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1505 Ljubljana

Tel: +3861 47 19 000
Fax: +3861 25 15 516

Translated by Amidas d.o.o.

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Abbreviations:

AJPES	Agency of the Republic of Slovenia for Public Legal Records and Related Services
AMC	Association of Management Companies
BoS	Bank of Slovenia
CCBM	Correspondent Central Banking Model
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors

CSCC	Central Securities Clearing Corporation
ECB	European Central Bank
ECBC	European Covered Bond Council
EFAMA	The European Funds and Asset Management Association
EFTA	European Free Trade Association
EMF	European Mortgage Federation
EMU	Economic and Monetary Union
EONIA	Euro OverNight Index Average (weighted average interest rate for overnight credit)
ESCB	European System of Central Banks
ERM II	Exchange Rate Mechanism II
EU10/12	EU member-states joining in enlargement of 1 May 2004 and 1 January 2007
EU12	Euro area member-states, excluding Slovenia, Malta and Cyprus
EU15	EU member-states prior to the enlargement of 1 May 2004
EU25	EU member-states prior to the inclusion of Bulgaria Romania
EU27	EU member-states
EU3	EU member-states prior to enlargement of 1 May 2004 not in the euro area
EURIBOR	Interbank interest rate at which representative banks in the euro area offer deposits to one another
Eurostat	Statistical Office of the European Communities
FED	Board of Governors of the Federal Reserve System
HFRS	Housing Fund of the Republic of Slovenia
IC	Investment company
IF	Investment fund
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IMF	International Monetary Fund
ISA	Insurance Supervision Agency
Leaseurope	The European Federation of Leasing Company Associations
LJSE	Ljubljana Stock Exchange
LTI	Loan-to-income ratio
LTV	Loan-to-value ratio
MCs	Management companies
MF	Mutual fund
MTS Slovenija	Portion of the Euro MTS electronic trading platform for state and para-state reference bonds denominated in euros
NACE	Statisitical Classification of Econimic Activities in the European Community
NHSS	National Housing Saving Scheme
OECD	Organisation for Economic Co-operation and Development
OFIs	Other financial institutions
PDII	Pension and Disability Insurance Institute
P/E	P/E reflects the ratio of share prices to the previous year's net earnings per share
PID	Authorised Investment company
PIX	Investment funds index
SAS	Slovenian Accountign Standards
SBI 20	Leading Slovenian stock market index
SI O/N	Interest rate for unsecured interbank overnight deposits in euros between Slovenian credit institutions and euro area credit institutions
SLA	Slovenian Leasing Association
SLONEP	Slovenian real estate portal (www.slonep.net)
SMA	Securities Market Agency
SORS	Statistical Office of the Republic of Slovenia
S&P	Standard and Poor's
RTGS	Real-Time Gross Settlement
TARS	Tax Administration of the Republic of Slovenia
TR	Turnover ratio
TUVL	Segment of Ljubljana Stock Exchange Trading for a Selection of Government Securities through Designated Market Makers
UP	Mutual fund unit price
Vzajemci.com	Portal of Slovenian mutual funds (www.vzajemci.com)

CONCLUSIONS

In the past year Slovenia's banking system has witnessed two important processes from the point of view of the development of systemic risks. The first is high lending growth, which was primarily financed by bank borrowing in the rest of the world, while the second was the tighter conditions on international financial markets after the outbreak of the sub-prime mortgage lending crisis on the US market.

The high lending growth was not encouraged by the favourable domestic economic growth alone, but also by the rapid increase in Slovenian banks' exposure to the rest of the world, particularly the Balkans, with the significant involvement of banks in financing equity consolidation and corporate takeovers, and, by no means least, by the decline in real interest rates as a result of rising inflation. The unsustainable nature of the high lending growth in the long term is confirmed by the increase in the ratio of nominal lending growth to nominal GDP growth. Signs of a slowdown in lending growth were already being seen in early 2008.

The heavy lending by banks was accompanied by the continuing transfer of financial risks to the corporate and household sectors. The transfer of interest-rate risk to households and corporates is evidenced in the sustained increase in the proportion of new loans with a variable interest rate. If it is the case for corporates that they can use derivatives to hedge against interest rate rises, this is not the case for households. A potential interest rate rise could therefore be reflected in an indirect increase in credit risk for banks.

There has also been sustained growth in loans denominated in Swiss francs. Such loans already account for more than 30% of housing loans to households, and this proportion is still increasing. Corporates have also frequently opted for foreign currency loans in the past year. The transfer of this type of foreign-exchange risk to clients is undesirable from a systemic point of view, particularly for long-term household loans, as the appreciation of the Swiss franc against the euro would increase the borrower's loan repayment burden and lead to a deterioration in the LTV ratio. This would result in an increase in banks' credit exposure. It should be noted that the realisation of exchange-rate risks in the event of the appreciation of the Swiss franc against the euro would not just affect Slovenian borrowers and, indirectly, Slovenian banks, but would also result in banks in the wider region facing similar problems.

The high lending growth is increasing banks' exposure to credit risk. Last year banks reduced their coverage of classified claims by impairments, and reduced the proportion of non-performing claims, but the high lending growth is masking the real picture of the ratings structure of claims. A decline in lending growth will see the proportion of bad loans begin to increase more rapidly. Further evidence that the credit rating structure of classified claims is relatively favourable in a phase of economic growth and business optimism, and that a deterioration in the economic climate brings changes to this structure, comes from the relatively poorer quality of banks' lending portfolio, in terms of the average number of days that loan repayments are overdue. Some corporate sector indicators, such as the increase in financial leverage, rising debt, the deterioration in liquidity, and the differences between economic sectors in the average number of days that loan repayments are overdue, point to a trend of deteriorating business conditions, particularly in certain sectors. Banks have not yet fully evaluated these movements by raising risk premiums, and further rises in risk premiums over the EURIBOR on corporate loans can therefore be expected in 2008, along with the continuing tightening of other credit standards.

Growth in domestic saving at banks did not keep up with the increased demand for loan financing, and banks therefore sharply increased their borrowing in the rest of the world. This profoundly increased the dependence of Slovenian banks on the lending terms available on instable foreign financial markets, which are still facing a loss of confidence among market participants, and a consequent periodic deterioration in liquidity in individual segments of the financial market.

Given their low exposure to non-liquid, high-risk financial instruments (i.e. structured financial instruments), Slovenian banks and insurers were not directly affected by the outbreak of instability on international financial markets. However their high exposure to the rest of the world meant that banks felt the indirect effects of the deteriorating financing conditions such as higher risk premiums and extremely short loan terms. This is particularly the case for the banks under majority domestic ownership, for which foreign sources of financing are a relatively less stable resource than domestic deposits by non-banking sectors. The relative increase in the sensitivity of the banks under majority domestic ownership to the uncertain direction on international financial markets is also being exacerbated by structural liquidity (refinancing risk) and a deterioration in the structure of regulatory capital. It is recommended that banks improve the coverage of loans by non-banking sectors' deposits, and maintain capital adequacy, or improve it by increasing share capital.

The exposure of the Slovenian financial system to developments on foreign financial markets has increased in the past year, while movements on these markets have remained uncertain and unpredictable. Liquidity risk and credit risk at banks have increased, although banks are managing the increased risks thanks to excellent business results and sufficient capital adequacy. The exposure of the corporate and household sectors to various financial risks, including capital risk, deteriorated. The increased fluctuation in share prices is increasing the sensitivity of households to financial changes.

Marko Kranjec, Ph.D.
Governor

EXECUTIVE SUMMARY

Financial stability is defined as a situation in which the components of the financial system (financial markets, financial institutions and the financial infrastructure) function without systemic disruptions, and in which each component of the system provides the greatest possible degree of flexibility in responding to any shocks that occur. In line with this operational definition, the purpose of the May 2008 Financial Stability Review is to highlight financial developments in the economy in 2007 and in the first quarter of 2008, and to contribute to the early identification of potential systemic risks which could affect the normal functioning of a large number of financial institutions or the financial infrastructure.

The Financial Stability Review examines not only financial relationships within the financial system, but also the financial system's relationships with the corporate sector, the household sector and the rest of the world. Based on national financial accounts, the first section illustrates the financial claims and liabilities between sectors, which facilitate the identification of net debtors and net creditors at the macroeconomic level. This is followed by a detailed description of financial changes in the household sector and the corporate sector. This year's review places more emphasis on identifying the financial positions of specific economic activities, as the process of transferring various forms of financial risk from the financial sector to corporates and households plays an important role in defining business conditions. In addition, in their financial decisions the two sectors have an impact on the financial flows with the rest of the world and between financial intermediaries, which is directly reflected in individual segments of the financial market. The core section of the Financial Stability Review examines the development of high credit growth at Slovenian banks last year, and analyses the financial risks to which banks are exposed in this process. The increased attention given to the banking sector is justified given its increasing exposure to the rest of the world. On the asset side, banks are exposed to uncertainties and instability on well-developed international financial markets, resulting from the outbreak of turmoil on the US sub-prime mortgage loan market. With regard to investments, Slovenian banks are increasingly exposed directly and indirectly to uncertainties on the financial markets of south-eastern Europe. The same applies to other financial intermediaries, to a greater extent for investment companies and mutual funds, and to a lesser degree for insurers and leasing companies. With entry to the euro area the financial infrastructure, described in the last section of this review, was also subjected to changes.

In 2007 high economic growth was stimulated by high investment growth, which was not tracked to a sufficient degree by growth in domestic savings. This resulted in increased borrowing in the rest of the world, particularly by banks in the form of loans, and also by the government with the restructuring of domestic debt into foreign debt through the issue of long-term bonds in the rest of the world. The widening gap between investments and savings as a proportion of GDP in recent years is seen in a rapidly increasing deficit in Slovenia's international investment position, e.g. net debt from the rest of the world, which reached 19% of GDP in the last quarter of 2007. Households are the only sector which record net financial claims against the rest of the world, primarily on account of increased investments in equity. In line with slowing growth in capital investments in Slovenia by non-residents, net liabilities to the rest of the world in equities fell to just 3% of GDP. On the other hand net loans raised in the rest of the world, at 37% of GDP, account for the majority of liabilities to the rest of the world. The unfavourable structure of net financial liabilities to the rest of the world clearly exposes the Slovenian economy to settlement risk with regard to its liabilities.

Despite the increase in the net financial assets of households to 82% of GDP, their liabilities are still growing at a high rate of 19%. Households' indebtedness increased most at the domestic banks (by 27%), with bank loans already representing more than 70% of all household financial liabilities. In addition to an increase in debt to 28% of GDP, other household debt ratios have deteriorated accordingly. At the end of 2007 household debt at banks reached 8.2 times the amount of monthly employment earnings. The average proportion of household employment earnings earmarked for the repayment of loans was up 3 percentage points last year to 22%.

Households' exposure to financial risks also increases in line with their rising indebtedness. Last year the majority, or 87%, of housing loans were approved with a variable interest rate. Thus the stock of all loans to households with a variable interest rate rose by 3 percentage points to 66%. Therefore households are increasingly exposed to the risk of rising interest rates.

Another important aspect of the transfer of financial risks to households is the increasing proportion of loans raised in Swiss francs. Loans tied to a currency clause or denominated in Swiss francs already account for 15% of loans to households. That proportion is even higher and approaching 33% for long-term housing loans. Besides changing interest rates, changes in the exchange rate also affect foreign currency loans. Following depreciation against the euro in the last four years, the Swiss franc appreciated 6.7% against the euro from the end of October 2007 to the end of March 2008, resulting in a direct increase in the debt of borrowers.

With regard to savings, households are increasingly exposed to market risks. Favourable stock market trends in the first half of last year resulted in the restructuring of financial investments in favour of an increasing proportion of investments in equities and investment fund units. Last year these two forms of investments accounted for 37% of financial assets, up 6 percentage points from the end of 2005. Falling share prices in the last quarter of 2007 and at the beginning of 2008 led

to a decrease in this portion of household financial assets. Loans intended for the purchase of securities, which were raised during the period of high growth in share prices and during the partial privatisation of NKBM, represent an additional risk to the financial position of households. According to bank survey results, the proportion of newly approved lombard loans for these purposes was four times higher last year compared to 2006. At the end of 2007 these loans accounted for 6% of the stock of household loans.

High growth in housing loans in the last two years is reflected in the growth in real estate prices. Last year growth in housing transaction prices in the Ljubljana urban area slowed to 10%, while growth in prices in the rest of Slovenia has risen sharply to 26%. Based on the trend of advertised housing prices, we assess that, due to the high level of financial assets needed to purchase housing in Ljubljana, demand is shifting to the surrounding area or to other parts of Slovenia where prices are 25% to 50% lower. The ratio of actual prices to fundamental prices, as an indicator of the overvaluation of housing in the capital, fell significantly for the first time in 2007 following an increase in recent years. However the ratio still exceeds 1.2 for smaller housing units. Based on the ratio of housing prices to net wages, the housing affordability index and the ratio of actual prices to fundamental prices, we find that the sustainability of housing prices in Ljubljana did not deteriorate in 2007 compared to 2006.

High growth in real estate prices in Slovenia is still the result of insufficient supply, which is however increasing. Price developments in Ljubljana and its surrounding areas indicate slowing growth. We can expect the price gap with the capital to close in the rest of Slovenia, where price developments on the real estate market follow prices in Ljubljana with a delay. The high growth in housing prices in Slovenia in 2007 was also affected by uncertainty regarding the anticipated rise in VAT, as households wanted to purchase housing prior to the possible VAT increase for new constructions. Uncertainty was removed in the second quarter of 2007. The future development of housing demand will primarily depend on interest rate trends, the tightening of credit standards, accessibility to sources of bank financing and growth in household income. Based on data regarding approved building permits and growth in gross investments in residential buildings, housing supply will increase, alleviating pressure on price growth. Given the limited response in supply, measured by the number of dwelling per 1,000 inhabitants, investments in residential buildings as a proportion of GDP and current economic forecasts, it is unlikely that growth in housing prices will completely stagnate or that prices will fall nation-wide. Above all we expect the segmentation of the real estate market to increase.

High economic growth had a significant impact on the increasing stock of corporate financial liabilities. Average annual growth in financial liabilities of 11% in the period from 2002 to 2006 rose to 26% in 2007. The prevailing form in the structure of financial liabilities remains equity, which maintained its proportion primarily due to changes in value. In contrast loans as a proportion of financial liabilities remained at 30% due to high growth in borrowing. Slovenian corporate debt rose to 79% of GDP in 2007.

More pronounced are the differences in financing flows. Growth in liabilities to the domestic banks represented nearly 50% of current corporate financing, while corporate financing in the rest of the world fell below 15%. A significant change in the method of financing can be seen in an increase in business-to-business financing. Mutual capital investments are also increasing in addition to trade and other business-to-business lending. Ownership consolidation in the corporate sector was reflected in a five-fold increase in equity transactions amongst corporates compared to 2006. Last year the flow of corporate financing via loans nearly doubled in nine months compared to the same period in 2006, primarily on account of the lending activities of the domestic banks. The maturity of loans raised at the domestic banks changed drastically already in 2006 in favour of short-term loans, which reached 45% on average in 2007. The shortening of loan maturities represents a significant factor of liquidity risk for the corporate sector.

Rising corporate debt is confirmed by an increase in the debt ratio which, according to corporate balance sheet figures, exceeded 55% in 2006. The economic sectors which stand out with regard to the level of the debt ratio include construction, transport and storage and trade. This ratio is deteriorating most rapidly in the business activities and real estate sector. The high average corporate debt ratio of the aforementioned sectors represents a significant risk for creditors and business partners due to the burden of rising interest.

Last year the proportion of loans with a variable interest rate rose to more 99% of newly approved corporate loans, with banks transferring nearly the entire burden of interest-rate risk to corporates. Loans with a variable interest rate account for 95% of loans raised which, in a period of rising interest rates, will result in lower corporate income due to interest payment costs. From 2004 to 2006 the ratio of net interest paid to income generated was relatively stable at 0.5%. However, according to bank estimates for 2007, that ratio has risen to 0.8%. The greatest burden on income arising from net interest payments is faced by the following sectors: business activities and real estate, agriculture, fishing and forestry, hotels and restaurants and construction.

Due to the rapid growth in corporate debt financing, average corporate financial leverage deteriorated to 133%. Construction companies recorded the highest level and greatest deterioration in financial leverage. In addition the transport and storage and trade sectors stand out with a high debt ratio. Corporates from sectors with the highest level of debt primarily borrow from domestic creditors. A higher level of financing in the rest of the world was only present in

trading companies, and remains for the most part short-term. Thus mostly domestic creditors are exposed to the risk associated with the high level of debt of these sectors.

High debt and deteriorating corporate liquidity are reflected in the failure to settle liabilities in due time. Sectors which, based on the aforementioned indicators are considered higher-risk (construction, trade, hotels and restaurants as well as transport and storage), also stand out in the proportion of corporates which repay liabilities with delays.

Due to the trend of rising interest rates, the interest rate for long-term corporate loans rose by 0.9 percentage points in 2007, and by 1 percentage point for short-term loans. The majority of this increase occurred in the last quarter of 2007, following the outbreak of instability on international financial markets. The average interest rate for long-term corporate deposits rose by 0.3 percentage points in the last quarter, with the largest increase in the hotels and restaurants and construction sectors. Contrary to expectations there was a minimal average increase in the premium over the EURIBOR in the amount of 0.03 percentage points in the last quarter, which leads us to the conclusion that banks are not yet aware of the deterioration in the average values of debt ratios and the deteriorating liquidity in the corporate sector. However banks differentiate significantly between sectors. Premiums over the EURIBOR for long-term loans to the hotels and restaurants and construction sectors rose most in the last quarter, while premiums were increased for the trade sector during the year. Companies from sectors, for which debt ratios and liquidity indicators deviate from the average indicating increased risk, are faced with higher premiums over the EURIBOR when raising bank loans. We expect that the deterioration of the average values of risk indicators in the corporate sector will be reflected in rising risk premiums for newly approved loans in the near future.

Should the trend of rising interest rates continue, the trends described in the corporate sector such as increasing debt, an increasing proportion of loans with a variable interest rate, and a deterioration in liquidity will lead to an increase in credit risk for banks and other domestic lenders, such as leasing companies.

Last year Slovenian banks were faced with two major challenges which had a decisive impact on their balance sheet structure and operating profit. On the one hand, banks were faced with increased credit activity from the end of the first quarter of 2007 until the middle of the last quarter and, on the other hand, with tightening financing conditions on international financial markets in the second half of the year.

Growth in loans to non-banking sectors increased to 40% year-on-year, and has slowed in the first months of 2008. In addition to high economic growth as the most significant factor, high growth in lending was driven by an ex post decline in interest rates, high lending to non-banking sectors from the rest of the world and the inclusion of banks in the financing of corporate M&A activity, as the process of ownership consolidation in the Slovenian economy. The ratio of growth in loans to nominal GDP growth has once again risen above 3.7, confirming the fact that high lending growth is not sustainable over the long term.

Growth in deposits by non-banking sectors, which barely exceeded 10%, did not track high lending growth. The low growth in deposits and the decrease in the proportion of investments in securities meant that banks were forced to increase borrowing from foreign banks to meet the demand for loans by non-banking sectors. The proportion of the banking sector's liabilities to the rest of the world exceeded one-third of total assets. This led to a significant increase in Slovenian banks' dependence on financing conditions on international financial markets. In 2007 the unfavourable trend of deteriorating coverage of loans by deposits by non banking sectors continued, with coverage falling by an additional 15 percentage points. While borrowing by the banks under majority foreign ownership at parent banks in the rest of the world represents less risk, this method of financing is less favourable and represents more risk for the banks under majority domestic ownership. This is particularly true during a period of increased uncertainty on international financial markets. For the banks under majority domestic ownership liabilities to banks in the rest of the world are a relatively less stable source of financing than household deposits. Therefore household deposits are important to the long-term stability of banking operations.

High credit growth, together with rising lending rates, resulted in a 30% increase in pre-tax profit. In 2007 net non-interest income rose by the same percentage as net interest income. Favourable growth in net non-interest income was driven by nearly 40% growth in revenues from financial assets and liabilities held for trading. However this is also a reflection of the valuation of securities due to positive trends on the domestic capital market. The warning that the principle of valuing investments at fair value under the International Financial Reporting Standards results in the increased variability of banks' profit is even more important this year than in the past.

Last year an increased level of risks assumed and a higher profit margin contributed to an increase in the banking system's ROE to 16.3%, while lower risk-weighted income and a decrease in financial leverage acted to reduce ROE.

Another significant challenge for Slovenian banks was how to dampen the indirect effects of tightened conditions on global financial markets. In 2007 the direct effects of instability on financial markets on the Slovenian banking system were negligible. Based on survey responses from banks, the banking sector's total exposure to structured financial

instruments did not exceed 0.6% of total assets, or EUR 253 million, at the end of 2007. Only a small portion (25% of this amount) was represented by structured credit instruments, which were affected most by the lack of confidence and illiquidity on global markets. The largest proportion of Slovenian banks' investments in structured instruments (55%) was linked to a basket of shares, indices or funds. According to figures from bank surveys, the loss arising from structured financial instruments amounted to EUR 14.8 million at the end of 2007, and was primarily the result of valuation at markets prices, which was not realised.

Slovenian banks were indirectly affected by instability on international financial markets, initially in the form of increased liquidity risk, and later as a deterioration in structural liquidity. The tighter conditions for raising new loans in the rest of the world were reflected more in the shorter maturity of these loans than in the amount, and in a lack of possibilities to raise long-term loans. The proportion of short-term liabilities to the rest of the world for the entire banking sector increased by 5 percentage points, and reached 27% at the end of March 2008. The most significant deterioration of the maturity breakdown of new loans raised in the rest world was recorded by the banks under domestic ownership. In the last quarter of 2007 the proportion of this bank group's newly raised short-term loans rose to 80% of all loans raised in the rest of the world. Thus the risk related to the successful renewal of financing sources increased most for these banks. The tightening of financing conditions in the rest of the world was also seen in higher premiums over the EURIBOR charged to Slovenian banks under majority domestic ownership, and later in the uneven drawing of loans in terms of timing and in the raising of loans in currencies other than the euro. At the same time the proportion of loans with a variable interest rate has increased.

Directly after the outbreak of instability on financial markets, banks intensified borrowing on the domestic money market. This was followed by increased competition to attract larger depositors through the offer of higher interest rates for non-banking sector deposits. A more active policy for setting liability interest rates to attract deposits by non-banking sectors, particularly at the banks under domestic ownership was expected. However segmentation and relatively large differences in deposit rates between banks brings the additional risk of switching between banks by depositors.

In addition to the increasing risk of liquidity management, the structural liquidity of banks also deteriorated last year, which will lead to increased instability for banks in the management of sources of funds. This is seen in the deteriorating coverage of loans to non-banking sectors by deposits by non-banking sectors, a decrease in the proportion of secondary liquidity and in the deteriorating ratio of short-term loans to short-term deposits by non-banking sectors. While the growth of Slovenian banks in the first half of last year was driven by demand for loans, the importance of successful management of sources of bank funds increased significantly following the outbreak of instability on international financial markets. The growth of banks will be more dependent on the volume and quality of funds collected than in the past.

With high credit growth and an increased volume of operations, banks' exposure to credit risk has increased. The coverage of classified claims by impairments at banks has fallen to 3.2%. However high credit growth distorts the real picture of the credit rating structure of claims. The decrease in non-performing claims as a proportion of all classified claims at the end of 2007 was expected given high credit growth and business optimism, but is underestimated in the long term. The structure of classified claims will begin to deteriorate with a continuing slowdown in credit growth. This is partly confirmed by the fact that the quality of the banking sector's credit portfolio, taking into account days past due in the repayment of loans, is relatively poorer than the structure of classified claims and the coverage of claims by impairments. The following factors contributed to increased exposure to credit risk in 2007: lower standards for housing loans, a higher proportion of unsecured loans and loans to non-banking sectors secured by securities, high growth in exposure to the rest of the world, particularly to the countries of the former Yugoslavia and an increasing number of large exposures, primarily at the banks under majority foreign ownership.

In contrast to increased liquidity and credit risk, interest-rate risk decreased last year. While the risk of a change in the exchange rate decreased significantly following the introduction of the euro and remained low at the end of 2007, the net open foreign exchange position stood at 0.9% of regulatory capital. With foreign currency loans, including loans in Swiss francs, banks transfer exchange-rate risk to clients. However banks are exposed to additional credit risk if the Swiss franc appreciates against the euro, not only due the decreased ability of borrowers to settle their liabilities, but also because the credit exposure of banks, measured in euros, increases with each percent of appreciation of the Swiss franc against the euro.

Banks' high level of willingness to assume credit risk was seen in the high growth of capital requirements for credit risk which at 34% significantly outstripped growth in total assets. The rising proportion of total assets accounted for by loans at the expense of securities has resulted in the proportion of capital requirements for credit risk increasing to 96% of total capital requirements. Banks have given a considerable amount of attention to increasing capital due to uncertain conditions on international financial markets, rapid growth in capital requirements and preparations for the introduction of the new capital framework, which will mean higher capital requirements for the majority of Slovenian banks in the first phase. Nevertheless following significant fluctuations during the year, the banking sector's capital adequacy stood at 11.2% at the end of 2007, marginally higher than at the end of 2006. For the most part those banks whose credit growth exceeded 30% last year were faced with decreasing capital adequacy.

At the same time primarily the banks under domestic ownership were also faced with a less than optimal structure of capital, which is undesirable in current uncertain financial conditions. The proportion of subordinated instruments has approached 50% of regulatory capital at some banks, forcing them to increase share capital and capital surpluses. The significance of a low proportion of subordinated debt in the structure of capital can be seen as an important advantage in turbulent conditions, when banks are able to respond rapidly with various measures to increase capital to meet capital requirements, and not merely by increasing share capital. Failure to carry our previously planned capital increases points to the deficient business policy of some banks which have accelerated credit growth without an optimal structure of capital. It is important that banks reinforce the link between planned credit growth and their capital management policy in the decision-making process.

Despite a decreasing share of securities in their balance sheets, Slovenian banks are increasingly sensitive to developments on the capital market. In 2007 banks' exposure to events on the domestic capital market increased due to the rising proportion of newly approved loans secured by securities, which rose to 13% for non-banking sectors. Another aspect of the increased impact of events on the capital market on banking operations is reflected through the valuation of banks' investments in securities to market value, which leads to the increased dependence of banks' profit on capital market trends. Last year the 78% growth recorded by the Ljubljana Stock Exchange's SBI 20 was significantly higher than the growth of indices on well-developed European capital markets. The good operating results of companies only partly explain the high growth in share prices. Therefore, the following factors are important: the introduction of the euro and the changing psychological limits on share prices, increased demand from foreign investors for Slovenian shares prior to the outbreak of instability on foreign markets, M&As and the concentration of ownership at some companies and the issue of certificates on the shares of the largest Slovenian companies. Certificates issued by foreign banks also played an important role in the increased variability of share prices on the stock exchange in the first months of this year. By purchasing underlying instruments to secure their positions, foreign banks issuing certificates contributed to the growth in share prices in the first three quarters of 2007. In the last quarter of 2007 and the first quarter of 2008, the same banks contributed to a sharper drop in the Ljubljana Stock exchange index than otherwise would have been experienced through the net sales of shares due to the early triggering of knock certificates.

Increased fluctuations of stock exchange indices on the domestic and foreign capital markets, particularly in the Balkan region had a decisive impact on the returns of and net inflows to Slovenian investment funds. Growth in stock exchange indices in the first half of the year contributed to the growth in unit prices of domestic mutual funds, which reached 28% at the end of 2007. This spurred investors to net inflows which were nearly three times higher than those recorded in 2006. However the majority of these net inflows were realised in the first nine months, primarily in equity funds. Last year equity funds already accounted for 68% of the assets of mutual funds. This is the result of the high appetite for risk of Slovenian investors, who have not experienced significant capital losses in recent years. Some 37% of net inflows were invested in mutual funds with an investment strategy focusing on the Balkans. These funds grappled with higher net outflows in the last months of last year and the first months of this year due to increased political uncertainty, which has affected share prices in the Balkan region. This serves as evidence that the investment decisions of Slovenian investors remains strongly dependent on past returns and not on prudent investing with respect to their willingness to assume risk and the purpose of savings.

Last year high returns on capital markets and relatively low interest rates stimulated demand for unit-linked life insurance. The importance of life insurance tied to mutual fund units continues to rise rapidly, although at a slower pace. The proportion of total collected life insurance premium accounted for by life insurance in which policyholders assume the investment risk has risen to 45%. The proportion of life insurance investments in favour of policyholders that assume the investment risk exceeded 25%, and thus the same proportion in the euro area. The introduction of the International Financial Reporting Standards in 2007 and preparations for the introduction of Solvency II have further stimulated insurers to transfer risk to policyholders. The 2007 financial year was very successful for insurers. Their claims ratio improved for the fourth straight year, but not in all insurance segments. The claims ratio for export credits improved compared to 2006, while the claims ratios for consumer loans and housing loans deteriorated. This was expected given rising interest rates and the fact that the importance of insurance for housing and consumer loans at banks is decreasing. The risk faced by insurers arising from the deteriorating claims ratio for loans to households is negligible. Favourable trends on capital markets contributed to an 8 percentage point improvement in the coverage of net technical provisions by assets covering technical provisions. The introduction of the IFRS at insurers had the favourable impact of an increasing surplus of available capital over the minimum required capital. At EUR 32 million, insurers were less exposed than banks to investments in structured credit instruments.

We assess that risks in the Slovenian financial system have increased since the release of the last Financial Stability Review in 2007, and that further trends are difficult to predict. Liquidity and credit risks have increased at banks, with an acceptable level of capital adequacy, but a less than optimal structure of regulatory capital at the banks under majority domestic ownership. Uncertain conditions on international financial markets require more long-term planning of liquid asset management from banks and the preparation of contingent scenarios in the event of significant negative deviations from current conditions on financial markets. An increasing number of indicators confirm the increased credit risk at banks, particularly with regard to exposure to individual sectors of the economy. An unfavourable combination of deteriorating economic conditions and the restriction of lending could increase the likelihood that specific credit risks

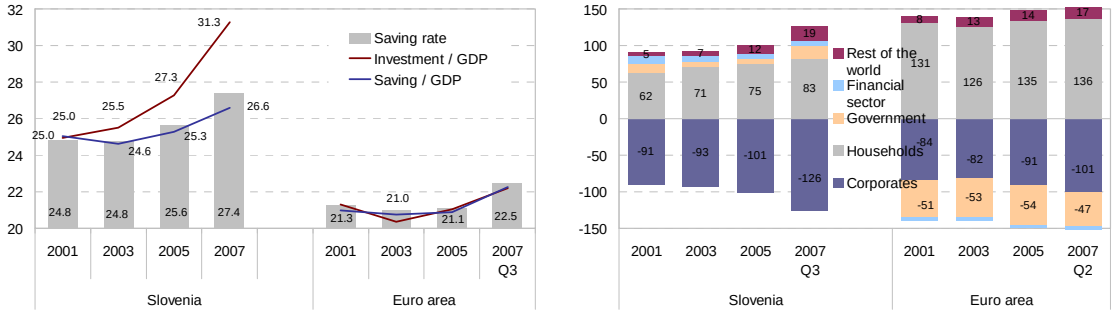
will be realised. The continuing process of the transfer of interest-rate, exchange-rate and market risks from banks and other financial intermediaries to the household and corporate sectors could, in conditions of deteriorating economic conditions, rising interest rates, significant fluctuations on capital markets and the appreciation of the Swiss franc against the euro, be transferred back to banks in the form of credit risk. For this reason banks must further reinforce the link between credit activities and their capital management policies. With greater diversification of operations, a stable structure of sources of funds, a higher surplus of capital over capital requirements and the improved quality of the structure of capital, banks will find themselves in a relatively better position in a period of increased uncertainty.

1 INTER-SECTOR FINANCIAL CLAIMS AND LIABILITIES

The domestic economy's net negative financial position against the rest of the world is increasing.

At 6.1% in real terms (in the context of a deflator of 3.9%), economic growth in Slovenia in 2007 was the highest since 1991. A major factor in this growth was the nominal growth of 21.5% in gross investment. Growth in saving was high at 14.4%, but lower than investment growth, which further widened the saving/investment gap, thus increasing the need for net borrowing from the rest of the world. The increase in the gap between investment and saving as a proportion of GDP in recent years has been seen in the increase in Slovenia's deficit in its asset position against the rest of the world, which had reached just over 19% of GDP at the end of the third quarter of 2007. Increased borrowing in the rest of the world entails greater sensitivity on the part of the domestic economy to conditions in the rest of the world, which after the instability on global financial markets could also mean that it is harder and more costly to obtain sources of financing. However, given their desire to diversify their assets, and the low depth and liquidity of the domestic capital market, Slovenian investors are increasingly investing in foreign financial instruments. As it catches up with wealth levels in the euro area, the Slovenian economy is achieving significantly higher investment-to-GDP and saving-to-GDP ratios, and also a higher saving rate than in the euro area overall.[1]

Figure 1.1: Saving rate, ratios of investment and saving to GDP (in %), and net financial position of individual economic sectors[2]



Note: In the euro area figures, the government sector is a residual.
Sources: Bank of Slovenia, SORS, ECB, Eurostat

Non-financial corporations' net negative financial position increased by 16 GDP percentage points in the first three quarters of 2007.

The need for financing from the rest of the world is caused by domestic saving being less than investment. The largest net negative financial position among the domestic economic sectors is held by non-financial corporations. The negative position widened by 16 percentage points in the first three quarters of 2007 to 126% of GDP, primarily as a result of high investment growth. Since 2005 non-financial corporations obtained approximately half of their financial resources via the domestic banking sector, which since 2003 has obtained more than 60% of its new financial resources via borrowing in the rest of the world, thus directly increasing the economy's net negative financial position against the rest of the world. Households, traditionally a sector with surplus assets, increased their net positive financial position by 5 percentage points of GDP in the first three quarters of 2007, far too little to meet the investment needs of non-financial corporations.

The forecasts of a slowdown in economic growth in Slovenia related to the projected scale-back of investment and lower growth in foreign demand could result in a slowdown in non-financial corporations' net negative financial position, and consequently a slowdown in the domestic economy's net negative financial position against the rest of the world. Further growth in inflation in the euro area and the uncertainty on international financial markets could additionally contribute to lower lending, and thus lower investment. At the same time these two factors could have an adverse impact on financial assets, and lead to lower household consumption via this wealth effect.

[1] The level of saving is an indicator calculated from sectoral accounts. It represents the ratio of gross saving to gross disposable income: in addition to employee compensation and social security benefits it also includes gross operating surplus from manufacturing, other current transfers such as compensation from non-life insurance, and ownership-related income such as interest and profit distributions. However, it does not include changes in value or capital gains.

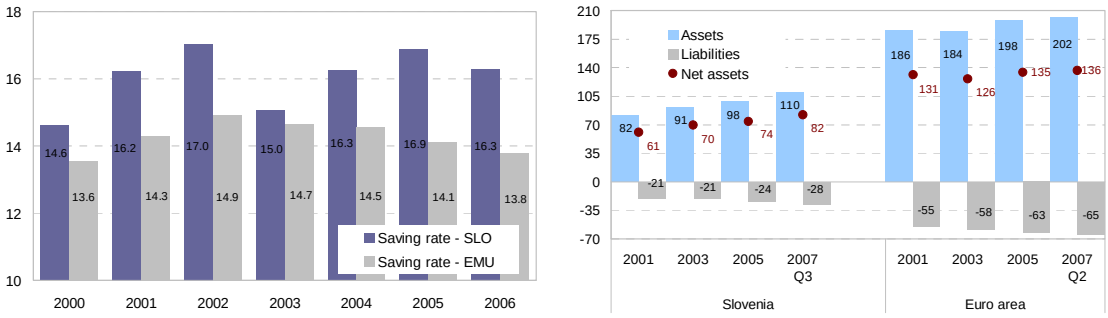
[2] The net financial position represents the difference between financial assets and liabilities.

Households

Slovenian households' saving rate has been above the euro area average since 2000.

The saving of Slovenian households exceeds their investment, and allows the financing of investments by other sectors, namely non-financial corporations and the rest of the world, primarily via the financial sector. The household saving rate declined in 2006 to a still-high 16.3%, partly as a result of a wealth effect or high growth in prices on capital markets and the real estate market, where Slovenian households invest the majority of their assets.

Figure 1.2: Saving rate, financial assets and liabilities, and net financial position (net assets) of households as a percentage of GDP

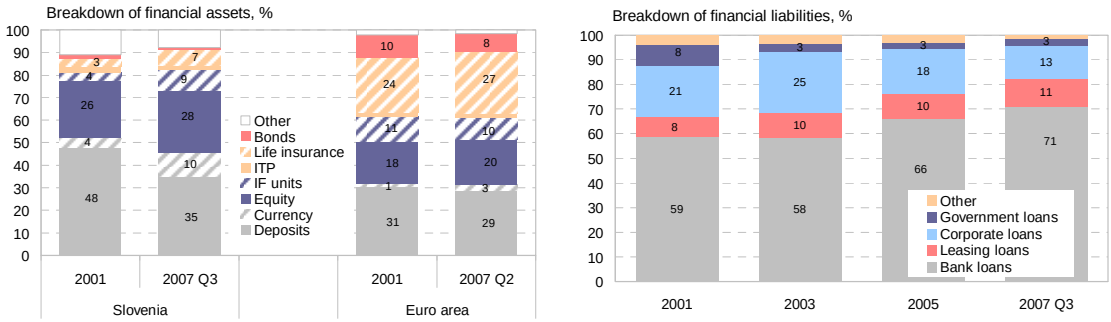


Sources: Bank of Slovenia, SORS, ECB

Slovenian households are significantly less indebted in terms of total financial liabilities as a proportion of GDP than euro area households.

At 110% of GDP, Slovenian households' financial assets are almost one-half less than the euro area average, but there is a notable process of catching-up with the financial depth in the euro area. The main reasons for the small size of the financial assets are: (1) lower economic development compared with the euro area average (Slovenia's per capita GDP is approximately 80% of the euro area average at standard purchasing power); (2) the high level of social security contributions, which means less money for saving from current income; (3) the high proportion of household assets in real estate (approximately 82% of households are owner-occupiers or co-owners of their housing); and, by no means least, (4) the rapid development of institutional investors, which play a vital role in long-term saving, only began recently. Despite the increase in household indebtedness in recent years, the sector in Slovenia is still significantly less indebted than that of the euro area overall. While the financial liabilities of Slovenian households stood at 28% of GDP at the end of the third quarter, the figure for euro area households was more than double at 65%.

Figure 1.3: Breakdown of financial assets of households in Slovenia and the euro area (left), and breakdown of financial liabilities of households in Slovenia (right) in percentages



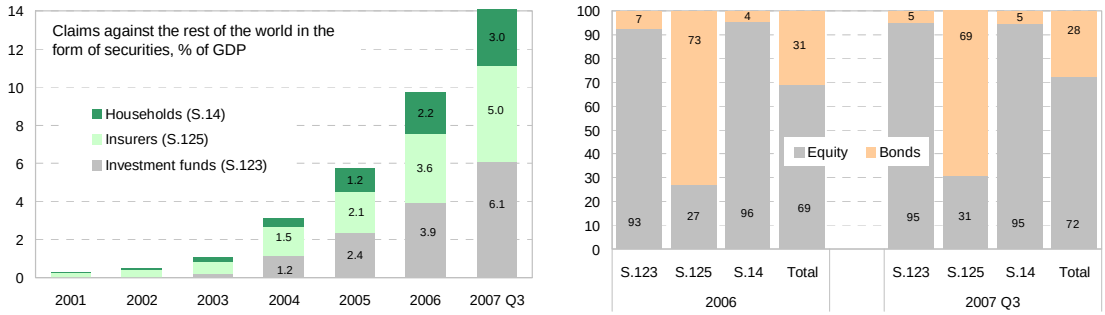
Note: ITP: insurance technical provisions; IF: investment fund. Includes the household sector (S.14) only. Does not include non-profit institutions serving households (S.15).
Sources: Bank of Slovenia, ECB

The proportion of Slovenian households' assets accounted for by life insurance and pension insurance is insufficient.

With a relatively high proportion of bank deposits, and a low proportion of life insurance and pension insurance provisions, the breakdown of Slovenian households' financial assets differs considerably from that of euro area households. In recent years there has been a significant trend of declining bank deposits and an increase in equity (including investment funds), primarily as a result of the positive developments on capital markets in 2006 and the first half of 2007. In the event of continuing uncertainty on global financial markets, and tighter conditions for obtaining foreign financial resources, the domestic

banks could be expected to take a more aggressive approach to attracting household savings. The unsustainable nature of the existing pension system and the ongoing reforms anticipated should bring an increase in long-term saving in the future in the form of life insurance and pension insurance, which will bring the breakdown of Slovenian households' financial assets closer to that of the euro area. Only minor changes in the breakdown can be expected to come from the restructuring of financial assets, an increase in depth primarily contributing to the increase in the proportion of household financial assets devoted to old-age provisions.

Figure 1.4: Breakdown of household claims against the rest of the world by intermediary as a percentage of GDP (left), and by foreign equity/debt securities (right) in percentages



Note: S.123: Other financial intermediaries, except insurers and pension funds (also includes investment funds); S.125: Insurers and pension funds; S.14: Households. The figures have been simplified, with all investments by sectors S.123 and S.125 in foreign securities being treated as household assets, although a specific portion are their own investments or corporate investments.[3]

Sources: Bank of Slovenia, SORS

The proportion of Slovenian households' savings earmarked for foreign investments is increasing.

An increasing amount of saving by Slovenian households is directly (or indirectly, via institutional investors) invested in the rest of the world, which is not necessarily optimal, given the great need for investment in the domestic economy, and the associated borrowing in the rest of the world. At the end of the third quarter of 2007, households held savings equivalent to 14% of GDP in foreign investments in the form of equity (72%) and debt capital. Other factors in the outflow of money to the rest of the world are the low depth and liquidity of the domestic capital market, the over-conservative investment policy pursued by domestic pension funds, which does not attract sufficient domestic saving, and the lack of financial knowledge and experience on the part of households, which are therefore opting for excessively risky or, conversely, conservative investments. The anticipated ongoing public offerings of government-owned companies, the instability on global and Balkan capital markets, the new financial experience gained by households, the reform required by the pension system and the deepening of the domestic debt and equity capital markets could mitigate the outflow of domestic savings to the rest of the world in the future.

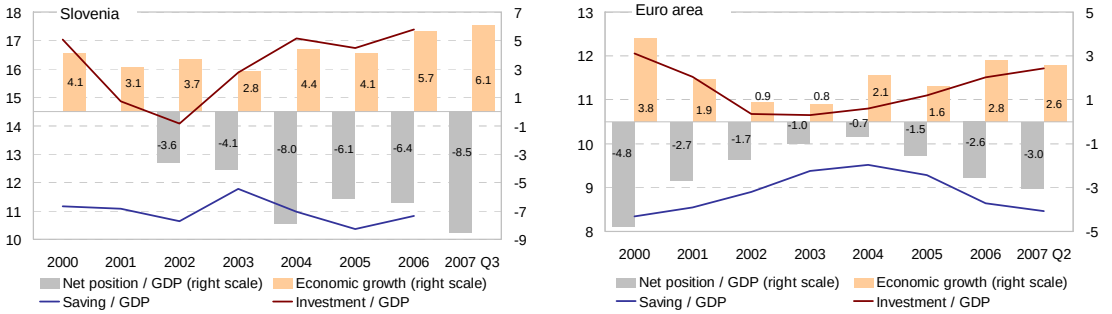
Non-financial corporations

The forecast slowdown in economic growth could bring a reduction in current corporate borrowing.

