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Contents

CONCLUSIONS	ix
1. MACROECONOMIC ENVIRONMENT	1
1.1 International environment	1
1.2 Economic developments in Slovenia	2
1.3 Real estate market	4
2. RISKS IN THE BANKING SECTOR	8
2.1 Credit risk and bank lending activity	8
2.2 Income statement and income risk	29
2.3 Interest rate risk	32
2.4 Funding risk	34
2.5 Bank solvency	41
3. NON-BANKING FINANCIAL INSTITUTIONS	46
3.1 Leasing companies	46
3.2 Insurers	48
3.3 Capital market and mutual funds	51
4. MACRO-PRUDENTIAL SUPERVISORY MEASURES	55
4.1 Monitoring of macro-prudential supervisory measures	55
4.2 Macro-prudential policy strategy	59
4.3 Introduction of new macro-prudential instruments in 2015	60

List of tables, figures, boxes and abbreviations:

Tables:

Table 1.1:	Bank of Slovenia's overview of risks in the Slovenian banking system	ix
Table 1.1:	European Commission forecasts of selected macroeconomic indicators for Slovenia's main trading partners	1
Table 2.1:	Proportion of transitions of SMEs and large enterprises between credit ratings, taking into account the number of customers, in percentages	11
Table 2.2:	Arrears in classified claims by sector, in EUR million and percentages	12
Table 2.3:	Coverage of classified claims and claims more than 90 days in arrears by impairments and provisions, in EUR million and percentages	16
Table 2.4:	Credit protection of claims more than 90 days in arrears in September 2015 by bank group, in percentages	17
Table 2.5:	Restructured classified claims and claims more than 90 days in arrears against non-financial corporations by sector, in EUR million and percentages	18
Table 2.6:	Itemisation of exposures and NPEs according to EBA definition as at 30 June 2015, in EUR million and percentages	20
Table 2.7:	Banking sector income statement, September 2015	30
Table 2.8:	Breakdown of capital requirements for credit risk, in percentages	44
Table 3.1:	Performance and funding of leasing companies	48
Table 3.2:	Overview of Slovenia's regulated capital market	52
Table 4.1:	Level and decline of LTD ratio of banking system and bank groups, basic indicator and excluding effects of recovery, i.e. excluding Factor banka and Probanka, and excluding the transfer of non-performing claims to the BAMC	56

Figures:

Figure 1.1:	Year-on-year growth in quarterly GDP in percentages (left) and commodity price indices, 2005 = 100 (right)	2
Figure 1.2:	Year-on-year inflation as measured by the HICP (left) and required yield on government bonds (right), in percentages	2
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 fixed prices in percentages (right)	3
Figure 1.4:	Saving rate, and ratios of investment and saving to GDP (left) and surveyed and registered unemployment rates (right), in percentages	3
Figure 1.5:	Net financial position of institutional sectors as percentage of GDP in terms of stock (left) and annual transactions (right)	4
Figure 1.6:	Net financial position against the rest of the world by economic sector (left) and by instrument (right), as a percentage of GDP	4
Figure 1.7:	Annual growth in prices of used and new-build residential real estate in Slovenia (left), and the basic housing price index (2010 = 100) (right), in percentages	5
Figure 1.8:	Percentage ratio of housing prices to net monthly wage in Ljubljana (left), and price to rent (P/E) ratio in Ljubljana (right)	5
Figure 1.9:	Housing loans to households in EUR million (left), and construction confidence indicator and annual growth in gross investment in housing and other buildings and infrastructure (right)	6
Figure 1.10:	Breakdown of new loans by type of remuneration (left), and fixed and variable interest rates on new housing loans (right)	7
Figure 2.1:	Classified claims and claims more than 90 days in arrears (left), and claims more than 90 days in arrears by bank group and customer segment in September 2015 (right), in EUR million	9
Figure 2.2:	Arrears of more than 90 days as a proportion of the banks' classified claims by bank group (left) and customer segment (right)	9
Figure 2.3:	Concentration of all debtors more than 90 days in arrears (left), and distribution of classified claims against the corporate sector more than 90 days in arrears by number of corporates (right) in September 2015	10
Figure 2.4:	Arrears of more than 90 days by corporate size (left) and proportion of claims more than 90 days in arrears by corporate size (right), in EUR million and percentages	12
Figure 2.5:	Number of initiated bankruptcy proceedings at year-end (left), and banks' classified claims against non-financial corporations in bankruptcy and proportion of total claims against non-financial corporations by sector accounted for by non-financial corporations in bankruptcy (right), in EUR million and percentages	13
Figure 2.6:	Leverage of all corporates and corporates against which banks hold classified claims in percentages (left), and financial debt of active firms and corporates in bankruptcy on bank balance sheets at the end of 2014 (right)	14
Figure 2.7:	Corporate debt-to-equity ratio (left), and comparison of corporate indebtedness with the euro area in 2014 (right), in percentages	15

Figure 2.8:	Leverage in percentages (left), and net financial debt to EBITDA in years (right) in selected sectors	15
Figure 2.9:	Coverage of unimpaired claims more than 90 days in arrears by capital (left), and coverage of claims more than 90 days in arrears by impairments and provisions (right), in EUR million and percentages	16
Figure 2.10:	Coverage of the banks' total classified claims (left), and coverage of claims more than 90 days in arrears (right) by credit protection, in percentages	17
Figure 2.11:	Write-offs of financial assets at banks, in EUR million	19
Figure 2.12:	Arrears of more than 90 days compared with non-performing claims, June 2015	21
Figure 2.13:	Breakdown of bank investments (left), and year-on-year growth in loans (right), in percentages	23
Figure 2.14:	New corporate loans in EUR million (left), and breakdown of long-term corporate loans in percentages and average maturity of long-term corporate loans in years (right)	24
Figure 2.15:	Year-on-year growth in loans to non-financial corporations by bank group (left), and loans to households by type (right), in percentages	24
Figure 2.16:	Credit standards for corporate loans as measured by survey (left), and factors affecting credit standards (right)	25
Figure 2.17:	Interest rates on corporate loans of up to EUR 1 million, comparison with the euro area (left), and spread over reference interest rate on new long-term loans by risk level and by corporate size (right), in percentages	25
Figure 2.18:	Credit standards for housing loans to households (left), and factors affecting demand for housing loans (right)	26
Figure 2.19:	Growth in demand and rate of excess demand for loans, in percentages	27
Figure 2.20:	Demand for loans by bank group in EUR million (left), and percentage breakdown of demand for loans (right)	27
Figure 2.21:	Excess demand for loans and rate of excess demand by bank group in EUR million (left), and percentage breakdown of excess demand for loans (right)	28
Figure 2.22:	Growth in demand for loans by sector in 2013 and 2014, in percentages	28
Figure 2.23:	Growth in demand by loan type (left), and frequency of most common reasons for denial of loans (right), in percentages	29
Figure 2.24:	Net interest margin on interest-bearing assets by bank group in Slovenia (left), and net interest margin in selected central European countries (right), in percentages	30
Figure 2.25:	Net interest margin and contribution made by changes in interest rate spread and gain/loss on net interest position (left), and interest rate spread, net interest margin and contribution to change in interest rate spread made by change in asset and liability interest rates (right), 1998 to September 2015	31
Figure 2.26:	ROE, net interest margin on interest-bearing assets and ratio of impairment and provisioning costs to total assets, 1998 to 2015, in percentages (left), and impact of four factors on developments in ROE: decomposition of ROE, 2008 to 2015 (right)	32
Figure 2.27:	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)	33
Figure 2.28:	Gap between interest-sensitive assets and interest-sensitive liabilities by individual bucket, in EUR million	34
Figure 2.29:	Changes in total assets and changes in wholesale funding in EUR million (left), and breakdown of bank funding in the Slovenian banking system (right)	35
Figure 2.30:	Growth in deposits by the non-banking sector (left), and LTD ratio for the non-banking sector by bank group (right), in percentages	36
Figure 2.31:	Annual growth in household deposits in percentages (left), and breakdown of changes in stock of household deposits by bank group in EUR million and percentages (right)	36
Figure 2.32:	Breakdown of deposits by the non-banking sector by sector (left) and by maturity (right)	36
Figure 2.33:	Year-on-year growth in loans to (left) and deposits by (right) non-financial corporations in selected euro area countries, in percentages	37
Figure 2.34:	Ratio of deposits by non-financial corporations to total liabilities across the banking system (left), and proportion of total deposits at banks by non-financial corporations accounted for by sight deposits (right), in percentages	38
Figure 2.35:	Proportion of financial assets of non-financial corporations accounted for by deposits in selected euro area countries, in percentages	38
Figure 2.36:	Breakdown of financial assets of non-financial corporations in Slovenia and the euro area overall (left), and in Portugal and Austria (right), in percentages	38
Figure 2.37:	Average cost of bank debt funding overall and 3-month EURIBOR (left), and average debt funding cost for banks by primary source/instrument (right), in percentages	39
Figure 2.38:	Daily first-bucket and second-bucket liquidity ratios (left), and stock of marketable secondary liquidity (monthly averages) in EUR million and ratio of marketable secondary liquidity to total assets in percentages (right)	40
Figure 2.39:	Proportion of the banking system's total liabilities accounted for by sight deposits (left), and coverage of sight deposits by liquid assets in the first and second buckets (right)	40
Figure 2.40:	Banks' claims and liabilities vis-à-vis the Eurosystem in EUR million and proportion of the pool of eligible collateral that is free (left), and stock of unsecured loans of Slovenian banks placed and received on the euro area money market (right)	41

Figure 2.41: Banking system's basic capital adequacy ratios on an individual basis, in percentages	42
Figure 2.42: Total capital ratio (left) and common equity Tier 1 capital ratio (right) on an individual basis by bank group, in percentages	42
Figure 2.43: Ratio of book capital to total assets on an individual basis by bank group, monthly figures, in percentages	43
Figure 2.44: Structure of regulatory capital (left) and structure of common equity Tier 1 capital (right) across the banking system on an individual basis, in percentages	43
Figure 2.45: Risk weights by credit exposure class on individual basis, in percentages	44
Figure 2.46: Total capital ratio (left) and Tier 1 capital ratio (right) of the Slovenian banking system compared with the euro area, figures on a consolidated basis, in percentages	45
Figure 2.47: Total capital ratio (left) and Tier 1 capital ratio (right) compared with the EU, figures by bank group on a consolidated basis, in percentages	45
Figure 2.48: Distribution of the ratio of book capital to total assets (left) and the ratio of capital requirements to total assets (right) for euro area countries, figures on a consolidated basis, in percentages	45
Figure 3.1: New leasing business in EUR millions and proportion accounted for by real estate leasing in percentages (left), and annual growth in new business, in percentages (right)	46
Figure 3.2: 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	47
Figure 3.3: Stock and proportion of leasing business more than 90 days in arrears in EUR million and percentages (left), and growth in stock of leasing business and bank loans to the non-banking sector in percentages (right)	47
Figure 3.4: Net profit in EUR million and total assets (2008 = 100) (left), and gross written premium by type of insurance in EUR million and annual growth in percentages (right)	49
Figure 3.5: Structure of insurers' assets covering mathematical provisions (left), and assets covering technical provisions other than mathematical provisions (right), in percentages	50
Figure 3.6: Proportion of the total investments of insurance corporations and pension funds accounted for by foreign investments, in percentages (left), and claims ratio of major insurance classes (right)	50
Figure 3.7: Year-on-year change in domestic (left) and foreign (right) stock exchange indices, in percentages	51
Figure 3.8: Market capitalisation on the Ljubljana Stock Exchange in EUR billion, and annual turnover ratios (left), and issuance of corporate bonds and commercial paper, net values and number of issues (right)	52
Figure 3.9: Monthly net inward investments by non-residents (left) and outward investments by residents (right), in EUR million	53
Figure 3.10: Net inflows into investment funds by sector (left) and net cash flow by type of investment fund (right), in EUR million	53
Figure 3.11: Year-on-year change in the average unit price of investment funds and the SBI TOP (left), and regional breakdown of investments in foreign shares by the entire other financial intermediaries sector (right), in percentages	54
Figure 4.1: Number of banks failing to meet GLTDF $\geq 0\%$ or GLTDF $\geq 40\%$ in the wake of a positive annual increase in deposits	55
Figure 4.2: LTD ratio of banking system and bank groups (left), and excluding effects of recovery, i.e. excluding the transfer of non-performing claims to the BAMC and excluding Factor banka and Probanka (right)	56
Figure 4.3: Annual changes in the LTD ratio and contribution of individual components of loans to or deposits by the non-banking sector to the change in the LTD ratio for the banking system and the bank groups, in percentage points	57
Figure 4.4: Distribution of LTD ratio of individual banks (left) and comparison of LTD ratio (loans before impairments, excluding government sector) with distribution across other euro area countries (right), in terms of 20 th /33 rd /66 th /80 th percentile	58
Figure 4.5: GLTDF of banking system and bank groups (left), and excluding Factor banka and Probanka and exemptions related to the transfer of non-performing claims to the BAMC and write-offs (right)	58
Figure 4.6: Breakdown of the banking system's liabilities, in percentages (left), and shortfall in liquid investments for each bank to meet the LR2 (fourth corrective measure) by bank group, in EUR million (right)	59

Boxes:

Box 2.1: Comparison of the definition of non-performing exposures under EBA regulations and the definition of arrears of more than 90 days announced by the Bank of Slovenia	20
Box 2.2: Activities carried out and in progress within the framework of the project for the restructuring of non-performing exposures at banks	21
Box 2.3: Results of the survey on demand for loans from non-financial corporations in 2015	27
Box 2.4: Liquidity assets at non-financial corporations	37

Abbreviations:

AJPES	Agency of the Republic of Slovenia for Public Legal Records and Related Services
SMA	Securities Market Agency
ISA	Insurance Supervision Agency
RTGS (system)	Real-Time Gross Settlement
BRIC	Brazil, Russia, India, China
BoS	Bank of Slovenia
CCBM	Correspondent Central Banking Model
OFIs	Other financial institutions
TARS	Tax Administration of the Republic of Slovenia
DSs	Debt securities
AMCs	Asset management companies
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
EU16	Euro area
EU27	EU Member States
EU3	European Union Member States prior to enlargement of 1 May 2004 that are not members of the euro area (Denmark, Sweden, UK)
EU8	Poland, Hungary, Czech Republic, Slovenia, Slovakia, Estonia, Latvia, Lithuania
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
SMARS	Surveying and Mapping Authority of the Republic of Slovenia
ICs	Investment companies
IFs	Investment funds
CSCC	Central Securities Clearing Corporation
TR	Turnover ratio
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
IMF	International Monetary Fund
IFRS	International Financial Reporting Standards
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
P/E	Price-to-earnings ratio
PID	Authorised investment company (privatisation fund)
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 concluded between Slovenian credit institutions and euro area credit institutions
SKD	Standard classification of economic activities (national version)
Slonep	Slovenian real estate portal (www.slonep.net)
SAS	Slovenian Accounting Standards
HFRS	Housing Fund of the Republic of Slovenia
SORS	Statistical Office of the Republic of Slovenia
S&P	Standard and Poor's
AUP	Average unit price of a mutual fund

MF	Mutual fund
Vzajemci.com	Portal of Slovenian mutual funds (www.vzajemci.com)
WFE	World Federation of Exchanges
BAS	Bank Association of Slovenia
Z-Doh	Personal Income Tax Act
AMC	Association of Management Companies
SLA	Slovenian Leasing Association
PDII	Pension and Disability Insurance Institute

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

Over the last year and a half, economic development has provided encouragement for the recovery of the real sector and an improvement in the outlook for the financial sector. The stabilisation of the situation in the banking system is continuing. Credit risk is diminishing, but remains significant on account of portfolio segments that are still heavily burdened by non-performing claims. Bank profitability is improving, primarily as a result of the favourable impact of diminishing credit risk. This remains relatively high, owing to the difficulty of achieving required returns in an environment of low and falling interest rates. The quest for higher returns as the maturity of high-yielding investments in securities approaches could lead to an renewed increase in credit risk. The declining dependence on wholesale funding and the increased stability of the funding structure, which is primarily based on domestic resources, are contributing to an additional decline in refinancing risk, while at the same time the shortening of the average maturity of funding is increasing the instability of its structure. The shortening of the average maturity of funding is not directly increasing liquidity risk at the banks, since with high secondary liquidity they can bridge the maturity mismatch between funding and investments. The widening of the maturity gap and the increasing proportion of investments with fixed interest rates are increasing interest rate risk at the banks.

Table 1.1: Bank of Slovenia's overview of risks in the Slovenian banking system

Systemic risk	Risk assessment		Trend in risk	Commentary
	for Q4 2014	for Q1 2015		
Macroeconomic risk			→	Economic growth remains mostly driven by export growth, while the recovery of private consumption means that the structure of economic growth is becoming more balanced. By contrast, the dynamics in government investment mean that the contribution made to economic growth by the government will decline.
Real estate market			→	New loans are increasing, although the rate of growth is slowing. Growth in volume also slowed. The fall in prices of residential real estate came to an end, and a reversal in the dynamics is possible. The LTV ratio for new loans in the third quarter of 2015 was up both in quarterly terms and in year-on-year terms.
Credit risk			↓	Credit risk stabilised in the third quarter, the proportion of claims more than 90 days in arrears remaining at 11.1%. The highest figures were again recorded by the non-financial corporations sector, where SMEs had the heaviest burden of claims more than 90 days in arrears. Coverage of claims more than 90 days in arrears by impairments and capital is improving. Coverage by credit protection is also improving.
Income risk			→	Remains relatively high owing to the adverse conditions for generating banking income. A fall in lending rates and increased difficulty in achieving required returns, as lending contracts. A slowdown in the fall in liability interest rates and an additional fall in returns on securities. Operating costs are continuing to fall, but are increasing relative to gross income. Favourable developments in impairment and provisioning costs.
Funding risk			→	Remains at a relatively low level. The banks have high excess liquidity, a high proportion of unencumbered collateral, and thus a potential source of liquidity at the ECB. The proportion of wholesale funding is declining, and the repayment burden has diminished with regard to the residual maturity of the maturing debt. Deposits by the non-banking sector are recording positive growth, while growth in household deposits is solid. The LTD ratio for the non-banking sector has stabilised. The proportion of sight deposits has increased further: potential instability in funding.
Contagion risk and large exposures			→	Contagion risk declined over the first three quarters of 2015, both in terms of scale and in terms of the number of potential contagions. Concentration risk remains significant in the context of the large proportion of investments in government securities. It will decline if the banks are able to diversify their assets into investments in other securities as the aforementioned securities mature.
Solvency risk			→	The capital adequacy of the Slovenian banking system improved over the first three quarters of 2015, and remains above the EU average. The increase in own funds is the result of the banking system's profitability and the recapitalisation of certain banks. The contraction in capital requirements slowed slightly. The small domestic banks remain the most vulnerable in capital terms, despite a gradual improvement in their capital adequacy.

Traffic light code:



Source: Bank of Slovenia

The economic recovery is having a favourable effect on the financial position of corporates and their creditworthiness. After years of concerted debt repayment, in many sectors the high corporate indebtedness has returned to the level seen before the start of rapid increase in leveraging. In other sectors and segments of the economy the level of indebtedness remains high. An important component in reviving the credit cycle is an improvement in the structure of financing through growth in capital, and not merely a reduction in debt.

The banks are showing greater caution in lending to small and medium-sized enterprises (SMEs), which has been reflected in the rising spread in interest premiums compared with large enterprises. A significant portion of the banks' non-performing portfolio (more than 40%) is concentrated in this category of corporates, but it is a very heterogeneous customer group. For this reason the banks need greater customer diversification in terms of their attributes, both in resolving non-performing claims and in lending. A differentiated approach is also needed for customers that have easier access to external markets and are more sensitive to the competitive conditions in the rest of the world.

Identifying the right opportunities for financing would additionally help to increase the healthy portion of the portfolio and to improve its quality. The banks are encouraging household borrowing, via a modest easing of credit standards and more favourable loan terms. The revival in volume on the real estate market, in the wake of the end to years of falling real estate prices, points to buyers taking the view that conditions are better now for buying real estate, and that livelier growth in the market may now be expected.

The persistently high proportion of non-performing claims on bank balance sheets is a significant factor contributing to the maintenance of high credit standards. The potential easing of standards and more favourable lending terms should only be enjoyed by firms whose loans would contribute to an increase in the quality of the entire bank portfolio. That the indebtedness and creditworthiness indicators of corporates being financed at banks are more favourable than those for the corporate sector overall reveals that assessment of customers has been more cautious in recent years than in the past.

Although there has been a continued reduction in non-performing claims, both in absolute and relative terms, **credit risk remains relatively high**. Via higher corporate profitability and increased debt servicing capacity, the favourable effects of economic growth are reducing the increase in new claims more than 90 days in arrears, and raising the rate of transition from non-performing to performing claims. The banks are more actively managing the non-performing portion of the portfolio via restructuring and increased write-offs. Despite the favourable trends in the economy, SMEs and non-residents continue to record larger non-performing claims, in absolute terms and in terms of proportion. The recently adopted guidelines for managing non-performing claims against SMEs should serve as guidance for senior managers at commercial banks in the thorough restructuring of this portion of the portfolio.

The high proportion of non-performing claims entails higher credit risk, when it is combined with low coverage of such claims by impairments and with low coverage of unimpaired claims by capital. Both coverage indicators are at a relatively high level in the Slovenian banking system, both in terms of historical value and compared with other euro area countries. The intensive creation of impairments and provisions in previous years, which temporarily contributed to large losses, increased the stability of the banking system and reduced the risk of substantial credit risk losses in the future. Despite high coverage by impairments, the large proportion of non-performing loans is nevertheless reducing the capacity of the banks to generate income.

Capital adequacy, which since the latest recapitalisations by the government has surpassed the euro area average, has provided banks with increased resilience in the event of major shocks. In 2015 capital adequacy was additionally increased by the generation of internal capital via profitability. In the wake of low and declining lending activity and low interest rates, the generation of profit, and thereby capital, is limited. An important part in maintaining capital adequacy thus still falls to the optimal use of existing capital, which did not significantly improve in the first half of 2015, in light of the breakdown of capital requirements for credit risk. Here there are still individual banks that are not achieving appropriate levels, both in terms of capital adequacy and in terms of coverage of unimpaired non-performing claims.

The increase in portfolio quality is having a favourable impact on the banks' profitability via lower impairment and provisioning costs. **Income risk** nevertheless remains **relatively high**. The profitability of the unimpaired portion of non-performing claims is markedly lower than the remainder of the portfolio, which is forcing banks to seek higher returns from other investments. Low and falling interest rates, and the decline in the interest spread simultaneous with the contraction in interest-bearing assets and liabilities – the latter owing to a shortening of the average maturity of funding – are contributing to the persistence of income risk into the future. The banks themselves are also contributing to the maintenance of low interest rates through the placement of excess liquidity on the market, including in lower-yielding investments. In seeking greater returns, the banks are directing funds into longer-term investments with very low interest rates. As the average maturity of investments lengthens and the average maturity of funding shortens, an adequate stock of secondary liquidity is becoming increasingly important. In the wake of these developments, the banks are becoming more exposed to both interest rate risk and income risk, and also to credit risk in relation to higher-risk investments. The growing burden on the banks from regulatory and reporting requirements, which are raising operating costs, is also having an adverse impact on bank profitability.

After several years of debt repayment by the banks, financial dependence on the wholesale markets has fallen considerably, while the maturity structure of the maturing remaining debt is more favourable than in previous years. High excess liquidity and the availability of liquidity via the ECB's non-standard measures are having a beneficial impact in **reducing funding risk**. The proportion of funding accounted for by deposits by the non-banking sector is increasing, but as interest rates fall the maturity structure is shifting towards sight deposits. Sight deposits account for fully 70% of corporate deposits, and more than half of household deposits. The stability of sight deposits, especially those of households, is relatively high, but there are no reliable forecasts of future trends in the context of historically low interest rates. In the wake of the latest developments in the real estate market, which suggest growth in investment in real estate, and the macroeconomic forecasts of increased household consumption, there is increasing likelihood of the redirection of a portion of deposits from savings to investment and consumption. Positive economic growth will also increase the likelihood of the partial redirection of corporate deposits towards investment, and a revival of demand for loans. However, the banks will only be ready to follow up on the supply side in the wake of a concomitant increase in own funds and equity on corporate balance sheets. A higher share of equity on corporate balance sheets entails not just a more stable structure of financing, but also greater capacity on the part of the corporate sector in managing the business risks taken up.

The shortening of the average maturity of funding is **not directly increasing liquidity risk** at the banks, since the banks' high secondary liquidity can serve to cover past-due liabilities and to bridge the maturity mismatch of funding and

investments. However, **interest rate risk is increasing** at the banks as a result of the simultaneous lengthening of the average maturity of investments. The gap between the average repricing periods for asset and liability interest rates is widening across the banking system, largely via the lengthening of the repricing period on the asset side, and less via a shortening on the liability side. By lengthening the average maturity of investments, thereby partly mitigating the effects of falling interest income, and increasing the proportion of investments with fixed interest rates, the banks have been widening the gap in the maturing of claims and liabilities, since a rise in interest rates will be reflected in interest expenses before interest income. Given the lengthening average maturity of investments and the predominant proportion of loans approved with variable interest rates, greater caution is required in the assessment of debtors' debts servicing capacity in the conditions of a probable rise in interest rates. In the quest for returns, the question of where banks will direct excess liquidity is also becoming significant, particularly in the sense of avoiding, in the desire to diversify and reduce concentration risk, a further increase in their exposure to interest rate risk, or to risks that are poorly understood and managed.

EXECUTIVE SUMMARY

The situation in the banking system improved in 2015, as a result of the effects of the bank stabilisation measures and the stabilisation of the macroeconomic environment in which the banks and their customers operate. More than in previous years, economic growth was based on final consumption in addition to exports, which could encourage an increase in household lending and the revival of the real estate market.

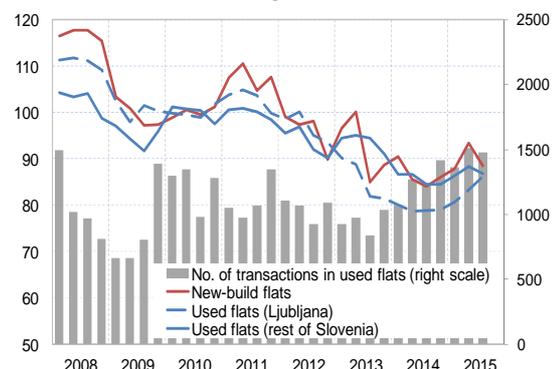
The recovery on the real estate market is continuing. Transactions in residential real estate and new housing loans are increasing, albeit slightly more slowly than in previous months. Favourable loan terms at banks, lower interest rates and an easing of credit standards are encouraging higher demand for housing loans. The fall in real estate prices seen over several years has come to an end: the SORS figures reveal renewed growth in the first half of 2015. As prices rise, housing affordability as measured by the ratio of prices to net wages has declined again slightly. In the wake of increased demand, the lack of construction of new-build housing in recent years could contribute to further rises in real estate prices.

Of the key risks in the banking system, credit risk remains at a relatively high level, albeit with a declining trend. The proportion of claims more than 90 days in arrears had declined to 11.1% of the banks' classified claims by the third quarter of 2015. Non-residents and non-financial corporations, most notably SMEs, remain the most heavily burdened segments of the portfolio. SMEs account for 42% of total claims more than 90 days in arrears, and 26.7% of claims against SMEs are more than 90 days in arrears. The corresponding figure in the large enterprises segment declined to 10.3% after significant transfers to the BAMC and restructuring processes under MRAs. In 2015 the banks actively reduced non-performing claims against corporates and non-residents via write-offs and restructuring. The success of restructuring as measured by the proportion of claims that again fell into arrears after restructuring varies from customer category to customer category: the best performance was in manufacturing, where the economic recovery has also been strongest. The economic recovery process is also having a beneficial impact on portfolio quality via a smaller increase in non-performing claims and a higher level of transitions from non-performing to performing claims.

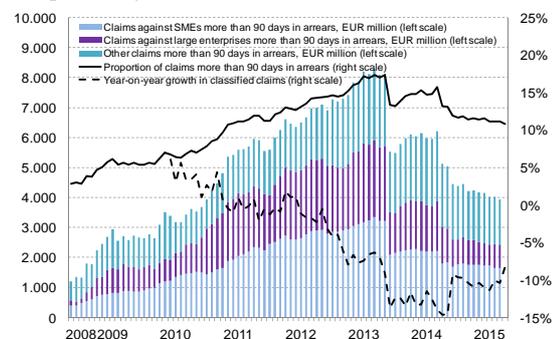
Coverage of claims more than 90 days in arrears by impairments is relatively high at 63%, with a trend of increase. Coverage of the unimpaired portion of claims more than 90 days in arrears by capital is also high. Before the stabilisation of the banking system was begun, the level of capital did not suffice to cover unimpaired claims more than 90 days in arrears, but by September 2015 it was 3.5 times in excess. Both indicators of coverage of non-performing claims are having a significant impact on the banks' resilience in the event of major unforeseen deteriorations in the credit portfolio.

Certain indicators of corporate lending suggest a more favourable dynamic in the future. Economic growth has seen corporate demand for loans strengthen since last year. After several years of decline, demand for loans for investment is again increasing, while demand for loans for restructuring, which in previous years was an expression of corporate difficulties with debt servicing, is declining. The proportion of new corporate loans accounted for by long-term loans is increasing sharply, which is an expression of the quest for higher returns on the longer part of the yield curve. In the wake

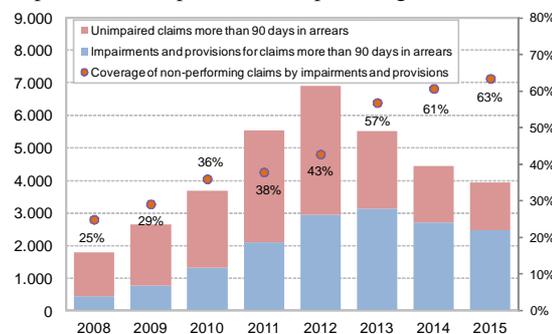
Housing price index (2010 = 100) and number of transactions in used housing



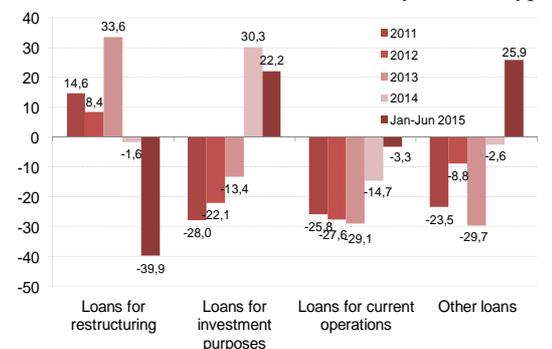
Arrears of more than 90 days: stock in EUR million and percentages



Coverage of claims more than 90 days in arrears by impairments and provisions, in percentages



Growth in demand for loans by loan type



of the contraction in short-term loans, the proportion of the stock of loans that they account for had fallen to just 12% by September 2015, a third of the figure in 2008. The decline in short-term corporate lending entails limits on current financing, which partly explains the increase in corporate deposits at banks.

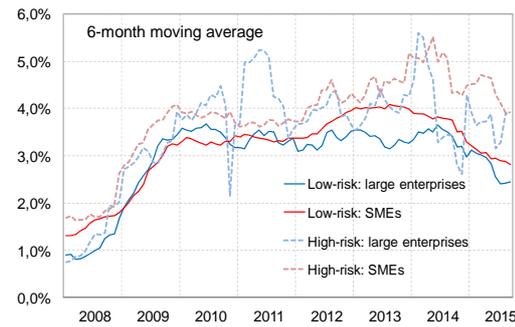
The banks' lending rates fell sharply in 2015, and are encouraging new borrowing. On loans of up to EUR 1 million they are just 0.4 percentage points above the euro area average. Slovenian banks' credit standards have remained at the high levels previously reached, in contrast to the euro area, where the standards have been eased over the last year. The burden on the credit portfolio from non-performing claims is one of the most significant factors in the banks' reticence to make new lending. The banks' increased caution in lending is also expressed in increased differentiation of corporates with regard to size and risk level, via higher and rising premiums on loans to SMEs.

After several years of debt repayment, corporates have reduced leverage: the average value of 123% is the same as that in 2005, before the onset of the substantial growth in corporate loans. High leverage is now concentrated in certain more vulnerable corporate segments and in particular sectors. In some segments, most notably manufacturing, leverage was actually moderate at the outbreak of the crisis, and had fallen further by 2014: leverage stood at 106%, while the ratio of net financial debt to EBITDA stood at two years. The corporate sector primarily deleveraged by paying down debt by 14%; equity increased by just 2%.

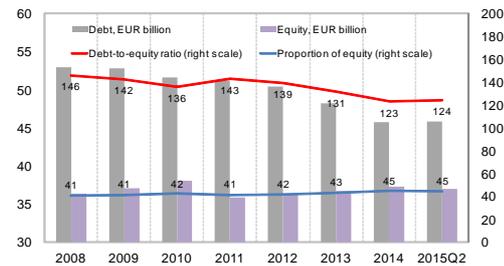
As they have continued to reduce corporate lending activity, the banks have shown a greater appetite for household lending, and have encourage borrowing by moderately easing credit standards and through more favourable loan terms, including increased approval of loans with a fixed interest rate. The proportion of new housing loans with a fixed interest rate reached 26% in the third quarter of 2015, compared with just 2% in 2014. Household borrowing is also being encouraged by cuts in fixed interest rates, which is sharply reducing the risk to debtors and is easing debt servicing, given the high probability of a rise in the EURIBOR over the average housing loan repayment term of 16.7 years (the average maturity of loans concluded with a fixed interest rate in the third quarter of 2015).

Generating income in a situation of low interest rates and contracting balance sheets will remain a major challenge for the banks in the future, which is maintaining income risk at a relatively high level. As a result of the decline in credit risk and the large impairments created in previous years, impairment costs were significantly lower in 2015, which was the decisive factor in the increase in the banks' profit over the first nine months of 2015 to EUR 197 million, up 62% on the same period of 2014. The unimpaired part of non-performing claims is still burdening the banks' income performance, owing to the low, uncertain profitability of this part of the portfolio. Net interest income is declining, although the contraction in total assets meant that the net interest margin only declined minimally. Diminishing returns on investment mean that the margin will come under increasing pressure in the future. In the quest for greater returns in an environment of low interest rates and contracting lending activity, the banks are lengthening the maturities of their investments, be they loans or securities. They are also directing excess liquidity into lower-yielding investments with longer maturities, and are themselves also contributing to the maintenance of low interest rates. As relatively high-yielding securities mature, there is a

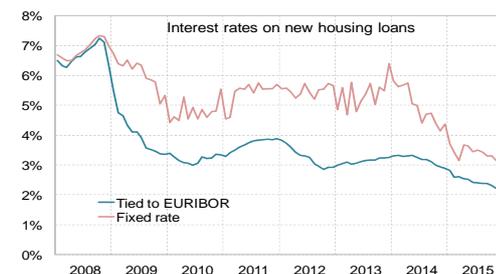
Spread over reference interest rate with regard to risk of loans and corporate size, in percentage points



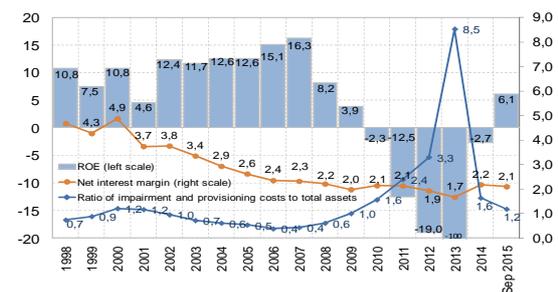
Indebtedness of non-financial corporations and proportion of equity, in percentages



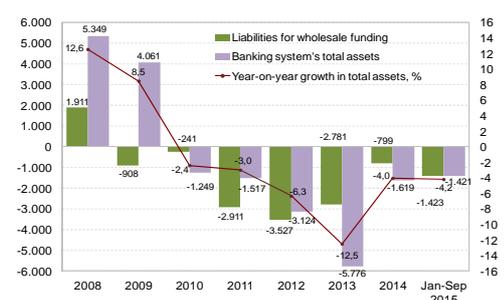
Interest rates on housing loans, in percentages



ROE, net interest margin and ratio of impairment costs to total assets, in percentages



Change in total assets and wholesale funding, in EUR million



risk that the banks will place funds in higher-risk securities from other countries and corporate bonds. In the event of a deterioration, the redeemability of these investments will be questionable, which could increase liquidity risk at the banks.

