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1505 Ljubljana
Slovenia
Tel: +386 01 4719000
Fax: +386 1 2515516

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**Abbreviations:**

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|---|---|
| AJPES | Agency of the Republic of Slovenia for Public Legal Records and Related Services |
| AMC | Association of Management Companies |
| AUP | Average unit price of a mutual fund |
| BoS | Bank of Slovenia |
| BRIC | Brazil, Russia, India, China |
| CCBM | Correspondent Central Banking Model |
| CSCC | Central Securities Clearing Corporation |
| DS | Debt securities |
| ECB | European Central Bank |
| ECBC | European Covered Bond Council |
| EFAMA | European Funds and Asset Management Association |
| EFTA | European Free Trade Association |
| EIOPA | European Insurance and Occupational Pensions Authority |
| EMF | European Mortgage Federation |
| EMU | Economic and Monetary Union |
| EONIA | Euro OverNight Index Average (weighted average interest rate for overnight credit) |
| ERM2 | Exchange Rate Mechanism 2 |
| ESCB | European System of Central Banks |
| EU 17 | Euro area |
| EU 27 | EU Member States |
| EURIBOR | Interbank interest rate at which representative banks in the euro area offer deposits to one another |
| Eurostat | Statistical Office of the European Communities |
| EU-SILC | European Union Statistics on Income and Living Conditions |
| FED | Board of Governors of the Federal Reserve System |
| FESE | Federation of European Securities Exchanges |
| HFRS | Housing Fund of the Republic of Slovenia |
| ICs | Investment companies |
| IFRS | International Financial Reporting Standards |
| IFs | Investment funds |
| IMF | International Monetary Fund |
| ISA | Insurance Supervision Agency |
| Leaseurope | European Federation of Leasing Company Associations |
| LJSE | Ljubljana Stock Exchange |
| LJSEX | Former Ljubljana Stock Exchange index calculated for entire market until October 2010 |
| LTI | Loan-to-income ratio |
| LTV | Loan-to-value ratio |
| MCs | Management companies |
| MF | Mutual fund |
| MTS Slovenia | Part of the Euro MTS electronic trading platform for euro-denominated government and para-government benchmark bonds |
| NUTS | Nomenclature of territorial units for statistics |
| OECD | Organisation for Economic Co-operation and Development |
| OFIs | Other financial institutions |
| P/E | Price-to-earnings ratio |
| PDII | Pension and Disability Insurance Institute |
| PID | Authorised investment company (privatisation fund) |
| RTGS (system) | Real-Time Gross Settlement |
| S&P | Standard and Poor's |
| SAS | Slovenian Accounting Standards |
| SBI 20 | Former Slovenian stock market index |
| SBI TOP | Blue-chip index at Ljubljana Stock Exchange |
| SI O/N | Interest rate on unsecured interbank euro-denominated overnight deposits between Slovenian credit institutions and euro area credit institutions |

| | |
|---|---|
| SKD | Standard classification of economic activities (national version) |
| SLA | Slovenian Leasing Association |
| Slonep | Slovenian real estate portal (www.slonep.net) |
| SMA | Securities Market Agency |
| SMARS | Surveying and Mapping Authority of the Republic of Slovenia |
| SORS | Statistical Office of the Republic of Slovenia |
| TARS | Tax Administration of the Republic of Slovenia |
| TR | Turnover ratio |
| Vzajemci.com | Portal of Slovenian mutual funds (www.vzajemci.com) |
| WFE | World Federation of Exchanges |
| Z-Doh | Personal Income Tax Act |

NOTE: The demarcation of the banking system into homogeneous groups of banks, namely large domestic banks, small domestic banks and banks under majority foreign ownership, used for analytical purposes in this publication does not derive from the prevailing ownership of the banks. The demarcation is instead based on the features of their operations, in particular their funding structure.

# CONCLUSIONS

The main factors affecting systemic risk in the domestic financial sector last year were economic recovery in the euro area, which had a positive impact on economic growth in Slovenia, and the beginning of the recovery and resolution of the domestic banking sector in the second half of the year. Yet, the emergence of the Slovenian economy from recession does not mean the end of the economic crisis.

The positive influences from the international environment are undoubtedly strongly supporting the further recovery of the domestic economy and facilitating the financial restructuring of the economy, although this process will be gradual and lengthy. The slow pace of change in corporate balance sheets and balance sheets in the banking sector, which are interconnected and interdependent, will make this process a lengthy one. The relatively high indebtedness of non-financial corporations, which is evidenced in their high leverage, was built up in the pre-crisis period primarily as a result of the prevalence of bank financing. The absence of alternative forms of corporate financing based on equity instruments from the domestic or international capital markets is a significant limiting factor in the slow and uncertain resolution of the economic crisis. Corporate over-leveraging is usually addressed by deleveraging, i.e. by means of divestment and the repayment of debt to banks. Corporates have indeed reduced their debts to banks by EUR 4.6 billion over the last four years, during which time their leverage has declined by 19 percentage points to 123 percent, half of which occurred in the final quarter of 2013 as a result of the valuation methods applied to non-performing loans transferred to the Bank Asset Management Company (BAMC). However, reducing corporate leverage solely via divestment and repayment of debt to banks will not ensure a rapid and sustainable economic recovery, since it only results in a deterioration in liquidity and in poor performance by the real sector, and contributes to a rise in the number of bankruptcies initiated at firms for reason of a lack of liquidity. The increase in saving in the corporate sector in 2013 was an atypical financial position, which can only be temporary; it is an indication of precautionary saving by successful firms, limited investment opportunities and accelerated repayment of debts to lenders. In the future reducing corporate leverage should be based to a greater extent on increasing equity and other forms of financing and less on reducing debt. Otherwise, the deteriorating liquidity of the real sector will bring about a further deterioration in the quality of the banking system's credit portfolio. A coordinated approach by the banks to the financial and operational restructuring of firms is necessary, and the Bank of Slovenia too can actively contribute through various measures and coordination efforts.

Changes to the structure of bank financing and the strengthening of lending activity have continued since the recovery and resolution process began at certain major banks last December in accordance with the Government Measures to Strengthen Bank Stability Act, under which certain non-performing claims were transferred from two banks to the BAMC and five banks were recapitalised. These transactions involved relatively profound changes in certain bank balance sheet items, such as a reduction in the proportion of non-performing claims in the portfolio, an increase in capital adequacy, and a reduction in the proportion of investments accounted for by loans and an increase in the proportion of securities, in addition to the recovery and resolution of bank balance sheets. Nonetheless, increasing credit growth will require operational, financial and ownership restructuring in the real sector.

The banking system's credit risk was reduced by the transfer of certain non-performing claims to the BAMC, but it remains high, and is still the most significant risk at the majority of banks in the system. Claims more than 90 days in arrears in the banking system's portfolio were reduced by 26 percent by the bank recovery and resolution measures carried out. In addition, the increase in the proportion of low-risk government-guaranteed BAMC securities had a beneficial impact on the structure of risk on the asset side. However, the transfer of non-performing claims to the BAMC is not yet complete, as only the two largest banks were able to take part in the first stage, having obtained European Commission approval for their restructuring programmes. A further transfer of non-performing claims to the BAMC will be carried out this year, which will additionally help to reduce the proportion of non-performing claims in the banking system's portfolio. The length of the economic crisis has resulted in a deterioration in the quality of loans in all economic sectors, and not just in the most cyclically sensitive such as construction and real estate. The resolution of the non-performing portfolio therefore requires the active involvement of banks in the restructuring of firms whose current performance can ensure the repayment of at least some debt and allow them to operate as going concerns. A more stable and long-lasting improvement in the quality of the credit portfolio will require the restoration of positive credit growth to creditworthy clients, which will help to increase the proportion of lower-risk claims in the credit portfolio. The future reduction of credit risk at the banks thus depends on a number of interacting factors; not just institutional factors related to bank recovery methods, but also the development of healthy credit demand from firms whose business models have good prospects and adequate and stable funding for the banks themselves.

The banks' income risk declined at the beginning of the year, primarily as a result of the beginning of the recovery process at the large domestic banks in December, which restored confidence to depositors. The banking sector recorded a large loss last year - for the fourth consecutive year - as a result of high impairment and provisioning costs, in light of the high proportion of non-performing claims in the portfolio and as a result of the contraction in loans. After the recovery process began, the trend of decline in the net interest margin came to an end, which was partly attributable to the pronounced fall in interest rates on deposits from the middle of the year after the introduction of the orderly wind-down process at two small banks. The Bank of Slovenia played an active part in the decline in interest rates on deposits with its 2012 measure to limit competition between banks for deposits from the non-banking sector. The banking system's positive pre-tax profit in the first quarter of this year is thus an important change, which has increased confidence in the domestic banks, including among foreign investors.

The banks' refinancing risk has stabilised this year, after a long period of increase. The banks have continued to make debt repayments to banks in the rest of the world, although the pace of these in the remainder of 2014 at least is expected to be significantly slower than in previous years. Between October 2008 and March 2014 the banks' net repayments of debt on the wholesale markets exceeded 32 percent of GDP. The main counterpart to these repayments was the deterioration in liquidity in the corporate sector. The banks' rapid debt repayments to the rest of the world in the initial period of the financial crisis led to a sharp rise in the cost of debt financing which, however, were successfully reduced last year and in the first quarter of this year, most notably at the large domestic banks. The process of restructuring funding and reducing bank balance sheets is not yet complete, and will continue over the coming years. The banks face a relatively large amount of maturing liabilities to the Eurosystem and liabilities from issued securities in the first half of 2015. With the aim of slowing the relatively intensive process of deleveraging at the banks and non-financial corporations and managing the repayment of loans to the rest of the world on the basis of the collection of domestic deposits. In June 2014 the Bank of Slovenia introduced a macro-prudential instrument to place a lower limit on the ratio of the increase in a bank's loans to the non-banking sector before impairments to the increase in its deposit liabilites towards the non-banking sector.

Bank solvency as measured by the overall capital adequacy ratio and the Tier 1 capital ratio improved sharply at the end of last year. Five banks were included in the process of recapitalisation in the form of state aid at the end of last year, which brought an increase of 2.1 percentage points in the banking system's overall capital adequacy to 14.0 percent. This was close to the average overall capital adequacy across the euro area, which is still increasing. Capital adequacy ratios can be expected to increase further in the Slovenian banking system until full implementation of all restructuring measures and the projected recapitalisations of the other major banks are completed. By contrast, the potential continued deterioration in the quality of the credit portfolio and the large discounts on the book value of the non-performing claims transferred to the BAMC will lead to further write-downs, thereby reducing capital adequacy ratios. Because the bank recovery process only includes certain banks, attention is focused on individual capitally-weak banks that remain more exposed to solvency risk than the system overall.

The start of the process of the recovery and restructuring of the banking system had a series of positive effects on bank performance: an increase in overall capital adequacy, a decline in the proportion of non-performing claims in the portfolio, a fall in lending and deposit rates, and improved performance in the first quarter of 2014. All of this has been reflected in the renewed strengthening of confidence in the domestic banks, including among foreign investors. Lower bank funding costs and higher capital adequacy are prerequisites for a renewed increase in lending to creditworthy clients with credible business models. Yet, any attempt at resolving the over-leveraged part of the economy via new loans would ultimately result in even higher costs for the recovery of the banks. A favourable macroeconomic environment and an optimistic economic outlook are not sufficient conditions for emergence from the crisis. Further developments will depend strongly on the success and efficiency of the requisite adjustments in bank and corporate balance sheets, especially in the sense of ensuring greater stability in funding/financing. The consolidation of the banking system and the restructuring of a critical mass of non-financial corporations will facilitate the deleveraging of banks and corporates where necessary, and will help to start new credit growth.

Dr. Boštjan Jazbec
Governor

# EXECUTIVE SUMMARY

December's measures to stabilise the banking system brought an improvement in the indicators of the stability of the banking system. The overall capital adequacy of the banking system rose by 2.1 percentage points to 14.0%, while the proportion of non-performing claims declined to 13.4% The surplus liquidity in the banking sector increased. Confidence in the banking system recovered, having previously been hit particularly hard at the large domestic banks. The confirmation of the sovereign debt rating in the context of an improvement in the overall outlook is an indication of the financial markets' restored confidence in Slovenia and its banking system. However, the bank recovery process is not yet complete. There is still a large part of the portfolio that is of poor quality, which entails potential risk to the banks' income position. Despite the temporary stabilisation of refinancing risk, the approaching maturity of liabilities to the ECB in early 2015 could increase this risk.

Following the transfer of certain non-performing claims to the BAMC, the proportion of claims more than 90 days in arrears declined significantly to 13.4% from 17.3%. The two largest banks and thus the banking system as a whole were relieved of a large portion of their lowest-quality claims, particularly those against firms undergoing bankruptcy proceedings, which accounted for just over a half of all the claims transferred. Average credit quality has improved greatly at the large domestic banks, and a further improvement can be expected after the additional transfers of non-performing claims. The proportion of non-performing claims at the small domestic banks other than Probanka and Factor banka (which are in administration) is a half lower, roughly at the level of the average across the system. The proportion of non-performing claims at the banks under majority foreign ownership remains below 10%, which is partly attributable to their internal processes for resolving non-performing claims.

The elimination of certain non-performing claims from the two large banks relieved the burden on the banking system from the largest debtors. The 50 largest debtors more than 90 days in arrears accounted for 7.6% of bank credit before the transfer to the BAMC, and for just under 5% in February, although their debts are dispersed throughout the entire banking system. The further resolution of the problem of non-performing claims at the banks, together with corporate restructuring, will therefore require a coordinated approach on the part of all creditors involved.

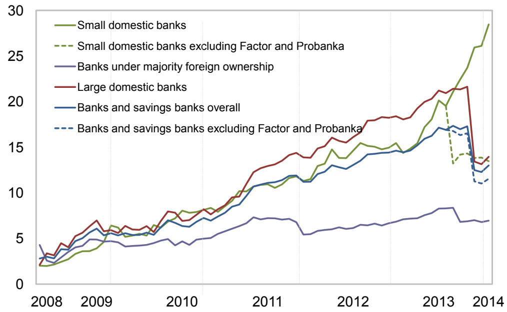
The banks sharply increased their recognition of impairments and provisions in December, in light of the findings of last year's comprehensive assets quality review. Coverage of the banks' non-performing claims by impairments thus improved significantly, from 43% at the end of 2012 to 57% in December 2013, where it remained in February of this year.

The significant impairments at the end of the year were the main reason for the banking system's exceptional loss of EUR 3.4 billion last year. Another factor in the banks' poor performance was the decline in net interest income, primarily as a result of the ongoing decline in lending activity.

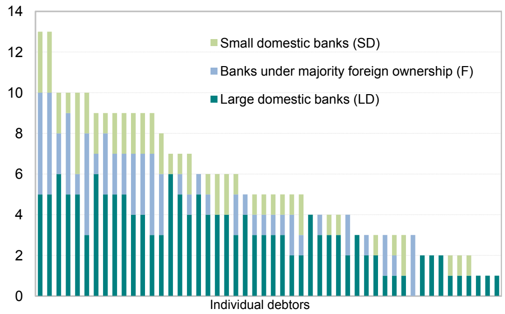
In light of the reduction in credit risk, and the large amount of impairments already undertaken, which partly derived from the findings of the comprehensive asset quality review under conservative conditions, the banks can be expected to see less pressure on profitability this year, and less exposure to income risk. The banks recorded positive growth in net interest income, a positive operating result, and a higher net interest margin in the first quarter of this year. The net interest margin nevertheless remains below those seen in other countries in the region.

The strong declining trend in liability interest rates and the promise of increased demand for loans in light of the positive

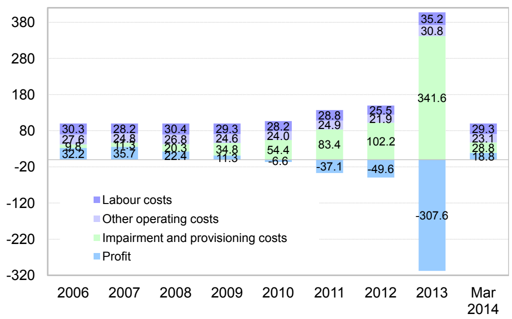
Proportion of the banks' classified claims more than 90 days in arrears by bank group, in percentages



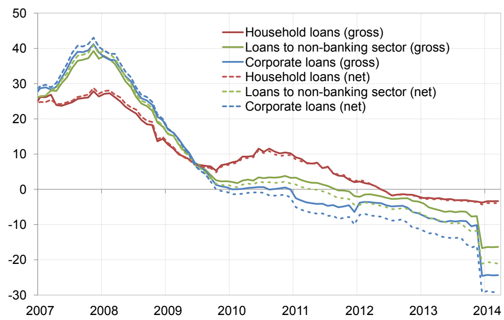

Number of banks exposed to the 50 largest debtors with arrears of more than 90 days, February 2014




Disposal of the banks' gross income, in percentages




Year-on-year growth in loans by sector, in percentages



macroeconomic forecasts for 2014 will have a beneficial impact in reducing income risk and raising the interest margin.

At the very beginning of 2014 year-on-year growth in loans was strongly negative, particularly in the corporate sector, where the 30% year-on-year decline was a reflection of the strong contraction in lending activity and the effects of the transfer of claims to the BAMC, additional impairments and the wind-down of two small banks. On the supply side the bank recapitalisations and the recovery and resolution of bank portfolios have freed up capacity for renewed lending, particularly to the healthy parts of the economy.

The debt-to-equity financing ratio, a key constraint on corporate financing at banks, fell further last year to 123%. The flow of corporate debt financing was again negative last year. Corporates made debt repayments at banks and in business-to-business financing. Limited liquidity and insolvency discouraged corporates from lending to suppliers and customers. Continuing to pursue corporate deleveraging solely by means of debt repayments and without new financial resources could result in firms missing out on opportunities for growth. The export sector increased its financing in the rest of the world: foreign financing accounted for 24% of all corporate loans last year, more than in 2004.

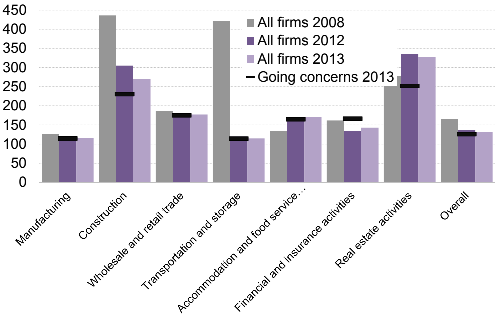
Debt repayments were made by firms in the majority of sectors, whereas indebtedness was significantly lower in firms generating positive operating profit. There is a high concentration of debt at a small number of firms, and a high concentration of firms with low debt servicing capacity expressed as the ratio of net financial debt to earnings before income, taxes, depreciation and amorisation (EBITDA).

Household demand for loans was low, given the stagnation in disposable income and the decline in consumption. Growth in housing loans has remained positive in all years since the outbreak of the crisis, albeit at a diminishing pace. Despite the high growth in borrowing in the years after the outbreak of the crisis, household debt has remained sustainable at 34% of GDP. Households' net disposable income, which is available to other sectors, increased last year, as a result of the decline in consumption and the increase in saving. In light of this year's poor outlook for growth in private consumption, there can be no expectation of any major recovery in household demand for loans, which also depends on developments on the real estate market.

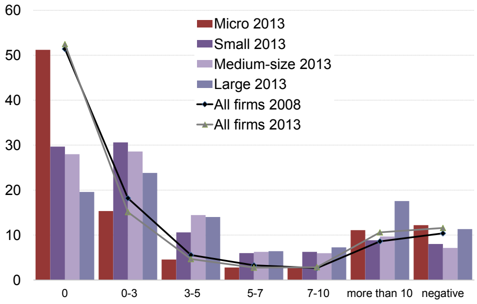
The beginning of the recovery and resolution of the banking system had a beneficial impact in the form of increased confidence in the large domestic banks, which have seen a renewed increase in household deposits after two years of outflows to the other bank groups. There has also been an inflow across the entire banking system, which did not see major withdrawals of household deposits despite occasional fluctuations during the extraordinary developments last year.

More than in previous years, bank funding relied on household deposits and deposits by the non-banking sector as a whole. Deposits accounted for 57.9% of bank funding, up 14.3 percentage points relative to the end of 2008. Repayments of funding obtained on the wholesale markets accelerated last year, which sharply reduced the banks' dependence on financial markets. The banks have made net repayments of EUR 11.4 billion of wholesale funding, or two-thirds of the total, since October 2008, including almost 30% last year alone. Refinancing risk, which in previous years was one of the largest risks in the banking system, is now lower,

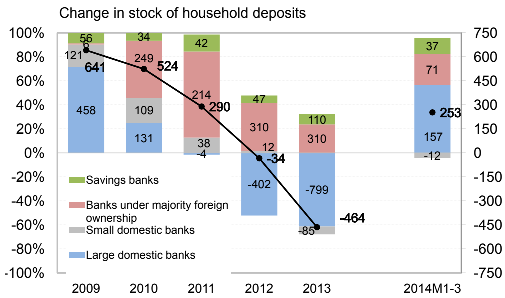
Leverage by sector, in percentages



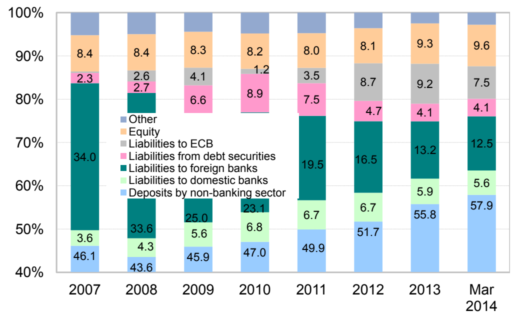

Net financial debt / EBITDA by corporate size, distribution of indicator



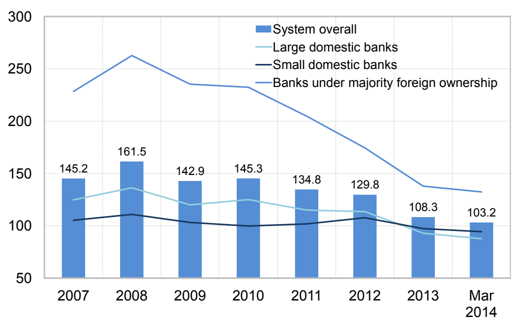

Breakdown of changes in stock of household deposits by bank group in percentages




Breakdown of bank funding in percentages




LTD ratio for the non-banking sector by bank group in percentages



particularly at the large domestic banks. The banks will again be strongly exposed to a refinancing burden in the first quarter of 2015, when they see EUR 2.6 billion of long-term liabilities to the Eurosystem mature.

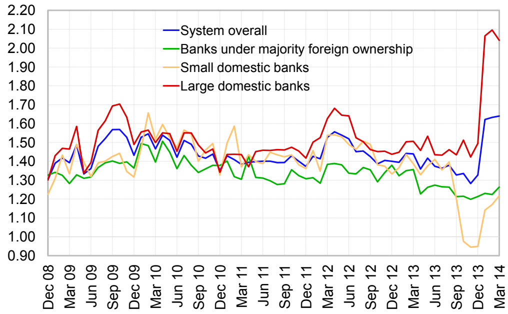
The LTD ratio for the non-banking sector, an indicator of the sustainability of bank funding, declined from 162% at the outbreak of the crisis to 103% in March of this year as lending activity contracted. As a result of the greater focus on local funding by all the bank groups, the differences in funding structure have diminished, and LTD ratios are converging. A further decline in the LTD ratio could adversely affect the banks' structural liquidity ratios and corporate access to liquidity, with feedback into further deterioration in the credit portfolio. In order to slow the reduction of the LTD ratio, the Bank of Slovenia introduced a new instrument in 2014 that requires higher liquidity ratios at any bank where lending to the non-banking sector is contracting despite an increase in deposits.

The liquidity position of Slovenian banks improved last year: first as a result of the precautionary stockpiling of liquidity before the announcement of the results of the stress tests, and then additionally as a result of the recapitalisations carried out and the government bonds received after the transfer of claims to the BAMC. The banks typically placed the additional liquidity in 1-week fixed-term deposits with the Eurosystem, or used it to make early repayments of the 3-year LTROs or to purchase low-risk securities. To date the banks have repaid 29% of their LTRO debt, which has increased the proportion of the pool of eligible collateral at the Eurosystem that is free. The fall in the required yields on government securities reduced the liquidity risk to which the banks were exposed as a result of the high proportion of these securities in the pool of eligible collateral for ECB financing operations. The banks' favourable liquidity situation has been reflected also in the maintenance of a net creditor position in the euro area unsecured money market, while lending on the Slovenian interbank market has dried up.

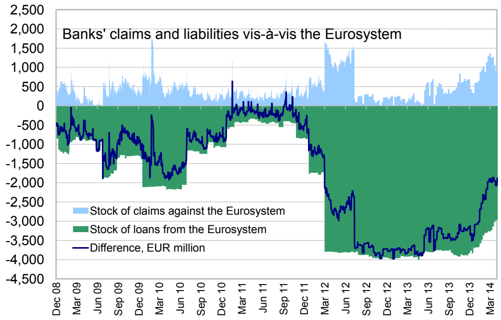
The banking system's overall capital adequacy improved significantly to 14.0% at the end of last year. One factor in the increased overall capital adequacy - besides recapitalisations by the government - was the reduction in capital requirements, both as a result of the elimination of certain non-performing claims from the banking system and as a result of the contraction in lending activity. December's measures were reflected primarily in an increase in capital adequacy at the large domestic banks, while the small domestic banks remain weaker in terms of capital. The capital adequacy ratios of the Slovenian banking system are approaching the average of EU countries, but remain lower primarily because of the larger capital requirements necessitated by higher risk weights. Slovenian banks meet their capital requirements with the highest-quality forms of capital, as a result of which the Tier 1 capital ratios of 13.3% on a solo basis and 12.9% on a consolidated basis are just 0.2 percentage points below the EU average.

The real estate market saw low turnover volume last year as prices continued to fall. Prices of residential real estate fell by a further 4.3% last year, as prices fell in Ljubljana but rose slightly elsewhere in the country. Although prices of residential real estate are already down 20% on their peak in 2008 and prices of commercial real estate are down 25%, demand is still low, partly owing to expectations of a further fall in prices, and partly owing to low household purchasing

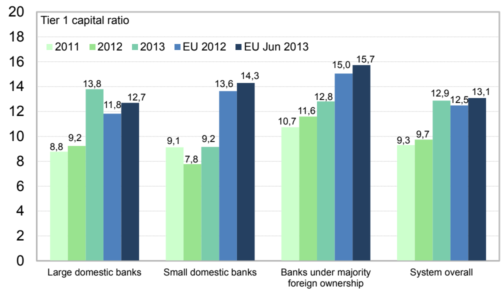
First-bucket liquidity ratio by bank group




Claims, liabilities and net position against the Eurosystem in EUR million




Tier 1 capital ratio compared with euro area, figures on a consolidated basis

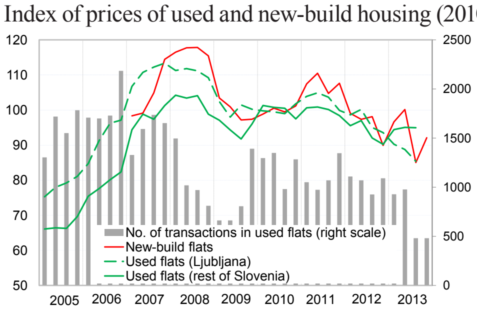



Key risks and expectations regarding their further development

| Systemic risk | Risk assessment for last year | Risk assessment PFS 2014 | Risk trend |
|---|---|---|---|
| Credit risk | | | |
| Income risk | | | |
| Refinancing risk | | | |
| Solvency risk | | | |
| Macroeconomic environment | | | |

Colour ranking:

Index of prices of used and new-build housing (2010 = 100)



power and insufficient corporate liquidity. Low liquidity is hindering the sale of real estate from foreclosed loans and collateral redemption, which too raises the likelihood of further price falls. In contrast, the return on investment property, which has been increasing over a sustained period, is acting to raise prices. Given an improvement in legislation in this area, the rental of real estate owned by banks would help to improve the functioning of the housing rental market. The supply of new housing is low, and gross investment in housing amounted to just 2.6% of GDP last year, compared with a peak of 4.6% in 2008.

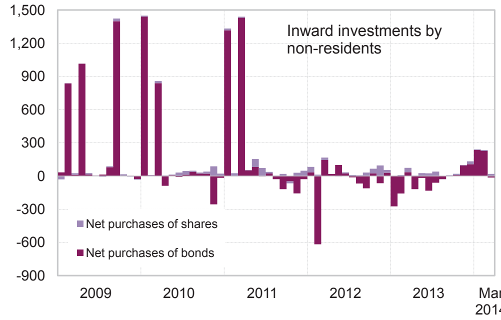
The announcement of the privatisation of 15 firms under majority or partial government ownership raised the prices of these firms and, as a consequence, prices across the entire share market. This did not have a major impact on the volume of trading in shares, as non-residents reduced their investments in shares last year. The lack of liquidity in the market is seen in the high concentration of volume: shares of just five shares account for four-fifths of the total volume of trading. The options for firms to finance themselves by means of alternative resources on the capital markets are consequently very limited. There was an increase last year in commercial paper as a form of direct borrowing on the short-term money market, but at EUR 193 million it accounts for just 1.2% of the volume on the stock exchange. Owing to their lack of profile and their over-leveraging, Slovenian firms have no presence in foreign capital markets in the form of bond issues. The lack of liquidity in the domestic market means that some firms have opted for parallel listings on foreign stock exchanges.

Residents sharply increased their investments on foreign capital markets, and simultaneously continued to make net withdrawals from mutual funds despite the positive growth in the average unit price. As a result of the loss of confidence and the decline in purchasing power, households have been consistently withdrawing from investments in mutual funds, where holdings average EUR 900 per capita. The comparable figure for the euro area overall excluding Luxembourg and Ireland is EUR 12,000.

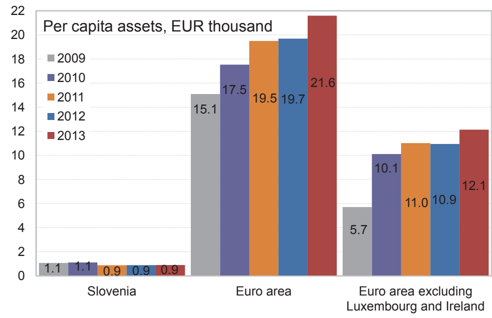
Leasing companies' business is declining, and was down 15% last year. Despite a slight increase relative to 2012, new loans were just a third of those made in 2007. Leasing companies are primarily withdrawing from the real estate market, where leasing business contracted by a quarter. Slovenian leasing companies nevertheless remain more involved in real estate business than their counterparts elsewhere in Europe. This involvement, given the low liquidity of the real estate market is hindering a more rapid recovery in the Slovenian leasing sector. Leasing business with non-financial corporations accounts for two-thirds of leasing investments. In addition to low demand, the leasing companies are also facing the continuing deterioration in the quality of their investments and declining asset valuations. The proportion of claims more than 90 days in arrears is increasing, and reached 9.5% by the end of 2013.

As a result of the economic crisis conditions in 2013 the insurance sector again faced a decline in gross written premium last year, of 2.6% at the insurance companies and 11.2% at the reinsurance companies. Insurers recorded lower net profits, and a lower ROE. Their profitability was adversely affected by the continuation of low interest rates, which has increased the risk to the achievement of the guaranteed return on certain products. Insurers' performance was also affected

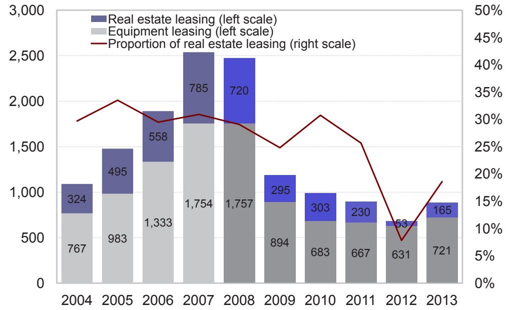
Non-residents' net inward investments in Slovenia in EUR million



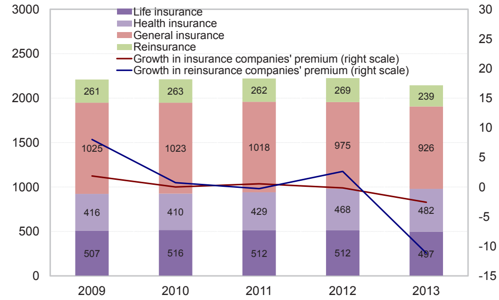

Investment funds' assets under management per capita, comparison with euro area, in EUR thousand



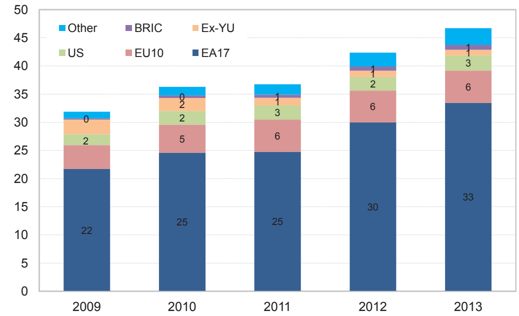

New leasing business in EUR million, and proportion accounted for by real estate leasing in percentages




Gross written premium by insurance class in EUR million and annual growth in percentages




Proportion of the insurance sector's total investments accounted for by foreign investments in percentages



by the measures to strengthen the banking system, whose write-offs and impairments of subordinated bonds and equity instruments resulted in a decline in insurers' total assets and an increase in finance expenses. The claims ratio deteriorated in almost all insurance classes. Life insurance has maintained the proportion of insurers' written premium that it accounts for, but households' increasing risk aversion since 2008 is reducing the amount of unit-linked life insurance.

Insurers' investments show a trend reduction in the share deposited at domestic banks, which stood at 26% last year, as a result of lower returns in light of the fall in deposit rates, and as a result of reduced confidence in the banking sector. The proportion of investments accounted for by the rest of the world is increasing sharply, approaching half in 2013, as is the proportion accounted for by investments in foreign mutual funds, on which the insurance sector realised a positive revaluation change last year.

# 1 MACROECONOMIC TRENDS

## 1.1 International environment

**The EU economy is expected to recover in 2014, which will have a positive impact on the domestic economy.**

The macroeconomic situation in the main trading partners and in the major global economies improved in the second half of 2013.[1] According to the forecasts of the European Commission and other major international institutions, economic activity in Slovenia's main trading partners will gradually strengthen this year and next year. This is having a positive impact on the recovery of the domestic economy, and is reducing the impact of external economic factors on an increase in systemic risks in the domestic financial sector.

The recovery in economic activity began in the euro area in the second half of 2013. GDP declined by 0.4% over the whole of 2013. The European Commission is forecasting GDP growth of 1.2% in 2014, as a result of the recovery of domestic and foreign demand. Foreign demand is under the beneficial impact of the gradual recovery in the global economy, while confidence is improving in the domestic environment, which is having a positive impact on investment developments. The economic sentiment indicator in the euro area has been rising since the second half of 2013. Access to financing is forecast to gradually improve in the euro area, while domestic demand is also expected to be encouraged by a less restrictive fiscal policy. However there are significant differences between the individual members, and between the economies of different sizes. Private consumption is forecast to improve as a result of a slight improvement in the situation on the labour market. The unemployment rate in the euro area stabilised at close to 12% in early 2013. According to the latest forecasts, uncertainty in the external environment has increased, particularly in emerging markets, most notably Russia and, to a lesser extent, China.

Table 1.1: European Commission's spring 2014 forecasts of major macroeconomic indicators for Slovenia's main trading partners and certain other countries

| | Real BDP | | | | Unemployment rate | | | | Inflation | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2012 | 2013 | 2014* | 2015* | 2012 | 2013 | 2014* | 2015* | 2012 | 2013 | 2014* | 2015* |
| **EU** | -0.4 | 0.1 | 1.6 | 2.0 | 10.4 | 10.8 | 10.5 | 10.1 | 2.6 | 1.5 | 1.0 | 1.5 |
| **Euro area** | -0.7 | -0.4 | 1.2 | 1.7 | 11.3 | 12.0 | 11.8 | 11.4 | 2.5 | 1.3 | 0.8 | 1.2 |
| Germany | 0.7 | 0.4 | 1.8 | 2.0 | 5.5 | 5.3 | 5.1 | 5.1 | 2.1 | 1.6 | 1.1 | 1.4 |
| Italy | -2.4 | -1.9 | 0.6 | 1.2 | 10.7 | 12.2 | 12.8 | 12.5 | 3.3 | 1.3 | 0.7 | 1.2 |
| Austria | 0.9 | 0.4 | 1.6 | 1.8 | 4.3 | 4.9 | 4.8 | 4.7 | 2.6 | 2.1 | 1.6 | 1.7 |
| France | 0.0 | 0.2 | 1.0 | 1.5 | 9.8 | 10.3 | 10.4 | 10.2 | 2.2 | 1.0 | 1.0 | 1.1 |
| Croatia | -1.9 | -1.0 | -0.6 | 0.7 | 15.9 | 17.2 | 18.0 | 18.0 | 3.4 | 2.3 | 0.8 | 1.2 |
| **US** | 2.8 | 1.9 | 2.8 | 3.2 | 8.1 | 7.4 | 6.4 | 5.9 | 2.1 | 1.5 | 1.7 | 1.9 |
| **China** | 7.7 | 7.7 | 7.2 | 7.0 | - | - | - | - | 2.6 | 2.6 | 2.4 | 2.4 |
| **Russia** | 3.4 | 1.3 | 1.0 | 2.0 | - | - | - | - | - | - | - | - |
| **Slovenia** | -2.5 | -1.1 | 0.8 | 1.4 | 8.9 | 10.1 | 10.1 | 9.8 | 2.8 | 1.9 | 0.7 | 1.2 |

Note: Shaded area signifies the European Commission forecasts.
Source: European Commission

**Low inflation could have an adverse effect on the deleveraging process.**

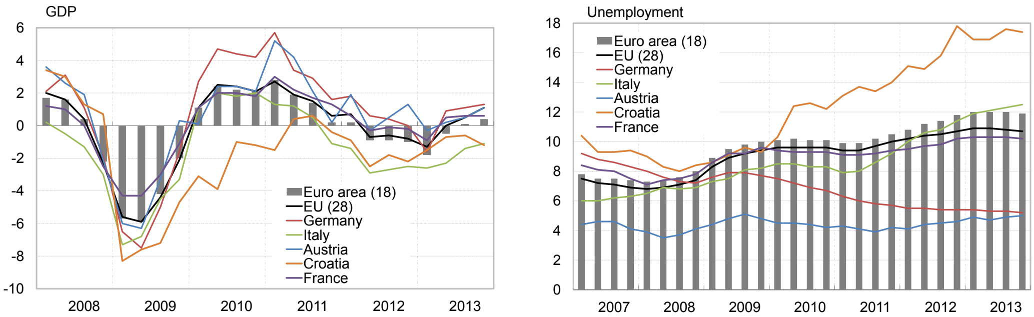
Inflation in the euro area fell below 1% in the final quarter of 2013, as a result of lower commodity prices, the appreciation of the euro and a decline in economic activity. A lengthy period of persistently low inflation would have an impact on the real value of private and public debt and on real interest rates. This could have an adverse effect on the deleveraging process, and even on investment and consumption. Low inflation is also persisting in Slovenia, and could have a similar adverse impact on the economy. Although low inflation entails a certain risk, it is expected that this risk will gradually diminish as the economic recovery strengthens.

**The risk premiums of Slovenia and the periphery countries have declined in 2014.**

The maintenance of low key interest rates by the central banks is producing downward pressure on government bond yields. Spreads within the euro area continued to narrow in early 2014. Investors have also favoured bonds from more vulnerable members in the environment of low interest rates. Another factor in the fall in risk premiums was the favourable situation on the international financial markets.

[1] Slovenia's most important export market in 2013 was the EU, which accounted for three-quarters of merchandise exports. The following countries stood out in terms of exports: Germany (20.6% of total exports), Italy (11.5%), Austria (8.5%), France (5.4%) and Croatia (6.6%). The aforementioned countries were followed by Russia, which accounted for 4.7% of total Slovenian exports in 2013.

Figure 1.1: Year-on-year growth in quarterly GDP (left) and unemployment rate (right) in Slovenia's main trading partners in percentages



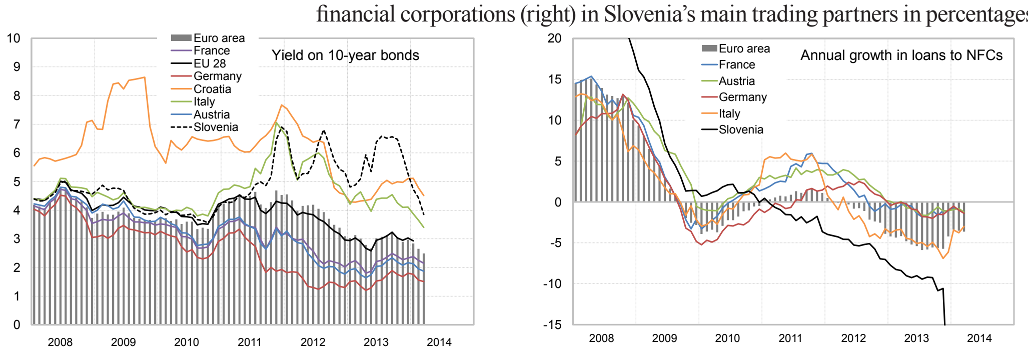

Note: GDP figures are not seasonally adjusted.
Source: Eurostat

**Credit growth to households and non-financial corporations is still negative in the euro area.**

So far the recovery in the euro area has mostly been driven by firms using internal financing or issues of their debt securities, and not by bank financing. Euro area banks improved their capital adequacy in 2013, and switched to more stable forms of funding. The interbank market became very shallow in the economic crisis, as a result of risk aversion on the part of investors (the lender banks) and the accumulation of contingency liquidity reserves by financial institutions. The banks are increasing the proportion of funding accounted for by deposits, while reducing their dependence on wholesale funding.

Investors are cautious and bank shares are still valued at below book value overall. This is a particular problem in countries facing the combination of poor credit portfolio quality, hampered access to medium- and long-term financing from the banking sector, high indebtedness in the private sector, high unemployment and limited economic growth. There is considerable segmentation in the euro area banking market, which is reflected in varying developments in credit growth and bank interest rates.

Figure 1.2: Yields on 10-year government bonds (left) and annual growth in loans to non-financial corporations (right) in Slovenia's main trading partners in percentages




Sources: Eurostat, ECB

**Euro area corporates temporarily have a positive current net financial position.**

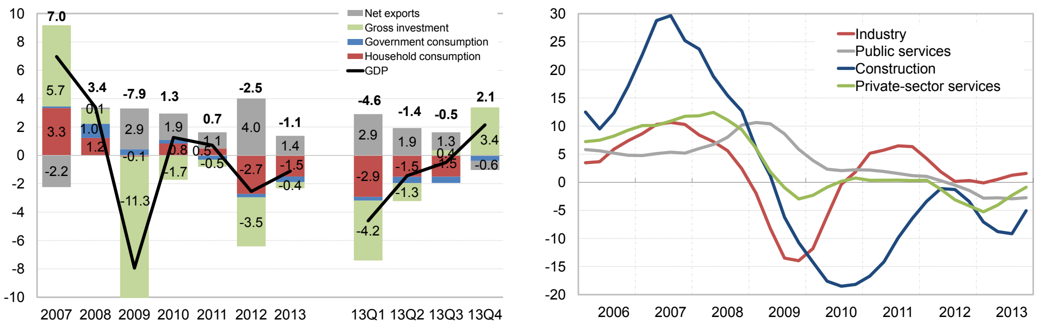
The weak bank financing in the euro area is the result of supply-side and demand-side factors, despite the slow recovery of the economy. The weak demand for loans is partly attributable to the stock of bank loans to corporates tracking the business cycle with a certain lag, and to the important role of internal financing in the initial stage of financial recovery. A recovery is nevertheless faster and broader if it is simultaneous with credit growth. Other major factors in the weak lending in the euro area are the high indebtedness of the corporate sector and the corresponding need for corporate deleveraging and balance sheet cleaning in the banking sector. Where banks have a large proportion of non-performing claims, they are less inclined to lend and have higher interest rates, because losses on loans are eating away their capital, which is the case for Slovenia. Since 2009 the euro area economy has been less dependent on bank financing, which is evident in the decline in the ratio of bank loans to GDP, and has relied much more on internal financing, and on financing via the capital markets, trade credits, business-to-business loans and loans via non-bank institutions. The economic crisis therefore led to an increase in corporate saving, particularly in the more vulnerable countries such as Slovenia, and to reductions in corporate investment. The European Commission is forecasting growth in bank loans to finally turn positive towards the end of 2014, and moderate growth in 2015. Given the anticipated economic recovery and growth in investment, it is likely that the rate of internal financing (the ratio of saving to investment) will decline, and in the years ahead corporates will have a greater need for external financing.

## 1.2 Economic developments in Slovenia

**Economic activity continued to decline in 2013 as a result of a decline in consumption and investment.**

GDP in Slovenia declined by 1.1% in 2013. Positive economic growth is forecast for 2014, primarily as a result of the strengthening of exports and expectation of a slowdown in the contraction in consumption.[2] The decline in economic activity was the result of a decline in consumption and in investment. Household consumption remains constrained, as a result of the decline in purchasing power, high unemployment and fiscal consolidation. The negative contribution made to GDP developments by investment was the result of limited demand, high corporate indebtedness and constraints on financing. Investment was a factor in GDP growth in the final quarter of 2013, particularly investment in buildings and infrastructure as a result of civil engineering work. Investment in machinery and equipment also increased slightly, which is an indication of the gradual revival of corporate investment activity. The export sector remains the most flexible. Industry is the most active in seeking export markets: around 60% of its net sales revenue is generated on foreign markets, and it is maintaining positive growth in value-added.

Figure 1.3: Year-on-year growth in GDP in percentages and contributions by components of demand to GDP growth in percentage points (left) and year-on-year growth in value-added by sector at constant prices in percentages (right)

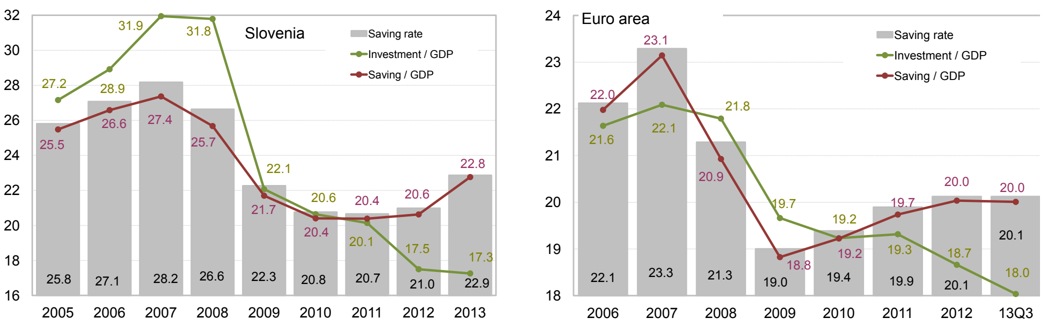



Note: The quarterly rates of growth for 2013 are calculated with regard to the same quarter of the previous year.
Source: SORS

**Economic growth of 0.6% is forecast for 2014.**

The GDP growth in the final quarter of 2013 translated into a high carry-over into the forecasts, which suggest recovery and positive economic growth as early as 2014. Economic growth in 2014 will be attributable to a faster recovery in foreign demand and an easing of the situation on the labour market. The start of the recovery and resolution of the banking system and the resulting improvement in Slovenia's access to funding and reduction in uncertainty in the economy will have a positive impact on economic developments in 2014. Access to financing for the indebted corporate sector and the need for further fiscal consolidation remain problematic.

Figure 1.4: Saving rate, and ratios of investment and saving to GDP in percentages for Slovenia (left) and for the euro area (right)




Sources: Bank of Slovenia, SORS, ECB, Eurostat

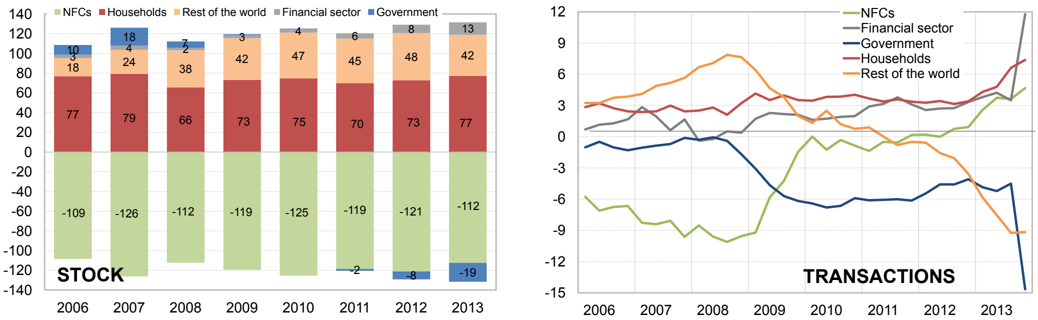
**The surplus in saving over investment in the national economy increased to 5.5% of GDP in 2013.**

Slovenia has disclosed a current surplus in saving over investment in the national economy since 2011. The surplus increased further in 2013 to 5.5% of GDP, and is an indication of the need for the repayment of the liabilities to the rest of the world accumulated in the past. The surplus in investment over saving in the national economy before 2009 was financed

[2] The forecasts of macroeconomic variables are from Macroeconomic Developments and Projections, April 2014, Bank of Slovenia.

with foreign resources. However investment at that time was not sufficiently effective to now allow the repayment or servicing of the accumulated debt. The repayment of liabilities to the rest of the world means less domestic resources for promoting investment. There are similar developments across the euro area, although the overall savings-investment gap is significantly lower at 2% of GDP. The Slovenian economy has saved more and invested less as a proportion of GDP than the euro area average since 2012. The decline in investment in recent years was the result of excessive borrowing in the past, and also of other factors in the domestic economy such as constrained consumption and limited investment opportunities, the persistent lack of sufficient activity in the lending market, the over-leveraged corporate sector and unsustainable public finances.

Figure 1.5: Net financial position of economic sectors as percentage of GDP in terms of stock (left) and annual transactions (right)




Sources: Bank of Slovenia, SORS

**Net lending to other sectors is an atypical position for non-financial corporations.**

Slovenia's net financial liabilities to the rest of the world amounted to 42% of GDP at the end of 2013, at the level of those of 2009. The banking sector has been the most aggressive in making debt repayments to the rest of the world, while the general government sector has increased its net external debt, and thereby its net claims against other sectors. The banking sector increased its current net claims against other sectors towards the end of the year as a result of government capital transfers. Households increased their net positive position, as a result of the decline in consumption and the corresponding increase in saving, despite limited disposable income. Corporates began reducing their net negative position, and moved into a current net positive position in 2012, which they increased further in 2013. This is an atypical position for corporates, and is an indication of the limited investment opportunities and poorly functioning loan market, a certain type of cash hoarding by corporates, and the deleveraging process in the over-indebted corporate sector. Until there is significant new investment, there can be no job creation that would sustain household income. Households are limiting their consumption, despite the positive net financial position. There was an increase in corporate investment at the end of 2013, which contributed to growth in domestic demand.

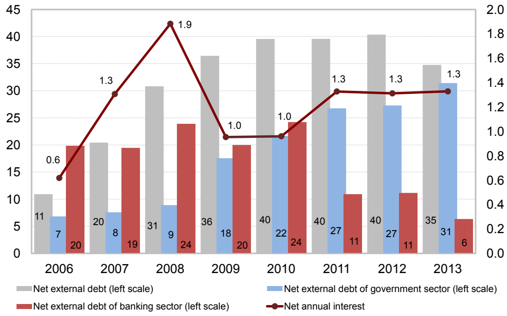
### Rest of the world

**The net external debt of the government is increasing, while that of the banking sector continues to decline.**

In 2013 the banking sector again had limited access to funding on international financial markets, which resulted in a further decline of EUR 2.5 billion in the banking sector's net debt to the rest of the world. The general government sector's net debt to the rest of the world increased by a further EUR 4 billion in 2013.[3] A decline in liabilities from the TARGET2 position nevertheless meant that Slovenia's net external debt declined to 35% of GDP or EUR 1.9 billion in 2013. Corporates have relatively large net financial liabilities to the rest of the world at 24% of GDP, an indication of the limited opportunities to obtain funds in Slovenia and the problems of the domestic banking sector. With a start made to the recovery and resolution of the banking system, the expectation is that corporates with better prospects will have easier access to financing. Net liabilities to the rest of the world in the form of equity remain low at 5%. In circumstances when domestic capital is rather limited, foreign capital represents a very important source of fresh capital for igniting investment in Slovenian corporates.

[3] The government issued three bonds on foreign markets in 2013. May saw the issue of two bonds with a nominal value of USD 3.5 billion, namely a 10-year bond with a coupon rate of 5.85% and a 5-year bond with a coupon rate of 4.7%, while November saw the issue of a 3-year bond with a nominal value of EUR 1.5 billion and a coupon rate of 4.7%. This February saw the issue of two more bonds with a nominal value of USD 3.5 billion, namely a 5-year bond with a coupon rate of 4.125% and a 10-year bond with a coupon rate of 5.25%. In early April the government issued two more bonds with a nominal value of EUR 2 billion on the euro market, namely a 3.5-year bond with a coupon rate of 1.77% and a 7-year bond with a coupon rate of 3.08%.

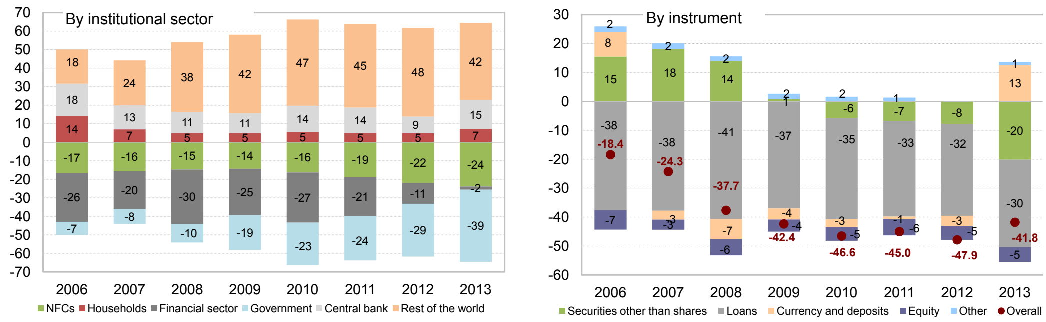
Figure 1.6: Net external debt of Slovenia and the government sector, net annual interest paid and annual property income as a percentage of GDP




Note: The difference between Slovenia's net external debt and the net financial position against the rest of the world in the financial accounts is the result of differences in methodology. The external debt does not include equity, for example.

Sources: Bank of Slovenia, SORS

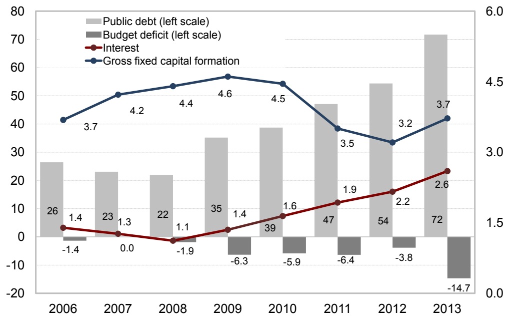
Figure 1.7: Net financial position against the rest of the world by economic sector (left) and by instrument (right) as a percentage of GDP




Source: Bank of Slovenia

## Government sector

Figure 1.8: Public debt, budget deficit, interest payments and gross government investment as a percentage of GDP




Source: SORS

**The public debt increased to 71.7% of GDP in 2013, as a result of bank recapitalisation costs. The euro area average figure was over 90%.**

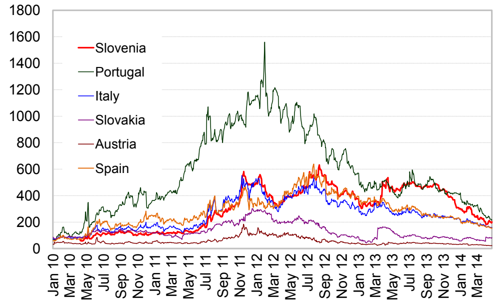
The public debt of the general government sector increased by 17.3 percentage points in 2013 to 71.7% of GDP, as a result of bank recapitalisation costs of EUR 3.2 billion. The overall current deficit of the general government sector therefore widened to 14.7% of GDP, although it would have amounted to 4.4% of GDP in 2013 without the additional expenditure caused by the financial crisis. The cost of servicing the general government debt increased to 2.6% of GDP in 2013 as a result of the rise in the public debt and the high required yields on issued Slovenian bonds in 2013. The government increased its expenditure on investment in 2013 to 3.7% of GDP, partly as a result of increased disbursement of EU funds. According to SORS forecasts drawn up in conjunction with the Ministry of Finance and the Bank of Slovenia, the general government deficit in 2014 is estimated at 4.1% of GDP, which would take the gross consolidated general government debt to 80.9% of GDP.

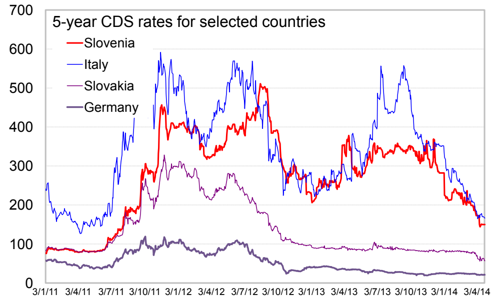
**Risk premium on Slovenian government securities**

**The risk premiums on Slovenian government securities over the German benchmarks fluctuated significantly last year, then fell sharply this year.**

The movements in the required yields on 10-year Slovenian government bonds last year and this year have reflected the changes in long-term sovereign debt ratings. The premiums first rose sharply in March and April last year, when they exceeded 500 basis points over the German benchmark, as a result of speculation on the financial markets that Slovenia would be the next EU Member State to request a bailout. This was followed by a decline in the spread after the successful issue of 18-month Slovenian treasury bills in April. The required yield on 10-year Slovenian government securities then rose again in the following months as a result of the fall in prices of Slovenian government securities. The yield on 10-year securities reached fully 6.7% several times last autumn. The required yield fell again gradually last December after the announcement of the results of the asset quality review and the stress tests and the initial recovery measures adopted for the largest banks under majority domestic ownership. In early April it stood at 3.4%, with a risk premium of 180 basis points over the benchmark German bond.