The forecast slowdown in investment activity and, consequently, in economic growth could bring a reduction in the Slovenian corporate sector's current net negative financial position, which had reached 8.5% of GDP over the year to the third quarter of 2007.

[3] According to Insurance Supervision Agency figures, the insurance sector's own investments accounted for just over 16% of its total investments in the rest of the world at the end of 2007.

Figure 1.5: Investment, saving, net position in transactions of non-financial corporations as a percentage of GDP, and real economic growth in Slovenia and the euro area in percentages



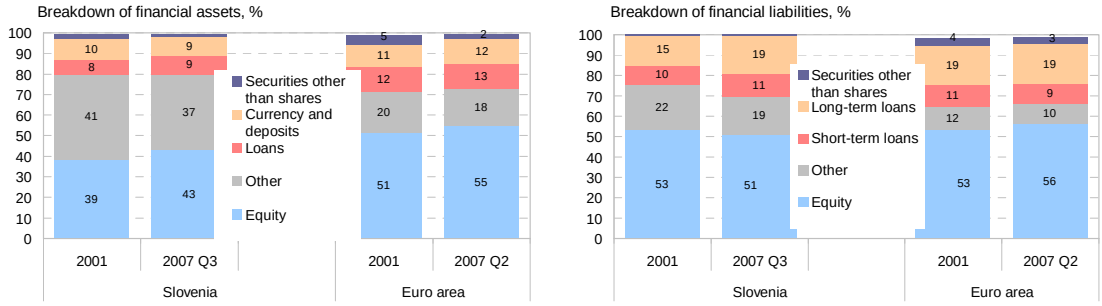
Note: The third quarter figures for Slovenia and second quarter figures for the euro area include the four preceding quarters. Real economic growth is shown for the whole of 2007. The net financial position represents the difference between financial transactions from assets and liabilities in the period in question.

Sources: Bank of Slovenia, SORS, ECB, Eurostat

Financial assets: equity links between corporates increased in 2007.

Slovenian non-financial corporations recorded an increase in the proportion of their financial assets accounted for by equity in 2007 (first three quarters), but it remains significantly below that of the corporate sector in the euro area. Two-thirds of the increase was the result of high values on capital markets in the first half of the year, while the remainder came from additional equity links via leveraged buy-outs. The proportion of the Slovenian corporate sector's financial assets accounted for by trade credits, advances and other remained high compared with that of the euro area, despite a decline in 2007. This could result in lower efficiency in the performance of Slovenian corporates, which still face problems with mutual financing, in addition to their principal business activities. In this area the financial sector has the opportunity to develop additional financial services to ease the burden on the corporate sector.

Figure 1.6: Breakdown of financial claims and liabilities of non-financial corporations in percentages



Sources: Bank of Slovenia, ECB

Financial liabilities: bank loans remain the main current source of financing for Slovenian non-financial corporations.

Slovenian non-financial corporations primarily financed their investments via loans again in 2007 (first three quarters). A certain portion of the loans was also earmarked for M&A activity. The rarity of capital increases and debt security releases by Slovenian corporates means that the proportion of financial liabilities accounted for by issued equity and debt capital is lower than that of the euro area corporate sector overall. Corporates did not exploit the extremely high values seen in the first three quarters of 2007 (the average P/E ratio for shares on the official markets was almost 35 at the end of September) to obtain additional resources via capital increases. In addition to financing via retained earnings, which is rather common among Slovenian corporates, the high values of corporate shares was another factor in the higher proportion of equity in the breakdown of the liabilities of Slovenian non-financial corporations.

Financial sector

The commercial banks have retained their dominant position among financial institutions in terms of assets.

As an intermediary of resources, the Slovenian financial sector maintains a slightly positive financial position. The commercial banks account for a prevailing proportion (approximately 70%) of the Slovenian financial system's assets (excluding the central

bank). This is significantly higher than the figure of 57% in the euro area overall, where other financial intermediaries (including investment funds and leasing companies) and the insurance sector still play a much larger role than in Slovenia. Among the individual financial sub-sectors, there was a decline in the proportion of assets accounted for by the central bank, which recorded a reduction in its total assets when joining the euro area. The assets of other financial intermediaries and banks are increasing: the latter primarily as a result of the high demand for lending associated with the recent high economic growth, which the banks have mostly financed using foreign resources.

General government sector

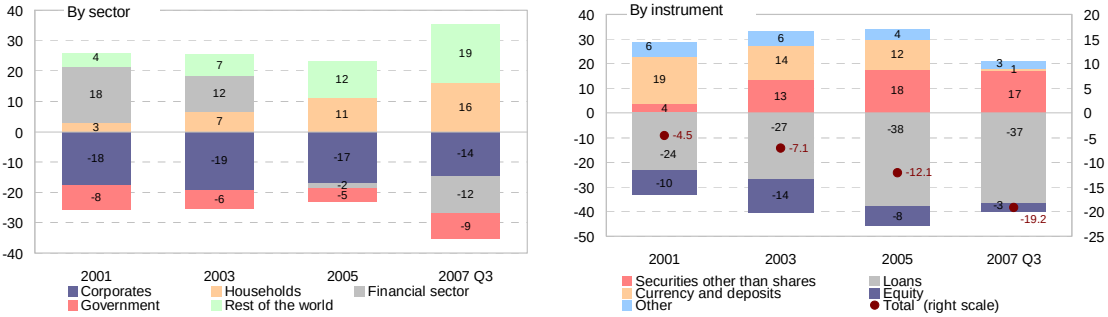
The general government sector recorded an increase of 7 GDP percentage points in its net positive financial position.

The general government sector recorded an increase of 7 GDP percentage points in its net positive financial position over the first three quarters of 2007 to 16% of GDP. The reason was the favourable conditions on the domestic capital market in the first three quarters of 2007. The general government sector holds 22% of issued equity. The higher values meant that the proportion of the general government sector's financial assets accounted for by equity increased by 7 percentage points in 2007 to 67%, despite some sales. The unfavourable conditions on the domestic capital market in the final months of 2007, which have continued in 2008, will have the opposite impact on the government sector's financial assets. Over the first three quarters of 2007 the general government sector reduced its financing via releases of debt securities and loan issues, which account for more than one-half of its liabilities.

Rest of the world

In the first three quarters of 2007, the Slovenian economy increased its net financial liabilities to the rest of the world to 19.2% of GDP. The net financial position against the rest of the world varies significantly between the individual institutional sectors, and from instrument to instrument.

Figure 1.7: Net financial position against the rest of the world as a percentage of GDP, by sector and financial instrument

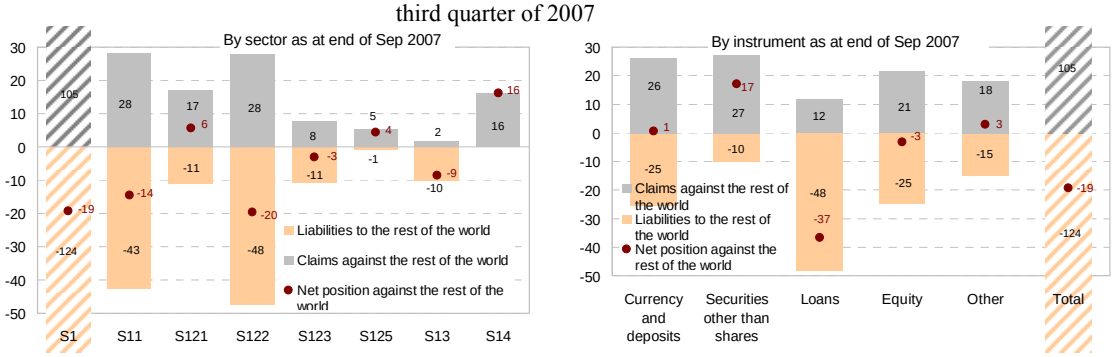


Source: Bank of Slovenia

Households remain the only sector with net financial claims against the rest of the world.

The household sector was the only sector that has net financial claims against the rest of the world, and it continued to invest in the rest of the world during the first three quarters of 2007. The general government sector and financial corporations increased their net liabilities to the rest of the world. Non-financial corporations continued to reduce their net liabilities to the rest of the world, the convergence of terms on domestic and foreign lending allowing them to increase their borrowing via the domestic banks. Despite heavier bank borrowing in the rest of the world, there was a decline in net liabilities to the rest of the world in the form of loans as a proportion of GDP, as a result of a switch by leasing companies from foreign borrowing to domestic borrowing via banks. In line with the increase in household investments in foreign equity, the Slovenian economy's net liabilities to the rest of the world via this instrument are declining. The successful release of government bonds on the European MTS market in early 2007 did not lead to a decline in net claims against the rest of the world in the form of bonds. This was a result of increased purchases of foreign bonds by the domestic banking sector, primarily using the money released from Bank of Slovenia bills and repayments of domestic government bonds. Claims and liabilities vis-à-vis the rest of the world in the form of currency and deposits almost equalised in 2007, as a result of Slovenia joining the euro area and an increase in the central bank's liabilities to the rest of the world in the form of this instrument.

Figure 1.8: Financial claims, liabilities and net position against the rest of the world as a percentage of GDP, by sector and financial instrument at the end of the third quarter of 2007



Note: S.1: Slovenian economy; S.11: Non-financial corporations; S.121: Central bank; S.122: Other monetary financial institutions (includes commercial banks and savings banks); S.123: Other financial intermediaries, except insurers and pension funds (includes investment funds and leasing companies); S.125: Insurers and pension funds; S.13: General government; S.14: Households.

Source: Bank of Slovenia

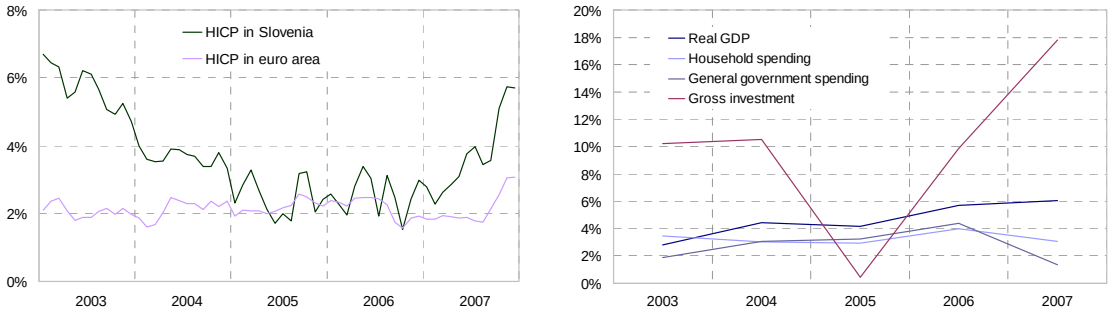
2 ECONOMIC TRENDS IN SLOVENIA

2.1 Inflation trends and economic growth[4]

Rise in inflation in 2007.

At the end of 2007 inflation in Slovenia as measured by the HICP stood at 5.7%. The gap between this rate and the Maastricht price stability criterion stood at 1 percentage point at the end of the year. The relatively high inflation was the result of both supply shocks reflecting conditions in the global economy (rises in prices of food, oil and other commodities), and internal macroeconomic factors, most notably growth in aggregate demand that outstripped potential supply, and more favourable real financing conditions.

Figure 2.1: Movement of inflation indices in Slovenia and the euro area, and GDP growth and components of GDP growth in percentages



Source: Bank of Slovenia

Economic growth in Slovenia last year was the highest since independence.

Economic growth in Slovenia increased to 6.1% in 2007, the highest rate since independence. The gap between growth in Slovenia and the euro area increased by 0.6 percentage points last year to 3.5 percentage points. Exports of goods and services were the most important factor in economic growth for the fourth consecutive year; they were up 13% in real terms last year, accounting for 8.8 percentage points of economic growth. Imports grew by 14.1% in real terms, as a result of which net trade made a negative contribution (of 0.9 percentage points) to economic growth. The highest growth among GDP expenditure categories was recorded by investment, which was up 17.8% last year, contributing 5 percentage points to economic growth. The largest increases among investments were recorded by investment in the construction of structures (20.8%) and investment in transport equipment (24.7%). There was also high growth in investment in housebuilding, which averaged around 20% last year. By contrast, growth in final consumption was low last year, with expenditure on final consumption rising by just 2.7%, and household spending by 3.1%.

GDP growth fell to 4.7% in the final quarter of 2007. The main factors in the slowdown in growth were slower investment growth and a decline in export growth. Economic growth is expected to slow in the future.

Last year's current account deficit was higher than in previous years at 4.9% of GDP.

Slovenia failed to maintain its current account deficit at the relatively low level of previous years, the deficit widening to 4.9% of GDP in 2007.

2.2 Country risk

No change in Slovenia's country risk ratings in the last year.

Having improved for several years in succession, and having reached a relatively high level before Slovenia joined the euro area, international rating agencies' ratings of Slovenia were unchanged last year. The reasons for the relatively good risk assessments achieved lie in the current good economic outlook and the favourable results achieved by fiscal policy, namely a balanced budget in 2007, high economic growth and a moderate

[4] For more about economic trends in Slovenia, see the April 2008 Price Stability Report, published on the Bank of Slovenia website.

debt-to-GDP ratio. At the same time attention is being drawn to the aging of the population, which could put the sustainability of public finances under significant pressure in the long term, while in the short term warnings are being voiced over the rise in inflation and the widening of gap between price growth in Slovenia and in the euro area, and the risk of these movements passing through into wage growth, which would adversely impact competitiveness in foreign trade. In this context, increased productivity and labour market flexibility are therefore becoming even more important to maintaining competitiveness (S&P, March 2008).

S&P was holding Slovenia's rating at AA/A-1+ as at 13 March 2008. The last upgrade was in May 2006. At that time it cited the commitment to fiscal prudence and the good outlook for economic growth as the main factors behind Slovenia's good rating. Like last year, it cited as weaknesses the low wealth level in comparison with the "median for AA countries", and its sluggishness in structural reforms. The outlook remains stable, and is a reflection of the continuing fiscal prudence and solid growth. At the same time the agency stated that improvements in competitiveness and further economic restructuring to support Slovenia's process of convergence with other AA countries would be key factors in a long-term rating improvement. Pressure for a downgrade could arise in the event of a major deterioration in the public finance position.

A comparison of Slovenia with EMU member-states with similar country risk ratings (Portugal AA-/A-1+, Italy A+/A-1+, Greece A/A-1, Belgium AA+/A-1+, Malta and Cyprus A/A-1+) shows above all that Slovenia is less wealthy, as its per capita GDP is just 66% of the median value. However Slovenia has comparable relative unit labour costs and better fiscal results. The latter are nevertheless sensitive to factors related to the aging of the population.

Similarly, there has been no change recently in Slovenia's ratings at Moody's. Having been upgraded to Aa2 on 25 July 2006, Slovenia has remained at that level ever since. In December 2007 the agency cited similar upgrade factors and major challenges to those in the previous report. However in its most recent assessments Moody's cited the commitment to an incomes policy in which real wage growth is outpaced by productivity growth and potential measures to reduce the general government sector's structural deficit as factors that could lead to an upgrade in the future. It classed a decline in economic competitiveness, a deterioration in the fiscal position for demographic reasons and ineffective pension reforms as factors that could result in a downgrade.

Slovenia's relatively favourable ratings are also reflected in the spread between the comparable market yields on Slovenian and German 10-year government bonds. The low spread of just over 34 basis points is an indication of Slovenia's relatively low country risk premium.

3 HOUSEHOLD SECTOR

3.1 Household borrowing

Growth in household consumption in 2007 was slightly slower than in 2006, and was outpaced by growth in disposable income in the sector. A larger portion of disposable income than in previous years was earmarked for increasing household assets.

Further increases in household indebtedness.

The increase in household indebtedness in 2007 was similar to that in the two preceding years. Households borrowed both to finance consumption and to increase real assets. The household borrowing comes primarily from loans, and, to a lesser extent, from trade credits granted by corporates. The financing of consumption directly at sellers of goods and services accounted for almost 15% of households' financial liabilities between 2001 and 2003. With financial intermediaries expanding their offer of favourable forms of financing, this proportion has gradually declined, to reach just over 10% in 2007.

Table 3.1: Stock of household financial liabilities by instrument in EUR million

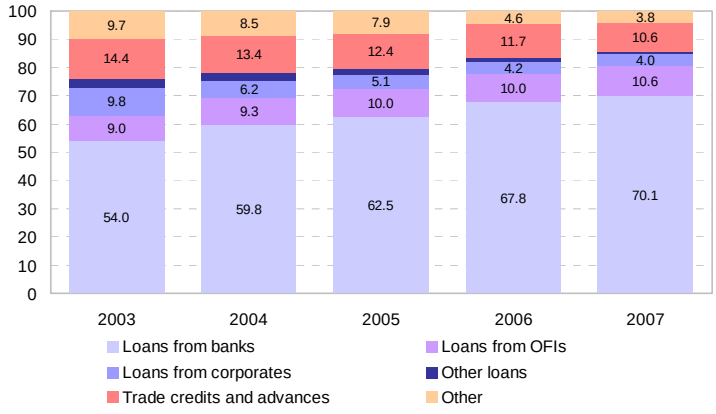
	2003	2004	2005	2006	2007 [1]
	(EUR million)				
Total	5,296	5,748	6,882	8,093	9,356
Growth rate (%)	11.5	8.5	19.7	17.6	19.1
Loans	4,020	4,491	5,482	6,777	8,009
Corporates	518	357	348	336	375
Banks	2,861	3,439	4,298	5,491	6,559
Other financial intermediaries	474	537	690	813	993
Government	90	86	87	82	79
Rest of the world	77	73	58	55	3
Trade credits and advances	764	770	855	945	989
Other	512	486	545	371	359

Note: [1] Figures for September 2007.
Source: Bank of Slovenia

Households are primarily increasing their indebtedness by financing at domestic banks.

Loans raised at the domestic banks accounted for the majority of total loans taken, the share rising to 85% in 2007. Banks account for 70% of total household debt, up 16 percentage points on 2003. The proportion of loans accounted for by other financial intermediaries remains stable at 12%, their financing accounting for 10% of the sector's total debt. Borrowing in the rest of the world, which in the past represented an additional source of financing for sole proprietors (mostly not included among existing resources), has almost ceased in recent years. In previous years households made net repayments of loans from the rest of the world, so that this portion of the debt was almost paid off in 2007.

Figure 3.1: Percentage breakdown of household financial liabilities by instrument



Source: Bank of Slovenia

Household borrowing at banks

Increase in household indebtedness in 2007 and heavier loan repayment burden.

Household borrowing at banks recorded average growth of 24% and 25% over the last two years, the dynamic varying. A slowdown in the growth in borrowing in 2006 was followed by a gradual increase in 2007, and the stabilisation of year-on-year growth at 27% at the very end of the year. At 36.6%, growth in housing loans was higher than growth in consumer loans (19.9%).

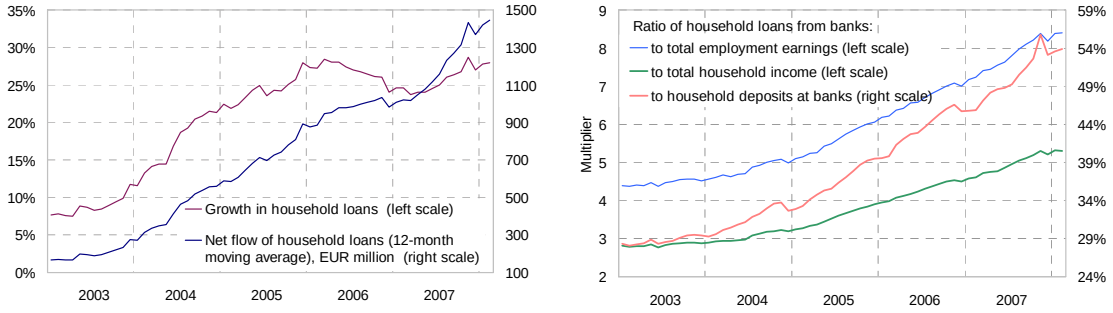
Household debt at banks in 2007 was 8.7 times higher than monthly employment income.

The indicators reflecting household debt deteriorated in 2007. The ratio of household debt at banks to monthly employment earnings rose from 7 at the end of 2006 to 8.2 at the end of 2007. The ratio of household debt to total household income, including social security and pensions, was slightly lower (5.2 at the end of 2007), but still displayed a rising trend.

The proportion of household employment income earmarked for bank loan repayments increased to 22% in 2007.

The average burden on households in repaying bank debt was estimated on the basis of bank surveys and available statistics. With household borrowing increasing, and interest rates rising, the debt repayment burden on households increased in 2007. The average proportion of household employment earnings earmarked for loan repayment increased to 22% at the end of 2007, 3 percentage points higher than in 2006. The proportion accounted for by interest was 3.1%, compared with 2.5% in 2006.[5] The average debt repayment burden on total household income in 2007 was slightly lower at 13.8%.

Figure 3.2: Growth in household loans in percentages and in EUR million, and indicators of household debt at banks



Source: Bank of Slovenia

High growth in new short-term consumer loans in 2007.

The volume of new loans to households increased by almost 26% in 2007, housing loans and consumer loans recording almost equal increases. There were major changes in the average maturity of new loans: the average maturity of housing loans increased, while that of consumer loans decreased. Short-term consumer loans to households were up 118% in 2007 and accounted for 21% of total new consumer loans to households, compared with 12% in 2006. The high growth in short-term loans was particularly notable towards the end of the year, when households were using them to finance purchases of shares in NKBM. Long-term consumer loans increased by just 13.6% in 2007.

Table 3.2: Maturity breakdown of new housing loans in percentages

(%)	up to 5 years	5 to 10 years	10 to 15 years	15 to 20 years	over 20 years
2003	3.0	19.7	52.8	20.1	4.4
2004	3.2	18.6	46.7	20.8	10.6
2005	2.2	13.0	35.0	24.2	25.6
2006	2.3	14.9	25.0	23.8	34.0
2007	3.1	14.4	22.0	21.6	38.9

Note: The figures up to 2005 relate to loans by the eight largest banks, while the figures from 2006 cover all banks.
Source: Bank of Slovenia

Average maturity of housing loans lengthening.

The proportion of new housing loans with the longest maturity term of over 20 years approached 40%, having barely exceeded 10% three years ago. The lengthening of average maturity was reflected most notably in loans with a maturity term of between 10 and 15 years, which three years ago accounted for about one-half of new housing loans, but accounted for just 22% last year.

[5] The figures for annuities and interest paid come from bank surveys at the beginning of 2008.

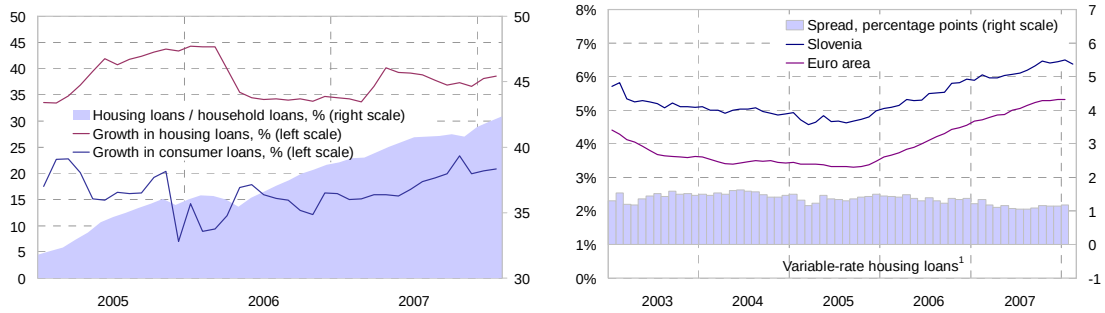
There was no significant change in the spread between interest rates on household loans at Slovenian banks and in the euro area in 2007. Interest rates on housing loans converged slightly with those in the euro area, as a result of slower growth in interest rates at Slovenian banks. Slovenian borrowers still face interest rates on housing loans 1.1 percentage points higher on average than those on loans from euro area banks.

The positive spread in interest rates on housing loans compared with euro area banks has been maintained.

The majority of existing household loans are variable-rate. The proportion of housing loans with a variable interest rate increased to almost 78% in 2007, while almost 87% of new loans raised in 2007 were variable-rate. Potential interest rate rises are a major risk factor for households.

The increasing proportion of housing loans with a variable rate is increasing the interest-rate risk to households.

Figure 3.3: Growth in household loans (left), and comparison of interest rates on new housing loans with interest rates in the euro area (right) in percentages

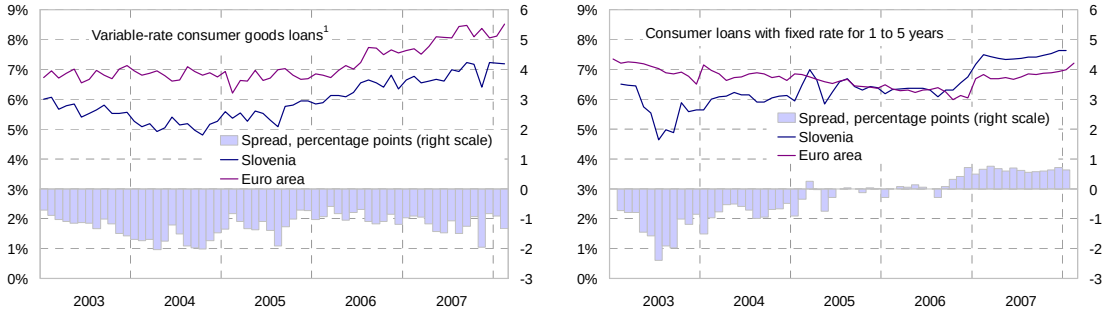


Note: [1] Includes loans in which the agreed interest rate is variable or fixed for up to one year. Since May 2005 the figures for Slovenia have been in line with ECB methodology, having previously been estimated on the basis of reports by eight major banks.
Source: Bank of Slovenia

The comparison of interest rates on consumer loans in Slovenia with those of the euro area varies according to the type of interest rate. Interest rates on variable-rate consumer loans have long been below the euro area average. In 2007 the spread averaged 1.2 percentage points, slightly more than in 2006. On consumer loans with the interest rate fixed for a term of 1 to 5 years, full convergence with the euro area was achieved before Slovenia joined the euro. In 2007 Slovenian banks raised their interest rates in this segment more than euro area banks, thus reducing their own interest-rate risk.

The variable rates on consumer loans are lower than the euro area average.

Figure 3.4: Comparison of interest rates on consumer loans in Slovenia with those in the euro area, by type of interest rate in percentages

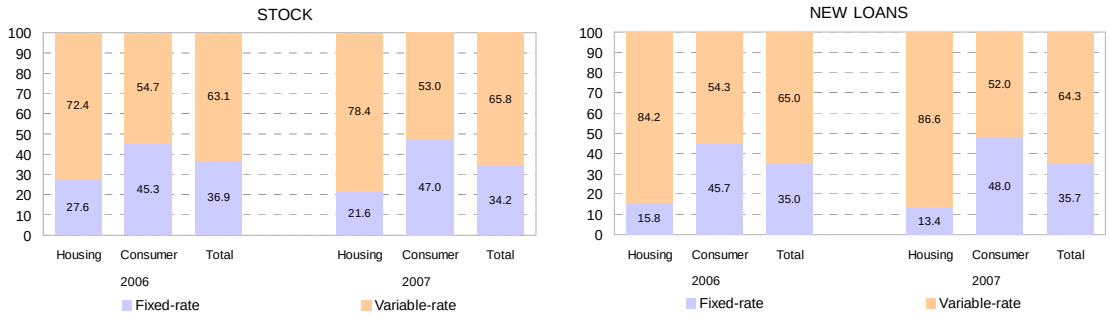


Note: [1] Includes loans in which the agreed interest rate is variable or fixed for up to one year.
Source: Bank of Slovenia

The proportion of consumer loans with a fixed interest rate is significantly higher than that of housing loans, in terms of both the stock and new loans, and is displaying a rising trend. From the point of view of the interest-rate risk to households, these loans are more favourable during conditions of rising interest rates, but are significantly more expensive than variable-rate loans (by 0.6 to 0.9 percentage points).

The proportion of consumer loans with a fixed interest rate is increasing, which is also increasing the cost of these loans.

Figure 3.5: Breakdown of household loans by type of interest rate in percentages



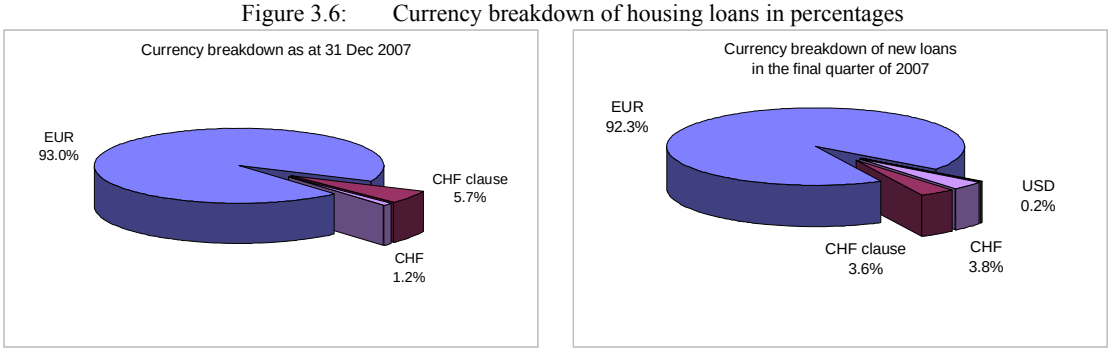
Source: Bank of Slovenia

Currency breakdown of household loans

The proportion of long-term consumer loans in Swiss francs is increasing.

Euro-denominated loans account for more than 90% of consumer loans, in terms of both the stock and new loans. Loans in other currencies, Swiss francs in particular, account for a small but growing proportion of consumer loans. They are rarely seen among short-term loans, but accounted for 8.3% of new long-term loans in 2007, and have accounted for 9.2% at the beginning of 2008.

Figure 3.6: Currency breakdown of housing loans in percentages

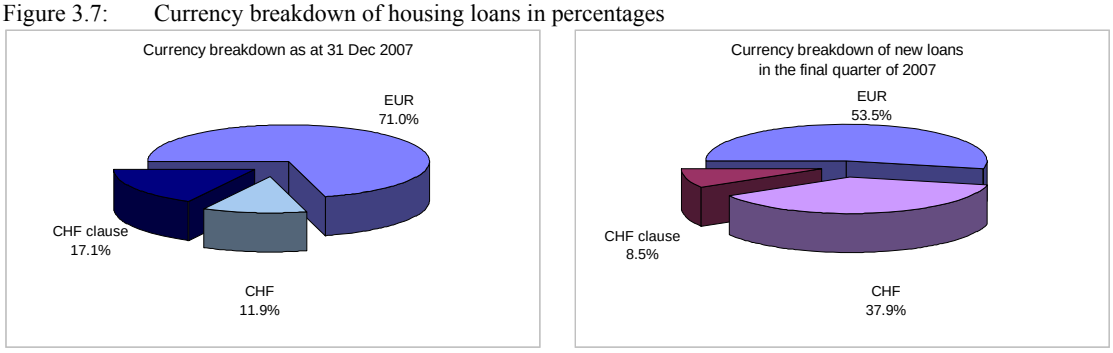


Source: Bank of Slovenia

The proportion of new housing loans tied to the Swiss franc is approaching 47%.

The proportion of housing loans in foreign currency is high, and rising. Lower interest rates on loans in Swiss francs and the euro's appreciation against the former over several years have provided a strong incentive for households to borrow in Swiss francs. Last year there was a sharp rise in the total proportion of housing loans either tied to Swiss francs with a currency clause or denominated in Swiss francs to 29% by the end of the year. There was a very sharp increase in the proportion of loans denominated in Swiss francs, which account for 11.9% of total housing loans. On these loans borrowers must also take into consideration the transactions costs of currency exchange in the approval and repayment of the loan, which are not included in the calculation of the effective interest rate. In the final quarter of 2007, the proportion of new housing loans denominated in Swiss francs was almost 39%, while including the currency clause the proportion was 47%. The exchange-rate risk and interest-rate risk to households from housing loans is further increased by the average maturity of the loans lengthening even further, which entails a high level of debt for a large proportion of households. The threat of exchange-rate risk was realised in the first quarter of 2008, with the euro's significant depreciation against the Swiss franc.

Figure 3.7: Currency breakdown of housing loans in percentages



Source: Bank of Slovenia

Almost 70% of new housing loans in Swiss francs in 2007 were approved by the banks under majority foreign ownership. Loans in Swiss francs account for more than 50% of the total at these banks. The small domestic banks became more actively involved last year in the financing of households via housing loans in Swiss francs, which accounted for 12% of their total lending (compared with just 1% in 2006). The banks under majority foreign ownership dominated the market for new housing loans to households in Swiss francs with a share of almost 95%, which also raised their market share of total household loans in foreign currency.

Table 3.3: Proportion of new household loans in Swiss francs in percentages

	Proportion of new loans in CHF (%)					
	Housing loans			Household loans		
	Proportion of loans in CHF		Bank group's proportion of total loans	Proportion of loans in CHF		Bank group's proportion of total loans
	2006	2007	2007	2006	2007	2007
Large banks	21.9	24.1	29.1	6.3	8.1	25.2
Small banks	1.2	11.9	1.5	0.2	1.7	1.0
Banks under majority foreign ownership	42.5	55.7	69.4	28.8	32.9	73.7
Banking sector	31.0	38.7	100.0	13.2	16.3	100.0

Source: Bank of Slovenia

3.2 Forms of household financial assets

Rapid growth in household assets in 2007, as a result of both new investments, and increases in value.

The increase in household financial assets in 2007 was larger than that in previous years. This was partly the result of increased current household investments during the year, but was more the result of the favourable stock market trends before September 2007. Household financial assets increased by EUR 4.7 billion over the first nine months of 2007. New net household investments accounted for EUR 2.1 billion of this increase, while the remaining EUR 2.7 billion came from value changes.

The increase in household financial assets was primarily the result of money invested in equity and investment fund units, which increased by EUR 2.9 billion over the first nine months of the year. High returns on the financial markets saw households increase their net payments into investment funds during the year. The new investments and rise in prices meant that assets in investment funds ended 2007 up EUR 920 million on the end of 2006, the proportion of total financial assets that they account for rising by 1.5 percentage points.

The favourable stock market trends over the first nine months of the year also brought an increase in the proportion of household assets in the form of equity (other than investment funds), which reached almost 28%, these investments increasing by almost EUR 2 billion over the first nine months of the year. The increase in these assets was entirely the result of value changes, no net new investments being recorded over the first nine months of the year.

Table 3.4: Stock of household financial investments by instrument in EUR million

	2003	2004	2005	2006	2007 [1]
	(EUR million)				
Total	22,806	26,053	28,167	31,959	36,607
Growth rate (%)	12.8	14.2	8.1	13.5	19.7
Cash and deposits	11,578	12,995	14,150	15,397	16,740
Bank deposits	9,345	10,041	10,651	11,447.7	12,255.0
Securities other than shares	594	744	512	547.9	492.1
Loans	630	626	885	838.4	888.0
Shares and other equity	5,835	6,759	6,906	8,147.1	10,119.3
Investment fund shares/units	1,012	1,549	1,828	2,461.2	3,379.9
Life insurance	732	920	1,137	1,448.3	1,644.0
Pension insurance	233	386	510	643.2	747.8
Other technical reserves	548	565	633	655.0	661.1
Other claims	1,644	1,508	1,606	1,820	1,935

Notes: [1]Figures for September 2007.
Source: Bank of Slovenia

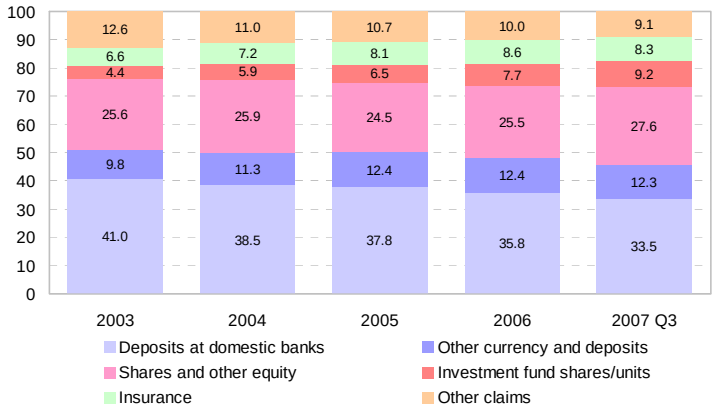
Decline in household assets as a result of falling prices on financial markets.

The falls in stock markets in the final quarter of 2007 and in early 2008 reduced these household financial assets. In addition to the uncertainty over the continuation of these trends, a further risk to households' financial position comes from the loans to purchase securities that they raised while there was a favourable climate on the financial markets. According to bank surveys, the amount of new lombard loans approved for this purpose in 2007 was four times that in 2006. According to the survey, 11 banks approved household loans for purchasing securities. The proportion of the stock of household loans accounted for by these loans amounted to 6% at the end of 2007.

Decline in the proportion of household assets accounted for by bank deposits and insurance, with potential for growth in the future.

Households still hold the largest proportion of their assets in the form of deposits with the domestic banks. The declining trend in the proportion accounted for by these assets is the result of the redirection of assets into higher-yielding forms of investment. In 2007 household deposits grew slightly faster than in the previous years, to a certain extent as a result of banks' efforts to attract additional financial resources, which with rising inflation do not offer sufficient incentive for this form of investment. That households are facing the first major declines in asset values as a result of stock market falls will probably increase investors' preferences for more secure forms of investment, which include various forms of life insurance and pension insurance in addition to bank deposits. These forms of insurance have recorded annual growth of between 20% and 30% in recent years, but nevertheless do not yet account for a significant proportion of household financial investments.

Figure 3.8: Breakdown of household financial investments by instrument in percentages



Source: Bank of Slovenia

Net household financial assets increased by EUR 3.4 billion over the first nine months of 2007 to reach the equivalent of 82% of GDP. There has been a nominal decline in net assets held at banks over the last three years. The recent faster growth in bank deposits

was still significantly below growth in borrowing. Net savings at banks were equivalent to 17.7% of GDP, down one-third on 2003.

Table 3.5: Stock of net household investments at banks (financial accounts) in EUR million

	2003	2004	2005	2006	2007 [1]
			(EUR million)		
Loans	3,044	3,619	4,480	5,558	6,592
Growth (%)	11.0	18.9	23.8	24.1	25.0
Deposits	9,466	10,189	10,798	11,640	12,403
Growth (%)	8.2	7.6	6.0	7.8	11.1
Net claims against banks	6,422	6,570	6,318	6,082	5,811
As % of GDP	26.0	24.6	22.4	20.0	17.7

Note: [1]Figures for September 2007.
Source: Bank of Slovenia

Interest rates on household deposits at banks

Interest rates on short-term deposits in Slovenia and in the rest of the world had almost equalised by the end of 2007.

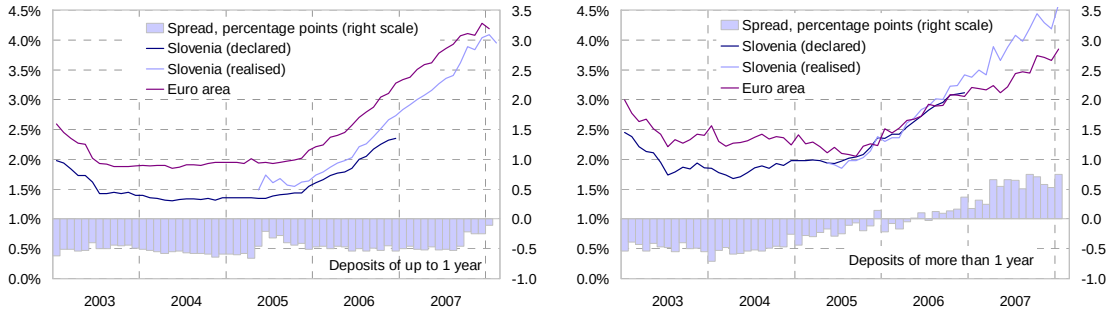
On household deposits of up to 1 year, there remained a negative spread between domestic interest rates and average interest rates in the euro area for the majority of the year. Interest rates in the euro area were 0.5 percentage points higher on average. Growth in interest rates in Slovenia picked up in the final quarter, which narrowed the spread to 0.2 percentage points, and then to 0.1 percentage points in January 2008.

Interest rates on long-term deposits in Slovenia overtook those in the euro area in the last year and a half.

Interest rates on deposits of more than 1 year overtook the comparable interest rates in the euro area in the middle of 2006. The spread has widened further over the last year and a half. At the end of the year domestic interest rates were 0.6 percentage points higher than the euro area average.

By raising interest rates banks succeeded in attracting a portion of household assets away from alternative forms of saving, which had left households with negative experiences in the context of the tougher conditions on the financial markets. Short-term deposits in particular began to record faster growth, the acceleration particularly evident in the final quarter of 2007.

Figure 3.9: Comparison of Slovenian interest rates on deposits of up to 1 year (left) and more than 1 year (right) with euro area interest rates in percentages



Note: The figures for realised deposit rates in Slovenia are available from May 2005. The spread with the euro area before this date has been calculated from declared interest rates.
Source: Bank of Slovenia

3.3 Real estate market

Slowdown in growth in advertised prices of housing in Ljubljana.

The slowdown in housing price growth seen in the euro area was less evident in Slovenia. Advertised prices were pointing to a slowdown in housing price growth in Ljubljana at the end of 2007, which was expected given the high level of prices. The transaction prices of housing in the Ljubljana urban region[6] also show a gradual slowdown in housing price

[6] The geographical breakdown of transaction prices of housing was made in line with level 2 statistical regions (SKTE 2), where the Ljubljana urban region is the same as the Central Slovenia level 3 region, and the rest of Slovenia comprises the 11 other level 3 regions. The Ljubljana urban region is then further divided into the city of Ljubljana, and the surroundings.

growth, while growth in the transaction prices of housing in the rest of the country is strengthening. This was the result of relatively low prices in the past, and the migration of demand to areas with lower housing prices.

Transaction prices of housing

Growth in transaction prices of housing declined in the Ljubljana urban region, but strengthened in the rest of the country.

Growth in transaction prices of housing slowed in the Ljubljana urban region in 2007, but strengthened sharply in the rest of Slovenia, which also led to an increase in growth in prices at the national level.