After several years of debt repayment on the wholesale markets, the structure of bank funding has stabilised, with a large proportion of deposits by the non-banking sector. At 12.8%, the proportion accounted for by foreign funding is just a third of the figure in 2008. The amount and the maturity structure of the remaining debt maturing are more favourable than in previous years, and debt repayment does not entail a major burden for the banks. The banks are only rolling over maturing funding in the rest of the world to a lesser extent: there were two such debt security issues over 2014 and the first nine months of 2015. Funding structure has stabilised with a prevailing proportion of deposits by the non-banking sector, which have maintained positive growth. Deposits by the non-banking sector accounted for two-thirds of the stock of bank funding in September, and household deposits for 41%.

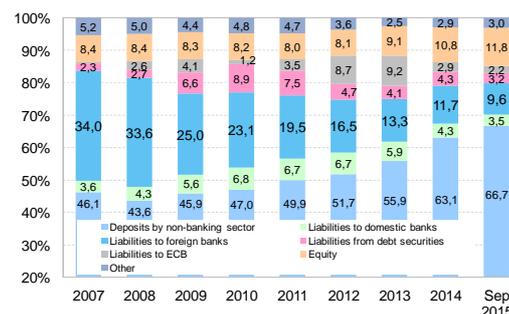
The maturity structure of deposits, which is shortening under the influence of falling interest rates, is having an adverse impact on financing risk. Interest rates on deposits fell more slowly in 2015 than in 2014, but the low level at longer maturities, which since the end of 2014 has been practically equal to the euro area average, are discouraging the commitment of funds for longer terms. Over half of household deposits are sight deposits. The average maturity of household deposits is shortening, primarily via a switch from short-term deposits to sight deposits, but also via a switch from long-term deposits in recent months. Sight deposits account for fully 70% of corporate deposits, and the increase in and retention of these deposits at banks is primarily of the nature of a liquidity reserve.

The maturity mismatching of funding and liabilities does not entail major risk for the banks in a situation of high excess liquidity and the availability of liquidity via the ECB's non-standard measures. Although the high proportion of sight deposits is stable, in an environment of extremely low interest rates there remains a possibility of a switch to consumption and investment.

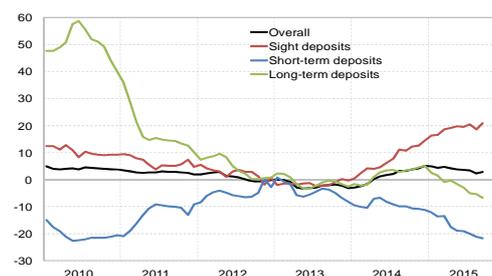
Interest rate risk is increasing at the banks as a result of the shortening of funding maturities and the simultaneous lengthening of the average maturity of investments. The average repricing period for asset interest rates continued to lengthen in 2015, from 13.6 months to 14.8 months. The increase was the result of the lengthening of the average maturity of loans, and also an increase in the proportion of loans, primarily housing loans, and investments in securities with fixed returns throughout the term of the investment. The average repricing period on the liability side shortened by 0.3 months to 4.9 months. The widening of the gap means that a rise in interest rates will be reflected in interest expenses before interest income, which is exposing the banks to increased interest rate risk.

The banks further improved their capital adequacy in 2015, by 1.2 percentage points 20.5%, or 18.1% on a consolidated basis. Since the end of 2014 the indicator has been above the euro area average, which now stands at 16.1%. In contrast to previous years, the banks have begun strengthening their capital by means of positive earnings, which has been reflected in an increase in proportion of common equity Tier 1 capital accounted for by earnings. The proportion of own funds accounted for original own funds strengthened again to 96.3%, which is confirmation of the high level of capital quality at Slovenian banks. The small domestic banks remain the most

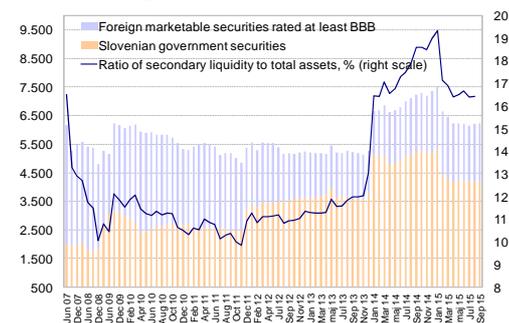
Structure of bank funding, in percentages



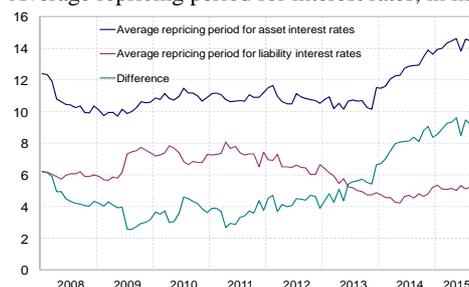
Growth in household deposits by maturity, in percentages



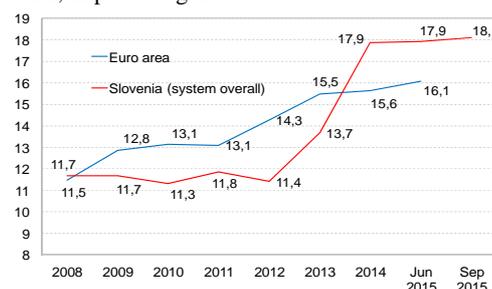
Stock of marketable secondary liquidity in EUR million, and ratio of marketable secondary liquidity to total assets in percentages



Average repricing period for interest rates, in months



Total capital ratio compared with the EU, consolidated basis, in percentages



exposed to solvency risk, despite a moderate improvement in capital adequacy indicators.

The favourable economic environment had an impact on the leasing sector in 2015. There was an increase in new equipment leasing business, primarily involving cars, commercial vehicles and freight vehicles. Real estate leasing business has continued to contract, and has also seen the largest write-offs. Performance is improving: leasing companies generated net profit of EUR 22 million over the first nine months of the year. The lengthening of arrears in repayments is slowing in relation to total business. The proportion of claims more than 90 days in arrears stood at 10.3% in September. As at the banks, non-financial corporations represented the largest credit risk at leasing companies; 14.0% of their claims are more than 90 days in arrears. Leasing business in the form of loans has the largest proportion of arrears, although it accounts for a small proportion of total business with non-financial corporations. Finance leases are prevalent in the financing of non-financial corporations.

In the insurance sector, the recovery of the domestic economy has not yet been reflected in major changes in policyholders' purchasing habits, and they remain reticent with regard to insurance products. Insurance corporations' performance was down relative to 2014, primarily as a result of a contraction in written premium and a deterioration in the net result from investing activities. There was an increase in gross written premium in the reinsurance sector, and performance also improved.

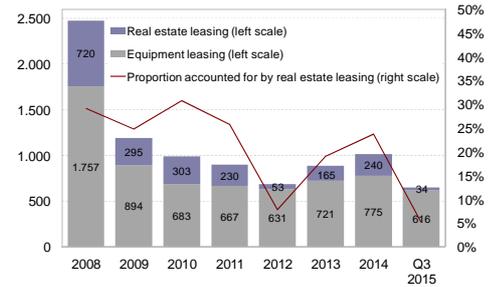
The performance of the entire insurance sector was affected by the increased volatility on the capital markets in connection with low interest rates. The gradual maturing of life insurance and the negative growth in gross premium will have an adverse impact on the claims ratio in life insurance. The investment risk of insurance corporations and pension funds inherent in supplementary pension insurance is gradually being transferred to savers via the current introduction of lifecycle funds.

On the financial markets, both domestic and international, the positive growth in the early part of the year saw a reversal in the second half of the year. Liquidity declined on the domestic stock market, as a result of stalled M&A activity, which had raised volume in the previous year. The environment of low interest rates is encouraging corporates to finance themselves via debt security issues. Issues of bonds amounted to EUR 89.8 million over the first nine months of the year, while there was a decline in financing via issues of commercial paper, which amounted to EUR 75 million, compared with EUR 189.2 million in 2014.

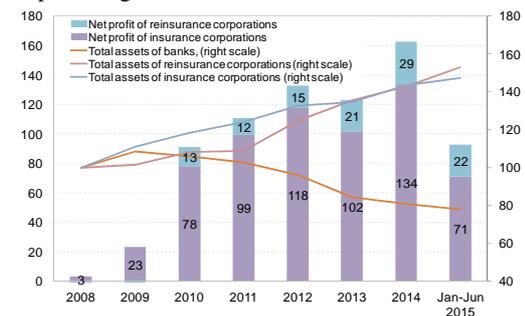
The strong growth in net inflows into investment funds has slowed since May in line with the increased uncertainty on the capital markets. Households were responsible for the largest inflows into investment funds in the early part of the year, but growth then slowed. Investments in investment funds in September 2015 were up 7.4% in year-on-year terms.

Non-residents' demand for domestic bonds remains high, primarily on account of the environment of low interest rates. In issues of Slovenian government securities with a total nominal value of EUR 2.9 billion, non-residents recorded net purchases of EUR 2.2 billion in domestic bonds. The environment of low interest rates and higher-risk investments is increasing the risk of the reallocation of funds, which could further reduce liquidity on the domestic financial market.

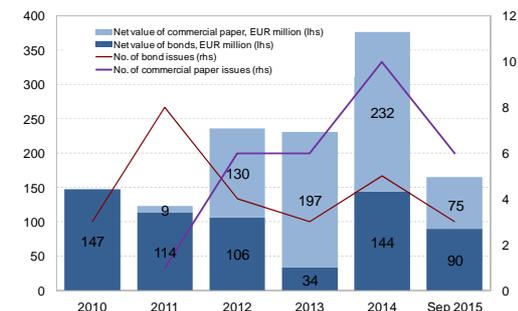
Volume of new leasing business, in EUR million



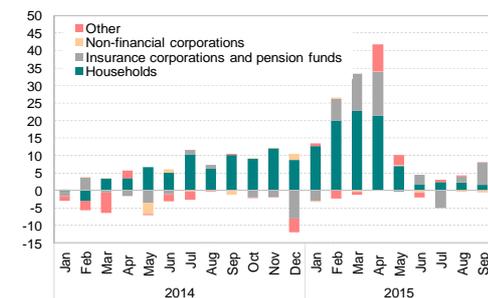
Net profit of insurance corporations and reinsurance corporations in EUR million, and change in total assets in percentages



Net issues of corporate bonds and commercial paper and number of issues



Net inflows into investment funds by sector, in EUR million



1. MACROECONOMIC ENVIRONMENT

Summary

The risks are increasing in the international environment. The main challenges for 2016 are the cooling of certain major economies, and geopolitical tensions in the Middle East, although to date these have not had any major economic consequences. Another risk is low inflation, which has persisted despite the ongoing expansionary monetary policy and additional non-standard measures by the ECB.

There were improvements in the macroeconomic forecasts for 2015 and 2016 for Slovenia by international institutions, while the main engines of economic growth are export growth and private consumption. Growth in disposable income and household consumption is gradually strengthening. The indebtedness of Slovenian households remains relatively low, and does not entail increased credit risk for the Slovenian banking system. With the recovery in household purchasing power, there is an expectation of a gradual revival of consumer lending, while low interest rates and real estate prices mean that greater activity in housing lending can be expected. With the stabilisation of the public debt and the ongoing fiscal consolidation measures, the rating agencies' confidence in Slovenia improved, and was reflected in positive outlooks.

The real estate market was showing signs of recovery over the first three quarters of 2015. The trend of increasing volume on the real estate market continued, albeit more slowly. The fall in housing prices came to an end. There were improvements in the factors acting to increase demand on the housing market. The gradual recovery in the amount of new housing loans continued in 2015, although the supply-side factors remain limiting for the real estate market.

1.1 International environment

Economic growth in the euro area has displayed similar dynamics since 2014. The largest factor in the growth of 1.2% in the first half of 2015 was net exports, primarily as a result of an improvement in price competitiveness as the euro depreciated, while a significant contribution also came from private consumption. As a result of the improvement in the situation on the labour market, the fall in commodity prices (oil in particular), and the increase in purchasing power, private consumption can again be expected to make a larger contribution to economic growth in the future. The ongoing financial and operational restructuring of financial and non-financial corporations, the slow pace of structural reform and the high unemployment rate will continue to have an impact on economic growth.

The euro area continued to record economic growth in the first half of 2015, primarily as a result of growth in exports and increased private consumption.

Table 1.1: European Commission forecasts of selected macroeconomic indicators for Slovenia's main trading partners

	Real GDP				Unemployment rate				Inflation			
	2014	2015	2016*	2017*	2014	2015	2016*	2017*	2014	2015	2016*	2017*
EU	1,4	1,9	2,0	2,1	10,2	9,5	9,2	8,9	0,6	0,0	1,1	1,6
Euro area	0,9	1,6	1,8	1,9	11,6	11,0	10,6	10,3	0,4	0,1	1,0	1,6
Germany	1,6	1,7	1,9	1,9	5,0	4,7	4,9	5,2	0,8	0,2	1,0	1,7
Italy	-0,4	0,9	1,5	1,4	12,7	12,2	11,8	11,6	0,2	0,2	1,0	1,9
Austria	0,4	0,6	1,5	1,4	5,6	6,1	6,1	6,0	1,5	0,9	1,8	2,0
France	0,2	1,1	1,4	1,7	10,3	10,4	10,4	10,2	0,6	0,1	0,9	1,3
Croatia	-0,4	1,1	1,4	1,7	17,3	16,2	15,6	14,7	0,2	-0,1	0,9	1,7
Slovenia	3,0	2,6	1,9	2,5	9,7	9,4	9,2	8,7	0,4	-0,6	0,8	1,4

Note: Shaded area signifies European Commission forecasts.

Source: European Commission, autumn forecasts

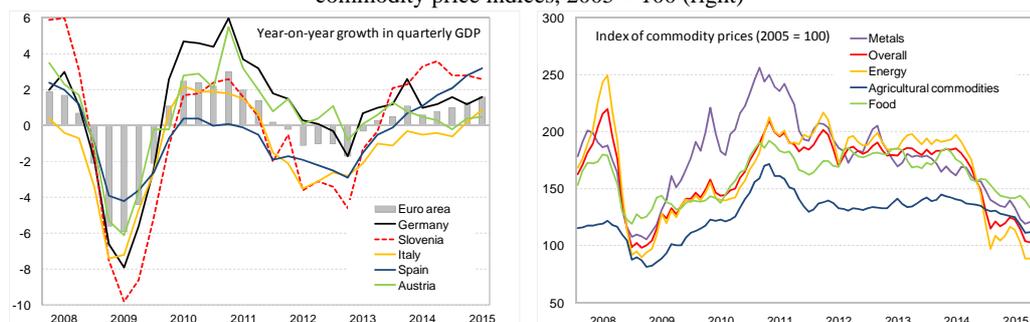
Despite an improvement in international institutions' forecasts, economic growth remains weak in Slovenia's most important economic partners¹ other than Germany; economic activity in the euro area remains volatile and varies significantly from country to country. Economic activity is forecast to increase in all euro area countries in 2016, despite international institutions lowering their forecasts at the end of 2015. Growth will remain significantly subject to risk and uncertainty.

¹ The European Union is Slovenia's most important export market, and accounts for just over three-quarters of all exports. The most important trading partners are Germany (20.8% of total exports), Italy (11.5%), Austria (8.4%), Croatia (7.6%) and France (5.1%).

As developments in Greece have stabilised, the cooling of certain major economies has become a more significant risk to economic growth in Slovenia.

The risks from the international environment are continuing to increase, and represent a definite uncertainty for the attainment of stable economic growth in Slovenia. The agreement between Greece and its creditors in early 2015 stabilised one of the major risks in the euro area, but risks remain with regard to the economic situation in Russia, Brazil, China and Turkey. The effects of the Volkswagen affair are also uncertain, including the direct impact on Slovenia, as the firm is one of the largest customers for the Slovenian car industry. The refugee crisis has brought restrictions in the form of increased border controls in certain European countries, which is causing disruptions to transport and the risk of an adverse impact on exports. Geopolitical tensions are also increasing in the Middle East, although to date these have not had any major economic consequences.

Figure 1.1: Year-on-year growth in quarterly GDP in percentages (left) and commodity price indices, 2005 = 100 (right)

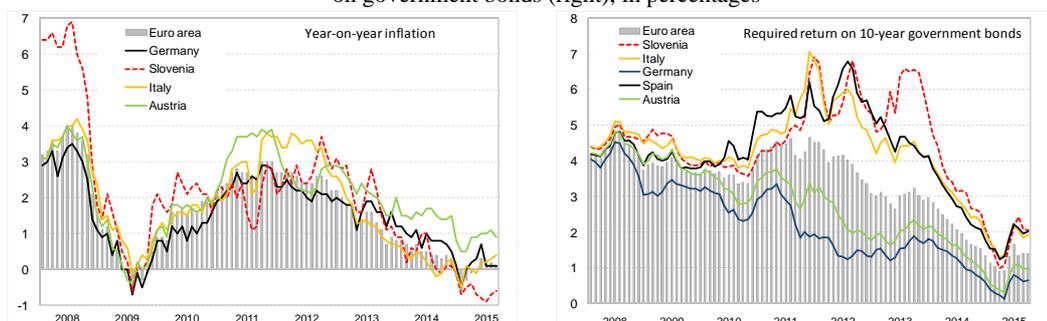


Note: GDP figures are not seasonally adjusted.
Sources: Eurostat, IMF database

Inflation remains low in the euro area, despite the ECB's expansionary policy and additional non-standard measures.

In the euro area there is still the risk of a long period of low inflation or even deflation, despite the ECB's expansionary monetary policy in the form of an expanded programme of securities purchases. In early December 2014 the ECB extended this measure for six months to March 2017. Given the ECB's expansionary policy, further positive effects on the competitiveness of the euro area economy can be expected.

Figure 1.2: Year-on-year inflation as measured by the HICP (left) and required yield on government bonds (right), in percentages



Source: Eurostat

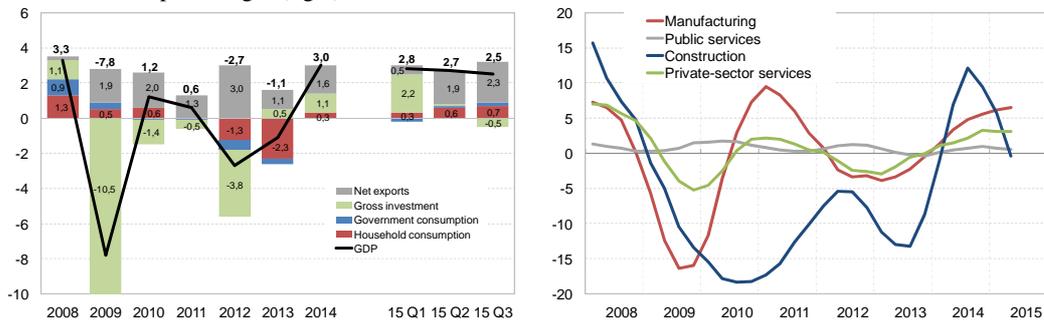
After the successful negotiations and agreement with Greece, required yields on government securities fell slightly again in the second half of 2015, and stabilised at relatively low levels. This has had a favourable impact on debt refinancing, and is easing the burden of the fiscal consolidation to which countries are committed under the fiscal compact.

1.2 Economic developments in Slovenia

Economic growth continued in 2015, as a result of the gradual recovery in household consumption and net exports.

Growth remained favourable in Slovenia over the first three quarters of 2015 at 2.5%. The recent GDP growth was again the result of the positive impact of foreign demand, although a significant contribution was also made by the gradual recovery in household consumption. Given the slowdown in growth in government investment and the weak recovery in private-sector investment, stronger growth in gross investment cannot be expected this year.

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 fixed prices in percentages (right)

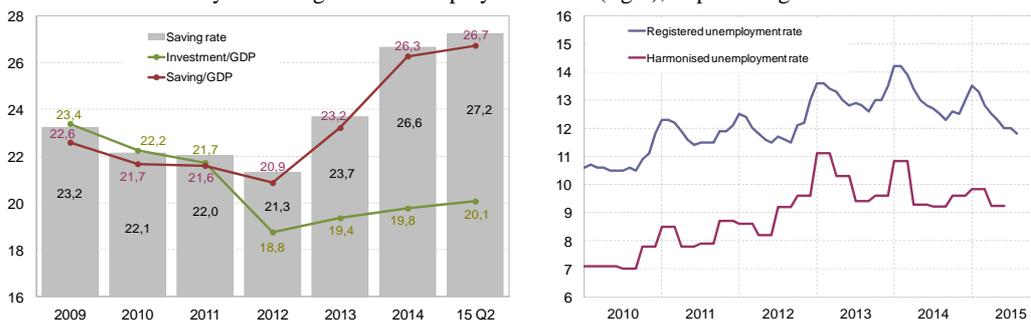


Note: The quarterly rates of growth for 2015 are calculated with regard to the same quarter of the previous year.

Source: SORS

The largest contribution to economic growth came from manufacturing, which is expected to remain a significant factor in economic growth over the next two years as a result of its high export-orientation. The slowdown in growth in value-added in 2015 was primarily attributable to the fall in value-added in construction, which is expected to continue in 2016. Annual GDP growth is forecast at between 2.1% and 2.7%. The structure of economic growth is expected to become more balanced as final household consumption gradually recovers.

Figure 1.4: Saving rate, and ratios of investment and saving to GDP (left) and surveyed and registered unemployment rates (right), in percentages



Source: SORS

Saving is still increasing in the Slovenian economy, albeit at a slower pace, partly as a result of the persistent caution with regard to consumption and investment. Slovenian households are among the highest savers in Europe: the saving rate stood at 14.1% in 2014. Autonomous financing, of which the most important type is saving by domestic households, is of particular importance to domestic investment. As economic growth continues, there is an expectation of further favourable developments on the labour market and a recovery in gross real wages. After declining for two years, household disposable income increased by 1.4% in 2014 and by 0.6% in the first half of 2015, primarily as a result of employment, as household consumption recorded growth of 0.4%.

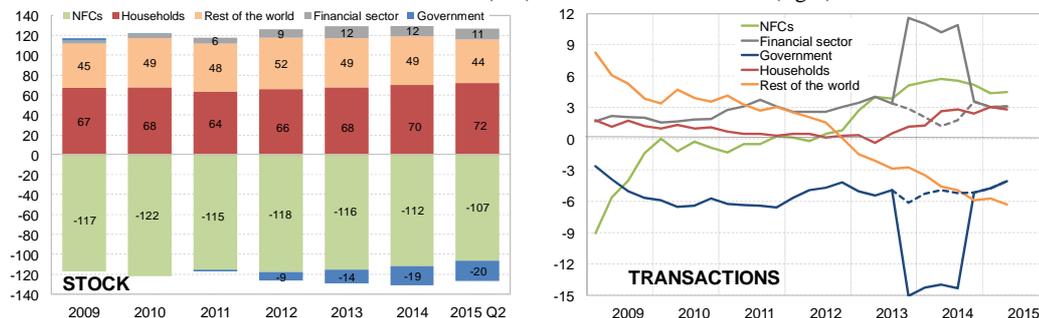
The improvement in the economic situation has also been reflected in the labour market, via growth in employment and a recovery in household disposable income.

Slovenia reduced its negative net international investment position over the first half of the year to 44% of GDP. Slovenia's financial surplus against the rest of the world from transactions in the first half of 2015 stood at 6.3% on an annualised basis, up 1.7 percentage points on a year earlier, which entails a widening of the saving-investment gap. Households have maintained a surplus in current annual financial assets over liabilities at 3% of GDP, while the figure for the corporate sector stood at around 4.4% of GDP. The corporate sector's saving-investment gap is also positive for the euro area overall, and could be attributable to various factors. During the crisis, and with limited access to financing, corporates undertook precautionary saving and simultaneously streamlined production, which was also attributable to lower commodity prices, the workforce and deflation. Precautionary saving is also reflected in lower demand for loans and finally in lower lending activity by the banks. Household consumption and government consumption were also relatively limited in previous years, and with them demand. Corporates are primarily earmarking their savings for paying down debt and improving the structure of financing. The financial corporations sector's surplus and the

Slovenia is reducing its net negative position against the rest of the world.

government sector's deficit returned to a stable level in the wake of the measures to stabilise the banking system at the end of 2014.

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



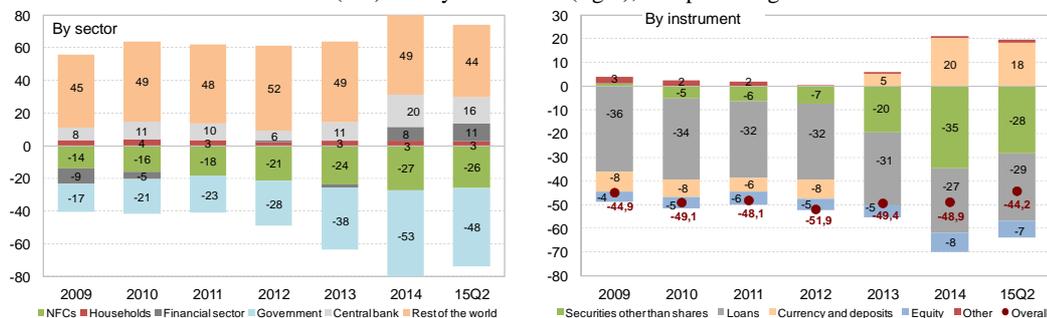
Note: Annual transactions are calculated as four-quarter moving sums. Transactions excluding the effects of the recapitalisations at the end of 2013 and 2014 are illustrated in dotted lines for the financial sector and the government sector.

Sources: Bank of Slovenia, SORS

The government sector and the banking sector reduced their liabilities to the rest of the world in the first half of the year.

The banks became net lenders to the rest of the world in the second half of 2014 as a result of the ongoing reduction in liabilities to the rest of the world. Slovenia's financial sector thereby increased its net positive financial position against the rest of the world by 3 percentage points over the first half of 2015 to 11% of GDP. An increase in its deposits at foreign banks in the first half of the year meant that the government sector reduced its net liabilities to the rest of the world by 5 percentage points of GDP, as the domestic banks showed little interest in government deposits in light of their excess liquidity. Another factor in the decline in the government sector's liabilities to the rest of the world in the first half of the year was the repurchase of Slovenian government bonds from foreign banks by the Slovenian central bank within the framework of the ECB's non-standard measures (the PSPP).

Figure 1.6: 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

According to forecasts, Slovenia's budget deficit is expected to have fallen to less than 3% of GDP, under the influence of relatively high economic growth, revenue-side and expenditure-side measures, and more favourable funding. The improvement in the economic situation, the stabilisation of public debt and the ongoing fiscal consolidation measures were the main factors highlighted by Moody's in its upgrading of Slovenia's sovereign credit rating to investment grade (Baa3) in early 2015, as the other two major rating agencies modified their outlooks from stable to positive. The agencies nevertheless warn of the importance of continuing work on the requisite structural reform, and of the challenges faced in banking, primarily as a result of the ongoing deleveraging process.

1.3 Real estate market

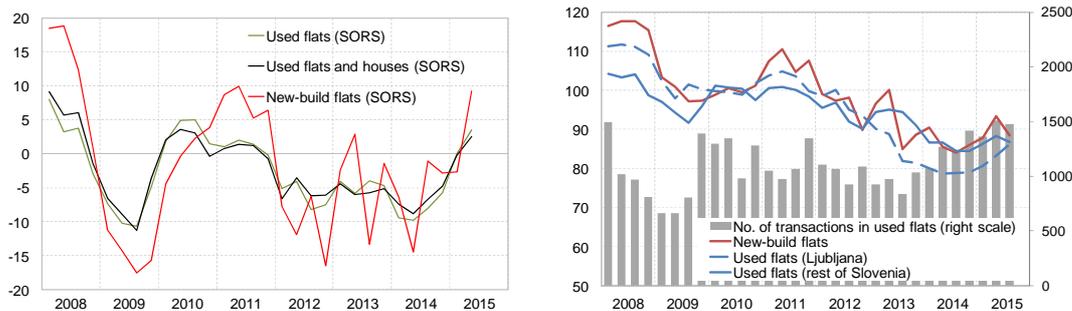
Real estate price developments

The fall in real estate prices came to an end in 2015. The trend of increasing volume has continued, although it slowed slightly in the second quarter of 2015.

After three years of falls, the fall in housing prices came to an end in 2015. According to SORS figures, average prices of flats and houses in the third quarter of 2015 were up 1.0% in year-on-year terms. Prices of used flats were up 5.4% in year-on-year terms,

while prices of new-build flats were up 5.2%.² House prices have not yet stabilised, and continued to fall in year-on-year terms in the third quarter. Prices of used houses were down 8.7%, while prices of new-build houses were down 17.7%. Prices of used flats in the third quarter of 2015 were down 19.0% on their peak in the first quarter of 2008, while prices of new-build flats were down 24.9% on their peak in the third quarter of 2008. According to SORS figures, the trend of increasing volume on the real estate market has continued. The volume of transactions in used flats and houses in 2014 was up almost a third on the previous year, although growth in volume had slowed slightly to 26.2% by the third quarter of 2015.

Figure 1.7: Annual growth in prices of used and new-build residential real estate in Slovenia (left), and the basic housing price index (2010 = 100) (right), in percentages



Note: Owing to a changeover to a new information system for reviewing and updating data, and the resultant break in data series, average prices are lower compared with previous half-years.

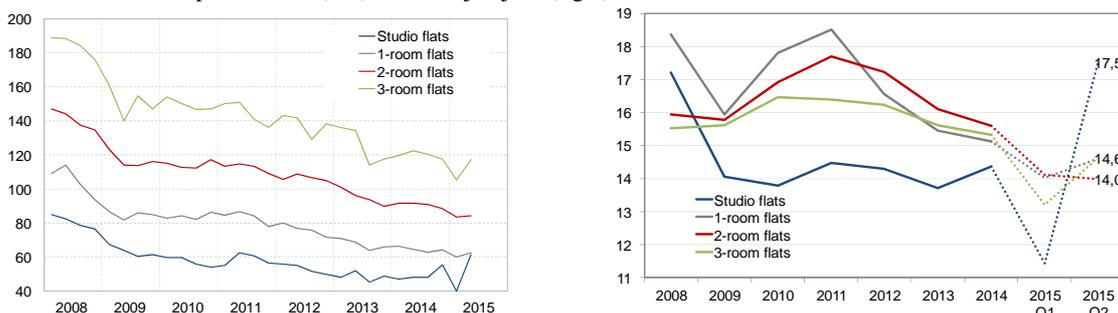
Sources: SORS, Bank of Slovenia

As the fall in real estate prices has come to an end, housing affordability in Ljubljana has also begun to deteriorate. After improving for six years, housing affordability in the capital as measured by the ratio of prices of used flats to the annual moving average of net monthly wages began to deteriorate for studio flats and three-room flats in the second half of 2014.

Housing affordability in Ljubljana has been deteriorating since the second half of 2014.

A similar picture is painted by the housing affordability indicator that takes account of loan terms,³ which in Ljubljana began deteriorating in the second half of 2014. In the second quarter of 2015 the deterioration was primarily attributable to a rise in the average price of used flats relative to the previous quarter. This effect prevailed over the favourable effect of lower variable interest rates on housing loans and the lengthening of the average maturity of housing loans, which reached 18.3 years.

Figure 1.8: Percentage ratio of housing prices to net monthly wage in Ljubljana (left), and price to rent (P/E) ratio in Ljubljana (right)



Note: Ratio of prices of used flats to annual moving average of net monthly wages.

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

The price to rent (P/E) ratio for housing in Ljubljana continued to fall in the first half of 2015; real estate prices fell more on average than rents. The average P/E ratio was a fifth

² Improvements in methodology mean that the figures for prices of used flats differ slightly from those published in previous issues of the Financial Stability Review. As of 2015 not all transactions by private individuals are included in the figures, but only those where the price is itemised by individual category of real estate. The statistics therefore no longer capture the entire market population, but only a non-random sample of homogeneous transactions.

³ 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.

higher than the underlying ratio,⁴ although the gap narrowed in the first half of 2015. The P/E ratio was still 14 percentage points down on its pre-crisis peak: in the first quarter of 2007 it was fully half higher than the underlying ratio. According to the two indicators of trends in real estate prices, the period of price volatility has ended, and real estate prices will stabilise.

Supply and demand factors on the real estate market

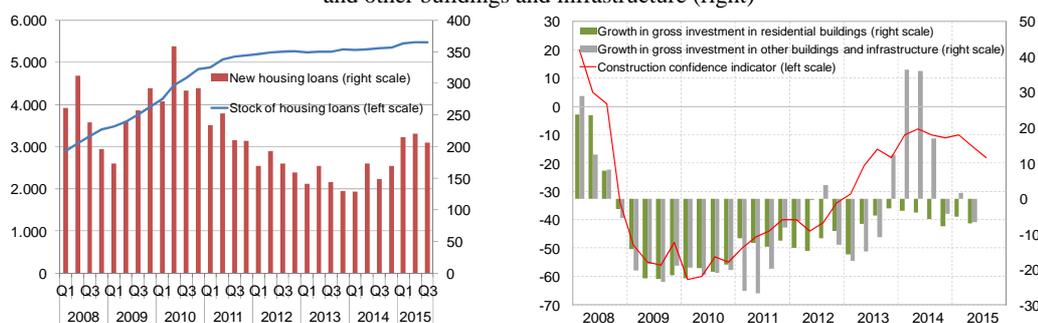
There were significant improvements in demand-side factors on the housing market.

One of the more important factors in demand for real estate is household purchasing power, which is gradually improving. The indebtedness of Slovenian households remains relatively low, and does not entail increased credit risk for the Slovenian banking system. The proportion of household loans more than 90 days in arrears remains stable, at just over 4%. Interest rates on housing loans averaged 2.3%, and there was a continuation of the gradual trend of decline and convergence on the euro area average, which is 0.2 percentage points lower. A sharp increase in the proportion of new loans with a fixed interest rate was evident. The figure stood at just 2% in 2013 and 2014, but began increasing in 2015, reaching 28% in September. The increase in the proportion of new long-term loans with a fixed interest rate in a period of low interest rates and relatively small spreads between fixed and variable interest rates is an indication of caution on the part of households, and also rational behaviour, as they would not be exposed to interest rate risk in the event of a slight rise in prices. With interest rates and real estate prices favourable, and in the wake of an improvement in household purchasing power, housing lending is gradually expected to expand. Household investment increased by 3.2% in the first half of 2015, having recorded growth of almost 10% in 2014. On the real estate market this was reflected in an increase in the volume of transactions in real estate and in an end to price falls.

Growth in housing loans continued in 2015.

Evidence of the gradual revival of the real estate market comes from the figures showing an expansion in housing loans, which increased by EUR 127 million or 2.4% over the first three quarters of 2015, most notably at the savings banks and the banks under majority foreign ownership. New housing loans increased by EUR 192 million or 43% over this period, having recorded growth of 6.1% in the previous year, which ended a three-year trend of decline. The segment of households that borrowed in Swiss francs in the past remains exposed to currency risk, which has increased by 10% since the beginning of the year. The proportion of housing loans in Swiss francs stands at 12%, and is declining.

