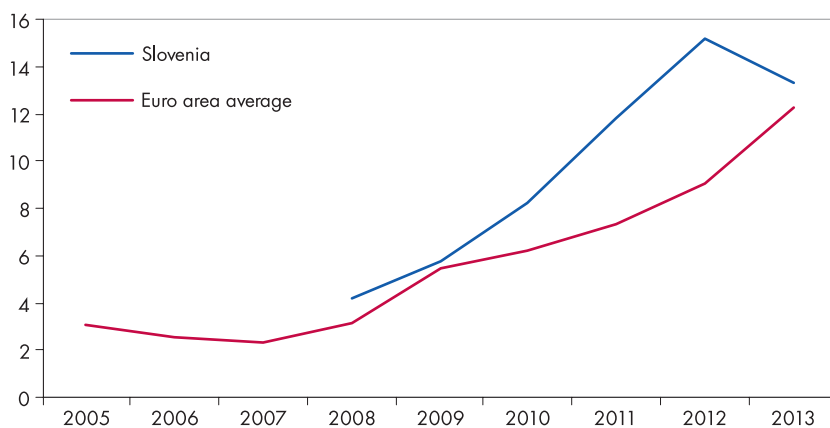
**A vicious circle of mounting NPLs and deepening recession ensued.**

With capital flows reversing and foreign funding drying up, banks reduced their lending dramatically. Facing rapidly tightening financial constraints, the corporate sector cut investment sharply, aggravating the recession. In turn this reduced borrowers' expected cash flows and creditworthiness, leading banks to further contract their credits. NPLs increased rapidly, from 2.6 percent of

total classified claims<sup>3</sup> at end 2007 to 18.1 percent in November 2013.<sup>4</sup> The acceleration was particularly pronounced among the large domestic banks, where the NPL ratio reached 21.6 percent in mid-2013. At end-2012 NPLs net of provisions accounted for about 86 percent of banks' capital, some 23 percentage points more than in the euro area average, which was itself on a steep upward trajectory (right chart below). **Corporate borrowers were the main source of problem loans.** Among claims on non-financial companies, the share classified as "non-

performing" (i.e., in arrears for more than 90 days) reached 28 percent by November 2013. At the level of the individual sector, the NPL share reached 50 percent in construction and 33 percent in accommodation and food service activities. NPLs were even higher—reaching a peak share of 37 percent in August 2013 – among classified claims on "other financial intermediaries", namely holding companies (through which many leveraged buyouts were implemented). The 50 corporates with the largest exposure in arrears accounted for some 43 percent of all banking sector arrears (by value) by November 2013. On the other hand, claims on households, including mortgages, are in much better shape (with only 4 percent of them in arrears).

**NPLs to Total Gross Loans (percent)**



Source: IMF FSI.

<sup>3</sup> Classified claims include financial assets at amortised cost and some risk-bearing off-balance-sheet items on which a payment liability could arise.

<sup>4</sup> The text charts show annual end-year NPL ratios. The decline in the NPL ratio for Slovenia by the end of 2013 reflects the December 2013 transfer of NPLs to the asset management company, as discussed in the next section.

### III. Repairing bank balance sheets to unlock credit supply

A number of important measures have been taken over the past two years to address problems in banks. But further efforts are needed to strengthen bank balance sheets and reduce vulnerabilities.

#### What has been done?

In 2013 the Bank of Slovenia

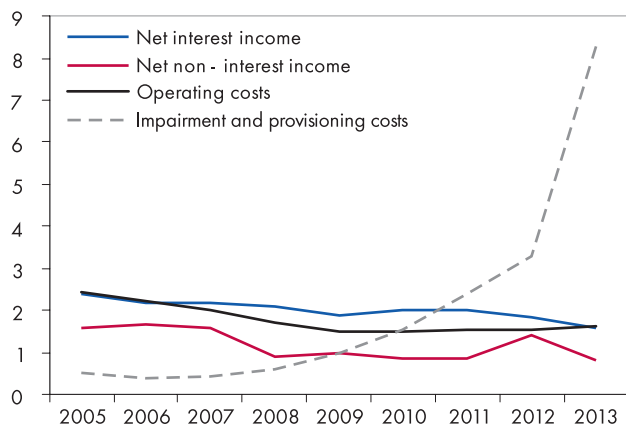
(BoS) carried out a comprehensive diagnostic of the main banks, in conjunction with the Ministry of Finance and with the help of international consultants. This exercise consisted of an Asset Quality Review (AQR) and stress tests of the eight largest Slovenian banks and aimed at determining the requisite capital injections and establishing the price for the transfer of NPLs to a newly established Bank Asset Management Company (BAMC).

The exercise identified a total capi-

tal shortfall of EUR 4.8 billion.<sup>5</sup> For the three large state-owned banks the shortfall amounted to some EUR 3.7 billion. This was addressed by a transfer of NPLs to the BAMC, burden-sharing with qualified subordinated instruments, and an outright

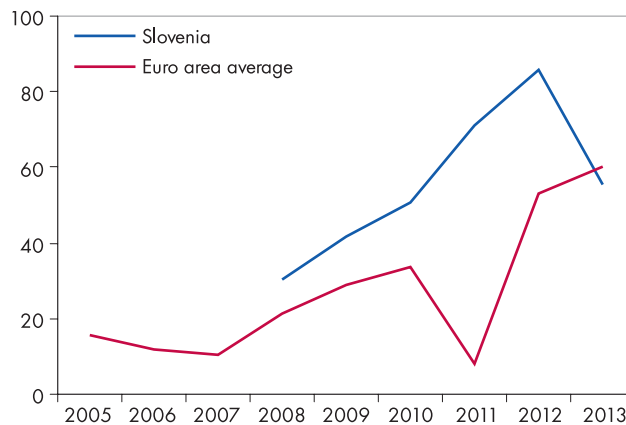
<sup>5</sup> This figure emerged from the adverse scenario in the bank-level bottom-up stress tests. The BoS also commissioned a top-down system-level stress test which yielded a somewhat lower aggregate capital shortfall (about EUR 3.3 billion). The BoS took the findings of the top-down stress tests as evidence that the bottom-up stress tests had been sufficiently conservative.

**Key components of P&L  
(Percent of average assets)**



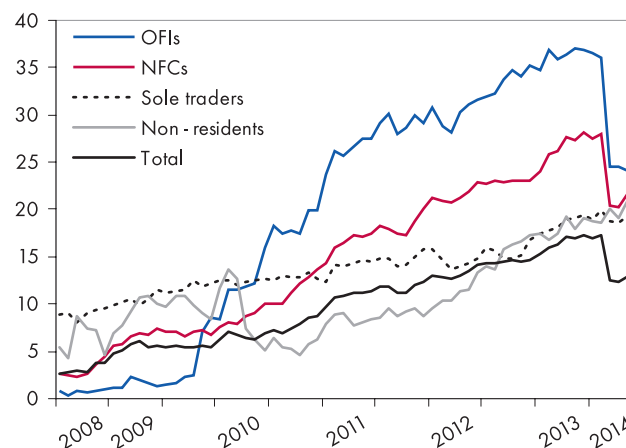
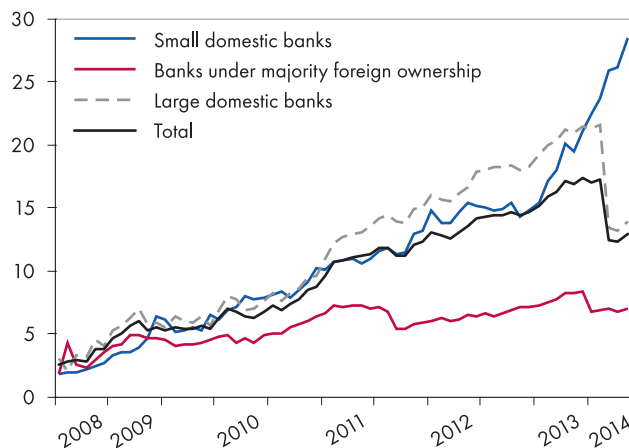
Source: Figure 6.39, 2014 Financial Stability Report, Bank of Slovenia

**NPL Net of Provisions to Capital  
(percent)**



Source: IMF FSI.

**Arrears of more than 90 days as a proportion of banks' classified claims by bank group (left) and client segment (right) 1/ (Percent)**



Source: Figure 6.13, 2014 Financial Stability Report, Bank of Slovenia

1/ The decline of the NPL ratios in December 2013 reflects the transfer of NPLs to the asset management company BAMC (see next section).



capital injection.<sup>6</sup> Banka Celje also turned out to require public capital (the authorities now plan to merge it with Abanka), while Gorenjska Banka has been given until the end of 2014 to raise the required capital from private sources, failing which it will also be recapitalized by the state. Two other small banks (Factor Banka and Probanka, accounting for 4.5 percent of the system's assets) were separately put under an orderly wind-down procedure by the BoS in September 2013, with the necessary capital (some EUR 445 million) provided by the state.

### What remains to be done?

**Despite the above-mentioned interventions, domestically-owned banks remain saddled with a high share of NPLs.**

Following the December 2013 transfer of NPLs to the BAMC, the banking system NPL ratio declined to 13.4 percent at end-2013, from 18.1 percent in November 2013 (Bank of Slovenia (2014) reports that the transfer of NPLs to the BAMC more than explains this decline, accounting for a 4.9 percentage point reduction in the system's overall NPL ratio). NPLs have, however, increased again in the first two months of 2014, bringing the system-wide NPL ratio to 13.9 percent, and could increase further in the absence of effective debt restructuring, especially of overleveraged corporates.<sup>7</sup> High NPLs divert bank resources from core activities to NPL workouts, weigh on banks' profitability, hinder extension of new credit, and push up interest rates on genuinely new loans. Ever-greened loans also crowd out the flow of credit to viable firms.<sup>8</sup>

**Moreover, the BAMC's effectiveness in facilitating restructuring has been impeded by incomplete transfers of exposures of borrowers**

**in arrears.** In its first annual report, the BAMC management indicated that, at least for the transfers already implemented (i.e., from NLB and NKBM), these did not include—as recommended by the BAMC and endorsed by the Bank of Slovenia—each bank's full exposure to company groups with significant non-performing loans, but only the worst-performing exposures for each borrower. This, they note, unduly undermines the BAMC's hand in restructuring negotiations with non-cooperative business owners.<sup>9</sup>

**Thus additional transfers of problem loans to the BAMC are in order,** both to further cleanse banks' balance sheets from legacy problem loans and to strengthen BAMC's capacity to act as a catalyst for the much-needed corporate restructuring. The recently completed AQR and Stress Tests conducted under the aegis of the ECB and the European Banking Authority offer, at least for the two largest banks, an opportunity to determine the value of the assets to transfer and quantify the size of their existing capital buffers. This is important because, to the extent that the transfer price is below the book value of the loans (net of relevant provisions), the transfer would generate a loss for the transferring bank.<sup>10</sup>

**While such additional transfers would help, bank profitability is likely to remain subdued.** New activity is unlikely to reach the pre-crisis levels any time soon, and new income-generating opportunities will emerge only slowly, as the economic recovery gradually takes hold. This calls for reducing administrative costs accordingly, including through further banking sector consolidation. **Going forward, there is a need to strengthen the banks' governance and supervision frameworks** to prevent the re-emergence of the vulnerabilities that led to the accumulation of problem loans following the

crisis. Governance can be improved through privatization. The BoS estimates that, as of mid-2014, the Slovenian government owns 62 percent of the banking system capital. Privatizing the intervened banks in due course would ensure that their management responds solely to commercial motives and weaken the link between the creditworthiness of the government and that of the banks — a key source of vulnerability. Efforts in the supervision area should focus on improving the control of connected lending. This requires the BoS (and the Single Supervisory Mechanism) to have access to a comprehensive database of groups of connected clients based on a uniform definition of connectedness. **Finally, the BoS should ensure that banks deal effectively with their NPLs.** The amendment to the regulation on the assessment of credit risk losses introduced earlier this year, enabling banks to write off claims they assess to be uncollectible even in the absence of court-sanctioned bankruptcy, is thus welcome. The BoS should now monitor that banks fully use this additional leeway, and encourage banks to dispose of problem loans via regulatory measures (such as maximum time limits for bad loan retention). A mandatory

<sup>6</sup> The total capital injection across the three large domestic banks (NLB, NKBM and Abanka) amounted to about EUR 3 billion (of which EUR 2.1 billion in cash). The face value of the NPLs transferred to BAMC amounted to EUR 4.6 billion. For the EUR 3.3 billion NPLs already acquired from NLB and NKBM, BAMC paid an average price of about 30 cents on the euro.

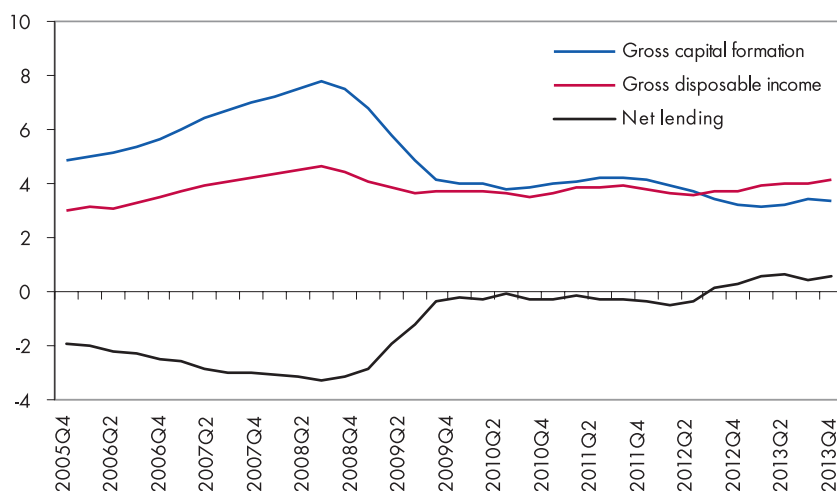
<sup>7</sup> Bank of Slovenia (2014) reports that 7 percent of claims against non-financial corporates were already in arrears, but not for more than 90 days, and thus not included in the NPL count.

<sup>8</sup> According to Bank of Slovenia (2013, page 43), loans to restructure loans in arrears (ever-greening) accounted for 47 percent of loans for the overall banking system in 2012 (and as high as 55 percent among the large state-owned banks).

<sup>9</sup> See, in particular, the last paragraph on page 16 of BAMC (2014).

<sup>10</sup> If the transfer takes place at a value which exceeds the market value of the loans, then transferring banks would be in effect receiving state aid, and thus the transaction would need to be approved by DG COMP.

### Corporate savings and investment 2005-2013 (4-quarter moving average, billion euros)



Source: Statistical Office of the Republic of Slovenia.

transfer of all written-off corporate claims to the BAMC would increase its effectiveness in restructuring over-indebted corporates.

#### IV. Tackling corporate debt overhang to revitalize credit demand

*Corporate debt overhang is weighing on investment and growth. Urgent progress is therefore needed to reduce corporate leverage and to create conditions for a healthy revival in the demand for credit.*

##### What is the situation now?

Corporates remain overleveraged, both relative to their euro area peers and historical trends. This is mainly due to a lack of equity, as corporate debt to GDP is about the euro area average. After peaking at 146 percent in 2008, the overall debt to equity ratio has moderated gradually to 123 percent in 2013. The deleveraging initially reflected the winding down of failed companies, and in the last two years net repayment of debt by going concerns, as corporates have turned into net lenders to other sectors (see chart). Finally, observed

leverage ratio benefitted from the statistical write-off of loans transferred to the BAMC to the transfer price levels in the last quarter of 2013.<sup>11</sup>

**Notable variations in company performance by sector, size, market orientation, and ownership shed light on the origins of the problem as well as on possible solutions.** Leverage is lower and debt service is more manageable in exporters. While there is not a significant difference in leverage levels between foreign-owned and domestically-owned firms, the former have significantly better earnings relative to their interest expense. These stylized facts suggest that the origin of the problem likely lies in the pre-crisis non-tradable investment boom, and concomitant leveraged mergers and buyouts. A similar picture arises from the sectoral distribution of leverage ratios where real estate, construction, and financial sector (mostly financial holding companies) stand out in terms of leverage ratios, whereas manufacturing remains below average.

**Financial distress is widespread.** Damijan (2004) reports that more than 15,000 companies suffer from debt overhang (defined as having net debt in excess of four times their EBITDA), comprising about 45 per-

cent of all firms that have some debt. The debt overhang is macro-economically relevant: firms for which the interest bill exceeds earnings account for 16 percent of total employment. Within this broad picture of financial stress, debt to earnings ratios are especially high for large corporates, which helps explain the NPL concentration pattern, and for micro enterprises (those with fewer than 10 employees), which poses additional challenges to restructuring frameworks.

**Corporate debt overhang weighs on credit growth, investment, and economic recovery.** On a macro level, evidence suggests debt overhang leads to worse macroeconomic outcomes. This is most starkly evident in the investment expenditure; Slovenia's investment to GDP ratio declined to 18 percent during 2012-13, the lowest rate recorded in the country's history. There is also micro evidence in the Slovenian context that leverage indeed damages firm performance. For example, Gabrijelcic et al (2013) find a significant negative link between leverage and firm performance in both pre-crisis and post-crisis periods. Similarly, Damijan (2014) finds that the extent of financial leverage and ability to service debt reduces firms' productivity growth, as well as the growth of exports, employment, and investment.

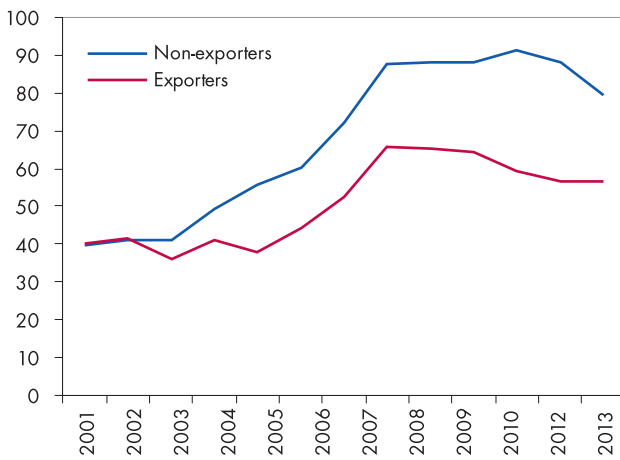
##### What is the way out?

**Debt restructuring and subsequent equity injections are key to restoring the health of many highly-indebted corporates and restarting sustainable credit growth.** Continued gradual debt repayment from these firms' own resources implies years

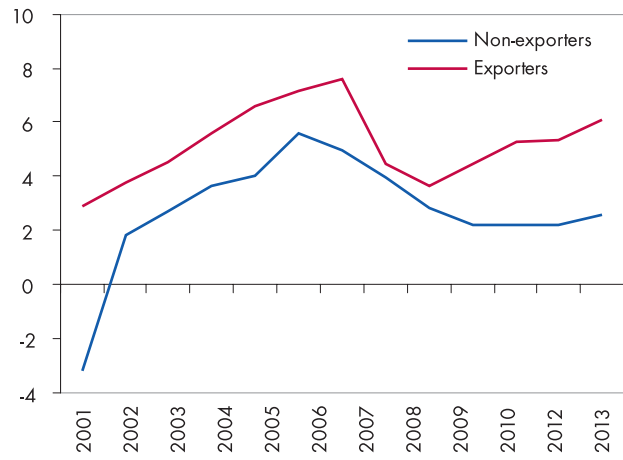
<sup>11</sup> This treatment had an impact of about 6 percentage points in the leverage ratio (Bank of Slovenia, 2014). From an economic viewpoint, the statistical treatment does not provide actual relief to the borrowers who are still legally liable for the full amount.

**Exporters are less leveraged and are better able to cover their interest expenses with earnings.**

**Net debt to equity (percent)**

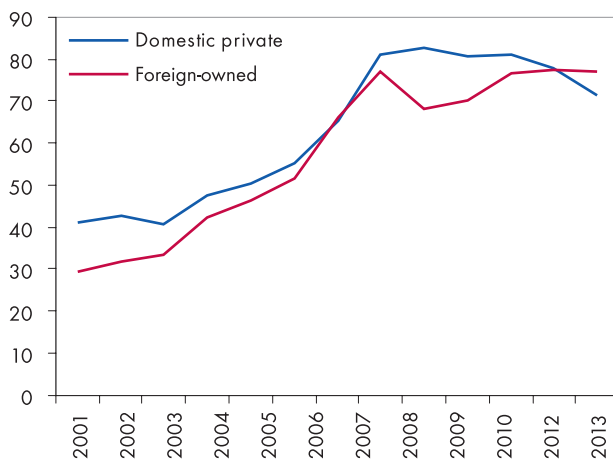


**EBIT to interest expense 1/ (percent)**

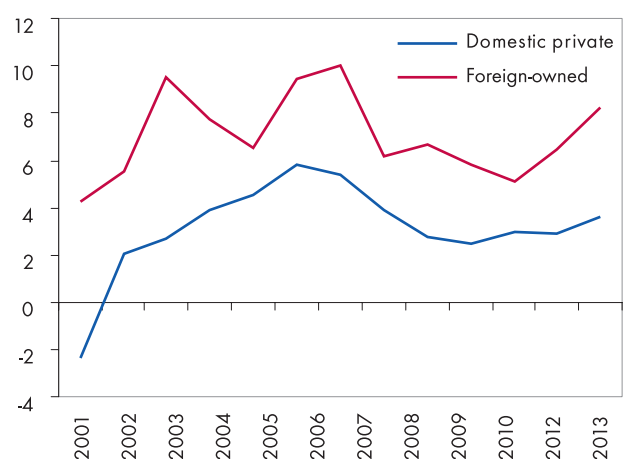


**While private domestic firms' leverage has declined, their interest coverage lags that of foreign firms.**

**Net debt to equity (percent)**

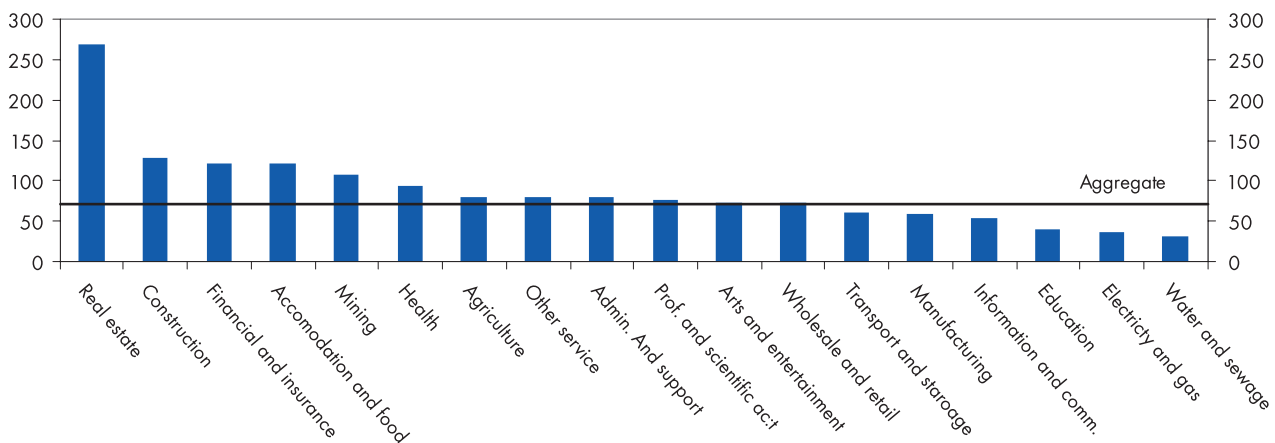


**EBIT to interest expense 1/ (percent)**



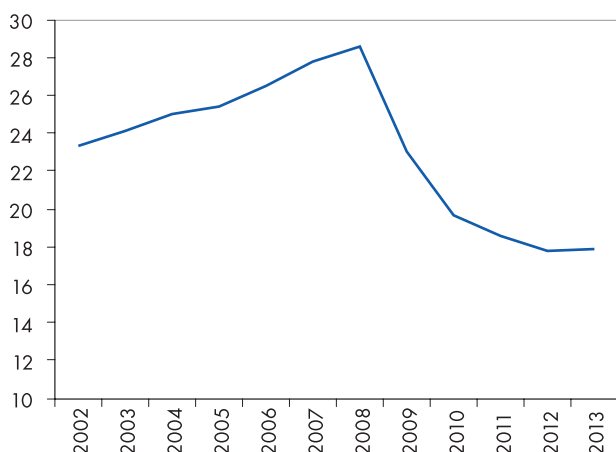
**Debt-to-equity ratio remains high in the non-tradable sectors.**

**Net debt to equity (percent)**



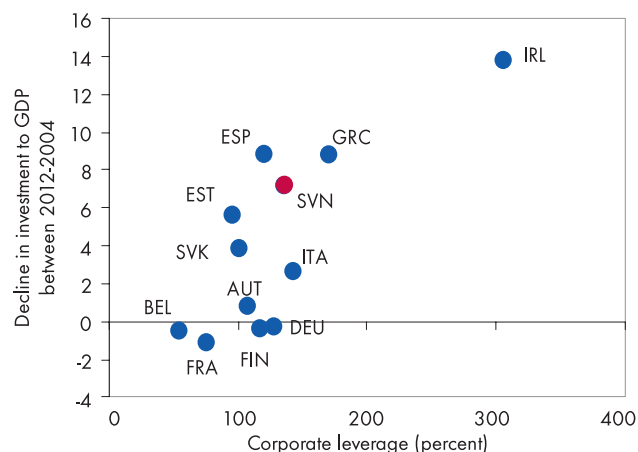
Sources: AJPES, and IMF and BoS staff calculations. 1/ EBIT stands for earnings before interest and taxes.

**Slovenia: Investment to GDP (percent)**



Source: Eurostat

**Leverage in 2008 and investment decline, 2012-2014**



Sources: ECB and Eurostat.

of corporate underperformance and financial volatility, which Slovenia cannot afford. Equity injections are needed; however, it is clear that debt overhang makes voluntary equity injections less likely to take place in firms where they are most needed. Moreover, debt restructuring is only worthwhile in cases where the firm's underlying business model is viable, or else the firm will find itself in financial strains again in the future. In some cases, viability requires operational restructuring as well as debt restructuring.

**International experience suggests that there are great benefits from corporate debt restructuring when it takes place within a comprehensive strategy.** For policy-makers, the key is to create an environment which incentivizes debtors and creditors to engage in meaningful debt resolution and attracts potential deep-pocketed new investors with the expertise and resources needed to turn viable businesses around. A comprehensive strategy should encompass legal and tax incentives for debt restructuring, adequate capitalization and provisioning in banks, effective use of an asset management company, provision of new financing for distressed but viable firms, and outreach and financial counselling services for companies in

distress. Such a strategy could benefit from regular monitoring to identify and address any bottlenecks and gaps.

**On the legal front, an effective corporate insolvency regime would be necessary to swiftly rehabilitate viable companies and liquidate non-viable ones.** In this respect, the 2013 amendment to Slovenia's bankruptcy law is a step in the right direction. The prior legal framework proved complex and rigid, and overly protective of debtors, allowing them to block or delay restructuring. It also reportedly did not provide useful tools for rehabilitating viable firms. The amendment helps reduce these problems by introducing a simplified pre-insolvency regime and an enhanced compulsory settlement procedure.

**The recently established BAMC can be helpful, if supported by all stakeholders.** The high concentration of NPLs in a few corporates suggests that a large reduction in leverage can be achieved by involving relatively few parties in restructuring negotiations. By collecting claims from the three biggest banks and potentially supplementing these claims with NPLs purchased from other banks, the BAMC can drastically reduce creditor coordination problems. The effectiveness of the BAMC could be increased by further transfers from

state-owned banks as described in the previous section, covering both new debtors and remaining assets of debtors that already saw part of their debts transferred to the BAMC to maximize recovery.

**Rebuilt financial buffers need to be put to good use.** Strengthening the balance sheet of the financial sector and realistic provisioning for inevitable losses is a necessary but not sufficient condition to resume credit growth. As long as banks refrain from drawing on provisioning and entering into restructuring, corporate debt overhang will persist. There may be managerial, legal, and tax-related incentives in banks to avoid write-offs and debt restructurings which need to be addressed.

**For the small- and medium-size enterprises (SMEs) in need of debt restructuring, additional measures may be needed.** While creditor coordination problems take a back seat, small enterprises are particularly at risk from debt distress, as restructuring is held back by the generally secured nature of claims that incentivizes foreclosure over rehabilitation. Moreover, claim sizes are too small for banks to negotiate over especially in the absence of good financial data and information about business prospects. To address the specific needs of small



enterprises, a multi-pronged strategy that encompasses legal reform, incentives for debt restructuring, improving the health of the banking sector, possible use of an asset management company (as in Korea (1997), Malaysia (1998), and Sweden (1992)), provision of new financing for distressed but viable SMEs, and debt counselling services for SMEs would be useful. Standardized approaches for restructurings (used in Iceland (2011) and Turkey (2001)) can also help simplify negotiations by providing simple tests for viability and a set of harmonized restructuring terms.

**Foreign capital can play an important role in revitalizing the corporate sector.** As the restructuring and deleveraging process goes on, banks and the BAMC will find themselves in ownership of equity and equity-like claims. The BAMC is intended as a temporary institution with a sunset clause five years from its establishment. And banks are not well positioned to become long-term corporate owners. Thus these claims will need to be sold to financially and operationally sound buyers. Here, FDI is the most plausible source of fresh equity and should be provided with a level playing field.

**Nonbank financing sources can be considered.** To the extent that banks are the factor that constrains credit, nonbank financial channels can be helpful. For larger corporates, direct access to capital markets may be a plausible alternative, most likely outside Slovenia. Efforts to reduce legal and tax-related complexity of bond issuance can help expand this option to a wider set of companies. Such efforts helped start a 'mini-bond' market in Italy, which is not large but holds promise.

**Looking ahead, strengthening corporate governance would guard against a repetition of the current problems.** This would involve reducing state involvement in the economy.

Currently, the state owns and controls substantial sections of the economy through an elaborate (and often non-transparent) holding structure.<sup>12</sup> The state can divest its holdings through privatization and strengthen corporate governance by encouraging the consolidation and simplification of ownership structures. Relinquishing ownership and control of state-owned banks can be particularly helpful, as the notable underperformance of state-owned banks in terms of asset quality (documented above) attests. For remaining state-owned enterprises, unified, professional, independent, and accountable management is of key importance. The new Slovenian Sovereign Holding, d.d. can prove useful in this regard.

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*A comprehensive strategy for debt restructuring is needed.*

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## V. Conclusion

**Slovenia is at a crossroads.** The economy has started to recover from the worst financial crisis and deepest recession in the country's history. Yet, corporate and bank balance sheets remain weak, holding back an expansion in bank credit, investment, and employment. A strong and sustainable recovery is far from assured. **Early and decisive action is therefore needed to address balance sheet weaknesses, restore credit growth, and support a durable recovery.** While important steps have been taken to restructure and

recapitalize the largest banks, further measures are needed to cleanse bank balance sheets from the remaining overhang of NPLs and to unlock credit supply. On the corporate side, work has already begun to strengthen the bankruptcy regime and use the BAMC for corporate restructuring. Looking ahead, it will be important to fully avail of the BAMC and improve its effectiveness by completing NPL transfers from banks. At the same time, privatization of government-owned and controlled companies should continue to improve their financial and economic performance and attract investors capable of injecting much-needed additional equity (including through FDI).

**The road ahead is difficult.** While the reforms discussed in this paper are necessary, they are unlikely to generate immediate results – it will take some time before credit resumes and the economic activity reaches its pre-crisis levels. Even if bank recapitalization can be carried out relatively fast, completing corporate restructuring may take years, given the size and the complexity of the problem. Yet, successful corporate restructuring is essential to prevent bank problems from recurring in the future and to lay the foundation for productive investment and stronger employment creation. This underscores the importance of timely action by the government to put in place the necessary reforms.

<sup>12</sup> Georgieva and Riquelme (2013) estimates at least 11 percent of employment is in enterprises directly or indirectly owned by the state, including the banks. Using a broader definition, Ogorevc and Verbic (2013) estimate one third of assets in the economy can be traced to the state.

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# Quantitative easing and non-bank debt financing in Slovenia

*Marko Simoneti\**

## QUANTITATIVE EASING AND NON-BANK DEBT FINANCING IN SLOVENIA

The objective of the paper is to explore why the development of non-bank financial institutions has become a precondition for Slovenia to increase the benefits of being a part of the Eurozone. The existence of modern banking integrated with non-bank institutions is assumed when strategic decisions are made in the Eurozone. First, we review how monetary policy works in the complex financial system and what are the main challenges for implementing quantitative easing (QE) effectively in the Eurozone. Second, we analyse why not many direct benefits should be expected in countries like Slovenia with a small non-bank financial sector. We conclude by proposing financial reforms needed in Slovenia to change this in the future.

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There are two big themes for post crisis banking in the Eurozone: financial stability and monetary measures to support growth. The Eurozone solutions are sought in the context of a modern well-developed financial system composed of commercial banking, investment banking, shadow banking, non-bank financial institutions and functioning capital markets. On the other hand, commercial banks in Slovenia are predominant financial institutions by holding 75% of all financial assets and companies are financed almost exclusively by bank loans.

## Introduction

Stability of the banking sector has been clearly the first short term priority with massive government sponsored bank rehabilitation programs in most Eurozone countries. The developed non-bank financial institutions are the advantage as they offer the alternatives for financing at the time when the banking sector is blocked. They also offer additional opportunities to take actions on time, to design a broad range of bank rehabilitation instruments and to involve the private sector and banks in rehabilitation process as well: sale of non-core businesses, sale of tradable securities, securitisation of loan portfolios, sale of bad assets, guarantees on borrowing and lending, private sector recapitalisations, issuing of preferred shares, hybrid and other debt funding instruments. In Slovenia the solutions chosen for bank rehabilitation were late coming, simple and expensive for taxpayers: the government was the only important player buying bad assets from banks and providing liquidity, funding and capital for troubled banks.

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In the complex financial systems financial stability by definition has to take a broader view of banks and non-banks. We have learnt in the last global financial crisis that both types of institutions can be: too big, too important, too complex or too interlinked to fail. Long term solutions for maintaining financial stability in the Eurozone are the new micro and macro prudential regulations, the banking union, separation of investment banking from commercial banking and regulation and supervision of shadow banking<sup>1</sup>. These rules will change the way how the banking business is operated in Slovenia as well, but they should not have dramatic effects on the overall financial structure given the simplicity of the system.

To support growth and to fight deflation in the Eurozone ECB has been using conventional interest rate setting monetary measures, complemented by mid-term low cost financing operations for banks. In Slovenia these measures have not been channelled through the banking sector to the real economy. The lending interest rates remain to be high and the volume of lending is stagnating for many years. The low cost ECB funding was mainly used by troubled banks for repayments of debt on the wholesale market. ECB has recently announced new broad quantitative easing measures (QE) following the examples of FED and Bank of England (BoE) in fighting recession and deflation. Details of this program are yet to be announced, but securitisation, non-banks and shadow banking institutions will be important as additional channels for allocation of new money in the economy. The objective of this paper is to explain why the development of non-bank financial institutions and capital market in Slovenia has become a precondition to increase benefits of being part of the Eurozone. The

structure of the paper is as follows: first, we review how monetary policy works in the complex financial systems and what are the main challenges for implementing QE effectively in the Eurozone; second, we analyse why not many direct benefits should be expected for countries like Slovenia with limited non-bank financial sector and last, we propose what type of financial reforms are needed to change this.

### Conventional monetary policy

Monetary policy consistent with stable and low inflation target of around 2% in the modern economy

*There is no automatic multiplication of reserve money.*

is implemented by setting the nominal interest rates on central banks reserves or the base money. This base short term rate is then influencing interbank interest rates and the range of other interest rates in the economy. This base rate is the main input for setting lending and deposit rates by banks and for determining the size of their lending activities. In the modern economy most of the money is created by commercial banks' lending and simultaneously creating matching deposits in the account of the borrower. On the other side, the amount of overall broad money creation and bank lending is limited (1) by the profitability concerns of banks in the competitive financial environment; (2) by the macroeconomic situation and the behaviour of bank customers – mainly corporates, non-bank financial institutions and

households - that can destroy newly created money by paying back old loans, (3) by micro and macro prudential regulation and (4) above all by the monetary policy. (BoE, 2014) In the normal situation the central bank is therefore focusing on the price of base money and not the quantity of base money as it is described by the money multiplier model in most textbooks. The quantity of broad money is therefore endogenous, the money multiplier is not stable and the quantity of base money depends on the amount needed by banks to carry out their business profitably. The oldest central bank in the world has described these textbook misconceptions in its recent report very openly: "Rather than banks receiving deposits when households save and then lending them out, bank lending creates deposits. In normal times, the central bank does not fix the amount of money in circulation, nor is central bank money 'multiplied up' into more loans and deposits." (BoE, 2014)

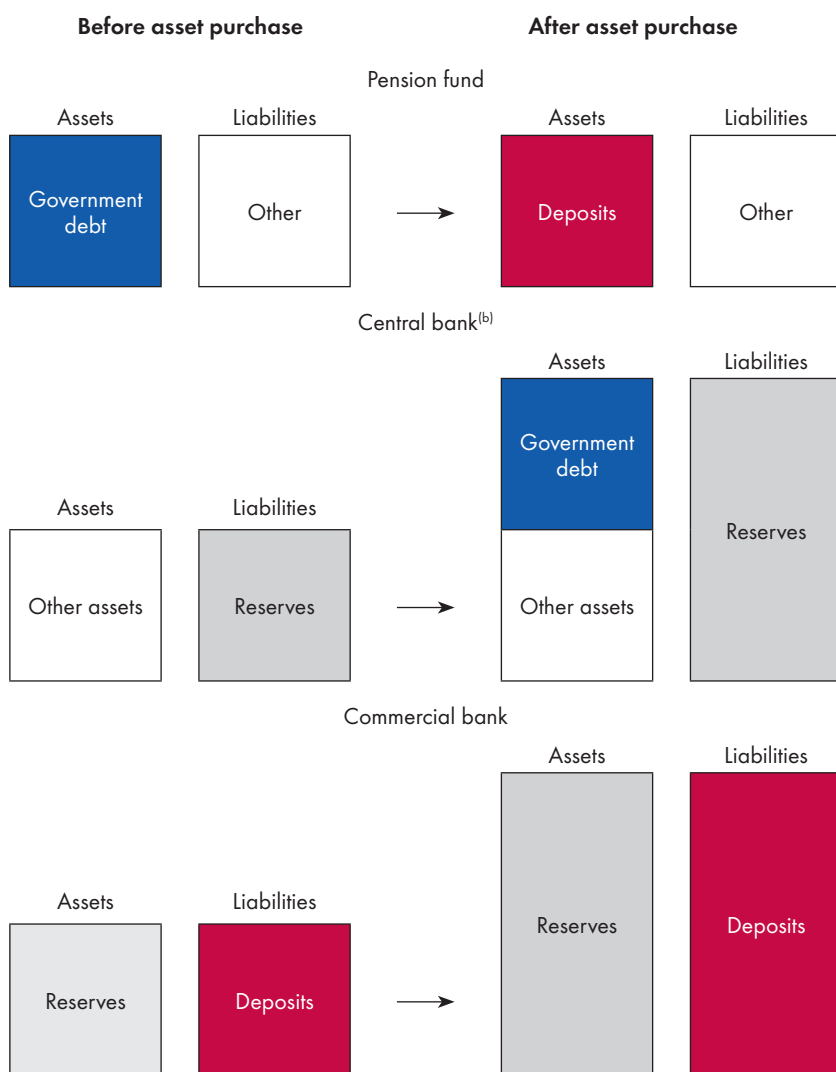
### Unconventional monetary policy

In the time of recession and deflationary pressures, once the basic nominal interest rate is set close to zero, the conventional monetary policy has reached its natural limit. On the other side, the short term real interest

<sup>1</sup> Former Federal Reserve Chair Ben Bernanke provided a definition in April 2012: "Shadow banking, as usually defined, comprises a diverse set of institutions and markets that, collectively, carry out traditional banking functions—but do so outside, or in ways only loosely linked to, the traditional system of regulated depository institutions. Examples of important components of the shadow banking system include securitization vehicles, asset-backed commercial paper (ABCP) conduits, money market mutual funds, markets for repurchase agreements (repos), investment banks, and mortgage companies." Shadow banking has grown in importance to rival traditional depository banking in debt financing and was a primary factor in the subprime mortgage crisis of 2007-2008 and global recession that followed. Regulated non-bank financial institutions like insurance companies, pension funds and equity mutual funds are not considered to be a part of shadow banking (see FSB, 2013).



**Figure 1: Impact of QE on balance sheets of banks and non-banks**



<sup>(a)</sup> Balance sheets are highly stylised for ease of exposition: quantities of assets and liabilities shown do not correspond to the quantities actually held by those sectors. The figure only shows assets and liabilities relevant to the transaction.

<sup>(b)</sup> Government debt is actually purchased by the Bank of England's Asset Purchase Facility using a loan from the Bank of England, so does not actually appear directly on the Bank's official consolidated balance sheet.

Source: Bank of England (2014)

rate and other longer term real interest rates can still be too high. One possible response to provide additional stimulus to economic activity by the central bank is to undertake a series of asset purchases, increasing the amount of central bank reserves in the system or so called quantity easing.

The BoE report (2014) is describing the basic logic behind this measure very clearly: "QE is intended to boost the amount of money in the economy directly by purchasing assets, mainly from non-bank financial

companies. QE initially increases the amount of bank deposits those companies hold (in place of the assets they sell). Those companies will then wish to rebalance their portfolios of assets by buying higher-yielding assets, raising the price of those assets and stimulating spending in the economy. As a by-product of QE, new central bank reserves are created. But these are not an important part of the transmission mechanism." Therefore, the same as in the conventional monetary policy, these reserves cannot be lend out di-

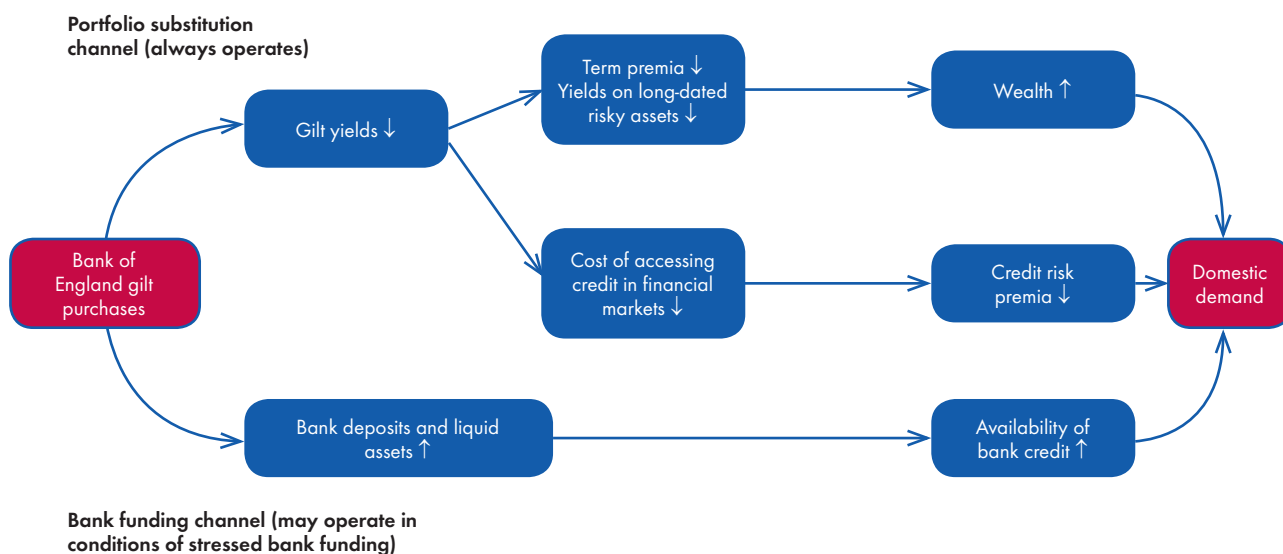
rectly to customers and they will not be automatically multiplied into more loans and deposits (see Figure 1).

### How QE works in today's complex financial systems?

Economists generally agree that the interest rate that matters for stimulating investment and consumption is not the short but the longer term expected real interest rate. Any real long term rate is technically a function of the main components: average expected short term interest rates for the period (i.e., the one that can in principal be influenced by traditional monetary policy every period), a term (duration) risk premium and a credit risk premium, and expected inflation (Fawley and Juvenal, 2013). The monetary policy, being conventional or unconventional, has to influence these components through various channels to be effective. QE does work on expectations as it is signalling to markets that economic conditions are worse than previously thought and that low short-term rates will be warranted for longer than expected. In a sense by QE the central bank even financially commits itself to easy monetary policy and low interest rates for the longer time period. After QE is implemented the central bank is holding a large portfolio of bonds and if the interest rates are to be increased very shortly the potential losses on portfolio can be spectacular.<sup>2</sup> The effects of QE on long term inflation expectations critically depend on when and how the exit from this policy is to be implemented which is at present the main topic in US. Effects of QE on expectations are generally referred to as **the signalling channel**.<sup>3</sup>

<sup>2</sup> For example, FED and BoE have increased their balance sheets five times during the current economic recession and they hold respectively about one third and one half of the outstanding government issued securities.

Figure 2: Key channels for the impact of The Bank of England’s gilts purchases on domestic demand



Source: Miles, D., Bank of England (2012)

QE may also directly impact term and/or credit risk premiums on the financial markets for the range of debt instruments. If the central bank purchases longer term bonds, removing them from the market, prices will go up and required long term returns down. New money issued to investors in exchange for bonds acts like “hot potato”. It is pushing the investors out of balance in their chosen portfolios and they start to buy other more risky assets like non-government bonds and equities, raising their price, reducing the required returns and the spreads above risk free returns. There are wealth effects for the owners of these financial instruments and reduced rates for new issuing of these instruments, both stimulating consumption and investment. With reduced returns on longer term and more risky assets the moral hazard and negative selection problems on the bank lending are mitigated as well, improving the bank lending conditions in support of economic activity. Effects of QE on premiums, or relative asset prices, are referred to as **the portfolio rebalance channel** (see Figure 2). There is another possible **bank**

**funding channel** through which QE works, particularly at times of stress in bank funding markets. This happens when banks themselves take advantage of lower long term interest rates on the market to obtain more stable and low cost funding for themselves (e.g., as a result of banks issuing new bonds or taking in long term deposits from non-bank institutions selling the bonds) which is likely to facilitate bank lending, particularly for those entirely dependent on banks for credit, for example SMEs (see Figure 2).

### QE in the market based financial systems

There is strong empirical evidence that the portfolio rebalance channel of QE is working well in the current recession in the economies with well-developed non-bank financial sector. Miles (2012) is reporting for UK that the purchase of longer term government securities (changing the yield curve for government bonds), but reducing the spreads for more risky debt instruments of financial and non-financial

corporations as well. Therefore, premiums for longer maturity and for credit risk in debt instruments were both reduced to support economic activity and resume economic growth in UK. The same channel has worked strongly in the USA as well where due to the size of the intervention the impact of additional liquidity on the markets has been felt globally by reducing long term interest rates for foreign sovereign debt as well (Neely, 2012).<sup>4</sup> The evidence for the working of bank funding channel on economic activity is less convincing. The banks might well choose to participate in this new asset price rally on the financial markets instead of looking for new opportunities in the financing of the

<sup>3</sup> The best example of effectively using the signalling channel to influence the selected markets was the statement of the ECB President Mr. Draghi at the pick of the euro sovereign bond crisis that ECB is ready to do whatever it takes to protect euro. This OMT program from 2012, with potentially unlimited capacity to buy sovereign bonds, has never been even implemented in practice but market participants reacted with substantially lower required returns for troubled euro member countries.

<sup>4</sup> Slovenia was a non-intended beneficiary of this policy, selling new bonds when this window of opportunities opened on the high yield market and avoiding the international financial assistance that would include conditionality by troika (IMF, ECB, EU).

real economy. There are many other side effects of these measures on foreign exchange and equity markets as well. Only the future will tell if this general inflation of asset prices, which has been the key part to revive the growth in the short term, will be translated into long term and sustainable growth of US economy as well or it is only the beginning of the next asset price bubble. For the rest of the world, including EU, this is more or less an academic issue as they have practically no choice but to follow the US and UK lead in this area.

### QE in the Eurozone with no "Eurobonds"?

It is interesting to note that the real intention of QE programs is to lower interest rates for private debt, while the purchase in US and UK is made almost exclusively of risk free government debt. Why the central bank is not buying these private debts directly? This would imply that the central bank is taking on the balance sheet not only the market risk associated with the change in the interest rate level but the credit risk of individual issuers as well. This is very relevant for the ECB as there are no bonds issued on the level of the Eurozone while they are institutional limits on buying bonds of the member countries. In addition, at present sovereign bonds of some of the member countries are not really risk free.<sup>5</sup> The financial system in the Eurozone (and Japan as well) is also much more bank based than in US and UK and the portfolio unbalance effect in the non-banking sector will be automatically smaller (Fawley and Neely, 2013). The banking channel has to play more direct and important role in fighting the deflationary pressures in the Eurozone as this is the only large enough channel that exists in many member countries. The ECB unconventional monetary

interventions during the crisis had to take these structural and institutional limitations into account. The largest ECB programs - long term repurchase operation (LTRO) and the new targeted LTRO, being conditional on new financing of non-financial sector - can hardly be compared with QE programs in US and UK. ECB is creating additional reserve money by providing banks with medium term financing at low cost and expanding its balance sheet with wider range of eligible assets taken as collateral. The purchase of sovereign bonds from banks is therefore indirect and

## *ECB measures can hardly be compared with QE in US and UK.*

temporary. But additional reserves in banks do not automatically multiply into cheaper new lending and money creation as in the textbook money multiplier model. Precondition for this bank funding channel to work at all is that banks are financially stable and new lending is profitable. Many of the banks used this ECB facility simply to refinance their liabilities on the wholesale banking market (including the banks from Slovenia) but the overall lending to non-financial corporate sector has remained stagnant. In addition, the fragmentation of the banking sector in the Eurozone in this period has been further increased with wider dispersion of bank interest rates for corporate clients. On the other side, it can be argued that with-

out the ECB intervention in providing refinancing for over-leveraged banks the credit crunch in the Eurozone would be much deeper (Rant and Gregorič, 2014). It should not come as a surprise that banks with capital adequacy concerns would be very reluctant to increase lending as well. The non-participation of the EU banks in the first round of TLTRO in the fall 2014 is the case in point. Systemically important banks are waiting for the final results of stress tests and they find little interest in new funding and implicit commitments to new lending before they now how much additional capital will be needed for existing portfolio of loans.

QE measures in the US and the UK are targeted at non-bank financial institutions holding large portfolio of government bonds and banks serve only as intermediaries to unbalance their asset mix. For participating banks (prime dealers in the US) this "dancing with the central bank" is rather lucrative and low risk activity as long as the program last as promised. Therefore, banks willingness to participate in QE to unbalance the portfolios of non-banks is really not a problem, but willingness of banks to increase their own lending depends on many other factors in the economy.