Table 3.6: Year-on-year growth[7] in transaction prices of housing in percentages

(%)	Slovenia	Ljubljana urban region	Ljubljana city	Ljubljana surroundings	Rest of Slovenia	Euro area[1]
2005	11.9	10.0	10.9	6.5	12.1	7.8
2006	13.4	13.3	13.8	11.2	13.4	6.5
2007	20.3	10.1	11.4	7.3	25.5	5.0

Note: [1]Figures for 2007 are second quarter.
Sources: TARS, Bank of Slovenia, ECB

A comparison of housing prices between regions reflects the slight narrowing of the gap between price levels in the Ljubljana urban region and the rest of the country.

Table 3.7: Regional differences in housing prices[8]

	Slovenia	Ljubljana urban region	Ljubljana city	Ljubljana surroundings	Rest of Slovenia
2004	100	145	156	108	75
2005	100	147	157	111	75
2006	100	146	156	112	75
2007	100	145	154	115	76

Sources: TARS, Bank of Slovenia

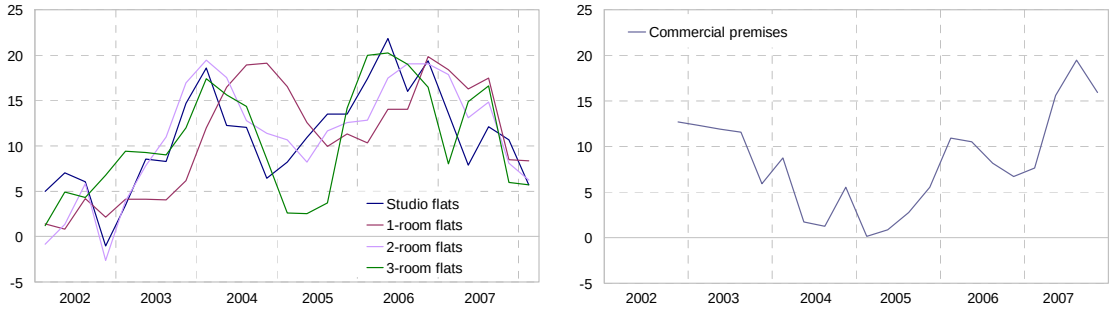
Advertised prices of housing

Demand for larger housing migrated to the surroundings of Ljubljana.

Growth rates in advertised prices of housing in Ljubljana declined significantly in 2007, to stand between 10.9% for studio flats and 5.9% for three-room flats. Year-on-year growth in advertised prices of studio flats and two-room flats declined slightly further in the first quarter of 2008. On the basis of the figures for the movement of advertised prices of housing, the assessment is that the larger absolute sums needed to purchase large dwellings in Ljubljana mean that demand for large dwellings has migrated from Ljubljana to the surroundings, where prices per square metre are 15% to 30% lower.

Following the low growth in previous years, growth in prices of commercial real estate increased by just over 9 percentage points to 16%.

Figure 3.10: Year-on-year growth in advertised prices of housing (left) and commercial real estate[9] (right) in Ljubljana in percentages



Sources: SLONEP, own calculations

[7] The year-on-year rates are calculated from the Fischer indices.
[8] The regional differences in price levels are calculated from the weighted average of transaction prices in each year.
[9] Prices for office space in Ljubljana were used to calculate the growth rate.

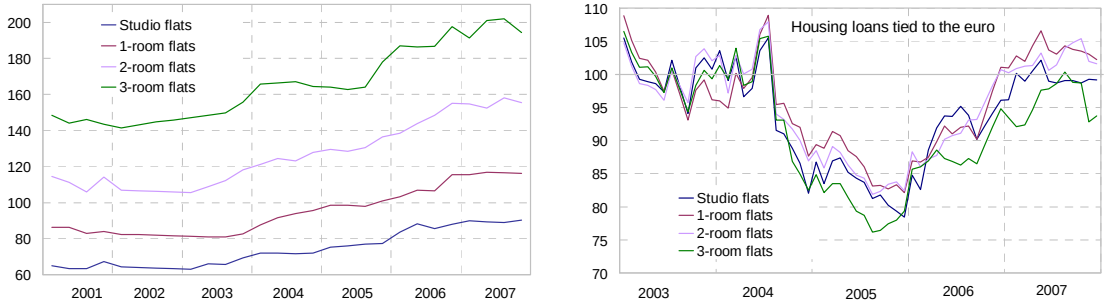
Price sustainability

The sustainability of housing prices is a reflection of the ratio of actual prices to fundamental prices, i.e. the prices justified on economic and institutional grounds. Three indicators of price sustainability on the real estate market in Ljubljana[10] are given, namely the ratio of housing price to average net monthly wages, the housing affordability index, and the ratio of housing prices to rents, based on which the fundamental price of housing was calculated.

No discernible deterioration in housing affordability.

There was no significant decline in housing affordability as expressed by the ratio of housing prices in Ljubljana to the annual moving average of monthly net wages in 2007, as a result of the relatively high growth in the latter. The purchase of studio flats, one-room flats and two-room flats required 2.4 average net monthly wages, 0.8 average net monthly wages and 0.5 average net monthly wages more respectively than in 2006, while purchasing a three-room flat required 3.2 average net monthly wages less than in 2006.

Figure 3.11: Ratio of housing prices to annual moving average of net monthly wages in Ljubljana[11] (left), and housing affordability index (2003=100) (right)



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

Growth in housing prices and interest rate rises were compensated by growth in net wages and the lengthening of the average maturity of housing loans.

There was also no significant deterioration in actual housing affordability, which in addition to movements of housing prices takes into consideration conditions in the housing loan market. The housing affordability index,[12] which is expressed as the ratio of monthly loan repayments to net wages, increased by 3% for studio flats and 0.3% for three-room flats in 2007. Housing affordability declined in the first half of the year as a result of interest rate rises. In the second half of the year the average maturity of new housing loans lengthened, which together with growth in net wages returned the housing affordability indices to levels similar to those at the end of 2006. Interest rates on variable-rate housing loans were up 65 basis points in 2007, while the weighted average maturity of new housing loans in December 2007 was just under 10 months longer than a year earlier.

Growth in rents in Ljubljana outpaced growth in housing prices in 2007, which was reflected in a decline in the P/E ratios on all housing other than three-room flats. The ratio of actual prices to fundamental prices has increased in recent years. At the end of 2006 actual prices were strongly above fundamental prices[13] for all types of housing, smaller dwellings in particular. With rents rising faster than housing prices, the aforementioned

[10] Limited data availability means that the price sustainability calculations have been made for Ljubljana only. Based on these indicators alone, there can be no talk of a price bubble in the real estate market. In interpreting these indicators, there should also be an awareness of the limitations related to the quality of the figures for advertised prices and housing rents.

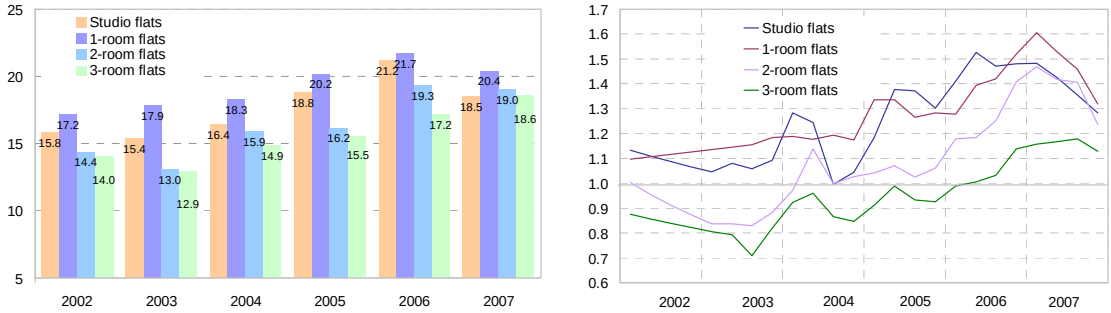
[11] In calculating the ratio of housing prices to average monthly wages, advertised housing prices were reduced by 10%. Those involved in the real estate market estimate that advertised prices are 10% to 15% higher than actual prices. The gap varies from month to month, for which reason the calculated affordability can also differ from the actual affordability.

[12] It is assumed in the calculation that the full value of the real estate is financed via a housing loan from a bank. In the calculation of the index, the monthly annuity for a loan in the amount of housing value is first computed on the basis of the interest rates and the weighted average maturity of new housing loans in a particular month. The next step is to calculate the ratio of the monthly annuity to the 12-month moving average of net monthly wages in Ljubljana, from which the basic index is then calculated. A rise in the index reflects a decline in housing affordability.

[13] The calculation of fundamental housing prices on the basis of the ratio of housing prices to housing rents (P/E) takes into consideration the average P/E value between 1995 and 2003, with fundamental prices for 2002 to 2007 being calculated from figures for rents.

ratio declined significantly in 2007 for studio flats, one-room flats and two-room flats, but was still in excess of 1.2, while for three-room flats it remained at its level from the end of 2006.[14]

Figure 3.12: Ratio of housing prices to rents (P/E) (left), and ratio of actual prices to fundamental prices of housing in Ljubljana calculated on this basis (right)



Sources: SLONEP, own calculations

The overpricing of housing in Ljubljana diminished slightly.

On the basis of the ratio of housing prices to net wages, the housing affordability index and the ratio of actual prices to fundamental prices, it is assessed that there was no deterioration in housing price sustainability in Ljubljana in 2007. Housing prices in Ljubljana, particular prices of smaller dwellings, remain unjustified by the fundamentals. However overpricing as measured by the ratio of actual prices to fundamental prices declined.

Factors in real estate prices

The discrepancy between supply and demand is gradually diminishing. This process can be expected to continue, with regard to the development of supply and demand factors.

Supply-side factors

The increased supply response to high housing prices is continuing.

The supply-side response to high housing prices remained significant in 2007. Based on the increases of 26% in gross investment in housebuilding and 27% in the number of building permits issued, the number of new dwellings can be expected to increase in 2008.

Growth in the costs of constructing new residential buildings other than land costs was outpaced by inflation and growth in housing prices in 2007. The main factor in the growth of the former was increased growth in labour costs, while growth in material costs slowed.

There was no significant change in the size of the housing stock as measured by the number of dwellings per thousand inhabitants, which remains a limiting factor in the supply of housing. In 2006 the number of new builds increased slightly, but was still less than the number needed to retard growth in housing prices. There were just 3.8 dwellings built per 1,000 inhabitants in 2006, which was far too few[15] to move the figure closer to the EU27 average of 458.[16]

[14] A more accurate calculation of the fundamental price would require the calculation of the average P/E ratio over a longer, more stable period of at least 10 or 15 years. The short time in which the Slovenian housing market has functioned normally makes this impossible. These limitations must be borne in mind when interpreting the results, although over a longer timeframe a lower average P/E ratio would be anticipated, and housing would appear to be even more overpriced according to this indicator.

[15] The latest figures show an average of 4.84 new builds per 1,000 inhabitants in the EU27, and an average of 5.7 in the EU15. The figures do not include Belgium, France, Greece, Italy and Malta (Source: EMF).

[16] Figure for 2006 (Source: EMF).

Table 3.8: Completed dwellings, building permits issued and gross investment in housebuilding

	2002	2003	2004	2005	2006	2007
			Estimate of housing stock			
Number of dwellings[1]	730,064	736,420	743,133	750,355	757,522	
Number of dwellings per 1,000 inhabitants	366	369	372	375	374	
			Completions including extensions and change of purpose			
Number of new dwellings	7,265	6,567	7,004	7,516	7,538	
Number of new dwellings per 1,000 inhabitants	3.6	3.3	3.5	3.8	3.8	
Floor area (m^2)	824,608	746,517	761,430	807,607	860,537	
			Building permits issued			
Number of dwellings[1]	5,080	6,122	7,002	7,235	8,463	10,780
Floor area (m^2)	597,366	711,385	793,200	880,751	1,028,024	1,202,396
			Supply of the Housing Fund of the Republic of Slovenia (HFRS)			
Number of dwellings delivered	76	59	160	353	453	685
Proportion of new dwellings (%)	1.0	0.9	2.3	4.7	6.0	
			Gross investment in residential buildings			
Growth rate (%)	8.5	-8.0	15.7	20.5	17.2	26.0
As % of GDP	3.5	3.1	3.9	4.2	4.1	4.7
			Growth rate (%)			
Construction costs - new housing[2]	4.5	6.6	11.7	3.0	4.6	4.2
Material costs			14.7	1.0	5.5	2.8
Labour costs			4.4	8.4	2.5	8.0

Notes: [1]The housing stock includes occupied and temporarily unoccupied dwellings for permanent use.
[2]Costs of construction, finishing work, and fixtures on new housing, excluding land costs.
Sources: SORS, own calculations

Tighter credit standards will not lead to excess supply of housing.

There is very little likelihood of the tightening of credit standards leading to excess supply on the Slovenian housing market. This has occurred in some euro area countries, where higher interest rates and tighter credit standards in the context of exceptionally heavy construction activity caused by many years of high growth in real estate prices brought a significant slowdown or even falls in real estate prices. In 2006 Ireland recorded 22 new builds per 1,000 inhabitants, Spain 13, and Slovenia just 3.8.[17]

The role of the Housing Fund of the Republic of Slovenia (HFRS) in the supply of market housing, as measured by the proportion of all new builds handed over to final purchasers that it accounts for, is increasing. However, with the exception of individual local markets, the HFRS's role is still too small to have a more discernible impact on housing prices.

Demand-side factors

High growth in net wages and lengthening of the average maturity of housing loans.
Growth in housing loans remains high at 36.6%.

The high nominal growth in net wages, which in combination with the increased original maturity of housing loans more than neutralised the effect of rising interest rates, had a positive impact on the demand for housing and housing loans in 2007.

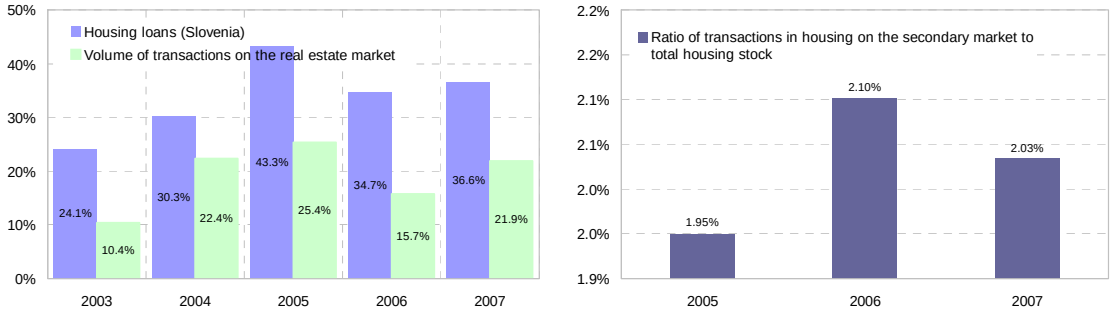
The stock of housing loans increased to EUR 2.67 billion or 8% of GDP in 2007. Year-on-year growth in housing loans in Slovenia strengthened to 36.6%, but declined to 7% in the euro area.[18] The high growth in housing loans compared with the euro area was also the result of the relatively low stock of housing loans compared with the euro area, where it is equivalent to 39% of GDP. Household debt is constantly increasing, but at 28% of GDP at the end of the third quarter of 2007 it was still less than half the euro area average at the end of 2006.[19] The increase in household debt will lower creditworthiness. Future lending growth in the housing loans segment will depend on banks' access to financial resources.

The volume of new housing loans increased by 25% in 2007 to EUR 1,023 million, which was 53.8% of the estimated volume of transactions on the secondary real estate market by

[17] EMF.
[18] ECB.
[19] ECB.

households. The average weighted original maturity of new housing loans over the whole of 2007 was up 0.2 years on the previous year at 15.5 years. In the final quarter the average original maturity of new housing loans lengthened to 16 years.

Figure 3.13: Year-on-year growth in the stock of housing loans and growth in the volume of real estate transactions by households[20] (left), and ratio of transactions in residential real estate to housing stock (right)



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

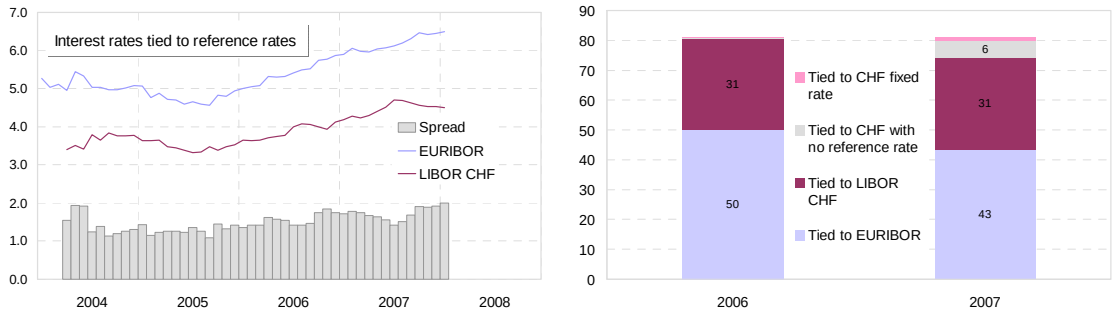
Increase in proportion of housing loans tied to the Swiss franc.

The spread between interest rates in Slovenia and in the euro area on housing loans in domestic currency narrowed to 110 basis points in 2007. Including loans tied to the Swiss franc, which are relatively insignificant in the euro area, in the calculation of the average variable interest rate on housing loans in Slovenia, the spread is significantly narrower at just over 20 basis points. The rise in interest rates was compensated at the aggregate level by an increase in the proportion of loans tied to the Swiss franc, thus maintaining housing loan affordability.

The transfer of exchange-rate risk to households is increasing the credit risk of banks.

In addition to interest-rate risk, households also face exchange-rate risk on their loans tied to the Swiss franc, which in the event of a gain in the Swiss franc against the euro is reflected in a heavier housing loan repayment burden on income and an increase in debt measured in euros. This could even lead to an inability to meet repayments by the relatively more indebted households. The credit exposure of banks whose claims are denominated in or index-linked to the Swiss franc increases as the currency strengthens. At the same time, the Swiss franc's appreciation against the euro brings a deterioration in the LTV ratio, which could fall below the critical value at which the bank calls on the borrower to increase the collateral.

Figure 3.14: Interest rates on housing loans (left) and prevailing types of interest rate on new housing loans (right)



Source: Bank of Slovenia

A decline in premiums over reference interest rates.

The premiums over the reference interest rate for housing loans continued to decline in 2007. The premiums over the EURIBOR and LIBOR declined by approximately 55 basis points. The nominal convergence of interest rates continued in 2007. The average LTV ratio on new housing loans increased, from 54.6% in 2006 to 60.5% in 2007.[21]

[20] The volume of transactions on the real estate market is estimated on the basis of the figures for payments of 2% real estate sales tax made by private individuals. It is the seller of the real estate that customarily pays the tax. Sales of new real estate are not included. Henceforth the volume of transactions on the real estate market refers to the volume generated by households.

[21] Estimate of LTV ratio from a sample of survey figures from 15 banks.

The impact of non-residents on demand for housing in large cities, Ljubljana in particular, remains negligible. The majority of real estate purchases by non-residents in 2007 were recorded by the tax offices in Koper, Murska Sobota, Nova Gorica and Kranj.

Table 3.9: Breakdown of non-residents' purchases of real estate by tax office[22]

	Structure (%)								Number of purchases by non-residents	Proportion of all purchases (%)
	Celje	Koper	Kranj	Ljubljana	Maribor	Murska Sobota	Nova Gorica	Other		
Jul - Dec 2004	6.5	26.0	11.1	5.9	7.7	21.4	10.8	10.6	443	-
2005	4.0	16.4	18.5	6.1	6.7	18.4	14.3	15.6	642	4.4
2006	5.5	20.7	12.8	4.7	4.2	16.9	20.3	14.9	740	4.7
2007	7.0	22.5	11.5	4.2	4.9	19.5	16.6	13.8	730	4.7

Sources: TARS, SMARS, own calculations

Institutional factors in real estate prices

The retention of the VAT rate will continue acting to slow growth in housing prices.

In December 2007 the Council of the European Union extended the period in which Slovenia can apply a VAT rate of 8.5% to the construction, renovation and maintenance of housing structures that are not subject to social policy by three years to 2010. The uncertainty over the anticipated increase in VAT in 2006 and the first half of 2007 led to increased demand for housing and growth in housing prices, as households aimed to make their housing purchases before VAT on new builds rose to 20%. At the end of April 2007 the Ministry of Finance ended this period of uncertainty over the anticipated VAT increase by announcing that it had drawn up a contingency scenario to retain the lower VAT rate should its proposal to extend the transitional period be rejected at the EU level. The retention of the lower VAT rate on new housing, whose anticipated increase had also been reflected in the prices of old housing, will bring a slowdown in price growth or even stagnation in 2008, and perhaps even in the second half of 2007.

By carrying out a real estate census in 2007, the Surveying and Mapping Authority (SMARS) created the basis for drawing up a real estate register and effecting the mass valuation of real estate for the needs of taxation. This was a step forward in the preparation of the basis for introducing a real estate tax aimed at reducing the structural imbalances in the real estate market.

Increased transparency in the Slovenian real estate market.

A guarantee of public access to real estate market records was put in place in October 2007, thus allowing an insight into the actual selling prices achieved on individual items of real estate, which has significantly reduced the asymmetry of information on the real estate market.[23] The transparency of the Slovenian real estate market will increase further this year. In February 2008 draft rules for calculating the annual indices of real estate prices and for determining the indices of real estate values were put forward for coordination, based on which the SMARS will calculate and publish indices of real estate prices by individual pricing zone for sub-categories of the same type of real estate on a quarterly basis.

The high growth in real estate prices in Slovenia is the result of insufficient supply, and is only to a lesser extent generated by expectations of future growth, which are characteristic of a real estate bubble.

The high growth in real estate prices in Slovenia is primarily the result of insufficient supply, which is otherwise increasing, and only partly the result of expectations of future growth, which are characteristic of a real estate bubble. The development of advertised and transaction prices in Ljubljana and its surroundings points to a slowdown in growth. In the rest of Slovenia, where price movements on the housing market follow those in Ljubljana with a delay, the gap with prices in the capital market can be expected to narrow. The future demand for housing will depend primarily on interest rate movements, the possible tightening of credit standards and access to banks' sources of financing, and growth in household income. A lengthening of the original maturity of housing loans is still possible, particularly via the issue of mortgage bonds. Given the figures for approvals of building permits and growth in gross investment in housebuilding, the supply of housing will increase, which will reduce the pressure for price growth. In the context of current economic forecasts, there is little likelihood of a complete halt in growth in housing prices or even a fall at the level of the country as a whole, given the limited

[22] The numerator includes all purchases by non-residents, irrespective of the type of real estate, while the denominator includes all purchases of housing in the specific period at the tax office in question.

[23] There is free access to real estate market records at the SMARS at http://prostor.gov.si/jv_etn/index.jsp.

response in supply as measured by the number of dwellings per 1,000 inhabitants and the ratio of investment in housebuilding to GDP. The real estate market can be expected to show increasing segmentation in the future. Demand will move from the oldest housing in bad locations to newer housing, which will accelerate as the number of new builds increases.

Purchase of housing as an alternative to financial investments

Diminished returns on investments in real estate in Ljubljana.

Slower growth in housing prices meant that the return on investments in housing in Ljubljana declined in 2007, and was significantly outpaced by the rise in prices on the capital markets. For this reason there was relatively little interest in the purchase of real estate for investment purposes for the majority of 2007. In the final quarter of 2007 and early 2008, the increased volatility and price corrections on the capital markets after the outbreak of the crisis on the market for sub-prime mortgage loans slightly increased the attractiveness of saving in real form, which in the past had proven to be secure and high-yielding.

Table 3.10: Return[24] on investments in housing in Ljubljana allowing for loan repayment and comparison of return on investments in housing with other forms of financial investment[25]

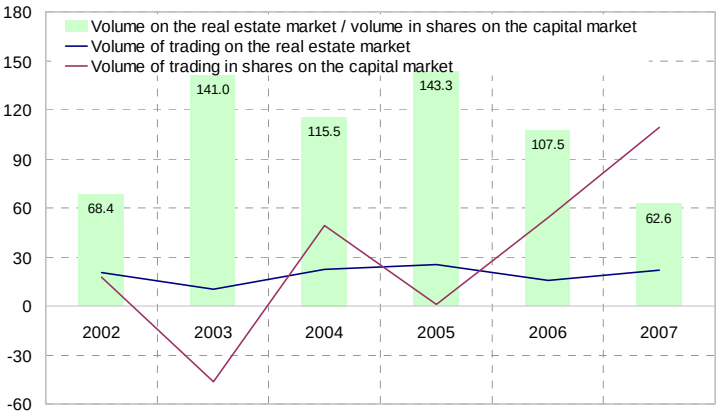
(%)	Purchase of housing with loan tied to the euro	Investing own funds			
		Housing	Capital market indices		Deposit rate[1]
			SBI20	VEP MF	
2003	19.0	30.3	17.7	17.1	7.8
2004	11.7	19.8	24.7	17.8	4.5
2005	13.9	19.1	-5.6	7.2	3.3
2006	19.1	25.0	37.9	18.8	3.4
2007	6.0	13.1	78.1	28.0	4.2
	Average annual return				
2003-2007	17.2	19.9	27.8	17.6	4.6

Note: [1]Average annual interest rate for deposits of more than 1 year. Prior to the end of 2005 the figures for interest rates on tolar deposits are tied to the TOM base rate, but from 2006 the figures are for euro deposits.
Sources: SLONEP, Bank of Slovenia, SORS, LJSE, Vzajemci.com, own calculations

Despite stronger growth in households' volume of transactions in real estate, the ratio of households' transactions on the real estate market to the volume of trading in shares on the Ljubljana Stock Exchange declined significantly in 2007, as a result of the exceptional growth in the latter.

[24] All returns are before tax.
[25] Calculations are for a 60m^2 flat in Ljubljana. The calculation of return uses the price of the flat at the beginning of the year in question. For the purchase of the apartment via a loan the LTV ratio is assumed to be 100%, while the return is calculated under the assumption that the loan is repaid early when the flat is sold at the end of the year in question. Rents have been included alongside capital gains as income. The return on the investment of the buyer's own funds in a flat includes the increase in the value of the flat and rental income.

Figure 3.15: Year-on-year growth in volume of trading on the capital market and volume of transactions on the real estate market, and ratio of volumes in percentages



Sources: TARS, LJSE, own calculations

Based on the available information it is estimated that the flow of household savings from the capital markets, mutual funds and bank deposits into the real estate market will be limited, given the high level of real estate prices, low rent yields, the expected slowdown in growth in housing prices and the large offer of other financial products.

Table 3.11: Changes in households' time deposits and alternative financial investments, volume of transactions on the real estate market, and changes in the stock of housing loans

	2003	2004	2005	2006	2007
			(EUR million)		
Change in stock of household time deposits excluding sight deposits	257	538	-424	163	1,177
Change in stock of household financial assets[1]	2,569	3,257	1,982	3,779	6,004
Turnover in shares on the capital market	623	931	941	1,451	3,035
Turnover on the real estate market	879	1,075	1,348	1,559	1,900
Change in the stock of housing loans	151	235	439	464	781
			Growth rate (%)		
Household time deposits excluding sight deposits	5.0	9.9	-7.1	2.9	20.6
Household financial assets[2]	12.9	14.5	7.7	13.6	19.9
Turnover in shares on the capital market	-46.4	49.4	1.0	54.3	109.1
Turnover on the real estate market	10.4	22.4	25.4	15.7	21.9

Notes: [1]The change for 2007 has been calculated from the values at the end of the third quarters in 2007 and 2006.
[2]Year-on-year growth for 2007 relates to the end of the third quarter.
Sources: Bank of Slovenia, TARS, LJSE, own calculations

4 CORPORATE SECTOR

4.1 Corporate financing and net debt

Corporate financing flows

High corporate borrowing continued in 2007.

Corporate borrowing in 2007 increased even further from the high growth seen in the previous year. Prime among the main factors encouraging further increases in borrowing was the dynamic economic growth being driven by strong investment activity. In the second half of the year the high pace of economic growth began to decline, while certain new factors made contributions to further growth in borrowing. With inflation rising, interest rates on loans at the domestic banks have become more favourable in real terms. Another factor in the growth in corporate demand for sources of financing was M&A activity, which to a great extent was financed by corporate borrowing at banks.

Alongside the predominant role of banks, the increase in business-to-business financing was notable in 2007.

Corporate financing in the rest of the world increased slightly last year, but actually accounted for a slightly lesser proportion of the total, as a result of the faster growth in financing from domestic sectors. The domestic banks were the prevailing source of corporate financing, their net flows of EUR 3 billion accounting for almost half of the total in 2007. There was a notable leap to a higher level of borrowing in business-to-business financing in 2007.

Table 4.1: Flow of corporate financial liabilities by sector in EUR million

	2003	2004	2005	2006	2007[1]
	(EUR million)				
Total	3,039	1,483	4,329	4,650	6,559
Growth in financial flows (%)	-13.6	-51.2	192.0	7.4	73.2
Slovenia	2,451	748	3,773	3,718	5,590
Growth in financial flows (%)	21.0	-69.5	404.3	-1.4	79.8
Corporates	1,084	-1,053	1,079	1,016	2,244
Banks	1,114	1,427	1,886	2,352	3,097
Non-monetary financial institutions	87	164	196	275	310
Government	-112	184	-58	29	-85
Households	279	26	669	47	25
Rest of the world	588	735	556	932	969
Growth in financial flows (%)	-60.6	25.0	-24.3	67.4	42.9
	Structure (%)				
Slovenia	80.7	50.5	87.1	80.0	85.2
Corporates	35.7	-71.0	24.9	21.8	34.2
Banks	36.7	96.2	43.6	50.6	47.2
Non-monetary financial institutions	2.9	11.1	4.5	5.9	4.7
Government	-3.7	12.4	-1.3	0.6	-1.3
Households	9.2	1.8	15.5	1.0	0.4
Rest of the world	19.3	49.5	12.9	20.0	14.8

Note: [1] First nine months.
Source: Bank of Slovenia

Increase in short-term financing among corporates.

Last year corporates mostly financed each other via trade credits, but there was also a sharp increase in business-to-business financing via loans. The latter was entirely short-term, while corporates made net repayments of long-term loans (similarly to 2006, but in a larger amount).

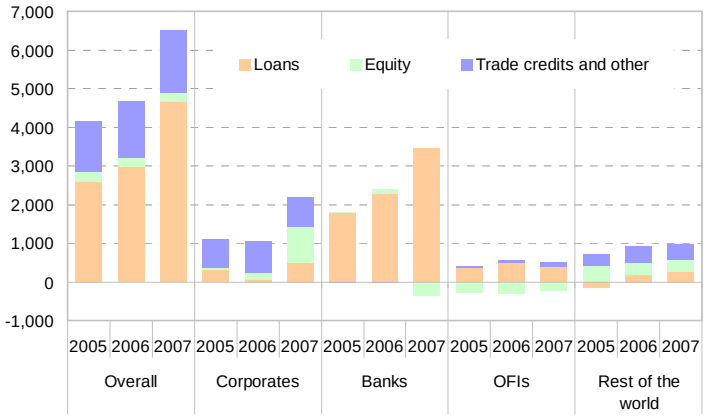
Equity: equity purchases are prevalent among financial transactions between corporates.

Ownership consolidation in the corporate sector last year was reflected in an increase in transactions in corporate equity. There was no significant change in net corporate indebtedness from other sectors as a result of these flows, because most transactions in equity were executed within the corporate sector (EUR 945 million, almost five times more than in 2006). M&A activity, which managers generally carried out via their own

corporates, can to a certain extent explain the higher corporate borrowing in the final months of the year, when the largest of these transactions were made.

In addition to the corporate sector itself, net purchases of equity in the sector were also made by non-residents, while other institutional sectors recorded net sales.

Figure 4.1: Flows of corporate financing by creditor sector and prevailing instrument in EUR million



Source: Bank of Slovenia

Loans: in recent years corporates have borrowed more intensively from non-monetary financial institutions.

Loans remain the prevailing method of corporate financing, and display a rising trend. The proportion of current corporate financing accounted for by loans in the first nine months of 2007 increased to 71%, up one-tenth on the previous year. Corporates raised a net total of EUR 3.4 billion of loans at banks during this period, up 90% on the same period in 2006. In addition to the prevalent role of banks, there has been a notable increase in corporate borrowing via loans from other providers. The aforementioned business-to-business financing accounted for 10% of total corporate loans raised during the period. Corporates are also increasing their borrowing from non-monetary financial institutions. There has also been a notable shortening of the average maturity of loans in this segment: loans of up to 1 year represented more than 30% of the total in 2007, almost double the figure in 2006.

Table 4.2: Corporate financing flows via loans in EUR million

	2003	2004	2005	2006	2007 [1]
			(EUR million)		
Total	1,780.7	2,039.3	2,584.9	2,973.4	4,663.5
Growth in financial flows (%)	9.7	14.5	26.8	15.0	93.5
			Structure (%)		
Slovenia	79.1	91.3	106.2	94.3	94.6
Corporates	1.2	11.0	12.5	1.7	10.4
Banks	66.8	66.8	68.8	76.5	73.9
Non-monetary financial institutions	7.6	14.3	14.2	17.1	8.8
Households	4.6	-1.0	9.7	-1.1	1.4
Rest of the world	20.9	8.7	-6.2	5.7	5.4

Note: [1] First nine months.
Source: Bank of Slovenia

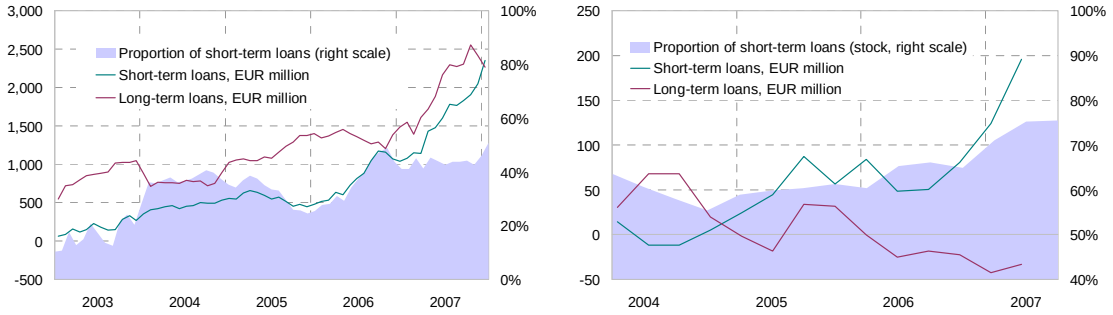
Loan-raising in the rest of the world increased slightly in 2007, but more slowly than loans from other providers, which further reduced the proportion of corporate financing accounted for by the rest of the world. There is no noticeable decline in the average maturity of these loans; instead there is great variation from year to year, in both maturity and volume.

A shortening of the average maturity of loans raised at banks.

The average maturity of loans raised at the domestic banks declined during 2006, then remained steady during 2007, with short-term loans accounting for approximately 45% of the total. Borrowing via loans with shorter maturities increased again at the end of the year. To a certain extent this increase can be attributed to corporate M&A activity, which

was also financed by shorter-term loans, and to the deterioration in financing conditions as a result of the uncertainty on international financial markets.

Figure 4.2: Corporate borrowing at domestic banks (12-month moving sums; left) and at other corporates (3-quarter moving sums; right) in EUR million



Source: Bank of Slovenia

The shortening of the average maturity of loans that corporates raise at banks and other financial institutions, and also in business-to-business financing, is a liquidity risk factor in the corporate sector.

Corporate financial liabilities

The stock of corporate financial liabilities had recorded a year-on-year increase of 26% by September 2007, double the rate in 2006. Corporate financial resources in Slovenia were equivalent to 262% of GDP, up almost 30 percentage points on 2006.

Changes in the breakdown of corporate financial resources as a result of growth in the value of equity.

While loans and trade credits are prevalent among current corporate financing, a major impact on the stock of financial liabilities also comes from changes in equity, which are defined more by value changes than by actual transactions in equity.

Table 4.3: Stock of corporate financial liabilities by sector in EUR million

	2002	2003	2004	2005	2006	2007 [1]
	(EUR million)					
Total	47,407	52,263	56,589	62,358	71,040	86,072
Growth rate (%)	15.3	10.2	8.3	10.2	13.9	26.1
As % of GDP	208.3	211.5	212.1	220.8	233.3	262.0
	Structure (%)					
Slovenia	82.5	82.3	82.5	82.1	82.6	83.7
Corporates	33.9	34.1	31.3	31.4	30.1	29.4
Banks	14.1	15.1	16.5	18.2	19.5	20.3
Bank loans	13.2	14.1	15.3	16.9	18.0	19.1
Non-monetary financial institutions	7.0	6.9	7.3	6.7	6.9	7.6
Government	13.6	12.3	13.3	12.1	12.6	13.0
Households	13.9	13.9	14.0	13.7	13.6	13.3
Rest of the world	17.5	17.7	17.5	17.9	17.4	16.3
Loans at foreign banks [1]	3.0	2.6	2.3	1.7	1.5	1.4

Note: [1] September 2007.
Source: Bank of Slovenia

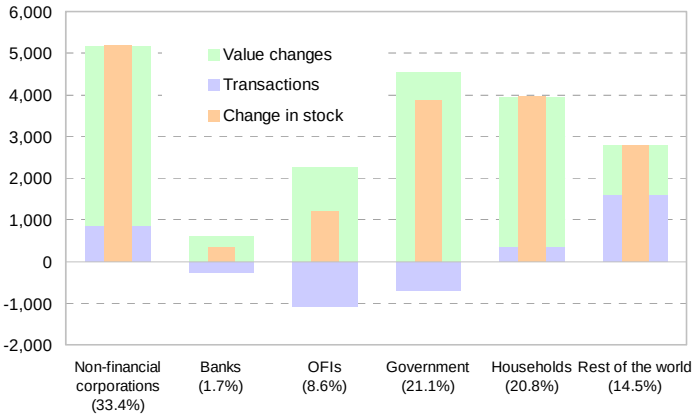
Equity accounts for a prevailing proportion of total corporate sources of financing.

Equity is prevalent in the breakdown of corporate financial resources, accounting for 51% of the total, despite the high growth in corporate debt in 2007. The role of equity in current corporate financing is small (less than 5% of the total) and has declined, but as a result of value changes, which were particularly pronounced in 2007, the proportion of financial resources that it accounts for actually increased.

In 2007 only the corporate sector and the rest of the world recorded net purchases of corporate shares, while over a longer term of five years they are joined as net purchasers by the household sector. The general government sector, which has made net sales of corporate equity throughout this period, still accounts for 21% of corporate financial resources. Despite net sales by certain sectors, the rise in corporate share values means

that the value of their investments in corporates has actually increased in the last five years.

Figure 4.3: Breakdown of changes in the equity of non-financial corporations in the last five years by owner sector and type of change



Note: [1] The figures in brackets show the breakdown by owner sector at the end of the third quarter of 2007.
Source: Bank of Slovenia

Trade credits and non-residents' equity are growing in importance in the debt against the rest of the world.

The proportion of total corporate debt accounted for by the rest of the world declined again in 2007, to reach 16.3% at the end of September. With similar financing conditions at the domestic and foreign banks, corporates are increasingly opting for financing in Slovenia. Trade credits granted in the rest of the world remain high, in association with the high level of turnover with the rest of the world and the rising trend in foreign trade in goods and services. The proportion of total corporate debt accounted for by trade credits has remained at 30% in the last two years, while debt based on foreign loans raised has declined to 23%. The proportion of non-residents' equity is rising, and has reached 45%.

Change in the breakdown of corporate financial liabilities in the direction of larger numbers of loans.

In contrast to equity, the importance of loans in the breakdown of corporate financial liabilities is increasing because of their vital role in providing current corporate financing. The proportion of financial resources that they account for had approached 30% by September 2007. The trend of declining average maturity, on both loans from banks and from other creditors, is reflected in this figure being larger than in previous years. Together with trade credits, which are predominantly short-term, the proportion of corporate debt accounted for by resources with a maturity of up to 1 year exceeded 25%.

Table 4.4: Stock of corporate financial liabilities by instrument in EUR million

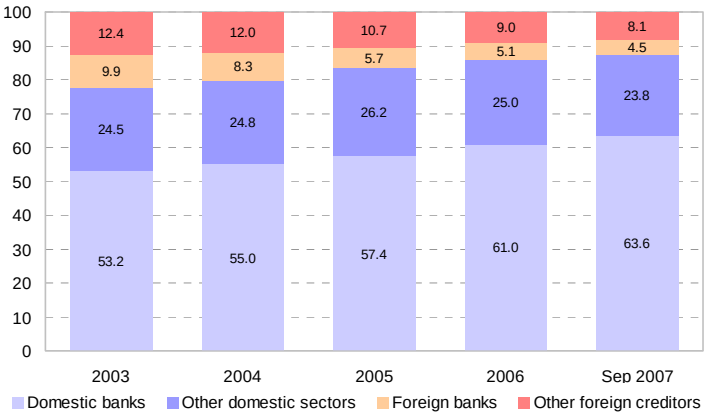
	2002	2003	2004	2005	2006	2007 [1]
	(EUR million)					
Total	47,407	52,263	56,589	62,358	71,040	86,072
Growth rate (%)	15.3	10.2	8.3	10.2	13.9	26.1
Debt[2]	11,839	13,743	15,953	18,697	21,333	26,072
Growth rate (%)	16.8	16.1	16.1	17.2	14.1	24.8
As % of GDP	52.0	55.6	59.8	66.2	70.1	79.3
	Structure of financial liabilities (%)					
Securities other than shares	0.4	0.4	0.6	0.8	0.7	0.7
Loans	24.6	25.9	27.6	29.2	29.3	29.7
Short-term	8.8	9.0	8.7	9.5	9.8	11.2
Long-term	15.8	16.9	18.9	19.6	19.5	18.5
Shares and other equity	53.8	53.4	53.2	50.1	49.9	51.0
Other accounts payable	21.1	20.3	18.6	19.9	20.1	18.6
Trade credits and advances	15.5	14.8	13.8	14.2	15.0	14.1
Other	5.7	5.4	4.9	5.7	5.0	4.6

Notes: [1] September 2007.
[2] Debt includes loans, debt securities (excluding derivatives) and insurance technical reserves, and in the Slovenian corporate sector practically consists solely of loans raised.
Source: Bank of Slovenia

The ratio of corporate debt to GDP in Slovenia is slightly below the euro area average.

Corporate debt, which is a narrower aggregate than total liabilities, rose to 79.3% of GDP in 2007, slightly below euro area debt. These had reached 87% of GDP by 2006. Corporate indebtedness varies significantly from country to country, even between those with similar levels of wealth. Thus Portuguese corporates, whose debt is equivalent to 100% of GDP, are among the most indebted in the euro area, while Greece's corporate sector is notable for the lowest debt ratio among the members of the euro area, at less than 50% of GDP.

Figure 4.4: Breakdown of Slovenian corporate debt in percentages



Source: Bank of Slovenia

Debt ratios

The most-indebted corporates are in the sectors of transport, construction and trade; they are being joined by real estate and business activities.