Figure 1.9: Housing loans to households in EUR million (left), and construction confidence indicator and annual growth in gross investment in housing and other buildings and infrastructure (right)



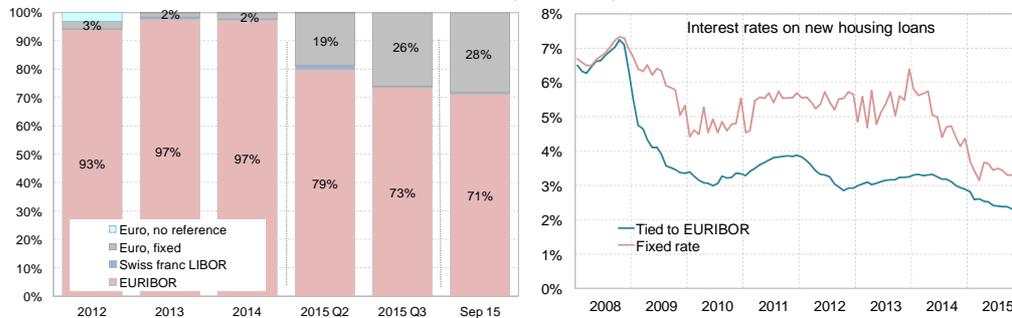
Sources: Bank of Slovenia, SORS

The traditionally high level of home ownership in Slovenia acts to limit excessive growth in housing prices. Around 80% of households in Slovenia are owner-occupiers, compared with the euro area average of around 60%. A traditionally high saving rate and an aversion to excessive risk are also typical of Slovenian households. Despite a slight easing, the credit standards on housing loans are still high relative to their pre-crisis level, while uncertain forms of employment (temporary employment, self-employment) are still increasing, which is hindering access to bank loans for employees. The banks and savings

⁴ 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.

banks slightly eased the terms during approval of housing loans in 2015. The LTV ratio for new housing loans (the ratio of the loan to the value of the collateral) averaged 58% over the first three quarters of 2015, up 4 percentage points on the same period of the previous year.⁵

Figure 1.10: Breakdown of new loans by type of remuneration (left), and fixed and variable interest rates on new housing loans (right)



Source: Bank of Slovenia

Certain limiting factors remain in the supply of housing. The stock of loans to construction firms continued to decline in 2015. The employment expectations indicator remained negative in the third quarter, while the expected orders indicator was positive overall in the same period. Should demand continue to recover, the lack of construction of new-build housing in recent years could be a factor in rises in real estate prices. Gross investment in housing in the third quarter of 2015 was down 5.1% on the same period of the previous year. A positive sign was the increase in newly issued building permits, the number of which in the third quarter was up 9.2% in year-on-year terms. According to SMARS figures, the volume of transactions in land for the construction of buildings in the first half of 2015 was up 11.6% in year-on-year terms.

⁵ The average LTV ratio rose by 2 percentage points to 57% at the large domestic banks, 8 percentage points to 52% at the small domestic banks, and 7 percentage points to 62% at the banks under majority foreign ownership.

2. RISKS IN THE BANKING SECTOR

2.1 Credit risk and bank lending activity

Summary

The quality of the credit portfolio gradually improved in 2015. Claims more than 90 days in arrears declined by EUR 516 million in 2015 to stand at EUR 3.9 billion, or 11.1% of classified claims in September. Non-financial corporations continue to account for the majority of the banks' claims more than 90 days in arrears, although in recent years active firms (going concerns) have reduced their indebtedness to the pre-crisis level, while corporate debt servicing capacity is also improving. The corporate sector has deleveraged, although equity remains almost at the same level as during the peak of indebtedness in 2008. Corporate deleveraging should be based more on growth in equity, and less on debt reduction. A major factor in the low quality of the banks' portfolio is the burden of claims against corporates in bankruptcy, which account for 43.5% of corporate claims more than 90 days in arrears.

The burden placed on the credit portfolio by claims more than 90 days in arrears is a limiting factor in the banks' capacity to generate income from this segment of the portfolio, and is contributing to the persistence of income risk at a relatively high level. It is also a significant factor in the banks' maintenance of high credit standards. The potential easing of credit standards and more favourable lending terms should only be enjoyed by corporates whose loans would contribute to an increase in the quality of the entire bank portfolio. With more favourable loan terms and easier standards, the banks are showing greater propensity for lending to lower-risk segments, households in particular.

One customer segment that is heavily burdened by non-performing claims is SMEs, whose claims more than 90 days in arrears have increased significantly faster since the outbreak of the financial crisis than those of large enterprises. Given the specific granularity of the claims, the SMEs credit portfolio requires a different approach from the banks to the resolution of non-performing claims than those applied to large enterprises with multiple exposures to different banks. Classified claims against SMEs accounted for 17.3% of the credit portfolio in September 2015, and 42% of total claims more than 90 days in arrears.

Restructuring as an approach to resolving the banks' non-performing claims is most widespread in the corporate sector. The success of restructuring as measured by the proportion of claims that again fall more than 90 days in arrears varies from sector to sector; it is above-average in the manufacturing sector, where there has been an improvement in the portfolio as a result of the favourable impact of economic growth. The efficiency and success of the restructuring of claims more than 90 days in arrears will be confirmed in time. It is a complicated process of assessing the debtor's performance and the general economic situation, to which the terms of the restructuring have to be tailored.

Under Regulation 575/2013 (the CRR), the EBA introduced new capital requirements on 1 January 2014, and standardised the definition of non-performing and forborne exposures. In addition to arrears of more than 90 days the EBA definition of non-performing exposures includes those satisfying the criterion of "unlikely to pay". According to the prescribed methodology, under the EBA definition non-performing claims also include forborne exposures, i.e. exposures for which the banks have modified the terms and conditions of repayment owing to the customer's financial difficulties. The stock of non-performing claims is thus increased by forborne exposures that are not more than 90 days in arrears.

In the remainder of the review non-performing claims means claims more than 90 days in arrears, as this maintains consistency over the data series with past financial stability reviews. In addition, the EBA's report on non-performing claims is available only for the balance sheet date of 30 June 2015, and it is therefore impossible to determine the developments in non-performing claims before and during the crisis.

2.1.1 Quality of the credit portfolios of banks and savings banks

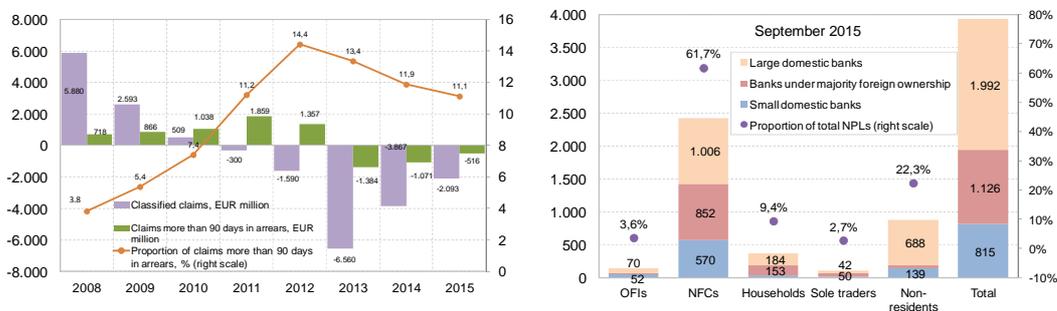
Classified claims more than 90 days in arrears

The proportion of claims more than 90 days in arrears declined by 0.8 percentage points over the first three quarters of 2015 to stand at 11.1% of the banks' classified claims, its level of July 2011. With the exclusion of Probanka and Factor banka, the banks undergoing orderly wind-down, the figure was 9.9%. Had the transfer of non-performing claims to the BAMC not been carried out, the proportion of claims more than 90 days in arrears would have stood at 18.4%, all other conditions being equal.

The trend of decline in the proportion of claims more than 90 days in arrears has continued.

The stocks of classified claims and claims more than 90 days in arrears are also declining. In addition to the three transfers to the BAMC in 2013 and 2014, the decline is also attributable to the contraction in corporate lending. At the same time the banks increased their write-offs in 2015. Classified claims amounted to EUR 35.4 billion in September 2015, down EUR 9.5 billion on November 2013, i.e. before the first transfer to the BAMC, the lowest level since 2007.

Figure 2.1: Classified claims and claims more than 90 days in arrears (left), and claims more than 90 days in arrears by bank group and customer segment in September 2015 (right), in EUR million

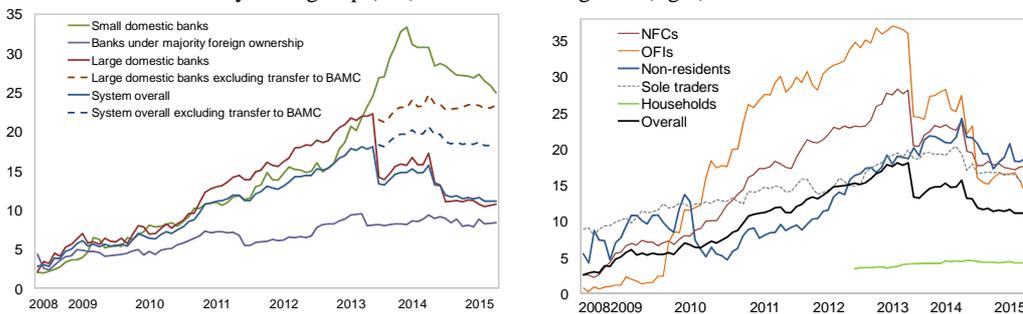


Source: Bank of Slovenia

Claims more than 90 days in arrears at the large domestic banks amounted to EUR 2 billion in September 2015, a third of the figure before the first transfer to the BAMC in November 2013, or 10.7% of classified claims. They still account for a half of the banking system's total claims more than 90 days in arrears. The figure also improved in 2015 at the banks under majority foreign ownership, to 8.3% in September, although it was slightly higher than the figure of 8% from before the initial stabilisation of the banking system. This group includes Raiffeisen banka and Sberbank, who have announced their intention to withdraw from the Slovenian market. Despite the exclusion of these two banks, the proportion of claims more than 90 days in arrears would be unchanged in September 2015.

The proportion of claims more than 90 days in arrears declined at the large domestic banks in 2015.

Figure 2.2: Arrears of more than 90 days as a proportion of the banks' classified claims by bank group (left) and customer segment (right)



Source: Bank of Slovenia

Non-financial corporations continue to account for the majority of the banks' claims more than 90 days in arrears, although in recent years active firms (going concerns) have reduced their indebtedness to the pre-crisis level, while corporate debt servicing capacity is improving. Corporates in bankruptcy remain on bank balance sheets alongside active firms, and account for 43.5% of the corporate arrears of more than 90 days. Households are the least problematic sector in the credit portfolio, and their proportion of claims more than 90 days in arrears has been unchanged since the beginning of 2014. They were the only sector apart from the government to record an increase in classified claims at the

The proportion of claims more than 90 days in arrears accounted for by non-residents is increasing.

banks in 2015. Claims more than 90 days in arrears accounted for 4.2% of classified claims in this sector in September 2015.

The proportion of the banking system's claims more than 90 days in arrears accounted for by non-residents has been increasing since 2011, partly as the residual part of the portfolio that was not subject to the transfer of non-performing claims to the BAMC, but also as an indicator of the resolution of subsidiary banks on foreign markets via the transfer of claims to the portfolio of the parent banks of the group established in Slovenia. Claims against non-residents more than 90 days in arrears accounted for 22.3% of the banks' total claims more than 90 days in arrears in September 2015, 10.1 percentage points more than before the transfer to the BAMC. The stock of claims against non-residents more than 90 days in arrears is nevertheless down slightly on two years ago, and is one of the most dynamic parts of the banks' credit portfolio in terms of total claims and non-performing claims.

The stock of claims against non-residents more than 90 days in arrears has been declining since the final quarter of 2014, partly as a result of large write-offs, particularly in June and August 2015, primarily at the large domestic banks. Classified claims against non-residents in this bank group declined by EUR 584 million in 2015, although there was a significantly smaller decline of EUR 118 million in claims more than 90 days in arrears. The burden on this segment of the portfolio entailed by arrears of more than 90 days remains high at 23.3%. These claims also account for 35% of total claims in arrears at the large domestic banks, compared with 13% before the first transfer to the BAMC.

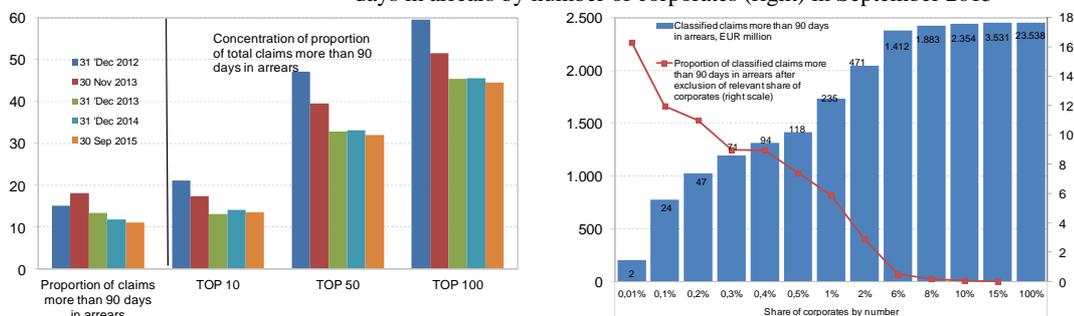
The small domestic banks are also burdened by claims against non-residents, most notably at Factor banka and Probanka. By contrast, this is the least burdened segment of the credit portfolio at the banks under majority foreign ownership, which have recorded an increase in classified claims against non-residents since the beginning of 2014, primarily against parent banks in the rest of the world, but simultaneously recorded a decline in claims more than 90 days in arrears in 2015.

Classified claims against non-financial corporations more than 90 days in arrears remain concentrated.

There was no significant improvement in the quality of claims against non-financial corporations in 2015, despite a decline in claims more than 90 days in arrears throughout the year, as the rapid contraction in corporate lending is having a profound impact on the indicator. According to survey figures, the contraction in demand for loans from active firms is ending, although this has not yet been reflected in the amount of lending, while the stock of new long-term loans has increased.

Claims against corporates more than 90 days in arrears declined by EUR 162.7 million over the first nine months of 2015 to stand at EUR 2.4 billion, or 17.6% of classified claims against corporates, compared with EUR 5.7 billion and 28.1% in November 2013. The change in the quality of the portfolio in this customer segment in 2015 varied at the different bank groups: there was an improvement at the banks under majority domestic ownership and a deterioration at the banks under majority foreign ownership.

Figure 2.3: Concentration of all debtors more than 90 days in arrears (left), and distribution of classified claims against the corporate sector more than 90 days in arrears by number of corporates (right) in September 2015



Source: Bank of Slovenia

A high concentration of claims more than 90 days in arrears across a small number of corporates.

Even as claims more than 90 days in arrears have declined, their concentration has remained high: the top 50 customers more than 90 days in arrears account for 32% of claims more than 90 days in arrears, down slightly on the previous year. The concentration of arrears of more than 90 days is evident in the corporate sector: they are concentrated in 3,626 corporates, or just under 15% of the total number of corporates

irrespective of the stock of classified claims. EUR 1.7 billion of claims more than 90 days in arrears, or 71% of the total, is concentrated in the top percentile of corporates. The proportion of classified claims more than 90 days in arrears in the remainder of the portfolio is just under 6%. Were the banks to continue a joint approach to the resolution of the largest corporates more than 90 days in arrears, the proportion of claims more than 90 days in arrears would decline sharply.

Transitions of non-financial corporations between credit ratings: downgradings are slowing

The pace of transitions of corporates between credit ratings continued to slow in 2015. The pace of transitions between credit ratings is analysed by means of transition matrices calculated separately for SMEs and large enterprises. The pace of transitions over the first nine months of 2015 is compared with that of the same period of the previous year. The transition matrix for 2015 discloses an improvement in all combinations of transitions and for both segments of corporates. A greater improvement is evident in the large enterprises segment. The problems of these corporates have to date been actively resolved via transfers to the BAMC and efforts at restructuring, while SMEs have not benefited from such attention. This is reflected in the significantly larger proportion of loans more than 90 days in arrears in this segment of corporates.

Fewer transitions to lower credit ratings in 2015.

Table 2.1: Proportion of transitions of SMEs and large enterprises between credit ratings, taking into account the number of customers, in percentages

Micro, small and medium-size enterprises (SMEs)

		Sep 2014					Sep 2015						
		A	B	C	D	E			A	B	C	D	E
Dec 2013	A	84,3	13,3	1,4	0,9	0,2	Dec 2014	A	84,8	12,7	1,5	0,8	0,2
	B	9,3	78,6	8,6	2,9	0,7		B	13,0	75,7	9,0	2,1	0,2
	C	2,4	7,6	60,5	22,5	6,9		C	4,7	14,7	66,1	12,4	2,0
	D	0,6	0,7	2,1	63,6	33,0		D	0,5	1,6	1,7	73,2	23,0
	E	0,1	0,0	0,1	2,0	97,7		E	0,1	0,1	0,2	1,1	98,6
Large enterprises													
		Sep 2014					Sep 2015						
		A	B	C	D	E			A	B	C	D	E
Dec 2013	A	89,0	8,3	1,3	1,2	0,1	Dec 2014	A	94,4	4,3	0,9	0,3	0,3
	B	7,4	76,2	11,2	4,7	0,5		B	16,1	77,1	4,5	2,3	0,0
	C	0,7	2,8	59,9	33,6	3,1		C	0,5	9,3	81,3	7,8	1,0
	D	0,4	0,0	0,8	80,6	18,2		D	0,0	1,1	5,2	85,2	8,5
	E	0,0	0,0	0,0	3,0	97,0		E	0,0	0,0	1,8	4,3	93,9

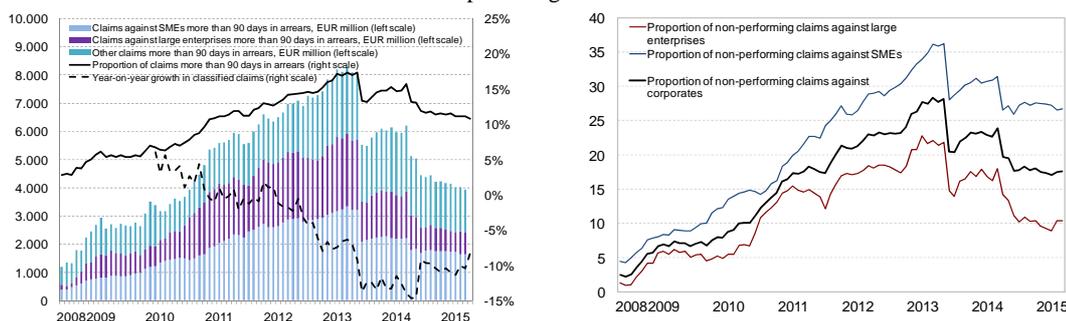
Source: Bank of Slovenia

Classified claims more than 90 days in arrears by corporate size

Claims more than 90 days in arrears against SMEs⁶ and against large enterprises have increased significantly faster since the outbreak of the financial crisis. Claims against large enterprises have been resolved via MRAs, while the SMEs portfolio requires an alternative approach from the banks on account of its granularity. Classified claims against SMEs accounted for 17.3% of the Slovenian banking system's credit portfolio in September 2015, and 42% of total claims more than 90 days in arrears.

⁶ SMEs include micro, small and medium-sized enterprises, the size of enterprises being defined on the basis of the definition set out in Article 55 of the ZGD-1H. For corporates that have ceased publishing their financial statements, their last known size is taken into account throughout the subsequent existence of their exposure in the banking system.

Figure 2.4: Arrears of more than 90 days by corporate size (left) and proportion of claims more than 90 days in arrears by corporate size (right), in EUR million and percentages



Source: Bank of Slovenia

Since the outbreak of the financial crisis, claims more than 90 days in arrears against SMEs have increased significantly faster than those against large enterprises.

Classified claims against SMEs declined significantly faster over the first nine months of 2015 than claims more than 90 days in arrears: the decline in the former was nine times the decline in the latter. Despite a decline of EUR 44 million in claims against SMEs more than 90 days in arrears to EUR 1.6 billion, the proportion of claims against SMEs that they account for remained high in 2015, at 26.7%. The figure was down 9.5 percentage points on the peak of 36.2% in November 2013.

Classified claims against non-financial corporations more than 90 days in arrears by sector

The quality of the credit portfolio against non-financial corporations improved slightly over the first nine months of 2015 overall, although there was a variation from sector to sector. The most notable improvement was recorded by manufacturing, where the trend of decline continued: claims more than 90 days in arrears declined by EUR 145 million, while the proportion of claims that they account for declined by 3 percentage points to 9.2%.

The improvement in the breakdown of the portfolio in manufacturing is mostly the result of favourable economic growth, to which the largest contribution came from manufacturing firms. Economic growth is being reflected in higher corporate profitability and increased debt servicing capacity, which could have a favourable impact in reducing the increase in new claims more than 90 days in arrears, and raising the rate of transition from non-performing to performing claims.

Table 2.2: Arrears in classified claims by sector, in EUR million and percentages

	Classified claims			Classified claims more than 90 days in arrears			Proportion of classified claims against sector more than 90 days in arrears, %		
	Dec 13	Dec 14	Sep 15	Dec 13	Dec 14	Sep 15	Dec 13	Dec 14	Sep 15
Agriculture, forestry, fishing, mining	239	208	204	39	39	34	16,4	19,0	16,5
Manufacturing	4.732	3.994	3.777	748	493	348	15,8	12,4	9,2
Electricity, gas, water, remediation	1.068	1.063	1.103	48	79	48	4,5	7,5	4,3
Construction	1.927	1.490	1.398	967	674	604	50,1	45,2	43,2
Wholesale and retail trade	3.183	2.607	2.565	596	490	466	18,4	18,8	18,2
Transportation and storage	1.836	1.676	1.559	141	58	50	7,1	3,5	3,2
Accommodation and food service activities	505	427	384	167	96	107	33,0	22,6	27,8
Information and communication	451	483	389	61	66	61	13,6	13,8	15,8
Financial and insurance activities	406	282	235	116	36	100	28,6	12,9	42,5
Real estate activities	814	789	727	186	252	277	23,3	32,5	38,1
Professional, scientific and technical activities, administrative and support service activities	1.631	1.318	1.158	406	271	299	25,1	20,6	25,8
Public services	363	327	311	34	35	34	9,4	10,6	10,8
Overall	17.155	14.664	13.811	3.508	2.590	2.428	20,4	17,7	17,6

Source: Bank of Slovenia

In 2015 there was also a decline in claims more than 90 days in arrears against firms in the sectors of construction and wholesale and retail trade in absolute and relative terms, which together account for 44% of claims against non-financial corporations more than 90 days in arrears. Claims more than 90 days in arrears accounted for 43.2% of classified claims against the construction sector in September 2015, despite the transfer of non-performing claims to the BAMC, for which reason construction remains a high-risk sector.

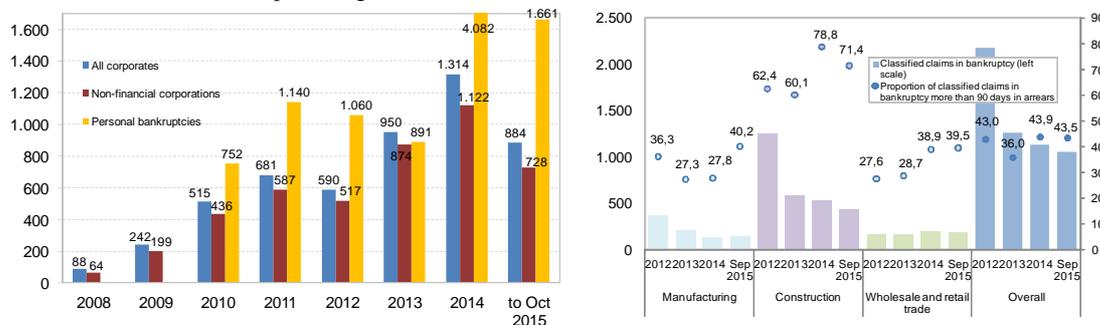
The sectors of financial and insurance services and real estate activities recorded an increase in the amount and proportion of claims more than 90 days in arrears in 2015. In June and July the financial and insurance services sector was more burdened by claims more than 90 days in arrears than the construction sector. However, they account for just 4.1% of claims more than 90 days in arrears in the corporate sector.

Classified claims more than 90 days in arrears against corporates in bankruptcy proceedings and personal bankruptcies

The number of bankruptcies has been rising sharply since the end of 2012, which was additionally encouraged by the entry into force of a new law⁷ in May 2013, which provides for the payment of an advance to a corporate that files for its own bankruptcy or against which employees file for bankruptcy owing to unpaid wages. The number of corporates undergoing bankruptcy proceedings over the first ten months of 2015 exceeded the figure for the entire year of 2012, before the entry into force of the new law, but was less than in 2014. The number of personal bankruptcies had also exceeded the number recorded in the whole of 2013, but was down significantly on 2014. The household segment nevertheless remains the lowest risk.

The number of corporates in bankruptcy proceedings and personal bankruptcies is still rising.

Figure 2.5: Number of initiated bankruptcy proceedings at year-end (left), and banks' classified claims against non-financial corporations in bankruptcy and proportion of total claims against non-financial corporations by sector accounted for by non-financial corporations in bankruptcy (right), in EUR million and percentages



Sources: Bank of Slovenia, AJPES

The banks' exposure to corporates in bankruptcy constitutes the largest risk of claims being lost or only partly repaid. The number includes corporates in the sectors of non-financial corporations, OFIs and sole traders, but does not cover non-resident corporates.⁸

The stock of claims against corporates in bankruptcy continued to decline in 2015, but nevertheless accounted for 43.5% of total claims against corporates more than 90 days in arrears. Despite a decline in 2015, construction remains the sector with the largest classified claims in bankruptcy, in both absolute and relative terms. The sectors of professional, scientific and technical activities, administrative and support service activities, and transportation and storage also have above-average proportions. The figure is also high in the manufacturing sector, where the proportion of claims more than 90 days in arrears accounted for by corporates in bankruptcy increased from 27.8% to 40.2% as claims more than 90 days in arrears declined, despite the stock of classified claims in bankruptcy remaining virtually unchanged.

2.1.2 Corporate indebtedness

Corporate indebtedness as measured by the debt-to-equity financing ratio has declined significantly in recent years. Alongside debt repayment, a major factor in the deleveraging of the corporate sector was the number of bankruptcies, after which the corporates are no longer included in the indicator for the sector as a whole. The corporate sector was thus relieved of the burden of certain highly indebted corporates that were not capable of servicing their debts. The excessive credit growth of a decade ago and the increase in the banks' exposure to the corporate sector without the proper vetting of debt servicing

The excessive credit growth of a decade ago remains a burden on bank balance sheets.

⁷ Act Amending the Financial Operations, Insolvency and Compulsory Dissolution Act (ZFPPIPP-E; Official Gazette of the Republic of Slovenia, No. 47/13).

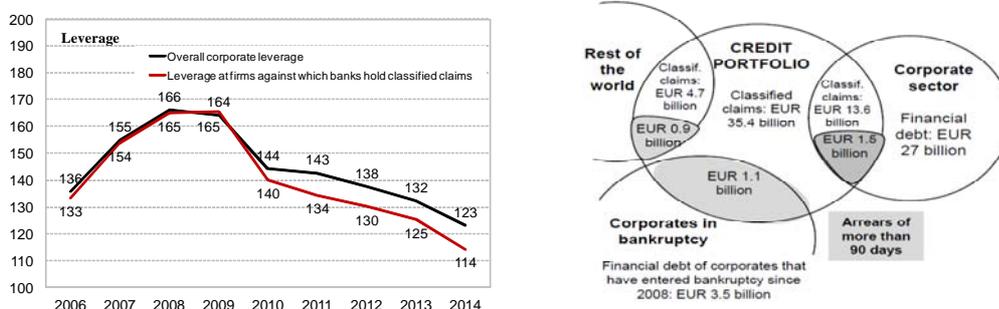
⁸ It includes all corporates established in Slovenia to which banks were exposed as at 30 September 2015 that were undergoing personal bankruptcy proceedings or corporate bankruptcy proceedings.

capacity remains a burden on bank balance sheets.⁹ Bank balance sheets were burdened with EUR 1.1 billion of claims more than 90 days in arrears against corporates in bankruptcy at the end of 2014, or 44% of total claims against corporates more than 90 days in arrears. The remainder of these claims in the amount of EUR 1.5 billion consists of the arrears of active firms.

Indebtedness at certain existing corporates that have expanded turnover and young corporates has increased since the outbreak of the crisis.

Corporate deleveraging is thus partly a result of corporate bankruptcies, although corporates that survived the crisis are also deleveraging. The leverage of corporates operating as going concerns in 2008 and in 2013 declined from 128% to 98% over this period.¹⁰ On one hand highly indebted corporates are deleveraging, while on the other hand leverage at existing corporates that have expanded their turnover and at young corporates has increased. In bank financing the focus therefore needs to be on the proper allocation of loans to corporates with sound business models. The leverage of corporates being financed at banks is lower than overall corporate leverage, which indicates that corporates that have classified claims have paid down a greater amount of debt to the banks (partly as a result of the greater impact of corporates in bankruptcy), and that the banks have been more cautious in lending to customers in recent years.

Figure 2.6: Leverage of all corporates and corporates against which banks hold classified claims in percentages (left), and financial debt of active firms and corporates in bankruptcy on bank balance sheets at the end of 2014 (right)



Note: Corporates against which banks hold classified claims are defined as those corporates against which the banks held classified claims at the end of the year in question.

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

The corporate sector has deleveraged substantially over the last three years, albeit primarily by reducing debt; equity has remained at virtually the same level.

Corporates have sharply reduced their indebtedness over the last three years. The debt-to-equity ratio declined from 131% in 2014 to 123%,¹¹ down 23 percentage points on its peak in 2008. The corporate sector primarily deleveraged by paying down debt by 14%; equity increased by just 2%. Corporate deleveraging stalled in 2015. The debt-to-equity ratio remained almost unchanged in the second quarter of 2015 at 124%.

Corporate deleveraging should be based more on growth in equity, and less on debt reduction.

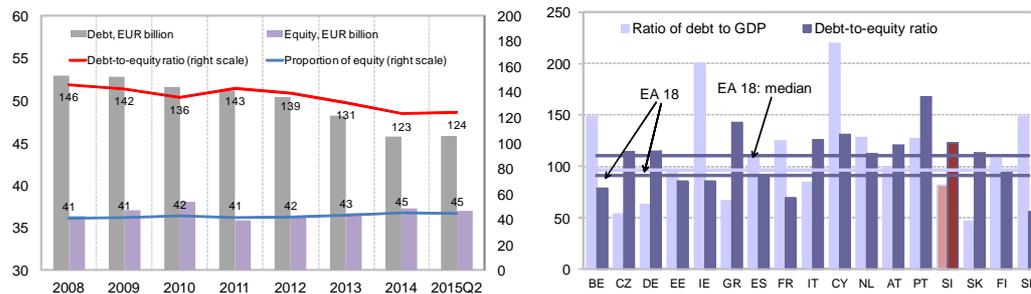
The corporate financing model should be based more on growth in equity in the future, and less on debt financing. The ratio of corporate debt to GDP is below the euro area average, while the debt-to-equity ratio is still above the euro area average, despite an improvement. The actual level of corporate debt is therefore not problematic, but the financing structure is inappropriate, as corporates lack equity. Changes in capital valuation have had a profound impact on the debt-to-equity ratio: corporate deleveraging has gone hand-in-hand with a trend of capital devaluation. In addition to capital revaluations, which can have an impact in both directions, corporate equity can be increased not only by new investment or recapitalisations, but also by improved performance and an increase in retained earnings.

⁹ The calculation of the debt-to-equity ratio for the active part of the economy does not take account of corporates in bankruptcy, but they nevertheless remain on bank balance sheets.

¹⁰ Indebtedness was reduced at 60% of corporates that survived the crisis, i.e. those that operated as going concerns both in 2008 and in 2013. See Stability of the Slovenian Banking System 2015, p 56.

¹¹ The corporate debt-to-equity ratio was different from that published in the previous Financial Stability Review as a result of a change in financial accounts statistics in the valuation of non-performing claims transferred to the BAMC. As of the second quarter of 2015 claims transferred to the BAMC have been disclosed at nominal value, and no longer at transaction value. Had the non-performing claims been stated at transaction value in the calculation, the figure would have stood at 112% at the end of 2014. Here it should be noted that the majority of corporates whose claims were transferred to the BAMC and were included in the calculation were in bankruptcy.

Figure 2.7: Corporate debt-to-equity ratio (left), and comparison of corporate indebtedness with the euro area in 2014 (right), in percentages

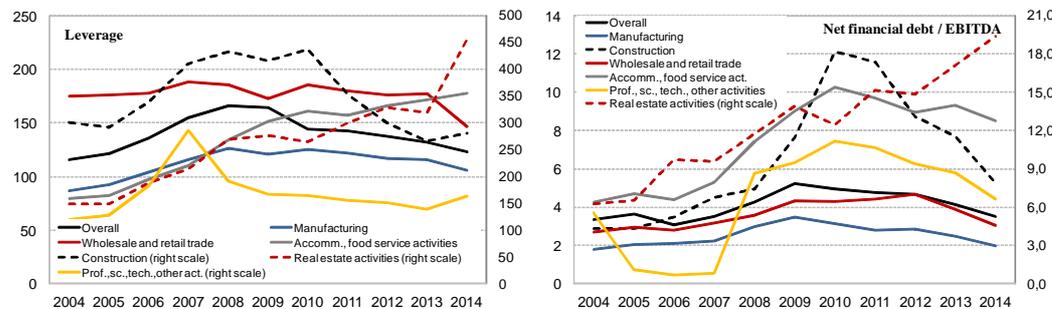


Sources: Bank of Slovenia, Eurostat, Bank of Slovenia calculations

The indebtedness of the corporate sector at the end of 2014 stood at its level from before the crisis, i.e. before the beginning of the heavy corporate borrowing in 2005 to 2007. The level and trends in corporate indebtedness and debt servicing capacity vary from sector to sector. The indebtedness of manufacturing firms was actually moderate at the outbreak of the crisis, and had fallen further by 2014; leverage stood at 106%, while the ratio of net financial debt to EBITDA¹² stood at two years.

The leverage of construction firms is lower than in the pre-crisis years, but their debt servicing capacity is low. The indebtedness of firms in the sectors of accommodation and food service activities and real estate activities is increasing.

Figure 2.8: Leverage in percentages (left), and net financial debt to EBITDA in years (right) in selected sectors



Sources: AJPEs, Bank of Slovenia calculations

Leverage remains highest at construction firms and firms in the real estate activities sector. Leverage at construction firms declined from 433% in 2008 to 281% in 2014, and is thus lower now than in the pre-crisis years. They nevertheless still have difficulties with debt servicing, because of low profitability. The risk has also been increasing in certain other sectors in recent years. Firms in the real estate activities sector recorded a sharp increase in leverage from the outbreak of the crisis, from 269% in 2008 to fully 455% in 2014, and their debt servicing capacity also declined. Leverage is also increasing at firms in the accommodation and food service activities sector, and had reached 178% by 2014, while the ratio of net financial debt to EBITDA stood at 8.5 years.

Despite the deleveraging of the corporate sector in recent years, a certain segment remains highly indebted. Part of the corporate sector has succeeded in reducing leverage since the outbreak of the crisis, strengthening capital and contributing to domestic economic growth. The remainder of the sector still requires debt restructuring and operational restructuring, and is a burden on bank balance sheets, which is a factor in weak credit growth. It includes SMEs, which have reduced leverage faster and further than large enterprises since the peak of the crisis, but are still more indebted and at greater risk in repaying their liabilities. The Bank of Slovenia and the Bank Association of Slovenia have drawn up the Guidelines for restructuring SMEs to make the restructuring of claims against SMEs faster and easier. Creating a supportive environment for SMEs would also strongly improve the potential for economic growth.