### QE in the Eurozone and securitisation

The ECB has already announced the beginning of its own version of QE that will be focused on purchasing

<sup>5</sup> Buying such bonds in large quantities for monetary purposes would be far from neutral operation for member countries. As critics are quick to say this would be the same as bailing out troubled countries and subsidizing their banking institutions which are usually holding a large portion of domestic sovereign bonds. One can argue that similar credit risks are present at least partially in US where government agencies guaranteed mortgage backed securities (MBS) were part of the QE purchase as well. FED has already announced the exit from QE program at the end of 2014 with the intention to hold accumulated assets till maturity. This in turn means that FED will be an important participant in housing finance in US for many years to come.

structured products like asset back securities (ABS) and collateralised debt obligations (CDO) in support of financing SME sector in the Eurozone. Paradoxically, securitization of loans and practice of distributional banking used for subprime housing loans in US that were the main reasons for the global financial meltdown are proposed by the ECB as a solution to overcome recession in the Eurozone. It will be interesting to observe what will be the size of the program and the eligibility criteria. Will it be possible to include in the programme the mezzanine tranche in addition to senior tranche of these structured securities? More broad definition of eligibility will be needed to have large enough volumes to make an economic impact but that would imply the ECB helping banks to save regulatory capital and assuming additional credit risk that might well be larger than in the case of buying directly sovereign bonds. With the fully integrated financial markets one can argue that simulative effects of increased asset prices and reduced required returns are broadly distributed to investors in all asset classes and to all potential issuers. But the reality of the Eurozone is that financial sector is fragmented and capital markets are less important than in the market based financial systems. Who owns the assets to be purchased, who can generate new assets to be purchased and who is to be chosen to “dance with the central bank” in the Eurozone might well become the major political issue.

Countries like Slovenia, with no domestic market for corporate debt securities and limited experience in securitisation will likely receive minimal direct and indirect benefits. On the other side, some larger member countries like Italy have already made major steps forward to encourage debt financing of SMEs on

the capital markets to complement traditional bank financing. These policy measures will be reviewed in the next section as we believe there are lessons to be learned for Slovenia. It seems that the future of corporate financing in the Eurozone will become much more like in US and UK, where securitisation, capital markets, non-bank financial institutions and shadow banking will play an important role beside commercial banks. To benefit from these developments Slovenia should, like it or not, adjust to this new trend as soon as possible.

### **Minibonds and securitisation in Italy**

Italy, like most continental European countries, have had for many years a typical bank based financial system with the great majority of companies almost exclusively relying on domestic banks for short and long term financing. Bond financing was used only by a few large listed companies and financial institutions which could attract international investors as well. With the objective to improve SMEs and unlisted companies access to debt financing on the capital market and support economic growth, Italy introduced in December 2012 a special legislation for minibonds and commercial papers. In December 2013 this was accompanied by a new securitisation law, regulating establishing of SPVs to acquire corporate loans and securitise them. The legal framework to build up domestic shadow banking is in place. Banks can now set up investment funds with securitisation of existing portfolio of loans by retain a large part of first loss equity tranche or start new debt funds with outside investors.<sup>6</sup>

Minibonds can now be issued by SMEs that are not listed on the stock exchange and they are not intended for retail investors but only

for professional investors. Offering disclosures and regular reporting requirements for minibonds are lower than for retail bonds, no prospectus is needed, and sensitive information reporting is limited to major events, all reducing the costs of issuing for SMEs. To issue short term notes SME has to nominate professional sponsor. Minibonds can be participatory providing they have at least three years duration and they pay at minimum the ECB base interest rate. Therefore, bondholders can participate in the profit of the SMEs and share the risk with the owners of the SMEs. Corporate tax treatment of this profit sharing with creditors is the same as for regular interest payments, providing that bondholders do not have more than 2% ownership stake in SME. Minibonds are traded on the special segment of the stock exchange reserved for professional investors trading in bonds, commercial papers and project bonds. It should be very easy to use the same market infrastructure to organise centralised book building process on the primary market for minibonds as well. All these institutional arrangements are making transactions with minibonds cheaper and more easy to use by institutional investors who received also some regulatory reliefs in Italy to buy minibonds.

The minibond instrument is risky by its nature as it issued by SMEs and, in addition, interest payment can be participatory. As they are not appropriate for retail investors, requirements can be lowered, but some standardisation is needed to achieve the main objectives, to support the program by favourable tax regime and to promote the broader use of

<sup>6</sup> See for example Vestini, Tancredi (2014) and Linhard (2014). It seems that Italy has anticipated well in advance the ECB measures focused on the support to SME financing. In addition, institutionally Italy is well positioned to take the advantage of QE program focused on ABS and CDO securities, once details are disclosed by ECB President Mr. Draghi in October 2014.



new instruments. These instruments in Italy seem to be well adjusted to the financing and operational reality of SMEs as they are half-way between bank financing and public bond financing. Extensive financial covenants as in the banking loans are combined with the standard public bonds provisions of negative pledge, "pari passu" and limited restrictions on asset disposal and extraordinary transactions.

### Debt financing and the capital market in Slovenia

The size of the Slovenian financial system has been reduced to 161% of GDP during the financial crisis and it remains small compared to the 612% of GDP in the Eurozone. Banks with 75% of the assets under management are dominating players despite the contraction of the lending activities in recent years, while the other non-bank financial institutions have been underdeveloped in terms of size, structure and variety of financial instruments. In addition, the cross-linkages with the banking sector are not very strong as the main investors in all non-bank institutions, including the investment funds, are retail investors. The organized domestic capital market is small and suffers from low liquidity and remains off limits to companies and other entities as an alternative source of financing. The five most heavily traded prime market shares accounted for more than four-fifths of total volume of trading with 64 listed companies and two most heavily traded bonds accounted for nearly one-half of the total volume of trading. (BoS, 2014, p. 84- 98)

At present non-bank financial institutions are not very relevant for domestic corporate financing as they mostly invest in government bonds and foreign assets. The insurance sector has increased its foreign assets

during the financial crisis from 30% in 2009 to 45% in 2013. The mutual funds, mostly equity or mixed funds are 70% to 80% invested in foreign securities. A few money market funds and debt funds have been created recently but they are still small in size. Real estate funds and hedge funds are not present at all. Foreign asset management companies have mostly left the country during the financial crisis. Pension funds have at present very conservative investment policy due to legally required minimum return and they are mostly invested in government bonds and deposits.

## *Banks' deleveraging in Slovenia was »brutal« to corporates.*

Contrary to the banking sector this part of the domestic financial industry was able to survive the implosion of equity and real estate price bubbles and the long lasting economic recession without the assistance of the government. It also showed a lot of resilience in the recent turmoil caused by the collapse of the domestic banking sector where the losses due to investments in shares, hybrid and subordinated debt instruments issued by domestic banks were substantial. The consolidation of the industry is close to complete and surviving institutions are financially strong and profitable.

In 2014, the bank deposit rates in Slovenia were sharply reduced due to BoS intervention which might induce some bank depositors to switch their savings to alternative non-bank

institutions. At the same time, domestic insurance companies and pension funds are forced to look for better returns in alternative investments at home and abroad. On the regulatory front, the introduction of the new life-cycle investment policies in pension funds will increase the demand for shares and corporate bonds, while the introduction of solvency 2 in insurance industry will likely switch demand from longer term to shorter term debt instruments. Therefore, in the near future some changes in investment policies are expected, some additional de-satisfied retail and institutional bank depositors might be attracted, but the overall organic growth of the non-bank institutions will depend mostly from the improvements in disposable income of households due to economic recovery and reduced unemployment.

Financial crisis always leads to deleveraging of banks and corporates, but "good" deleveraging would try to minimise the negative impact of this process on economic growth. The deleveraging of banks in Slovenia was "brutal" to the corporate sector that depends almost entirely on bank financing. Between October 2008 and March 2014 the banks' repayment of debt on the wholesale markets exceeded 32% of GDP. The main counterpart of these repayments was reduced bank financing for corporate sector and sharp increase in cost of debt financing (BoS, 2014, p. xii). The LTD ratio in the banking sector was in this period reduced from 160% to 103% and business models of both foreign-owned and domestic-owned banks were transformed into simple savings and loans institutions on the domestic market. With the government assistance in the amount of close to 12% of GDP the banking sector is now well capitalised and liquid, but the lending activity is still low and interest rates for corporate lending about

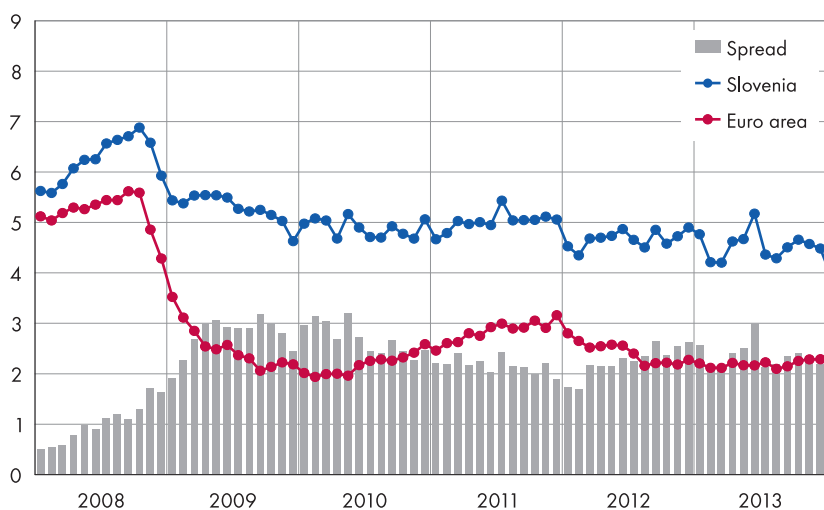
3% to 4% higher than in Eurozone (see Figure 3).

The precondition for overall credit growth is the restructuring of over-indebted corporate sector that is lagging behind banking sector in restructuring of their balance sheets. It is estimated that this excessive corporate debt might be around one third of GDP and is not limited only to a few large debtors but to thousands of SMEs as well (UMAR (2014) and Damijan (2014)). It is clear that organised and coordinated efforts of the BAMC, banks and the government will be needed to financially restructure these companies and secure them new equity financing before they can take on new loans (Simoneti and Jašovič (2013), Simoneti (2014a, 2014b)).

Based on the BoS survey on the access to finance from 2011 to 2013 availability of bank loans has deteriorated, bank rejected more applications and companies received fewer funds than they demanded. They increased their demand for external financing in the period while the supply did not follow and the financial gap has increased. Most companies still do not expect that external financing in Slovenia will improve in 2014 (Geršak, 2014).

Good companies are trying to escape from this long lasting financial repression on domestic bank loan market by borrowing from abroad, which is available to big traditional exporters and by issuing debt instruments on the capital markets, which is limited to large and financially sound companies. Financial experts estimate that only 5 to 10 Slovenian companies can issue debt instruments on international markets due to minimum size and rating requirements. Additional 50 companies might have the size and the quality to issue bonds and notes on the domestic market. The demand for these instruments is at present strong

**Figure 3: Interest rates on corporate loans of more than euro 1 million in percentages in comparison with the euro area**



Source: Bank of Slovenia (2014)

even on domestic market as deposit rates were sharply decreased. There have already been first transactions indicating that a handful of qualified domestic companies will seize the opportunity to replace expensive domestic bank financing with debt financing on the capital market. But for most of the companies in Slovenia, being SMEs, this is not a solution unless there is a radical change introduced on the supply and demand side of the market.

### Conclusions

The underdeveloped capital market and non-bank financial institutions in Slovenia are by-product of the distributional model of mass privatisation, non-transparent and bank supported domestic consolidation of ownership, large residual state ownership and of the key role played by state owned banks in the gradual transition to the market economy. In the transition and development model based on strong relationship among the state and domestic financial and corporate sector, supported by the ideology of "national interest", transparency and disclosure rules of the capital market

were not really welcomed (Šušteršič, IER, 2010).

With the banking crisis and the collapse of this development model many new opportunities have opened for the debt and equity capital market development to assist in solving the main economic challenges of Slovenia: restructuring of banks and companies, privatisation, corporate governance in state owned sector, new equity financing, foreign financing of domestic economy through non-bank channels, long term households savings and pension reforms. An extensive study from 2010 served to form a broad consensus of the financial industry participants what should be done for the revival of the capital market in Slovenia.<sup>7</sup> A comprehensive and consistent package of measures to increase confidence in the market and quality of the market, to strengthen the supply side and demand side of

<sup>7</sup> The new strategy for development of the capital market was drafted based on the initiative proposed by the Ljubljana Stock Exchange, proposals by market participants and the research conducted by the Slovene Institute for Economic Research (IER) entitled »Development Opportunities for the Capital Market in Slovenia Following the Financial Crisis« (2010).

the market and to improve market infrastructure was agreed upon that is still relevant four years later.<sup>8</sup> This paper only adds one more opportunity for non-bank institutions to play a positive role in the economy: increasing the benefits of the Eurozone membership for Slovenia.

The expansionary monetary measures of the ECB have not been transmitted into new lending and lower interest rates for the real sector in Slovenia. Therefore, the new monetary policy of ECB focusing on corporate and SME financing through TLTRO and QE seems like a very timely and relevant measure for Slovenia. But how can these proposals work in the system which is dominated by banks that are still burdened with more than 20% of corporate NPLs after the transfer of bad assets to the BAMC at the end of 2013? They cannot because the bank funding channel does not function if banks are still under stress and preoccupied with their internal problems and most of the companies are still over indebted. But even if Slovenian banks and companies are once financially restructured there would be a problem as there is no infrastructure available to securitise bank loans. For many years Slovenian banks were using wholesale market and parent banks' loans for additional funding and they have no experience in securitisation. The financial system in Slovenia is operating so differently that the proposed instruments cannot be used effectively in the near future.

Some countries with traditional bank-based systems and a strong SME sector have already realised that being different and less developed in the Eurozone comes at cost and

they are making big steps forward in closing this gap. Is there a lesson for Slovenia, to use minibond concept for alternative new financing of SMEs and, above all, to use securitisation of existing corporate loans once the financial restructuring of over-indebted borrowers is completed. For such a program to work we need (1) a supportive legal, tax and institutional environment, (2) motivated and capable issuers in corporate and banking sector and (3) strong foreign and domestic demand. With the ECB announcing QE programs the main constraint is no more on the demand side but on the limited domestic professional capabilities to design the overall framework and to execute transactions. The by-product of the suppression of capital market development in Slovenia for many years is that there is a lack of investment banking skills that are needed today to efficiently restructure banks and their corporate clients and to take full advantage of the new growth promoting initiatives within the Eurozone.

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<sup>8</sup> See »Slovene capital market development strategy«, <http://www.ljse.si/cgi-bin/jve.cgi?doc=1468>

# Structural changes in European banking and influence on banking business models

*Robert Priester\**

## **BANK STRUCTURAL CHANGES**

The regulatory reform agenda of the G20 has been implemented in the EU via some 40 legislative and regulatory measures that already constitute a full structural reform. The increased and higher quality capital requirements combined with new liquidity buffers set banks on a more solid footing and will force a sharper focus on the capital cost of business lines and activities. In addition, measures to make a bank resolvable in an orderly manner and to have banks absorb any losses internally first via bail-in mechanisms without having to rely on taxpayers in emergencies will also force bank management to review their firm's organisation and structure to satisfy supervisors, who now already have powers to force a separation of activities if not satisfied. Europe's banks are very sceptical whether an additional measure such as proposed on bank structural reform with forced separation of some trading activities is still necessary and will distract from the focus on stimulating growth in Europe.

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**A**fter the financial crisis of 2007 and the international response among policymakers to address deficiencies in bank supervision, the European banking system is at present seeking to implement and comply with a wide range of reforms following a sweeping re-regulation with a view to strengthening banks' resilience and focussing their role on supporting the real economy. The new rules will in themselves lead to a change in the structure of banking in Europe.

It is clear that measures such as the new capital and liquidity requirements, which in principle were meant to be phased in gradually until 2019, already apply today through market pressure and in themselves entail a full structural reform. Europe's banks have been busy building the capital levels at an accelerated pace, and some EUR 450 billion of the 550 billion capital shortfall identified by the Basel Committee at the outset of the crisis have been found already by means of gross new issuance, retained earnings, convertible bond issuance and shedding non-core assets or business lines.

The new liquidity rules, and esp. the long-term liquidity ratio, are expected to change the funding structure of European banks, some of which had in the past a high propensity to seek cheap short-term funding on the wholesale markets to grow their longer-term lending business. The crisis has put paid to this model and has reinforced the attractiveness of a higher proportion of deposits as a more stable base of funding.

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Other key pieces of financial services legislation address excessive risk-taking by banks in significant ways. Capital Requirements (CRR) and Capital Requirements Directive (CRDIV) call for substantially higher and better capital layers to build inherent resilience of the banks. The cost of capital to the banks themselves alone will force about a sharper attention on the uses of the capital and will shape business models to shed marginal business lines and markets. Banks are already refocussing their attention to core activities and markets as a result.

The governance demands of the CRDIV will also make banks' boards and senior management more attentive to the business lines and activities to pursue. The sharper responsibility that these officers will carry within the bank they preside should cause a shift in the composition and skillset in the boards of many banks, and first signs are appearing that non-executive board members are shying away from such responsibility levels. Especially when in other sectors more attractive remuneration is combined with less personal or collective risk attached to the decision making. The Bank Recovery and Resolution Directive (BRRD) is also a key piece of legislation which obliges Member States to put in place recovery and resolution tools that offer all supervisors in the EU a same set of processes to ensure an escalation of interventions in a bank before it is considered a failing institution, which can be resolved by means of an orderly process that does not put at risk the stability of the financial system of that Member State or beyond. It is to be expected that the mere possibility that incumbent bank management can be replaced by a supervisory intervention as a critical step in the escalating measures to avoid a bank failing, will have a strong impact on bank managers' responsiveness to

supervisory calls.

A BRRD-inspired process that will be mandated from the banks already at a much earlier stage is the establishment of a recovery and resolution plan, or the so-called 'living wills', which must pass muster of the supervisory authorities. Such recovery and resolution plans demand of management that they take a long and hard look at their banks' organisation and structure to put in place processes whereby parts of a wider banking group can come to the assistance in terms of capital or liquidity for another part of the bank without endangering the survival of the wider group. In a worst-case scenario the resolution side of the plan will guide the supervisory community on the steps that can and need to be taken to salvage the viable parts of a non-viable bank if all earlier measures have been to no avail. Rather than facing these tough decisions over a weekend with little clarity on a crumbling bank's positions and structure, the recovery and resolution plans will give supervisors insight into structure as well as steps to take and whom to contact among the other supervisors involved that will allow a much more orderly resolution of a failed bank. These plans therefore serve a very serious purpose, esp. for cross-border active banks in the EU but even more so for the globally active banks. The fact that supervisors must approve these plans will help in this regard to balance the home-host relationship in a college of supervisors of cross-border banks. The fact that the first set of recovery and resolutions plans of US banks have not fully satisfied their supervisors is a clear indication that these plans are not to be taken lightly and form an encouraging sign that supervisors will be able to rely on each other's assessments to an increasing degree. It is interesting to note that as part of the escalating intervention powers

of supervisors under BRRD they can decide that certain activities need to be separated out of the main bank structure. This is, however, not a mandatory step but one that is triggered if the supervisors are increasingly concerned over the accumulation of risk in certain activities of the bank under closer scrutiny.

The bail-in component of the BRRD will also cause a structural shift in Europe's banking sector, where the largest banks will indeed rush to have sufficient bail-inable liabilities in their balance sheets. It is expected that the larger banks in Europe will be able to find sufficient investors in the market for these types of bonds that deliver a higher return due to the conversion or haircut risk they carry in case of crisis. The larger banks also have an inherent advantage of already having a more diversified range of creditors and corresponding liabilities. The challenge will be for smaller banks with less such diversity in their balance sheets to find under wider market pressure the investors at affordable pricing levels.

### **European Commission proposal for bank structural reform**

Against this backdrop, the European Commission (EC) released on 29 January 2014 its *proposal for a regulation on structural measures improving the resilience of EU credit institutions*. The proposal suggests a prohibition of proprietary trading and engagements in hedge funds, as well as a requirement for separation of trading activities into a separate entity when a set of as yet undefined separation limits are met. The supervisor can, however, allow the bank to carry out trading activities above the separation limits if the bank can prove that this does not endanger financial stability. The supervisor can also decide to separate out trading

activities below the separation limits. The bank structural reform provisions will apply to EU banks that are G-SIBs (as defined in the CRD) or that for three consecutive years have total assets that equal or exceed EUR 30 billion and trading activities that equal or exceed EUR 70 billion or 10% of total assets. It is not entirely clear from the proposal whether the supervisor could apply the separation requirements to banks below this general threshold.

Foreign subsidiaries and branches of EU banks can be exempted from the regulation if they are subject to an equivalent legal framework. Also, supervisors are granted the power to exempt from separation foreign subsidiaries of groups with autonomous geographic decentralised structure pursuing a multiple point-of-entry (MPE) resolution strategy. EU subsidiaries and branches of third country banks that do not have equivalent structural reform rules in place must also comply with the regulation. The proposal contemplates the possibility for EU Member States to derogate from the separation requirements if they already have equivalent and compatible structural reform primary legislation in force on 29 January 2014. Banks will then have to comply with the proprietary trading ban from 1 January 2017, and the provisions on separation of trading activities from credit institutions will become effective from 1 July 2018.

### **The industry reaction**

The EBF has from the outset challenged the European policy makers need for further regulation on the too-big-to-fail viewpoint with a mandatory ring-fencing or separation of certain activities without taking into consideration the full raft of regulatory reforms. This comprehensive impact assessment would serve to de-

termine if there is a deficiency in the rules and tools that the supervisory community has received to address the perceived excessive risk taking or an implicit subsidy of the deposit-taking side of the bank to the investment banking side. Commissioner Barnier has indeed in the final stages of his mandate released a start to this overall assessment, but concedes that in many cases it concludes that it is too early to assess the impact of the rules in their entirety, including possible unintended consequences.

The Federation would like to reiterate the message of its response to the Commission consultation in June 2013. The EBF does not see the

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*Supervisory  
intervention is  
a critical step  
in measures to  
avoid a bank  
failing.*

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additional value of the Commission proposal for structural reform for the European banking sector in the current context where key pieces of the financial services regulatory reform agenda have not yet been finalised and/or fully implemented (for example Banking Union, BRRD, DGS, CRD IV/CRR, MIFID, EMIR).

The EBF is uncertain about the overall purpose of the Commission proposal on bank structural reform since it does not appear to contribute to enhancing financial stability but instead introduces a substantial amount of uncertainty and has likely adverse effects on the financing of the European economy and the EU

banking sector. Especially, the EBF finds the Commission proposal for structural reform to be in contradiction to the aim of the Commission's Europe 2020 growth agenda and the Communication on Long-Term Financing of the European Economy. According to the European Commission the proposal in its current form would target only 29 banks out of a total of around 8.000 European banks. The major part (80%) of the European investment bank's sector has been covered meanwhile by national legislation on structural reforms (Germany, UK, Belgium and France). The European proposal should therefore be assessed according to the principles of subsidiarity and proportionality provided for in the Treaty. Also, the Commission proposal is not compatible with national structural reform approaches, but goes beyond those approaches by suggesting both to introduce a ban on proprietary trading and to separate out a broader range of trading activities, for example market making. The EBF is especially concerned about the Commission proposal for separation of trading activities that could potentially be very far-reaching as many important activities would be inside the range of possible separation. Furthermore, the proposal creates considerable uncertainty around the definition and status of separation limits; the potential additional instruments to be left out of the separation scope; the process for the supervisory assessment of trading activities and the supervisory decision for separation. These features add further to the EBF's concerns that the proposed separation requirements would harm the ability of European banks to play their continued important role in financing of the European economy. EBF believes that there is a substantial risk that activities that are customer-driven and useful for

the real economy, as for example market-making, securitisation and derivatives trading, executed on behalf of clients, could end up being subject to separation. These activities are fundamental for the proper functioning of the financial markets and fulfil two essential functions: (i) the provision of liquidity to all financial instruments in the secondary market; and (ii) the supply of risk management tools (derivatives) to end-users (e.g., corporates, financial companies, public entities, pension funds, and mutual funds).

In addition to lending to customers, banks' balance sheets also offer other valuable services to the real economy. For example the ability to carry inventory to support market making is essential to the provision of liquidity in European financial markets, which in turn delivers lower funding costs to corporates and governments.

It seems contradictory to advocate for developing the European capital markets, both in equity and bonds, as the Commission does in its recent "Communication on Long-Term Financing of the European Economy" and then, at the same time, hamper the market-making activity necessary for such development by allowing regulators to require banks to separate market-making activity into a trading entity and, as a result, increasing costs of corporate capital markets.

Furthermore, the possible separation of certain activities related to derivative instruments reduces the capacity of banks' clients to manage their risks. This burden is particularly unnecessary since EMIR already deals with the vulnerabilities arising from these activities. In EBF's view European banks should be allowed to do proper treasury management and provide hedging services without any restrictions.

The proposed separation measures

would potentially imply serious disruptive consequences for European banks - especially for universal banks. Their business position would be negatively impacted due to the lack of diversification and a greater volatility in revenues, and their funding ability compromised by the lack of a diversified funding base. Overall this proposal creates considerable uncertainty in the European banking sector at a critical time related to the conduct of the Asset Quality Review and the European stress test, in the view of the implementation of the single supervision by the end of 2014. It could also hamper the ability of some banks to

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*Bail-in  
component  
will cause a  
structural shift  
in Europe's  
banking sector.*

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raise capital on the markets - if and when necessary - given the potential threat of this European regulation on their business model.

It should also be noticed that the FSB announced in parallel supplementary measures for Global SIBs to ensure they have sufficient loss absorbency capacity in resolution (GLAC), whilst to date structural reform has not been a part of the G20 measures introduced to address financial crisis. Furthermore, the emerging G20 discussion on the issue especially stresses that careful consideration should be given to avoid unnecessary constraints on the integration of the global financial

system or the creation of incentives for regulatory arbitrage.

### Conclusion

Overall, the regulatory reform programme delivered to date - significantly enhancing capital and liquidity buffers, and facilitating credible cross border resolution for banks, including creditor bail-in - means that banks will need to adjust to a new reality and are significantly safer than before the crisis. Hence, the benefits of additional specific structural reform are not immediately obvious.

Although the worst of the financial crisis has abated the current problems facing banks are almost as daunting when taken altogether. Regulation continues to increase in both complexity and stringency across the board: new rules for capital, liquidity, and funding; surcharges for financial institutions deemed systemically important; and a raft of consumer-protection initiatives. Collectively, the new rules could have significant consequences, including a longer-lasting negative impact on return on equity (RoE).

After decades of consistent success, banking faces a period of profound change.

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# Sectoral indebtedness and balance sheet repair in euro area

*Tina Zumer\**

## SECTORAL INDEBTEDNESS AND BALANCE SHEET REPAIR IN EURO AREA

The global financial crisis has left a number of economic sectors across the euro area reeling from high debt levels and debt servicing obligations. Against this background, the paper analyses sectoral exposures to risks stemming from indebtedness in the euro area countries. The heavy debt burdens, as well as the unfavourable autonomous debt dynamics have triggered the on-going repair of overleveraged balance sheets of the private sector, while governments absorbed some of the slack in domestic demand created by the private sector deleveraging. Looking ahead, the gradual deleveraging process in several euro area countries indicates more scope for deleveraging in the future, which could, in turn, propagate negative feedback loops between the financial and real cycles, thus remaining a drag on growth for some time.

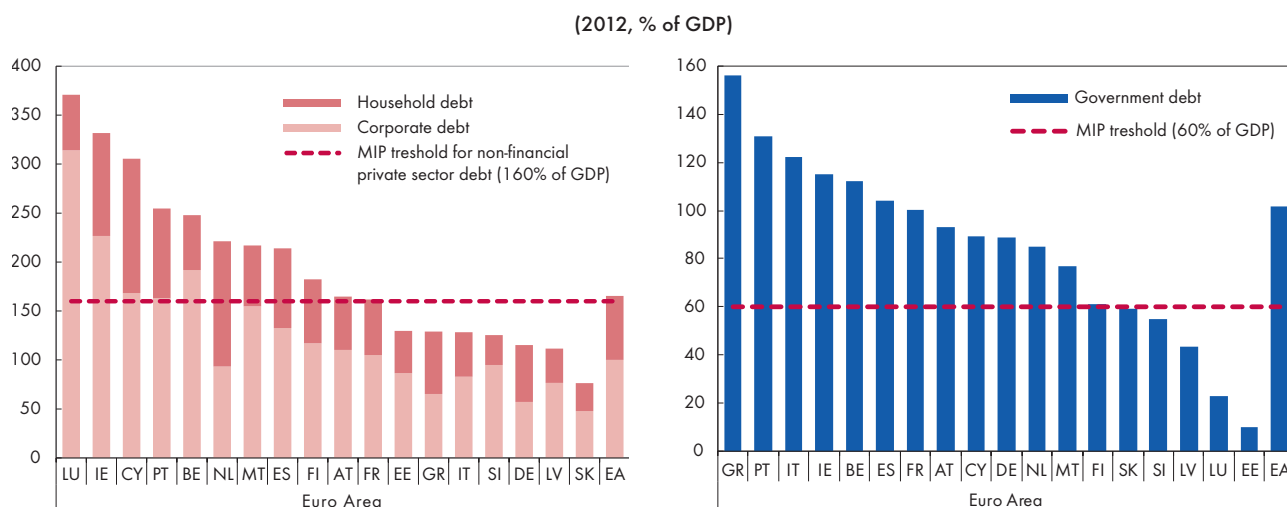
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In the run-up to the global financial crisis, credit growth accelerated throughout the EU, resulting in the significant build-up of private sector indebtedness in a number of countries. Accordingly, the risks associated with debt exposure and debt servicing obligations have mounted, and were revealed when the crisis hit. Since 2008, debt accumulation process of the private sector has been largely interrupted, and the process of balance sheet repair started – a necessary and welcome process, which however, further contributed to a slack in domestic demand, thus propagating the real-financial cycle. At the same time, the indebtedness of the public sector increased significantly as countries implemented counter-cyclical policies and in some cases engaged in banking sector bail-outs, while lower domestic absorption created fiscal revenue shortfalls.

## Introduction

Against this background, the paper i.) analyses sectoral indebtedness in the euro area countries), with a focus on Slovenia; ii.) looks at how the deleveraging process and balance sheet repair progressed across individual sectors in euro area countries since the start of the global financial crisis and how this has impacted on real economy; iii.) it concludes with some discussion looking ahead.

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**Figure 1a and Figure 1b: Private and public sector indebtedness in the euro area**


Source: EUROSTAT and own calculations.

Note: The debt stock includes the outstanding amounts of loans and debt securities. Data is unconsolidated within each sector, except in the case of the general government.

### 1. Indebtedness across the euro area: a sectoral overview

Debt levels in the EU are high (Figure 1a and 1b). In its 2014 Alert Mechanism Report, the European Commission concludes that despite on-going deleveraging, the private and public sector debt exceed the MIP indicative thresholds in most Member States (EC, 2013b). Prior to the crisis, debt of the private sector was increasing rapidly in most EU countries, largely in the form of bank lending. It was often associated with the (income) catch-up process and its prospects and warranted financial deepening. The risks associated with debt accumulation were often underestimated, as their assessment was based on, in hind sight, erroneous (too high) estimates of potential output, erroneous (too optimistic) income expectations and hence misjudged debt repayment capacity. The analysis of indebtedness has gained interest following the crisis, especially as credit activity abruptly slowed down and economic environment remained persistently weak. This in turn has triggered discussions

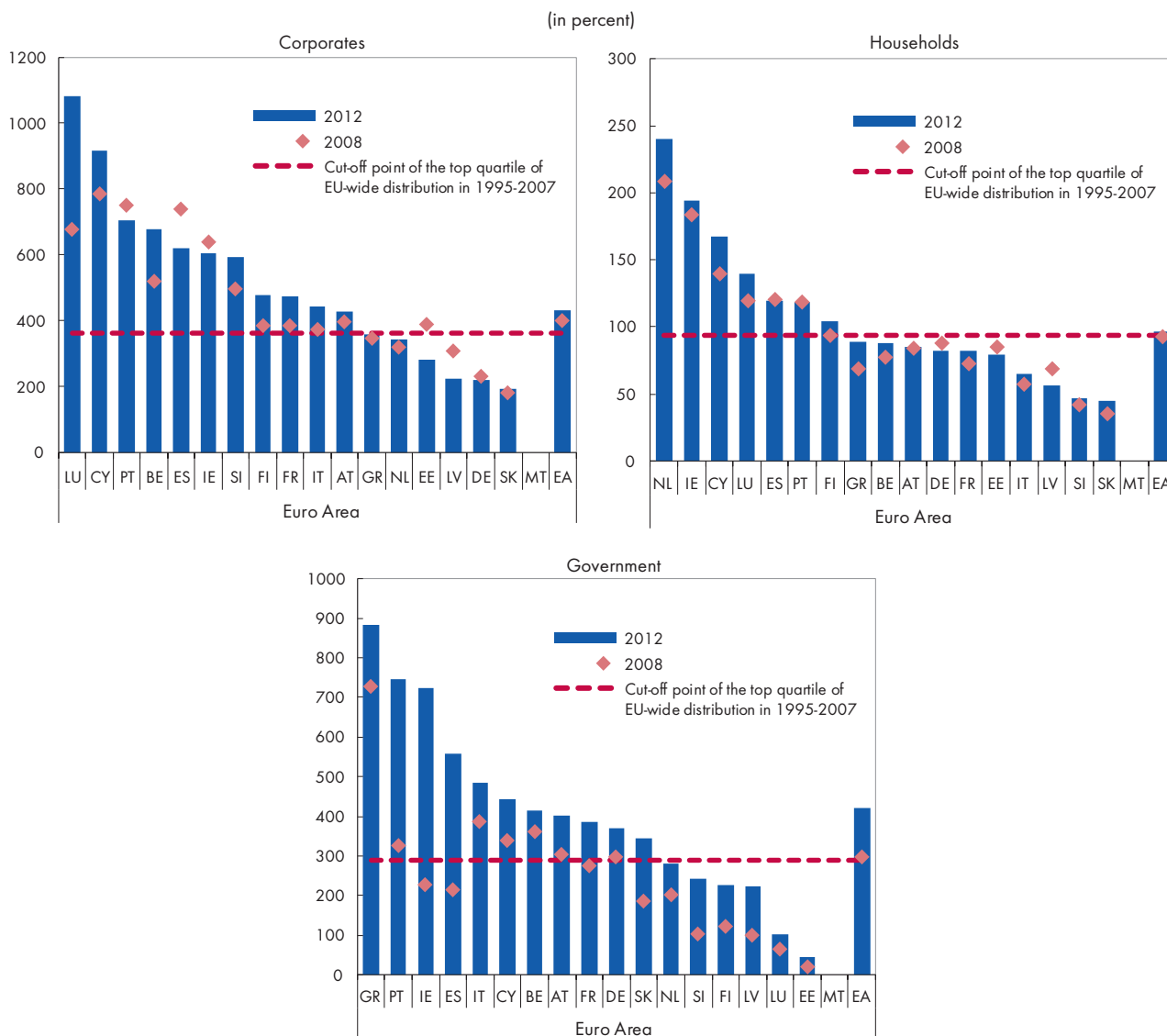
on the deleveraging needs and balance sheet adjustments. It has been widely recognised that the pre-crisis “flow problem” has now become a “stock problem”. While in the EU the discussion on indebtedness focused initially on the public sector, with the launch of the European Semester also private sector indebtedness has been monitored in the context of Macroeconomic Imbalance Procedure (MIP). However, the focus so far has been largely put on monitoring the debt of the private sector in total and with relation to the GDP. Our metrics, in contrast, offers analysis of risks stemming from indebtedness for each of the four major economic sectors and is based on indicators which better measure the underlying debt servicing burden/capacity as well leverage across sectors, while they also add a forward looking component to debt servicing prospects by looking at the sectoral interest rate – income growth differentials. In this way the exposure and the associated risks stemming from indebtedness in a country are flagged more accurately. Indeed, some countries, like Slovenia, which do not appear among the very

vulnerable EU countries in terms of indebtedness on the aggregate level, do turn out to have significant risk exposure in some sectors based on our risk metrics.

High debt levels expose borrowers to liquidity risks, solvency risks, and risks to autonomous debt dynamics. A liquidity risk reflects the potential inability of borrowers to service debt obligations (principal and interest rates) out of their current income and liquid assets (i.e. without recourse to more debt). Solvency risk measures the potential inability of each sector to keep the value of its assets above that of liabilities to other sectors. The risk to autonomous debt dynamics signals that higher the interest rate – income growth differential over the medium- to long-term, higher the risk of the autonomous dynamics of the debt-to-income ratio becoming unsustainable (so called “snowballing” effect). The main triggers of these risks are negative external and domestic real shocks, and unfavourable fluctuations in exchange rates, interest rates, and consumer and asset prices. Changes in investor sentiment are another frequent cause of financial distress of borrowers.



Figure 2. Euro area countries: Debt-to-Income Ratio by Sector of Economy



Source: EUROSTAT and own calculations.

Note: Ratio of stock of debt to gross disposable income. Data for Malta are not available.

Figures 2-4 present the three metrics that capture the three aspects of debt-related risks: *liquidity risk* (debt burden/affordability measure), *solvency risk* (leverage measure) and the *risk to autonomous debt dynamics* (interest rate-income growth differential). Figures 2-4 also include as a benchmark the cut-off values of the upper quartile of the EU distribution of these variables over the period 1995-2007. This is in line with the scoreboard of the EU Macroeconomic Imbalance Procedure (MIP) for assessing vulnerabilities arising from

private sector debt exposure<sup>1</sup>. In the case of the general government, the findings from this analysis should be seen as complimentary and subordinated to assessments of fiscal sustainability, based on national and internationally-agreed legal and regulatory regimes.

Most euro area countries are highly exposed to liquidity and solvency risks stemming from indebtedness, while they also face unfavourable autonomous debt dynamics. The most recent readings on *liquidity risk metrics* exceed the indicative threshold in

large majority of euro area countries for the corporates, and governments, while the exposure of households is somewhat lower, although most of the

<sup>1</sup> Data are currently available until 2012 for most EU countries. The debt stock includes the outstanding amounts of loans and debt securities on the liability side of sectoral balance sheets. Data are unconsolidated, except for the government. Interest rate includes "ESA interest" and a financial intermediation service charge indirectly measured (FISCIM). Gross disposable income is taken before interest payments and, in the case of corporates, also before payments to shareholders (i.e., reinvested earning on FDI and distributed income of corporations). Net worth is proxied by the difference between financial assets and liabilities for households and by the value of "Shares and Other Equity" for financial and non-financial corporations.

euro area countries are either above or close to the threshold (Figure 2). Euro area member states from Central and Eastern Europe, which started the process of financial deepening more recently and thus still have lower indebtedness levels, are relatively less exposed. At the same time, countries with more developed financial sectors may have overall better capability to deal with debt, while there could also be other mitigating factors at play that are not explicitly taken into account in this analysis (for example longer maturity structures and fixed interest rates generally lower the risks). Since 2008, debt-related liquidity risks have increased or remained broadly unchanged across euro area countries for corporates and households (reflecting low income growth and only gradual deleveraging of the private sector). For the governments, increases in debt played the major role.<sup>2</sup> The most recent readings on the leverage ratios depicting the solvency risks exceed the EU-wide threshold in several countries across all three pri-

vate sectors (Figure 3). Since 2008, debt-related solvency risks have decreased or remained broadly stable in most euro area countries. In the aftermath of the global financial crisis, all euro area countries are experiencing unfavourable autonomous debt dynamics, which if they persist, can put debt on unsustainable path relative to income (with the notable exception of some individual sectors) (Figure 4). The interest rate-income growth differential, depicting the autonomous debt dynamics, has been particularly high in the corporate sector and governments. This is in sharp contrast to the pre-crisis period, when all euro area countries benefited from historically low (and in most cases negative) interest rate-income growth differentials. This, in turn, fuelled unsustainable credit growth in many countries, in particular in the euro area periphery and the CEE countries, while the associated consumption and investment binges depressed further the interest rate – income growth differential.

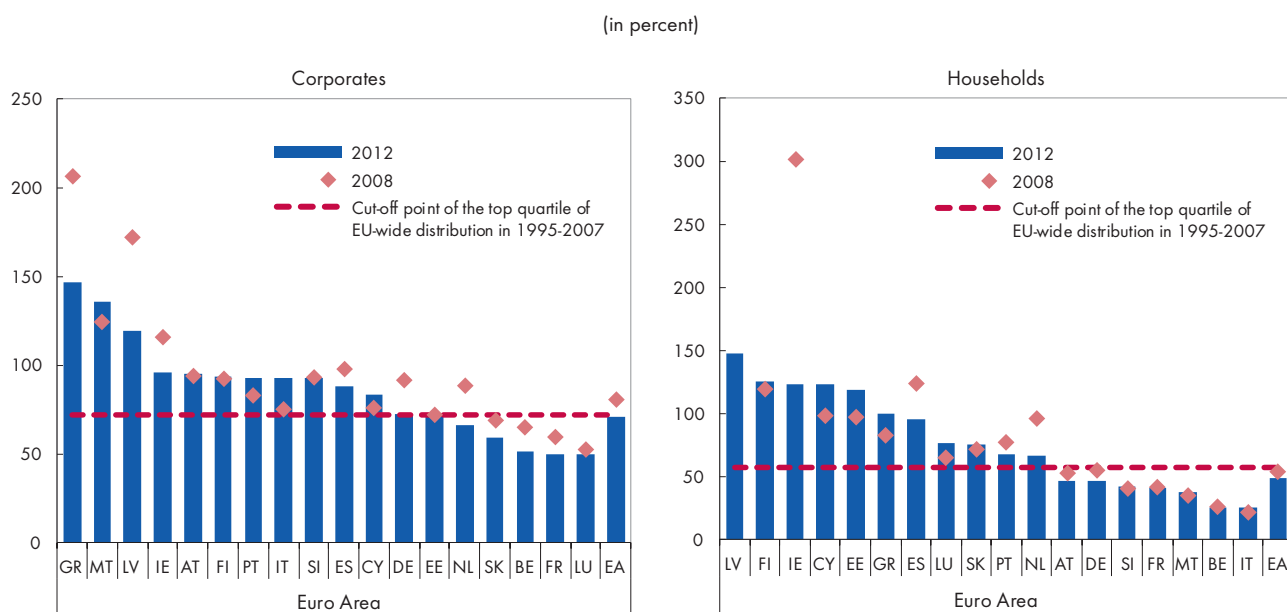
As the crisis hit, risks were revalued, interest rates rose sharply in an environment of low income growth, and this indicator worsened substantially, signalling potential risks to debt financing going ahead.

**Summary of risk indicators of sectoral indebtedness in Slovenia:**

Slovenia faces significant risks due to high indebtedness of the economy in the EU-wide comparison. This finding is in contrast to the conclusion based on “standard” indicators as used in the MIP (and shown in Figure 1), as in the MIP scoreboard debt of both the public and the non-financial private sector were below the indicative thresholds. We find that while the estimated risks are high in all main economic sectors, they are particularly high – and above the indicative threshold – in the non-financial

<sup>2</sup> In the case of the general government, gross disposable income is equal to total revenues minus social benefits other than social transfers in kind.

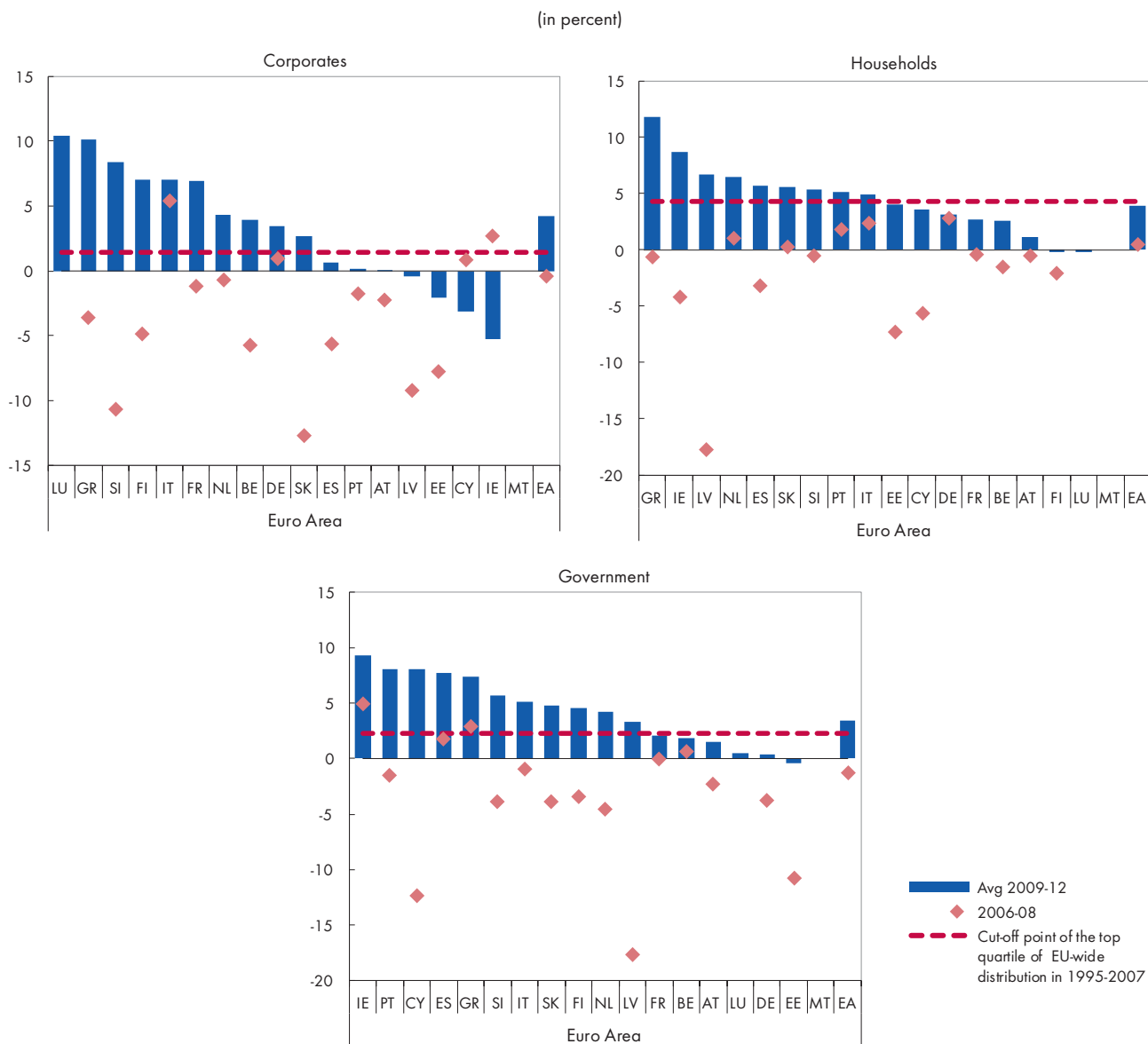
**Figure 3. Euro area countries: Leverage Ratio by Sector of Economy**



Source: EUROSTAT and own calculations.

Note: Ratio of stock of debt to firms’ capital/households’ net worth. This metric cannot be used for the general government, as the concept of “going concern” is not applicable in the case of sovereign states.

Figure 4. Euro area countries: Interest Rate - Income Growth Differentials



Source: EUROSTAT and own calculations.

Note: Difference between the implicit interest rate on debt and the nominal growth rate of gross disposable income. The implicit interest rate is calculated as the ratio of interest payments (including both “ESA interest” and FISIM) over the average of beginning and end-period stock of debt of each sector. Data for Malta are not available, while data for Portugal end in 2011.

corporate sector. In 2012, the debt exposure of non-financial firms – as measured by the proposed risks metrics was second highest in the euro area. Risks stemming from indebtedness are elevated also for Slovenia households, although they do not turn out to be above the indicative threshold.

Looking at the individual indicators, the main findings are:

- the corporate sector in Slovenia is highly exposed to all three

risks indicators, namely liquidity risk (reflecting poor debt servicing capacity of that sector), solvency risk (reflecting high leverage of the sector) and risk of unsustainable debt dynamics (reflecting a wide gap between interest rate and income growth of that sector, signalling risks to debt repayment looking ahead). Following the crisis, these risks have even increased somewhat (despite a reduction in debt

to the sector), reflecting slow deleveraging of the sector, while at the same time incomes were low, asset prices had fallen and interest rates were high, reflecting higher risk premium for Slovenian companies (which, however, is partly associated also with high indebtedness).

- Risks stemming from households’ indebtedness are elevated, but not yet above the indicative threshold. In particular, debt

servicing capacity of households compares relatively well in EU-wide comparison, while the leverage ratio is closer to the indicative threshold. Despite a halt in accumulating new debt by the sector, the risks related to indebtedness have increased somewhat since the crisis, primarily on account of the widening of interest rate-income differential, while the deleveraging has been slow.

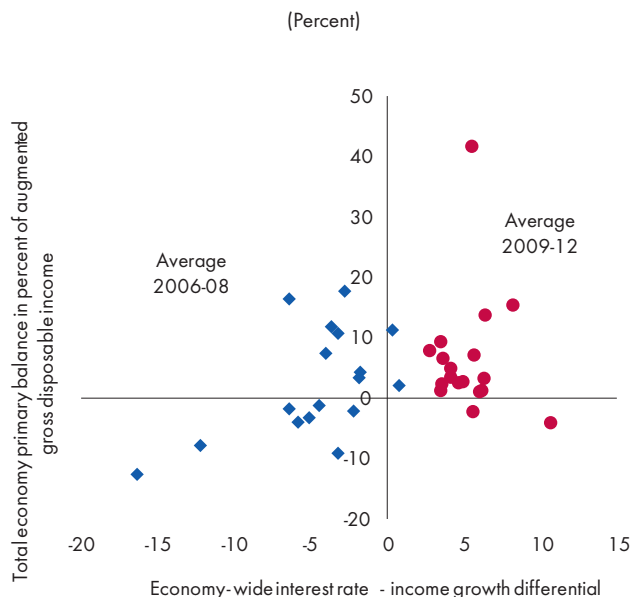
- Government’s exposure to indebtedness risks as computed by the proposed metrics was elevated in 2012, but still relatively contained in EU-wide comparison. However, as debt of the government increased significantly since 2012 (following banks’ recapitalizations) and the economic recession hit again, a significant deterioration of these risks has likely happened.

## 2. Sectoral deleveraging, balance sheet adjustments in the euro area and links to growth

The heavy debt burdens, the sharp drop in incomes, negative asset prices valuations as well as the unfavourable autonomous debt dynamics have triggered the on-going repair of overleveraged balance sheets of the private sector throughout the euro area. When the interest rate – income growth differential moved abruptly from negative to positive territory (i.e. the autonomous debt dynamics were suddenly put on an unsustainable path relative to income), the economies switched from leveraging to deleveraging (Figure 5).

The balance sheet adjustment is captured by the improvement in the economy-wide saving-investment balances in nearly all euro area countries (Figure 6). Corporations and households have improved their net debtor positions since 2008 and

**Figure 5. Link between Risk to Autonomous Debt Dynamics and (De)leveraging Effort in the euro area**



Source: EUROSTAT and own calculations.