Further evidence of the increasing corporate indebtedness comes from the increase in the debt ratio, which shows the proportion of total corporate assets financed by long-term and short-term debts. This indicator has been rising constantly since 2004, and exceeded 55% in 2006. In the last few years the most indebted sectors have been transport,[26] trade and construction. The construction sector is showing a trend of further rises in indebtedness, while the debt ratio in the trade sector has remained at 63% in the last three years. In addition to high debt ratios, these two sectors are also notable for above-average growth in value-added in 2006 and 2007. This is particularly the case in the construction sector, which after recording growth of 15% in 2006 went on to record growth of 23% over the first nine months of 2007.

Table 4.5: Debt ratios by sector

	2001	2002	2003	2004	2005	2006
	Debt ratio – financial and operating liabilities/total assets (%)					
Agriculture, forestry, fishing and mining	26.0	28.6	32.8	37.4	40.2	41.0
Manufacturing	40.1	40.6	41.7	44.6	46.1	48.6
Electricity, gas and water, environmental remediation	34.1	34.6	32.3	32.7	33.6	36.4
Construction	63.7	66.0	68.5	70.7	71.2	72.8
Trade	58.3	60.1	60.2	63.3	63.3	63.2
Transport and storage	80.4	81.0	78.9	78.8	78.1	77.6
Hotels and restaurants	32.3	35.7	37.0	42.0	42.2	46.3
Information and communications	41.9	45.0	41.9	42.5	41.5	40.8
Business activities and real estate	37.2	38.4	40.1	42.4	46.7	51.5
Public services	43.6	46.4	40.2	48.3	48.7	50.0
Total	48.2	49.3	49.0	51.7	52.9	55.2

Note: The figures are based on book values, and differ from the figures in the financial accounts.
Sources: AJPES, own calculations

[26] Under the revised classification of sectors in 2008, the communications sector has been removed from the old category of transport and communications, and is now classed under the new sector "information and communications", while motor vehicle repair and extraction of crude petroleum are now grouped in the transport sector. Under the previous classification, transport, storage and communications was one of the less indebted sectors.

Indebtedness has also risen rapidly in the sector of real estate and business activities. The debt ratio in this sector has risen by 13 percentage points in the last four years. With the exception of companies providing financial services, the companies in this sector have above-average debt ratios of more than 60%, while at the same time the sector is recording below-average growth in value-added.

The increase in debt and shortening of its average maturity entail increased liquidity risk for corporates.

The high level of indebtedness in the aforementioned sectors entails a high risk to creditors and business partners caused by the burden of rising interest. During the expected slowdown in economic growth, servicing the debt, the main features of which are an increase in stock and a shortening of average maturity, will entail increased pressure on corporate liquidity.

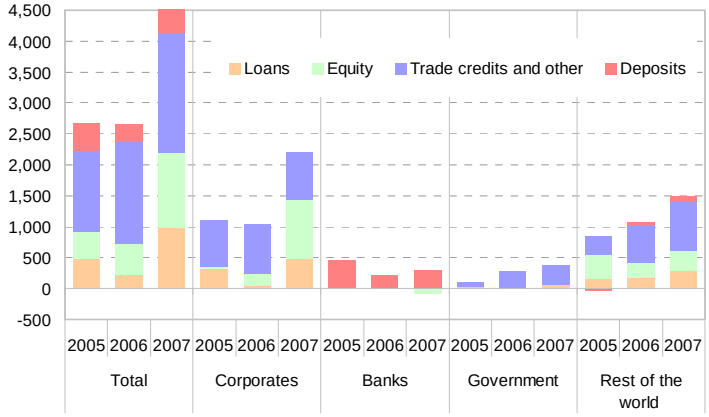
Corporate financial assets and net financial position

Corporates are increasing their financial investments within the corporate sector and in the rest of the world.

In 2007 corporates increased the stock of their current financial investments by 80% compared with the previous two years. Investments within the corporate sector recorded the largest increase, while growth in corporate investments in the rest of the world also remained stable.

The fastest growth last year (almost 140%) was recorded by investments in equity, within which investments inside the corporate sector[27] were particularly prominent. In addition to equity investments, the volume of lending between corporates via loans, primarily short-term loans, is increasing. Mutual corporate financing via trade credits is also primarily short-term, and represents the predominant form of corporate investment each year.

Figure 4.5: Flows of corporate investment by creditor sector and prevailing instrument (transactions in EUR million)



Source: Bank of Slovenia

The outward flow of investments to the rest of the world in recent years accounts for approximately one-third of all corporate investment, and has grown at rates between 30% and 60% over the last three years. The prevalent form is trade credits granted, which are intended to support the business of subsidiaries in the rest of the world and, to a greater extent, to promote exports to non-affiliates. The increase in loans to the rest of the world comes primarily from the increased financing of subsidiaries, and is thus classed as additional FDI, in the form of debt instruments.

[27] Investments in the corporate sector are equal in value terms to liabilities to the corporate sector described in the section on borrowing and sources of financing.

Table 4.6: Corporate financial assets, stock at year end in EUR million

	2002	2003	2004	2005	2006	2007 [1]
	(EUR million)					
Total	26,242	29,315	29,682	33,820	37,681	44,728
Growth rate (%)	16.0	11.7	1.3	13.9	11.4	19.9
As % of GDP	115.3	118.6	111.3	119.8	123.8	136.1
	Structure (%)					
Slovenia	85.5	84.7	83.2	81.0	79.8	79.3
Corporates	61.2	60.8	59.6	58.0	56.7	56.6
Banks	12.3	11.5	11.8	11.6	11.2	10.2
Non-monetary financial institutions	3.3	3.4	3.7	3.5	4.1	4.8
Government	4.8	4.2	4.3	4.1	4.5	4.6
Households	3.7	4.6	3.7	3.7	3.2	2.9
Rest of the world	14.5	15.3	16.8	19.0	20.2	20.7

Note: [1] September 2007.
Source: Bank of Slovenia

The increase in the outward flow of corporate financial investments to the rest of the world was reflected in stable growth in the proportion of the stock accounted for by the rest of the world. In just under four years the proportion of the stock of corporate financial assets accounted for by the rest of the world has increased by just over 5 percentage points to more than 20%. The proportion accounted for by other financial institutions is also increasing, which given the insignificant current investments is primarily the result of value changes in equity in this sector.

Deterioration in the overall net financial position, in the context of a more favourable financial position against the rest of the world.

With liabilities growing faster than assets, the net corporate financial position (financial liabilities netted against financial assets) has deteriorated further in recent years. At the end of September 2007, the net financial liabilities of the Slovenian corporate sector stood at 126% of GDP.

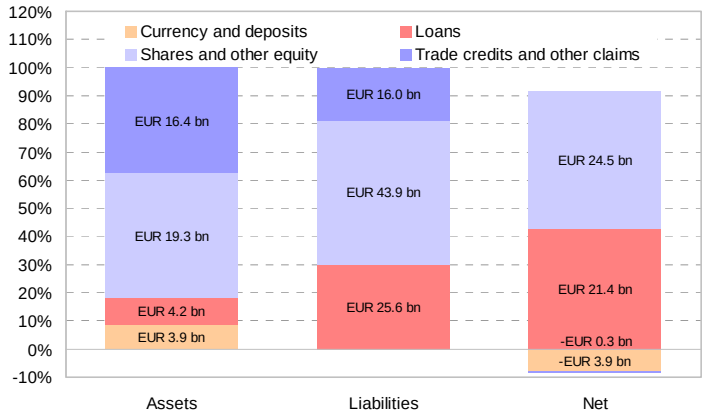
Table 4.7: Net corporate financial liabilities, stock at year end in EUR million

	2002	2003	2004	2005	2006	2007 [1]
	(EUR million)					
Total	22,027	23,233	26,895	28,546	33,358	41,344
Growth rate (%)	10.0	5.5	15.8	6.1	16.9	33.5
As % of GDP	96.8	94.0	100.8	101.1	109.6	125.8
	Structure (%)					
Slovenia	78.8	79.2	81.7	83.3	85.7	88.5
Banks	16.3	19.6	21.8	26.1	28.8	31.3
Non-monetary financial institutions	11.7	11.5	11.3	10.4	10.0	10.6
Government	24.6	22.5	23.3	21.4	21.7	22.1
Households	26.5	25.9	25.4	25.5	25.4	24.6
Rest of the world	21.2	20.8	18.3	16.7	14.3	11.5

Note: [1] September 2007.
Source: Bank of Slovenia

Corporates in the euro area record a lower net debt of 101% of GDP. Both record similar stocks of debt (just over 260% of GDP), while there are significant differences on the financial asset side: the stock is 136% of GDP in Slovenia, compared with 165% of GDP in the euro area.

Figure 4.6: Breakdown of corporate assets and liabilities by instrument in percentages and amounts in EUR billion



Source: Bank of Slovenia

The net corporate debt at banks approached 40% of GDP.

The main components of net corporate debt are net loans raised and net equity, while corporate deposits are the prevailing form of net investment. The two main factors in the sectoral breakdown of net debt are the rapid increase in debt at the domestic banks on the liability side, and the increase in investments in the rest of the world on the asset side. Both contributed to a decline in the net debt to the rest of the world, and an increase in the net debt to the domestic banks.

Table 4.8: Corporate loans and deposits at banks, stock at year end in EUR million

	Corporate borrowing at banks		Corporate deposits	Net corporate borrowing at banks		
	Corporate loans (EUR million)	(as % of GDP)	(EUR million)	(EUR million)	Ratio	(as % of GDP)
	(1)	(2)=(1)/BDP	(3)	(4)=(1-3)	(5)=(1/3)	(6)=(4)/GDP
2000	3,915.6	21.5	1,843.5	2,072.1	2.1	11.4
2001	4,870.1	23.9	2,160.5	2,709.6	2.3	13.3
2002	5,353.2	23.5	2,524.4	2,828.8	2.1	12.4
2003	6,663.6	27.0	2,585.5	4,078.1	2.6	16.5
2004	8,087.0	30.3	2,654.6	5,432.4	3.0	20.4
2005	9,907.0	35.1	3,128.1	6,778.9	3.2	24.0
2006	12,364.1	40.6	3,341.1	9,022.9	3.7	29.6
2007	16,821.2	50.0	3,660.1	13,161.0	4.6	39.1

Source: Bank of Slovenia

4.2 Interest rates and interest-rate risk for corporates

Lending rates for corporates

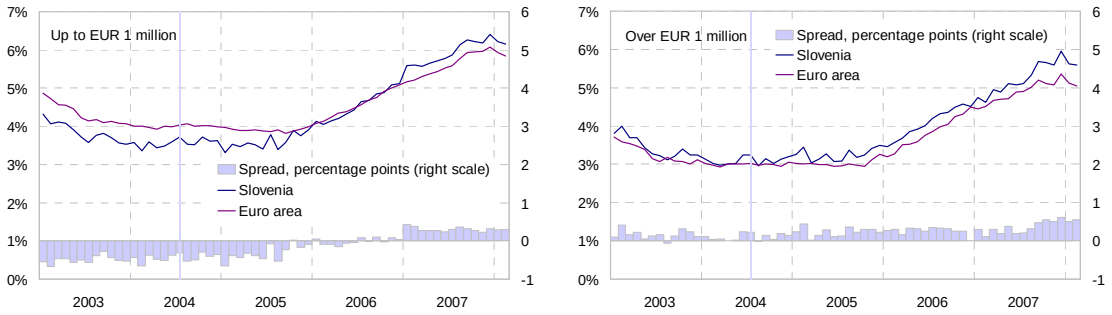
Interest rates on corporate loans were 0.3 percentage points higher on average in 2007 than those in the euro area.

In the final year of the tolar as the domestic currency, interest rates on low-value loans to corporates almost equalised with the euro area average (a spread of up to 0.9 percentage points). When the euro was introduced at the beginning of 2007, the terms on the previous, slightly more expensive tolar loans were to a certain extent transferred to new euro loans, as a result of which the average euro lending rate for corporates rose slightly. The spread of 0.3 percentage points then established with the euro area was maintained throughout 2007.

In the final quarter of 2007 interest rates on larger loans rose more than in the euro area.

Interest rates on larger loans were already 0.3 percentage points higher than in the euro area in 2006. As a result of the uncertainty on the financial markets and the resulting tighter financing conditions in the rest of the world for the domestic banks, this spread continued to increase, reaching 0.5 percentage points by September 2007.

Figure 4.7: Interest rates on loans in Slovenia and in the euro area, and spread between them in percentage points

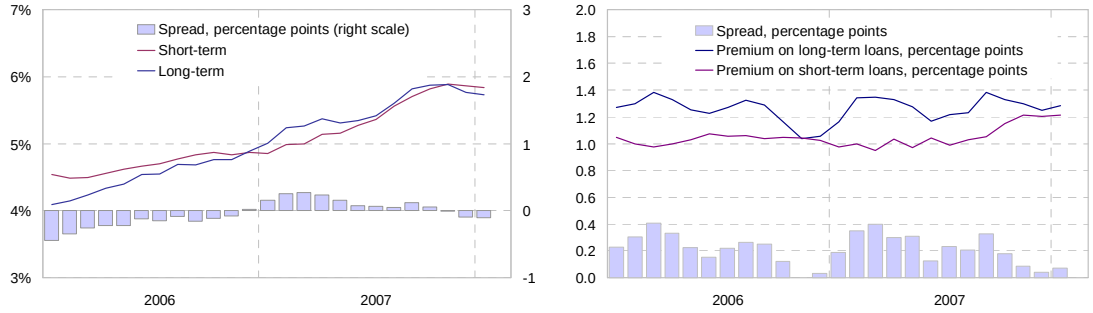


Sources: Bank of Slovenia, ECB

Larger increase in interest rates on shorter-term loans.

There was a rise in interest rates on short-term corporate loans in the second half of the year in particular. At the end of the year these interest rates were 0.4 to 0.5 percentage points higher than before the tightening of conditions on the financial markets. Interest rates on long-term loans increased by 0.3 percentage points. The premiums over the EURIBOR on short-term loans increased during this period, and reached the level of those on long-term loans. The shift towards short-term loans (from 68% of new loans in 2006, to 76% in 2007) means that these premiums entail a deterioration in corporate financing conditions.

Figure 4.8: Spreads in interest rates on corporate loans by maturity



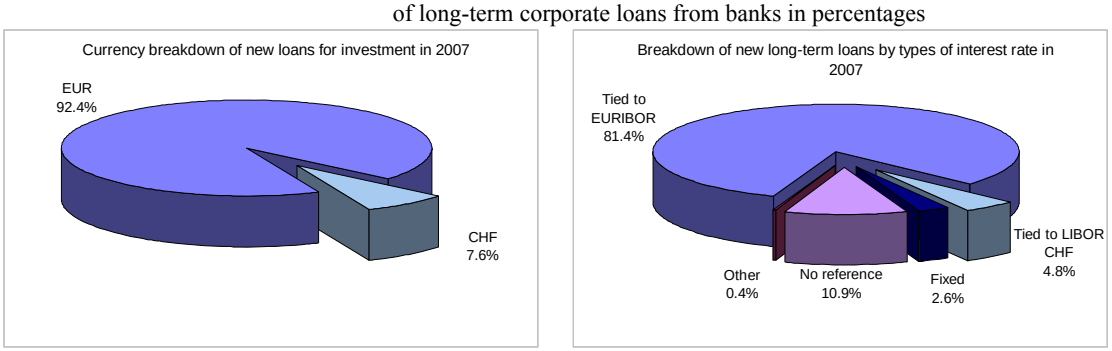
Sources: Bank of Slovenia, ECB

Interest-rate risk for corporates (proportions of fixed and variable interest rates)

The increase in the proportion of loans with a variable interest rate is increasing interest-rate risk for corporates.

Euro-denominated loans are prevalent among new long-term corporate loans, while loans with a rate tied to the EURIBOR are prevalent among these. The proportion of loans in Swiss francs also increased in 2007, by 3 percentage points to 7%. These loans are mostly tied to the Swiss franc LIBOR, and entail the assumption of exchange-rate risk by corporates in addition to interest-rate risk.

Figure 4.9: Currency breakdown (left) and breakdown by type of interest rate (right) of long-term corporate loans from banks in percentages



Source: Bank of Slovenia

There was a significant decline in the proportion of new long-term loans with a fixed interest rate,[28] from 9% in 2006 to just under 3% in 2007. There are increasingly more variable-rate loans that are not tied to any reference interest rate. The proportion exceeded 10% in 2007, and is still rising. This loan segment is exposed to interest-rate risk, as a result of the variable rate clause, while foreign currency loans are also exposed to exchange-rate risk.

The larger proportion of loans in Swiss francs is also increasing exchange-rate risk.

Table 4.9: Proportion of new corporate loans with a variable interest rate[1]

	2005 [2]	2006	2007	Q4 2007
		(%)		
Euro area	88.0	87.1	87.6	87.6
Under EUR 1 million	87.5	85.9	85.5	85.6
Over EUR 1 million	88.2	87.6	88.4	88.3
At domestic banks	95.2	97.2	99.2	99.3
Under EUR 1 million	96.0	97.3	98.1	98.2
Over EUR 1 million	94.8	97.1	99.6	99.7

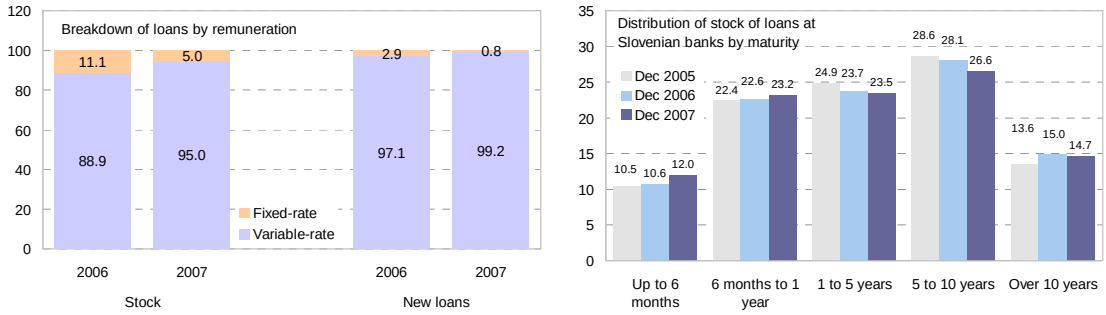
Notes: [1] For comparability with ECB methodology, variable-rate loans include loans on which the agreed interest rate is fixed for a period of less than one year (the table includes all short-term loans otherwise shown as fixed-rate loans in the separate disclosure of short-term loans).
[2] The figure for the domestic banks in 2005 relates to the final quarter.
Sources: Bank of Slovenia, ECB

A similar trend in remuneration is seen for short-term corporate loans. Having accounted for just over half of new loans in 2006, fixed-rate loans[29] accounted for less than 30% in 2007.

Fixed-rate loans are more common in corporate financing in the euro area, accounting for approximately 13% of the total in the last three years, and displaying a gentle rising trend among low-value loans. The proportion of loans from Slovenian banks with a fixed interest rate was less than 1% in 2007, with very few larger loans carrying a fixed rate.

The proportion of loans of more than 1 year with a fixed interest rate is higher in the euro area than at Slovenian banks.

Figure 4.10: Percentage breakdown of corporate loans from banks by type of interest rate (left) and maturity (right) in percentages



Source: Bank of Slovenia

Premiums over the EURIBOR on loans with regard to debtor's credit rating

The tightening of financing conditions in the final months of 2007 was felt by corporates in both a shortening of average maturity, and an increase in premiums over the EURIBOR. The premiums on short-term loans increased soon after the outbreak of financial unrest, on both high-risk and low-risk loans. On high-risk short-term loans the average premiums increased by 0.3 percentage points from the summer to reach 1.8 percentage points in the final months of 2007, and remained at this level in early 2008. There was a lesser increase in the cost of low-risk short-term loans, on which rates rose by 0.2 percentage points from the stable two-year average.

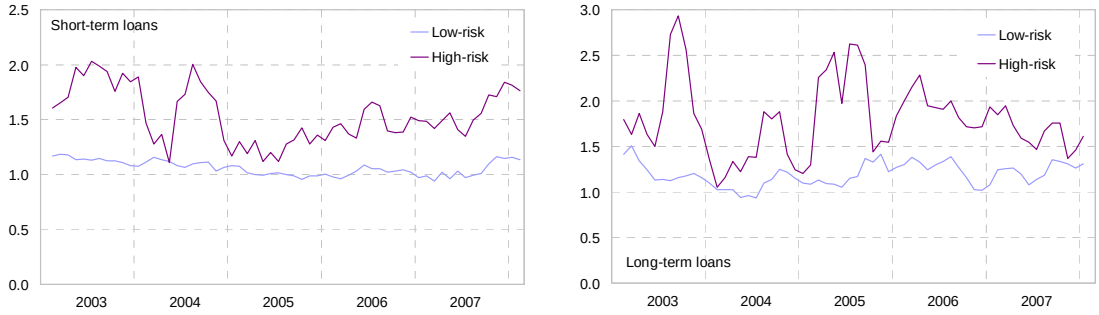
Increase in premiums over the EURIBOR on short-term loans.

[28] A fixed interest rate on long-term loans refers to an interest rate that is unchanged for at least one year after the loan agreement is concluded.
[29] A fixed interest rate on short-term loans refers to an interest rate that is unchanged for no more than one year after the loan agreement is concluded. Repricing is envisaged in a minority of these loans (less than 10% in 2007).

No significant change in premiums over the EURIBOR on long-term loans.

The average premiums over the EURIBOR on long-term low-risk loans over the year differed little from those in 2006, when the average stood at 1.2 percentage points. On high-risk[30] long-term loans, there was a discernible decline in premiums between 2006 and 2007, from an average of 1.9 percentage points to an average of 1.7 percentage points. In late 2007 and early 2008 the premiums over the EURIBOR rose again slightly.

Figure 4.11: Premiums over the EURIBOR for short-term (left) and long-term (right) euro-denominated corporate loans, by client credit rating (3-month moving average in percentage points)



Source: Bank of Slovenia

Corporate loan repayment burden

Higher corporate indebtedness and rising interest rates in 2006 were not reflected in a heavier interest burden on corporates.

With corporate borrowing increasing, primarily via financial loans, and in light of the trend of rising interest rates since the end of 2005, corporate financial expenses for interest are also increasing. High economic growth nevertheless meant that by 2006 this had not been reflected in a heavier corporate loan repayment burden. The ratio of interest paid to total income actually declined in 2006 to 0.7%.

The ratio of net paid interest to generated income remained unchanged at around 0.5% between 2004 and 2006. Corporates in the most indebted sectors of construction, transport, hotels and restaurants, and real estate and business activities also face an above-average net interest burden, but there was no increase in this burden in 2006, with the exception of the real estate sector (2.5%). According to bank surveys, the ratio of paid interest to income at corporates significantly increased from 0.5% to 0.8% in 2007, and the debt servicing burden can therefore be expected to increase in the coming years, particularly in the cooler economic climate anticipated.

Table 4.10: Indicators of corporate interest repayment burden

	2002	2003	2004	2005	2006
Ratio of interest paid to income	1.1	1.1	0.9	0.8	0.7
Ratio of net interest paid to income	0.6	0.6	0.5	0.5	0.5
Agriculture, forestry, fishing and mining	0.2	0.6	0.9	0.9	0.7
Manufacturing	0.5	0.6	0.5	0.4	0.5
Electricity, gas and water, environmental remediation	0.6	0.5	0.3	0.2	0.3
Construction	0.7	0.8	0.7	0.7	0.6
Trade	0.4	0.3	0.3	0.3	0.3
Transport and storage	0.8	1.3	0.8	0.5	0.6
Hotels and restaurants	1.5	1.3	1.1	1.1	0.8
Information and communications	1.3	1.2	1.0	0.8	0.2
Business activities and real estate	0.8	1.0	0.7	1.1	1.2
Public services	0.4	0.5	0.5	0.5	0.5
Ratio of net interest paid to net profit	27.9	22.4	17.4	16.4	13.2

Sources: AJPES, own calculations

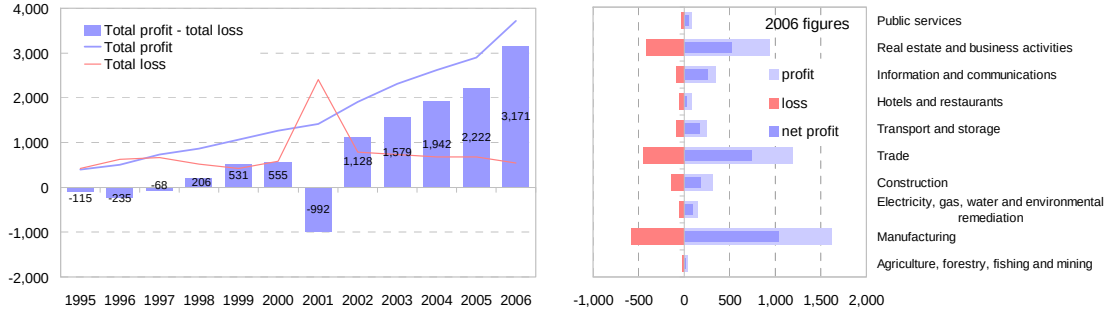
[30] Loans classified A or B by banks under the valid regulation on the assessment of the credit risk losses of banks and savings banks are classed as low-risk loans.

4.3 Corporate performance and risk by sector

Good corporate performance in 2006.

The high economic activity in 2006 was reflected in favourable corporate performance. Net profit reached EUR 3.2 billion, up 43% on the previous year. Growth in profit at corporates with positive operating results more than doubled, while loss declined at those with negative operating results. The favourable climate had a positive impact on the performance of all sectors, which was seen in growth in profit outpacing growth in loss in all sectors of the economy.[31]

Figure 4.12: Total profit and loss by year (left) and by sector (right) in EUR million



Sources: AJPES, own calculations

High growth in net profit in sectors with high growth in borrowing.

The good economic growth was supported by growing corporate borrowing. In the sectors that recorded the highest growth in net profit in 2006, there was also an above-average increase in financial and operating liabilities. This is particularly the case in the sectors of construction, where net profit was up almost 80%, and hotels and restaurants, which recorded a profit in 2006 after two years of operating at a loss. Despite above-average growth in liabilities, the hotels and restaurants sector is among the least indebted. By contrast, the information and communications sector has generated above-average growth in profit since 2003 in the context of low growth in borrowing and declining levels of indebtedness.

The three sectors with the fastest-growing financial and operating liabilities (real estate and business activities alongside the aforementioned sectors of construction and hotels and restaurants) accounted for 28.2% of the total of these liabilities, up 2.2 percentage points on the previous year. By contrast, the proportions accounted for by manufacturing and trade, which account for 45% of financial and operating liabilities, have actually declined slightly in recent years.

Table 4.11: Corporate financial and operating liabilities by sector in percentages

					Growth rate (%)			
	2003	2004	2005	2006	2003	2004	2005	2006
Corporate financial and operating liabilities (EUR million)	26,687.3	30,890.9	35,788.3	40,662.2	9.1	15.8	15.9	13.6
	Structure (%)							
Agriculture, forestry, fishing and mining	1.1	1.2	1.1	0.9	19.6	21.8	9.2	-5.7
Manufacturing	25.1	23.8	23.8	23.8	17.7	9.4	15.8	14.0
Electricity, gas and water, environmental remediation	6.7	6.0	5.6	5.4	-4.1	4.7	7.1	9.4
Construction	7.0	7.4	7.6	8.5	19.6	23.4	18.1	27.9
Trade	22.0	22.8	22.3	21.2	9.5	20.2	13.4	7.8
Transport and storage	17.9	17.5	16.4	15.8	-4.4	13.4	8.3	10.1
Hotels and restaurants	1.9	2.1	1.9	2.0	9.8	29.8	3.3	22.5
Information and communications	4.3	4.2	3.7	3.4	-5.5	11.8	3.8	2.8
Business activities and real estate	12.8	13.8	16.5	17.7	22.6	24.7	38.4	21.8
Public services	1.3	1.2	1.2	1.2	18.4	11.2	14.3	17.6
Total	100.0	100.0	100.0	100.0	9.1	15.8	15.9	13.6

Sources: AJPES, own calculations

[31] The sole exception was public services, where net profit declined by one-quarter in 2006 after growing at 10% in 2005.

Corporate liquidity continued to deteriorate in 2006.

In the last four years, and particularly in the last two years, short-term corporate liabilities have grown faster than short-term claims, which has resulted in a decline in liquidity ratios. The coverage of short-term liabilities by short-term claims declined further by just over 2 percentage points in 2006 to 77.4%.

Table 4.12: Maturity breakdown of financial and operating claims and liabilities in percentages

	2002	2003	2004	2005	2006
	Structure (%)				
Financial and operating claims					
Long-term	38.9	42.2	40.3	42.8	39.5
Short-term	61.1	57.8	59.7	57.2	60.5
Financial and operating liabilities					
Long-term	42.2	40.8	41.8	41.5	41.2
Short-term	57.8	59.2	58.2	58.5	58.8
	Ratio of claims to liabilities (%)				
Total	78.0	84.1	79.7	81.2	75.1
Long-term	71.9	87.1	76.8	83.7	71.9
Short-term	82.4	81.9	81.8	79.5	77.4

Sources: AJPES, own calculations

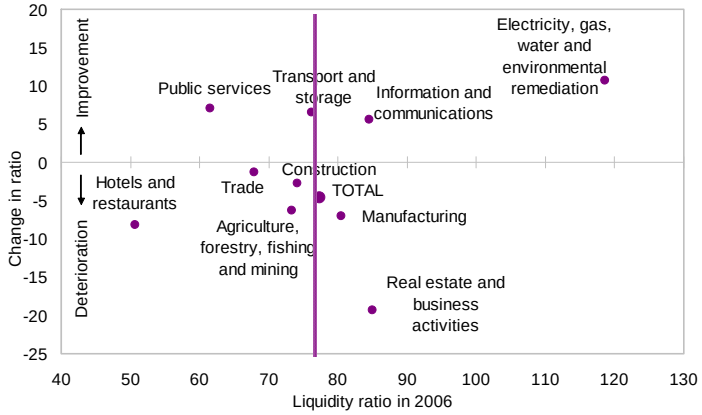
Risk indicators by sector

Liquidity ratio: current liquidity was lower than three years ago in the majority of sectors.

Only corporates in the sector of electricity, gas and water supply disclose full coverage of short-term liabilities by short-term claims, with a liquidity ratio of just under 120%. There was a sharp decline in liquidity in the transport and storage sector in 2006, but it was nevertheless close to the average, and was higher than it had been three years earlier. Corporates in the hotels and restaurants sector recorded a slight improvement in the low liquidity ratio (51%) after three years of decline.

There has been a significant decline in liquidity at corporates in the sector of real estate and business activities in the last two years. The real estate segment is notable within this sector for its below-average current liquidity ratio (62%) and the decline of 25 percentage points in the last three years.

Figure 4.13: Liquidity ratios by sector and change in percentage points in the last three years



Sources: AJPES, own calculations

Financial leverage: financial and operating liabilities exceeded corporate equity by one-third.

The rapid growth in corporate debt financing saw corporate financial leverage deteriorate further in 2006 to 133%. The highest level and largest increase in recent years was recorded by corporates in the construction sector, where financial and operating liabilities are 3.3 times in excess of equity. Corporates in the transport and storage sector are also notable for a comparably high level, albeit with a declining trend. Financial leverage is also high in the trade sector, and is higher than the level of three years earlier in all sectors other than information and communications.

In two of the three sectors with the highest financial leverage, namely trade and transport, financial leverage has remained stable over the last two years, or has even declined. In addition to the construction sector, average financial leverage is also being increased in smaller sectors such as hotels and restaurants, and real estate and business activities. Because these sectors are sensitive to changes in the economic climate, they are more exposed to risk than other sectors when a slowdown in economic growth is forecast.

Table 4.13: Financial leverage by sector in percentages

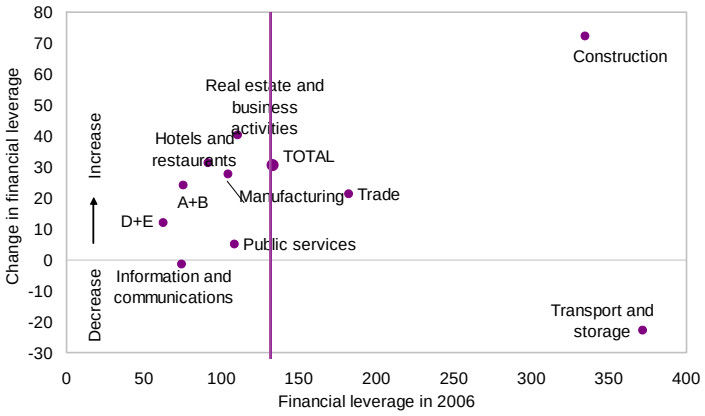
	2001	2002	2003	2004	2005	2006
	Financial leverage: financial and operating liabilities/capital (%)					
Agriculture, forestry, fishing and mining	37.0	41.6	51.0	62.0	70.0	75.0
Manufacturing	72.7	73.6	76.7	86.7	91.5	104.3
Electricity, gas and water, environmental remediation	56.3	55.9	50.3	51.4	54.0	62.2
Construction	206.0	238.5	262.3	307.6	300.7	334.7
Trade	150.9	162.1	160.5	182.3	182.4	181.8
Transport and storage	428.5	447.6	394.4	388.5	369.5	371.7
Hotels and restaurants	49.2	56.9	59.7	74.0	76.0	91.1
Information and communications	75.6	86.1	75.4	77.2	74.5	74.1
Business activities and real estate	62.9	65.7	70.3	77.0	91.2	110.5
Public services	82.5	92.3	103.2	100.7	100.5	108.2
Total	100.2	104.1	102.6	113.9	119.3	133.2

Sources: AJPES, own calculations

The most indebted sectors borrow primarily at domestic creditors.

Corporates in the most indebted sectors are primarily borrowing from the domestic banks. Corporates in the trade sector record a larger proportion of financing in the rest of the world. However trade is financed in the rest of the world almost entirely via short-term loans, which generally do not increase the stock of debt to the rest of the world. The rest of the world accounts for around 20% of the stock of financial and operating liabilities in the sectors of trade and transport, but less than 6% in the most indebted sector of construction, with a declining trend. Thus domestic creditors are more exposed to the total debt in these sectors than the rest of the world, primarily banks and the corporate sector via interacting commercial and financial links.

Figure 4.14: Financial leverage by sector and change in the last three years



Note: A+B: agriculture, forestry, fishing and mining; D+E: electricity, gas and water supply, environmental remediation.
Sources: AJPES, own calculations

Arrears in bank repayments are more common at corporates in more-indebted sectors.

High corporate indebtedness and deteriorations in liquidity are also reflected in a failure to settle due liabilities on time. Sectors that are defined as high-risk on the basis of the aforementioned indicators (construction, trade, transport, and hotels and restaurants) are also notable for the proportion of corporates with arrears in payments at banks. There is also an above-average proportion of corporates in arrears in the manufacturing sector, while the highest figure is recorded by the agriculture, forestry, fishing and mining.

Trade, hotels and restaurants, construction and manufacturing are also notable for the proportion of classified assets at banks that are more than 90 days overdue. Exposures to

non-financial corporations that are more than 90 days overdue represent on average 2.2% of total classified claims against this sector.

Table 4.14: Number of days past due for payments at banks as at the end of 2007

	Number of corporates in arrears	Proportion of corporates in arrears in the total number of corporates at banks			Proportion of classified claims of corporates in arrears in bank's portfolio		
			Of these: a delay of			Of these: a delay of	
		Total	30-90 days	over 90 days	Total	30-90 days	over 90 days
Agriculture, forestry, fishing and mining	52	16.0	1.2	11.7	15.4	0.5	5.2
Manufacturing	553	9.9	1.4	6.3	7.2	2.2	2.7
Electricity, gas and water, environmental remediation	7	1.9	0.5	0.8	6.2	0.1	0.3
Construction	312	9.9	1.4	5.4	8.5	1.7	1.4
Trade	750	9.2	1.2	6.0	9.3	0.7	3.7
Transport and storage	166	11.7	1.7	6.6	2.4	0.7	0.6
Hotels and restaurants	142	13.8	2.3	8.9	6.1	1.1	2.9
Information and communications	73	5.4	0.6	3.7	2.1	0.2	1.0
Business activities and real estate	435	7.2	0.7	4.5	3.6	0.7	1.4
Public services	66	5.7	2.0	2.5	4.3	1.1	0.8
Total	2,559	8.9	1.2	5.6	6.4	1.2	2.2

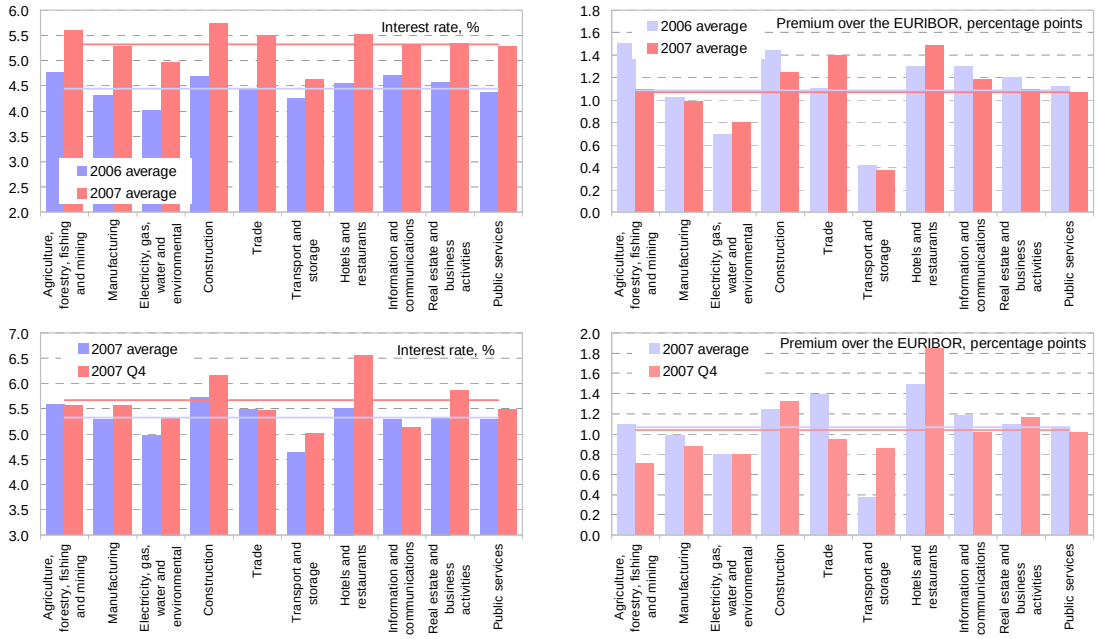
Sources: Bank of Slovenia

Premiums over the EURIBOR at banks by sector

Differing rises in interest rates in 2007 in different sectors.

As a result of the general rise in interest rates, interest rates on long-term corporate loans at the domestic banks rose by 0.9 percentage points on average in 2007. The rise in the final quarter was 0.3 percentage points over the average for the year. The other premiums over the EURIBOR were almost unchanged overall during the year, rising by just 0.03 percentage points in the final quarter.

Figure 4.15: Overall interest rate (left) and premiums over the EURIBOR (right) on long-term bank loans, by sector in percentages



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

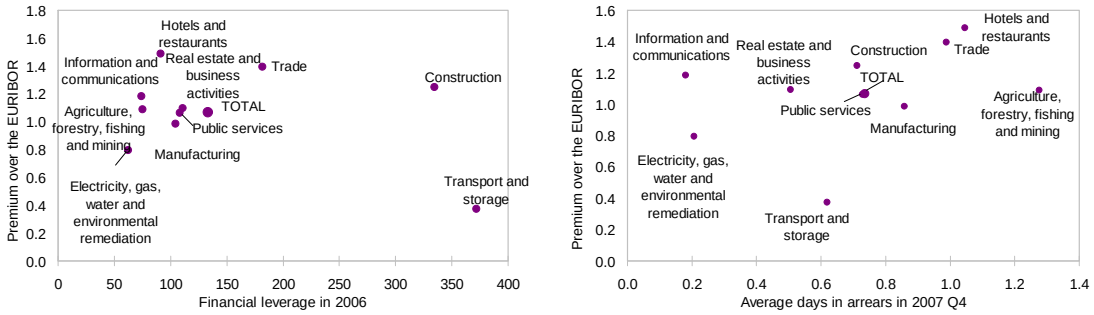
Premiums over the EURIBOR are highest in the sectors of hotels and restaurants, trade and construction.

Interest rates on new corporate loans at the domestic banks vary from sector to sector. The interest rate variation between corporates in different sectors is evidenced in the different premiums over the EURIBOR, which in 2007 were above-average in the sectors of

construction, trade, and hotels and restaurants.[32] The premium over the EURIBOR for corporates in the trade sector was 0.3 percentage points higher on average last year than in 2006, despite a decline in the final quarter.

There are numerous factors in the setting of the interest rate on an individual loan, as a result of which the level and range of average interest rates can fluctuate considerably from period to period. A certain impact on the level of actual or realised lending rates from corporate financial indicators can nevertheless be discerned from the available data.

Figure 4.16: Average premium over the EURIBOR on new bank loans to corporates in 2007 in relation to corporate financial indicators by sector



Source: Bank of Slovenia

Corporate indebtedness and liquidity also have an impact on the risk premium.

Corporates in sectors in which the indicators of indebtedness and/or current liquidity deviate from the average in the direction of higher risk face higher premiums over the EURIBOR at banks compared with sectors classed as less risky according to these indicators.

Premiums over the EURIBOR were prominently high on loans to corporates in the hotels and restaurants sector, which disclosed low liquidity ratios and above-average arrears in the repayment of bank debts. There was no significant change during the last two years in the premiums for corporates in the construction sector, which according to all the illustrated indicators is a high-risk sector (they were slightly above average throughout this period); in the final quarter they increased slightly to reach 1.3 percentage points. Banks also charged above-average premiums in 2007 to corporates in the trade sector, which is one of the first three sectors in terms of all the financial indicators.

Table 4.15: Financial performance indicators by sector, and premiums over the EURIBOR on new loans at domestic banks

	Debt ratio	Financial leverage	Liquidity ratio	Average number of days in arrears	Overall rank	Premium over EURIBOR	Rank
	2006	2006	2006	Dec 2007		2007	
Agriculture, forestry, fishing and mining	41.0	75.0	73.3	62.2	4	1.1	5
Manufacturing	48.6	104.3	80.5	36.9	4	1.0	3
Electricity, gas and water, environmental remediation	36.4	62.2	118.6	7.1	1	0.8	2
Construction	72.8	334.7	74.1	14.7	9	1.2	8
Trade	63.2	181.8	67.8	27.8	10	1.4	9
Transport and storage	77.6	371.7	76.1	4.5	7	0.4	1
Hotels and restaurants	46.3	91.1	50.7	33.5	7	1.5	10
Information and communications	40.8	74.1	84.5	5.0	2	1.2	7
Business activities and real estate	51.5	110.5	85.0	16.9	3	1.1	6
Public services	50.0	108.2	61.5	5.9	6	1.1	4
Total	55.2	133.2	77.4	23.2		1.1	

Note: For the liquidity ratio, a higher ratio represents better liquidity, while for all the other indicators a higher value is less favourable. The overall ranking is calculated from the individual rankings for each indicator, where a higher ranking indicates higher risk. The premiums refer to those on long-term loans tied to the EURIBOR.