Part of the corporate sector remains highly indebted, and requires the restructuring of its debts and operations.

¹² 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.

2.1.3 Coverage of claims more than 90 days in arrears by impairments and provisions and by credit protection

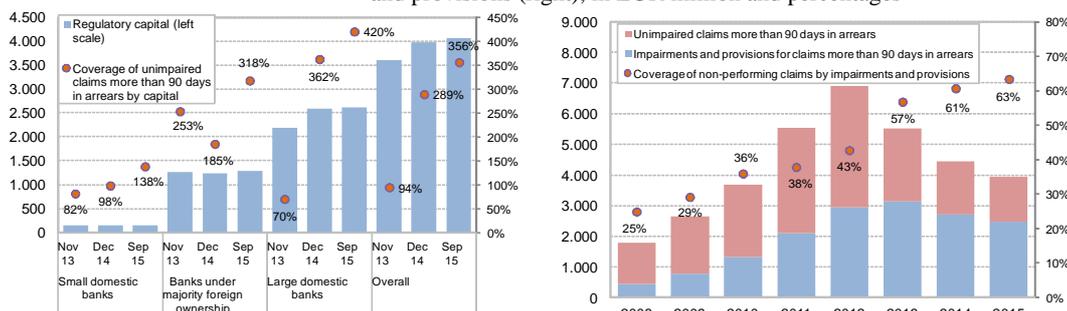
Coverage of claims more than 90 days in arrears by impairments and provisions improved further in 2015. Coverage reached 63% in September, up 6.2 percentage points since the first transfer of claims more than 90 days in arrears to the BAMC in December 2013. The stock of impairments and provisions declined in the wake of relatively large write-offs of claims over the first nine months of the year; these claims had a high level of coverage by impairments. The high coverage of claims by impairments and provisions means that the banks are more resilient to the prospect of zero recovery of claims more than 90 days in arrears. The banks would take a capital hit in this event, in the amount of the portion uncovered by impairments and provisions. Uncovered claims amounted to EUR 1.5 billion in September 2015, or 37% of claims more than 90 days in arrears.

The banks under majority foreign ownership recorded the largest increase in impairments in 2015. Their coverage of non-performing claims more than 90 days in arrears by impairments stood at 58.2% in September, up 6.1 percentage points on the end of 2014. The ratio of unimpaired claims more than 90 days in arrears to capital also improved: coverage by capital stood at 185% in December 2014, and 318% in September 2015.

The large domestic banks have the highest coverage of claims by impairments.

Coverage of non-performing claims more than 90 days in arrears by impairments at the large domestic banks was higher than at the end of 2014, at 65.5% in September. The large domestic banks also have the highest coverage of unimpaired claims more than 90 days in arrears by capital. From a shortfall of capital for the coverage of unimpaired non-performing claims before the beginning of the bank stabilisation process (the figure was 70%), coverage by capital had increased to 420% by September 2015. The small domestic banks also increased their coverage of unimpaired claims more than 90 days in arrears by capital, from 98% in December 2014 to 138% in September 2015.

Figure 2.9: Coverage of unimpaired claims more than 90 days in arrears by capital (left), and coverage of claims more than 90 days in arrears by impairments and provisions (right), in EUR million and percentages



Note: ¹ Factor banka and Probanka have been excluded from the left figure.
Source: Bank of Slovenia

Coverage by impairments is increasing in the majority of sectors.

The indicator of the coverage of claims more than 90 days in arrears by impairments and provisions does not take direct account of the debtor's collateral for the claim, although this is taken into account in the individual approach to the creation of impairments and provisions at banks. Despite the increased write-off of claims against non-residents, coverage by impairments remained at almost the same level as in December 2014.

Table 2.3: Coverage of classified claims and claims more than 90 days in arrears by impairments and provisions, in EUR million and 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	Dec 14	Sep 15	Dec 11	Dec 12	Dec 13	Dec 14	Sep 15
NFCs	8,8	11,5	17,1	16,3	16,0	38,2	39,2	50,6	57,1	58,7
OFIs	14,4	24,9	26,9	14,4	15,2	38,7	64,1	76,5	69,0	67,3
Households	3,6	3,9	4,5	4,3	4,2	-	-	65,2	66,8	70,8
sole traders	8,8	9,1	13,5	14,7	13,7	43,7	43,3	51,6	57,0	56,2
other households	3,0	3,3	3,7	3,7	3,7	-	-	70,9	70,7	70,8
Non-residents	6,6	10,4	22,4	38,7	39,6	32,9	42,6	71,0	72,9	71,3
Government	0,1	0,2	0,5	0,6	0,6	3,3	5,3	28,4	30,9	84,0
Banks and savings bank	0,5	1,2	1,2	0,5	0,5	12,1	12,2	0,8	0,6	44,0
Overall coverage	6,6	8,7	12,2	10,9	10,4	37,8	42,7	56,8	60,8	63,0
	Total classified claims					Total arrears of more than 90 days				
EUR million	49.466	47.876	41.329	37.449	36.159	5.547	6.904	5.520	4.448	3.933
EUR million	Total impairments					Impairments for arrears of more than 90 days				
	3.249	4.170	5.054	4.091	3.750	2.097	2.949	3.133	2.703	2.478

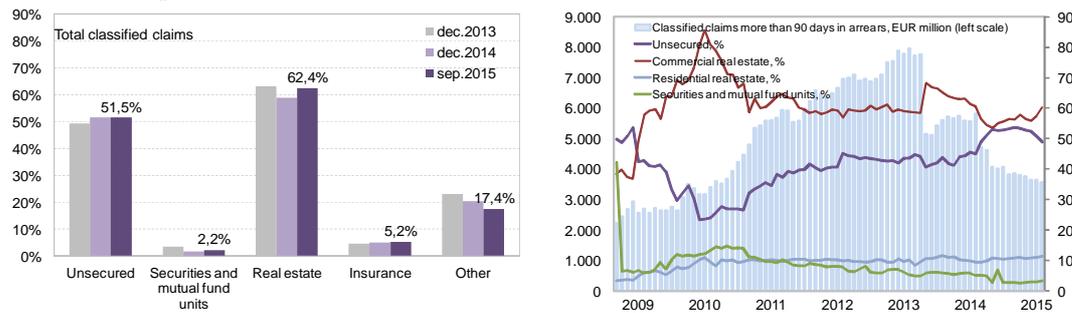
Source: Bank of Slovenia

Loan collateral

The proportion of unsecured claims in the banking system has been increasing since 2012, although it is lower for claims more than 90 days in arrears. Unsecured claims accounted for a half of claims more than 90 days in arrears in 2015. The value of all types of collateral is declining, other than insurance with insurers, which accounts for a small proportion of credit protection. The total value of collateral received (measured at fair value) is equivalent to 89.7% of claims more than 90 days in arrears, up 8.7 percentage points on the end of 2014.

The proportion of unsecured non-performing claims has increased since the end of 2013, while the total value of credit protection has declined.

Figure 2.10: Coverage of the banks' total classified claims (left), and coverage of claims more than 90 days in arrears (right) by credit protection, in percentages



Source: Bank of Slovenia

The large domestic banks had the highest proportion of unsecured claims, at 52.6%, down on the beginning of the year. During the transfer of certain claims more than 90 days in arrears to the BAMC, the aforementioned bank group also transferred the corresponding collateral, thereby increasing the proportion of unsecured claims in the portfolio. The savings banks are notable for their low proportion of unsecured claims (25%), while they also have highest ratio of the total value of credit protection to claims more than 90 days in arrears, at 175.6%. The savings banks do however have a significantly smaller amount of claims in arrears than the other bank groups. Real estate collateral remains the prevailing form of credit protection; the proportion of total credit protection value that it accounts for increased to 71.6% in 2015. Real estate collateral has been impacted by the lower volume of trading in real estate, which actually improved in 2015, and the fall in real estate prices since 2008, which came to an end in 2015. The proportion accounted for by collateral in the form of securities and mutual fund units has declined since 2011, as a result of which the banking system's credit portfolio is not significantly exposed to the volatility in securities values in the context of the low liquidity of the capital market in Slovenia.

Real estate collateral remains the prevailing form of credit protection.

Table 2.4: Collateral claims more than 90 days in arrears in September 2015 by bank group, in percentages

	Comparison of credit protection ² with classified claims more than 90 days in arrears, %						
	Classified claims, EUR million	Unsecured ¹	Shares, equity and mutual fund units as collateral	Commercial real estate as collateral ³	Housing as collateral ³	Other forms	Total value of collateral ³
Savings banks	7,2	25,4		91,3	84,1	0,2	175,6
Small domestic banks	776,0	43,6	7,1	61,2	22,9	29,3	120,4
Banks under majority foreign ownership	973,4	46,5	2,3	58,1	11,5	23,8	95,7
Large domestic banks	1.808,2	52,6	2,2	60,8	6,1	3,7	72,9
Overall	3.564,9	48,9	3,3	60,2	11,4	14,8	89,6

Notes: ¹ The figure includes unsecured claims and claims secured with forms of credit protection 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. The collateral value is thus multiplied, both for these forms of collateral and as an aggregate.

Source: Bank of Slovenia

2.1.4 Resolution of claims more than 90 days in arrears at the banks

Restructuring of claims

There were EUR 3.8 billion of restructured claims in the banks' credit portfolios in September 2015.

Restructuring has been more successful at large enterprises.

Restructuring is one of the most important approaches to resolving non-performing claims at banks. In previous years a large portion of claims, particularly those against large enterprises, have been restructured via MRAs involving a large number of creditor banks. Cases of the restructuring of claims at the level of the individual bank are significantly higher in number, but smaller in size. The highest proportion of claims were restructured by means of the extension of the maturity, the deferral of repayment, or the extension of the maturity in combination with reductions in the interest rate and/or non-interest charges. The stock of restructured claims in the banking system's portfolio declined in 2015. It stood at EUR 3.8 billion in September, down EUR 204.6 billion on December 2014. The corporate sector accounts for 73.6% of restructured claims in terms of amount.

Unsuccessfully restructured claims, i.e. those where arrears of more than 90 days have arisen again, amounted to EUR 1.4 billion in September 2015, or 35.5% of the total. The figure is slightly lower in the corporate sector at 32.4%.

The banks have undertaken more restructuring of claims against large enterprises, in relation to which there is a specific level of granularity of customers and lower exposure to the customer. Restructured claims against large enterprises accounted for 60% of all restructured claims against corporates in September 2015, down 2.4 percentage points on December 2014. When measured by arrears of more than 90 days in arrears, there is significantly more success in the resolution of claims via restructuring at large enterprises, where 22.7% of restructured claims are in arrears, than at SMEs, where almost half (47.2%) of restructured claims are more than 90 days in arrears.

Table 2.5: Restructured classified claims and claims more than 90 days in arrears against non-financial corporations by sector, in EUR million and percentages

	Classified claims in restructuring, EUR million		Proportion of classified claims in restructuring, %		Restructured claims more than 90 days in arrears, EUR million		Proportion of restructured claims more than 90 days in arrears, %	
	Dec 14	Sep 15	Dec 14	Sep 15	Dec 14	Sep 15	Dec 14	Sep 15
Agriculture, forestry, fishing, mining	62	72	31,9	35,4	7,9	14,1	12,7	19,5
Manufacturing	880	767	23,0	20,3	149,7	103,7	17,0	13,5
Electricity, gas, water, remediation	43	21	4,0	1,9	39,9	12,2	91,8	56,6
Construction	210	193	14,7	13,8	96,5	98,3	46,0	51,0
Wholesale and retail trade	688	672	26,7	26,2	186,9	202,6	27,2	30,2
Transportation and storage	118	115	7,5	7,4	4,9	4,3	4,1	3,8
Accommodation and food service activities	166	157	42,5	40,7	40,3	63,6	24,3	40,6
Information and communication	69	64	15,1	16,4	42,6	40,4	62,1	63,5
Financial and insurance activities	142	157	58,5	67,0	17,5	69,4	12,3	44,1
Real estate activities	301	304	40,0	42,0	99,3	174,4	33,0	57,5
Professional, scientific and technical activities, administrative and support service activities	250	174	21,8	15,1	73,0	116,7	29,1	66,9
Public services	88	132	28,2	42,5	13,3	17,8	15,1	13,4
Overall	3.018	2.828	21,6	20,5	772	918	25,6	32,4

Source: Bank of Slovenia

The stock of restructured claims against the manufacturing sector reached EUR 767 million in September 2015, or 20.3% of total classified claims, of which EUR 104 million or 13.5% had again been classed as more than 90 days in arrears. This is indicative of an improvement in restructuring procedures in manufacturing in 2015 compared with 2014, and the above-average success of restructuring in the sector compared with other sectors. Transportation and storage is notable for the success of restructuring and also good portfolio quality. Half of all restructured claims in the construction sector had fallen more than 90 days into arrears by September 2015. The proportion of restructured claims was very high in the financial and insurance activities sector at 67%, while the success of restructuring as measured by restructured claims again falling more than 90 days into arrears was low.

Above-average success of restructuring in manufacturing.

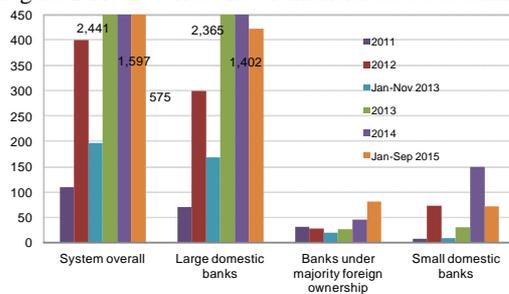
The efficiency and success of the restructuring of claims more than 90 days in arrears will be confirmed in time. It is a complicated process of assessing the debtor's performance and the general economic situation, to which the terms of the restructuring have to be tailored. It is not essential for all restructuring procedures to be successful, or for success to be reflected in the percentage of claims again falling more than 90 days in arrears. It is important that good restructuring practices that yield the best results are formulated and applied intensively in the resolution of non-performing claims in the banks' portfolio.

Write-offs of financial assets at banks

The banks are writing off unsecured claims against debtors 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 liquidation of collateral over the same period.¹³ The banks wrote off claims in the amount of EUR 575 million over the first nine months of 2015, surpassing their bank survey forecasts of a reduction of EUR 328 million in claims more than 90 days in arrears over the whole of 2015. The large domestic banks accounted for 73.6% of the claims written off in 2015.

The large domestic banks accounted for the largest proportion of write-offs of claims more than 90 days in arrears.

Figure 2.11: Write-offs of financial assets at banks, in EUR million



Source: Bank of Slovenia

The small domestic banks' write-offs in 2015 were 1.7 times those in the same period of 2014, as a result of which coverage of claims by impairments was up 2.7 percentage points on December 2014, despite a decline in impairments.

¹³ Regulation amending the Regulation on the assessment of credit risk losses of banks and savings banks (Official Gazette of the Republic of Slovenia, Nos. 29/12 and 12/14).

Box 2.1: Comparison of the definition of non-performing exposures under EBA regulations and the definition of arrears of more than 90 days announced by the Bank of Slovenia

The European Banking Authority (EBA) has set out a standard definition of non-performing and forborne exposures¹⁴ to standardise the definition of non-performing exposures across banking systems in the euro area. The EBA definition of non-performing exposures (NPEs) is broader than the definition of claims more than 90 days in arrears announced for the Slovenian banking system by the Bank of Slovenia for monitoring the quality of the credit portfolio.

In addition to arrears of more than 90 days the EBA definition of NPEs includes those satisfying the criterion of “unlikely to pay”. According to the prescribed methodology, under the EBA definition non-performing claims also include forborne exposures, i.e. exposures for which the banks have modified the terms and conditions of repayment owing to the customer’s financial difficulties. The stock of non-performing claims is thus significantly increased by forborne exposures that are not more than 90 days in arrears. Although forbearance is one of the approaches taken by banks to reducing or resolving the problem of non-performing claims, under the EBA definition they remain non-performing claims for a specific period.

The EBA defines the period after which forborne exposures may be reclassified out of NPEs by when the exposure meets all of the following criteria:

- after extension there is no objective evidence of impairment or reclassification among defaulters,
- a year has passed since the extension,
- there are no more arrears or doubts with regard to full payment.

If a forborne performing exposure (i.e. after reclassification from NPEs back to performing exposures) in the probation period, when the exposure is under observation for a minimum of two years, is forborne again or is more than 30 days in arrears, it is reclassified as an NPE. All forbearances that before the change in terms and conditions of repayment were defined as NPEs or would have been classified as NPEs had the forbearance not been undertaken, or where the exposure has been written off in part or in full, and the problematic transaction is being resolved on the basis of the drawdown of a new loan approved at the bank, are also classified as NPEs.

In addition to the aforementioned expansions to the numerator in the NPEs indicator, under the EBA definition there is also an expansion in the denominator, which, alongside the existing financial assets measured at amortised cost (loans and debt securities) and commitments given under off-balance-sheet items based on which a payment liability could arise for the bank, also includes available-for-sale financial assets, financial assets designated at fair value, and approved undrawn loans.

Table 2.6: Itemisation of exposures and NPEs according to EBA definition as at 30 June 2015, in EUR million and percentages

	Gross carrying amount of exposure				
	of which non-performing		of which forborne and non-performing		
	EUR million	%	EUR million		
Debt instruments excluding those held for trading:	36.552	5.535	15,1	0	2.817
- of which debt securities	8.828	0	0,0	0	0
- of which loans, advances and other financial assets	27.724	5.535	20,0	0	2.817
- of which loans, advances and other financial assets to NFCs	11.530	4.437	38,5	0	2.569
Off-balance-sheet exposures	5.449	417	7,6	0	28
Overall	42.001	5.951	14,2		2.845

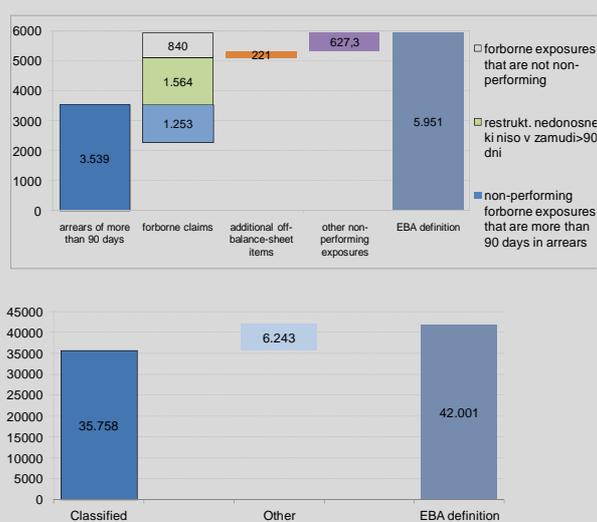
Note: The figures for the banking system exclude Factor banka and Probanka

Source: Bank of Slovenia

Of the claims more than 90 days in arrears, which amounted to EUR 3.5 billion in June 2015, EUR 1.3 billion were forborne claims that had again fallen into arrears of more than 90 days. The broader definition of non-performing exposures includes an additional EUR 1.6 billion of forborne exposures that are not more than 90 days in arrears, but are classified as non-performing according to the aforementioned criteria. The stock of non-performing off-balance-sheet liabilities captured by the new definition of non-performing claims was EUR 0.2 billion larger than in the previous capture, most likely as a result of the expansion in exposures included in the EBA’s broad definition. The remaining EUR 0.6 billion in the broadest capture of non-performing exposures on the basis of available reporting cannot be precisely defined, but the largest portion probably derives from soft criteria based on which a bank classifies claims as non-performing.

¹⁴ Commission Implementing Regulation (EU) 2015/227 (OJ L 48 of 20 February 2015) prescribes two forms for information on non-performing exposures and forborne claims (Forms F.18 and F.19). The banks’ reports on the basis of the EBA definition for non-performing and forborne claims were made as at 30 June 2015.

Figure 2.12: Arrears of more than 90 days compared with non-performing claims, June 2015



Source: Bank of Slovenia

The denominator of the proportion of claims more than 90 days in arrears, classified claims, amounted to EUR 34.8 billion according to the Bank of Slovenia definition, and EUR 42 billion according to the broader EBA definition. Claims more than 90 days in arrears are also smaller than non-performing exposures (EUR 3.5 billion versus EUR 6 billion), as a result of which the proportion of claims more than 90 days in arrears is 10.2%, instead of 14.2%. Taking account of the broader EBA definition limited solely to loans in the banking portfolio, the proportion of NPEs is 20%.

Box 2.2: Activities carried out and in progress within the framework of the project for the restructuring of non-performing exposures at banks

As part of the project for the restructuring of non-performing exposures at banks, the Bank of Slovenia conducts supervisory activities and actively participates in other activities related to the restructuring of non-performing exposures at banks. Certain activities are no longer the subject of this project, but are part of the Bank of Slovenia's ordinary supervision and restructuring processes at banks (the first four activities), while there is intensive activity to carry out the last three.

1. Formulation of guidelines for the gradual elimination of impairments for investments for which banks have signed a master restructuring agreement (MRA)

In December 2014 the Bank of Slovenia sent banks guidelines for the gradual elimination of impairments for claims for which banks have embarked on restructuring. The guidelines were also coordinated with auditors.

2. Overhaul of reporting to the Bank of Slovenia

For the purpose of reducing the reporting workload and simultaneously improving the quality and usefulness of existing reports, the Bank of Slovenia abolished the reporting that it required in the first trimester and required the submission of selected documents in the area of the management of claims against corporates that are over-leveraged but nevertheless have good prospects, and introduced changes and additions to reporting on the DEN TOK and POR-195/5 forms. The banks have been reporting under the updated scheme since the first quarter of 2015.

3. Preparation and issue of guidelines for early warning systems (EWSs) at banks for customer monitoring and optimisation of restructuring processes (for non-performing claims) at banks

A review and analysis of EWSs and the organisation of processes at the banks drawn up by the Bank of Slovenia on the basis of a survey revealed major differences in the approach and sophistication of the systems of individual banks. In light of the importance of the EWS as a preventive tool, and the importance of process organisation to effective functioning, the Bank of Slovenia's assessment is that it is vital to standardise the minimum requirements in this area. The Bank of Slovenia issued the guidelines to all banks. The banks that had failed to put in place adequate and sufficiently sophisticated processes and systems received requirements for improvement together with the Bank of Slovenia guidelines.

4. Monitoring of MRAs

The banks had until September 2015 (pursuant to the reporting regulation) to report to the Bank of Slovenia on progress in restructuring the 71 firms and groups with which master restructuring agreements (MRAs) have been signed. They had been required to report accordingly since May 2013. In 12 cases there was a repeat of the restructuring (in three cases the creditors opted for bankruptcy in the end), or the agreed restructuring was revised, the original restructuring having lacked sufficient foundation, primarily owing to inadequate cooperation between the banks, a lack of good banking

practice (solutions that were merely short-term and partial), and the fact that the restructuring principles had not yet entered into force at the time of the majority of the negotiations. The classified claims in the reported cases amounted to EUR 1.8 billion in November 2015, although the amount from the end of November 2013 of EUR 3.6 billion is more relevant, some of the claims having been transferred to the BAMC in the interim, while some of the claims were converted into equity (EUR 284 million), some were written off and some were repaid. These firms employed more than 34,000 people at the end of 2014, and generated almost EUR 5.5 billion of revenue in 2014.

The problems in the implementation of MRAs (approximately 25% of the total) in the majority of cases arise with firms where the owners and senior management are not involved in the restructuring to a sufficient degree, and the creditors are over-tolerant of this situation and hold off from using more aggressive tools such as the termination of the agreement and, in consequence, insolvency proceedings.

5. Management of non-performing exposures

In the area of NPEs, the Bank of Slovenia required banks to draw up and submit plans for managing (reducing) NPEs for the three-year period of 2015 to 2017. The banks and savings banks drew up numerical and descriptive plans on the basis of the Bank of Slovenia's requirements, and submitted them by the end of May 2015. The results of the analysis of the plans were presented to the banks by the Bank of Slovenia in July 2015. The banks submitted their additional clarifications and addenda by 31 October 2015, and each year will draw up a plan of reduction for the next three-year period.

6. Guidelines for managing non-performing exposures to SMEs

In the first phase of restructuring (2012 to 2014), the banks primarily focused on the restructuring of large enterprises, having been compelled to do so because of their poor financial situation. In the SMEs segment the banks have to date only dealt with the most critical cases, which was primarily the result of a shortage of human resources, deficient internal organisation and a lack of knowledge in the restructuring of this segment, which differs greatly from the restructuring of large enterprises.

The guidelines introduce detailed guidance with regard to the following into bank practice:

- the handover of the debtor to the workout unit;
- the segmentation of debtors in relation to the method of treatment;
- a larger role and greater powers for the coordinator;
- the use of external contractors and analysis of the viability of the business model;
- write-offs, and the use of conversion of certain claims into equity or assets.

The guidelines will aid the senior management of banks in making faster decisions, which will lead to the comprehensive restructuring of SMEs, and not to the continuation of the existing (often inviable) situation. They instruct the senior management and owners of these firms that successful restructuring requires them to act fairly and honestly, which includes the disclosure of all relevant information, that the banks' requirements and conditions should be observed, and that additional financial engagement is required of the owners, either in the form of personal guarantees or in the form of recapitalisation.

7. ECB task force for reducing banks' non-performing exposures

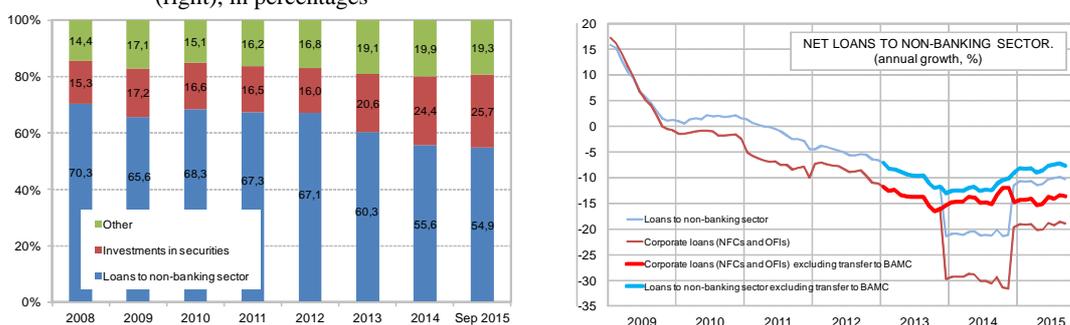
Within the framework of the Single Supervisory Mechanism (SSM), in September 2015 the ECB created a task force charged with establishing a consistent approach by supervisors and banks to managing the high level of non-performing exposures in the euro area. Activities are in progress within various working groups, in which Bank of Slovenia representatives are also participating. The most important objectives of the activities are:

- analysing current national legislation, accounting practices and supervisory approaches to managing non-performing claims;
- drawing up a plan for resolving non-performing claims;
- formulating minimum joint guidelines for conducting supervision.

2.1.5 Bank lending activity

The burden placed on the credit portfolio by non-performing claims is a limiting factor in the banks' capacity to generate income from this segment of the portfolio, which is driving them to seek higher returns on other investments. The proportion of bank investments accounted for by securities continued to increase in 2015. The proportion of total assets accounted for by loans to the non-banking sector declined from more than 70% in 2008 to less than 55% in September 2015.¹⁵ The proportion of total assets accounted for by investments in debt securities increased to more than a quarter, most notably at the large domestic banks. The increase in investments in securities is partly the result of loan repayments not being placed back in the real sector by the banks; they include repayments of non-performing loans being undertaken by new creditworthy owners after acquisitions. Over half of the securities in the banks' portfolio, EUR 4.8 billion worth, will mature by the end of 2017, and will have to be replaced by lower-yielding or higher-risk investments.

Figure 2.13: Breakdown of bank investments (left), and year-on-year growth in loans (right), in percentages



Source: Bank of Slovenia

The stock of loans to the non-banking sector is continuing to decline, although the pace of the contraction is gradually slowing. Year-on-year growth in loans to the non-banking sector in the banking system overall stood at -10.4% in September 2015, or -7.7% if the effect of the transfer to the BAMC is excluded. The slowdown in the contraction is evident in corporate loans and household loans at the large domestic banks. They recorded the largest year-on-year contraction in corporate loans at 20%, although if the effect of the transfer of the non-performing claims of Abanka and Banka Celje at the end of 2014 is excluded the figure was more favourable than at the other bank groups, at just under 8%.

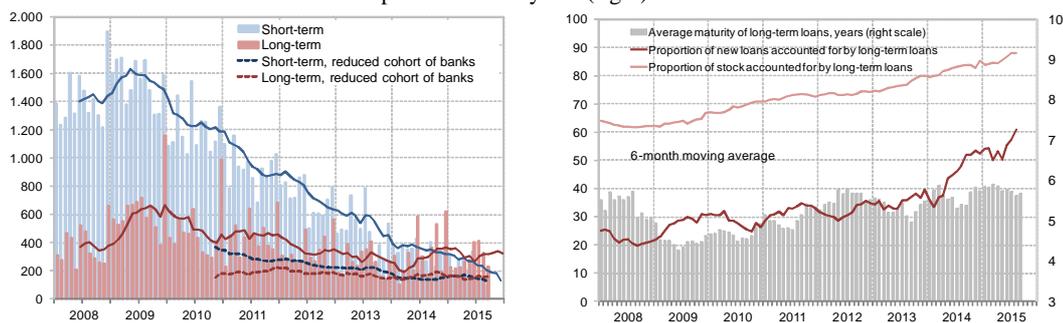
The contraction in corporate loans is gradually slowing, most notably at the large domestic banks.

New long-term corporate loans have been increasing since the second half of 2014, while short-term loans have continued to decline. The average maturity at approval of long-term loans has also been increasing. As a result of the lengthening of the average maturity of new loans, the proportion of the stock of loans accounted for by long-term loans increased from 63% in 2008 to 88% in 2015. The sharp decline in short-term loans is an indicator of changes at corporates that had previously hedged by increasing their liquid investments, most notably currency and deposits (for more, see box). It could also be an indicator of lower demand for liquid assets, i.e. short-term loans.

The average maturity of new corporate loans is increasing.

¹⁵ The decline was more pronounced in 2013 and 2014 as a result of the transfer of certain non-performing claims to the BAMC. The banks participating in the transfer of claims received the aforementioned firm's securities in exchange, in addition to Slovenian government bonds.

Figure 2.14: New corporate loans in EUR million (left), and breakdown of long-term corporate loans in percentages and average maturity of long-term corporate loans in years (right)



Note: The reduced cohort of banks excludes the banks undergoing orderly wind-down, the banks withdrawing from the Slovenian market and the banks reducing turnover owing to commitments given to the European Commission.

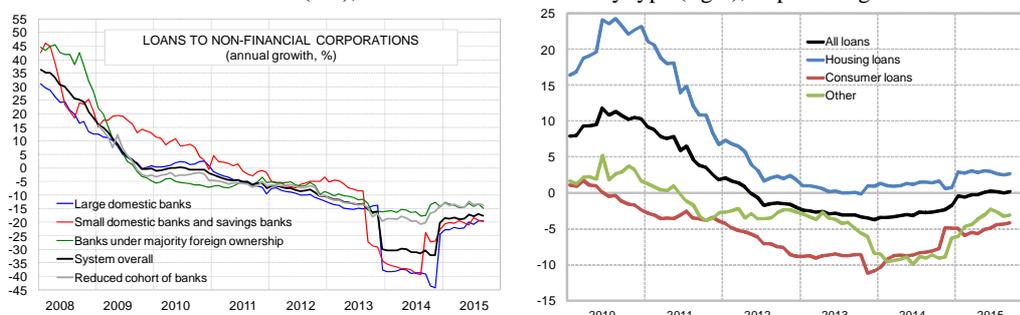
Source: Bank of Slovenia

There are several factors in the slow recovery in bank lending activity. In addition to loan supply and loan demand factors, to a certain extent the recovery is being affected by the commitments given to the European Commission by the banks that received state aid with regard to a contraction in turnover. The withdrawal announced by certain banks under majority foreign ownership leaving the Slovenian market because of their failure to generate the anticipated returns also entails the reduction and closure of existing investments and a decline in new loans. The bank consolidation and merger process could also entail a greater focus on the search for synergies for the banks over a specific period, and less focus on core business.

Growth in household loans has been positive since May 2015.

After declining for three years, household loans have been increasing again since May 2015. Year-on-year growth in household loans is positive at the banks under majority foreign ownership and the small domestic banks and savings banks, the savings banks recording the highest growth. Given their low indebtedness and the low level of non-performing loans, households are a relatively safe customer category for the banks, and they are being encouraged to borrow by more favourable loan terms.

Figure 2.15: Year-on-year growth in loans to non-financial corporations by bank group (left), and loans to households by type (right), in percentages



Source: Bank of Slovenia

Housing loans have continued to record positive growth, while the contraction in consumer loans is slowing.

Households too are seeing an increase in new long-term loans, both housing loans and consumer loans. Growth in housing loans remained positive over the majority of the crisis, while the rise in the Swiss franc was also a factor in the increase in the stock of loans in early 2015. While housing lending is to a great extent indicative of the above-average propensity for this form of investment on the part of Slovenian households, which meant that growth in housing loans remained positive throughout the period after 2008, growth in consumer loans is more subject to consumer confidence and the economic sentiment. Housing loans were up 2.5% in year-on-year terms in September. Given the historically low interest rates, low real estate prices and the easing of the banks' credit standards for housing lending, housing loans can be expected to record higher growth in the coming year. Consumer loans were down 3.4% in year-on-year terms in September, although the pace of the contraction has been slowing since the beginning of 2015, in line with the expectations of increased household consumption.

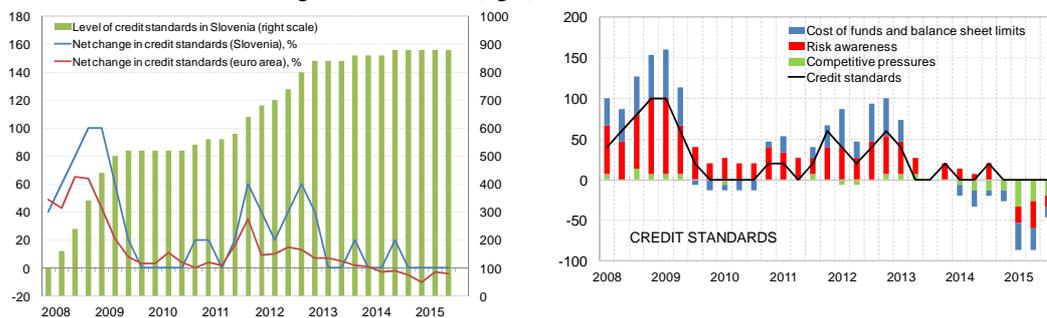
Levels and factors of credit supply and demand

Credit standards¹⁶ on corporate loans in Slovenia have been maintained at the previous high levels, although there has been no tightening since the final quarter of 2014. The banks have however identified factors that could move them to ease standards. The most notable are competitive pressures, risk awareness in the event of improved economic circumstances, and funding costs and balance sheet limits as a result of the environment of low interest rates and the ECB's expansionary monetary policy. As a result of the favourable impact of these factors, credit standards in the euro area have been easing since the beginning of 2014.

Credit standards are no longer being tightened, and certain factors point to easing in the future.

The persistently high proportion of non-performing claims on bank balance sheets is a significant factor contributing to the maintenance of high credit standards. The potential easing of credit standards and more favourable lending terms should only be enjoyed by corporates whose loans would contribute to an increase in the quality of the entire bank portfolio.