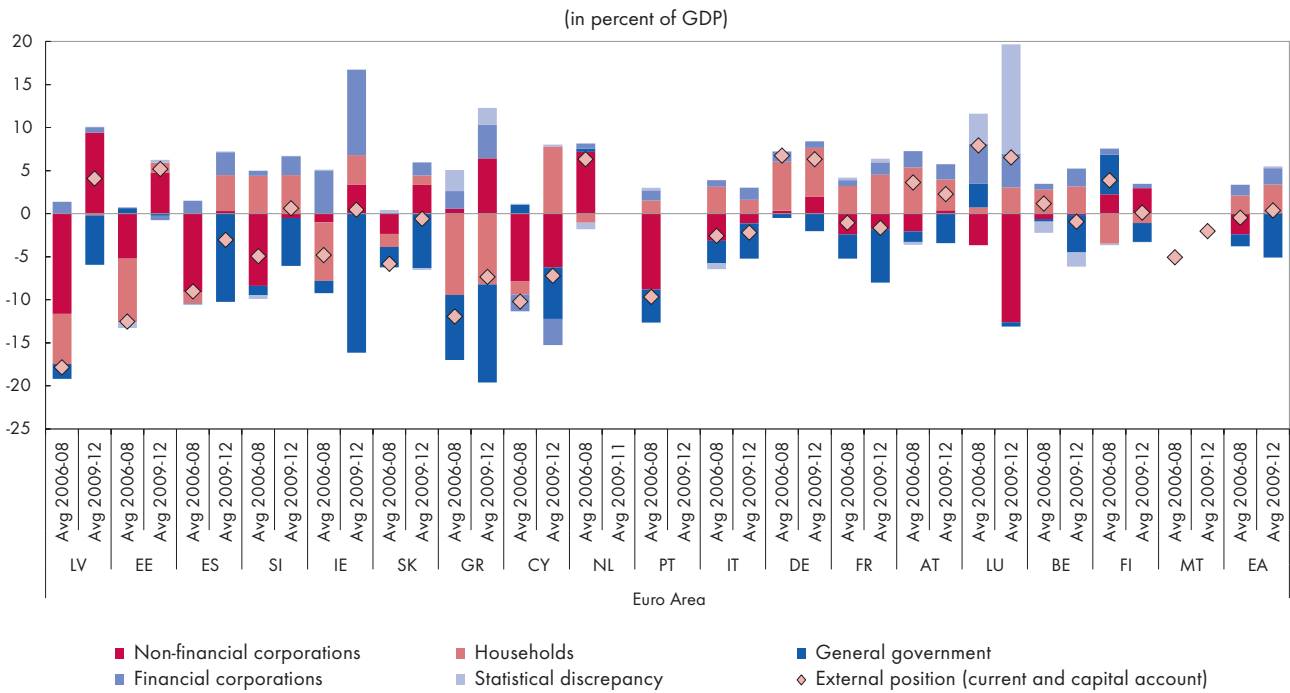
Notes: The total economy primary balance is the sum of the total economy net lending/borrowing position and interest payments to the rest of the world. An increase (decrease) in the primary balance relative to gross disposable income indicates deleveraging (leveraging) effort of the sector.

have often moved to net creditor position, which in effect enabled them to deleverage. The adjustments were particularly large in countries that exhibited the largest imbalances in pre-crisis period, including Slovenia. The large and wide-spread adjustments of non-financial corporations indicate the severity of the over-indebtedness in this sector, as along the balanced growth path firms are typically net borrowers, putting household savings to productive uses. In most countries, households returned to being net savers. This is a welcome development, as along the path of balanced growth households are typically net savers, with the financial system intermediating the funds to the (productive) corporate sector. On the other hand, governments absorbed some of the slack in domestic demand created by the private sector deleveraging, in an environment of steep revenue shortfalls and high social expenditures,

thereby widening of the net debtor positions, the most in the stressed/programme countries.

The interlinkages between sectors in the process of balance sheet repair are very important and, therefore, should not be overlooked. On the one hand, the repair of overleveraged balance sheets by either the government, the corporate, or household sectors generally makes the adjustment by the other two sectors more difficult. A simultaneous deleveraging by all three sectors would reduce domestic absorption, which in a fragile external environment could translate in lower domestic output and income. This would complicate the task of repair of overleveraged balance sheets. Indeed, countries that experienced the largest pre-crisis increases in indebtedness were usually those that also experienced the steepest declines in domestic demand (Figure 7). The post-crisis adjustment was

Figure 6. Net Lending/Borrowing by Sector of Economy in the euro area



Source: EUROSTAT, ECB and own calculations.

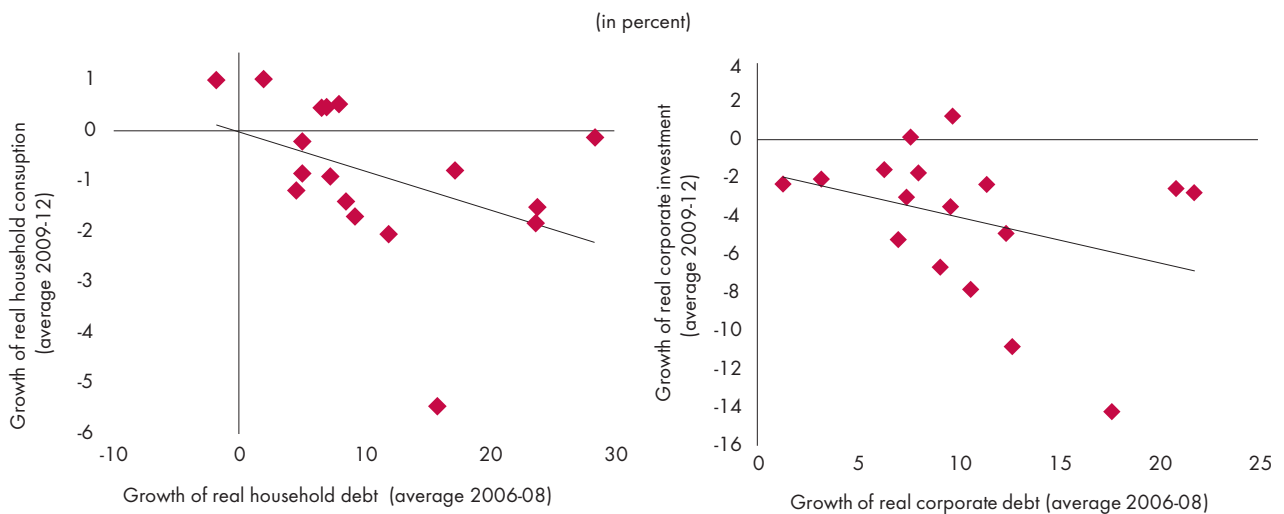
Note: The figure focuses on flow adjustment in the post-crisis period (2009-12) compared to the pre-crisis period (2006-08). For the total economy, except for statistical discrepancies, domestic sectors' net lending/borrowing is equal to the sum of the current and capital account balances. Data for Malta are not available, while data for Portugal end in 2011. Country ranking is according to the size of total economy post-crisis adjustment.

particularly pronounced in the corporate sector, as investment growth rates often plunged into very negative territory, resulting in persistently

lower investment ratios in many euro area countries. On the other hand, paying down of debt by the private non-financial sector facilitates the

deleveraging process of the banking sector, as repaid amounts can be used to lower foreign liabilities. This is particularly relevant for the CEE

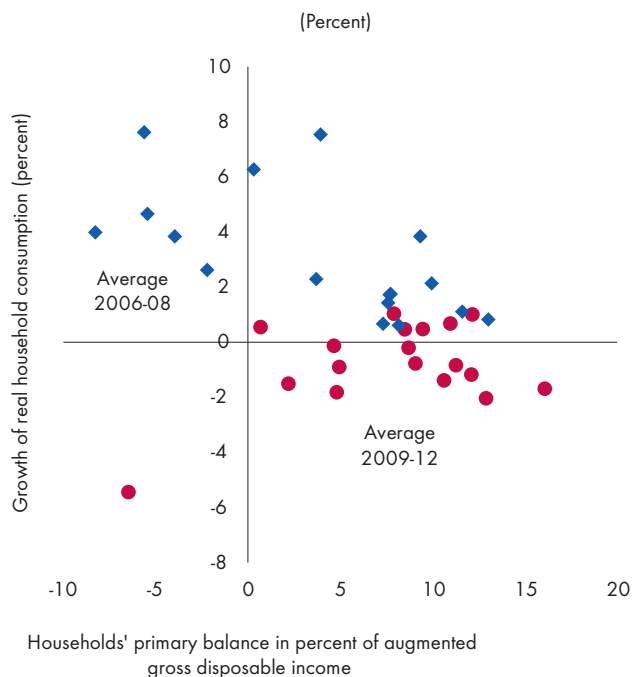
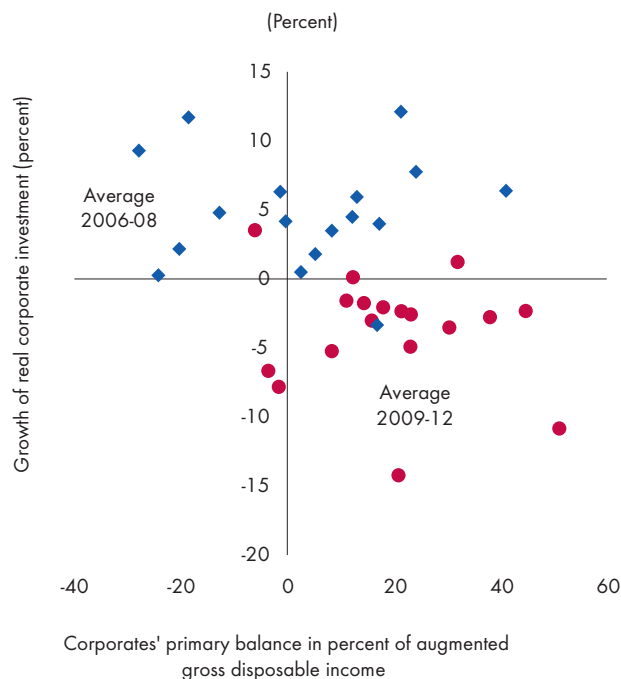
Figure 7: Pre-crisis debt accumulation and post-crisis real economy adjustment in the euro area



Source: EUROSTAT and own calculations.

Note: Growth rate of debt is calculated from notional stocks that are adjusted for reclassifications, other revaluations, exchange rate variations and any other changes which do not arise from transactions. The debt stock includes the outstanding amounts of loans and debt securities other than shares. The transactions are deflated by GDP deflator.



**Figure 8a: Household (De)leveraging Effort and Consumption Growth in the euro area**

**Figure 8b: Corporate (De)leveraging Effort and Investment Growth in the euro area**


Source: EUROSTAT and own calculations.

Note: For each sector, the primary balance is given by the sum of its net lending/borrowing position and interest payments, including both "ESA interest" and FISCIM. An increase (decrease) in the primary balance relative to gross disposable income indicates deleveraging (leveraging) effort of the sector.

countries, where banks' the pre-crisis lending was funded mainly from abroad (often via parent banks). The negative impact the private sector deleveraging has on economic growth can be simplistically presented in cross-plots between (de)leveraging efforts of the household and corporate sectors and the real growth rates of consumption and investment, respectively. (Figures 8a and 8b). In the boom phase of the credit cycle, both corporate and households borrowed to finance the acceleration in their absorption. In the bust phase, debts became more difficult to roll over, the burden of debt servicing increased and the households and corporations started to repay their debts, which has crowded out consumption and investment.

### 3. Conclusions

Indebtedness of both private and public sectors remains a key source of vulnerability for several euro area countries. The deleveraging process has been gradual and several euro area countries still face elevated risks associated with the accumulated debt levels or debt overhangs across sectors. The crisis has highlighted risks associated with (too) fast debt accumulation and resulting debt stocks, which are difficult to repay, especially in economic downturns. Therefore debt exposure should be watched with caution. The risks should be analysed on the sectoral level, as aggregate monitoring could mask important sectoral differences. This is also important if we want to properly understand the impact that deleveraging will have on growth and what the optimal policy responses should be.

Overall, countries' ability to overcome legacy debt overhang would depend on their success in returning to economic growth and to a sustainable path of economic convergence, which will require the implementation of structural reforms.

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# In search for sustainable funding structure of commercial banks

Marko Košak\*

## IN SEARCH FOR SUSTAINABLE FUNDING STRUCTURE OF COMMERCIAL BANKS

The deleveraging process in banks triggered with the onset of the recent financial crisis has revealed weaknesses in the funding strategies of banks. In times of accelerated credit growth banks tend to rely excessively on wholesale funding, incur maturity and currency mismatch and underestimate the problem of funding sources concentration. In this article we scan the main characteristics of the funding structures in European and non-European banking, compare briefly the funding structures of banks in Slovenia with those in the selected euro area countries and summarize the lessons that should be taken by banks with unsound funding practices. Based on these lessons banks should be able to implement corrective measures and set up viable, robust and sustainable funding structures that would support sustainable credit growth without compromising the profitability expected by bank owners and without weighing on government budgets and taxpayers.

JEL G01 G21 G28

One of the consequences of the recent financial crisis for the European banks and the financial sector in general has been the process of deleveraging, which has been manifested not only in a reduced credit activity of banks but also in considerable adjustments in the funding structure of banks. Blundell-Wignall and Atkinson (2012) distinguish good from bad deleveraging as two possible ways for deleveraging to take place.

## 1. Introduction

With bad deleveraging Wignall and Atkinson (2012) denote either the asset contraction or risk-weighted assets manipulation activities of banks, while according to them good deleveraging occurs when banks raise more capital. Regardless of its character a deleveraging process is eventually reflected in the changing funding structure of banks and always puts a significant pressure on the funding policy and liquidity management of banks. At the same time adjustments in the credit activity of banks are unavoidable, which inescapably leads to credit rationing behaviour by banks. The intensity of the deleveraging process usually differs among banks if observed at the micro level, and among countries, if observed at the aggregate level. Similarly, the differences in the duration of the deleveraging process and in the adjustments to a new stable equilibrium level are also expected to be different among banks. A strongly pronounced levering cycle followed by a rapidly evolving deleveraging process have been detected also with Slovenian banks in last ten years.

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The leveraging cycle started with an intense upswing in the credit activity of banks in the 2004 – 2008 period, accompanied with substantial changes in their funding structures, which can, to a large extent, be also blamed for the banking crisis that followed in the Slovenian banking market after 2008. The deleveraging process that has been commenced in banks in Slovenia after 2008 is unavoidable and should lead to a new more sustainable banking model, characterized by greater stability and predictability in banking operations. A new, more sustainable funding structure of banks is expected to be established in the course of this process, which means that banks will have to restructure their funding in favour of more stable and reliable funding sources. A similar funding restructuring process has also been started in Slovenian corporate sector as a result of the deleveraging pressures and should end up in a more sustainable funding structure of the nonfinancial companies, which have traditionally over-relied on bank funding and have neglected alternative funding possibilities. For both, the deleveraging in banks and deleveraging in corporates the duration of the entire process is unpredictable, as much as are unpredictable the new equilibria, that are expected to be reached at the end of this process. The purpose of this article is to evaluate the transition from the pre-crisis to the post-crisis funding structure in banks in Slovenia and to draw attention to best practices in other European banking sectors together with some theoretical guidelines that could be helpful in the search for a sustainable funding structure.

## 2. Bank funding structures in the EU area and comparison to non-European banks

As reported by the ECB (Banking Structure Report, Nov. 2013) banks

tried to increase their reliance on more stable funding in the aftermath of the financial crisis, by reducing their dependence in interbank funding and increasing the significance of deposits among their liabilities. Additionally banks also managed to substitute partially the declining interbank funding by the increased share of central bank funding in the 2008 – 2013 period, where the impact of the LTRO instrument was substantial. So, on average the share of interbank funding in banks' total assets in the euro area decreased from about 30% in 2008 to roughly 20% at the end of the second quarter of 2013.

### *The loan to deposit ratio in European banks remains relatively high.*

Similarly the monetary financial institutions statistics reveal that the share of non-bank deposit liabilities in banks' total assets increased from 38% (i.e. median value) at the beginning of 2008 to more than 42% in the first quarter of 2013. Of course, as noted in the ECB report, despite the common dynamic in the euro area countries there were significant differences between countries and between individual banking firms. The increasing reliance of banks on customer deposits, accompanied with the reduced availability of credit for the economy has resulted in declining loan-to-deposit ratio, that dropped from 138% in 2008 to less than 126% at the end of the second quarter in 2013, which is also a clear manifestation of a noticeable

reduction in the leverage of the banks in the euro area. Some characteristics of the funding models of European banks can be recognized as common and typical and those can also be blamed for the raised vulnerability and sensitivity of banks to market shocks. Le Leslé (2012, p. 6) lists several characteristics of the troublesome European funding models such as a high loan-to-deposit ration, an unsustainable funding gap, excessive reliance on wholesale funding, insufficient deposit funding and core funding ratio, high level of interbank exposures and the level of deposit rates vs 3-month Euribor. Some of these characteristics are clearly inter-related and describe problematic bank funding characteristics from somewhat different perspectives. Le Leslé (2012) specifically points out at two distinguishing features describing the specificities of the funding model prevailing in European banking: (1) a high level of the loan to deposit ratio and (2) excessive reliance on wholesale funding.

The loan to deposit ratio in European banks remains relatively high in the aftermath of the financial crisis if compared to the average ratio values in non-European banking systems. So, according to Le Leslé (2012) the average LTD ratio for selected set of European countries<sup>1</sup> went from 140 % in 2006 down to 118 % in 2012, while the LTD reduction in the same time span was from 80 to 62 % in the USA and from 87 to 78 % in Japan. As claimed by Le Leslé (2012) the bank led credit model for corporate financing and high asset-to-deposit ratios have to be blamed for relatively high levels of average LTD ratios in Europe. The latter being a result of a large asset

<sup>1</sup> Le Leslé (2012) included in her study a sample of 109 banks from 23 countries in Europe, Americas (Western Hemisphere) and Asia Pacific area.

base, which reflects a substantial reliance on non-lending operations among European banks. The excessive reliance on wholesale funding, as the second distinguishing feature, is a consequence of a high funding gap in European banking, where “funding gap” is defined as a difference between customer loans and customer deposits. Le Leslé (2012) estimates the funding gap on a sample of large European and US banks and shows a persistent funding gap in case of European banks, while US banks manage to operate with a funding surplus. Similarly, the share of wholesale funding in total liabilities, as an alternative measure reveals that with European banks wholesale funding represents more than 60 % of total liabilities while this percentage is roughly 33 % with Asian banks and about 37 % on average with banks in emerging economies as categorized by Le Leslé (2012). Additionally, the unfavorable maturity structure can even further aggravate a heavy dependence on wholesale funding, as the reliance

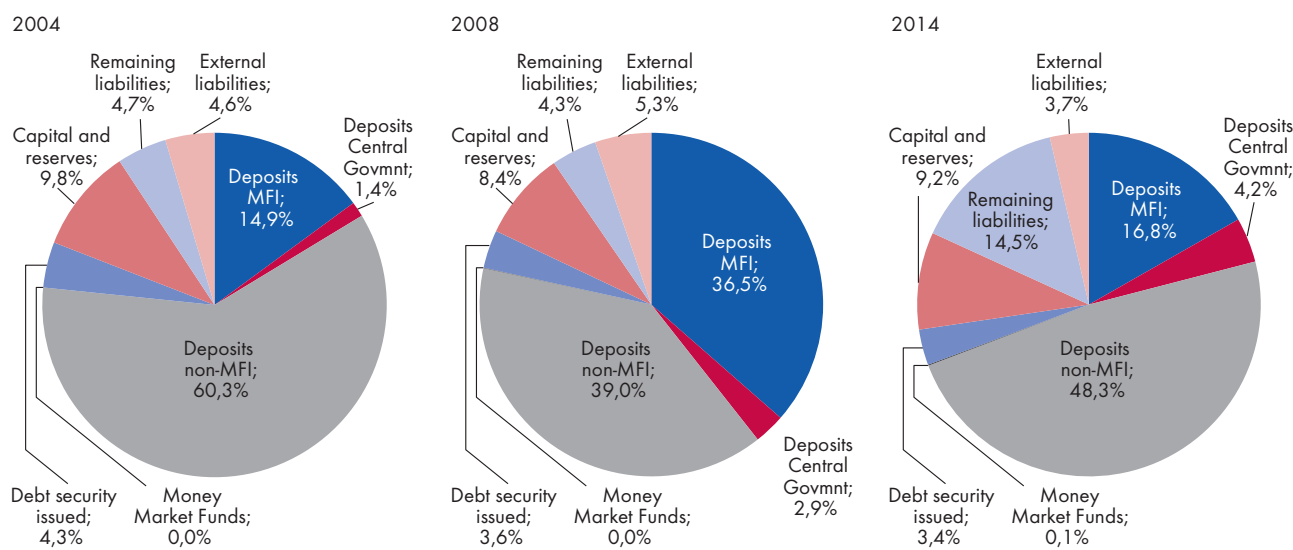
on shorter term funding makes banks more vulnerable to the external shocks. Again, as reported by Le Leslé (2012) the proportion of short term wholesale funding is about 20 % higher with European than with US banks, which on average maintain about 16 % share. The recent developments in bank funding structures and differences between euro area and US banks are also discussed in the Banking Structures Report by ECB (2013) and the conclusions are pretty much the same. First, US banks on average rely significantly more on non-bank deposits than euro area banks, as share of non-bank deposits exceeded 70 % on average for US banks, while it was only slightly over 40 % for euro area banks in 2012. Second, the dependence on wholesale funding is substantially lower with US banks, as compared to euro area banks, which is reflected in the LTD ratio. The presented characteristics of the bank funding structures in the European banks clearly augment the exposure of banks to financial

market fluctuations and make them more susceptible to market shocks like we witnessed during the recent financial crisis.

### 3. The developments in funding structure of banks in Slovenia and selected euro area countries

A closer look at the developments in the funding structure of banks in Slovenia in the last decade clearly reveals a cyclical transformation of the funding structure that mirrors the entire business cycle, embracing the pre-crisis upswing and the recession in the aftermath of the crisis onset. Due to the interconnectedness between the banking and corporate sector the transmission of the effects between both of them was virtually immediate, leaving very little of maneuvering space (time) for the preventing activities and adjustments that could effectively alleviate all the consequences of the compelling deleveraging process that has taken place in banks and corporate sector.

**Figure 1: The proportion of the individual types of funding in total liabilities of the banking sector for banks in Slovenia at the aggregate level for years 2004 (end of year), 2008 (end of year) and mid-year 2014**



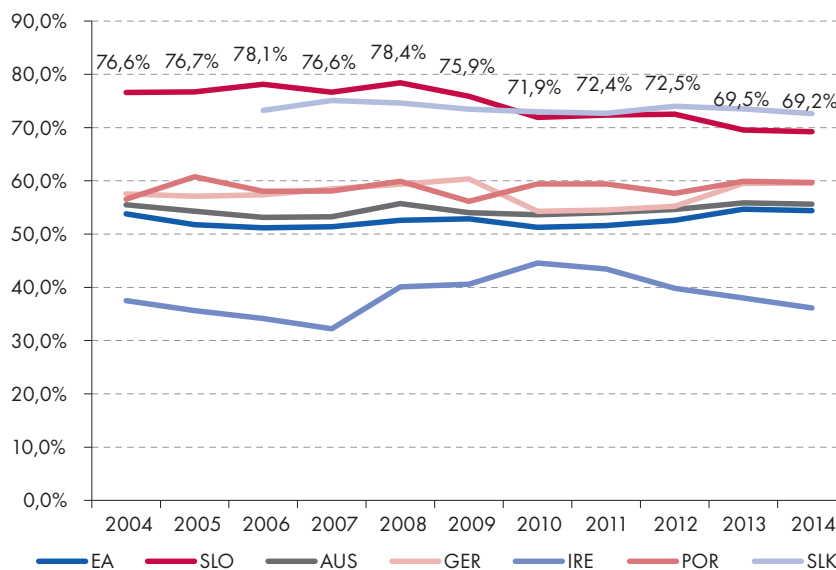
Source: Own calculations and data from the ECB Statistical Data Warehouse, Monetary Statistics, MFI Balance Sheets. (Note: 2014 data is for end of June)

As shown in Figure 1 the funding of Slovenian banks<sup>2</sup> at the year end of 2004 was based on deposits by non-MFIs, representing more than 60% of total liabilities of the banking sector. At the same time deposits by MFIs represented close to 15% and capital and reserves 9.8% of total liabilities. All other funding components of banks, as reported by the ECB national Monetary Statistics, represented less than 5% of total liabilities each, including debt securities issued by banks, which constitute 4.3% of total liabilities only.

The four year period from 2004 to 2008, that was characterized by an unprecedentedly accelerated growth in credit activity of banks, ended up in a substantially restructured funding position of banks. The proportion of the most significant funding source for banks, i.e. the proportion of the non-MFI deposits was reduced to 39% of total liabilities, which is a change by minus 21 percentage points in four years, while on the other side the proportion of MFI's deposits expanded to 36.5% of total liabilities, which is a change by plus 21.6 percentage points. The total nominal increase in total assets of the Slovenian banking sector from the end of 2004 till the end of 2008 amounted to approximately 24 billion Eur and about 76% of this increase can be explained by the raise in MFI and non-MFI deposits. Of course the contribution of MFI deposits clearly dominates and explains about 58% while non-MFI deposits explain only 18% of the total increase in total assets.

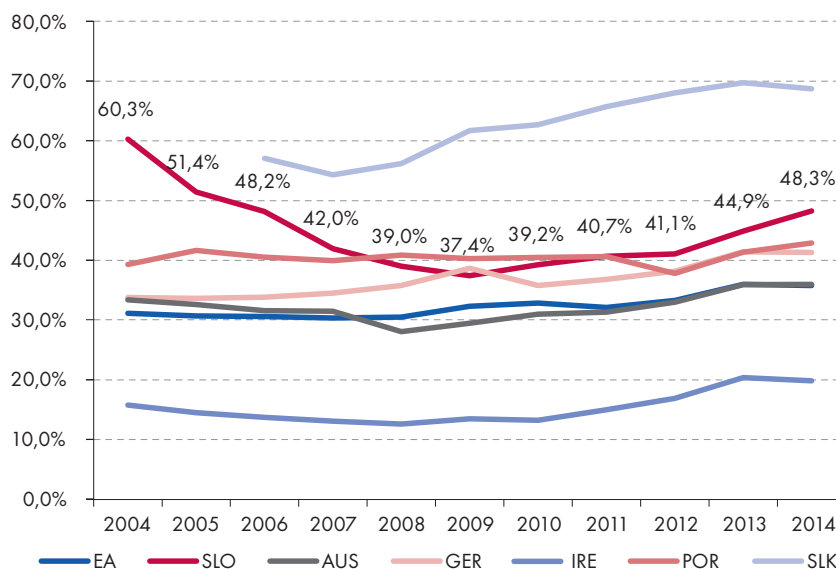
After 2008 the dynamics of the banking sectors' balance sheet changes has reversed dramatically, because of the intense deleveraging pressures put on banks. The rollover possibilities for MFI funding have become limited and refinancing in many cases impossible which has led to a sharp decline of the proportion

**Figure 2: The proportion of total deposits in total liabilities for banking sectors in the euro area (average), Slovenia, Austria, Germany, Ireland, Portugal and Slovakia.**



Source: Own calculations and data from the ECB Statistical Data Warehouse, Monetary Statistics, MFI Balance Sheets. (Note: 2014 data is for end of June)

**Figure 3: The proportion of non-MFI deposits in total liabilities for banking sectors in euro area (average), Slovenia, Austria, Germany, Ireland, Portugal and Slovakia**



Source: Own calculations and data from the ECB Statistical Data Warehouse, Monetary Statistics, MFI Balance Sheets. (Note: 2014 data is for end of June)

of the MFI deposits in total banking sector's liabilities; MFI deposits shrank by almost 20 percentage points from 36.5% to 16.8% of total liabilities in the 2008 - 2014 (mid-

year) period. Clearly it was impossible to expect that the funding void

<sup>2</sup> All the data are taken from the ECB Statistical Data Warehouse, Monetary Statistics, MFI Balance Sheets.



could be completely replaced by the non-MFI deposits, although the proportion of the latter has improved from 39% to 48.3% of total liabilities until end of June 2014. In addition to non-MFI deposits banks had to rely on central government deposits that increased from 2.9% to 4.2% in proportion to total liabilities and also on central bank funding which is displayed in Figure 1 under label “remaining liabilities” as reported in the ECB statistics. Since “remaining liabilities” contain several inseparable items we show central bank funding separately in Figure 5, based on ESRB Risk Dashboard data. Recapitalizations of banks of course also helped to fill the funding gap, therefore the portion of capital and reserves in total liabilities as displayed in Figure 1 improved from 8.4% (2008) to 9.2% (June 2014). Interestingly, the proportion of debt securities issued by the banks has even lessened slightly, i.e. from 3.6% to 3.4% of total liabilities in the period from December 2008 to June 2014..

A distinctive funding pattern of banks in Slovenia is easy to identify if we observe the dynamics of changes in the funding structure also in the context of a selected set of other euro area countries. We included in our comparison Germany, Austria and Slovakia as examples of relatively stable euro area banking sectors and Ireland and Portugal as typical representatives of the euro area peripheral countries. In addition also the average values for the euro area are displayed in all the Figures based on the data as reported by the ECB. By jointly observing Figure 2 and Figure 3 we can easily see from Figure 2 the prevalence of total deposits in banks’ liabilities in Slovenian banking sector throughout the observed period (i.e. 76.6% in 2004, 69.2% in 2014), which has been very much alike the funding

structure in Slovakian banks, with one important difference. Namely, as revealed in Figure 3, there is a clear divergence in the proportion of non-MFI deposits between Slovenian and Slovakian banks after 2006, because of the persistent decline of the non-MFI deposits in the funding structure of Slovenian banks from 2004 until the end of 2009, when this proportion stabilised and started to increase slightly and reached 48.3% in June 2014, while non-MFI deposits in Slovakian banks represented about 69% of total liabilities at the same time.

*Recapitalizations of banks also helped to fill the funding gap.*

With the intensified deleveraging pressures in Slovenian banking sector the government deposits have become a noticeable source in banks’ funding structure. In Figure 4 we display the proportion of government deposits in total deposits for Slovenian banks and selected euro area peer countries for the 2004 – 2014 period. The data evidently demonstrate extremely high proportion of central government deposits in the funding structure of Slovenian banks after year 2008 if compared to other countries in the sample. So the share of government deposits amounted to 6.6% in 2009 and did not fall below 5% of total deposits till end of 2012, while a drop to 2.8% in 2013 reflects also the conversion of some government deposits in government shareholdings in troubled banks. Interestingly, a comparably high level of government deposits can only be detected in Slovakian banks (5.2%) in 2007, but it has decreased rapidly in years that followed.

Banks in liquidity distress typically

**Figure 4: The proportion of central government deposits in total liabilities for banking sectors in euro area (average), Slovenia, Austria, Germany, Ireland, Portugal and Slovakia**

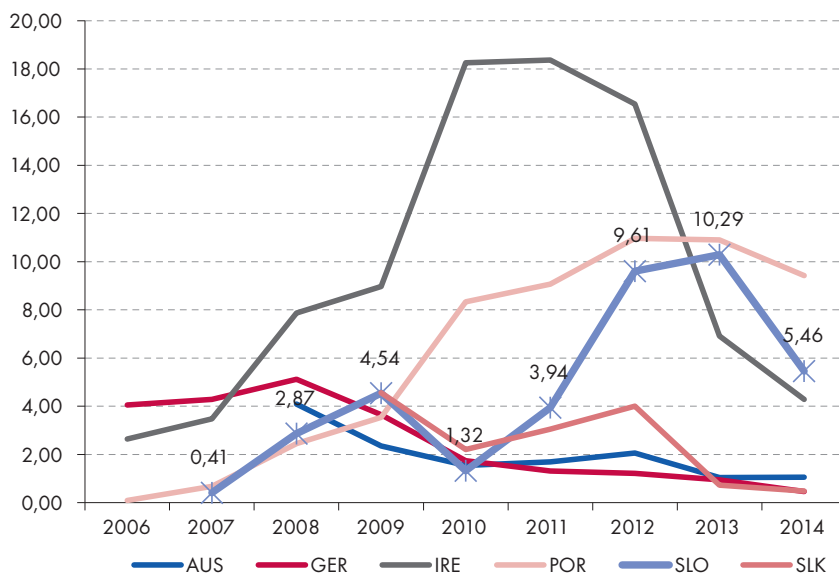


Source: Own calculations and data from the ECB Statistical Data Warehouse, Monetary Statistics, MFI Balance Sheets. (Note: 2014 data is for end of June)

revert to central bank funding if available. This kind of funding pattern can be observed for Irish, Portuguese and Slovenian banks in Figure 5<sup>3</sup>. For Slovenian banks the ECB funding clearly picked up after 2010 and reached its peak proportion in total liabilities with 10.3% in year 2013, which could be characterized as the most critical year for Slovenian banks since the onset of financial crisis. Obviously with the relieved situation in 2014 the proportion of ECB funding has also decreased to 5.5% until the mid-year 2014, although it still remains substantially above the levels in Austria, Germany and Slovakia.

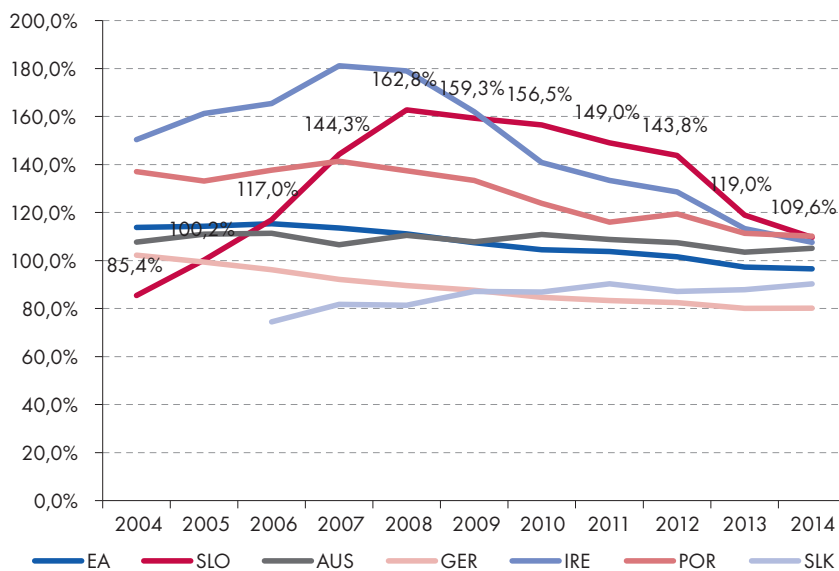
Both the adjustments on the asset and liability side of banks' balance sheets have been simultaneously reflected in the loan-to-deposit (LTD) ratio of the banks (Figure 6). The LTD ratio as calculated by using the ECB Monetary Statistics data clearly demonstrates a considerable volatility of the ratio for Slovenian banks through the cycle. While the LTD was kept below 90% in 2004 it escalated significantly in years that followed and reached the historically highest level of 163% in 2008, when the credit expansion came to an end and the phase of strong deleveraging set in. Consequently banks had to respond not only by the adjustments on the liabilities side of their balance sheets but also by a rapid accommodation on the asset side, which has resulted in declining LTD ratio that has fallen towards 100% and according to the intermediate data published by the Bank of Slovenia has reached 97% in mid year 2014. Among the countries included in the comparison only Irish banks demonstrated similar volatility of the LTD ratio in the observed period, while in all other countries the fluctuations in the ratio were much less intense and ratios more stable. As for Slovenian banks the average

**Figure 5: The share of ECB funding in banks' liabilities in euro area (average), Slovenia, Austria, Germany, Ireland, Portugal and Slovakia**



Source: ECRB data.

**Figure 6: Loan-to-deposit ratio for banking sectors in euro area (average), Slovenia, Austria, Germany, Ireland, Portugal and Slovakia**



Source: Own calculations and data from the ECB Statistical Data Warehouse, Monetary Statistics, MFI Balance Sheets. (Note: 2014 data is for end of June)

LTD ratio is definitely not expected to climb the levels as seen before the beginning of the financial crisis, which means that the credit activity of banks may remain hampered and dependent on the deposit potential of the bank customers.

**4. Lessons for banks**

Can we identify the properties of a robust bank funding model? Le

<sup>3</sup> Central bank funding data is based on the ESRB Risk Dashboard.

Leslé (2012) advocates a holistic approach, based on dynamic, efficient and forward looking asset-liability management in the bank. As regards the liability side of this approach banks should really focus on diversity, stability and simplicity of the engaged liability instruments. Diversity of funding should be reached in several aspects, starting with the diversity of investors and financial instruments, further with regard to a viable mix of currencies and finally also geographical-wise. Funding stability is the second quintessential element that has to be taken into account when it comes to both retail and wholesale funding sources and should be based on investors' investment constraints and preferences as well as on investors' resilience and behavior. Limited level of over-complex funding instruments is recommended and a high level of capital and deposits seems to be a necessary condition for funding stability. Additionally Leslé (2012) proposes only a limited mismatch between assets and liabilities, both in terms of maturity and currencies. Specifically she recommends the use of medium to long term funding that exceeds medium to long term assets and more short term assets (with maturities less than one year) than short term wholesale funding that could dry up in periods of prolonged market malfunctioning. Importantly, an integral part of the holistic approach proposed by Le Leslé (2012) is also an adequate consideration of the asset side of banks' balance sheets. So, strong asset quality, based on borrowers' resilience and stable collateral values is recommended. Further, the asset encumbrance should be limited, preferably simple assets should be considered and appropriate disclosure policies applied, as well as sufficient level of liquid and marketable assets should be available.

Very similar findings are also presented in the IMF (2013) paper in which the resilience of bank funding structures and factors influencing these structures are examined by empirically investigating a sample of 751 banks worldwide in the 1990 – 2012 period. The main findings suggest that bank funding is mainly affected by bank specific factors and to a lesser extent by macrofinancial, market specific or institutional factors, although the regulatory characteristics proved to be important as well. The authors of the empirical study concentrate on exploring the relation between funding characteristics of banks and probability of their distress. The results show that banks' stability hinges on their funding structures that should be stable, sufficiently diversified and should involve less leverage. Furthermore, the mismatch between loans and deposits should be limited, as this way the need for wholesale funding is effectively confined. More specifically the following factors are exposed in the study:

- Sufficient capitalisation of banks, in the sense of a higher equity-to-asset ratio, is recognized as decisive for bank stability in both, advanced and emerging market economies. Only systemically important banks seem to be less sensitive to the capitalization effect, which might be due to their too-big-too-fail status in most of the countries during the sample period.
- Short term debt is recognized as harmful for bank stability, as greater dependence on short term debt is significantly related to higher probability of bank distress. The result specifically holds for banks in emerging markets and for systemically important banks in the entire sample.
- The dependence on wholesale funding, measured by the loan-to-deposit ratio, is also associated

with higher probability of bank distress

- Higher concentration of funding sources is seen as a factor leading on average towards higher probability of bank distress.

In addition authors (IMF, 2013) also elaborate more on the significance of wholesale funding as a major source of instability in banks in crisis periods. First of all it seems that popularity of wholesale funding has increased in modern banks as a response to financial innovation and a build-up of excess savings in the corporate sectors of some countries (IMF, 2013, p. 113). On the other hand, wholesale funding has become more attractive for banks as a funding source in times of accelerated growth that had to be supported by additional funding.

Wholesale funding has become a source of instability due to several reasons, of which we should expose the following ones:

- Banks borrowed at short maturities due to lower interest rates and seemingly unlimited refinancing possibilities that could in fact easily vanish in case of any significant financial distress. Namely the uninsured depositors as wholesale funds providers use their claims as disciplining device (Calomiris and Kahn, 1991) for bank managers not to take excessive risks. In case such depositors suspect or anticipate any signs of bank instability they would run and withdraw their deposits from the bank. Additionally, Brunnermeier and Oehmke (2013) also show that the incentive to shorten the maturity structure of funding is particularly strong during periods of high volatility, such as financial crisis. In such circumstances banks as wholesale borrowers would effectively shorten funding structure and actually make themselves

even more vulnerable.

- Mismatch between assets and liabilities in terms of maturity and liquidity, or even a currency mismatch may deteriorate the sensitivity of banks to distress in financial markets.
- Most of the wholesale funding is based on collateralization of borrowed funds, which means that any concerns about the quality or liquidity of the collateral may lead to the withdrawal of wholesale creditors. This particular aspect was for example investigated by Gorton and Metrick (2012) who describe the behavior of creditors as “a run on repo”.
- An extensive use of wholesale funding may also cause interconnections between banks and other financial institutions and therefore increase the sensitivity of the whole system to shocks and distress in financial markets.

Several other studies also discuss a controversial role of wholesale funding in banks. So, for example Huang and Ratnovski (2011) model what they call a “dark side” of wholesale funding and suggest that wholesale funds can be beneficially used in traditional banks that hold mostly relationship loans, while wholesale funding can create significant risks in contemporary banks that hold mostly arm’s length assets with available but noisy signals on their values. Likewise, Agur (2013) raises some warnings regarding the overuse of wholesale funding because according to his findings the wholesale funding increases the impact of capital requirements on banks as compared to retail funding, and the collateralization of loans to banks can expand credit rationing. Further, Damar, Meh and Terajima (2013) empirically prove that banks with wholesale funding are expected to exhibit higher leverage procyclicality.

In addition they argue that banking-sector leverage procyclicality is important for aggregate economy by providing empirical evidence that banking-sector leverage procyclicality forecasts aggregate market volatility in the equity market.

As the volume and forms of wholesale funding have been broadly recognized as important triggers and catalysts of instability during the recent financial crisis some implications should be acknowledged and lessons for the banks and regulators should be taken. From the perspective of banks the alternative funding models should be taken into consid-

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*Banks in liquidity distress typically revert to central bank funding if available.*

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eration, although growth oriented banks business models could be compromised this way. Furthermore, the banking sector regulators and supervisors should pay much more attention to the viability and sustainability of the funding policies applied by banks and due to the increased interconnectedness and complexity also by other non-banking financial institutions in order to prevent the accumulation of liquidity management related risks.

## 5. Discussion and conclusions

A rapidly developing deleveraging process that was triggered in the aftermath of the recent global

financial crisis has affected not only globally active banks but also banks with regionally and locally oriented business models, which were to an unproportionally large extent supported by unsustainable funding sources in the long run. It has turned out that not only sufficient capitalisation of banks but also a stable, sound, robust and sustainable funding structure is absolutely necessary for banks in order to maintain their credit activity throughout the business cycle intact. Unfortunately, the evidence from the recent financial crisis has shown very different developments in banking markets of the euro area and the European Union, as credit activity of banks has slowed down across most of Europe. Credit crunch has proved to be even more intense in the so called euro area peripheral countries, where the accelerated credit growth before the crisis was to a large extent supported by intense wholesale funding, very often not properly adjusted to the maturity, currency and credit risk structures of the banks’ assets. The consequences in some of the banks were unprecedentedly devastating and costly for the taxpayers in the affected countries.

Slovenian banking sector and specifically some of the banks were affected as well and the consequences are still visible, as the credit activity has not recovered yet and some of the banks still depend on the government support. The unbalanced, vulnerable and in the long run unsustainable funding structures that have been developed in a relatively short period of an intense credit growth between 2003 and 2008, are to be blamed (although not exclusively) for the difficulties in the most affected banks and also in a broader sense in the entire Slovenian banking sector. The lessons for Slovenian banks as regards their funding structure could be multifold and should incorpo-

rate several considerations. First, over-reliance on wholesale funding combined with the domination of short-term debt in the funding structure is unacceptable and proved to be lethal for many banks in Europe. It seems that this particular lesson has already been taken, as banks have clearly reoriented their funding structures more towards retail deposits, where greater stability is anticipated but unfortunately the deposit base itself is not likely to be sufficient for supporting a desired credit growth. The alternative will have to be found. Second, greater diversification of funding sources should be established and maintained in order to minimize the dependency of banks on only few or even on one prevailing funding source. The diversification issue should be considered also when it comes to the retail deposits as a very important funding source for commercial banks. Third, the structure and quality of the assets has to be permanently evaluated

and considered when the funding structure of banks is planned. The assets side considerations should also include the volume and quality of the collateral taken by the banks, as it has been evident that banks' creditors adjust their behaviour also by observing the developments in the collateral markets. All in all it has been evidenced that sound and in the long run sustainable funding structures are necessary for establishing stable and robust banking sectors, which would be able to adequately support businesses with credit and other accompanying financial services without compromising the expected profitability of their owners and without weighing on government budgets and taxpayers.

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# Banks' capital and their funding

*Ivan Ribnikar\**

## **BANKS' CAPITAL AND THEIR FUNDING**

**Bank capital is at the same time bank funding, but its function is predominantly different. One can say that it is more important than funding but it may not be so. As trust is the most important for banks than funding should be of the same importance. And one of the things the paper wants to pay attention to is, for instance, the importance of bank funding that is not properly recognized. For instance, this has been obvious during the process of bank rehabilitation. In addition, there are other wrong explanations, wrong terms and lies that have been used in the communications and relations between the EU or Brussels and the so-called peripheral countries. The paper wants to draw special attention to those wrong explanations, wrong terms and lies. They are, for instance, what privatisation really means, how free movement of capital is understood, the problem of financial intermediation in the small post transitional countries, why budget deficit is considered the main problem and not the balance of payments deficit and. Why double talk, wrong explanations and lies are used.**

**B**anks, their capital and funding, is what we are predominantly interested in. Not only in banks in Slovenia but also in banks in other similarly small (post)transitional countries. One could say in the countries of the former Yugoslavia and in few other neighbouring countries, but the name Yugoslavia is usually politically incorrect. And, we are not just interested in banks as such, but more in connection with EU. What these countries are demanded to fulfil, how these demands have been explained, justified and, of course, the claim that the fulfilment of those demands is necessary in their own interest. However, we will see that it is not always true.

Banks in the region, if we stay with this geographical identification, were not affected by the financial crisis at the very beginning. They had almost no "toxic assets". Sometime later, because of the lack of confidence among banks in the USA and Europe, interbank money market stopped functioning. Although the central banks stepped in, starting to supply banks with liquidity and replacing horizontal flows of money between banks by vertical flows, bank loans to business enterprises started to decrease. Uncertainty prevailed and risks increased. Partly because the banks were highly indebted they were afraid that they would not be able to refinance themselves. And even more important was that business enterprises suddenly discovered that they were highly indebted just at the time when economic activity started to go down. Banks and business enterprises would have come in problems even if there had not been financial crisis, although probably not so great and long lasting.

If we add to this the so-called fiscal consolidation, structural reforms and privatisation, as we know, almost all banks have more or less the same problems. There are bad assets, not because of the so-called “toxic assets” but because of problems with their customers, predominantly business enterprises as their debtors. Further on, they must be recapitalised because their bad assets had destroyed a substantial part of their capital. There is additional reason for their recapitalisation, namely higher capital requirements from their regulators at home or abroad, i. e. in Brussels. And if the banks are able to expand their credit activities, they need additional capital.

We come to the demands that are permanently coming from Brussels, Frankfurt, and sometimes from Washington, instructions and guidelines what these countries should do.

However, these words have become empty slogans. In most cases those who use them, do not know what they mean and even less how these required changes can be achieved in particular country.

Disregarding all this, there is no doubt, that countries must solve their economic problems, it means problems of banks and business enterprises, but their solutions should not be proscribed across the board in such a primitive and faulty way. Not to mention vocabulary used – using words and explanations that are in most cases simply wrong.

When looking for proper solutions, countries will find out that at the end, the solutions will be sometimes very unpleasant. Mistakes that were made in the past, and made without any resistance at home or from abroad, are to be paid for. Here, we do not think this should be some kind of consolation, because it does not exist.

We are interested in the first place in banks – in their capital, recapitalisation and funding. Fiscal consolidation

and structural reforms, for instance, greater flexibility of labour market is not of our direct focus of interest. We will, nevertheless, come across them. But also in the case of banks, we are not interested in the things that are permanently agenda in Brussels; at least not in the same way. We are interested in issues such as: (1) bank capital and funding, (2) savings (S) as a basis for capital formation, (3) free movement of capital among countries or just free import of capital, (4) financial intermediation in small and financially undeveloped countries, (5) relevance of Piketty (2014), his book on capital and labour, for us. In this way, i.e. indirectly by using different concepts and different words, we may better understand what it is all about than by using standardised and in many cases wrong words and concepts. The point is that we do not think that thorough changes are not necessary, many demands coming from Brussels are the proper ones, but official arguments and even goals are sometimes just wrong, on purpose or by accident. We should not make the same mistake when we choose supposedly the best, the most just and economically the best way for the abolishment of the social ownership of nonfinancial business enterprises.

### 1. Bank capital and their funding

The title may provoke some hesitation or doubt, namely capital and funding. According to one understanding of capital, and it is generally accepted in finance, capital is fund. It means that we can find it on the liabilities side of the balance sheet. We can find it at J. Hicks (Hicks, 1979). Hicks talks about “fundists”, if they think that capital is fund. On the opposite side there are so-called “realists”, for whom capital are assets, it means real assets, and one can find

it on the assets side of the balance sheet. As we will talk about Piketty later on, of course, in connection with capital, let us say immediately that Piketty is a realist when capital is in question.

Although capital is fund, at least also fund, we have in the title capital and funding as they are two different things. When we talk about capital, for instance, bank capital, we have in mind equity and when we talk about funding we have in mind other items on the liability side of the balance sheet – like, for instance, deposits.

Capital is without doubt both – capital as equity and funding. It enables banks to give loans. If there is a financial institution that gives loans only on the basis of the money brought to it as equity it is not a bank as financial intermediary but just moneylender. But the primary purpose of capital is not this but something different. Bank finance itself or its main way of funding are deposits and, of course, issue of various debt securities. And this at least partly different role of capital and funding is good to have in mind. But it is not always the case even in financially much more developed countries than we are.

In the case of bank rehabilitation in Slovenia, for instance, one can see through experts and politicians’ discussions and statements that they are not quite aware of the difference between capital and funding. With recapitalisation of banks, they should be getting funds to increase loans to businesses. But it may not happen, although there is no credit crunch<sup>1</sup>.

<sup>1</sup> We can talk about the so-called credit crunch, when banks have enough capital and funding, and there are customers that are willing to get loans, and although being also creditworthy, they do not get loans. When we cannot logically explain why loans are not given, we can talk about credit crunch. It is probably because of uncertainty. We have been talking about credit crunch at least for five years, although it probably appeared only recently once the banks were recapitalised.

Banks may have enough capital but not necessarily at the same time enough funds. And if they do not have enough funds, they cannot give additional loans.<sup>2</sup> It is simply not true that bank recapitalisation will enable banks to give additional loans. This is can be found in Slovenia, as we will see, after recapitalisation of banks. It is probably not quite unexpected to have a mess as concerning capital and funding in Slovenia, but it is a bit strange when at Wall Street Journal, experts are not quite sure about the difference (Miller, 1995: Miles, Young & Marcheggiano, 2011). It is understandable that if the bank capital increase is only enough for filling up black holes in their balance sheet and/or just the required capital ratio is achieved, banks would be unable to increase loans. But even if they have enough capital, and as concerns capital they are able to increase loans, it will not happen if funding does not allow that it happens.

Importance of bank funding is not sufficiently taken into account. It is for instance true for Slovenia. Everything has been concentrated on additional capital. Importance of trust in banks has not been taken into account at all. Without trust in banks there cannot be bank funding and cannot be banks. But with their behaviour, for instance, the behaviour of the most responsible man for rehabilitation of banks incited the citizens, the so-called tax-payers to leave one of the banks, because, of course, supposedly so, there is no solution for the bank. Because of this, its funding is encroached and its very existence jeopardised. Tax-payers, if we stay with this expression favoured by politicians, are the ones that lose most. Bank capital is not everything, although it is vital for banks to be able to give loans. It would be the most important and even everything for banks if they would not be banks but,

as has been already said, money lenders. So, at the end, we can say that for banks the most important thing is trust in them. Without funding there is no banking. If there is only a bank capital, we can have, as we said, money lenders and their loans. For money lenders only trust in their borrowers is required. Banks need to be trusted both by their depositors and borrowers.

## 2. Saving, bank capital and their funding

Trust is, as we have seen, the most important non-material condition for existence of banks. But beside this, banks of course need something material, namely they need funding. And this is, if we go to the source,

*When we talk  
about bank  
capital, we have  
in mind equity.*

savings (S). If we for the moment leave aside foreign countries, these are savings; it means the part of income (Y) that does not go for consumption (C) and government spending (G) are additional funds or potential additional capital. It appears in concrete or material form as an increase of real assets and net claims on other countries. It is additional bank funding only as much as additional real assets belong to somebody who got bank loan and these real assets are via bank as intermediary claim of bank depositors or bank lenders in general. It means that at the end or at the beginning there must be savings. Although saving is the basis for bank

funding, a part of savings, and it may be of very different size, does not appear as bank funding. Bank funding is smaller because of auto financing of investments, transfer of savings from savers via financial markets and capital export. At the end, it may remain for bank funding very little or even nothing – if there is no trust in banks. It is something in “the clouds” that may disappear very quickly. Therefore it is very bad when financial authorities in times of crisis, when there are holes in banks’ balance sheets, do not take into account how delicate the banks are and that with irresponsible statements trust in banks may be undermined.<sup>3</sup> They are supposedly angry with banks because tax-payers would be obliged to pay the bill again. Therefore banks’ recapitalisation is not all. When the importance of trust is ignored, worries for tax-payers turns into the opposite, i.e. they believe that the authorities just do not care for them.