Figure 1.9: Premiums on 10-year government bonds of Slovenia and selected countries over the German benchmark in basis points (left), and 5-year credit default swap rates in percentages (right)




Source: Bloomberg

# 2 HOUSEHOLD SECTOR

**Summary**

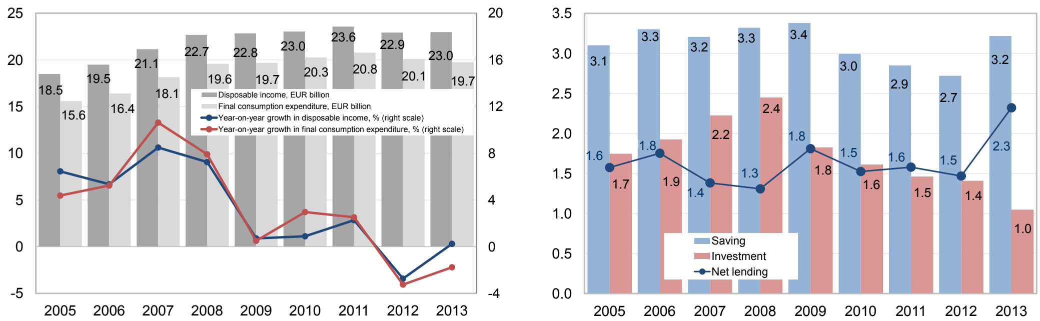
Household indebtedness does not entail a major systemic risk to the banking system. Although the proportion of non-performing claims against the household sector is increasing, at around 4% of bank loans it is manageable, and significantly less than the figure for the corporate sector. Household deposits began returning to the domestic banking system in the first two months of 2014, which signifies the restoration of confidence in the domestic banks after the beginning of the bank recovery process, and the reduction of refinancing risk at the banks. Household saving and the amount of household assets available to other sectors are increasing, despite the stagnation in annual household disposable income, as a result of a decline in consumption and also investment. The household sector's net assets available to other sectors increased in 2013, as a result of an increase of 3% in household financial assets and a decline of 2.8% in household financial liabilities. The decline in borrowing also resulted in a decline in the burden placed on household income by bank loan repayments.

## 2.1 Household financial assets

**Household disposable income in 2013 remained at its level of the previous year.**

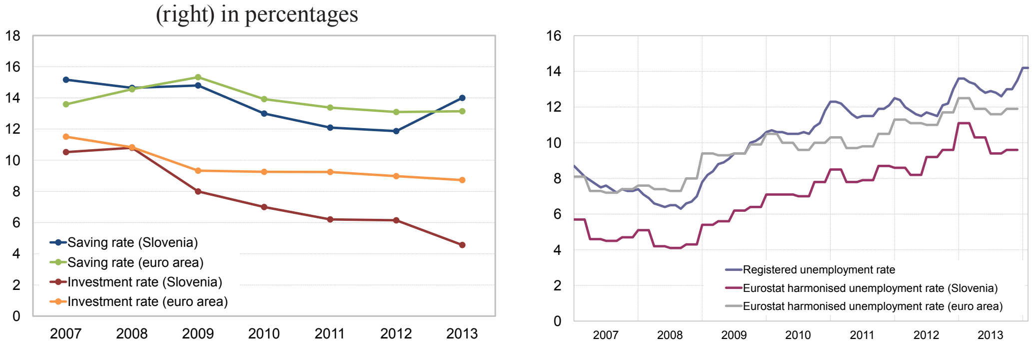
Household disposable income in 2013 remained at almost the same level as in the previous year, as the rise in unemployment and fall in wages came to an end in the middle of the year. The surveyed unemployment rate declined by 1.5 percentage points from the first quarter of 2013 to end the year at 9.6%. The number of self-employed was up in year-on-year terms, particularly in the second half of the year. The decline in disposable income having come to an end, last year's decline in household consumption was smaller than in the previous year. The decline in consumption while income remained unchanged resulted in an increase in the actual saving and also the saving rate of Slovenian households, which after four years was again higher than the euro area average in 2013. The investment rate of Slovenian households declined further last year. Alongside the situation on the labour market, the decline in household investment was also the result of the situation on the real estate market. It can be concluded from the uncertainty on the real estate market and the behaviour of households that they expect further corrections in prices on the real estate market, in the context of further segmentation of the market.

Figure 2.1: Disposable income and household final consumption expenditure in EUR billion and percentages (left), and savings, investments and net borrowing of households in EUR billion (right)




Sources: SORS, Eurostat

Figure 2.2: Household saving rate and investment rate (left) and unemployment rate (right) in percentages




Note: The saving rate and investment rate are calculated as saving and investment as a proportion of disposable income.

Sources: SORS, Eurostat, ECB

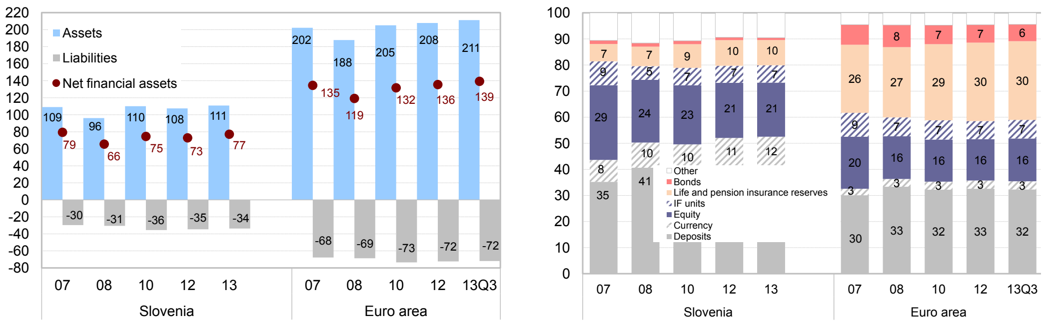
**Slovenian households primarily hold their contingency reserves in real estate.**

At 77% of GDP or 118% of annual disposable income, Slovenian households' net financial assets are down a half on the euro area average, an indication of the smaller contingency financial reserves of households in Slovenia. Slovenian households have twice as many assets in housing than financial assets, while euro area households overall have the same amount of assets in residential property as in financial assets. Slovenian households are ranked among those with a high level of real estate ownership (80%, compared with the euro area average of 60%), while the proportion of households with mortgage debt is low (6.5%, compared with the euro area average of around 19.4%; source: EU-SILC).

**Slovenia households' holdings of currency increased in 2013.**

The financial assets of Slovenian households increased by 3% in 2013, as a result of an increase in holdings of currency and, to a lesser extent, an increase in investments in mutual funds and pension funds, life insurance and equity, where valuation also played a significant role. Deposits remain the most important form of financial saving for Slovenian households, accounting for 40% of the total, although they declined for the second consecutive year. The financial accounts figures disclose a smaller decline in deposits than the figures of Slovenian banks, some deposits having been switched to banks in the rest of the world. There was no significant change in the breakdown of Slovenian households' financial assets, other than a small decline in deposits and an increase in currency.

Figure 2.3: Financial assets, liabilities and net financial position as percentages of GDP (left), and breakdown of Slovenian and euro area households' financial assets in percentages (right)




Sources: Bank of Slovenia, SORS, ECB

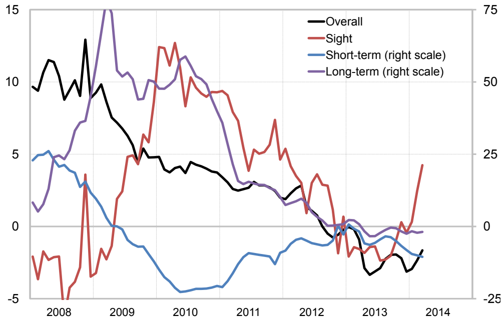
**Household deposits at banks increased by EUR 253 million in the first three months of 2014, or 54% of last year's decline.**

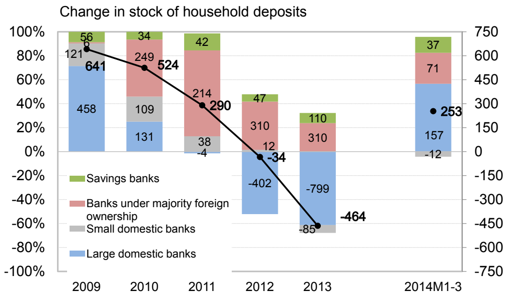
Household deposits at Slovenian banks declined by just over EUR 460 million or 3% in 2013. The largest outflow of deposits was at the large domestic banks, during periods when there were also major withdrawals of cash. There were 50% more withdrawals of EUR 500 banknotes in 2013 than in the previous year. The withdrawals were most pronounced between March and May, as a result of the uncertainty related to the events in Cyprus. The next period of an increase in currency and a decline in deposits at banks was in autumn 2013. In the first three months of the year 54% of the deposit outflow recorded in 2013 returned to the banks, the large domestic banks recording the largest inflows. The relatively large inflow of deposits back to the banking system is partly an indication of the restoration of confidence in the domestic banks after the beginning of the recovery process in the banking system. Household deposits at Slovenian banks amounted to EUR 14.4 billion at the end of 2013, equivalent to deposits of EUR 7,000 per capita or around EUR 17,700 for the average Slovenian household.[4] Given the distribution of bank deposits across households, the median value would be significantly lower than the mean, as a small proportion of wealthy households have deposits of major value at their disposal.[5] Alongside the most important factor of confidence, another significant factor in the movement in deposits is the economic situation in the country, which determines the movement in household disposable income, consumption and saving. In addition, the movement in deposits is dependent on the legislation governing social transfers, such as the Exercise of Rights to Public Funds Act, which defines which assets are to be included in the calculation of an applicant's income bracket, the applicant's debt being excluded.

[4] According to the financial accounts figures (including deposits held by households at foreign banks), the average person in the euro area has EUR 19,500 of bank deposits, 2.5 times those of the average person in Slovenia. The figure reveals the significantly larger size of household financial assets in the euro area.

[5] According to the Eurosystem Household Finance and Consumption Survey of 2010 conducted at the ECB's request, the median value of deposits (sight and fixed-term) per euro area household was EUR 6,100. The figures from the survey covering all euro area households reveal that the lowest quintile of households holds less than EUR 2,000 of deposits, while households at the peak of the distribution hold deposits of more than EUR 19,000 (source: ECB, Eurosystem Household Finance and Consumption Survey, Results from the first wave, April 2013).

Figure 2.4: Annual growth in household deposits (left) and breakdown of changes in stock of household deposits by bank group (right) in percentages



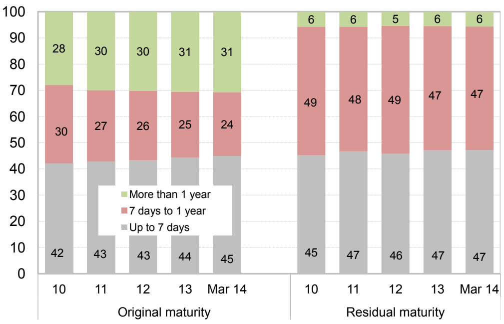




Source: Bank of Slovenia

The maturity breakdown of household deposits has remained unchanged in the last year. Around 30% of deposits are fixed for more than 1 year in terms of original maturity. The proportion accounted for by short-term deposits is declining, and the proportion of sight deposits is increasing. The breakdown of deposits in terms of residual maturity reveals that the proportion accounted for by long-term deposits is around 6%, an indication that the majority of long-term deposits are fixed for just more than 1 year. For Slovenian banks transforming short-term funding into long-term loans therefore represents a significant additional cost in matching maturity on the asset and liability sides, as the supply of funding is primarily short-term.

**The majority of household deposits have maturities of up to 1 year.**

Figure 2.5: Maturity breakdown of deposits in terms of original and residual maturity in percentages

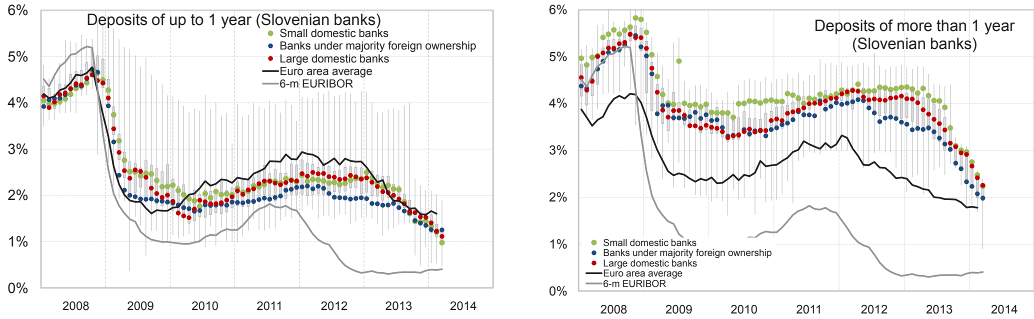



Source: Bank of Slovenia

The average interest rates on household deposits fell by 0.9 percentage points in 2013, and by a further 0.3 percentage points in the first three months of this year. The largest fall was in interest rates on maturities of more than 1 year, which were down 1.3 percentage points at 2.8%, and by a further 0.4 percentage points in the first three months of 2014. They thus remained just 0.6 percentage points higher than the euro area average. Interest rates were lowered by all bank groups by a similar amount. The interest rates at the banks under majority domestic ownership remain around 0.3 percentage points higher than the interest rates at the banks under majority foreign ownership. Despite the higher interest rates at domestic banks, the outflow of deposits in 2013 was primarily recorded by these banks, an indication of the great importance that the confidence or lack of confidence of Slovenian savers plays in the movement of deposits. Interest rates on deposits of up to 1 year in Slovenia fell by 0.8 percentage points last year, less than the euro area average, and at 1.2% were still below the euro area average in February 2014.

**Interest rates on household deposits fell by 0.9 percentage points on average in 2013.**

Figure 2.6: Interest rates on household deposits and their dispersion at Slovenian banks of up to 1 year (left) and more than 1 year (right) in percentages



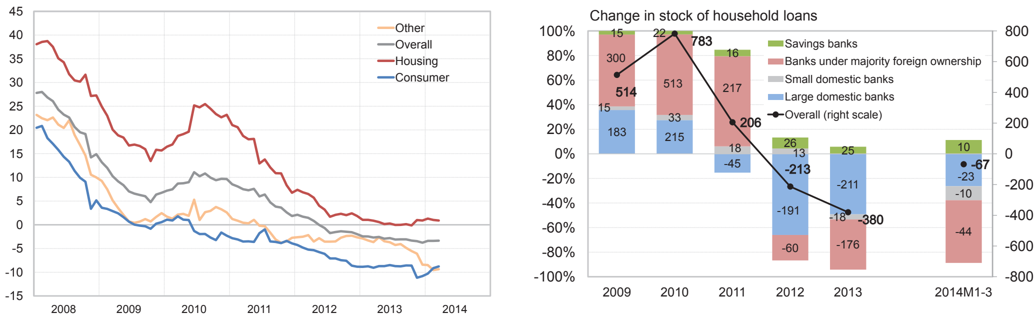

Sources: Bank of Slovenia, ECB

## 2.2 Household financial liabilities

**Slovenian households' debt is one of the lowest in the euro area at 34% of GDP.**

At around 34% of GDP and 52% of disposable income, the financial debt of Slovenian households is half less than that of euro area households overall. It declined by a further 2.8% in nominal terms in 2013. Debt to Slovenian banks accounts for around three-quarters of the total financial debt of Slovenian households. Just over 4% of bank loans to Slovenian households are more than 90 days in arrears.[6] The proportion increased by 0.5 percentage points in the 12 months to February 2014, in connection with the economic situation in the country, which was causing limited household disposable income and high unemployment. Despite the small increase, the proportion of non-performing claims against households remains manageable. The manageable figure is an indication of the banks' relatively tight credit standards on household loans, particularly in cases of temporary employment and self-employment. The proportion of the workforce in employment accounted for by the self-employed stood at just over 12% at the end of 2013, while the proportion accounted for by temporary employment stood at 9.6%.

Figure 2.7: Annual growth in individual types of household loan (left) and breakdown of changes in stock of bank loans to households by bank group (right) in percentages




Source: Bank of Slovenia

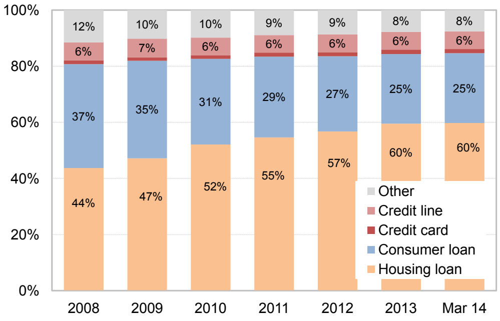
**Housing loans increased by 0.9% in 2013, while consumer loans declined by 11%.**

Household loans declined by 3.8% in 2013. Consumer loans declined by almost 11%, while housing loans remained at their level of 2012. In the first three months of 2014 the contraction in consumer loans slowed to 8.8%, partly in connection with the small improvement in consumer confidence. The developments in housing loans are subject to the economic situation and, in particular, price developments on the real estate market, and have coincided with a decline in household investment. Housing loans account for 60% of total bank loans to households. The differing intensities in the developments in housing loans and consumer loans are evidence that the household segment that is burdened by housing debt is different from that indebted via consumer loans. The micro data from the EU-SILC survey conducted by the SORS reveals that households with consumer debt are less wealthy than those with mortgage debt, are older (significantly more pensioners) and have lower qualifications on average. The main demand for housing loans comes from younger households that are resolving their housing issues and households that are slightly more wealthy in financial

[6] The figure does not include sole traders. If sole traders are taken into account, the proportion of households' non-performing claims is just over 1 percentage point higher.

terms. The developments in household loans are strongly subject to the uncertain situation in the economy, high unemployment, changes in types of employment (more self-employment and temporary employment) and the banks' strict credit standards.

Figure 2.8: Breakdown of stock of household loans in percentages

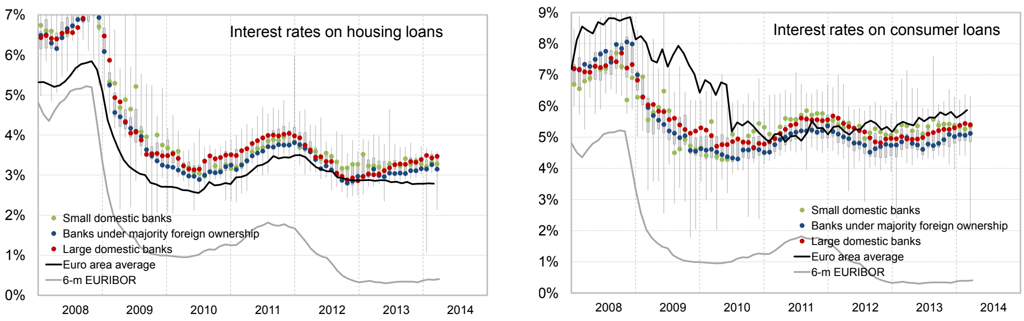



Source: Bank of Slovenia

**The fall in liability interest rates and the rise in asset interest rates in the household segment have brought an improvement in the bank's interest margin.**

Interest rates on housing loans rose by 0.3 percentage points on average in 2013 in Slovenia, compared with a fall of 0.1 percentage points in the euro area overall. This meant that interest rates in Slovenia were around 0.5 percentage points higher than the euro area average. By the end of March 2014 interest rates on housing loans were 1.1 percentage points higher than interest rates on deposits of more than 1 year, which is comparable to the overall spread in the euro area, having been approximately the same amount lower a year earlier. The fall in liability interest rates and the rise in asset interest rates in the household segment last year brought an improvement in net interest income, thereby reducing the income risk presented by households. Interest rates on consumer loans in Slovenia remain around 0.6 percentage points lower than the euro area average. They rose by 0.1 percentage points on average in Slovenia in 2013, and by 0.5 percentage points on average across the euro area.

Figure 2.9: Iinterest rates on housing loans (left) and consumer loans (right and their dispersion ) at Slovenian banks in percentages




Source: Bank of Slovenia

**Between 2009 and 2011 the proportion of households in Slovenia where the ratio of a housing loan instalment to disposable income was more than 40% averaged 8.5%.**

In terms of the aggregate figures, the burden placed on household disposable income by interest payments on housing and consumer loans declined to 1.1% in 2013, while the overall debt repayment burden declined to 8.3%. The reason for the decline was the decline in borrowing. The EU-SILC micro data reveals that the median ratio of the payment of a housing loan instalment alone to annual disposable income stood at 15.7% in 2011, having increased relative to the previous years. The highest ratio of 24% in 2011 was at households in the lowest income quintile, while the ratio at households in the highest income bracket had declined to 11%. The vulnerability of households with mortgage debt is evident from examination of the proportion of households in a particular category where the ratio of a housing loan instalment to disposable income is more than 40%.[7] Between 2009 and 2011 the proportion of households in Slovenia where the ratio of a housing loan instalment to disposable income was more than 40% averaged 8.5%, 1 percentage point more than between 2006 and 2008. The proportion of households exceeding the aforementioned ratio is highest in the lowest income categories, households with older members, and has increased in particular at households with unemployed or retired members and at households whose members have lower qualifications. This category of households is also the most vulnerable segment, and are deserving of greater attention.

[7] The literature primarily mentions two debt servicing thresholds when households become more vulnerable: when the total loan instalment exceeds 30% and 40% of disposable income.

Table 2.1: Proportion of households with mortgage debt where the ratio of a housing loan instalment to disposable income is more than 40%

| | Households where ratio of instalment to disposable income is higher than 40% | | | | |
|---|---|---|---|---|---|
| | households with mortgage debt. proportion of total | | | breakdown of households with mortgage debt | |
| | **2006-08, %** | **2009-11, %** | **Change, p,p,** | **2006-08, %** | **2009-11, %** |
| **Overall** | **7.5** | **8.5** | **1.0** | **100.0** | **100.0** |
| **Income bracket, EUR** | | | | | |
| up to 10.000 | 42.8 | 41.4 | -1.4 | 51.3 | 36.9 |
| 10.000 to 20.000 | 8.8 | 17.7 | 8.9 | 38.9 | 50.2 |
| 20.000 to 30.000 | 1.8 | 2.3 | 0.6 | 7.8 | 9.2 |
| over 30.000 | 0.6 | 0.9 | 0.3 | 1.9 | 3.7 |
| **Age group** | | | | | |
| under 35 | 12.3 | 8.5 | -3.9 | 41.9 | 27.2 |
| 35-44 | 7.6 | 10.9 | 3.3 | 27.4 | 40.0 |
| 45-54 | 5.5 | 4.7 | -0.8 | 19.7 | 11.8 |
| 55-64 | 5.2 | 11.2 | 6.0 | 9.1 | 19.3 |
| 65 and over | 2.0 | 2.6 | 0.6 | 1.9 | 1.7 |
| **Economic status** | | | | | |
| Employed | 7.4 | 7.6 | 0.2 | 77.5 | 71.1 |
| Unemployed | 17.7 | 26.5 | 8.8 | 14.9 | 18.5 |
| Retired | 3.1 | 5.8 | 2.7 | 5.8 | 9.6 |
| **Qualifications** | | | | | |
| Primary and secondary | 8.7 | 10.9 | 2.2 | 83.6 | 87.5 |
| Tertiary | 4.3 | 3.3 | -1.0 | 16.4 | 12.5 |

Source: SORS, Database of research on living conditions, EU-SILC, 2011

# 3 REAL ESTATE MARKET

**Low liquidity on the market for new-build housing.**

## Summary

Demand on the real estate market is low, marked by the long economic and financial crisis and by expectations of further price falls. The stagnation of housing loans is limiting demand on the real estate market, and is thereby contributing to the low volume of transactions. As lending to the construction sector and the number of issued building permits have fallen, so has the supply of new-build real estate declined. Prices of residential real estate are becoming increasingly heterogeneous. Housing prices in Ljubljana fell significantly in 2013, while prices in the rest of Slovenia, which accounts for three-quarters of the total volume, rose slightly. The fall in real estate prices has been accompanied by increased segmentation of the market.

Prices of new-build real estate fluctuate greatly, and in light of the low volume of transactions depend primarily on sales of foreclosed residential real estate from debtors' outstanding loan liabilities to banks. The low liquidity on the real estate market is hindering the sale of foreclosed real estate from unsettled loan relations, which is increasing the risk of further real estate price falls and the risk of a failure to repay claims from lengthy collateral redemption proceedings.

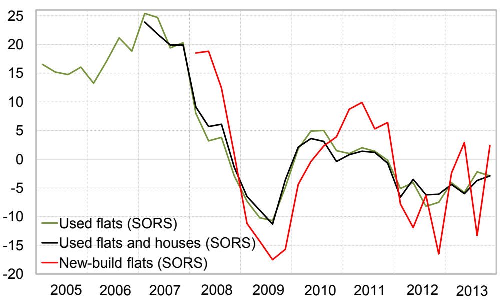
Growth in housing loans to households has almost ceased. The willingness and ability to purchase housing with a loan is being constrained by diminished purchasing power and the rise in unemployment and more flexible forms of employment, which is having an impact on household creditworthiness and is potentially increasing credit risk. The ratio of debt to disposable income at households is still below the euro area average. The relatively high return on real estate rental is leading to imbalances on the real estate market, which will demand price adjustments.

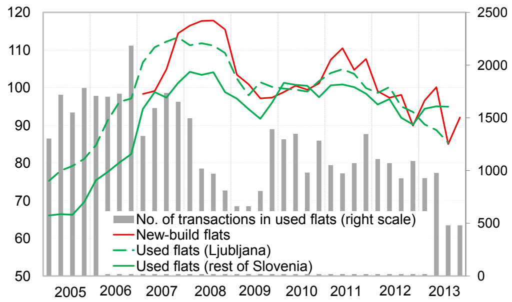
## Residential real estate prices

**Prices of residential real estate fell by 4.3% last year, primarily as a result of a large fall in real estate prices in Ljubljana.**

According to SORS figures, prices of residential real estate fell by 4.3% in 2013. Prices of used housing fell by 3.8% last year, and in the final quarter of 2013 were down 17% on their peak in the first quarter of 2008. According to survey figures, prices of new-build housing fell by 2.6% last year, having fluctuated during the year. Prices were down 13.3% in year-on-year terms in the third quarter of 2013, primarily as a result of the sale of foreclosed real estate from the bankruptcy estate of a major construction firm, but were up 2.4% in the final quarter, as a result of the deferral of the sale of foreclosed real estate by the BAMC.

Figure 3.1: Growth in prices of used and new-build housing in Slovenia (left), and the basic housing price index (2010 = 100) (right) in percentages




Source: SORS

**Prices of used housing began diverging last year according to the location of the real estate for the first time.**

Prices of used housing began diverging last year according to the location of the real estate. Prices of used housing in Ljubljana fell by 10.5%, while prices in the rest of Slovenia, which accounts for three-quarters of the total volume, rose by 0.8%. According to the latest figures of the Surveying and Mapping Authority of the Republic of Slovenia (SMARS), the average price of used housing in Slovenia stood at EUR 1,530 per m2 in the first half of 2013. The highest price of EUR 2,180 per m2 was in Ljubljana, while the lowest price of EUR 1,100 per m2 was in Maribor. Greater divergence in prices can also be expected in the future with regard to the quality of construction and the location, and also for foreclosed real estate from outstanding credit liabilities, partly as a result of pressure from rising maintenance costs.

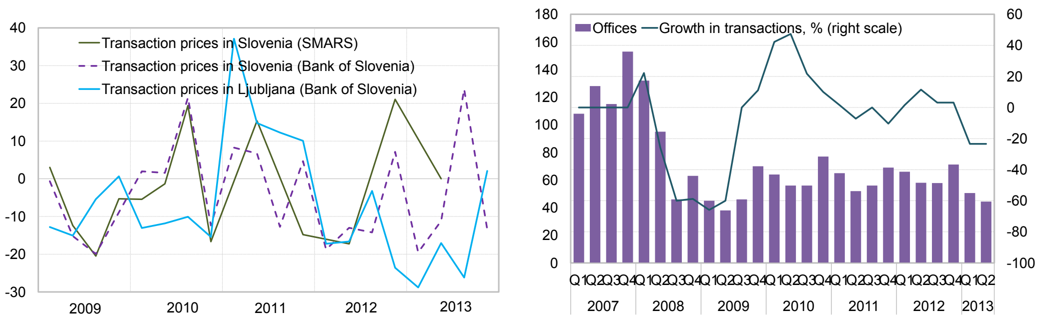
Liquidity is low on the real estate market, although prices of residential real estate fell by 20% between the peak in the third quarter of 2008 and the final quarter of 2013. Prices of used housing in Ljubljana recorded the largest fall, of 26% between the peak in the second quarter of 2008 and the final quarter of 2013. The fall in real estate prices has not brought a revival of the real estate market. The volume of transactions in used real estate fell by a further 30% last year, while the volume of transactions in new-build real estate recorded a smaller fall of 8.1%. The Energy Act[8] (EZ-1), which requires sellers of real estate and owners who wish to rent out residential real estate for a year or more to draw up an official energy rating sheet, is also giving rise to the risk of a further decline in liquidity on the real estate market.

### Commercial real estate prices

**Office prices in the final quarter of 2013 were down 13% in year-on-year terms, and down 25% on their peak in the third quarter of 2008.**

Excessive corporate indebtedness and the weakness of the economy are limiting demand on the commercial real estate market. The index of commercial real estate prices fluctuates hugely, and valuations are hindered by the lack of market liquidity. Office prices in the final quarter of 2013 were down 13.4% in year-on-year terms, and were down 25.1% on their peak in the third quarter of 2008. Office prices in Ljubljana fell by 2.1% in the final quarter of 2013, and were down 37.3% on their peak. Transactions in office real estate in the first half of 2013 were down 26% on the average of the comparable figures in the five previous years, an indication of the sharp decline in economic activity in recent years.

Figure 3.2: Growth in commercial real estate (office) prices (left) and number of transactions included in the calculation of average price and growth therein




(right) in percentages

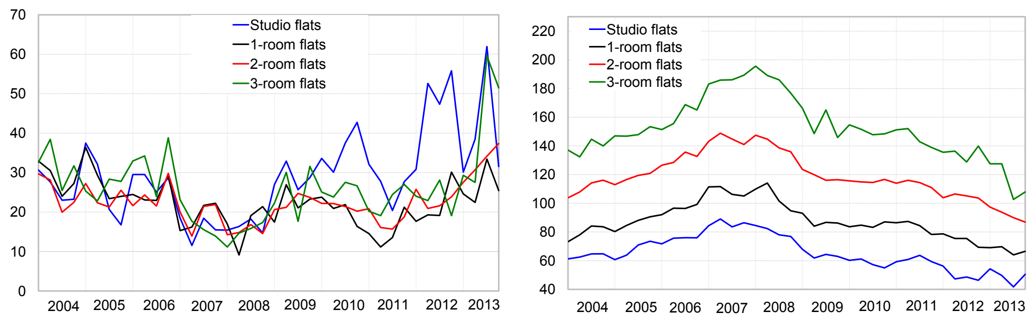
Sources: SMARS, Slonep, Bank of Slovenia calculations

### Indicators of over- and under-pricing of housing

**Advertised prices were more than a third higher on average than selling prices of used housing in Ljubljana in 2013.**

The fall in advertised prices of used housing in Ljubljana in 2013 was the largest of the last five years, and ranged from 5.5% on three-room flats to 8% on studio flats. The fall in advertised prices was low relative to the large fall in the volume of transactions in real estate and the significantly larger fall in selling prices. The gap between advertised prices and selling prices therefore widened further last year, to reach its largest figure of the last ten years. Advertised prices in Ljubljana were 35.4% higher on average than selling prices of used housing. Sellers' insistence on high prices is one of the main factors in the fall in the volume of transactions in real estate. Given the large gap between selling prices and advertised prices and the low volume of transactions, selling prices can be expected to fall slightly further in the future.

Figure 3.3: Gap by which advertised prices exceed selling prices per square metre (left) and ratio of housing prices to annual moving average of net monthly wages in Ljubljana (right) in percentages




Sources: TARS, SMARS, Bank of Slovenia, Slonep, SORS, Bank of Slovenia calculations

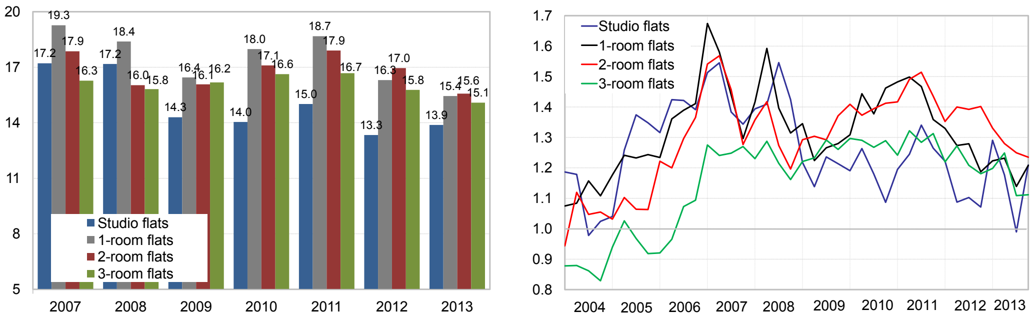
[8] Official Gazette of the Republic of Slovenia, No. 17/14.

**Housing affordability as measured by the ratio of prices to wages improved again last year, once lending terms are taken into account.**

Housing affordability in Ljubljana as measured by the ratio of used housing prices to the annual moving average of net monthly wages improved slightly for the sixth consecutive year. The overall year-on-year fall in prices of used housing had a beneficial impact on the indicator. Purchasing a flat required an average of 15 fewer monthly wage payments than a year earlier. The ratio is below its long-term average, which could act to limit further falls in real estate prices. Once lending terms have been taken into account, the affordability of used housing in Ljubljana improved overall last year.[9] Lower prices of real estate and lower flexible interest rates on housing loans (on average during the year) were factors in the improvement, while the average maturity of housing loans lengthened slightly to average 18.6 years.

The housing price to rent (P/E) ratio in Ljubljana improved again last year, real estate prices having fallen more on average than rents. The overpricing of housing has diminished significantly since 2007. The average P/E ratio last year was a fifth higher than the underlying ratio[10] as measured by the average P/E ratio between 1995 and 2003, while before the crisis in the first quarter of 2007 it was a half higher than the underlying ratio.

Figure 3.4: Ratio of housing prices to rents (P/E) (left), and ratio of actual prices to underlying prices of housing in Ljubljana calculated on this basis (right)




Sources: Slonep, TARS, SMARS, Bank of Slovenia calculations

**The yield on investment property was the highest of the last eight years, a reflection of imbalances that will demand price adjustments.**

Given the aforementioned ratio, real estate owners received their largest yields via rents in the last eight years, from 6.4% of the market value of the real estate for a one-room flat, to 7% for a three-room flat. The relatively large yield is a reflection of the imbalances on the real estate market, which will also result in pressure for price adjustments via a reduced yield on real estate and upward pressure on real estate prices. The burden placed on tenants by housing costs increased sharply, from 15.2% in 2008 to 26.6% in 2012, and reached the euro area average.[11] Potential domestic or foreign investors could help to improve the functioning of the real estate market by renting out foreclosed real estate owned by the banks, were there to be an improvement in legislation in the rental market.

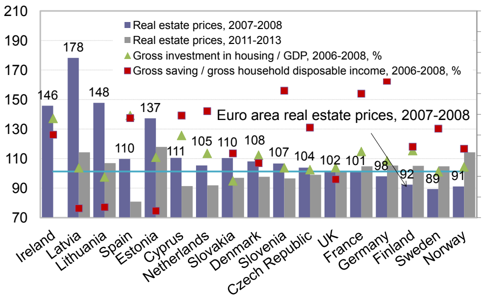
The adjustment of real estate prices in Slovenia after the peak in 2007 and 2008 has not differed greatly from the euro area average. The real estate price index averaged 107 on a basis of 100 in 2010, 5 percentage points above the euro area average. The rise in real estate prices was highest in Ireland, the Baltic states and Spain, where the price adjustment in the following years was also largest. In Ireland the average index fell from 146 in 2007 and 2008 to 80 in the 2011 to 2013 period. The high real estate prices in Ireland and Spain in that period were accompanied by high gross investment in housing, which averaged 12% of GDP, while in the Baltic states there was negative household saving of 1.7% on average. Gross investment in housing in Slovenia stood at 4.6% of GDP during the construction boom in 2008, below the euro area average of 6.8%. The household saving rate in Slovenia and in the majority of other countries with low price growth was also relatively high. The falls in real estate prices over the last two years of 6.9% in 2012 and 4.3% in 2013 have already brought a significant adjustment in prices, and have reduced the imbalances on the real estate market in Slovenia.

[9] The assumption is that the purchase of the housing is financed entirely by a loan, subject to terms of approval calculated as an average for the banking system.

[10] The calculation of underlying housing prices on the basis of the ratio of housing prices to rents (P/E ratio) takes account of the average P/E ratio between 1995 and 2003. A more accurate calculation of the underlying price would require the calculation of the average P/E over a longer, more stable period of 10 to 15 years. The short time that the Slovenian housing market has functioned normally makes this impossible. A change in the baseline period would also lead to a change in the underlying P/E ratio. The aforementioned limitations should be taken into account in the interpretation.

[11] Source: Eurostat; SORS; EU-SILC (households in the survey cite the burden of housing costs with regard to the housing situation).

Figure 3.5: Average real estate price index in the 2007 to 2008 period and in the 2011 to 2013 period (2010 = 100), gross investment in housing as a percentage of GDP in the 2006 to 2008 period, and percentage ratio of gross household saving to gross household disposable income in the 2006 to 2008 period for selected countries




Sources: Eurostat, Bank of Slovenia calculations

The assessment of cycles in real estate price developments is accompanied by uncertainty. Real estate prices rose fast in Slovenia, but the price adjustment was also rapid and considerable. Overpricing of housing has been diminishing since 207. The P/E ratio approached the underlying ratio last year, while housing affordability also increased as the ratio of real estate prices to wages declined. The ratio of debt to disposable income at households is still below the euro area average. According to European Commission estimates, downward pressure on real estate prices in Slovenia was medium-high in 2012.[12] Real estate prices underwent further adjustments last year. Although the overpricing of real estate has already diminished, and there are signs of economic recovery, there are also expectations of a further fall in prices.

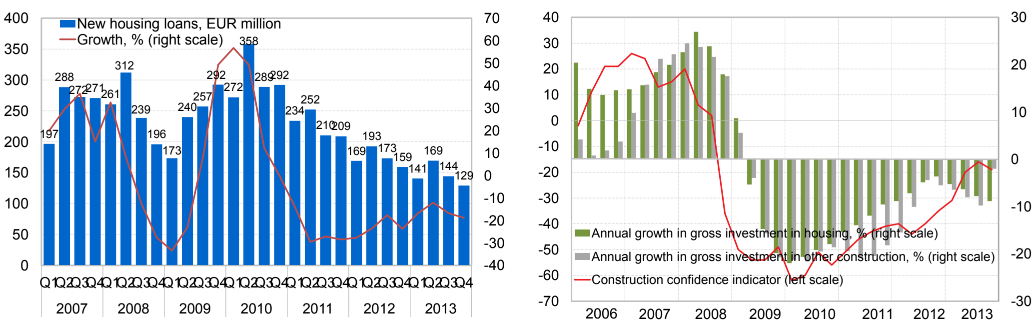
### Supply and demand factors on the real estate market

**Households' willingness and ability to purchase housing with a loan is being constrained by diminished purchasing power and the rise in unemployment and more flexible forms of employment.**

Growth in housing loans, which has been positive ever since 2008, albeit slowing, approached zero last year, and stood at 1% in early 2014. The LTV ratio for new housing loans (the ratio of the loan to the value of the collateral) fell by 3 percentage points last year to 67% across the banking system. The average LTV ratio rose by 1 percentage point to 68% at the large domestic banks, and fell by 2 percentage points to 73% at the banks under majority foreign ownership. The LTV ratio also rose at the small domestic banks and the savings banks, by 8 percentage points to 60%.

Households' willingness and ability to purchase housing with a loan is being constrained by the stagnation in household disposable income and the rise in unemployment and more flexible forms of temporary employment, contract work and self-employment, which is having an impact on their creditworthiness and is potentially increasing credit risk for the banks. The ratio of household debt to disposable income nevertheless remains relatively low. At 52% in 2013, it was still well below the euro area average.[13]

Figure 3.6: New housing loans to households (left) and construction confidence indicator and annual growth in gross investment in housing and other buildings and infrastructure (right)




Sources: Bank of Slovenia, SORS, Bank of Slovenia calculations

[12] Source: European Commission: Quarterly Report on the Euro Area, Volume 11 N° 4, 2012
[13] Source: Eurostat, Statistics database

The real estate market is under the influence of past behaviour by investors in the construction sector. New loans in construction declined by almost a half last year. The banks approved or rescheduled EUR 623 million of new loans for construction firms, just a fifth of the high recorded in 2009. That the stock of loans to the construction sector at the end of last year was down a half on the third quarter at EUR 1.3 billion was primarily attributable to the transfer of non-performing claims to the BAMC. The banks are reluctant to lend to the construction sector.

**The amount of new loans approved or rescheduled for construction firms by the banks last year was just a fifth of the high recorded in 2009.**

Gross investment in housing remains low: it amounted to 2.6% of GDP last year, compared with a peak of 4.6% of GDP in 2008. After falling for five years, the number of issued building permits for residential construction rose by 7% last year, but only permits issued to private individuals. The number of issued building permits for buildings in January 2014 was again down on the previous month, by 24.2%. The advent of investment property funds on the real estate market would provide fresh capital for investments, and would also be likely to bring an improvement in the effectiveness of project management.

# 4 CORPORATE SECTOR


### Summary

The contraction in domestic financing for the corporate sector has continued, and is hindering the faster recovery of economic activity. Loan financing by banks has been declining since 2009, and continued to contract last year, while corporate deleveraging was reflected much more in bank balance sheets than in corporate balance sheets. Rapid corporate deleveraging is not just affecting the indebted firms, but also their suppliers and customers. With liquidity and solvency limited, also business-to-business financing via loans, which to date had not been as hard hit as bank financing, declined in 2012 and, above all, last year. Indiscriminate corporate deleveraging could threaten corporate activity, despite the anticipated economic growth and increased demand. Corporate access to financing is vital to the revival of economic activity. Reducing leverage should be based more on capital growth and less on debt reduction in the future. Corporate restructuring and the continuing recovery and resolution of the banking system will contribute to an improvement in the situation in the economy, given greater credit support to firms for current operations and for investment decisions.

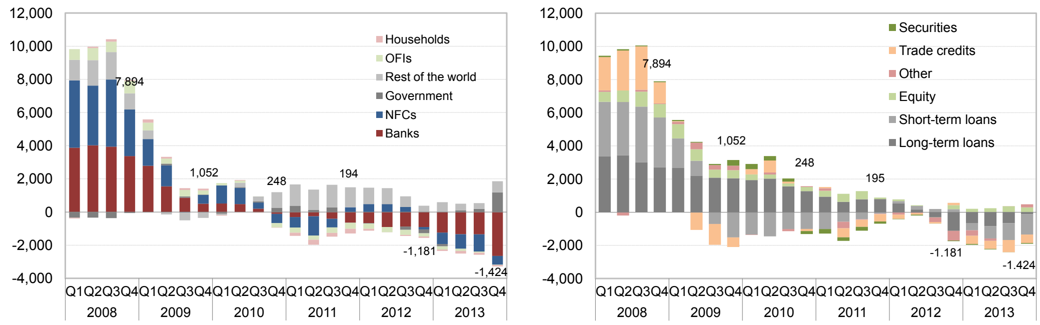

## 4.1 Corporate financing and net indebtedness

### Corporate financing flows

**The flow of financing at Slovenian corporates was negative for the second consecutive year.**

The corporate sector again made debt repayments in 2013. The flow of financing at Slovenian corporates was negative for the second consecutive year, in the amount of EUR 1.4 billion. Financing at the domestic banks continued to decline last year. Corporate debt at the domestic banks declined further as a result of the transfer of non-performing claims to the BAMC, while loans in the general government sector increased by EUR 912 million. Business-to-business financing via loans in Slovenia declined further, having previously not been hit as hard as bank financing by the crisis. The disappearance of business-to-business financing could lead to greater corporate dependence on banks.

Figure 4.1: Corporate borrowing by sector (left) and by instrument (right), annual moving total of flows in EUR million




Source: Bank of Slovenia

**The contraction in business-to-business financing continued last year.**

Loan financing at banks has been declining since 2009, and corporates have recorded net repayments of debt at banks since 2011. The contraction in business-to-business financing via loans and trade credits continued in Slovenia last year. In 2012 and, above all, last year net repayments of debt also began being made in business-to-business financing via loans in Slovenia, short-term loans declining by EUR 423 million as long-term loans increased by EUR 182 million. As a result of the decline in economic activity in the last two years, corporates also sharply reduced their financing at suppliers and customers via trade credits and advances in Slovenia and the rest of the world, by EUR 508 million.

**The inflow of equity strengthened last year, particularly from the rest of the world.**

Corporates slightly strengthened their equity in 2013. The flow of equity into corporates amounted to EUR 295 million last year, of which EUR 78 million was of domestic origin. As in previous years, the largest inflow of equity came from business-to-business capital investments and banks, while the government also increased its holdings of equity in corporates last year. The decline in disposable income meant that households recorded net sales of their equity holdings in corporates. The inflow of foreign equity strengthened last year, most notably an inflow of EUR 141 million from EU Member States.

Corporate deleveraging in 2013 was reflected much more in bank balance sheets than in corporate balance sheets. The banks sharply reduced their corporate loans last year, as a result of the decline in lending activity, the transfer of non-performing claims to the BAMC and sharp loan impairments, which was not as evident in the corporate balance sheet. The stock of bank loans on corporate balance sheets declined by 4.6% last year to EUR 18.2 billion.

**Business-to-business financing via trade credits and advances declined sharply.**

Business-to-business financing via trade credits and advances declined sharply in 2013. Weak domestic demand, limited liquidity and insolvency prevented corporates from lending to suppliers and customers. Corporates made net repayments of EUR 410 million in trade credits and advances to domestic corporates last year. Foreign suppliers and customers also reduced their exposure to Slovenian corporates last year; the inflow of trade credits and advances from the rest of the world was negative in the amount of EUR 94 million. This segment of corporate financing contracted as Slovenian corporates' merchandise imports declined slightly, while trade credits received from foreign partners declined by 5.5% in year-on-year terms. The proportion of financing via trade credits and advances from the rest of the world accounted for by credits from countries outside the EU declined, which has coincided with a fall in merchandise imports from these countries.

Table 4.1: Corporate financing flows (total, via loans and via trade credits) in EUR million

| | Flow | | | Stock | | Growt 2013 |
|---|---|---|---|---|---|---|
| | 2011 | 2012 | 2013 | 2012 | 2013 | |
| | (EUR million) | | | | | (%) |
| Total | 194 | -1,181 | -1,424 | 86,056 | 82,160 | -4.5 |
| - growth, % | -21.6 | -707.3 | 20.6 | -1.6 | -4.5 | |
| | | | | | | |
| Loans | 704 | -944 | -1,345 | 33,043 | 29,323 | -11.3 |
| - business-to-business | 609 | -137 | -241 | 4,261 | 3,963 | -7.0 |
| - from banks | -559 | -846 | -2,606 | 19,090 | 14,329 | -24.9 |
| - from NMFIs | -348 | -163 | -4 | 2,251 | 2,178 | -3.2 |
| - from rest of the world | 1,095 | 167 | 596 | 6,536 | 7,058 | 8.0 |
| - of which: from corporates | 5 | 298 | -35 | 1,470 | 1,450 | -1.4 |
| - from foreign banks[1] | 830 | -153 | 56 | 3,018 | 3,088 | 2.3 |
| - from IFIs | 223 | 28 | 505 | 1,995 | 2,426 | 21.6 |
| | | | | | | |
| Trade credits | -441 | 136 | -508 | 11,806 | 11,189 | -5.2 |
| - business-to-business | -343 | -29 | -410 | 6,420 | 6,072 | -5.4 |
| - from rest of the world | -33 | 276 | -94 | 4,483 | 4,238 | -5.5 |

Note: [1]The figures for 2011 include a major transaction between a foreign owner and corporates established in Slovenia for property management. The figures for 2013 include two major transactions with international financial institutions.
Source: Bank of Slovenia

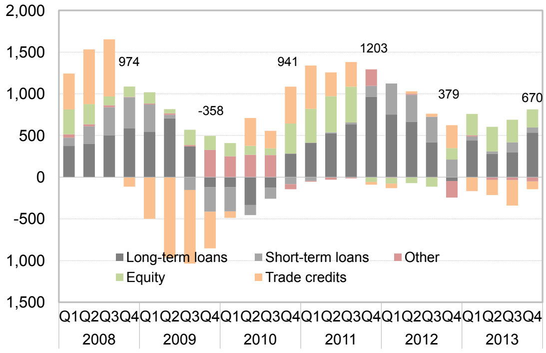
It was in 2012 that corporates' loan repayments were larger than their new loans for the first time, and corporate debt repayments continued in Slovenia last year. The net decline in loans to all sectors in Slovenia amounted to EUR 1,941 million in 2013. While it was primarily long-term loans that declined in 2012, last year short-term loans in the corporate sector declined by EUR 1,286 million while long-term loans declined by EUR 656 million.

Further evidence of the hampered access to loans comes from the figures from a survey of non-financial corporations' demand for loans in 2013, which reveal that it is mainly long-term loans for investment where there is surplus demand for loans, while last year saw a notable increase in surplus demand for loans for current operations. The reasons cited most often by banks for rejecting loans for investment are the client's poor credit rating, inadequate collateral and the client's non-acceptance of the terms. A poor credit rating and the client's non-acceptance of the terms are also the most common reasons for the rejection of loans for current operations.

Table 4.2: Corporate financing in the rest of the world, stock in EUR million and breakdown in percentages

| | Stock at year end | | | |
|---|---|---|---|---|
| | 2010 | 2011 | 2012 | 2013 |
| Total, EUR million | 16,596 | 17,596 | 18,074 | 18,676 |
| growth, | 7.9 | 6.0 | 2.7 | 3.3 |
| | Breakdown, % | | | |
| Securities[1] | 1.5 | 1.4 | 1.5 | 1.5 |
| Loans | 31.1 | 37.5 | 39.4 | 42.5 |
| of which: at banks in rest of the world | 13.7 | 17.2 | 16.7 | 16.5 |
| at MFIs[2] | 10.6 | 11.2 | 11.0 | 13.0 |
| at corporates in rest of the world | 6.1 | 6.3 | 8.1 | 7.8 |
| Equity | 40.0 | 39.0 | 39.1 | 41.3 |
| Trade credits and other | 27.4 | 28.1 | 28.9 | 27.2 |

Figure 4.2: Corporate financing flows in the rest of the world, annual moving total of flows in EUR million




Notes: [1]Securities other than shares.
[2]International financial institutions.
Source: Bank of Slovenia

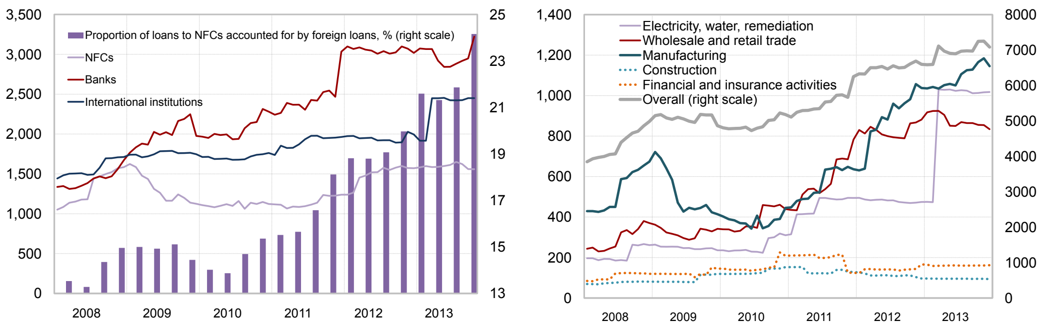
**With contraction of domestic financing loans from the rest of the world account for an increasing proportion of corporates' loans.**

With contraction of domestic financing loans from the rest of the world account for an increasing proportion of corporates' loan financing. Loans to corporates from the rest of the world accounted for 24% of all corporate loans at the end of last year, up 4 percentage points on a year earlier. The proportion of loans from the rest of the world thereby exceeded its level of 2004, when it stood at more than 20%, although in the following years it declined sharply as a result of the rapid growth in loans at the domestic banks in the pre-crisis period.

The proportion of foreign loans increased last year, albeit primarily as a result of loans at two international financial institutions. Loans at foreign banks also increased last year, while loans at corporates from the rest of the world declined slightly. Corporates from the rest of the world reduced their exposure to Slovenian corporates in the second half of last year because of the uncertain situation in the Slovenian economy and banking system.

Export growth was the key engine of economic activity last year. Firms in the manufacturing sector, which made the largest contribution to economic growth thanks to their export focus, recorded the highest positive year-on-year growth in financing in the rest of the world last year. It should be noted that manufacturing is also one of the sectors with an above-average decline in financing at domestic banks.

Figure 4.3: Stock of corporate loans from the rest of the world by foreign creditor sector (left), and for selected sectors (right) in EUR million




Sources: AJPES, Bank of Slovenia calculations

Other forms of corporate financing remain modest. Financing via commercial paper increased by a half last year and amounted to EUR 193 million, although the low volume means it does not yet entail an alternative form of corporate financing. Unlike the few successful offerings of commercial paper by large enterprises, SMEs do not have any alternative financing possibilities.

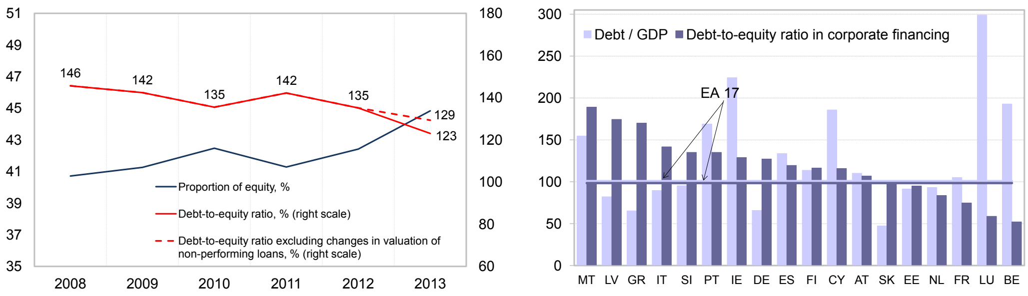
**Reducing leverage should be based to a greater extent on capital growth and less on debt reduction in the future.**

The debt-to-equity ratio in corporate financing declined last year from 135% to 123%, and by 8 percentage points in the final quarter alone, primarily as a result of the valuation of non-performing loans in the transfer to the BAMC.[14] Were corporates to have disclosed the

[14] Only the economic values of corporate liabilities that were transferred from the banks to the BAMC and recognised by the latter were disclosed in the financial accounts statistics, i.e. liabilities were reduced by the difference between their gross value and economic value. These corporate liabilities are still included in AJPES figures in their full amount, as the debt of the aforementioned corporates was not reduced by the transfer to the BAMC.

EUR 3.3 billion of non-performing loans in full in the financial accounts statistics at the end of last year, leverage would have stood at 129%. The debt-to-equity ratio has declined by 19 percentage points and 6 percentage points over the last two years. The weak net inflow of capital has accompanied the trend of capital devaluation. Corporate deleveraging has a strong impact on their profitability and market value, which maintained the corporate debt-to-equity ratio at high levels in 2012 compared with other EU Member States. Reducing leverage should be based more on capital growth and less on debt reduction in the future.

Figure 4.4: Corporate debt-to-equity ratio and level of equity financing (left) and comparison of corporate indebtedness across the euro area in 2012 (right) in percentages




Source: Bank of Slovenia

Corporates' total debt and equity liabilities amounted to EUR 82,160 million at the end of last year. Corporates held over EUR 10 billion in debt liabilities to other corporates (loans, trade credits and debt securities), while the stock of outstanding loans from banks stood at EUR 14.3 billion. Corporate equity amounted to EUR 36.8 billion at the end of last year, Slovenia accounting for the majority (81.4%).