Figure 2.16: Credit standards for corporate loans as measured by survey (left), and factors affecting credit standards (right)

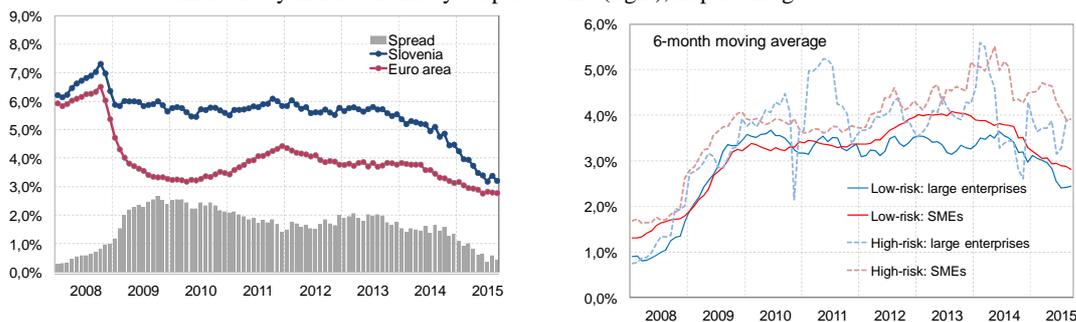


Sources: Bank of Slovenia, ECB

The shortening of the average maturity of bank funding, household deposits in particular, could be a limiting factor in the financing of long-term corporate projects. However, in the supply of ECB funding there are several options for long-term bank funding aimed at encouraging corporate financing. The banks have to date made use of this funding for the needs of liquidity, and in recent times have used it rarely in light of their excess liquidity. Access to funding is thus not a limiting factor for increased credit growth.

The shortening of average funding maturity could limit the supply of loans, although longer-term funding is available at the ECB.

Figure 2.17: Interest rates on corporate loans of up to EUR 1 million, comparison with the euro area (left), and spread over reference interest rate on new long-term loans by risk level and by corporate size (right), in percentages



Source: Bank of Slovenia

The most notable supply-side factor for loans in 2015 was the sharp decline in lending rates. Interest rates on new corporate loans of up to EUR 1 million declined by 1.6 percentage points over the first nine months of the year to leave the spread with the euro area average at just 0.4 percentage points, the lowest since 2008. The competitiveness of Slovenian banks relative to the rest of the world thereby improved sharply, which could attract some customers who would previously have opted for financing in the rest of the world owing to the spread in interest rates. The process of reductions in asset interest rates is mostly the result of a fall in the banks' liability interest rates.

High interest rates are no longer a limiting factor on the supply side.

¹⁶ Credit standards are the internal guidelines and criteria according to which a bank approves a loan. They are established before the actual negotiation of loan terms, and before the actual decision to approve or deny a loan. Credit standards define the required attributes of the borrower (e.g. assets, income situation, age, employment status) based on which a loan can be obtained.

The interest rate spread between loans to SMEs and loans to large enterprises is widening.

The banks are maintaining stricter credit standards on lending to higher-risk customers, both with regard to customer credit rating and with regard to corporate size. After declining in early 2015, the difference in the spreads over the reference interest rate on new low-risk long-term loans between SMEs and large enterprises began widening again, reaching 0.4 percentage points in the third quarter. The change was primarily the result of a faster reduction in spreads for large enterprises.

Spreads on long-term loans for high-risk transactions with regard to corporate size are larger on average than those on low-risk loans, although the high volatility of the data series means that quantitative conclusions cannot be drawn. In qualitative terms the same conclusion can be drawn as for low-risk transactions: average spreads for SMEs are slightly higher than those for large enterprises.

Corporate demand for loans is increasing.

According to ECB survey data, corporate demand for loans has been increasing since the beginning of 2014, and a similar trend is evident across the euro area. According to a survey of non-financial corporations' demand for loans (see box in this section), demand for loans for investment purposes is notably increasing as demand for loans for restructuring contracts, which is in keeping with the improvement in the economic environment and corporates' greater creditworthiness and need for investment.

Corporate indebtedness is notably diminishing as a limiting factor in demand.

After a deleveraging process lasting several years, reduced corporate indebtedness is also having a positive impact on demand for loans. Many corporates have reduced their indebtedness to the level seen before the beginning of the period of rapid borrowing between 2005 and 2007, and fully half of all corporates have no financial liabilities to banks. Alongside lower indebtedness, a vital prerequisite for healthy credit growth is the banks' assessment of corporate debt servicing capacity, particularly in a situation of rising interest rates.

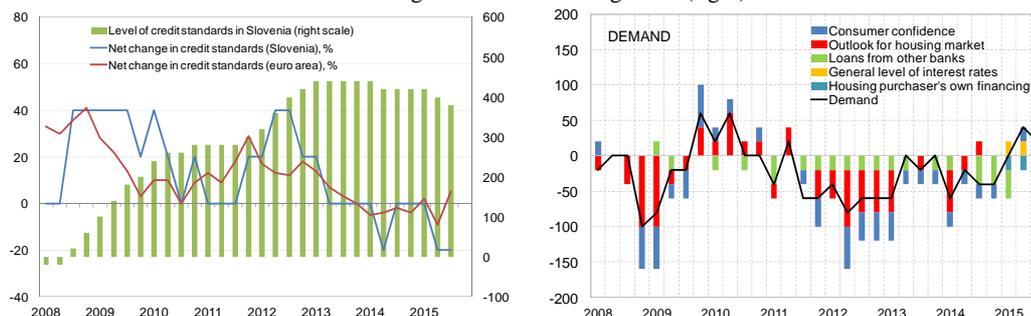
The banks are encouraging demand for household loans via interest rates and the method of remuneration.

In household lending there was an easing of terms on housing loans in 2015, and an increase in the use of fixed interest rates in the environment of low interest rates. In light of the long maturity of housing loans and the projected rise in the EURIBOR in the future, this has entailed a significant reduction in interest rate risk for households, while the banks are also encouraging borrowing by narrowing the spread between fixed and variable interest rates.

There has been a slight easing in credit standards for household loans.

There has been no additional tightening of credit standards for household loans since 2013, and a slight easing has been evident in certain quarters. Similar trends in credit standards are evident in housing loans and consumer loans, the difference being that the tightening of credit standards on consumer loans was significantly larger than in the euro area overall.

Figure 2.18: Credit standards for housing loans to households (left), and factors affecting demand for housing loans (right)



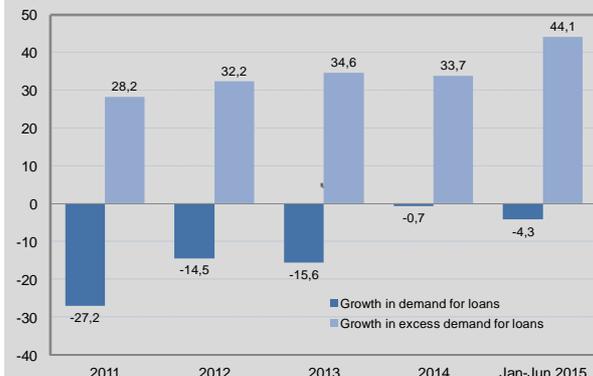
Sources: Bank of Slovenia, ECB

Interest rates on housing loans averaged 2.3% in September 2015, and there was a continuation of the gradual trend of decline and convergence on the euro area average, which is 0.2 percentage points lower. Average interest rates on long-term consumer loans declined by 0.7 percentage points between mid-2014 and the second half of 2015. Interest rates remain lower than the euro area average.

Box 2.3: Results of the survey on demand for loans from non-financial corporations in 2015¹⁷

With the recovery in economic activity, the contraction in credit demand came to an end in 2014. Non-financial corporations' total demand for loans amounted to EUR 8.8 billion, down EUR 66 million or 0.7% on the previous year, less than in previous years (the decline in 2013 was EUR 1.7 billion or 15.6%). Demand for loans increased at 11 banks and savings banks, and declined at eight.¹⁸ Initial estimates are that demand for loans again declined slightly in the first half of 2015, by 4.3%.

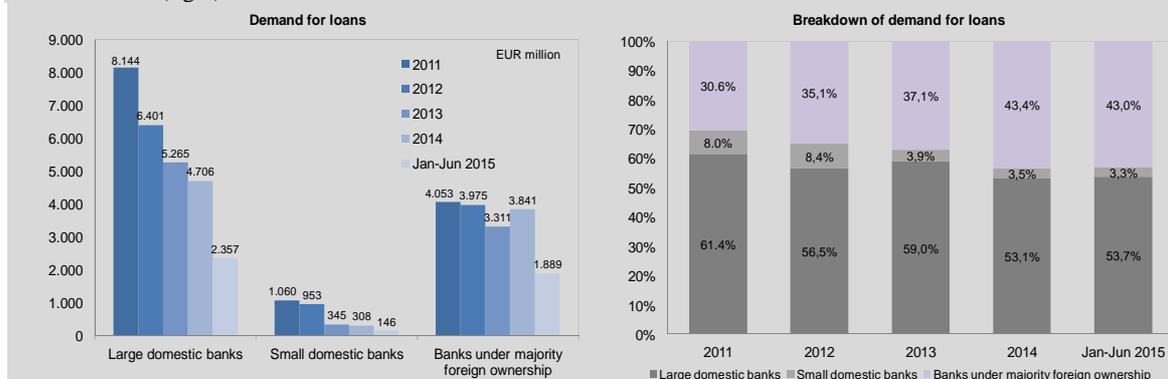
Figure 2.19: Growth in demand and rate of excess demand for loans, in percentages



Note: Excludes Probanka and Factor banka since 2013.
Source: Bank of Slovenia survey, 2011 to 2015

The trend of non-financial corporations' demand for loans being switched from the large domestic banks to the banks under majority foreign ownership continued. For the first time since the survey was first conducted (2010), demand for loans at this bank group also increased in absolute terms, by 16% in 2014 and 8% in the first half of 2015. Demand declined at the large domestic banks and small domestic banks, by 11% in 2014 and 12% and 4% respectively in the first half of 2015. The banks under majority foreign ownership accounted for 43% of non-financial corporations' demand for loans, compared with 28% in 2011.

Figure 2.20: Demand for loans by bank group in EUR million (left), and percentage breakdown of demand for loans (right)



Source: Bank of Slovenia

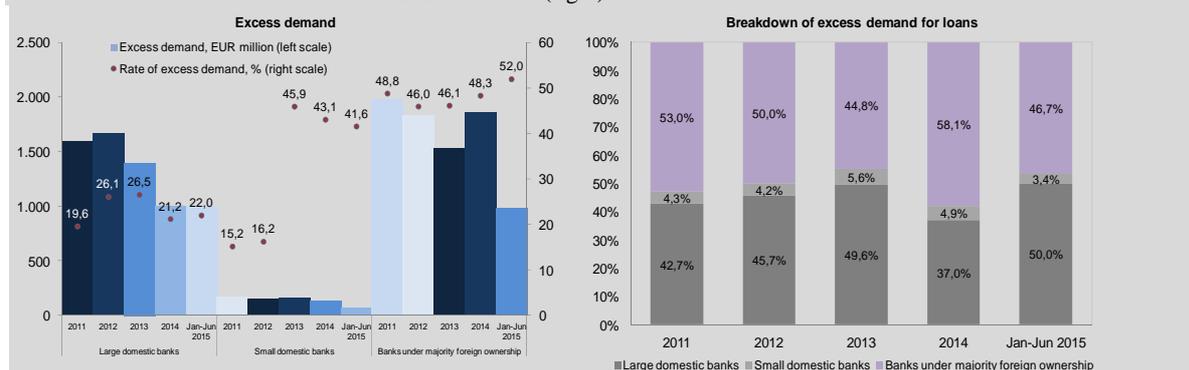
The banks under majority foreign ownership did not respond the same way to the increased demand for loans in 2014: approvals were up 11%, while in the first half of 2015 the increase was 12%. The banks under majority foreign ownership remain the most restrictive in corporate lending, which is reflected in the highest rate of excess demand.¹⁹ Corporate loans accounted for 34% of new loans in 2014, but 43% of demand for loans. Despite a decline in demand the large domestic banks recorded a smaller decline in new loans of 4%, which means that the rate of excess demand at this bank group declined further in 2014 and remained the lowest among all the bank groups.

¹⁷ In the survey banks and savings banks answer questions regarding the level of demand for loans and new loans to non-financial corporations by individual sector, the level of demand by loan type and the reasons for the denial of loans to non-financial corporations. The survey includes data for the last two years and the first half of the current year, and since 2013 has covered 19 banks and savings banks.

¹⁸ The results of the survey of non-financial corporations' demand for loans differ slightly from the results of the BLS (the section on the structure of and developments in bank investments) owing to methodological differences in the composition of the sample and the method of assessing demand.

¹⁹ Excess demand is defined as the difference between the amount of demand and the amount of newly approved loans. The rate of excess demand is calculated as the ratio of excess demand to the amount of demand, expressed as a percentage.

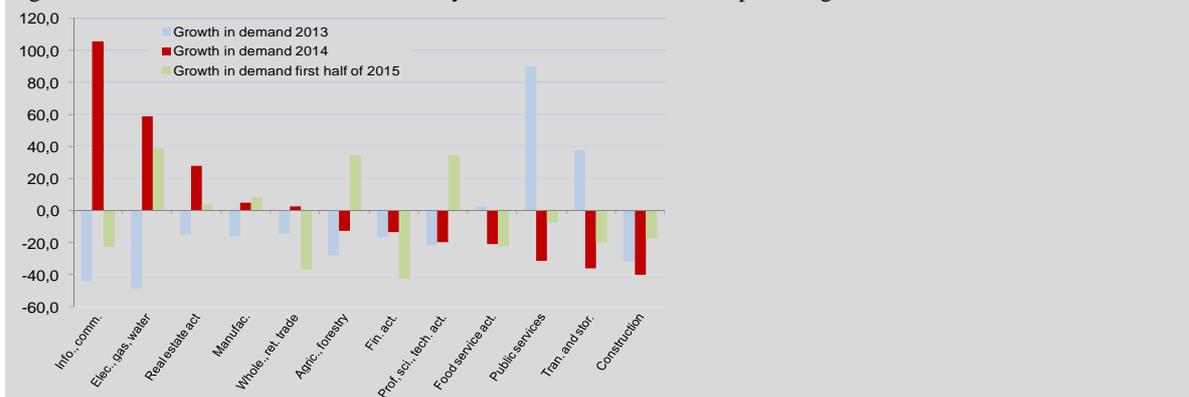
Figure 2.21: Excess demand for loans and rate of excess demand by bank group in EUR million (left), and percentage breakdown of excess demand for loans (right)



Source: Bank of Slovenia

An indication of the correlation between demand for loans and economic growth is given by the information that in 2014 demand increased in those sectors that recorded the largest increase in value-added: manufacturing firms and trade firms recorded increases of 5% and 2.8% respectively (EUR 2.4 billion and EUR 1.9 billion). These two sectors accounted for almost half of all corporate demand in 2014. In the sector of wholesale and retail trade, which had seen a trend of positive growth in demand in recent years, demand declined sharply in the first half of 2015. Demand for loans increased in the sector of electricity, gas and water supply, and remediation activities. With the increasing indebtedness of firms in the accommodation and food service activities sector, demand for loans also declined, by 22% in the first half of 2015.

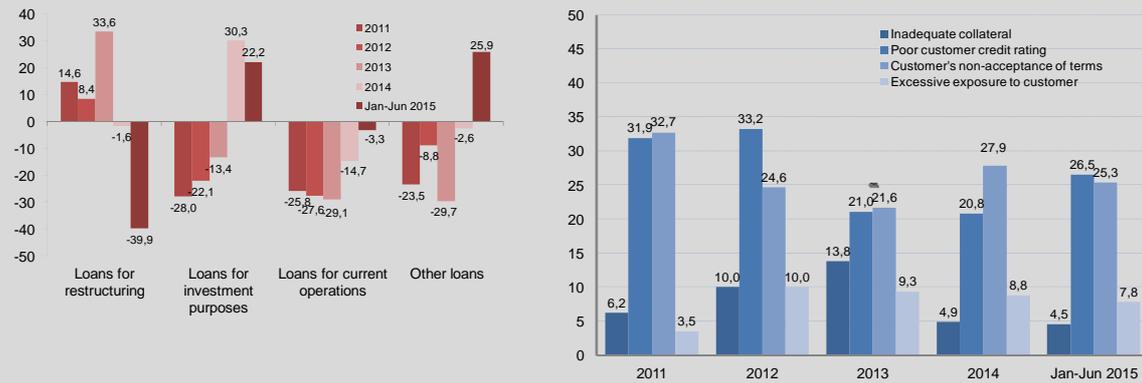
Figure 2.22: Growth in demand for loans by sector in 2013 and 2014, in percentages



Source: Bank of Slovenia

There was a reversal in demand for loans with regard to loan type in 2014 and the first half of 2015. Non-financial corporations reduced their demand for loans for restructuring, by 1.6% in 2014 and by 39.9% in the first half of 2015. With the recovery in economic activity, demand for loans for investment purposes increased by 30.3% in 2014 and by 22.2% in the first half of 2015. In the years of economic slowdown the sole increase was in demand for loans for restructuring purposes, as an indicator of corporate difficulties with debt repayment. Growth in demand for loans for investment purposes in 2014 was highest at the banks under majority foreign ownership at 43.5%, compared with a rate of 20% at the large domestic banks. Non-financial corporations' demand for loans for restructuring purposes is still primarily focused on the large domestic banks, which accounted for 83% of the total in 2014, while the banks under majority foreign ownership accounted for 62% of demand for loans for investment purposes.

Figure 2.23: Growth in demand by loan type (left), and frequency of most common reasons for denial of loans (right), in percentages



Source: Bank of Slovenia

The most frequent reasons given by banks and savings banks for the denial of loans were poor customer credit rating, the customer's non-acceptance of the terms and excessive exposure to the customer, at 26.5%, 25.3% and 7.8% respectively in 2014. While the reason of "inadequate collateral" increased in significance in previous years, in 2014 and the first half of 2015 the banks eased their conditions with regard to credit protection in the assessment of customers.

2.2 Income statement and income risk

Summary

The banks recorded a pre-tax profit of EUR 197 million over the first three quarters of 2015, up sharply on the same period of the previous year. The improvement in performance was attributable to a decline of more than a half in impairment costs. The improvement in the quality of the credit portfolio is having a beneficial impact in the reduction of income risk in the banking system. Pressure in the opposite direction, acting to reduce net interest income and gross income, is being applied by reduced asset interest rates on loans and the ongoing contraction in lending activity. The decline in interest income is the result of the poor credit portfolio, which was the reason for the recovery and resolution of bank balance sheets. The banks have mitigated the adverse developments on the side of interest income by means of cuts in interest expenses as a result of low interest rates and bank funding costs, and an increase in the proportion of sight deposits. Despite the decline in net interest, the simultaneous contraction in total assets meant that the net interest margin only declined minimally.

Despite an improvement in cost-effectiveness, in the context of weak lending activity the banks continue to face relatively high income risk as a result of the projected further decline in interest income. The banks could be exposed to additional income risk on account of increased interest rate risk caused by the widening of the gap between the average repricing periods for asset and liability interest rates.

Operating result and income risk

The banks' net interest income over the first three quarters of 2015 was down 10.5% in year-on-year terms. Both interest income and interest expenses declined, by 23% and 42% respectively. The banks also recorded a decline in non-interest income. The decline in non-interest income was the result of a contraction in lending activity and a negative result in trading. A comparison over a 15-year period reveals that the banks' net interest income over the first nine months of the year was down a quarter on the average since 2000, and was just 60% of non-interest income.²⁰ In conditions of negative credit growth and the current situation on the financial markets, the banks cannot compensate for the loss of net interest income by increasing net non-interest income. The proportion of the banks' gross income accounted for by net interest over the first nine months of the year slightly exceeded the average of 65% over the last 15 years. Impairment and provisioning costs were down sharply on the same period of the previous year, by 56%, which was the decisive factor in profitability.

The banks generated a pre-tax profit of EUR 197 million over the first nine months of the year 2015.

²⁰ It is a comparison of values in individual years with 2015, in which inflation over the period is taken into account. The figures for 2015 are for the 12 months to the end of September.

Table 2.7: Banking sector income statement, September 2015

	Amount, EUR million				Growth, %				Ratio to gross income, %			
	2012	2013	2014	Sep 15	2012	2013	2014	Sep 15	2012	2013	2014	Sep 15
Net interest	886	708	832	561	-12,9	-20,1	17,5	-10,5	56,6	64,9	67,6	65,8
Non-interest income	679	383	399	292	58,3	-43,6	4,1	-17,4	43,4	35,1	32,4	34,2
of which net fees and commission of which net gain/loss from financial assets and liabilities held for trading	339	339	346	253	-2,0	0,0	2,0	-2,7	21,7	31,1	28,1	29,7
	-2	-3	7	-14	...	...	...	...	-0,2	-0,3	0,6	-1,7
Gross income	1566	1091	1231	853	8,2	-30,3	12,8	-13,0	100	100	100	100
Operating costs	743	721	687	499	-4,4	-2,9	-4,7	-0,9	47,4	66,1	55,8	58,5
labour costs	400	384	367	273	-4,0	-3,8	-4,6	-0,2	25,5	35,2	29,8	32,0
Net income	823	370	544	354	22,8	-55,0	47,0	-25,7	52,6	33,9	44,2	41,5
net impairments and provisions of which impairments and provisions at amortised cost	1599	3809	650	157	32,5	138,1	-82,9	-55,8	102,2	349,1	52,8	18,4
	1201	2903	524	102	26,4	141,8	-81,9	-63,4	76,7	266,1	42,6	11,9
Pre-tax profit	-776	-3439	-106	197	-44,7	-342,9	96,9	62,4	-49,6	-315,2	-8,6	23,1
corporate income tax	22	-147	-8	-34	...	...	...	...	1,4	-13,4	-0,6	-4,0
Net profit	-754	-3586	-114	163	...	...	...	...	-48,2	-328,6	-9,3	19,1

Source: Bank of Slovenia

The main indicator of the high income risk in the banking system in 2015 was attributable to the ongoing contraction in lending and the fall in asset interest rates, which is preventing the generation of more stable banking income. The fall in liability interest rates continued last year, although it is gradually slowing. Interest rates on new deposits by the non-banking sector in the short-term segment are below the euro area average, while interest rates in the long-term segment are at the same level, as a result of which the space for additional cuts in interest expenses is gradually diminishing. An additional beneficial impact on the banks' net interest income can only be anticipated in the event of a further increase in sight deposits, albeit with an adverse impact on funding stability.

The maturing of the banks' current portfolio of securities and their replacement with lower-yielding securities in the future.

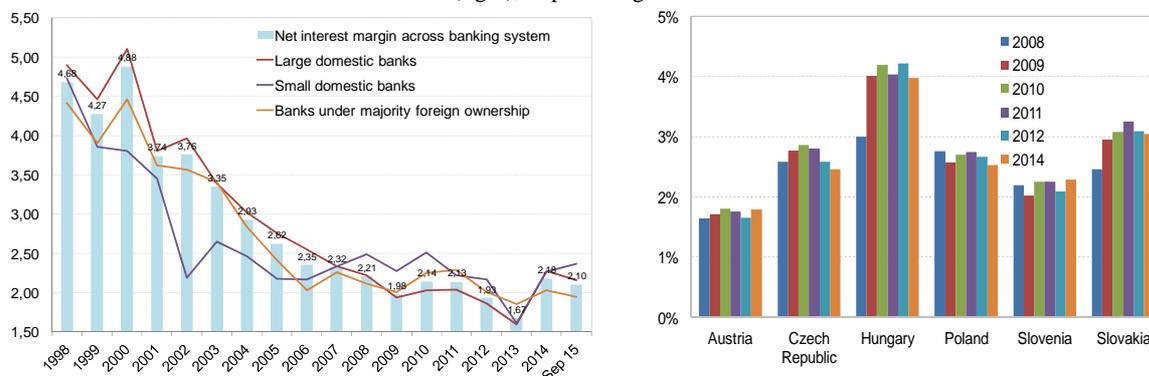
The banking system's portfolio has a relatively high proportion of debt securities, which account for a quarter of the banks' total assets. These securities still have relatively high yields. Half of the banks' current securities portfolio will mature by the end of 2017. Replacing these with lower-yielding securities will entail a certain loss of income, which in the environment of low interest rates will be impossible to replace with investments of the same returns and risk levels. In the quest for high returns the banks could face increased credit risk in the future.

Given the additional pressure on net interest income that will arise as the environment of low interest rates persists, the key to controlling income risk at the banks will be increased lending activity and the simultaneous control of credit risk.

Net interest margin

After an increase in 2014, which was the result of a combination of one-off institutional factors, the fall in liability interest rates and the contraction in total assets, the net interest margin stabilised in 2015. Its value over the first three quarters of the year of 2.1% was down just 0.1 percentage points on the previous year.

Figure 2.24: Net interest margin on interest-bearing assets by bank group in Slovenia (left), and net interest margin in selected central European countries (right), in percentages



Notes: ¹The net interest margins on interest-bearing assets in the left figure for September 2015 are calculated for the preceding 12 months. ² The net interest margins in the right figure are calculated on the basis of CBD reporting, for which reason they differ slightly from those for the Slovenian banking system on an individual basis (illustrated in other figures and tables).

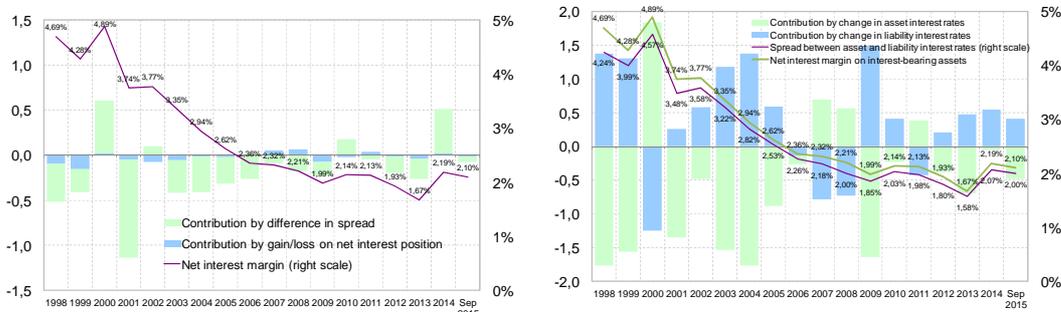
Sources: Bank of Slovenia, ECB (SDW, CBD)

At 2.3%, the net interest margin of the Slovenian banking system was 0.7 percentage points lower than the average for central European countries in 2014: the average net interest margin for Poland, the Czech Republic, Slovakia and Hungary stood at 3% in 2014. The net interest margin will come under increasing pressure in the future owing to a decline in returns and a fall in asset interest rates, which could result in certain banks further reducing their turnover because they are failing to record a sufficient ROE. At the same time there is increasing likelihood that in the quest for higher returns certain banks could focus on lower-quality debt securities of banks and corporates.

Developments in net interest margin by principal components (DuPont method)

If net interest margin is broken down into its principal components (the DuPont method), its variation over time can be explained.²¹ Net interest margin between 1998 and the first half of 2015 is broken down into interest rate spread and gain/loss from the banks' net interest rate position.

Figure 2.25: Net interest margin and contribution made by changes in interest rate spread and gain/loss on net interest position (left), and interest rate spread, net interest margin and contribution to change in interest rate spread made by change in asset and liability interest rates (right), 1998 to September 2015



Notes: ¹ The calculation of the categories in the figures takes account of the 12-month moving sum of interest income/expenses and interest-bearing assets/liabilities on each occasion, and the net interest margin is calculated on each occasion for the preceding 12 months. ² The change in liability interest rates is multiplied by -1, as a rise in liability interest rates results in a narrower spread, while a fall results in a wider spread.

Source: Bank of Slovenia

The changes in the components of the net interest margin in previous years reveal that the banks primarily produced a change in the net interest margin through changes in the interest rate spread. For example, the net interest margin rose from 1.7% to 2.2% in 2014, almost entirely as a result of a change in the interest spread, and only minimally as a result of a gain on the net interest position. It is a similar case for the other years. The change in the net interest margin is primarily explained by the change in the spread, i.e. the changes in effective asset and liability interest rate and the spread between them.

The change in the spread between asset and liability interest rates is the main factor in the change in the net interest margin.

Operating costs, net income, and impairment and provisioning costs

The banks' net income, i.e. income before impairment and provisioning costs, amounted to 42% of gross income over the first nine months of 2015, slightly in excess of the pre-crisis figure. The banking system's nominal net income over the 12 months to September was down 18% on the pre-crisis level.²² Net income was comparable to that in 2005 in nominal terms. In an environment of low interest rates the banks are faced with additional downward pressure on net income, and will be forced to further reduce operating costs and to optimise business processes or to switch to business models that place greater emphasis on generating increased net interest income.

The banks' net income remains down on its pre-crisis level.

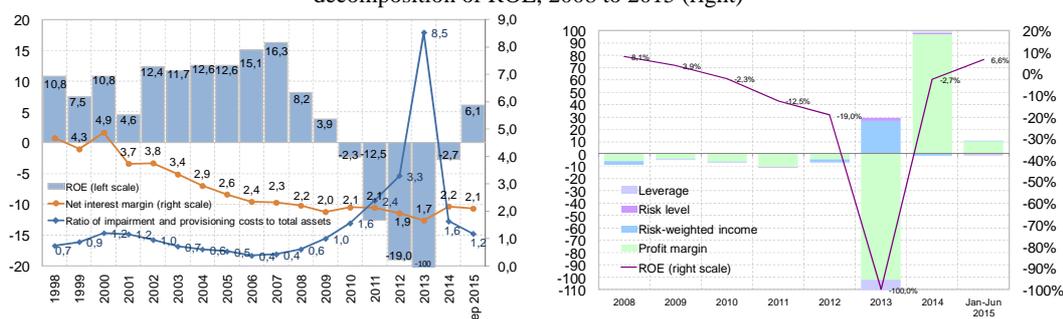
²¹ For more, see the Fed article entitled Net Interest Margin Performance (Federal Reserve Bank of Atlanta, 2012), which gives an illustration of the breakdown of net interest margin into its principal components and their contribution to changes. The following categories were defined to this end in this case: interest income on interest-bearing assets, interest expenses on interest-bearing liabilities, the spread between them (YCS), the net interest rate position and the gain/loss on the net interest position (GLNIP). The categories were calculated on the basis of the 12-month moving averages.

²² Comparison with the 2004 to 2008 period. A comparison of net income in 2015 with the average over this period, taking account of inflation to 2015, reveals that the figure trails by almost 44%.

A decline in the banking system's operating costs. Operating costs are continuing to decline, for the fifth consecutive year now. Operating costs are declining at the banks despite the additional regulatory burden that they face, and were down 0.9% in year-on-year terms in September 2015, an indication of the successful management of operating costs. In terms of the ratio of operating costs to gross income, which stood at 58.5% for the banking system overall over the first nine months of the year, the large domestic banks were notable for their lower value of 53%.

The trend of declining impairment and provisioning costs has continued. The improvement in the quality of the credit portfolio has also brought a decline in impairment and provisioning costs in the banking system's income statement. Impairment costs over the first nine months of 2015 were down 56% on the same period of the previous year, and accounted for less than fifth of the disposal of the banks' gross income, comparable to the pre-crisis period.

Figure 2.26: ROE, net interest margin on interest-bearing assets and ratio of impairment and provisioning costs to total assets, 1998 to 2015, in percentages (left), and impact of four factors on developments in ROE: decomposition of ROE, 2008 to 2015 (right)



Notes: ¹ The September 2015 figures for net interest margin on interest-bearing assets and the ratio of impairment and provisioning costs to total assets are calculated over the preceding 12 months. The September 2015 figure for ROE is calculated for the first nine months of the year. ² Owing to items relating to risk-weighted income and capital requirements, the data required for the calculation of the decomposition of ROE is only available until June 2015.

Source: Bank of Slovenia

Decomposition of ROE: increased profit margin was the main factor in the improvement in profitability in the banking system.

Analysis of the movement in the banks' ROE via the breakdown of profitability into the four components of profit margin, risk-weighted income, risk level and leverage (see right figure above) reveals that profit margin and risk-weighted income contributed to an increase in the banking system's profitability over the first half of 2015,²³ while the other two components of risk level and leverage did not. The profit margin, i.e. the ratio of profit to gross income, was positive last year, as a result of the profit generated across the banking system. For the second consecutive year it made a significant contribution to the improvement in profitability, the banks having reduced their losses or increased their profits over the period in question. Risk-weighted income, the ratio of the banks' gross income to risk-weighted assets, is increasing as the contraction in loans brought a larger decline in risk-weighted assets than in gross income, although the contribution to the improvement in profitability was minimal. Risk level, the ratio of risk-weighted assets to total assets, declined slightly as a result of the more rapid contraction in loans than in total assets. Leverage declined again: the amount of equity in the banking system increased further in the first half of the year, as total assets contracted.

2.3 Interest rate risk

The difference between the average repricing periods for asset and liability interest rates is still widening, thereby increasing the banks' exposure to interest rate risk, ignoring credit protection instruments. It stood at 9.8 months in September 2015, having lengthened by 1.4 months since December 2014. The banks remain more exposed to the risk of a rise in interest rates. The difference widened primarily as a result of a lengthening of the average repricing period for asset interest rates, and less as a result of a shortening of the average repricing period for liability interest rates. On the asset side, the average repricing period for securities lengthened slightly, while on the liability side there was an increase in the proportion of deposits received, which have shorter

²³ Data for the banks' risk-weighted assets and capital requirements was available until June 2015 at the time of the writing of this report. The figures for capital requirements have been calculated on the basis of the new CRR as of 2014 inclusive.

maturities than borrowings via loans. In 2015 interest rate risk increased most at the banks under majority foreign ownership and at the small domestic banks, which are also the most exposed to a rise in interest rates.

Interest rate risk increased in the past as a result of the replacement of non-performing claims with BAMC bonds, because loans have a shorter maturity redefining period than securities. Exposure to interest rate risk is increasing, and reinvestment risk remains significant as a result of low interest rates. Certain banks hedge against interest rate risk by means of interest rate derivatives.

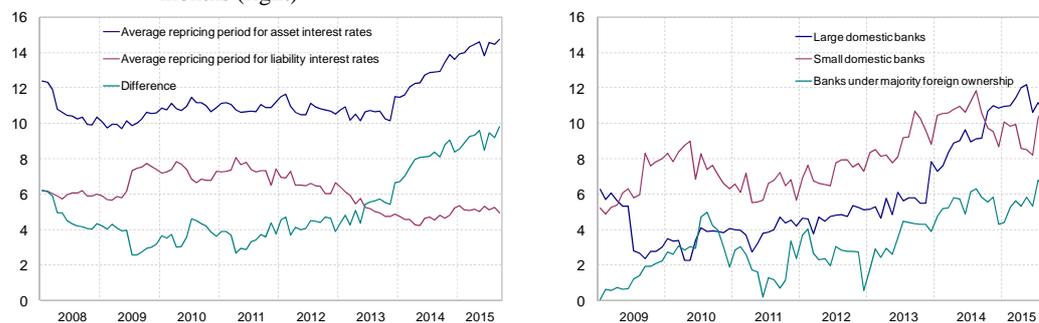
Between December 2014 and September 2015 the cumulative interest rate gap of up to 1 year between interest-sensitive assets and liabilities widened by EUR 0.1 billion to a negative gap of EUR 3 billion. All the bank groups recorded a negative interest rate gap.

Average repricing period for interest rates

Interest rate risk as measured by the difference between the average repricing periods of asset and liability interest rates stood at almost 9.8 months in September 2015, compared with 8.4 months at the end of 2014. The average repricing period for asset interest rates increased from 13.6 months in December 2014 to 14.8 months in September 2015, while the average repricing period for liability interest rates declined from 5.2 months to 4.9 months over the same period. The difference between the average repricing periods for asset and liability interest rates thus widened by 1.4 months over the first nine months of 2015. The key factor in the lengthening of the average repricing period for asset interest rates by 1.1 months was the increase in the average repricing period for debt securities. There was no significant change in the breakdown of bank investments in 2015. The key factor in the shortening of the average repricing period for liability interest rates by 0.3 months was the simultaneous shortening of the average repricing period for deposits received as a result of the shortening of their average maturities and an increase in the proportion of liabilities that they account for.