As a solace for bank funding, if there is not enough domestic saving that would go to banks and increase their funding, there are foreign countries – import of capital via banks. In not so distant past, funding abroad was quite substantial; otherwise bank loans would not have increased as much. It ended with the beginning of the financial crisis – generally not in a very pleasant way. Even for their subsidiaries in foreign countries, mostly transitional countries, big foreign banks changed their strategy. Local funding is taking hold.

<sup>2</sup> There may be no increase in bank loans because the best customers go for loans abroad where the interest rates are lower. This is an additional reason why the dynamics of bank loan cannot be simply deduced whether there is or there is not credit crunch. It may be relevant in the periphery countries.

<sup>3</sup> It may even happen, as for instance it happened some time ago in Slovenia, when the most responsible person for bank restructuring and recapitalisation, with his statement more or less openly incited citizens, i.e. tax-payers, to leave one of the banks because there is no viable solution for it.

### 3. Free movement of capital among countries or something else

Transitional countries we are talking about opened up and abolished obstacles for free movement of capital across border. Balance of payment has neither been taken as a constraint for them nor for the countries on the other side – non-transitional developed countries. The required and at the same time quick privatisation would not be possible without foreign savings, i. e. without import of capital from developed countries. This has gone so far that in even very severe Maastricht requirements there is no requirement concerning balance of payments<sup>4</sup>. If there would be, for instance, requirement of longer term sustainability of the balance of payments, it probably would not be desirable message to transitional countries to take care of the balance of payments. This would have meant that they should not allow almost unrestricted import of capital. Countries cannot be net importers of capital without balance of payments deficit, i.e. current account deficit, in the amount of net import of capital. There is no other reasonable explanation why balance of payments does not matter.

This standpoint on balance of payments especially prevails during the financial crisis. So-called peripheral countries are being criticised for excessive budget deficit, more than 3 per cent of the GDP, and public debt, more than 60 per cent of GDP<sup>5</sup>. Behind all this is probably something else. "Living beyond one's means" has got a completely new meaning. In Brussels, Frankfurt and sometimes also in Washington they namely think, or at least they preach, that it means having or living with budget deficit. More than 3 per cent of the GDB is already intolerable and must be punished and sooner or

later abolished. Everybody knows, if one has no special interests, that budget deficit does not mean living beyond one's means. It is the balance of payments that gives us that information.

Nevertheless, as we know, government budget and public debt are very suitable targets. Owing to the fact that countries generally cannot stay within their limits, budget and public debt are imposed on them as constraint, and without curtailing social transfers and public goods for their citizens what is really desired is achieved. They talk about the increased competitiveness of the economy that will benefit all. But what lies between the lines is some-

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*Importance of bank funding is not sufficiently taken into account.*

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thing different. It may mean, if we call Piketty for help, it may be a desire to prevent that a big state should, to some degree, neutralise bigger "r", average rate of return on capital, than "g", rate of growth of the GDP. In this way the difference between greater "r" and smaller "g" is not substantially diminished. It means that the difference of income from capital is predominantly at the top of the income ladder, and income from labour is mostly at the bottom and keeps increasing.

Diminishing of the state may mean diminishing of administration and bureaucracy. But there is probably not much room for such diminishing of a state. Almost each day there are

new and additional demands what the state should do. Financial sector and especially banks are a good example of how the state can become smaller. It is still more emphasised in the case of small countries, and the countries we are talking about are just such countries. It does not matter very much whether they are already in the EU or preparing themselves to become members.

But there are still some other strange things as concerns the balance of payments. We come across them when we look at what in reality economic benefits of free movement of capital among countries are. We have in mind how these benefits are perceived by the countries we are talking about. It is well known, that as concerns balance of payments, it is not just the balance, surplus or deficit that are important. If we simplify a bit, economic benefits are in the fact that we can, for instance, import goods and services that we would produce at higher costs, and/or we export what we can produce cheaper than our trading partners. Majority of big and developed economies have neither current account surplus nor deficit. Such is the case, for instance, of the EU and Euro area. The USA, China and oil exporting countries are the excep-

<sup>4</sup> The required stability of the exchange rate within a band of 15 per cent around the central rate is no genuine restriction and does not mean anything important.

<sup>5</sup> Until some time ago public debt of more than 90 per cent of the GDB should be economically excessive and dangerous for the economy. It should be almost scientifically confirmed on the basis of the book written by C. M. Reinhart and K. S. Rogoff (Reinhart & Rogoff, 2009) until it was found out that the authors unintentionally made a mistake when they made calculations.

There is, of course, no such limit that is not good to surpass. It may become economically dangerous much earlier or there is no such limit. It may be even more than 200 per cent as Japan has. What is important is, where the debt is, i. e. who are the lenders. If they are abroad, than especially in the case of small countries it may become dangerous much earlier. If the lenders are at home, there is no such dangerous limit. Japan is the case. But in this case we can see again that the most important is the balance of payments and foreign indebtedness and not budget and public debt.

tion that proves the rule, i.e. what we have just claimed. Even if the countries have a balanced current account, nevertheless, foreign trade is of vital importance to them. Economic benefits are great.

The same is true for capital and financial account. These accounts are also in balance in the big countries or areas; we know that net import or export of capital requires deficit or surplus of the current account of the same size. If current account is in balance, than capital and financial account must be balanced, too. For the countries that are neither net exporters nor net importers of capital, cross border capital flows are of a great economic benefit for them. But when in Slovenia and neighbouring countries it is talked about free movement of capital among countries, the free movement of capital is of course firmly supported, but what is usually in mind is free import of capital. And import of capital is not welcome because it means import of new and better technology and management of business enterprises. Additionally it is not welcome because it would enable the capital importing countries to export capital as well, and with it their better technology and management, without necessity to run current account deficit. Export of capital is sometimes considered in our countries as something very strange. Finally, we should add what is not unimportant, but it is not taken into account at all, that foreigners would not be looked at critically as intruders, as is usually the case<sup>6</sup>, and we would not be similarly looked at abroad, what may be something very hypothetical now. Free movement of capital means in the case of Slovenia and similar countries in the first place free import of capital and not free flow of capital in both directions as it should be. More or less the same amount of capital flowing in both directions means that both

sides are on equal footing. No side is subordinate and/or superior.<sup>7</sup> In this context, if we make a short detour, we can understand president Obama, when he has recently announced that he is proud and happy as concerns the USA because they are again the most attractive country for foreign investment. He did not say that the USA were technologically and as concerns management backward and foreigners should help them. Neither he did mention that because they needed foreign funds or capital, they were happy to get foreign funds again. They do need foreign funds, they are big net importers of capital, but it is not the point. They have been able to solve this problem easily, some would say too easily, by selling government bonds to foreign investors. Therefore their concern for the balance of payment and exchange rate is usually called "benign neglect". Funds are for them not the problem, at least has not been so far.

We cannot behave as concerns balance of payments and foreign indebtedness in a similar way. Nevertheless, free movement of capital should not mean only free import of capital or funds, which is eagerly expected when it will happen, to finance something that cannot be financed with our savings. It looks that we lack money for everything important and therefore foreigners are called to help. Foreigners should help us to privatise. But it is not the right word for what foreigners should do. Privatisation means that business enterprises are left to foreign companies to transform them into their subsidiaries. The government does not have money and others may have money but they do not want to become owners. The latter is to a great extent true but not because of not having enough domestic savings or domestic capital, as one can hear almost permanently.

#### 4. Financial intermediaries in small, financially not well-developed countries

We have already said that as concerns capital what is important are gross and not net capital flows; it means not net imports or net exports of capital. In developed economies, net flows of capital among countries are usually near zero. Nevertheless, the capital flows among them are economically very important. In our case, if we take what experts and politicians think, these are net flows of capital, i.e. net import of capital that are important. But just in small economies, gross capital flows should be considered as much more important than in big countries. The point is that within small economies, and even more if they are not so financially developed, it is impossible for various transformations of funds or savings to be properly accomplished. Maturity transformation is, for instance, especially important. Similar problem we are facing nowadays appeared after the World War II in relation between the USA and

<sup>6</sup> Various self-proclaimed experts on foreign direct investments usually knowingly explain how the country, for instance Slovenia, or its people, are against foreigners and that it is something queer in national character of its inhabitants and/or that some individuals, usually professors are to be blamed that ownership of business enterprises is not in foreign hands yet. The experts should look at data of the balance of payments or foreign claims and foreign indebtedness of the countries with normal people. They would see that capital flows are more or less balanced flows in two directions – similarly as flows of goods and services are.

<sup>7</sup> This looks now, namely not to be in subordinate position, more or less utopian. But it was not so at the beginning of nineties. Now we belong to countries in which foreign capital is coming and with it industrial production and we are happy with this and jealous if other countries are more attractive for such activities. James Dylon (Dylon, 2014) inventor and owner of enterprise, that produce aspirators without cables for electricity and VREČE for rubbish, says, for instance, what benefits the Britain has because the production was transferred to Singapore and Malaysia. In Britain there are 3000 engineers. In addition there are great financial benefits as well form intellectual ownership, taxes and repatriated profits. In Singapore and Malaysia value added is very small. It means, in plain language, that wages and various contributions are very low. "Made in France" means nothing or, we can say that "Made in Slovenia" means nothing. To be proud of it is just a stupid idea.



Europe. European countries needed external liquidity, and the US dollar was the only currency available and acceptable as international monetary reserve and as working balances of banks. To be able to stay liquid, European countries had to get loans in the USA and these loans had to be longer term loans. In this way Europe had short term or very short term claims towards the USA banks. On one side, a substantial part of these claims were simply American bank notes and demand deposits with American banks, and on the other side, Europe had long term debt towards USA. Relations between Europe, her banks and business enterprises, and banks in the USA were similar to relations between the banks and their customers. Europe was a customer with short term bank deposits and long term bank indebtedness. The USA, it means its banks and financial markets, played the role of financial intermediaries<sup>8</sup>.

Relations between the small transitional or, as it is sometimes said, post transitional countries and Europe, her banks and financial markets, is similar to relations between Europe and the USA after the World War II. It is impossible that within small economies, and in addition, financially not well-developed, transformation of funds or savings would be done properly. Although it might be very important, it is not only maturity but also other transformations that are required and preferences of various institutions and individuals as concerns financial assets and financial liabilities within a small country is almost impossible to fulfill. Owing to this fact, in small countries that are financially not quite developed, gross capital flows are much more important<sup>9</sup>. Even if the country has a balanced current account with no net capital flows in either direction, which is according to our

popular understanding the only thing that matters, we have seen that the gross flows are the flows that are important for us. Otherwise, the necessary transformations of funds would not happen. On one side, to satisfy preferences of savers, and they may be very diverse, and at the same time desires of nonfinancial investors on the other side, that may also be diverse, huge cross border gross flows of capital are required.

### 5. The relevance of Piketty's book on capital and labour for us

Although a lot of things are required from us to make and/or achieve, let us not mention again phrases

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*Banks are a good example of how the state can become smaller.*

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or clichés and we'd better not use Aesopian language. In many cases it is not just double talk, but simply lies. Public media are supposedly helpful. They make efforts that lies should not be discovered. In this way they make us accepting all those 'necessary' reforms, changes and so on easily and quickly. They seem to behave in a socially responsible way. But in a reality they are making damage. We should just have in mind what abolishment of social ownership promised and what we have got. Maybe Piketty's book came just at the right time, primarily because of dealing with the issues we have just talked about. Namely, it can

remind us of something important. Besides his main thesis that looking historically, the rate of return on capital ("r") is greater than the rate of growth of GDP ("g"), what means that the difference between incomes from capital and incomes from work has becoming greater, there are other things of interest. We may mention his four forms of capital. Capital is for him assets, and these assets are agricultural land, houses or residences in general and all other assets. Of course, there is also the fourth form of capital and that is the net foreign capital or net foreign assets or claims. It is this form of capital that might of interest for us. Net foreign capital that may be negative is the difference between all foreign claims of a country and all its foreign debts or liabilities. If the difference is positive than the country, besides its agricultural land, houses and other real assets, also has net foreign capital. If that difference is negative than the country has as much as is the difference less capital than the sum of three forms of real capital. In developed countries the difference is around zero, although gross flows are substantial. Exceptions are, as we already said, the USA, China and oil exporting countries. In the former colonies the difference was negative and in colonial monopolies the difference was positive and rather large. According to Piketty, colonial powers had in Africa and Asia three quarters of their industrial

<sup>8</sup> We should remind us what the French President said for the USA. The idea came from the economist Jacques Rueff that the USA had the unique privilege. They may be running the balance of payments deficit without tears ("sans larmes"). He had in mind the USA bank notes in the hands of foreigners and short-term bank deposits owned by foreigners.

<sup>9</sup> Foreign indebtedness of a country usually means net indebtedness. But in our country gross indebtedness is usually taken as foreign indebtedness. Probably because it looks for whatever reason more. But there is another catch. Why gross indebtedness if it is net indebtedness, it means net import of capital, we are predominantly interested in. Gross indebtedness and gross foreign claims should be used once we will discover the problems of financial intermediation in small economy.

capital and little less of capital as defined by Piketty. Today's former colonial powers have approximately zero of "net foreign capital". Will this be improved for them and for the countries we are talking about, once all of them have achieved what Brussels demand from them? If it is really impossible to do something for the economy to recover, besides what Brussels demands, and local politicians are eager to fulfil, than at least, we should try to change the way and manners the advice, recommendations and commands coming from Brussels are interpreted and explained locally. First of all, we should get rid of home produced lies. These are the things that are at least in our hands. The

proper names that will be in accordance with their meaning should be used. There should be less double talking and intentionally unclear or false explanations. And in the first place, lies that have crept in either on purpose or by accident should be eliminated. We have, for instance, in mind "to live beyond one's means", "strategic partnership", "privatisation", "free movement of capital", "fiscal consolidation", "rehabilitation of banks", "lack of domestic savings and therefore capital formation". Without clear talking or writing there cannot be clear thinking and without clear thinking proper solutions cannot be found. We should bear in mind that one can "fool some people some time, but cannot fool all the

people all the time", i.e. to sell them permanently false things.

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# Positioning Slovenian banking sector in EU

*Timotej Jagrič and Rasto Ovin\**

## POSITIONING SLOVENIAN BANKING SECTOR IN EU

In order to define the position and performance of the banking sector in Slovenia within banking sectors of EU, we study the process of the integration of the banking sector in the EU. Using a new method based on neural networks we conclude that the Slovenian banking system can be placed between the two clusters: old EU members and new EU members. Although fiscal imbalances were not included in calculations, the results show clear placement of the domestic banking sector next to the banking sector of Greece. Such outcome supports the evaluations that the shortcomings of the Slovenian banking system do not derive just from cyclical developments but also from the abnormality of the Slovenian economy response to economic stimulus after joining the EU in 2004 and the euro area in 2007.

JEL G21

The Slovenian national banking sector is seeking the way out of a vicious circle: the banks are trying to fulfil the regulator's requirements on capital, to deleverage due to optimistic loan policy in the past and to serve the economy. The latter mainly consists of companies which in the years after Slovenia's accession to the EU and the euro area participated in domestic and international transactions with too much optimism. In 2004 and in the following years, also the curtain on management takeovers was lifted in Slovenia and all this propelled credit transactions into the skies. Supported by overpriced shares on the domestic stock exchange and overpriced land and real property as loan guarantee, the door for today's straits opened dramatically in 2009. Now the great part of companies needs to deleverage, lacking at the same time the finances to support the current business needs let alone the need for the investment in new technology. They are hard to get as they rarely meet the loan criteria of now very cautious banks.

## Introduction

Banks' rush entering into the EU markets was accompanied by overwhelming optimism that the system will sustain such economic upspring and that the domestic knowledge and experience in the field allows independent entrance in the international capital markets by the means of foreign credits.

In this paper we analyse the comparative Slovenian banking system position in the EU by means of topological data analysis and try to locate the reasons for its placement.

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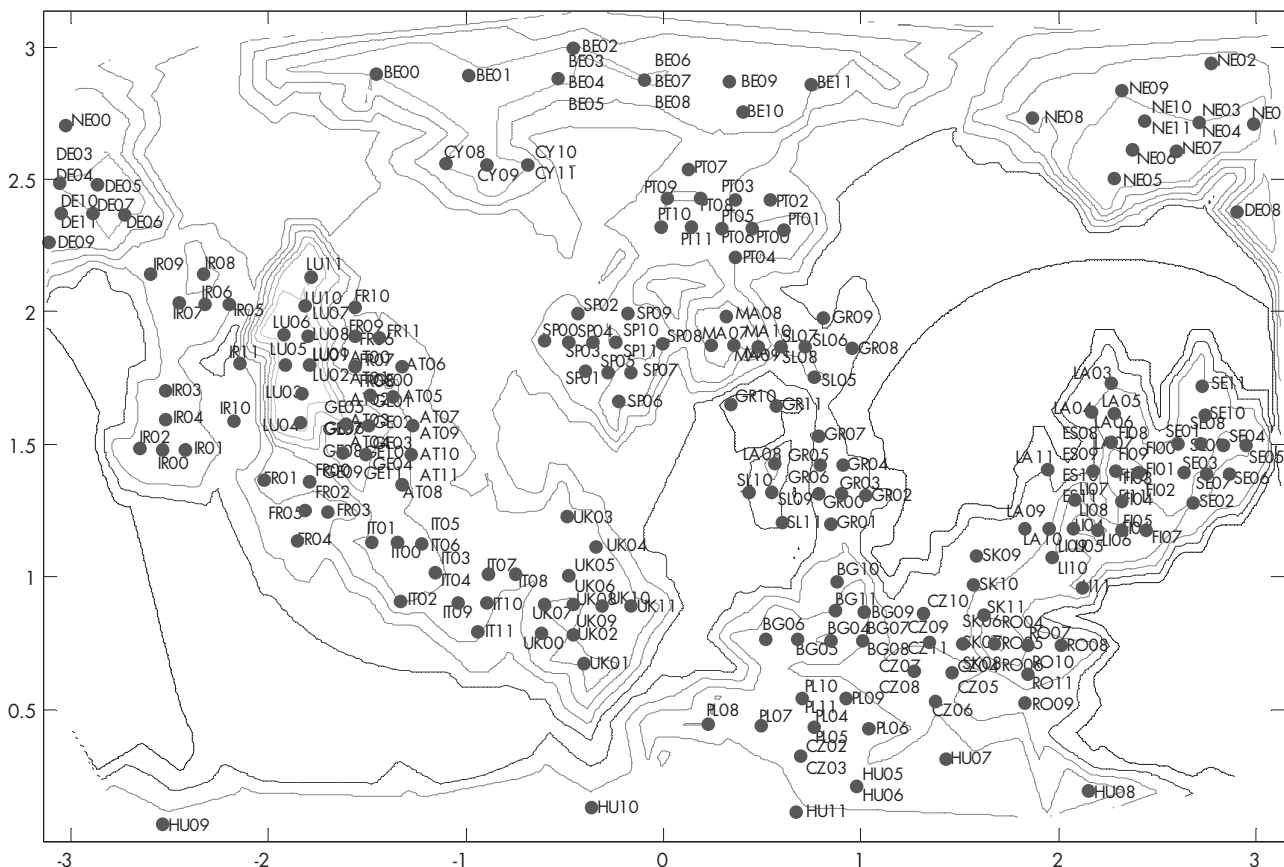
**1. Topological data comparative analysis**

In order to determine the position and performance of the banking sector in Slovenia within banking sectors of EU, we study the process of the integration of the banking sector in the EU using two topologies, which are calculated using optimized spiral spherical SOM due to its expected abilities of overcoming methodological shortcoming of the conventional analysis, like handling unbalanced data panel, nonlinearities, outliers, multicollinearity and, nevertheless, high dimensional input data space (see Jagric 2013). The selected method uses an unsupervised learning algorithm and belongs to the family of neural networks. Two topologies, appearing as 3-dimensional maps of the analysed

period from 2000-2011, resulted from the EU-wide study and are developed in Jagric (2014) and have been presented and discussed in Jagric et al. (2014). In cases of both topologies the data is unbalance panel for the period 2000-2011. The databases for both models include a wide range of indicators. The macro database includes 20 variables on 27 national EU banking sectors, collected from statistical data bases of ECB, World Bank and Eurostat. The macro data basis does not include indicators on public finance, but national banking sector data. On the other hand, the micro data base includes 19 variables on the performance and characteristics of selected commercial banks collected from their annual reports. The sample of 125 analysed banks was selected using the criteria of market share in

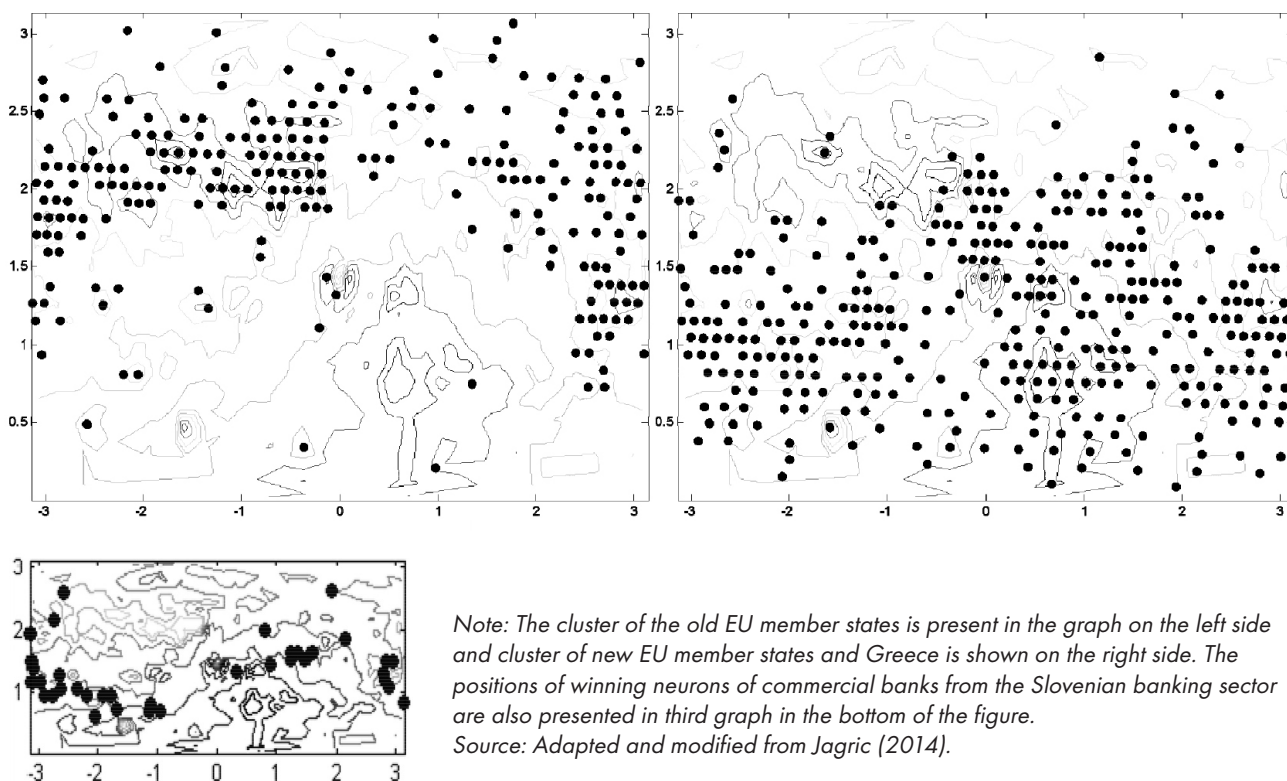
the national banking sector and the relative presence in the observed period. In this way we tried to capture banks, which have been present in the market for as long as possible and have played a substantial role in the market (Jagric 2014 and Jagric et al. 2014). These results have clearly shown the persistence of the two groups of the national banking sectors throughout of the analysed period, on both levels of the analysis, the micro and macro topology. The first cluster comprises Austria, Germany, France, Ireland, Belgium, Netherlands, Spain, Portugal, Italy, Luxembourg, UK, Sweden, Denmark and Finland. It is seen that the first cluster is formed of "old" EU member states, except Greece, which appears in the second one. The second cluster is formed by the Czech Republic,

**Figure 1: TWO DIMENSIONAL DYNAMIC ANALYSIS OF THE MACRO TOPOLOGY**



Source: Jagric 2014.

Figure 2: MICRO TOPOLOGY



Note: The cluster of the old EU member states is present in the graph on the left side and cluster of new EU member states and Greece is shown on the right side. The positions of winning neurons of commercial banks from the Slovenian banking sector are also presented in third graph in the bottom of the figure.

Source: Adapted and modified from Jagric (2014).

Cyprus, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, Slovenia, Bulgaria and Romania, as well as Greece.

We shall next turn to the question of the relative position of the Slovenian banking sector on these EU maps, at both levels. On both topologies, micro and macro, Slovenian banking sector is positioned in the cluster of EU member states, which joined the EU together with Slovenia at 2004, or later, and Greece. Within this cluster one can recognize groups of countries, which are closer together. The macroeconomic topology has shown Slovenian banking sector to be positioned in the group with Malta and Greece. This group is placed on the equatorial position of the sphere. The macroeconomic data base includes the Slovenian banking sector data from 2005 to 2011. The dynamic analysis shows that the Slovenian banking sector is moving away from Malta. First four included years (2005 to 2008) have found

*Dynamic analysis shows that Slovenian banking sector is moving away from Malta.*

winning neurons, in whose neighbourhood are winning neurons of Greek banking data for the years 2008 and 2009 on the right hand side and Maltese banking data for the years 2007 to 2010 on the left hand side. Additionally, on the north of the described 3-country position we find Portugal, while on the left hand side from Malta one finds Spain. An interesting move of the Slovenian banking sector is then noticed

for the year 2009, when the winning neuron is positioned downwards and remains relatively stable there also for the years 2010 and 2011. However, in the closest neighbourhood to this position, there are winning neurons for the Greek banking sector from 2000 to 2006, when the move upwards on the map is noticed. In the very same neighbourhood an isolated winning neuron for Latvia in 2008 is position, just next to the winning neurons for Slovenian banking sector in 2009 and 2010.

In Figure 1 dynamic analysis of the macro topology is shown. It should be noted that when the three dimensional map is projected into a two dimensional map, elements positioned on the north or south pole appear to be apart from each other, while they are close together on a sphere. In order to study dynamics of the integration process we also calculated the path of a particular country. For the Slovenian banking sector the total displacement in the analysed



period is 1.10 units. For comparison: in the same period (2005-2011) Greece shifted by 1.44 countries, while Germany shifted only by 0.22. What should be pointed out is the maximum shift, which the Slovenian banking sector realised from 2008 to 2009, that is, by 0.55 units. The number of the observed units in the micro model is compared to the macro model substantially higher, since each national banking sector is now represented on average by 4 or 5 banks. Each selected bank for each observed year is assigned to its winning neuron. Therefore, the first interesting question of this analysis was whether banks from the same banking sectors tend to the same neighbourhoods. On Figure 2 we can see that clusters, which were identified by the macro topology, very much hold also in the micro topology. This means that individual banks will more probably be more similar to banks from the same national banking sector or national banking sector from the same cluster than to banks from another cluster although some outliers are present in both clusters. We can explore the position of Slovenian banks in the micro topology map on the lower part of Figure 2, which shows the isolated winning neurons for all included observations of commercial banks from the Slovenian banking sector. It is seen that with the exception of 3 outlier observation winning neurons are positioned into the cluster of new EU member states and Greece, which are positioned on the southern hemisphere of the topology.

## 2. Main contributing factors to such positioning of the Slovenian banks

Optimistic acting of Slovenian companies and banks on the eve of the crisis was surely nurtured by favourable domestic economic growth. In

**Table 1: GDP GROWTH 2006 – 2013 IN SELECTED EU ECONOMIES**

Country	2006	2007	2008	2009	2010	2011	2012	2013
Austria	3.6	3.7	2.2	-3.9	1.8	2.8	0.9	0.4
Croatia	4.9	5.1	2.4	-5.8	-2.3	-0.2	-1.9	-1.0
Estonia	11.2	7.1	-5.1	-14.1	2.6	9.6	3.9	0.8
France	2.2	2.4	0.2	-2.6	1.7	2.0	0.0	0.2
Germany	3.4	2.7	1.0	-4.7	4.0	3.3	0.7	0.4
Italy	2.0	1.5	-1.3	-5.0	1.7	0.4	-2.4	-1.9
Slovakia	8.5	10.6	6.2	-6.2	4.2	3.0	1.8	0.9*
<b>Slovenia</b>	<b>5.8</b>	<b>6.8</b>	<b>3.5</b>	<b>-7.8</b>	<b>1.4</b>	<b>0.7</b>	<b>-2.5</b>	<b>-1.1*</b>

Source: World Bank.

\* Source: Eurostat.

Table 1 above we present some comparative data in the years preceding the financial and economic crisis and its aftermath.

The data demonstrates that the Slovenian economy was still quite resilient in 2008 but reacted strongly in 2009 when reserves of high growth were spent. The way this growth was financed is in a way predicting, that the path to sustainable economic growth will be difficult.

According to the data available at the Slovenian national bank (Banka Slovenije 2014,33) the relationship between debt and equity financing of the Slovenian companies in 2012 was 135% (compared to the euro area with 95%) in favour of debt financing. In this respect worse relationship was recorded only in Greece and Malta, both exceeding 160%). With 104% in 2007 (equity financing reaching 49%) it has rocketed in 2008 to 146% (reducing equity financing share to 41%). During the process of deleveraging this relationship was reduced to 133% (Q2 2013), while the equity financing rose by less than 2 percentage points.

One has to be aware of the fact that such abnormal structure of companies' financing is not just a consequence of the banks' management misjudgement or of the regulators' overlooking that the capital import structure is abnormal. It is also to be

attributed to the general self-confidence and perception that favourable economic conditions resulted from the domestic knowledge and experience with business and financial transactions. So despite the cooling of the economy in 2008 with the GDP growth of 3.5% (as opposed to 6.8% in 2007), the borrowing of domestic non-financial companies grew by 17%. Characteristically here are statements presented at the "Financial – stock exchange conference (Finančno – borzna konferenca) held in Portorož in May 2006 (Dnevnik 2006), where the message was that debt financing of the companies' growth is not necessarily a threat meaning that loan financing should prevail from equity capital with financing of companies' growth. Here the majority of the discussions attracting this daily's interest came from the representatives of the companies - national champions: Prevent, Mercator, Istrabenz and Sava - today representing examples of companies, whose management took wrong business decisions and is even subject to criminal persecution. Ovin et al. (2011) systemise the reasons which help us understand positioning of the Slovenian banking system as shown in the former chapter, as follows:

- Joining the EU in 2004 and inclusion in the euro area in 2007

eliminated reservations towards lack of experience in business and financial transactions and Slovenian banks and companies adopted the policy of uncritical using of finances available on foreign markets.

- The emerging of the financial and economic crisis disclosed abnormal financial grounds of the industrial and ownership consolidation – their loan guarantees were mostly based on overpriced land and shares or were given with blind faith into the future performance of the companies subject to management takeovers. The whole burden of such developments fell on the banks;
- Ricochet came when due to contaminated balances the banks were no more ready or able to support growing demand for loans reprogramming. Additionally faced with more severe regulator's demands regarding balance sheets they have reacted with high interest rates thus repressing the economy even more.
- The state as a majority owner of biggest Slovenian banks had no back up strategy for economic developments arising with the financial and economic crisis and hesitated with recapitalisation on time as well as with sufficient funds.

The intensity of the Slovenian bank system's problems grew bigger with the lasting of the economic downturn causing greater and greater number of companies proving unable to service their debts. Additionally traditional reservation towards foreign capital and knowledge prevented entering of needed foreign funds in form of equity capital.

After the stress test performed at the end of 2013 and the approval of the European Commission, the state has assured 3.2 billion of euro for recapitalisation of five Slovenian banks – among them are two biggest banks NLB and NKBM as well as two banks (Probanka and Factor banka) who are now subject to controlled liquidation. This propelled the public debt towards 80% of GDP (in 2008 it was 22%) demonstrating the complexity of the economic policy task trying to assure functioning of the banking system along with fiscal sustainability.

## *Relationship between loan and equity financing of the companies in 2012 was 135%.*

### 3. Conclusions

The results of our study show that the Slovenian banking sector is positioned closely to the Greek one, which is surprising since no public finance data was used. It might be worrying that the Slovenian banking sector characteristics resemble more the countries in a crisis, especially Greece, but also Malta, and the two Iberian states. The obtained results show that the Slovenian banking sector, as observed on both the macro and micro level, did not manage to integrate closely to the core of the

EMU, despite introducing the euro already in 2007. The persistence of its relative position in the cluster of "new" EU member states might indicate that there are other factors influencing the characteristics of the national banking sectors much more than the impact of the common monetary policy with the single euro currency. The dynamics and the displacement will be of our interest in our future analysis when we expect to discover some shifts of the Slovenian banking sector, due to the intensified process of unification in the banking business rules and the introduction of the Single Supervisory Mechanism, all influencing the business conditions and environment of E(M)U banks.

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# Financial instability, government intervention and credit growth

*Božo Jašovič and Matej Tomec\**

## FINANCIAL INSTABILITY, GOVERNMENT INTERVENTION AND CREDIT GROWTH

Government intervention as a policy response at the onset of a crisis has been the most frequent reaction of authorities when financial stability was at stake. Governments exercise intervention in effort to maintain smooth flow of bank credit to non-financial sectors, which has alleged effect on economic growth. The simple empirical research presented in this paper shows that the recapitalisation of banks by government resources in times of crises did not have the expected positive effect on growth of credit activity. In contrast, banks which were not recapitalised demonstrated on average higher growth of lending volume. The explanation for such a finding could be that banks which needed recapitalisation were in a financially much worse condition than other banks. In addition, state aid rules require from recipient banks to refrain from expansionary strategies financed by state resources. However bank credit growth is influenced by many other factors which should be taken into consideration.

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The reasons for government intervention once a financial (banking) crisis breaks out came under scrutiny a couple of years ago (Jašovič, 2011). Then it seemed natural to conclude that given the intensity of State aid poured into the financial systems in so many countries, competent institutions have been doing whatever it takes to preserve financial stability. At this point it makes sense to ask what scale and scope the consequences of banking crises may have if governments have spared no effort to avert them. In this paper we start by establishing who may be affected at the onset of financial crises, particularly if banks become distressed and conclude that shareholders of troubled banks are in the first line of fire and then also savers are asked to shoulder bank losses, if their volume is substantial. Not so much small savers protected by all sorts of deposit guarantee schemes, but no eyebrows should be raised if bank creditors or subordinated debt holders who were prepared to take on ex ante higher risk have to share the burden of rescue. It has been recently incorporated in the State aid rules as a precondition for granting public subsidies that shareholders and subordinated debt holders are first in the line of the burden-sharing approach.

### 1. Safeguarding financial stability – potential consequences of the financial system instability

The key finding made is that when credit institutions face financial troubles, the real victims are businesses – borrowers that depend on banks to provide funding.

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The contraction of credit activities and seeking alternative sources of funding incurs adjustment costs. If there are no alternative sources of funding to be tapped, businesses have to make adjustments due to lack of funding by downsizing the volume of operations. In turn, this is directly reflected on lower economic growth that it could have been without the storm clouds of the financial crisis.

Official authorities with a mandate to provide for financial stability have been trying to mitigate the consequences of the crisis described above. To that end, they have intervened by taking corresponding measures. This is how we arrive at ultimate social group that bears costs of financially troubled credit institutions – taxpayers. Taxpayers' costs are direct due to fiscal expenses governments allocated to rehabilitation of the financial system and indirect as social welfare and standard of living decline – standard companions of economic recessions.

What happens first in a crisis hitting the banking system is fast and unexpected contraction in the money supply, and then this adjustment is transmitted through the credit channel of monetary policy transmission into the contraction in the supply of credit and the economy eventually enter into recession (Kashyap and Stein, 1993; Hoggarth and Saporta, 2001; Schwierz, 2004, Laeven and Valencia, 2013). It leads to impaired quality of loan portfolio and liquidity problems, forcing credit institutions to respond by quick disposing of assets. It builds up pressure on prices of financial assets and real property and, in turn, these prices add up to deteriorating quality of bank portfolios. The vicious circle of shrinking bank balance sheets and downsizing their business gets more vicious as it further impacts economic agents and as a consequence social

welfare and material living standard eventually drop. The banking and economic crisis in Slovenia has been dominated by autonomous inertia both due to certain specific features in operation of the Slovenian banks and the absence of adequate government measures for the banking system.

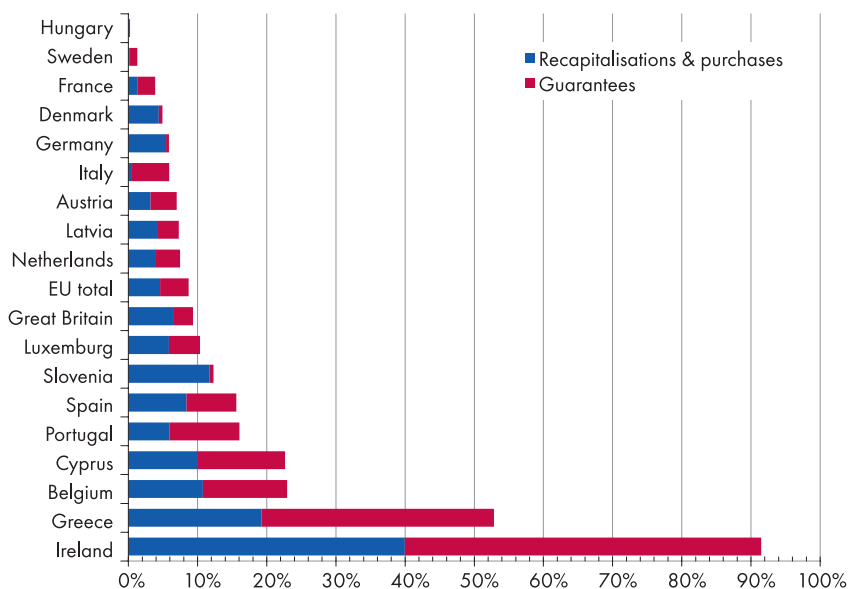
The aim of the paper is to explain what benefits are to be expected of the state intervention measures from the angle of promoting credit growth. To this end, we try to establish whether these expectations are plausible also by examining the empirical data referring to bank recapitalisations in the past. The sections in the paper are structured to start by presenting an empirical review of costs of financial crises followed by an evaluation of how effective the measures taken are in giving impetus to credit growth and the economic activity, then we take a look by taking into account the empirical data at the impact made by recapitalisation on credit activity of systematically important banking groups and we close with obstacles still standing in the way of credit growth.

## 2. Empirical review of financial crises costs

Policy-makers in the countries hit by a financial crisis take various crisis-response measures to contain its negative impact. Besides guarantees for bank debt, deposit guarantee schemes, direct financing and recapitalisations, the concept of "bad bank" as one of more radical interventions was also used in numerous past crises. The main objective of setting up a bad bank was to improve economics of a certain portfolio segment by putting in place a better incentive system and specialised management of assets in liquidation. In the most recent crisis, the key objective of setting up a bad bank was

to boost confidence of investors and rating agencies in credit institutions. Stakeholder trust should be restored when a distressed bank divides its assets into strategic and non-strategic and by providing transparency into the bank's core performance (Martini et. al., 2009, p. 7). Drawing the line between the two structures is of key importance. In the first wave of the financial crisis, banks carved out toxic financial instruments; later on, they did it also with assets that due to recession impact reflect a higher probability of default and non-core investments, they wish to divest to comply with the changed business models or simply to deleverage. The key objectives of setting up state-sponsored bad banks include ensuring the banking sector stability, avoiding a credit crunch and minimising costs to the taxpayers. The last two goals are in a conflict, since to avoid the threat of a credit crunch, the price, at which the toxic asset can be transferred to the bad bank, plays a crucial role. (Hauck et. al., 2011, p. 3). The supply of loans is positively correlated with the transfer value and thus with the costs borne by the state for ensuring bank stability. If the looming threat of a credit crunch is big, then the transfer value (or recapitalisation as its substitute) should be sufficiently high to reduce that risk. When weighing up pros and cons of establishing a state-sponsored bad bank, it should be remembered that different bad bank schemes also mean different allocation of risks between the original bank and the bad bank i.e. taxpayers. This is why the key circumstances of the banking crisis and the priority of ultimate goals have to be considered carefully before deciding. Banking system stability and averting credit crunch should be the key objectives, the objective to minimise engagement of public funds should be subordinate to the first two objectives.

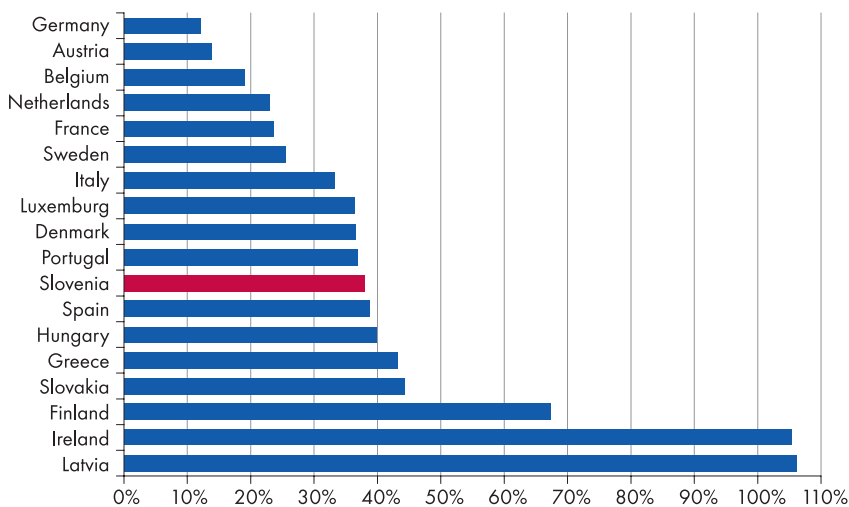
**Figure 1: State aid approved to financial institutions in the period 2008-2012 (in % GDP 2012) \***



Source: State Aid Scoreboard, 2013 and authors' calculation.

\* For Slovenia the amounts allocated to bank recapitalisation in December 2013 have been included.

**Figure 2: Output losses in the financial crisis since 2008 in % of GDP**



Source: Laeven and Valencia, 2013.

Before we start assessing effectiveness of state intervention from the position of delivering credit growth, or rather averting a credit crunch, it is worth checking the size of fiscal expenditure of the EU Member States in the most recent financial crisis. Figure 1 shows in the increasing order state aid approved to financial institutions over the period from 2008

to 2012 as a share of GDP for the last year of that period. The measures taken by the countries that translate into direct, fiscal costs of the financial crisis are divided in two categories: government guarantees and recapitalisations and/or purchases of non-performing loans and other assets. The key finding is that the volume of state aid varies vastly and depends si-

gnificantly on the depth and duration of the financial (banking) crisis, the significance of banks in financial intermediation, the level of development of the economy and the modalities of state intervention plan (for more on this topic see Hoggarth and Saporta, 2001; Schwierz, 2004; Laeven and Valencia, 2008 and 2013). In addition to direct costs, there are also indirect costs of lost GDP in financial crisis. There are methodological dilemmas about measuring output losses to capture as many elements as possible and the approach offered by Laeven and Valencia (2013) provides a fairly complete picture. It calculates indirect loss as the cumulative loss in income relative to a pre-crisis trend.<sup>1</sup>

Figure 2 illustrates the method deployed to calculate losses of GDP by country, which at the end of the day is reflected in lower social standard and welfare of individuals. Given the size of GDP/output losses the countries incurred at the onset of the financial (banking) crisis, we can draw the following conclusions:

- the countries that have reacted quickly and sufficiently and have staved off a slump in bank credit activity and economic contraction have suffered lower output losses,
- the countries in which the financial system is large and significant for channelling savings have suffered higher output losses at the onset of the banking crisis.

In the light of the above data and the conclusions drawn, we should bear in mind that the approach to display output losses may not be optimal since it is derived from a statistically computed pre-crisis trend, which may not reflect the effective level of domestic output in crisis situations

<sup>1</sup> Under the described approach not only differences between trend real and actual GDP growth rates are added up, but the cumulative sum of difference between the GDP levels is determined.



when available capacities have drastically changed. Besides, it is not possible to determine the cause-and-effect link for output losses. There is no evidence for the claim that these losses have been incurred due to the banking crisis; we may claim, however, that these losses have incurred simultaneously with the break out of the banking crisis. This is even more true if the crisis has been caused by external factors, which have subsequently led to unfolding of the crisis also in the banking sector. When the presented results for output losses of the banking (financial) crises are interpreted, these reservations have to be borne in mind. Without prejudice to the above, it is fair to say that a delayed and inadequate response by authorities is known to have led to a situation in which, due to the financial crisis, indirect losses may be substantially higher than direct, fiscal costs.

### **3. Effectiveness of government intervention in connection with credit activity and economic growth**

The paradigm on the neutrality of finance vis-à-vis economic activity was accepted by mainstream economics long ago. The paradigm was built on unrealistic assumptions of the Modigliani-Miller theorem repeatedly proven to be incorrect; hence, economists embraced the thesis that financial markets do not function perfectly without deficiencies and glitches. In turn, it all arises from the information asymmetries and risks associated with financing that are reflected on costs of company bankruptcies, i.e. losses borne by financiers. Therefore the provision of financial resources, i.e. company financing matters for real economic activity.

A number of empirical studies have examined the link between financial

crises, the situation in banks and monetary and fiscal policy measures on the one hand and bank credit activity on the other (Bernanke and Lown, 1991; Kashyap and Stein, 1993; Schwierz, 2004; Laeven and Valencia, 2008). The findings leave no doubt since empirical data prove that the financial situation of lenders (banks) influence their decisions to grant loans. But these studies are not categorical regarding the effects of changes in the supply of credit on real economic activity (Laeven and Valencia, 2011, p. 4). It is conventional wisdom that, in general, a financial crisis causes a shock in the supply of credit and economic policy-makers strive to prevent it by taking various measures. At this point a question that comes to mind is: what are the effects of these measures on the supply of credit and what is their impact on economic activity? We may ask a more specific question: does the supply of credit have a positive impact on economic activity? Laeven and Valencia (2011) have tried to give an answer to this question and have developed a model deployed to evaluate effectiveness of various measures taken by authorities and designed to ensure the supply of credit by choosing company real value-added growth as an observed variable. The empirical model Laeven and Valencia used comprised various measures addressed to banks and the effects of those measures on changes in value added generated by companies. The dependence of companies on bank lending is a significant factor in the described model and this is the reason for having a separate variable for the dependence of businesses on external finance. They have used it to describe the importance of the supply of credit for the examined companies. They have proven with the results obtained that of all intervention measures only bank recapitali-

sation is statistically significant and disproportionately positively affects real economic activity of the companies dependent on external financing (Laeven and Valencia, 2011, p. 4). The effects of other intervention measures (state guarantees, liquidity support, purchase of assets) individually are not statistically significant but these measures taken collectively have a statistically significant impact on added value of the observed companies. Another interesting finding is that fiscal policy actions are more effective than monetary measures in alleviating the effects of the financial crisis on financially-dependent companies. It seems that monetary policy actions in a crisis situation are directed more to a short-term mitigation of the consequences of liquidity woes of financial institutions, whereas effects on economic activity are less pronounced.

Bank recapitalisation is key measure according to the findings of the paper cited above capable to positively affect economic activity of companies in a financial crisis situation by alleviating any constraints on the supply of credit. Since the onset of the financial crisis in 2008, a number of governments have reached out for that measure, and recapitalisation efforts have become a mantra of supervisory authorities with the EBA leading the way. In this context we have looked into the degree in which the recapitalised bank have contributed to growth in lending to the non-bank sector during the period from 2008 until the end of 2013, i.e., whether there is any difference in the supply of credit between the recapitalised banks in comparison with those that have not been recapitalised. In order to be able to give answers to these questions we have conducted a shorter empirical analysis on a sample of 82 systemically important credit institutions in the EU.

#### 4. A description of the empirical approach and findings

We have included in the sample systemically important banks assessed as banks critical for the stability of the financial system according to the ECB and placed under its direct supervision within the framework of the banking union. There are 130 credit institutions in the euro area that fit the description and the principal factors for a credit institution to be on the list is its size and its importance both for the economy of the home country and the whole of the EU. We have added to the sample the systemically important banks with the registered office in the EU Member States and which fulfil the ECB criteria for being classified as systemically important. We have used the data at the consolidated level and to avoid double counting excluded subsidiaries owned by a banking group already comprised in the study. Moreover, we have excluded special purposes banks such as »Landesbanken« and special development banks such as the Slovenian SID. The sample does not include those banks that in the course of the observation period experienced unusually high changes in loan volume (more than 100%), since it would probably be a consequence of a merger or an acquisition or substantial divestiture processes. Several banks posted negative equity in particular year and such banks have also been eliminated from the sample. The final sample comprised 82 banking groups.

The data regarding recapitalisations have been gathered from the banks' annual reports. We have counted as recapitalisation only new capital that arrived in a bank as issued shares and/or conversions of convertible bonds. Only recapitalisations in excess of 5% of equity qualified and it has enabled us to avoid recapitalisa-

tions being a consequence of paying out bonuses to employees in the form of shares. We have chosen to simplify the matter, since for certain banks such increase in capital is not clear from the reports. As state-sponsored recapitalisation we have taken into account capital injections specified as such by the European Commission and/or recapitalisations executed directly by the national governments. The criteria applied were the same as for other recapitalisations.

We have performed a comparative analysis by classifying banks in different groups according to the selected criteria (see Table 1) and then we tried to establish whether there was a statistically significant difference between the average rates of growth in gross loans to the non-banking sector during the period between 2008 and 2013 between the compared couples of selected groups. The computed variables (the average growth rate, the value of the variable  $t$  and its probability  $p$ ) on the basis of the described statistical analysis are shown in Table 1. The recapitalised banks posted during the period under review significantly slower average credit growth than the banks, which have not been recapitalised (the difference in average growth rates is statistically significant at 5% confidence level). The result shown does not prove effectiveness of the recapitalisation measure as illustrated in the paper from the previous section. Perhaps this result could be explained by saying that credit growth would fare far worse without recapitalisation, i.e. negative, but we have no empirical proof to make such a statement. If the banks, which have been recapitalised, are divided into those that needed public finance and those, which have been able to attract private capital, we may conclude that the first group had on average negative credit growth during the period under review and

the second group had positive credit growth; also the difference in average credit growth rates is statistically significant. We arrive at a similar result if we exclude from the previously described division all the banks, which were after recapitalisation or even before that in majority state ownership. In other words, we have divided the sub-group of privately-owned banks in two groups based on how the recapitalisation bill was paid: by public or private funds. The average credit growth in the banks in private ownership, which used private funding for recapitalisation, was positive and statistically significantly higher than in the banks, for which the rescue package came from public funds. The results may appear surprising at first sight; nevertheless, an explanation for these differences may be the finding that the banks, which receive state aid, must present their programmes for restructuring. These programmes comprise also the burden-sharing activities because of the received state aid, which often take the form of scaling down, i.e. winding up certain activities. We could also add another explanation for the noted difference in average credit growth also by a negative selection: the banks that needed recapitalisation but were not able to attract private investors, were probably in a worse shape than those that managed to obtain new capital by tapping private funding. We have also compared the banks, which have not been recapitalised and those, which have been recapitalised with private funds and concluded that both groups demonstrate positive average credit growth. The difference between these two groups is minor and statistically insignificant. In conclusion, it is worth reflecting on the comparison between banks in majority state ownership (irrespective of the difference being a consequence of recapitalisation or

of being state-owned even before recapitalisation) and private banks: the second group has a higher average credit growth rate than the state-owned banks in which the average growth rate in credit supply was negative during the period under review. We could also look for the explanations for this difference in different efficiency of corporate governance in two groups of banks, but the reasons lie also in the restructuring measures carried out by quite a few banks, which are in majority state ownership and the previously mentioned negative selection on the aforementioned group.