Table 4.3: Corporate financing, stock and breakdown at the end of 2013 in EUR million and percentages

| | Stock at end of 2013, EUR million | | | | | Breakdown, % | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Debt securities | Loans | Trade credits | Equity | Other claims and liabilities | Debt securities | Loans | Trade credits | Equity | Other claims and liabilities |
| Total debt and equity liabilities | 818 | 29,323 | 11,189 | 36,834 | 3,995 | 1.0 | 35.7 | 13.6 | 44.8 | 4.9 |
| | | | | | | | | | | |
| Total debt and equity liabilities | 818 | 29,323 | 11,189 | 36,834 | 3,995 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| In Slovenia | 577 | 22,265 | 6,951 | 29,982 | 3,708 | 70.5 | 75.9 | 62.1 | 81.4 | 92.8 |
| - business-to-business | 77 | 3,963 | 6,072 | 12,751 | 1,022 | 9.4 | 13.5 | 54.3 | 34.6 | 25.6 |
| - to banks | 182 | 14,329 | 3 | 402 | 121 | 22.3 | 48.9 | 0.0 | 1.1 | 3.0 |
| - to NMFIs | 22 | 2,101 | 101 | 579 | 59 | 2.7 | 7.2 | 0.9 | 1.6 | 1.5 |
| - to government | 30 | 1,140 | 326 | 8,172 | 1,558 | 3.7 | 3.9 | 2.9 | 22.2 | 39.0 |
| - to households | 31 | 654 | 371 | 7,596 | 890 | 3.8 | 2.2 | 3.3 | 20.6 | 22.3 |
| In rest of the world | 241 | 7,058 | 4,238 | 6,852 | 287 | 29.5 | 24.1 | 37.9 | 18.6 | 7.2 |

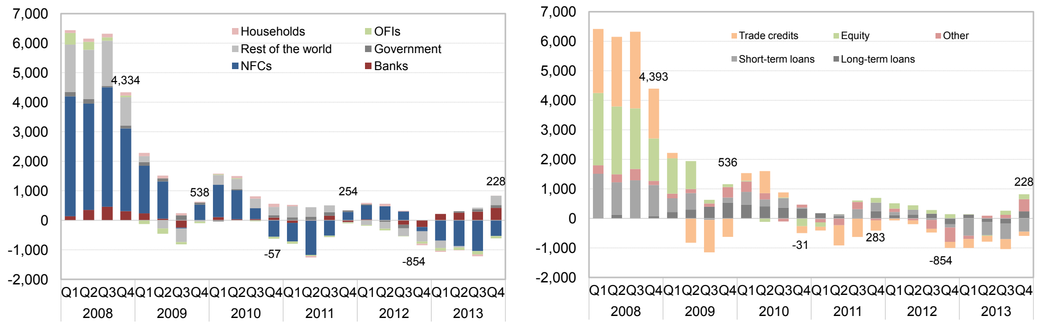
Source: Bank of Slovenia

### Corporate financial assets and net financial position

**Business-to-business financial assets are continuing to decline.**

The annual flow of corporate financial assets amounted to EUR 228 million last year. Corporates' financial assets in banks increased by EUR 421 million last year, while the largest decline of EUR 528 million was in business-to-business investments, which are prevalent in the breakdown of corporate financial assets. There were net repayments of trade credits and advances, which in 2008 were an important resource for promoting sales between corporates, and short-term loans. There was a notable increase of EUR 367 million in transferable deposits. The breakdown of financial assets remains relatively unchanged compared with 2012. The large proportion accounted for by financial and trade receivables means that corporates are strongly exposed to credit risk. The stock of trade credits and advances stood at EUR 12.6 billion at the end of last year, while the stock of loans stood at EUR 6.2 billion.

Figure 4.5: Corporate financial assets by sector (left) and by instrument (right), annual moving total of flows in EUR million




Source: Bank of Slovenia

In addition to trade credits, investments in equity account for a significant proportion of Slovenian corporates' financial assets in the rest of the world. The stock of financial assets held in equity in the rest of the world declined at EUR 3 billion last year, as corporate assets in countries outside the EU notably declined from EUR 2.6 billion at the end of 2012 to EUR 1.9 billion at the end of 2013.

**The net corporate debt position declined to 112% of GDP.**

Net corporate financial liabilities stood at EUR 39.6 billion at the end of 2013, down 7.3% on a year earlier. As a proportion of GDP they declined by 7.1 percentage points to 112.4%. The proportion of debt accounted for by net corporate debt at banks declined by 27.3 percentage points last year to end the year at 26.5%. The main decline in net corporate debt at banks was in the final quarter, when the proportion that it accounts for declined by 8 percentage points, primarily as a result of the transfer of non-performing claims to the BAMC, while the proportion accounted for by corporate debt to the general government sector increased by 5 percentage points.

Table 4.4: Net corporate financial liabilities, stock at year end and breakdown in EUR million and percentages

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|
| Total, EUR million | 41,771 | 42,311 | 44,475 | 42,840 | 42,760 | 39,654 |
| growth, % | -4.2 | 1.3 | 5.1 | -3.7 | -0.2 | -7.3 |
| as % GDP | 112.2 | 119.5 | 125.3 | 118.5 | 121.1 | 112.4 |
| | | | Breakdown, % | | | |
| In Slovenia | 86.9 | 88.0 | 87.0 | 84.2 | 81.8 | 78.7 |
| banks | 40.5 | 40.9 | 38.5 | 38.8 | 36.5 | 26.5 |
| NMFIs | 9.0 | 9.3 | 7.9 | 7.1 | 6.4 | 6.8 |
| government | 15.7 | 15.3 | 19.6 | 19.5 | 19.4 | 24.4 |
| households | 21.7 | 22.6 | 21.0 | 19.0 | 19.5 | 21.1 |
| In rest of the world | 13.1 | 12.0 | 13.0 | 15.8 | 18.2 | 21.3 |

Source: Bank of Slovenia

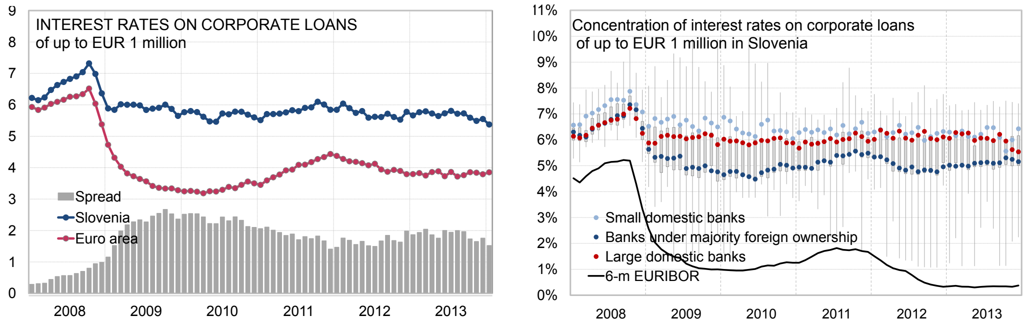
## 4.2 Interest rates and interest rate risk for corporates

### Asset interest rates for corporates

**Slovenian banks' interest rates on corporate loans were higher than the euro area average. The spread has continued to narrow significantly since the final quarter of 2013.**

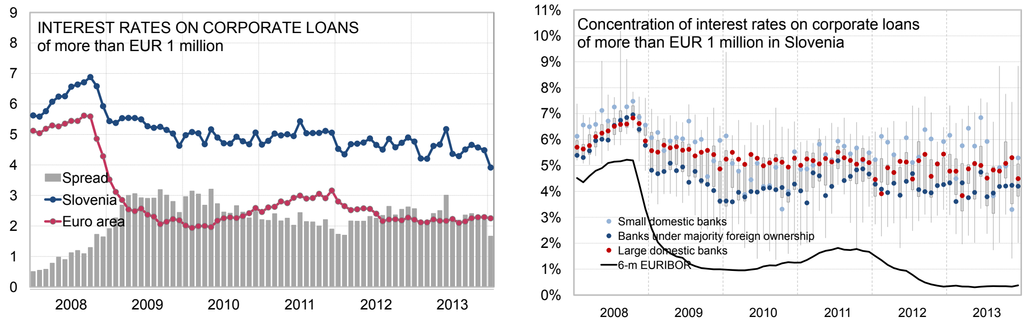
Slovenian banks' interest rates on new corporate loans of up to EUR 1 million fell last year. The fall has been particularly pronounced since the final quarter of 2013: over the last six months interest rates have fallen by 0.6 percentage points to average 5.2% in February 2014. Slovenian banks' interest rates on corporate loans of more than EUR 1 million fell by slightly less, and stood at 4.4% in February. Despite the fall, interest rates on corporate loans in Slovenia are still significantly higher than the euro area average (by 1.5 percentage points on loans of up to EUR 1 million and by 1.7 percentage points on loans of more than EUR 1 million in January 2014), and a further fall in asset interest rates is in the interest of the banks, not least to retain their good clients. The fall in asset interest rates is mostly the result of a fall in the banks' liability interest rates. Lower corporate financing costs could increase accessibility to the economy for bank loans.

Figure 4.6: Interest rates on corporate loans of up to EUR 1 million in percentages: comparison with the euro area (left) and distribution at Slovenian banks (right)




Source: Bank of Slovenia

Figure 4.7: Interest rates on corporate loans of more than EUR 1 million in percentages: comparison with the euro area (left) and distribution at Slovenian banks (right)



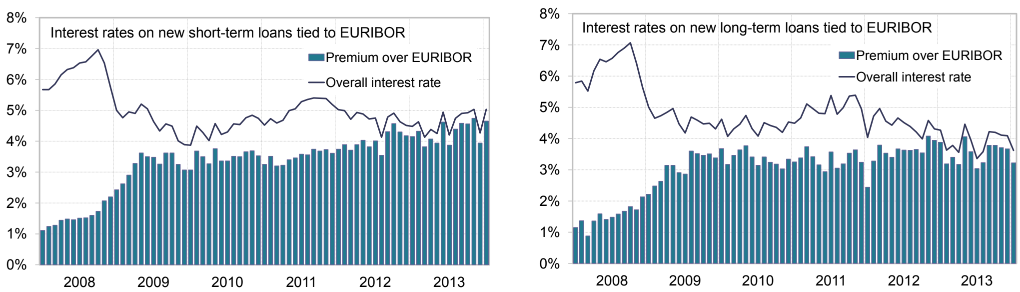

Source: Bank of Slovenia

The distribution of interest rates on loans of more than EUR 1 million between the bank groups widened last year. The spread between the highest and lowest interest rates on larger loans averaged 5.2 percentage points, similar to the figure for loans of up to EUR 1 million. The banks under majority foreign ownership have lower interest rates than the other bank groups. The banks under majority domestic ownership in particular reduced their lending rates in late 2013 and early 2014, thereby narrowing the average spread between the domestic banks' interest rates and those of the banks under majority foreign ownership to just over 1 percentage point.

**The banks under majority foreign ownership had the lowest interest rates on corporate loans.**

The average premium over the reference interest rate on short-term loans increased slightly last year, by 0.3 percentage points to 4.3%, while the average premium on long-term loans remained unchanged from the previous year at 3.5%. The overall interest rate on short-term loans was down 0.2 percentage points on the average in 2012, while the overall interest rate on long-term loans was down 0.5 percentage points.

Figure 4.8: Premiums over the EURIBOR and overall variable interest rates on new short-term (left) and long-term (right) corporate loans in percentages




Source: Bank of Slovenia

The average risk premium on loans to clients who settle their liabilities on time and those in arrears on short-term loans declined last year, while the average premium on long-term loans increased sharply, particular at the end of last year, to 5.7 percentage points, the highest figure of the last six years.

**The high risk premiums do not vary significantly with regard to the risk level of the client.**

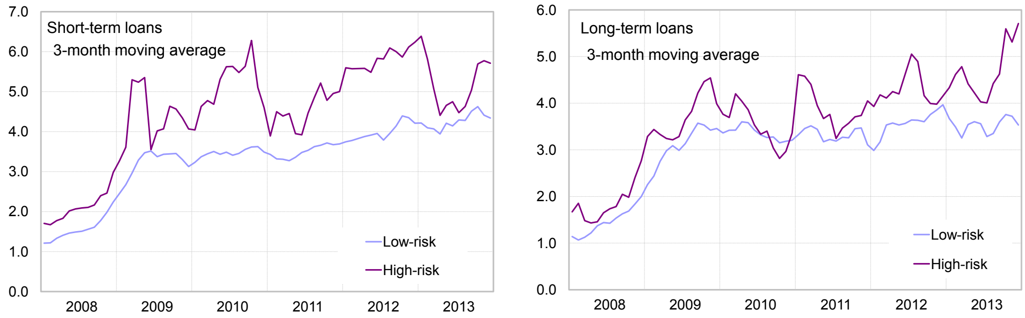
The fluctuations in risk premiums have been extremely high in the last two years, on both short-term and long-term loans. Last year's decline in the risk premium on short-term loans can partly be attributed to the high proportion of new short-term corporate loans accounted for by restructured loans. Although these loans are approved for high-risk clients, the banks are using lower interest rates to try to reduce the debt servicing burden for these clients and to increase the likelihood of repayment.

Slovenian banks' corporate loans are among the most costly in the euro area. Increased lending at lower interest rates to the healthy part of the economy could contribute to higher economic growth and to an increase in the stock of high-quality bank investments.

**While reference interest rates are low, there is high interest rate risk at corporates.**

Interest rate risk is present at corporates owing to the high proportion of loans with variable interest rates, which are currently at a low level because the reference interest rates are low. A rise in the reference interest rates could in the future cause problems in loan repayments, particularly in respect of clients who have borrowed to the limits of their creditworthiness.

Figure 4.9: Risk premiums over the reference interest rate (EURIBOR) on short-term (left) and long-term (right) euro-denominated corporate loans, by client credit rating, 3-month moving average in percentage points




Source: Bank of Slovenia

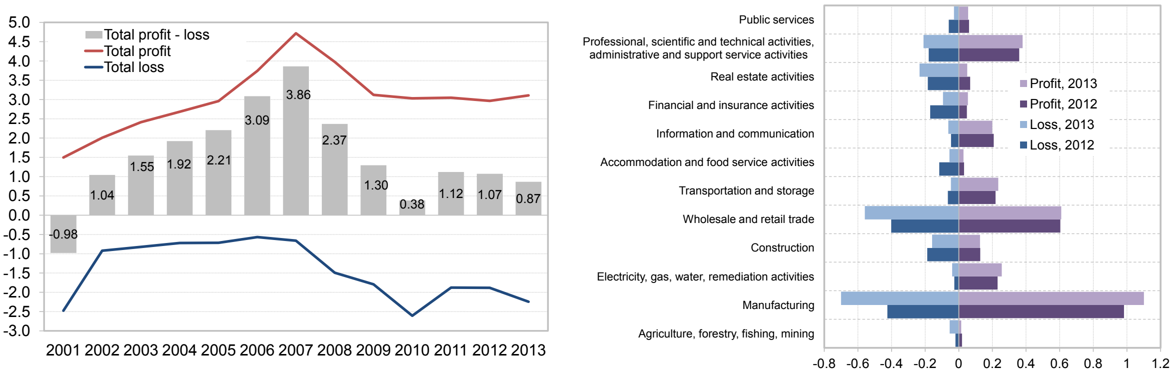
**Corporate loan repayment burden**

According to figures from the annual survey of banks, the debt servicing burden declined last year for the third consecutive year. Payment of principal and interest declined by 11% in 2012 and by 27% in 2013, as a result of corporate debt repayment and the fall in interest rates at banks. The lower debt burden has also brought a reduction in interest payments. As the stock of corporate borrowing at banks declined, and there was a resulting decline of 27.2% in the principal servicing burden, interest payments declined by 25%.

## 4.3 Corporate performance and risk by sector

With the slow economic recovery in 2013, non-financial corporations' performance was slightly worse than in the previous year. Non-financial corporations' net profit declined by almost a fifth to EUR 865 million. Total profit declined from EUR 4.7 billion in 2007, the highest figure of the last decade, to EUR 3 billion in 2012, before rising by 5% to EUR 3.1 billion last year, while total loss increased by 19% last year to EUR 2.2 billion. Firms in the manufacturing sector recorded the most notable increase in total profit in 2013, which was up 12% at EUR 1.1 billion. Together with wholesale and retail trade, manufacturing generated more than half of non-financial corporations' total loss last year. In the context of weak domestic demand, firms in the wholesale and retail trade sector recorded an increase in loss for the second consecutive year, at more than a third. Improvements in profitability were primarily constrained by weak demand and low purchasing power, although the number of firms in bankruptcy is also increasing. Last year's main declines in net profit were recorded by large enterprises, by almost a half, and by micro enterprises, by 20%, while medium-size enterprises increased their net profit by more than a half and small enterprises by 13%.

Figure 4.10: Total profit and loss and net profit (left) and total profit and loss by sector in 2013 (right) in EUR billion




Sources: AJPES, Bank of Slovenia

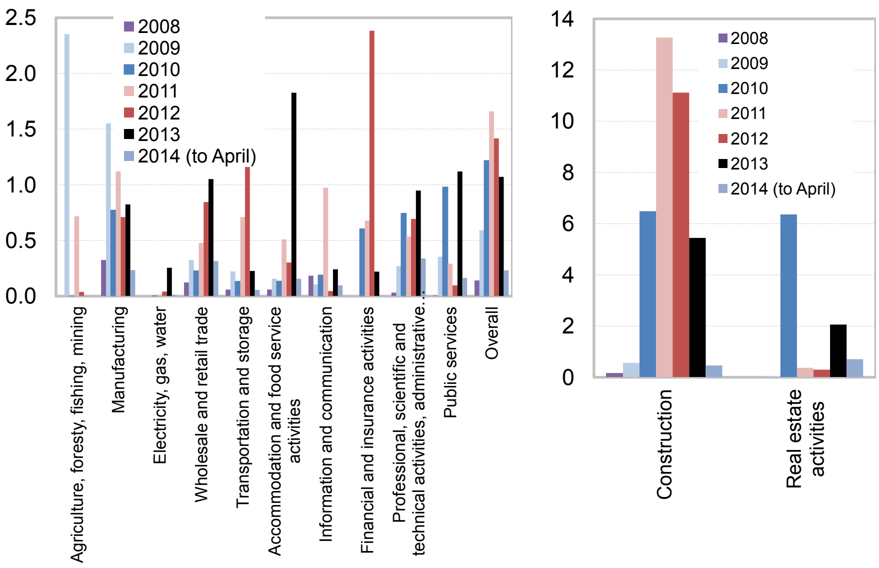
## Corporate bankruptcies

There were almost 900 bankruptcies initiated in 2013, up almost three-quarters on the previous year, although the proportion of the total balance sheet assets of the corporate sector accounted for by firms at which bankruptcy proceedings were initiated during the year declined by a quarter. This means that the average size of firms at which bankruptcy proceedings were initiated declined. In addition to construction and real estate activities, the sector with the largest proportion of total assets accounted for by firms in bankruptcy in 2013 was accommodation and food service activities, which also recorded one of the lowest figures for total profit in the last two years. The trend of increase in the proportion of total assets in wholesale and retail trade accounted for by firms at which bankruptcy proceedings were initiated continued, partly as a result of this sector's heavy dependence on weak domestic demand.

**The proportion of the total assets of the corporate sector accounted for by firms at which bankruptcy proceedings were initiated declined by a quarter last year as the number of bankruptcies initiated rose sharply.**

Corporate bankruptcies in the wholesale and retail trade sector and the construction sector were again prominent in 2013. The proportion of the construction sector's total assets accounted for by firms at which bankruptcy proceedings were initiated was less than in the previous year. The financial and economic crisis hit construction firms very hard: bankruptcy proceedings were initiated in the following years at firms that accounted for 43% of the sector's total assets in 2007. The next highest figure is in the financial and insurance activities sector, where 16% of the sector's total assets are accounted for by firms in bankruptcy. By mid-April this year the real estate activities sector was also notable for the proportion of total assets accounted for by firms in bankruptcy.

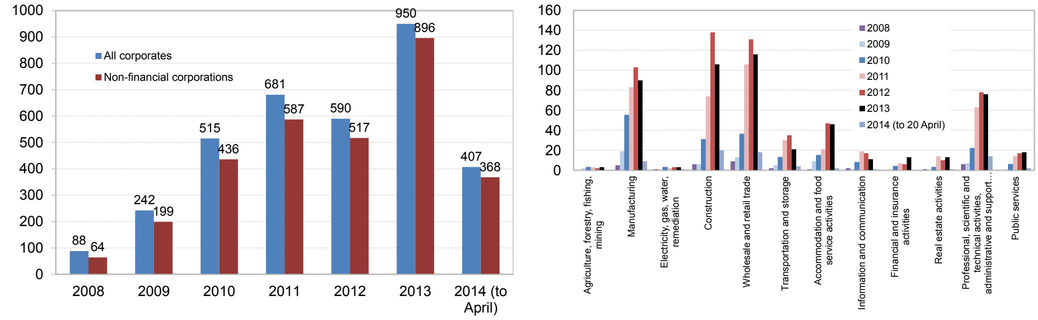
Figure 4.11: Percentage of total assets in the sector accounted for by firms in bankruptcy by year of initiation of bankruptcy proceedings*




*Note: Calculated as the ratio of the total assets of firms in bankruptcy to the total assets in the sector. The figures are for the year before bankruptcy proceedings are initiated, when the firms were still compiling annual financial statements.

Sources: AJPES, Bank of Slovenia, Supreme Court

Figure 4.12: Number of bankruptcy proceedings initiated against firms overall (left) and by sector (right)

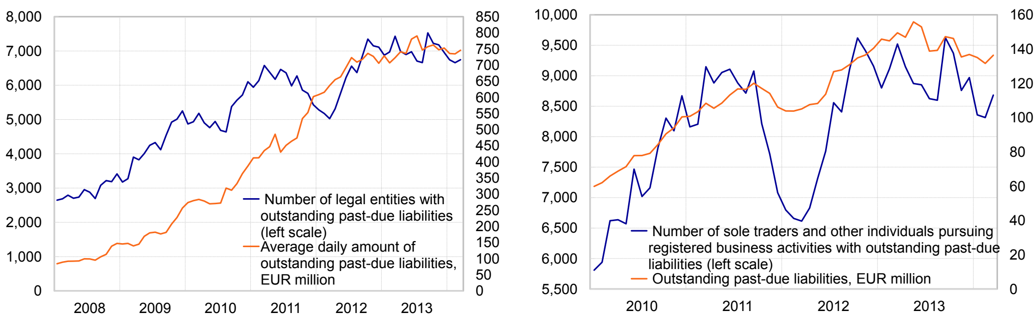



Sources: AJPES, Bank of Slovenia, Supreme Court

**The rise in the number of firms with outstanding past-due financial liabilities came to an end in 2013.**

The rise in the number of firms with outstanding past-due financial liabilities from court enforcement orders and tax debt came to an end in 2013. There is a similar trend in the number of sole traders and other private individuals with outstanding past-due liabilities from court enforcement orders and tax debt. The rise in the average daily amount of these liabilities at legal entities also came to an end. The average daily amount of these liabilities at sole traders began falling in the second half of last year.

Figure 4.13: Number of legal entities (left) and sole traders and private individuals pursuing a registered economic activity (right) with outstanding past-due liabilities from court enforcement orders and tax debt and their average daily amount of outstanding past-due liabilities in EUR million




Source: Bank of Slovenia

### Corporate performance in terms of leverage and debt servicing capacity

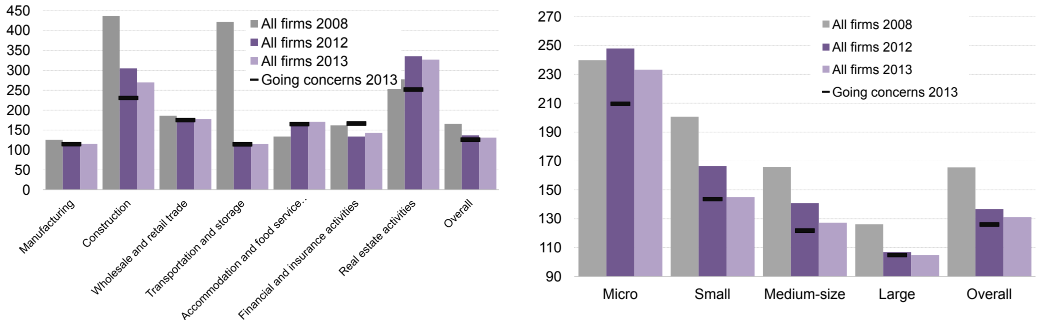
**Corporate indebtedness as measured by leverage declined between 2008 and 2013, albeit primarily as a result of a decline in debt, and less as a result of an increase in equity.**

There has been a continuous trend of decline in corporate leverage as measured by the debt-to-equity ratio since 2008. Non-financial corporations' leverage[15] declined from 166% in 2008 to 131% last year. The main factor in the decline in leverage since 2008 was a decline of 16% in debt liabilities, equity having increased by 6%. Leverage in 2008 was highest in the transportation and storage sector and the construction sector, where it had declined by almost a half by last year, primarily as a result of the elimination of firms in bankruptcy from the overall indicator. Leverage increased slightly in the accommodation and food service activities sector. The net financial debt to EBITDA ratio[16] declined from 4.6 to 4.1 last year, an indication of the slight improvement in debt servicing capacity. Indebtedness in the manufacturing sector was among the lowest. The indicators for firms operating as going concerns in a particular year show a lower level of indebtedness. Leverage at going concerns stood at 126% last year, while the net financial debt to EBITDA ratio stood at 3.8.

[15] The value for leverage calculated here differs from the indicator published in previous sections, which illustrates the ratio of debt to equity in corporate financing on the basis of financial accounts figures (the differences are the result of the differences in the methodology of data capture). In this section leverage is calculated as the debt-to-equity ratio from closing corporate balance sheet figures collated by AJPES.

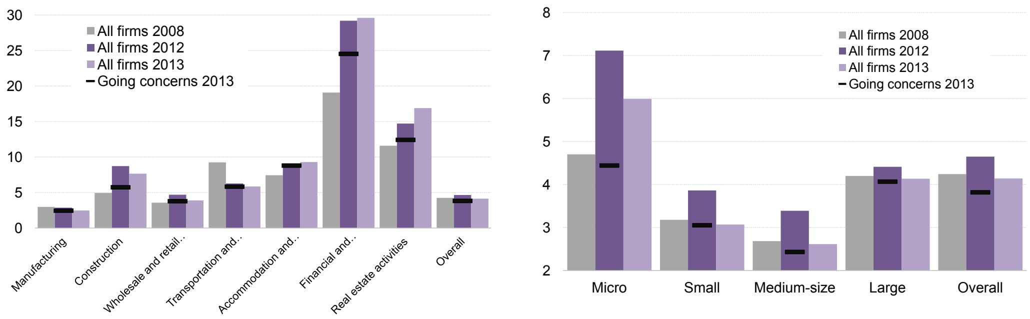
[16] The net financial debt to EBITDA indicator is measured as the ratio of financial liabilities, less cash and cash equivalents, to cash flows from operating activities. The indicator shows a firm's capacity to regularly service debt (interest and principal), and shows how many years of cash flow the firm needs to repay debt; the lower the ratio, the lower the risk in the repayment of the firm's liabilities.

Figure 4.14: Leverage for selected sectors (left) and in terms of corporate size (right) in 2008, 2012 and 2013 in percentages




Note: Going concerns are defined as firms not in bankruptcy proceedings that had positive operating revenues in 2013.
Sources: AJPES, Bank of Slovenia

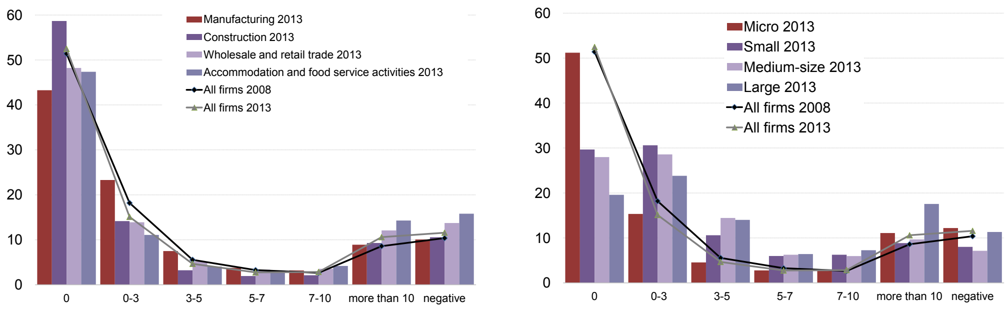
Figure 4.15: Net financial debt to EBITDA in terms of years for selected sectors (left) and in terms of corporate size (right) in 2008, 2012 and 2013




Note: Going concerns are defined as firms not in bankruptcy proceedings that had positive operating revenues in 2013.
Sources: AJPES, Bank of Slovenia

Due to the duration of the financial crisis the proportion of firms with high capacity to service financial liabilities declined between 2008 and 2013, while the proportion of firms with the lowest debt servicing capacity (an indicator of more than 10) increased. This has also been reflected in caution and stricter requirements from the banks in their credit standards, alongside less willingness to take up additional risks. Last year firms in the sectors of manufacturing and of accommodation and food service activities saw higher risk in their repayments of liabilities.

Figure 4.16: Distribution of the net financial debt to EBITDA indicator for selected sectors (left) and in terms of corporate size (right) in 2008 and 2013



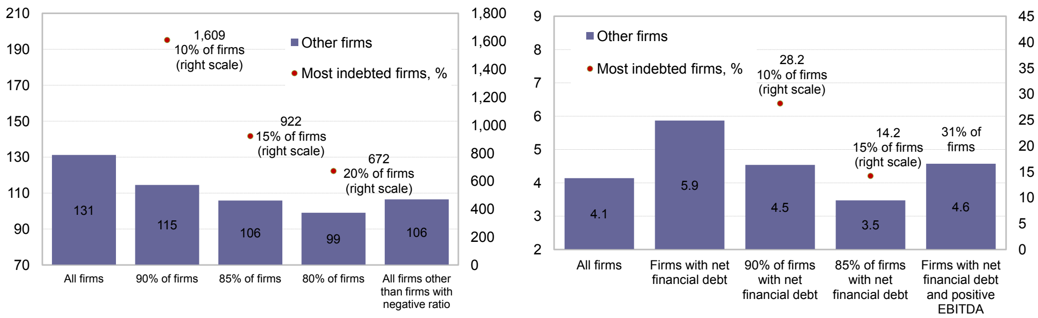

Note: "0"includes firms with no financial debt, "more than 10" includes firms with net financial debt and zero EBITDA, and "negative" includes firms with net financial debt and negative EBITDA. The calculation has been made on the basis of provisional AJPES figures.
Sources: AJPES, Bank of Slovenia calculations

There was increased risk in repayments of liabilities by both large enterprises and SMEs last year. With duration of the economic and financial crisis SMEs find it harder to access financing than large enterprises. They face many obstacles to obtaining financing, and are more dependent on bank financing, but also face higher financing costs because of the higher interest rates demanded. They are often less profitable than large enterprises, for which reason they must strengthen their liquidity more. The banks have also become more cautious and more demanding in their choice of borrowers, in order to raise the quality of their portfolios.[17]

**Corporate indebtedness is highly concentrated, with only 10% or 15% of firms classed as highly indebted.**

Corporate indebtedness is highly concentrated. The distribution of corporate indebtedness indicators is large, still excluding the 10% most-indebted firms, leverage at the remainder of firms stands at 115%, while leverage is 106% if the 15% most-indebted are excluded. A similar picture is presented by the net financial debt to EBITDA indicator, which stands at 5.9 for firms with net financial debt, and at 4.6 for firms with net financial debt and positive EBITDA. These firms accounted for 31% of the total number and 74% of the total assets of all non-financial corporations. The overall ranking of performance indicators in terms of sector is also reflected in the banks' premiums on loans tied to the EURIBOR as the premium for the risk taken up by the bank. Firms in the sectors of accommodation and food service activities, construction and real estate activities have the highest risk rankings on the basis of selected financial indicators, and also have the highest premiums at the banks.

Figure 4.17: Leverage (left) and net financial debt to EBITDA ratio (right) for most-indebted firms and remaining firms at the end of 2013




Sources: AJPES, Bank of Slovenia calculations

Table 4.5: Selected financial performance indicators by sector, and premiums over the EURIBOR on new loans at the domestic banks

| | Leverage, % | Liquidity ratio, %[1] | Proportion more than 90 days in arrears, %[2] | Net financial debt / EBITDA | Overall ranking[3] | Premiums over EURIBOR, percentage points[4] | Ranking |
|---|---|---|---|---|---|---|---|
| | Dec 2013 | | | | | 2013 | |
| Agriculture, forestry, fishing, mining | 138.4 | 54.3 | 16.1 | 7.1 | 7 | 4.1 | 9 |
| Manufacturing | 115.7 | 74.5 | 15.9 | 2.5 | 3 | 3.3 | 1 |
| Electricity, gas, water, remediation activities | 53.5 | 104.9 | 5.5 | 2.8 | 1 | 3.5 | 3 |
| Construction | 269.8 | 64.7 | 50.0 | 7.7 | 11 | 4.2 | 11 |
| Wholesale and retail trade | 177.2 | 62.9 | 18.1 | 3.9 | 8 | 3.8 | 4 |
| Transportation and storage | 114.9 | 80.6 | 7.1 | 5.8 | 4 | 4.0 | 6 |
| Accommodation and food service activities | 171.0 | 32.7 | 33.0 | 9.3 | 12 | 4.2 | 10 |
| Information and communication | 106.6 | 99.7 | 13.6 | 1.9 | 2 | 3.4 | 2 |
| Financial and insurance activities | 143.0 | 60.2 | 28.6 | 29.6 | 9 | 4.0 | 7 |
| Real estate activities | 327.0 | 71.2 | 23.3 | 16.9 | 10 | 4.3 | 12 |
| Professional, scientific and technical activities, administrative and support service activities | 145.2 | 79.8 | 25.2 | 5.8 | 6 | 4.0 | 5 |
| Public services | 156.4 | 47.9 | 9.6 | 3.4 | 5 | 4.0 | 8 |
| Overall | 131.2 | 71.8 | 20.4 | 4.1 | | 3.5 | |

Notes: [1] The liquidity ratio is calculated as the percentage ratio of current receivables to current liabilities. A higher ratio represents better liquidity, while for all the other indicators a higher value is less favourable.
[2] Proportion of the banks' classified claims against the sector more than 90 days in arrears.
[3] The overall ranking is calculated from the individual rankings for each indicator, where a higher ranking indicates higher risk.
[4] The premiums refer to those on long-term bank loans tied to the EURIBOR.

Sources: AJPES, Bank of Slovenia, Bank of Slovenia calculations

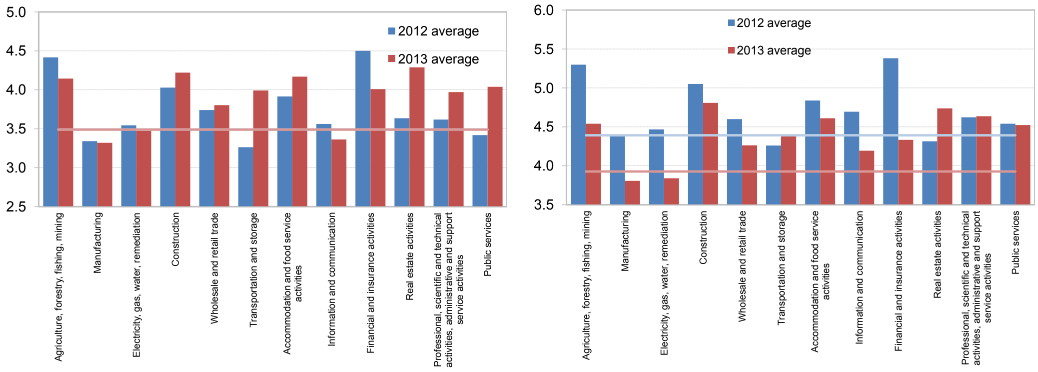
[17] Economic and Financial Committee; Finance for growth: Report of the high level expert group on SME and infrastructure financing, 2013.

## Risk premium at banks by sector and corporate size

**Last year's largest increase in premiums was recorded by transportation and storage, while the smallest was recorded by manufacturing.**

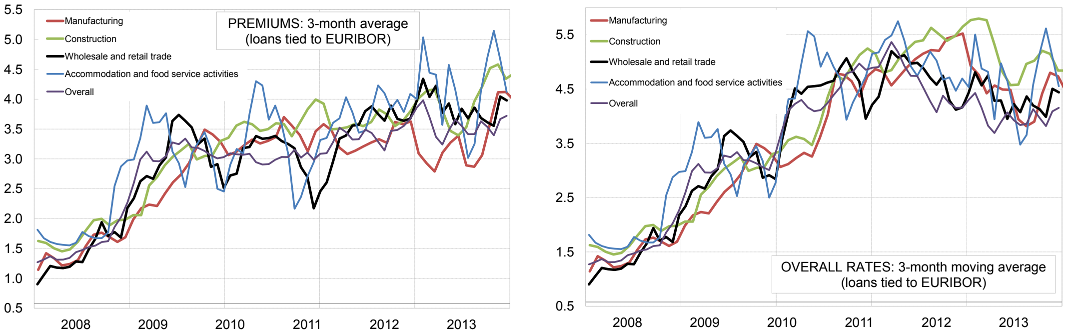
The overall interest rate fell in the majority of sectors in 2013, although the premiums increased in some sectors. The premiums over the reference interest rate remain high in construction, which is to be expected given the performance of the sector and the large proportion of arrears of more than 90 days. Last year's largest increases of 0.7 percentage points were recorded by the average annual premiums in transportation and storage and in real estate activities. Premiums in the accommodation and food service activities sector, which was notable for its poor performance indicators last year, increased markedly in the first half of 2013 and in the early part of this year. The average premiums over the year remained at almost the same level for the manufacturing sector, which last year recorded better performance than other sectors, although they increased considerably in the final months of the year. In light of the small number of new loans, the fluctuation in premiums over the year could be an indication of a different make-up of clients and a large proportion of restructured loans, which in individual months lead to fluctuations in interest rates.

Figure 4.18: Premiums over the EURIBOR (left) and overall interest rates (right) by sector in percentages




Note: Interest rates on long-term bank loans; only loans tied to the EURIBOR are included in the premium figures.
Source: Bank of Slovenia

Figure 4.19: Premiums over the EURIBOR (left) and overall interest rates (right) by sector in percentages

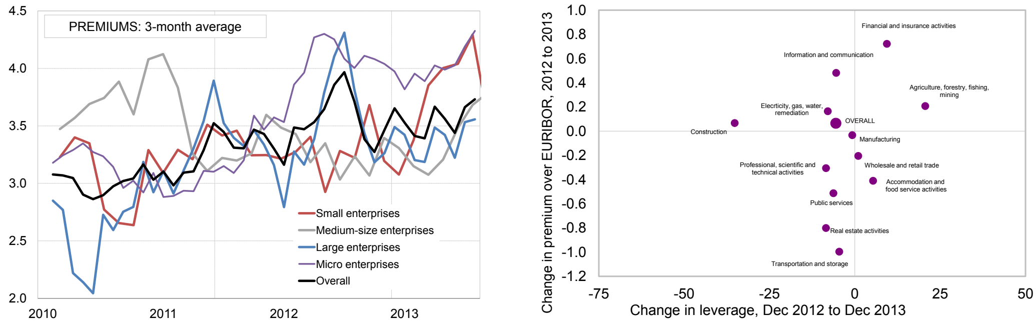



Source: Bank of Slovenia

The average premiums for micro and small enterprises were higher than those for medium-size and large enterprises, particularly in the second half of last year. Given their higher indebtedness, last year small enterprises had higher financing costs at banks than large enterprises, although they increased their net profit, while large enterprises, which had the lowest average premium at the end of last year, recorded a decline in net profit.

Evidence of the link between the premiums over the EURIBOR on new bank loans and corporate leverage comes from the coefficient of correlation between the change in the premium over the EURIBOR between 2012 and 2013 and the change in leverage during the same period in individual sectors. Firms in the majority of sectors reduced their leverage in 2013, while the banks mostly increased their premiums, particularly in the sectors of financial and insurance activities, and information and communication activities.

Figure 4.20: Premiums over the EURIBOR in terms of corporate size (left) and premiums over the EURIBOR on new bank loans to corporates in relation to corporate leverage by sector (right) in percentages




Source: Bank of Slovenia

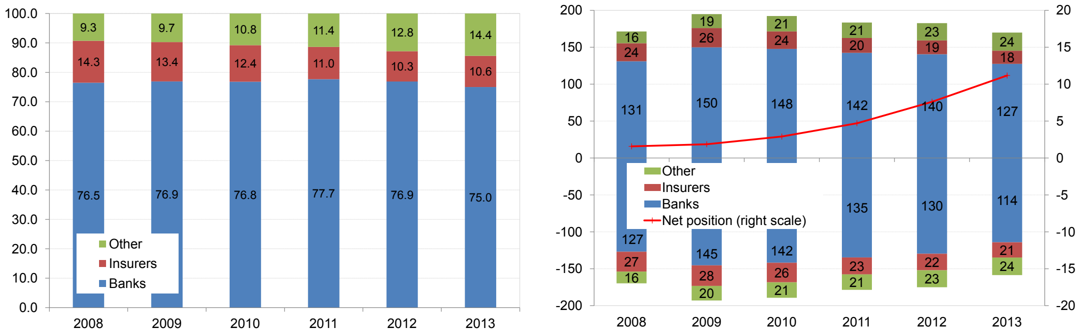
# 5 FINANCIAL SYSTEM

## 5.1 Structure of the financial system

**The assets of the Slovenian financial system declined by 12.3% in 2013. They also declined in terms of the ratio to GDP, which reached 161%.**

The assets of the Slovenian financial system declined by 12.3% in 2013. They also declined in terms of the ratio to GDP, which reached 161%. The financial system remains small compared with the euro area overall, where the financial system is equivalent to 612% of GDP. A comparison with the euro area also reveals the relative lack of development in intermediaries that are not classed as banks or insurers. These manage just 14% of financial assets in Slovenia, compared with 31% in the euro area overall. The banks retain a large proportion of financial assets under management, although their assets are declining owing to the contraction in lending activity.

Figure 5.1: Structure of the financial sector in terms of financial assets (left) and ratio of financial assets, liabilities and net position to GDP by financial sub-sector (right) in percentages




Note: S.122: Other monetary financial institutions (commercial banks and savings banks); S.123: Other financial intermediaries and financial auxiliaries, except insurance corporations and pension funds (including investment funds and leasing companies); S.125 Insurance corporations and pension funds.

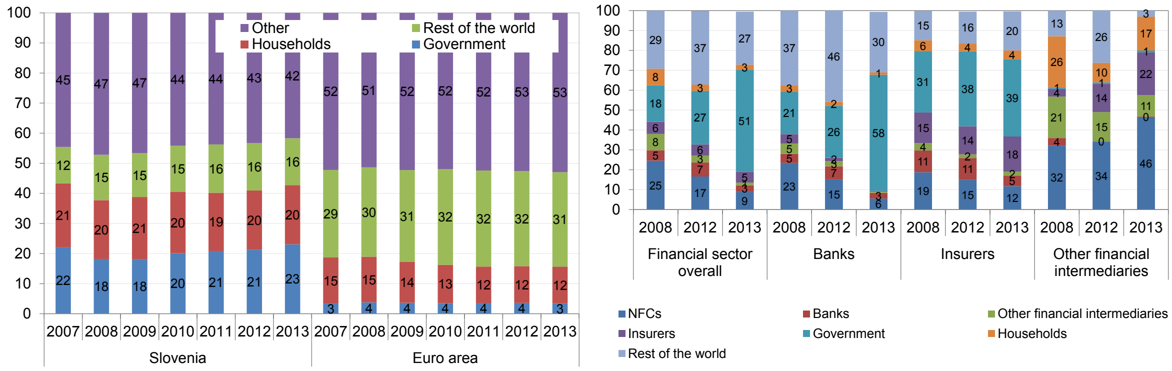
Sources: Bank of Slovenia, ECB, Eurostat, SORS

Loans remain the most important form of financial asset in the Slovenian financial system, although the proportion that they account for is declining. As a result of the transfer of non-performing claims to the Bank Asset Management Company in exchange for debt securities, the proportion of financial instruments accounted for by the latter increased. The proportion of financial liabilities accounted for by loans also declined, as a result of repayments of loans to foreign banks and the withdrawal of banks undergoing restructuring from funding segments of the financial sector.

**Loans remain the most important form of financial asset in the Slovenian financial system, although the proportion that they account for is declining. Alternative sources of financing for the Slovenian economy remain poorly developed.**

Alternative sources of financing for the Slovenian economy remain poorly developed, which is reflected in the large proportion of equity in all sectors that is under the direct ownership of households. FDI in equity is still lower in Slovenia than the euro area average. The proportion of equity held by the general government sector has been gradually increasing since the outbreak of the crisis, and was strengthened further by the bank recapitalisations in December 2013. The general government sector thus directly owned 23% of the equity of all sectors and 51% of the equity of the financial sector at the end of 2013. In light of the commitments made in the restructuring plans of the banks receiving state aid, and the Slovenian government's intention to sell off interests in government-owned firms, the proportion of foreign ownership in Slovenia can be expected to increase.

Figure 5.2: Breakdown of equity by owner sector in Slovenia and the euro area (left) and ownership structure of the financial sector (right) in percentages




Note: Only direct ownership is considered in the ownership structure of the financial sector.
Sources: ECB, SORS (left), CSCC (right)

Table 5.1: Overview of the Slovenian financial sector in terms of total assets

| | Total assets, EUR million | | | Breakdown, % | | | As % of GDP | | | Growth, % | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2011 | 2012 | 2013 | 2011 | 2012 | 2013 | 2011 | 2012 | 2013 | 2012 | 2013 |
| Monetary financial institutions[1] | 49,243 | 46,119 | 40,442 | 72.8 | 72.1 | 71.3 | 136.2 | 130.6 | 114.6 | -6.3 | -12.3 |
| NMFIs | 18,392 | 17,828 | 16,251 | 27.2 | 27.9 | 28.7 | 50.9 | 50.5 | 46.1 | -3.1 | -8.8 |
| insurers | 6,108 | 6,762 | 6,957 | 9.0 | 10.6 | 12.3 | 16.9 | 19.1 | 19.7 | 10.7 | 2.9 |
| pension companies/funds[2] | 1,518 | 1,491 | 1,475 | 2.2 | 2.3 | 2.6 | 4.2 | 4.2 | 4.2 | -1.8 | -1.0 |
| investment funds | 1,816 | 1,835 | 1,859 | 2.7 | 2.9 | 3.3 | 5.0 | 5.2 | 5.3 | 1.0 | 1.3 |
| leasing companies | 5,177 | 4,712 | 3,537 | 7.7 | 7.4 | 6.2 | 14.3 | 13.3 | 10.0 | -9.0 | -25.0 |
| BHs, MCs, others | 3,774 | 3,028 | 2,423 | 5.6 | 4.7 | 4.3 | 10.4 | 8.6 | 6.9 | -19.8 | -20.0 |
| Total | 67,635 | 63,948 | 56,693 | 100.0 | 100.0 | 100.0 | 187.1 | 181.1 | 160.7 | -5.5 | -11.3 |

Notes: The figures for leasing companies, brokerage houses, management companies and others are obtained from the AJPES database of closing accounts based on the SKD 2008 classification of business activities. The figures for leasing companies include all companies included under financial leasing, activity code K64.91, according to the SKD 2008.
[1]Monetary financial institutions do not include the central bank.
[2]The First Pension Fund is included among pension funds.
Sources: Bank of Slovenia, ISA, SMA, AJPES

# 6 BANKING SECTOR

## 6.1 Structural features of the banking sector

### Banking sector size and changes of status

At the end of 2013 there were 17 banks, three savings banks and three branches of foreign banks operating in Slovenia. The banks and branches dominate the banking sector, with a market share of 98.0% in terms of total assets. The total number of credit institutions was unchanged from the previous year, although a decision to perform out an orderly wind-down at two smaller banks was taken in early September 2013. The Bank of Slovenia received notifications from 16 new credit institutions last year, while four credit institutions revoked their notifications, taking the total number of credit institutions that had provided notification of cross-border activities in Slovenia to 318 by the end of the year.

**A total of 23 credit institutions were operating in Slovenia at the end of 2013, the banks dominating the banking sector.**

The total assets of all banks and savings banks stood at EUR 40.4 billion at the end of 2013, of which banks and the branches of foreign banks accounted for EUR 39.7 billion, while savings banks accounted for EUR 721 million. The banks thus account for nearly the entire banking system. The total assets of banks and savings banks amounted to 115% of GDP at the end of the year. The total assets of banks and savings banks as a percentage of GDP were down 15 percentage points last year as a result of the contraction in total assets, which were down 12.3%. The banking system's total assets declined for the fourth consecutive year. Last year's decline of EUR 5.7 billion exceeded the previous year's decline of EUR 2.6 billion. The cumulative decline in the banking system's total assets from 2009 until the end of 2013 was thus EUR 11.6 billion or 20.3%. A reduction in the banks' leverage can also be expected in 2014.

**The banking system's total assets stood at 115% of GDP last year.**

### Changes in the balance sheet structure

On the funding side the decline in growth in total assets over the first eleven months of last year coincided with the banks' debt repayments on wholesale markets in the rest of the world and in a decline in equity as a result of generated losses, while the largest decline on the asset side was recorded by loans, as a result of impairments created. The measures taken by the Slovenian government and the Bank of Slovenia to stabilise the banking system in December had a strong impact on the movement in total assets.

**The banking system's total assets declined by 12.3% last year.**

Measures to stabilise the banking system have had a relatively strong impact on the major balance sheet categories. The following measures were taken: a) the recapitalisation of NLB d.d., NKBM d.d., Abanka Vipa d.d. and two smaller banks, Factor banka d.d. and Probanka d.d., which have been undergoing an orderly wind-down process since September; b) recapitalisation via government securities obtained by the aforementioned banks in their portfolios, with the exception of Abanka; c) the write-down of subordinated instruments (bail-in); and d) the transfer of certain non-performing claims at NLB d.d. and NKBM d.d. to the BAMC. This resulted in an increase in equity on the liability side, and a decline in government deposits and subordinated debt. On the asset side, there was an increase in investments in securities as a result of the bonds and treasury bills received in the banks' portfolios.

**The measures taken by the Slovenian government and the Bank of Slovenia to stabilise the banking system in December 2013 have resulted in a change to the balance-sheet structure.**

Table 6.1: Total assets of banks compared with GDP

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|
| Total assets, EUR million | 47,948 | 52,009 | 50,760 | 49,243 | 46,119 | 40,442 |
| GDP (current prices), EUR million | 37,245 | 35,556 | 35,607 | 36,172 | 35,466 | 35,275 |
| Total assets as % of GDP | 129 | 146 | 143 | 136 | 130 | 115 |
| No. of bank employees | 12,232 | 12,188 | 11,943 | 11,813 | 11,498 | 11,218 |

Source: Bank of Slovenia

### Bank ownership

There was a significant change in the ownership structure of the banking system in 2013, as the Slovenian government recapitalised five banks on the basis of a decision on state aid and thus became the sole owner of those banks. In addition to the seven subsidiary banks and three branches that were under full foreign ownership at the end of 2013, there were seven banks under full domestic ownership, and three banks under majority domestic ownership. The proportion of capital held by non-residents as measured by equity stood at 31.3%, while the proportion under direct government ownership was 58.7% and the proportion held by

**The recapitalisation of five banks by the Slovenian government on the basis of a state aid decision led to a change in the ownership structure of the banks.**

other domestic owners was 10.0%. As a result of the initiation of the recovery process, the proportion of equity in the banking system held by the government increased by 35.9 percentage points, while the proportion held by non-residents declined by 10.7 percentage points and the proportion held by other domestic owners declined by 25.3 percentage points. The proportion of the banks' equity held by non-residents was 31% as at 31 December 2013.

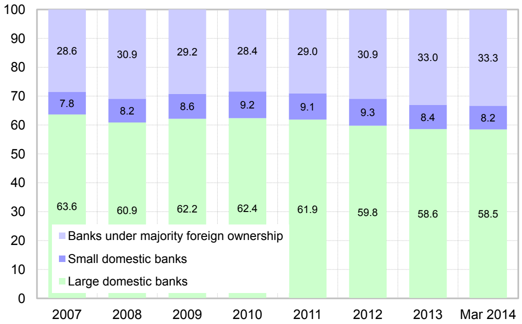
Table 6.2: Ownership structure of the banking sector (in terms of equity)

| (%) | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|
| Central government | 17.7 | 20.5 | 20.1 | 22.7 | 22.8 | 58.1 |
| Other domestic entities | 44.1 | 43.0 | 42.9 | 38.1 | 35.2 | 10.9 |
| Non-residents | 38.2 | 36.6 | 37.1 | 39.3 | 42.0 | 31.0 |
| non-residents (over 50% control) | 27.6 | 26.8 | 27.9 | 30.1 | 33.3 | 30.6 |
| non-residents (under 50% control) | 10.6 | 9.8 | 9.2 | 9.1 | 8.7 | 0.4 |

Source: Bank of Slovenia

The banks are divided into three groups in the Financial Stability Review: the large and small domestic banks, including savings banks, and the banks under majority foreign ownership. Each bank is classified into one group only. An analytical breakdown of the banking system into homogeneous groups, based on the characteristics of the banks' operations, in particular the prevailing form of bank funding, is applied.

Figure 6.1: Market shares of banks under majority foreign ownership and under majority domestic ownership in terms of total assets in percentages




Source: Bank of Slovenia

### Concentration in the banking sector

**Market concentration in the banking system diminished last year.**

Market concentration on the banking market is declining owing to a reduction in the market shares of the largest banks. Market concentration on the banking market as measured by the market share of the five largest banks and by the Herfindahl-Hirschman index (HHI) has declined in recent years. The concentration of the banking system remains higher in terms of instruments on the liability side than on the lending side. Concentration diminished last year in deposits by and loans to the non-banking sector. At 1,096 at the end of 2013, the value of the HHI for deposits by the non-banking sector was still more than 174 points above the value of the same index for loans to the non-banking sector. On the liability side, the concentration of liabilities to domestic banks increased last year, while the concentration of deposits by the non-banking sector diminished. The diminishing concentration of household deposits, particularly the last two years, is the result of a switch in deposits from the large domestic banks to the banks under majority foreign ownership. Last year's decline in market shares in loans to the non-banking sector was primarily the result of diminishing concentration in December due to the transfer of the non-performing claims of the two largest banks to the Bank Asset Management Company.

Table 6.3: Market concentration of the Slovenian banking market as measured by the Herfindahl-Hirschman index, and market share of the top three/five banks

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | Change 2012-2013 |
|---|---|---|---|---|---|---|---|
| | | | | Herfindahl-Hirschman index | | | |
| Total assets | 1,275 | 1,262 | 1,149 | 1,110 | 1,041 | 993 | -48 |
| Loans to non-banking sector | 1,218 | 1,164 | 1,122 | 1067.6 | 1,042 | 922 | -120 |
| Liabilities to non-banking sector | 1,578 | 1,587 | 1,471 | 1,392 | 1,256 | 1,096 | -160 |
| Liabilities to banks | 1,217 | 1,047 | 1,243 | 1,209 | 1,179 | 1,337 | 158 |
| | Market share of top 3 banks, % | | | | | | percentage points |
| Total assets | 47.7 | 47.7 | 45.7 | 44.7 | 43.2 | 42.5 | -1.5 |
| Loans to non-banking sector | 46.7 | 46.0 | 45.9 | 44.4 | 42.5 | 38.0 | -1.9 |
| Liabilities to non-banking sector | 55.9 | 55.7 | 54.3 | 53.1 | 49.7 | 44.5 | -3.4 |
| Liabilities to banks | 48.0 | 46.3 | 53.9 | 53.6 | 52.3 | 55.7 | -1.3 |
| | Market share of top 5 banks, % | | | | | | percentage points |
| Total assets | 59.1 | 59.8 | 59.2 | 58.9 | 57.1 | 56.2 | -0.9 |
| Loans to non-banking sector | 59.2 | 58.5 | 59.0 | 58.2 | 56.7 | 52.9 | -3.8 |
| Liabilities to non-banking sector | 68.2 | 67.9 | 66.7 | 65.5 | 62.5 | 59.6 | -2.9 |
| Liabilities to banks | 63.6 | 61.3 | 67.9 | 67.9 | 67.5 | 72.2 | 4.7 |

Source: Banka Slovenije

## 6.2 Risks in the banking sector

**Contribution of institutional factors to the stability of banks.**

The transfer of non-performing claims to the Bank Asset Management Company (BAMC) in exchange for the latter's bonds and the recapitalisation of banks were factors in the improvement in the indicators of the banking system's stability at the end of 2013. The overall capital adequacy of the banking system reached 14.0%, while the proportion of claims more than 90 days in arrears stood at 13.4% There was also a significant improvement in both prudential liquidity ratios, with even the "second-bucket" liquidity ratio exceeding a value of unity. However, the bank recovery process is not yet complete. Two banks are still waiting on approval of their restructuring plan and government-funded recapitalisation.

Table 6.4: Effects of bank recovery measures at the end of 2013

| MoF and Bank of Slovenia measures, Dec 2013 | Recapitalisation | Write-off of sub-ordinated debt | Transfer of claims to BAMC* | | Receipt of BAMC bonds |
|---|---|---|---|---|---|
| *Changes to date, EUR million* | | | gross claims | net loans | |
| **1) NLB d. d.** | **1,551** | **-257** | **-2,286** | **-1,257** | **622** |
| a) Cash recapitalisation via conversion of deposits | 1,140 | | | | |
| b) Recapitalisation via government securities | 411 | | | | |
| **2) NKBM d. d.** | **870** | **-64** | **-1,033** | **-578** | **390** |
| a) Cash recapitalisation via conversion of deposits and currency | 619 | | | | |
| b) Recapitalisation via government securities | 251 | | | | |
| **3) Abanka Vipa d. d.** | **348** | **-120** | **…** | **…** | **…** |
| a) Cash recapitalisation via conversion of deposits | 348 | | | | |
| b) Recapitalisation via government securities | | | | | |
| **4) Factor banka d. d.** | **269** | **-23** | | | |
| a) Cash recapitalisation via conversion of deposits | 160 | | | | |
| b) Recapitalisation via government securities | 109 | | | | |
| **5) Probanka d. d.** | **176** | **-41** | | | |
| a) Cash recapitalisation via conversion of deposits | 160 | | | | |
| b) Recapitalisation via government securities | 16 | | | | |
| Cash recapitalisation. total | 2,427 | | | | |
| Recapitalisation via securities | 787 | | | | |
| **Total recapitalisation** | **3,214** | **-505** | **-3,319** | **-1,835** | **1,012** |

Source: Bank of Slovenia

**The increase in household deposits indicates the gradual restoration of confidence in the banks.**

The increase in household deposits during the first quarter of 2014 indicates the gradual restoration of confidence in the banks. Diminished confidence in the soundness of the banks following events in Cyprus in March, the start of the orderly wind-down of two banks in September and uncertainty regarding the results of the comprehensive assessment of the banks in the final quarter of 2013 were seen in a decline in household deposits of EUR 464 million. Households' deposits were up by EUR 253 million in the first quarter of 2014, partly as a reflection of increased confidence in the banks.