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

Figure 2.27: 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

Interest rate risk increased at all the bank groups from the beginning of the year. The difference between repricing periods increased most at the small domestic banks, by 3 months, and at the banks under majority foreign ownership, by 2.9 months. The reasons are primarily on the investment side, where there was an increase in the proportion of debt securities with longer maturities at the expense of a decline in loans. By contrast, on the liability side there was an increase in deposits received with shorter average maturities than borrowings via loans, the proportion of which declined. The difference at the large domestic banks increased by 0.4 months. The reason can be found on the liability side, as a result of the same factors as at the small domestic banks and the banks under majority foreign ownership.

Interest rate risk has risen at all the bank groups.

The small domestic banks and large domestic banks are most exposed to the risk of a rise in interest rates, while the banks under majority foreign ownership are less exposed, having reduced interest rate exposure by entering into transactions with their parent banks. The difference between the average repricing periods of asset and liability interest rates was larger at the domestic banks, at 11.7 months and 11.2 months respectively in September 2015, than at the foreign banks, at 7.2 months.

The period of low interest rates is also having an impact on the banks' exposure to interest rate risk. One consequence of the lengthy period of low interest rates could be a change in the maturity breakdown of deposits by the non-banking sector, and thus a shortening of the average repricing period for liability interest rates. The banks will also seek higher

The environment of low interest rates is having an adverse impact on interest rate risk.

returns because of low interest rates. This will have an impact on the structure of investments, and could potentially lengthen the average repricing period for asset interest rates, as the banks seek to increase returns by lengthening loan maturities. They could also increase returns by purchasing higher-yielding securities, which could expose them to market risk. The difference between the average repricing periods for asset and liability interest rates would thus widen further. In the event of a rise in interest rates the banks would be exposed to pressure from a faster increase in expenses for short-term funding than in income from long-term investments.

Interest rate risk is also increasing as a result of the rise in the number of investments with a fixed interest rate that are not hedged on the liability side.

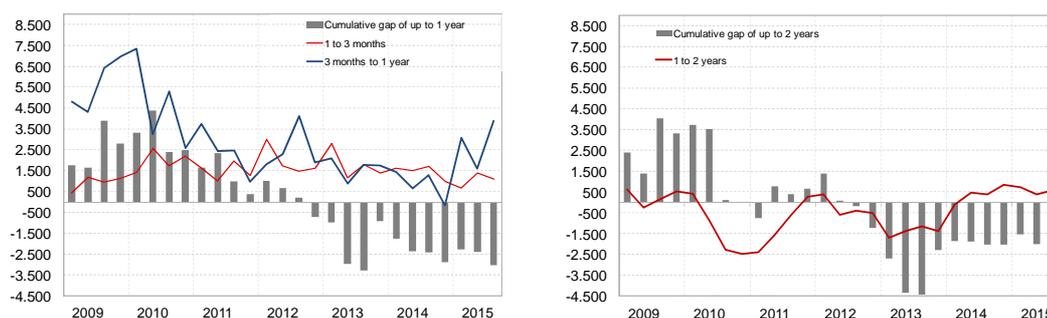
Given the rise in the number of new housing loans with a fixed interest rate, an additional increase in the average repricing period for asset interest rates can be expected in the future. According to available information, the banks will only partly hedge on the liability side, for which reason interest rate risk could increase further in the future. Housing loans account for 16% of the banking system's asset side, although the figure is more than 30% at certain banks. New housing loans to households with a fixed interest rate have recently been increasing, particularly at the banks under majority foreign ownership. Fixed-rate loans accounted for 28% of all new housing loans in September.

Interest rate gap

All the bank groups have a negative cumulative interest rate gap.

The cumulative interest rate gap of up to 1 year between interest-sensitive assets and liabilities was negative in the amount of EUR 3.0 billion at the end of the third quarter of 2015, having been negative in the amount of EUR 2.9 billion in December 2014. All the bank groups recorded a negative interest rate gap before hedging against interest rate risk is taken into account. The banks under majority foreign ownership had the smallest gap, at barely EUR 81 million, while the large domestic banks had the largest, at EUR 2 billion.

Figure 2.28: Gap between interest-sensitive assets and interest-sensitive liabilities by individual bucket, in EUR million



Source: Bank of Slovenia

The cumulative gap of up to 2 years widened from a negative gap of EUR 2 billion in December 2014 to a negative gap of EUR 2.5 billion in September 2015. All the bank groups recorded a negative gap in this bucket. The banks under majority foreign ownership again had the smallest gap, at barely EUR 424 million, while the large domestic banks had the largest, at EUR 1.2 billion.

2.4 Funding risk

Summary

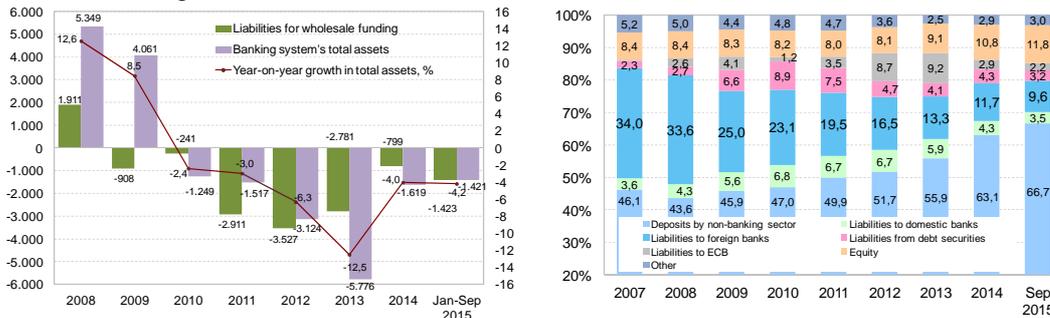
Refinancing risk, which declined in recent years after the banks made significant debt repayments on the wholesale markets, remained unchanged in 2015. The shortening of deposit maturities represents a potential source of instability. The sharp fall in interest rates is not encouraging households to save over longer periods, which in the event of a change in the situation could result in increased instability in bank funding. The banks are continuing to pay down debt on the wholesale markets, albeit less than in the past. High excess liquidity and the availability of liquidity via the ECB's non-standard measures are having a beneficial impact on refinancing risk. As the average funding maturities shorten and the proportion of sight deposits increases, adequate secondary liquidity is becoming increasingly important. Deposits by the non-banking sector, household deposits in particular, are becoming an increasingly important source of bank funding.

2.4.1 Continuation of the banks debt repayments on the wholesale markets

The banks are continuing to pay down debt on the wholesale markets. Repayments in 2015 strengthened slightly compared with 2014, but remain slower than between 2011 and 2013. The banking system made debt repayments to foreign banks of EUR 12.5 billion between the end of 2008 and the end of September 2015, or a third of Slovenia's GDP. The proportion of total liabilities accounted for by wholesale funding, which at the outbreak of the crisis stood at 36%, had fallen below 13% by the end of September 2015.

The banks are continuing to pay down debt on the wholesale markets, although the pace and amount of the repayments are less than in the crisis years.

Figure 2.29: Changes in total assets and changes in wholesale funding in EUR million (left), and breakdown of bank funding in the Slovenian banking system (right)



Note: Liabilities to the rest of the world include issued debt securities.
Source: Bank of Slovenia

The pressure on refinancing has declined sharply after the banks' significant debt repayments in previous years. The proportion of liabilities maturing within one year has declined. The banks will see only EUR 1 billion or EUR 23% of total debt to the rest of the world mature by the end of September 2016, while a year earlier the figure had stood at 33%, equivalent to EUR 1.9 billion of debt to foreign banks.

In September 2015, the proportion of debt to the rest of the world maturing within one year was less than a year earlier.

The banks under majority foreign ownership made the largest changes to their funding structure in previous years. The funding restructuring process at the aforementioned bank group has been intensive for several years now. In parallel with their debt repayments in the rest of the world the banks under majority foreign ownership have focused on attracting deposits by the non-banking sector on the Slovenian market.

The banks under majority foreign ownership are increasingly focusing on local funding.

2.4.2 Deposits by the non-banking sector

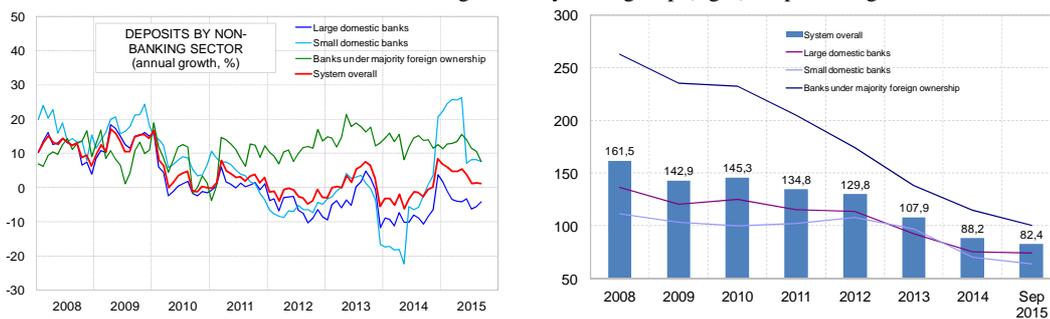
Slowdown in growth in deposits by the non-banking sector and in household deposits

Growth in deposits by the non-banking sector gradually slowed over the first nine months of the year. It had fallen to 1.1% by the end of the third quarter of 2015. Deposits by all sectors other than OFIs and non-residents increased in nominal terms over the first nine months of the year. Deposits by the non-banking sector have been the most important and stable source of bank funding in recent years. The proportion of bank funding that they account for is similar to the figure from 2005.

The proportion of total liabilities accounted for by deposits is increasing.

The LTD ratio for non-banking sector has declined for the seventh consecutive year as a result of positive growth in deposits and a contraction in lending activity. The decline in this indicator of funding sustainability was fastest in the initial years of the banks' intensive debt repayments on the wholesale markets. The ratio is gradually stabilising: the level reached 80% in the third quarter of 2015, comparable to mid-2005.

Figure 2.30: Growth in deposits by the non-banking sector (left), and LTD ratio for the non-banking sector by bank group (right), in percentages

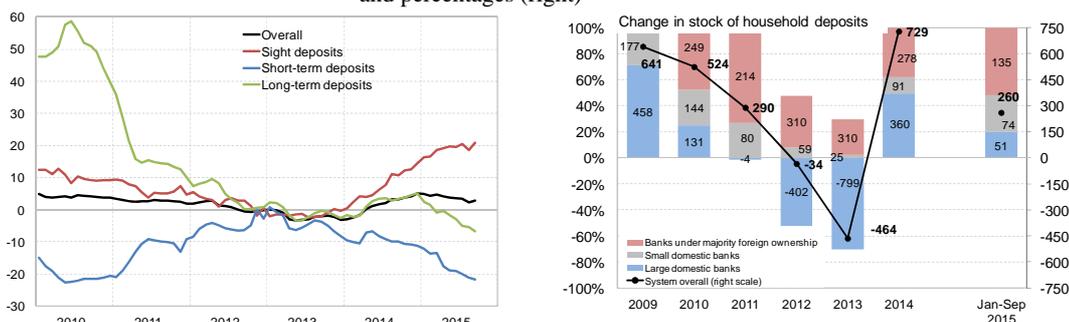


Source: Bank of Slovenia

Household deposits at banks increased further over the first three quarters of 2015, despite the low and falling interest rates.

Year-on-year growth in household deposits stood at a solid 2.8% in September 2015. Household deposits increased by EUR 260 million over the first three quarters of 2015, despite the low and falling interest rates. The main increases in household deposits were at the banks under majority foreign ownership and the savings banks, which have slightly higher interest rates than the large domestic banks. The falling average interest rate on deposits of over 1 year reached the average euro area level in early 2015. Interest rates on deposits of up to 1 year are slowly stabilising, but remain at historically low levels around 0.3%, 0.4 percentage points less than the euro area average.

Figure 2.31: Annual growth in household deposits in percentages (left), and breakdown of changes in stock of household deposits by bank group in EUR million and percentages (right)



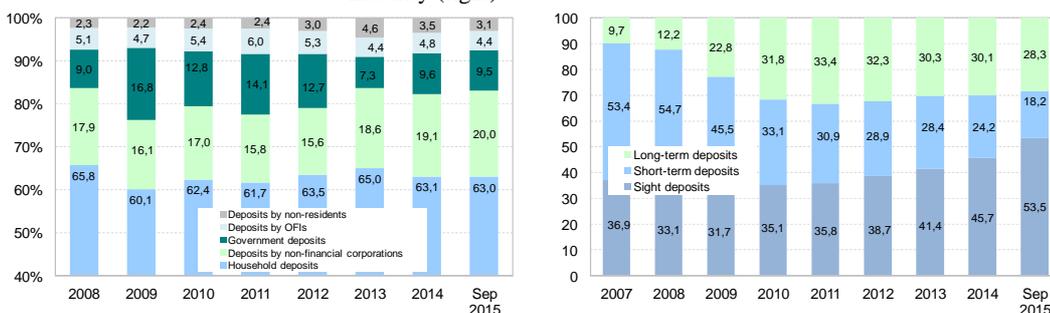
Source: Bank of Slovenia

Increase in the proportion of sight deposits: potential instability of funding

The increase in the proportion of sight deposits accelerated in particular over the last two years as a result of the sharp fall in liability interest rates.

As interest rates have fallen sharply, the maturity breakdown of deposits by the non-banking sector has also shifted: there has been a notable increase in the proportion of sight deposits in the last two years. The figure stood at just under 54% in September 2015, up 8 percentage points on the end of 2014. Alongside interest rates, which are no longer encouraging household saving, another factor in the increase in sight deposits at banks was the option of switching to alternative forms of investment in mutual funds, while corporates are increasingly financing their current needs themselves and are therefore maintaining larger liquid assets at banks.

Figure 2.32: Breakdown of deposits by the non-banking sector by sector (left) and by maturity (right)



Source: Bank of Slovenia

Household deposits increased by EUR 0.3 billion over the first nine months of 2015, as household sight deposits increased by EUR 1.2 billion, while short-term and long-term household deposits declined in nominal terms. In an environment of persistently low interest rates, the proportion of sight deposits can be expected to remain high, or even to increase. The stability of sight deposits, especially those of households, has been relatively high to date, but there are no reliable forecasts of future trends in a context of historically low interest rates. The increase in sight deposits in the wake of falling returns on bank saving suggests that a certain proportion of deposits may be more mobile.

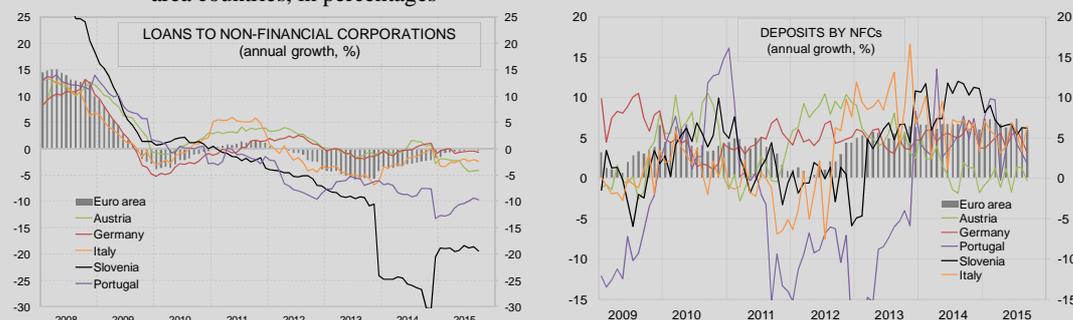
Corporate deposits at banks have increased in the last three years: in September 2015 they were up 19% on the end of 2013, as savings have increased in importance for corporates in the wake of the decline in loan financing. Like households, corporates too are recording an increase solely in sight deposits, while short-term and long-term deposits are declining. The proportion of corporate deposits accounted for by sight deposits had approached 70% by the end of September 2015, having doubled since the outbreak of the crisis. The increase in the proportion of corporate sight deposits at banks indicates that corporates are increasingly financing their current needs themselves, and that the uncertain financing conditions mean that they are opting for investment less often.

Sight deposits account for close to 70% of non-financial corporations' deposits at banks.

Box 2.4: Liquidity assets at non-financial corporations

Since 2009 the euro area economy has been less dependent on bank financing, and has relied much more on internal financing, financing via the capital markets (issues of equities and debt securities) and business-to-business financing. Bank loans to non-financial corporations declined for three consecutive years between 2012 and 2014, although an improvement is evident in 2015. Corporate deleveraging was faster and sharper in countries where corporates had accumulated more debt before the crisis, as was the case in Slovenia and Portugal. Corporate profitability has been highly limited since the outbreak of the crisis, but is showing signs of recovery. Corporate profitability can be expected to begin improving with the further recovery of the euro area economy. External financing of non-financial corporations, primarily via issues of debt securities, slowed significantly in 2015, partly as a result of the strengthening of retained earnings at corporates, which is reducing their need for external financing.

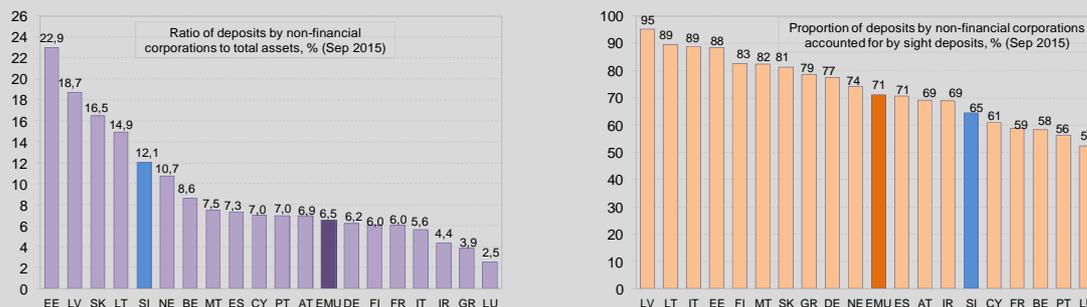
Figure 2.33: Year-on-year growth in loans to (left) and deposits by (right) non-financial corporations in selected euro area countries, in percentages



Source: ECB

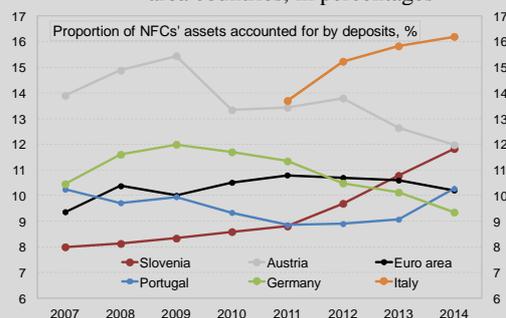
The proportion of liquid assets held by euro area non-financial corporations is significantly higher than its historical average, which is acting to significantly reduce debt and/or the financing of the economic recovery. According to the financial accounts, euro area non-financial corporations hold 10.4% of their financial assets in deposits, up 1 percentage point on the pre-crisis figure. There is considerable variation from country to country: in recent years growth has been most evident in Italy, Portugal and Slovenia. Deposits by non-financial corporations across the euro area have increased at an annual rate of more than 6% since the end of 2013, most notably in the three aforementioned countries. The trend is most evident in Italy, where sight deposits account for 90% of corporate deposits, while the figure is lower in Slovenia and Portugal. Non-financial corporations in Austria used to hold more than 15% of their financial assets in the form of deposits, but since 2009 the figure has declined to 12%. Slovenian non-financial corporations hold just over 12% of their financial assets in the form of liquid assets, although in their case the figure has been increasing since the outbreak of the crisis. The liquidity of euro area non-financial corporations is high on account of the low opportunity costs of holding liquid assets in the recent period, and the uncertainty with regard to the stable recovery of the economy in the future.

Figure 2.34: Ratio of deposits by non-financial corporations to total liabilities across the banking system (left), and proportion of total deposits at banks by non-financial corporations accounted for by sight deposits (right), in percentages



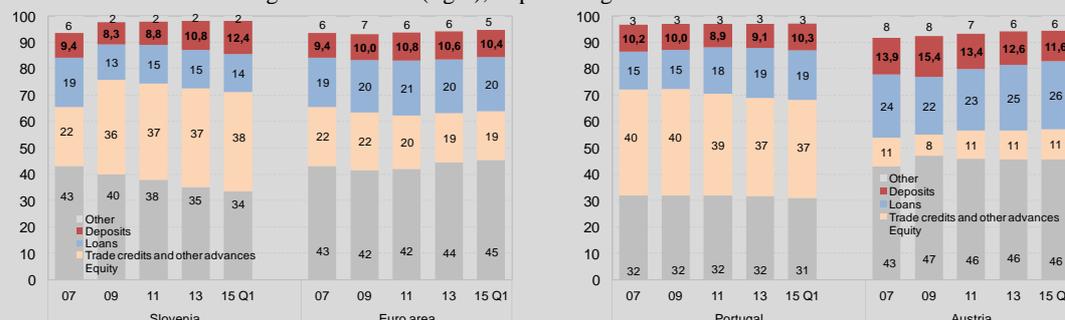
Source: ECB

Figure 2.35: Proportion of financial assets of non-financial corporations accounted for by deposits in selected euro area countries, in percentages



Source: ECB

Figure 2.36: Breakdown of financial assets of non-financial corporations in Slovenia and the euro area overall (left), and in Portugal and Austria (right), in percentages



Source: ECB

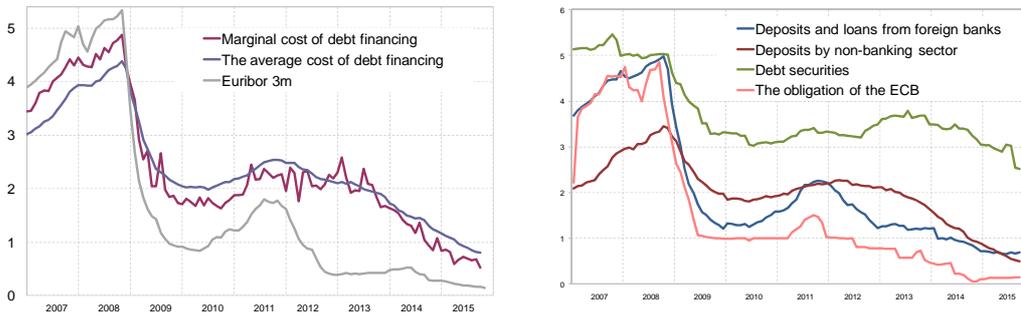
Non-financial corporations are increasing their liquid assets because of a lack of access to loans, mismatching between inward and outward payments, and uncertainty surrounding future cash flows, which could lead to illiquidity or insolvency. By maintaining a higher proportion of liquid assets, non-financial corporations avoid having to sell assets under pressure and consequently at a lower price, and at the same time protect their future investments in the event of restrictions on the credit market. Since the outbreak of the crisis euro area non-financial corporations have found it harder to access bank loans and other assets, and have therefore increased their security saving. More-indebted non-financial corporations can be expected to have a lower proportion of currency and deposits, as their cost of holding liquid assets is greater.

Costs of bank debt funding

Debt funding costs fell further in 2015.

The average cost of bank debt funding is declining for the fourth consecutive year, largely as a result of the fall in interest rates on deposits by the non-banking sector. These costs had fallen below 1% by the end of 2014, and fell by a further 0.4 percentage points over the first three quarters of 2015 to 0.6%. The fall amounted to 0.92 percentage points between December 2013 and September 2015. The average interest rate on deposits by the non-banking sector fell particularly sharply during this period, by 1.1 percentage points to 0.50%.

Figure 2.37: Average cost of bank debt funding overall and 3-month EURIBOR (left), and average debt funding cost for banks by primary source/instrument (right), in percentages



Source: Bank of Slovenia

The cost of funding raised at banks in the rest of the world in the form of loans and deposits fell by less over this period than did that of deposits by the non-banking sector: it was down 0.51 percentage points at 0.69%. Financing via issued debt securities recorded the largest fall in cost: it was down 0.98 percentage points at 2.5%. All the bank groups are reducing their debt funding costs. The banks under majority foreign ownership continued to record the lowest cost of debt funding, at 0.54% in September, followed by the large domestic banks at 0.60% and the small domestic banks at 0.87%.

The banks under majority foreign ownership have the lowest debt funding costs.

2.4.3 Liquidity risk

Liquidity risk remained low and stable in the Slovenian banking system in the first three quarters of 2015, which has been reflected in a high first-bucket liquidity ratio, a rising second-bucket liquidity ratio, a high proportion of the pool of eligible collateral at the Eurosystem that is free, and a stable stock of marketable secondary liquidity. The options for managing excess liquidity on the international financial markets nevertheless remain limited for Slovenian banks, and the Slovenian interbank market remains inactive. The increase in the proportion of the banks' liabilities accounted for by sight deposits could lead to increased liquidity requirements in the future. At the same time, as the average maturity of investments lengthens and the average maturity of funding shortens, an adequate stock of secondary liquidity is becoming increasingly important.

The first-bucket liquidity ratio remains high, while the second-bucket liquidity ratio has increased.

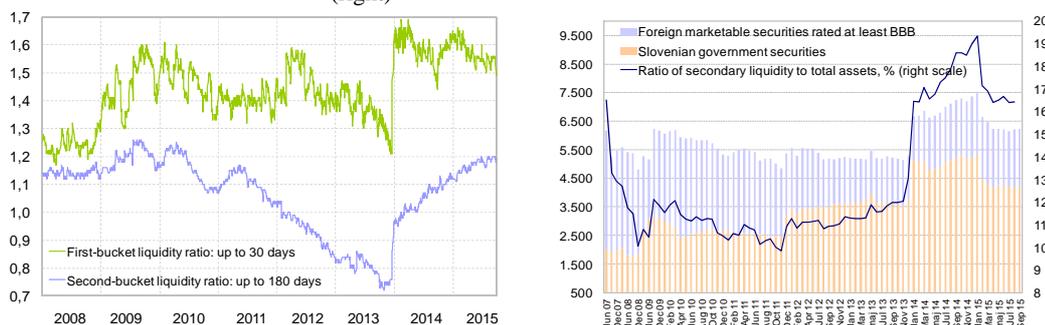
The banking system's excess liquidity is being reflected in a high and relatively stable first-bucket liquidity ratio, which averaged 1.57 over the first nine months of the year, similar to its average level of the previous year. The ongoing slow but steady increase in the second-bucket liquidity ratio is attributable to the decline in funding on the wholesale markets and at the Eurosystem. It averaged 1.17 over the first nine months of the year, up 0.12 on the previous year, and has already exceeded its pre-crisis level.

Following the exclusion of BAMC bonds from the liquidity ladder,²⁴ i.e. between February and September 2015, the proportion of total assets accounted for by marketable secondary liquidity averaged 16.6%, the same as its level before the outbreak of the financial crisis. The amount of marketable secondary liquidity reached EUR 6.2 billion in September. The breakdown of the marketable secondary liquidity also remained unchanged: Slovenian government securities account for just over two-thirds of the total. This concentration means that the banks remain exposed to liquidity risk as a result of a potential sovereign downgrading. This is particularly the case for the small domestic banks, where Slovenian government securities account for 90% of marketable secondary liquidity. To diversify the portfolio and to reduce the aforementioned concentration, as these securities mature certain banks are expected to place the funds into bank and government securities that are eligible collateral for the Eurosystem.

The concentration of secondary liquidity remains highest at the small domestic banks.

²⁴ For more, see Financial Stability Review, May 2015.

Figure 2.38: Daily first-bucket and second-bucket liquidity ratios (left), and stock of marketable secondary liquidity (monthly averages) in EUR million and ratio of marketable secondary liquidity to total assets in percentages (right)

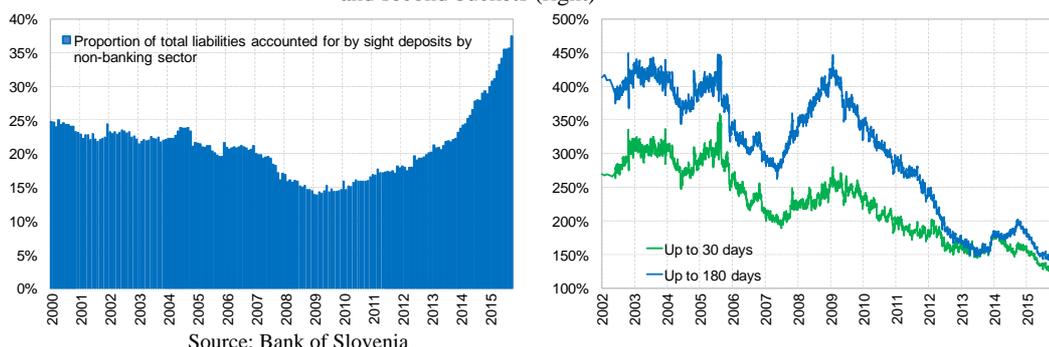


Note: Secondary liquidity is calculated from liquidity ladder data as the sum of the monthly average of Slovenian government securities and foreign marketable securities rated BBB or higher.

Source: Bank of Slovenia

In an environment of low interest rates the stability of sight deposits could be lower than in the past, which is exposing the banks to liquidity risk. Given the high proportion of sight deposits and the minimal interest rates, which are at the same level or lower than those in neighbouring countries, the banks are more exposed to the risk of deposit flight, where deposits could be directed into consumption, into the capital market or into the rest of the world.

Figure 2.39: Proportion of the banking system's total liabilities accounted for by sight deposits (left), and coverage of sight deposits by liquid assets in the first and second buckets (right)

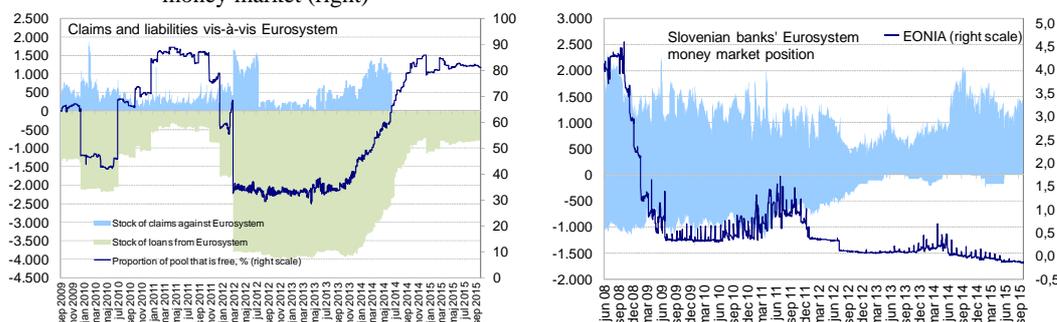


Source: Bank of Slovenia

The proportion of the pool of eligible collateral at the Eurosystem that is free is around 81%.

Liabilities to the Eurosystem were stable between March and September, at around EUR 800 million. The banking system's adequate excess liquidity was reflected in Slovenian banks' low participation in the Eurosystem's open market operations. At the same time, the persistence of low lending activity meant that the banks gave almost no response to the targeted longer-term refinancing operations (TLTROs). The proportion of the pool of eligible collateral at the Eurosystem that is free thereby remained high, averaging 81% over the period in question. In the event of a major reversal in the credit cycle, the banks could be expected to show greater demand for Eurosystem funds, as this funding would be advantageous in cost terms.

Figure 2.40: Banks' claims and liabilities vis-à-vis the Eurosystem in EUR million and proportion of the pool of eligible collateral that is free (left), and stock of unsecured loans of Slovenian banks placed and received on the euro area money market (right)



Source: Bank of Slovenia

Slovenian banks have maintained their position as net creditors on the euro area unsecured money market. Their net claims averaged EUR 1.4 billion in September 2015, down just EUR 86 million on March. The leading role is played by the banks under majority foreign ownership, which place surplus funds with their parent banks in the rest of the world over the short term. The domestic banks remain limited in the management of excess liquidity on this market, and given the large excess liquidity throughout the Eurosystem there is no expectation that this will improve in the near future. Neither is the revival of the Slovenian interbank market to be expected. The stock of deposits given and received on this market amounted to a modest EUR 131 million at the end of the third quarter.

The domestic banks are limited in the management of liquidity on the international financial markets.

2.5 Bank solvency

Summary

The solvency of the Slovenian banking system improved over the first nine months of 2015, although there remain significant variations between the bank groups. The small domestic banks remain the most exposed to solvency risk, despite a moderate improvement in capital adequacy ratios. The increase in capital adequacy ratios at the level of the banking system slowed as expected, but they remain above the available figures for the euro area average. The capital quality structure remains high, as the banks improved their capital adequacy not only via recapitalisations, but also by generating internal capital via profitable performance.

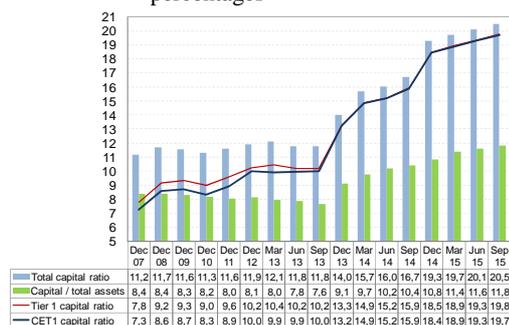
In a period of weak lending activity and low asset interest rates, the generation of profit, and thereby capital, is relatively limited. For this reason, an important part in maintaining capital adequacy is played by optimal use of existing capital. The faster, more effective reduction of non-performing claims will make a significant contribution to this. The banks must adjust their business models to be able to meet the new banking regulations, thereby succeeding in maintaining stable capital adequacy.

1.1.1 Capital adequacy

The Slovenia banking system's capital adequacy ratios continued to improve over the first nine months of 2015, albeit less intensively than in 2014. The increase in the ratios was attributable to an increase in own funds as a result of the positive profit and the recapitalisation of certain banks, and a contraction in capital requirements. The total capital ratio increased by 1.2 percentage points to stand at 20.5%. The small differences between the levels of the capital ratios are an indication of the high quality of the capital structure.

The increase in capital adequacy ratios slowed over the first nine months of 2015.

Figure 2.41: Banking system's basic capital adequacy ratios on an individual basis, in percentages



Source: Bank of Slovenia

There remain significant differences in total capital ratios between the bank groups. The large domestic banks are notable for high capital ratios.

Capital adequacy improved at all the bank groups over the first nine months of 2015, although there remain significant variations between them. The large domestic banks continue to stand out for their high capital adequacy ratios, although the increase in the capital adequacy slowed sharply as expected. The total capital ratio, which reached 23.6% at the end of September, improved additionally in 2015 as a result of growth in own funds, which increased as a result of a positive profit, and not as a result of recapitalisations as in the previous year. They also continued reducing capital requirements, primarily on account of the ongoing contraction in lending activity. The pace of growth in the total capital ratio also slowed at the banks under majority foreign ownership, where it reached 17.2% at the end of June.

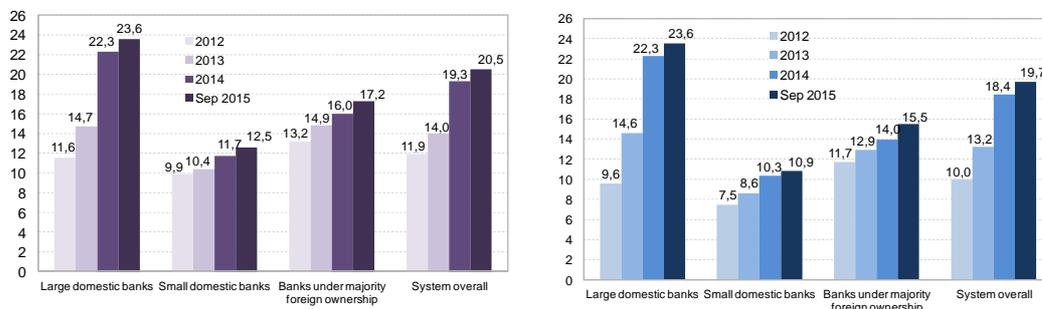
The small domestic banks remain the most vulnerable in capital terms.