The described empirical analysis opens a possibility for additional, in-depth empirical researches in connection with recapitalisation of banks. An interesting question to ask is whether private funding is used more efficiently than public finance. A plausible thesis is that the banks that needed state aid were worse hit than their peers and the recapitalisation mostly served to cover past losses and not to increase the volume of bank operations, i.e. lending. Nevertheless, we may draw a conclusion

that in comparison with other banks, the banks in private ownership had on average higher growth regardless of the fact that they needed additional capital injections or not. Which are the key factors for the obtained result is also a subject-matter of further research.

### 5. Obstacles to credit growth

The data regarding bank lending is not encouraging: in the euro area loans extended to the non-bank sector keep falling with shrinking of credit exposure vis-à-vis the non-financial companies sector and stagnating household lending. Slovenia is no exception and bank credit activity has the minus sign and the level of credit contraction is even higher. Against the backdrop of adverse data, the question to ask is: which are the key factors that influence bank lending and what will be their expected impact over a shorter time horizon? We will start by examining the factors that operate across the euro area, and end with certain local factors that still determine bank activity in Slovenia.

### Sluggish economic recovery and different views on adequate economic policy

Despite a rather loose monetary policy, the economic recovery in the euro area has been frail and on top deflationary risks have emerged. The ECB has pulled out from the arsenal of unconventional measure the targeted longer-term refinancing of credit institutions designed to boost lending to small and medium-sized enterprises. The architects of the measure believe that anaemic lending is a key reason for frail recovery of the economy and deflationary pressures. Bank analysts do not see eye-to-eye whether the ECB measure will be a success. The offered longer-term financing is not targeted in one part and it is general, and only in its second part it provides a stimulus for those banks that will lend to the real sector. At this point one may wonder where are the obstacles for more vigorous credit activity – on the part of credit institutions as provider of credit (a shortage in long-term funding and capital, regulatory restrictions, modified business models) or

**Table 1: Growth in volume of lending to the non-banking sector (gross loans) in period 2008 – 2013 (in %)**

	Povprečna rast v %	s	t	P (t)	n
Recapitalised banks	4,80	32,9889	2,3811	<b>0,0259</b>	67
Non-recapitalised banks	24,58	28,1236			15
Banks recapitalised with public funds	-12,68	26,5524	-4,3486	<b>0,0001</b>	29
Banks recapitalised with private funds	18,14	31,3903			38
Non-recapitalised banks	24,58	28,1236	-0,72539	0,4740	15
Banks recapitalised with private funds	18,14	31,3903			38
Privately-owned banks not recapitalised	23,44	29,9818	0,71549	0,48219	13
Privately-owned banks recapitalised with private funds	16,51	30,1535			37
Privately-owned banks not recapitalised	16,51	30,1535	2,84051	<b>0,00674</b>	37
Privately-owned banks recapitalised with private funds	-5,10	25,8160			20
Privately-owned banks recapitalised with private funds	-10,29	40,7822	-1,77802	0,0988	12
Privately-owned banks recapitalised with public funds	11,63	30,5684			70

Source: authors' calculations

on the part of demand (absence of investments in fixed assets due to entrepreneurial pessimism and overgeared companies and overindebted households). The answers to the question asked do not speak with one voice to the point that even the architects of economic policies advocate different approaches. On one side there is the IMF and majority of important central banks that swear by the standard measures of loose monetary policy (read it as zero interest rate policy) and are tempted to reach out for unorthodox measures that will blow up central banks' balance sheets so that cash flows would finally reach those in a position to use money productively. On the other side there is the BIS with its Annual Report (Bank for International Settlements, 2014) promoting a completely different way of contemplating solutions and questioning the central bankers' stance up to now. Their view is that loose monetary policy with low interest rates and purchasing bonds encourages additional borrowing by already overindebted entities, price growth of financial instruments and real property and postpones urgent debt restructuring. Excessive debt (companies and households) has a hand-brake action on growth of productive investments by the private sector and, consequently, stands in the way of a sound economic recovery. Confusion over what appropriate conduct of economic policy should be is linked to different views and assessments of what will be a lesser of two evils for the economy of a certain country. There is no doubt whatsoever that indebted companies will have to reduce their leverage levels as credit institutions are doing already. However, the question to ask is what is less costly and more acceptable from the social perspective: to deleverage in a stimulating environment of low interest rates

that provides for the wheels of the economy to keep turning somehow, or against the backdrop of a less stimulating monetary policy that forces entities into unavoidable and hasty fixing of balance sheets (read "deleveraging"), meant to deliver sustainable economic growth. Even if we know the answer to the question asked, a new question follows almost instantly: Can a loose monetary policy actually set the wheels of the economy in motion? The U.S. central bank has shown in practice that it works, but we should bear in mind that their financial market is not so monolithic and it has a higher share of capital market institutions that it is the case in Europe, where bank financing prevails. Therefore, it is not by chance that the ECB has given the centre stage place to the measure of longer-term financing through banks designed to reach the segment of small and medium-sized enterprises by providing them with an access to so much needed financing and has put on the second place direct purchases of covered bonds. Regardless of the speculations about the measures hitting the target or not in effort to revive bank credit activity, we may conclude that, for the time being, monetary policy in the eurozone will not create headwinds. The question arises, nevertheless, whether the monetary softening measures due to swell the central bank's balance sheet are adequate and effective for dismantle the hurdles on the side of credit supply. The European Investment Bank (2014, p. 16) has arrived at a conclusion based on a survey of the banks operating in the CESEE region that among the key obstacles on the supply side of credit there is a high share of non-performing loans, changes in regulations, restrictions on capital and macroeconomic prospects. The aforementioned survey indicates that bank financing does not pose hurdles to credit activity, and it

makes us reflect on the plausibility of the targeted longer-term refinancing measure put in place by the ECB.

### **Regulatory changes in banking and a comprehensive review of asset quality**

Banks are subject to numerous regulatory changes. The dynamics and volume of changes are such that it all borders on entropy. The key requirements these changes impose on the business of credit institutions are: more capital, lower financial leverage, more effective and consistent risk management, etc. All these, as well as other measures, have been out in place with the aim to fix bank balance sheets – a process credit institutions embarked on some time ago and still remaining "work-in-progress" with no end in sight. High financial leverage booming during the "fat" years is one of the main vulnerabilities of banks. It is, therefore, not a surprise to watch the fast pace at which bank capital is being beefed up and outpacing by a great length the phasing in of tighter requirements laid down in effective regulations. Not only financial markets expect banks to walk the extra mile, but also for the industry regulators beefing up capital is the unconditional objective, in spite of its potential short-term negative consequences. In general, when a bank has more capital, its capacity to lend increases. The yardstick for financial soundness of a bank in absorbing a reasonable amount of loss is its capital ratio as a proportion between capital (e.g. Core Tier) and risk-weighted assets. The value of the ratio can be increased either by increasing the numerator (capital) or by lowering the denominator

<sup>2</sup> CESEE is the abbreviation for Central Europe and South and Eastern Europe.

(bank assets). It is the choice of how to boost capital ratios that creates a huge difference between the U.S. and the European banks: in the U.S. banks were increasing capital (nominator) at a higher rate than the rate at which assets were going up (denominator). What took place in the euro area was just the opposite – most banks were shrinking their assets, risk weightings followed suit and increasing capital directly proved to be the weakest factor. The described boosting of capital ratios has not positively affected credit activity in the euro area so far. Demand for credit remains subdued and under a strong influence of the stagnating economic activity with banks taking advantage of the situation to amplify capital adequacy by credit contraction. Sluggish credit activity dents the quality of the existing credit portfolio as the share of non-performing loans increases and negatively affects bank profitability. Banks may get caught up in a vicious circle in which they are not able to generate capital with profits since the requirements to form additional impairments will make profits crumble. It has been empirically validated that retained earnings are by far the most important source of bank capital (Berger et al., 2008; Cohen and Scatigna, 2014).

The BIS annual report addresses this issue and draws attention in particular to banks in peripheral countries of the euro area, which due to the vulnerability of their balance sheets cannot obtain new credit. The key reason for such a situation lies in the uncompleted process of fixing banks' balance sheets also encouraged by low interest rates. Thanks to low interest rates, banks are earning hefty interest margins and keep postponing restructuring of their balance sheets and recognising losses arising from the existing credit portfolio. A combination of these factors negatively

affect credit supply and put credit growth in the reverse across the euro area, as opposed to the U.S. and other emerging countries where the volume of bank loans granted to the non-financial sector is already above the pre-crisis levels.

The source of strong headwinds in bank credit activity can then be detected in stricter regulations (more capital for the same volume of operations, lower financial leverage), more restrictive risk taking, a need for fixing banks' balance sheets and changed business models. The result of such situation is a shrinking role banks have in financial intermediation when it comes to financing companies in the euro area. The empty space is filled up by the capital market which plays an important role in the provision of funding by enabling companies to borrow directly and non-bank financial intermediaries (shadow banking), which are not subject to the same prudential regulation as banks with balance sheets free of the suffocating legacy of unsustainable expansion seen in the past. Growth in the volume of operations enjoyed by non-bank financial institutions (without insurance undertakings and pension funds) has been steep over the past few years and accounts in global terms for approximately half of bank assets (Financial Stability Board, 2013). The disintermediation process in the banking industry has been intensive also thanks to »shadow banking«. At this point the comprehensive asset quality review (AQR) and the stress tests of bank should be accorded special attention for the scale and scope of the operation. Even by abstract and logical reasoning we see that the exercise will not result in reversing impairments and generating capital, but the other way round. It does not mean that it is an improper activity. On the contrary, it is welcome, but the question is how to

undertake a systematic cleaning up of balance sheets in cases in which it might be eventually discovered that there are more contingent losses arising from credit risks than it was disclosed. Many banks have fretted for some time already haunted by potentially bad scenarios and are racing to beef up capital, others focus effort on reducing risk-weighted assets with the aim to improve capital ratios. Regardless of the tactics deployed so far for achieving capital ratios, what really matters at the end of the day is a bank's potential for generating own capital (profitability). The trends seen so far in the eurozone suggest that profitability is flagging as a consequence of falling credit portfolio quality and contraction in the volume of operations. The interest rates at historically low levels can compensate only partly the negative impact on profitability as it will be revealed eventually also by stress tests. Over a short term, also this activity will not have a beneficial effect on credit activity.

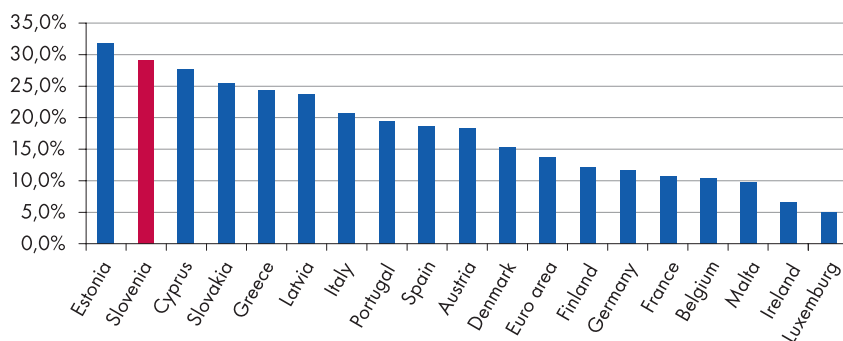
### **Local factors – overleveraged companies**

The Slovenian banks will enjoy their share of benefits brought along by low interest rates (the BIS claims that such a policy moves away in time urgent restructuring of banks' balance sheets) and the targeted longer-term refinancing by the ECB, while the effects of direct purchases of covered bonds will be felt only indirectly in Slovenia, since local banks have not issued these instruments. The systemically important banks have got capital injections (increasing the denominator of the capital ratio) and these measures should have produced beneficial effects on credit activity. These are good news and now we have to give you bad news as well: our banks are still struggling to shake off the



burden of loans that have turned sour in their balance sheets, we are in the group of countries with the highest outstanding corporate debt and therefore a high probability of default, our capital market is undeveloped and shallow and, consequently, the non-bank segment of the financial sector that could take over the financial intermediation function is also underdeveloped and last but not least, banks are already overexposed to the domestic entrepreneurial sector with their existing portfolios (see Figure 3). What it means is that these banks will have to scale down exposure to domestic companies and not the other way round in order to reduce risks inherent in excessively high dependence on local companies. These are the arguments that leave little room for optimism when it comes to a giving impetus to credit growth. Similar »headwinds« are blowing also in other parts of the euro area, but they are still stronger in Slovenia for the set-out reasons. There is something else that can be noted in Slovenia: we have developed a monocultural financial model in which banks prevail. It is eleventh hour to have the capital market play a more important role in financial intermediation in the Slovenian financial sector, but without taking adequate structural measures, we should not expect it anytime soon. Regrettably, there are hardly any company going public in Slovenia and offering shares of stocks to the public on the primary markets (IPOs) and there is just a handful of listed corporations with international ratings and among them there are practically no non-banking financial institutions in a position to provide financing to small and medium-sized companies. The strategy for the development of Slovenia's financial market should not be monocultural and left to contingent development, if we are to keep crises like the

**Figure 3: Share of loans to non-financial corporations in total assets (as at end-September 2014, in %)**



Source: ECB Statistical Data Warehouse, authors' calculations

2008-crisis away in the future. Corporate clients (non-financial corporations) geared to too high levels are one of the fundamental causes for the impasse in lending activities of bank in Slovenia. The Slovenian companies are among the most indebted borrowers in the euro area when measured by the ratio between debt and equity financing (leverage ratio). Under the circumstances, when the non-financial corporations sector is dominated by overleveraged, poorly capitalised entities, we could claim based on the anecdotal evidence that a portion of banks' claims on these customers have de facto the nature of equity. If banks assess that certain claims they have vis-à-vis their corporate customers will not be repaid in full, it means that credit risk has materialised to such a level that the losses arising from it spread over to creditors of such companies. It is up to the owners of the companies (domestic or foreign, if there are no domestic shareholders) to provide capital in the first place. Many Slovenian companies face the situation of severe capital shortage and practically penniless shareholders. Efforts to attract potential foreign owners, i.e. investors fail as there is no interest in an overleveraged company or a company with a muddled financial position. Under these circumstances, debtors first turn

to their creditors (banks) to provide sufficient capital in the first phase as a lifeline for the drowning company to survive, provided it has a viable business model, then attention turns to a search for an owner with a long-term mind-set. Banks are reluctant to reduce debt by converting the debt into equity. And they have a legitimate reason for their stance since governing companies under restructuring calls for knowledge and experience banks usually lack. From this angle it becomes highly important for the banks with shareholdings in companies to provide for the proper corporate governance. To this purpose the regulator should demand that banks have to transfer their holdings of shares, i.e. stakes to special purpose vehicles and leave day to day management of troubled companies under restructuring to third-party providers with high reputation. Such outsourcing would achieve several goals: professional governance that demands constant control of management and their carrying out of rehabilitation programmes, possibility to pro-actively seek investors for those companies and, last but not least, also efficient and transparent disposal of companies as the ultimate objective. How successful banks will be in the future depends to a high extent on the outcome of restructuring programmes

for financially distressed companies. By making headway in this direction will eventually take care of the key reason for the present impasse in credit activity.

## 6. Concluding remarks

Providing financial stability by resorting to state intervention measures has proven to be a crucial measure during the recent crisis by enabling faster exit from the crisis and returning to economic growth. Some countries have been better at it than others. The speed at which intervention measures were launched and the size of the financial system mattered the most. Direct recapitalisation has been a wide-spread form of the support schemes undertaken both by private investors and governments that delivers the fastest and the most effective results in providing financial stability. Two problems arise, however, when it comes to funding capital shortfall: vested interests of private investors and with it as limited as possible state intervention, as well as also commitment to deliver on one of the key objectives of recapitalisation: arriving at a higher volume of lending and with more finance give impetus to the economy to grow. As demonstrated by the empirical findings presented in the paper, the recapitalised banks have shown slower growth in credit supply than the banks, which have not been recapitalised. We are led to believe that the recapitalised banks were hit by the crisis in rather badly and deployed additional capital primarily to cover losses from operations. In a non-crisis period, we would expect to get different results knowing that additional capital is largely allocated to expand the bank's business. Moreover, credit growth was significantly

lower at the banks, which needed a capital injection from the state for recapitalisation and it has led us to draw the following conclusion: state aid was given to the banks, which were in a rather bad shape and would not be able to look for investors themselves plus their room for manoeuvre was limited by restructuring programmes that call also for divestiture. Generally, state intervention measures should remove obstacles to bank lending to corporate customers. In the wider environment, however, there may be also other factors at work, which affect bank business. Loose monetary and stimulating fiscal policy certainly have an important influence as long as the actions taken go in the right direction. Regardless of the undisputed long-term positive effects of intensive prudential regulation of the banking sector, its current impact on bank credit activity is not beneficial. In Slovenia we are faced also with specific factors, which are not seen as beneficial for bank credit growth over the short term. Banks will have to participate actively in restructuring of their corporate debtors to reduce the share of non-performing loans. By playing their part, the key obstacle standing in the way of credit supply will be dismantled.

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# Concept of business restructuring and sustainable funding of Slovenian companies

*Bojan Ivanc\**

## CONCEPT OF BUSINESS RESTRUCTURING AND SUSTAINABLE FUNDING OF SLOVENIAN COMPANIES

The comments are structured in two pillars. The first outlines the definition of business restructuring, the rationale behind it, self-assessment tests and the agency problem. This part of the analysis is not country-specific but gathers the data from the most important international sources.

Sustainable funding of the Slovenian corporate sector is the second pillar. It analyses reduced profitability of the Slovenian corporate sector also due to deleveraging. Companies invested less than depreciation and, therefore, their capacity to retain profitability likely deteriorated. It is, therefore, vital that business restructuring pursues not just shedding of non-core assets (portfolio restructuring) but also the organisational one which involves doing things differently (organisational restructuring) and increasing the profitability and, therefore, reducing the leverage to a more sustainable level.

JEL G34 G38

Corporate or business restructuring is defined in business literature as a way for a company to get smaller by selling, splitting off, or otherwise shedding assets (divestiture). It can be defined as a »major change in the composition of a firm's assets combined with major change in its corporate strategy« (Hoskinsson and Turk, 1990). Corporate restructuring is a process that can take many forms but should be differentiated from only financial restructuring which is a narrower concept. Three distinct types of corporate restructuring can be defined (Bowman and Singh, 1993): portfolio, financial and organisational restructuring.

### Three types of corporate restructuring

Portfolio restructuring involves a reconfiguration of the firm's main lines of business through acquisitions and divestitures. It usually follows a change in managerial insight as to what the score of the firm should be. Managers may believe that more diversification is appropriate to utilise capabilities company has in place, or, inversely, that downsizing through programs of strategic divestiture is necessary (Hoskinsson and Hitt, 1994). Financial restructuring is different from portfolio restructuring, in that it is not principally concerned with changing strategic scope of the organisation, but with altering its capital and ownership structure. Financial restructuring is appropriate when debt-to-equity ratio is high and debt service management is insufficient.

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Organisational restructuring is undertaken when managers want to stress the importance of increasing the organisation’s efficiency or effectiveness. It is often a by-product of portfolio or financial restructuring, as significant changes in the strategic scope and capital structure of the firm need to be accompanied by corresponding changes in authority and decision-making hierarchy (Prechtel, 1994). At lower levels of integration, many corporate restructuring attempts consist of several transactions. It can include a range of organisational developments - leveraged buy-outs, management buy-outs and simultaneous changes in the ownership, financial structure and incentive systems of firms. Corporate restructuring can lead to efficiency gains for the restructuring firm and hence to better corporate governance. On the other hand, that disrupts social and political counter forces, due to their effects on personal lives and on economic prosperity of communities (Pursey P.M.A.R Heugens and Schenk H., 2004).

**Reasons for restructuring**

Most often reasons for restructuring are (Clayman et al., 2008):

- **Change in strategic focus.** Companies often become engaged in multiple markets through acquisitions or other investments. Management may decide to improve performance by eliminating divisions or subsidiaries that are outside core strategic focus.
- **Poor fit.** This includes when a company does not have expertise to fully exploit opportunities pursued by specific division and may decide to sell the segment to another company that has necessary resources. A division may simply not be profitable enough to justify continued investment based on the company’s cost of capital.

**Table 1: Priority Lines of Action for Business Clusters (see: excel file)**

Financial strength	High	<b>STABLE</b> Strengthen and improve	<b>STRONG</b> Take the offensive-drive reshaping the industry. Continue strengthening already advantaged positions
	Low	<b>FAILING</b> Stabilize and survive-key focus on cash preservation-consider exit	<b>STRUGGLING</b> Stabilize and survive-consider selling competitive lines of business in return for financial stability or merging with an industry winner
		Low	High
	Competitive advantage		

Source: Booz&Co.

- **Reverse synergy.** It is possible that division and parent company are worth more separately than combines. A segment of a company may be undervalued by the market just because of poor performance of overall company.

than just postpone bad loans recognition and companies may reduce their profitability due to high cash flow from operations that has to be allocated to creditors what implies less cash flow for capex and working capital needs.

**Divesting assets & self-assessment test**

Three basic ways that a company divests assets are a sale to another company, a spin-off to shareholders, or liquidation (Clayman et al., 2008).

A sale to another company involves offering to sell the assets of a division or an equity carve out. Last involves creation of a new legal entity and sales of equity in it to outsiders.

In a spin-off, shareholders of parent company receive a proportional number of shares in a new, separate entity. This does not result in inflow of cash to parent company. A spin-off simply results in shareholders owning stock in two different companies.

Liquidation involves breaking up a company, division or subsidiary and selling off its assets piece by piece. It is typically associated with bankruptcy.

Companies can use self-assessment tests (Institute of Management & Administration, 2010), that help companies review, and perhaps reformulate their strategies. Key point

*Financial restructuring is appropriate when debt-to-equity ratio is high.*

- **Financial or cash flow needs.** During recession or sectorial headwinds, managers may decide to sell off divisions of company to raise cash or cut expenses. This reason is currently the most pressing in Slovenia as restructuring is being suggested by company’s creditors which may impose a chief restructuring officer or a consulting/turnaround company.

Business restructuring is especially performed as financial restructuring due to high indebtedness. Creditors

is that the starting point for management discussion is strength of a business, not the macro environment. Companies place their companies within grid by:

- **Assessing financial strength** by agreeing or disagreeing with statement: My company is financially strong today and is not in immediate need of external financial support.
- **Assessing competitive status.** Managers gauge whether their companies are better or worse than their rivals in five competitive dimensions: costs, products and positioning, technology and capabilities, leadership and management and ability to influence and collaborate with regulatory authorities.

These two assessments place companies in one of four quadrants in this grid. For each quadrant, different strategies should company follow:

**Financially weak with competitive disadvantages.** These are failing companies. Managers should focus on securing funding and ensuring their cash flow, trying to survive. These companies should exit underperforming businesses, cut costs where possible, manage their working capital to improve cash flow, and reduce their exposure to operational and non-operational risks. They should engage with suppliers, customers, investors, and employees to accept temporary wage reduction and shortened workweeks. Often, managers of failing companies should hunt for buyers.

**Financially weak but with competitive advantages.** These are struggling and should focus on stabilizing operations and strengthening their balance sheets. This way they can create their own investment capital and ensuring strategic flexibility. These companies should stick with their core assets and monetize all noncore business. If selling noncore businesses

is difficult at this time, they should run these businesses for cash only.

**Financially strong but with competitive disadvantages.** In such stable businesses, managers should strengthen and improve operations. Even though the core businesses aren't threatened, managers should nevertheless reassess their product portfolio and engage in process enhancements and strategic cost-cutting initiatives. This is time that companies remove complexity in their service offerings. Such companies should focus in their most valuable customers and address how to serve them better. Shedding marginal customers is just as important as shedding marginal business. In difficult economy, stable companies that serve their most valuable customers better may gain a market share.

**Financially strong with competitive advantages.** These strong companies are in a position to leverage their balance sheets and cash flow. They should spend time reviewing where their industry is headed, determining the capabilities they want to develop, which products they want to introduce.

In a time of high uncertainty and rapidly changing external factors, improved responsiveness becomes a competitive advantage.

### Agency problem in corporate restructuring

According to Jensen's (1996) agency problem plays an important role in corporate restructuring. Top management in firms with free cash flow invests in overdiversification and organisational inefficiencies. As agency costs increases, a threat of hostile takeover arises forcing management to restructure the corporation. Three types of corporate restructuring transactions occur: financial restructuring including recapitalisation, stock repurchases, and changes in capital

structure; (2) portfolio restructuring involving divestments and acquisitions and refocusing on core business, resulting in change of diversity of businesses in the corporate portfolio, (3) operational restructuring including retrenchment, reorganisation, and changes in business level strategies. These types of restructuring are not mutually exclusive. Financial restructuring involves distributing free cash flow to shareholders, limiting the management's ability for new investments outside their core business. But, management's promise to distribute free cash flow to shareholders is not credible if existing corporate governance mechanisms are ineffective in monitoring and controlling management's actions. Leveraging the firm beyond its ability to service debt from current operating cash flow acts to constrain self-serving behaviour and creates the crisis necessary to overcome organizational inertia or resistance to change. To reduce high debt, management is forced to cut expansion programs and sell those assets which are more valuable to others.

Managers have personal incentives (e.g. minimize risk, increase income and power) to diversify the corporate business portfolio and to grow the firm beyond the point that optimises shareholder value (Jensen and Meckling, 1976; Amihud and Lev, 1981; Murphy, 1985). Retention of excess cash flow allows managers to avoid monitoring by the financial market (banks) and to invest in expansion, diversification, and organisational slack which yield below market return.

### Reduced profitability of slovenian corporate sector

Companies can finance their capex and working capital either through internal or external sources. Internal resources involve financing through

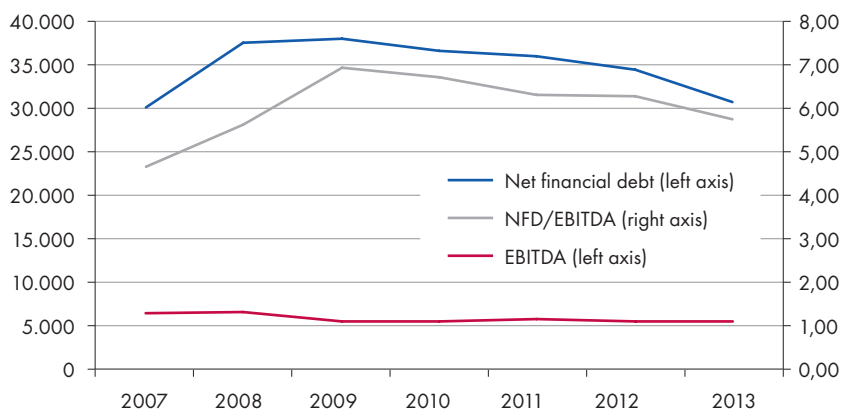


EBITDA, which nominally fell for corporates from 2007 to 2013 for 17.6 % to EUR 5.35 billion. EBITDA margin fell from 8.9% to 7.2% reducing the capacity to fund capex and working capital. Net working capital-to-sales fell from 6.6% to 4.5% reflecting deleveraging in the corporate sector. Therefore, internal funding sources shrank in the period 2007-2013 (Chamber of Commerce&Industry, 2014). External funding sources, which consist of bank loans, loans from parent companies and other financial liabilities rose from EUR 32.5 billion in 2007 to EUR 34 billion (up by 10%). Bank loans fell from EUR 24.5 billion in 2007 to EUR 21.9 billion (by 10 %). Loans from parent companies (intra-group loans) rose by EUR 1 billion in the same period (from EUR 3.7 to EUR 4.7 billion). Other financial liabilities rose from EUR 4.6 billion to EUR 6.8 billion (up by 32%). Corporates therefore reduced their exposure to bank loans but increased exposure to parent financing and other financing. Aggregate interest expense fell from EUR 697 million to 616 million (down by 11.5%). Weighted interest rates (calculated as interest expense-to-total financial liabilities) on external funding sources fell in the period 2007-2013 from 2.1% to 2.05%. EBIT-to-interest expense ratio rose from 0.96 in 2010 to 1.59 in 2013, the level not seen before 2007 (2.18). Liquidity ratios improved as quick ratio increased from 0.77 in 2008 to 0.82 in 2013, the level not seen before 2007 (0.86).

### Dark side of improved debt ratios

As profitability deteriorated in the period 2007-2013 and financial

**Graph 1: Net financial debt and EBITDA 2007-2013 development (EUR mn)**



Source: KAPOS, SKEP Chamber of Commerce&Industry

debt rose, net debt-to EBITDA in corporate sector rose from 4.63 in 2007 to 5.74. Deleveraging accelerated in 2010-2013 period and net debt-to EBITDA fell from local high of 6.72 in 2010. Compared to 2010, when debt-to-EBITDA ratio started to fall, fixed assets fell by 2.9%. Value of land fell by 5% to EUR 4.4 billion (not subject to depreciation but of impairment), value of buildings fell by 2.7% to EUR 18.2 billion. The most concerning part is a 7.4% reduction in value of machinery (to EUR 5.7 billion) what may imply reduction in future profitability capacity, reflecting in lower future EBITDA margin. Other fixed assets and equipment fell by 10% to EUR 3.1 billion. One has to note also survivorship bias in data as most of the companies which went bankrupt in the period 2007-2013, reported lower EBITDA margin on average. Taking this into account this profitability figure deteriorated markedly. It is therefore vital that corporate sector improves its profitability and reverses the subpar investments in machinery and other equipment.

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# CEE banking: Switching to sustainable track

*Carmelina Carluzzo and Milen Kassabov\**

## CEE BANKING: SWITCHING TO SUSTAINABLE TRACK

The banking sector in the CEE region was quite underdeveloped at the beginning of the current millennium. Following a rapid lending growth phase through 2009, driven by pent-up demand, a period of more moderate growth has settled-in. Looking forward in 2015 expectations are that lending growth should remain healthier on average.

In the meantime, there has been an important transformation in the way balance sheet growth was funded in the past few years, following the financial crisis from 2009. A significant shift took place, as external liabilities were partially substituted by domestic sources. Capital and reserves have expanded their share of total liabilities too. Profitability levels, as measured by return on assets, have deteriorated significantly following the fast growth phase, driven by slower revenue growth but also a rapid increase in provisions for non-performing loans. Going forward, in 2015, expectations are that profitability will improve on average for the CEE countries included in this study.

JEL G01 G21

The CEE banking sector has been characterized by remarkable lending growth into the new millennium. As the new market economies began opening to a new world of opportunities, households and businesses saw a rapidly growing need for financing fresh consumption and investment ideas.

### Lending growth shifts to a more moderate pace, following a phase of rapid catch-up

Between the end of 2004 and 2008, with the European Union enlargement to Eastern Europe countries and just before the onset of the financial crisis in 2009, lending in CEE<sup>1</sup> was growing on average at around 30% per year<sup>2</sup>. During the same time, retail lending was outpacing corporate<sup>3</sup> lending growth (35% vs 27% respectively), due to relatively lower banking penetration in the former. Still, at the onset of the financial crisis, at the end of 2008, the CEE region remained with quite an under-penetrated banking market judging by the loans to nominal GDP ratio, which on average was at 41%.

With all the economies except Poland dipping into recession in 2009, annual lending growth suddenly crumbled to around 1.9% (Table 1). Lending growth acceleration was reignited in the following year, but growth dynamics were reset at a slower pace during 2010-2013, with an average annual rate of 12.4%.

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<sup>1</sup> CEE in this analysis includes Bosnia-Herzegovina, Bulgaria, the Czech Republic, Croatia, Hungary, Poland, Romania, Russia, Serbia, Slovakia, Slovenia, Turkey and Ukraine.

<sup>2</sup> All averages unless otherwise stated in this report are CAGR (Compound Average Growth Rate); all figures in this report are in local currency terms and aggregates are computed at constant 2008 year-end local currency exchange rates versus the euro currency.

<sup>3</sup> Corporate includes non-financial corporations, government and non-bank financial institutions.

Importantly though, the double digit growth rate in this more recent period has been driven to a large extent by Turkey and Russia, which posted average growth rates of 27.8% and 19.4%, respectively.

In the meantime, several countries in the CEE region underwent a significant adjustment, with declining loan books. Excluding the heavyweights Russia and Turkey, the countries considered in this study registered decelerating lending growth to 3.6% on average in the period 2010-2013, significantly down from the 24.1% annual growth pace in 2005-2008. Importantly, following the period of fast lending expansion through 2008, in the following years deposits grew faster than loans or at least almost in line with loans in all countries besides Turkey, indicating a switch to a more sustainable and balanced local funding driven banking model. Looking at the figures between the end of 2004 and 2008, the loans-to-deposits ratio (loans divided by deposits) of the CEE countries in this analysis increased from 82% to 113%, before a major reversal took part with the ratio falling to 106%

**Table 1: Lending growth measured in local currency, %**

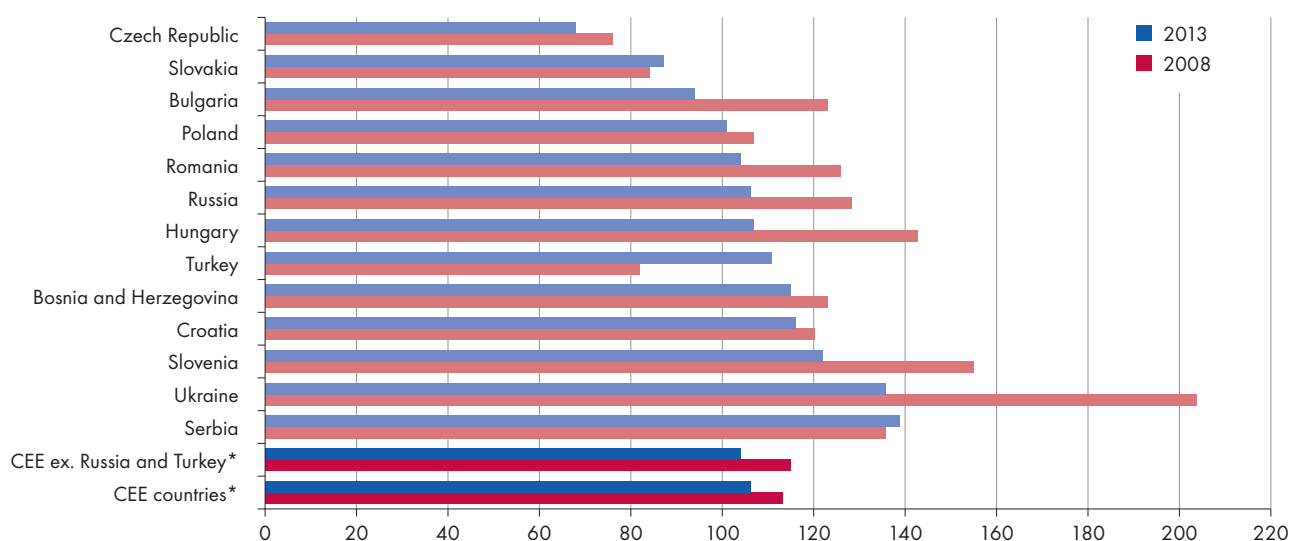
Lending growth, %	2005-2008	2009	2010-2013
Bosnia and Herzegovina	25,1%	-3,2%	4,0%
Bulgaria	37,5%	3,9%	2,1%
Croatia	17,7%	2,2%	3,4%
Czech Republic	17,8%	1,5%	3,5%
Hungary	17,5%	-3,5%	-3,6%
Poland	25,1%	8,7%	6,7%
Romania	48,4%	3,5%	2,1%
Russia	43,1%	-2,2%	19,4%
Serbia	40,7%	25,1%	11,5%
Slovakia	22,2%	1,4%	4,6%
Slovenia	26,4%	2,8%	-5,2%
Turkey	36,5%	6,0%	27,8%
Ukraine	69,6%	-1,5%	5,9%
CEE countries*	29,9%	1,9%	12,4%
CEE countries ex. Russia and Turkey*	24,1%	3,1%	3,6%

\* CEE aggregates are computed via constant 2008 year-end local currency rates against the euro. Growth rates are calculated as CAGR (Compound Average Growth Rate).

in 2013. Considering the group of countries excluding Russia and Turkey, the adjustment was even more pronounced, as the loans-to-deposits ratio declined from 117% in 2008 to 104% in 2013 (Chart 1). Although there are historical structural reasons behind the high loans-to-deposits ratios in the region - mainly the domestic savings gap and the

lack of an inherited stock of financial wealth - a healthier funding structure has been pursued thereafter. The financial crisis made evident the vulnerabilities of the CEE banking model developed during the years of booming lending growth. Leveraging on abundant international liquidity, banks financed domestic lending via international capital inflows. That

**Chart 1: Loans-to-deposits ratios, %**



\* CEE aggregates are computed via constant 2008 year-end local currency rates against the euro.

model was unsustainable and the financial crisis provided an incentive for banks to make the switch, replacing external financing sources with domestic ones, driven by core deposits.

Balance sheet restructuring has been a major theme for the CEE banking sector in the most recent years. From the end of 2008 through 2013, total assets grew at an average rate of 10.8%, while excluding the two big markets – Russia and Turkey – growth was 4.1%. Within the components of the balance sheet, on the assets side the fastest growing have been the securities. Within liabilities, debt issued and customer deposits grew the fastest, while capital buffers have also gained a significant amount. On the other hand, external liabilities showed the slowest growth and even declined on average when excluding Turkey and Russia, leading to their lower significance as a source of funding. For illustration (Chart 2), the share of deposits grew

from 51.0% to over 57.0% between the end of 2008 and 2013, while capital's share increased from 10.6% to 13.9%. When adding Turkey and Russia the adjustment was less pronounced, due to different dynamics in Turkey, where the declining share of deposits was mostly replaced by external liabilities, but the overall trend was still in the same direction. Capital buffers have also increased in response to higher risks, increasing non-performing loans and as a result of new regulatory requirements.

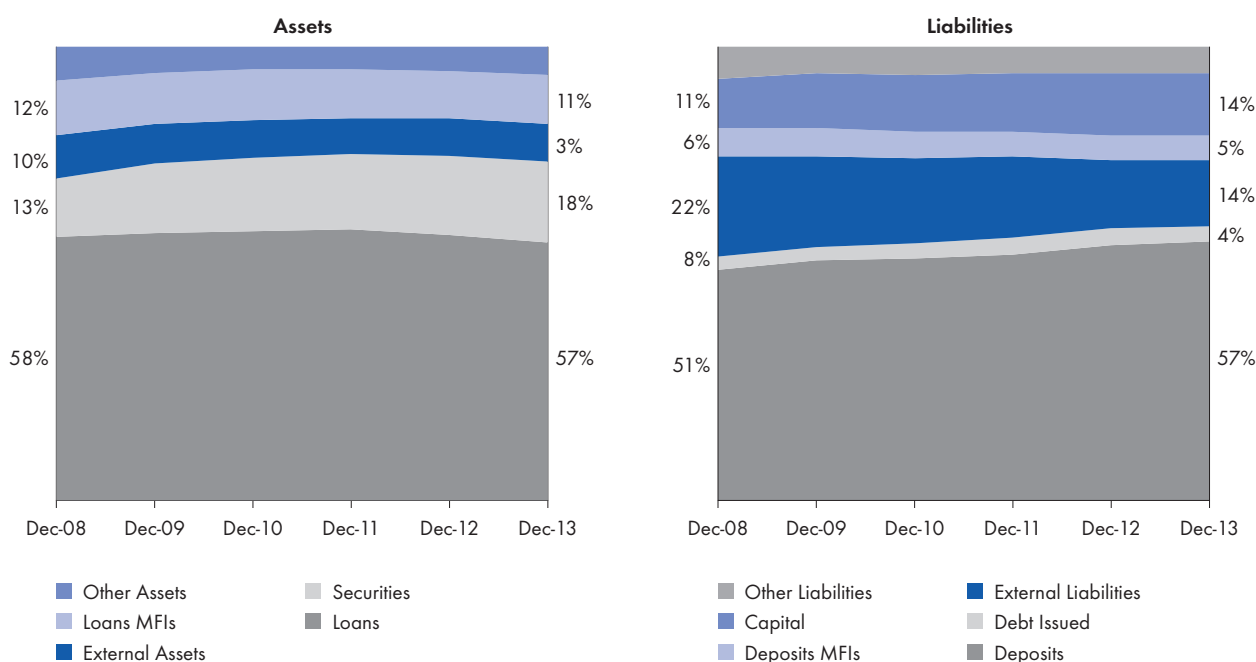
*Financial crisis made evident vulnerabilities of CEE banking model.*

**2015 to be marked by healthier lending growth and further funding structure adjustment**

Despite the dynamic developments so far, as of December 2013, lending penetration in the CEE region remains relatively low compared to major Western European countries, highlighting a potential for further banking sector growth. The loans-to-GDP ratios (Chart 3) illustrate that a gap remains, although the different economic structures should also be taken into consideration before drawing conclusions.

Similar to 2014, measured in local currencies, lending growth in the CEE countries taken together is expected to be in the high single digits in 2015, and should be driven by the big countries, Turkey and Russia, and to a lesser extent, Poland. Still, growth in Russia is expected to slow down while in Ukraine lending may contract (due also to the ongoing cri-

**Chart 2: Balance sheet structure evolution of CEE countries excluding Russia and Turkey**



\*Calculations based on local currency volumes, with currencies kept at constant 2008 year-end exchange rates versus the euro. Data for Croatia is as of December 2012, and for Ukraine as of September 2013.

sis). In Hungary, further contraction is likely in 2015 too, impacted by the FX conversion scheme. The rest of the countries should see lending growth at a moderate low-single-digit percentage pace, with at least half of the countries showing improving performance. By segments, in retail lending Turkey and Russia (despite a slow-down in the latter) are likely to retain the fastest growth pace, while in the corporate segment also Poland is set to closely follow them.

In 2015, in most countries the loans-to-deposits ratio is likely to remain virtually flat or even slightly contract in Poland, Croatia, Bulgaria, Hungary, Romania, Bosnia-Herzegovina, and Ukraine. The ratio is expected to expand only in Turkey and to a lesser extent in the Czech Republic and Slovakia.

By segments, in retail deposits the fastest expansion is expected in Turkey and Russia, while Poland and Bosnia-Herzegovina are also posed to expand briskly. In the corporate segment, Turkey, Russia and Poland are likely to be the leaders in terms of deposit growth.

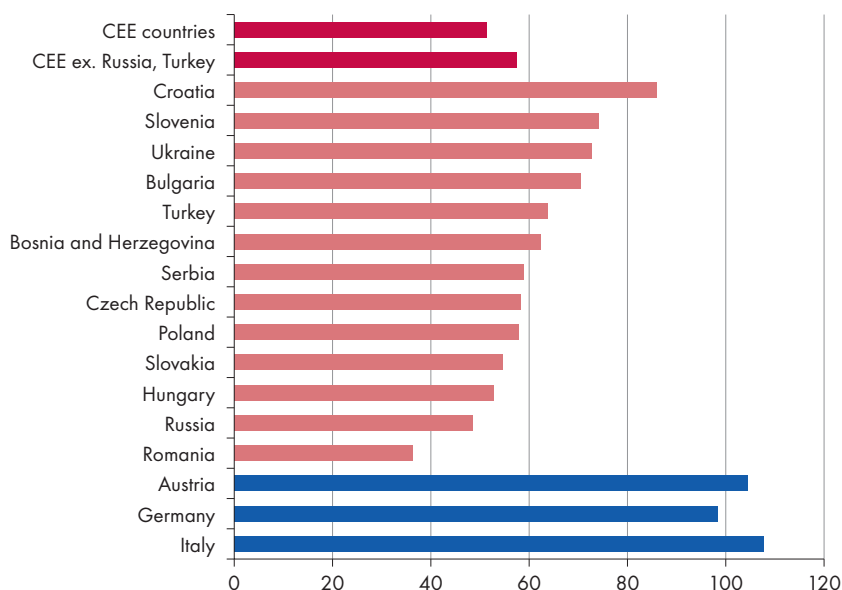
The trend towards further rebalancing of the balance sheet structure should remain in place. In most countries the shift from external liabilities to deposits is likely to continue. In Russia, in particular, also as a result of the imposed sanctions, there is likely to be a further shift in the funding structure away from external liabilities, which would be largely compensated by central bank funding.

**Profitability is expected to improve following a bumpy phase**

ROA<sup>4</sup> was on average at comparatively high levels before the crisis -

<sup>4</sup> ROA is return on assets, computed based on profit before tax.

**Chart 3: Loans to Nominal GDP\*, 2013 %**

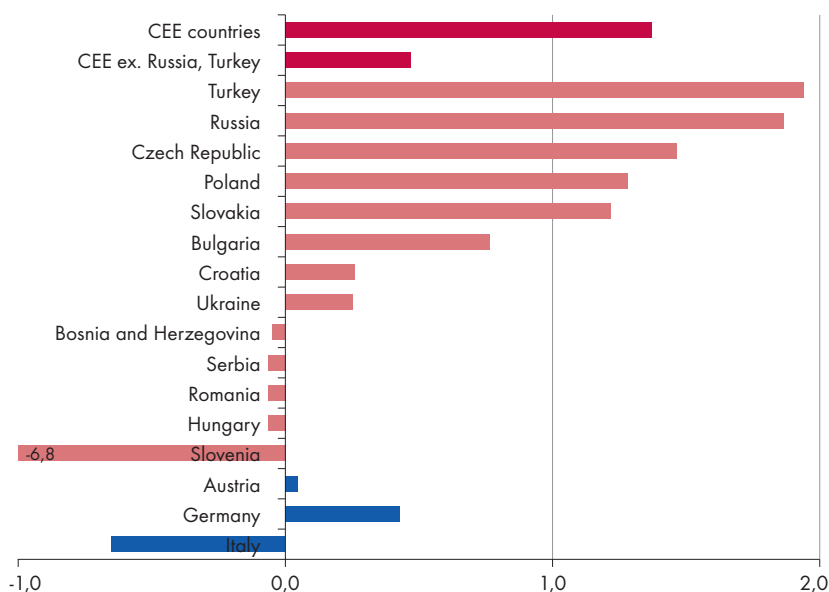


\* Data on all Western European countries excluding loans of Monetary Financial Institutions.

2.1% at the end of 2007. In 2008, as provisions for non-performing loans increased rapidly, ROA deteriorated to 1.9%. In 2009, ROA was further negatively impacted and dropped to 1.0%, as revenue growth registered a sharp reversal from the double-digit annual growth rates in the previous years. In addition, there was a continued solid

increase in provisions due to rising NPLs. Country specifics continued to drive the averages. As in Turkey, where revenue growth remained very strong, ROA actually was quite solid also in 2009 at 3.2%, returning to the level seen in 2006, and in the Czech Republic, where the ratio also remained little changed at 1.7%. In all other countries the dynamics were

**Chart 4: Return on Assets (ROA)\*, 2013 %**



\* Germany data is for year 2012 instead of 2013.



unfavourable. Nevertheless, with the adjustment unfolding, profitability measured by ROA moderately improved on average, increasing to 1.4% in 2013. It should be noted however, that the average was driven by improvements in selected countries. The major driver in this phase was actually Russia, where ROA increased from 0.7% in 2009 to 1.9% in 2013. Poland and Slovakia also contributed significantly, while in Slovenia, following the major asset quality review and the significant provisions and loss registered, ROA deteriorated sharply in 2013, to -6.8%. Interestingly, in Turkey profitability started to erode, as growth in profit before tax slowed down, while assets continued to expand more briskly. In all other countries profitability deteriorated, driven by stagnating or declining revenues and, in many cases, increasing provisioning cost.

Rapidly deteriorating loan books in many countries led to higher levels of provisions. Looking at the individual countries, between 2008 and 2013 provisions expanded most in Slovenia, with a CAGR of 73%, Croatia, with 40%, and Bulgaria, with 27%. On the other hand there has been

a decline in CAGR of provisions in Slovakia.

It is important to mention that profitability in CEE continued to compare favourably with major Western European countries, including Austria, Germany, and Italy, highlighting also in this respect the convergence potential for the CEE banking sector. Looking forward, we expect profit-

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*Capital buffers  
have also  
increased in  
response to  
higher risks.*

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ability in the CEE countries, as measured by ROA, to improve to 1.3% in 2015 after another sizable deterioration to 1.0% expected in 2014 - trends again largely driven by shifts in provisioning cost dynamics, this time particularly in Russia and Ukraine. On a country by country

basis, the highest ROA in 2015 is expected to be retained in Turkey and Russia, followed by the Czech Republic, Slovakia and Poland.

### Conclusion

*The CEE countries are likely to shift to a period of moderate lending growth, following a rapid catch-up phase and a period of adjustment. Future balance sheet expansion is expected to continue to be funded predominantly by local sources, as an important shift away from external liabilities has been taking place in most countries. Profitability levels are unlikely to return to pre-crisis levels in the short term, but nevertheless they should improve from the current status, which mainly reflects provisioning cost.*

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# Potential for restructuring and new business models for banks

*Gvido Jemenšek\**

## POTENTIAL FOR RESTRUCTURING AND NEW BUSINESS MODELS FOR BANKS

In this article we will show why banks in Slovenia have to restructure their operations and look for new business models. We will focus on a group of foreign-owned banks in Slovenia which have certain common characteristics but some measures can be applied also to other banks. The main goal is to show how to carry out potential restructuring of a bank with a focus on RWA (risk weighted assets) optimisation, liquidity optimisation and cost reduction. We will also show how to find a business model which can generate a decent income and profitability for a bank.

JEL G21

At the beginning of the crisis, the Slovenian banking sector was in a relatively good shape in comparison with the larger part of the EU banking sector. With the onset of the global crisis, there was little direct influence on Slovenia's economy. Exports were hit, but local demand was still relatively high. There was almost no immediate effect on the real estate market and on the unemployment rate. Back then it seemed that the global crisis was not going to affect Slovenia too much. The only real problem in 2007 and 2008 was liquidity. Banks already started to feel that money market was not working as it used to. On the interbank market there was almost no money available for Slovenian banks anymore.

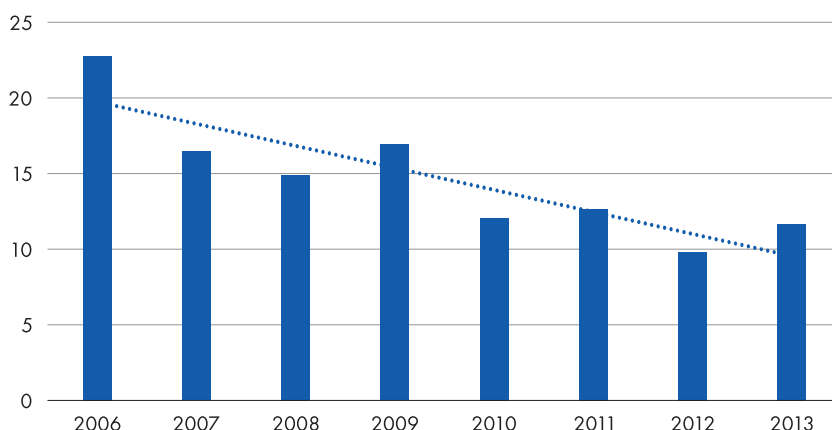
## Introduction

In 2010 and 2011, banks faced first significant increase of non-performing loans (NPL), especially domestic banks. The group of non-domestic banks had much lower NPL ratio than the average on the market but this group was also heavily affected by the crises. The rise of NPLs started in financial institution and large corporate segment, later it was transferred also to the SME (small and medium-sized enterprises) segment. At the same time the unemployment rate started to rise: therefore, it became clear that an increase in NPLs was to be expected also in the retail segment.