Sources: AJPES, Bank of Slovenia, own calculations

[32] The main factor in the low premiums in the transport sector was individual extremely large loans with a low interest rate.

4.4 Corporate position against the rest of the world

The net corporate debt position against the rest of the world is stable.

In the last three years corporates have disclosed an unchanged net financial position against the rest of the world in the amount of debt of EUR 4.8 billion. In the background of this stable position, which is declining each year as a proportion of GDP, corporate transactions with the rest of the world have been increasing, on both the liability and investment sides.

Rapid increase in trade credits from the rest of the world.

Financial transactions with the rest of the world on the liability side approached EUR 1 billion during the first nine months of last year. Just over one-third of this flow comprised equity investments in Slovenian corporates by non-residents, which have totalled between EUR 300 million and EUR 400 million each year over the last four years. The fastest-growing source of corporate financing in the rest of the world is trade credits received, which accounted for approximately one-third of the stock of total liabilities to the rest of the world.

Table 4.16: Corporate financing from the rest of the world, transactions and stock in EUR million and in percentages

	Financial flows from the rest of the world					Stock at the end of the period				
	2003	2004	2005	2006	2007 [1]	2003	2004	2005	2006	2007 [1]
Total (EUR million)	573	731	557	932	969	9,249	9,921	11,183	12,367	14,028
Growth rate (%)	-59.3	27.5	-23.9	67.4	42.9	11.6	7.3	12.7	10.6	16.2
					Structure (%)					
Securities other than shares	-2.5	-2.4	1.0	1.1	-1.2	0.3	0.1	0.1	0.2	0.1
Loans	64.8	24.2	-28.7	18.2	25.8	32.9	32.4	27.3	24.1	23.4
Equity	22.5	55.0	74.1	32.9	34.7	43.3	43.8	44.4	44.4	45.2
Trade credits and other	15.2	23.3	53.6	47.7	40.8	23.6	23.7	28.1	31.3	31.3

Note: [1] Figures to September 2007.
Source: Bank of Slovenia

Slovenian corporates have been net financers of the rest of the world since 2005.

Corporate financial investments in the rest of the world have exceeded borrowing in the rest of the world in each year since 2005. The stock of investments in the rest of the world increased by almost 86% between 2005 and 2007, compared with an increase of 41% in the stock of liabilities. The main factor in investments exceeding debt was trade credits granted to the rest of the world, which accounted for more than half of all corporate investments in the rest of the world, and approximately 60% of the stock. Loans granted have also exceeded loans raised vis-à-vis the rest of the world since 2005, partly as a result of the trend of declining corporate borrowing in the rest of the world, and also partly as a result of more active financing of the rest of the world by Slovenian corporates.

Table 4.17: Corporate financial investments in the rest of the world, transactions and stock in EUR million and in percentages

	Asset flows from the rest of the world					Stock at the end of the period				
	2003	2004	2005	2006	2007 [1]	2003	2004	2005	2006	2007 [1]
Total (EUR million)	679	502	800	1,075	1,524	4,473	4,996	6,421	7,611	9,276
Growth rate (%)	5.8	-26.1	59.4	34.3	53.2	17.7	11.7	28.5	18.5	21.9
					Structure (%)					
Securities other than shares	-0.3	4.3	0.2	0.3	1.8	0.3	0.7	0.6	0.5	0.7
Loans	17.4	-13.5	21.9	17.2	19.9	10.5	8.0	9.0	7.6	10.1
Equity	32.5	38.3	45.6	21.1	19.8	23.5	26.2	33.6	28.5	29.3
Trade credits and other	44.1	65.2	37.1	57.6	52.4	64.2	63.1	55.8	62.0	58.1

Note: [1] Figures to September 2007.
Source: Bank of Slovenia

Corporates are financing their subsidiaries and parent companies in the rest of the world via loans.

The corporate sector primarily uses loans to finance its subsidiaries in the rest of the world. Two-thirds of loans in 2007 were directed towards subsidiaries, particularly in the former Yugoslavia. In addition to lending to their own subsidiaries established in the rest of the world, Slovenian corporates also make loans to their parent companies in the rest of the world, particularly in the European Union, in some years even exceeding the amounts received in return in loans.

Table 4.18: Percentage breakdown[1] of loans to and from the rest of the world with regard to ownership links

	Loans from the rest of the world				Loans to the rest of the world			
	From parent companies	From subsidiaries	From non-affiliates	Total	To parent companies	To subsidiaries	To non-affiliates	Total
2005	-1.5	9.4	-107.9	-100.0	59.6	11.2	29.2	100.0
2006	50.6	-5.5	54.9	100.0	-57.6	37.7	119.8	100.0
2007	26.8	13.5	59.6	100.0	28.4	67.4	4.2	100.0
	From EU countries	From ex-YU countries	From other countries	Total	To EU countries	To ex-YU countries	To other countries	Total
2005	101.5	-0.3	-1.2	100.0	59.1	9.0	31.9	100.0
2006	5.0	-0.3	95.4	100.0	17.9	90.8	-8.7	100.0
2007	6.4	-0.1	93.8	100.0	56.6	38.6	4.8	100.0

Note: [1] A negative sign signifies net repayment of loans.
Source: Bank of Slovenia

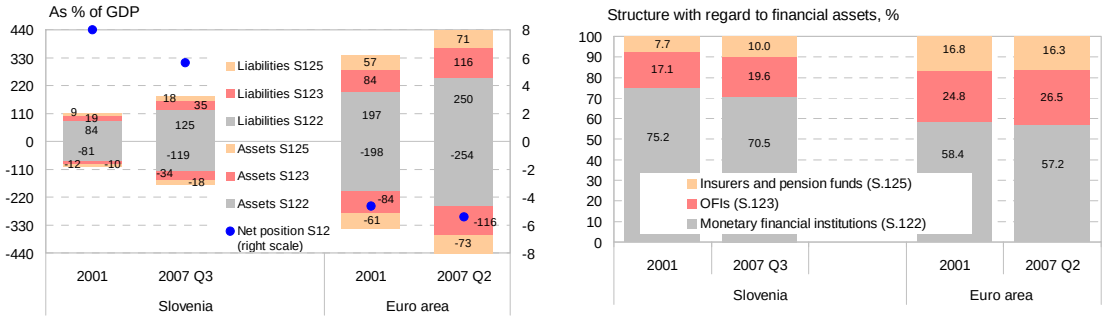
5 THE SLOVENIAN FINANCIAL SYSTEM

5.1 Structure of the Slovenian financial system

The Slovenian financial system achieves only 40% of the depth of the euro area financial system.

The Slovenian financial system (excluding the central bank) had financial assets of 177% of GDP at the end of the third quarter of 2007, or 40% of the depth of the financial system of the euro area (source: financial accounts). Compared with the euro area, the Slovenian financial system is still rather weak, and is only slowly catching up with the depth of the euro area; the contributing factors include the lower level of wealth, that Slovenia's institutionalised capital market has barely 15 years of experience, and that the notable development of institutional investors has only recently begun. The ratio of financial assets to GDP in Slovenia increased by 18 percentage points over the first three quarters of 2007, having increased by almost the same amount over the first two quarters in the euro area.

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



Note: Excludes the central bank. S.122: Other monetary financial institutions (includes commercial banks and savings banks); S.123: Other financial intermediaries, except insurers and pension funds (includes investment funds and leasing companies); S.125: Insurers and pension funds; Net position S.12 (difference between the financial assets and liabilities of the entire financial sector).
Sources: Bank of Slovenia, ECB, Eurostat, SORS

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

	Assets (EUR million)		Structure (%)		% of GDP		No. of inst.	
	2006	2007	2006	2007	2006	2007	2006	2007
Monetary financial institutions[1]	34,080	42,450	72.3	73.2	111.9	126.6	25	27
Non-monetary financial inst.	13,044	15,508	27.7	26.8	42.8	46.2		
Insurers[2]	3,895	4,959	8.3	8.6	12.8	14.8	15	16
Pension companies/funds	893	1,001	1.9	1.7	2.9	3.0	11	10
Investment funds	2,845	4,138	6.0	7.1	9.3	12.3	106	116
Leasing companies	4,041	4,041	8.6	7.0	13.3	12.0	20	20
BHs, MCs, others[3]	1,370	1,370	2.9	2.4	4.5	4.1	-	-
Total	47,123	57,958	100.0	100.0	154.8	172.8		

Note: The figures for financial institutions other than banks, insurers, pension funds and pension and investment funds have been obtained from the AJPES database of closing accounts on the basis of the SKD 2008 code.
[1] Excludes the central bank.
[2] The total assets figure relates to the end of the third quarter of 2007.
[3] The total assets figures are for the end of 2006 only.
Sources: Bank of Slovenia, ISA, SMA, SLA, AJPES

The banking sector is still predominant in the financial sector, accounting for 70% of the financial assets.

The result of the weaker development of the domestic financial system can be a larger outflow of funds saved domestically to the rest of the world, and thus less money available domestically for investment, which entails greater demand for foreign resources on the part of the domestic economy. In terms of financial assets, (excluding the central bank) the banking sector is still predominant in the Slovenian financial system,

accounting for 70% of the total, while the corresponding figure in the euro area is 13 percentage points lower. In the euro area other financial intermediaries (investment funds, leasing companies) and the insurance sector (including pension funds) both account for a significantly larger proportion of the financial sector than in Slovenia, which is still a very bank-oriented economy. Despite their increasing role, institutional investors are only slowly gaining importance in the optimisation of the structure of financial assets and savings.

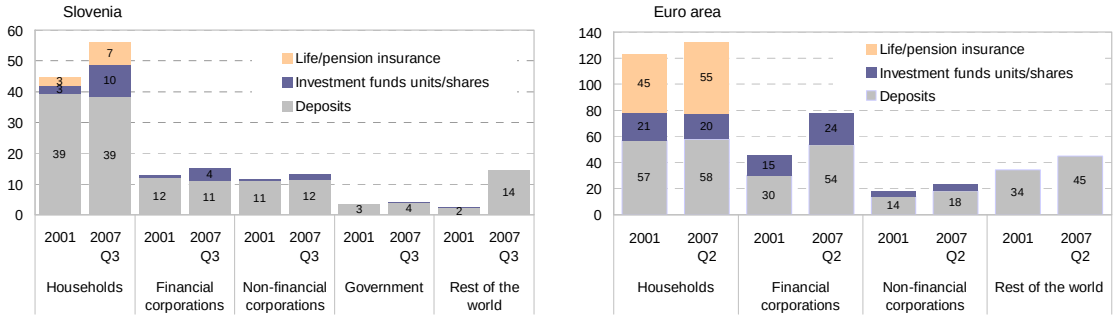
The actions of the various types of financial institution are not directly comparable, as the ranges of financial instruments that they offer are aimed at different client profiles, on both the investor side and the borrower side. In addition, the banking sector has other important duties, such as ensuring the functioning of the payments system. The use of total assets as an indicator of comparability is therefore not always the most appropriate option.

Comparison of financial institutions in terms of intermediation of savings

Households continue to assume financial risks.

In recent years Slovenian financial institutions have transferred more and more financial risk to savers. In the case of investment funds, households have assumed the market risks in full. Households also bear the risk in life insurance with investment risk, which accounts for an increasing proportion of collected life insurance premium. Ideas of establishing defined-contribution pension plans without clear definition of future benefits are appearing, which again entails the transfer of risks to households and, not least, the majority of loans approved for households being tied to a variable interest rate. Here there remains the question of households' awareness of the size and diversity of the financial risks to which they are exposed via investments in financial instruments. The demand for higher national saving and the comparison with the euro area indicate that the trend of an increase in the importance of non-monetary financial intermediaries will continue, which is associated with the further transfer of risks to households. There is thus a need to provide additional financial education for Slovenian households, which are less experienced because of the short history of the market economy in Slovenia. This is reflected in part by excessively risky financial decisions, and conversely by excessively conservative decisions. Here the question is raised of whether financial institutions are aware of the overall risks concentrated with individuals.

Figure 5.2: Value of certain financial instruments owned by individual sectors as a percentage of GDP in Slovenia (left) and the euro area (right)



Note: Excludes the central bank.
Sources: Bank of Slovenia, ECB, Eurostat, SORS

The role of non-monetary financial intermediaries is increasing for Slovenian households.

The household sector primarily makes use of financial intermediation to invest its savings in the form of bank deposits, investment fund shares or units, and life insurance and pension insurance. There is considerable exploitation of these services within the financial sector in the euro area. In Slovenia the total assets from intermediation stood at 103% of GDP (up 28 percentage points on 2001), significantly less than the euro area figure of 278% of GDP (up 57 percentage points on 2001), which indicates the low depth of financial intermediation in the Slovenian financial system.[33] The role of non-monetary intermediaries is significantly less important to households in Slovenia, where they account for just under one-third of assets from intermediation, than those in the euro area, where the figure is 56%. There has been a pronounced trend of their increasing

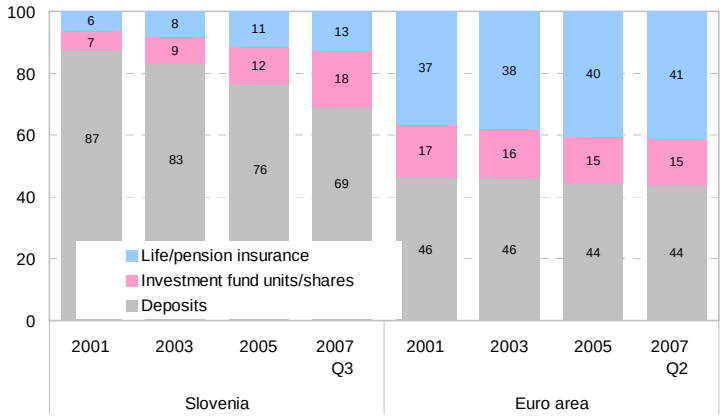
[33] Assets from intermediation are defined with regard to the financial instrument, and include bank deposits, life insurance and pension insurance provisions, and investment fund units and shares. They are defined as in the ECB's Report on Financial Structures, 2002.

importance since 2001, which is also the result of favourable conditions on the capital markets, and a more aggressive approach by institutional investors to promoting their saving products. Ignoring transferable deposits (sight deposits), the proportion of Slovenian households' assets from intermediation accounted for by deposits has fallen by 25 percentage points since 2001, reaching 56% at the end of the third quarter of 2007.

Institutional investors should focus more on long-term saving by households for old age.

Compared with the euro area, the asset structure of Slovenian households is short of long-term life insurance and pension insurance. Given the rising old-age dependency ratio,[34] which by 2007 had reached 0.227 in Slovenia (compared with 0.185 ten years earlier), households could be expected to show greater readiness for saving for old age. Life insurance and pension insurance can be expected to gain in importance in Slovenia, owing to the deepening of financial intermediation and increased saving for old age, and also to a certain extent because of the reallocation of financial assets. The strengthening of saving for old age depends strongly on when the necessary changes in pension insurance, which must be better tailored to age groups and saver profiles, will be introduced.

Figure 5.3: Breakdown of households' financial assets from intermediation in Slovenia and the euro area in percentages



Sources: Bank of Slovenia, ECB

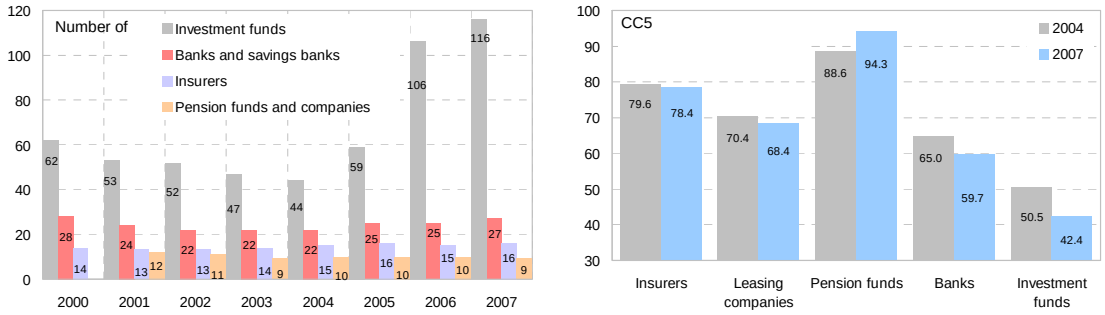
Market concentration in the financial sector

Competition remains strongest among investment funds.

Despite the increase in the number of new financial service providers, market concentration within individual financial institutions remains high. Competition is strongest in the investment fund segment, where the top five now account for just over 42% of the total assets. Investment funds are also feeling fierce competition from the foreign funds officially marketed in Slovenia. A decline in concentration can also be seen within the banking sector and the leasing companies sector. With the conversion of one of the pension companies into an insurer, concentration declined in the insurance sector, but increased in the pension companies sector. The necessary further reforms of the pension system could bring an increase in competition in this segment, which could result in greater collected assets from long-term pension insurance. In general it can be said that an increase in competition within the individual types of financial institution and between them is expected in the future.

[34] The old-age dependency ratio is the ratio of the total number of people past working age (over 65) to the number of people in the workforce (between 15 and 64). Source: Eurostat.

Figure 5.4: Number of financial institutions of different type (left), and market concentration of the five largest (CC5; right in percentages)



Note: The CC5 index is calculated in terms of total assets, with the exception of leasing companies, for which it is calculated in terms of volume of transactions concluded. Insurers include reinsurance companies, whose total assets relate to the end of the third quarter of 2007. Pension funds do not include the First Pension Fund, as this is a closed fund that does not envisage any more contributions.
Source: Bank of Slovenia, ISA, SMA, SLA

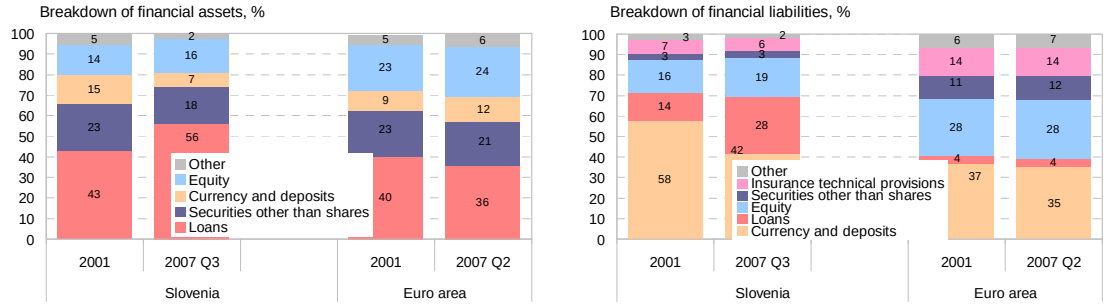
Comparison of the structure of the financial sector's financial assets and liabilities with the euro area

Loans are prevalent in the structure of Slovenian financial corporations' assets.

The structure of the assets and liabilities of the Slovenian financial system differs significantly from that of the euro area. Despite already being significantly higher than in the euro area, the proportion accounted for by loans in Slovenia increased further over the first three quarters of 2007 to 56%. The reason that banks have a larger role in the Slovenian financial system than in the euro area, and the high demand for loans, is connected to the investment activity over the last two years. The euro area financial sector has a significantly larger proportion of equity and debt capital than Slovenia, where the proportion of assets accounted for by debt securities declined by a further 4 percentage points in 2007. A decline in debt capital was seen in the financial sectors of both the euro area and Slovenia, as a result of the high values on capital markets, and the associated increase in the proportion accounted for by equity. In 2007 the Slovenian banking sector also reduced its investments in bonds as a result of the maturing of Bank of Slovenia bills, and the redemption of domestic government securities, which to a certain extent were replaced with purchases of foreign government securities.

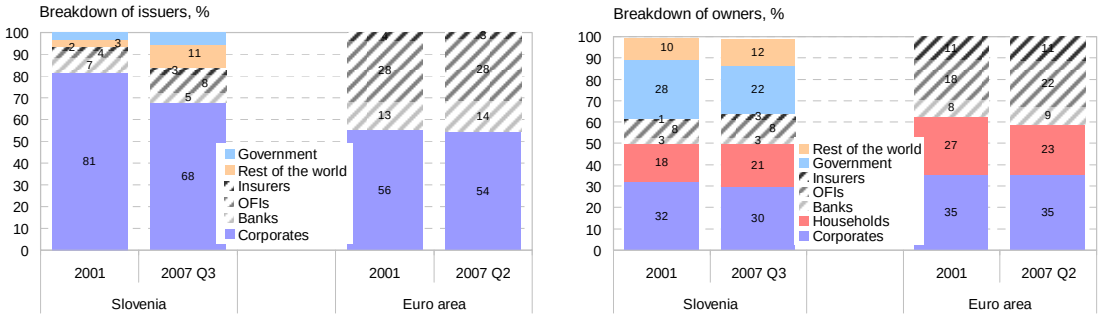
The low proportion of the Slovenian financial sector's assets accounted for by equity is an indication of the lack of cross-ownership within the financial system, and also of its lack of ownership of the non-financial sector. The Slovenian financial system holds just 14% of total issued equity, compared with the 42% held by the euro area financial system. From this it can be concluded that it is the financial sector in particular that should be interested in acquiring the government-owned holdings in Slovenian corporates.

Figure 5.5: Breakdown of the financial sector's financial assets (left) and liabilities (right) in percentages



Note: Excludes the central bank.
Sources: Bank of Slovenia, ECB

Figure 5.6: Breakdown of equity issuers (left) and owners (right) in percentages



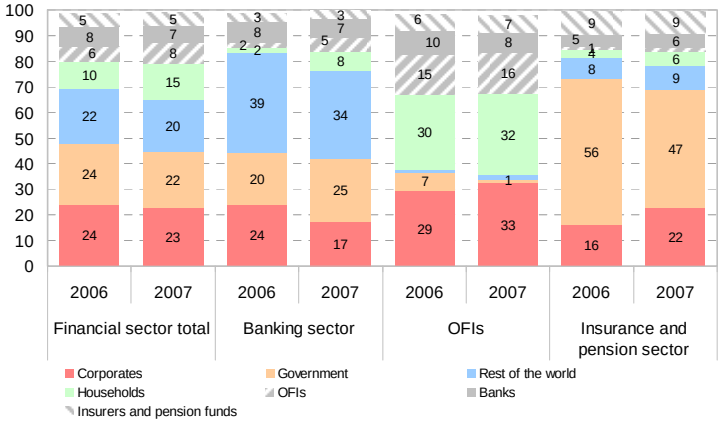
Note: This is the F.5 instrument (shares and other equity) according to the ESA95 definition, which in addition to issued share capital also includes units in investment funds and ownership in other corporate forms such as limited liability companies and unlimited partnerships. At the end of September 2007, issued share capital (irrespective of whether listed on the stock exchange) accounted for just over 60% of total equity. The euro area figures exclude the rest of the world and the general government sector.
Sources: Bank of Slovenia, ECB

Structure of the financial system's financial liabilities.

On the liability side, the Slovenian financial system has a significantly larger proportion of loans than the euro area, again because of the larger role played by the banking sector in the Slovenian financial system, and its recent financing via foreign loans. The increasing importance of non-monetary financial intermediaries means that the proportion accounted for by deposits is declining. There has also been a notable decline in the proportion accounted for by equity and debt capital. Like non-financial corporations, financial corporations in Slovenia do not make sufficient use of the possibility of raising assets via bond issues or capital increases. In Slovenia financial corporations account for just 16% of total issued equity on the issuer side, compared with 45% in the euro area. The high figure in the euro area is partly the result of the larger role of investment funds.

Capital links in the financial sector

Figure 5.7: Ownership structure of financial sectors in percentages



Note: Includes direct ownership only.
Sources: CSCC, own calculations

Cross-ownership between financial institutions is still low at 20%.

The level of cross-ownership between domestic financial institutions is still low, at 20%.[35] As a result of the sale of the 49% government holding in Nova kreditna banka Maribor (NKBM) at the end of 2007, the proportion of the banking sector owned by investment funds and households increased (by a total of 9 percentage points). However there was no decline in the proportion owned by the general government sector, as a result of the changeover from book valuation to market valuation of NKBM shares after December's listing on the stock exchange. An increase in the general government sector's ownership of the banking sector came from the Slovenska razvojna in izvozna banka,

[35] The banking sector accounts for the predominant proportion (52%) of the financial sector's total issued share capital (excluding the central bank), followed by other financial intermediaries with 28%, and insurers and pension funds with 18%.

which was created from the Slovene Export Corporation, and is under majority government ownership. In 2007 the general government sector reduced its ownership of the insurance sector by 10 percentage points. This was a result of private legal persons acquiring shares in Zavarovalnica Triglav from the Slovenian Reimbursement Fund under the Insurance Companies Ownership Transformation Act (the ZLPZ-1). Given the increasing contract-based cooperation between banks, insurers, management companies and brokerage houses, an indication of the greater need for integration in the financial sector, stronger ownership consolidations within the financial sector can be expected in the future.

One financial conglomerate had been officially recognised in Slovenia by 2008.

In 2006 Slovenia adopted the Financial Conglomerates Act (the ZFK) with the aim of regulating more sectoral groups, particularly in the sense of risk management, effective supervision and better transparency, and the prudent functioning of the financial system. The first such conglomerate, between Zavarovalnica Triglav and Abanka, was recognised at the end of 2006, with the Insurance Supervision Agency coordinating supervision. In connection with the anticipated ownership consolidation within the financial sector, the recognition of more financial conglomerates can be expected in the future.

Risk in the financial system

More complex financial systems make risk assessment harder.

The increasing role of institutional investors in the Slovenian financial environment is also increasing their importance to financial stability. The development of institutional investors leads to more comprehensive and stable financial markets, but at the same time stronger linkage between financial sectors also increases the complexity of financial systems. The actual location of risk is thus much more difficult to assess, while the risk of contagion between financial sectors is increased.

Table 5.2: Investment links between Slovenian financial institutions

	2001	2003	2005	2007Q3	2001	2003	2005	2007Q3
	Domestic banks' exposure to[1]							
	other fin. Intermediaries (S.123)				insurers, pension funds (S.125)			
Value (EUR million)	220	489	869	2,026	34	81	57	100
Bank invest. in debt securities	4	19	3	0	3	28	14	14
Bank loans granted	123	283	685	1,736	15	20	0	4
Bank capital investments	93	187	180	290	16	33	42	82
As % of:								
Total financial assets	1.3	2.2	2.9	4.9	0.2	0.4	0.2	0.2
Bank invest. in debt securities	0.1	0.3	0.0	0.0	0.1	0.4	0.2	0.2
Bank loans granted	1.4	2.4	4.0	6.0	0.2	0.2	0.0	0.0
Bank capital investments	13.6	21.0	15.3	15.1	2.3	3.7	3.6	4.3
	Exposure to domestic banks of[2]							
	other fin. intermediaries (S.123)				insurers, pension funds (S.125)			
Value (EUR million)	235	491	537	721	545	702	816	938
Investments in bank deposits	164	227	355	488	384	438	384	510
Investments in bank debt sec.	42	196	132	140	115	202	359	335
Investments in bank capital	29	68	51	93	47	62	72	93
As % of:								
Total fin. assets of S.123 or S.125	6.7	10.3	8.0	6.8	31.3	23.0	20.9	16.2
Investments in deposits	99.9	99.9	92.8	99.8	99.2	99.8	99.3	92.7
Investments in debt securities	50.9	60.1	28.5	39.1	18.7	14.0	15.1	11.1
Capital investments	1.3	2.6	1.8	1.7	20.2	13.9	9.7	5.2

Note: The table shows the investment links between the banking sector, and both the sector of other financial intermediaries (including investment funds and leasing companies) and the sector of insurers and pension funds.
[1] Investments by domestic banks in the other two sectors, via equity, debt securities and loans granted. The proportion of total bank financial assets accounted for by the aforementioned investments, and the ratio of exposure to the two aforementioned sectors via a particular instrument to the total value of the instrument are illustrated.
[2] Investments by other financial intermediaries and insurers in bank equity, debt securities and deposits. The proportion of the total assets of these two sectors accounted for by these investments and the proportion of exposure to banks via a particular instrument are also given.
Sources: Bank of Slovenia, SORS

Banks' investment exposure to other financial sectors remains relatively low.

In addition to contract-based and ownership links, banks and institutional investors are also linked via investments. The proportion of total bank loans accounted for by loans approved for other financial sectors (leasing companies are prominent here) increased to 6% in 2007, which does not yet entail a large exposure for the banking sector. The banking sector's exposure to other financial sectors via equity is larger: 20% of banks' total capital investments are in the insurance sector (4.3%) and the sector of other financial intermediaries (15.1%). This is expected, given the increasing importance of institutional investors. The banking sector's actual exposure to institutional investors also depends on the distribution of exposure between institutional investors.

Other financial sectors' investment exposure to the domestic banks is larger than the reverse exposure. The sector of other financial intermediaries has just 7% of its financial assets invested in bank deposits, bonds and shares, while the insurance sector holds 16% of its assets in bank instruments. As a result of increasing investments in the rest of the world, the insurance sector is reducing its exposure to the domestic banks, in the form of both deposits and securities.

5.2 Domestic financial markets

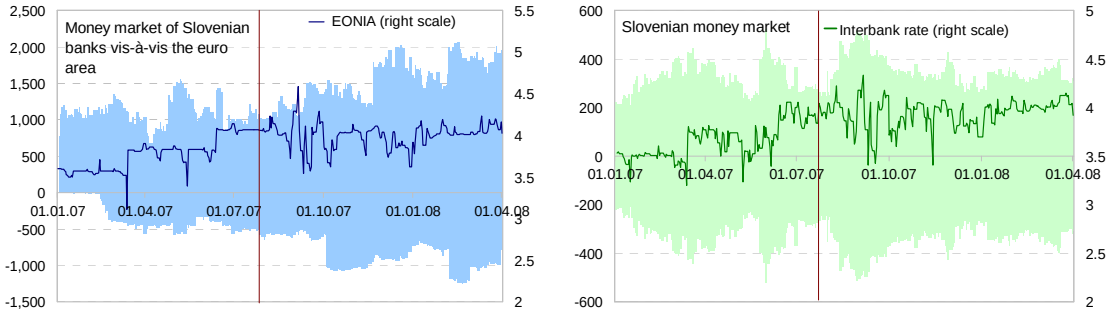
5.2.1 Money market

Coordinated movement by the EONIA and the SI O/N in 2007.

The unstable conditions on international financial markets impacted on the movement of interest rates on the money market in the second half of last year. The interest rate on the Slovenian money market having almost equalised with that in the euro area even before the euro was introduced, the SI O/N36 and the EONIA were mostly coordinated in their changes last year. In 2007 the EONIA was on average 7 basis points higher than the SI O/N, a reflection of the net creditor relationship of Slovenian banks with foreign banks on the money market. Slovenian banks have been net creditors of the rest of the world on the money market for unsecured euro area interbank loans since the euro was introduced. The average net credit position against the rest of the world in the first quarter of 2008 was even higher than that in the final quarter of last year, at close to EUR 800 million. Last year's movement of the SI O/N displayed a rising trend until 9 August, when the rate reached 4.2%, followed by increased volatility as a result of the deterioration in liquidity on international financial markets and the decline in confidence in interbank transactions.

Slovenian banks remain net lenders on the international unsecured interbank market.

Figure 5.8: Stock of unsecured deposits of Slovenian banks placed and received on the euro area money market (left) and the Slovenian money market (right) in EUR million, and movement of the EONIA (left) and SI O/N (right) in percentages



Source: Bank of Slovenia

The volume of the Slovenian money market, i.e. unsecured interbank deposits placed and received, averaged between EUR 300 million and EUR 400 million last year. The volume of transactions increased sharply, to over EUR 500 million, at the end of August and in early September as a result of Slovenian banks' greater demand for liquidity. They borrowed more on the domestic market because of the increased difficulty in obtaining more expensive liquidity on international markets. Slovenian banks compensated for the

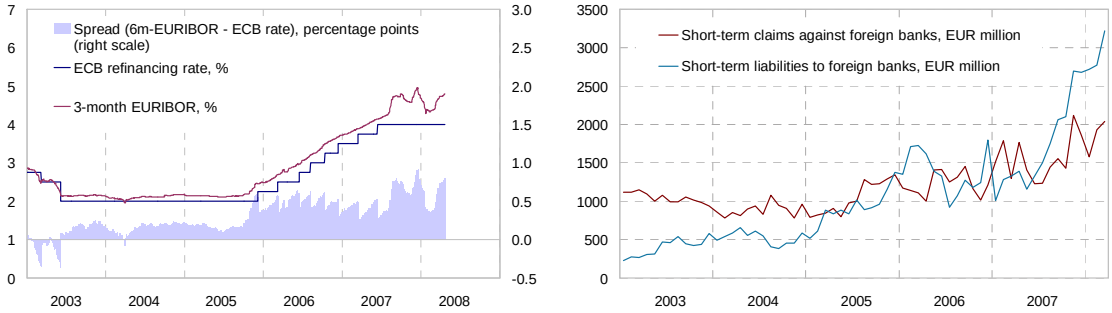
[36] The interest rate on unsecured overnight interbank deposits in euros concluded by Slovenian credit institutions with credit institutions in the euro area.

liquidity shock on international financial markets by increasing their trading on the domestic money market.

Greater fluctuation in the spread between the ECB refinancing rate and the EURIBOR upon the outbreak of turmoil on the financial markets.

There was a change in the coordinated movement of market interest rates and the ECB refinancing rate upon the outbreak of turmoil on the financial markets. The distrust arising between banks and the resulting deterioration in current liquidity on interbank markets raised the price of liquid assets on the market, which was also felt by Slovenian banks when borrowing in the rest of the world. Between mid-August 2007 and the end of February 2008, the spread between the ECB rate and the 3-month EURIBOR fluctuated between 29 and 95 basis points. The increased demand for current liquidity saw the 3-month EURIBOR rise to the level of the 6-month EURIBOR, and even exceed it for a brief period.

Figure 5.9: Comparison of the EURIBOR and the ECB refinancing rate (left, in percentages), and short-term claims and liabilities vis-a-vis foreign banks (right, in EUR million)



Source: Bank of Slovenia

The tightening of liquidity conditions on international financial markets meant that Slovenian banks faced more difficult access to resources in the rest of the world, declining average maturities, and an increase in the price of such resources. As a result the average maturity of loans raised in the rest of the world declined in the final quarter of last year.

An increase in the dependency of banks' short-term financing on conditions on foreign markets.

As a result of the increase in Slovenian banks' short-term borrowing from banks in the rest of the world, the surplus of liabilities over claims began to rise rapidly after June 2007, when it stood at EUR 95.3 million. By the end of the year the surplus was approaching EUR 820 million, and by March 2008 it had reached EUR 1,183 million, an indication of the increasing dependence of banks in Slovenia on conditions on foreign markets.

5.2.2 Capital market

A decline in market yields on long-term government securities in the second half of 2007.

The market yield on long-term Slovenian government securities increased by 65 basis points in 2007 to 4.55%, the spread with the yield on comparable German government bonds widening to 34 basis points. The increase in yields on government bonds in the first half of the year was the result of rises in the ECB's interest rates. After the increase in uncertainty on global financial markets there was increased risk-aversion, which was reflected in a withdrawal to safer investments and a decline in yields on government securities. The decline in market yields on long-term government securities continued in 2008.

Figure 5.10: Market yields on Slovenian and German 10-year government bonds

Sources: Bank of Slovenia, ECB

The year-on-year growth in the SBI 20 declined to 78.1% at the end of 2007, having reached a record high in August.

After recording very high growth in the first eight months of 2007, share prices on the Slovenian capital market began to fall, while volatility increased. The fall in prices gained further momentum in the first quarter of 2008. The SBI 20 strongly outpaced leading global stock markets with growth of 78.1% in 2007. The year-on-year growth in the index peaked at 124.6% in August, but had declined to 12.8% by March 2008 as a result of falls over the subsequent months. The Slovenian bond index lost 2% in 2007, while the investment fund index gained 45%.

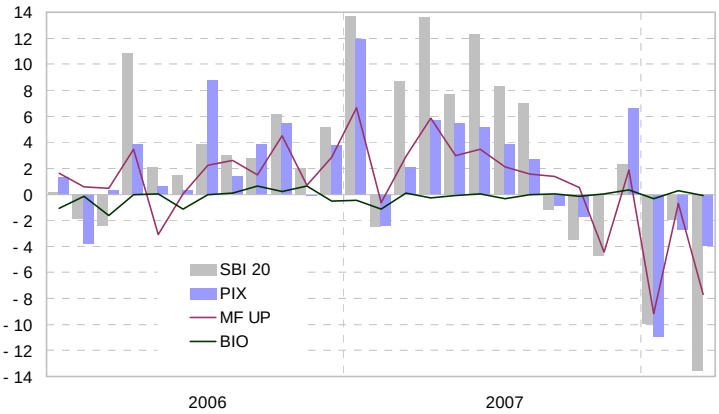
Figure 5.11: Annual growth in domestic (left) and foreign (right) stock exchange indices in percentages

Sources: LJSE, Reuters, SMA, Vzajemci.com, own calculations

There were several factors for the high growth in prices in the first eight months of 2007.

The rise in share prices as measured by the SBI 20 during the first eight months of 2007 can only partly be attributed to good corporate results. There were a number of other factors in the rise in prices: (1) the introduction of the euro, as a result of pricing in euros, brought changes in the psychological barriers in share prices; (2) the increased liquidity in the euro area prior to the outbreak of the sub-prime mortgage crisis in the US brought increased demand for Slovenian shares on the part of foreign investors; (3) M&A activity and ownership consolidation efforts connected with the gradual withdrawal of the government from the commercial sector had a discernible impact on prices; and (4) the issue of retail certificates on shares of Slovenian blue-chips. The trend reversed in September 2007, which was no surprise, given the high share prices, the developments on global capital markets, and the assembling of assets in November to participate in the privatisation of NKBM. The stock exchange was slightly revived by the listing of NKBM shares in December 2007, but it only stalled the fall in prices temporarily.

Figure 5.12: Monthly growth in domestic stock market indices in percentages



Sources: LJSE, Vzajemci.com, SMA

The fall in prices continued in the first quarter of 2008.

The price correction continued in 2008. The SBI 20 had lost 23.7% by the end of March. The main factors in the fall in share prices were the movements on global capital markets, the delays in the government's withdrawal from the commercial sector, and the net outflows from mutual funds, particularly Balkan funds, that hold some of their investments in Slovenian shares. The fall in share prices received extra momentum from the retail certificates issued on shares of Slovenian blue-chips reaching the knock-out barriers.

The P/E ratio[37] for the SBI 20 increased sharply over the first nine months of 2007. It had declined by the end of February 2008, but remains significantly higher than the ratio for leading global stock market indices.

Table 5.3: P/E ratio for selected indices

	SBI 20	SBI TOP	DJ EURO STOXX 50	S&P 500	DAX
Dec 2006	23.5	28.5	12.6	17.7	14.5
Sep 2007	34.6	35.1	13.0	18.0	14.0
Dec 2007	32.6	33.8	12.5	20.1	13.6
Feb 2008	28.1	28.2	10.6	19.6	11.6

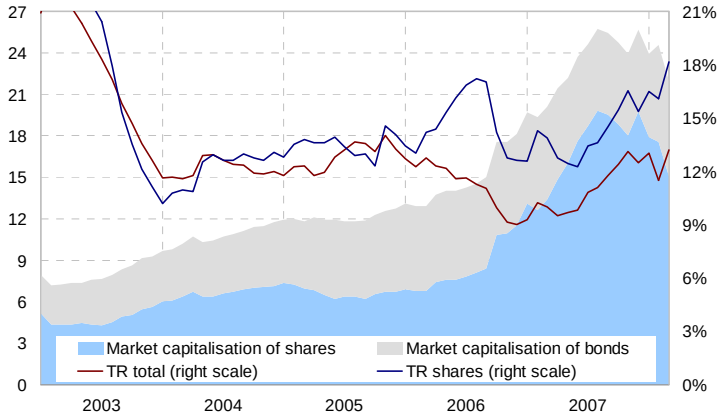
Sources: LJSE, Bloomberg

The market capitalisation of shares on the LJSE increased by 72% in 2007, while the volume of trading in shares increased by 109%.

The market capitalisation of corporate shares increased by almost 72% in 2007, despite the delisting of two major companies and several smaller companies successfully taken over. The rise in market capitalisation was the result of high growth in securities prices, the listing of NKBM, and, to a lesser extent, capital increases in other companies. The market capitalisation of shares declined by 23.8% in the first quarter of 2008, as a result of a fall in prices and the delisting of Merkur. The volume of trading in corporate shares[38] increased by a high 109% in 2007 to EUR 3 billion, which was reflected in an increase in the turnover ratio. Although the annual turnover ratio for shares increased in the first quarter of 2008, in recent months there has been a decline in liquidity on the Ljubljana Stock Exchange. The monthly turnover ratios declined, and in February and March were significantly below the 2007 average. The average monthly volume of trading in shares excluding block trades in 2008 was just 78% of the average monthly volume in 2007.

[37] The P/E ratio is the ratio of the share price to the most recent annual net profit per share.
[38] The volume of trading also includes block trades outside the regulated market.

Figure 5.13: Market capitalisation on the stock exchange in EUR billion, and turnover ratios (TR) in percentages



Note: Excludes listed investment companies and mutual funds. The turnover ratio (TR) is the ratio of annual volume to market capitalisation at the end of the year. The volume includes block trades.
Source: LJSE

A decline in the market capitalisation of bonds in 2007 and the abolition of trading in government securities on the TUVL.

The market capitalisation of bonds declined by just over 10% in 2007, primarily as a result of the early redemption of 14 government bonds following the syndicated release of 11-year government bonds in the amount of EUR 1 billion on the MTS Slovenia market in March 2007. In addition to two government bonds, there were ten bank bonds listed on the stock exchange that matured in 2007, while there were eight bank bonds admitted to the regulated market. The market capitalisation of bonds increased by EUR 1 billion in February 2008 as a result of the release of RS63 11-year reference government bonds with a face value of EUR 1 billion, which are listed on both the MTS Slovenia market and on the Ljubljana Stock Exchange. The volume of trading in government securities on the TUVL declined sharply in 2007. Trading on the TUVL, which was established in September 2005 with the aim of promoting trading in government securities and increasing liquidity, was abolished in 2008

Box 5.1: Government borrowing on the capital market[1]

In 2007 the net borrowing requirement in Slovenia's state budget was just under EUR 850 million, of which approximately EUR 200 million was via the issue of securities on the foreign market, and EUR 149 million was via the issue of securities on the domestic market.