**The repayment of liabilities to the ECB remains a significant factor in refinancing risk.**

The banking system's surplus liquidity has increased in conjunction with the improvement in capital adequacy ratios and reduced exposure to credit risk, and with the increased stock of liquid investments and diminishing uncertainty in the banking system. The banks have reduced their stock of liabilities to the Eurosystem by one-quarter over the last six months. Nevertheless, the repayment of liabilities to the ECB remains a significant factor in refinancing risk.

The refinancing risk associated with wholesale funding (via foreign banks and issued securities) has diminished due to intensive debt repayments in previous years. There has been a partial substitution of wholesale funding with deposits by the non-banking sector in the balance-sheet structure. The banks repaid EUR 10.7 billion in wholesale funding between the end of 2008 and March 2014. The remaining EUR 6.7 billion in liabilities account for 16.6% of total assets, just one-half of the proportion accounted for by such liabilities in 2008. The proportion of liabilities accounted for by deposits by the non-bank sector rose by 14.3 percentage points over the same period to stand at 57.9%. The contraction in lending to the non-banking sector was also an important source for the repayment of wholesale funding. Although refinancing risk on the wholesale markets has diminished in 2014, it will rise significantly during the first half of 2015. The restructuring of the banks' funding thus continues.

**The financial crisis has driven down credit demand, although the first indications of improvement are being seen.**

Credit demand has declined due to the financial crisis. Fewer investment opportunities and the decline in foreign demand in recent years have contributed to declining economic growth and diminished credit demand. Further hindering the latter were the large number of initiated bankruptcy proceedings, high financing costs and high corporate indebtedness, and a lack of eligible collateral. Indicators of credit demand are, nonetheless, improving. Economic growth was up in the final quarter of 2013 on account of exports and investment. Indicators of economic sentiment have improved to the level recorded in the third quarter of 2008, prior to the outbreak of the economic crisis, in both manufacturing and the construction sector. At 23%, the proportion of corporate debt financing accounted for by loans from the rest of the world has already reached the 2004 level.

**Significant limiting factors to credit growth can also be seen on the supply side.**

Alongside limited creditworthy demand, significant limiting factors to credit growth can also be seen on the supply side. Despite surplus liquidity and recapitalisations, the banks remain reluctant to lend to the non-banking sector. Credit standards are tighter than in the pre-crisis period. Despite being cut, interest rates remain above the euro area average, while the level of excess corporate credit demand that the banks fail to service is rising. The latter is highest at the banks where the ratio of loans to the non-banking sector to deposits by the non-banking sector (LTD ratio) is declining most rapidly.

**In the context of a deficit in capital, corporates are unable to counter the contraction in lending by the banks with alternative sources of financing.**

In a period when the banks are contracting their lending significantly, corporates are facing the dilemma of how to reduce their debt. Nevertheless, the net financial position of corporates vis-à-vis others sectors fell by 13 percentage points between 2010 and 2013 to the level recorded in 2008, or 112% GDP. Corporates became net savers at the end of 2012, and further improved their net positive position in 2013. The restructuring of the banking and corporate sectors is a parallel process that is being implemented faster in the banking sector but could proceed more slowly in the corporate sector. Slovenian corporates are less indebted than their euro area counterparts in terms of the ratio of debt to GDP, and only stand out in terms of the level of their leverage. This primarily points to a deficit in capital and the withdrawal of corporate debt financing, which only makes the situation worse for corporates.

**The repayment of wholesale funding via deposits and a contraction in lending bring new risks that prevent the normalisation of corporate financing and the banks' operations.**

Risks associated with the funding structure in the banking system are becoming significant. The repayment of longer-term wholesale funding in the context of a simultaneous increase in short-term deposits and a contraction in lending is driving down the banking system's second-bucket liquidity ratio. Reducing financing provided to the non-banking sector could lead to a further deterioration in the quality of the banks' credit portfolio. Exposure to potential losses from credit risk is mostly transferred to depositors and the guarantee scheme. Lastly, the strategy of a bank that reduces the scope of lending in the context of growth in deposits indicates the need for a change to the business model, as a bank whose core activity is represented by deposit and lending activities vis-à-vis the non-banking sector does not generate revenue from lending.

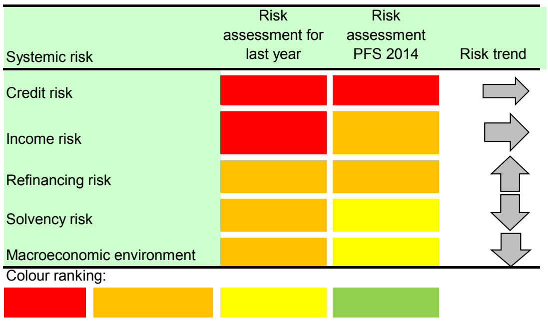
The Bank of Slovenia therefore introduced a macro-prudential instrument with the aim of slowing the decline in the LTD ratio for the non-banking sector, and requires that the banks meet higher liquidity ratios if they reduce lending to the non-banking sector despite positive growth in deposits.

**The main risks in the future will be income risk and credit risk.**

By cutting liability interest rates in 2013, which was in part encouraged by the Bank of Slovenia via its macro-prudential measure to limit deposit rates, the banks mitigated the drop in interest income due to the contraction in lending.

The main risks in the future will be income risk and credit risk (Figure 6.2). Their importance will be dictated to a great extent by developments in corporate lending. Interest rate risk could become another significant limiting factor in the banks' operations due to the shortening of average maturities and changes in the structure of liabilities, and due to the lagging of the Slovenian economic and credit cycles behind other EU countries and the impact on interest rates.

Figure 6.2: Key risks and expectations regarding their further development




Source: Bank of Slovenia

**The more intensive consolidation of the banking system can be expected.**

Processes aimed at the consolidation of the banking system have begun, and are expected to focus on ensuring capital stability, the dispersion of risks, a stable structure of funding and increased profitability. Consolidation on such bases is expected to provide capitally more sound banks easier and more affordable access to wholesale funding and ensure more streamlined operations, while having a positive impact on the interest margin and profitability.

**The privatisation of the banks is also required.**

Government ownership of the banks measured as the proportion of their capital will reach 62% in the middle of 2014 due to government-funded recapitalisations. The privatisation of the banks will be important for reducing interdependence between the government and the banks, reducing the impact on operations and for improving the governance of the banks.

### Box 6.1: Macro-prudential supervision and Bank of Slovenia instruments

With the adoption of the Act on the Macro-Prudential Supervision of the Financial System on 21 December 2013, the legal basis was laid for the implementation of macro-prudential supervision in Slovenia, where macro-prudential supervision means the prevention and mitigation of systemic risks in the financial system, and covers banks, insurers the financial instruments market, investment companies, management companies and leasing companies. The act introduces the Financial Stability Committee and sets out the methods for the implementation and functioning of supervisory authorities in the area of macro-prudential supervision. In the implementation of macro-prudential policy, supervisory authorities are responsible for macro-prudential supervision over the financial institutions for which they are responsible under the relevant sectoral laws. According to the aforementioned act, the Bank of Slovenia is responsible for supervision over leasing companies.

The Financial Stability Committee comprises eight members: two representatives each from the Bank of Slovenia, the Insurance Supervision Agency, the Securities Market Agency and the Ministry of Finance, the latter two having no voting rights. The committee, presided over by the Governor of the Bank of Slovenia, is responsible for formulating macro-prudential policy that it implements in conjunction with supervisory authorities.

Macro-prudential policy starts with the identification, monitoring and assessment of systemic risks to financial stability, and aims to safeguard the stability of the entire financial system by strengthening the resilience of the financial system and preventing and reversing the build-up of systemic risks, thereby ensuring the sustainable contribution of the financial sector to economic growth. In this respect, systemic risk is the risk of disruptions in the financial system that could have serious negative effects on the functioning of the financial system and the real economy.

Guidelines in the area of macro-prudential supervision are defined by the European Systemic Risk Board. The latter has issued six recommendations to date. The following three have been implemented: 1) the macro-prudential mandate of national authorities; 2) the granting of loans in foreign currencies; and 3) the financing of credit institutions in US dollars by the Bank of Slovenia. The following three recommendations are in the process of being implemented: 1) defining intermediate objectives and instruments of macro-prudential policy; 2) the financing of credit institutions; and 3) money market funds.

The ESRB's recommendation on intermediate objectives and macro-prudential policy instruments (ESRB/2013/1) defines the intermediate objectives of macro-prudential policy as operational specifications of the ultimate objective to safeguard the stability of the financial system. The recommendation calls for the definition of a macro-prudential policy strategy that links the ultimate objective of macro-prudential policy with the intermediate objectives and macro-prudential instruments. A framework must be established for the application of instruments with indicators to monitor the emergence of systemic risks and to guide decisions regarding the application, deactivation and calibration of instruments. A macro-prudential authority must have direct control or powers to issue recommendations associated with at least one macro-prudential instrument for each intermediate objective of macro-prudential policy. It is recommended that intermediate objectives and the effectiveness and efficiency of instruments be assessed periodically, and the set of intermediate objectives and instruments be adjusted whenever necessary. Countries must report changes to the set of intermediate objectives and instruments to the ESRB.

**Macro-prudential instruments of the Bank of Slovenia**

The Bank of Slovenia introduced an instrument in March 2012 to limit deposit rates. This measure is implemented as part of the internal capital adequacy assessment process-supervisory risk evaluation process (ICAAP-SREP) process and defines a premium on capital requirements for new deposits by the private non-banking sector where the realised deposit interest rate exceeds the ceiling set by the instrument. The Bank of Slovenia introduced the instrument with the aim of mitigating income risk in the context of an excessive increase in interest rates on deposits by the non-banking sector. This instrument is linked to the intermediate objective of limiting the systemic impact of misaligned incentives with a view to reducing moral hazard.

The GLTDF instrument entered into force in June 2014 and defines minimum requirements regarding the ratio of annual changes to the stocks of loans to, and deposits by the non-banking sector. The purpose of the instrument is to slow the rapid decline in the LTD ratio, to establish a stable structure of bank funding, and to mitigate the systemic liquidity risk associated with financing structures. This instrument is linked to the intermediate objective of mitigating and preventing excessive maturity mismatch and market illiquidity.

At the EU level, a great deal of attention is being given to the countercyclical capital buffer, which some countries have already introduced. This instrument is linked to the intermediate objective of mitigating and preventing excessive credit growth and leverage. The definition of the aforementioned buffer will be mandatory for all EU Member States from 2016 on.

**1. Limiting deposit rates**

**The reason** for the implementation of the instrument was excessive competition between the banks for deposits by the non-banking sector by raising deposit rates, which was conditioned by difficult access to the financial markets by the banks under majority domestic ownership and the tendency to reduce the LTD ratio at the banks under majority foreign ownership. The nominal value of deposits by the private non-banking sector has been stable at around EUR 21 billion since the end of 2010. The raising of deposit rates was not reflected in an increase in the stock of deposits, but merely in the switching of deposits between the banks and an increase in their funding costs.

**The objective** of the instrument was to limit the excessive raising of liability interest rates on deposits of the private non-banking sector.

**The methodolog**y defines the calculation of the premium on capital requirements for profitability risk from liability interest rates within the framework of the ICAAP-SREP process, from March 2012.

The premium on capital requirements =

$$\sum_{r=1}^{5} (\text{realised deposit rate}r - \text{interest rate ceiling}r)\ \text{stock of new transactions}_r \qquad (1)$$

r … deposit maturity category

r = 1 for deposits with a maturity of up to 1 month
r = 2 for deposits with a maturity from 1 to 3 months
r = 3 for deposits with a maturity from 3 to 6 months
r = 4 for deposits with a maturity from 6 months to 1 year
r = 5 for deposits with a maturity from 1 to 2 years

realised average deposit rate$_r$ – realised average bank deposit rate in category r, where the bank exceeds the interest rate ceiling

interest rate ceiling$_r$ – interest rate ceiling in category r. Calculated as the average of the daily EURIBOR for the period in question + premium

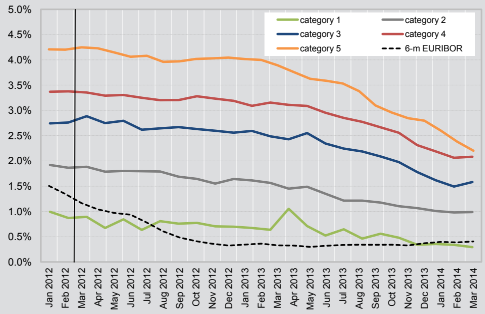
if r = 1, the weekly EURIBOR is applied + 50 bp
if r = 2, the 1-month EURIBOR is applied + 70 bp
if r = 3, the 3-month EURIBOR is applied + 150 bp
if r = 4, the 6-month EURIBOR is applied + 200 bp
if r = 5, the 12-month EURIBOR is applied + 220 bp

stock of new transactionsr – the amount of a bank's new transactions in category r, where the bank exceeds the interest rate ceiling for deposits.

The calculation of the premium in capital requirements includes new transactions in the item deposits by and loans to non-banking clients with an original maturity of up to 2 years and denominated in euros.

**Effects of the instrument.** In 2013 the banks began cutting the interest rates on deposits of all maturity buckets that are subject to the instrument. The average interest rate on deposits by the private non-banking sector with a maturity of up to 2 years fell by 1.2 percentage points from January 2013 to March 2014. There has also been a notable narrowing of the distribution of interest rates on deposits of all maturity buckets over the last six months, which indicates diminishing competition among the banks with regard to the setting of liability interest rates. This instrument has contributed to a reduction in deposit rates, although we assess that measures aimed at the stabilisation and recovery of the banks played the main role in the lowering of deposit rates.

Figure 6.3: Average interest rates on deposits at banks and savings banks (excluding bank branches) by five maturity buckets in percentages for the period January 2012 to March 2014



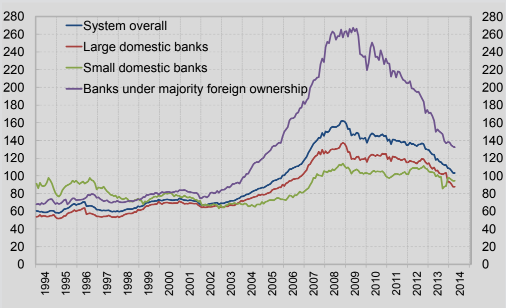

Note: r = 1 for deposits with a maturity of up to 1 month; r = 2 for deposits with a maturity of 1 to 3 months; r = 3 for deposits with a maturity of 3 to 6 months; r = 4 for deposits with a maturity of 6 months to 1 year; r = 5 for deposits with a maturity of 1 to 2 years.

## 2. GLTDF

GLTDF is the ratio of the annual change in the gross stock of loans to the non-banking sector (before impairments) to the annual change in the stock of deposits by the non-banking sector (Gross Loan To Deposit Flows). GLTDFq is a variation on the aforementioned ratio, calculated based on quarterly changes in the stock.

**The reason** for the introduction of the instrument was the rapid decline in the ratio of loans to the non-banking sector to deposits by the non-banking sector (hereinafter: the LTD ratio). After reaching its peak of 161% at the end of 2008, the LTD ratio for the entire banking system fell by 31 percentage points over a four-year period to stand at 130% at the end of 2012. The LTD ratio fell by 22 percentage points in 2013 alone to 108%, and stood at 103% in March 2014. In previous years, the LTD ratio fell primarily at the banks under majority foreign ownership, but fell rapidly at all bank groups in 2013.

Figure 6.4: LTD ratio for the non-banking sector by bank group in percentages




| | System overall | Large domestic banks | Small domestic banks | Banks under majority foreign ownership |
|---|---|---|---|---|
| | LTD, % | | | |
| 1997 | 60.3 | 54.2 | 74.9 | 71.9 |
| 2004 | 86.9 | 79.0 | 70.4 | 119.2 |
| 2005 | 100.6 | 90.1 | 73.5 | 144.3 |
| 2008 | 161.5 | 136.3 | 111.0 | 262.7 |
| 2012 | 129.8 | 113.6 | 107.7 | 174.4 |
| 2013 | 108.3 | 93.0 | 97.4 | 137.9 |
| Mar 14 | 103.2 | 87.7 | 94.5 | 132.4 |
| | Change, percentage points | | | |
| 2012-2008 | -31.7 | -22.7 | -3.2 | -88.3 |
| 2013 | -21.5 | -20.6 | -10.3 | -36.5 |
| Mar 2014-2013 | -5.1 | -5.3 | -2.9 | -5.5 |

Source: Bank of Slovenia

An increase in deposits by the non-banking sector in the context of a simultaneous contraction in lending by the banks increases systemic risk, not only in terms of long-term liquidity risk associated with bank funding; this type of behaviour by the banks also reduces the liquidity of the non-banking sector and its access thereto. This could be reflected in the further deterioration in the quality of the banks' credit portfolio, resulting in additional pressure on their liquidity. When the banks increase the stock of deposits and reduce lending to the non-banking sector to repay debt to other banks and creditors (including owners), they transfer a significant portion of credit risk and exposure to losses to depositors and the guarantee scheme. Lastly, a strategy reducing lending to the non-banking sector in the context of growth in deposits is incompatible with a business model that is sustainable in the long term, as the bank will not generate revenue from lending, which limits its ability to increase capital from retained earnings.

**The objective of the instrument** is a sustainable reduction in the LTD ratio, the establishment of a stable structure of bank funding, and the mitigation of the systemic liquidity risk associated with financing. The purpose of the instrument is to encourage the banks to moderate the contraction in lending to the non-banking sector, or to increase their stock of liquid investments and improve their liquidity ratios.

A target LTD interval of between 105% and 125% was set at the banking system level, based on the long-term ratio between growth in the LTD ratio and GDP (see the 2013 Financial Stability Review). The GLTDF ratio is being introduced as a temporary instrument, and is expected to remain in place until the establishment of a stable structure of bank funding, the stabilisation of the LTD ratio and the reduction of systemic liquidity risk.

**Methodology associated with the GLTDF instrument**

As a macro-prudential instrument, the GLTDF ratio is being introduced under the Regulation on the minimum requirements for ensuring an adequate liquidity position at banks and savings banks. Minimum GLTDF requirements, corrective measures in the event of failure to fulfil minimum requirements and exceptions from the calculation of the GLTDF ratio have been defined in the scope of changes to the aforementioned regulation.

Minimum requirements. In the event of positive growth in deposits, a bank must achieve a minimum GLTD ratio greater than or equal to 0% (i.e. no contraction in lending) during the first year the measure is in force, and a minimum GLTDF ratio greater than or equal to 40% (i.e. the stock of gross loans increases by at least 40% of the growth in deposits) during the second year.

Corrective measures. A bank that does not meet the GLTDF requirements calculated based on annual changes in the stock must, as the first corrective measure, meet stricter GLTDFq requirements calculated based on quarterly changes in stock. In the event of positive quarterly growth in deposits, a bank must achieve a minimum GLTDFq ratio greater than or equal to 40% (i.e. quarterly growth in the stock of gross loans increases by at least 40% of the quarterly growth in deposits) during the first year the measure is in force, and a minimum GLTDFq ratio greater than or equal to 60% during the second year. If, despite the requirement of the first corrective measure to fulfil the stricter GLTDFq requirements, a bank fails to fulfil either the minimum GLTDF requirements or the stricter GLTDFq requirements, it must fulfil liquidity ratios in the following order: following the first quarter in which it fails to fulfil either the minimum GLTDF requirements or the stricter GLTDFq requirements, a bank must begin to fulfil, within two months, the first-bucket liquidity ratio, without taking into account the pool of eligible collateral at the Bank of Slovenia. Following the second quarter in which it fails to fulfil either the minimum GLTDF requirements or the stricter GLTDFq requirements, a bank must also begin to fulfil the second-bucket liquidity ratio, by taking into account the pool of eligible collateral at the Bank of Slovenia. Following the third month in which it fails to fulfil either the minimum GLTDF requirements or the stricter GLTDFq requirements, a bank must also fulfil the second-bucket liquidity ratio. A value of at least 1 must be achieved for all liquidity ratios. All corrective measures cease to apply when the bank fulfils the minimum GLTDF requirements at the end of a quarter.

Exemptions. When fulfilling minimum requirements and implementing corrective measures, a bank should not take into account claims transferred to the BAMC, the transfer of claims and liabilities between banks based on a Bank of Slovenia decision, or the derecognition of claims for reason of irrecoverability, securitisation, or conversion into equity in the corresponding debtors.

**3. Countercyclical capital buffer**

As of 2016, all countries must introduce a countercyclical capital buffer (CCB), the aim of which is to ensure that the banks have at their disposal additional capital to absorb losses during a crisis and that they are better prepared to finance the economy.[1] Through higher capital requirements during expansionary periods, the CCB can also prevent the excessive build-up of risks and thus limit, to some extent, potential losses during a period of growth.

The capital buffer may range from 0% to 2.5% of risk-weighted assets (RWA). The banks must fulfil this requirement in the form of Common Equity Tier 1. The banks have 12 months to ensure the necessary level of capital following every decision to increase the CCB. A reduction in or the elimination of the CCB may apply immediately.

Presented below is the basic approach for setting the CCB as proposed by the Basel Committee on Banking Supervision [i](BCBS) and included in the CRD IV capital directive: the CCB should be set on the basis of the ratio of loans to GDP, taking into account deviations in the aforementioned indicator from the long-term trend. This indicator has proven to be the best signal of pending banking crises for a panel of several countries. Nevertheless, the BCBS warns that this indicator is not necessarily appropriate for all countries, and should be used in conjunction with other indicators such as GDP growth, growth in loans, growth in real estate prices, the banking system's profit, etc., and at the bank's own discretion. It has also been seen that the indicator is primarily appropriate for decisions to build up the capital buffer and not for decisions regarding the release thereof.

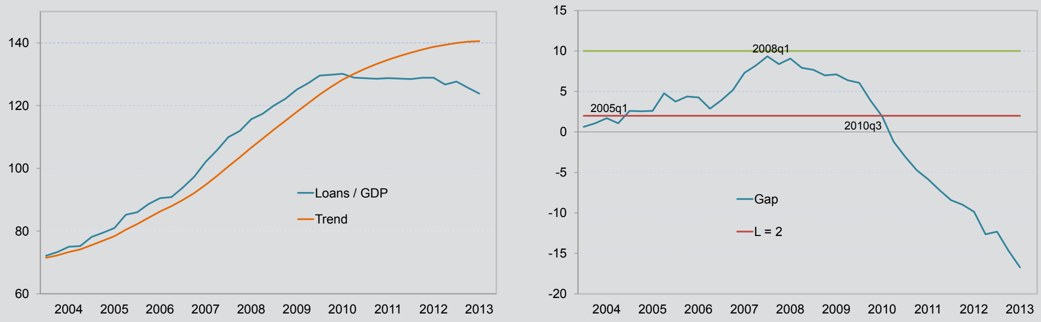
In accordance with the BCBS (2010), the calculation of the ratio of loans to GDP includes loans in the broader sense, meaning the entire financial debt of domestic private non-financial entities, including debt to the rest of the world. Although the CCB only relates to the banks, it is important to capture debt to other sectors, as the consequences of excessive borrowing by the economy as a whole could also be felt by the banks. The BCBS (2010) recommends the recursive Hodrick-Prescott (HP) filter with a lambda parameter of 400,000 for the calculation of the trend. Because this involves a gradual assessment of the trend, it is important that the latter is assessed using the longest possible data series. For Slovenia, data regarding loans in the broader sense are only available since 2001. Thus, a calculation based on data regarding loans to the domestic private non-financial sector by Slovenian banks, available since 1995, is also illustrated.

An assessment of the ratio of loans in the broader sense to GDP indicates that the ratio is currently well below trend, and is at the level recorded in the second quarter of 2009. The ratio, trend and the difference (or gap) relative to the trend are illustrated in the figures below. In accordance with the BCBS (2010), the banks must begin to build a capital buffer when the gap exceeds 2 percentage points. The latter would then increase linearly to a threshold of 10 percentage points, when the buffer would reach 2.5% of RWA, and would no longer increase, even if the gap continued to widen. In the case

[1] Norway and Switzerland have already implemented the CCB.

of Slovenia, the gap exceeded the threshold of 2 percentage points in the first quarter of 2005. The gap did not exceed the threshold of 10 percentage points, but was very close to that value in the first quarter of 2008. Stated in somewhat simplified terms, the banks should have created a CCB in the amount of 2.5% of RWA by the first quarter of 2008.

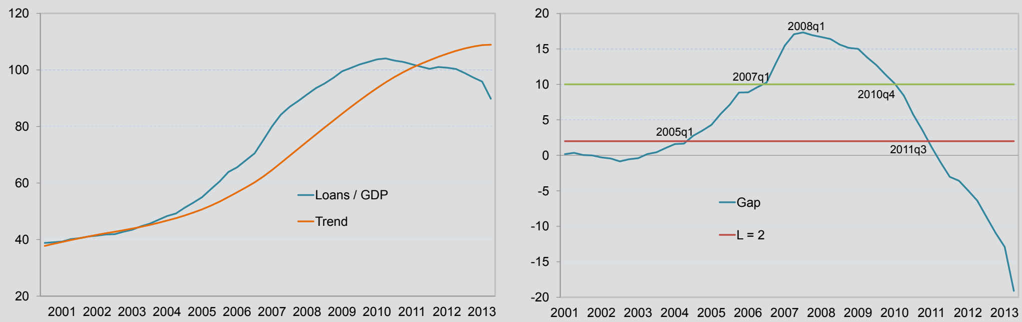
Figure 6.5: Ratio of the total financial debt of the domestic private non-financial sector to GDP in percentages (left) and deviations from the trends assessed using the HP filter in percentage points (right)




Note: The gap represents the difference between the indicator and the trend, where L is the lower threshold, i.e. a gap of 2 percentage points and H is the upper threshold, i.e. a gap of 10 percentage points.
Source: Bank of Slovenia

The assessment based on the debt of the private non-financial sector financed by Slovenian banks paints a similar picture. In this case, the gap exceeds the lower threshold one quarter earlier, i.e. in the fourth quarter of 2004, and the upper threshold in the third quarter of 2007, meaning that the banks would have already had a maximum capital buffer at the onset of the crisis. At the end of 2013 the ratio of loans by Slovenian banks to GDP was at the level recorded in the first quarter of 2008. The same is true for the stock of loans itself, which recorded the sharpest decline in the final quarter of 2013 due to the transfer of a portion of non-performing claims to the BAMC.

Figure 6.6: Ratio of total bank loans to the domestic private non-financial sector to GDP in percentages (left) and deviations from the trends assessed using the HP filter in percentage points (right)




Note: The gap represents the difference between the indicator and the trend, where L is the lower threshold, i.e. a gap of 2 percentage points and H is the upper threshold, i.e. a gap of 10 percentage points.
Source: Bank of Slovenia

Taking into account all loans to the non-banking sector and not merely loans to the private sector, the banks would have been required to start building a capital buffer in the first quarter of 2005 and would have reached the upper threshold in the first quarter of 2007, while the maximum gap would have been reached in the first quarter of 2008.

Based on past experience, we can say that the capital buffer could have helped mitigate initial or milder negative effects, but is not a substitute for prudent and effective risk management. The Slovenian banking system had an overall capital adequacy of between 10.5% and 11.7%, or more than 2.5 percentage points above the required capital adequacy of 8%, throughout the entire period when a countercyclical capital buffer should have been built, i.e. between 2005 and 2008. The Bank of Slovenia created a prudential filter to accompany the introduction of the IFRS in 2006 with the aim of preventing the disbursement of “excess” provisions. Use of the aforementioned filter was discontinued in October 2008. This was just before the outbreak of the economic crisis, when Slovenia slid into recession in the final quarter of 2008. The discontinuation of the prudential filter at the end of 2008 improved the overall capital adequacy of the banking system by 0.8 percentage points. Hypothetically, however, the overall capital adequacy of the banking system should have been 20% at the end of 2009 (compared with 11.6%) and the core Tier 1 capital ratio should have been at least 21% (compared with 9.3%) in order for capital to cover the losses generated by the banks over the last four years (2010–2013), in the context of unchanged risk-weighted assets, and in order for the banks to still achieve overall capital adequacy of 8% and a core Tier 1 capital ratio of 9%. Thus, a buffer of 10% of risk-weighted assets would have been needed. This is a cost that could not have been justified in the context of entry to the EU and EMU, the nominal convergence of interest rates, and the large proportion of the banks’ total assets accounted for by securities issued earlier to sterilise excess capital flows.

[i] BCBS (2010). Guidance for national authorities operating the countercyclical capital buffer.

**Box 6.2: Financial Stability Committee**

The need for macro-prudential supervision has been seen in the context of the recent financial crisis with the revealing of deficiencies in existing financial supervision, which could not foresee or prevent the build-up of systemic risks in the financial system. With the aim of improving the effectiveness and coordinated functioning of macro-prudential supervision in Member States and at the European Union level, the ESRB issued the Recommendation of 22 December 2011 on the macro-prudential mandate of national authorities (Recommendation ESRB/2011/3).

Recommendation ESRB/2011/3 mandates Member States to designate an authority entrusted with the conduct of macro-prudential policy in national legislation. The objective of macro-prudential policy is to contribute to safeguarding the stability of the entire financial system, and includes strengthening the resilience of the financial system and preventing and reducing the build-up of systemic risks, thereby ensuring a sustainable contribution of the financial sector to economic growth. Resilience to systemic risk depends on the establishment of a robust macro-prudential policy framework, together with micro-prudential supervision.

The Macro-Prudential Supervision of the Financial System Act (ZMbNFS) was adopted at the end of last year in order to comply with Recommendation ESRB/2011/3, and defines the conduct of macro-prudential supervision in Slovenia, as well as the tasks, supervisory measures and functions of sectoral supervisory authorities in the area of macro-prudential supervision. The ZMbNFS improves supervision over financial institutions that, due to ownership or other cross-links, operate in different segments of the financial system. The ZMbNFS strengthens cooperation between sectoral supervisory authorities that are otherwise only responsible for the supervision of their own segment of the financial system, while threats from one segment can pass through to the entire financial system if not identified in a timely and efficient manner. The ZMbNFS provides the legal basis for the establishment of coordination between sectoral supervisory authorities.

It also provides the legal basis for the establishment of the Financial Stability Committee (hereinafter: the Committee), which formulates macro-prudential policy and imposes the measures implemented by sectoral supervisory authorities. The key tasks and competences of the Committee are to identify, monitor and assess systemic risks to financial stability, coordinate cooperation and the exchange of information between sectoral supervisory authorities, and to implement the recommendations and admonishments issued by the ESRB. With the aim of conducting macro-prudential policy, the Committee propose supervisory measures and instruments set out in sectoral legislation, or other measures and instruments aimed at increasing the financial infrastructure's resilience to financial shocks. The Committee may also propose measures on the basis of recommendations and admonishments issued by the ESRB. The Committee will impose three types of measures based on the seriousness of identified disruptions in the financial system: recommendations, admonishments and guidelines.

The Committee comprises two representatives from each of the sectoral supervisory authorities (the Bank of Slovenia, the Insurance Supervision Agency and the Securities Market Agency) and two representatives from the ministry responsible for finance. Each member of the Committee has one vote, except the representatives of the ministry responsible for finance. The Committee is chaired by the Governor of the Bank of Slovenia. The Bank of Slovenia also has a secretariat that provides the Committee analytical, administrative and logistical support. It thus ensures on the basis of Recommendation ESRB/2011/3 that the central bank plays a leading role in macro-prudential policy. The Committee acts independently in conducting macro-prudential supervision, and is answerable to the National Assembly of the Republic of Slovenia for its work.

## 6.3 Credit risk and bank investments

### Summary

The quality of the banking system's credit portfolio improved with the transfer of the non-performing claims of the two largest domestic banks to the Bank Asset Management Company (BAMC) at the end of 2013. Non-performing claims, defined as those more than 90 days in arrears, accounted for 13.9% of the banks' total classified claims in February 2014. A further one-off reduction in the aforementioned proportion is expected following additional transfers of non-performing claims to the BAMC.

The development of credit risk in the coming period will depend on the recovery in economic growth, which will improve the average quality of banks' assets via additional demand from the healthy part of the economy, and on the success of the corporate restructuring process. The Bank of Slovenia's activities are similarly focused, both in terms of a better overview of the appropriateness of credit risk management at the banks, and in terms of spurring the banks to effective cooperation in the restructuring of prospective companies, or the more effective recovery or write-off of claims against corporates with no chance for survival.

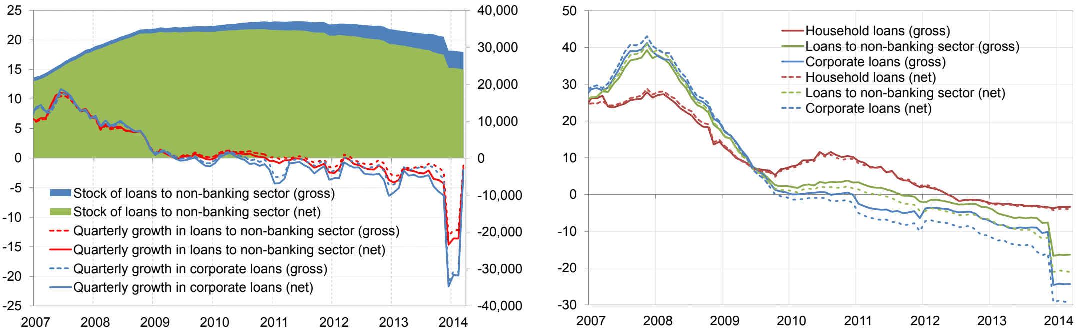
### 6.3.1 Credit activity and changes in the structure of the banking system's investments

The contraction in loans to the non-banking sector continued for the third consecutive year in 2013. This is particularly true with regard to the contraction in loans to non-financial corporations. The gap between loans before and after the creation of impairments widened further during the year

**The contraction in loans to the non-banking sector continued for the third consecutive year in 2013. This is particularly true with regard to the contraction in loans to non-financial corporations.**

due to the deterioration in the banks' credit portfolio and the resulting increase in impairment and provisioning costs. The high negative growth in loans to the non-banking sector is partly the result of the purging of the banks' credit portfolio, but also due to the contraction in the stock of newly approved loans. The stock of newly approved loans to non-financial corporations was down nearly 30%, while the stock of newly approved loans with a maturity of more than 1 year contracted by 18%. The contraction in newly approved corporate loans continued during the first quarter, while the proportion of newly approved loans for restructuring purposes was also down. The proportion of loans for restructuring purposes with a maturity of more than 1 year fell from 42% to 18%. Faced with difficult access to debt financing for working capital and investments, corporates are turning to alternative sources of financing that are very limited.

Figure 6.7: Quarterly growth and stock of loans to the non-banking sector in percentages, gross and net (left) and year-on-year growth in loans by sector in percentages (right)

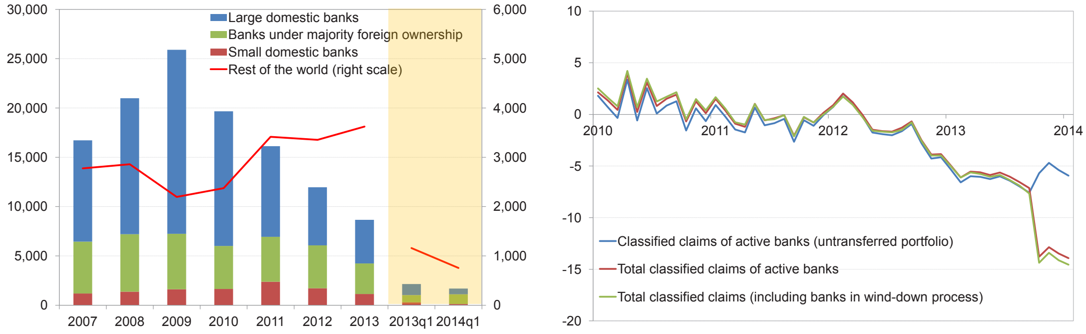



Source: Bank of Slovenia

Loans to the non-banking sector contracted further in December 2013 due to the transfer of non-performing claims to the Bank Asset Management Company and owing to requirements for additional impairments following the comprehensive assessment. The start of the orderly wind-down process at two banks in autumn 2013 also impacted the aforementioned contraction. According to one estimate, the transfer of claims to the BAMC contributed 6 percentage points to the decline in year-on-year growth in loans to the non-banking sector, while additional impairments as the result of the findings of the AQR contributed 2.4 percentage points. Excluding the two banks undergoing the orderly wind-down process, the year-on-year decline in loans to the non-banking sector was less severe, by 1.8 percentage points. The effect of the aforementioned factors on loans to corporates (non-financial corporations and OFIs) was more significant: the effect of the transfer of non-performing claims to the BAMC was 10.5 percentage points, the effect of additional impairments was 4.2 percentage points, while the effect of banks undergoing the wind-down process was 2.1 percentage points. Excluding all of the aforementioned factors, the year-on-year decline in loans to the non-banking sector and corporates was 10.8% and 12.6% respectively in March. Estimates may be somewhat more optimistic when assessing the effect of additional impairments as the result of the findings of the AQR, because it is not known to what extent the banks themselves would impair the aforementioned portion of the portfolio.[18]

[18] The classified claims of active banks measured at amortised cost for the portion of the banks' portfolio that was not subject to transfer contracted by 6% in December 2013, while total classified claims measured at amortised cost were down 14%. The exchange of non-performing claims for debt securities resulted in an increase in the latter as a proportion of total assets to 19%.

Figure 6.8: Newly approved corporate loans by Slovenian banks and loans from the rest of the world (left) and growth in classified claims against the non-banking sector measured at amortised cost for the entire portfolio and for the portion of the portfolio that was not subject to transfer to the BAMC in percentages (right)



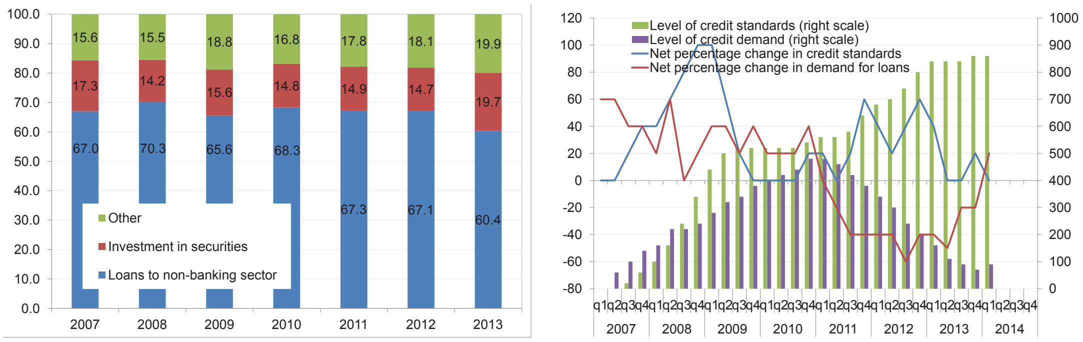

Source: Bank of Slovenia

**Supply-side limits have eased on the loan market with the transfer of non-performing claims to the BAMC and the recapitalisation of banks. However, this has not yet been reflected in increased lending activity by the banks.**

Following positive macroeconomic data for 2013, forecasts of the factors that in the past constrained corporate credit demand the most are somewhat more favourable. Demand for loans is stabilising more rapidly in the corporate sector due to expected growth in investment and exports. Low growth in private consumption and disposable income will continue to constrain household demand for loans.

Supply-side limits have eased on the loan market with the transfer of non-performing claims to the BAMC and the recapitalisation of banks. However, this has not yet been reflected in increased lending activity by the banks. The stabilisation of funding sources is a necessary prerequisite for the launching of a new credit cycle, which must be driven exclusively by creditworthy demand.

Figure 6.9: Structure of the banking sector's investments (left) and the banks' assessment of changes to demand for loans and changes to credit standards based on the survey on demand for loans (right)




Sources: Bank of Slovenia, ECB

In the banks' reporting for the needs of the survey on demand for loans and credit standards in Slovenia and in the euro area, the banks reported a decline in demand for corporate loans and the tightening of credit standards in all four quarters of 2013. In the most recent survey on demand for loans and credit standards in April 2014, the banks reported that credit standards were unchanged from the previous report, but nevertheless higher relative to the average credit standards during the crisis, which confirms that the banks' remain averse to lending.

### 6.3.2 Quality of the banks' credit portfolios

#### Banks' total classified claims

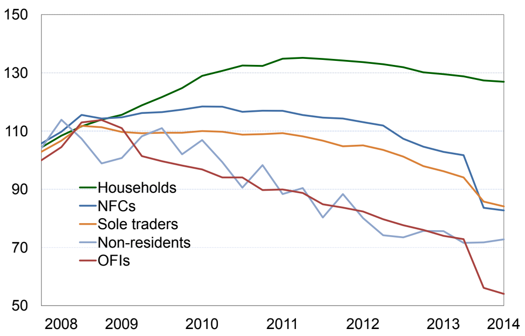
**Classified claims fell to the level recorded in 2007 across the system of banks and savings banks.**

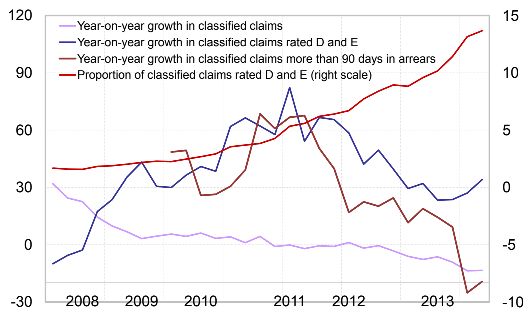
According to the latest figures for February 2014, the banks' classified claims amounted to EUR 41.7 billion, and thus fell to the level recorded at the end 2007. The classified claims of banks have been declining since the middle of 2012, as a result of the decline in the banks' lending activity and the comprehensive resolution of non-performing claims. The entire banking system is thus moving away from the highest levels achieved between 2010 and 2012 in the amount of EUR 50 billion or around 137% of GDP, compared with merely 118% of GDP this February.

The following significant events in the banking system affected the movement in classified claims, particularly non-performing claims, last year:

- the start of the orderly wind-down process at Factor banka d.d. and Probanka d.d. in September 2013, which resulted in an increase in non-performing claims at the small domestic banks;
- the transfer of a portion of non-performing claims from NLB d.d. and NKBM d.d. to the BAMC, which resulted primarily in a decrease in classified and non-performing claims at the large domestic banks in December 2013; and
- the most significant event at the banks under majority foreign ownership was October's internal purging of the balance sheet at Hypo Alpe-Adria d.d., which transferred a portion of non-performing claims to a special purpose vehicle owned by the parent bank HAAB International AG.

Figure 6.10: Movement in classified claims (basic index: 2007 = 100) by client segment in percentages (left) and growth in classified claims, and D- and E-rated claims (right)




Source: Bank of Slovenia

**A decline in lending has been noted in all higher-risk client segments.**

The structure of the portfolio by client segment has changed in the context of a level of classified claims similar to 2007. Exposure to higher-risk client segments (corporates, non-residents, OFIs and to a lesser extent sole traders) has decreased, primarily due to the decline in lending and the purging of balance sheets of non-performing claims, while the proportions of total classified claims accounted for by other segments classed as low-risk have risen. Changes are particularly pronounced in the proportions accounted for by corporates and OFIs following the transfer to the BAMC.

Despite the decrease in classified claims at the banking system level, total classified claims reached their highest level at the savings banks this year, while one bank under majority foreign ownership recorded growth in classified claims relative to 2012.

#### Credit standards for newly approved corporate and household loans

#### Loan-to-value (LTV) ratio

**The LTV ratio on loans to households with real estate collateral declined.**

The banks tightened their credit standards for households somewhat last year relative to 2012. The average LTV ratio on newly approved housing loans fell from 70% to 67%. At 55%, the aforementioned ratio is lower taking into account only those loans for which a bank requested collateral, but was still slightly higher than the previous year. The LTV ratio was also down for consumer loans, but was up slightly for corporate loans to stand at 94%.

Table 6.5: Average loan-to-value (LTV) ratio for newly approved loans and the value of all collateral in percentages

| | All loans | | Secured loans | |
|---|---|---|---|---|
| | 2012 | 2013 | 2012 | 2013 |
| Corporate loans | 89.1 | 94.4 | 52.4 | 56.0 |
| Consumer loans | 128.3 | 118.2 | 68.9 | 69.0 |
| Housing loans | 70.1 | 66.7 | 54.0 | 55.0 |

Note: LTV is the ratio of the loan to the value of pledged collateral expressed in percentages.
Source: Bank of Slovenia

The proportion of newly approved unsecured loans was also down last year. At 17%, the proportion of unsecured housing loans is lowest. The higher proportion of unsecured consumer loans and loans to corporates is partly the result of the shorter average maturities of the aforementioned loans, both due to fewer collateral requirements for shorter maturities and the inclusion of these loans multiple times when they are rolled over during the financial year. There was an increase in the proportion of collateral in the form of real estate on all loans.

Table 6.6: Proportion of total collateral accounted for by real estate collateral and the proportion of newly approved loans accounted for by unsecured loans in percentages

| | Proportion of new loans secured by real estate collateral | | Proportion of new loans accounted for by unsecured loans | |
|---|---|---|---|---|
| | 2012 | 2013 | 2012 | 2013 |
| Corporate loans | 64.3 | 65.2 | 41.3 | 40.4 |
| Consumer loans | 18.6 | 19.3 | 46.3 | 41.2 |
| Housing loans | 84.7 | 85.6 | 23.0 | 17.1 |

Note: LTV is the ratio of the loan to the value of pledged collateral expressed in percentages.
Source: Bank of Slovenia

**The maximum LTI ratio was up slightly last year.**

### Loan-to-income (LTI) ratio

The average LTI ratio for the banking system overall was up slightly last year, from 54.2% to 54.5%. The LTI ratio at the banks depends on several factors: type of loan, type of collateral, repayment period, the absolute amount of the applicant's receipts, where the legally defined minimum wage, which must remain after all of the borrower's deductions for loans, represents an additional limiting factor.

The average actual LTI ratio was significantly lower. It was 33% for housing loans, down slightly on the previous year, and down 1 percentage point for consumer loans to stand at 23.8%. This indicates the banks' aversion to assume additional credit risk in newly concluded transactions, as well increased prudence on the part of households with respect to additional borrowing. Confirmation of the latter is the fact that the proportion of newly approved housing loans for which the LTI ratio was more than 33% declined by 6 percentage points to 36.1%. That proportion is lower for consumer loans at 18.7% owing to lower loan amounts and lower instalments for consumer loans. The proportion of newly approved loans with an LTI ratio exceeding 50% was also down.

Table 6.7: Loan-to-income (LTI) ratio in percentages

| | Average maximum LTI under banks' business policy | Average LTI for newly approved | | Actual proportion of newly approved housing loans | | Actual proportion of newly approved consumer loans | |
|---|---|---|---|---|---|---|---|
| | | housing loans | consumer loans | LTI >= 33% | LTI >= 50% | LTI >= 33% | LTI >= 50% |
| 2012 | 54.2 | 33.7 | 24.8 | 42.1 | 17.1 | 23.4 | 12.2 |
| 2013 | 54.5 | 33.0 | 23.8 | 36.1 | 12.0 | 18.7 | 5.7 |

Note: LTI is the ratio of the loan instalment to the borrower's income. Factor banka and Probanka were not included in the survey.
Source: Bank survey

### Classified claims more than 90 days in arrears (non-performing claims)

Classified claims more than 90 days in arrears totalled EUR 5.8 billion in February, equivalent to 13.9% of the banks' total classified claims. That proportion ranges from 19% to 24% in the highest-risk client segments (non-financial corporations, OFIs, foreign companies and sole traders). The largest non-performing claims in absolute terms were recorded by corporates, in the amount of EUR 3.7 billion, an indication that this portion of the banks' portfolio accounts for the prevailing credit risk.

Table 6.8: Breakdown of classified claims by client segment in terms of number of days in arrears in the settlement of liabilities to banks in EUR million and in percentages

| | Classified claims | | | | Proportion of claims more than 90 days in arrears in client segment | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | change Nov 13 to Dec 13 | | |
| | Dec 12 | Nov 13 | Dec 13 | Feb 14 | Dec 12 | Nov 13 | Dec 13 | effect of transfer and other effects | excluding effect of transfer | Feb 14 |
| Total, EUR million | 47,876 | 44,879 | 41,329 | 41,735 | 6,904 | 8,117 | 5,520 | -2,597 | 35 | 5,786 |
| | | | | | | | | % | | |
| NFCs | 47.5 | 45.4 | 41.7 | 40.9 | 24.0 | 28 | 20.4 | -7.6 | 0.7 | 21.8 |
| OFIs | 4.2 | 5.3 | 4.5 | 4.3 | 24.5 | 36 | 24.5 | -11.5 | 0.0 | 24.1 |
| Households[1] | 20.8 | 21.4 | 23.0 | 22.7 | 4.9 | 5.4 | 5.3 | -0.1 | 0.1 | 5.4 |
| sole traders | 2.0 | 1.9 | 1.9 | 1.9 | 14.9 | 19.9 | 18.7 | -1.2 | 0.7 | 19.4 |
| other households[1] | 18.9 | 19.5 | 21.1 | 20.8 | 3.8 | 4.1 | 4.1 | 0.0 | 0.0 | 4.1 |
| Non-residents | 10.8 | 11.8 | 12.2 | 12.3 | 15.8 | 18.7 | 20.1 | 1.4 | 1.5 | 21.2 |
| Government | 7.5 | 6.8 | 8.3 | 8.3 | 0.5 | 0.9 | 1.0 | 0.1 | 0.1 | 1.0 |
| Banks and savings banks | 7.1 | 6.0 | 6.4 | 6.3 | 0.0 | 0.1 | 0.1 | 0.0 | 0.0 | 0.1 |
| Central bank | 1.7 | 3.0 | 3.7 | 5.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Other | 0.3 | 0.2 | 0.1 | 0.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 14.4 | 18.1 | 13.4 | -4.7 | 0.2 | 13.9 |

Source: Bank of Slovenia, bank survey

### Impact of the transfer of certain non-performing claims to the BAMC

**The transfer of a portion of non-performing claims to the BAMC reduced the amount required to recapitalise the two largest domestic banks.**

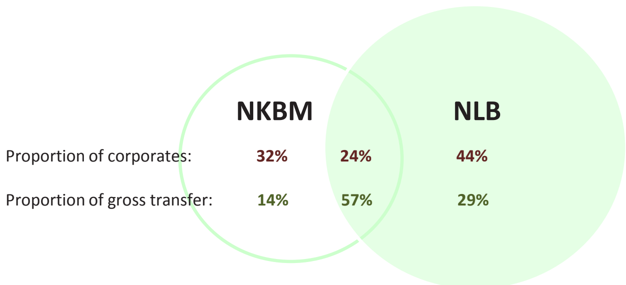
A deficit in the highest-quality capital was identified at certain banks in the scope of the asset quality review performed during the second half of 2013. Recapitalisations were thus required. State aid in the recapitalisation of the banks was only permitted if approved by the European Commission. The aforementioned institution first required the write-off of all subordinated debt, followed by the approval of the list of claims for transfer to the BAMC, by which the required amount of recapitalisation was reduced. A portion of non-performing claims could thus be transferred to the BAMC following the approval of state aid to the two largest domestic banks (NLB d.d. and NKBM d.d.) at the transfer value set out in the Government Measures to Strengthen the Stability of Banks Act and the Decree on the implementation of measures to strengthen bank stability.

A minor indirect transfer of non-performing claims from PBS d.d. and Adria Bank AG of NKBM's banking group was also made due to certain common debtors, with the aim of ensuring that the BAMC receives the highest possible concentration of clients and thus the more effective management of non-performing claims. This means that it will be easier for the BAMC to convert (combined) claims into capital of the debtor, in accordance with the amended Financial Operations, Insolvency and Compulsory Dissolution Act, making it possible for the debtor to borrow again on the financial market by strengthening its capital. The BAMC will also be able to manage and sell real estate that it received as collateral more effectively.

**The transfer of loans alone totals EUR 3.2 billion to date.**

The total gross value of the loans transferred to the BAMC was EUR 3.2 billion. The majority, or 57%, of the gross value of claims transferred to the BAMC was accounted for by two banks. The claims were against corporates that were clients of both banks. In terms of the number, these clients account for 24% of the debtors whose liabilities were transferred.

Figure 6.11: Proportions accounted for by corporates and by the value of the gross transfer to the BAMC in percentages




Source: Bank of Slovenia

The majority of loans transferred were accounted for by groups of claims which, given the attributes of debtors or the attributes of assets pledged as collateral, represent a homogeneous whole in terms of management. Only those clients classified as domestic non-financial corporations, OFIs and sole traders were transferred to the BAMC.

Table 6.9: Proportion of the gross transfer to the BAMC accounted for by client segments

| | Gross transfer to BAMC, % | (EUR million) |
|---|---|---|
| Non-financial corporations | 87.2 | 2,768 |
| OFIs | 11.7 | 371 |
| Sole traders | 1.1 | 35 |
| **Total** | 100 | 3,175 |

Source: Bank of Slovenia

**Corporates from the construction sector stand out notably among the transferred claims of companies in bankruptcy.**

In addition to loans, the two banks soon intend to transfer seized equities, which are not included in the analysis below. The off-balance-sheet liabilities of individual debtors were not transferred to the BAMC. These debtors therefore remain on the banks' balance sheets.

It is evident from the table below that half of the gross transfer was accounted for by loans to companies in bankruptcy proceedings, while 40% of the transfer related to companies that are not the subject of insolvency proceedings. Corporates from the sectors of construction, financial intermediation and manufacturing account for the largest proportion of both companies subject to bankruptcy and solvent companies.

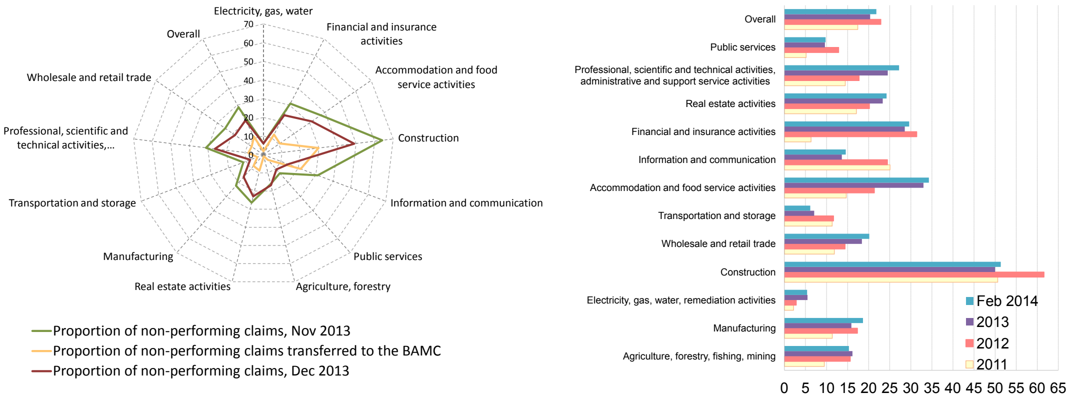
Table 6.10: Proportion of classified claims transferred to the BAMC by sector with regard to the type of proceedings initiated against legal entities in percentages

| Sector | Type of proceedings initiated against legal entities | | | | | |
|---|---|---|---|---|---|---|
| | Not in insolvency proceedings | Corporate bankruptcy proceedings | Personal bankruptcy proceedings | Composition proceedings | Voluntary liquidation | Total |
| Agriculture, forestry, mining | 1.0 | | | 0.6 | | 0.5 |
| Manufacturing | 14.1 | 18.0 | | 28.9 | 46.1 | 17.5 |
| Electricity, gas, water, remediation activities | 2.2 | 0.3 | | 3.3 | | 1.3 |
| Construction | 17.7 | 42.9 | | 20.1 | 13.0 | 30.6 |
| Wholesale and retail trade | 10.5 | 6.9 | 100 | 27.1 | 28.0 | 10.3 |
| Transportation and storage | 3.7 | 3.3 | | | | 3.2 |
| Accommodation and food service activities | 6.0 | 0.4 | | 17.9 | | 4.2 |
| Information and communication | 9.9 | 0.3 | | | 12.8 | 4.2 |
| Financial and insurance activities | 19.9 | 19.8 | | 0.4 | | 18.0 |
| Real estate activities | 7.4 | 1.7 | | | | 3.9 |
| Professional, scientific and technical activities, administrative and support service activities | 6.6 | 6.1 | | | | 5.7 |
| Public services | 1.0 | 0.4 | | 1.7 | | 0.8 |
| **Proportion of gross transfer value** | **40.3** | **50.3** | **0.03** | **9.1** | **0.2** | **100** |

Source: Bank of Slovenia

The gross amount of claims transferred to the BAMC is not reflected in full in the proportion of non-performing claims, as certain clients were not 90 days in arrears and thus did not contribute to the reduction in the proportion of non-performing claims. The latter accounted for 16% of the total number of clients, and together accounted for 19% of the value of gross claims transferred. Likewise the transfer of claims from Adria Bank AG in Vienna did not contribute to the reduction in the proportion of non-performing claims. This part of the transfer was minimal, as it accounted for merely 0.3% of the total value of gross claims transferred. The effect of the transfer was seen at PBS d.d., whose claims were transferred in the scope of NKBM, which resulted in a reduction in the proportion of non-performing claims at the small domestic banks. The banks recorded the transfer at the book values in their balance sheets as at 20 December 2013, Thus the full effect of the transfer was reflected in the banks' credit portfolios at the end of December 2013. The transfer of claims to the BAMC was carried out in five tranches.