The small domestic banks and savings banks remain the most vulnerable in capital terms. Their total capital ratio increased by 0.8 percentage points over the first three quarters of 2015 to stand at 12.5%, still down significantly on the average across the banking system. In contrast to the two other bank groups, the growth in their total capital ratio in 2015 was a consequence of a larger increase in own funds as a result of recapitalisations compared with the increase in capital requirements. These primarily increased because of positive lending activity at the savings banks. In the context of their lower capital adequacy, the vulnerability of this bank group is greater because of their increased exposure to credit risk. The small domestic banks succeeded in moderately improving the quality of the credit portfolio over the first nine months of the year as measured by the proportion of claims more than 90 days in arrears, although at 11.7% it remains above the average across the banking system. At the same time they are maintaining a low ratio of capital to total assets, which additionally exposes them to higher solvency risk.

The banks are exposed to regulatory risk, the small domestic banks in particular.

Their small size means that the small domestic banks are more exposed to regulatory risk, even more so than the other two bank groups. Meeting all the requirements and new macro-prudential instruments introduced by the new European banking regulations (the CRR and the CRD IV) will be a major challenge. They will have to adjust their business models to be able to uphold the new requirements and to secure enough capital of the requisite quality.

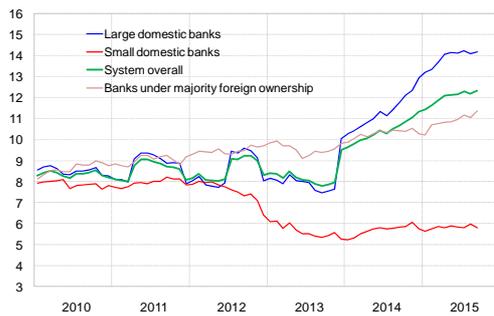
Figure 2.42: Total capital ratio (left) and common equity Tier 1 capital ratio (right) on an individual basis by bank group, in percentages



Note: The two banks undergoing the orderly wind-down process are excluded from the figures for the banking system as of 2014 inclusive, and from the figures for small domestic banks as of 2013.

Source: Bank of Slovenia

Figure 2.43: Ratio of book capital to total assets on an individual basis by bank group, monthly figures, in percentages



Note: The two banks undergoing the orderly wind-down process are excluded from the figures for the banking system as of 2014 inclusive, and from the figures for small domestic banks as of 2013.

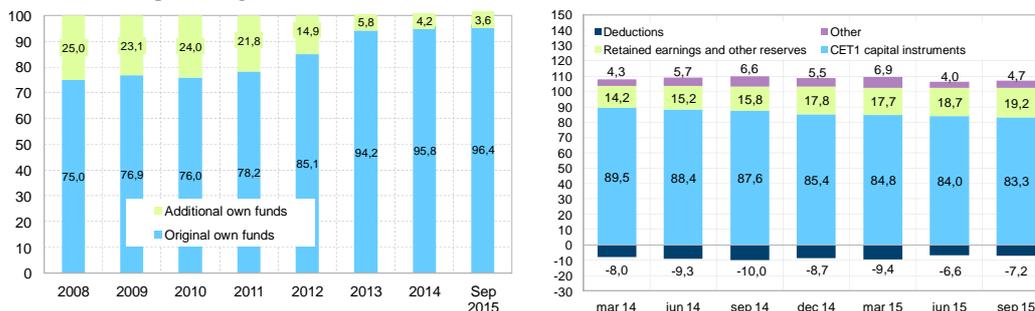
Source: Bank of Slovenia

Capital structure

The Slovenian banking system's stock of regulatory capital increased by EUR 103 million over the first nine months of 2015 to EUR 4,084 million. In contrast to previous years, the banks have begun strengthening their capital by means of positive earnings, which has been reflected in an increase in the proportion of common equity Tier 1 capital accounted for by earnings. The proportion of own funds accounted for original own funds strengthened again to 96.4%, which is confirmation of the high level of capital quality at Slovenian banks.

The banks increased their capital via positive earnings and recapitalisations.

Figure 2.44: Structure of regulatory capital (left) and structure of common equity Tier 1 capital (right) across the banking system on an individual basis, in percentages



Source: Bank of Slovenia

In a period of low lending activity, falling lending rates and high income risk, the banks are relatively limited in their generation of profit. In addition to the generation of internal capital, the optimal use of capital is therefore vital to the maintenance and strengthening of capital adequacy.

Capital requirements

The contraction in capital requirements slowed over the first nine months of 2015. They declined by 3.5% or EUR 57 million over the aforementioned period to EUR 1,595 million. The main factor in the decline in capital requirements remains the contraction in lending to the non-banking sector, which slowed slightly.

A decline in capital requirements as a result of the contraction in lending activity.

Capital requirements for credit risk declined by EUR 55 million over the first nine months of the year to stand at EUR 1,419 million, or 3.8% of total assets. The changes in their breakdown do not reflect a significant improvement in the use of capital. Capital requirements for exposures to corporates and retail exposures declined over the period in question as a result of the contraction in lending activity. These two classes nevertheless continue to account for a high proportion of the capital requirements for credit risk, 62% in total, and entail a significant burden on capital owing to their high weights. Capital requirements for exposures secured by real estate collateral, which allow banks to apply lower risk weights, continued to account for a relatively low proportion of capital requirements. They increased by just EUR 5.6 million over six months, to stand at EUR 88 million.

The changes in the breakdown of capital requirements for credit risk do not reflect the optimisation of capital.

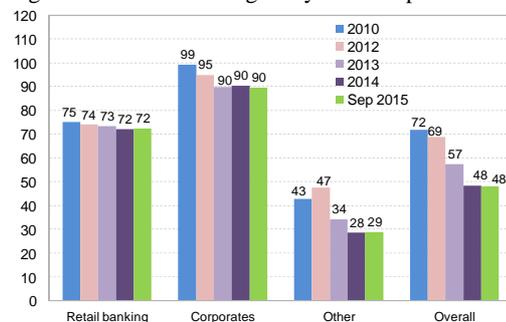
Table 2.8: Breakdown of capital requirements for credit risk, in percentages

	Old methodology				New introduction of CRR										
	2013				2014				Sep 15						
	Large domestic banks	Small domestic banks	Banks under majority ownership	Banks under foreign ownership	Overall	Large domestic banks	Small domestic banks	Banks under majority ownership	Banks under foreign ownership	Overall	Large domestic banks	Small domestic banks	Banks under majority ownership	Banks under foreign ownership	Overall
Capital requirements for credit risk, EUR million	1085	167	632	1883	809	87	578	1474	775	88	556	1419			
	Breakdown of capital requirements for credit risk, %														
General government, international organisations	0,7	1,6	1,0	0,9	1,4	2,7	2,1	1,7	1,4	3,6	2,5	2,0			
Institutions	13,1	1,9	2,7	8,6	10,0	1,6	3,6	6,6	9,4	1,3	3,2	6,5			
Corporate	38,3	28,7	45,5	39,9	33,5	19,5	40,5	33,1	31,3	18,9	40,0	34,0			
Retail	21,5	23,9	33,8	25,7	25,4	35,5	30,4	27,9	25,5	34,1	30,6	28,0			
Secured by mortgages on real estate	2,6	8,3	4,9	3,9	3,5	13,0	7,4	5,6	3,9	15,3	8,0	6,2			
Exposures in default	4,4	7,6	4,1	4,6	13,8	16,9	10,8	12,7	15,6	13,2	10,7	13,5			
Exposures associated with particularly high risk	9,6	21,9	4,0	9,0	4,1	1,6	1,6	2,9	3,9	1,8	1,1	2,6			
Other	9,9	6,2	4,0	7,5	8,3	9,2	3,5	9,4	9,0	11,9	3,8	7,2			

Source: Bank of Slovenia

In the wake of the new demands for capital, a significant role in the maintenance of stable capital adequacy will be played by the optimal use of existing capital and by the faster, more effective clean-up of bank balance sheets, i.e. the reduction of non-performing loans.

Figure 2.45: Risk weights by credit exposure class on individual basis, in percentages



Note: The risk weight is calculated as the ratio of risk-weighted assets for credit risk to the total credit exposure for each class of credit exposure, expressed as a percentage.

Source: Bank of Slovenia

High risk weights are hindering capital optimisation.

In the optimisation of capital, the banks face high risk weights, which are attributable to several factors. First, almost all the banks use the standardised approach to risk assessment, which limits the use of lower risk weights. Second, in the breakdown of the credit portfolio the banks have a high proportion of exposures to corporates and retail banking, whose risk weights were high, at 90% and 72% respectively at the end of September 2015. Third, the banks could for example apply lower risk weights to exposures secured by real estate, but in so doing are limited by a failure to meet conditions and by the resources necessary for putting in place a system for assessing and monitoring real estate valuations. Fourth, capital requirements for exposures in default and for items associated with particular high risk, to which the highest weights are assigned, account for 16% of the banks' capital requirements for credit risk. The average risk weight for these exposures stood at 120% at the end of September. The clean-up of the credit portfolio, which could ease the burden on capital, is proceeding relatively slowly. More effective bankruptcy proceedings are one factor that could contribute to the faster reduction of non-performing claims, which would also entail key support for credit growth. This would ease debt recovery, thereby reducing the costs of liquidating credit protection.

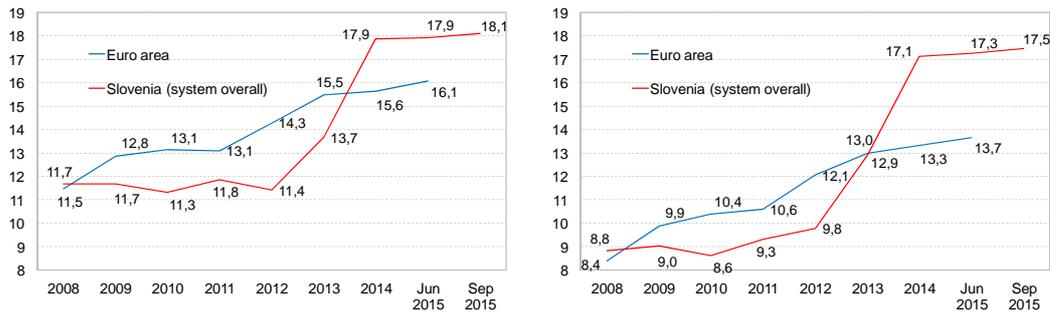
1.1.2 Comparison of capital adequacy with the EU (consolidated figures)

The banking system's solvency ratios remain above the latest figures for the EU average.

The Slovenian banking system's total capital ratio and Tier 1 capital ratio on a consolidated basis improved over the first nine months of 2015, thereby remaining above the euro area averages.²⁵ The former increased by 0.2 percentage points to 18.1%, while the Tier 1 capital ratio improved by 0.4 percentage points to 17.5%. The small difference between the two ratios at Slovenian banks compared with the difference across the euro area is an indication of the higher-quality capital structure at Slovenian banks.

²⁵ The latest available figure for the euro area average is for June 2015.

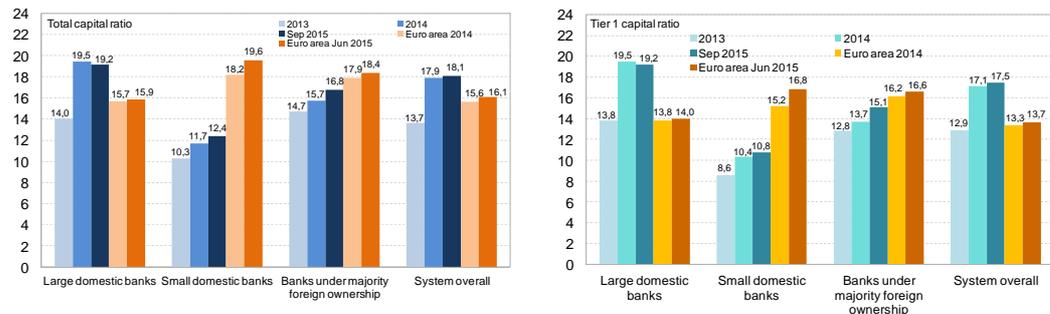
Figure 2.46: Total capital ratio (left) and Tier 1 capital ratio (right) of the Slovenian banking system compared with the euro area, figures on a consolidated basis, in percentages



Sources: ECB (SDW), Bank of Slovenia

Similarly to the figures on an individual basis, the large domestic banks are notable for their high capital adequacy, while the small domestic banks remain the most vulnerable in capital terms. Despite a slight improvement in capital adequacy over the period in question, it is the small domestic banks that most trail the comparable banks across the euro area. With renewed improvement in capital adequacy, the banks under majority foreign ownership again closed the gap with the euro area average.

Figure 2.47: Total capital ratio (left) and Tier 1 capital ratio (right) compared with the EU, figures by bank group on a consolidated basis, in percentages



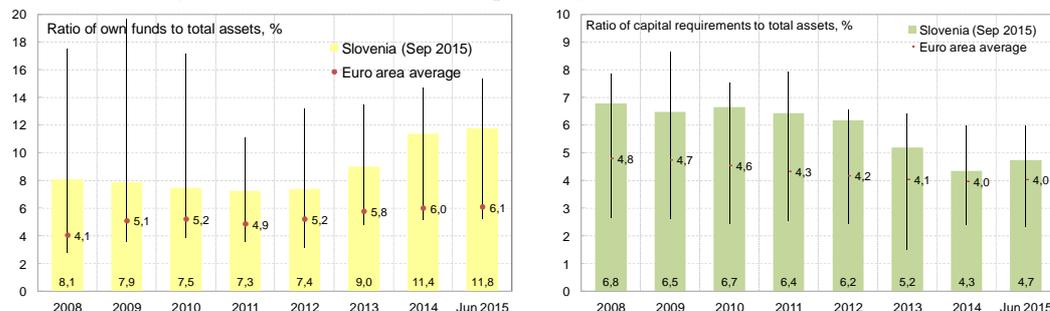
Note: The figures for the small domestic banks as of 2013 inclusive do not include the two banks undergoing the orderly wind-down process.

Sources: ECB (SDW), Bank of Slovenia

The decline in the Slovenian banking system’s solvency risk is being reflected not only in higher capital ratios, but also in a higher ratio of book capital to total assets. In the wake of the increase in own funds and the ongoing contraction in total assets, the ratio increased to 11.8% at the end of September 2015, significantly above the euro area average. By contrast, despite the contraction in lending, Slovenian banks continue to record a relatively high ratio of capital requirements to total assets compared with the euro area overall, at 4.7%. The main reason remains the high risk weights of Slovenian banks, which limit them in the more efficient use of capital, as highlighted above.

The ratio of book capital to total assets remains above the euro area average.

Figure 2.48: Distribution of the ratio of book capital to total assets (left) and the ratio of capital requirements to total assets (right) for euro area countries, figures on a consolidated basis, in percentages



Sources: ECB (SDW), Bank of Slovenia

3. NON-BANKING FINANCIAL INSTITUTIONS

3.1 Leasing companies

Summary

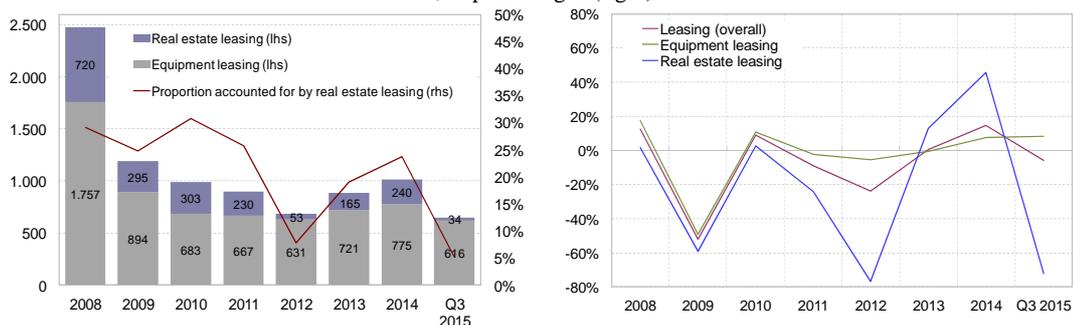
The favourable economic environment is primarily being reflected in the leasing sector via increased activity in real estate business. The increase in the ratio of arrears in repayments to total leasing business is slowing. Leasing companies' performance is improving: they generated a net profit in all of the first three quarters of 2015.

The consolidation process, which began in 2015, is being reflected in the liquidation of individual leasing companies whose business has been taken over by the parent companies (most often commercial banks), and in the sale of individual leasing companies and business to other firms not engaged in leasing. The contraction in loans domestically and in the rest of the world is increasing liquidity risk for leasing companies.

Leasing companies' turnover

New leasing business over the first nine months of 2015 was down 6% on the same period of 2014. The decline in new business was attributable to a contraction in real estate leasing business. The main factor in activity in the real estate segment over the last two years has been business involving previously repossessed real estate from finance and operating leases.

Figure 3.1: New leasing business²⁶ in EUR millions and 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

A positive trend in new equipment business and a negative trend in new real estate business.

The trend in equipment leasing remained positive in 2015. Equipment leasing business over the first nine months of the year was up 8.3% in year-on-year terms at EUR 615.9 million. The main lease agreements entered into were for cars, commercial vehicles and freight vehicles. The LTV ratio remained stable at 79.4%. Leasing companies' new real estate business amounted to EUR 34.1 million, down 72% in year-on-year terms. The majority of the business was on the basis of previously repossessed commercial buildings, which suggests that the renewal of existing agreements was involved. The LTV ratio remained high at 97.1%.

The stock of leasing business has continued to contract. There was a slight improvement in the proportion of claims more than 90 days in arrears.

The withdrawal of leasing companies from the real estate market was reflected most notably in the stock of total leasing business. This stood at EUR 2.9 billion in September 2015, down 8.5% in year-on-year terms. The stock of real estate leasing business declined by 17.9% to EUR 1.2 billion, while the stock of equipment leasing business declined by 0.9% to EUR 1.7 billion. The proportion of claims more than 90 days in arrears stood at 10.3% in September 2015, down 0.3 percentage points in year-on-year terms. The market value of leasing assets repossessed for non-performance of contractual obligations declined by 5.1%.

Financing of other institutional sectors

Non-financial corporations and households remain leasing companies' largest customers. They accounted for 61.9% and 38.0% respectively of the total stock of leasing business at the end of September 2015.

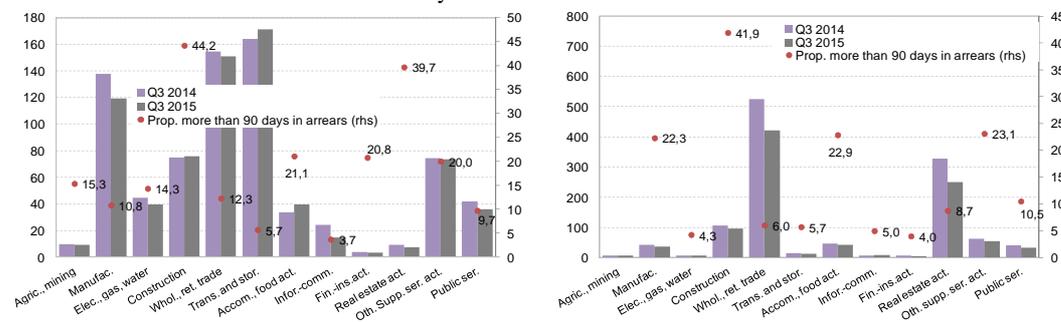
²⁶ Leasing business is disclosed at historical cost until 2008 due to the availability of figures, and at financed value since, excluding the financing of inventories since 2010.

The stock of leasing business with households in the third quarter was down 0.4% in year-on-year terms at EUR 1.1 billion. The risk level of the household sector from the perspective of a failure to settle liabilities promptly remains low. The proportion of claims against households more than 90 days in arrears increased by 0.9 percentage points over the first nine months of the year to 5.2%. This was attributable to the deterioration in the real estate segment.

The stock of leasing business with non-financial corporations was down 12.9% in year-on-year terms at EUR 1.7 billion. The contraction was primarily attributable to a contraction in real estate business, which was the result of a lack of activity in the financing of the construction of residential and commercial buildings. Given the lack of interest in entering into new real estate business, the trend of decline in new and existing business can be expected to continue. Non-financial corporations retain a greater appetite for equipment leasing, although business in this segment declined by 4.1% to EUR 740.9 million. The demand for commercial vehicles and freight vehicles and for cars nevertheless strengthened by 8.1% to EUR 260.6 million and by 1.4% to EUR 201.2 million respectively.

Business with non-financial corporations has continued to decline as a result of a contraction in real estate business.

Figure 3.2: 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



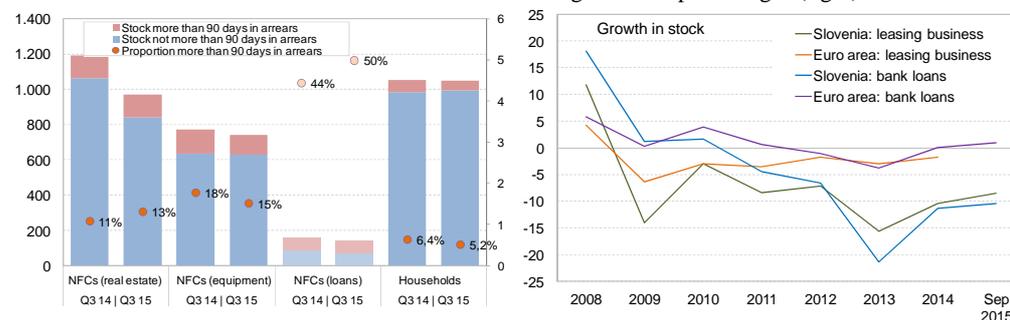
Note: The proportion more than 90 days in arrears for real estate leasing is 95% in the agriculture and mining sector.

Source: Bank of Slovenia

Non-financial corporations are the highest credit risk for leasing companies because of the relatively large exposure and because of the higher proportion of non-performing claims in this category of debtor. The proportion of claims more than 90 days in arrears increased by 0.9 percentage points over the first nine months of the year to 14.0%. The stock of claims more than 90 days in arrears declined in both the real estate and the equipment segments; the relative increase was attributable to a faster decline in the stock of leasing business.

Claims more than 90 days in arrears increased to 14% at non-financial corporations as a result of the contraction in the stock of leasing business.

Figure 3.3: Stock and proportion of leasing business more than 90 days in arrears in EUR million and percentages (left), and growth in stock of leasing business and bank loans to the non-banking sector in percentages (right)



Sources: Leaseurope, BAS, ECB, Bank of Slovenia, own calculations

The type of business that prevails at non-financial corporations is finance leasing, which accounts for 60.2% of the total stock of leasing business with non-financial corporations, or EUR 1,029.7 million. There was no significant change in the breakdown of leasing business in the last year. The proportion of finance leases in arrears increased by 0.5 percentage points to stand at 15.8%, primarily as a result of the contraction in the stock of leasing business.

Performance of leasing companies

The sector was profitable, despite increased write-offs.

The leasing sector was profitable over the first nine months of 2015. Write-offs were up 160% on the same period of 2014, although this was the result of an above-average write-off undertaken by a single leasing company on its real estate business. Leverage was unchanged at 10.6 as equity and debt declined simultaneously. Leasing companies have focused on more profitable equipment leasing in recent years.

During the period of major real estate projects, leasing companies were established solely to finance projects of this type. Today these companies are not generating any new business, and their cash flow is reliant solely on rents. A trend of their discontinuation began in 2015, either in the form of takeovers by firms whose principal line of business is unrelated to leasing, or through liquidation and the transfer of their business to other existing leasing companies. Certain banks also began absorbing their leasing subsidiaries, primarily offering finance lease services.

Table 3.1: Performance and funding of leasing companies

	2008	2009	2010	2011	2012	2013	2014	Sep 15	Growth, %							
									2008	2009	2010	2011	2012	2013	2014	Sep 15
Total assets, EUR million	5.620	5.663	5.427	5.088	4.842	3.826	3.461	3.093	18,4	0,8	-4,2	-6,2	-4,8	-21,0	-9,5	-10,6
Shareholder equity, EUR million	267	200	205	204	114	5	288	256	14,2	-25,2	2,4	-0,3	-43,9	-95,6		-11,3
Total profit/loss, EUR million	29	-33	-30	-19	-121	-266	-50	22	-38,5	-215,3	10,9	34,8	-527,3	119,3	-81,1	
ROA, %	0,6	-0,6	-0,5	-0,4	-2,4	-6,9	-1,5	0,9								
ROE, %	11,5	-14,2	-14,6	-9,4	-76,0	-5228,7	-17,5	11,0								
Financial and operating liabilities, EUR million	5.314	5.427	5.179	4.843	4.681	3.729	3.061	2.702	18,5	2,1	-4,6	-6,5	-3,3	-20,4	-17,9	-11,7
liabilities to banks/corporates in group / total assets	95	96	95	95	97	97	88	87								
Investment property	560	580	836	929	1.118	1.002	822	656	4,1	3,6	44,0	11,2	20,3	-10,3	-18,0	-20,2
investment property / assets, %	10	10	15	18	23	26	24	21								
Finance expenses from impairments and write-off of financial assets, EUR million	10	120	167	127	157	192	98	97								

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

Financial loans from the rest of the world remain the principal source of funding for leasing companies, but declined by 17% in year-on-year terms. Owing to the increasing trend of withdrawal from the funding of leasing companies, by domestic banks in particular, the proportion of funding accounted for by foreign loans increased by 3.7 percentage points to 73.5%, of the total financial liabilities of EUR 2.6 billion.

3.2 Insurers

Summary

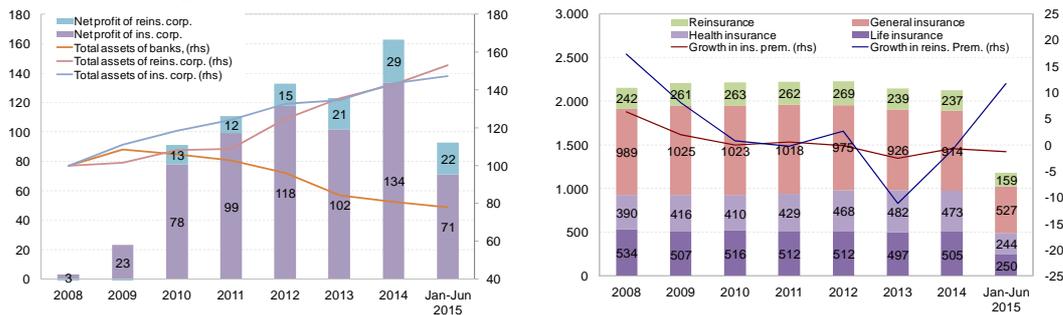
In the insurance segment the recovery in the domestic economy has not been reflected in growth in written premium, while the situation in the reinsurance segment is improving.

The performance of the entire insurance sector was additionally impacted by the increased volatility on the capital markets in connection with low interest rates. Investments in bonds, shares and mutual funds account for 77.6% of the total assets of insurance corporations and reinsurance corporations. The environment of low interest rates is reducing the returns on insurance corporations' principal class of investments, namely bonds, and is increasing the risk of the reinvestment of coupons and maturing bonds.

Features of insurers' performance

The insurance corporations and reinsurance corporations withstood the economic and debt crisis better than did the banks. The total assets of insurance corporations and reinsurance corporations increased over the last five years, while the total assets of the banking sector declined sharply.

Figure 3.4: Net profit in EUR million and total assets (2008 = 100) (left), and gross written premium by type of insurance in EUR million and annual growth in percentages (right)



Sources: ISA, Bank of Slovenia

The improved economic situation had a positive impact on growth in reinsurance corporations' premium, while insurance corporations continued to record a decline in premium. The economic crisis altered policyholders' purchasing habits and reduced the number of active business entities, which is still being reflected in restrained demand for insurance products. Insurance corporations' premium in the first half of 2015 was down 1.3% in year-on-year terms at EUR 1,021 million. Gross premium contracted in all three classes of insurance.

Insurance corporations' net profit in the first half of 2015 was down 20.5% in year-on-year terms at EUR 71.1 million. The profitability indicators also declined in year-on-year terms as a consequence: ROE stood at 5.5% over the first half of the year, and ROA at 1.1%. The picture was reversed in the reinsurance segment: net profit increased by 21.5% to EUR 21.8 million, which improved the profitability indicators.

Stability and risk of the insurance sector

Uncertainties surrounding future social welfare could have an additional impact on policyholders' habits in the future, which would impact insurance corporations' performance. In light of the investment structure of insurance corporations and reinsurance corporations, currency risk remains small, as euro-denominated investments account for 96.7% of their total investments.

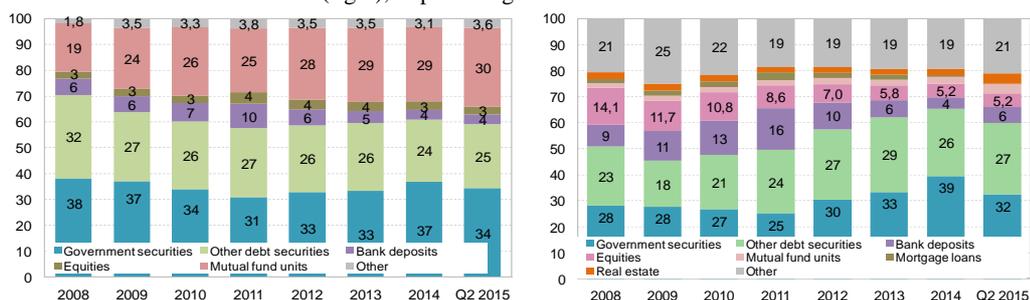
The environment of low interest rates entails a greater threat to insurance corporations that have a large number of products committed to a fixed return. There is a limited proportion of products of this type in the Slovenian insurance sector. Low interest rates nevertheless remain a significant risk factor for insurance corporations, as investments in debt financial instruments account for a significant proportion of the balance sheet, which is increasing reinvestment risk. In addition, difficulties in the matching of assets and liabilities are increasing in the environment of extremely low interest rates.

The investment structure and the corresponding investment risk in life insurance and general insurance nevertheless remain stable. There was a shift in the structure of the assets covering mathematical provisions in the first half of 2015 primarily in relation to exposure to government securities, as a result of the maturing of individual bond issues and low yields. Exposure to mutual fund units and to other debt securities increased, at the expense of government securities. There was a similar structural change in the assets covering technical provisions other than mathematical provisions.

The environment of low interest rates is increasing investment risk and difficulties in the matching of assets and liabilities.

Low yields and the maturing of government bonds are encouraging investment in mutual fund units.

Figure 3.5: Structure of insurers' assets covering mathematical provisions (left), and assets covering technical provisions other than mathematical provisions (right), in percentages



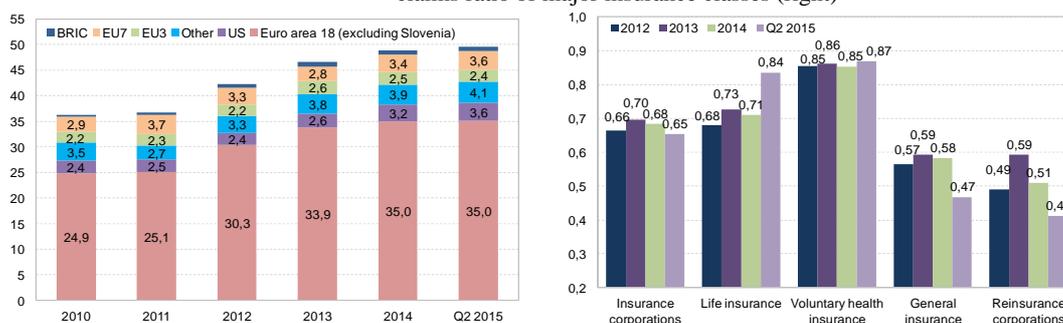
Sources: ISA

The proportion of total investments accounted for by investments in the securities of domestic issuers remains above 50%.

The proportion of the total investments by the insurance sector, including pension companies, accounted for by investments in the securities of domestic issuers stood at 50.4% at the end of June 2015, having declined by 0.7 percentage points over the preceding six months, as a result of a further contraction in exposure to domestic investments. There were net purchases of EUR 277.0 million in foreign bonds and net purchases of EUR 8.5 million in foreign shares in the first half of the year. The insurance sector including pension funds only remains exposed to a lesser extent to emerging countries, where economic activity is slowing significantly more sharply than originally expected.

In 2015 insurance corporations and pension funds began marketing lifecycle funds, thereby upgrading the current arrangements for supplementary pension insurance. The investment policy of a lifecycle fund allows the policyholder's assets and contributions during the saving phase to be allocated, depending on age, across asset pools with various levels of investment risk. The environment of low interest rates and the introduction of lifecycle funds will have a significant impact on the structure of investments, which until the beginning of 2015 was based on debt securities. Policyholders approaching retirement and risk-averse policyholders are automatically allocated to guaranteed-return funds. The introduction of lifecycle funds allows for the possibility of pursuing higher returns that are not attainable for guaranteed-return funds, although the investment risk is also thereby transferred from the operator to the saver.

Figure 3.6: Proportion of the total investments of insurance corporations and pension funds accounted for by foreign investments, in percentages (left), and claims ratio of major insurance classes (right)



Sources: Bank of Slovenia, ISA

The claims ratio deteriorated as a result of a simultaneous decline in premium and an increase in claims.

The claims ratio at insurance corporations as measured by the ratio of gross claims paid to gross written premium stood at 0.65 over the first six months of 2015, 0.03 points less than in 2014, and a deterioration of 0.04 points in year-on-year terms. Developments in life insurance and voluntary health insurance acted to cause a deterioration in the claims ratio, while the claims ratio in general insurance improved. Premium declined in all insurance classes as a result of changes in policyholders' habits. Only general insurance recorded a decline in claims, while life insurance and voluntary health insurance claims increased as a result of the gradual maturing of life insurance, the average term of which is usually 10 to 15 years. The highest annual increase in life insurance was recorded between 2005 and 2007.

The business of the reinsurance corporations is highly diversified in geographical terms. The main factor in the improvement in the claims ratio in reinsurance was an increase in

insurance premiums, which were up 11.6%. Claims also increased, albeit to the lesser extent of 3.0%.

3.3 Capital market and mutual funds

Summary

After a positive start to the year, the trend turned negative in the second quarter of 2015. There were several factors in the increased pressure to sell, most notably concerns over future developments in global economic activity and speculation surrounding the future measures of central banks. Developments in the rest of the world were also reflected in the domestic capital market, where the situation additionally deteriorated owing to a decline in liquidity as a result of a lack of M&A activity and a lack of new share listings on the exchange.

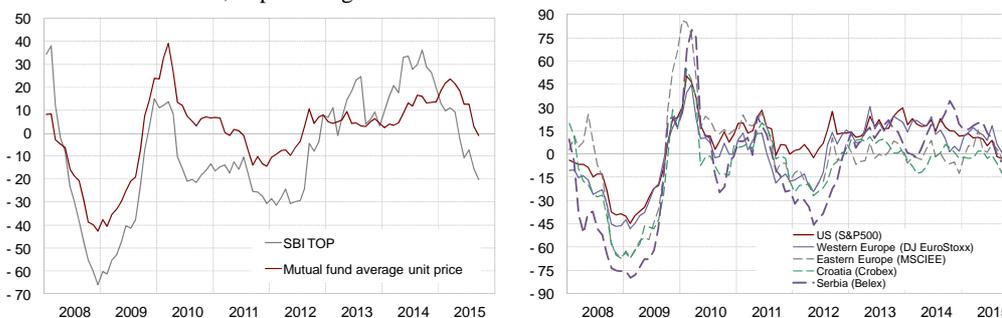
The environment of low interest rates is encouraging corporates and governments to finance themselves via debt security issues. The persistent environment of low interest rates is increasing the risk of asset reallocation, as market participants have to take up increasing risk to achieve the targeted returns.