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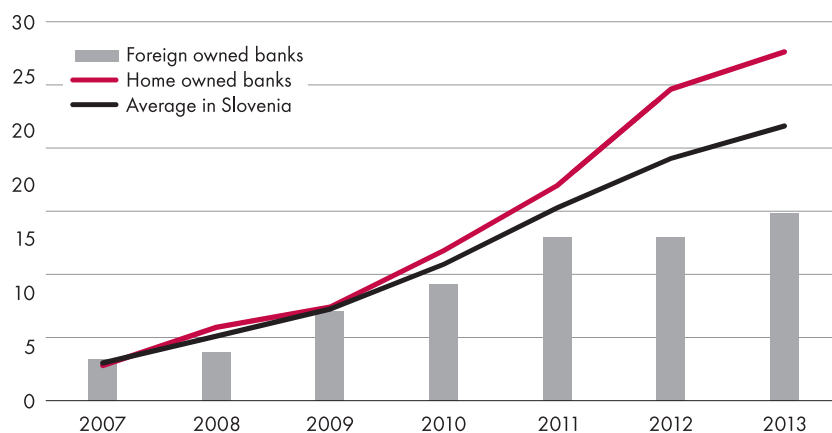
Moreover, high volumes and low margins created a very high leverage of debt in companies making them highly vulnerable. Capital market could not serve its purpose to raise fresh capital for corporates. In addition, there were number of companies where management embarked on a management buyout spree. For many of them at that time this seemed to be a reasonable decision because some banks were willing to finance these management buyouts. And the peak of all this was just one year before the global crisis. An additional challenge was that the Slovenian market was a low margin environment over the last ten years. In 2004, Slovenia entered the EU and in 2007 Slovenia adopted the euro as its legal tender. All this had additional effect on margins. Slovenia at that time was flooded with liquidity from abroad which of course again lowered margins. This was partly accepted by all participants in the market, because banks could generate enough potential for profit and growth. But, unfortunately, this was mainly a consequence of the fact that at the same time, risk costs were also very low. Immediately after risk costs increased, banks started to face problems and since margins and interest rates were so low, there was very little motivation for corporates to raise capital. It was much easier to get cheaper lending facilities since banks were also competing to find opportunities to place liquidity and find additional potential for business with good companies. In addition, the business models of a lot of banks at that time were based on economy of scale to expand lending and to grab as much as possible of the market to earn enough income also with low margins. Since the effect of the global crisis on Slovenia was limited at that time, there was also no real political will to implement structural reforms which

**Figure 1: Liquid assets / deposits and short-term funding - average for ten biggest banks in Slovenia (in %)**



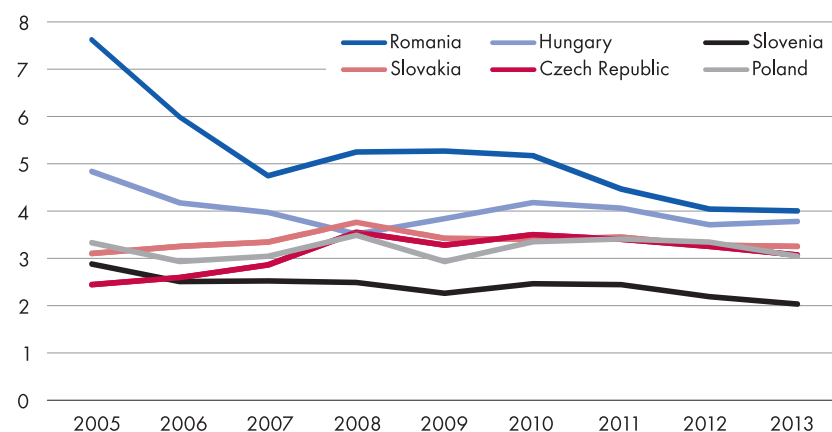
Source: Bankscope (2014)

**Figure 2: Non-Performing Loans / Gross Loans in Slovenia (in %)**



Source: Bankscope (2014)

**Figure 3: Net interest margins for ten biggest banks in the selected CEE countries (in %)**



Source: Bankscope (2014)

would improve the state budget and consequently help the economy. There was no structured measure implemented to help the banking system, besides government unlimited guarantee on deposits for a short period of time to prevent outflow of deposits mainly from the state-owned banks. There were only some capital injections into the state-owned banks where government had to act as an owner to maintain capital adequacy of these banks. Because of these facts, risk cost for provisioning was increasing while on the other hand margins and consequently interest income were still relatively low. At the same time, globally capital for the banks became very scarce resource. It was clear that long-term sustainability of the Slovenian banks was threatened. Therefore, a need for restructuring the banks and changing the business models was recognised in 2011.

### Bank restructuring

The first question to ask at the start of restructuring is how to have a profitable bank which will generate enough return on capital invested in the bank. Therefore, the optimal capital structure has to be defined first. Because capital became a scarce resource during the global crisis, banking groups started to allocate capital to different markets very carefully and on a highly selective basis. It goes without saying that for any banking group it makes sense to allocate more capital to the markets where there are more possibilities to achieve better return on this capital. Because of the characteristics of the Slovenian market described at the begging of this article, there is only a small chance that the Slovenian market could compete with other CEE markets in this sense. As a consequence, a restructuring project has to identify a business model on

existing resources, which will be able to generate its own capital needed for new business in the future. Adequate capital ratios are priorities in banks, because more capital means possibility to do more business or that the bank can better cover the losses during a crisis, comply with the current minimum capital regulatory requirement, and, also very important, they maintain client confidence, which is crucial in the banking sector, especially during a crisis. And it is also, well known that "better capitalized banks are better able to maintain lending during the crisis" (Kapan and Minou, 2013; Kok in Schepens, 2013).

## *A need for restructuring the banks was recognised in 2011.*

In general, banks that seek to increase their risk-adjusted capital ratio have a number of options at their disposal (Cohen and Scatigna, 2014): A bank that seeks to increase its risk-adjusted capital ratio has a number of options at its disposal.

- Banks can reduce their risk-weighted assets by replacing riskier loans with safer ones, or with government securities.
- Reducing the share of its profit it pays out in dividends or alternatively, it may increase the volume of profit (increasing the spread between interest rates it charges on loans and those it pays on its funding; increasing profit margins on other business lines or reduce

overall operating expenses).

- Issue of new equity to existing shareholders or equity offering on the open market.
  - Reducing loan portfolio, or sell assets; slow down lending growth and in some cases an asset sale can boost capital through an accounting gain, as the assets are revalued to their purchase costs.
- Although capital increase and selling of assets are very effective ways to strengthen balance sheets, both can be achieved very difficult in time of crisis. Besides, fresh capital will not improve the bank's business model, it can only strengthen its capital ratio and give the bank some more time to create and implement a strategy of a new business model, which will be successful in the future.

### Implementation of a new business model

The main goals of a potential business model have to be stability, effectiveness and profitability. The most important measures the bank has to take to achieve these goals are changes in risk-weighted assets (RWA), optimisation of liquidity, management of bad assets and cost optimisation.

### Funding

Before a bank embarks on a restructuring process and implementation of new business model, it has to ensure stable funding, such as retail deposits, longer-term funding and equity. Funding structures should be well balanced in terms of maturity and other risk exposures (van Rixtel and Gasperini, 2013). Moreover, events have shown that funding structures should be well balanced in terms of maturity and other risk exposures. However, in general, we could say that funding in the crises times is a problem for all banks. It does not bring any help to restructur-

ing efforts. On the contrary, it brings additional costs which would have to be compensated with an increase of interest rates and margins on the asset side. But since the general situation in the Slovenian banking system is that average maturity of liabilities is very short, while on the other hand maturity of loans on the asset side is sometimes extremely long, this takes time. There is also the also issue of the impact of higher interest rates on the economy.

There is a wide-spread opinion that non-domestic banks in Slovenia controlled by larger banking groups have an easy access to cheap funding. Of course, this is not true. There is an access to the international money market through parent banks, but the price for such funding has to be the market price. In other words, at the peak of the crisis, when the interest rates for the Slovenian government bonds were also at the peak, all foreign funding became extremely expensive. Because of this and because of the fact that foreign banks in Slovenia historically had higher loan/deposit ratio, they were affected by higher cost of funding immediately. The banks that have many retail clients with a lot of à vista money were at the beginning in a much better position.

During the crisis, Slovenian banks slowly started to lose deposits as their most important source of funding. To mitigate a flee of deposits to foreign banks on a larger scale, domestic banks (especially smaller ones) increased their interest rates on deposits. Consequently, that significantly increased their funding costs and also the costs for non-domestic banks, although foreign banks did not follow the market with an immediate increase on deposit interest rates. Still the price for maintaining deposits for foreign banks in Slovenia was also high. The situation on the market started to improve after liquidation

of two small local banks. These two banks did not have an access to foreign money markets. They also had liquidity problems and, therefore, they could not afford to lose deposits and, consequently, they were pricing deposits very high. The main advantage of foreign banks is that they still had somebody who could provide funding, while local banks had very limited access to the foreign market and maintaining liquidity has to be the highest priority for every bank, especially in crises, when it is measured in days. On the other hand, the cost of funding is important, but the effects are only on the profit and loss account and we see these effects only after some time.

#### Risk weighted assets optimisation

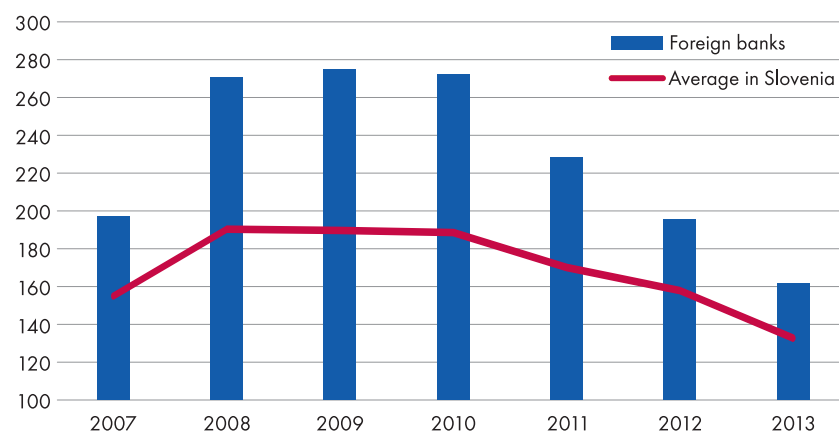
When a bank embarks on the process of restructuring and implementation of a new business model, risk-weighted asset optimisation is naturally the first to look at. RWA optimisation are steps to improve the coverage and granularity of risk models, the quality of data entered into models, the eligibility of collateral, and improvements in RWA-relevant processes (Babel et al., 2012). Because equity capital is the most expensive source of financing for banks, the main goal is to set risk

weights with the purpose of reducing the quantity of capital that is needed to support a given level and structure of total assets (Beltratti and Paladino, 2013). On one side, there should be measures for decrease of RWA without reducing total assets and if this is not enough, next steps have to follow how to optimize total assets.

Banks usually first analyse the usage of RWA and with that underlying capital in different client segments. Some segments are more efficient than others, thus logical conclusion would be to simply exit none or less efficient segments and concentrate on the most efficient ones. All of this has to be accompanied by heavy cost reduction, having in mind that income in such reduction will also decrease faster than costs.

But because of the small size of the Slovenian banks and Slovenia's small market, it would be impossible to just exit certain segment of clients in a short period of time. Namely, in such a case, it would be very difficult to compensate for lost income in one segment with an immediate increase of business in the other segment. Thus, instead to simply exiting certain client segments, a bank has to look for a different solution, which would enable it to keep enough income, to have a sustainable business with requested return on equity. To be able

Figure 4: Loan-to-Deposit Ratio (in %)



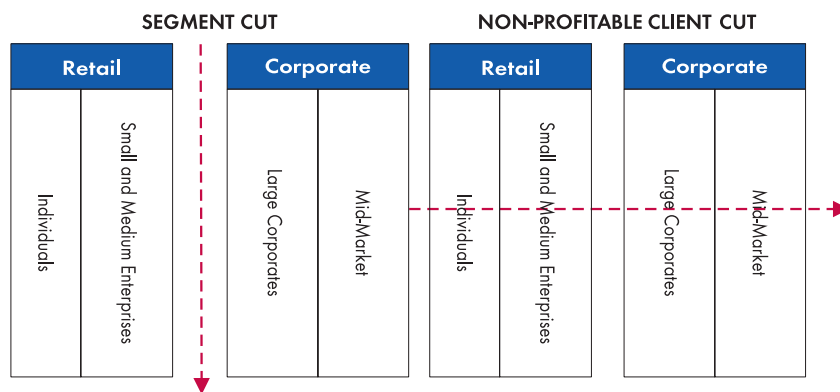
Source: Bankscope (2014)



to find such a solution, a bank has to analyse and calculate profitability not only on segment, but also on the client level.

Therefore, the starting point for defining a future business and operating model is an analysis of the existing client portfolio. First question that has to be answered is: does the bank has enough healthy business/clients which could be a basis for a new business model. A bank has to evaluate a potential of income which can be kept out of this portfolio. Afterwards this has to be compared on one hand, to the potential of cost reduction and on the other hand to the potential of decrease of RWA and with that a potential capital relief. Using RWA, a bank can divide clients into different groups, according to the fact how efficient these groups are and consequently how profitable are for the bank. In general, bank can divide clients in two main groups - profitable and non-profitable and this has to be done through all segments of clients. After analysing profitable clients, bank has to recognize if it can generate enough income to cover decreased costs and having in addition enough profit to have a sustainable bank with these clients in the future. For non-profitable clients,

**Figure 5: Possibilities of defining the future business model of the existing client portfolio**



bank has to define a clear strategy how to exit business relationship with them. Of course also a non-profitable client can become profitable for the bank if e.g. Increase of income with this client or decrease of underlying RWA is possible. This would make this client profitable and it would be preferable for the bank to keep business relationship with it. This is much more difficult to do then to simply exit certain client segments, but because of the small size of majority of the banks, especially in the group of foreign-owned banks in Slovenia, this seems to be a much better solution for long-term sustainability of the bank. With this, bank can carve out non-profitable business

in all segments on the client level. It can also keep the majority of good business and income in the bank and the same time reduce assets and capital need on the part of the business, which is not profitable for the bank. Last but not least, if the bank is cutting off certain segments, it increases potential concentration risk. With keeping more segments and cutting down only on non-profitable clients, it reduces the concentration risk.

**Management of non-performing and non-profitable assets**

There are several ways how to split good and bad business and how to manage bad assets:

**Figure 6: Types of bad banks**

Accounting model	On balance sheet	<b>On-balance-sheet guarantee</b> <ul style="list-style-type: none"> <li>No balance-sheet »deconsolidation«</li> <li>High structural complexity                             <ul style="list-style-type: none"> <li>- External guarantee</li> <li>- Specific regulatory/legal framework</li> </ul> </li> </ul>	<b>Internal restructuring unit</b> <ul style="list-style-type: none"> <li>No balance-sheet »deconsolidation«</li> <li>Transfer of asset info one separate business unit (locations, subsidiaries)</li> <li>Separate org. and operations</li> <li>Internal risk/profit split between business units and bad bank</li> </ul>	<ul style="list-style-type: none"> <li>Capitalization available</li> <li>Faster, simpler</li> <li>Limited risk transfer</li> </ul>	
	Off balance sheet	<b>Special-purpose entity</b> <ul style="list-style-type: none"> <li>Limited asset scope (living loan portfolios)</li> <li>Complexity in current market                             <ul style="list-style-type: none"> <li>- External rating/funding</li> <li>- Asset transfer, P&amp;L implications</li> <li>- Capitalization needs</li> </ul> </li> </ul>	<b>Bad-bank spinoff</b> <ul style="list-style-type: none"> <li>Structural complexity                             <ul style="list-style-type: none"> <li>- Legal, tax, accounting, regulatory</li> <li>- Asset transfer vs carve out</li> </ul> </li> <li>Capitalization and funding restrictions</li> <li>Operational complexity and setup</li> </ul>		<ul style="list-style-type: none"> <li>Maximum risk transfer/protection</li> <li>Higher complexity</li> </ul>
		Structured solution	Banking entity		
<b>Management model/risk transfer</b>					

Source: Brenna et al. (2009)

In such split of business, a clear segregation of portfolio and management responsibility for this portfolio is needed. Solutions to do that, can vary from the possibility to do only separate reporting for both businesses in the bank, to the solution to split non-profitable business or to separate unit inside or even outside of the organisation. The best solution for a single bank should be defined after analysing all impacts of single solution on different areas, such as management responsibility, proximity to clients, competence of involved specialists, segregation of clients, implementation complexity, etc. Here we have to point out that we are not talking only about segregation of problematic clients with non-performing loans (which is a common solution), but also about other clients, which can honour their obligations to the bank when due, but are not profitable enough for the bank. After taking a decision about organisational handling of non-performing and non-profitable clients, a strategy for managing these assets has to be defined.

For non-performing assets, a potential strategy is more or less clear - we need a pro-active strategy for the reduction of these assets. We can have different solutions from relatively simple collection activities for retail clients, to the most sophisticated "work-out" activities for mostly corporate clients, where a lot of legal and economic know-how is required. This topic is in times of severe crises probably the most important in the bank and in short-term, bank can profit a lot from collection activities and from recovery of "work-out" cases.

On the other hand, we can have a lot of different strategies for non-profitable clients. Since these clients are normally serving their obligations to the bank, there are also limited legal possibilities to react. Bank can for example define a passive strategy

for retail clients, with low priced mortgage loans from the past, who are normally repaying their loans, but are not having other products with the bank and are therefore not profitable. There is no legal possibility to ask such client to repay loan faster. Of course bank can always try to sell additional products to such clients, but usually response rate of clients to mass activities in such cases is very limited. Therefore this is too costly and it makes more sense to have passive approach with these clients. An example of a pro-active approach the bank can have vis-à-vis

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*Main goals  
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corporate clients (there are usually more products in use and contracts are made for single deals) where usually shorter tenors are used. In that case, the bank has a possibility not only to sell additional products to such client, but also to re-negotiate low pricing from the past and to turn such client from non-profitable to profitable. It is important that the bank defines these strategies not only for all client segments, but also for different groups of clients with different characteristics (products) within the segments. It can be even defined on a single client level for large corporate clients.

There is also a possibility that a bank sell parts of portfolios, which are not

preferred. This can be a very good solution, if there is a market for such transaction and if the price is favourable. KPIs (Key Performance Indicators) like NPL can improve very fast with such action, but at the end of the day the impact on the profit and loss account of the bank should not be too much different, if the bank sells bad assets or tries to collect as much as possible with its own resources. Therefore, we should treat selling or any other transfer of bad assets more as a tool - how to arrive at a final solution to clean up the bank balance sheet.

Because of all these reasons, bad asset management is extremely important for successful restructuring of the bank and requires a lot of resources. Thus this area of the bank is in the time of restructuring probably the only area that will require even more resources than usually. The bank needs a clear plan how and when these assets will be reduced and when these extraordinary resources can be afterwards reduced as well.

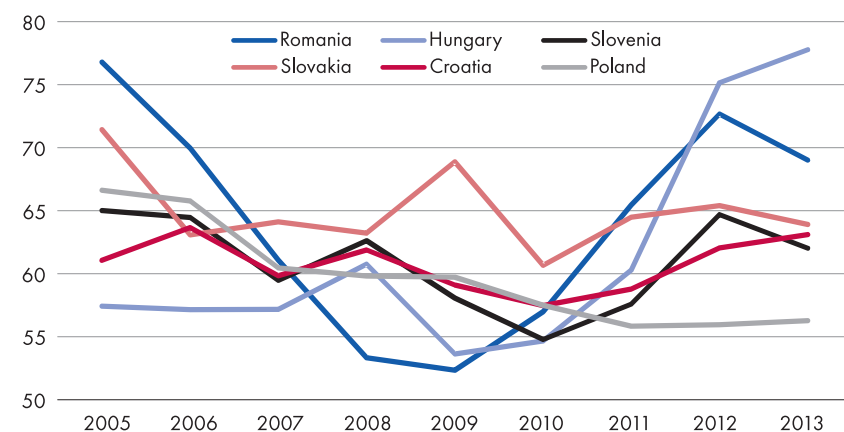
#### **Cost optimisation**

After restructuring reduction of assets on non-profitable business and replacement of this business with profitable one, which would use very little or no risk-weighted assets in a short period of time, it is very likely that the bank will consequently see an impact on its income. Therefore, already from the beginning of the restructuring, the bank has to focus also on cost reduction.

Usually for different historical reasons, banks are not the most efficient institutions. Nevertheless, the Slovenian banks are among the efficient ones when compared to other CEE markets due to the low margin environment in the past.

Usually the problem is more on the income, rather than on the cost side, where again the size of the bank plays an important role. However,

**Figure 7: Cost-to-Income Ratio for ten biggest banks in some of the CEE countries (in %)**



Source: Bankscope (2014)

**Table 1: Indicative Cost Savings**

Cost reduction Steps	Themes	Indicative Cost Savings
1. Strategic cost savings opportunities	T1: IT Optimization / Rationalization	10-30% of overall IT cost
2. Asset & people Reorganization	T2: Remote Infrastructure Management Services	25-40 % of Infrastructure Management cost
	T3: Shared Services	20-30% of Development / Operations cost
	T4: Testing Centre Of Excellence	15-45% of Quality Assurance cost
	T5: Data Centre / Server consolidation	30-40% of the hardware costs
	T6: IT & Operations - Standardization of processes	10-15% of IT / Operations cost
3. Optimization through an efficient Operating model		

Source: Singh et al. (2009)

in every bank there is a potential for cost reduction. So where to look for this potential?

There are three major groups of costs in an average bank: staff cost, IT costs and all other (rents, depreciation, material). Usually every bank first tries to focus on the last group. There can be a significant cost reduction also in that group, but since these costs are the lowest, success can be only limited. There is no real restructuring and cost reduction in the bank possible, if first two groups are not tackled. Therefore, cost saving opportunities derived from a change of the business model must be combined with general operating

model levers for cost optimisation. The lever for the business model can be to carve-out certain business line or product line. In this case, bank can have significant cost reduction through the whole process starting in front office, through the risk analyses and back office, and even in controlling and accounting functions. The danger in smaller banks is they have to be very careful what is in this case a real cost reduction, which can be actually achieved and which costs will be at the end of the day shifted to other business lines or products because of the certain minimum size of banks operations. The levers in the operating model

can be outsourcing, organisational optimisation, process optimisation and IT optimisation. Outsourcing is always a possibility, but there has to be a very clear business case behind such activities, otherwise we can achieve very limited results, with a lot of efforts. A danger in outsourcing is also that in this case we only shift costs from one group of costs to another - e.g. from staff cost to supplier costs.

Organisational optimisation is on the other hand a lever, which can bring a bank a lot of potential for cost reduction. Here we can think about horizontal merge of several departments, or about vertical decrease of management levels. In both cases, a lot of synergies can be found which can lead to a reduction in the number of employees. Under organisational optimisation, we have to mention also optimisation of sales channels, where especially the right size of the branch network is very important for a bank.

Probably the biggest potential for optimisation in a bank is the process and IT optimisation. Comparing to the production industry, banks are usually much worse in their processes. Historically this can be a consequence of the fact that banks were not so much under pressure of cost optimisation and were rather focusing on growth and developing new products and not optimizing the old product range at the same time. Lately, banks are burdened with a lot of reporting to regulators and other institutions and are legally obliged to perform certain activities, which are not core business of a bank. Practically all main processes in a bank are affected by such activities and optimisation of such processes then becomes a very difficult task. But nevertheless, process optimization can bring a significant cost reduction. It makes sense that bank starts with processes where it has most

of capacities allocated, because the biggest short-term impact can be achieved in that area. From the point of IT, processes can be automated, but this requires investment to achieve cost savings. A bank has to be very careful, that clear business case behind such investment is available in order not to automate every process which could be performed efficiently also manually. This is even more important in a small bank. A bank also has to be very careful that the time benefit, after process is automated, is efficiently used for something else or that the number of employees engaged in such a process is reduced. If not, there will be savings only on paper for one process but on the overall level, the bank will have additional cost because of investment in the automation of the process. The bank has also a possibility in optimisation of IT cost by reducing the number of applications which are in use. Consequently, it can improve efficiency by reducing complexity of its IT function. In theory, there is also a number of possibilities to work on process improvement with instruments like Six sigma or Lean, which were proven in other industries. These instruments can probably give good results in big banks with scalable processes, while on the other hand, benefit of performing these activities can be helpful, but unfortunately only limited for small banks.

### Conclusion

Restructuring and implementation of new business models for banks in Slovenia is absolutely necessary to have profitable and sustainable banks in the future. Simply to continue to do business as it was usual in the past is not a solution for the future and may create a new crisis in the

banking system in a couple of years' time. Even now, after big recapitalisation of the banking system, these problems are still present and without improving, profitability and efficiency of banks on long-term bank cannot be sustainable.

For the purpose of this article, we concentrated on banks and we did not assess other external economic factors which are preconditions for sustainable business in banks, such as recovery of the economy with stable economic growth, deleveraging of corporates (in case of Slovenia), a stable real estate market, a stronger capital market, etc. Impacts of these factors on banks are of course

*There is also a possibility that a bank sell parts of portfolios.*

substantial, as we can say that banks are mirrors of the economy. We also did not assess the impact of risk management, different credit policies in the banks and potential for recovery from non-performing loans granted in the past. All these factors will have much bigger impact on P&L of the Slovenian banks in the near future and, therefore, efforts for restructuring and forming new business models may be not so visible or, in the worst case, all these efforts might not be enough to have successful banks in the future, if economy does not recover. But without these efforts we cannot have successful and sustainable banks.

Restructuring and forming a new business model for a bank, should be a value preserving way forward. It should have a positive impact on capital by reducing RWA comparing to total assets which are used for client business and consequently improving return on equity. It should first preserve and afterwards in the future, increase an income from profitable clients as much as possible and improve efficiency by optimising cost structure of the bank. With that, it should have a positive effect on producing positive income - cost jaws between so that in the future the bank is able to digest all costs arising from risk provisioning and still produce profits which could generate its own equity for future growth.

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# Transforming NLB, Slovenian market leader

*Janko Medja, Tanja Šajnič and Mitja Učakar\**

## TRANSFORMING NLB, SLOVENIAN MARKET LEADER

Alongside with the approval of the state aid for the Slovenian largest bank in form of recapitalisation, EU Commission has also approved an extensive restructuring plan that foresees cleaning up a balance sheet and building a profitable business model that will make it sound again. According to the plan NLB started a very complex transformation programme, organised through seven interdependent streams. The business model and underlying strategy are client-centric with an emphasis on further development. To achieve that, the bank needs to transform completely, from processes, products, distribution channels and technological support to changes of mind-set and proactive orientation of its staff. The bank is also putting a lot of effort in the innovative approaches to start making positive impact in Slovenia's economic and social environment.

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**A**fter a prolonged period of being the main financial problem in Slovenia, the NLB Group is back to positive figures and set to actively pursue its vision and strategic goals. The core entities of the NLB Group in the mid-term at least 10 % return on equity on a self-sustainable basis and / or maintain above 15% market share on each target market or customer segment. We will execute the transformation plan to improve C/I ratios below 60% and will maintain high liquidity and security for depositors.

NLB was entrusted the capital which it will manage responsibly by improving profitability, delivering proactively solutions that meet client needs, proactively looking for new business opportunities, optimizing cost base and distribution channels. Moreover, we will actively help to contribute to the society via various initiatives and will improve the quality of work for the entire NLB team.

### 1. Changes in the environment require banks and bankers to adapt

Change has become the constant, the norm. Demographic trends, consumer habits, globalization and consolidation of industries, technology accelerators, mobility, social networks and much more are just some of the drivers.

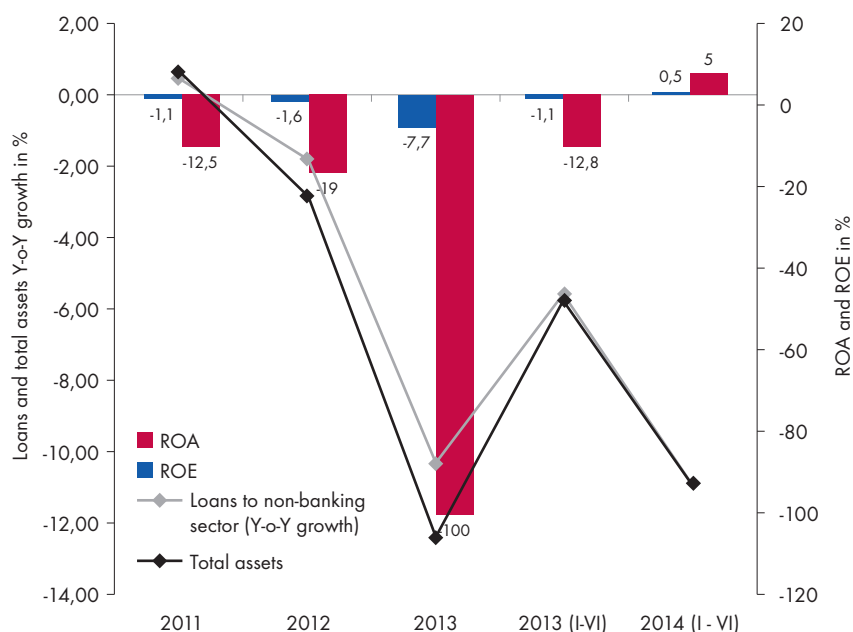
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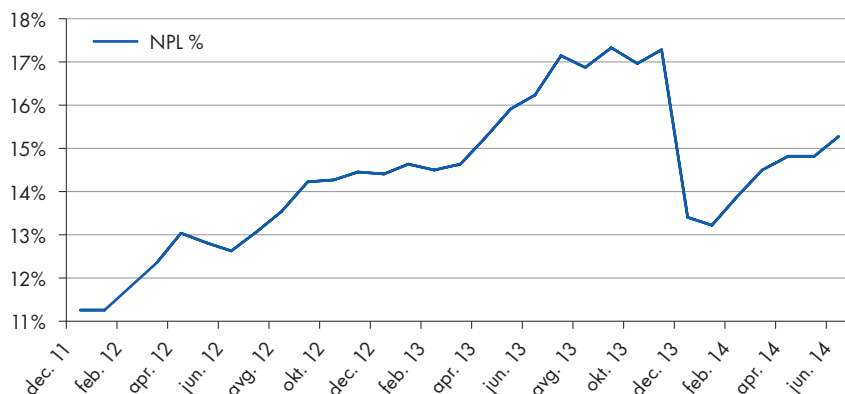
The trend doesn't seem to be slowing. But – is that the whole picture? What about human nature? There seems to be plenty of evidence we change our basic responses, relations, assumptions, cultural traits just slightly, if at all. This causes friction and supports the idea of the general resistance to change, inherent in our nature. We also need firm ground, things to rely on. We find the answer in the good old values, communication, strategy development and execution, as well as invention (and re-invention) of one's own unique character. Only organizations and individuals that learn to understand both – the inevitability of change and the strength in preserving positive values and building their own character – can become drivers of positive change.

The banking industry and bank customers have been confronted with grass-root going through some potentially ground-breaking changes. Conventional wisdom tells us that the awareness of change came with the global crisis in 2008-09 and the initial response of most was to slam on the brakes, be it in the investing in development or in the risk we are willing to take. Some of the banking (like lending in over-leveraged environments) went back to the basics, using lessons learned to improve. Sometimes this leads to avoiding risk rather than mitigating it. But some banks and some new non-banking competitors have in time gone on the quest for offering better services and it now seems to be a clear move to looking for opportunities in niches and segments, as well as using technical innovation to support new business models. Slovenian banks try to follow these trends with varying success, but on average with a significant lag to some the best practice examples found in some other European markets. The lag is mainly the result

**Figure 1: Slovenia's banking sector suffered heavily from 2011 to mid-2014, resulting in negative profitability. (Banking System, 2014 and NLB internal data, based on unpublished monthly report from the Bank of Slovenia)**



**Figure 2: The share of NPLs in total claims in Slovenian banking market is rising again. Does this indicate further deterioration of Slovenian economy? (Bank of Slovenia, 2014)**



of the very slow (several years late) response to the banking crisis in Slovenia, forcing banks to focus on the healthy basics first before being able to leap ahead, and also caused by the structure of this market with too-high state ownership, over-leveraged and poorly competitive economy, labour market inflexibility and simply too many banks with too few (classic) revenue pools. As the end of 2014 is drawing closer, some things have changed for the better, while others remain a chal-

lenge. On one hand, the banking system is more stable thanks to extraordinary measures put in place by the Slovenian government and the Bank of Slovenia at the end of 2013 and banks that are no longer under threat of failing are re-focussing on the business, as well as on their own efficiencies. The liquidity of the banking system is solid and there is no obstacle to finance good projects for growth. Exports remain a driving force as the Slovenian exporters continue to sharpen their competitive

edge. On the other hand, the economic environment for companies, including exporters, is far from kind. The economy (companies) has not yet deleveraged nor restructured or increased its competitiveness overall, pointing to further stagnation or slight contraction of the banking system total balance sheet; investments are extremely scarce and so is FDI; privatisation is a patchwork rather than a transparent and finely running process; most structural reforms are still in the waiting room and alignment on solutions is low; state budget deficit, public sector efficiency and effectiveness don't seem to have a near-by solution; consumer confidence is shaky. Even though some of the forecasts for EU are getting slightly better, for Slovenia the economic activity might even decline further.

The Slovenian economy has not restructured or increased its competitiveness as a result of its aggressive expansionary strategy in the previous decade (in terms of credit growth, business fields in addition to banking and of course geographical footprint), the failure to re-focus in time on core business efficiency and the Slovenian market crisis starting in 2009,. Subsequently, NLB had two recapitalisations in 2011 and 2012. Even though NLB has been majority state owned, both re-caps (by the Slovenian government) were deemed state aid, which led to formal state aid procedure led by the European Commission against the Republic of Slovenia and a request for a comprehensive restructuring plan. As new management took over the bank at the end of 2012, NLB worked in parallel on the new Strategy as well as on a Restructuring Plan for the European Commission.

As per EU rules EC's main request was for the Slovenian government to prove that NLB can – after it clearly needed another, but last state aid – achieve self-sustained viability

in terms of funding, capital, and adequate profitability, in order to be able to attract possible investors and finally be privatised within a 5-year restructuring period.

NLB has developed direction for its new Strategy and the Slovenian government delivered a Restructuring plan for the NLB to the EC at the end of 2012. Both defined a framework for the future development of the NLB Group and were basis of changes that the bank needs to implement in order to regain viability.

The Strategy has been fine-tuned during 2013 (while important parts of its implementation started in the first half

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## *The Slovenian economy has not restructured or increased its competitiveness*

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of 2013) and formally adopted in the start of 2014. The Strategy serves as an overall direction for the NLB (beyond the Restructuring plan as its first and key milestone pillar) as the bank aspires to further develop into one of the top regional players by implementing certain best practises in its focus areas of development.

### **2. Three processes of change**

Bank runs three major change processes in parallel as they mutually support and complement each other.

#### **1. Restructuring plan and the Slovenian government commitments to the EC**

In 2013, an asset quality review (AQR) was performed by independ-

ent evaluators following the central bank's request and NLB's new management reviewed the bank's portfolio against the backdrop of deteriorating market circumstances. The results of the AQR/ST revealed in December 2013 deficit capital shortfall. Consequently, the Restructuring plan of the NLB, as the first pillar of the NLB's return to viability, was approved along with an approval of state aid by EC at the end of 2013, coupled with the Slovenian government adopting commitments to EC with regard to the NLB, the Slovenian government (under MSBSA<sup>1</sup>) implementing the measures of transfer of some NPLs to the Bank asset management company (BAMC) and the recapitalization of the NLB in the amount of EUR 1,5bn. The latter was together with other needed steps enacted by the extraordinary measures of the Bank of Slovenia under the Banking Act (ZBan) with the aim of preventing failure of the NLB, which would have caused extremely high and irreparable damage to the Slovene banking sector stability as well as its economy.

#### **2. Transformation aims to reinvigorate the bank**

After restructuring plan enabled the survival of the bank, the Transformation Programme was launched consisting of 22 projects and 3 business initiatives that enable the organisation's future capabilities and implementation of the strategy of the bank. The process started by analysing existing operating models and defining target operating models in many business areas, and continues with the implementation of changes. A set of quantified measures define each project, combining into overall

<sup>1</sup> Measures of the Republic of Slovenia to Strengthen the Stability of Banks Act (MSBSA) – Zakon o ukrepih Republike Slovenije za krepitev stabilnosti bank MSBSA.

**Figure 3: 7 areas of Transformation Programme feature a highly complex structure that calls for sensible management.**



transformation plan. Most projects should be completed by mid-2015. Naturally, some IT intensive and non-core wind-down related projects will continue past that date.

The Transformation Programme is organised in seven streams: governance, business model review, risk policy and process review, ensure capital adequacy, process redesign, human resources, communication. Considering the scope and great complexity of interdependent activities the Transformation Programme requires active participation of most of the NLB team. Constant monitoring is crucial not only to take timely corrective measures, but also to provide sufficient upfront information and motivation for the team. Therefore, a comprehensive management structure has been set involving management and direct supervision by the Management Board supported by the Program Management Team to coordinate all the activities.

### 3. Reorganisation is supporting core transformation principles

Organisation of the bank should reflect market circumstances, competitiveness, and prioritisation of activities with implementation of the Strategy. It is no longer true that organizations can be static – quite the opposite: flexible organization and quick adaptation of relationships and processes (in order to become or stay competitive) will become a key competence going forward, and changes will both follow as well as enable and support the execution of the NLB strategy.

Reorganisation efforts in the NLB aim to follow core principles of lean organisation. The bank is re-engineering its structures and organisation to achieve higher degree of optimisation of operations and processes. We are actively reducing organisational layers and units, trying to set up better information flow, effective decision making and similar, for

purposes of efficiency, effectiveness and flexibility.

In 2013 and 2014 deeper, sometimes structural changes were needed to set up the bank to properly start implementing the Strategy. These have been taking place in several stages, most of which should be finalised by the end of 2014. After that, NLB will focus on improving processes and organisation with lean methodologies and with continuous improvement.

### 3. What will the NLB become in the following years?

The successful execution of the Strategy (including fulfilling the Slovenian government EC commitments, Transformation Programme and improvements in organisation of the NLB Group) will contribute mostly to implement the NLB Group's vision for the year 2020:

- NLB will be a sustainably profitable banking group, predominantly working with customers in those core markets (or market segments, niches) where it can achieve and hold a top three competitive position in terms of (relative) profitability and/or market share.
- In its core business NLB will differentiate by in-depth client understanding, by service level and advisory competence, by bank accessibility and by a competitive product / channel mix. It will compete mainly in traditional banking services, complemented by new offerings in line with market needs. The NLB Group will be focused on quality and efficient day-to-day client service and will achieve top client satisfaction rankings.
- The NLB Group will be the employer of choice (family friendly), steadily investing in developing the NLB team competence and

experience based on regular goal achievement. Finally, the NLB Group will support notable projects of local environments where it is present, especially in the fields of (social) entrepreneurship, sports for youth, culture and philanthropy.

- By end of 2020, the NLB Group will complete divesting its non-core business activities.

We are placing NLB's new corporate values at the very heart of all our endeavours. These have to be embedded in every development activity, every encounter with client and other stakeholders. Basically, we strive for these positive values in everything we do. By that we transform our work into added value and positive change for NLB, its stakeholders and our environment.

**We emphasize:**

- Responsibility towards clients, colleagues and society at large;
- Commitment to deliver on our promises and objectives;
- Efficiency in the fulfilment of our commitments;
- Open communication and cooperation;
- Nurturing a win-win attitude.

**4. The NLB's new strategy and business models**

The NLB describes its strategic goals in two groups. The first deals with clients, financial markets, core subsidiaries and non-core activities. The second focuses on knowledge centres and processing activities (organisation and HR, processing and IT, risk management).

We propagate a customer centric strategy that stretches beyond pure product sales to (pro)active relationship (and in the future, client experience) management. Hence we are developing deep understanding of various client needs and require-

ments and are actively looking for optimal ways to satisfy them, with the goal of building long-term business relationships to mutual benefit. This is done through extensive work with the NLB team, best practise sharing and education. Occasional glitches in the service quality will of course still occur, but we are trying to learn from them and are using them as examples in the continuous improvement process.

**Business strategy is client centric and focused on development**

The NLB business model relies on two strong pillars: Retail (including Small Enterprises, "SE") and Corporate that are characterized by the segment specific treatment of clients and corresponding processes. Both pillars are further sub-segmented to adequately address specifics and to develop in-depth understanding of client groups. The bank has started to focus on:

- constantly improving professionalism in dealing with clients (speed, knowledge, win-win, open communication, simplicity), going for increasing client satisfaction;
- proactive approach to clients (vs. the "sit and wait for request to come in") and active development of sound business with them, including cases of restructuring;
- cross selling efforts as well as fostering joint support services and development wherever appropriate.

**Corporate segment as a strong professional pillar**

The corporate segment is the most troubled in Slovenia, as the firms suffered heavily from the negative macroeconomic developments and are generally excessively leveraged. It is thus anticipated that the overall loan volumes and the demand for banking products will be further declining for some time, afterwards

it will linger on low levels over a considerable period before starting to slowly recover.

In order to allow for specialized treatment with the right focus on the activities most needed per particular group of clients, the whole corporate segment has been split into core performing, restructuring and workout cases. Efforts of the NLB in the core corporate segment are to maintain our leading market position while improving profitability and stability of business over time.

The core corporate segment model encompasses eight fields of improvement that will assure a long term sustainable and improved corporate banking business:

1. Initial high-level division of the portfolio parts of bank's corporate portfolio were carved out to specialized units for non-core and the non-performing core assets. The sales units within the corporate division today focus on the performing part of the core portfolio;
2. Sub-segmentation of the core performing portfolio: segmenting the corporate into medium sized and large corporate segments to address the specifics of groups of companies based on their characteristics, complexity and proximity (local regional presence vs. fully centralized client management);
3. Changing the client management approach:
  - from the transactional relationship approach and geography distribution to a holistic client management approach based on client characteristics and needs. Introducing a dedicated relationship manager principle to develop quality client relationships;
  - from the historic reactive culture to a client oriented, proactive, solution oriented sales

culture, enabling the bank to identify and target desired clients and businesses;

- introducing the contemporary client management model, with parent account managers steering the relationship with particular group of borrowers across the whole network of the NLB Group;
4. Further micro-segmentation of key segments to target the desirable (potential) client niches and opportunities;
  5. Adapting the product mix to relevant business segments to achieve cost effectiveness: focusing on an upgraded client approach rather than on increasing complexity of the products;
  6. Managing client relationships' profitability in addition to product (or transaction) profitability;
  7. Redesigning the sales process to allow for a more efficient (proactive and risk aware) sales approach and to properly measure, manage and reward sales performance;
  8. Teaching risk awareness: transforming relationship managers into "the first line of the risk management" to assure smart lending and achieve a balanced risk underwriting culture (somewhere between risk abandon and risk avoidance, neither of which are desirable).

Sound risk awareness to appropriately structure new deals with "healthy" corporate as well as specialized knowledge and decisive approach in restructuring cases are paramount in order to ensure that the Slovenian economy stabilizes and gains its momentum again.

### Retail segment still offers a lot of banking potential

Retail segment of the NLB performs in the very mature Slovene retail banking market. This segment has

represented the historic core of the bank and is an important source of future stability. Deposits generated within the retail segment serve as the most important funding source in terms of both volume and stability. Furthermore, the segment is a key contributor to the overall profitability and economic value added of the bank, having relatively low risk and consuming little capital. We realized that small enterprises require the same level of flexibility and ubiquitous access to banking services as private individuals. Therefore it was not efficient to treat them in different segments, so we have joined the segments within united retail segment in order to effectively offer those clients standardised automated processes and to secure faster service, which are beneficial for clients and for the bank.

With respect to the market maturity of the **private individuals segment** the goal is to strengthen the leading position in the market:

- "our client as our first focus" – listening to our clients and understanding market trends leads to segmenting client groups in order to understand their needs, their development cycles and their potential, and respond to those responsibly, as well as achieve increasing levels of client satisfaction;
- addressing them with customized service models: standard level of service, personal (premium) level of service for affluent clients and private banking approach with a focus on assets under management services;
- boosting sales activities through targeted campaigns and proactive sales approach;
- improving sales performance management (Sales Force Effectiveness principles);
- simplifying and enhancing product portfolio, including banking-

related products (investment and insurance products) while reducing overall bank costs.

Due to high market shares in the retail segment the focal point of our relationship management strategy is the reduction of negative churn. The centre of our attention is in regaining client trust, supported by good communication, attractive product solutions and quality as well as speed of service. In addition we aim to introduce and use contemporary marketing approaches, already successful in other markets and industries (loyalty programs, frictionless service, and communication through social media).

Small (family run) business represent the backbone of every mature and stable economy. Hence we assess that **small enterprises** will in view of current macroeconomic developments most likely be the main drivers of revitalisation of the Slovenian economy. For this reason the NLB firmly believes in the necessity of professional support and services offered to this segment. Moreover this is the only segment where the bank can count on increasing its market share in certain niches (for example lending), since the segment hasn't been actively targeted in a structured way before. The bank has already established independent segment management, with corresponding organisational changes, that will implement the new business model. Although competitors have also already started targeting small enterprises segment, the NLB market position along the different sub-segments could be retained and even improved. The fact that the bank's market share with various target groups has been consistently on similar levels indicates that competition hasn't yet proficiently adopted similar strategy. Primary client relationship management direction for this segment should obviously be



focused towards acquisition, having in mind development of mid to long-term client relationships.

To support the achievement of set goals, specialised process has been introduced to constantly monitor client potential in order to allocate its SE clients over three basic service levels – resulting in promotion of different product packages as well as pricing differentiation. We do want to serve clients with standardized needs more effectively and thus be able to provide quick response also to those with special banking requirements. The analysis of the current portfolio shows great potential in activating dormant clients as well as focusing on special target groups. The NLB determined its regional differentiation (core, development and other regions), based on the potential and our presence in a particular region, and adjusted relationship management capacities accordingly. We reduced a number of business centres and have introduced a specialised new mobile force to reach prospective clients in the remote areas. Our sales activity is paramount in order to win good clients, proactive approach is therefore also an important part of KPIs within the adopted Sales force effectiveness principles.

We realised that special efforts will still be required at optimizing processes, particularly those of onboarding and well as lending, where we have to assure fast and smooth service. When it comes to lending, the small enterprises are rather specific in their business models and transparency of true financial position. Hence the bank is constantly developing a special segment-wise understanding and has already achieved a major breakthrough in the lending process by introducing first scoring models. As appropriate credit limits for companies and sole proprietors can now be effectively assessed in a matter of

hours, the bank is considering process (campaigns) that should secure a loan to eligible companies in 48 hours from initiation till disbursement.

#### Optimizing and modernising distribution channels

At the end of 2013 the bank operated the network of 143 branches that were organized under 10 regions. As part of the restructuring of distribution network / channels, during 2013 we have carefully examined the viability of the whole branch network (every individual outlet) as well as the ATM network. The findings clearly pointed to and resulted in closing down of 22 non-profitable branches and removing almost

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*It's now high time for Slovenia to create an investment friendly environment.*

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1/10 of ATMs. As for the remaining branches, the strategy foresees their revitalisation and redesign in order to bring us closer to clients with openness, approachability and contemporary concepts.

We have performed an extensive review of the electronic channels. Assessment of their maturity levels shows a lot of potential especially in improvements of user experience and introduction of additional functionalities. As also mobile banking is gaining in the market, we will continue to invest in both areas E-banking and mobile banking apps.

#### NLB took a leading role in financial restructuring of Slovenian corporates

Based on the OECD Economic Survey Slovenia 2013, the average debt-to-equity ratio of Slovenian non-financial corporations is with 141.4 – well above OECD averages that amounted 118.7. While there is still potential with private individuals to increase borrowing, we are reasonably concerned that with corporate entities. Therefore, Slovenian banks are now largely engaged in the financial restructuring of the overleveraged companies.

As the market leader, NLB took over the responsibility to be in a driving seat of the most essential and biggest restructuring corporate cases in the country. We have managed to successfully wrap up financial restructurings of some of the complex client groups like Mercator, Pivovarna Laško, Trimo and others.

However, international competitiveness of Slovenia's economy remains the most important national mid-term goal as the key element for creating added value and stability. It should become one of the main drivers of development. Therefore, only financial restructuring will not do the job! Slovenia's economy needs to use a temporary (1-2 years) window of stability provided by financial restructuring of companies to also tackle their business restructuring. The best candidates are those that have the potential to compete not only in performing their daily business, but also use their innovativeness and investment capabilities. They are the best guarantees for developing and sustaining international competitiveness in the long term.

Not all companies will be able to restructure in financial or business terms. Therefore, also effective dissolution processes are needed to turn over the corner of Slovene economy. The topic will ultimately also require

a decisive role of the state. Slovenia needs a clear legislation (some improvements were introduced in 2014) and effectively run insolvency procedures to efficiently address the motivation as well as interests of stakeholders in restructuring processes.

Equally important is the understanding that it is now high time for Slovenia to create an investment-friendly environment, with support and cooperation of all government institutions and openness to FDI and privatisation. We firmly believe that such cooperation between all participants in Slovenia's economy is crucial to reach the restructuring goals.

## 5. The whole strategy of NLB had or still has to transform.

### Financial markets

This segment, in addition to the Asset Liability Management (ALM) function, works with several client businesses: corporate finance, brokerage, custody and other.

Within the regular ALM, NLB has at the beginning of 2013 made some important changes to the price policy of products and the repayment of third party funding as much as possible, while at the same time looking to maximize stability of bank funding and liquidity. Within a year it is clear these decisions were one of the most important for improved results – while we (also due to recapitalization) now keep very good liquidity, the NLB has also substantially increased profitability of its balance sheet (non-banking sector business) and its profitability overall.

In the commercial part of financial markets, the client business, the NLB has set itself goals to review the best international practices for managing these businesses, prepare a gap analysis and a development plan. One of the first solutions was to merge (in the beginning of 2014) the

asset management business with NLB skladi, a fully owned subsidiary with practically the same activity, to leverage of efficiency and development potential. As for the other businesses, we engaged in the business model analysis activities throughout 2014 and the implementation of changes will start towards the end of the year, bringing both efficiencies to the bank as well as value added to clients in the mid-term.

### Core subsidiaries

In addition to product factories NLB Skladi (asset management), NLB Vita (life insurance) and Bankart (processing) where NLB intends to further develop co-operation and keep a majority stake, the core group encompasses six universal banks: in Skopje, Belgrade, Podgorica, Pristina, Tuzla and Banja Luka. Each of these banks has their own various market and internal development dynamics, from a restructuring modus in Serbia to focusing on profitable growth in Macedonia. Within restructuring, the NLB worked mainly on challenges of leadership, governance, risk management and other key policies with these banks; however, in Serbia and Montenegro we entered ambitious restructuring programs that are already showing improvements and bring optimism that all of these the banks, if not yet so, will be stable and profitable in the future.

### Non-core activities

Even though NLB d.d. had sold a portion of its NPL portfolio to the BAMC, significant chunks remained, as these assets failed to fulfil the MS-BSA criteria for transfer. In addition, the NLB has a number of non-core subsidiaries and other assets. For the entire non-core business, the goal (and partially a commitment of the Slovenian government to the EC) is to decrease by several times in the restructuring period, i.e. towards

2017. This is one of the most important challenges of the NLB Strategy with impact on banks overall profitability, capital strength, the possibilities for growth of the core businesses (the quicker we decrease non-core, more we can grow the bank business in the core segments) and reduction of complexity.