Figure 6.12: Change in the quality of the banks' portfolios (non-performing claims) in December relative to November 2013 as the result of the transfer to the BAMC (left) and the proportion of the banks' classified claims against non-financial corporations more than 90 days in arrears (right) in percentages




Source: Bank of Slovenia

**Non-performing claims against non-financial corporations and OFIs were down sharply due to the transfer to the BAMC.**

The non-performing claims transferred to the BAMC accounted for 38% of the banking system's total non-performing claims in November 2013. The proportion of non-performing claims accounted for by three client segments (non-financial corporations, OFIs and sole traders) averaged 28.6%. The non-performing claims that were booked off the banks' balance sheet the following month accounted for 10.8% of the aforementioned amount. The proportion of non-performing claims accounted for by those three client segments was reduced in the following month by an average of 7.9 percentage points, to stand at 20.8%. At the banking system level, the proportion of non-performing claims was down 4.7 percentage points, at 13.4%. That proportion has risen slightly this year, by 0.5 percentage points over the first two months of the year, to stand at 13.9%.

Despite recapitalisations and the transfer of non-performing claims to the BAMC, the banking system still has a large number of claims against over-indebted, but in many cases prospective companies that could soon become insolvent and again burden the banks' balance sheets without an active role by the banks and the appropriate government initiative.

**The Bank of Slovenia has implemented several measures to further reduce the banks' non-performing claims.**

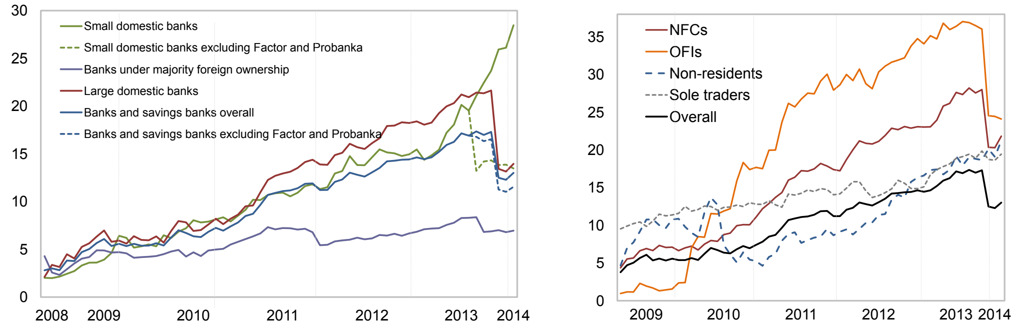
Since 2012, when the trend of declining classified claims was identified, the Bank of Slovenia has striven to encourage, accelerate and improve the restructuring of over-indebted but otherwise prospective companies through various activities. Improving the financial position of restructured companies will gradually purge the banks' balance sheets and restart lending activity.

Through changes to implementing regulations, the Bank of Slovenia also intends to improve the overview of the appropriateness of credit risk management at the banks and spur the banks to effective cooperation in the restructuring of prospective companies, or the more effective recovery or write-off of claims against corporates with no chance for survival. The Bank of Slovenia has made recent changes to the following regulations in this area: 1) amendment to the Regulation on risk management and implementation of the internal capital adequacy assessment process for banks and savings banks aimed at strengthening the monitoring of restructured exposures to corporates and reporting relating to concluded restructuring agreements; 2) amendment to the Regulation on the assessment of credit risk losses, which amended the definition of restructured exposures and established a framework for the more expedient write-off of non-performing exposures and redemption of collateral; 3) amendment to the Guidelines for implementing the regulation on the assessment of credit risk losses, which now require reporting on exposures to debtors at the individual transaction level and reporting on restructured exposures; and 4) Restructuring principles drafted by the Bank of Slovenia in conjunction with the banks.

### Classified claims more than 90 days in arrears

The proportion of claims more than 90 days in arrears was down sharply at the large domestic banks (by 8.2 percentage points) and at the banks under majority foreign ownership (by 1.5 percentage points) following the transfer of a portion of non-performing claims from their balance sheets. The small domestic banks recorded the highest proportion of non-performing claims (at 28.5%) primarily on account of the two banks undergoing the orderly wind-down process. The proportion of claims in arrears would be significantly lower excluding those two banks, at 13.5%.

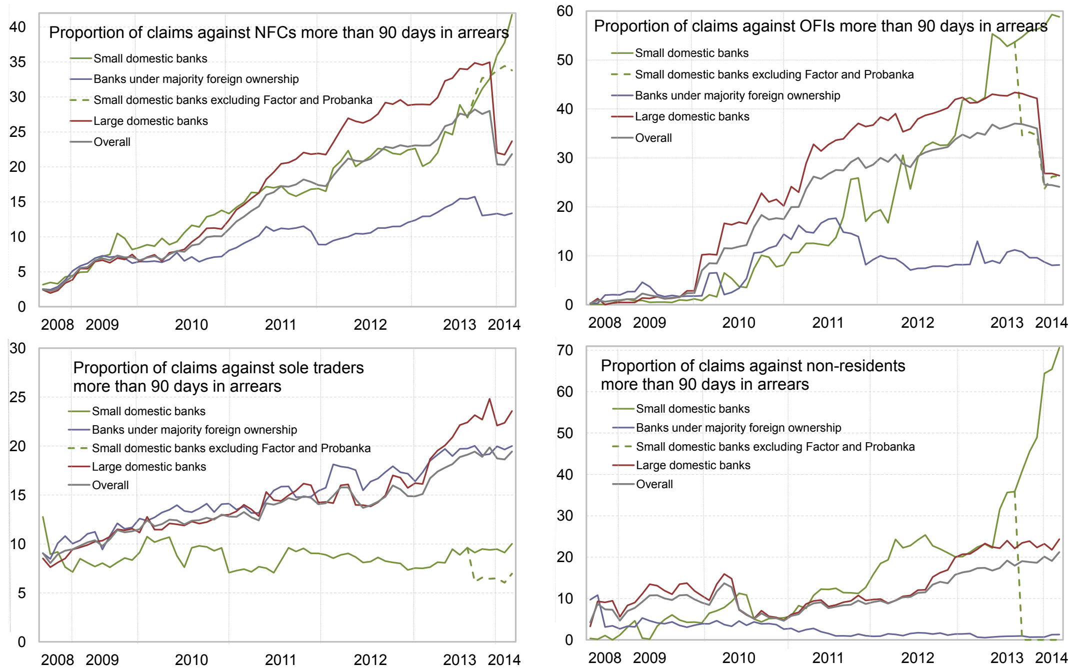
Figure 6.13: Arrears of more than 90 days as a proportion of the banks' classified claims by bank group (left) and client segment (right) in percentages




Source: Bank of Slovenia

The proportion of non-performing claims was down in all of the highest-risk client segments following the transfer to the BAMC in December 2013, by 7.6 percentage points at non-financial corporations, by 11.5 percentage points at OFIs and by 1.1 percentage points at sole traders. There was also a decrease in the proportion of non-performing claims against non-residents, by 1.5 percentage points. Following a sharp drop in claims in arrears at the end of 2013, the proportion of non-performing claims has risen slightly this year, by 0.5 percentage points.

Figure 6.14: Arrears of more than 90 days as a proportion of the banks' total classified claims by bank group and individual client segment in percentages




Source: Bank of Slovenia

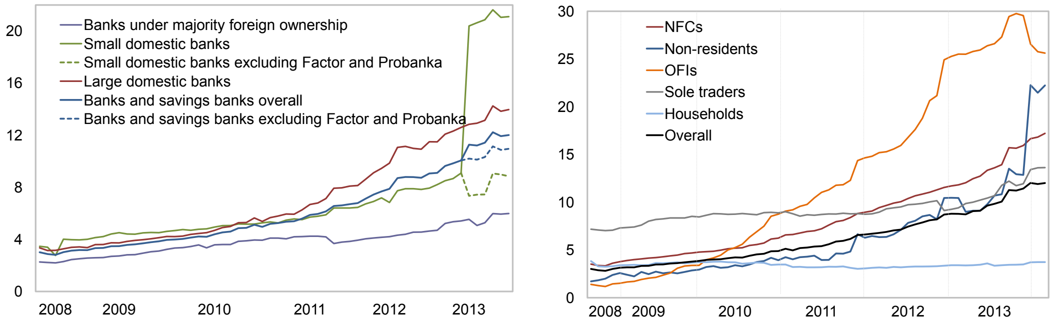
The proportion of claims more than 90 days in arrears for non-residents indicates the banks' exposure to both non-resident corporates and foreign banks. The banks under majority foreign ownership have very few non-residents in their portfolios, while certain Slovenian banks have a large number of non-resident corporates in their portfolios due to operations on foreign markets, particularly in south-eastern Europe. The aforementioned corporates have shown to be high-risk. The small domestic banks, excluding Factor and Probanka, are not exposed to non-resident corporates.

### Coverage of classified claims by impairments

**The level of impairments and provisions remains high.**

In contrast to classified claims, impairments and provisions have been rising consistently since 2008. After reaching their peak of EUR 5.1 billion in November 2013, they have fallen slightly due to the transfer of non-performing claims to the BAMC. The coverage of total classified claims by impairments had risen to 12% by February, an increase of 3.3 percentage points on the end of 2012.

Figure 6.15: Coverage of classified claims by impairments by bank group (left) and by client segment (right) in percentages




Source: Bank of Slovenia

There has been a sharp increase in impairments at the small domestic banks since September 2013, as a result of the orderly wind-down process at two small banks, coverage of claims reaching the above-average level of 21%. If the two aforementioned banks are excluded from the calculation, total coverage at the small domestic banks has fallen to 9% since September. Impairments are rising slightly but persistently at the large domestic banks and at the banks under majority foreign ownership.

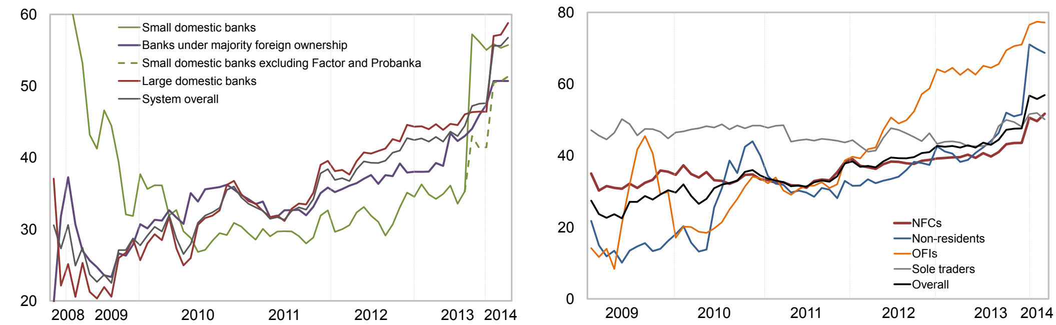
**Primarily the banks under majority foreign ownership have recorded an increase in coverage of claims by impairments.**

In terms of client segment, primarily impairments of claims against non-resident corporates were up in December relative to November 2013, by 61%, while classified claims against non-residents were down 6%. Impairments of claims against non-residents are also rising at the large domestic banks, an indication of the above-average risk associated with this client segment. The coverage of claims against non-financial corporations and sole traders is also rising, while coverage of claims against OFIs is declining. Impairments of claims against non-financial corporations were down 9% in December relative to November 2013 at the banking system level, primarily owing to the transfer of a portion of non-performing claims to the BAMC from the two largest domestic banks. Impairments of claims against non-financial corporations have begun to rise again this year. Because exposure to OFIs is decreasing, impairments in this portion of the portfolio are not expected to rise significantly. The total coverage of classified claims by impairments is rising from year to year due to the deterioration in the quality of the banks' credit portfolio and insufficient lending activity, which could lead to an increase in classified claims in lower-risk ratings.

**Some 73% of total impairments are earmarked for covering non-performing claims.**

Of the banks' total impairments in the amount of EUR 5 billion, EUR 3.1 billion was earmarked in February for covering non-performing claims more than 90 days in arrears. The indicator of the coverage of claims more than 90 days in arrears by impairments does not take into account credit protection in the form of collateral pledged by the debtor. The coverage of claims more than 90 days in arrears by impairments is increasing from year to year, and stood at 57% in February.

Figure 6.16: Coverage of non-performing claims by impairments by bank group (left) and by client segment (right) in percentages




Source: Bank of Slovenia

Impairments at Factor banka and Probanka increased sharply in September, which brought a pronounced increase in the coverage of non-performing claims by impairments at the small domestic banks to 56%, compared with 35% at the end of 2012. All banks achieved coverage of non-performing claims by impairments of more than 50%. The large domestic banks and the banks under majority foreign ownership have increased impairments and reduced their non-performing claims, which in February resulted in the highest level of coverage, 59% at the domestic banks and 51% at the foreign banks.

Table 6.11: Coverage of total classified claims and non-performing claims more than 90 days in arrears in percentages

| | Coverage of total classified claims by impairments | | | | Coverage of claims more than 90 days in arrears by impairments | | | |
|---|---|---|---|---|---|---|---|---|
| | Dec 11 | Dec 12 | Dec 13 | Feb 14 | Dec 11 | Dec 12 | Dec 13 | Feb 14 |
| NFCs | 8.8 | 11.5 | 17.1 | 17.2 | 38.2 | 39.2 | 50.6 | 51.7 |
| OFIs | 14.4 | 24.9 | 26.9 | 25.6 | 38.7 | 64.1 | 76.5 | 77.2 |
| Households | 3.6 | 3.9 | 4.5 | 4.5 | - | - | 65.2 | 64.4 |
| sole traders | 8.8 | 9.1 | 13.5 | 13.6 | 43.7 | 43.3 | 51.6 | 50.1 |
| other households | 3.0 | 3.3 | 3.7 | 3.7 | - | - | 70.9 | 70.4 |
| Non-residents | 6.6 | 10.4 | 22.4 | 22.2 | 32.9 | 42.6 | 71.0 | 68.7 |
| Government | 0.1 | 0.2 | 0.5 | 0.5 | 3.3 | 5.3 | 28.4 | 29.1 |
| Banks and savings banks | 0.5 | 1.2 | 1.2 | 1.2 | 12.1 | 12.2 | 0.8 | 0.6 |
| Total coverage | 6.6 | 8.7 | 12.2 | 12.0 | 37.8 | 42.7 | 56.8 | 56.9 |
| | Total classified claims | | | | Total arrears of more than 90 days | | | |
| EUR million | 49,466 | 47,876 | 41,329 | 41,735 | 5,547 | 6,904 | 5,520 | 5,786 |
| - as % of GDP | 136.8 | 135.0 | 117.2 | 118.4 | 15.3 | 19.5 | 15.7 | 16.4 |

Source: Bank of Slovenia

**The coverage of claims by impairments was up sharply last year, particularly at OFIs and non-residents.**

The coverage of classified non-performing claims in individual portfolio segments indicates which client segments bear the highest risk, taking into account the quality of collateral. The highest coverage of non-performing claims is recorded in claims against OFIs, where coverage stood at 77% in February 2014. The banks created additional impairments for non-residents, the majority in November and December 2013, when impairments were up by 62%, of which 41% was for classified claims in arrears.

The quality of portfolios continues to deteriorate in terms of ratings, as the proportion of claims classified in lower-risk ratings (A and B) is declining. The reasons for the decline in the proportion of higher-rated claims include the low lending activity of the banks, as newly approved loans are typically assigned higher ratings. The proportion of total classified claims accounted for by claims with the highest coverage by impairments (D- and E-rated claims) reached 13.3% in February 2014.

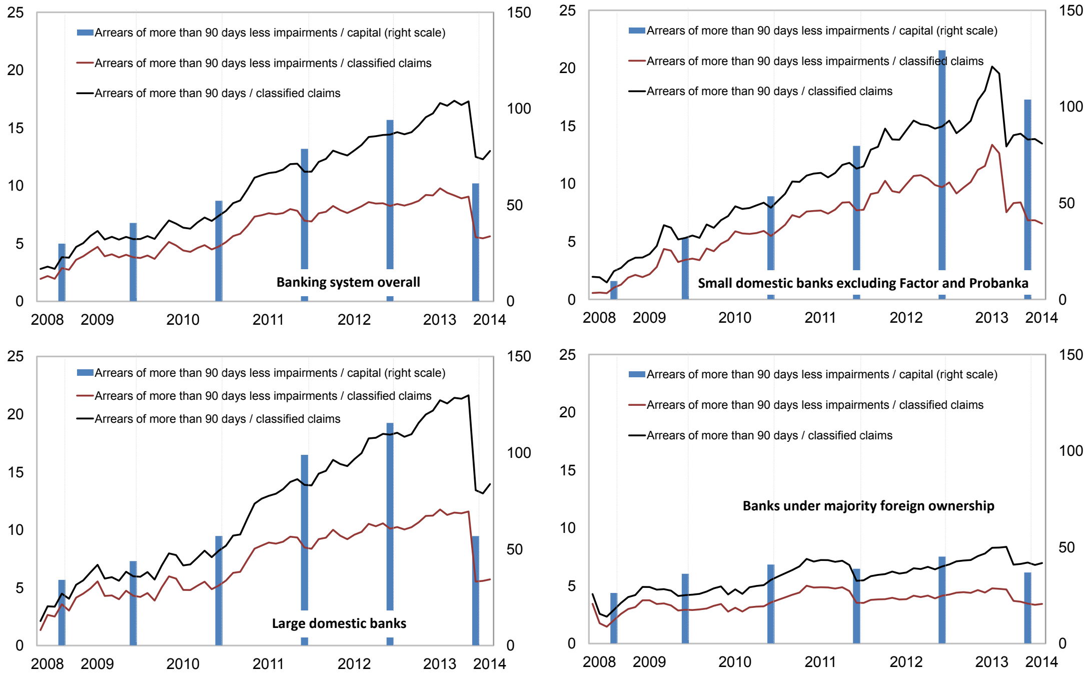
Table 6.12: Structure of classified claims in terms of rating and coverage of claims by impairments and provisions in EUR million and percentages

| | 31 December 2012 | | | 31 December 2013 | | | 31 December 2014 | | |
|---|---|---|---|---|---|---|---|---|---|
| | Classified claims | Impair-ments | Coverage of claims by impair-ments, % | Classified claims | Impair-ments | Coverage of claims by impair-ments, % | Classified claims | Impair-ments | Coverage of claims by impair-ments, % |
| Total, EUR million | 47,876 | 4,169 | 8.7 | 41,328 | 5,068 | 12.3 | 41,734 | 5,015 | 12.0 |
| | Breakdown, % | | | Breakdown, % | | | Breakdown, % | | |
| A | 57.3 | 2.0 | 0.3 | 59.1 | 1.2 | 0.3 | 59.9 | 1.2 | 0.3 |
| B | 28.1 | 12.5 | 3.9 | 20.8 | 7.0 | 4.1 | 20.7 | 7.2 | 4.2 |
| C | 5.6 | 17.2 | 26.8 | 6.7 | 14.3 | 26.3 | 6.2 | 13.5 | 26.2 |
| D | 8.2 | 59.9 | 63.6 | 11.7 | 62.9 | 66.1 | 11.4 | 62.4 | 65.9 |
| E | 0.7 | 8.5 | 100.0 | 1.8 | 14.7 | 100.0 | 1.9 | 15.6 | 99.9 |

Source: Bank of Slovenia

The banks assess potential losses for claims more than 90 days in arrears and create additional impairments accordingly. The difference between the proportions of classified claims accounted for by claims more than 90 days in arrears with and without impairments was 7.4 percentage points in February. The ratio of the net value of claims to capital indicates a sufficient level of the latter to cover the unimpaired portion of non-performing claims, and exceeded 100% prior to December's measures. This does not take into account the recoverability of non-performing claims from the redemption of collateral and recovery proceedings. Due to the reduction in non-performing claims and following the recapitalisation of five banks, the aforementioned ratio fell to 61% at the end of 2013, down 33 percentage points on the end of 2012. The level of capital is slightly below the unimpaired portion of non-performing claims at the small domestic banks, even when Factor banka and Probanka are excluded from the equation, an indication of the vulnerability of this bank group to the realisation of credit risk losses.

Figure 6.17: Proportion of the banks' classified claims more than 90 days in arrears with and without impairments by bank group in percentages

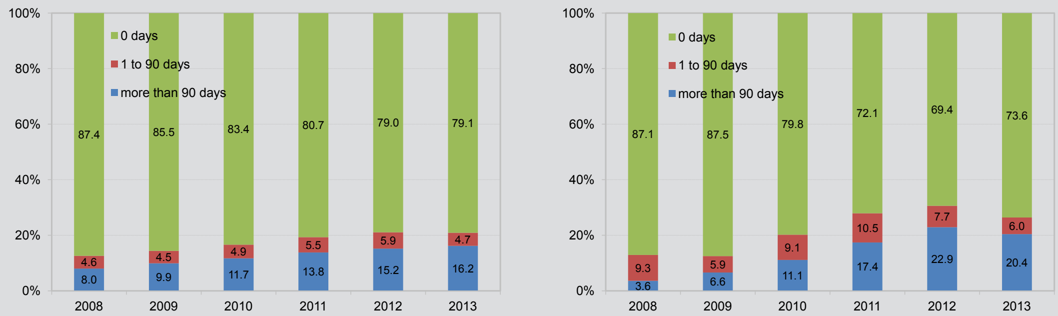



Source: Bank of Slovenia

**Box 6.3: Changes in credit risk associated with non-financial corporations**

The transfer of non-performing claims to the BAMC had a positive effect on the proportion of classified claims against non-financial corporations more than 90 days in arrears, which was down 2.5 percentage points relative to 2012 and down 7.6 percentage points relative to November 2013. Nevertheless, the proportion of claims against non-financial corporations more than 90 days in arrears remains high, at 21.8% in February 2014. At 6%, the proportion of claims against non-financial corporations that are already in arrears, but not more than 90 days in arrears, indicates the possibility of a further deterioration in the credit portfolio in the absence of effective and prompt restructuring of the debt of over-leveraged corporates.

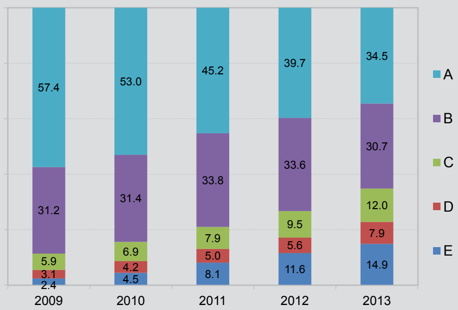
Figure 6.18: Structure of arrears in the repayment of loans with regard to the number of non-financial corporations (left) and exposure (right) in percentages




Source: Bank of Slovenia

The figure below illustrates the credit rating structure of clients that had a lending arrangement with a bank for five consecutive years between 2009 and 2013. Although the clients whose liabilities to the banks were transferred to the BAMC are excluded from this illustration for the entire period, the credit rating structure deteriorated significantly over time. The proportion of A- and B-rated clients declined by 23.5 percentage points over the five-year period illustrated, while the proportion of D- and E-rated clients rose by 17.3 percentage points.

Figure 6.19: Credit rating structure for the same non-financial corporations at an individual bank in percentages




Source: Bank of Slovenia

The table below presents a transition matrix for 2013 compared with the previous year; with 2009, which saw the largest fall in GDP during the crisis; and with the average transition matrix for the pre-crisis period. As expected, the transition matrix for 2013 is worse than the average transition matrix for the pre-crisis period and for the most part worse than the transition matrix for 2009. Some positive shifts are seen relative to 2012, in particularly fewer transitions of non-financial corporations from the D rating to the E rating, which is in part the result of the transfer of non-performing claims to the BAMC. Nevertheless, the deviation that measures changes in all credit ratings indicates that the level of deterioration measured by the transitions of clients between credit ratings is similar to 2012, while the level measured by the transitions of classified claims is considerably more negative.

Table 6.13: Probability of transitions of non-financial corporations between credit ratings in percentages

Average transition matrix 2001-2008

| | | current year | | | | |
|---|---|---|---|---|---|---|
| | | A | B | C | D | E |
| predhodno leto | A | 90.76 | 7.07 | 1.33 | 0.60 | 0.24 |
| | B | 9.47 | 80.48 | 6.02 | 3.70 | 0.33 |
| | C | 4.04 | 11.53 | 72.05 | 10.28 | 2.09 |
| | D | 2.45 | 3.85 | 4.21 | 81.11 | 8.38 |
| | E | 1.93 | 1.26 | 0.97 | 2.13 | 93.72 |

Transition matrix 2009

| | | 2009 | | | | |
|---|---|---|---|---|---|---|
| | | A | B | C | D | E |
| 2008 | A | 86.31 | 9.30 | 2.36 | 1.24 | 0.79 |
| | B | 3.78 | 80.44 | 9.17 | 5.79 | 0.83 |
| | C | 1.13 | 8.83 | 65.79 | 17.73 | 6.52 |
| | D | 0.25 | 2.80 | 3.65 | 81.17 | 12.13 |
| | E | 0.08 | 0.16 | 0.08 | 1.04 | 98.63 |

Transition matrix 2012

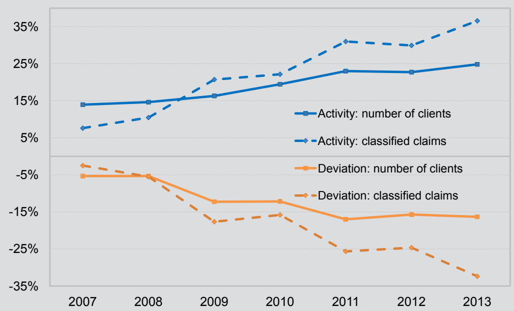
| | | 2012 | | | | |
|---|---|---|---|---|---|---|
| | | A | B | C | D | E |
| 2011 | A | 79.70 | 15.91 | 2.70 | 1.20 | 0.49 |
| | B | 6.69 | 77.24 | 9.67 | 4.80 | 1.61 |
| | C | 1.79 | 8.48 | 59.29 | 17.51 | 12.93 |
| | D | 0.44 | 1.33 | 3.73 | 46.78 | 47.72 |
| | E | 0.04 | 0.15 | 1.04 | 0.81 | 97.96 |

Transition matrix 2013

| | | 2013 | | | | |
|---|---|---|---|---|---|---|
| | | A | B | C | D | E |
| | A | 80.19 | 14.94 | 3.15 | 1.22 | 0.50 |
| | B | 7.96 | 70.97 | 13.92 | 5.49 | 1.66 |
| | C | 1.56 | 7.63 | 56.87 | 19.61 | 14.34 |
| | D | 0.26 | 1.56 | 2.92 | 56.72 | 38.55 |
| | E | 0.11 | 0.21 | 0.28 | 4.16 | 95.24 |

Source: Bank of Slovenia

Figure 6.20: Activity and deviation in percentages




Source: Bank of Slovenia

The default rate data point to the continuing deterioration of the credit portfolio. The default rate measured by the number of clients who transitioned from A, B or C credit ratings to D or E ratings reached a record high level in 2013, at 7.1%. The value of classified claims against non-financial corporations amounted to EUR 2.5 billion or 18% of classified claims against non-financial corporations with a credit rating of A, B or C last year. At 6.5%, the default rate measured by the proportion of transitions to arrears of more than 90 days also remains very high. The exclusion of non-performing claims has no significant impact on the aforementioned indicator, because the majority of claims transferred were already in arrears for some time or were against clients in bankruptcy.

Table 6.14: Default rates on the basis of credit ratings and corporate arrears in loan repayments in percentages

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|
| A, B, C → D, E[1] | 2.69 | 4.79 | 5.38 | 6.26 | 5.99 | 7.09 |
| Arrears of less than 90 days → more than 90 days[2] | 3.62 | 5.28 | 5.42 | 5.82 | 6.80 | 6.45 |

Note: [1] Proportion of clients who transition from A, B or C credit ratings to D or E ratings in one year.
[2] Proportion of clients who had arrears of less than 90 days in the previous year and arrears of more than 90 days in the current year.

### Classified claims against bankrupt clients and write-offs

**Claims against companies in bankruptcy account for 28% of non-performing claims.**

Classified claims against bankrupt clients were down sharply last year, by EUR 1.6 billion, primarily due to the transfer of non-performing claims to the BAMC from the two largest domestic banks. Of the total non-performing claims of EUR 5.8 billion in February, 28% were accounted for by claims against companies in bankruptcy proceedings. That figure was 40% in November.

Table 6.15: Classified claims against Slovenian companies in bankruptcy, end of November 2013 and February 2014 in EUR million

| | Nov 13 | | | | Feb 14 | | | |
|---|---|---|---|---|---|---|---|---|
| | NFCs | OFIs | Sole traders | Total | NFCs | OFIs | Sole traders | Total |
| | Corporate bankruptcy proceedings | | Personal bankruptcy proceedings | | Corporate bankruptcy proceedings | | Personal bankruptcy proceedings | |
| Agriculture, forestry, mining | 12 | | | 12 | 3 | | | 3 |
| Manufacturing | 502 | | 8 | 510 | 209 | | 7 | 216 |
| Electricity, gas, water, remediation activities | 9 | | | 9 | 5 | | | 5 |
| Construction | 1,255 | | 1 | 1,256 | 589 | | 1 | 591 |
| Wholesale and retail trade | 276 | | 3 | 279 | 186 | | 2 | 188 |
| Transportation and storage | 141 | | 4 | 145 | 89 | | 4 | 94 |
| Accommodation and food service activities | 37 | | 2 | 40 | 33 | | 2 | 35 |
| Information and communication | 12 | | | 12 | 7 | | | 7 |
| Financial and insurance activities | 65 | 621 | | 686 | 32 | 292 | | 324 |
| Real estate activities | 76 | | 0.1 | 76 | 59 | | 0.1 | 59 |
| Professional, scientific and technical activities, administrative and support service activities | 142 | 104 | 0.2 | 246 | 82 | 38 | 0.2 | 120 |
| Public services | 2 | | 0.1 | 2 | 5 | | 0.2 | 5 |
| Total number of classified claims against bankrupt entities | 2,530 | 725 | 18 | 3,272 | 1,299 | 330 | 18 | 1,646 |
| Total classified claims, EUR million | 20,392 | 2,400 | 850 | 23,642 | 17,059 | 1,782 | 779 | 19,620 |
| Ratio of classified claims against bankrupt entities to total classified claims, % | 12.4 | 30.2 | 2.1 | 13.8 | 7.6 | 18.5 | 2.3 | 8.4 |

Note: The figures for the arrears of households for 2012 are estimated based on annual bank surveys, and from the credit portfolios of banks' as arrears of more than 90 days in groups with credit ratings of D, E and P for 2013 and 2014.
Source: Bank of Slovenia

Non-financial corporations account for 79% of classified claims against clients in bankruptcy, while OFIs and sole traders account for 20% and 1% of bankrupt claims respectively. Despite the transfer of a large portion of bankrupt firms from the construction sector to the BAMC, nearly half of the exposure in the banks' portfolios is still to the aforementioned sector.

The Bank of Slovenia first encouraged the write-off of non-performing claims in 2012, and with the amendment to the Regulation on the assessment of credit risk losses (Official Gazette of the Republic of Slovenia, No. 29/12) allowed for the more expedient write-off of claims, even if no court decision on the completion of bankruptcy proceedings has been issued, provided that the banks assess during recovery proceedings that the claims will not be repaid. The banks were thus able to write off unsecured claims against debtors that were more than three years in arrears or in bankruptcy proceedings for more than one year, and claims secured by real estate collateral more than five years in arrears or for which the bank in question did not receive any payment from the redemption of collateral over the same period.

The total amount of write-offs by the banks in 2012 was EUR 403 million, while that total was EUR 184 million until November last year. Write-offs were up sharply in December due to the transfer of non-performing claims to the BAMC. Total write-offs for all banks amounted to EUR 2.2 billion in 2013.

**Legislative changes that set out the conditions for the more expedient write off of financial assets are expected to contribute to the more expedient purging of non-performing claims from the banks' balance sheets.**

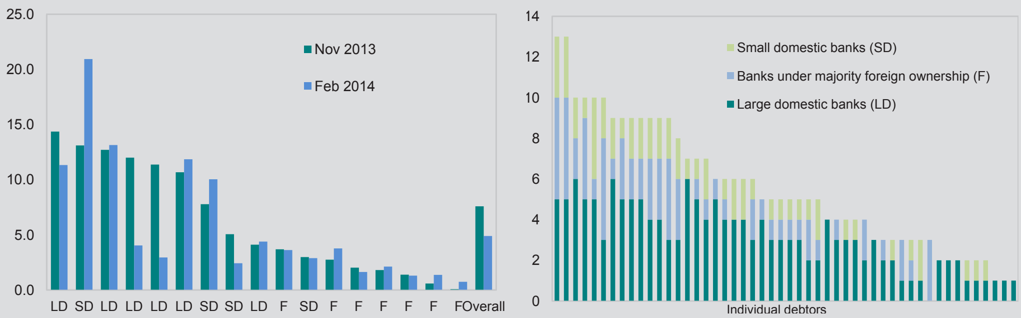
With a second amendment to the Regulation on the assessment of credit risk losses (Official Gazette of the Republic of Slovenia, No. 12/14) in the area of the recovery and write-off of financial assets, which entered into force in February 2014, the banks were able to write off unsecured claims against debtors that are more than one year in arrears or in bankruptcy proceedings, and claims secured by real estate collateral more than four years in arrears or for which the bank in question did not receive any payment from the redemption of collateral over the same period. The quality of the banks' portfolios is expected to improve further in the future on the basis of the amendment to the aforementioned regulation, as the number of non-performing claims in the banks' portfolios is reduced by an increase in write-offs.

**Box 6.4: Largest debtors more than 90 days in arrears in systemic terms**

The burden on the banks' portfolios by the largest debtors changed with the transfer to the BAMC. The 50 corporates with the largest exposures in arrears to the banking system (based on the 90 day rule) accounted for 7.7% of the banks' classified claims (EUR 3.5 billion) before the transfer to the BAMC, while that figure stood at 5.0% (EUR 2.1 billion) this February. Because large debtors accounted for the largest proportion of transferred claims, not only of the two largest banks but also at the banking system level, a third of the companies that were included among the 50 largest debtors prior to the transfer to the BAMC were no longer in that group of clients as of this February. The other banks are still exposed to these corporates. However, following the transfer to the BAMC, their aggregate arrears at the banking system level are no longer included among the 50 largest debtors.

Non-financial corporations, OFIs and non-residents account for the highest proportion of the 50 corporates that disclose the highest arrears of more than 90 days in aggregate terms at the banking level, the proportion accounted for by the latter having risen following the transfer to the BAMC, from 4.2% in November to 14.3% in February.

Figure 6.21: Proportion of classified claims accounted for by the 50 largest debtors with arrears of more than 90 days by bank group (left) and number of banks exposed to the 50 largest debtors with arrears of more than 90 days, February 2014 (right)




Note: LD – large domestic banks; SD – small domestic banks; F – banks under majority foreign ownership.
Source: Bank of Slovenia

The burden on the banks from claims against the largest debtors at the level of the banking system was down sharply at NLB and NKBM: claims against the 50 largest debtors more than 90 days in arrears accounted for merely 4.3% of NLB's classified claims in February (12.2% in November) and 3.0% at NKBM (11.4% in November). Changes at other banks depend on the structure of the portfolio, i.e. exposure to 50 largest debtors either in November or February.

The largest debtors accounted for more than 10% of claims at all large domestic banks, except SID, while NLB and NKBM were no longer among those banks following the transfer to the BAMC. The proportion of the largest debtors at the system level fluctuates below 4% at the banks under majority foreign ownership.

The largest debtors have borrowed (and are more than 90 days in arrears) from a large number of banks, and most frequently the large domestic banks. A total of 32 of those 50 corporates have borrowed from five or more banks, most frequently from the large domestic banks. The resolution of the problem of non-performing claims, in particular the restructuring thereof, will require a coordinated and united approach by all involved banks.

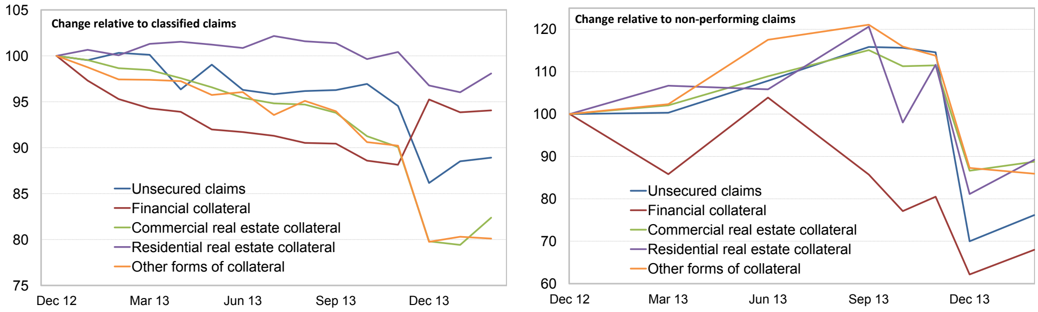
### Collateralisation of claims

According to figures from the credit register at the Bank of Slovenia's disposal, total collateral value amounted to 96.6% of the total value of the banks' classified claims in February 2014. Here it should be noted that unsecured claims account for more than one-half of total classified claims. The main problem is the high proportion of unsecured claims against higher-risk client segments: non-financial corporations, OFIs, non-resident corporates and sole traders.

**Unsecured claims accounted for more than a half of total classified claims in February 2014.**

Real estate remains the prevailing form of collateral in the banks' portfolios. In terms of risks associated with collateral, the banks are more exposed to a drop in real estate prices and the risk of the protracted and unsuccessful redemption (sale) of real estate, in particular commercial real estate. At 65%, commercial real estate pledged as collateral accounted for the highest proportion of the total value of collateral in February 2014, followed by residential real estate at 11%. At 17%, the proportion accounted for by other forms of collateral is very high. However, these forms of collateral are frequently more difficult to redeem. Financial forms of collateral, which can be redeemed more expediently, also account for 17% of the total value of collateral.

Figure 6.22: Changes in unsecured claims and collateral relative to total classified claims (left) and relative to non-performing claims (right) in percentages (base year: 2012)




Note: Financial forms of collateral include bank deposits, irrevocable Slovenian government guarantees, shares and other equity, debt securities, units in collective investment undertakings and insurance with an insurer.

Source: Bank of Slovenia

**The transfer of a portion of non-performing claims to the BAMC from the two largest domestic banks was the main factor in shifts in individual forms of collateral.**

The most significant changes at the banking system level were primarily the result of the transfer of non-performing claims to the BAMC from the large domestic banks, which were mostly secured by collateral in the form of real estate, in particular commercial real estate. Total classified claims accounted for by unsecured claims were down 8.9% at the banking system level in December 2013 relative to November, and by 11% at the large domestic banks. This had no significant impact on the total proportion of unsecured claims (more than 50%) due to the simultaneous decline in total classified claims. Collateral in the form of irrevocable Slovenian government guarantees was up by nearly one-half, while other forms of collateral were down, most notably collateral in the form of commercial real estate, followed by other forms of collateral, shares and participating interests and residential real estate. The portion of unsecured claims was up again between December 2013 and February 2014, while the value of collateral also rose, in particular collateral in the form commercial real estate.

Table 6.16: Collateral on the banks' classified claims by client segment in February 2014 in percentages

| | | Comparison of collateral[2] with classified claims, % | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | | Secured | | | | | |
| | Classified claims, EUR million | Unsecured[1] | Shares, equity and mutual fund units as collateral | Commercial real estate as collateral[3] | Housing as collateral[3] | At insurer | Other | Total value of collateral[3] |
| NFCs | 17,058.9 | 39.5 | 5.3 | 75.4 | 8.7 | 0.1 | 36.4 | 125.9 |
| OFIs | 1,781.9 | 63.1 | 18.0 | 11.8 | 2.1 | 0.0 | 20.2 | 53.0 |
| Households | 9,478.4 | 28.8 | 0.3 | 14.9 | 102.0 | 20.1 | 10.1 | 147.3 |
| Non-residents | 5,124.4 | 75.5 | 1.6 | 26.1 | 2.3 | 0.0 | 11.6 | 41.5 |
| Government | 3,458.8 | 66.2 | | 3.0 | 0.1 | | 46.2 | 49.3 |
| Banks and savings banks | 2,640.8 | 96.3 | | 0.1 | 0.0 | | 3.6 | 3.8 |
| Total | 41,734.5 | 51.5 | 3.2 | 38.2 | 27.1 | 4.6 | 23.5 | 96.6 |

Notes: [1] The figure includes unsecured claims and claims secured with forms of collateral that are not taken into account in the banks' calculation of impairments and provisions (e.g. collateral in the form of bills of exchange).
[2] Collateral is stated at fair value.
[3] With regard to collateral in the form of real estate, several banks may register a mortgage on the same real estate. In such cases the value of the mortgage at each successive bank is reduced by the value of the claims of banks with seniority in the possible redemption of the collateral. Consequently, the value of these forms of collateral is multiplied both for these forms of collateral and as an aggregate.

Source: Bank of Slovenia

**Collateral in the form of commercial real estate represents the prevailing form of collateral, although its appraised value is questionable.**

The coverage of claims by collateral is highest in the household sector, whose claims are primarily secured by residential real estate. The general market value as published by the Surveying and Mapping Authority of the Republic of Slovenia (SMARS) can be used as the valuation for residential real estate valued at no more than EUR 500,000. From this point of view, assuming that the SMARS valuation model is reasonable, the valuations of the majority of residential real estate at the banks are correct.

There is also a high coverage of classified claims, 126% in the corporate sector, which is considered among the highest-risk client segments. Commercial real estate is the prevailing form of collateral in this segment. Last year's comprehensive assessment of the banking system revealed that the appraised value of the aforementioned real estate was questionable. The banks must therefore create additional impairments in the event of major discounts on individual real estate prices.

### Collateralisation of the non-performing portion of the portfolio

Because the majority of claims transferred to the BAMC in December 2013 were non-performing claims, the reduction in the value of collateral and unsecured claims was most notable in the non-performing portion of the portfolio. The unsecured portion of non-performing claims was down 39%, while the most significant decreases in collateral were recorded by collateral in the form of commercial real estate (by 22%) and in the form of residential real estate (by 27%).

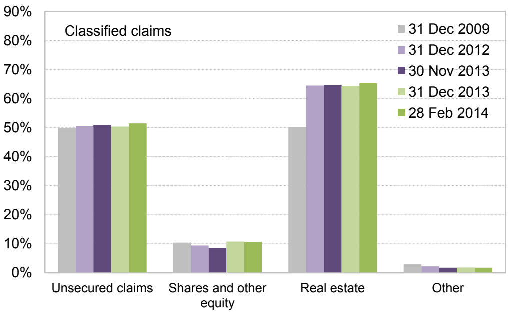
There is a significant difference in coverage by collateral between the bank groups with regard to non-performing claims. The coverage of claims by collateral is 45 percentage points higher at the banks under majority foreign ownership than at the large domestic banks in the context of a similar proportion of non-performing claims.

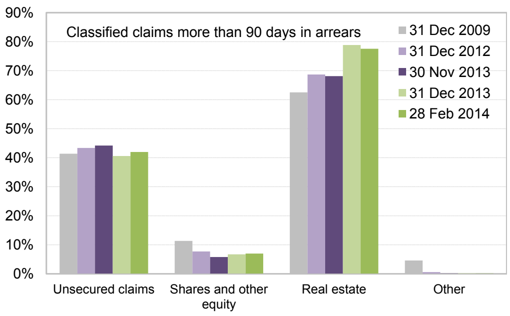
Table 6.17: Collateralisation of non-performing assets by bank group in February 2014 in percentages

| | Comparison of collateral[2] with classified claims, % | | | | | | |
|---|---|---|---|---|---|---|---|
| | Unsecured[1] | Shares, equity and mutual fund units as collateral | Commercial real estate as collateral[3] | Housing as collateral[3] | At insurer | Other | Total value of collateral[3] |
| Savings banks | 26.7 | | 144.1 | 87.5 | | 30.1 | 261.7 |
| Small domestic banks | 36.7 | 12.5 | 70.5 | 18.8 | 0.0 | 18.9 | 120.7 |
| Banks under majority foreign ownership | 43.0 | 2.5 | 72.0 | 23.0 | 0.0 | 33.8 | 131.4 |
| Large domestic banks | 43.5 | 5.0 | 63.6 | 5.0 | 0.0 | 13.3 | 86.9 |
| Overall | 42.0 | 6.1 | 66.5 | 11.0 | 0.0 | 18.1 | 101.7 |

Notes: [1, 2, 3] See previous table. The table does not include the household sector.
Source: Bank of Slovenia

Figure 6.23: Coverage of banks' total classified claims (left) and coverage of banks' classified claims more than 90 days in arrears (right) by collateral in percentages




### Survey figures on collateral redemptions due to clients' inability to repay loans

According to survey figures, [19] the banks redeemed collateral of EUR 685 on loans in 2013, compared with EUR 750 million in 2012. Of the aforementioned amount, the majority, or 98%, was collateral on corporate loans. The latter was down slightly on 2012, by EUR 30 million. The success rate of repayment of corporate loans from collateral was 22%. In most cases, the collateral redeemed was commercial real estate or shares and other equity. The success rate was considerably higher for household loans, at 76%. Collateral redemptions on household loans declined relative to 2012, from EUR 18 million to EUR 3.6 million for housing loans and from EUR 30 million to EUR 11.9 million for non-housing loans. Collateral redemptions amounted to just 2.9% of non-performing loans in 2013.

**The success rate of repayment of loans from collateral was 22% in 2013.**

19 Annual bank survey, March 2014.

Table 6.18: Loans for which banks redeemed collateral in 2013 and the amount of collateral redemptions by type in EUR million

| | Bank deposits and irrevocable government guarantees | Shares, equity, debt securities and mutual fund units | Commercial real estate | Housing | At insurer | Other | Total collateral |
|---|---|---|---|---|---|---|---|
| | Corporate loans | | | | | | |
| Loan amount | 48.9 | 155.6 | 225.6 | 35.8 | 0.0 | 203.6 | 669.5 |
| Value of redeemed collateral | 20.8 | 29.8 | 34.0 | 17.6 | 0.0 | 47.6 | 149.8 |
| | Housing loans to households | | | | | | |
| Loan amount | 0.0 | 0.0 | 0.0 | 2.3 | 1.0 | 0.3 | 3.6 |
| Value of redeemed collateral | 0.0 | 0.0 | 0.0 | 1.3 | 0.7 | 0.1 | 2.1 |
| | Non-housing loans to households | | | | | | |
| Loan amount | 0.1 | 0.1 | 1.2 | 0.8 | 9.3 | 0.5 | 11.9 |
| Value of redeemed collateral | 0.1 | 0.1 | 0.3 | 0.4 | 8.7 | 0.1 | 9.6 |
| | Total loans | | | | | | |
| Loan amount | 49.0 | 155.7 | 226.7 | 38.9 | 10.2 | 204.4 | 685.0 |
| Value of redeemed collateral | 21.0 | 29.8 | 34.3 | 19.2 | 9.4 | 47.8 | 161.5 |

Source: Bank of Slovenia

## 6.4 Refinancing risk and changes in the breakdown of bank funding

### Summary

The banks have been faced with refinancing risk for some time now, i.e. since the outbreak of the crisis. Pressures to make net repayments of funding on the wholesale markets were overcome successfully several times in previous years: through the issue of three-year debt securities with a Slovenian government guarantee and an increase in government deposits in 2009, and through funding via the ECB's three-year LTRO's in 2012. Maintaining a low rollover rate of liabilities to banks in the rest of the world and reducing liabilities to the ECB will result in the continued contraction in the banks' balance sheets. Taking into account wholesale sources of funding and sources from the ECB, the banks will be heavily exposed to a refinancing burden in the first half of 2015, most notably in the first quarter when they see EUR 2.6 billion of long-term liabilities to the Eurosystem mature.

Refinancing risk in shorter maturities has diminished due to the intensive repayment of bank funding secured in the past on the wholesale markets. The banks have a lower proportion of liabilities to the rest of the world in their balances sheets than prior to the crisis. The stock of liabilities from wholesale funding fell by EUR 11.4 billion in the period from the peak of borrowing in the rest of the world (i.e. from October 2008) until March 2014, to stand at EUR 6.6 billion or 16.6% of total assets. The intensive restructuring of bank funding has also been carried out in recent years. Even the banks under majority foreign ownership, which in the past were financed by parent banks in the rest of the world, have focused increasingly on local sources of funding in recent years. Thus, the differences between banks are narrowing, in terms of both structure and cost of funding.

### 6.4.1 Changes to funding

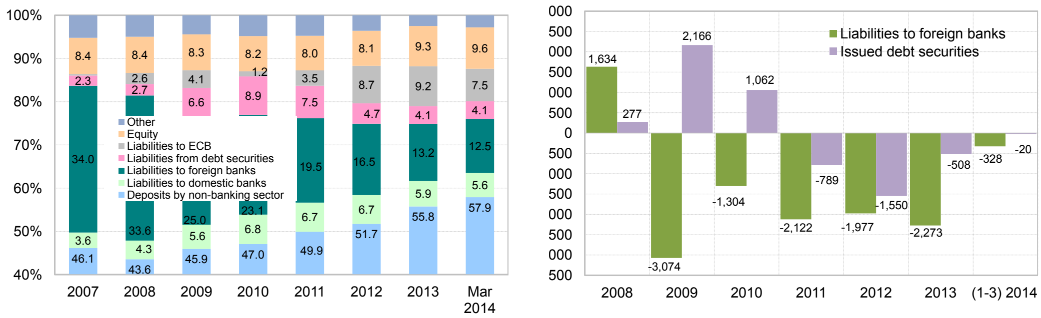
**The proportion of banks' total assets accounted for by wholesale funding was down last year.**

The process of restructuring funding, which began at the outbreak of the financial crisis, continued last year. The banks have reduced their dependence on wholesale funding. During the first two years of the crisis, the banks compensated for their debt repayments to banks in the rest of the world by issuing debt securities, while intensive debt repayments were made in the aforementioned segment of the wholesale market from 2011 to 2013. The uncertain economic, political and financial situation in Slovenia, as well as the deterioration of the banking portfolio, have hampered the banks' access to the international financial markets. The proportion of total assets accounted for by wholesale funding, which at the outbreak of the crisis was more than a third of total bank funding in Slovenia had halved by the end of 2013, fell below 17% in March 2014.

**Deposits by the non-banking sector were down last year due to the conversion of government deposits into equity at the end of the year.**

Deposits by the non-banking sector declined by 5.5% in year-on-year terms in 2013, primarily owing to a decrease in government deposits. The latter rose at the banking system level until the end of November due to the issue of Slovenian government bonds, but were down by EUR 2.4 billion in December owing to the conversion of government deposits into equity at five banks. The decline in household deposits was moderate, despite the adverse economic situation and the unfavourable conditions on the labour market, which in the context of simultaneous repayments to the rest of the world increased the importance of deposits as a form of bank funding. Deposits by the non-banking sector accounted for 55.8% of the stock of bank funding at the end of 2013, and household deposits for 35.5%. Compared with the outbreak of the crisis, the first figure was up almost 12 percentage points and the second was up 7.5 percentage points.

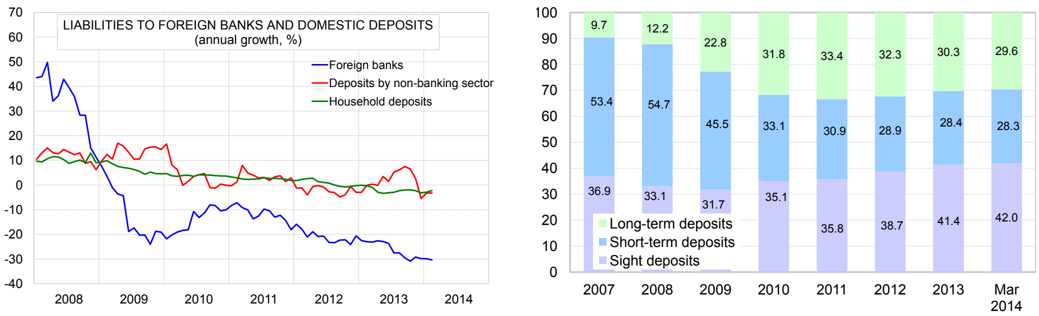
Figure 6.24: Percentage breakdown of bank funding (left) and the banks' net debt repayments on the wholesale markets in EUR millions (right)




Source: Bank of Slovenia

Only the banks under majority foreign ownership recorded growth in deposits by the non-banking sector, as a result of an increase in deposits by households and non-financial corporations. The proportion of deposits by the non-banking sector accounted for by short-term deposits was up for the second consecutive year in 2013.

Figure 6.25: Year-on-year growth in bank funding (left) and maturity breakdown of deposits by the non-banking sector (right) in percentages




Source: Bank of Slovenia

### Differences in the breakdown of funding at individual bank groups

All the bank groups reduced their debt on the wholesale markets in the rest of the world. The banks under majority foreign ownership, where the aforementioned sources accounted for one-half of total liabilities prior to the crisis, recorded the sharpest reduction.

Table 6.19: Ratios of individual forms of funding to total liabilities by bank group

| (%) | Large domestic banks | Small domestic banks | Banks under majority foreign ownership | Banking system overall |
|---|---|---|---|---|
| | | | | Liabilities to foreign banks |
| 2008 | 27.7 | 6.4 | 52.3 | 33.6 |
| 2012 | 11.1 | 0.4 | 31.8 | 16.5 |
| 2013 | 8.9 | 0.0 | 24.3 | 13.2 |
| Mar 2014 | 8.3 | 0.0 | 23.0 | 12.5 |
| | | | | Deposits by non-banking sector |
| 2008 | 47.8 | 58.8 | 31.2 | 43.5 |
| 2012 | 52.9 | 62.2 | 46.4 | 51.7 |
| 2013 | 54.2 | 65.2 | 56.1 | 55.8 |
| Mar 2014 | 56.7 | 67.4 | 57.7 | 57.9 |
| | | | | Household deposits |
| 2008 | 32.0 | 33.1 | 18.6 | 28.0 |
| 2012 | 34.6 | 41.1 | 24.8 | 32.2 |
| 2013 | 36.8 | 52.4 | 28.8 | 35.5 |
| Mar 2014 | 37.9 | 54.9 | 29.3 | 36.4 |
| | | | | Government deposits |
| 2008 | 4.3 | 6.6 | 2.5 | 3.9 |
| 2012 | 7.2 | 8.8 | 4.7 | 6.6 |
| 2013 | 4.4 | 2.7 | 3.9 | 4.1 |
| Mar 2014 | 5.0 | 2.5 | 4.5 | 4.6 |
| | | | | Issued debt securities |
| 2008 | 3.5 | 6.3 | 0.0 | 2.7 |
| 2012 | 6.9 | 6.1 | 0.0 | 4.7 |
| 2013 | 6.3 | 4.6 | 0.1 | 4.1 |
| Mar 2014 | 6.3 | 4.3 | 0.1 | 4.1 |
| | | | | Liabilities to Eurosystem |
| 2008 | 2.1 | 2.8 | 3.3 | 2.6 |
| 2012 | 9.6 | 11.0 | 6.2 | 8.7 |
| 2013 | 11.0 | 14.6 | 4.7 | 9.2 |
| Mar 2014 | 8.9 | 12.5 | 3.9 | 7.5 |

Source: Bank of Slovenia

The banking system made debt repayment to foreign banks of EUR 11.1 billion from the end of 2008 to the end of March 2014. Total net debt repayments on the wholesale markets, with debt securities issued by the banks taken into account, amounted to EUR 10.7 billion. Taking into account the peak of borrowing in the rest of the world in October 2008, net debt repayments to banks in the rest of the world during the aforementioned period totalled EUR 12 billion, and to EUR 11.4 billion taking into account all wholesale funding. The amount of net debt repayment in the context of total wholesale funding thus reached 32% of Slovenian GDP.

The differences in the structure of funding between individual bank groups remain relatively large, as the proportion of wholesale funding at the banks under majority foreign ownership of 23% is 8 percentage points higher than the same figure at the large domestic banks.

**The proportion of funding accounted for by deposits by the non-banking sector was up last year at all the bank groups.**

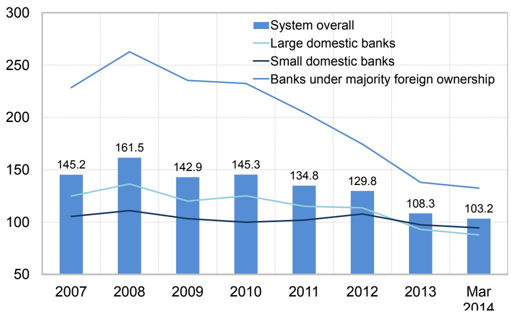
The large domestic banks made debt repayments in the rest of the world, while they also recorded a decline in deposits by the non-banking sector, most notably government and household deposits. Nevertheless, deposits by the non-banking sector as a proportion of total assets were up last year in this bank group. Household deposits still represent the prevailing form of funding at the banks under majority domestic ownership. They accounted for more than a third of total liabilities at the large domestic banks at the end of last year, and for one-half at the small domestic banks and savings banks. Despite the early repayment of LTROs at the ECB, both bank groups remain more exposed via liabilities to the Eurosystem than are the banks under majority foreign ownership.

### Loan-to-deposit ratio for the non-banking sector

**The ratio of loans to the non-banking sector to deposits by the non-bank sector declined last year.**

The indicator of the sustainability of bank funding, defined as the loan-to-deposit ratio for the non-banking sector, has declined since the outbreak of the crisis. It declined by around 58 percentage points between the end of 2008 and March 2014 to stand at 103%, 22 percentage points of the aforementioned decline having been recorded last year. The decline was not uniform across all bank groups. The banks under majority foreign ownership recorded the sharpest decline in the LTD ratio for the non-banking sector, to 132% This is still 30 percentage points above the average of the Slovenian banking system. The decline in the ratio at the aforementioned banks was the result of a decline in lending and an increase in household deposits. By focusing on securing local funding in the form of deposits by the non-banking sector, the banks under majority foreign ownership are changing their funding business model.