Developments on the capital market

The markets' positive mood in early 2015 turned negative in the second quarter, and market volatility thereby increased. The change in mood was attributable to fears of a cooling global economy and speculation regarding the ECB's new measures and the end of expansionary policy in the US. The negative impact of the ECB's stimulus measures has been reflected in a decline in volume on the bond market, which is increasing liquidity risk for financial instruments.

The majority of share indices were down in year-on-year terms at the end of the third quarter of 2015. Only the western Europe composite index (the DJ EuroStoxx) had a positive year-on-year change. The Slovenian stock exchange index was down more than others. Alongside the negative trends on foreign stock exchanges, the Ljubljana Stock Exchange was also impacted by low liquidity and a loss of appetite on the part of previous majority owners to continue the privatisation process.

Figure 3.7: Year-on-year change in domestic (left) and foreign (right) stock exchange indices, in percentages



Sources: Bank of Slovenia, LJSE, Bloomberg

The halting of the privatisation process had a significant impact on volume on the Ljubljana Stock Exchange. The volume of trading in shares and bonds declined sharply in 2015, which lowered the turnover ratios. The low liquidity is increasing the possibility of price manipulation, which is indirectly acting to increase volatility on the market, and to artificially inflate the values of assets used as collateral. The risk of ineffective collateralisation of securities transactions is therefore increasing.

The volume of trading in shares almost halved.

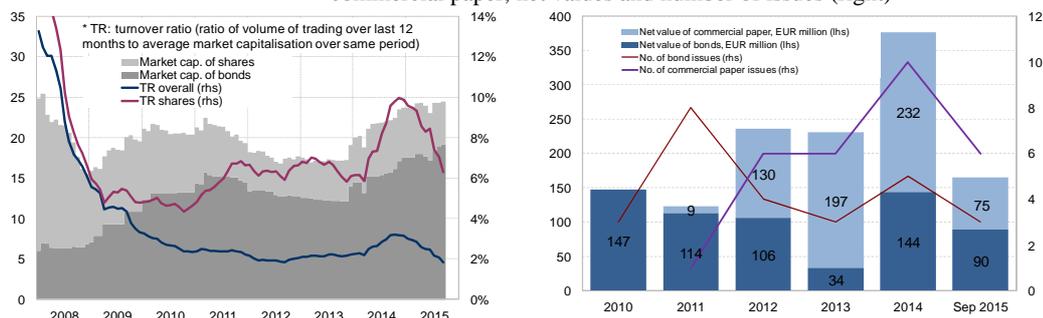
Table 3.2: Overview of Slovenia's regulated capital market

	2009	2010	2011	2012	2013	2014	Sep 2015
Shares							
Market capitalisation							
amount, EUR billion	8,5	7,0	4,9	4,9	5,2	6,2	5,3
as % GDP	23,9	19,7	13,5	13,9	14,7	16,7	14,0
annual growth, %	-0,1	-17,3	-30,3	0,8	5,3	20,1	-17,9
proportion held by non-residents, %	7,2	10,0	12,3	13,6	15,5	25,4	26,1
Volume							
amount, EUR million	719,8	360,8	394,5	302,9	299,4	608,1	252,3
as % GDP	2,0	1,0	1,1	0,9	0,8	1,6	0,7
annual growth, %	-24,4	-49,9	9,3	-23,2	-1,1	103,1	-47,3
Annual change in SBI TOP, %	15,0	-13,5	-30,7	7,8	3,2	19,6	-20,2
P/E (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	17,5	19,2
as % GDP	30,6	37,2	40,0	36,1	41,2	47,0	50,6
annual growth, %	59,2	21,9	9,6	-11,9	15,6	20,7	22,3
Volume							
amount, EUR million	156,3	108,9	59,6	55,4	86,1	69,0	38,0
as % GDP	0,4	0,3	0,2	0,2	0,2	0,2	0,1
annual growth, %	-39,2	-30,3	-45,3	-7,0	55,4	-19,8	-30,3

Note: Excludes listed investment companies, mutual funds and banker's drafts.
Sources: LJSE, SORS

As a result of the negative trend and the delisting of individual shares, the market capitalisation of shares fell by 17.9% over the period in question, while the market capitalisation of bonds increased by 22.3% as a result of new borrowing, primarily by the government and partly by corporates.

Figure 3.8: Market capitalisation on the Ljubljana Stock Exchange in EUR billion, and annual turnover ratios (left), and issuance of corporate bonds and commercial paper, net values and number of issues (right)



Sources: LJSE, CSCC, Bank of Slovenia, own calculations

Corporate bond issuance strengthened, while commercial paper issuance declined.

Three corporates issued bonds with a total nominal value of EUR 89.8 million during the first nine months of 2015. Corporate bond issuance amounted to EUR 28.5 million over the same period of 2014, although the figure increased sharply in the final quarter of 2014 as a result of two major issues. Six corporates issued commercial paper with a total nominal value of EUR 75.0 million in 2015. Four commercial paper issues were undertaken on the Ljubljana Stock Exchange. Corporate borrowing via commercial paper issuance thus slowed slightly: commercial paper issuance amounted to EUR 189.2 million over the same period of 2014. The government²⁷ issued four bonds with a total nominal value of EUR 2.9 billion over the same period.

The environment of low interest rates is increasing the risk of asset reallocation, which is reducing liquidity on the market.

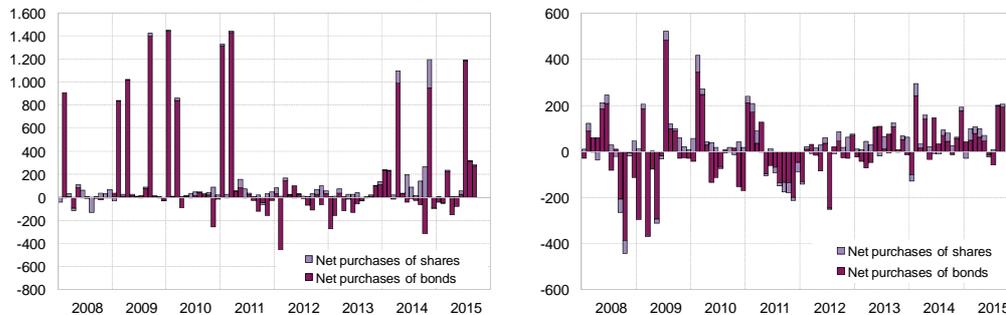
In the environment of low interest rates, Switzerland was the first European country to succeed in issuing a 10-year bond with a negative yield. In a situation where investors are willing to accept significantly greater risks in the quest for the desired returns, or are willing to invest in debt instruments with a negative return solely for the sake of security, liquidity risk is increasing as a result of the reallocation of assets. The cause could be the end of expansionary monetary policy by the Fed, with a rapid rise in the key interest rate. Liquidity risk on the international secondary bond market is also increasing as a result of restrictive banking regulations and the ECB's expansionary monetary policy. The supply of new bonds is not meeting the increased demand produced by the expansionary policy, which is raising bond values and depressing yields. This is creating good conditions for

²⁷ Government includes the entire S.13 sector as defined in the Standard Classification of Institutional Sectors.

issuing new bonds, but at the same time the fall in yields is forcing market participants to seek alternative investments.

An asset reallocation effect could also be reflected in Slovenia's sovereign borrowing, which could increase risks on the domestic capital market. This would further reduce the already-low liquidity, and would tighten the conditions for new borrowing, which would put adverse pressure on new borrowing and on the actual market capitalisation of equities and debt securities.

Figure 3.9: Monthly net inward investments by non-residents (left) and outward investments by residents (right), in EUR million



Note: Includes investments in listed shares and bonds, and in those not listed on the exchange.

Sources: CSCC, Bank of Slovenia, own calculations

Non-residents' net inward investments remain high, particularly investments in bonds, while demand for Slovenian shares declined in 2015 in line with the slowdown in the privatisation process. Non-residents' investments are strongly positively correlated with issuance of domestic government bonds, which was evidenced in the increases in non-residents' net investments in domestic bonds in March and July.

Non-residents' demand for Slovenian bonds remains high.

Residents were more favourable to investments in foreign bonds during the first nine months of 2015: they were up 6.6% in year-on-year terms at EUR 592.2 million. The net cash flow into foreign shares over the aforementioned period was up 2.1% at EUR 124.78 million. The largest net purchasers of bonds were mutual pension funds, whose net purchases of bonds amounted to EUR 209.2 million. The largest net purchasers of foreign shares were investment funds, as a result of increased inflows into funds from households, particularly in the first half of the year.

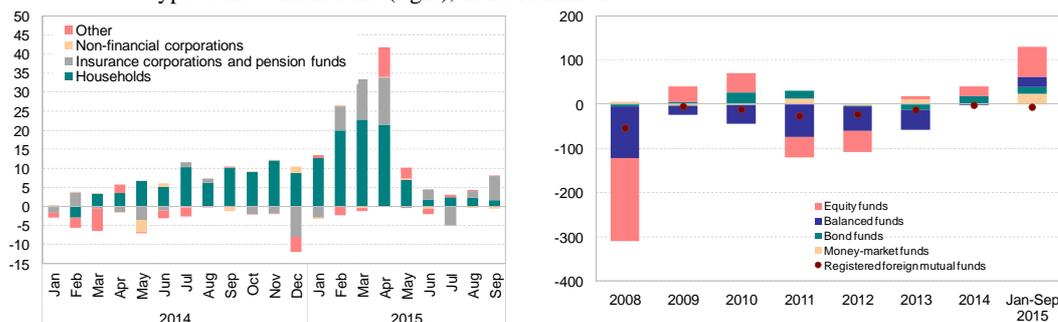
Investment funds

The net cash flow into foreign shares over the first nine months of 2015 was up 4.4-fold in year-on-year terms at EUR 129.9 million. The strong growth in net inflows into investment funds has slowed since May in line with the increased uncertainty on the capital markets.

Households recorded the largest net inflows into investment funds. They made net investments of EUR 91.8 million over the first nine months of the year, or 70.7% of total net inflows. When the trend reversed in May 2015, inflows declined sharply and shifted to safer forms of investment, such as money-market funds. Household assets held in investment funds amounted to EUR 1.2 billion in September 2015, up 7.4% in year-on-year terms and equivalent to 56.4% of all investment fund assets. Insurance corporations remain the second-largest investor, with 31.2% of the total.

Household assets held in investment funds increased by 7.4%.

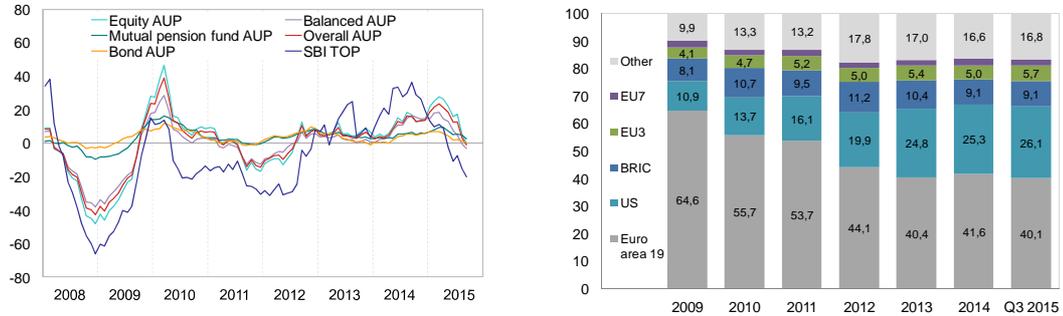
Figure 3.10: Net inflows into investment funds by sector (left) and net cash flow by type of investment fund (right), in EUR million



Sources: SMA, Bank of Slovenia

The geographical diversification of the investments prevented any particular type of investment funds from recording larger negative returns. Balanced funds recorded the largest annual fall, despite the nature of their investments. The average unit price of balanced funds was down 3.3% in year-on-year terms in September.

Figure 3.11: Year-on-year change in the average unit price of investment funds and the SBI TOP (left), and regional breakdown of investments in foreign shares by the entire other financial intermediaries sector (right), in percentages



Sources: SMA, LJSE, Bank of Slovenia

4. MACRO-PRUDENTIAL SUPERVISORY MEASURES

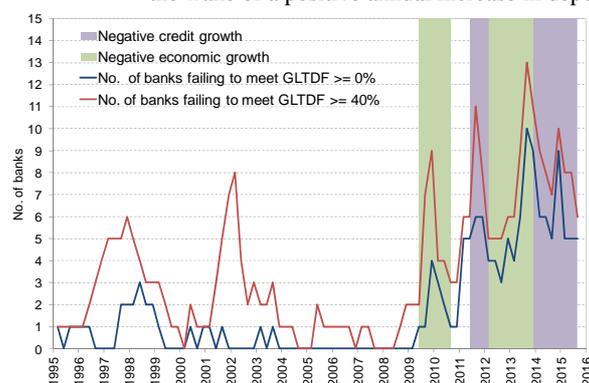
4.1 Monitoring of macro-prudential supervisory measures

At the end of June 2014 the Bank of Slovenia introduced GLTDF,²⁸ a macro-prudential instrument aimed at slowing the decline in the loan-to-deposit (LTD) ratio for the non-banking sector, thereby helping to stabilise funding structure and to reduce system liquidity risk in funding. The degree to which three predetermined objectives of the instrument have been met and the developments in variables on which the instrument can have an impact on the basis of the anticipated transmission mechanism are examined below. However, the responses and effects of the illustrated variables cannot be ascribed solely to the introduction of GLTDF, as other factors such as bank and corporate restructuring, the economic recovery and the ECB's non-standard measures are also having an impact.

4.1.1 Meeting of requirements in 2015

Five banks were failing to meet the GLTDF requirements at the end of September 2015, which meant that they recorded a contraction in lending in the wake of a positive increase in deposits by the non-banking sector, and their GLTDF was less than 0%. The number of banks failing to meet the minimum requirements was unchanged throughout 2015, although the identity of the banks changed. Of the five banks that were failing to meet the GLTDF requirements at the end of September, three have to meet the stricter requirements for GLTDFq, while the other two have to meet higher liquidity ratios. The number of banks failing to meet the minimum requirements is relatively stable, although several adjustments are occurring in the area of deposits by the non-banking sector.

Figure 4.1: Number of banks failing to meet GLTDF $\geq 0\%$ or GLTDF $\geq 40\%$ in the wake of a positive annual increase in deposits



Source: Bank of Slovenia

²⁸ GLTDF is the ratio of the annual change in the gross stock of loans to the non-banking sector before impairments (gross loans to the non-banking sector) to the annual change in the stock of deposits by the non-banking sector. The instrument gives a bank the option of either meeting the GLTDF requirements, or increasing liquidity buffers. For banks with a positive annual inflow of deposits by the non-banking sector, meeting the minimum requirements would entail them not reducing lending (GLTDF $\geq 0\%$). The minimum requirements place a lower limit on the pace of the decline in the LTD ratio for the non-banking sector. The bank must apply corrective measures should it fail to meet the minimum requirements for GLTDF. The first corrective measure defines stricter requirements for GLTDF at the quarterly level, i.e. for banks with a positive quarterly increase in deposits the expectation is that the quarterly increase in loans to the non-banking sector will reach at least 40% of the increase in deposits by the non-banking sector, i.e. GLTDFq $\geq 40\%$. The first corrective measure thus pushes the bank towards meeting the minimum requirements for GLTDF. The three remaining corrective measures relate to higher requirements with regard to liquidity ratios, and push the bank towards meeting the second-bucket liquidity ratio (LR2), i.e. the ratio of financial assets to financial liabilities with a residual maturity of up to 180 days, which has to reach a value of at least 1 in the fourth corrective measure. All the corrective measures cease to apply when the bank meets the minimum requirements for GLTDF.

4.1.2 Slowdown in decline in the LTD ratio

The decline in the LTD ratio is slowing. The LTD ratio for the non-banking sector continued to decline even after the introduction of the instrument, albeit at a significantly slower pace than in previous years. The LTD ratio declined by just under 6 percentage points over the first nine months of the year to 82.4%, just under 40% of the decline recorded in the previous year, when the ratio declined by 15 percentage points over the first nine months of the year.

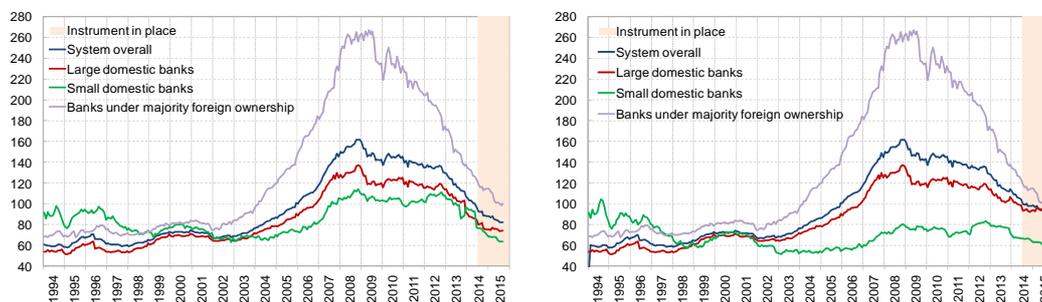
Table 4.1: Level and decline of LTD ratio of banking system and bank groups, basic indicator and excluding effects of recovery, i.e. excluding Factor banka and Probanka, and excluding the transfer of non-performing claims to the BAMC

	System overall		Large domestic banks		Small domestic banks		Banks under majority foreign ownership
	LTD	LTD excluding BAMC and Factor/Probanks	LTD	LTD excluding BAMC	LTD	LTD excluding Factor/Probanks	
1997	60,3	59,9	54,2	54,2	74,9	68,8	71,9
2004	86,9	86,6	79,0	79,0	70,4	54,5	119,2
2008	161,5	161,7	136,3	136,3	111,0	79,6	262,7
2012	129,8	128,7	113,6	113,6	107,7	81,2	174,4
2013	107,9	114,2	92,4	106,7	97,0	71,6	137,9
2014	88,2	98,2	75,1	93,4	70,2	64,5	114,6
Sep 2015	82,4	92,2	74,1	93,0	63,5	59,3	100,1
Change, percentage points							
2004-1997	26,5	26,8	24,8	24,8	-4,5	-14,3	47,2
2008-2004	74,6	75,1	57,3	57,3	40,6	25,1	143,5
2014-2008	-73,3	-63,5	-61,2	-42,9	-40,7	-15,1	-148,1
2013-2012	-21,9	-14,6	-21,2	-6,9	-10,7	-9,5	-36,5
2014-2013	-19,7	-15,9	-17,3	-13,3	-26,8	-7,1	-23,2
Decline relative to previous year	90,3%	109,5%	81,6%	191,5%	250,7%	74,6%	63,6%
Over 9 months							
Sep 14 - Dec 13	-15,0	-14,0	-10,9	-11,6	-21,8	-4,8	-21,2
Sep 15 - Dec 14	-5,8	-6,0	-1,0	-0,5	-6,7	-5,2	-14,5
Decline relative to previous year	38,6%	42,7%	9,3%	3,9%	30,9%	107,6%	68,6%

Source: Bank of Slovenia

The LTD ratio has practically stabilised at the large domestic banks. The ratio declined by 1 percentage point over the first nine months of the year to 74%, and would stand at 93% excluding the transfers of non-performing claims to the BAMC. Excluding the two banks undergoing the orderly wind-down process, the LTD ratio at the small domestic banks declined slightly faster than in the previous year, although the decline is primarily the result of high growth in deposits. There are two factors at the banks under majority foreign ownership. On one side two banks announced that they would cease operations, and are rapidly reducing their stock of loans, while on the other side certain banks are recording very high growth in deposits. The two factors explain the large decline in the LTD ratio of almost 14 percentage points over the first five months of the year, while since May the ratio has also been stable at the banks under majority foreign ownership at 100%.

Figure 4.2: LTD ratio of banking system and bank groups (left), and excluding effects of recovery, i.e. excluding the transfer of non-performing claims to the BAMC and excluding Factor banka and Probanka (right)



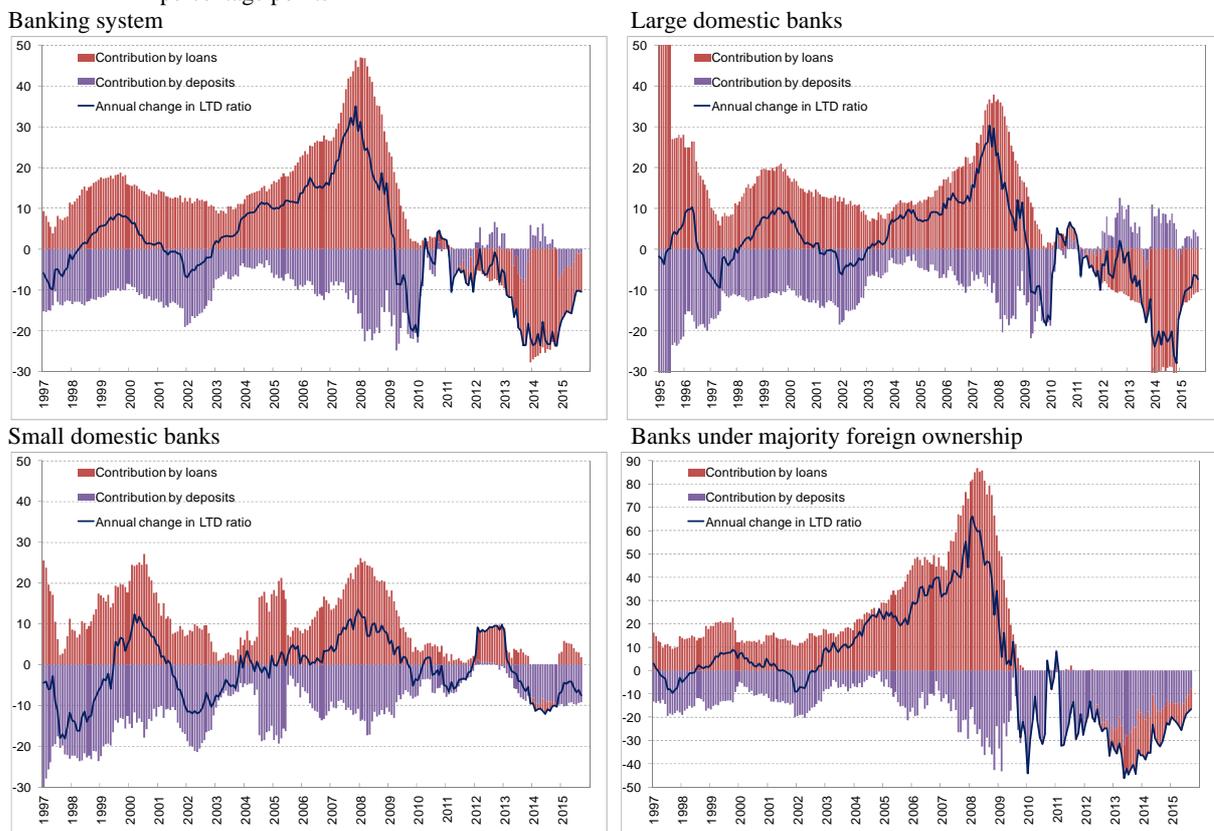
Source: Bank of Slovenia

The main factor in the slowdown in the LTD ratio is the slowdown in the contraction in lending, particularly at the large domestic banks, and less so at the banks under majority foreign ownership, while at the small domestic banks the contribution made by loans has been positive since the beginning of 2015.

The contribution made by deposits to the annual change in the LTD ratio is minimal, and reflects the varying positions of the banks. Across the banking system the

contribution made by deposits to the annual rate of decline in the LTD ratio has been negative in the amount of 1 percentage point over the last three months. The figure remains positive at the large domestic banks, which is a reflection of the negative annual change in deposits, and is also the result of the recovery and resolution of two banks in the final quarter of 2014. The small domestic banks have recorded a very large increase in deposits in recent years, which is the key factor in the decline in their LTD ratio. Although they completely ceased lending to the non-banking sector, the banks under majority foreign ownership retained confidence during the financial crisis and recorded very high growth in deposits, thereby reducing their LTD ratio. The contribution made to the decline in the LTD ratio at the banks under majority foreign ownership has been smaller in recent years, although it remains entirely comparable to the contribution made by the small domestic banks. Some banks have made adjustments to their stock of deposits to suit the reporting date. However, the reverse trend of a slowdown in the decline in the LTD ratio is evident across the banking system and in the bank groups (or at the small domestic banks, a decline in the LTD ratio on account of an increase in deposits), which was a key objective of the instrument.

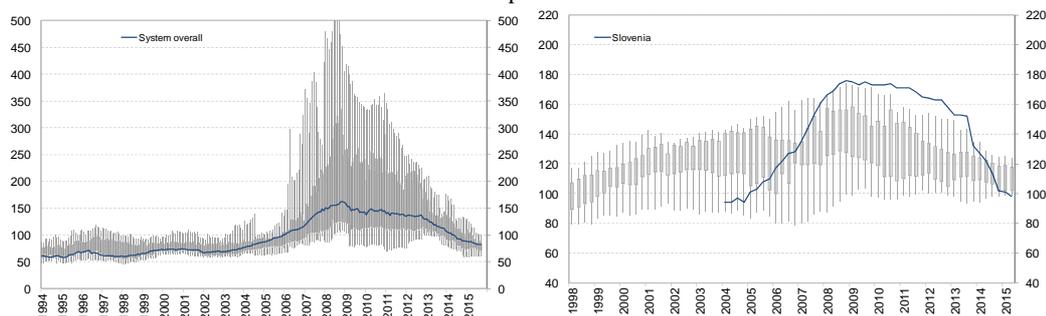
Figure 4.3: Annual changes in the LTD ratio and contribution of individual components of loans to or deposits by the non-banking sector to the change in the LTD ratio for the banking system and the bank groups, in percentage points



Source: Bank of Slovenia

The distribution of the LTD ratio across individual banks narrowed further: the gap between the 80th and 20th percentiles was just 40 percentage points, comparable to the beginning of 2005. The LTD ratio (defined by loans before impairments, excluding the government sector) is also one of the lowest in the euro area, at the level of the 20th percentile of the distribution.

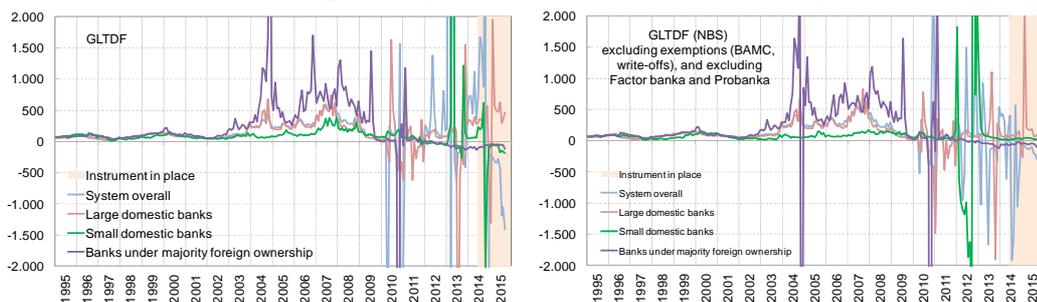
Figure 4.4: Distribution of LTD ratio of individual banks (left) and comparison of LTD ratio (loans before impairments, excluding government sector) with distribution across other euro area countries (right), in terms of 20th/33rd/66th/80th percentile



Source: Bank of Slovenia

GLTDF is also showing signs of stabilisation. GLTDF cleaned of the effects of the transfers of non-performing claims to the BAMC and excluding the two banks undergoing the orderly wind-down process became very stable both at the banks under majority foreign ownership, where it remains negative, and at the small domestic banks, where it remains weakly positive. Individual deviations are providing signs of stabilisation with regard to GLTDF for the large domestic banks.

Figure 4.5: GLTDF of banking system and bank groups (left), and excluding Factor banka and Probanka and exemptions related to the transfer of non-performing claims to the BAMC and write-offs (right)

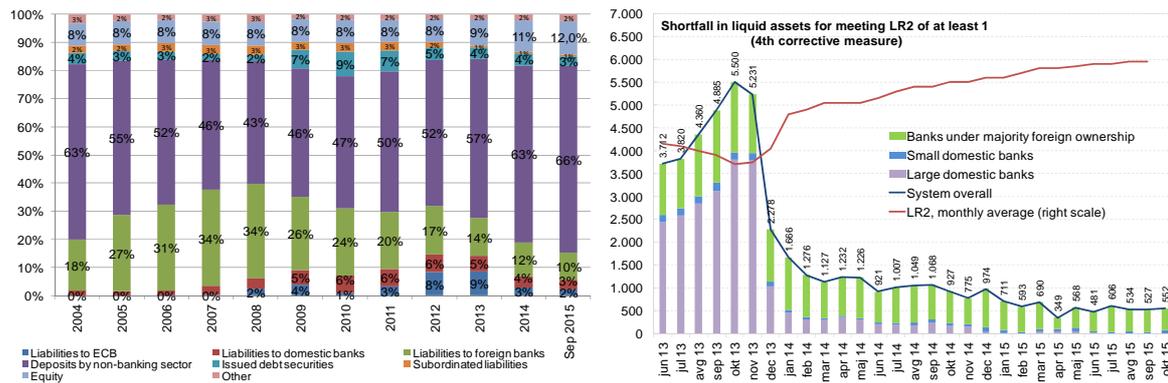


Source: Bank of Slovenia

Stabilisation of funding structure and funding risk

Funding structure is stabilising in the sense of reduced dependence on wholesale funding and the situation on the financial markets. The proportion of the banking system's total liabilities accounted for by deposits by the non-banking sector is high at two-thirds, comparable with the end of 2003, while the proportion accounted for by liabilities to foreign banks is just 10%. For this funding structure to be a suitable basis for funding their lending activities, the banks will have to focus in particular on stabilising the maturity breakdown of the funding, given that short-term resources prevail. Sight deposits account for more than half of all deposits by the non-banking sector.

Figure 4.6: Breakdown of the banking system's liabilities, in percentages (left), and shortfall in liquid investments for each bank to meet the LR2 (fourth corrective measure) by bank group, in EUR million (right)



Source: Bank of Slovenia

The shortfall in eligible financial assets for all banks to meet the second-bucket liquidity ratio (LR2) stabilised at the level of just over EUR 500 million, while the LR2 is still increasing, albeit at a slower pace. The shortfalls in eligible financial assets for all banks to meet the two intermediate liquidity ratios also stabilised. The banks have had no shortfall in meeting the adjusted LR1 (first-bucket liquidity ratio) over the last three months, while the shortfall in meeting the adjusted LR2 is around EUR 300 million.

All three targets set by the definition of the instrument are being met, which is not attributable to the instrument alone. The instrument is just one of the factors affecting developments.

4.2 Macro-prudential policy strategy

The aim of macro-prudential policy is to identify, monitor and assess systemic risks to financial stability, thereby helping to safeguard the stability of the entire financial system, including strengthening the resilience of the financial system and preventing and reducing the build-up of systemic risks, thereby ensuring the financial sector's sustainable contribution to economic growth.²⁹

With the aim of operationalising macro-prudential policy the Bank of Slovenia adopted a strategy document in September 2015 entitled Macro-Prudential Policy for the Banking Sector: Strategic Framework,³⁰ which builds on the Bank of Slovenia's Macro-Prudential Policy Guidelines adopted in early 2015. A properly designed macro-prudential policy strategy is a prerequisite for the successful administration of macro-prudential policy.

The strategy document, which is non-binding, proceeds from the institutional framework and economic circumstances in Slovenia, and sets out a detailed strategic framework for realising the final and intermediate objectives of macro-prudential policy by means of instruments under direct Bank of Slovenia control. On the basis of past developments in the real economy and the financial sector it identifies vulnerabilities that have threatened and could threaten the stability of the financial system, and describes the instruments by which these vulnerabilities could be reduced or eliminated. It could be concluded on the basis of past experience that the cyclical instruments will play a more significant role than the structural instruments. The strategy then gives a detailed elaboration of the circle for the administration of macro-prudential policy, and identifies the areas in which the Bank of Slovenia will focus its activities. The early warning system, which has already been put in place or will be introduced in the near future, is tied to the principles that will guide the use, deactivation or calibration of macro-prudential instruments.

²⁹ Article 2 of the Macro-Prudential Supervision of the Financial System Act (hereinafter: the ZMBNFS; Official Gazette of the Republic of Slovenia, No. 100/13); ESRB: ESRB Handbook on Operationalising Macroprudential Policy in the Banking Sector, 2014.

³⁰ <https://www.bsi.si/library/includes/datoteka.asp?DatotekaId=6647>

4.3 Introduction of new macro-prudential instruments in 2015

The Bank of Slovenia developed two macro-prudential instruments in 2015 that entered into force in January 2016. In accordance with the Banking Act (the ZBan-2), a framework has been put in place for a countercyclical capital buffer and a capital buffer for other systemically important institutions. Because lending is expected to begin rising again only in certain segments of the market, most notably housing loans, the plan in the future is to develop real estate macro-prudential instruments.

4.3.1 Countercyclical capital buffer

The countercyclical capital buffer pursues one of the intermediate macro-prudential policy objectives set out by the Macro-Prudential Policy Guidelines: mitigating and preventing excessive lending growth and excessive leverage. The purpose of the instrument is to protect the banking system against potential losses when excessive growth in lending is linked to an increase in risks in the system as a whole, which directly increases the resilience of the banking system. The countercyclical capital buffer indirectly contributes to a curb on the expansive phase of the credit cycle by reducing the supply of loans or increasing the cost of lending. The relaxation of the buffer, which happens at the reversal of the credit cycle, mitigates the risk of the supply of loans being limited by regulatory capital requirements. The buffer rate may range from 0% to 2.5% of risk-weighted assets, and may exceptionally be higher. The basic criterion for determining the buffer rate is the gap between the credit-to-GDP ratio and its long-term trend, but in light of the specific attributes of the Slovenian economy other indicators are relevant, such as annual growth in real estate prices, annual growth in loans to the private non-financial sector, the LTD ratio for the private non-banking sector, ROE and the ratio of credit to gross operating surplus. The buffer is set at 0% on the basis of the historical values of the aforementioned indicators.

4.3.2 Capital buffer for other systemically important banks

The buffer for other system important institutions (O-SIIs) aims to limit the systemic impact of misaligned incentives with a view to reducing moral hazard, which is also one of the intermediate macro-prudential policy objectives set out by the Bank of Slovenia's Macro-Prudential Policy Guidelines.

The reason for the special regulation of systemically important institutions is that their collapse could endanger financial stability and could lead to significantly larger adverse effects on the financial system and the entire economy than could the collapse of a systemically unimportant institution. The objective of special regulation is for the expected loss in the event of the collapse of a systemically important institution to be the same as the expected loss in the event of the collapse of an institution that is not systemically important. To meet this objective, the more systemically important an institution is, the smaller the probability of the collapse of the institution should be (compared with a bank that is not systemically important) by way of compensation. A smaller probability of collapse is achieved by setting additional capital requirements for systemically important banks.

In identifying O-SIIs the Bank of Slovenia followed the EBA Guidelines, having committed itself to their application under the Regulation on application of the Guidelines on the criteria to determine the conditions of application of Article 131(3) of Directive 2013/36/EU (CRD) in relation to the assessment of other systemically important institutions (O-SIIs) (Official Gazette of the Republic of Slovenia, No. 66/15). Banks are evaluated with regard to the criteria of size, importance to the economy of the European Union or of Slovenia, cross-border activity, and the interconnectedness of the bank or group with the financial system. Eight banks were identified as O-SIIs on the basis of the aforementioned indicators.

The buffer rate ranges from 0.25% to 1.00% depending on the importance of an individual bank with regard to the aforementioned criteria, the buffer rates envisaged for O-SIIs in other EU Member States, and certain other factors.³¹

The cyclical effects (the possibility of increased deleveraging by banks) that could be produced by structural instruments when introduced should be neutralised by the long transition period: the banks will only have to meet the buffer as of 1 January 2019.

³¹ For more, see <https://www.bsi.si/library/includes/datoteka.asp?DatotekaId=6740>.