Table 5.4: Net state budget borrowing requirement in 2007 in EUR million

(EUR million)	Borrowing	Domestic borrowing		Borrowing in the rest of the world
		Total	Securities issues	via securities issues
I	1,113.1	252.0	197.7	861.2
II	-619.7	33.0	-0.6	-652.6
III	-50.0	-41.2	-48.6	-8.8
IV	406.2	406.2	0.6	0.0
2007 total	849.6	649.9	149.0	199.7

Source: Bulletin of Government Finance 1/2008, Ministry of Finance

In line with the programme for financing the state budget in 2007 and 2008, for the purpose of renewing short-term borrowings and managing liquidity there was a continuation of the practice of issuing 3-and 6-month treasury bills, and, in periods of mismatches between revenue and expenditure, current liquidity borrowing within the system of the government's single treasury account. The net stock of short-term borrowing increased by EUR 588.5 million in 2007, of which EUR 149 million was via the issue of 3-month treasury bills, and the remainder was in the form of short-term loans.

Long-term financing was provided in two ways during 2007. The government offered the 10th-issue of RS59 bonds at an auction in the middle of February, investors subscribing in the amount of EUR 298.5 million. Then in March the government made the first release of reference bonds on the MTS Slovenia market. These 11-year bonds with a face value of EUR 1 billion and a fixed yield of 4% were an important element of the process of Slovenia's integration into the euro area financial system. Demand from investors was considerable, with foreign investors accounting for 95% of the total. EUR 199.7 million of the money raised was used to finance the budget, and EUR 89.5 million for the

prepayment of loans, while the majority was used to redeem government bonds in the total amount of EUR 710.7 million between the middle of March and the end of May 2007.

The general government debt increased by just EUR 44 million in 2007, but the internal debt declined by just over EUR 900 million, in favour of an increase in the external debt, which brought an increase in financial inflows in the Slovenian financial system. By restructuring the debt, the general government sector reduced the cost of servicing the public debt.

Table 5.5: Public debt structure

	Total debt	Internal debt			External debt		
		Total	Loans	Securities	Total	Loans	Securities
Dec 2006	7,351	5,796	298	5,498	1,555	205	1,350
Dec 2007	7,395	4,884	718	4,166	2,511	161	2,350
Difference	44	-912	420	-1,332	956	-44	1,000

Source: Public Finance Bulletin 3/2008, Ministry of Finance

On 29 January 2008 the government released the second reference bond with a face value of EUR 1 billion and a yield of 4.375% via a syndicated sale on the MTS Slovenia market. Demand from investors was heavy, the final order book comprising orders of more than EUR 1.8 billion from 82 bidders. Among the major customers were banks (34%), insurers (24%), investment funds (20%) and pension funds (13%). The Benelux countries accounted for 35% of the sales, Slovenia for 13%, and France and Scandinavia 10% each. The government placed almost half of the money raised with several commercial banks in Slovenia on a short-term basis.

[1] The information for this section is sourced from the Ministry of Finance. Rounding means that some values differ from the official figures.

Table 5.6: Overview of the Slovenian regulated capital market

	2003	2004	2005	2006	2007	Feb 2008
			Shares			
Market capitalisation						
(EUR billion)	5.6	7.1	6.7	11.5	19.7	17.6
As % of GDP	23.0	27.2	24.2	38.7	58.7	51.8
Annual growth (%)	8.6	27.3	-5.9	72.0	71.5	38.8
Held by non-residents, %	5.9	4.5	3.3	4.8	5.9	6.11
Turnover						
(EUR billion)	0.6	0.9	0.9	1.5	3.0	0.3
As % of GDP	2.6	3.6	3.4	4.9	9.0	-
Annual growth (%)	-46.4	49.4	1.0	54.3	109.1	-42.5
Annual growth in SBI 20	17.7	24.7	-5.6	37.9	78.1	41.9
P/E	17.4	24.9	18.7	23.5	32.6	28.5
Dividend return	1.8	1.7	1.6	1.4	1.0	1.1
			Bonds			
Market capitalisation						
(EUR billion)	3.7	4.6	6.0	6.6	5.9	7.0
As % of GDP	15.1	17.6	21.9	22.3	17.6	20.6
Annual growth (%)	26.7	26.4	31.0	9.6	-10.5	3.9
Turnover						
(EUR billion)	0.54	0.47	0.75	0.19	0.17	0.02
As % of GDP	2.2	1.8	2.7	0.6	0.5	-
Annual growth (%)	17.3	-12.4	58.1	-74.9	-11.8	-43.3
Annual growth in BIO	5.7	4.1	0.9	-3.0	-2.1	-0.5
Turnover on TUVL						
(EUR billion)			0.49	1.03	0.27	-

Note: Excludes listed investment companies and mutual funds. The volume includes block trades. The TUVL began operations on September 2005. The figures for 2008 are for the first two months of the year only.
Sources: LJSE, SORS

Impact of capital market movements on banks' performance.

As a result of the increase in the proportion of loans secured with securities, banks' exposure to developments on domestic and foreign capital markets also increased in 2007. The proportion of newly approved loans to non-banking sectors on which equity securities were the predominant form of collateral increased to 9% in 2007, and 10.4% in early 2008. The increase in price volatility on regulated securities markets saw the quality of

this bank loan collateral diminish, as banks were compelled to constantly monitor the coverage of outstanding loans by the securities collateral. Another aspect of the increased impact of developments on the capital markets on banks' performance was seen via the valuation of banks' investments in securities at market value. The fall in stock markets in early 2008 was directly reflected in a decline in banks' net income from trading in financial assets.

Foreign banks' retail certificates on Slovenian corporate shares

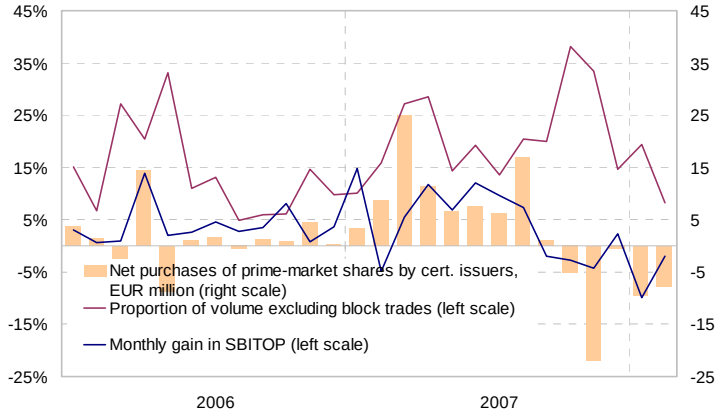
Increased impact of retail certificate issuing banks on the Slovenian capital market.

In 2006[39] foreign banks began issuing retail certificates (a structured financial instrument) on shares of major Slovenian companies listed on the Ljubljana Stock Exchange. They are issued abroad, and are linked to Slovenian shares and indices including Slovenian shares. They are traded on foreign stock exchanges, Stuttgart and Vienna in particular. When issuing them the foreign banks do not assume any risks, and hedge their positions by purchasing or selling the underlying instruments on which the retail certificates are issued. The majority of retail certificates issued directly on Slovenian shares to date have been knock-out certificates, which expire prematurely if the price of the underlying instrument reaches a predetermined knock-out barrier.

Knock-outs of retail certificates added momentum to the fall in prices, and increased volatility.

By purchasing the underlying instruments to hedge their positions, the issuing banks have an impact on the prices of the underlying instruments, which is particularly pronounced in shallower, less liquid capital markets such as Slovenia's. The impact of retail certificates on the Slovenian capital market, particularly prime-market shares, increased in 2007. In the first eight months of the year foreign banks gave additional impetus to the rise in prices on the Ljubljana Stock Exchange by issuing long certificates and making net purchases of shares to hedge their positions. In the remainder of 2007 and early 2008, knock-outs of retail certificates and sales of shares held by banks to hedge their positions exacerbated the fall in prices, and brought increased volatility to the Slovenian capital market.

Figure 5.14: Net purchases and volume of trading in prime-market shares by banks issuing retail certificates on Slovenian shares and indices[40]



Sources: CSCC, Bank of Slovenia calculations

High net purchases of prime-market shares by retail certificate issuing banks in the first three quarters of 2007.

Foreign banks issuing retail certificates made net purchases of EUR 87 million of prime-market shares in the first three quarters of 2007, and net sales of EUR 28 million in the final quarter. They made further net sales of such shares in the amount of EUR 20.3 million in the first two months of 2008. The proportion of the total volume of trading prime-market shares accounted for by certificate-issuing banks increased by 6 percentage points in 2007 to just over 23%, and thus had a significant impact on quoted prices.

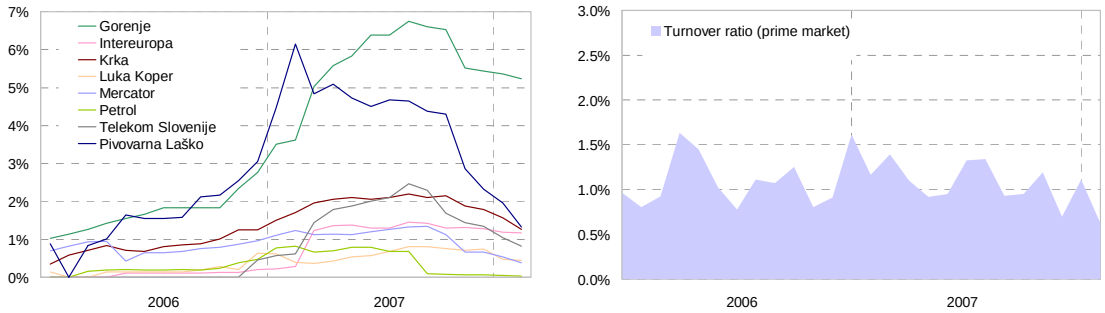
Proportions of total market capitalisation in individual shares on which retail certificates are issued accounted for by the issuing banks.

The impact of retail certificate issuing banks is also clear from the proportion of total market capitalisation in individual shares that they account for. These proportions rose over the first three quarters of 2007, before beginning to fall over the end of the third quarter, in the final quarter of 2007 and in 2008 as a result of premature expiries and the ordinary maturity of retail certificates, and issue of short knock-out certificates. Although

[39] Some retail certificates on indices including Slovenian shares were issued by foreign banks already in 2005.
[40] Proportion of total volume in the shares, excluding block trades, accounted for by issuing banks.

the proportions accounted for by retail certificate issuing banks are relatively low, given the low turnover ratios of prime-market shares, these foreign banks can have a significant impact on the short-term movement of prices, particularly in the sense of reinforcing price falls.

Figure 5.15: Proportion of market capitalisation of individual shares accounted for by retail certificate issuing banks (left) and monthly turnover ratios of shares on the prime market[41] (right)



Sources: CSCC, Bank of Slovenia calculations

Box 5.2: Foreign banks' retail certificates on Slovenian shares[1]

Retail certificates are structured financial instruments issued by top-rated foreign banks. In legal terms they are debt securities. The amount of the claim that the investor holds against the issuer depends on the movement of the value of the underlying instrument on which the certificate is issued. Retail certificates offer new opportunities for the small investor, but also expose them to new risks.

Retail certificates have recently become a more important form of investment throughout Europe. Coming in numerous forms, they offer both conservative and speculative investors a chance to invest money, and allow returns to be generated in various phases of the stock market cycle. Depending on the type, investments in retail certificates can be less or significantly more risky than direct investments in the underlying instrument. Retail certificates are complex financial instruments, and price formation can therefore be difficult for investors to understand.

For the moment, in Europe there is no special legislative framework to regulate retail certificates alone, as there is for mutual funds (the UCITS Directive). At the moment this area is primarily regulated (indirectly) by the Prospectus Directive and the MiFID Directive, which sets out the rules of trading and distribution of securities. There are aspirations to establish standardised EU legislation for various types of investment product aimed at small investors.

Austrian, German and Dutch banks mostly began issuing certificates on Slovenian shares in 2006, but particularly intensified their activities in 2007. In addition to retail certificates on individual shares, they also issue certificates on the SBI 20 and SBITOP indices, on baskets of shares from south-eastern and eastern Europe that include Slovenian shares, and on indices including shares from stock markets in central, south-eastern and eastern Europe (SETX, CECE Banking, CECExt, CECE Healthcare, CECE Oil&gas, CECE Telecom, NTX). By issuing retail certificates on indices of markets in central, south-eastern and eastern Europe, issuers are also increasing the co-dependence of these capital markets, and their volatility.

It is primarily the more risky knock-out certificates (leveraged certificates) that are issued directly on Slovenian shares. Their use of financial leverage allows investors to achieve above-proportional returns, but also exposes them to the risk of losses, which can lead to the loss of all the money invested. Index certificates, discount certificates, bonus certificates and guaranteed certificates are issued on Slovenian shares and indices including Slovenian shares. At the end of March there were 75 retail certificates issued directly on Slovenian shares and 133 issued on indices or baskets including Slovenian shares quoted on the Stuttgart Stock Exchange, where the majority of retail certificates on Slovenian shares are listed.

Residents, primarily households, held EUR 17.6 million of investments in retail certificates issued on Slovenian shares or indices including Slovenian shares. These were predominantly higher-risk knock-out certificates, further evidence that households opting to invest in capital markets are extremely risk-inclined. Given the high gains realised by investors in retail certificates (including those issued on Slovenian shares), which for the moment are not subject to taxation under Slovenian legislation, and the possibility of generating profits even during a phase of falling stock market prices, investment in derivatives can be expected to increase further. To date two banks (Volksbank and Reiffeisen Bank) are

[41] Block trades are excluded from the calculation of the monthly turnover ratio in prime market shares.

directly marketing retail certificates in Slovenia, but additional direct marketing in Slovenia can be expected, particularly from banks whose parent banks are retail certificate issuers.

Table 5.7: Residents' investments in retail certificates issued on Slovenian shares and on indices and baskets including Slovenian shares

	2005	2006	2007
Value (EUR million)	0.1	5.6	17.6
Structure: issuer (%)[1]	100.0	100.0	99.9
Raiffeisen Centrobank (AUT)	97.0	93.7	37.1
Erste Bank (AUT)	3.0	6.3	30.3
ABN Amro (NLD)			17.6
Societe Generale (FRA)			14.9
Structure: underlying instrument (%)[2]			
Krka		21.1	63.6
Central European indices/baskets	100.0	22.6	8.2
SBITOP		13.8	6.7
Pivovarna Laško		0.4	5.9
Other	0.0	42.0	15.5
Proportion held by households (%)[3]	100.0	80.8	89.7
Proportion of knock-out certificates (%)[4]	0.0	63.9	86.4

Notes: [1] The issuers of retail certificates tied to Slovenian shares also include Hypovereinsbank.
[2] Retail certificates tied to shares in Gorenje, Petrol, Luka Koper, Telekom Slovenije, Mercator, Merkur and Intereuropa are also significant.
[3] Corporates and financial institutions own a minor proportion.
[4] Index certificates and guaranteed certificates are prominent among the other types of retail certificate.
Sources: Bank of Slovenia, Stuttgart Stock Exchange, other retail certificate website.

[1] Summarised from a paper by A. Gorišek and M. Leber entitled *Retail Certificates – Investment Products.*

Investment links with the rest of the world

Increased demand for Slovenian shares from non-residents in 2007.

In 2007 non-residents made net purchases of EUR 537 million in Slovenian shares, both listed and unlisted. This is double the figure in 2006, and represents 18% of the total volume of trading in shares on the Ljubljana Stock Exchange. Non-residents' increased demand for Slovenian shares is the result of the Ljubljana Stock Exchange's promotional activities in the rest of the world, the increased issue of structured financial instruments on Slovenian shares and indices, the privatisation of the second-largest Slovenian bank, and the increased equity holdings of non-residents and sale of companies to non-residents. The proportion of the market capitalisation of shares on the Ljubljana Stock Exchange held by non-residents increased to 5.9% by the end of 2007, and to 6.11% by the end of February 2008, even though non-residents withdrew from investments in Slovenian issuers (both listed and unlisted shares) in 2008. With non-residents' participation in the domestic capital market and residents' participation on foreign capital markets increasing, the Slovenian capital market is gradually becoming more responsive to developments on foreign markets. The correlation between the movement of Slovenian and global capital markets increased slightly during the final quarter of 2007 and in 2008, although it remains relatively low.

Non-residents reduced their investments in bonds of Slovenian issuers in 2007.

Non-residents' demand for Slovenian bonds, other than government bonds listed on the MTS Slovenia market, is low, given the low depth and liquidity of the Slovenian bond market. Non-residents made net sales of EUR 11.9 million in bonds of Slovenian issuers in 2007, which was primarily the result of the early redemption of government bonds. Non-residents' demand for Slovenian government bonds picked up again in 2008. They purchased 87% of the release of the 11-year RS63 government bonds in the amount of EUR 1 billion.

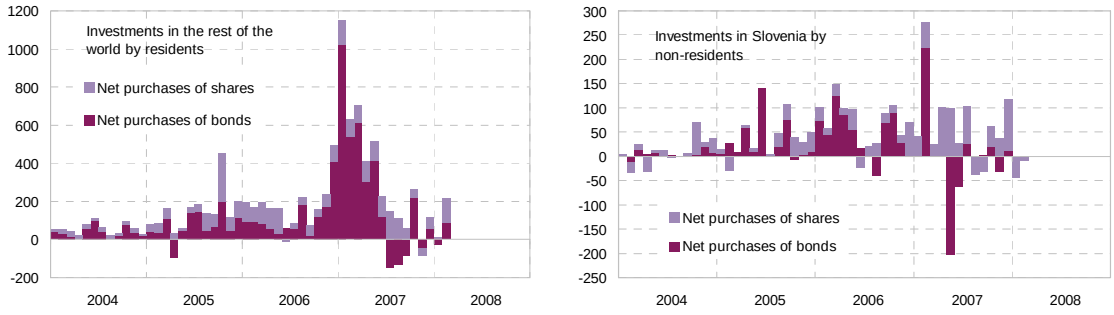
Table 5.8: Overview of investment links with the rest of the world

	2004	2005	2006	2007	Feb 2008
	Residents' investments in the rest of the world				
Shares					
Stock (EUR billion)	0.5	1.5	2.6	4.0	3.7
As % of GDP	2.2	6.3	11.0	12.1	11.0
Annual growth (%)	114.6	192.8	73.7	55.6	27.9
In total stock of issued Slovenian equities (%)	2.7	8.0	10.7	11.8	11.7
Net purchases (EUR billion)	0.23	0.76	0.83	1.02	0.14
Bonds					
Stock (EUR billion)	0.8	1.5	2.9	5.7	5.7
As % of GDP	3.4	6.4	12.1	16.9	16.8
Annual growth (%)	122.8	89.2	89.7	95.1	29.2
In total stock of issued Slovenian debt sec. (%)	13.0	20.6	37.5	87.2	76.5
Net purchases (EUR billion)	0.43	0.88	1.38	2.87	0.06
	Non-residents' investments in Slovenia				
Shares					
Stock (EUR billion)	2.2	2.5	3.2	4.3	4.1
As % of GDP	7.4	8.3	10.7	12.8	12.1
Annual growth (%)	60.1	13.0	28.5	33.1	-4.6
In total stock of issued Slovenian equities (%)	11.8	13.5	13.3	12.6	12.8
Net purchases (EUR billion)	0.09	0.16	0.26	0.54	-0.05
Bonds					
Stock (EUR billion)	0.2	0.5	0.9	0.9	1.9
As % of GDP	0.6	1.6	3.0	2.7	5.5
Annual growth (%)	5.5	172.8	85.2	1.7	103.6
In total stock of issued Slovenian debt sec. (%)	2.9	6.7	11.8	14.2	25.1
Net purchases (EUR billion)	0.05	0.36	0.55	-0.01	0.91

Note: The 2008 figures are for net purchases in the first two months of the year only.
Includes all investments in Slovenia by non-residents, in both listed and unlisted securities.
Non-residents' net purchases of bonds in 2008 include RS63 bond, as they are also listed on the Ljubljana Stock Exchange, while the reference bond issued in March 2007 on the MTS Slovenia market is not included among the 2007 figures for residents' net purchases of bonds.

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

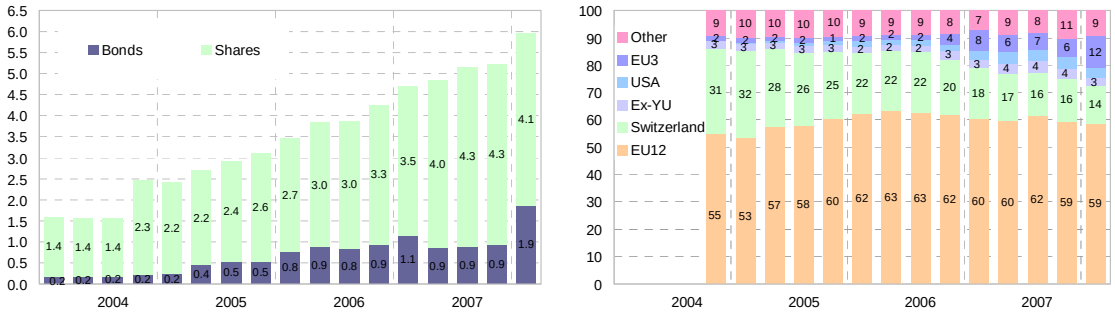
Figure 5.16: Monthly net investments by residents in the rest of the world (left) and by non-residents in Slovenia (right) in EUR million



Sources: CSCC, Bank of Slovenia, own calculations

Residents of the euro area are prevalent in the breakdown of non-residents' investments in Slovenian securities by region, accounting for 59% of the total. Compared with the end of 2006, by the end of February 2008 the proportion accounted for by residents of Switzerland had declined, and that of residents of the EU3 had increased.

Figure 5.17: Stock of non-residents' investments in securities of Slovenian issuers in EUR billion (left), and regional percentage breakdown (right)



Note: Includes investments in listed shares and bonds, and in those not listed on the exchange. The 2008 figures relate to February.
EU3: UK, Denmark, Sweden; Ex-YU: former Yugoslav republics.
Sources: CSCC, own calculations

Bonds of euro area issuers accounted for the majority of net purchases of foreign bonds.

The trend of increasing outward investments by Slovenian investors is continuing. In 2007 the stock of residents' investments in foreign securities rose to EUR 9.7 billion, equivalent to 29% of GDP. Residents made net purchases of EUR 1 billion in shares and EUR 2.9 billion in bonds of foreign issuers. Prevalent among the net purchases of bonds were investments in bonds of euro area issuers by banks (EUR 2.2 billion, or 86% of the total) and insurers (EUR 0.3 billion). By eliminating exchange-rate risk and transaction costs the introduction of the euro expanded the selection of debt instruments, which are more liquid than Slovenian government bonds. The main factors in the increased demand for foreign bonds were the early redemption of domestic government bonds, the declining liquidity and depth of the domestic bond market and, in the first quarter, the release of money from Bank of Slovenia bills. High net purchases of foreign bonds entail greater diversification of investments into debt securities.

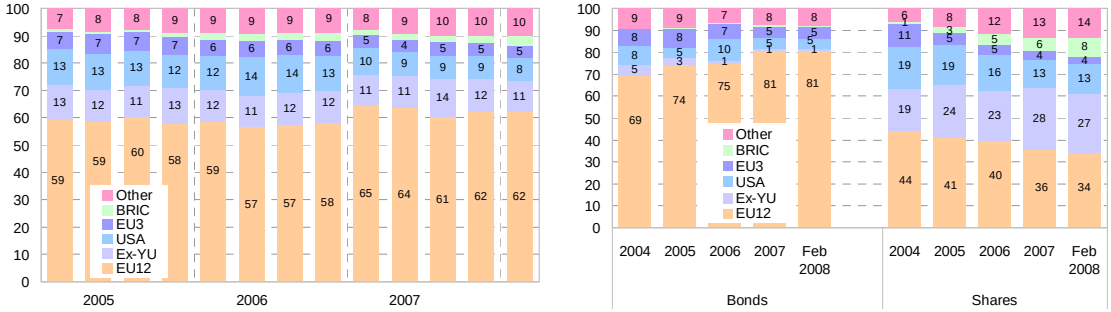
Almost half of net purchases of foreign shares were directed at emerging markets, Balkan markets in particular.

Prevalent among the net purchasers of foreign shares were the sector of other financial intermediaries (53%), the insurance sector and households. Investments in foreign shares were determined primarily by the quest for high returns. Almost half of the net purchases were directed at emerging markets, in particular the capital markets of the former Yugoslav republics (33% of total net purchases), while 28% went to the capital markets of the euro area. The largest net purchases on the capital markets of the former Yugoslavia were made by the sector of other financial intermediaries (41%), households (28%) and the banking sector (17%), which were also the most exposed to these capital markets.

The largest increase in exposure was to the stock markets of the former Yugoslav republics.

In the regional breakdown of residents' investments in the rest of the world, exposure to issuers from the euro area increased, while exposure to issuers from the US declined. The proportion of investments in foreign bonds accounted for by issuers from the euro area rose to 81% while their corresponding proportion of investments in foreign shares declined by 4 percentage points to 38%. The largest increase of 5 percentage points was recorded by the proportion of investments in foreign shares accounted for by issuers from the former Yugoslavia, which rose to 28%.

Figure 5.18: Regional breakdown of investments by residents in foreign securities overall (left), and bonds and shares separately (right) in percentages



Note: The 2008 figures relate to February.
EU3: UK, Denmark, Sweden; BRIC: Brazil, Russia, India, China; Ex-YU: former Yugoslav republics.
Source: Bank of Slovenia

In 2007 households increased their exposure to low-liquidity, shallow capital markets, Balkan markets in particular. The direct increase in households' exposure to the capital market of the former Yugoslavia amounted to EUR 123 million, while the indirect increase via other financial intermediaries amounted to EUR 177 million. Adverse consequences were felt as early as the second half of 2007, and in 2008 in particular, when increased political instability saw investors withdraw and a major fall in prices on these capital markets. In the first two months of 2008 households and other financial intermediaries recorded net sales of EUR 10.5 million in shares of issuers from the former Yugoslav republics and EUR 6.2 million in shares of issuers from Bulgaria, Romania and Turkey. By the end of March 2008 prices on the capital markets of the former Yugoslavia had fallen by between 27% and 55% from their peaks in 2007.

Households felt the consequences of exposure to capital markets, particularly Balkan markets, in the second half of 2007 and in 2008.

6 BANKING SECTOR

6.1 Structural features of the banking sector

The ratio of the banking system's total assets to GDP increased significantly in 2007, but Slovenia still trails the euro area average by a long margin according to this measure. The privatisation of NKBM meant that there was a significant decline in the proportion of the banking system owned by the general government sector in 2007. The trend of diminishing market concentration continued in 2007, but nevertheless remains above the EU average.

Banking sector size and changes of status

Banks' total assets reached EUR 42.2 billion in 2007, or 126% of GDP. Savings banks accounted for a negligible proportion of 0.8% of GDP.

There are 24 banks operating in Slovenia, of which three are branches. The SID began operating as a bank in 2007, and a branch of RCI Banque Societe Anonyme was established. In addition to the banks and branches, there were also three savings banks operating in 2007. Banks remain by far the most important financial intermediaries, while the proportion of savings banks is negligible. Banks had total assets of EUR 42.2 billion in 2007, while those of savings banks stood at EUR 255.2 million. The total assets of banks were thus equivalent to 126% of GDP, those of savings banks to 0.8% of GDP, and those of non-monetary financial institutions to around 45% of GDP.

At 24.7%, growth in banks' total assets was the highest since 1995. The ratio of banks' total assets to GDP increased by 14.7 percentage points in 2007, comparable only with 2005. However the ratio of banks' total assets to GDP in the euro area is still 2.5 times that in Slovenia.

Growth in total assets in 2007 was 2.4 times higher than nominal GDP growth.

After extremely rapid deepening in 2005 and a slowdown in 2006, the ratio of nominal growth in total assets to GDP growth rose again slightly in 2007, to stand at 2.4 at the end of the year, approximately 40% above its long-term average of 1.7.

Table 6.1: Total assets of banks compared with GDP

	2003	2004	2005	2006	2007
Total assets (EUR million)	21,098	23,691	29,287	33,868	42,195
GDP - current prices (EUR million)	24,716	26,677	28,243	30,448	33,542
Total assets (as % of GDP)	85.4	88.8	103.7	111.2	125.8
Ratio of growth in total assets to GDP growth	1.3	1.5	4.0	2.0	2.4
No. of bank employees	11,397	11,534	11,632	11,838	

Source: Bank of Slovenia

In 2007 the Bank of Slovenia received 69 notifications of the direct provision of services and no notifications of the provision of services via a branch. To date 195 banks have issued notification of the direct provision of services, the majority from Austria and the UK.

Bank ownership

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

(%)	2003	2004	2005	2006	2007
Central government	19.4	19.1	18.2	17.9	15.1
Other domestic entities	48.2	48.6	46.9	44.4	47.2
Non-residents	32.4	32.4	34.9	37.7	37.7
Non-residents (over 50% control)	16.6	16.5	19.4	27.7	26.8
Non-residents (under 50% control)	15.8	15.9	15.5	10.0	11.0

Note: Relative proportions of ownership are considered.
Source: Bank of Slovenia

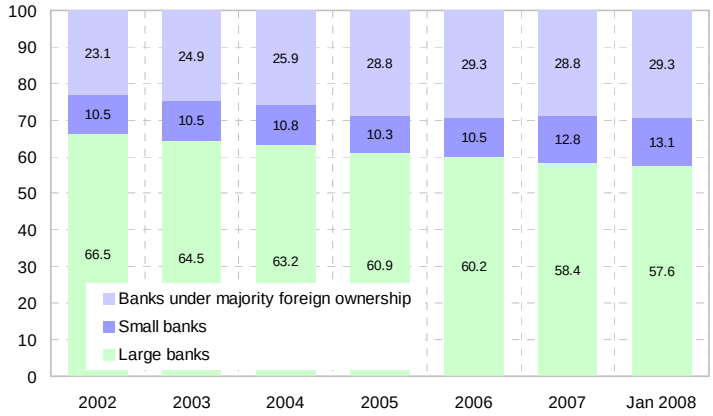
The privatisation of NKBM brought a decline in the proportion of the banking sector under government ownership in 2007.

The privatisation of NKBM brought a decline in the proportion of the banking sector under government ownership in 2007. This came in return for an increase in the

proportion owned by domestic persons, while the proportion owned by foreign persons was unchanged.

In the analysis below, banks are divided into three groups: large banks, small banks and banks under majority foreign ownership. There is no overlap between the groups, so each bank is classified into one group only. The size of the bank is determined by its total assets. The top nine banks in terms of total assets are classed as large banks, while the others make up the small banks. All the banks under majority foreign ownership are placed in the same category, regardless of size, owing to differences in their behaviour and operational methods.

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



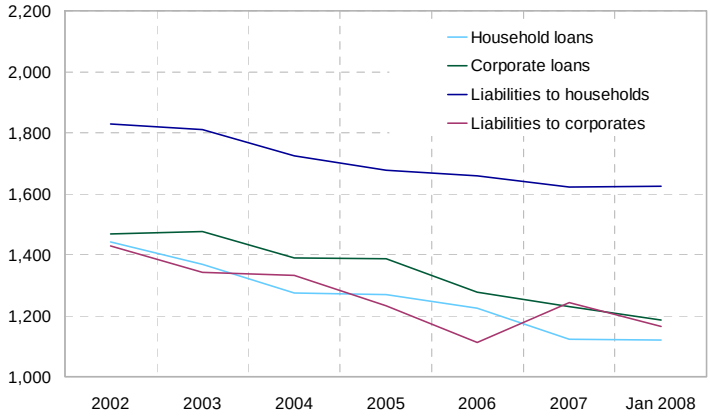
Source: Bank of Slovenia

Concentration in the banking sector

The trend of declining market concentration in the Slovenian banking sector continued in 2007, an indication of the still-strong competitive pressures in the sector. An exception is liabilities to non-banking sectors, where concentration increased, primarily as a result of liabilities to corporates.

The decline in concentration continued, with the exception of liabilities to non-banking sectors.

Figure 6.2: Market concentration in bank operations with non-banking sectors as measured by the Herfindahl-Hirschman index



Source: Bank of Slovenia

The increase in concentration in the segment of liabilities to non-banking sectors was to a certain extent the result of the tighter conditions on international financial markets in the second half of the year, when banks faced difficulties in borrowing from banks in the rest of the world. As a result the banks not under majority foreign ownership focused more attention on attracting deposits by non-banking sectors on the domestic market.

Slovenia's level of concentration is significantly higher than the euro area average. However the gap is diminishing, which is reflected in the market share of the five largest

banks, which in January 2008 was just 5.2 percentage points higher than the unweighted euro area average for 2006.

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

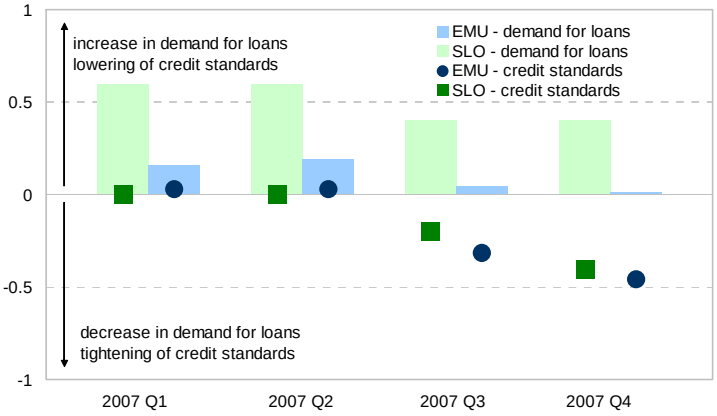
	2003	2004	2005	2006	2007	Jan 2008	Change 2007/2006
				Herfindahl-Hirschman index			
Total assets	1,553	1,472	1,395	1,342	1,299	1,278	-42
Total assets (euro area)	578	600	641	629			
Unweighted	941	966	1,001	971			
Loans to non-banking sectors	1,393	1,310	1,307	1,232	1,184	1,152	-47
Liabilities to non-banking sectors	1,607	1,570	1,462	1,434	1,474	1,456	41
Liabilities to banks	1,379	1,278	1,339	1,236	1,145	1,124	-90
				Market share of top 3 banks (%)			
Total assets	53.3	52.0	50.3	50.0	48.8	48.1	-1.2
Loans to non-banking sectors	52.5	50.5	49.2	48.0	46.5	45.6	-1.5
Liabilities to non-banking sectors	55.7	55.3	54.1	54.0	54.1	53.7	0.1
Liabilities to banks	51.7	49.0	49.7	48.0	43.1	43.3	-4.9
				Market share of top 5 banks (%)			
Total assets	67.4	65.1	63.3	62.7	59.7	58.9	-2.9
Total assets (euro area)	40.5	41.6	42.7	42.8			
Unweighted	53.1	53.3	54.3	53.7			
Loans to non-banking sectors	66.7	64.2	62.6	61.3	58.9	58.1	-2.4
Liabilities to non-banking sectors	70.6	68.9	67.3	66.7	66.4	66.2	-0.4
Liabilities to banks	64.9	62.0	62.9	61.4	57.0	56.5	-4.4

Sources: Bank of Slovenia, ECB: Report on EU Banking Structure

6.2 Banks' assessments of demand for loans and credit standards[42]

Demand for corporate loans

Figure 6.3: Demand for corporate loans and credit standards



Sources: ECB, Bank of Slovenia

The increase in demand for corporate loans slowed in the second half of 2007.

Based on the quarterly bank lending survey, demand for corporate loans in Slovenia increased in 2007, although less intensively in the second half of the year. Corporates

[42] The ESCB supplements the prevailing quantitative information with its Bank Lending Survey. The results for the euro area are published regularly on http://www.ecb.int/stats/money/lend/html/index.en.html. Methodological limitations mean that the results for Slovenia and for the euro area as a whole are not directly comparable, and the substantive conclusions are less solid than in quantitative analysis.

recorded more demand for long-term loans from banks in Slovenia at the beginning of 2007. There was a pronounced increase in demand for short-term loans in the final quarter. The factors affecting demand for loans also changed in line with this. The increased demand for loans for investment that was a feature of the first three quarters of 2007 ended in the final quarter. At the same time demand for loans for financing inventories and working capital increased. According to bankers' assessments, demand for corporate loans at banks in the euro area increased further in the first half of 2007. In the final quarter it remained at the level of the previous quarter.

Terms and standards of corporate lending

Credit standards[43] for corporate loans were tightened by a few banks in the third quarter and by more banks in the final quarter of last year. The change in the third quarter was caused by the deterioration in access to sources of financing, and the anticipated slowdown in general economic growth. Here it is notable that in Slovenia, in contrast to the euro area, competition from other banks brought a slight lowering of credit standards. Another difference is that by the third quarter of 2007 banks in the rest of the euro area had clearly already been exposed to the tightened conditions on financial markets to such a degree that in raising credit standards they took greater account of risk factors (expectations regarding general economic activity, expectations associated with the individual sector, and required collateral).

Slovenian banks did not significantly change their lending terms in the first half of 2007. In the third quarter there was a slight tightening of some lending terms (non-interest costs, size of loans, maturity and required collateral) in a few cases, while in the euro area this process was more pronounced. There then followed a tightening of the majority of financing conditions at Slovenian banks in the final quarter of 2007.

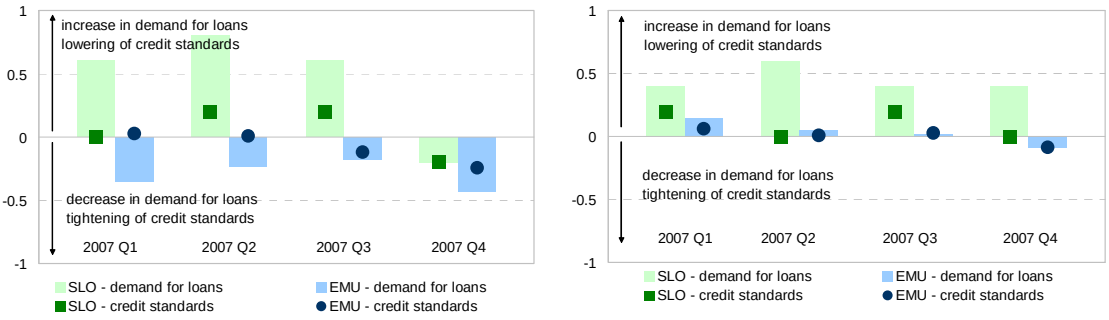
Banks in the euro area tightened lending terms one quarter earlier than Slovenian banks.

Demand for household loans and credit standards

Demand for household loans at Slovenian banks increased in the first three quarters of 2007, with credit standards relaxing slightly in the middle of the year. There was a turnaround in the final quarter, in both demand and credit standards. The competitive pressures that brought a slight lowering of credit standards in Slovenia in the middle of the year were replaced towards the end of the year by a moderate impact from expectations of movements on the real estate market, which acted in the opposite direction.

Banks in the euro area began tightening credit standards on housing loans in the third quarter of 2007, while banks in Slovenia began in the final quarter.

Figure 6.4: Households' demand for housing loans (left) and consumer loans (right), and changes in credit standards



Sources: ECB, Bank of Slovenia

There was less change in demand and credit standards for consumer loans than for housing loans. The estimated demand for consumer loans increased throughout the year. In line with other movements, there was also stagnation and a slight tightening of credit standards for consumer loans towards the end of the year.

Banks began tightening credit standards in the third quarter of 2007 primarily as a result of the shocks on the financial markets. The impact was more pronounced on loans to large

[43] Credit standards are defined in the survey as internal guidelines or criteria that reflect the bank's lending policy. Lending terms are the specific obligations or elements of the agreement between the bank and the borrower (margin, non-interest costs, size of loans, required collateral, maturity, loan clauses).

The shocks on the financial markets brought a tightening of credit standards.

corporates, and in terms of purpose, on loans for M&As and corporate restructuring, but less so on loans for capital expenditure, and less still on loans for financing inventories and working capital.

6.3 Changes in balance sheet structure

The increase in lending growth coincided with growth in bank borrowing in the rest of the world.

A major feature of 2007 was high lending activity by banks. Growth in loans to non-banking sectors increased consistently from the end of the first quarter to the end of the final quarter of 2007, when it stood at 37.4%. Banks' investments in securities declined again last year. The proportion of total assets accounted for by securities had fallen below 18% by the end of 2007, while the proportion accounted for by loans rose to just over two-thirds. With growth in deposits low, banks financed the high lending growth by borrowing at banks in the rest of the world. The increase in liabilities to foreign banks represented 55% of the increase in loans to non-banking sectors in 2007. Growth in liabilities to foreign banks strengthened despite the instability on the financial markets, reaching 41.3% in December.

Table 6.4: Market shares and growth in total assets and loans to non-banking sectors by individual group of banks in percentages

(%)	Market shares					Growth rates				
	2004	2005	2006	2007	Mar 2008	2004	2005	2006	2007	Mar 2008
	Total assets									
Large banks	63.2	60.9	60.2	58.4	57.7	10.0	19.1	14.3	20.8	22.3
Foreign banks	25.9	28.8	29.3	28.9	29.5	16.8	37.1	17.9	22.7	33.8
Small banks	10.8	10.3	10.5	12.7	12.8	15.5	17.5	17.4	51.7	25.1
Total	100	100	100	100	100	12.3	23.6	15.6	24.6	25.8
	Loans to non-banking sectors									
Large banks	60.9	58.7	56.5	55.0	54.0	16.7	21.4	21.6	33.9	31.9
Foreign banks	29.6	31.9	33.8	34.4	35.4	30.8	36.2	33.7	40.0	45.5
Small banks	9.5	9.4	9.8	10.6	10.7	20.5	24.7	31.5	48.6	41.5
Total	100	100	100	100	100	21.0	26.1	26.4	37.4	37.4

Source: Bank of Slovenia

Growth at the banks under majority foreign ownership continued to outpace that of the domestic banks.

As measured by total assets, the market share of the large banks under majority domestic ownership declined, while that of the small domestic banks increased.[44] The banks under majority foreign ownership recorded faster growth in lending to non-banking sectors than the domestic banks.

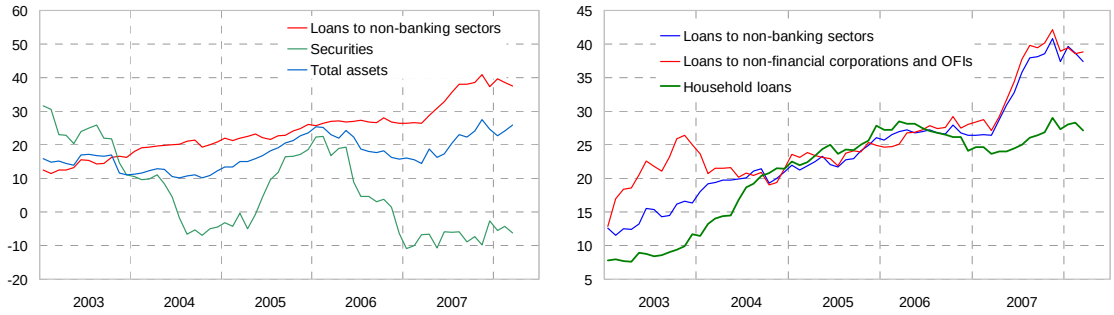
6.3.1 Major factors in the high lending growth in 2007

Real growth in loans was again very high in 2007.