Figure 6.26: LTD ratio for the non-banking sector by bank group in percentages




Source: Bank of Slovenia

**Renewed growth in household deposits at domestic banks in 2014 reflected the restoration of confidence following the adoption of measures in December.**

The over-dependence of the banks on wholesale funding, which accumulated in the years leading up to the crisis and increased the banks' dependence on foreign sources of funding, continues to decrease due to permanent debt repayments. The domestic banks have always been less dependent on wholesale funding than the banks under majority foreign ownership. In addition to net debt repayments to the rest of the world, household deposits were down at the domestic banks due to increased uncertainty and waning public confidence in the context of negative publicity regarding this bank group. The first wave of an increasing lack of confidence in the domestic banks was triggered in spring 2013 by the way the banking crisis in Cyprus was resolved and speculation about a similar resolution to the crisis in Slovenia. The second wave followed in the summer at the start of the asset quality review of five Slovenian banks and the performance of stress tests, while a lack of confidence was again expressed in the weeks prior to the publication of the results of the stress tests in December 2013. The situation has improved since the adoption of measures by the Slovenian government and the Bank of Slovenia. Deposits were up at all bank groups in the first quarter of this year, most notably at the large domestic banks, primarily owing to an increase in household deposits, which points to the restoration of confidence following the adoption of measures in December 2013. Thus, the deposits withdrawn from the banking system by households last year are being returned to the system. During the first quarter of 2014 the banking system recovered 55% of the household deposits withdrawn from the system in 2013.

**For the third consecutive year, the banks under majority foreign ownership were the only group to record an increase in deposits by the non-banking sector.**

The banks under majority foreign ownership were the only group to record an increase in deposits by the non-banking sector in 2013, by 13%. Solid growth in deposits by households and non-financial corporations contributed to last year's increase in deposits at the aforementioned banks. The switching of deposits by households and non-financial corporations between the bank groups was not the result of higher deposit rates at the banks under majority foreign ownership, but primarily due to a lack of confidence in the domestic banks. The higher negative growth in corporate and government deposits at the small domestic banks was due to the initiation of the wind-down process at Factor banka and Probanka last September.

Table 6.20: Increases and growth in household deposits in EUR millions and percentages, and growth in deposits by the non-banking sector

| | Increase in household deposits, EUR million | | | Year-on-year growth in household deposits, % | | | Year-on-year growth in deposits by non-banking sector, % | | |
|---|---|---|---|---|---|---|---|---|---|
| Bank group | 2012 | 2013 | (1-3) 2014 | 2012 | 2013 | Mar 2014 | 2012 | 2013 | Mar 2014 |
| Large domestic banks | -402.4 | -798.9 | 156.6 | -4.1 | -8.4 | -5.7 | -8.6 | -11.8 | -11.2 |
| Small domestic banks | 11.9 | -85.0 | -11.8 | 0.9 | -6.1 | -11.0 | -8.0 | -27.1 | -29.9 |
| Savings banks | 46.7 | 109.9 | 36.9 | 14.4 | 29.7 | 9.3 | 12.3 | 32.9 | 34.2 |
| Banks under majority foreign ownership | 310.1 | 309.7 | 71.4 | 9.6 | 8.8 | 31.2 | 13.5 | 13.1 | 13.5 |
| System overall | -33.7 | -464.3 | 253.1 | -0.2 | -3.1 | -1.7 | -2.9 | -5.5 | -5.2 |

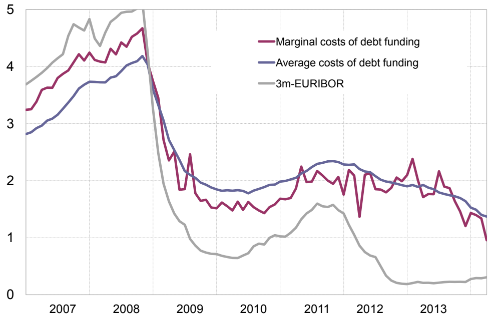
Source: Bank of Slovenia

### 6.4.2 Bank funding costs

**The cost of debt funding was down in the first quarter of 2014.**

The average cost of debt funding was down last year due to a change in the breakdown in bank funding. The average cost of debt capital declined by 0.53 percentage points between December 2012 and March 2014 to 1.37%, while the cost of equity increased sharply due the rising price of bank equity in the context of declining share prices. The decline in the cost of debt capital was primarily the result of a decrease in the banks' liability interest rates on deposits by the non-banking sector, which fell by 0.7 percentage points during the same period to 1.42%. Also contributing to the aforementioned decline was the increase in the proportion of bank funding accounted for by ECB funding and a decrease in the proportion accounted for by debt securities. The banks under majority domestic ownership recorded the sharpest decline in the cost of debt funding due to the higher proportion of total funding accounted for by deposits. [20] Debt repayments to foreign banks at the banks under majority foreign ownership were the main factor in their smaller decline in funding costs, as the associated cost declined less in relative terms than the cost of deposits.

Figure 6.27: Average and marginal debt funding costs for banks and movement in the 3-month EURIBOR in percentages

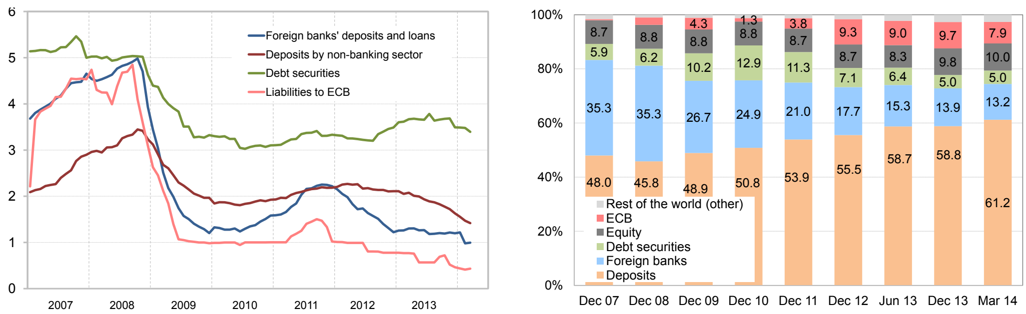



Source: Bank of Slovenia

**Interest rates on deposits by the non-banking sector recorded the sharpest fall last year, and contributed to the reduction in the cost of bank debt funding.**

With an average interest rate of 1.4%, deposits by the non-banking sector are the second most expensive source of funding. Slovenian banks cut their interest rates on deposits by the non-banking sector considerably last year, and attempted in part to improve cost competitiveness and relieve the pressure to reduce the net interest margin. We can expect further positive effects this year from the low interest rates on deposits by the non-banking sector, but to a lesser extent than last year. Another major factor in the decline in the average cost of debt funding last year was the further decline in bank funding via issues of debt securities, which are the most expensive source of debt funding.

Figure 6.28: Average cost of bank debt funding (left) and breakdown of funding (right) in percentages




Source: Bank of Slovenia

### Differences in funding costs between bank groups

**The small domestic banks and savings banks recorded the largest decline in debt funding costs in 2013.**

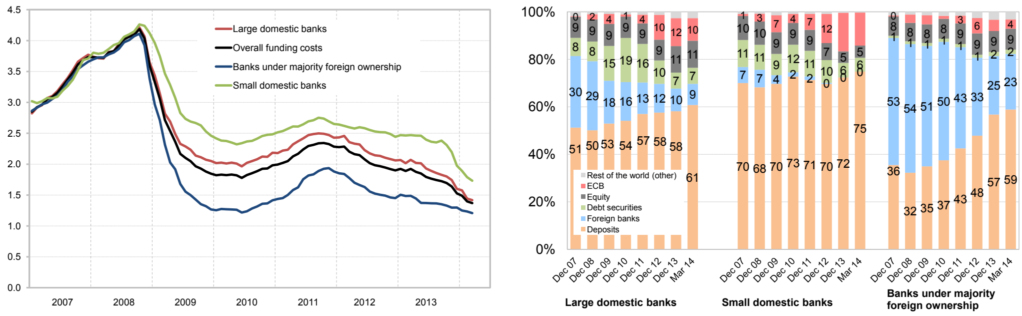
The lowest average cost of debt funding at the end of March 2014 was recorded by the banks under majority foreign ownership at 1.2%, followed by the large domestic banks at 1.4% and the small domestic banks at 1.7%. The small domestic banks recorded the sharpest decrease in funding costs from December 2012 to March 2014, by 0.71 percentage points, followed by the large domestic banks at 0.64 percentage points, while the cost of debt funding at the banks under majority foreign ownership was down by one-quarter of a percentage point.

[20] In size terms, the funding used to calculate funding costs is slightly smaller than total liabilities, as only equity and interest-bearing items are included, as a result of which the proportions of individual forms of funding are slightly higher than their ratios to total liabilities.

**All the bank groups have increased the proportion accounted for by relatively more expensive deposits by the non-banking sector.**

The proportion of more expensive forms of funding was up at all bank groups due to their focus on securing local funding in the form of deposits by the non-banking sector in the context of simultaneous debt repayments to banks in the rest of the world. However, the cost of more expensive forms of funding has fallen sharply in the most recent period, while the differences in the cost of debt funding and deposits between individual bank groups are narrowing. Although the banks under majority foreign ownership still have the highest proportion of relatively cheap funding (i.e. liabilities to banks) and thus lower funding costs, deposits by the non-banking sector have become the most important source of funding for this bank group.

Figure 6.29: Average cost of bank debt funding (left) and breakdown of funding (right) in percentages




Source: Bank of Slovenia

### 6.4.3 Refinancing risk

**The importance of government deposits decreased at the end of 2013 when the government converted a portion of its bank deposits into equity.**

The banks continued to make net debt repayments to the rest of the world on the wholesale markets in 2013. Total net debt repayments on the wholesale markets amounted to EUR 2.8 billion in 2013, EUR 0.6 billion less than the previous year. In March this year the banks were less exposed to the burden of repayment over shorter time periods.

As a result of the banks' intensive debt repayments on the international wholesale markets in previous years, and a significant decline in the stock of these liabilities, the short-term pressure on refinancing eased. Towards the end of last year the banks were exposed to the maturing of government deposits, which were partly converted into equity in the early part of the recovery process at certain large domestic banks in December 2013. With the maturity of a 3-year LTRO and liabilities on the wholesale market approaching, the banks will be most exposed to refinancing risks in the first half of next year. Liabilities to the Eurosystem in the amount of EUR 2.6 billion mature at the beginning of 2015, while a total of EUR 4.2 billion in liabilities mature during the first half of 2015, taking into account wholesale funding.

#### a) Government deposits at banks

**Government deposits as a proportion of total liabilities fell to a level comparable with the pre-crisis level.**

The importance of deposits by the general government in bank balance sheets decreased with the conversion of the aforementioned deposits into the equity of banks in accordance with measures adopted in December 2013 to stabilise the banking system. During the crisis the government became an important source of funding for the banks. The proportion of general government deposits to total assets in December of last year compared with the outbreak of the crisis, more than doubled to reach one-tenth of the banking system's total assets. The majority of the government deposits were fixed-term deposits by the Ministry of Finance. The fixed-term deposits at banks by the Ministry of Finance declined sharply on 18 December 2013, by EUR 2,140 million. The government converted them into equity at five banks. [21] Total government deposits at banks were thus halved. The proportion of government deposits fell to a level comparable with the pre-crisis proportion. Deposits by the Ministry of Finance, which account for the majority of government deposits, still amounted to EUR 1 billion at the end of March and accounted for more than half of all general government deposits. The majority of the aforementioned deposits mature in 2014. In the context of a relatively good liquidity position, the banks were not interested in accepting short-term government deposits in the first quarter of 2014. The government therefore increased its stock of overnight deposits. At 5%, the large domestic banks had a higher ratio of liabilities to the government sector to total assets than the small domestic

[21] On 18 December the Ministry of Finance increased the capital of Abanka, Factor banka, NKBM, NLB and Probanka. Part of the capital increase at these banks was undertaken via the conversion of fixed-term deposits by the Ministry of Finance into equity in the banks.

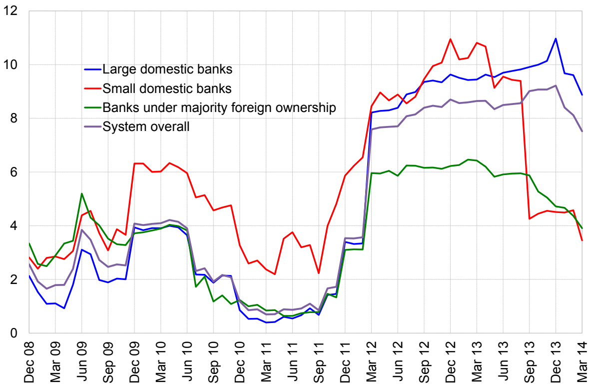
banks and the banks under majority foreign ownership. General government deposits do not represent a stable and long-term source of bank funding. We therefore expect the proportion of total assets they account for to decline during the second half of the year.

### b) Bank funding from the Eurosystem

**The banking system had EUR 3.0 billion of liabilities to the Eurosystem at the end of March 2014.**

The stock of liabilities to the Eurosystem had declined by EUR 0.7 billion to EUR 3.0 billion by the end of this March, as a result of early repayments by certain banks and the withdrawal of access to ordinary ECB instruments at two smaller banks in the ordinary wind-down process. The relative importance of liabilities to the Eurosystem increased slightly last year due to the more rapid contraction in total assets than funding from the Eurosystem, but diminished again in the first quarter of 2014 due to the early repayment of 3-year LTROs.

Figure 6.30: Liabilities to Eurosystem instruments as a proportion of the banking system's total liabilities




Source: Bank of Slovenia

By the end of March 2014, the banks had made early repayments of EUR 1,077 million or 29% of liabilities totalling EUR 3,699 million from 3-year LTROs concluded in the first quarter of 2012. Slovenian banks continued to make early repayments of 3-year LTROs during the second quarter of 2014.

**Refinancing risk and the risk of a further contraction in the banks' balance sheet rise as the first quarter of 2015 approaches.**

The first quarter of 2015, when the banks will have to repay liabilities from the 3-year LTROs at the Eurosystem, is approaching. The majority of the debt from the 3-year LTROs is concentrated at the large domestic banks, which accounted for EUR 2.1 billion at the end of March 2014. The approaching maturity is increasing the refinancing risk associated with this form of funding. However, the banks have a sufficient level of surplus liquidity at their disposal. In structuring their investments the banks are preparing for the repayment of the liabilities from the 3-year LTROs. At maturity, the banks will compensate for at least a portion of these long-term sources with short-term funding from the Eurosystem.

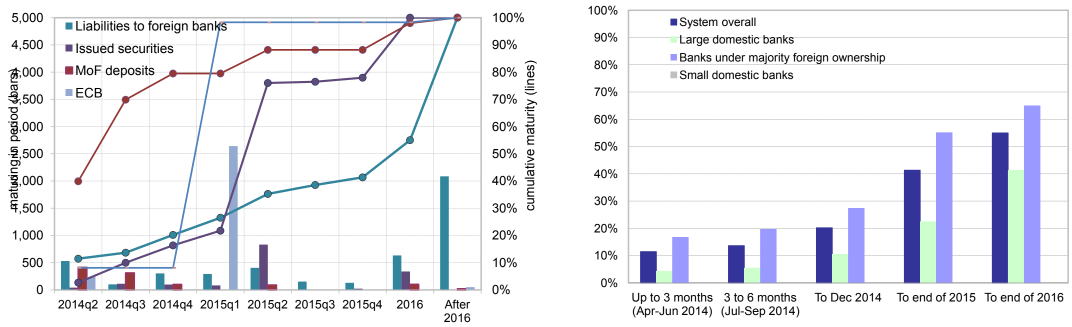
### c) Maturing bank liabilities to the rest of the world and debt securities issued by the banks

**The banks rolled over only a minimum proportion of maturing liabilities to the rest of the world in the year ending this March.**

In the years since the outbreak of the crisis, the banks have only rolled over maturing liabilities on foreign financial markets to a lesser degree. Thus the process of debt repayment has been ongoing for several years at both the banks under majority domestic ownership and the banks under majority foreign ownership. The banks under majority foreign ownership made total debt repayments to the rest of the world between 2011 and 2013 (loans, deposits and repo transactions) of EUR 3.7 billion, while that figure was EUR 2.6 billion for the large domestic banks. According to survey figures, the banks rolled over merely 4.5% of maturing debt to foreign banks between March 2013 and April 2014. That proportion is 12.5% at the banks under majority foreign ownership, while the banks under majority domestic ownership failed to roll over funding in the rest of the world. The banks' limited access to funding on the interbank market is not only linked to speculation about the deteriorating portfolio, but also to political uncertainty, delays in the implementation of necessary structural changes to improve competition and delays in the fulfilment of existing commitments.

The banks under majority domestic ownership reduced their liabilities to foreign banks by 31.4% or EUR 0.96 billion last year. Taking into account maturing issued debt securities, the banks reduced funding from the wholesale markets by an additional EUR 0.42 billion. The banks under majority foreign ownership reduced their liabilities to banks in the rest of the world by EUR 1.3 billion or 28.5% in 2013, almost the same amount as the previous year.

Figure 6.31: Maturing of liabilities by form of wholesale funding, liabilities from Ministry of Finance deposits and liabilities to the ECB by maturity interval (left) and maturing liabilities to banks in the rest of the world by bank group (right) in percentages (March 2014; bank survey figures)




Source: Bank of Slovenia

The liabilities of Slovenian banks to banks in the rest of the world are relatively evenly distributed across individual maturity buckets. A total of 20% of banks' liabilities to the rest of the world mature over the remaining three quarters of 2014, while that figure is 21% in 2015 and 14% in 2016. The majority or 58% of liabilities to banks in the rest of the world are concentrated at the banks under majority foreign ownership. A total of EUR 0.9 billion in liabilities to banks in the rest of the world will mature both this year and next year.

Table 6.21: Stock and maturity breakdown of liabilities to foreign banks (loans, deposits and repo transactions) for the banking system overall and by bank group in percentages (as at 31 March 2014)

| Liabilities to banks in rest of the world | Total, EUR | By maturity bucket, % | | | | | |
|---|---|---|---|---|---|---|---|
| Banks | million | 2014 Q2 | 2014 Q3 | 2014 Q4 | in 2015 | in 2016 | after 2016 |
| Savings banks | | | | | | | |
| Small domestic banks | 0.0 | | | | | | |
| Large domestic banks | 1,955.1 | 4.3 | 1.2 | 5.0 | 12.0 | 18.9 | 58.7 |
| Banks under majority foreign ownership | 2,678.3 | 16.7 | 3.0 | 7.7 | 27.8 | 9.9 | 35.0 |
| System overall | 4,633.4 | 11.5 | 2.2 | 6.5 | 21.1 | 13.7 | 45.0 |

Source: Bank of Slovenia

If we also take into account issued debt securities, the aforementioned liabilities totalled EUR 1.5 billion at the end of March 2014, while the associated refinancing burden will be highest in 2015, when maturing liabilities will total EUR 944 million. EUR 832 million of the aforementioned amount matures in the second quarter at the banks under majority domestic ownership.

Table 6.22: Stock and maturity breakdown of issued debt securities for the banking system overall and by bank group in percentages (as at 31 March 2014)

| Issued debt securities | Total, EUR | By maturity bucket, % | | | | | |
|---|---|---|---|---|---|---|---|
| Banks | million | 2014 Q2 | 2014 Q3 | 2014 Q4 | in 2015 | in 2016 | after 2016 |
| Savings banks | 0.9 | 54.8 | 35.0 | 0.0 | 0.0 | 4.3 | 5.9 |
| Small domestic banks | 65.5 | 0.7 | 0.0 | 0.0 | 100.0 | 0.0 | 0.0 |
| Large domestic banks | 1,450.4 | 2.3 | 7.7 | 6.2 | 56.1 | 23.3 | 4.4 |
| Banks under majority foreign ownership | 14.4 | 45.0 | 0.0 | 54.6 | 0.0 | 0.0 | 0.3 |
| System overall | 1,531.2 | 2.7 | 7.3 | 6.4 | 61.7 | 22.1 | 2.0 |

Source: Bank of Slovenia

## 6.5 Liquidity risk

### Summary

Liquidity risk decreased in the Slovenian banking system following the recapitalisation of banks and the transfer of non-performing claims to the Bank Asset Management Company at the end of 2013, and following the issue of government bonds in 2013 and February this year. Nevertheless, attention remains focused on specific banks whose liquidity position is less favourable. The banking system's surplus liquidity, which the banks place via 1-week fixed-term deposits with the Eurosystem, and use to make partial early repayments of the

3-year LTROs or to purchase low-risk securities, increased. The more favourable liquidity position is reflected in higher liquidity ratios, an increase in the proportion of the pool of eligible collateral at the Eurosystem that is free, an increase in the stock of marketable secondary liquidity and, finally, waning interest on the part of the Slovenian banks in government deposits, which the latter offered following the issue of new euro bonds at the beginning of April.

Despite surplus liquidity and recapitalisations, the banks remain reluctant to lend to the non-banking sector. Priority is given to the repayment of liabilities and a contraction in total assets, which does not contribute to the normalisation of the financing of the economy. In addition, the Slovenian interbank market continues to stagnate. The Slovenian banks have maintained their position as net creditors on the euro area money market, which reflects foreign investors' lack of confidence. Opportunities for effective liquidity management and securing new funding in the event of increased liquidity needs thus remain limited.

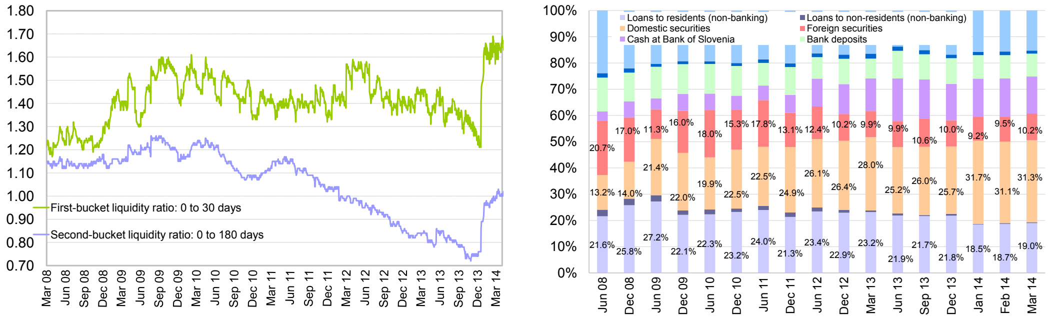
### 6.5.1 Liquidity ratios

**The first-bucket and second-bucket liquidity ratios improved significantly.**

December's measures by the Slovenian government resulted in a significant improvement in the banking system's liquidity ratios. The first-bucket liquidity ratio averaged at 1.37 in 2013, down 0.09 from the previous year, but reached a value of 1.61 at the end of 2013 and fluctuated at this level during the first quarter of 2014. Growth in the first-bucket liquidity ratio at the end of last year was the result of a decrease in government deposits due to the recapitalisation of five banks and an increase in the stock of securities on account of the bonds received from the Bank Asset Management Company following the transfer of non-performing claims to the latter.

The decline in the second-bucket liquidity ratio, since the beginning of 2011, came to a halt in December. The second-bucket liquidity ratio was down 0.14 in 2013 to stand at 0.80, a reflection of the deterioration in the quality of the credit portfolio. Similar to the first-bucket liquidity ratio, the second-bucket liquidity ratio improved significantly during the first quarter of 2014, its value exceeding 1.

Figure 6.32: Daily first-bucket and second-bucket liquidity ratios (left) and breakdown of the method of meeting the first-bucket liquidity ratio by instrument (right) in percentages



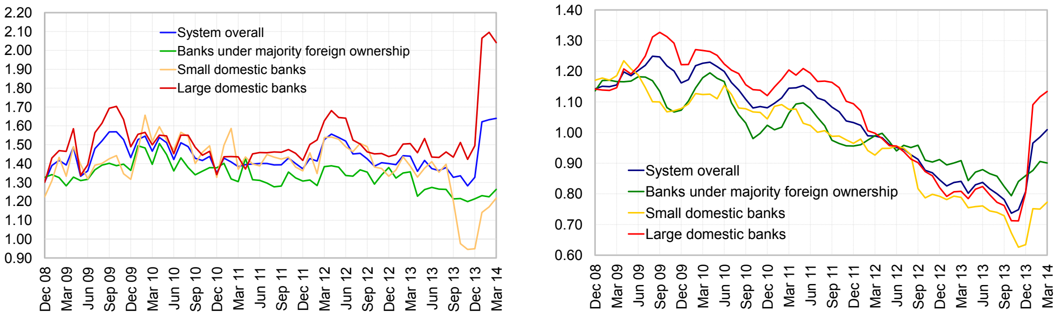

Source: Bank of Slovenia

**Liquidity ratios improved significantly only at the domestic banks due to measures implemented by the Slovenian government.**

The more pronounced improvement in the liquidity position of the banking system overall was not felt by all the banks. Because December's measures included three large domestic banks and the two small domestic banks undergoing the orderly wind-down process, there was only a marked improvement in the liquidity ratios of the aforementioned banks. The first-bucket liquidity ratio averaged at 2.07 at the large domestic banks in the first quarter of 2014, up 0.6 from the 2013 average. Following a sharp fall in September, the first-bucket liquidity ratio at the small domestic banks improved at the end of December due to the initiation of the orderly wind-down process at two banks and the recapitalisation thereof, and averaged at 1.18 during the first quarter of 2014.

The first-bucket liquidity ratio of the banks under majority foreign ownership is below the system average. It fell to 1.24 during the first quarter of 2014, which is not necessarily an indication of the poor liquidity position of these banks, but is partly a reflection of their amended liquidity management policy.

Figure 6.33: Liquidity ratios for the first bucket (0 to 30 days; left) and the second bucket (0 to 180 days; right) of the liquidity ladder by individual bank group, monthly averages




Source: Bank of Slovenia

**The approaching maturity of 3-year LTROs will result in a decline in liquidity ratios.**

With the approaching maturity of liabilities from 3-year LTROs at the Eurosystem, the banks will face increased liquidity risk. According to the situation at the end of March 2014, the banks will have to repay liabilities of EUR 892 million at the end of January 2015 and an additional EUR 1,725 million at the end of February. If the banks fail to replace the aforementioned funding with new resources, the approaching maturity will first result in a decrease in the second-bucket liquidity ratio followed by a decrease in the first-bucket liquidity ratio one month prior to final maturity, at the end of July and August respectively. According to their own forecasts, the banks will not rush into larger partial early repayments of the aforementioned liabilities.

**The banks will be subject to new regulatory changes and reporting requirements.**

Due to changes to banking regulations, the banks will be subject to new reporting requirements in the area of liquidity. The new European CRR directive introduces new liquidity standards, the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR), with the aim of strengthening the liquidity position of EU credit institutions and harmonising liquidity regulations. The purpose of the LCR is to provide the appropriate level of short-term liquidity in extraordinary liquidity conditions, by defining the necessary stock of highly-liquid assets to settle maturing liabilities over a 30-day period. Achieving the required LCR value will be introduced gradually, i.e. from 2015 when the banks will be required to achieve 60% of the value, to 100% of the value, or full achievement, in 2018. According to preliminary assessments, the Slovenian banks are not expected to have any problems achieving the first binding value of 60% of the LCR, which will present a challenge primarily in terms of fulfilling all requirements properly. The purpose of the NSFR liquidity standard is to secure the medium- and long-term stable funding of banking operations. Only test reporting will be carried out in the period to 2018, when the banks are not required to meet the requirement of 100%, after which meeting 100% of the NSFR value will be mandatory.

### 6.5.2 Liquidity position vis-à-vis the Eurosystem and interbank markets

**The position of the Slovenian banks as net debtors vis-à-vis the Eurosystem is gradually diminishing.**

Slovenian banks closed their net debt position vis-à-vis the Eurosystem in 2013, and even more so in the first quarter of 2014. The net liabilities to the Eurosystem totalled EUR 1,956 million in March 2014, EUR 1.8 billion less than in December 2012. The banks accumulated liquidity towards the end of 2013 with the aim of meeting potential higher liquidity needs following the performance of bank asset quality reviews and stress tests. Liquidity was further bolstered by the issue of new Slovenian government bonds. The banks thus placed the surplus liquidity via 1-week fixed-term deposits with the ESCB. The latter averaged at EUR 1,023 million during the first quarter of 2014, nearly triple the 2013 average.

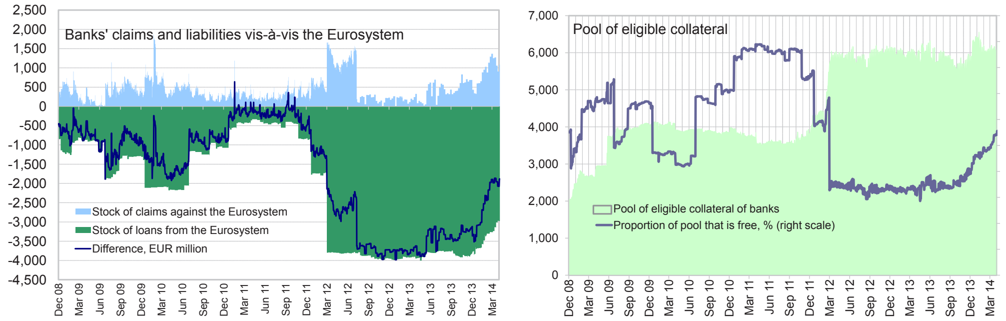
**Slovenian banks have made partial early repayments of 29% of their liabilities from 3-year LTROs.**

Certain banks also earmarked surplus liquidity to the partial early repayment of 3-year LTROs and thus reduced their debt to the Eurosystem. By the end of March 2014 five of the 19 banks made partial early repayments of the aforementioned liabilities, four banks in full. Two of the latter were the banks undergoing the orderly wind-down process. In total, the banks repaid 29% of those liabilities or EUR 1,082 million.

**The average proportion of the pool of eligible collateral that is free increased to 52%.**

The precautionary accumulation of surplus liquidity by the banks at the end of 2013 was also reflected in an increase in the pool of eligible collateral at the Eurosystem. Certain banks began to gradually withdraw their assets from the aforementioned pool following the results of stress tests and bank asset quality reviews, and the implementation of government measures. The needs for such collateral were also reduced with the partial early repayments of 3-year LTROs. The repayment of those liabilities has been reflected in an increase in the proportion of the pool of eligible collateral at the Eurosystem that is free. The latter fluctuated at around 34% for most of 2013, but was up sharply and averaged 52% in March 2014 following the aforementioned events.

Figure 6.34: Commercial banks' claims, liabilities and net position vis-à-vis the Eurosystem (left), and pool of eligible collateral at the Eurosystem (right) in EUR millions




Source: Bank of Slovenia

The Slovenian banks have maintained their position as net creditors on the euro area unsecured money market. Net claims averaged EUR 741 million in March 2014, up EUR 290 million from the average in December 2012. The main factor was an increase in claims, while liabilities contributed to a lesser degree.

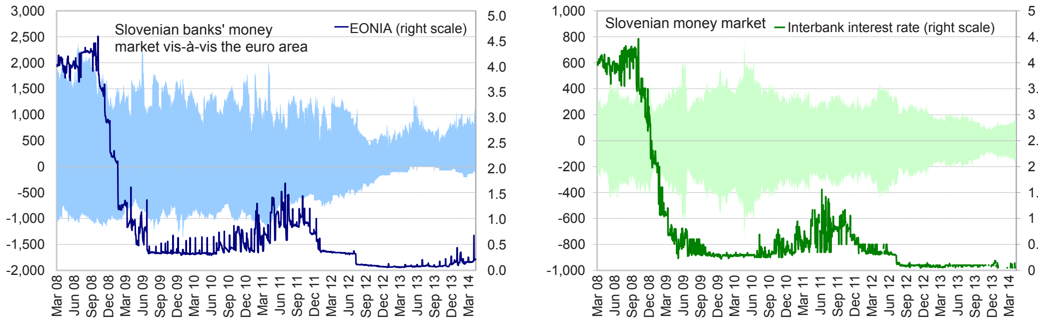
**The banks have maintained their position as net creditors on the euro area money market. Primarily the banks under majority foreign ownership were active.**

The banks under majority foreign ownership, which place surplus funds with their parent banks overnight, are still the most active banks on this market. Due to the amended liquidity risk management policies of the parent banks, flows in the other direction are infrequent. Certain domestic banks also place surplus funds at foreign banks in the short term. However, due to their small size and low profile, the interest rates they achieve are lower than comparable market interest rates or the interest rates they achieve for deposits at the Eurosystem. In contrast to certain banks under majority foreign ownership, the domestic banks do not secure funding on this market, which continues to be an indicator of foreign investors' lack of confidence.

**The Slovenian interbank market is contracting.**

Volume on the Slovenian interbank market remains very low. The stock of deposits placed and received between the Slovenian banks averaged EUR 138 million in March 2014, down EUR 94 million on December 2012. The banks are thus more inclined to place funds with the Eurosystem rather than among themselves or to invest those funds in other liquid forms.

Figure 6.35: Stock of unsecured loans of Slovenian banks placed and received on the euro area money market (left) and the Slovenian money market (right) in EUR millions, and movement of the EONIA and the interbank interest rate on the Slovenian money market, in percentages




Source: Bank of Slovenia

### 6.5.3 Marketable secondary liquidity

**Slovenian government measures and the issue of bonds increased marketable secondary liquidity.**

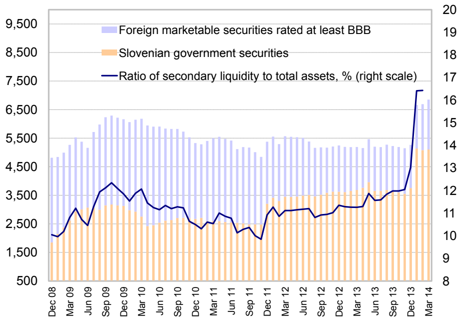
The banking system's surplus liquidity at the end of 2013 was reflected in a higher stock of marketable secondary liquidity24[22]. Marketable secondary liquidity averaged at EUR 6.9 billion in March 2014, an increase of EUR 1.6 billion on the December 2013 average. The proportion of total assets accounted for by marketable secondary liquidity was up by 3.4

[22] Marketable secondary liquidity is calculated from liquidity ladder data as the sum of the monthly average of Slovenian government securities and foreign marketable securities rated BBB or higher.

percentage points at the end of February 2014 to 16.4%. The reason for the aforementioned growth lies in the bonds received from the BAMC, while the banks also purchased foreign marketable securities and Slovenian treasury bills in the context of surplus liquidity.

The structure of secondary liquidity swung further in favour of Slovenian government securities during the first quarter of 2014, by 3.2 percentage points to stand at 74.5%. The insufficient regional diversification of investments in secondary liquidity exposes the banks to increased liquidity risk if the sovereign rating were to fall below the appropriate level. This would result in the exclusion of government securities from the liquidity ladder due to their ineligibility. Sovereign ratings improved slightly following the implementation of measures by the Slovenian government, which mitigated the potential realisation of the aforementioned risk.

Figure 6.36: Changes in the stock of marketable secondary liquidity (monthly averages in EUR millions) and ratio of marketable secondary liquidity to total assets in percentages




Note: Secondary liquidity is calculated from liquidity ladder data as the sum of the monthly average of Slovenian government securities and foreign marketable securities rated BBB or higher.

Source: Bank of Slovenia

## 6.6 Income risk and the performance of banks

### Summary

The banking system generated a large loss in 2013 due to the realisation of credit risk and the associated high impairment and provisioning costs. Higher credit growth is required to improve the banking system's operating results. Due to extraordinary impairments at the end of the year, in part due to the comprehensive assessment of the banks, impairments are expected to have a lesser effect on the banks' operating results this year. Changes to banking regulations will require the further streamlining of operations and consolidation in the banking system. All of this will be necessary to improve operating results.

### Income risk

**The banks were exposed to high income risk last year, which was manifested in reduced net interest income and in rising impairment and provisioning costs.**

Two factors contributed to the banks' high exposure to income risk last year: the deteriorating quality of the credit portfolio and a decrease in the stock of loans. This resulted in a decrease in the banks' total interest income and an increase in impairment and provisioning costs. By cutting liability interest rates and through additional debt repayments, the banks also reduced interest expenses. That reduction, however, was unable to offset the drop in interest income. The loss generated by the banking system increased sharply in the autumn months, when the orderly wind-down process was initiated at two smaller banks. Impairments at the largest domestic banks as the result of the asset quality review contributed to the sharp increase in the banking system's losses.

**The banking system generated a loss of EUR 3.3 billion in 2013.**

The loss generated by the banking system was up sharply relative to 2012, and amounted to EUR 3,338 million according to unaudited figures. The banking system generated a loss last year for the fourth consecutive year.

Table 6.23: Banking sector income statement

| | Amount, EUR million | | | Growth, % | | | Ratio to gross income, % | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2012 | 2013 | Mar. 2014 | 2012 | 2013 | Mar. 2014 | 2012 | 2013 | Mar. 2014 |
| Net interest | 886 | 711 | 206 | -12.9 | -19.8 | 6.1 | 67.6 | 65.2 | 65.5 |
| Non-interest income | 679 | 379 | 108 | 58.3 | -44.2 | 16.3 | 32.4 | 34.8 | 34.5 |
| of which net fees and commission | 339 | 339 | 85 | -2.0 | 0.0 | 2.5 | 28.9 | 31.1 | 27.1 |
| of which net gain/loss from financial assets and liabilities held for trading | -2 | -1 | -1 | … | … | … | 3.3 | -0.1 | -0.3 |
| Gross income | 1,566 | 1,090 | 314 | 8.2 | -30.4 | 9.4 | 100 | 100 | 100 |
| Operating costs | 743 | 720 | 164 | -4.4 | -3.1 | -6.0 | 61.0 | 66.0 | 52.4 |
| labour costs | 400 | 384 | 92 | -4.0 | -3.9 | -4.6 | 33.6 | 35.2 | 29.3 |
| Net income | 823 | 370 | 149 | 22.8 | -55.0 | 33.5 | 39.0 | 34.0 | 47.6 |
| net impairments and provisioning | 1,599 | 3724 | 90 | 32.5 | 132.8 | -13.5 | 36.5 | 341.6 | 28.8 |
| of which impairments and provisioning at amortised cost | 1,201 | 2,820 | 70 | 26.4 | 134.9 | 132.2 | 10.4 | 258.7 | 22.2 |
| Pre-tax profit | -776 | -3,353 | 59 | -44.7 | -331.9 | 702.8 | 2.6 | -307.6 | 18.8 |
| corporate income tax | 22 | -137 | -2 | … | … | … | -1.1 | -12.6 | -0.5 |
| Net profit | -754 | -3,490 | 57 | … | … | … | 1.4 | -320.2 | 18.3 |

Source: Bank of Slovenia

### Net margin and net non-interest income

**The decline in net interest income outstripped the decline in average total assets last year.**

The banking system's net interest income was down by close to 20% in year-on-year terms last year. The banks' interest income fell by 23%, as the result of the previously mentioned decrease in lending and the deterioration of the credit portfolio. Also contributing to the aforementioned decrease were lower average interest rates on the international financial markets.[23] The decline in interest expenses by one-quarter had a beneficial impact on the banking system's income. Interest expenses were down due to the contraction in total assets, i.e. the stock of bank funding, lower interest rates on the international financial markets and the cutting of interest rates on deposits by the non-banking sector.

**Average effective interest rates were down last year on both the asset and liability sides.**

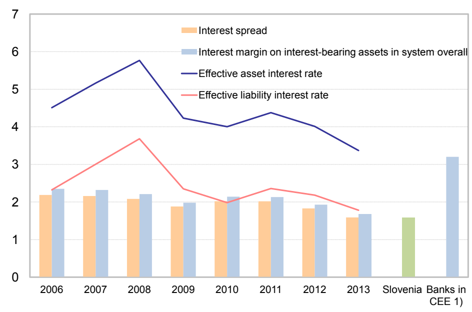
As a result of the decline in net interest outpacing the contraction in total assets, the net interest margin continued to decline last year, reaching 1.68% at the end of the year. The decline in net interest income outpaced the contraction in average total assets considerably last year. The latter were down 8% over the same period. Average effective asset and liability interest rates were down last year relative to a year earlier, the former by 0.6 percentage points to 3.4% and the latter by 0.4 percentage points to 1.8%.

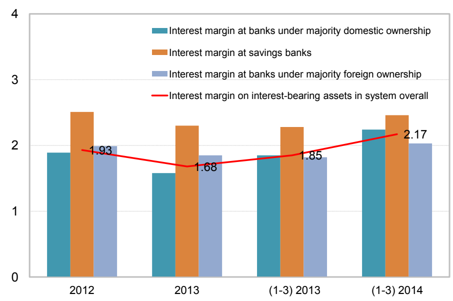
**The banks recorded positive growth in net interest during the first quarter of this year.**

Last year's sharp decline in net non-interest income was driven by the fact that there were no early repayments of subordinated debt with a significant discount, as there were in 2012, which would have resulted in an increase in non-interest income. Growth in net income from fees and commissions, which represent the most important component of non-interest income, fluctuated at around zero last year.

The banks recorded positive growth in net interest income during the first quarter of this year. This resulted in a higher net interest margin, particularly at the banks under majority domestic ownership. The strong trend of decline in liability interest rates resulted in a higher net interest margin.

Figure 6.37: Average effective asset and liability interest rates calculated from interest income and expenses, interest spread and net interest margin in percentages (left) and interest margin by bank group (right)



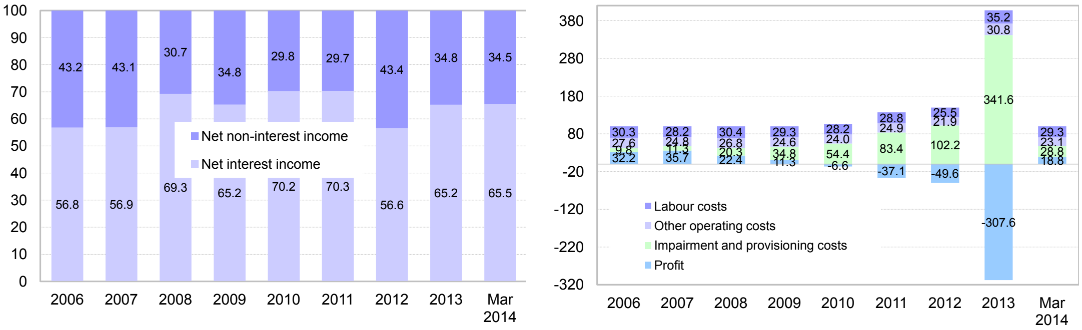




Notes: The separate figures in the two columns on the right are for the interest margin in Slovenia in 2014 and for EU countries in June 2013, and were calculated as the ratio of net interest income to total assets.

Sources: Bank of Slovenia, ECB, Consolidated Banking Data, June 2013

[23] The 3-month EURIBOR averaged 0.22% in 2013, down 0.35 percentage points on the previous year, while the 6-month EURIBOR averaged 0.34% and was down 0.49 percentage points.

Figure 6.38: Proportion of banks' gross income accounted for by net interest and net non-interest income (left) and the disposal of gross income (right) in percentages




Source: Bank of Slovenia

**The banks will require higher lending growth for the stable generation of profit in the future.**

The banks will require higher lending growth, as the basis for increasing interest income, for the stable generation of profit in the future. With the exclusion of a portion of non-performing claims, the loans that remain in the banks' portfolios are expected to generate more stable interest income. With the improving structure of bank assets due to the exclusion of a portion of non-performing claims and the previously created high impairment and provisioning costs last December, which were mainly the result of the bank asset quality review at the largest banks under majority domestic ownership, this year's impairment and provisioning costs are down on last year's level. Similar trends in the context of the stabilising economic situation and the continued restructuring of the banks' claims can be expected in the future.

### Differences in the generation and disposal of banks' gross income

Increased impairment and provisioning costs were the main factor in the loss recorded by the banking system. The aforementioned costs totalled EUR 1.4 billion at the end of November, but rose to EUR 3.7 billion in December. The result was a pre-tax loss of EUR 3.3 billion. The largest loss in the banking system in 2013 was generated by the large domestic banks and two smaller banks that have been undergoing the orderly wind-down process since last September. Deteriorating payment discipline and the downgrading of debtors contributed to the sharp increase in impairment and provisioning costs last year.

**Rising impairment and provisioning costs were the result of the deteriorating quality of the portfolio and the comprehensive assessment of the banks.**

The proportion of gross income accounted for by impairment and provisioning costs stood at 342% in 2013. At the end of the year impairment and provisioning costs were 4.8 times the gross income generated at the large domestic banks and 4.4 times the gross income generated at the small domestic banks.

The income generated by the banks prior to impairment and provisioning costs, i.e. net income, was positive last year and totalled EUR 370 million at the banking system level, which indicates that the realisation of credit risk had a significant impact on the final result, i.e. the high loss generated by the banking system. Lower non-interest income also had a significant effect on growth in the banks' net income, which was negative last year. The large domestic banks recorded the largest increase in net income during the first quarter of this year, followed by the banks under majority foreign ownership, while net income stagnated at the small domestic banks, primarily as the result of the orderly wind-down of two smaller banks, in progress since last September.

Table 6.24: Bank performance indicators in percentages

| (%) | 2009 | 2010 | 2011 | 2012 | 2013 | Mar 2014 |
|---|---|---|---|---|---|---|
| ROA | 0.32 | -0.19 | -1.06 | -1.60 | -7.51 | 0.59 |
| ROE | 3.87 | -2.30 | -12.54 | -19.04 | -97.30 | 6.40 |
| Costs / gross income | 53.95 | 52.22 | 53.68 | 47.43 | 66.04 | 52.39 |
| Interest margin on interest-bearing assets | 1.98 | 2.14 | 2.13 | 1.93 | 1.68 | 2.17 |
| Interest margin on total assets | 1.88 | 2.02 | 2.02 | 1.83 | 1.59 | 2.07 |
| Non-interest margin | 1.00 | 0.86 | 0.85 | 1.40 | 0.85 | 1.11 |
| Gross income / average assets | 2.88 | 2.88 | 2.87 | 3.23 | 2.44 | 3.18 |

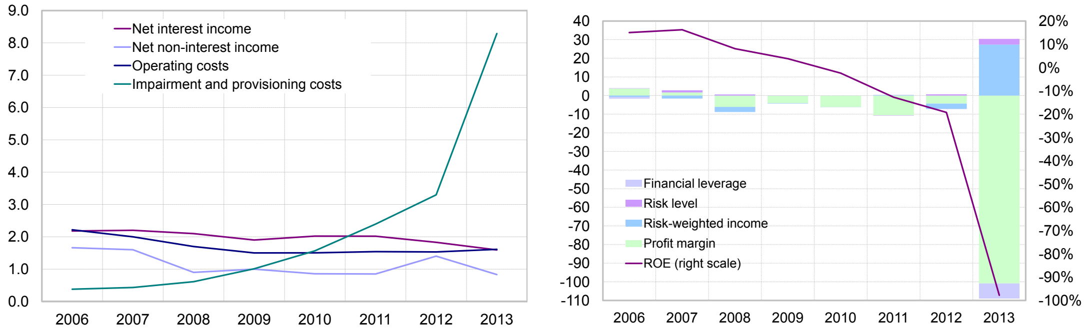
Source: Bank of Slovenia

**The domestic banks stood out last year in terms of the level of impairment and provisioning costs.**

The banks under majority domestic ownership had a lower net interest margin on interest-bearing assets last year than the banks under majority foreign ownership. It stood at 1.58% at the domestic banks, and at 1.85% at the banks under majority foreign ownership. Last year's decline in the net interest margin was in part the result of the deteriorating quality of the credit portfolio, particularly at the banks under majority domestic ownership. A relatively low interest margin, including at the banks under majority foreign ownership, contributed to less profitable operations. Following the improvement in the quality of the banks' portfolios at the end of 2013 due to the purging of a portion of non-performing claims from the banks' balance sheets and in the context of positive growth in net interest income, the net interest margin improved to 2.13% over the first two months of 2014 at the banking system level and to 2% at the banks under majority domestic ownership. The net interest margin nevertheless remains below those of other countries in the region.

An additional increase in the net interest margin can be expected in 2014 in the context of the planned further purging of claims from the banks' balance sheets and the current positive growth trend in net interest income, and due to the relatively sharp cuts in liability interest rates.[24]

Figure 6.39: Net interest income, net non-interest income, operating costs and net provisioning as a percentage of average assets (left), and movement in ROE and impact of four factors on the direction of the movement in ROE (right)




Source: Bank of Slovenia

**The sharp decline in the profit margin contributed most to the decline in the banking system's profitability.**

If the movement in the banks' ROE is analysed by breaking down profitability into four components (profit margin, risk-weighted income, risk level and leverage), we find that a lower profit margin contributed significantly to the decline in the banking system's profitability last year. The main factor in the increase in profitability was risk-weighted income, as risk-weighted assets decreased more in relative terms than the gross income of the banks. On the contrary, the lower level of risk due to the more significant decrease in risk-weighted assets than in total assets contributed to an increase in profitability. The decrease in risk-weighted assets was the result of a contraction in the stock of loans. The level of risk had a negligible effect on the increase in profitability last year. Leverage also contributed to the decrease in profitability, as the stock of capital was up slightly due to the recapitalisations of banks, while total assets contracted.

Table 6.25: Breakdown of ROE into four factors

| | Profit margin pre-tax profit / gross income | * | Risk-weighted income gross income / risk-weighted assets | * | Risk level risk-weighted assets / total assets | * | Leverage total assets / equity | = | ROE |
|---|---|---|---|---|---|---|---|---|---|
| 2008 | 0.23 | | 0.039 | | 0.77 | | 12.17 | | 0.081 |
| 2009 | 0.11 | | 0.037 | | 0.78 | | 11.91 | | 0.039 |
| 2010 | -0.07 | | 0.037 | | 0.78 | | 11.98 | | -0.024 |
| 2011 | -0.38 | | 0.036 | | 0.79 | | 11.74 | | -0.127 |
| 2012 | -0.50 | | 0.042 | | 0.76 | | 11.81 | | -0.193 |
| 2013 | -3.15 | | 0.033 | | 0.74 | | 12.88 | | -0.978 |

Note: The breakdown of ROE is calculated for the banking system excluding savings banks.
Source: Bank of Slovenia

No improvement can be expected in the banks' income position until stable growth in loans and the volume of the banking system's operations is restored. Also affecting the low ROE of the banks in the future will be the implementation of the new CRD IV and CRR banking regulations, the introduction of the Single Supervisory Mechanism, the creation of a bank bail-out fund and, finally, changes in the practice of supervising banking operations. For the above-mentioned reasons, the streamlining of operations and consolidation in the banking system are necessary to improve future operating results.

[24] Following the decision of the European Commission and the resulting approval of recapitalisations by the Slovenian government and the transfer of a portion of claims from Abanka Vipa to the Bank Asset Management Company, the quality of the banking system's assets will improve similar to last December.

## 6.7 Other risks

### 6.7.1 Interest rate risk

The gap between the average repricing periods of asset and liability interest rates continues to widen. The difference between the average repricing periods for asset and liability interest rates stood at 7 months and 15 days in March 2014, having widened by 2 month since October 2013. The banks are becoming more exposed to the risk of a rise in interest rates. The main reason for increasing exposure to the risk of rising interest rates lies in the lengthening of maturities on the asset side and the shortening of maturities on the liability side. The proportion of loans with a shorter interest rate repricing period than securities (the proportion of which has increased) declined at the large domestic banks as the result of the transfer of non-performing claims to the BAMC.

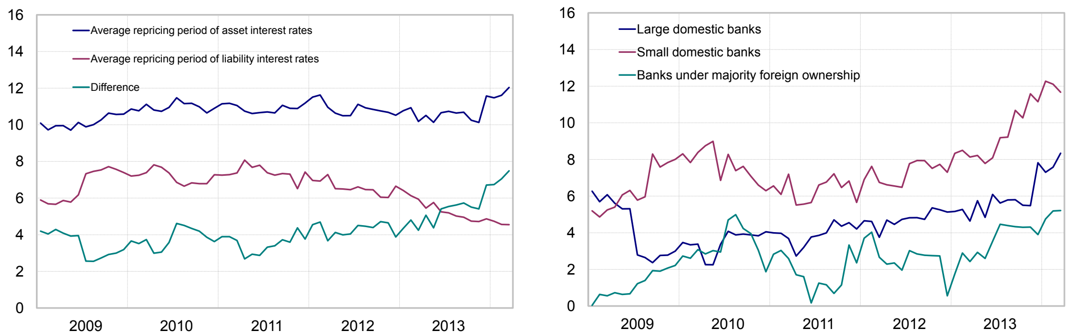
The cumulative interest rate gap of up to 1 year between interest-sensitive assets and liabilities narrowed by EUR 1.6 billion between October 2013 and March 2014 to the negative amount of EUR 1.6 billion. All the bank groups recorded a negative gap in March 2014. The banks are exposed to the risk of rising interest rates over the next one-year period.

#### Average repricing period for interest rates

**The gap between the average repricing periods for asset and liability interest rates widened.**

Interest rate risk as measured by the difference between the average repricing periods for asset and liability interest rates stood at 7 and a half months in March 2014. The average repricing period for asset interest rates was 12 months, while the average repricing period for liability interest rates was nearly 4 and a half months. The difference between the average repricing periods for asset and liability interest rates widened by 2 month since between October 2013 and March 2014. The reason for the widening of the gap during the aforementioned period lies on the asset side. The average repricing period for assets interest rates lengthened more (by 1.8 months) than the average repricing period for liability interest rates, which actually shortened by 0.2 months.

Figure 6.40: Average repricing period for interest rates in months (left) and difference between the average repricing period for interest rates by bank group in months (right)




Source: Bank of Slovenia

The main reasons for the lengthening of the average repricing period for asset interest rates were the decline in loans on the asset side of the banks' balance sheets and an increase in long-term securities. This led to a longer average repricing period for asset interest rates. A decline in deposits received, the repayment of loans raised and the shortening of maturities on loans received were the main factors in the shortening of the average repricing period for liability interest rates. Rapid changes to the structure of liabilities due to an increase in short-term funding exposes the banks to increased interest rate risk, which the banks manage via additional hedges against the aforementioned risk.

**The large domestic banks have contributed most to developments in recent months.**

The average repricing periods of asset and liability interest rates vary between the bank groups. The most significant recent change in the average repricing period for asset interest rates occurred at the large domestic banks. The average repricing period for asset interest rates has lengthened by 2.8 months since October 2013. The largest change in the average repricing period for liability interest rates over the same period was recorded by the small domestic banks. The average repricing period for liability assets interest rates has shortened by a half a month since October 2013. The difference between the average repricing periods of asset and liability interest rates is largest at the small domestic banks, at 11.7 months. The small domestic banks are thus most sensitive to the risk of a rise in interest rates. The difference between the average repricing periods for asset and liability interest rates has widened at all bank groups since October 2013. The difference between the average repricing periods for asset and liability interest rates widened by 2.8 months between October 2013 and March 2014 at the large domestic banks, by 1.4 months at the small domestic banks and by 0.9 months at the banks under majority foreign ownership.

### Interest rate gap

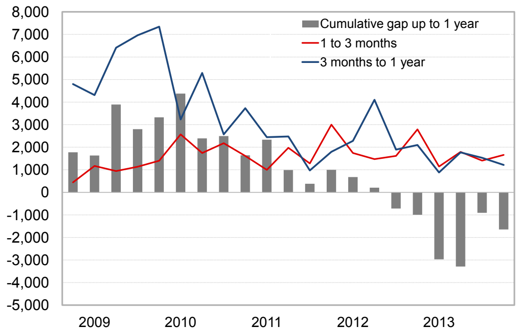
**The cumulative interest rate gap is negative.**

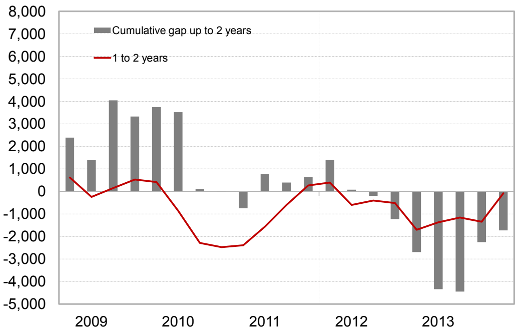
The cumulative interest-rate gap of up to 1 year between interest-sensitive assets and liabilities narrowed by between September 2013 and March 2014. The position remains short, at EUR 1.6 billion Interest-sensitive assets and liabilities with an interest rate repricing period of less than 1 year declined between September 2013 and March 2014. The reason for the short position lies primarily in the shortest buckets, which are the easiest to manage for the banks.

All bank groups recorded a negative cumulative interest rate gap of up to 1 year between interest-sensitive assets and liabilities in March 2014. The large domestic banks had the largest negative interest rate gap in the amount of EUR 1.2 billion in March 2014. The interest rate gap has changed most at the large domestic banks since September 2013, when it was negative in the amount of EUR 2.7 billion. The reason for the narrowing of the gap lies in a decrease in interest-sensitive liabilities in the context of virtually unchanged interest-sensitive assets.

All bank groups had a negative cumulative gap of up to 2 years. The cumulative gap, which is narrowing, was negative in the amount of EUR 1.7 billion in March 2014.

Figure 6.41: Gap between interest-sensitive assets and interest-sensitive liabilities by individual bucket in EUR million




Source: Bank of Slovenia

The banks' sensitivity to interest rate risk will increase further due to the expected gradual shortening of the average maturity on bank funding in the future. This will require the banks to be more active in their management and hedging against potential rises in interest rates.