Towards the end of 2014 the bank is ahead of all its plans with regard to exiting the non-core activities.

### Risk management, IT and Operations, HR and Organisation

Risk strategy, policies, processes, operations and risk management culture of the NLB have been under scrutiny since the end of 2012. We entered a wide-ranging number of improvements, both quick wins and long-term process development in order to bring risk management to the best practice levels within the restructuring period. With the execution of the Asset Quality Reviews in 2013 and again in 2014 (the latter was run by the ECB as a part of the Single Supervisory Mechanism preparation) we included further methodological and other changes to the risk management agenda.

In IT and operations NLB developed its strategy in 2013. We structured the main implementation directions in a group of IT projects. These will run their course over a multi-year period, simplifying and re-focusing the infrastructure of the bank in order to optimise time and cost of the processes and ultimately improve services to customers of the NLB Group.

In the organisation and HR, including the corporate culture change, NLB set its goals early in 2013. We believe that a modern bank needs above all to:

- Size its team to the potential in the market and then develop it in a clear direction, using contemporary managerial tools which NLB has already started these

activities and some are already finished (the sizing of the NLB d.d. team started in the second half of 2013, is now coming to an end).

- Structure its organisation for higher flexibility, speed, responsiveness to the market and the customers, with as few layers as possible. We implemented several organisational changes to that effect throughout 2013 and 2014, and believe that adapting the organisation needs to become a regular practice.

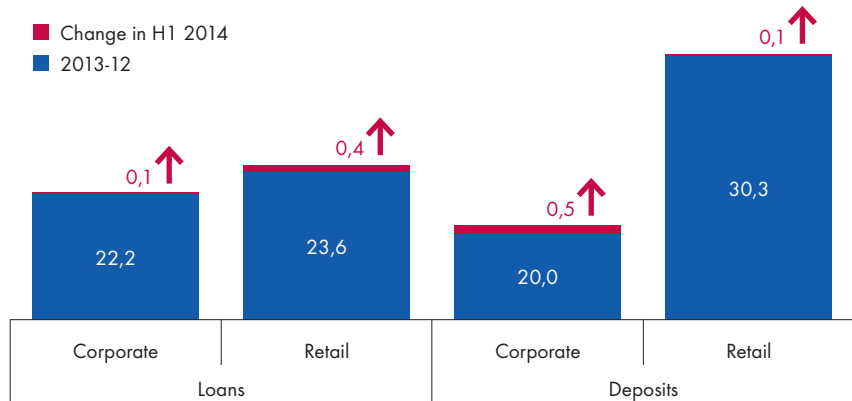
### 6. Midterm results show the bank is well on track

Halfway through its transformation, NLB has much to show: proactive sales approach and active relationship management reflected in improved market shares in all elementary banking products across segments, as well as in non-basic banking products (investment and insurance products).

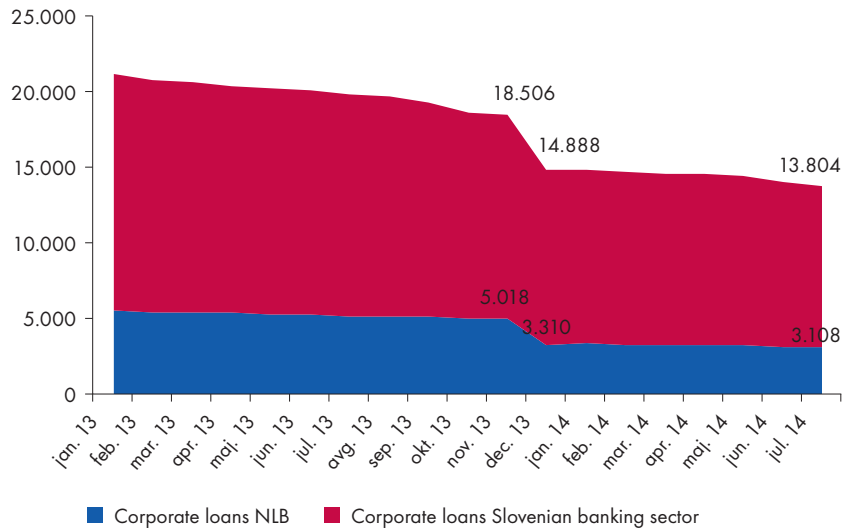
The very important message is that through the exhibited stability and service quality improvements bank is regaining clients' trust. This is greatly shown also through the increasing deposit volumes as well as the ever increasing volumes and market shares of its subsidiaries NLB Vita and NLB Skladi.

Last but not least, profitability has stabilised and improved. The results before provisions and one-offs, have now stabilised and have been rising slowly in 2014. After the third quarter of 2014 the NLB group already shows profit after taxes in the amount of 47,9 mio EUR. In addition to positive effects of recapitalisation the 2/3 of the results can be attributed to sales activities of NLB with customers and to diligent cost rationalisation. According to the results of stress tests conducted by ECB in 2014, the bank is sufficiently

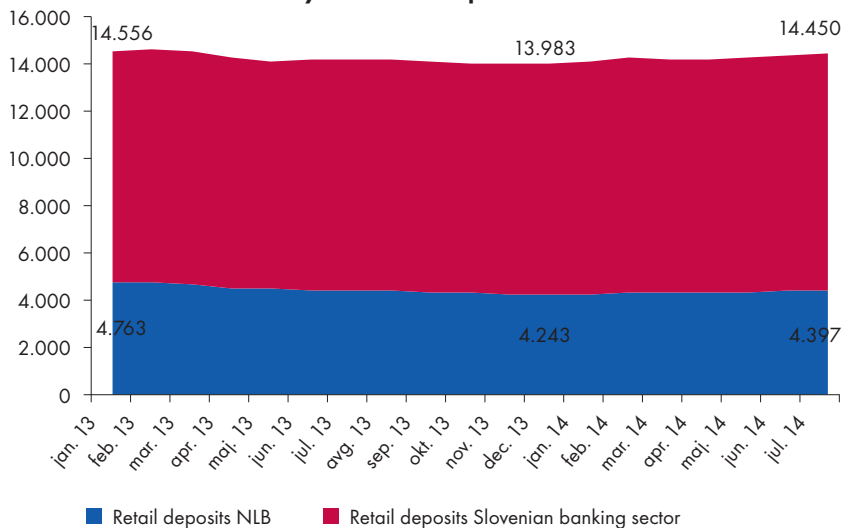
**Figure 5: In first 6 months of the year we have managed to increase our market shares in all key banking products.**



**Figure 6: After the transfer of assets to BAMC the size of Slovenian banking market is still declining. NLB will strive to maintain its market position.**



**Figure 7: The trust is returning to Slovenia's banking sector after the uncertainty reached its peak in December 2013.**



capitalised for the base scenario, while a manageable capital shortfall in the amount of 34.3 mio EUR was detected based on adverse scenario. ECB has already confirmed that due to improved profitability NLB can manage to cover that shortfall from its profits alone.

## 7. Innovation centre as an additional support to economy

At the end of 2013 The Economist Intelligence Unit conducted a survey to start inducing a break up from the bad publicity that banking industry has regularly been receiving ever since the beginning of the financial crisis. Their question was simple: What does it take to be the Good Bank? (The Economist Insights, 2014) The debate by financial industry experts finally came up with three top characteristics: A good bank needs to be effective, trustworthy and innovative!

Understanding that finding in the context of the Slovenian economy and NLB the question is obvious: when can we say NLB fits the profile and deserves to be widely recognised as a good bank?

We believe that a constant adherence to our corporate value system will together with our professional approach to sales and service concept continue to contribute towards further increase of trust. The deposit inflow is already a good sign that our customers value our undertakings.

The transformation programme very well addresses the effectiveness

issues, following lean principles and assuring the right support also by appropriate management tools, naturally not overnight. The changes in processes that the bank has already implemented have contributed to major increase of NLB's effectiveness. Following that path should bring even greater improvements in the near future.

This leaves us with the third characteristic: innovation. Considering that the whole banking industry is being endangered by many organisational and technology disruptors, it is of vital importance that the incumbent banks somehow secure their spot for the future. It's not just about introduction of new services and technologies that aim at making managing finances easier for the customers.

They are still important and as is stated throughout this paper NLB is already entering the development phases for many of those.

The greater challenge will be to change basic concepts of what a bank can really do for its customers that would allow it to stand out from others. NLB has identified such potential in active involvement in innovative entrepreneurship. Our vision in this area is to provide positive effects on social and economic environment locally and nationwide by following and co-creating global economic trends such as small business acceleration, new forms of self-employment and economy of sharing.

We shall respond to such requirements with the Innovation Centre (the project beginning its implementation

phase), which will provide space and special services to promote the development of entrepreneurship. The Centre as such will serve as the business accelerator and will be providing co-working environment. It should offer a one stop shop for business and financial consulting performed either by the bank or by partnership companies (tax advisory, business management, innovative or alternative funding options for start-ups). The Centre should also encourage its clients to actively participate in best practice sharing and business functions support. A flagship hub will be established at the headquarters of the bank, but we will start the initiatives also in other locations in across Slovenia.

We believe such approach should even further increase the recognition of the bank and will hence facilitate its market operations. More importantly raising and fostering the entrepreneurial culture should actively contribute to improving of the Slovenian economy. Such an innovative initiative may provide an important step in promoting the growth Slovenia will need to regain its status of healthy and sustainable economy.

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# Bank Assets Management Company – Experiences so far

Lars Nyberg\*

## BANK ASSETS MANAGEMENT COMPANY – EXPERIENCES SO FAR

Transferring bad assets from banks to separate entities – Asset Management Companies – in the process of handling a banking crisis is not a new idea. The further away from the bank the NPLs are handled, the greater the credibility of the solution. BAMC has made it possible to handle the process in Slovenia in a structured way even though the road towards the successful asset transfer was bumpy. The main purpose of BAMC is to regain as much money as possible from the assets transferred from the banks. Another task of BAMC is the restructuring of number of big conglomerates. Right now BAMC is in the first phase of the life of an AMC, the one of transferring and handling credits. Recovery and restructuring operations are speeding up and the final phase of selling will soon be initiated.

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In February 2013 I was asked by the Slovenian government to become a non-executive director of the Bank Asset Management Company and help to start it up. Arne Berggren and Carl Lindgren got the same question. Presumably we were asked because we had long experience from similar cases – and perhaps because we were outsiders and could be expected to create an independent board, three out of four non-executive directors. We all accepted: two Swedes and one Finn. In this paper, I will give you my view of what has happened since then – as I see things at mid-September 2014. Let me say at once that it is my own view and that my colleagues in the board may not necessarily share it – although I think they will agree with most.

### 1. Introduction

Establishing an AMC without conflicts and misunderstandings is difficult, if at all possible. Clearly, we have not in all matters agreed with the Ministry of Finance and the Bank of Slovenia. But there have been no attempts of political influence outside the normal and formal channels. The two state secretaries that, in different periods, joined the board as non-executive directors have both acted with integrity and independence, as indeed we had expected.

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### Why AMCs?

Transferring bad assets from banks to separate entities – Asset Management Companies – in the process of handling a banking crisis is not a new idea. It was used successfully in the US during the Savings and Loan crisis in the late 1980s, in the Sweden during its banking crisis in the early 1990s, in Asian countries during the Asian crisis of the late 1990s and most recently in Ireland and Spain.

But why transfer bad assets out of the banks? Should not the banks (and their owners) take care of their mistakes themselves? What signals will it send if bankers are relieved and forgiven and can continue as if no money had been lost? These are relevant questions, particularly when public money is involved. And furthermore, are the banks not in fact best suited to handle their problems, given that they know their customers? Normally, banks take care of their nonperforming loans (NPLs) as a part of their day-to-day business. All banks have customers that fail to pay in time and in some cases go bankrupt. Banks have people, usually lawyers and other specialists, to handle these problems and they do not absorb much time in management and board discussions.

In a financial crisis things are different. The NPLs grow in number and become more complicated. In a deep crisis, which is often nationwide, large customers with subsidiaries at home and abroad and intricate financial networks may run into trouble. Gradually, the bank management will move into a crisis mode. Eventually, the balance sheet of the bank may be questioned and funding will drain up.

In such a situation, transferring a major part of the NPLs into a separate entity may be a way of addressing the problem. The entity may be a

special department of the bank (as in the Baltic crisis of 2008-2010), a subsidiary (as done by a number of Swedish banks in the early 1990s) or a separate company. Note that this is a question of organising the workout, not a question of ownership. The shareholders keep all economic responsibility. The choice depends on how serious the problem is and what is required to restore confidence. The further away from the bank the NPLs are handled, the more independence and the greater the credibility of the solution.

Many AMCs entities are set up by individual banks. A centralized AMC may be created if the NPL problems cover many banks or if the banks are

## *The transfer prices determine where the losses show up.*

state owned - like in Slovenia.

As I see it, separating the bad asset has three main advantages. Firstly, if done correctly, the transfer of bad assets will make the process of handling the crisis more transparent. If accompanied by a sufficiently large capital injection by the owners an important step towards regaining confidence is taken. Of course, this assumes that a sufficient part of the bad assets have been transferred to the new unit. If a large number of NPLs remain in the bank, it will be difficult to convince the market that the bank is cured and can work normally.

Secondly, the new entity may employ experts on business restruc-

turing and real estate management that are not usually available in the banks – simply because there is no demand for them in normal times. Involving people without the heritage of relations between the bank and its customers has also proven to be a good idea in many cases. Taking care of the nonperforming assets on arms lengths from the bank is simply more efficient.

Thirdly, when the NPLs are managed separately, the bank management and the board will again be able to focus on normal banking business, which is essential to help the bank – and often country - out of the financial crisis. You may argue that the management should be able to handle the problems and plan for the future simultaneously. But in reality this is seldom the case. In my experience, there is little room for future initiatives in the minds of a management trying to survive. Having the bad assets taken care of separately makes it a lot easier to look forward.

### Two important issues

When setting up an AMC entity it matters how you do it. Judging in the future whether the AMC was an economic success or a failure will depend on this. When the entity is a subsidiary or a separate company - i.e. having a separate balance sheet - you will have to decide on two important things: The capital structure and the transfer prices.

The capital structure – the mix of equity and borrowed funds – is important since the assets taken over are by definition nonperforming. They will give a very small cash flow during the initial period until they are restructured and sold, which will usually take at least a couple of years. If the assets are funded by borrowed money, e.g. interest bearing securities, the company will run losses every month. To avoid losses,

the company must get access to cheap funding from the owner and/or enough equity to compensate for the minimal cash flow from the assets taken over.

The transfer prices determine where the losses show up – in the bank or in the AMC. Before the transfer of assets from a bank to an AMC there is usually a large difference between the book value in the balance sheet of the bank and the real value of the assets, however calculated. This difference is usually referred to as “the hole”. The higher the transfer prices, the better the bank will appear. If the transfer is done using book values (after impairments) the bank may need only a limited capital injection and “the hole” is completely transferred to the AMC – where it will appear in its financial statements and where it will have to be covered by a capital injection. If the transfer is done using market values, “the hole” will appear in the balance sheet of the bank – where it will have to be filled with new capital sooner rather than later.

In practice, the transfer prices are usually set somewhere between the book values and the current, distressed, market values. But it is important to realise that whatever transfer prices you choose, “the hole” remains the same. I have met politicians who think that transferring assets at high prices makes “the hole” smaller because there is less need to recapitalise the bank. This is not true, of course. “The hole” is there, in the AMC, but its public discovery may be somewhat postponed.

### **The phases of an AMC**

Although all AMCs are different due to their financial set up and asset portfolios, there are some common features. They all have a limited lifetime and they pass through some distinct but overlapping phases:

- The transfer phase, when assets, mainly nonperforming credits, are transferred, legally and physically. This work involves checking all the files provided by the bank to see whether they are complete, whether the collateral is available as recorded etc. This phase includes an initial valuation of the assets to be used in the AMC reporting.
- The credit management and workout phase, where the assets are handled one by one to preserve and improve their value. Particularly important and time-consuming are the “live” assets, e.g. corporates that have

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## *The government can use BAMC as a tool for recapitalising the banks.*

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- to be restructured financially or technically to survive. But “dead” assets, e.g. real estate to be recovered in a bankruptcy, may also have to be restructured and combined with other assets into marketable units.
- The sales phase, where the assets are eventually sold. This is a complicated process, particularly for the “live” assets. Typically, the assets remaining at the end of the AMC lifetime are mostly real estate and AMCs may be transformed into real estate companies and even sold on the stock exchange.

These three phases require different

skills and therefore the number and expertise of employees will change through the lifetime of the AMC.

## **2. The Slovenian background**

### **The 1990 Slovenian Development Corporation**

After the turbulent political and economic start of the 1990s, the Slovenian government decided to create a development fund, which in 1997 was transformed into the Slovenian Development Corporation, SRD. Formally a joint stock company, fully owned by the Republic of Slovenia, it was supposed provide project finance, promote and co-finance technological development and, most importantly, to take over, restructure and privatize a number of major companies in financial trouble. SRD took over nearly 100 companies with over 54.000 employees. SRD was created as a mixture of a development bank and an AMC, a combination that may well work if given sufficient independence. The problem was the corporate governance. SRD was run close to the government, with government employees in the board, and had to compromise between business logic and political interests. Restructuring of a company into long run survival often requires tough measures, including substantial downsizing of the work force in the short run. Such measures may be hard to digest for any government. As has been the case for state owned companies in many other countries, conflicts in governance objectives prevented SRD from working efficiently. SRD was liquidated in 2002. The general view seems to be that it had largely failed to deliver on its mission.

### The 2012 BAMC debate

When in 2012 the idea of BAMC surfaced and the government presented “The Act Defining the Measures of the Republic of Slovenia to Strengthen Bank Stability” (ZUKSB), the SRD experience was still in close memory. The debate on BAMC came to be much more political than is usually the case when establishing an AMC, normally considered as one means among others to handle a banking crises, a rather technical issue with little political content. An argument appearing in the debate was that establishing an AMC was an expensive way to address the problems in the banking sector and that mergers, private recapitalizations and selling off part of the troubled banks should be tried first. From an outsider’s view, part of this debate seems odd, particularly considering the serious situation in the banking system, with the major banks moving towards capital ratios that no longer would have allowed them to operate.

In the autumn of 2012 the issue became so politically affected that voices were raised in favour of bringing it to a national referendum – indeed an interesting idea in the history of banking crises. It was realised that voters could hardly be expected to know much about the subject but that it might nevertheless be necessary to resolve the political controversy. In the end, the Constitutional Court ruled against a referendum. In October 2012 the National Assembly passed the ZUKSB. But a lot of confusion regarding what an AMC really is and what it can be expected to do remains from the political debate – and of course from the SRD experience. In this way, BAMC got a very unusual and quite unfavourable start compared to many other AMCs.

### The ZUKSB

The BAMC is a state owned company, designed to take over non-performing assets primarily from the three banks where the state and various public entities had a majority ownership, NLB, NKBM and Abanka. The law envisaged that other banks might follow. Notice that the Slovenian BAMC is not related to a particular bank and that it has no private ownership.

BAMC was set up to help regain confidence and credibility in the Slovenian financial system, trust in the country’s most important banks and as much of taxpayers’ money as pos-

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## *What BAMC tries to do is to take a lead in the restructuring process.*

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sible. Ambitious targets, no doubt, and certainly not to be attained by BAMC alone.

The legal backing for the BAMC (the ZUKSB) was passed in parliament in October 2012. It covers the process for a bank wanting to apply for public support in the form of a capital transfer from the government and transfer of nonperforming assets to the BAMC.

From an international viewpoint, ZUKSB (and BAMC) is the evidence that Slovenia has addressed the problems in the banking system in a constructive way. Many European countries where banks struggle with huge NPL ratios would have use for

a similar legislation. In this sense, Slovenia has set an important example internationally.

A few issues in the ZUKSB are of particular interest for the development of BAMC. The first one relates to the choice of assets to be transferred and the transfer prices. To assure transparency, the non-performing assets to be transferred and the transfer prices should be discussed between the bank and the AMC. This is not the way the process was set up in the ZUKSB. The law certainly states what assets that can be transferred. But the legal set up was complicated by the involvement of the European Commission, notably the Directorate General for Competition (DG Comp), which according to the EU Treaty should assess the amount of state aid that could be given to each bank without unduly affecting the competitive situation. In practice this meant that the Commission had their experts doing independent valuations of all assets suggested by the banks and the supervisor (the Bank of Slovenia) for transfer to BAMC. When the list of assets and the prices had been decided in Brussels there was little room for further discussions. The BAMC had no say in the selection or valuation of the transferred assets. The second issue relates to the BAMC funding. The law is very clear on what kind of bonds that should be issued by BAMC to finance the acquisition of nonperforming assets and how these bonds could be guaranteed by the government. But the need for equity to bridge the gap between assets with a minimal cash flow and bonds with a coupon to be paid regularly is not covered. The BAMC could in principle, without coming into conflict with the law, run the business with very limited equity and rely only on funding in government guaranteed bonds – if

the owner were willing to accept substantial negative results for an initial period. Running an AMC with no equity and substantial losses would not be credible internationally, of course, and eventually the government decided to inject € 200 mn as a start-up capital.

A third issue concerns the lifespan of BAMC. The law stipulates that the company should be closed after five years, i.e. at the end of 2017, and that at least ten per cent of the assets be sold each year. The short lifespan is unusual internationally, but perhaps not a big problem. What is left of the assets after five years, probably mostly real estate could be taken over by another government entity. But the requirement to sell ten per cent every year, including the first year (in this case 2014, since no assets were transferred until this year), is unfortunate. An important idea with an AMC is to avoid forced sales and instead seek to maximize asset values. Indeed the desire to avoid forced sales is explicitly spelled out in the ZUKSB.

The fourth issue is more unusual. The main purpose of BAMC is to regain as much money as possible from the assets transferred from the banks. This is very straightforward; in fact it is the job of any AMC. But in addition to that, the law opens for another task, which is unfamiliar to an AMC. The government can use BAMC as a tool for recapitalising the banks. Technically the government would inject the money for recapitalising the banks into BAMC and BAMC would use that money to buy newly issued shares in the banks. BAMC would then become the dominant owner of the banks and have to take responsibility for their restructuring. Whether this would have been good for the recovery of the Slovene banking system or not can be discussed, but the govern-

ment never used the option. I can understand that. Having BAMC as a major owner of the big banks on top of all other assets transferred to it, including some big corporates, would have been too much, politically if not economically.

Finally, there is a task that is not in the law, but nevertheless has become very important for the BAMC, not least publicly. This is the task of restructuring – financially and sometimes operationally – a number of big conglomerates, where the BAMC after taking over NPLs from the banks has become a major stakeholder. Reading the papers, it is clear that views of how these restructurings should be done vary widely. I was told in parliament that this is the most important task for the BAMC. But there is no explicit legal mandate for restructuring of businesses and BAMC has not been given any particular tools. BAMC has to act as any major creditor in competition – and often in conflict – with other creditors and owners. I will return to this issue later.

### 3. The BAMC start up<sup>1</sup>

#### **An intense April and May 2013**

The BAMC was established in late March 2013. The non-executive directors named three temporary executive directors and during the following weeks the new board intensively discussed plans for the build-up of the company and a strategic road map. The road map assumed that the transfer of assets and the recapitalisation of banks should be made during the autumn.

On April 8, in a meeting with the finance minister, who had just taken office, and the vice governor at the Bank of Slovenia in charge of supervision, new instructions were given. These instructions involved a very tight time schedule. By the end

of June, BAMC should be ready to recapitalize the first bank (NLB) and to start transferring nonperforming assets from that bank. In addition, BAMC was asked to give an opinion on the first corporate restructuring case, Cimos d.d. from Koper.

This was a tremendous challenge, particularly considering that the company yet had no staff except for three executive and four non-executive directors. Outside help was needed to handle a number of issues, including the legal and regulatory set up of the company. At that point, with the task to recapitalize NLB as defined in ZUKSB, BAMC would be investing large amounts of money into the bank and be responsible for its reconstruction. For a start, there was a need for considerable preparatory work on how to value the bank's equity and to form an opinion on how much capital that was needed to credibly restore its balance sheet. BAMC had no staff to do this. Furthermore, due diligence of a sample of nonperforming assets to be transferred from the NLB had to be made and the legal framework for the takeover of assets had to be set up. Consultants were engaged to work with all these issues.

BAMC also made a study of the Cimos case. No easy solution was identified. It was clear that Cimos already had been the subject of a long string of unsuccessful restructuring efforts driven by its owners and creditor banks. The Board concluded that very little could be done until BAMC had an ownership position of equity or loan exposures in Cimos from which it could lead the restructuring.

On May 16, the Inter-Ministerial Committee decided that NLB would be eligible for support by

<sup>1</sup> Sections 3 and 4 draw extensively on the BAMC annual report for 2013 and first half-year report for 2014.

the Government under the ZUKSB. BAMC engaged a transaction team of consultants, which started intensive preparations for the upcoming transactions.

On May 31, however, the Ministry of Finance informed BAMC that the scope of BAMC's work would be changed substantially: the State would carry out all the recapitalization of banks directly – rather than through BAMC. Consequently, BAMC would not be investing in banks and would not become a bank owner. The preparatory work for a BAMC ownership function was abandoned.

### **Transfer prices and DG Comp**

When BAMC started in March, assets to be transferred and transfer prices had already been proposed by the banks and discussed with the Bank of Slovenia. The price estimates were a year old, however, and when BAMC analyzed the sample of assets from the NLB that was provided, the prices were found to be far too high. Reasonable transfer prices would be approximately half of those indicated. The BAMC Board informally shared our worries with the Ministry of Finance and the Bank of Slovenia, since lower transfer prices would mean bigger holes in the balance sheet of the banks and a need for bigger recapitalizations. But BAMC continued preparations for the takeover of asset from NLB as planned.

During a visit in June, the team from DG Comp made clear that they would not allow any transactions to be executed at the initially proposed transfer prices. DG Comp was of the view that these prices were unrealistically inflated and thus would entail an inappropriate amount of state aid. DG Comp demanded that the valuation process be repeated and scheduled to be ready by the end

of July. A decision by the European Commission regarding the transfers was to be expected in September, at the earliest. The government set a new end-September deadline for the NLB transfers and BAMC started to plan accordingly.

In July, however, after having analyzed a sample of assets, DG Comp decided that further information was needed. They insisted that the transfers would have to await the outcome of an Asset Quality Review (AQR) and Stress-Testing (ST) exercise to be undertaken for the ten largest Slovenian banks, including the three banks set up for state recapitalization.

The BAMC Board was deeply concerned about the delay, as it was clear that the financial situation in the banks was deteriorating and that urgent restructuring of a number of corporates was delayed. BAMC sent a letter to DG Comp suggesting that the asset transfers should start immediately as planned and that the prices could be determined when the AQR results were known. After all, the transfers were to take place between two state owned entities, NLB and BAMC. But DG Comp did not approve this idea.

As it turned out, the transfer prices were not released from the Commission until early December. Half a year had been lost in the process and a number of deadlines set by the government had been broken. But more time had been given for discussions between the banks and BAMC and preparing for an orderly transfer during the first half of 2014.

The involvement of DG Comp certainly complicated the life of BAMC between April and December. But that was unavoidable, given the circumstances, although in my view far more bureaucratic than necessary. Another complication – in this case particular to Slovenia and cer-

tainly avoidable - was the difficulty in getting hold of data. Already in 2012 there had been a review of the asset portfolios in NLB, NKBM and Abanka performed by an international consultant, but this review was not shared with BAMC. Furthermore, the assets chosen for transfer and the suggested transfer prices existing in April were known to the supervisor, the Bank of Slovenia, but were not shared with BAMC. Neither was the valuation methodology for determining the transfer prices or later the AQR values. This reluctance to provide necessary information cost a lot of money, since BAMC had to use consultants to get hold of data from banks, asset by asset, and prepare separate valuations. Not until late in the autumn were data made available in a way that is common practice elsewhere. Access to the methodology came even later. I still find it difficult to understand that this initial reluctance to share information was in the interest of Slovenia.

### **Which assets to transfer?**

Normally the assets to be transferred from a bank to an AMC and the corresponding prices are discussed and agreed between the bank and the AMC. These discussions are not always easy, but at least the bank and the AMC will know in the end what is actually being transferred. In Slovenia, these discussions never took place. As a consequence it was in many cases unclear, which assets the transfer prices agreed with DG Comp really referred to. In a financial group, for instance, the different credits may not have been specified in detail. Hence it became possible for the bank to keep the cash generating credits and transfer the nonperforming credits to BAMC. This may seem logical – after all BAMC was created to take over the bad stuff – and it is certainly rational



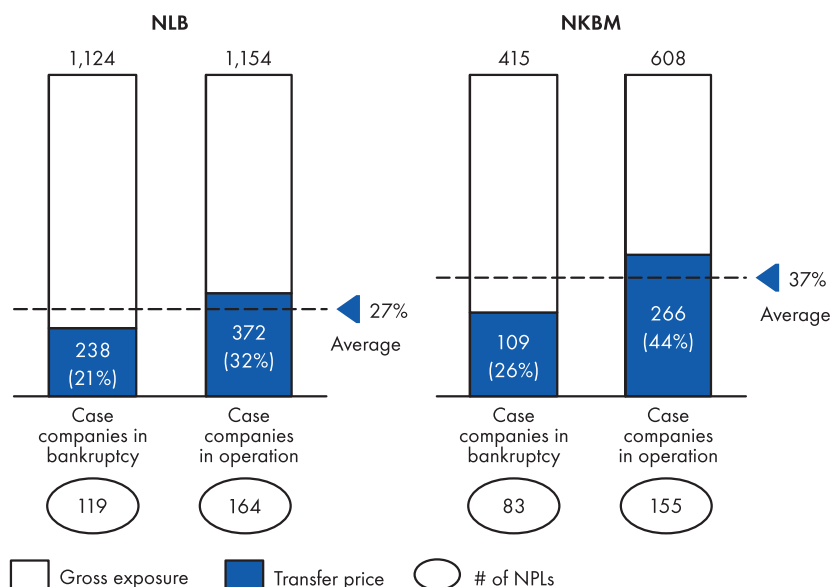
from the bank perspective. But it creates huge problems when the group is eventually to be restructured. Then the bank, that has a performing credit in a subsidiary, may take a completely different position than BAMC, which has the nonperforming credits and is responsible for restructuring the group. The state owned bank and the state owned BAMC end up at different sides of the table in the restructuring discussions, which is indeed a strange and hardly desirable outcome.

This would not have happened, of course, if discussions had taken place beforehand, as they usually have between a bank and an AMC. In Slovenia, BAMC did not even know the total exposure to a group by each bank. Only the bank and the supervisor knew, but they did not share that information.

A similar problem related to the fact that not only one bank, but three would transfer assets to BAMC. It happened that a group was considered nonperforming in one bank and transferred to BAMC, but considered to be performing and kept in another bank. Again BAMC ended up with only part the group exposure, which made the restructuring of the group difficult.

In mid-October, BAMC sought the support of Bank of Slovenia for some principles that should rule the asset transfer process in the banks. BAMC proposed that the exposures with regard to a group of companies should be transferred to BAMC in their entirety (i.e. both performing and non-performing assets) in order to ensure that effective loan restructuring is possible. Further BAMC proposed that the scope of transfers should be on equal terms for all three eligible banks (i.e., if a group exposure was considered non-performing and transferred from one bank, it should also be considered non-performing

**Figure 1: Exposure and transfer price for NPLs. BAMC annual report 2013.**



and transferred from the other two banks). The Governor of the Bank of Slovenia supported these principles and indicated that the Bank of Slovenia would enforce the banks' compliance. But in a number of cases, this turned out to be too late.

#### 4. The transfer process

##### The legal transfer

The plan, as it had been worked out together with NLB and NKBM during the autumn, was to transfer the assets successively over a 6-month period in a series of transactions grouped into tranches. It was assumed that the first transaction was to be executed before year-end and all tranches transferred before the end of June 2014.

On December 6, BAMC was informed by the Bank of Slovenia and Ministry of Finance that the strategy had changed fundamentally and that a completely different type of transaction was required to enable the state to recapitalize the two banks by year-end. The new situation required

all non-performing assets earmarked for transfer to BAMC to be legally transferred from the two banks to BAMC before Christmas vacations. Needless to say, it was completely unrealistic to expect the banks to physically transfer the documentation and the managerial control of the assets to BAMC so quickly. Neither would it be possible for BAMC to receive all the assets at once. Instead it was decided that the legal ownership of the NPLs would be transferred to BAMC before year-end but the credit files of the loans would be transferred during a transition period similar to the originally scheduled 4-month period. The banks would act as BAMC's trustee or asset manager over the physical transfer period. A period of intense discussions with the banks and the supervisor followed. Finally, on December 20, all legal documentation was in place and the transfer of assets could be completed.

Figure 1 illustrates the portfolio of assets transferred to the BAMC from NLB and NKBM respectively. The

gross value of the assets transferred (the banks' book value after impairments) was € 3.3 bn, € 2,3 bn from NLB and € 1 bn from NKBM, and the amount paid was just over € 1 bn. In percentage points BAMC paid 27 per cent of the book value for the NLB assets and 36 per cent for the NKBM assets. Most of the assets were loans, but the purchase also included € 24 mn of equity. Although a large number of the loans transferred related to companies in bankruptcy, loans to operating companies dominated the portfolio. About one third of the assets relates to the real estate and construction sector, one third to financial holding and manufacturing and one third to a mixture of various industries.

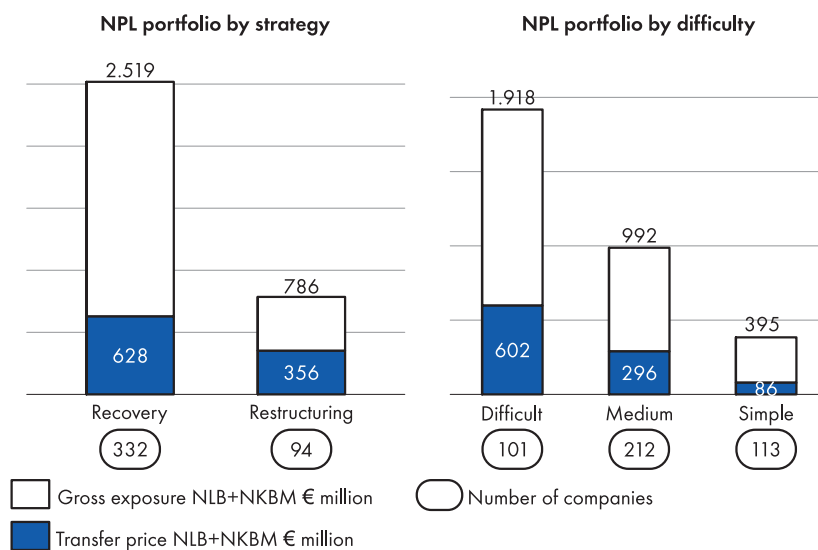
### The real transfer

At the end of January 2014, the cumbersome process of transferring the physical assets started. The process was complicated by the fact that many files were incomplete with essential information and documentation missing.

Figure 2 illustrates the split up of loans made after internal evaluations of strategy and difficulty in handling. The left part of the figure shows that there are more than 300 recovery cases but less than 100 restructuring cases. For the recovery cases the initial focus will be on liquidation. For the restructuring cases, on the other hand, focus will be on actively improving the value of the running business, e.g. by debt rescheduling, debt to equity swaps, business reorganization etc.

In the right part of the figure, difficulty is assessed in three categories, depending on factors like group structure and ownership, amount of exposure, the various positions of creditors, whether all credits have been transferred to BAMC etc. While admittedly subjective, this split according to difficulty helped

**Figure 2: The BAMC loan portfolio.**  
BAMC half-year report, August 2014.



BAMC in the allocation of time and expertise. The majority of cases were considered to be of medium difficulty (212), while the difficult and complex cases (101) were far more important in value.

All assets transferred so far come from NLB and NKBM. The asset transfer from Abanka has been delayed several times, waiting for a decision by DG Comp, and is expected to start in October. Assets from Banka Celje are also expected. Discussions with the two banks in liquidation, Probanka and Factor Banka, have taken place, but DG Comp is not involved with these banks and transfer prices had to be negotiated in the traditional way. An agreement where BAMC has bought assets from the two banks for € 39 mn has been reached in September. At the end of 2013, BAMC had a staff of 12 employees. By end-August 2014 this figure had risen to around 70. There were 22 case managers taking care of just over 400 cases. Some 20 of these cases involved particularly complex restructurings of financial groups or commercial companies in active operation. Hence BAMC has appeared regularly on

the front pages of the Slovenian newspapers.

I am overall very impressed with the people we have hired. They are bright, well-educated and hardworking, in competence equal to or above what I have seen elsewhere. I hope and trust that their work with the international experts hired by BAMC will give them some knowledge and experience that will be useful for them in the future – and useful for the Slovenian financial and corporate sectors as well.

### 5. What is "fair value"?

In January 2014 BAMC had to start writing the annual report for 2013. In the annual report, according to the IFRS, the portfolio has to be valued at "fair value". But what was "fair value" for a portfolio of nonperforming assets such as the one just taken over by BAMC?

Could the transfer prices be considered to represent "fair value"? According to ZUKSB and DG Comp, the transfer prices should be set to show "long run market prices", which could reasonably mean prices established when markets have returned

to normal conditions, whatever that is. Anyway, the transfer prices should be higher than present market prices. They could hardly be seen to represent “fair value”.

Could the recently calculated AQR-values be considered as “fair values”? Possibly, but, as with the transfer prices, BAMC had no information about the methodology used to determine them. In fact, BAMC did not even have access to the relevant AQR values for the assets transferred. Establishing a balance sheet with credible and auditable asset values for the year-end turned out to be a real challenge. There were the transfer prices, nothing else. In late March BAMC managed to get hold of a sample of AQR-values for companies transferred from the banks and could compare them with the corresponding transfer prices. On the average, they turned out to be nearly the same. But averages are dangerous. When looking at the different cases in details, some had transfer prices a lot higher than the AQR-values and some had transfer prices considerably lower than the AQR-values. There was a negative difference of more than € 90 mn and a positive difference of slightly less. It was not even obvious that the transfer prices and the AQR values referred to the same assets.

Against this background, the external auditors advised BAMC to take account of the negative differences, but not the positive, when calculating the “fair value”. An internal valuation of assets from 20 companies with a negative difference was made, which confirmed the AQR-values. Hence, in the preliminary report delivered in late April, BAMC took a loss of € 93 mn on the assets transferred, directly recognised in the balance sheet of 2013-12-31.

In spite of the cautious approach, the auditors refused to conclude the audit and issue an opinion on the

annual report, arguing that they had no way to check the methodology underlying the values of the transferred assets. And they were right, of course. The methodology was unknown to them as well as to BAMC.<sup>2</sup> By the end of June BAMC had concluded valuations of the assets in the 100 top companies making up approximately 80 per cent of the total value of transferred assets. The negative difference between the transfer values and the BAMC valuations had now shrunk from € 93 mn to € 40 mn, which was used in the BAMC final annual report for 2013. The 80 companies added to the 20 evaluated in March had been better than feared. € 30 mn of the difference was in the loan portfolio and € 10 mn in the equity portfolio. Since BAMC now had valued a significant part of the assets according to an established and robust valuation methodology (i.e. established a “fair value”), the annual report could finally be audited.

No doubt there will be further discrepancies between transfer prices and the BAMC internal valuation when the remaining 20 per cent of the BAMC assets have been evaluated. The final results will enter into the BAMC accounts and the amount will be written off against the BAMC € 200 mn of equity. It is clear, however, that BAMC bought the assets from the banks at prices that were higher than reasonably calculated “fair values”. The assertion that BAMC bought the assets from the banks at “discounted” prices is simply not correct.

## 6. BAMC financing

The nonperforming assets transferred to BAMC give a very tiny cash flow. This is as should be expected and this is the story in most AMCs. Nonperforming assets are nonperforming simply because customers do

not pay according to the contracts. Some assets may be sold quickly, but generally the process of restructuring and recovery will take a couple of years. During this period costs have to be covered.

The biggest costs relate to funding. To buy the assets from NLB and NKBM, BAMC issued bonds for around € 1 bn, half with a two-year maturity and half with a three year maturity. The first one had a coupon of 3.75 per cent paid annually and the second a coupon of 4.5 per cent.<sup>3</sup> Both were guaranteed by the state of Slovenia, a guarantee that costs 1.25 per cent per annum. Hence, for 2014, the cost of funding amounts to approximately € 54 mn for the NLB and NKBM assets.

To the costs of funding BAMC should be added the cost of operation. All in all, the cost of funding and operation should be around, say, € 200 mn, spread out over a four year period. Costs will fall towards the end of the period, when assets are sold off and bonds can be repaid.

The gap between the tiny cash flow on the income side and the cost of funding and operation was foreseen in the ZUKSB, where it is clearly stated that the costs should be paid by the banks. They should be deducted from the gross transfer prices to obtain net transfer prices, at which the transfer would take place.<sup>4</sup>

As it seems, however, the distinction between gross and net transfer prices somehow disappeared in the process. DG Comp, when asked,

<sup>2</sup> When the Commission wrote its reports on NLB (SA 33229) and NKBM (SA 35709) (both dated December 18, 2013 but published in April 2014, available on the DG Comp webpage) the amount of state aid was calculated by comparing the transfer value for each bank with the current market value. The difference for NLB was € 130 mn and for NKBM it was € 195 mn, totalling € 325 mn.

<sup>3</sup> These bonds were bought by the banks and can be discounted in the European Central Bank at a considerably lower rate, thus providing a net margin for the banks. In essence, this is a transfer from the government to the banks via BAMC.

<sup>4</sup> In practice it was supposed to be done by adjustments of the discount rate when calculating the net present values of the assets to be transferred.

“assumed” that the costs had been deducted, but no one apparently checked that this was the case. If handled correctly according to the law, the transfers could have been made at gross values and payments for operations and funding should have been made to BAMC and recognized as cost in the bank accounting. But there is no trace of that in the annual reports of the banks and no payments have been made. Alternatively, the transfers could have been made at net transfer values, clearly recognizing and documenting the difference between gross and net. But there is no documentation (at least shown to BAMC) on how costs have been deducted before fixing the actual transfer prices as required in the law. To this date, it remains unclear whether the transfer prices are gross or net, i.e. whether the estimated cost of running BAMC are subtracted or not.

Of course, if costs were not accounted for, this implies that the need to recapitalize the two banks were underestimated and should have been some € 200 mn bigger. The government would have had to put in € 2.6 bn into the banks instead of € 2.4 bn.

Now you may argue that it does not really matter, because the banks are state owned and BAMC is state owned. In fact, it says in the ZUKSB that the BAMC cost of funding and operation should be paid by the banks or by their owners – the latter being the state.

However, not taking account of the costs as stated in the law will mean red figures in BAMC for a number of years. In the economic plan, there is no credible way to compensate for some € 200 mn of costs that were not paid.

In this context one should note that BAMC can and will perform its expected role in Slovenia even if it shows losses rather than profits.

BAMC will restructure and sell the assets bought in the professional way expected and service and eventually pay off on its bonds. If losses are big, the government will have to provide additional capital, but the tasks given to BAMC will be performed.

## 7. Restructuring

BAMC is involved in the restructuring of a number of financial groups and of active companies, both within and outside such groups. Some of these companies are clearly viable in the long run, for others considerable uncertainty remains. Some of the companies may be restructured as going concerns; others may have to go through bankruptcy proceedings before continuing operations. Some require only a financial restructuring; others are not competitive in their business and also need an operational restructuring. There is no solution that will fit all – in fact they are all different.

The objective of BAMC is always to contribute to professional restructurings that will help restore the long run competitiveness of the Slovenian corporate sector. This is the best way to regain as much money as possible for the taxpayers. Of course, others may have different interests. Banks want their loans paid back, owners do not want to lose their money (although it is often in reality already gone), management wants to keep their positions etc.

When BAMC enters the scene it is usually as a creditor among other creditors. The company in trouble does not service its debt, so much is clear, otherwise BAMC would never had acquired the loans. But BAMC is not an owner and neither are the other creditors. The creditors cannot immediately change the board and kick out the management, even if this would be the desirable first step in a restructuring.

What BAMC tries to do is to take a lead in the restructuring process. There are often several banks involved, some of which have better collateral than others and judge their chances of getting their money back as reasonably good. Others may deem their loans to be of little value since they will be paid last. Getting all banks to agree on a compromise is a tough job – and often negotiations between the banks just get stuck.

If the banks manage to agree internally and also agree with the owners and the management, a restructuring plan may be signed. The banks may then prolong their credits and accept reduced interest payment or in other ways help the company to survive financially over a period. Some debt may be changed to equity in a debt-equity swap to restore the balance sheet. Then the banks – and BAMC – will enter as owners, at least to a part of the company.

If BAMC, alone or together with other banks, becomes a major owner, the board of directors and the management can be changed, and most often this is what happens. If in that context there are suspicions of fraud, this will be reported to the police. If there are signs of corruption, this will be reported to the CPC. But the responsibility of BAMC stops here. It is the task of the legal authorities to investigate possible corruption and economic fraud – naturally with full support from BAMC.

It is yet too early to comment in detail on most of the restructuring cases. Cimos will be the only exception. Cimos is mainly a producer of high quality car parts, selling to customers like Ford, BMW and Honeywell. Every third car running on the European highways has parts made by Cimos. The company employs some 7000 people and has important subsidiaries in Croatia, Bosnia and Serbia. Around 3000 suppliers

provide material and parts used in the production. The company has been financially restructured several times during the last decade and the government has provided considerable financial support.

When, in the winter of 2014, BAMC took over the NPLs to Cimos from NLB and NKBM, another reconstruction plan was already discussed.

Three things were clear: Firstly, the company needed a substantial operational restructuring to become viable, not only a financial one. Secondly, the financial reconstruction needed was so extensive that not only the banks, but also the customers and the suppliers had to participate. And thirdly, the big customers in particular, but also the main suppliers were willing to do so.

As BAMC became the main creditor, it could take the lead in the reconstruction work. Some 20 banks formed a consortium (NLB and NKBM were still there, in spite of having transferred NPLs to BAMC). A number of foreign banks and banks serving the foreign subsidiaries of Cimos also became involved. Needless to say, running a reconstruction case of this size is very complicated. All stakeholders – the owners, the creditors, the customers and the suppliers may agree on that a reconstruction is necessary. But they disagree on who should pay for it. In the Cimos case the owners, dominated by a state owned insurance company and an Italian bank, fought to keep in control. Considering that the external auditors found that the value of their equity was zero, they had a bad bargaining position. Eventually the banks had to put Cimos into compulsory settlement, which eliminated the owners. When this is written, the work with the reconstruction plan and agreement is still going on. Two experienced German car specialists have been added to the board as non-

executive directors. Negotiations with the customers and the suppliers are proceeding. Even though the outcome is still uncertain, the process is a lot more credible than in any previous reconstruction process. If all efforts succeed, Cimos should again become a major competitive export company in Slovenia.

## 8. Concluding reflections

Let me end by some reflections concerning the development so far. They are, to say it again, my own reflections, and all my colleagues in the BAMC board may not necessarily agree. As I see it, Slovenia is in a better position for recovery than many other European countries. There is a strong industrial tradition and unit labour costs have not risen as much as in a number of other countries competing with Slovenia on the export markets. There is good potential for growth when demand in Europe increases. Furthermore, important problems in the financial sector have been addressed. There is much more to do, of course, in the financial sector and elsewhere, and there are political obstacles to necessary reforms. But the process has started in the right direction.

- BAMC has helped Slovenia to address the nonperforming assets in the major banks in a structured way, in this manner setting an example for many other European countries, which still have considerable problems to face in the banking sector. Furthermore, BAMC has made it possible to handle the process on arm's length from the political system, which is important – in Slovenia as well as in other countries. The bad experience from the SRD can and should be avoided.
- The successful legal transfer of assets was necessary for the Slovenian government to recapitalize NLB and NKBM before yearend 2013. And the successful asset transfer and recapitalization helped increase confidence and substantially lower the interest rates paid by Slovenia on the international bond market. If the asset transfer had failed, things would have looked very differently.

- The road towards the successful asset transfer was extraordinary bumpy. Several changes in direction, some initiated politically, some due to actions by DG Comp, required considerable flexibility in the set up and work of BAMC – the last major change coming as late as December 6, 2013. This is now history, but last autumn should be remembered as a period of great confusion and uncertainty.
- The reluctance by the banks and authorities to provide adequate and timely information and the difficulties in getting access to pricing methodology was unfortunate, unnecessary and costly.
- The story around the transfer prices is a mess. In the process of setting the prices, the distinction between gross and net transfer prices should have been made clear. The banks and the Bank of Slovenia should have agreed in advance on how to handle the BAMC financial and operative costs in accordance with ZUKSB.
- Given the circumstances and the involvement of state aid, DG Comp had an important role to play in the process. This is not to question. But the cost to Slovenia of delaying a number of important restructuring cases for half a year was substantial. Doing some transfers and starting the restructuring in June (and setting the transfer prices later) would have saved time and money.
- The selection of assets to be trans-



ferred should have observed the need to facilitate reconstruction of a number of important financial groups and companies in operation. All assets in such groups and companies should have been sold to BAMC, whether performing or nonperforming. Situations where state owned banks have incentives to block restructurings that are in the interest of Slovenia are embarrassing, particularly in a situation when the need to restore corporate balance sheets are pressing.

- The balance sheet of BAMC could have been better handled in ZUKSB. Sufficient risk capital in the form of equity is important for an AMC. Furthermore, the government expectations for return on equity must be adjusted according to the economic and financial conditions given the company, e.g. the cost of finance and the transfer prices.
- An AMC can be successful in its restructuring work and in paying back its bonds and still make losses. But it will be much more

difficult to explain to the public and also to potential external investors.

- BAMC will obey the law and sell 10 per cent of the acquired assets during 2014. This may however hardly be done without “forced sales” and unnecessary losses. An AMC should keep the assets until they are restructured and the market has returned to normal.
- The banks still seem to have a considerable amount of NPLs left in their balance sheets. This is not strictly an issue for BAMC, but it is important for the banks’ ability to help getting the economy moving by giving new loans to commercial companies and it is important for the international credibility of Slovenia. To “Strengthen Bank Stability”, as is the purpose of ZUKSB, the remaining NPLs have to be addressed. Creating BAMC is just not enough.
- It seems to me that a major problem with the state owned Slovenian banks is their strong

political governance, which has penetrated far down in the organisations. So far I have seen no serious attempt to address this issue. Why not create an Accreditation Committee with international participation to assure that the Board of Directors have sufficient competence, integrity and independence? This would substantially increase credibility – both domestically and abroad. All change must start at the top!

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# Monetary policy paradoxes and banking crisis

*Emil Lah\**

Six years after the collapse of the Wall Street institution Lehman Brothers on 15 September, the European banking has still not fully recovered from the blow and the deep financial crisis that followed. This is particularly true of the peripheral euro area banks that lost access to short- and longer-term wholesale funding practically overnight, forcing them to shrink their balance sheets.