Growth in loans to non-banking sectors increased consistently last year from March onwards. The increased growth in loans came primarily from increasing loans to non-financial corporations, other financial institutions and non-residents, while household lending was comparable to that in the previous year. The relatively high lending growth in 2007 again significantly outpaced the increased growth in nominal GDP, taking the ratio of nominal growth in loans to nominal GDP growth from 3.4 to 3.7. Alongside economic growth, another factor in the high lending growth was the financing of ownership consolidation in the form of M&As, the financing of corporate expansion in the former Yugoslavia, and the entry of new banks into the banking system.

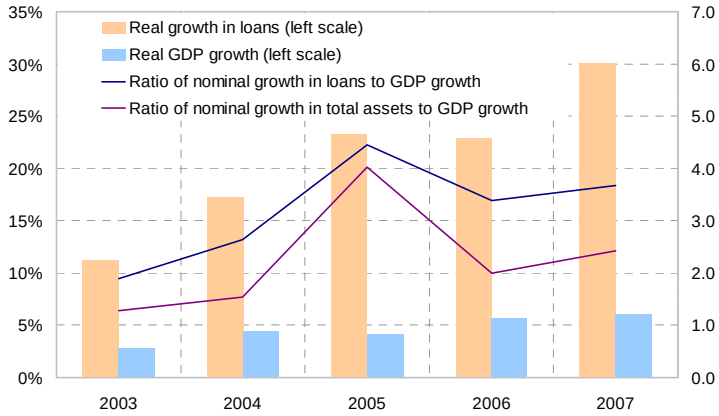
[44] The market share of the small banks also increased in 2007 as a result of the conversion of SID d.d. into SID banka d.d.

Figure 6.5: Year-on-year growth in bank investments and loans to non-banking sectors in percentages



Source: Bank of Slovenia

Figure 6.6: Real growth in loans to non-banking sectors, total assets and GDP, and ratios of nominal growth in loans to non-banking sectors and nominal growth in total assets to nominal GDP growth



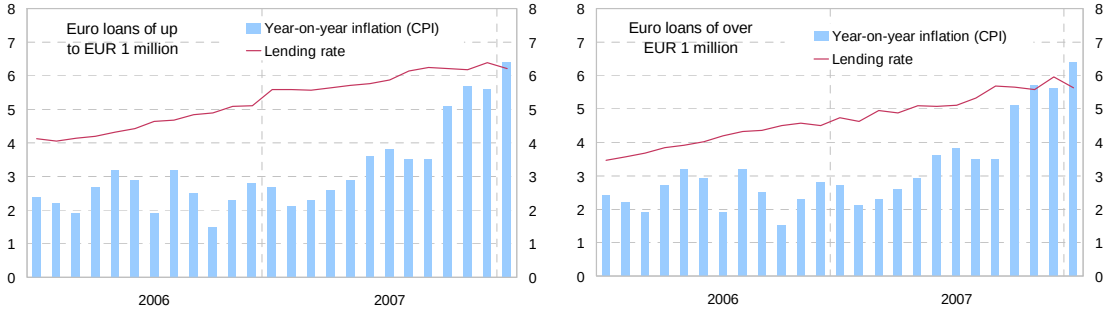
Source: Bank of Slovenia

Movement of interest rates and inflation as a factor of demand for loans

The decline in the gap between interest rates on corporate loans and inflation brought increased demand for loans.

The process of interest rate convergence between Slovenia and the euro area was completed towards the end of 2006, the spread between the interest rate on tolar corporate loans and the average euro area interest rate standing at 0.9 percentage points. Financing costs had to a great extent equalised, and in essence began to track the movement of the EURIBOR. Annual inflation in Slovenia (as measured by the consumer price index) ranged between 1.5% and 3.2% in 2006 and the first quarter of 2007, then gradually increased. Despite the trend of rising lending rates, the gap between the lending rate and rising annual inflation diminished rapidly from the beginning of 2007. Real ex post interest rates on loans became lower and lower. The decline in the gap between lending rates on corporate loans and annual inflation in the second half of 2007 contributed to the increase in corporate demand for loans.

Figure 6.7: Interest rates on corporate loans of up to EUR 1 million (left) and over EUR 1 million (right) and annual inflation in percentages



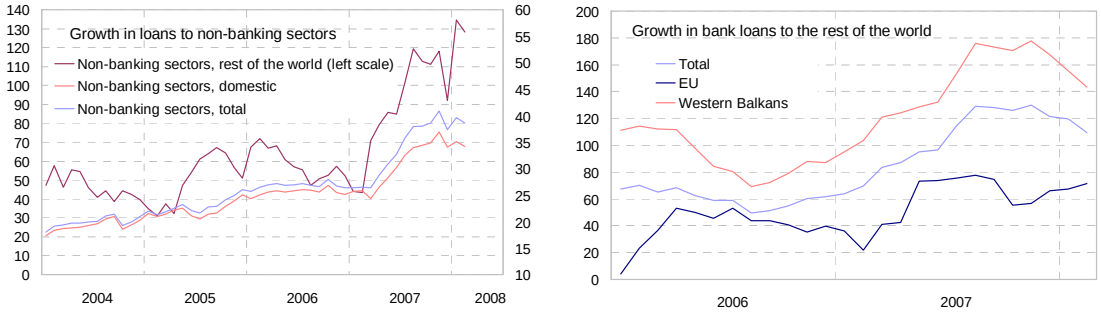
Source: Bank of Slovenia

High growth in loans to non-banking sectors in the rest of the world

Lending to the rest of the world contributed 3.2 percentage points towards growth in loans to non-banking sectors in 2007.

Loans to the rest of the world were the fastest-growing category of loans to non-banking sectors. Lending to the rest of the world had almost doubled by the end of December 2007, to reach 7.8% of total loans to non-banking sectors. Year-on-year growth in loans to non-banking sectors in the rest of the world reached 128% by February 2008. Although loans to the rest of the world account for a relatively small proportion of total loans to non-banking sectors, they contributed 3.2 percentage points towards the overall growth in loans to non-banking sectors in December 2007, and 4.4 percentage points in February 2008. Compared with growth in total loans to non-banking sectors, growth in loans to the rest of the world was above-average in the segments of EU countries and other countries, the former Yugoslav republics in particular.

Figure 6.8: Year-on-year growth in loans to non-banking sectors in Slovenia and in the rest of the world, and breakdown of year-on-year growth in loans to the rest of the world by country group in percentages



Source: Bank of Slovenia

Clients in the western Balkans recorded the fastest increase in loans.

The high growth in loans to non-banking sectors in the rest of the world came primarily from growth in loans to countries in the western Balkans. The proportion of loans to the rest of the world accounted for by this country group increased by 13 percentage points in 2007 to 75%. Growth in loans to this region doubled in 2007 to 168%, and remained above-average in the first two months of 2008.

The largest contribution to growth in loans to the rest of the world came from the increase in loans to Croatia. Of the total increase in loans to the rest of the world in 2007 of EUR 1.3 billion, clients from Croatia accounted for 41%. Also notable in terms of growth and the size of the increase in loans in 2007 were Montenegro with an increase of EUR 130 million, and Serbia with an increase of EUR 310 million.

Financing of M&A activity: bank exposure to other financial institutions (OFIs) [45]

Loans to OFIs accounted for 7.5% of all loans to non-banking sectors at the end of 2007.

The domestic banks recorded a sharp increase in loans to other financial institutions in 2007, and the trend of increase continued in the first quarter of 2008. By the end of March 2008 they accounted for almost 8% of total loans to non-banking sectors, up almost 2 percentage points on the end of 2006. Loans to leasing companies, banks subsidiaries in particular, account for around 60% of loans to other financial institutions.

The increase in loans was also the result of M&A activity, in connection with the ownership consolidation in the economy, the anticipated further withdrawal of the government from the corporate sector, and the considerable liquidity in 2007 before the outbreak of uncertainty on the global financial markets.

[45] OFIs include all financial corporations other than banks and the central bank. These are non-bank financial institutions and institutional sectors: other financial intermediaries (S.123), financial auxiliaries (S.124), and insurers and pension funds (S.125).

Table 6.5: Stock of loans approved by domestic banks for OFIs and selected non-financial corporations assumed to be involved in M&A activities

	Stock		Change in value	Annual growth
	Dec 2006	Dec 2007		
(EUR million)				
Other financial corporations	1,306	1,959	652	49.9
Leasing[1]	796	1,186	390	49.0
M&A activities[2]	162	224	62	38.5
Other	348	548	200	57.4
Non-financial corporations - M&A act.[2]	403	996	593	147.1
Structure (%)				
Other financial corporations	100.0	100.0	100.0	
Leasing[1]	61.0	60.6	59.8	
M&A activities[2]	12.4	11.5	9.6	
Other	26.6	28.0	30.6	

Notes: [1] Leasing: SKD2008 activity J64.91.
[2] OFIs and non-financial corporations assumed to be involved in M&A activities.
Source: Bank of Slovenia

Table 6.6: New loans (flow) approved by domestic banks for OFIs and selected non-financial corporations assumed to be involved in M&A activities

			Jan-Mar		Growth rate (%)	
	2006	2007	2007	2008	2007	Jan-Mar 2008
(EUR million)						
Other financial corporations	1,305	2,724	488	1,077	109	121
Leasing[1]	583	1,143	261	315	96	21
M&A activities[2]	211	501	78	197	138	152
Other	511	1,080	149	565	111	280
Non-financial corporations - M&A act.[2]	431	1,129	110	311	162	183
Structure (%)						
Other financial corporations	100	100	100	100		
Leasing[1]	45	42	53	29		
M&A activities[2]	16	18	16	18		
Other	39	40	31	52		

Notes: Includes loans repaid by the end of the month or not disbursed by the end of the month.
[1],[2]: See previous table.
Source: Bank of Slovenia

Loans to financial corporations involved in M&A activities increased by 38% in 2007.

Bank loans to financial corporations involved in M&A activities increased by 38% in 2007. Loans to financial corporations and non-financial corporations involved in M&A activities increased by 116% in total. However this does not mean that all the loans were intended solely for financing purchases of equity; they could also be used in part for their ordinary operations. According to bank survey data, at the end of 2007 EUR 970 million of loans were intended for corporates for M&A activities. Excluding the increase in bank loans approved for corporates involved in M&A activities, growth in loans to non-banking sectors would be 3.2 percentage points lower in 2007.

The volume of new loans approved for corporates involved in M&A activities increased by 154% in 2007. Among them are a significant number of corporates created from the former PIDs (authorised investment companies, a type of privatisation fund), an indication of their important (equity) role in the domestic economy. Three laws were adopted at the end of 2007 in connection with M&A activities and restrictions on the pledging of securities to which a takeover bid relates: the Takeovers Act (ZPre-1A), the Banking Act (ZBan-1A) and the Companies Act (ZGD-1A).

Box 6.1: Measures adopted by the Bank of Slovenia to restrict lending growth

As part of its duty to maintain financial stability, on 19 December 2007 the Bank of Slovenia adopted the following measures:

1. A decision on abolishing the capital deduction item that results from the difference between the amounts of impairments of collectively assessed financial assets to be created under regulatory stipulations and the actual amounts created has been temporarily deferred. Banks estimate potential losses in accordance with the IFRS and in accordance

with the regulation on the assessment of the credit risk losses of banks and savings banks. The difference between their estimates is included as a deduction item in the calculation of original own funds.

2. On 4 July 2006 the Bank of Slovenia released a letter warning banks of their duty to make appropriate disclosures of information, and to manage risks deriving from loans in or tied to a foreign currency and products tied to various market variables. On 19 December 2007 the Bank of Slovenia emphasised the expectation that banks should continue to treat the matters covered by the aforementioned warning as good practice, and should ensure its consistent application in their everyday business with clients. The Bank of Slovenia additionally expects banks to operate as follows:

- clients will always be given the offer in euros first, and their creditworthiness calculated on this basis;
- if the client then wants a loan in or tied to a foreign currency, despite having been made aware of the exchange-rate risk, the bank will assess the client's creditworthiness in light of the less favourable terms of raising the same loan in euros. The loan amount so determined will be taken into consideration as the maximum amount of the loan in the counter-value in the foreign currency.

3. The Bank of Slovenia has provided a detailed definition of the category "regulatory very high risk exposure" for the purposes of calculating capital requirements for credit risk. This category includes:

- all exposures to persons against which bankruptcy or composition proceedings have been initiated;
- exposures from investments in the capital of unlisted companies. Listed companies are companies whose securities have been admitted for trading on a regulated market in the Republic of Slovenia or another member-state (in accordance with the Market in Financial Instruments Act), or have been recognised on a stock exchange specified in Annex II of the Regulation on the Calculation of Capital Requirements for Market Risk;
- all exposures to venture capital companies and venture capital funds. These are corporates that in accordance with legislation have been granted the status of a venture capital company or venture capital fund in the country in which they are established;
- all exposures to unregulated venture capital companies and venture capital funds. These are corporates that in accordance with legislation have not been granted the status of a venture capital company or venture capital fund in the country in which they are established, but nevertheless have 50% of their assets invested in equity of unlisted companies for the purpose specified in the second paragraph of Article 4 of the Venture Capital Companies Act;
- all exposures to collective investment undertakings (investment funds) with particularly high risk. These are (a) all unregulated investment funds (their operations are not regulated by specific legislation and/or supervised by the competent supervisory authority, e.g. hedge funds), and (b) regulated investment funds, the majority of whose investments come from countries to which the OECD or any other competent export agency assigns the highest minimum export insurance premium;
- all exposures to unregulated entities that hold 50% of their assets in investments in financial instruments in the sense of the Market in Financial Instruments Act, and do not pursue holding activities. These entities include all companies established or operating primarily with the intention making a takeover bid in accordance with the Takeovers Act, including companies that are not the acquirer but are acting in concert with the acquirer, where the commercial grounds for the creation of the exposure to the company is financing or refinancing the takeover of another company.

Banks must assign a weight of 150% to the aforementioned exposures in accordance with the Regulation on the Calculation of Capital Requirements for Credit Risk Using a Standardised Approach for Banks and Savings Banks. The regulation entered into force on 1 January 2008.

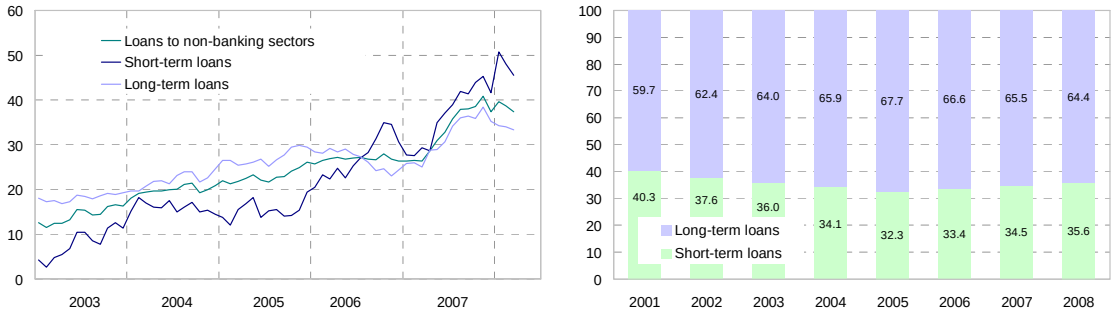
4. The Bank of Slovenia recommends to banks that they use the majority of their profit to create reserves, thus increasing their original own funds.

6.3.2 Structure of assets

Short-term lending outpaced long-term lending.

Growth in short-term loans last year outpaced growth in long-term loans, thus increasing the proportion of the stock of loans that they account for by 1 percentage point to 35.6%.

Figure 6.9: Year-on-year growth in loans to non-banking sectors by maturity, and percentage breakdown of loans to non-banking sectors by maturity



Source: Bank of Slovenia

Growth in loans in foreign currency outpaced that of loans in domestic currency, but the proportion of loans to non-banking sectors in foreign currency remained low, at 6%. Household loans recorded the highest proportion of loans in foreign currency, the figure reaching 11.6% by March 2008.

Table 6.7: Structure and growth in balance sheet items in the banking sector at year-end in percentages

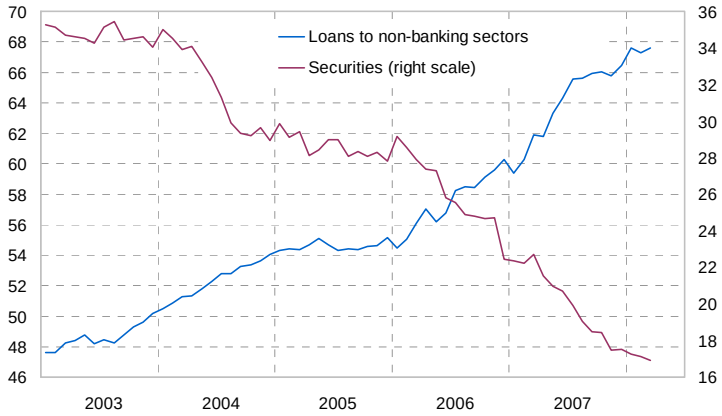
					Growth rate (%)			
	2005	2006	2007	Mar 2008	2005	2006	2007	Mar 2008
Total assets (EUR million)	29,287	33,868	42,195	43,909	23.6	15.6	24.6	25.8
Assets	Structure (%)							
Cash	2.0	3.1	1.4	1.4	1.9	76.3	-42.9	14.4
Loans to banks	9.8	9.1	9.6	9.4	35.6	6.8	32.6	36.1
Loans to non-banking sectors	55.1	60.3	66.5	67.6	26.1	26.4	37.4	37.4
Corporate loans	33.8	36.5	39.8	40.5	22.5	24.8	35.9	35.4
Households loans	13.9	14.9	15.2	15.3	28.0	24.1	27.1	26.9
Loans to government	2.3	1.7	1.1	1.0	11.6	-13.8	-18.9	-14.7
Loans to others	5.1	7.1	10.3	10.7	59.4	61.3	79.7	78.9
Financial assets/securities	28.1	23.3	18.3	17.5	19.4	-4.2	-2.2	-6.5
Bank of Slovenia	12.0	5.3			9.5	-48.9		
Government and other	16.2	18.0	18.3	17.5	28.0	28.8	26.4	-4.8
Capital investments	1.2	1.3	1.5	1.4	11.6	19.9	43.9	38.0
Other assets	3.6	3.0	2.7	2.7	12.0	-5.7	13.7	12.2
Liabilities								
Liabilities to banks	28.7	31.9	37.8	38.7	80.0	28.6	47.8	47.8
To foreign banks	26.9	29.9	33.9	34.7	86.4	28.1	41.3	50.8
Liabilities to non-banking sectors	54.7	51.7	45.9	45.0	8.8	9.3	10.6	14.9
To corporates	14.8	14.1	11.4	10.5	11.6	10.3	0.4	7.5
To households	36.0	33.4	29.3	28.9	6.0	7.4	9.3	10.4
To government	3.0	3.3	3.6	4.5	53.4	28.5	35.6	75.3
To others	0.9	0.8	1.6	1.1	-15.6	6.9	139.0	71.0
Liabilities from securities	3.4	2.9	2.3	2.2	5.7	-1.6	-1.3	3.2
Other liabilities	5.1	4.6	3.9	3.9	15.8	3.3	5.9	-7.3
Provisions	0.6	0.5	0.5	0.5	-64.1	2.2	12.3	8.2
Subordinated liabilities	2.4	2.9	3.5	3.3	18.4	40.0	48.1	31.3
Capital	8.5	8.4	8.4	8.6	29.6	14.3	25.2	23.8

Source: Bank of Slovenia

The proportion of banks' total assets accounted for by securities continued to decline.

The trend of a decline in the proportion of banks' total assets accounted for by securities continued in 2007. The final Bank of Slovenia bills having matured early last year, there were increases in both investments in government securities and foreign securities and in loans to non-banking sectors. With the decline in the stock of securities to EUR 210 million and the rapid growth in loans in 2007, the proportion of total assets accounted for by securities declined, reaching 16.9% in March 2008. The final months of last year and the early months of 2008 point to a slowdown in the decline in this proportion.

Figure 6.10: Percentage of total assets accounted for by loans to non-banking sectors and securities



Source: Bank of Slovenia

Comparison of the asset structure of Slovenian banks and EU banks

Table 6.8: Comparison of on-balance-sheet asset structure at Slovenian banks and EU banks reporting under the IFRS

(%)	2006		2007
	Medium-sized EU banks[1]	Small EU banks[1]	Slovenia
Cash	1.91	3.40	1.4
Loans to banks	9.02	16.49	9.6
Loans to non-banking sectors	68.90	59.83	66.5
Financial assets/securities	13.27	12.87	18.3

Note: [1] Domestic banks from EU member-states reporting under the IFRS.
Sources: Bank of Slovenia, ECB: EU Banking Sector Stability, November 2007

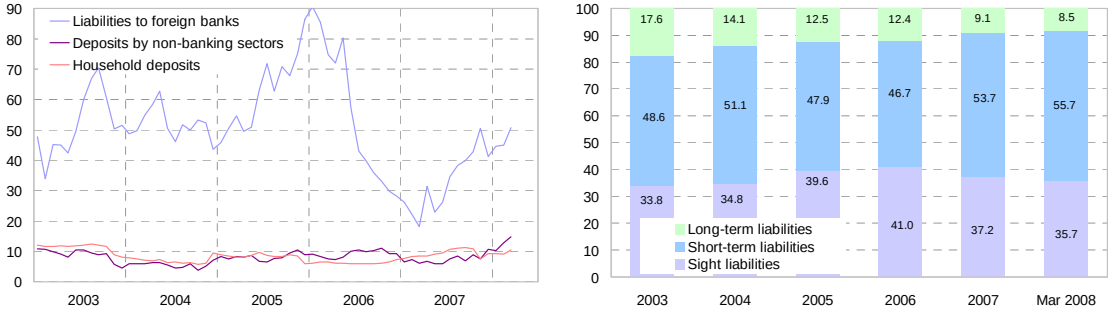
A comparison of the asset structure of the Slovenian banking system with that of medium-size EU banks reveals that the proportion of total assets accounted for by loans to non-banking sectors in Slovenia is comparable to that of medium-size EU banks. Despite a decline in recent years, the proportion accounted for by securities at Slovenian banks is still several percentage points higher than that at EU banks of comparable size.

6.3.3 Sources of financing for banks

Growth in deposits by non-banking sectors remained low.

In 2007 growth in deposits by non-banking sectors was significantly outpaced by growth in loans to non-banking sectors. In the context of relatively low growth in deposits, and a moderate decline in investments in securities, banks were forced to step up their borrowing from banks in the rest of the world in order to satisfy non-banking sectors' demand for loans. Growth in deposits by non-banking sectors reached 10.6% last December.

Figure 6.11: Growth in sources of assets (left) and breakdown of banks' liabilities to non-banking sectors (right) in percentages

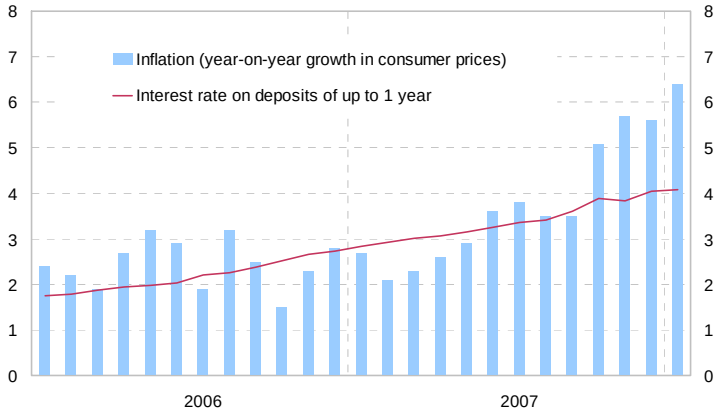


Source: Bank of Slovenia

Banks mostly covered the increased demand for resources by borrowing at banks abroad.

There was a slight change in the breakdown of deposits by non-banking sectors by maturity last year. The proportion accounted for by long-term bank deposits declined, to stand at just 9.1% at the end of 2007. Another factor in the trend of decline in the proportion accounted for by long-term deposits by non-banking sectors was the ex post negative real interest rates. Interest rates on short-term deposits in Slovenia were lower than those in the EMU, while interest rates on long-term deposits in Slovenia exceeded those in the EMU. The proportion of total assets accounted for by deposits has continued to decline, reaching 45% in March 2008.

Figure 6.12: Interest rates on deposits of up to 1 year, and inflation in consumer prices in percentages



Source: Bank of Slovenia

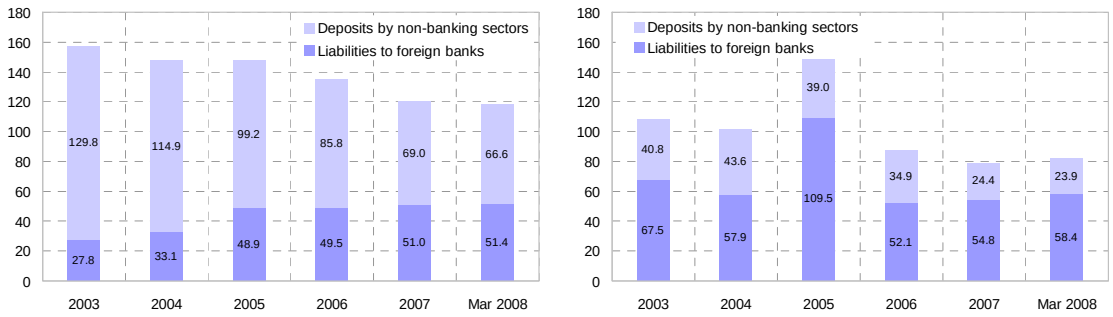
Liabilities to foreign banks are a more important source of financing for the banks under majority foreign ownership than for the domestic banks.

The continuing high growth in borrowing in the rest of the world by Slovenian banks meant that the proportion of total liabilities accounted for by liabilities to foreign banks increased to 33.9%. However there are major differences between the individual groups of banks. In December 2007 the proportion of total liabilities accounted for by liabilities to foreign banks at the large banks under majority domestic ownership was 27%, compared with 24% at the small domestic banks, and 52.3% at the banks under majority foreign ownership.

Household deposits are important to the long-term stability of bank operations.

Despite slow growth, deposits by non-banking sectors remain the most important source of financing for the large banks, accounting for almost 51% of total liabilities. However for the banks under majority domestic ownership, liabilities to foreign banks are a less stable and more expensive source of financing than household deposits, so household deposits are important to the long-term stability of banking operations. Further confirmation of this came after the outbreak of the sub-prime mortgage crisis. The trend of decline in the coverage of loans to non-banking sectors by deposits by non-banking sectors continued in 2007. At the end of the year the ratio of such deposits to loans stood at 69%, having stood at 130% at the end of 2003.

Figure 6.13: Percentage coverage of loans to non-banking sectors by liabilities to foreign banks and by deposits by non-banking sectors in terms of stock (left) and in terms of nominal increase (right)



Source: Bank of Slovenia

Given the borrowing conditions in the rest of the world, there are relatively large differences between banks in the way in which they finance lending growth. Thus at the

end of 2007 the coverage of loans to non-banking sectors by deposits stood at just over 81% at the large banks under majority domestic ownership, at just over 88% at the small domestic banks, and at just 43.7% at the banks under majority foreign ownership. The coverage of loans to non-banking sectors by liabilities to foreign banks was just over 43% at the large domestic banks, but stood at two-thirds at the banks under majority foreign ownership. The relative importance to Slovenian banks of financing in the rest of the world increased further last year. The banks under majority foreign ownership covered the largest proportion (48.6%) of the increase in loans to non-banking sectors by borrowing in the rest of the world, compared with 44.5% for the large domestic banks.

Comparison of the liability structure of Slovenian banks and EU banks

The decline of the proportion of total liabilities accounted for by deposits by non-banking sectors in the Slovenian banking system means that the figure is less and less comparable to that of banks of comparable size in the EU. At the same time the proportion of Slovenian banks' financing accounted for by issued securities is significantly lower than in the EU, particularly in comparison with medium-size banks in the EU. Banks in Slovenia also typically have a higher proportion of subordinated liabilities.

Table 6.9: Breakdown of on-balance-sheet total liabilities by selected liability item at Slovenian banks and at EU banks reporting under the IFRS in percentages

(%)	2006		2007
	Medium-sized EU banks[1]	Small EU banks[1]	Slovenia
Liabilities to banks	11.07	11.25	37.4
Liabilities to non-banking sectors	48.19	67.54	45.9
Liabilities from securities	23.47	4.22	2.3
Provisions	0.62	0.32	0.5
Subordinated liabilities	2.17	0.97	3.5
Capital	5.62	10.77	8.4

Note: [1] Domestic banks from EU member-states reporting under the IFRS.
Source: Bank of Slovenia

6.3.4 Off-balance-sheet items and fiduciary operations

At 38.3%, growth in off-balance-sheet items was 15.3 percentage points higher than growth in total assets last year. The main contributions to the increase in off-balance-sheet items came from guarantees received (38%) and derivatives (just under a quarter). The ratio of off-balance-sheet items to total assets increased by 162.8% in December 2007. There were no significant changes in the structure of off-balance-sheet items. The increase in the proportion accounted for by derivatives stood out slightly, the figure increasing by 3.2 percentage points last year to 16.2%.

Table 6.10: Structure of and growth in off-balance-sheet items in the banking sector at year end in percentages

					Growth rate (%)			
	2005	2006	2007	Mar 2008	2005	2006	2007	Mar 2008
Off-balance sheet items (EUR million)	39,779	49,465	68,408	78,543	9.4	26.3	38.3	44.3
	Structure (%)							
Letters of credit	0.5	0.3	0.3	0.3	52.5	-13.9	18.6	13.0
Guarantees and assets pledged as collateral	6.1	5.4	4.5	3.8	15.8	10.8	15.4	10.8
Assumed financial liabilities	9.4	8.1	7.5	6.6	21.7	6.9	28.6	11.2
Derivatives	12.2	13.0	16.3	14.9	36.8	32.0	73.2	46.0
Depo and other securities records	13.4	13.4	12.1	10.4	30.7	24.7	24.2	44.2
Records of written-off claims	0.3	0.2	0.2	0.2	-15.0	1.2	18.6	-4.5
Other off-balance sheet items	58.2	59.5	59.2	63.9	25.5	27.3	37.4	51.7
Warranties received	36.3	36.9	37.0	43.3	19.6	26.3	38.6	67.4
Guarantees and gov. sureties received	2.9	2.3	2.0	2.4	22.5	-3.3	21.1	59.0
Other	18.9	20.4	20.2	18.3	38.7	33.9	37.2	23.4

Source: Bank of Slovenia

Box 6.2: The impact and progress of the first phase of the privatisation of Nova kreditna banka Maribor

In November 2007 the Slovenian government held an IPO for a maximum holding of 49% in ordinary shares in NKBM, offering the shares to institutional investors inside and outside Slovenia and to small investors in Slovenia. NKBM is the second-largest banking group operating in Slovenia. After the indicative share price range of EUR 20.5 to EUR 27 was announced, there followed a subscription and payment period between 19 and 29 November. On the basis of the offers received, the government set the final price at EUR 27 on 4 December 2007.[1] Demand for the shares was huge: 110,256 small investors made subscription payments in a total of EUR 749.48 million. The 69 domestic institutional investors that met the purchase conditions submitted binding bids in the amount of EUR 199 million, while 36 foreign investors disclosed a binding interest in the amount of EUR 711 million. In line with the offer, all persons that submitted an order[2] were first assigned their guaranteed[3] shares. The remaining shares sold in a tranche to small investors were assigned pro rata by the number of shares for which the individual investor submitted an order and paid the sum required. In this manner 24% of the nominal capital in NKBM in the amount of EUR 151.35 million was sold to small investors, 10.19% (EUR 64.25 million) to domestic institutional investors, and 14.81% (EUR 93.41 million) to foreign institutional investors.

The privatisation of NKBM meant that last November and December there were significant temporary changes in the values of some categories in the banking sector's balance sheet, although the actual relative impact within each category is impossible to quantitatively determine entirely precisely. Household deposits thus declined in November in nominal terms. Household lending was also larger than usual, November's net increase in household loans significantly exceeding (by about 80%) last year's prior monthly average. The increase in "other liabilities" and the increase in claims against foreign banks were also worthy of note in the banking system. In the last third of November there was also a decline of approximately EUR 100 million in cash during the subscription of orders by small investors. Small investors financed their subscription payments for NKBM shares by reducing deposits and raising loans, and partly by restructuring other forms of financial assets.

In December the values of some categories in the banking system underwent the opposite changes to November: household deposits increased, while claims against foreign banks and "other liabilities" declined. At the same time repayments brought a reduction in the stock of consumer loans and other loans that households had raised in November for the purpose of making subscription payments for NKBM shares. Households having made subscription payments for NKBM shares of EUR 750 million in November, they repaid the loans in December and, in part, also increased their bank deposits. In the banking system's balance sheet the changes were most reflected in a decline in "other liabilities", under which November's subscription payments for the privatisation were booked, and in a decline in other claims against foreign banks, where the funds were temporarily placed.

The assembling of assets by small investors in the IPO for NKBM shares also brought a decline in prices on the Ljubljana Stock Exchange in November. In late November and early December prices on the exchange settled, partly as a result of expectations of the investment on the capital markets of some of the money returned from the over-subscription of NKBM shares, as the amount of over-subscription was already known by then. The share price having been set at EUR 27 per share, after the first day of listing on the stock exchange (10 December) it reached EUR 36.6 in heavy trading (EUR 33.5 million). The price then continued to rise sharply, peaking at EUR 44 on 24 December. It ended the year at EUR 41.9. The listing of NKBM shares also had a significant impact on the market capitalisation of shares on the Ljubljana Stock Exchange, which increased by EUR 1.81 billion or 9.6% in December, the listing of NKBM shares accounting for EUR 979 million of this.

The listing of NKBM shares therefore had a significant impact on developments on the Ljubljana Stock Exchange in the final month of last year. It accounted for more than one-third of total volume of trading in December. NKBM shares were included in the SBI 20 and SBITOP indices in the middle of January 2008. The share price declined gradually in January, and then settled at approximately EUR 38. It declined again in the middle of March and early April 2008, approaching EUR 33. The movement of the NKBM share price in 2008 matched the general trend in share prices on the Ljubljana Stock Exchange.

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[1] Summarised from the report from the government session.
[2] Each person was allowed to submit a single share order, the sum to be invested totalling no more than EUR 50,000.
[3] The number of guaranteed shares per small investor was determined with regard to the projected number of small investor orders received: 30 shares if fewer than 80,000 orders were received, 20 shares for 80,001 to 160,000 orders, and 10 shares for 160,001 to 500,000 orders. In the event of the number of orders exceeding 500,000, all small investors would be guaranteed the same number of shares, but no more than 10 shares to any small investor.

6.4 Profitability and performance indicators

Banks generated EUR 513.7 million of profit in 2007.

In 2007 banks generated EUR 513.7 million of pre-tax profit, up 30% on 2006. The main factors in the relatively high growth in profit were the favourable trend on the income side (growth in net interest and non-interest income exceeded 17%), and the moderate growth in operating costs. Impairment and provisioning costs recorded slightly slower growth than loans to non-banking sectors.

Table 6.11: Banking sector income statement

	Amount (EUR million)			Growth rate (%)				Proportion of gross income (%)			
	2005	2006	2007	2005	2006	2007	Mar 2008	2005	2006	2007	Mar 2008
Net interest	631.5	689.8	810.7	5.4	9.2	17.5	16.9	60.2	56.7	56.8	70.1
Net non-interest income	417.2	525.8	617.0	9.0	26.0	17.3	-34.7	39.8	43.3	43.2	29.9
Of which fees and commissions	281.7	308.5	335.4	9.1	9.5	8.7	10.9	26.9	25.4	23.5	27.8
Of which net gain/loss on financial assets held for trading	70.8	97.2	135.8	-15.7	37.2	39.7	-254.8	6.8	8.0	9.5	-19.6
Gross income	1,048.6	1,215.6	1,427.6	6.8	15.9	17.4	-5.4	100	100	100	100
Operating costs	647.4	702.1	752.7	5.8	8.5	7.2	5.2	61.7	57.8	52.7	56.6
Labour costs	342.5	367.4	399.9	5.0	7.3	8.8	7.3	32.7	30.2	28.0	31.1
Net income	401.2	513.5	675.0	8.5	28.0	31.5	-16.5	38.3	42.2	47.3	43.4
Net provisioning and impairments	140.1	119.8	161.2	3.2	-14.5	34.6	-115.1	13.4	9.9	11.3	-1.5
Pre-tax profit	261.2	393.7	513.7	11.5	50.7	30.5	7.5	24.9	32.4	36.0	44.9
Taxes	51.8	90.9	101.7	-35.9	75.5	11.9	-9.6	4.9	7.5	7.1	8.4
Net profit	209.4	302.8	412.1	36.5	44.6	36.1	12.4	20.0	24.9	28.9	36.5

Source: Bank of Slovenia

Net interest income and interest margin

There was almost no change in the structure of gross income last year.

The proportion of banks' gross income accounted for by net interest income remained at the same level in 2007 as in the previous year. It declined in the first half of the year, when growth in non-interest income strongly outpaced growth in net interest, but increased again in the second half of the year. At the end of the year growth in the two types of income had equalised. The main factors in the relatively high growth in net interest income were faster growth in interest-bearing assets than in interest-bearing liabilities (by an average of 5%), the increase in the proportion of interest-bearing assets accounted for by loans, and the rapid increase in lending rates. A factor in the increase in interest income was the increase in the proportion of liabilities to foreign banks, which are remunerated at higher rates than deposits by non-banking sectors.[46]

Table 6.12: Average effective asset and liability interest rates calculated from interest income and expenses, interest spread and interest margin in percentages

(%)	2003	2004	2005	2006	2007
Average asset interest rate	7.52	5.78	4.90	4.81	5.48
Average liability interest rate	4.44	3.04	2.44	2.59	3.36
Effective interest rate spread	3.08	2.74	2.46	2.22	2.12
Interest margin on interest-bearing assets	3.35	2.87	2.62	2.37	2.31

Source: Bank of Slovenia

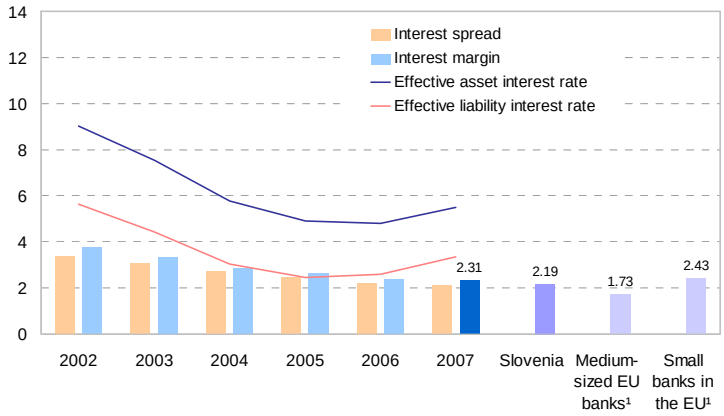
Last year the interest spread declined less than in previous years.

In contrast to previous years, effective asset interest rates[47] rose by 0.67 percentage points last year. Effective liability interest rates also rose, by 0.77 percentage points. The main factors in the increase in effective asset interest rates were the change in the structure of interest-bearing assets in favour of better-remunerated loans, and the faster repricing of interest rates. The main factor in the increase in liability interest rates was that interest rates on liabilities to foreign banks adjust immediately to changes in interest rates on international financial markets because of the tie to the EURIBOR.

[46] At 4.72%, the effective interest rate on liabilities to banks was almost 2 percentage points higher than the effective interest rate on deposits by non-banking sectors in the final quarter of 2007.

[47] The effective asset interest rates are calculated as the ratio of interest income to interest-bearing assets, while the effective liability interest rates are expressed as the ratio of interest expenses to interest-bearing liabilities.

Figure 6.14: Average effective asset and liability interest rates calculated from interest income and expenses, interest spread and interest margin in percentages



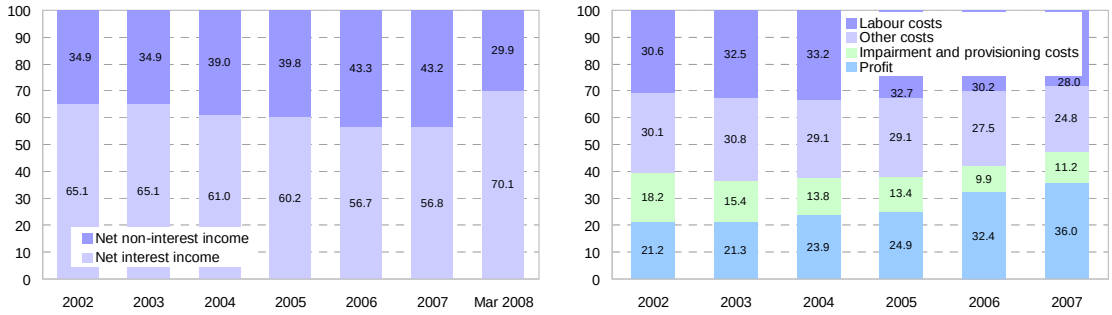
Note: [1] The separate figures for the interest margin in Slovenia and EU member-states reporting under international accounting standards are for 2006, and were calculated as the ratio of net interest income to total assets. The interest margin for EU banks was taken as the net interest margin for medium-size banks and small banks.
Source: Bank of Slovenia, EU Banking Sector Stability, November 2007

Net non-interest income

The importance of net non-interest income in banks' income structure last year was comparable to that in the previous year.

The proportion of banks' gross income accounted for by non-interest income increased consistently until the middle of 2007, primarily as a result of high income from trading in financial assets. This also reflected the valuation of securities, as a result of favourable movements on stock markets. Year-on-year growth began to decline sharply in the second half of the year. Between August and the end of the year, banks generated just one-tenth of their annual total of income from trading in financial assets. With growth in income from fees and commissions stable, this had an impact on the proportion of gross income accounted for by non-interest income. Warning was given last year that greater volatility in stock market prices could increase the volatility of banks' profits. Banks recorded a loss on this type of non-interest income in the early months of 2008, primarily as a result of price falls on stock markets.

Figure 6.15: Proportion of banks' gross income accounted for by net interest and non-interest income (left) and disposal of gross income (right) in percentages



Source: Bank of Slovenia

Gross income structure of Slovenian banks and EU banks

Slovenian banks' gross income structure is very similar to the average gross income structure of medium-size EU banks.

Table 6.13: Gross income structure of Slovenian banks and EU banks

	Income as a proportion of gross income (%)		
	Medium-sized EU banks (2006)	Small EU banks (2006)	Slovenia 2007
Net interest	57.4	50.7	56.8
Non-interest income	42.6	49.3	43.2

Source: Bank of Slovenia, ECB: EU Banking Sector Stability, November 2007

Banks' operating costs

Growth in operating costs was moderate. The large domestic banks were the most effective in controlling costs.