### Currency risk

**Currency risk remained low in 2013.**

The Slovenian banking system's currency risk decreased in 2013, and is relatively less important than other risks. The net open foreign exchange position amounted to EUR 9.5 million or 0.3% of the banks' regulatory capital. The small domestic banks were most exposed to currency risk, with a net open foreign exchange position of EUR 7 million or 4.7% of regulatory capital. With the exception of the Swiss franc, the net open foreign exchange positions were predominantly long. The banks were thus exposed to the risk of a fall in these currencies against the euro.

Table 6.26: Net open foreign exchange positions in EUR million

| | 2011 | 2012 | 2013 System overall | 2013 Large domestic banks | 2013 Small domestic banks | 2013 Banks under majority foreign ownership |
|---|---|---|---|---|---|---|
| Global currencies | -9.6 | 15.7 | 0.0 | -0.8 | 3.8 | -3.0 |
| US dollar | 4.4 | 5.9 | 3.6 | 3.8 | 0.0 | -0.2 |
| Swiss franc | -13.4 | 6.8 | -4.5 | -5.0 | 3.4 | -2.9 |
| other (GBP, CAD, AUD, JPY) | -0.6 | 3.1 | 0.9 | 0.4 | 0.5 | 0.1 |
| EEA currencies | -18.0 | -14.2 | 0.9 | 0.1 | 0.3 | 0.5 |
| Other currencies | 15.3 | 25.3 | 8.6 | 5.2 | 2.9 | 0.5 |
| CIU | 29.6 | 2.4 | 0.0 | 0.0 | 0.0 | 0.0 |
| Total. EUR million | 17.2 | 29.3 | 9.5 | 4.5 | 7.0 | -2.0 |
| As % of regulatory capital | 0.4 | 0.7 | 0.3 | 0.2 | 4.7 | -0.2 |

Note: EEA: European Economic Area, i.e. EU, Iceland, Norway and Liechtenstein; CIU: positions in collective investment undertaking units.
Source: Bank of Slovenia

The stock of loans to the non-banking sector in Swiss francs or with a Swiss franc currency clause was down 16.9% in year-on-year terms in 2013 to stand at EUR 1,119 million. These loans were up slightly in February 2014 relative to the end of 2013 on account of an increase in loans to OFIs. Loans in Swiss francs or with a Swiss franc currency clause accounted for 3.8% of total loans to the non-banking sector in February 2014. The volatility in the Swiss franc / euro exchange rate has increased slightly in the last year, but remains at a level similar to 2012.

## 6.8 Bank solvency

### Summary

The solvency of the Slovenian banking system improved following the introduction of bank recovery measures by the Slovenian government and the Bank of Slovenia at the end of 2013. Because the bank recovery process only includes certain banks, attention remains focused on capitally weak banks that are still exposed to the risk of low capital adequacy.

The recapitalisation of the banks, the transfer of non-performing claims to the Bank Asset Management Company and the write-off of subordinated debt have been reflected in higher capital adequacy ratios and the improved quality of the capital structure and capital requirements. Contributing to the improved capital adequacy ratios were lower capital requirements, not only due to the aforementioned measures, but also on account of the continuing contraction in lending activity. On the other hand, the contribution from paid-up capital was negative due to heavy operating losses. These effects were more evident at the large domestic banks subject to government measures, while the position of the small domestic banks remains weaker in terms of capital.

The capital adequacy ratios of the Slovenian banking system are approaching the average of EU countries. Higher capital requirements as the result of higher risks weights remain the reason for the gap to the EU average. Those risk weights are a reflection of the use of the standardised approach for assessing risks and the poorer optimisation of the use of capital. Slovenian banks maintain a higher level of regulatory capital as a proportion of total assets than EU banks.

The implemented measures alone will not suffice to maintain capital adequacy over the long term. Due to pending regulatory changes, the banks must also optimise their use of capital and re-establish healthy growth in lending to creditworthy clients in order to begin generating internal capital again. The protracted economic and financial crisis increases the likelihood of a deterioration in the quality of the credit portfolio. This leads to growing pressure to reduce the capital adequacy of specific banks. Owners will have to take a more active role in managing capital, and take timely measures, including the provision of fresh capital, should capital adequacy deteriorate.

### 6.8.1 Capital adequacy

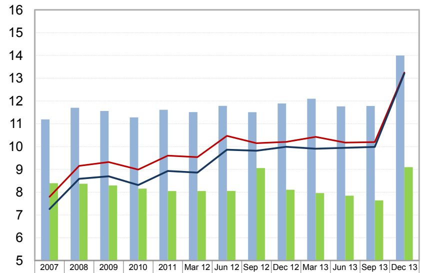
**The capital adequacy ratios improved in the final quarter of 2013.**

Overall capital adequacy stagnated over the first three quarters of 2013. Following the implementation of government measures at the end of the year, overall capital adequacy was up sharply, by 2.1 percentage points to stand at 14.0%. The quality of the capital structure improved with the recapitalisation of five banks and the write-off of subordinated debt. The core Tier 1 capital ratio was up 3.2 percentage points to stand at 13.2%, with five banks failing to achieve a value of 9% for this ratio. The Tier 1 capital ratio was up 3.1 percentage points to stand at 13.3%.

**The ratio of book capital to total assets was up due to the contraction in total assets.**

In contrast to overall capital adequacy, the ratio of book capital to total assets was down to stand at 9.1% at the end of 2013. The main factor in the aforementioned decline was a contraction in total assets, while the positive effect of recapitalisation was minimal due to heavy operating losses.

Figure 6.42: Basic indicators of the banking system's capital adequacy in percentages



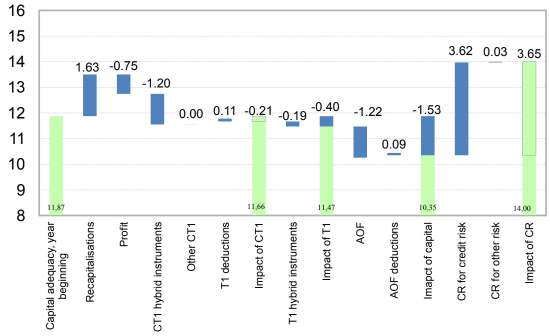

| | 2007 | 2008 | 2009 | 2010 | 2011 | Mar 12 | Jun 12 | Sep 12 | Dec 12 | Mar 13 | Jun 13 | Sep 13 | Dec 13 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Overall capital adequacy | 11.2 | 11.7 | 11.6 | 11.3 | 11.6 | 11.5 | 11.8 | 11.5 | 11.9 | 12.1 | 11.8 | 11.8 | 14.0 |
| Book capital / total assets | 8.4 | 8.4 | 8.3 | 8.2 | 8.0 | 8.0 | 8.1 | 9.1 | 8.1 | 8.0 | 7.8 | 7.6 | 9.1 |
| Tier 1 capital ratio | 7.8 | 9.2 | 9.3 | 9.0 | 9.6 | 9.5 | 10.5 | 10.1 | 10.2 | 10.4 | 10.2 | 10.2 | 13.3 |
| Core Tier 1 capital ratio | 7.3 | 8.6 | 8.7 | 8.3 | 8.9 | 8.9 | 9.9 | 9.8 | 10.0 | 9.9 | 9.9 | 10.0 | 13.2 |

Source: Bank of Slovenia

### Breakdown of capital adequacy

The breakdown of capital adequacy confirms the positive impact of the transfer of non-performing claims to the BAMC on the improvement in capital adequacy in 2013. The positive effects of lower capital requirements on the improvement in overall capital adequacy were most significant in the final quarter, while the positive effect of slightly higher capital contributed considerably less during the same period.

Figure 6.43: Breakdown of capital adequacy for the banking system in percentage points, capital adequacy in percentages




Notes: CA – overall capital adequacy; CT1 – core Tier 1 capital; T1 – Tier 1 capital; AOF – additional own funds; CR – capital requirements.

Source: Bank of Slovenia

**The effect of capital on overall capital adequacy was negative in 2013.**

The effect of capital on overall capital adequacy was negative over the first three quarters of last year due to operating losses. The breakdown of capital adequacy for the aforementioned period illustrates the negative effect of hybrid instruments and the positive effect of recapitalisation, which was merely the result of the conversion of the first form of capital into the second. The banks issued contingent convertible (CoCo) bonds in 2012 with the aim of improving their core Tier 1 capital ratio. The aforementioned bonds were then converted into share capital in 2013. December's recapitalisation and its positive contribution to overall capital adequacy in the final quarter of 2013 was not enough to cover heavy operating losses and the negative effect of write-offs of subordinated debt. The overall effect of capital on overall capital adequacy was thus negative in 2013. This means that overall capital adequacy deteriorated by 1.53 percentage points in 2013, excluding the effect of lower capital requirements.

**The positive contribution of lower capital requirements to the improvement in overall capital adequacy was significant.**

A significant reduction in capital requirements contributed most to the improvement in overall capital adequacy in 2013. Capital requirements were down during the year due to the contraction in operations, while the main factor in the decrease was the transfer of non-performing claims to the BAMC. Lower capital requirements contributed 3.7 percentage points to the improvement in overall capital adequacy in 2013.

Table 6.27: Breakdown of capital adequacy for the banking system in percentage points, capital adequacy in percentages

| | 2012 | 3Q 2013 | 4Q 2013 | 2013 |
|---|---|---|---|---|
| **Opening capital adequacy** | **11.61** | **11.87** | **11.78** | **11.87** |
| Recapitalisations | -0.04 | 1.06 | 0.66 | 1.63 |
| Profit | -1.68 | -1.27 | 0.60 | -0.75 |
| Other (hybrid original own funds) | 0.73 | -1.19 | -0.23 | -1.39 |
| Additional own funds | -1.29 | -0.30 | -1.06 | -1.22 |
| Deductions | 1.84 | 0.03 | 0.21 | 0.21 |
| Regulatory capital | -0.44 | -1.67 | 0.17 | -1.53 |
| Capital requirements | 0.70 | 1.58 | 2.04 | 3.65 |
| Overall | 0.26 | -0.09 | 2.21 | 2.12 |
| **Closing capital adequacy** | **11.87** | **11.78** | **14.0** | **14.0** |

Source: Bank of Slovenia

### Capital adequacy by bank group

**Capital adequacy ratios improved significantly at the large domestic banks.**

Solvency risk as measured by capital adequacy decreased most at the large domestic banks. Overall capital adequacy was up 3.7 percentage points in the final quarter to stand at 14.7%, while the core Tier 1 capital ratio was up 5.6 percentage points to stand at 14.6%. The improvement was the result of a relatively larger decrease in capital requirements than in capital. Despite the recapitalisation of three large domestic banks, regulatory capital decreased by 10.9% in year-on-year terms due to major operating losses. Capital requirements were down by 30% in 2013 due to the contraction in operations and the transfer of non-performing claims to the BAMC.

**The small domestic banks have the lowest overall capital adequacy.**

Solvency risk is decreasing gradually at the banks under majority foreign ownership. Overall capital adequacy improved by 1.7 percentage points in 2013, to 14.9%. Lower capital requirements also contributed to the improvement in overall capital adequacy in this bank group. Capital requirements contracted three times more than regulatory capital in relative terms. In addition to the continued contraction in lending activity, another reason lies in the transfer of non-performing claims from one bank in this group to the Bank Asset Management Company with the non-performing claims from its banking group. However, with a sufficient surplus of capital and without major capitalisations, the banks under majority foreign ownership covered comparably lower operating losses than the domestic banks. The more stable management of solvency risk is also an indicator of more active owners, which is seen through the better optimisation of capital and less-risky operations.

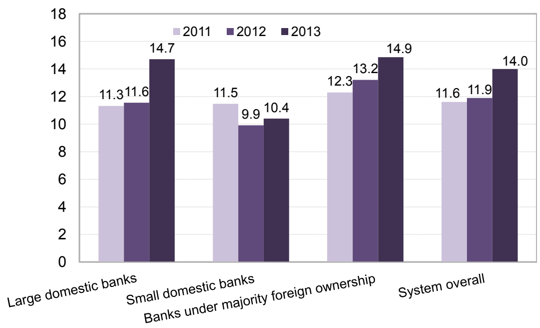
**The contraction in capital requirements was also the main factor in the improvement in overall capital adequacy at the banks under majority foreign ownership.**

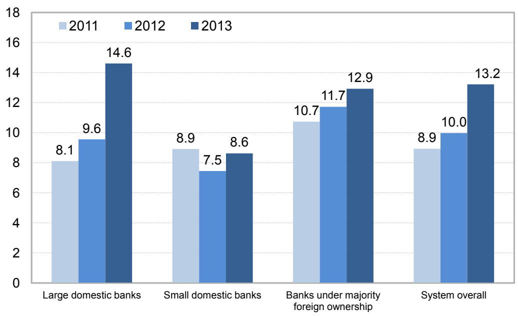
The small domestic banks are most exposed to solvency risk. Overall capital adequacy has deteriorated in this group of banks. The improvement in their overall capital adequacy in 2013 is solely the result of the exclusion of the two banks that are undergoing the orderly wind-down process since September 2013.[25] An analysis of the overall capital adequacy of the other five banks in this group shows a deterioration in this indicator at the small domestic banks by 1.0 percentage point in 2013 to 10.4%. Overall capital adequacy improved at two of the five banks in this group, but they would require a total of EUR 47 million in fresh capital for all five banks to achieve the average of the Slovenian banking system. The core Tier 1 capital ratio improved slightly, although two banks in this group fail to achieve the 9% threshold for this indicator.

**New European banking regulations with stricter capital requirements are being introduced.**

The banks will be exposed to the increased risk of regulatory changes in the future. New European banking regulations are gradually introducing changes to banking operations and new requirements regarding minimum capital and macro-prudential instruments. The aim of the stricter rules for the calculation of capital and capital ratios is to increase the level and improve the quality of capital, and to contribute to the increased transparency and comparability of the banks. Detailed understanding of and compliance with all requirements will represent a major challenge for the banks and an incentive for the more active management of capital.

Figure 6.44: Capital adequacy (left) and core Tier 1 capital ratio (right) by bank group in percentages




Note: The figures for the small domestic banks for 2013 do not include the two banks undergoing the orderly wind-down process.
Source: Bank of Slovenia

### 6.8.2 Capital structure

**The banking system's regulatory capital contracted, despite government measures.**

The stock of regulatory capital declined by EUR 540 million in 2013 to EUR 3.7 billion. Contributing most to the aforementioned decline was a decrease in additional own funds as the result of the write-off of subordinated debt prior to the allocation of state aid to two banks. Original own funds were up by nearly 11% owing to state-funded recapitalisation in the final quarter. However, the positive effect of fresh capital was negated at the end of the year due to heavy operating losses.

Table 6.28: Stock of and growth in components of regulatory capital in EUR million and percentages

| | Stock | | | | 2012 | | | 2013 | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2008 | 2009 | 2010 | 2011 | Stock | Increase | Growth | Stock | Increase | Growth |
| Regulatory capital | 4,475 | 4,616 | 4,523 | 4,361 | 4,196 | -164 | -3.8% | 3,657 | -540 | -12.9% |
| Original own funds | 3,835 | 4,116 | 4,001 | 4,047 | 3,678 | -369 | -9.1% | 3,496 | -183 | -5.0% |
| Additional own funds | 1,277 | 1,239 | 1,265 | 1,130 | 645 | -485 | -42.9% | 214 | -431 | -66.8% |
| Deductions | -636 | -739 | -742 | -816 | -126 | 690 | -84.5% | -53 | 73 | -58.0% |
| Tier 1 capital for capital adequacy purposes | 3,501 | 3,722 | 3,605 | 3,606 | 3,604 | -2 | -0.1% | 3,462 | -142 | -3.9% |
| Core Tier 1 capital for capital adequacy purposes | 3,283 | 3,453 | 3,332 | 3,352 | 3,524 | 172 | 5.1% | 3,452 | -72 | -2.0% |
| Capital requirements | 3,059 | 3,194 | 3,207 | 3,004 | 2,827 | -177 | -5.9% | 2,090 | -737 | -26.1% |

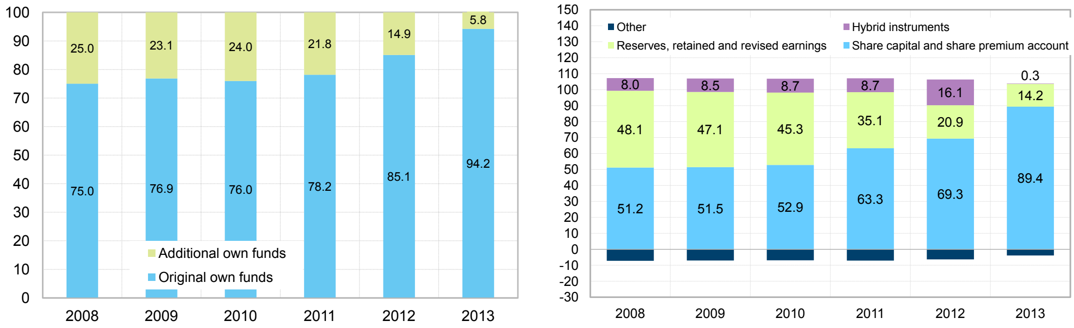
Source: Bank of Slovenia

[25] The two banks undergoing the orderly wind-down process since September 2013 must be solvent, but are not required to fulfil minimum capital requirements. The aforementioned banks were not included in the analysis of the small domestic banks for 2013.

**The structure of capital has improved, the proportion of original own funds stands at 94.2%.**

The proportion of capital accounted for by original own funds prior to deductions was up 8.7 percentage points in the final quarter of 2013 to stand at 94.2%. Both the stock and structure of original own funds changed. The proportion accounted for by the banking system's share capital was up 20.1 percentage points in 2013 to stand at 89.4% on account of recapitalisations and the conversion of CoCo bonds into share capital. The proportion of original own funds accounted for by components linked to operating results was down for the fifth consecutive year. The banks will have to reverse that trend, as it exposes them to increased solvency risk. The ability to generate capital internally is necessary to maintain and strengthen the banks' capital position in the long term.

Figure 6.45: Structure of own funds prior to deductions (left) and structure of original own funds (right) across the banking system in percentages




Source: Bank of Slovenia

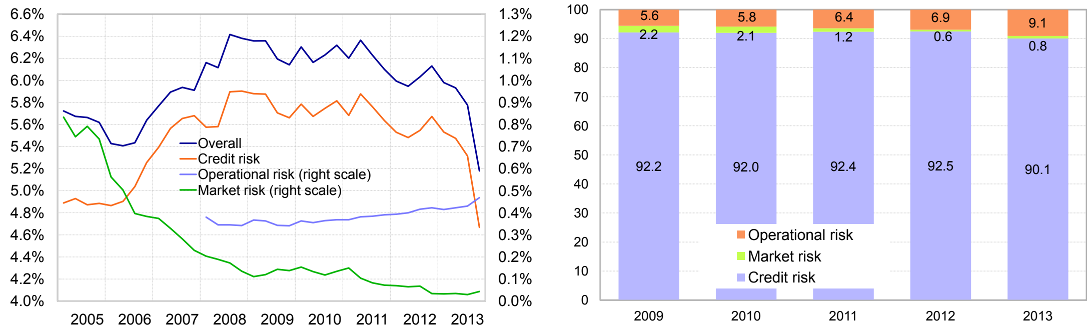
### 6.8.3 Capital requirements

**Capital requirements contracted sharply, by 26.1%.**

Capital requirements declined by EUR 737 million in 2013 to EUR 2,090 million, half of that decline coming in the final quarter. The transfer of non-performing claims to the BAMC, the continued contraction in the scope of operations and a shift to less-risky exposures all contributed to the aforementioned decline.

These factors contributed to the decline in capital requirements for credit risk as a proportion of total capital requirements to just over 90%. The proportion of total capital requirements accounted for by capital requirements for market risk remains negligible. Capital requirements for operational risk contracted by EUR 189 million in 2013, as they are tied to gross income, which has declined gradually in recent years.

Figure 6.46: Ratio of capital requirements to total assets (left) and the structure of capital requirements (right) in percentages




Source: Bank of Slovenia

**The proportion of past-due and regulatory high-risk items was down.**

The contraction in lending activity and December's measures affected the structure of the banking system's capital requirements for credit risk in different ways. The positive impact was reflected in a decrease in the proportion accounted for by past-due and regulatory high-risk items to 13.3%. However, the proportion of capital requirements accounted for by exposures to corporates was lower at 40%, while the amount declined sharply, by EUR 428 million. In addition to December's measures, this is a sign of the continued contraction in lending activity, which should not remain an engine for the contraction in capital requirements. To a lesser degree, this is the result of the improved optimisation of the use of capital. For example, capital requirements for exposures secured by real estate collateral, which allow for the use of lower risk weights, were up by EUR 7 million in 2013 to stand at EUR 73 million. The proportion of capital requirements for credit risk that they account for was up primarily due to a contraction in the base.

Table 6.29: Breakdown of capital requirements for credit risk in percentages

| | 2011 | | | | 2012 | | | | 2013 | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Large domestic banks | Small domestic banks | Banks under majority foreign owner-ship | System overall | Large domestic banks | Small domestic banks | Banks under majority foreign owner-ship | System overall | Large domestic banks | Small domestic banks | Banks under majority foreign owner-ship | System overall |
| Capital requirements for credit risk, EUR million | 1,707 | 271 | 798 | 2,775 | 1,608 | 251 | 758 | 2,617 | 1,085 | 167 | 632 | 1,883 |
| | Breakdown of capital requirements for credit risk. % | | | | | | | | | | | |
| General government, international organisations | 0.7 | 1.5 | 0.4 | 0.7 | 0.5 | 1.1 | 0.9 | 0.7 | 0.7 | 1.6 | 1.0 | 0.9 |
| Institutions | 11.7 | 5.4 | 2.7 | 8.5 | 15.6 | 2.9 | 2.9 | 10.7 | 13.1 | 1.9 | 2.7 | 8.6 |
| Corporates | 50.9 | 45.3 | 51.0 | 50.4 | 43.6 | 40.7 | 49.8 | 45.1 | 38.3 | 28.7 | 45.5 | 39.9 |
| Retail banking | 17.6 | 15.8 | 33.1 | 21.9 | 16.7 | 16.8 | 31.2 | 20.9 | 21.5 | 23.9 | 33.8 | 25.8 |
| Exposures secured by real estate | 0.3 | 7.3 | 1.7 | 1.4 | 1.3 | 7.7 | 3.3 | 2.5 | 2.6 | 8.3 | 4.9 | 3.9 |
| Past due items | 5.6 | 5.3 | 4.2 | 5.1 | 6.9 | 5.9 | 3.7 | 5.9 | 4.4 | 7.6 | 4.1 | 4.5 |
| Regulatory high-risk items | 9.4 | 14.5 | 2.8 | 8.0 | 10.8 | 19.2 | 3.7 | 9.6 | 9.6 | 21.9 | 4.0 | 8.8 |
| Other | 3.8 | 4.9 | 4.0 | 4.0 | 4.6 | 5.6 | 4.5 | 4.7 | 9.9 | 6.2 | 4.0 | 7.6 |
| Past due and regulatory high-risk items | 14.9 | 19.7 | 7.0 | 13.1 | 17.8 | 25.1 | 7.4 | 15.5 | 13.9 | 29.5 | 8.1 | 13.3 |

Source: Bank of Slovenia

### 6.8.4 Comparison of capital adequacy with the EU (consolidated data)

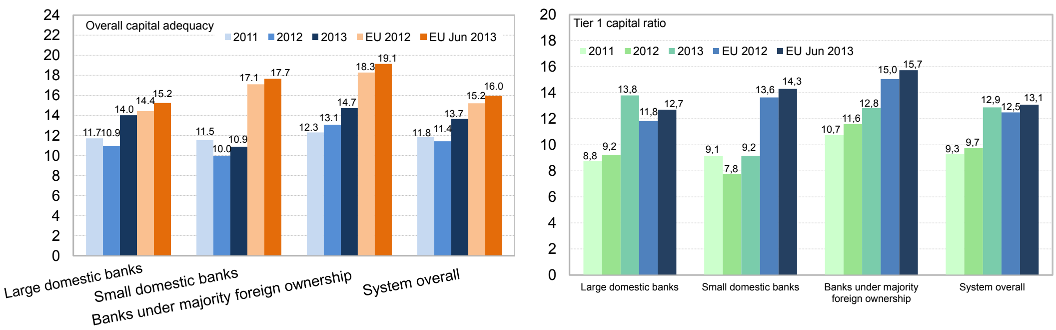
**The Tier 1 capital ratio has narrowed the gap to the EU average more than overall capital adequacy.**

The Slovenian banking system's capital adequacy on a consolidated basis rose by 2.3 percentage points in 2013 to 13.7%. The Slovenian banking system has thus narrowed the gap to the latest available average overall capital adequacy figure for EU countries, which has constantly and gradually improved. Because the Slovenian banks fulfil capital adequacy requirements with the highest-quality forms of capital, their Tier 1 capital ratio, which rose to 12.9%, lags just 0.2 percentage points behind the latest available average for EU countries.

**The gap by which overall capital adequacy ratios trail the EU average remains widest at the small domestic banks.**

There was a notable improvement in overall capital adequacy ratios on both the consolidated and individual bases in the final quarter of last year as a reflection of the previously described factors. The large domestic banks recorded the most significant improvement in capital adequacy. At 13.8%, the Tier 1 capital ratio of the aforementioned bank group actually exceeded the average of comparable EU banks by 1.1 percentage points. The gap remains widest at the small domestic banks [26], followed by the banks under majority foreign ownership. In order to achieve the average overall capital adequacy of comparable EU banks in the context of unchanged capital requirements, the small domestic banks would have to increase their capital by a total of EUR 57 million, while the banks under majority foreign ownership would have to increase their capital for the same reason by a total of EUR 378 million.

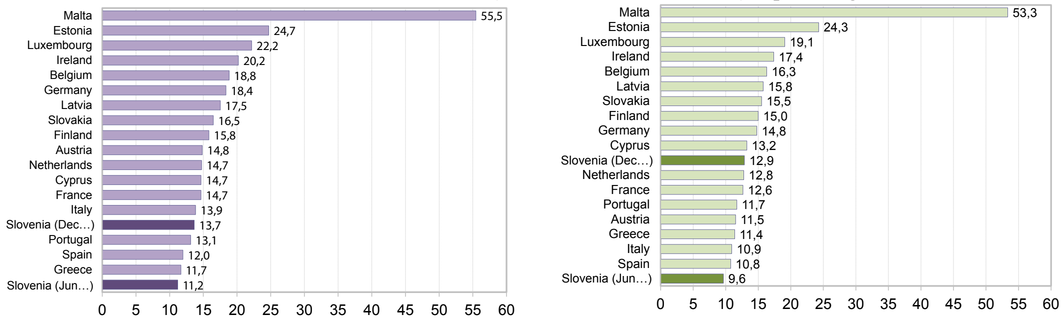
Figure 6.47: Capital adequacy (left) and Tier 1 capital ratio (right) compared with the EU, figures by bank group on a consolidated basis in percentages




Note: The figures for the small domestic banks for 2013 do not include the two banks undergoing the orderly wind-down process.
Sources: ECB (SDW), Bank of Slovenia

[26] The two banks undergoing the orderly wind-down process since September 2013 must be solvent, but are not required to fulfil minimum capital requirements. The aforementioned banks were not included in the analysis of the small domestic banks for 2013.

Figure 6.48: Capital adequacy (left) and Tier 1 capital ratio (right) for EU Member States, figures on a consolidated basis for June 2013 (December 2013 for Slovenia) in percentages

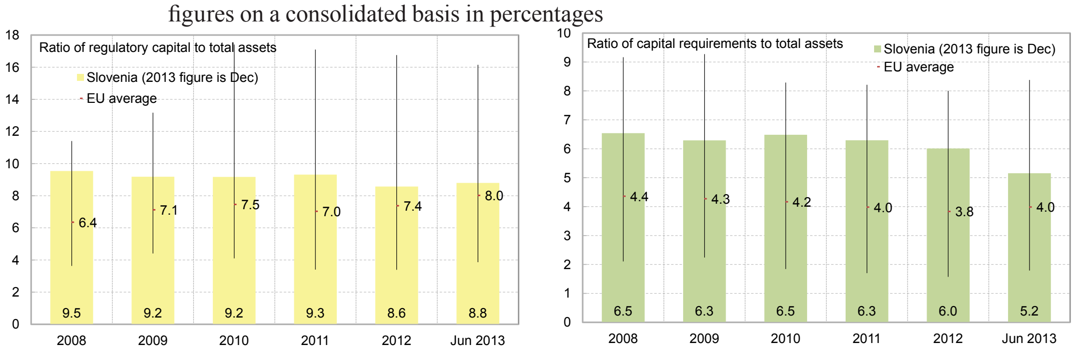



Sources: ECB (SDW), Bank of Slovenia

**The ratio of regulatory capital to total assets is above the EU average.**

The solvency indicator is not merely capital adequacy, but also the ratio of regulatory capital to total assets. That ratio had risen to 8.8% at the Slovenian banks by the end of 2013, and remains above the EU average. At 5.2%, however, the ratio of capital requirements to total assets remains higher at the Slovenian banks than the EU average of 4%. That ratio did not fall to the aforementioned level at the Slovenian banks until the final quarter due to the previously described factors.

Figure 6.49: Distribution of the ratio of regulatory capital to total assets (left) and the ratio of capital requirements to total assets (right) for EU Member States, figures on a consolidated basis in percentages

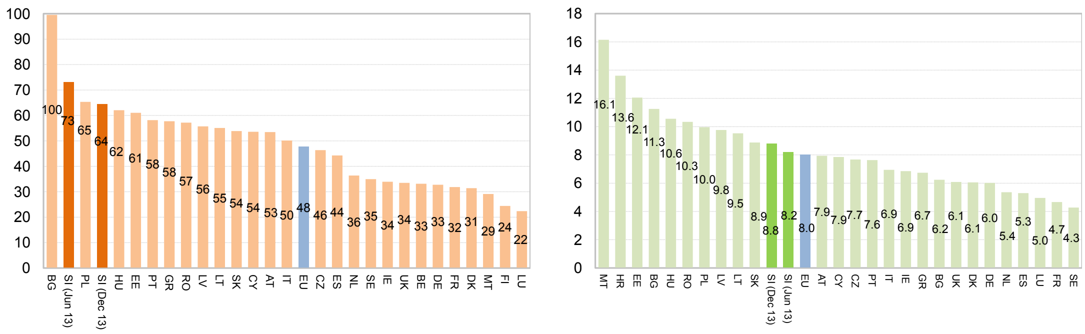



Sources: ECB (SDW), Bank of Slovenia

**Lower risk weights facilitate the better optimisation of capital.**

The relatively high capital requirements of the Slovenian banks compared with the EU are the result of higher weights. The Slovenian banks are limited by the use of the standardised approach (only one bank uses the IRB approach), while capital requirements for exposures to corporates and retail exposures account for two-thirds of the capital requirements for credit risk. The risk weights in these two categories are relatively high, having averaged 89.8% in the first category and 73.4% in the second category at the end of December 2013. The reason for the high weights lies in the fact that the majority of corporates have no credit rating, and that the banks are poorly positioned with regard to collateral via which they could meet the prescribed requirements and thereby apply lower risk weights or reduce capital requirements. In order to maintain and strengthen their solvency in the context of pending regulatory changes, the banks will have to manage the use of capital more effectively while focusing their activities on the generation of internal capital.

Figure 6.50: Risk-weighted assets (left) and regulatory capital (right) as a percentage of total assets by EU Member State, June 2013




Sources: ECB (SDW), Bank of Slovenia

# 7 NON-BANKING FINANCIAL INSTITUTIONS

## 7.1 Insurers

**Summary**

The most significant risk for the insurance sector is the continuation of the period of low interest rates. The low return earned by insurers' primary investment class - investments in long-term securities with a fixed yield - is the primary risk for insurance companies due the difficulty in achieving sufficient yield on insurance products with a guaranteed return. The second greatest risk relates to the reinvestment of coupons received and maturing bonds in very low-yield instruments. The period of low interest rates is linked to the adverse macroeconomic environment, which has a negative effect on demand for insurance products. Macroeconomic risks will remain significant for insurers until the economy recovers.

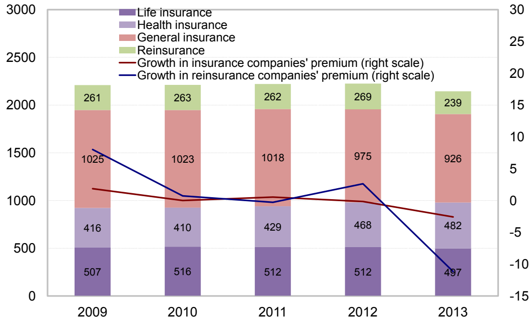
Developments in the banking sector affected the operating results of the insurance sector. Due to measures implemented to stabilise the banking system, the insurance sector was forced to write off and/or heavily provision for the subordinated debt and equity financial instruments of certain Slovenian banks. Write-offs were reflected in a reduction in the on-balance-sheet value of insurers' investments and an increase in finance costs, which drove down profits and hindered the achievement of sufficient returns on insurance products with a guaranteed return. Moreover, undermined confidence in the domestic banking system led to a reduction in bank deposits by the insurance sector. The diversification of investments among individual entities and the existence of buffers, such as provisions created during the period of excessive returns and capital surpluses, mitigated the effects of the aforementioned write-offs and prevented their pass-through to insurers.

### 7.1.1 Features of insurers' business

**Two insurance groups were formed in 2013.**

Two insurance groups were formed in 2013: SavaRe became the majority owner of Zavarovalnica Maribor, and the insurance company KD življenje was merged with Adriatic Slovenica. The number of insurance companies fell to 14 last year, while two reinsurance companies remain. The market share of the largest insurance company in terms of written premium was down relative to 2012, to stand at 32%. The largest insurance company makes up 37% of the life insurance market and 30% of the general insurance market. The market share of the largest reinsurance company in terms of written premium was at the level achieved in 2012, at 56%.

Figure 7.1: Gross written premium by type of insurance in EUR million (left scale) and annual growth in percentages (right scale)




Source: ISA

**The adverse economic conditions had a negative effect on growth in the premium written by insurance companies and reinsurance companies.**

The continuing economic crisis throughout most of 2013 had a negative effect on growth in the premium written by insurance companies and reinsurance companies. The gross written premium of insurance companies was down 2.6% relative to 2012, while that of reinsurance companies was down 11.2%. Only health insurance recorded positive year-on-year growth in insurance premium. The main reasons for the negative growth in gross written premium in 2013 were lower household purchasing power, a more cautious approach by households to entering into long-term insurance, the contraction in new bank lending and a decline in new vehicle sales. The downgrading of Slovenia and reinsurance companies in 2012 resulted in a decrease in the written premium of foreign reinsurance companies.

### Life insurance

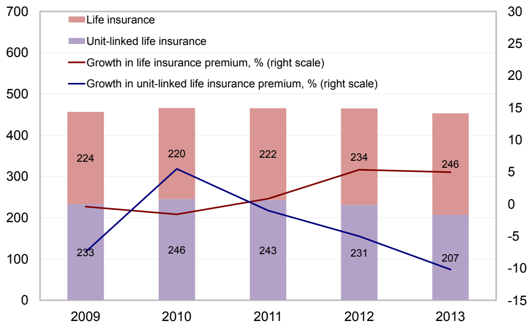
The economic crisis and the postponement of long-term investment decisions to the future resulted in a 3% contraction in life insurance premium. The life insurance total assets amounted to EUR 3.7 billion at the end of 2013, or 60% of insurers' total assets.

**The popularity of unit-linked life insurance has declined in recent years.**

Last year saw the continuation of the trend of rising premium from traditional forms of life insurance and declining premium from unit-linked life insurance. The proportion of total written premium accounted for by life insurance has remained almost unchanged in recent years, at 26%. The proportion of life insurance premium accounted for by traditional insurance was up 3.7 percentage points on the previous year, while the proportion accounted for by unit-linked life insurance was down 3.4 percentage points.

Premium from unit-linked insurance rose sharply every year prior to the crisis, having achieved its highest value in 2008, at EUR 252 million. The high returns on the capital markets and the insurers' aggressive sales policy contributed significantly to the popularity of this form of insurance in the pre-crisis period. Premium from unit-linked insurance fell to EUR 207 million between 2008 and 2013. The popularity of this form of investment has fallen sharply due to the increased risk associated with unit-linked insurance and negative returns. Life insurance premium written via banks totalled EUR 51.4 million in 2013. This marketing channel thus accounted for 10.3% of insurers' written life insurance premium.

Figure 7.2: Gross written premium by type of insurance in EUR million (left scale) and annual growth in percentages (right scale)




Source: ISA

### Insurers' financial statements [27]

Insurance companies and reinsurance companies recorded growth in total assets.

Insurers' total assets were up 1.4% during the 2013 financial year to EUR 6.2 billion. The total general insurance assets were down 0.8% during the same period to stand at EUR 2.5 billion, while life insurance assets were up 3.0% to stand at EUR 3.7 billion. The total assets of reinsurance companies increased by 16.1% between the third quarter of 2012 and the third quarter of 2013 to stand at EUR 779 million. The main factor in the growth of reinsurance companies' total assets was growth in the category 'investments in subsidiaries and associates'. The reinsurance company SavaRe increased its participating interest in Zavarovalnica Maribor to 100%.

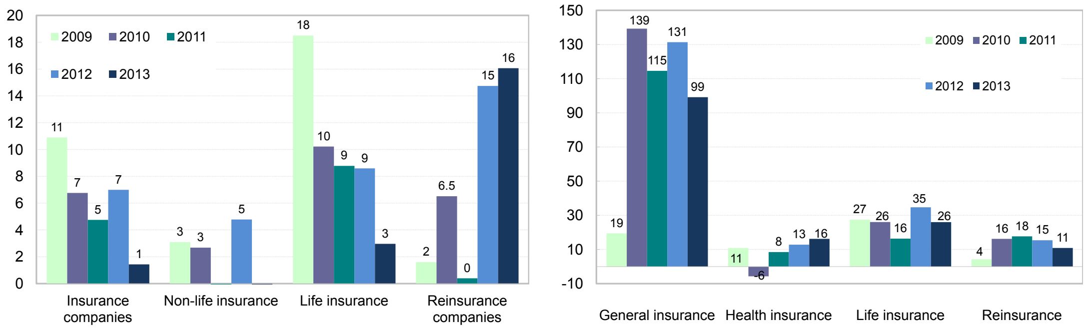
**Insurers generated lower profits in 2013 than the previous year.**

Insurers generated a net profit of EUR 101.8 million in 2013, representing negative year-on-year growth of 13.4%. Two insurers recorded a loss in the life insurance and health insurance segments, while one recorded a loss in the general insurance segment. The profitability indicators of insurers were down relative to the previous year. ROE amounted to 8.7% in 2013, compared with 10.8% a year earlier.

Developments in the banking sector affected the operating results of insurers. Due to measures implemented by the Slovenian government and the Bank of Slovenia to stabilise the banking system, insurance companies and reinsurance companies were forced to write off and impair the subordinated debt and equity financial instruments of certain Slovenian banks. Investments in the subordinated bonds of Slovenian banks by insurance companies and reinsurance companies totalled EUR 43.3 million in September 2013, or less than 1% of their total investments. Those investments amounted to just EUR 4.1 million at the end of the year. In addition to the 25.8% participating interest in Abanka held by Zavarovalnica Triglav, insurance companies and reinsurance companies held investments of EUR 6.7 million in the equity of Slovenian banks in October 2013, but just EUR 1.4 million at the end of the year.

[27] The figures used in this section are based on insurers' financial statements for 2013, which at the time of use had not yet been audited.

Figure 7.3: Growth in total assets in percentages (left) and result from ordinary activities in EUR million (right) of insurance companies and reinsurance companies

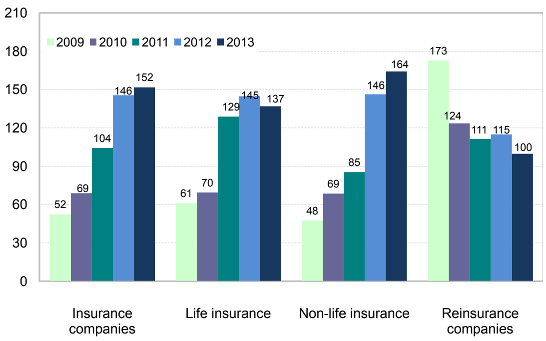



Note: The figures for reinsurance companies in 2013 relate to the end of the third quarter.
Source: ISA

**Impact of Solvency II on the calculation of capital adequacy and the investment policies of insurers.**

The capital adequacy of insurance companies and reinsurance companies is high. According to currently valid legislation, an insurance company or reinsurance company is capitally adequate if its available capital is greater than or equal to minimum capital requirements. The introduction of the Solvency II Directive will bring about significant changes in the calculation of solvency capital. Changes are also expected in insurers' investment policies.[28]At the end of 2013 the date for the entry into force of the Solvency II Directive was postponed to 1 January 2016 (Directive 2013/58/EU of 11 December 2013). Solvency II will not apply to insurance companies and reinsurance companies whose annual gross written premium does not exceed EUR 5 million and whose total insurance technical provisions do not exceed EUR 25 million.

Figure 7.4: Surplus of available capital over minimum capital requirements at insurance companies and reinsurance companies in percentages




Note: The figures for reinsurance companies in 2013 relate to the end of the third quarter.
Source: ISA

Two insurance companies and one reinsurance company underwent recapitalisations last year in the total amount of EUR 55.6 million. The majority of the total was accounted for by the recapitalisation of a reinsurance company through the issue of new shares listed on the Ljubljana Stock Exchange. Pozavarovalnica Sava carried out a recapitalisation in the amount of EUR 55 million on account of its acquisition of a 100% ownership stake in Zavarovalnica Maribor.

[28] Insurers are expected to increase their investments in debt instruments with a higher credit rating and shorter maturities. The stock of investments in securities with longer maturities and poorer credit ratings is expected to decrease. The capital requirement for the government bonds of EEA countries is 0%. Insurers are therefore expected to increase their exposure to this investment category. More changes are expected in insurers' investments in corporate bonds. Capital requirements for exposure to corporate bonds will depend on the maturity and credit rating: capital requirements will be higher for corporate bonds with longer maturities and a poorer credit rating. Insurers' demand for covered bonds will more than likely replace demand for unsecured bank bonds. Legislative changes (e.g. the directive on the recovery and resolution of credit institutions and investment firms) resulted in an increase in the risk associated with unsecured bank bonds. Insurers' demand for such securities is thus expected to be lower. Insurers will have to secure additional capital due to the mismatches in the maturities of investments and liabilities. Thus, primarily the life insurance segment, which has very long-term liabilities, is expected to increase its use of interest rate derivatives. Summarised from the article *Vpliv Solventnosti II na upravljanje dolžniških naložb zavarovalnic (Impact of Solvency II on the Management of Insurers Debt Investments), J. Kirin,* published in Zavarovalniški horizonti, January 2014.

The investment environment continues to present a major challenge for insurers. The primary investment class for insurers, long-term securities with a fixed yield, bear low returns. Forecasts of economic developments point to improving economic conditions in 2014. The economic recovery will have a positive impact on the financial markets. The strengthening of economic growth will lead to a rise in the yields on government bonds. Swiss Re assesses that the yield on German government bonds will rise from 1.8% at the end of 2013 to 2.3% at the end of 2014, and remain relatively low at the end of 2015, at 2.8%. Until yields begin to rise, insurance companies and reinsurance companies will face difficulties in ensuring a sufficient yield on insurance products with a guaranteed return and in reinvesting coupons received and maturing bonds.

**The continuation of the period of low interest rates has had a negative effect on the profitability of insurers.**

### 7.1.2 Stability of the insurance sector

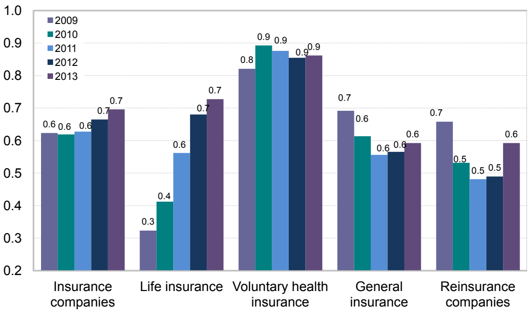
#### Underwriting risk

The claims ratio at insurers as measured by the ratio of gross claims paid to gross written premium rose by 0.03 index points in 2013 to stand at 0.70. This is the fourth consecutive year the insurers' claims ratio has gradually deteriorated, without threatening their performance.

**The claims ratio deteriorated in almost all insurance classes.**

Falling premium and rising claims resulted in the renewed deterioration in the claims ratio for life insurance. The claims ratio for life insurance deteriorated by 0.05 index points last year to stand at 0.73. Increased longevity and the early redemption of policies remain the main reasons for the deterioration in the claims ratio for this insurance class. The deterioration in the claims ratio for voluntary health insurance, despite growth in premium, is the result of the entry into force of the Fiscal Balance Act at the end of May 2012, which led to the transfer of the financing of certain health services from the Health Insurance Institute to supplementary health insurance. A decline in written premium led to the deterioration of the claims ratio for general insurance. The economic crisis has resulted in the reduction and redemption of the number of insurance policies held by households and corporates. In addition, fierce competition exists between insurance providers.

Figure 7.5: Claims ratio for major types of insurance




Source: ISA

The business of reinsurance companies is highly diversified in geographic terms. Global loss events thus affect their claims ratio. Also affecting the claims ratio of reinsurance companies was the payment of claims for natural disasters, the largest losses being linked to floods in Central and Eastern Europe in June 2013. Similar to previous years, the 2013 financial year for the Slovenian insurance sector was characterised by loss events as the result of floods, hailstorms, snow and ice. Climate change has increased the risk of extraordinary events, natural disasters and extreme weather conditions in recent years. Insurers must therefore adjust the process of taking up risks and the development of new products to the new situation.[29]

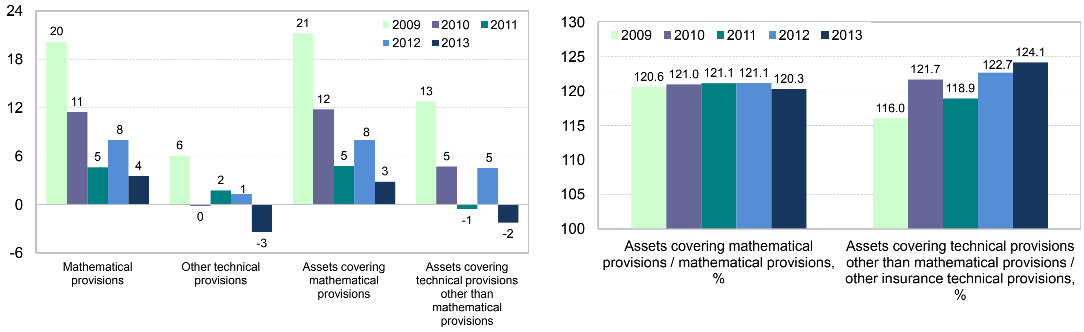
The proportion of insurers' risk retained in general insurance amounted to 77.8% in 2013.

[29] Swiss Re, Global insurance review 2013 and outlook 2014/2015, November 2013.
Loss events due to natural disasters and accidents caused by man resulted in total damage of USD 140 billion and insurance claims of USD 45 billion in 2013, down USD 56 billion and USD 36 billion respectively on the previous year. North America recorded the largest insurance claims, of USD 19 billion. The two largest individual loss events occurred in Europe. Massive floods struck Central Europe in the summer resulting in USD 4 billion in insurance claims, while hail in Germany in July 2013 resulted in insurance claims of USD 3.8 billion.

## Investment risk

Assets covering technical provisions rose by 1.1% last year to EUR 4,978 million, or 14.1% of GDP. The coverage of net insurance technical provisions by the assets covering technical provisions was practically unchanged relative to 2012 at 121.6%. The coverage of mathematical provisions by assets covering mathematical provisions for life insurance and health insurance decreased last year by 0.8 percentage points to 120.3%. This indicates that the liabilities of insurers are covered by assets. The Insurance Act sets out the types of permitted assets.

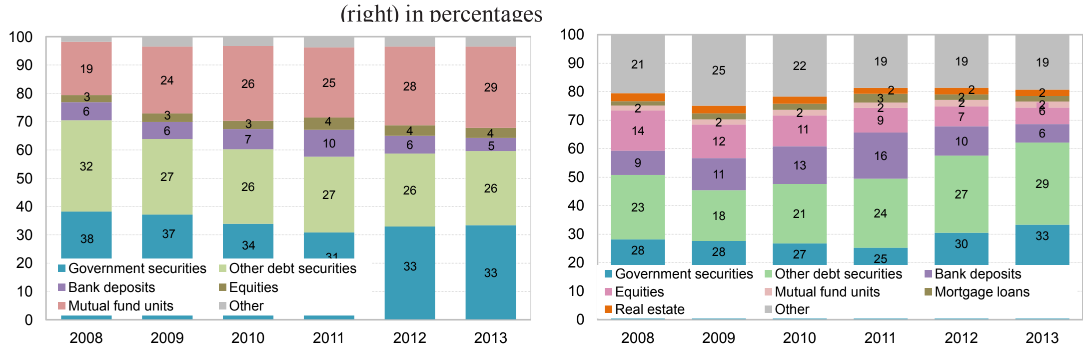
Figure 7.6: Growth in net insurance technical provisions and assets for general insurance and life insurance (left), and coverage of net insurance technical provisions by assets covering technical provisions for general insurance (right) in percentages




Source: ISA, Bank of Slovenia calculations

The largest decline in the breakdown of life insurance and general insurance investments in 2013 was recorded by deposits. The main factors in the contraction in deposits were the cutting of deposit rates and insurers' undermined confidence in the Slovenian banking system. Debt securities remain the largest category in value terms. The proportion that they account was up on the previous year. The proportion accounted for by investments in foreign securities was also up relative to 2012.

Figure 7.7: Structure of insurers' assets covering mathematical provisions (left) and assets covering technical provisions other than mathematical provisions (right) in percentages



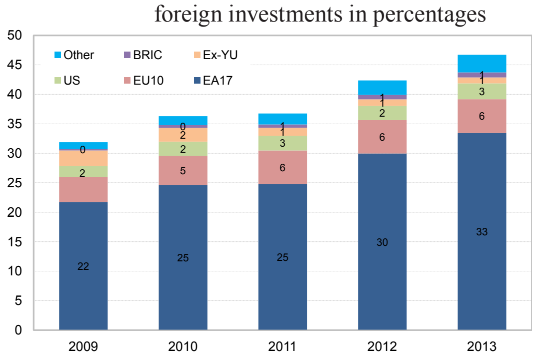

Source: ISA

**There is a trend of decline in investments in domestic securities.**

The proportion of the insurance sector's total investments accounted for by investments in the securities of domestic issuers stood at 53.3% at the end of 2013, down 4.4 percentage points on the previous year. Net purchases of foreign debt securities and foreign equities amounted to EUR 269 million and EUR 51 million respectively. Purchases of debt securities and equities were spread out among various countries. The majority of purchases in 2013 were in the debt securities of issuers from France. During the same period the majority of purchases of mutual fund units were of those registered in Ireland. The insurance sector recorded a positive revaluation from investments in the equities of companies from euro area countries and the US.

The insurance sector remains highly exposed to the government sector in Slovenia. Slovenian government bonds accounted for 23.6% of the insurance sector's investment portfolio or EUR 1.8 billion at the end of 2013. Year-on-year growth in domestic bank deposits was negative in December 2013 in the amount of 26%. There were significant differences in the year-on-year change in deposits between the bank groups. The largest decline was recorded by the large domestic banks. An increased lack of confidence on the part of insurers in the domestic banking system led to a reduction in bank deposits by the insurance sector.

Figure 7.8: Proportion of the insurance sector's total investments accounted for by foreign investments in percentages

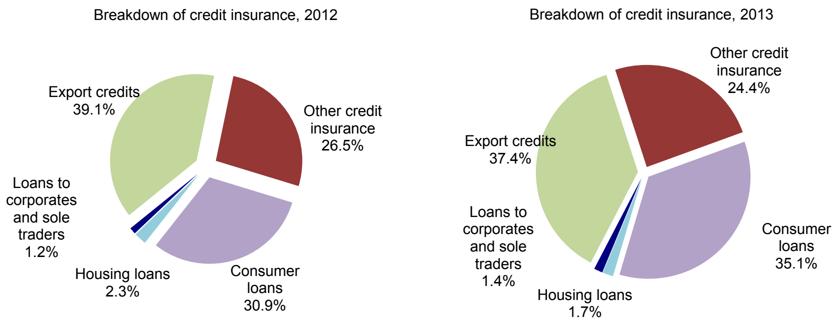



Source: Bank of Slovenia

### 7.1.3 Influence of insurers on the stability of the banking sector via credit insurance

The claims ratio of credit insurance improved last year. The proportion of insurers' total written premium accounted for by credit insurance stood at 2.3% in 2013, and at 3.1% as a proportion of written general insurance premium. This means that this form of insurance does not account for a significant proportion of written insurance premium. Written credit insurance premium was up 0.8% in 2013 at EUR 43.1 million. Claims paid declined by 6.1% to EUR 29.8 million. The decline in claims and rise in premium led to an improvement in the claims ratio, which stood at 0.69 in 2013.

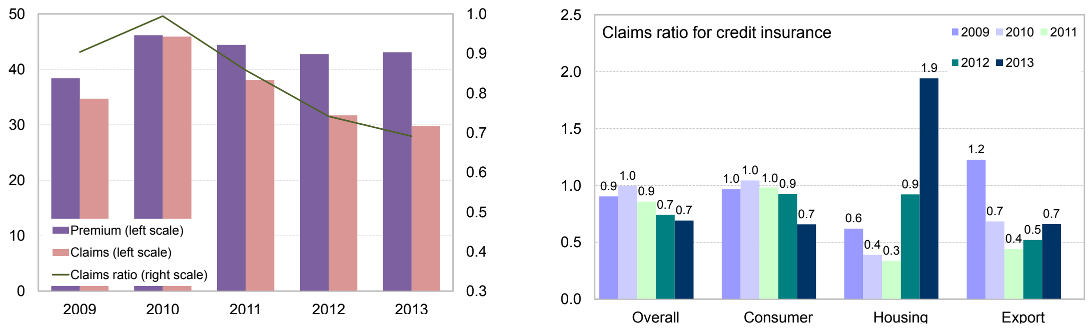
Figure 7.9: Breakdown of written premium from credit insurance in percentages




Source: ISA

Housing loan insurance recorded the largest deterioration in the claims ratio for the second consecutive year, to stand at 1.94 at the end of 2013. Written premium from credit insurance for housing loans declined by 27.6% in 2013, while claims paid increased by 52.6%. The decline in housing loan premium in recent years has been driven by a decline in new housing loans and a change in the banks' business strategy regarding loan insurance. Insurance premium for consumer loans rose by 14.6% last year, while claims paid were down 18.2%, resulting in an improvement in the claims ratio.

Figure 7.10: Written premium and claims paid in EUR million, and claims ratio for credit insurance




Source: ISA

Slovenian insurers' sum insured in credit insurance was down 5% on the previous year to stand at EUR 7 billion at the end of 2013. The sum insured for export credits was down 8.0% in 2013 relative to the previous year, at EUR 4 billion. The sum insured for credit insurance on housing loans stood at EUR 108 million at the end of 2013, down 1.3% relative to 2012.

The sum insured for credit insurance on consumer loans stood at EUR 368 million at the end of 2013, up 4.1% on 2012. We expect the sum insured for credit insurance on housing and consumer loans to decline further in the future.

## 7.2 Voluntary supplementary pension insurance

**The written premium of voluntary supplementary pension insurance providers was down.**

The written premium of voluntary supplementary pension insurance providers was down sharply last year. The main reason for the aforementioned decline was the adoption of the Fiscal Balance Act. As the result of an agreement on austerity measures, the premium for supplementary pension insurance for public-sector employees was cut for the period 1 June 2013 to 31 December 2014.

Table 7.1: Written premium and assets of voluntary supplementary pension insurance providers

| | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|
| Written premium, EUR million | 231 | 233 | 231 | 230 | 200 |
| Breakdown, % | | | | | |
| mutual pension funds | 46 | 46 | 45 | 46 | 38 |
| insurers | 21 | 21 | 21 | 23 | 29 |
| pension companies | 33 | 33 | 33 | 31 | 33 |
| Assets, EUR million | 1,528 | 1,794 | 1,846 | 1,801 | 1,788 |
| Breakdown, % | | | | | |
| mutual pension funds | 42 | 42 | 44 | 47 | 49 |
| insurers | 21 | 21 | 21 | 22 | 22 |
| pension companies | 36 | 36 | 35 | 31 | 29 |

Source: ISA, SMA

**The trend of ageing population in Slovenia represents a risk to financial stability due to the increased risk of unsustainable fiscal policy**

There is a pronounced trend of ageing population in Slovenia. This represents a risk to financial stability due to the increased risk of unsustainable fiscal policy. A new Pension and Disability Insurance Act (the ZPIZ-2 [30]) was adopted at the end of 2012, and entered into force in January 2013.The aforementioned law tightened the conditions for receiving an old-age pension and extended the period for the calculation of the pension base. The new law solves the issue of rising expenditure on pensions in the short term, but less so in the long term. The Ministry of labour, Family and Social Affairs is forecasting a rise in expenditure on pensions as a proportion of GDP to 16% in 2060 [31].Expenditure on pensions as a proportion of GDP stood at 12.2% last year [32], and was up in value terms by 2.6% in 2013 relative to 2012. The reason for the increase in expenditure was a rise in the number of pensioners. Higher year-on-year growth in the number of pensioners has been recorded since 2010, as the baby-boom generation enters retirement. Last year the average age of new pension recipients fell by 9 months for men to 60.8, and rose by 2 months for women to 58.3. The tax revenue generated by the PDII during the 2013 financial year was down 2.4% on 2012. The reasons lie in lower wage growth and a decline in employment [33]. Tax revenue accounts for two-thirds of the PDII's total revenue. Budget revenue from transfers was up 11.9% to stand at EUR 1.6 billion.