## Introduction

As opposed to the 2004 – 2008 credit cycle in the eurozone when lending grew faster than real GDP, with the exception of 2012, credit growth was negative between 2009 and 2013 and the euro area economy was again in recession in 2012 and 2013. True as it is that the burden of non-performing loans weighed the most on the banks in PIIGS – the troubled and heavily-indebted countries of Europe: Portugal, Ireland, Italy, Greece and Spain, as well in Cyprus and Slovenia, bank profitability plunged in the post-crisis period also in the credit institutions of the most developed countries in the eurozone. It is also clear that also the most developed eurozone countries (such as France, the U.K. or the Netherlands) are struggling to keep public finance in line with the EU-imposed ceilings and it does

not come as a surprise that also Greece and other most vulnerable countries find it difficult to comply. Over the period 2007-2013, the public debt across the euro area soared from 66% of GDP in 2008 to 92% in 2014. What comes to mind is that the Stability and Growth Pact was first breached (even before the worldwide crisis) by France and Germany, and the list of the euro area countries disregarding the constraints is getting longer with Slovenia being no exception. Another point worth noting is that the rising public debts and yawning budget deficits are largely attributable to the bank resolution models serving to bail out the distressed banks with public subsidies by making taxpayers pick up the bill. As an illustration: potentially more than 33% of the current Irish public debt that currently stands at approximately 120% of GDP is a consequence of the run to rescue of the Irish credit institutions. In order to prevent a full-scope collapse of the banking system, the European governments wrapped up rescue packages for their credit institutions only during the period from 2008 to 2011 worth approximately 1.5 trillion euros or 13% of the annual GDP of the European Union. By the end of 2013, the debt was already repaid in some EU countries showing that not all governments subsidised inef-

ficient and unscrupulous behaviour. If we take Greece as an example – by the end of 2013, the government handed out roughly 24% of GDP for bank recapitalisation, Slovenia and Cyprus allocated approximately 12% of GDP respectively, Portugal paid some 7% of GDP to shore up the stability of its banking sector, and Spain's bill was "only" 4.6% of GDP. However, saying that the only culprits for this world-wide financial and economic crisis are the financial sector and its greedy actors would be one-sided. The uncontrolled inflating the mortgage, stock exchange and debt bubbles was destined to burst sooner rather than later causing the financial crisis but it all went on for quite some time before the eyes of the (ir)responsible governments, corporate managers and speculative trading activities by private investors lavishly supported by credit offer in many countries.

The financial crisis unfolded in the U.S. market for sub-prime mortgage bonds and dealt a heavy blow to the liquidity of the U.S. banks. The ripple effects have been massive and the U.S. central bank (Fed) is still smoothing these effects out with the quantitative easing programme of buying bonds. The latest analyses confirm that the Fed and the U.S. government involvement in the market has been much more effective

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than the response by the European Central Bank (ECB) and the European Commission to the 2008 economic meltdown in the euro area. The European banks in general and in the PIIGS countries, Cyprus and in Slovenia in particular continue to struggle under the heavy burden of toxic assets and non-performing loans. Moreover, the funding crisis of the banking sector has affected lending to the real economy and the consequences of the bank credit crunch have been devastating for many small and medium-sized enterprises. Since initial liquidity shocks feed through the financial system, the advanced euro area countries have rescued their “too big to fail” banks with generous State aid packages and substantial capital injections, raising concerns about systemic risks and moral hazard. To relieve banks’ balance sheets from risks, governments in some country have implemented the bailout approach where banks that fail are resolved through some form of governmental, taxpayer-backed initiative, as opposed to the bail-in model the European Commission has imposed on Cyprus, Spain and Slovenia. The failed banks of the first two countries are still being propped up, whereas Slovenia’s banking sector has managed without a rescue deal.

### **1. Why are U.S. banks doing better than their European counterparts in the aftermath of the crisis**

A tell-tale sign for the performance of the U.S. and European banks before the financial crisis broke put was that the U.S. banks enjoyed record-high profits until the watershed events in 2008. In general, the U.S. banks have been much more profitable over the past two years than their European counterparts as illustrated by data on income, lending and

provisions<sup>1</sup>. Between 2011 and 2013, the six largest U.S. banks not only enjoyed stable earnings but at end-2103, their combined profit was at the highest level since 2006. On the other hand, European banks had lacklustre earnings. While the U.S. banks were making more loans to corporates, the European banks were particularly reluctant to lend to small firms even though they are seen as the lifeblood of Europe’s economy. Consequently, provisions for impaired assets as share of total assets of the U.S. banks were falling in contrast to the developments in the European banks. However, according to the ECB, there are encouraging signs as lending standards have eased for all corporate borrowers, including small firms, for the first time since 2007.

*U.S. banks have been much more profitable over the past two years.*

According to Bloomberg, the write downs made by the U.S. financial institutions during the financial crisis between 2007 and 2010, added up to 1.1 trillion US dollars, as opposed to approximately 0.5 trillion US dollars in Europe. The market value of bank shares has plunged in the post-crisis period in Europe mostly attributable to low profitability of the European banks. After-tax income of 22 largest European banks was decreasing between 2011 and 2013 largely due to double-dip recession affecting the European countries such as Greece, Italy, Slovenia and

a couple more. Besides, return on equity (after tax) was constantly rising between 2011 and 2013 in the U.S. banks as opposed to the European credit institutions posting ROE in 2011 close to zero. In 2013, the U.S. banks posted over 10% in return on equity after tax and the European banks managed ROE in the 6% bracket. However, we should bear in mind that commercial banks are far less important in the U.S. financial sector that it is the case in the European Union and that the development of the so-called shadow banking in the U.S. was particularly fast over the past decades. As an illustration: the combined assets of the European banking sector in 2012 totalled approximately 350% of GDP or 45 trillion euros, whereas the combined assets of the U.S. banking sector arrived only to approximately 90% of the U.S. GDP. Corporations in the U.S. go far more often than their European counterparts to debt markets to obtain capital by issuing corporate bonds and other securities. According to the analysis made by Deutsche Bank, the U.S. banks qualified for a clean bill of health rather quickly also thanks to higher economic growth from 2011 to 2013: it was in the range of 2% to 3% on average and the unemployment rate in the U.S. was much lower than in Europe<sup>2</sup>. As a consequence of the double-dip recession lending to the private sector in 2012 and in 2013 was shrinking in Europe, just the opposite of more than 5% growth

<sup>1</sup> For more information see Deutsche Bank, DB Research, Bank performance in the USA and Europe, September 26, 2013.

<sup>2</sup> Fed chair Janet Yellen warned that there was “a possibility that severe recession caused persistent changes in the labour market’s functioning ... along with cyclical influences, significant structural factors have affected the labour market, including the ageing of the workforce and other demographic trends, possible changes in the underlying degree of dynamism in the labour market, and the phenomenon of ‘polarization’ – that is, the reduction in the relative number of middle-skill jobs”. For more information see The Guardian, Janet Yellen cautious and speech on ‘damaged’ US economy, Friday, 22 August 2014.

in the U.S. in 2013. The opinions as to the cause for the credit crunch in Europe being attributable to lower credit offering by the European banks or to weak demand for credit, are still opposing. According to the analyses and estimates made by the ECB, dwindling lending experienced in 2012 and 2013 is largely a consequence of weak demand for loans and only partly a reaction to tighter credit standards followed by credit institutions. For lending to get an impetus, there is also the issue of the real property market in the EU Member States. If we take France, Sweden or the United Kingdom as an example, real property prices are still too high in those countries and it may be an adverse factor if household lending is to grow.

A comparison between balance sheets of the U.S. banks and the largest European banks is rather enlightening and even more so against the background of corporate lending and the volume of loans that have turned sour.

What could be observed between 2011 and 2013 is that the volume of non-performing loans in the U.S. banks declined, where it moved in the opposite direction in Greek, Italian, Portuguese, Spanish and Irish banks. The largest Slovenian banks are state-owned and, for one reason or another, managed to pile up more than a 20% share of NPLs of at the end of 2013 before unloading their NPL portfolio to the BAMC, Slovenia's "bad bank". In addition, deleveraging has been more painful for the European banks than for their U.S. counterparts also due to stricter capital and liquidity requirements imposed by Basel III. The advantages of the U.S. banks include a higher Tier 1 ratio than in most European banks with less prime equity capital and burdened by a higher capital leverage<sup>3</sup>. Even though the new capital ratio Core Tier 1 in the European

banks is higher than in the U.S. credit institutions, it was in the 12% bracket in 2013, the European banks have been struggling to raise their capital buffers. The debt crisis across the euro area has dealt heavy blows to many European banks – moaning in 2011 and 2012 under the heavy burden of financing, Greek sovereign debt crisis and losses piled on Greek government bonds and recession.

## 2. How to overcome the credit crunch

The European Central Bank and national regulators have been busy trying to work out the answer to the key question of overcoming the credit crunch and giving impetus to the euro area economic growth. The current trends in the European banking sector indicate that we have still not identified the right solution. The truth is that European banks have been reducing the volume of their operations and applying a handbrake on lending dynamics since «capital is the king» and that is the only way for banks to maintain high capital adequacy. In the most vulnerable CESEE countries, including Slovenia, banks have been forced due to business restructuring to pull out of less important lines of business and scale down their international operations. When it comes to economic growth, the forecasts are more optimistic for the U.S. than for the European economy both due to demographic trends and other reasons. Given poor quality of banks' assets and overleveraged enterprises, banks and state-owned enterprises primarily in the EU peripheral countries will be forced to sell assets at fire-sale prices, far below their book value. When the going got rough, the central bank in the U.S. and the European Central Bank rose to the occasion and developed the models expected to mitigate liquidity and

other problems of commercial banks. The Federal Reserve is generally seen as being efficient by putting in place the quantitative easing programme designed to assist the country's economy in getting back on track relatively fast. In comparison with the ECB, the Fed's intervention on the financial markets has been more aggressive and direct resulting in reducing price volatility. In comparison with the summer 2007, its balance sheet increased four times, whereas the total assets of the ECB was only twice the size it had before the financial crisis. It is a logical consequence of the liquidity support the Fed provided to the U.S. banks following the collapse of Lehman Brothers when banks could tap into approximately 1.6 trillion short-term liquidity loans. The Fed also used approximately 400 billion dollars for the purchases of Asset Backed Securities or covered bonds (ABS), and it poured approximately 1.3 trillion dollars into the mortgage markets for the purchases of mortgage-backed securities (MBS). It appears that the Fed used also approximately 300 billion dollars to purchase Treasury bonds. On the other hand, the ECB acted in line with conventional policies and "rode to the rescue" of banks by lowering the key interest rate that gradually slipped from 4.25% in August 2008 to 0.05% in September this year, by purchasing bonds and by putting in place LTRO. The ECB purchased in the post-crisis period slightly less than 500 billion euros in the euro area bonds and covered bonds. In addition, the ECB approved to banks in the euro area liquidity facilities known as longer-term refinancing operations (LTRO) and targeted longer-term refinancing operations (TLTRO) with the maturity of one and three years in the amount of approximately one trillion euros

<sup>3</sup> Ibid. p. 12.

with maturity in December this year and in February next year. We should note, however, that the ECB' room for manoeuvre to take monetary policy measures to enhance the functioning of the monetary policy transmission mechanism is not as big as the Fed's given the focus on the sole objective of 2% inflation over a medium term. The macroeconomic situation, faster deleveraging of the U.S. corporations, higher capital strength of banks in the U.S., more trust of the financial markets in the U.S. dollar and the U.S. economic policy have contributed to making the Fed's rather easy-going monetary policy more effective. True as it may be that the ECB subscribes to a rather conservative policy, it has been often criticised for its allegedly low (!) conservatism by one of the most powerful countries of the eurozone such as Germany<sup>4</sup>. It has been only lately that the critical voices have become less loud with the weakening of the economy. At this point the question to ask is whether the ECB and the Fed were sufficiently effective in the post-crisis period in effort to give a boost to a faster recovery of the euro area and of the U.S. economy and whether they will be effective also in the future. The voices criticising the monetary policies of the central banks on both sides of the Atlantic argue that there is a risk of secular stagnation when advanced economies are trapped in the persistent state of economic depression in which monetary policy becomes ineffective as there is a lower bound on nominal returns – the real interest rate becomes negative. This apparent paradox of the ECB monetary policy is shown in the latest developments where despite cutting the key interest rate, a surge in money offered and the generous (special) LTRO intervention and buying government bonds (these combined measures have more

than doubled the ECB's balance sheet), there has been a double-dip recession and a credit crunch in the European banks. It is obvious that the transmission mechanism on the ECB's monetary policy is not fully functional, since credit flows to the real economy has been reduced to a trickle in many countries of the euro area. It shows that the ECB accepts risks of important banks, whereas the banks remain reluctant to share risks with their corporate customers despite the ECB's liquidity support. The ECB took another unconventional measure in June this year when it introduced a negative deposit facility interest rate to apply also to average reserve holdings in excess of the minimum reserve requirements and other deposits held with the Euro-system designed to motivate banks

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*GDP of  
Germany is now  
by some 13%  
higher than  
before the crisis.*

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for more courageous lending to the real sector. The ECB was guided by the same motive when in July 2012 it slashed the deposit interest rate to zero per cent. So far, the ECB's endeavours in the first half of this year have not been fruitful since banks preferred to use fresh money to purchase sovereign bonds or insisted on placing deposits at the ECB rather than to increase their corporate lending operations. The next question to be asked is why the European banks are so reluctant to extend credit to corporate customers? As seen from the analyses, as far as the

credit institutions in the EU peripheral countries are concerned, it is mostly attributable to the whopping amount of non-performing loans in their balance sheets, lending seen as too risky given the fact that potential borrowers are already overindebted, the EBA's ever-increasing capital requirements, and, last but not least, low demand for bank credit by corporates. In other words, in light of the requirement forcing credit institutions to beef up their capital and improve capital adequacy, they are putting in place funding plans poised to affect the supply of credit to the real economy. At the European level it means a 20% decrease in their exposure to corporate customers.

### 3. Lessons for the Slovenian banks

Since the annual inflation rate in August 2014 was as low as 0.3%, which is considerably below the medium-term inflation target of 2%, a threat of deflation or even a stagflation is looming over the euro area. The ECB is faced with the fact that the recovery of the euro area economy has been frail and uncertain with Italy falling into triple-dip recession. Being constrained to follow blindly the policy dictated by Germany and advocated by the European Commission that leaves no choice to the PIIGS countries but to cut public spending, carry out full-scope fiscal consolidation and axe investments by the state, the EU peripheral countries have suffered yet another fall in economic growth and yet another round of recession in Greece and other

<sup>4</sup> According to the governor of the German Bundesbank President Jens Weidmann, a large-scale buying of private-sector bonds issued by the euro area countries means that such measures focus on the symptoms and don't cure the causes of the crisis in the euro area. For more information see the interview in Spiegel with the German Central Bank Head Weidmann: 'The Euro Crisis Is Not Yet Behind Us', 24 September 2014.



countries of the euro area<sup>5</sup>. Obviously, the EU peripheral countries have fallen in a vicious circle of low or even negative economic growth, falling credit growth and dwindling investments. In the second half of this year, the year-on-year growth in lending by credit institutions to the private sector has been negative in Cyprus, Greece, Ireland, Latvia, Malta, the Netherlands, Portugal, and Slovenia and in Spain. As stated by the authors Carmelina Carluzzo and Milen Kassabov (Unicredit Group) in their article for *Bančni Vestnik*, also in the CEE countries credit growth before the year 2009 was approximately 30%, during the period 2010-2013, it was still 12.4% p.a. Also in Slovenia credit growth during the period 2005-2008 was around 26% p.a.<sup>6</sup>, between 2010 and 2013, credit growth was negative, approximately -5.2% p.a. What draws attention is that among the CEE countries, credit growth during those years was negative only in Hungary (-3.6%). Against the backdrop of protracted recession, weaker credit demand, swelling non-performing loans and stricter credit standards, credit institutions operating in the CEE countries were forced to set aside higher provisions. Between 2008 and 2013, provisions jumped in the Slovenian banks and specifically by 73%, in the Croatian banks they went up by 40%, and in the Bulgarian banks this rise was 27%. In line with other credit institutions that operate in the euro area, Slovenian bankers are trying to get to the bottom of the developments that have brought to the financial crisis and to learn a lesson. We are all coming to terms with the fact that credit flows towards unproductive investment projects<sup>7</sup> sooner rather than later end up in a tight corner and falls short of the objective to support long-term economic performance. The quality of credit matters as much as their quantity and this

fact matters most when it comes to banks in less developed economies where the domestic capital market is shallow. The analysis of the macro-economic trends that characterised the period preceding the financial crisis confirms that the Slovenian bank regulator paid too little attention to the consequences of the credit boom reflected, among other things, on the current account deficit in the years 2004 to 2010 and the country's swelling external debt (it is worth noting that there was no net external debt in 2004 in comparison with the period from 2004 to 2012 when it increased to just over 40% of GDP). According to the available data, credit growth during the period 2005-2008 in the Slovenian real

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*Cyclical  
unemployment  
is becoming  
structural  
unemployment.*

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sector was approximately 25%, and in 2008 it jumped to as much as 35%. The bankers and the national regulator were aware of the fact that the credit boom was at its highest level in the construction sector and in the real property market. There is no official statistics for privatisation financing, since it has been treated as a taboo topic, but the leaked figures reveal that before and after the crisis banks allocated to financing management buyouts approximately 2.3 billion euros<sup>8</sup>. It should be noted that certain portions of the sales proceeds were allocated also to the state-owned KAD and SOD as the significant owners of

numerous corporations. There is little doubt that those were political projects, since the management buyouts turned sour were carried out without equity capital and with very low, symbolic contributions of future owners. The burned of risk was practically on banks that generously funded these shopping sprees and now also on the taxpayers.

#### 4. Exit strategy of the Slovenian banks

The Slovenian state-owned banks and the Republic of Slovenia as their majority owner have embarked on resolution programmes in the post crisis period and it is still work-in-progress. They have been more or less forced to do it when access to cross-border funding, investors demanded high yield on ten-year government bonds<sup>9</sup> and there was a protracted recession. It was revealed that during the period preceding the

<sup>5</sup> The analysis made by the IMF experts has shown that in the economically advanced countries fast fiscal consolidation causes lower economic growth. If it applies to the most advanced economies, it applies to an even higher extent to the less developed countries as best seen in the case of Greece. For more information see the IMF Working Paper, Growth Forecast Errors and Fiscal Multipliers, January 2013.

<sup>6</sup> Credits to the non-bank sector in Slovenia soared by nearly 40% in 2007, not out of line with the developments from 2003 to 2008 when domestic credit growth was record-high also in certain advanced countries, such as Denmark (over 50%), Great Britain (approximately 50%) or the Netherlands (more than 45%).

<sup>7</sup> For more information see the speech by Benoît Cœuré, Member of the Executive Board of the ECB, at IMF/Banka Slovenije high-level seminar on "Reinvigorating Credit Growth and Central, Eastern and Southern European Economies", Portorož, 26 September 2014.

<sup>8</sup> The crucial problem of the largest Slovenian corporations is low profitability, excessive financial leverage and an overwhelming impact of the state or politics on governance of those corporations. For the Slovenian privatisation model based on management buyouts where the bill is footed by bank loans only, it is more than obvious that it was in economic terms a complete failure and that those investment were all but productive.

<sup>9</sup> In March 2013, the ten-year Slovenian government bond was priced at a yield of 5%, in the wake of the Cyprus bank crisis it was above the psychological limit of 7% for a shorter period of time, after the measures for enhancing bank stability were taken at the end of 2013, the price of the bond started to slide down and stood at 2.68% on 7 September – the record-low level since entering the eurozone.

crisis, the Slovenian state-controlled banks were exposed also to high liquidity risk – funding tapped abroad accounted for approximately 30% of total bank liabilities. Therefore, in the years following the financial crisis and the general economic meltdown, these banks took steps to strengthen their balance sheets by getting rid of debt paying back to foreign creditor from 2008 until 2013 approximately 10 billion euros, bringing down their outstanding borrowings to only some 4.7 billion euros at mid-year 2014 or approximately 12% of their total liabilities. Although the Republic of Slovenia recapitalised the biggest state-owned banks in December last year by injecting approximately 4.6 billion euros serving to improve significantly the capital adequacy ratios of those banks, efforts to restore trust to the extent that credit can again flow to the real economy are still fruitless for all the reasons already examined in this paper. The volume of banks' operations continues to shrink. The share of bank's combined assets was roughly 146% of GDP in 2009 (the combined assets of all banks operating in Slovenia totalled 52 billion euros) and in comparison with the share of banks' combined assets accounting for 110% of GDP this summer, it is a significant fall (the combined assets of all banks operating in Slovenia totalled 39 billion euros). Client over indebtedness remains a "bridge too far" for the banks: their financial leverage is way too high, which means that the debt-to-equity ratio has reached the unsustainable level<sup>10</sup>. True as it is that there has been a step in the right direction when the ratio between net corporate debt and GDP decreased from 90% in 2008 to approximately 80% in 2013, there is still one third of corporations saddled with unsustainable debt as seen in the ratio between net debt and cash flow from operations (EBITDA) looming high

and clearly indicating that banks' corporate customers are unable to deleverage any time soon. The author Daria Zakharova argues in her paper for this issue of *Bančni Vestnik* that the ratio between net debt and equity capital is lower in exporting companies owing to the fact that their earnings are higher in comparison with their interest expense. Banks are weary that approximately half of corporate clients are struggling to repay outstanding debts, they have no money to increase productivity, exports and make new investments. This means that over indebted corporate customers will have to carry out financial, business and ownership restructuring and get access to fresh shareholder capital. It is a tall order made more complicated to resolve only by arcane insolvency legislation, but also due to the fact that whether we want foreign capital or not is not an easy question to answer and there is shortage of domestic capital as we all know.

Slovenia's economic policy is no exception when it comes to fighting the crisis. Just like in other countries in the euro area, the Slovenian government(s) undertook sorting out public finances the easy way: by raising taxes and drastic cutting of investments. Although Slovenia's GDP shrunk by approximately 7% in the aftermath of the financial crisis, in the double-dip recession the cuts made into public spending and private consumption did not keep abreast with slashes made to the investment budget. On the other hand, the banks operating in Slovenia will have to come to terms with consolidation of the banking sector<sup>11</sup> and unavoidable privatisation.

### Conclusion remarks

Six years since the fall of Lehman Brothers signifying the financial crisis it is mostly the credit institutions and

the economies in the euro area that still feel the after-effects. The U.S. economy has managed to wade through the general glut with relative ease, while the BRIC countries, some Scandinavian countries, Germany, Austria and a few other advanced countries have escaped barely scathed by the crisis. The macroeconomic indicators paint a bright picture of Germany where GDP is now by some 13% higher than before the crisis as opposed to GDP of Spain and Italy shrinking by approximately 6% and 1.5%, respectively. If we compare the euro area economy with the U.S. economy, we see that the U.S. GDP is approximately 7% above the pre-crisis level and GDP in the euro area has not achieved the pre-crisis level. Some high-calibre European macroeconomic experts estimate that for GDP per capita (at constant prices) to achieve the pre-crisis level across the eurozone and United Kingdom, it will take no less than two years, in Spain and Ireland it can be expected in four years, in Portugal and Italy ten years or more will be necessary. Nevertheless, some German economists including reputable Hans Werner Sinn argue that despite high the unemployment rate of 27% in Greece, 24% in Spain and in other vulnerable countries, the key problem of those countries is a low level of competitiveness of

<sup>10</sup> According to the available data, the number of overindebted companies in Slovenia is in the range of 15,000 as revealed by their net debt being four times higher than their net cash flow (EBITDA). Some Slovenian economists argue that other national economies in the EU are equally indebted and that the debt to EBITDA ratio for the entire economy of, for example, Sweden and Denmark exceeds indebtedness in Slovenia, while Finnish leverage is at the same level with Slovenia's.

<sup>11</sup> The European Commission expects the consolidation of the Slovenian banking sector and mergers of medium-sized banks. However, the question to ask is whether these steps will improve banks' performance. As the bar for capital requirements is raised, banking supervision expense goes up and EU banks will have to pay into standing funds that would be tapped to protect depositors when lenders fail, income risk looms high on the Slovenian banks. If the banks fail to achieve organic growth and generate sufficient profit, economies of scale won't help much either.

their corporations, believe that real depreciation (cutting back prices and salaries) and continuing extensive structural reforms are necessary. Also the president of the ECB Mario Draghi and the highest-ranking representatives of the European Commission say that for the peripheral countries it is absolutely necessary to undertake deep structural reforms, reduce the number of employees working in the public sector and lower salaries and pension benefits across the board. The fact remains that the countries of the euro area are at different development levels and have different economic structures in place. The cliché structural reforms, liberalisation, privatisation and economic policy of consistent market fundamentalism are not advised as universal solutions to the crucial economic and development problems of all countries. If we take Slovenia as an example, already some two thirds of employees have salaries that are below the average Slovenian salary, approximately 90% of the retired people are on the brink of poverty. Cyclical unemployment in Slovenia and in other peripheral countries is becoming structural unemployment with all negative social, psychological and development consequences. Put differently, the peripheral countries in the European Union, their commercial banks and corporate customers have been experiencing business problems due to the double-dip recession and, in addition, their economies lag behind the euro area average performance. For the state-owned banks in those countries it is painful that because of privatisation they put at stake their financial and

functional autonomy, international markets and development vision. These "stock-taking" thoughts about the financial crisis and banks have completed the round and we are back at the starting position: the bankruptcy of one of the U.S. largest investment banks Lehman Brothers with more than 600 billion US dollars in assets. The rule »too big to fail« has lost its sacrosanct meaning since then in the financial sector and it will be ever more true also for the European banks. The bailout model for bank rescue is becoming ever more difficult to implement due to the size of credit institutions and the bail-in bank rescue model is here to stay<sup>12</sup>. To reverse the economic meltdown without credit growth will not get us far and the time for overcoming the credit and capital crunch is running out both across the euro area and in the most vulnerable countries. We are careful what we wish for, and falling down into a deflationary scenario with sluggish or even negative growth of the economy is nobody's wish. Against the backdrop of recession hitting the economy of the euro area in 2012 and 2013, GDP growth is expected to be below one per cent with flat economic growth in France and even Germany in the second quarter of 2014 and all eyes are turned to the ECB as the lender of last resort ready to ride to the rescue should the German economy grind to a halt. Since "in the long run we are all dead" as John Maynard Keynes put it, the ECB will have to take timely measures and do it right. When and how it will take place, if necessary at all, remains to be seen. For the

Slovenian banks and, above all, for those owned by the state, as well as for credit institutions in other EU peripheral countries, it is true beyond reasonable doubt that they cannot afford «waiting for Godot» policy, but they have to carry on balance-sheet clean-ups and focus attention on putting in place new business models.

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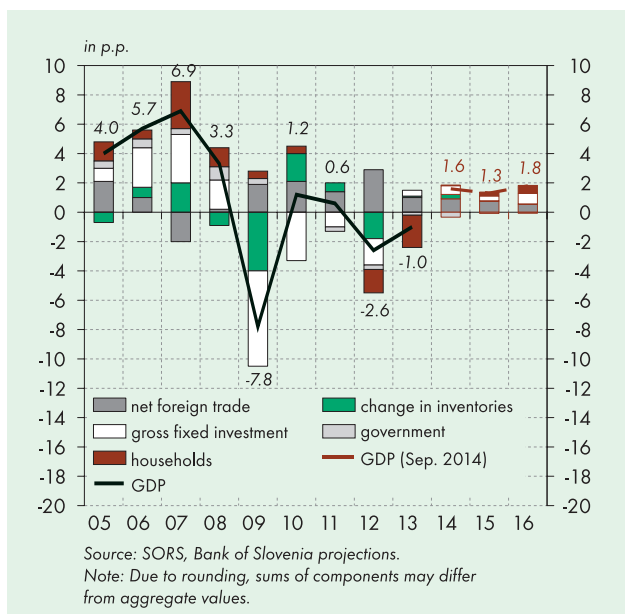
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<sup>12</sup> Since just below two thirds of the Slovenian banks by total assets is still state-controlled, risks associated with the bailout model for bank resolution and socialisation of potential new bank losses is still too high in Slovenia. This is the argument that makes the opposing voices of the Slovenian authorities against bank privatisation problematic.

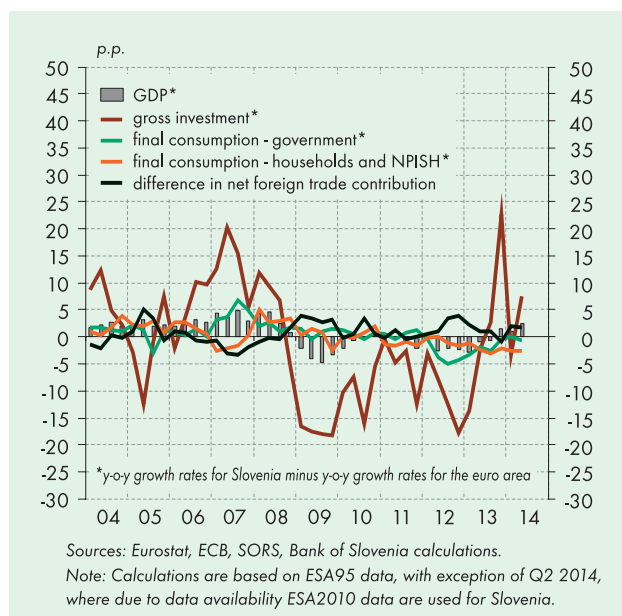
## SELECTED MACROECONOMIC INDICATORS

Luka Žakelj\*

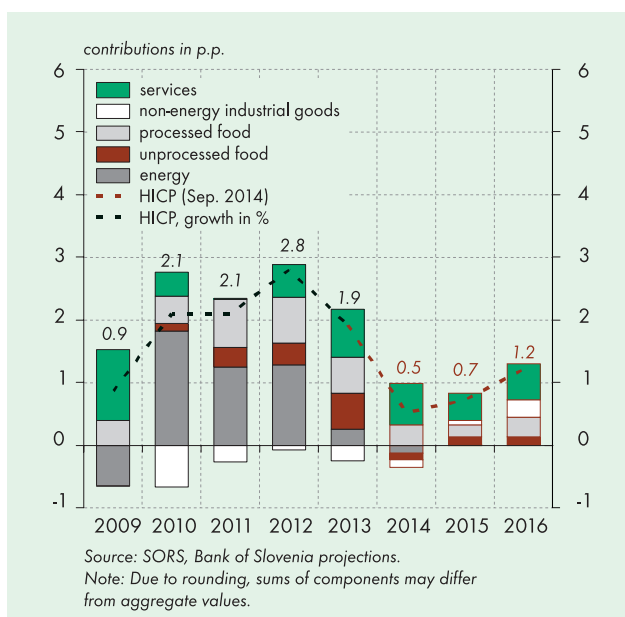
**Figure 1: Slovenia - projection of expenditure contributions to GDP growth rate**



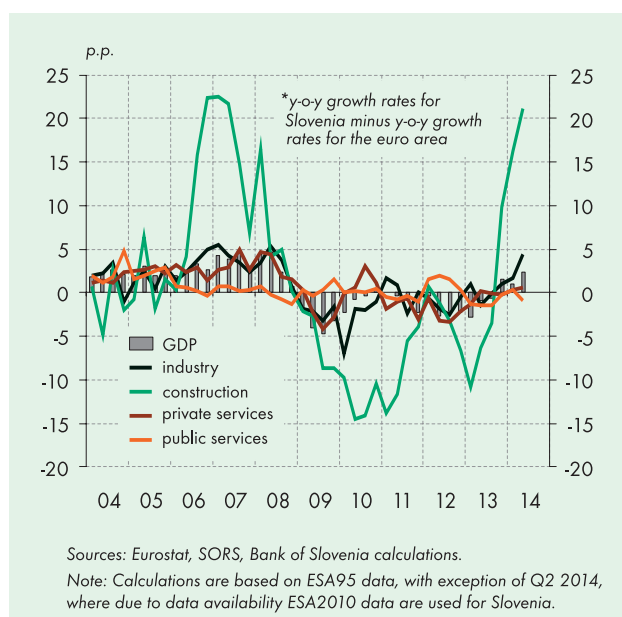
**Figure 3: Differences in y-o-y growth rates of GDP components between Slovenia and the euro area - expenditure side**



**Figure 2: Slovenia - projection of contributions to inflation by components**



**Figure 4: Differences in y-o-y growth rates of GDP components between Slovenia and the euro area - production side**



\*Luka Žakelj, Analitsko - raziskovalni center, Banka Slovenije

Figure 5: Employment growth

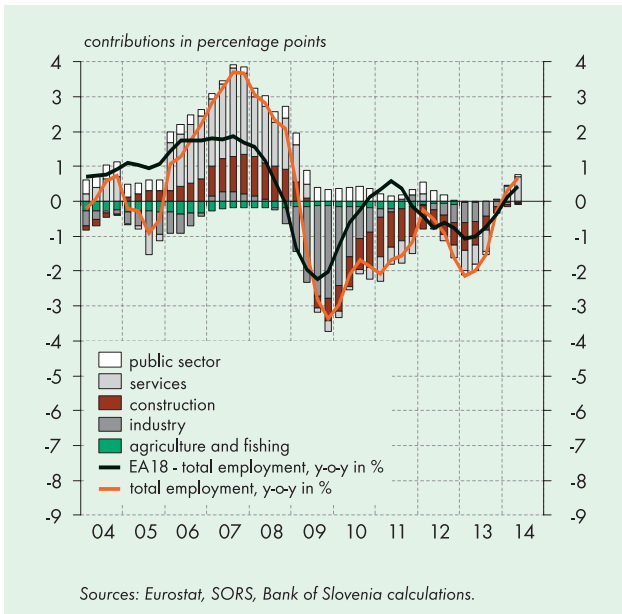


Figure 7: Fiscal position of the general government

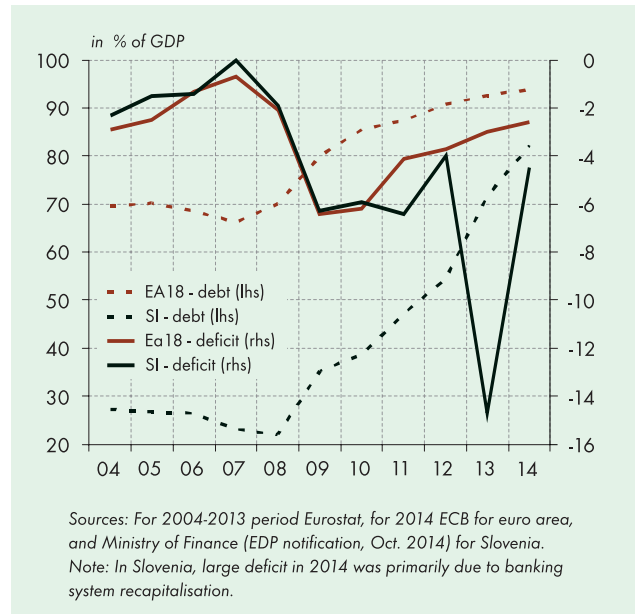
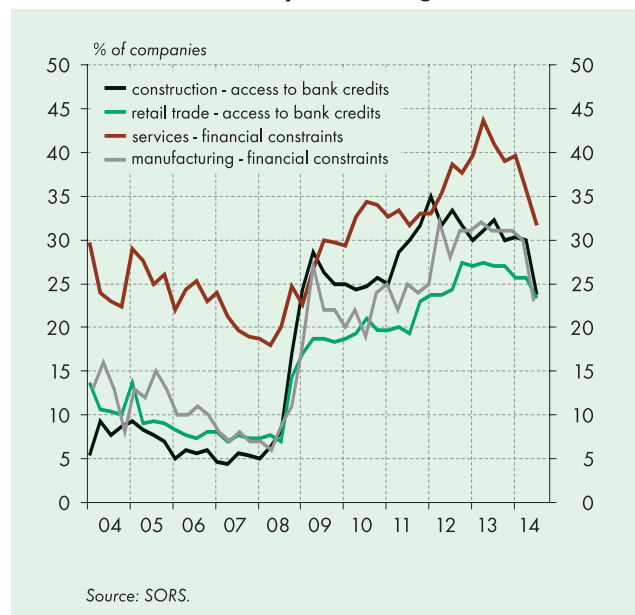


Figure 6: LFS unemployment rate



Figure 8: Slovenia - limiting factors to business activity - financing

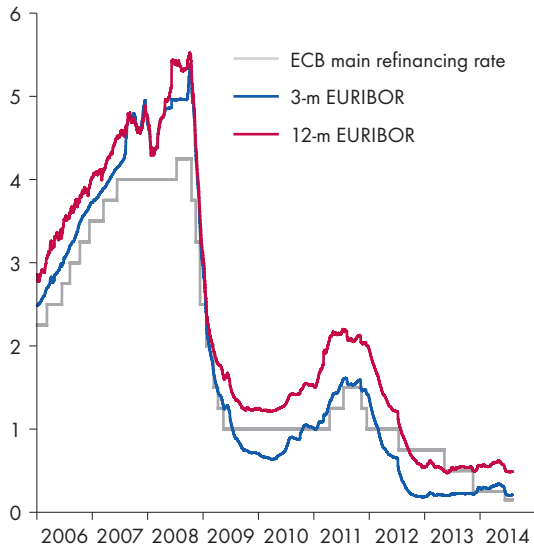




## BANKING SECTOR INDICATORS

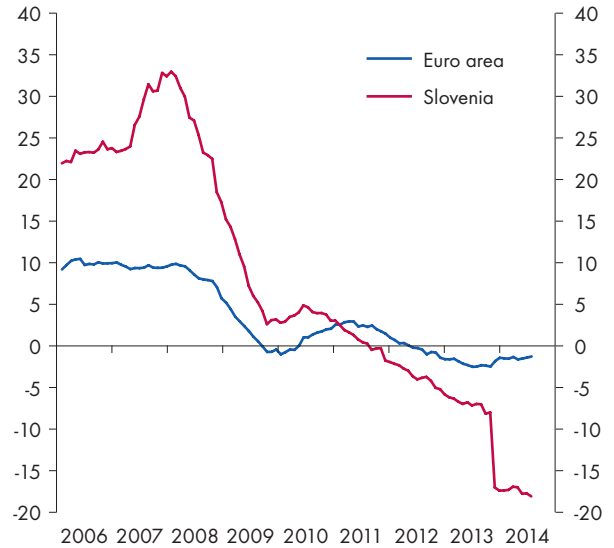
Franc Remšak\*

**Figure 1: Comparison of the EURIBOR and ECB refinancing rate**  
(in %)



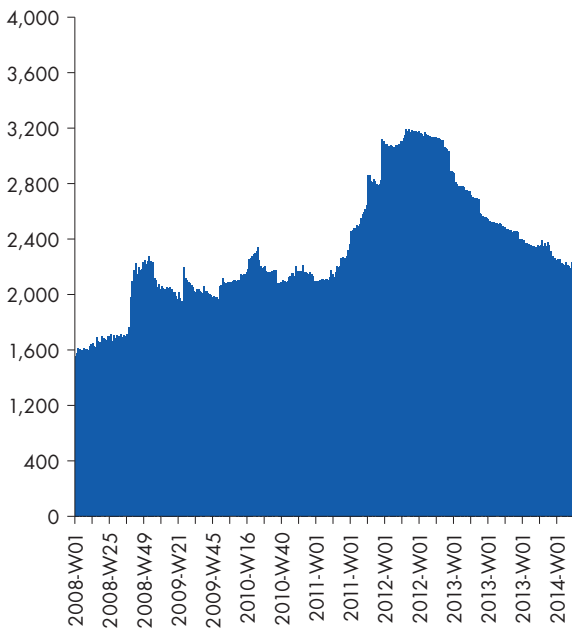
Source: ECB, Bank of Slovenia

**Figure 3: Credit to nonfinancial enterprises and households**  
(annual growth in %)



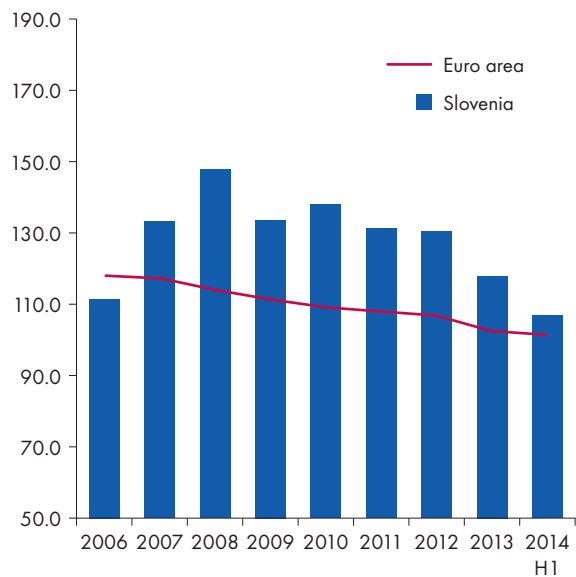
Source: ECB Statistical Data Warehouse (<http://sdw.ecb.europa.eu>)

**Figure 2: Total assets/liabilities of the Eurosystem**  
(in EUR billion)



Source: ECB Statistical Data Warehouse (<http://sdw.ecb.europa.eu>)

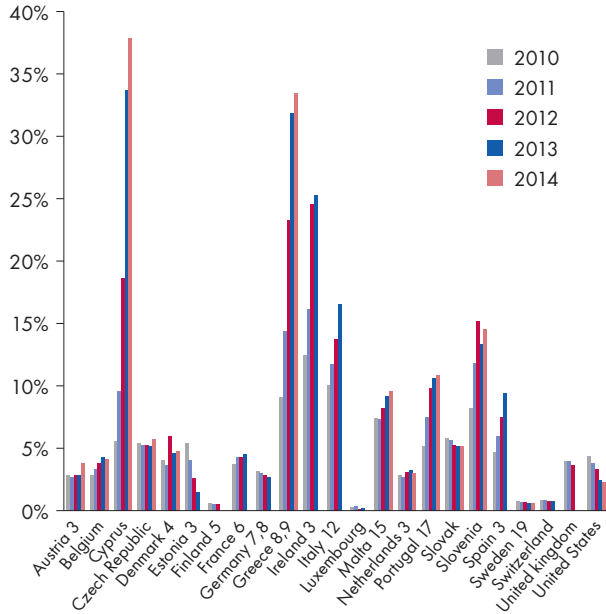
**Figure 4: Ratio of loans to non-banking sectors to deposits by non-banking sectors**  
(in %)



Source: ECB Statistical Data Warehouse (SDW)

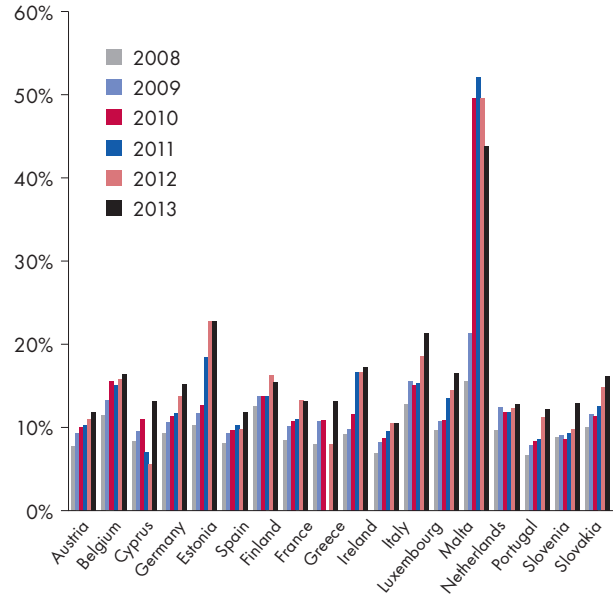
\* Franc Remšak, Finančna stabilnost in makrobonitetna politika, Banka Slovenije

**Figure 5: Bank Nonperforming Loans to Total Loans**  
(in %)



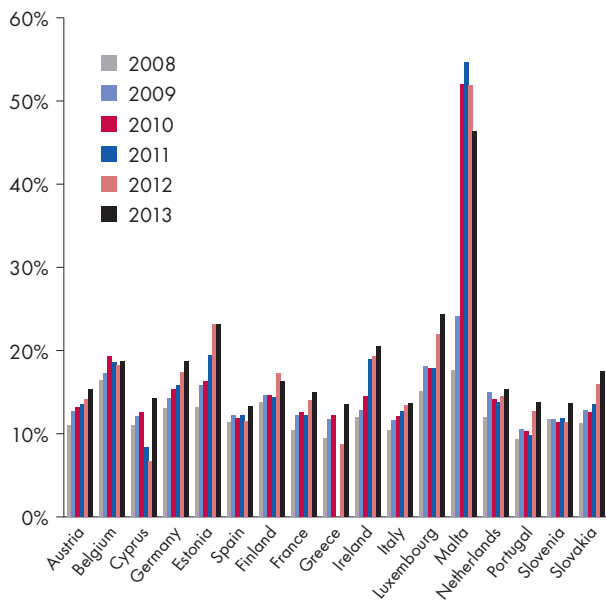
Source: IMF, Financial Soundness Indicators, October 2014  
<http://fsi.imf.org/fsitable.aspx> (See Notes under "Table 3. Bank Nonperforming Loans to Total Loans")

**Figure 7: Tier 1 ratio in EMU member states**  
(in %)



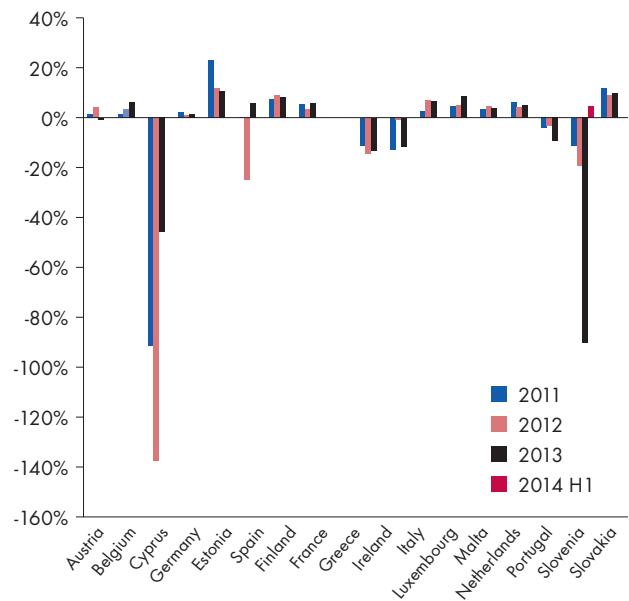
Source: ECB, Statistics on Consolidated Banking Data (Domestic banking groups and stand alone banks, foreign (EU and non-EU) controlled subsidiaries and foreign (EU and non-EU) controlled branches), October 2014

**Figure 6: Capital adequacy; Overall solvency ratio in EMU member states**  
(in %)



Source: ECB, Statistics on Consolidated Banking Data (Domestic banking groups and stand alone banks, foreign (EU and non-EU) controlled subsidiaries and foreign (EU and non-EU) controlled branches), October 2014

**Figure 8: Return on equity in EMU member states**  
(in %)

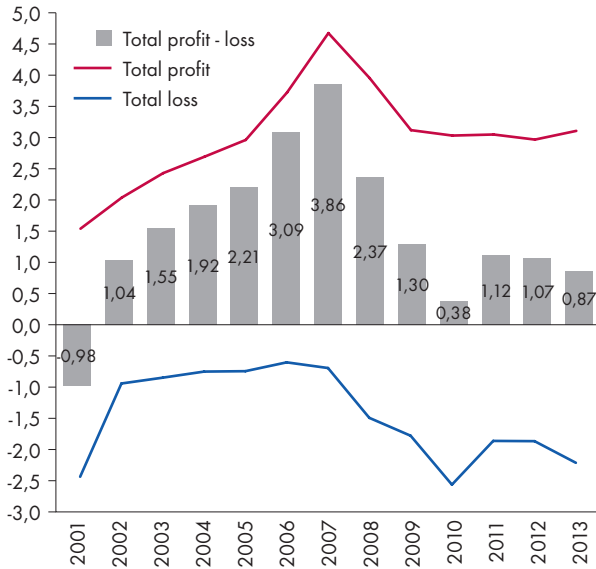


Source: Bank of Slovenia, ECB, Statistics on Consolidated Banking Data (Domestic banking groups and stand alone banks, foreign (EU and non-EU) controlled subsidiaries and foreign (EU and non-EU) controlled branches), October 2014

# CORPORATE SECTOR INDICATORS

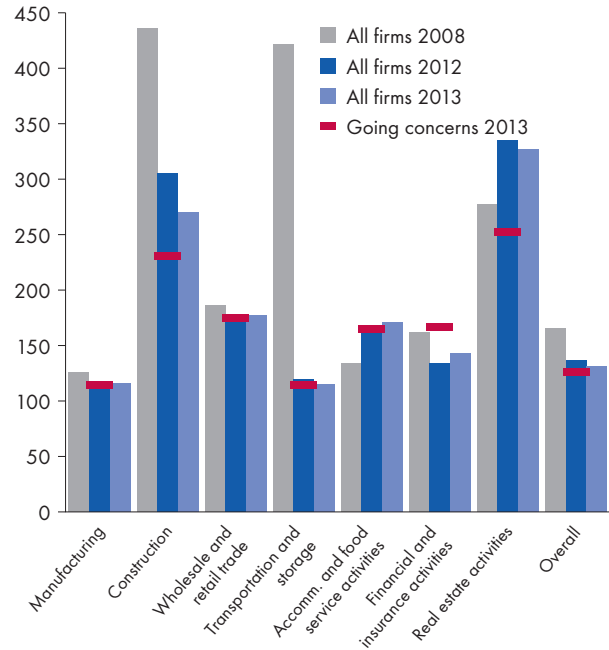
Jelena Čirjaković\*

**Figure 1: Total pre-tax profit and loss of non-financial corporation in Slovenia**  
(in EUR billion)



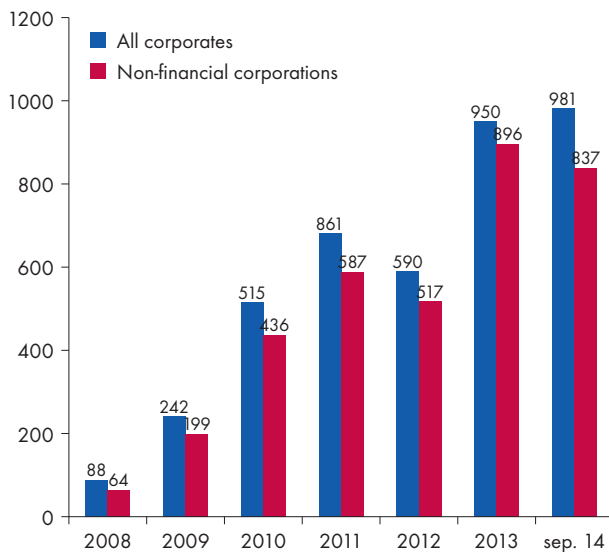
Source: AJPES, Bank of Slovenia

**Figure 3: Leverage by sector in Slovenia**  
(in %)



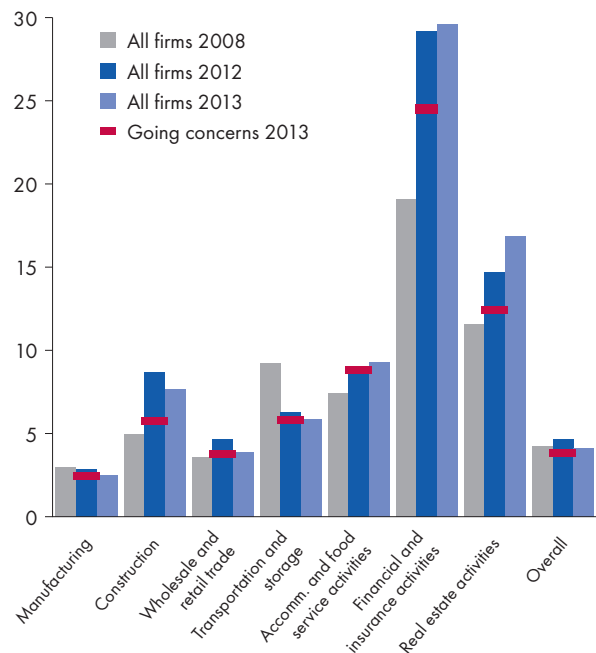
Note: Leverage is calculated as percentage debt-to-equity ratio  
Source: AJPES, Bank of Slovenia

**Figure 2: Number of bankruptcy proceedings initiated against firms in Slovenia**



Source: AJPES, Bank of Slovenia, Supreme Court

**Figure 4: Net financial debt to EBITDA in terms of years by sector in Slovenia.**



Source: Ajpes, Bank of Slovenia

\* Jelena Čirjaković, Finančna stabilnost in makrobonitetna politika, Banka Slovenije