Changes in the investment policies of pension funds can be expected this year. The ZPIZ-2 allows fund managers to pursue a life cycle policy. The umbrella pension fund will comprise three sub-funds that will differ in terms of investment policy. One of the three sub-funds will continue to pursue an investment policy of ensuring the minimum guaranteed return.

The ZPIZ-2 also placed severe restrictions on early withdrawals of funds saved in collective pension insurance. The assets that a policyholder invests in collective pension insurance until 31 December 2012 can still be withdrawn in a lump sum after 10 years, while those invested after 1 January 2013 cannot be withdrawn until retirement. The amount of assets withdrawn after 10 years was highest in 2012, while that amount was down in 2013. Policyholders opt for early withdrawal due to the decline in disposable income, the relatively low return of voluntary supplementary pension insurance providers and the lack of awareness that pensions from compulsory insurance will not facilitate a comfortable life after retirement [34].

[30] Source: Pension and Disability Insurance Act (ZPIZ-2). Official Gazette of the Republic of Slovenia No. 96/2012 of 14 December 2012.

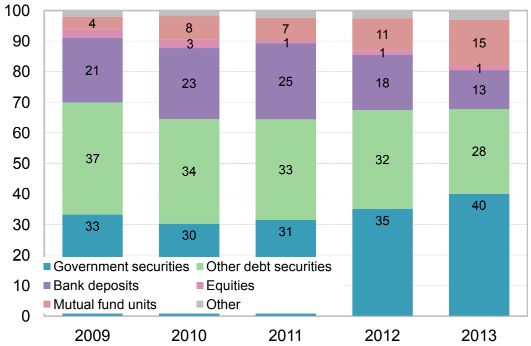
[31] Modernisation of the pension system (ZPIZ-2), Ministry of Labour, Family, Social Affairs and Equal Opportunities (MLFSAEO).

[32] The data source in the remainder of this paragraph is the PDII's annual report for 2013.

[33] The decline in the number of policyholders at the PDII and the increase in the number of pensioners led to a deterioration in the ratio of the workforce in employment to the number of pensioners in 2013. In December 2013 the workforce in employment exceeded the number of registered unemployed at the Employment Service and the number of retirees by just 65,000. Source: Employment Service of Slovenia and the PDII

[34] Some 46.7% of old-age pensions were below the poverty line for a single-member household in 2013. Sources:SORS, PDII

Figure 7.11: Structure of investments by voluntary supplementary pension insurance providers




Sources: ISA, Bank of Slovenia

The ratio of supplementary pension insurance assets to GDP stood at 5% at the end of 2013. The largest declines in the structure of investments by supplementary pension insurance providers relative to 2012 were recorded by the proportion accounted for by bank deposits, which was down 5.4 percentage points, and the proportion accounted for by other debt securities, which was down 4.8 percentage points. The largest increases relative to 2012 were recorded by government securities (up 5.1 percentage points) and mutual funds units (up 4.6 percentage points).

**The proportion of the highest quality forms of capital is increasing.**

There has been a ceiling on the minimum guaranteed return since January 2013. Prior to the change in the rules on the calculation of the minimum guaranteed return, the return on mutual pension funds could not be less than 40% of the average annual yield on Slovenian government securities with a maturity of more than 1 year. With the change to the aforementioned rules, the maximum average annual yield was set at 3.75%. This means that if the average annual yield on government securities exceeds 3.75%, the maximum average annual yield is taken into account and not the actual average yield on government securities. The required yield on long-term Slovenian government bonds fluctuated above 3.75% in 2013. The minimum guaranteed return was therefore 1.5% p.a. in 2013, and will remain unchanged in 2014.

Not all supplementary pension insurance providers generated a return higher than the minimum guaranteed return last year. The average annual return achieved by insurers and pension companies from voluntary supplementary pension insurance investments stood at 1.3% last year [35], while the year-on-year change in the average unit price of mutual pension funds was 1.5%. Provisions are created if the return achieved by supplementary pension insurance providers exceeds the guaranteed return. If the return achieved by supplementary pension insurance providers is below the guaranteed return, the difference between the actual and guaranteed return is covered by previously created provisions. If the provisions are not sufficient to cover the guaranteed return, the difference is covered by the supplementary pension insurance provider from its own funds. Some providers were forced to use provisions in 2013. A major reason for the lower return was the write-off and impairment of the subordinated debt and equity financial instruments of certain Slovenian banks as the result of measures implemented by the Slovenian government and the Bank of Slovenia to stabilise the banking system. In September 2013 the proportion of assets covering mathematical provisions for voluntary supplementary pension insurance accounted for by investments in the subordinated bonds and shares of banks with a registered office in Slovenia stood at 3.2% for insurers and 4.1% for pension companies. Those proportions had fallen to 0.5% for insurers and 1.1% for pension companies by the end of 2013. The proportion of investments by mutual pension funds in voluntary supplementary pension insurance accounted for by the subordinated bonds of banks with a registered office in Slovenia stood at 1% in September 2013 and at 0.3% at the end of 2013. The diversification of investments among individual providers and the provisions created during the period of excessive returns mitigated the effects of the write-offs and prevented their pass-through to insurers.

[35] The figures for the annual return of three insurers and one pension company are based on an estimate provided by the ISA, and not on publicly available figures. These figures were not yet available to the public at the end of April.

## 7.3 Capital market and mutual funds

### Summary

The Slovenian capital market was characterised in 2013 by the announced sale of 15 companies[36] under majority or partial government ownership and included on the list for privatisation. Seven of the 15 companies are listed on the Ljubljana Stock Exchange [37]. Speculation in connection with the privatisation process was the main engine for growth in the share prices of companies on the aforementioned list, and thus the entire market. Nevertheless, moderate growth in market prices was not reflected in growth in the volume of share trading on the Ljubljana Stock Exchange.

Market illiquidity, the high volatility of market prices and the modest operating results of the majority of listed companies were the main reasons that residents and non-residents were discouraged from more active trading on the Ljubljana Stock Exchange in 2013. Non-residents compensated for diminished demand for Slovenian shares by making net investments in Slovenian bonds. The government doubled the nominal value of bond issues on the foreign capital markets last year, while demand for the aforementioned bonds was several times more than the issue value offered. The premiums on Slovenian government bonds fell after the publication of stress test results at the end of 2013, meaning the government was able to secure more favourably priced borrowings on the foreign financial markets in the first quarter of 2014.

With the exception of a small number of well-established Slovenian companies, the possibility of securing debt financing on the domestic capital market is limited primarily to the government. The illiquid domestic capital market remains off limits to listed companies and other entities as an alternative source of financing. Even the banks' activity on the capital markets is very limited. Only two banks issued bonds last year, one on the domestic capital market and the other on a foreign capital market.

The extremely positive mood on the foreign financial markets encouraged residents to make the highest net purchases of shares and bonds in the last several years. Despite the positive mood on the foreign capital markets and year-on-year growth in the average unit price, investors' confidence in mutual funds did not return. Net withdrawals from mutual funds continued in 2013 and in early 2014, albeit to a lesser extent.

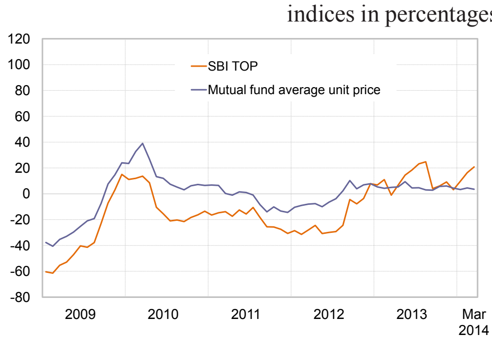
### Developments on the capital market

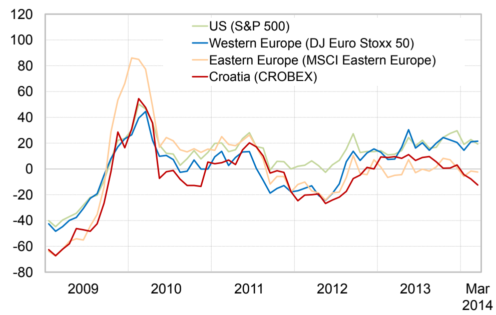
**Growth in the SBI TOP index was lower than the growth in the share indices of developed markets, but higher than the growth recorded by regional indices**

Year-on-year growth in the SBI TOP, Slovenia's main stock market index, stood at 20.8% at the end of March 2014. The majority of this high growth was generated over the final months of last year and the first months of this year, when information regarding the sale of two of the 15 companies included on the list for privatisation was published.

The SBI TOP rose by 3.2% overall in 2013. The major share indices on developed markets recorded high growth last year (the NASDAQ by 38.3%, the S&P by 29.6% and the DAX by 25.5%) and frequently reached record levels. The higher growth in major foreign share indices relative to the domestic index continued during the first quarter of this year. Central European CEESEG index, calculated by the Vienna Stock Exchange, the Eastern European MSELEMEE index and Balkan stock market indices recorded lower or negative growth compared with the domestic stock market index.

Figure 7.12: Year-on-year growth in domestic (left) and foreign (right) stock exchange indices in percentages




Source: LJSE, Bloomberg

[36] The National Assembly approved a list of 15 companies for privatisation in June 2013.

[37] Seven of the 15 companies in the list for privatisation were listed on the Ljubljana Stock Exchange until the withdrawal of NKBM shares from the capital market on 20 December 2013.

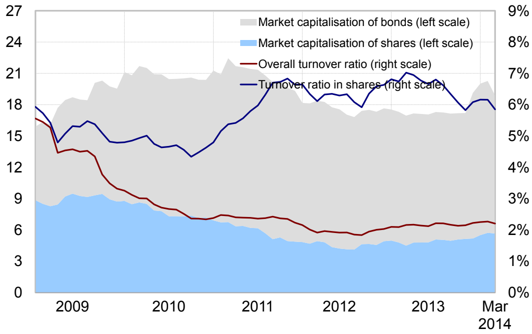
**Turnover on the Ljubljana Stock Exchange is rising due to an increase in the trading of bonds.**

The total volume of trading on the Ljubljana Stock Exchange was up 8.7% from the previous year in 2013, while the volume in the first quarter of 2014 was up 5.9%. The reasons for the aforementioned growth lie primarily in the increased volume of trading in bonds, in particular the bonds of banks undergoing the orderly wind-down process, and to a lesser extent in the increased trading of commercial paper, which at 1.2% of total volume in trading remains modest. The volume of trading in shares, which still account for more than three-quarters of the volume of trading on the Ljubljana Stock Exchange, was down 1.1% in 2013, which further affected their liquidity. The trading of treasury bills, including those of longer maturities, is negligible on the secondary market.

The market capitalisation of shares on the Ljubljana Stock Exchange amounted to EUR 5,173 million at the end of December 2013, up 5.3% in year-on-year terms. The five most heavily traded prime market shares accounted for more than four-fifths of total volume, a large proportion of trading relating exclusively to shares of Krka. This means that there was very low liquidity in the other shares in companies listed on the prime market, while the 55 companies listed on the standard market and entry market accounted for just 8.2% of the volume in shares on the Ljubljana Stock Exchange. Low liquidity was reflected in the high volatility of market prices, which was primarily the result of speculation regarding the announced sale of companies and fewer valuations of companies at high multiples of turnover.

Low liquidity on the domestic stock market, which has deteriorated further rather than improve for a number of years, forces companies listed on the prime market to list their shares in parallel on foreign capital markets. In addition to NKBM and Krka, Gorenje made a parallel listing of its shares on the Warsaw Stock Exchange at the end of 2013. Parallel listing on the aforementioned Central European stock exchange provides Slovenian companies with the opportunity to secure new sources of financing and a more diversified ownership structure, while increasing their international profile on markets where they generate a significant proportion of their consolidated revenue.

Figure 7.13: Market capitalisation on the Ljubljana Stock Exchange in EUR billion, and annual turnover ratios (TR)




Source: LJSE, Bloomberg

The market capitalisation of bonds on the Ljubljana Stock Exchange amounted to EUR 13,956 million at the end of 2013, up 9.6% in year-on-year terms. The Slovenian bond market also suffers from low liquidity, and is concentrated to trading in just a few bonds. The two most heavily traded bonds accounted for nearly one-half of the total volume of trading in bonds on the stock market.

**The government issued bonds in the amount of EUR 4.2 billion on the foreign capital markets in 2013, or more than any other year on the domestic market.**

The government doubled the nominal value of primary bond issues on the foreign capital markets in 2013, the bonds having been issued on the US dollar and euro markets. Moreover, the government is increasingly borrowing in the form of treasury bills. The government issued USD 1 billion of 5-year and USD 2.5 billion of 10-year US-dollar-denominated bonds in May 2013. The change to Slovenia's sovereign debt rating by Moody's just prior to the issue did not affect demand for bonds, as orders were high and exceeded USD 16 billion, several times more than the issue value offered. One of the reasons for foreign investors' interest in the two aforementioned bonds was the relatively high coupon rates, which at auction were higher than the rates of bonds issued by countries with a similar sovereign debt rating. The 5-year bonds were issued with a coupon rate of 4.75%, while the 10-year bonds carried a coupon rate of 5.85%. The government also carried out an unannounced 3-year bond issue in the amount of EUR 1.5 billion in November 2013. At 4.7%, the coupon rate was again high and nearly equal to the coupon rate on the previous issue of 5-year US-dollar-denominated bonds. The government issued a total of EUR 4,194.8 million in bonds on the foreign capital markets in 2013, twice as much as in the previous year.

Table 7.2: Overview of Slovenia's regulated capital market

| | 2009 | 2010 | 2011 | 2012 | 2013 | Mar 2014 |
|---|---|---|---|---|---|---|
| | | | Shares | | | |
| Market capitalisation | | | | | | |
| amount, EUR billion | 8.5 | 7.0 | 4.9 | 4.9 | 5.2 | 5.7 |
| as % GDP | 23.9 | 19.7 | 13.5 | 13.9 | 14.7 | 16.0 |
| annual growth, % | -0.1 | -17.3 | -30.3 | 0.8 | 5.3 | 26.0 |
| proportion held by non-residents, % | 7.2 | 10.0 | 12.3 | 13.6 | 15.5 | 14.9 |
| Volume | | | | | | |
| amount, EUR million | 719.8 | 360.8 | 394.5 | 302.9 | 299.4 | 93.1 |
| as % GDP | 2.0 | 1.0 | 1.1 | 0.9 | 0.8 | 1.0 |
| annual growth, % | -24.4 | -49.9 | 9.3 | -23.2 | -1.1 | 1.6 |
| Annual change in SBI TOP, % | 15.0 | -13.5 | -30.7 | 7.8 | 3.2 | 20.8 |
| P/E ratio (prime market) | 19.4 | 43.2 | 93.1 | 16.2 | 19.2 | 20.6 |
| Dividend yield (prime market), % | 2.1 | 2.1 | 3.2 | 3.9 | 4.0 | 4.5 |
| | | | Bonds | | | |
| Market capitalisation | | | | | | |
| amount, EUR billion | 10.8 | 13.2 | 14.5 | 12.7 | 14.5 | 13.2 |
| as % GDP | 30.6 | 37.2 | 40.0 | 36.1 | 41.2 | 37.5 |
| annual growth, % | 59.2 | 21.9 | 9.6 | -11.9 | 15.6 | 6.1 |
| Volume | | | | | | |
| amount, EUR million | 156.3 | 108.9 | 59.6 | 55.4 | 86.1 | 23.4 |
| as % GDP | 0.4 | 0.3 | 0.2 | 0.2 | 0.2 | 0.3 |
| annual growth, % | -39.2 | -30.3 | -45.3 | -7.0 | 55.4 | 59.7 |

Note: Excludes listed investment companies, mutual funds and banker's drafts.
Sources: LJSE, SORS

The pace of issues of government bonds on the foreign capital markets continued in the first quarter of 2014.The Ministry of Finance issued benchmark US dollar-denominated bonds with a nominal value of USD 3.5 billion (around EUR 2.56 billion). The 5-year bond with a nominal value of USD 1.5 billion had a required yield of 4.275% at auction, while the required yield on the 10-year bond with a nominal value of USD 2 billion was 5.48%. Demand for the Slovenian bonds registered at USD 16 billion, again significantly higher than the emission value. The heavy demand meant that the premiums on bonds fell, and stood at just 280 basis points over US government bonds, between 20 and 32.5 basis points lower than the initial expectations. The price of the bond issue was further reduced by a cross currency swap, which reduced the required yield by an additional 1 percentage point.

**Due to their over-indebtedness, corporates are looking for equity on the foreign capital markets rather than debt capital.**

In September 2013 SID banka issued new bonds on the international capital market in a closed placement. The bonds have a maturity of 12 months, a government guarantee, a nominal issue value of EUR 100 million, and bear a coupon rate of 3.34%. Only one bank issued bonds on the domestic capital market, in the modest nominal issue value of EUR 2 million. Corporates rarely choose to issue bonds on foreign markets due to their low profile, an excessive level of existing debt and a typically overly modest nominal issue value.

**Money-market instruments are being used increasingly by the government and larger companies listed on the prime market.**

In 2013 money-market instruments on the domestic capital market served as an alternative source of debt financing for the government and, in particular, larger corporates listed on the prime market. The government issued 25 treasury bills with a nominal value of EUR 2,156 million, which exceeded the nominal value of government bonds issued on the foreign capital markets in 2012. At EUR 193 million, corporates nearly doubled the nominal issue value of commercial paper relative to the previous year. By issuing commercial paper, corporates diversify their short-term debt financing and balance year-on-year fluctuations in the generation of free cash flow. Commercial paper represents direct corporate borrowing on the short-term money market. Despite the rising value of commercial paper issues and the demand demonstrated by non-residents, other listed companies and SMEs still do not choose to issue commercial paper. The reasons lie in the excessive existing debt of corporates, a lack of awareness of these types of instruments as a means for financing current financial liabilities, the relatively high interest rates on commercial paper and the required value of nominal issues.

Table 7.3: Overview of number of new bond issues by residents in Slovenia and in the rest of the world, and total value

| | Issued in Slovenia | | | | Value. EUR million | |
|---|---|---|---|---|---|---|
| | Banks | Financial institutions | Government | Non-financial corporations | Total | Of which. non-financial corporations |
| 2008 | 5 | 1 | 1 | 5 | 1,728 | 50 |
| 2009 | 5 | 4 | 3 | 2 | 4,222 | 77 |
| 2010 | 5 | 2 | 2 | 0 | 2,674 | 0 |
| 2011 | 2 | 2 | 3 | 5 | 3,121 | 63 |
| 2012 | 5 | 1 | 0 | 1 | 110 | 30 |
| 2013 | 1 | 2 | 0 | 2 | 1,045 | 32 |
| Mar 2014 | 0 | 0 | 0 | 1 | 24 | 24 |
| | Issued in rest of the world | | | | | |
| 2008 | 0 | 0 | 0 | 0 | 0 | 0 |
| 2009 | 2 | 0 | 0 | 1 | 2,300 | 300 |
| 2010 | 4 | 0 | 0 | 0 | 1,350 | 0 |
| 2011 | 2 | 0 | 0 | 0 | 500 | 0 |
| 2012 | 1 | 0 | 1 | 0 | 1,925 | 0 |
| 2013 | 1 | 0 | 3 | 0 | 4,295 | 0 |
| Mar 2014 | 0 | 0 | 2 | 0 | 2,560 | 0 |

Source: CSCC, Bank of Slovenia

**Investment links with the rest of the world**

In line with growth in the nominal value of government bond issues on the foreign capital markets, the interest of non-residents is shifting from government bonds issued on the domestic capital market to government bonds issued on the foreign capital markets. Non-residents made net sales of EUR 547.5 million in Slovenian bonds issued on the domestic capital market in 2013, an increase of EUR 43.4 million from the previous year. Non-residents also purchased commercial paper, which is evidence of their interest in investing in these types of financial instruments of Slovenian firms.

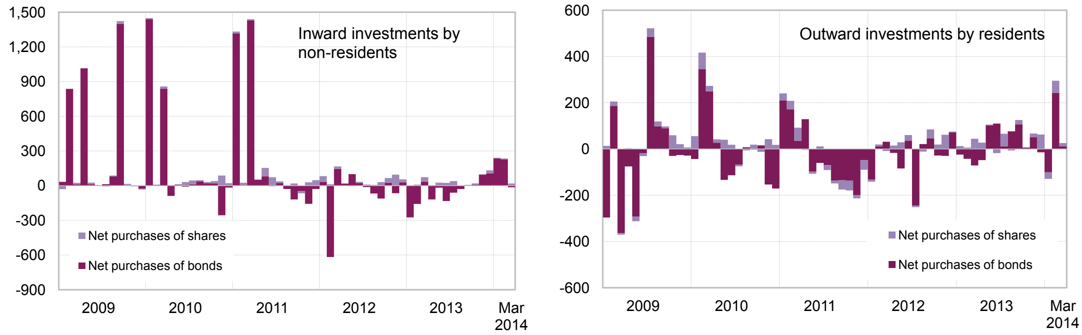
The protracted multiple attempts to sell one of the largest listed companies was also a factor undermining the confidence of non-residents in the Slovenian equity market. As a result, non-residents showed no interest in Slovenian shares in 2013 and in the first months of 2014, despite the announced sale of companies under majority government ownership. Of the 15 companies on the list for privatisation, only Helios was sold to non-residents by the end of 2013. During the first months of 2014 government-held PDP sold Fotona, the second company on the list for privatisation. The potential increased interest of non-residents in Slovenian shares is primarily linked to the successful sale of the 13 remaining companies, including Telekom Slovenije. The sale of companies on the list for privatisation will reduce the government's role in the economy.

Non-residents made net purchases of EUR 188.7 million in Slovenian shares in 2013, down EUR 111.2 from the previous year. At EUR 93.7 million, residents of Croatia were prevalent among non-resident purchasers of Slovenian shares. Despite modest net investments in 2013, the proportion of market capitalisation of shares on the Ljubljana Stock Exchange accounted for by non-residents has risen gradually to stand at 15.5% at the end of December, the highest figure in the last five years.

Driven by the extremely positive mood on the foreign capital markets, residents made net investments of EUR 486.6 million in 2013, while they made net sales the previous year. Growth in net investments was the result of higher net purchases of foreign shares by other financial intermediaries and a decrease in net sales of foreign bonds by the banks. Net purchases of foreign shares in the amount of EUR 220.7 million related primarily to purchases of shares of issuers from the former Yugoslav republics, the euro area and Central Europe. Net purchases of foreign bonds in the amount of EUR 265.9 million related primarily to purchases of euro area bonds, in particular by insurance corporations and pension funds. Households restructured their investment portfolios by reducing exposure to high-risk investments. Despite exceptional growth in market prices, households made net sales of foreign shares in the amount of EUR 14.6 million and net purchases of foreign bonds in the amount of EUR 6 million.

Currency risk is rising with the increased scope of investments by residents on the foreign capital markets. Residents made net investments of EUR 161.3 million on non-euro markets in 2013, or 33.1% of total net investments.

Figure 7.14: Monthly net inward investments by non-residents in Slovenia (left) and outward investments by residents to the rest of the world (right) in EUR million




Note: The RS63 government bond issued on the MTS Slovenia system is not included among net purchases made by non-residents in 2008.
Included are investments in listed shares and bonds, and in those not listed on the exchange.
EU3: UK, Denmark and Sweden; EU16: euro area; Ex-YU: former Yugoslav republics.

Sources: CSCC, Bank of Slovenia, own calculations

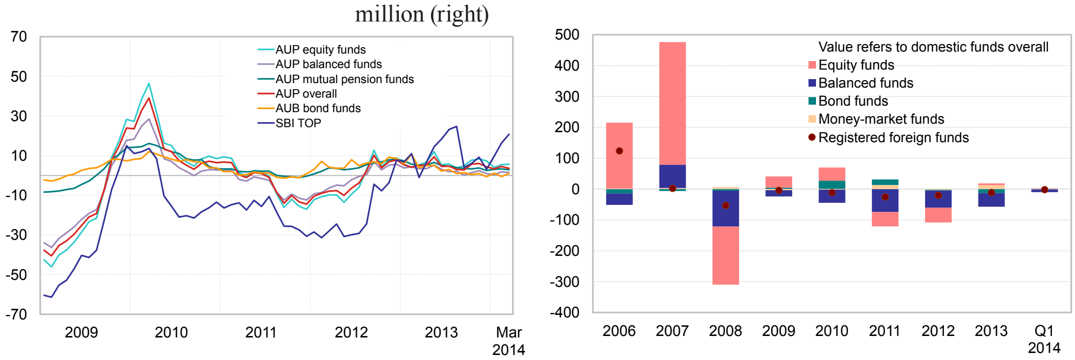
## Mutual funds

**The mutual funds' assets under management increased in 2013 as a result of a rise in the average unit price.**

The mutual funds' assets under management were up 1.3% in year-on-year terms to stand at EUR 1,860.3 million at the end of 2013. The increase was the result of 7.8% growth in the weighted average unit price. At EUR 38.8 million, net withdrawals from mutual funds decreased sharply from the same period last year, when net withdrawals totalled EUR 108.3 million.

With the exception of insurance corporations and pension funds, all investors made net withdrawals from mutual funds. The largest net withdrawals of EUR 15.6 million were made by corporates due to a lack of capital and liquid funds. Households made net sales of mutual fund units for the 44th consecutive month in December due to a loss of confidence in mutual funds, and in particular due to diminishing purchasing power. Households made net sales of mutual fund units in the amount of EUR 13.3 million in 2013, while net withdrawals continued during the first quarter of 2014, albeit at a slower pace. Insurance corporations and pension funds invest a relatively low proportion of assets into mutual funds. The latter find it more effective to place their assets on foreign markets due to the lower management fees. Insurance corporations and pension funds recorded net inflows into mutual funds of just EUR 21.9 million in 2013, a modest amount compared with their direct net investments of EUR 320 million in foreign securities.

Figure 7.15: Year-on-year change in the average unit price (AUP) of mutual funds and the SBI TOP in percentages (left) and inflows into mutual funds in EUR million (right)




Sources: SMA, LJSE, Bank of Slovenia

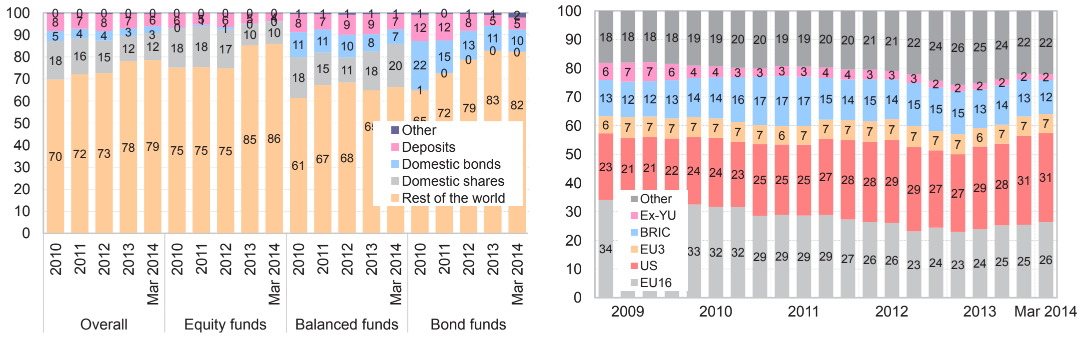
The positive mood on the foreign capital markets meant that investors were more risk-taking, with the exception of households. Net inflows of EUR 5.9 million were made into equity funds, while the majority of net withdrawals (in the amount of EUR 44.1 million) were made from safer, but less profitable balanced funds.

**Despite the prevailing trend of consolidation, several new mutual funds and management companies were established.**

The consolidation of the mutual funds continued in 2013. Management of Abanka's umbrella fund and 12 sub-funds was transferred in September to the acquiring company, Triglav Skladi DZU, which already manages 17 sub-funds in its own umbrella fund. Given their similar investment policies, the previous funds of Abanka were merged with the comparable Triglav mutual fund.

Despite the prevailing trend of merging and closing mutual funds, certain management companies established new mutual funds in 2013. A new management company with authorisation to manage one equity fund began operating.

Figure 7.16: Percentage breakdown of mutual fund investments (left) and regional percentage breakdown of investments in foreign shares by the entire other financial intermediaries sector (right)




Sources: SMA, Bank of Slovenia

### Comparison of Slovenian mutual funds with the euro area

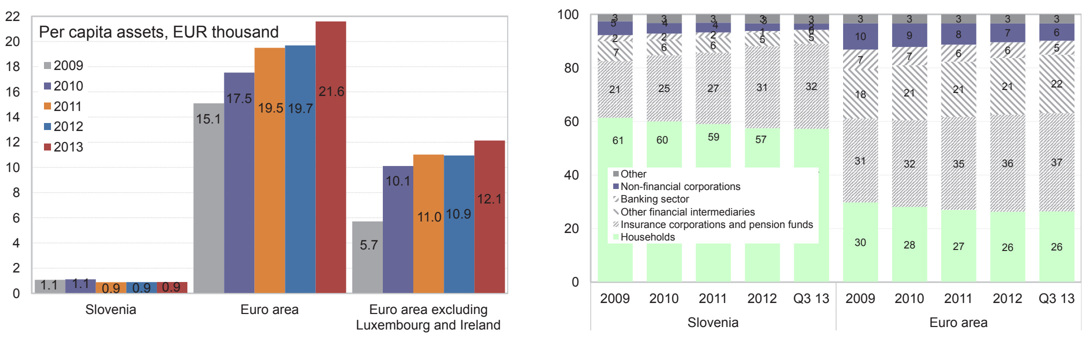
**The value of investment fund assets per capita is significantly higher in the euro area than in Slovenia.**

The domestic mutual funds' assets under management per capita stood at EUR 902 at the end of third quarter of 2013. The euro area average was significantly higher, at EUR 21,599. Excluding Luxembourg and Ireland as key countries of domicile for the issue of investment funds, the average for the remainder of the euro area is EUR 12,137. Assets under management at investment funds were up 9.7% at the end of the third quarter of 2013 in year-on-year terms for the euro area overall, compared with assets under management at domestic mutual funds, which were down 3.9% in the comparable period.

The reasons for the higher average assets under management per capita at investment funds across the euro area lie in better knowledge of investments on the capital markets and the more effective management of investment funds. The latter is the result of lower average management fees due to the economies of scale of investment funds and the more optimal allocation of funds.

The majority of owners of domestic mutual funds are households. The proportion they account for is declining gradually due to net sales of mutual fund units, but remains more than twice the euro area average. The proportion of investment funds held by euro area households is also declining over time, primarily due to an increase in the scope of investments by other investors, in particular insurance corporations and pension funds. The assets of euro area households under management at investments funds was up 8.9% at the end of the third quarter of 2013, while the assets of Slovenian households under management at mutual funds were up merely 0.6% over the same period, exclusively due to growth in the average unit price.

Figure 7.17: Comparison between Slovenia and euro area in investment fund assets per capita, in EUR thousand (left) and percentage breakdown of ownership of mutual/investment fund units/shares (right)




Note: The units/shares of all investment funds (investment companies and mutual funds), both domestic and foreign, are taken into account.
Source: Bank of Slovenia, ECB

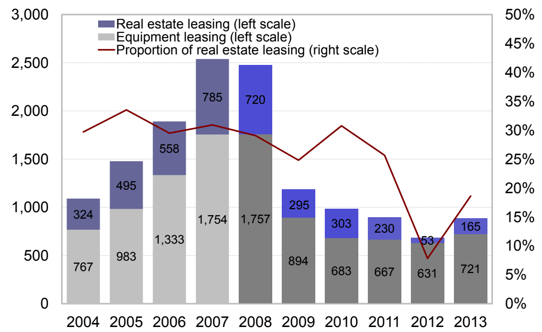
## 7.4 Leasing companies

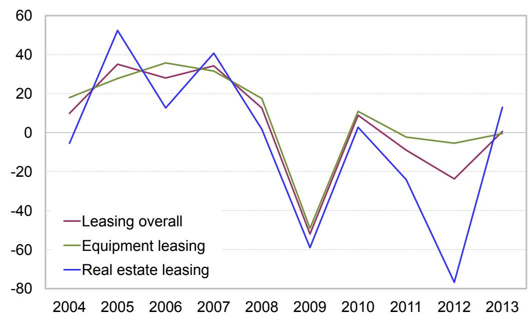
**Leasing business continues to decline, as companies withdraw primarily from the real estate market.**

Leasing business continues to decline as companies withdraw from the real estate market in particular. In addition to low demand, the leasing companies are also facing the continuing deterioration in the quality of their investments and declining asset valuations. The proportion of claims more than 90 days in arrears is increasing. The entire leasing sector was characterised last year by leasing companies that operate with an insufficient level of capital and that are primarily involved in real estate business. Slovenian leasing companies remain more involved in real estate business than their European counterparts. This, along the low liquidity of the real estate market, hinders a more rapid recovery in the Slovenian leasing sector.

According to the figures from the leasing companies' new reporting to the Bank of Slovenia,[38] the stock of leasing business was down 15.6% at the end of 2013 to stand at EUR 3.4 billion. Real estate leasing was down by one quarter to stand at EUR 1.6 billion, while equipment leasing was down 4.5% to EUR 1.7 billion. Demand for leasing has fallen sharply in recent years. The stock of leasing business was just one-third of the new business recorded in 2007, and has fallen to pre-2004 levels. New leasing business amounted to EUR 886 million in 2013. The stock of new leasing business was up slightly on the previous quarter, by 3.7% on average, equipment leasing business having recorded growth of 5.4%. The stock of new real estate leasing business was also up, but the majority of new business was generated by three leasing companies and was presumably intended for the completion of past projects.

Figure 7.18: New leasing business[39] in EUR millions and the proportion accounted for by real estate leasing in percentages (left), and annual growth in new business in percentages (right)




Sources: SLA, BAS, Bank of Slovenia

**Slovenian leasing companies remain more involved in real estate business than their European counterparts.**

The main driver of the leasing sector in the recent years was new car leasing business. At 51%, cars accounted for the majority of new leasing business in 2013, while the leasing of commercial and cargo vehicles has also recorded growth, of 19%. The leasing of real estate, primarily commercial buildings, accounted for 19% of new leasing business. The proportion of leasing business accounted for by real estate leasing was 12 percentage points higher than the European average at Slovenian leasing companies in 2012 [40]. The involvement of Slovenian leasing companies in real estate business was particularly high in 2007 and 2008, when the business environment was more favourable, which exposed the leasing sector to a higher degree of risk. The contraction in economic activity, a drop in prices and the number of transactions on the real estate market, and the deteriorating situation in the construction sector had an adverse effect on the performance of real estate companies.

There was no significant change in the average maturity of new equipment leasing business last year, the majority of which was approved with a maturity of 10 years or less. Of those transactions, 60% of agreements had a maturity of up to 5 years. Nearly one half of new real estate business was concluded as loans with a maturity of up to 1 year. The LTV ratio as measured by the ratio of the approved amount of financing to the value of the subject of the agreement remains high, at 79% for equipment leasing and 94% for real estate leasing.

[38] On 31 December 2012 the Bank of Slovenia introduced mandatory reporting by companies involved in leasing business. Institutions are selected for mandatory reporting on the basis of the materiality of their business, and must provide quarterly figures; the first reports were submitted for the final quarter of 2012. The analysis of leasing companies has been undertaken on the basis of the data from the new reporting, except where stated that it relates to the figures of the BAS's leasing committee to ensure year-on-year comparability.

[39] Leasing business is disclosed at historical cost until 2008 due to the availability of figures, and at financed value since, excluding the financing of inventories since 2010.

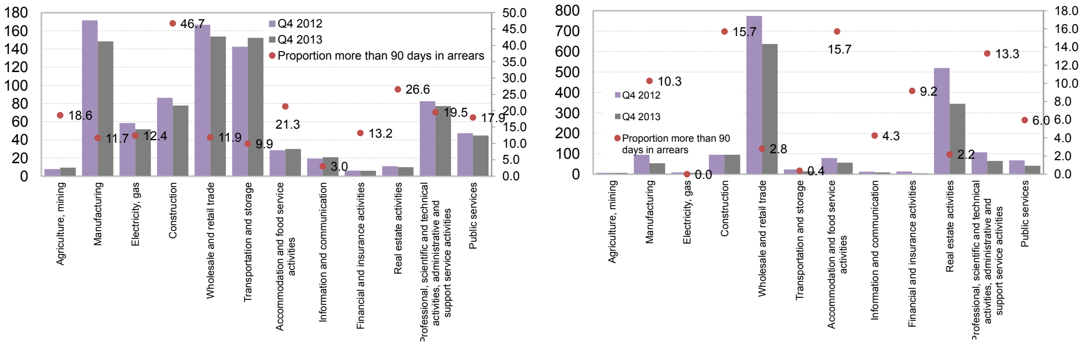
[40] Source: Leaseurope

The stock of leasing business with households amounted to EUR 818 million at the end of last year, 24% of total business. The majority, or 22%, was accounted for by equipment leasing, the proportion of which was down 4 percentage points in year-on-year terms. New leasing business with households totalled EUR 279 million, or 34% of total business. At 5.5% of total business, households account for a small proportion of liabilities more than 90 days in arrears. At 13%, arrears were highest in loans, while that figure averaged 4.1% for finance and operating leasing.

**Leasing business with non-financial corporations accounts for two-thirds of leasing investments.**

At EUR 2.1 billion, business with non-financial corporations accounted for nearly two-thirds of leasing investments at the end of last year. Non-financial corporations accounted for 83% of real estate leasing business and 45% of equipment leasing business. More than one-half or EUR 499 million of new leasing business was concluded with non-financial corporations last year. Three sectors accounted for nearly two-thirds of leasing business: wholesale and retail trade, real estate activities and manufacturing. For corporates, financing via leasing companies represents an alternative form of financing while they make significant debt repayments to banks.

Figure 7.19: Stock of non-financial corporations' leasing business by sector for equipment (left) and real estate (right) in EUR million, and the proportion of the stock more than 90 days in arrears



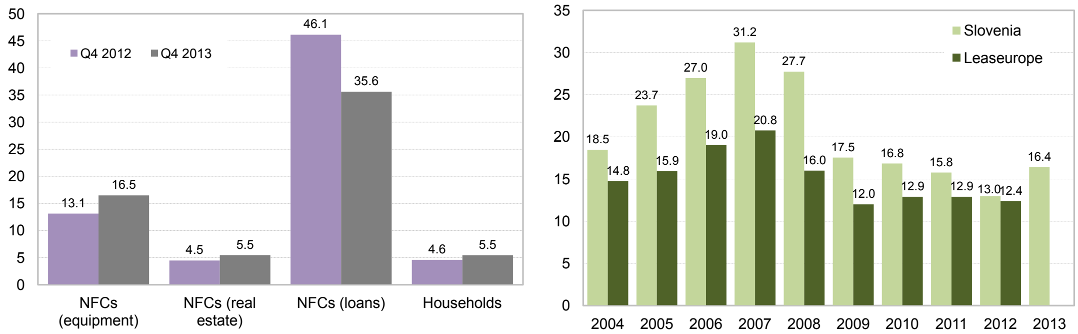

Note: The proportion more than 90 days in arrears for real estate business is 85.3% in the agriculture and mining sector.
Source: Bank of Slovenia

**The proportion of non-financial corporations' liabilities more than 90 days in arrears had risen to 9.5% by the end of 2013.**

Non-financial corporations represent increased credit risk for leasing companies owing to a higher level of exposure in relative terms and also due to the higher proportion of non-performing claims. The proportion of non-financial corporations' liabilities more than 90 days in arrears had risen from 7.2% to 9.5% by the end of 2013. In terms of liabilities more than 90 days in arrears, the construction sector and accommodation and food service activities stand out in real estate leasing, while real estate activities, professional, scientific and technical activities and administrative and support service activities stand out in equipment leasing, in addition to the two aforementioned sectors. While the stock of real estate leasing business was down in nearly all sectors, equipment leasing business was up with firms from the sectors of transportation and storage services and accommodation and food service activities, where the already high proportion of liabilities more than 90 days in arrears was up 6 percentage points last year to stand at 21.3%. Similar to households, loans are prevalent in terms of the proportion in arrears at non-financial corporations. The stock of loans was up 36% in year-on-year terms at the end of 2013 to stand at EUR 171 million, while the proportion of liabilities settled more than 90 days in arrears was down to stand at 35.6%.

The market value of leasing assets repossessed for non-performance of contractual obligations amounted to EUR 160 million, down 5% on the end of 2012. Real estate accounted for the majority (94%).

Figure 7.20: Proportion of the stock of leasing business more than 90 days in arrears (left) and ratio of leasing business to gross fixed capital formation (right) in percentages

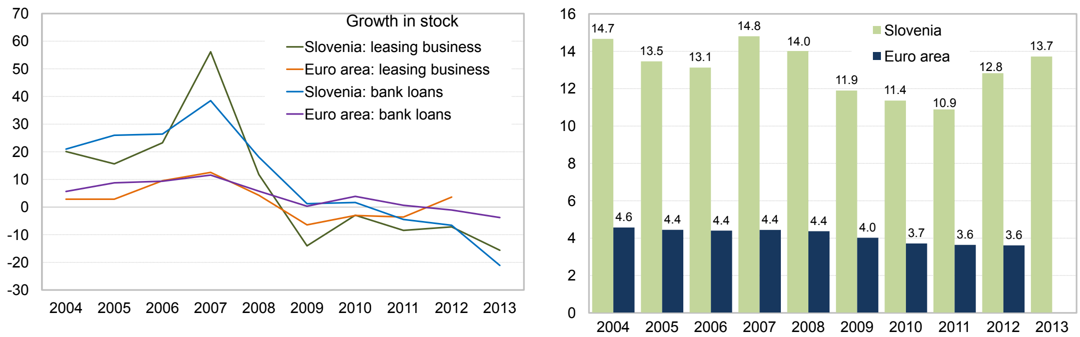



Note: The figures for new leasing business in 2013 used in the ratio of leasing business to gross fixed capital formation are taken from reporting to the Bank of Slovenia (previously the BAS), and includes non-members of the leasing committee, resulting in a higher ratio than in previous years.

Sources: SLA, BAS, Bank of Slovenia, SORS, Leaseurope

First estimates of the stock of new leasing business for 2013 indicate that last year was more encouraging on the European leasing market than the year before, when the stock was down 2.6%. The stock of business was up 1.9% last year. Primarily equipment leasing business was up during the second half of last year. Equipment leasing accounts for an average of 33% of total business in Europe overall, while that proportion is just 5.4% in Slovenia. According to the European Commission's forecast of positive growth in investment, more favourable operating conditions are expected for European leasing companies as early as this year, but not until next year for their Slovenian counterparts. The ratio of leasing business to bank loans was up 0.9 percentage points last year to stand at 13.7%, primarily due to the contraction in loans to the non-banking sector.

Figure 7.21: Growth in the stock of leasing business and bank loans to the non-banking sector (left) and ratio of leasing business to bank loans to the non-banking sector (right) in percentages




Sources: SLA, BAS, Bank of Slovenia, ECB

### Performance of leasing companies

**Leasing companies generated a loss for the fifth consecutive year.**

Slovenian leasing companies recorded a loss for the fifth consecutive year last year. They had merely EUR 5 million in capital last year in the context of total assets of EUR 3,826 million and a loss in the amount of EUR 266 million. The overall performance of leasing companies was sharply negative in 2013 due to the impairments created at the end of the year by two companies. The leasing sector is characterised by leasing companies that operate with an insufficient level of capital and that are primarily involved in real estate business. These companies account for one-half of total assets and contributed significantly to the negative performance of the entire leasing sector last year, which was somewhat more encouraging for the remaining leasing companies. The latter were less exposed to real estate leasing, which accounts for one-quarter of the stock of leasing business. At 6.6%, the proportion of the stock more than 90 days in arrears was one-third lower than the proportion at companies with insufficient capital. The remaining companies increased their capital by 3% in 2013 to EUR 216 million, but still generated losses to a lesser extent, at EUR 44 million.

Table 7.4: Performance of leasing companies and sources of funding

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | Growth. % 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Total assets, EUR million | 5,620 | 5,663 | 5,427 | 5,088 | 4,842 | 3,826 | 0.8 | -4.2 | -6.2 | -4.8 | -21.0 |
| Capital, EUR million | 267 | 200 | 205 | 204 | 114 | 5 | -25.2 | 2.4 | -0.3 | -43.9 | -95.6 |
| Total profit/loss, EUR million | 29 | -33 | -30 | -19 | -121 | -266 | 215.3 | 10.9 | 34.8 | -527.3 | -119.3 |
| ROA, % | 0.6 | -0.6 | -0.5 | -0.4 | -2.4 | -6.9 | | | | | |
| ROE, % | 11.5 | -14.2 | -14.6 | -9.4 | -76.0 | -5311.9 | | | | | |
| Financial and operating liabilities, EUR million | 5,314 | 5,427 | 5,179 | 4,843 | 4,681 | 3,729 | 2.1 | -4.6 | -6.5 | -3.3 | -20.4 |
| liabilities to banks and companies in group / total assets, % | 95 | 96 | 95 | 95 | 97 | 97 | | | | | |
| Investment property, EUR million | 560 | 580 | 836 | 929 | 1,118 | 1,002 | 3.6 | 44.0 | 11.2 | 20.3 | -10.3 |
| investment property / assets, % | 10 | 10 | 15 | 18 | 23 | 26 | | | | | |
| Finance expenses from impairments and write-downs of financial assets, EUR million | 10 | 120 | 167 | 127 | 157 | 192 | | | | | |

Note: The figures from financial statements cover leasing companies included in reporting to the Bank of Slovenia (Bank of Slovenia figures for 2013, previously AJPES figures)

Sources: AJPES, Bank of Slovenia

# 8 FINANCIAL INFRASTRUCTURE

## 8.1 Payment systems

**The TARGET2 payment system's availability was 100% in 2013.**

Given the size of its total transaction value and its role providing liquidity for the banking system, the TARGET2-Slovenija system is an important payment system for financial stability in Slovenia. As the national component of the centralised pan-European payment system for individual (gross) settlement of euro payments in real time (TARGET2), it is operated by the Bank of Slovenia. TARGET2 is technologically set up as a single shared platform of the Eurosystem, and thus central bank oversight of the system's functioning and administration is centralised under the aegis of the ECB. Because certain activities in the operation of this payment system are carried out at national level alone, the Bank of Slovenia conducts additional oversight of the administration of the Slovenian component. TARGET2 operated without disruptions and major deviations again in 2013, and its availability was 100%.

**The TARGET2 payment system was upgraded.**

The development of the functionality of the TARGET2 payment system continued in 2013 within the framework of Eurosystem activities. At the initiative of TARGET2 payment system participants, the new version of the single shared platform introduced new functionalities in the information and control module that will contribute further to more secure and efficient functioning.Due to the TARGET2 payment system's heavy dependence on the SWIFT network, which facilitates the transfer of data as a functionality of the aforementioned payment system, the Eurosystem adopted a decision that the latter's CoreNet network be used as a back-up for the needs of the TARGET2 payment system. A technological solution was put in place in 2013, and has already been included in the TARGET2 payment system's legal framework. Implementation in the production environment will follow in 2014, and will ensure the secure and efficient processing of critical payments in the payment system, even if the SWIFT network is inoperable.

**A data warehouse was set up to be used in analyses of the functioning of TARGET2-Slovenija.**

In 2013 the Bank of Slovenia introduced a data warehouse for the purpose of analysing the functioning of the TARGET2-Slovenija payment system. The constant monitoring of payment flows and changes in the available liquid funds of individual payment system participants by the Bank of Slovenia must also be established within the TARGET2-Slovenija payment system with the aim of identifying potential technical and/or liquidity problems of participants that could disrupt the functioning of the payment system.

Due to the large number of transactions processed daily, the SEPA internal credit transfer (SEPA ICT) payment system operated by Bankart d.o.o. is also important for Slovenia. The system is designed to process retail credit transfers (up to EUR 50,000) in line with the rules of the single euro payments area (SEPA). It functions according to the principles of calculating an individual participant's net claims or net liabilities in the payment system vis-à-vis other participants. The Settlement Guarantee Scheme, which was set up to manage financial risk in the payment system in the event of a participant's inability to settle its liabilities, was again not activated in 2013. The Bank of Slovenia regularly monitored changes in the volume of payments in the SEPA ICT payment system and events that could affect the security and efficiency of the system's functioning. No increases in risk were identified in 2013.

Table 8.1: Value and number of transactions in the TARGET2 and Giro Clearing / SEPA ICT payment systems [41]

| | Annual | | | | | Year-on-year growth, % | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2009 | 2010 | 2011 | 2012 | 2013 | 2009 | 2010 | 2011 | 2012 | 2013 |
| TARGET2[1] | | | | | | | | | | |
| value, EUR billion | 507.6 | 530.1 | 501.0 | 642.3 | 521.0 | 23.7 | 4.4 | -5.5 | 28.2 | -18.9 |
| number of transactions, million | 0.67 | 0.65 | 0.65 | 0.59 | 0.55 | 1.2 | -3.0 | -0.2 | -9.0 | -6.9 |
| Giro Clearing / SEPA ICT | | | | | | | | | | |
| value, EUR billion | 44.9 | 45.4 | 46.7 | 52.0 | 54.9 | -8.6 | 1.2 | 2.9 | 11.2 | 5.6 |
| number of transactions, million | 55.13 | 56.13 | 64.92 | 115.96 | 121.30 | -1.4 | 1.8 | 15.7 | 78.6 | 4.6 |

Note: [1] Transactions between participants in the TARGET2-Slovenija system (domestic payments).
Source: Bank of Slovenia

[41] The SEPA ICT system, which was established on 4 March 2009, replaced the Bank of Slovenia's Giro Clearing system, while the gradual migration of payments to the new payment system took place between the establishment of the SEPA ICT system and the end of July 2009.

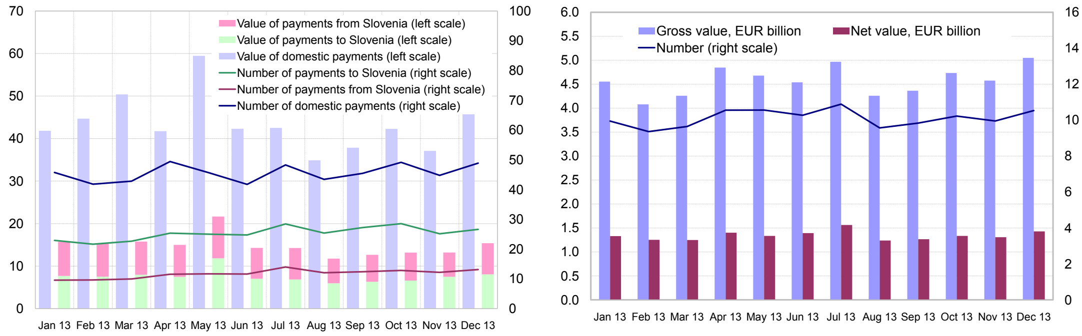
The value and number of transactions in the TARGET2-Slovenija payment system were down in 2013, while the number and value of transactions in the SEPA ICT payment system were up. The total value of transactions in the TARGET2-Slovenija and SEPA ICT systems were 14.1 and 1.6 times Slovenia's GDP respectively in 2013.

**The exceptional decrease in the deposit facility at the ESCB was a factor in the decrease in the value of transactions in the TARGET2-Slovenija system.**

There was a significant decrease in the value of transactions in the TARGET2-Slovenija payment system relative to 2012. In addition to various changes in the value breakdown of transactions, a drop in deposit facility transactions was also key to the aforementioned decrease.

The TARGET2-Slovenija system also facilitates cross-border transactions and thus gives rise to the cross-border transfer of risks, although the volume of these transactions is lower relative to the settlement of domestic payments. The number and value of incoming and outgoing cross-border transactions were up relative to 2012. Contributing most to growth in the number of payments to Slovenia were an increase in the number of payments by the clients of payment system participants (i.e. commercial transactions) and an increase in the value of interbank liquidity transfers, while an increase in the number of (pure) interbank payments and an increase in the value of interbank liquidity transfers contributed to growth in the number of payments from Slovenia.

Figure 8.1: TARGET2-Slovenija: domestic and cross-border payments; value in EUR billion (left axis) and the number in thousand (right axis) and SEPA ICT: value in EUR billion (left axis) and the number in million (right axis)




Sources: Bank of Slovenia, Bankart d.o.o.

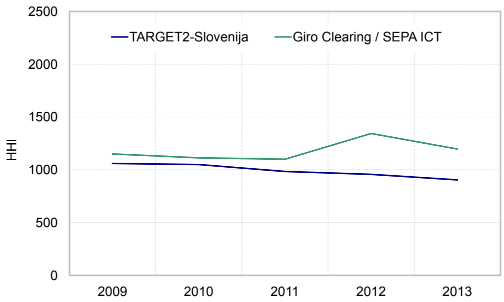
**The main reason for the increase in the number and value of transactions in the SEPA ICT system was the migration of pensions to SEPA credit transfers.**

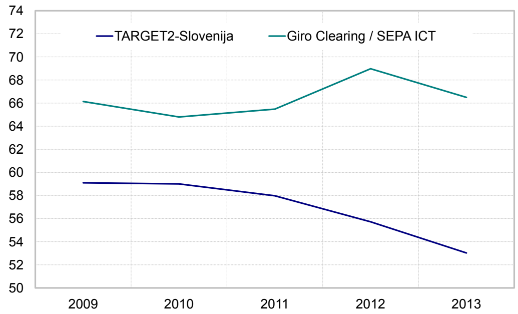
The number and value of transactions in the SEPA ICT payment system increased slightly last year, primarily as the result of the migration of payment transactions for the payment of pensions and similar benefits to SEPA credit transfers. Pension payments, which were executed in the form of direct bilateral credits between the payer and individual banks until November 2012, have been processed in the SEPA ICT payment system since that time in accordance with the decision of the Slovenian banking community.The average offsetting rate in the system was just over 70% in 2013, down nearly 5 percentage points on 2012, when it was almost 75%.The reason for the decline in the offsetting rate was a change in the proportions of the value of transactions processed in the payment system accounted for by participants relative to 2012, primarily due to pension payment transactions in which the Bank of Slovenia serves in the role of the payer's payment service provider.

**Exposure to systemic risk was down in 2013.**

The concentration of the number of transactions by participant as illustrated by the Herfindahl-Hirschman index is an indicator of systemic risk in the payment system. The Slovenian banking sector's exposure to systemic risk diminished in 2013, as the proportions of transactions in the TARGET2-Slovenija and SEPA ICT payment systems accounted for by the five largest participants was down relative to 2012, in addition to the concentration index. Here it should be noted that systemic risk in the settlement of interbank payments is concentrated in the TARGET2-Slovenija payment system due to the separation of large-value payments from retail payments.

Figure 8.2: Concentration of the number of transactions in the TARGET2-Slovenija and Giro Clearing / SEPA ICT systems (Herfindahl-Hirschman Index; left) and proportion of total number of transactions accounted for by the five largest participants (excluding the Bank of Slovenia; right)




Source: Bank of Slovenia

## 8.2 Securities clearing and settlement systems

The services of securities clearing and settlement in Slovenia are provided by the Central Securities Clearing Corporation (CSCC), a systemically important institution in the post-trading segment of the securities market that provides for the issuance of securities, the settlement of securities transactions concluded on the Ljubljana Stock Exchange and outside the regulated market, the administration of share registers and the management of security holders' accounts.

As the oversight authority for securities settlement systems, the Bank of Slovenia's activities in 2013 focused on the regular monitoring of changes in the functioning of the CSCC and an assessment of the security and reliability of the CSCC's functioning in accordance with Eurosystem oversight standards. With regard to the regular monitoring of changes in the functioning of the CSCC, the Bank of Slovenia issued two opinions in relation to the SMA in the scope of consultations in accordance with the ZTFI. During the second half of the year, the Bank of Slovenia initiated its first comprehensive examination of the functioning of the securities settlement system operated by the CSCC with respect to the new Eurosystem oversight standard adopted in June 2013. The assessment was completed in early 2014 and indicated that the functioning and operation of the securities settlement system by the CSCC are organised in such a way that the requirements of the aforementioned oversight standards are met to a great degree. The CSCC was also issued recommendations to improve the security and reliability of the securities settlement system. The CSCC functioned again in 2013 without notable deviations from its established schedule of operation. The guarantee fund, which the CSCC uses in the event of participants encountering liquidity problems in the settlement of stock exchange transactions, was not activated during the year.

**The Bank of Slovenia monitors risk management in the securities settlement system.**

On the basis of the Statute of the ESCB, all credit operations of ESCB central banks must be fully secured by means of eligible collateral, including securities registered at the CSCC. In this respect, the secure and reliable functioning of the CSCC is important to the Bank of Slovenia in terms of the uninterrupted management of collateral for the credit operations of the Bank of Slovenia and other ESCB central banks that have access to the securities registered at the CSCC by means of the correspondent central banking model (CCBM). For this reason the Bank of Slovenia periodically assesses the compliance of the CSCC's functioning with Eurosystem special reference standards, in conjunction with the ECB. To this end, the Bank of Slovenia prepared a user assessment in 2013 of the cross-border links between the securities settlement system operated by the CSCC and the foreign securities settlement system operated by Euroclear Bank, a central securities depository established in Belgium, and issued recommendations in 2014 on the basis of the findings of the assessment.

**The use of eligible securities registered with the CSCC as collateral for Eurosystem credit operations remains high.**

Slovenian banks and savings banks pledged a monthly average of EUR 2,829 million in eligible securities registered at the CSCC as collateral in 2013, down EUR 13.64 million or 0.48% on 2012. The use of this form of eligible collateral (which also includes bank loans and cash deposits) remains extensive, its value fluctuating in 2013 between a low of EUR 2,605 million in September and a high of EUR 3,002 million in May. Foreign banks' interest in using securities registered at the CSCC waned in 2013. The average monthly value of Slovenian securities used as collateral for the credit operations of other ESCB central banks decreased by EUR 41.03 million or 14.08% in 2013 to EUR 250.46 million.