At 7.2%, growth in banks' operating costs was significantly lower than growth in total assets. The cost-to-income ratio (the ratio of operating costs to gross income) fell below 53%. The most effective in controlling costs in 2007 were the large domestic banks, while the banks under majority foreign ownership were the least effective. Growth in labour costs rose to 8.8% last year, while general and administrative costs and amortisation/depreciation costs increased by just 6% and 3.5% respectively. The decline in growth in general costs can be attributed to the fact that last year there were no institutional changes as there had been in the previous year.

Table 6.14: Year-on-year growth in operating costs by group of banks in percentages

(%)	Total	Large banks	Foreign banks	Small banks
2004	3.6	2.1	7.6	2.6
2005	5.8	1.8	11.3	12.7
2006	8.5	9.5	8.6	6.3
2007	7.2	3.9	12.3	11.9

Source: Bank of Slovenia

The coverage of operating costs by net non-interest income improved last year to 81.7%. However the high value of this ratio is primarily the result of low growth in costs. With growth in operating costs relatively stable, fluctuations in non-interest income can significantly affect the coverage of costs by non-interest income.

Growth in impairment and provisioning costs was outpaced by growth in loans to non-banking sectors.

Banks having sharply reduced their impairment and provisioning costs in 2006, under the impact of the introduction of the IFRS, growth in these costs at the end of 2007 almost outpaced growth in loans to non-banking sectors. The gradual strengthening of provisioning costs coincided with the high growth in lending to non-banking sectors in 2007, but their ratio to gross income is much lower than four years ago.

Table 6.15: Loans, and impairment and provisioning costs

(%)	Large banks	Small banks	Foreign banks	Banking system
Growth in loans to non-banking sectors in 2007	34.0	48.6	40.0	37.4
Growth in provisions and impairments in 2007	23.5	761.5	-21.8	33.6
Provisioning and impairments/gross income in 2007	13.3	13.1	4.8	11.2
Provisioning and impairments/gross income in 2006	12.3	2.1	7.1	9.9

Source: Bank of Slovenia

Comparison of the operating cost structure of Slovenian banks and EU banks

Last year the trend of a decline in the ratio of operating costs to average total assets in the Slovenian banking system continued, the figure reaching 2%. Compared with banks in the EU, the ratios remain similar to the previous year. The ratio of operating costs to average total assets exceeds that recorded by medium-size EU banks (1.6%).

A comparison of the structure of operating costs reveals that labour costs continue to account for a lower proportion at Slovenian banks than at banks in the EU overall. In terms of the coverage of operating costs by non-interest income, Slovenian banks are comparable to banks in the EU overall.

Table 6.16: Breakdown of operating costs, cost-to-income ratio (CIR) and coverage of operating costs by non-interest income in Slovenia and the EU in percentages

(%)	2006		2007
	Medium-sized EU banks	Small EU banks	Slovenia
Labour costs	58.4	55.4	53.1
Administrative costs	34.5	37.7	35.7
Other costs	7.2	6.9	11.3
Operating costs	100.0	100.0	100.0
CIR (operating costs/gross income)	53.1	60.4	52.8
Non-interest income/operating costs	80.0	81.7	82.0

Sources: Bank of Slovenia, ECB: EU Banking Sector Stability, November 2007

Bank performance indicators

Profitability in the Slovenian banking system has increased in recent years.

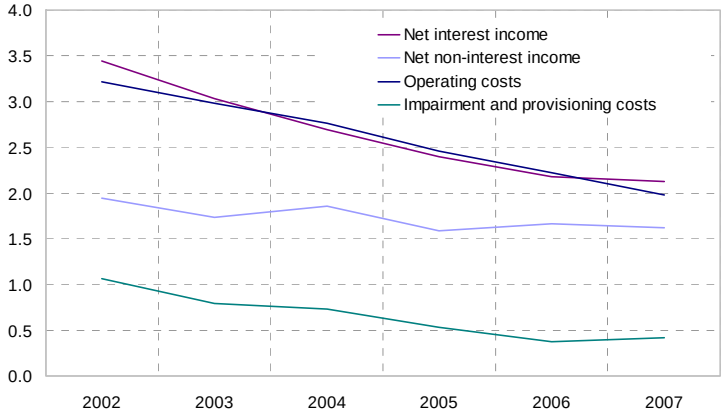
Banks' ROE increased by 1.2 percentage points last year to 16.3%. The main factors in banks' profitability remaining at a high level were the high growth in net interest income, the large increase in non-interest income, the moderate increase in operating costs, and the movement of impairment and provisioning costs within the boundaries of lending growth. The trend of a decline in the interest margin ceased last year. The non-interest margin rose rapidly over the first quarter, then towards the end of the year returned to a level comparable to the previous year.

Table 6.17: Bank performance indicators in percentages

(%)	2002	2003	2004	2005	2006	2007
ROA	1.11	1.00	1.06	1.00	1.25	1.36
ROE	12.55	11.89	12.72	12.72	15.07	16.28
Costs/gross income	60.61	63.28	62.32	61.74	57.76	52.72
Interest margin on interest-bearing assets	3.76	3.35	2.94	2.62	2.37	2.31
Interest margin on total assets	3.41	3.05	2.70	2.42	2.19	2.15
Non-interest margin	1.84	1.63	1.72	1.60	1.67	1.64
Gross income/average assets	5.25	4.68	4.42	4.02	3.86	3.79

Source: Bank of Slovenia

Figure 6.16: Net interest income, net non-interest income, operating costs and net provisioning as a percentage of average assets



Source: Bank of Slovenia

Breakdown of profitability into components.

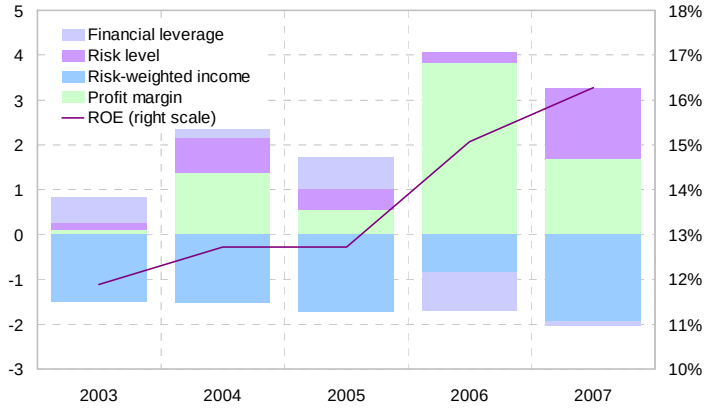
The movement and increase in banks' ROE can be analysed by breaking down profitability into four components: profit margin, risk-weighted income, risk level and financial leverage.[48]

Increases in the risk level and the profit margin were responsible for the increase in profitability in 2007.

Increases in the risk level and the profit margin were responsible for the increase in banks' profitability in 2007. Risk-weighted assets and financial leverage acted to decrease profitability. In contrast to previous years, last year there was a notable contribution to the increase in profitability from the higher risk level.

[48] For an example of the calculation of the breakdown of ROE, see *Financial Stability Review* 2006:2, Sveriges Riksbank, p 36, and Bank of England: *Financial Stability Review*, December 2003. The ratios are defined as follows in this case: a) profit margin = pre-tax profit / gross income; b) risk-weighted income = gross income / risk-weighted assets; c) risk level = risk-weighted assets / total assets, and d) financial leverage = total assets / equity.

Figure 6.17: ROE in percentages, and contribution towards change in ROE by the four factors in percentage points



Source: Bank of Slovenia

By contrast, the profit margin was one of the major factors in the increase in profitability in the previous three years, while financial leverage made a negative contribution to profitability in the last two years. Banks have also seen an unfavourable trend of decline in income per unit of risk-weighted assets for several years.

Table 6.18: Breakdown of ROE into four factors

	Profit margin (pre-tax profit / gross income)	*	Risk-weighted income (gross income / risk-weighted assets)	*	Risk level (risk-weighted assets / total assets)	*	Financial leverage (total assets / capital)	=	Profitability ROE
2005	0.249		0.055		0.728		12.811		0.13
2006	0.324		0.052		0.739		12.116		0.15
2007	0.360		0.046		0.818		12.052		0.16

Source: Bank of Slovenia

Profitability of Slovenian banks and EU banks

Table 6.19: Bank performance indicators

	2006		2007
(%)	Medium-sized EU banks	Small EU banks	Slovenia
Net interest / total assets	1.73	2.43	2.15
Non-interest income / total assets	1.28	2.37	1.64
Gross income / total assets	3.02	4.80	3.79
Operating costs / total assets	1.60	2.90	2.00
operating profit / total assets	1.41	1.90	1.79
Provisioning and impairment costs (and other)	0.27	0.10	0.43
Pre-tax profit	1.21	1.80	1.36
ROE[1]	15.88	13.10	16.28

Note: [1] ROE calculation for EU banks is based on Tier 1 capital (EU Banking Sector Stability, November 2007), and consolidated data.
For the two EU bank groups, which are in accordance with the IFRS, the data is consolidated, and profitability is calculated on the basis of Tier I capital. In Slovenia the profit is that of the entire unconsolidated banking system, based on total capital.
Sources: Bank of Slovenia, ECB: EU Banking Sector Stability, November 2007

6.5 Risks in the banking sector

Banks continue to indicate that the greatest risks are those linked to financial markets.

Survey of major risks

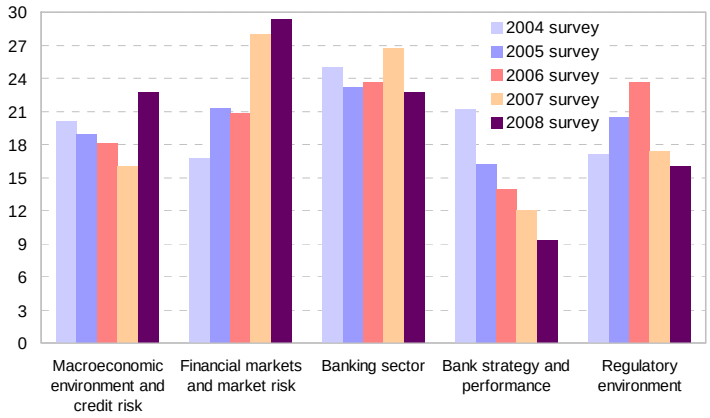
The results of a bank survey carried out in 2008 confirm that conditions on financial markets have not yet eased. Banks continue to be most concerned about developments on

financial markets. In addition to trends in interest rates, in particular their increased volatility, banks have pointed out the risk of a large correction on capital markets.

Risks linked to the macroeconomic environment and credit risk are greater than in previous years.

Banks are paying more attention to macroeconomic conditions than they have in past years. The greatest risk identified by banks is a turnaround in the credit cycle and the tightening of conditions on the real estate market, with a drop in prices. Banks have identified rising oil prices and inflation as problematic. Lower economic growth and tightened liquidity conditions are the major risks, not only for banks, but for their clients too. Banks therefore believe that the ability to service debt and the credit worthiness of borrowers are likely to deteriorate in 2008. Banks will dedicate more attention to monitoring outstanding loans, increased selectivity in choosing new projects and to the quality of their collateral. This however exposes banks to the risk of a slowdown in the growth of their operations.

Figure 6.18: Results of 2004 to 2008 surveys on main origins of risk for the coming year in percentages



Source: Annual bank surveys

Competition and tightened access to foreign sources of financing represent the key risks linked to the banking sector.

Risks linked to the banking system, particularly with regard to competitive pressures, remain significant for banks. These pressures are seen in the reduction of interest margins, an outflow of deposits to alternative investments and in the aggressive behaviour of banks and other financial institutions with the strong capital backing of foreign owners. The risk of higher costs and limited accessibility to foreign sources of financing have taken on considerably more meaning in this risk category due to the instability on international financial markets.

Regulatory risks are no longer considered one of the most significant risk categories.

As the implementation of major institutional changes (introduction of the IFRS, the euro and Basel II) is completed, banks are lowering their risk assessments arising from the regulatory environment. Within this risk group, banks have drawn attention to the particularities of the regulation of the calculation of capital adequacy, while documentary and administrative requirements have also increased. With regard to the IFRS, banks have mentioned the problem of valuation.

Banks consider risks associated with their strategies least significant, while pointing out operational risk and the risk of expansion to new markets.

Somewhat surprising is the fact that banks consider risks arising from their own strategies and operations least significant. The significance of this group of risks has decreased throughout the survey period. In part, this development is likely the result of the good operating results of banks in recent years and the fact that, of all risk groups, this category is largely controlled by the banks themselves. Nevertheless, this development indicates a certain degree of complacency at banks. Given the distinctly aggressive approach of individual banks and the expansion of operations to new markets and products, prudence in assessing own strategies and business policies is important in unstable conditions on international financial markets. In their detailed definitions of the most significant risks, banks mention operational risks and risks linked to expansion to new markets. Information technology support and risks associated with the financial innovations and complexity of products are significant among operational risks. With regard to expansion to new markets, banks point out regional political instability and the overheating of economies in some markets where they are expanding their operations.

Box 6.3: Distance to default indicator for Slovenian banks

Monitoring market information-based indicators is increasingly important when analysing the banking sector. Market indicators based on share price developments reflect the perception of market participants regarding their ability to generate future returns. Therefore the impact of events linked to a bank is taken into account before accounting data. They also reflect soft data not included in accounting data. Another important characteristic is that this data is forward looking, whereas accounting data reflects the past. One of the most frequently used market information-based indicators is distance to default (DtoD).

The DtoD indicator is a measure of the distance, based on standard deviations, of the current market value of assets from the point of default, where the market value of the assets is less than that of the liabilities. Because data regarding the market value of an asset and its volatility is not immediately available, an indirect calculation is typically used via the market value of equity, the volatility of share price returns and the value of debt using the Black-Scholes model of valuing share options[1]. The assumption when using this model is that the owners of a company posess a call option, the right to purchase all of a company's assets, (i.e. the investments of a bank) by repaying all liabilities to creditors[2]. Following the repayment of all liabilities, holders of equity are the only parties entitled to the company's assets. The exercise price of such an option is equal to the value of all liabilities. (See: Jašovič et al. 2008[3]).

However the shares of most Slovenian banks are not listed on the stock exchange. Longer data series of market share prices are only available for two banks. As of 2008 the shares of the second largest bank are listed on the stock exchange, while the listing of some other large Slovenian banks has also been announced. Thus over time, the importance of market indicators will increase in Slovenia as well. In the interim period the question arises as to whether the use of market indicators provides useful information, even if the ideal data is not available.

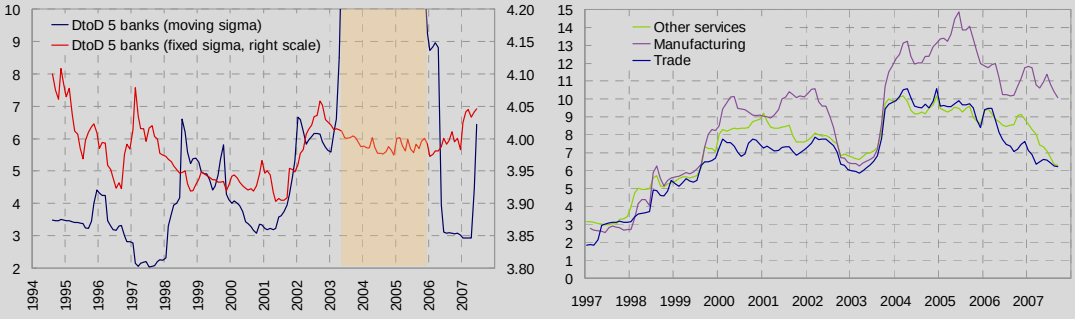
The DtoD indicator is calculated for five banks, where the market prices of their shares from the stock exchange or the grey market are taken into account. Share prices quoted by brokerage houses are considered the grey market[4]. The market share of the banks included in the calculation is 52% in terms of the banking system's total assets, according to figures for the end of 2007. Of this, banks for which stock market prices are taken into consideration account for 15.2%, while banks for which grey market prices are taken into consideration account for 84.8%.

For the group of five banks for which the aggregate DtoD indicator is calculated, the return is calculated as the weighted return of the share prices of the individual banks where the weights are determined based on an individual bank''s proportion of the equity of all five banks. Market capitalisation is calculated as the sum of market capitalisations of individual banks, while the standard deviation is calculated from the daily data of the weighted return of the group over a moving period of one year.

The DtoD indicator of the group of five banks fluctuated in the range from 2 to 7 throughout most of the observation period and was lower than the values calculated for large euro area banks, which fluctuated between 6 and 8[5]. This is expected given that Slovenian banks are considerably smaller and less diversified geographically and in terms of products, and thus more vulnerable. The DtoD indicator of Slovenian banks rose well above the reference value in the period from 2003 to 2005. This however is due to the fact that there is almost no data regarding the share prices of banks on the grey market for this period. As a result, the shares of banks from the grey market during this period have a very low level of volatility, while banks achieve a high DtoD indicator. The indicator reached its lowest (highest risk) value in 1997, when the growth in lending of Slovenian banks also reached its lowest level. In that year, year-on-growth in lending to non-banking sectors uniquely fell below 10%. Other periods when a very low value for the indicator was achieved were at the end of 1994 and for most of 1995, at the end of 2000 and the beginning of 2001 and in the second half of 2006 and the beginning of 2007.

If instead of a one-year moving period we use the entire observation period for the calculation of the standard deviation, so that market capitalisation volatility remains unchanged, we arrive at a long-term trend of the DtoD indicator for the system of five Slovenian banks which fluctuates at a level of approximately 4.

Figure 6.19: Distance to default for Slovenian banks (left) and for three sectors (right)



Source: Bank of Slovenia

In contrast to banks, considerably more companies are listed on the stock exchange. Twelve companies from the following three sectors were selected below: manufacturing, trade and other services. The DtoD indicator for an individual sector was calculated by weighting the returns and standard deviations of companies within the sector. The correlations between the DtoD indicators of individual sectors are remarkably high. The highest value of the indicator, with the largest distance to default is achieved in manufacturing, while the indicators for trade and other services are at the same level. The lowest value of the DtoD indicator of individual sectors was also achieved in 1997. More significant drops in the DtoD indicator were recorded by individual sectors in 2002, 2003 and 2007.

Confirmation of the link between changes in the DtoD indicator for banks and the DtoD indicators of sectors, taking into account the proportions of individual sectors in the structure of an individual bank's credit portfolio, would greatly stimulate the further use of the DtoD indicator. The confirmation of this type of link would mean that the DtoD indicator for individual banks and the entire banking sector could be assessed via developments in the DtoD indicators for sectors, despite the absence of bank listings. Based on the current results we can conclude that, when assessing the parameters of this link, it would be necessary to exclude the period from 2003 to 2005, when the calculations of the DtoD indicator for banks are not relevant. This however would shorten the assessment period considerably. It is therefore important to obtain additional data from the grey market. The other possibility is to use an alternative calculation of bank DtoD through the direct assessment of the market value of an asset and its volatility. Previously calculated volatilities for sectors would be taken into account for the credit portfolio, whereby the securities portfolio would be divided into equities and bonds. The volatility of the latter would be determined by the volatility of the share and bond stock market index.

The ultimate aim is to test the hypothesis that distance-to-default is indicative of changes in the risks of the banking system, as it precedes accounting indicators of bank performance and risks such as capital adequacy, net interest margin, profitability, impairments and provisions of financial assets and the z-score index (alternative to the calculation of DtoD, based on balance sheet data). However it is important to be aware of the limitations of forecasting with such an approach, in particular due to external effects on the increased volatility of share prices on a small, less liquid capital market.

[1] $V_{equity} = V_{assets} * N(d_1) - D * e^{-rT} * N(d_2)$ and $\sigma_{equity} = (V_{equity} / V_{assets}) * N(d_1) * \sigma_{assets}$,
where V represents market value, N() represents the cumulative normal distribution, r represents the risk-free interest rate and T represents the residual maturity of debt.
[2] $V_{equity} = \max(V_{assets} - Debt, 0)$.
[3] Jašovič, Košak, Šuler, Bukatarević: Use of market information in the analysis of the financial stability of banks, Financial Stability Review 2007, Expert Papers on Financial Stability, May 2008.
[4] For the period when banks' shares were not traded on the grey market, prices are defined with the help of the adjusted Wienner process. For each date where a price is not given, the calculated price is adjusted using the Wienner process for the part of deviation to the next known price. However a problem arises using this approach if the period between two known prices is very long and there is very little difference between the prices. The result is minimum volatility and a very high distance-to-default indicator value.
[5] ECB: Financial Stability Review, June 2005, p. 91.

Box 6.4: Macro stress tests for the Slovenian banking system

The purpose of this section is to present assessments of the banking system's sensitivity to simulated shocks in selected risk factors, and is a summary of a lengthier report prepared at the end of 2007. The macro stress test method is based on a top-down approach.

Methodological changes in the macro stress test model and definition of risk-factor shocks

Similarly to previous years, the shocks of lower economic growth and higher interest rates were simulated. In addition, liquidity shocks were also tested due to shocks on international financial markets and the increasing dependency of banks on foreign sources of financing. The level of simulated risk-factor shocks was limited to less probable, but still possible shocks. As in previous years, the size of the simulated shocks was limited to the largest historical changes, which occurred with a statistical probability of 5% in the period from 1995 onwards. In contrast to previous years this year's shocks are permanent, beginning in the first quarter of 2008. Their effect is measured until the end of the forecast horizon, i.e. until the final quarter of 2009.

Table 6.20: Shocks relative to the baseline scenario

Risk factors	Shock: change relative to the baseline scenario	Duration of shock (quarters)
Real GDP	Growth in GDP components down 2.3 percentage points	I/08 - IV/09
Interest rates	Interest rates up 2 percentage points	I/08 - IV/09
Liquidity shock	Withdrawal of foreign sources of financing	I/08 - IV/09
Liquidity shock and increase in premium	Withdrawal of foreign sources of financing and a 1 percentage point increase in the premium on the reference interest rate	I/08 - IV/09

Source: Bank of Slovenia

Results of the macro stress tests under the integrated approach

The effects of shocks are measured in terms of banks' pre-tax profit, return on equity, capital adequacy, growth in loans to and deposits by non-banking sectors, the change in their proportions of total assets and growth in total assets.

In the first year of the shock, the effect was greatest in the case of a simulated rise in interest rates. Growth in loans to non-banking sectors is 8.3 percentage points lower than in the baseline scenario given a rise in interest rates of 2 percentage points. A higher interest rate results in a decrease in demand for credit, and thus lower growth in loans. Relatively similar to the shock in interest rates is the change in loan growth rates during the shock of a deterioration in liquidity, except that the effect is gradual and highest in 2009, when the growth rate falls by 12.3 percentage points compared to the baseline scenario. In contrast to the shock in interest rates, which affects demand, the liquidity shock represents a limitation of lending supply. In this case the decrease in lending to non-banking sectors is highest (EUR 6.7 billion, or 16.7% compared to the baseline scenario), which would result in a radical limitation of financing of non-banking sectors. The shock of decreased economic activity is reflected to a lesser degree in lower growth in loans, but the effect is longer-lasting.

The response of growth in deposits by non-banking sectors is only negative when the GDP growth rate decreases, and even then it is only -0.2 percentage points in the first year and -1.4 percentage points in the second year of the shock. In the event of rising interest rates, growth in deposits by non-banking sectors increases most in the second year of the simulated shock (by 2.6 percentage points compared to the baseline scenario). Given the gap between changing growth rates of loans to and deposits by non-banking sectors, growth in borrowing by banks at foreign banks responds to an individual shock.

The decrease in profits is highest in the case of a shock of higher interest rates (EUR 276 million over two years, or 24% of estimated profit for 2008 and 2009). Profit is half as sensitive to the liquidity shock of decreasing liabilities to foreign banks accompanied by rising premiums on the reference interest rate, with a cumulative decrease in profit by 10.6% compared to the estimated profit from the baseline scenario. The effect of the other two shocks on profit is considerably less: during a decrease in economic activity the effect is primarily longer-term and increases over time. In line with changes to profit, return on equity also changes.

Despite a decrease in profit as an important source for increasing the capital of banks, the banking system's capital adequacy does not decrease in any of the simulated shocks. The effect of shocks on growth in capital requirements is greater than on growth in regulatory capital due to the relatively significant decrease in the growth in loans to non-banking sectors, which are given a higher risk-weight than other forms of risk-bearing assets.

Table 6.21: Impact of the individual shocks on changes in certain categories of banks' balance sheets, changes relative to the baseline scenario by years in percentage points

2008

Shock	Profit (EUR million)	ROE	Capital adequacy	Growth in loans to non-banking sectors	Loans/ TA	Growth in deposits by non-banking sectors	Deposits/ TA	Growth in TA
Shock 1 - GDP	-3.9	0.0	0.0	-1.2	-0.1	-0.2	0.3	-0.9
Shock 2 - change in interest rates	-213.6	-5.4	0.0	-8.3	-1.0	1.1	2.9	-6.0
Shock 3 - liquidity shock	-1.9	-0.1	0.8	-2.5	4.2	0.0	3.7	-8.9
Shock 4 - liquidity shock + premium	-63.7	-1.8	0.7	-2.5	4.2	0.0	3.7	-8.9

2009

Shock	Profit (EUR million)	ROE	Capital adequacy	Growth in loans to non-banking sectors	Loans/ TA	Growth in deposits by non-banking sectors	Deposits/ TA	Growth in TA
Shock 1 - GDP	-21.7	-0.1	0.1	-3.9	-0.6	-1.4	0.9	-3.1
Shock 2 - change in interest rates	-62.6	-0.1	0.1	-7.4	-1.8	2.6	6.3	-5.9
Shock 3 - liquidity shock	-4.5	-0.1	1.3	-12.3	3.6	0.0	8.4	-11.0
Shock 4 - liquidity shock + premium	-59.1	-1.4	1.3	-12.3	3.6	0.0	8.4	-11.0

Source: Bank of Slovenia

The stress test findings are similar to those for past years. The banks' response to the simulated shocks is essentially unchanged. In particular, banks are exposed to the risk of higher interest rates and the risk of tightening borrowing conditions at foreign banks, while the effect of tightening economic conditions is smaller. In this regard, none of the simulated shocks threatens the solvency of banks.

Assessing credit risk under a piecewise approach

The trend of an increasing proportion of loans to clients classified in the lowest-risk credit rating categories continued in 2006, while the proportion of loans to the highest-risk clients decreased, according to data from banks. However an analysis of data regarding the credit rating structure of the same clients over a longer period indicates that banks are overly optimistic in their classification of clients to credit rating categories. This is also confirmed by the results of a

credit risk model that takes into account changes to the asset structure of business entities and changes in macroeconomic conditions over time. The 2005 Model predicted a higher proportion of non-performing loans in 2006 (by 1.36 percentage points) than banks actually disclosed in the structure of their credit portfolio.

In contrast to other types of risk, stress tests for credit risk are conducted using the piecewise approach with the help of a credit risk model. The results of the stress tests are similar to 2006. The shock of deterioration in business entities' liquidity has a greater effect on the deterioration of the credit rating structure of banks' portfolios than increased short-term indebtness: in the first case, the proportion of non-performing loans increases by 7.04 percentage points compared to the baseline scenario, while it rises by 2.27 percentage points in the second case. This confirms the fact that deteriorating liquidity in the economy represents a significant risk factor, not only for banks, but also for business entities.

6.6 Liquidity Risk

The consequences of the instability on international financial markets have been felt indirectly by the Slovenian banks that borrow in the rest of the world. Financing conditions have tightened and loan maturities have been shortened due to the fear of a liquidity shortage and an increasing lack of confidence among banks on the European financial market. It is primarily the domestic banks, which would be faced with increasing difficulty in renewing sources of financing in the event of an additional tightening of conditions on foreign markets, that are exposed to higher liquidity risk. This group of banks has therefore placed greater emphasis on obtaining domestic sources through the segmentation of interest rates for non-banking sector deposits, with regard to maturity and deposit amount.

Deterioration in the liquidity position is also reflected in lower liquidity coefficients and other indicators, among which a decrease in the coverage of loans to non-banking sectors by deposits by non-banking sectors is noteworthy.

The Bank of Slovenia systematically monitors the banking sector's liquidity, and warns banks to take sufficient account of conditions that have arisen since Slovenia's entry to the euro area and the instability on international financial markets when managing liquidity risk.

6.6.1 Impact of the instability on international financial markets on the financing conditions in the rest of the world for Slovenian banks

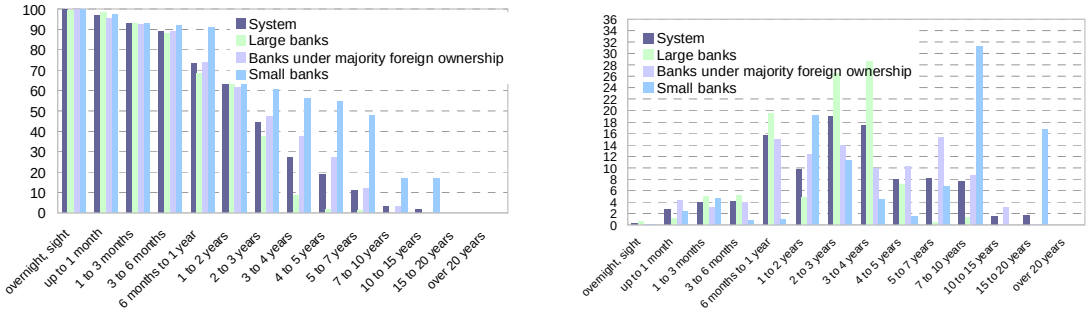
Liabilities to foreign banks as a proportion of total assets increased after the outbreak of instability on financial markets.

Borrowing by banks in the rest of the world remains an important source of financing, and actually increased after the outbreak of instability on financial markets. By the end of 2007 it increased by 41.2% compared to 2006, of which more than half came in the second half of the year. During this period the largest increase in liabilities to the rest of the world was recorded by the banks under majority foreign ownership, which borrowed primarily from their parent banks, and in contrast to other banks had no major difficulties in obtaining sources of funds.

Increase in banks' short term liabilities to the rest of the world; difficulies with obtaining long-term sources at banks under domestic ownership.

Since the outbreak of instability on the financial markets, the proportion of short-term liabilities has increased by 5.1 percentage points, and stood at 26.8% at the end of March 2008. Here the main exposure is with the large banks, 31.4% of whose total liabilities to the rest of the world are short-term, and the renewal of these sources would be made more difficult should there be any deterioration in the conditions on the financial markets. The banks under majority foreign ownership hold 26.3% of their liabilities to the rest of the world in short-term form, but the likelihood of any difficulty with short-term liquidity is small, given the greater reliability of their sources at parent banks. The majority of banks' liabilities to the rest of the world are still long-term, of which 44.4% have a maturity of 2 to 5 years.

Figure 6.20: Non past due liabilities to foreign banks (left) and maturity breakdown (right) as at 31 March 2008, for the banking system and by groups of banks in percentages



Source: Bank of Slovenia

Table 6.22: Non past due liabilities to foreign banks and maturity breakdown as at 31 March 2008, for the banking system and by groups of banks in percentages

	Non past due liabilities				Breakdown of liabilities by maturity			
(%)	System	Large banks	Banks under majority foreign ownership	Small banks	System	Large banks	Banks under majority foreign ownership	Small banks
Total (EUR million)	14,720	6,253	7,085	1,383				
Overnight, sight	99.6	99.3	99.9	99.9	0.4	0.7	0.1	0.1
Up to 1 mo	96.9	98.3	95.7	97.4	2.7	1.1	4.2	2.5
Over 1 up to 3 mos	92.9	93.3	92.6	92.8	4.0	5.0	3.1	4.6
Over 3 up to 6 mos	88.8	88.1	88.7	92.1	4.1	5.1	3.9	0.7
Over 6 mos up to 1 yr	73.2	68.6	73.7	91.1	15.6	19.5	15.0	0.9
Over 1 yr up to 2 yrs	63.4	63.7	61.3	72.0	9.8	4.9	12.4	19.1
Over 2 yrs up to 3 yrs	44.4	37.3	47.4	60.7	19.0	26.5	13.9	11.3
Over 3 yrs up to 4 yrs	27.0	8.6	37.5	56.3	17.4	28.7	9.9	4.4
Over 4 yrs up to 5 yrs	19.0	1.6	27.3	54.8	8.0	7.0	10.2	1.4
Over 5 yrs up to 7 yrs	10.8	1.2	11.9	48.1	8.2	0.4	15.3	6.8
Over 7 yrs up to 10 yrs	3.2	0.0	3.3	16.8	7.6	1.2	8.6	31.2
Over 10 yrs up to 15 yrs	1.6	0.0	0.1	16.8	1.5	0.0	3.2	0.0
Over 15 yrs up to 20 yrs	0.0	0.0	0.0	0.0	1.6	0.0	0.1	16.8
Over 20 yrs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total					100.0	100.0	100.0	100.0

Source: Bank of Slovenia

Despite turmoil on financial markets, the amount of new loans raised by banks in the rest of the world remained high in 2007.

The instability on the financial markets in the third quarter of 2007 was temporarily reflected in a decline in the amount of new loans raised in the rest of the world, the consequences of turmoil on financial markets primarily being faced by the banks under majority domestic ownership. A similarly low amount of loans raised in the rest of the world was also seen in the first quarter of 2008. The majority of banks, irrespective of ownership, were primarily faced with tighter financing conditions for new borrowing. According to survey results,[49] banks expect the tightening of financing conditions in the rest of the world to continue in 2008.

[49] A survey sent by the Bank of Slovenia to all banks and branches at the end of February 2008.

Table 6.23: New loans of banks raised at banks in the rest of the world, by maturity and currency

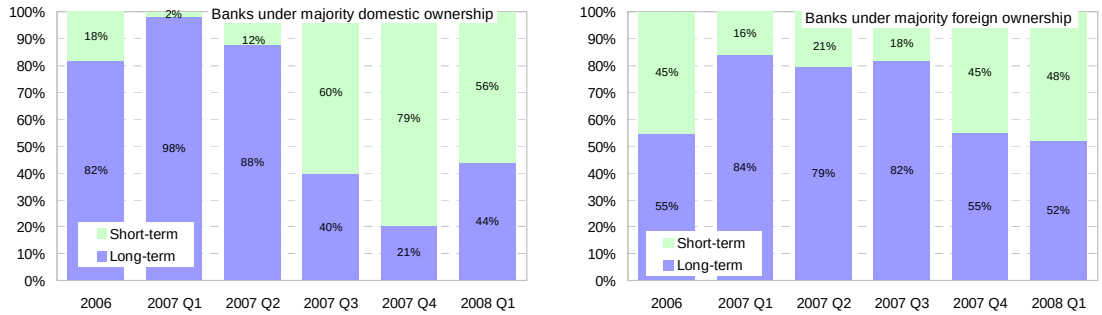
	Loans by maturity (EUR million)			Breakdown by currency (%)			
	Total	Short-term	Long-term	CHF	EUR	SIT	USD
2006	1,904.2	539.2	1,365.0	6.8	87.8	5.4	0.0
2007	5,304.8	1,877.8	3,426.9	8.2	91.5	-	0.3
2007 Q1	1,300.9	72.5	1,228.4	3.4	96.6	-	0.0
2007 Q2	1,162.8	192.6	970.2	10.6	89.4	-	0.0
2007 Q3	776.4	209.3	567.1	22.8	76.0	-	1.2
2007 Q4	2,064.7	1,403.5	661.2	4.5	95.3	-	0.2
2008 Q1	618.5	284.6	333.8	6.2	93.8	-	0.0

Source: Bank of Slovenia

Shortening of the maturity of foreign loans at banks under majority domestic ownership.

The tighter conditions for raising new loans in the rest of the world were reflected more in the maturity of the loans than in the amount. The proportion of short-term loans among loans raised in the rest of the world by the banks under majority domestic ownership was 60% in the third quarter of 2007, and 79% in the final quarter.

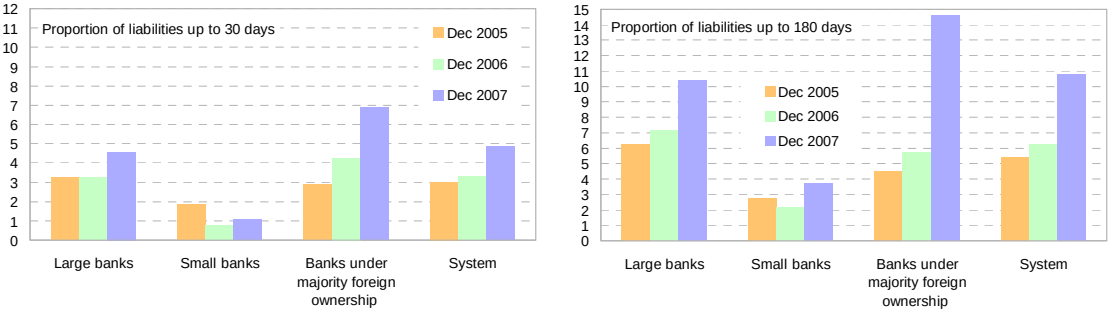
Figure 6.21: Maturity breakdown of new loans for banks under domestic ownership (left) and banks under majority foreign ownership (right) in percentages



Source: Bank of Slovenia

The largest increase in the proportion of liabilities to foreign banks with a residual maturity of up to 30 days and up to 180 days was recorded by the banks under majority foreign ownership. Within the banking sector as a whole, there was an increase in the proportion accounted for by the first category of 1.6 percentage points to 4.9%, and an increase of 4.5 percentage points to 10.8% in the second category. Although the banks under majority foreign ownership recorded a large increase in liabilities to the rest of the world in 2007, they were primarily exposed to their parent banks, and the risk of any difficulties in renewing the resources is therefore low.

Figure 6.22: Liabilities to foreign banks as a proportion of total liabilities with a residual maturity of up to 30 days (left) and up to 180 days (right), by groups of banks



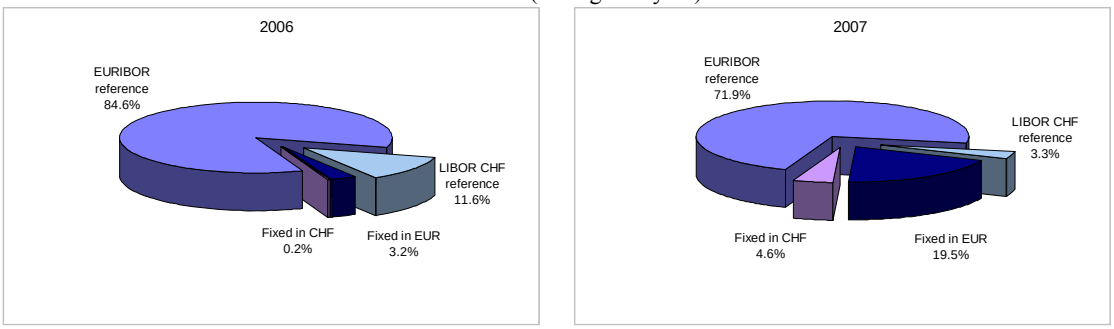
Source: Bank of Slovenia

Along with the reduction in maturity, there was also a change in the currency breakdown of bank borrowing in the rest of the world. During 2007 banks increased the amount of loans raised in the rest of the world in Swiss francs, which accounted for fully 22% of total loans raised in the rest of the world in the third quarter of 2007.

High growth in loans with a fixed interest rate.

As a result of the increasing proportion of loans raised in the rest of the world, there was an increase in the proportion of loans with a fixed interest rate. Fixed-rate loans accounted for approximately 25% of the total in 2007, compared with just 3.4% in 2006. There was a sharp increase in the proportion of long-term loans with a fixed interest rate from 2% in 2006 to 32% in 2007, double that of short-term loans (16% in 2007), for which fixed-rate remuneration is more common.

Figure 6.23: Breakdown of banks' new loans in the rest of the world by type of remuneration (average for year)



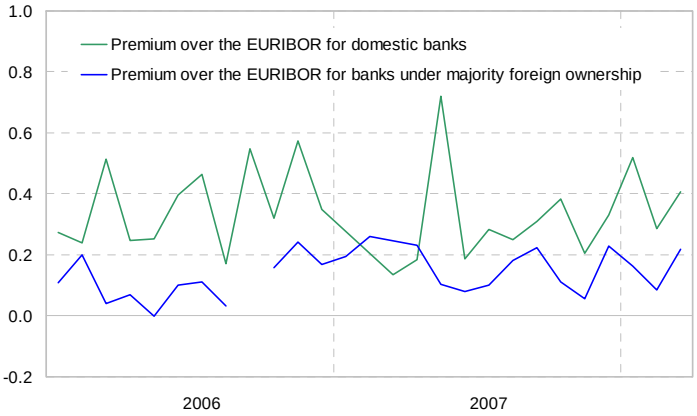
Source: Bank of Slovenia

Higher premiums over the EURIBOR for the banks under majority domestic ownership when borrowing in the rest of the world.

The tightening of financing conditions in the rest of the world was reflected in the higher premiums over the EURIBOR charged to Slovenian banks under majority domestic ownership. From an average of 0.3 percentage points at the half-way point of 2007, premiums had risen to over 0.5 percentage points in the first quarter of 2008.

There was no significant change in premiums over the EURIBOR for the banks under majority foreign ownership during this period. They fluctuated between 0.1 and 0.2 percentage points, as in the period before the outbreak of turmoil on the financial markets. Of course another factor in the rising cost of bank borrowing in the rest of the world was the increase in the spread between the 3-month and 6-month EURIBOR reference rates, and the ECB's main refinancing rate.

Figure 6.24: Premium over the EURIBOR for banks' loans raised in the rest of the world, with regard to majority ownership in percentage points



Source: Bank of Slovenia

Spread in deposit rates

The tightening of borrowing conditions in the rest of the world compelled banks to seek other sources of financing. By autumn 2007 banks were focusing on attracting deposits from non-banking sectors by raising deposit rates.

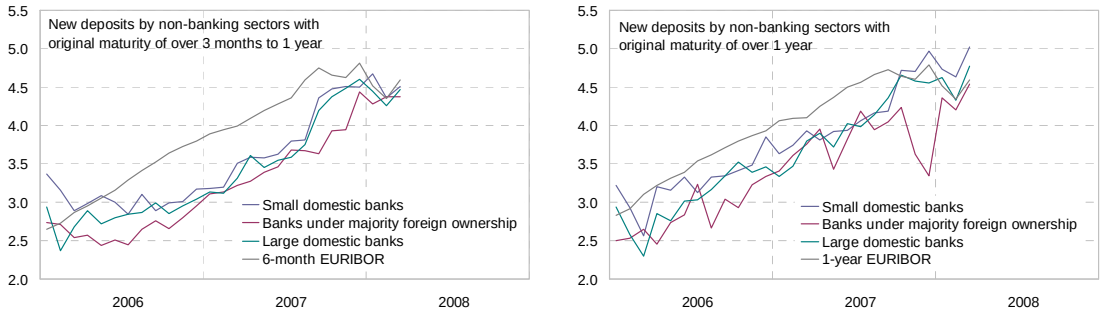
Competition among domestic banks to attract non-banking sector deposits.

The fiercest competition among the groups of banks to attract deposits by non-banking sectors is between the domestic banks. Deposits are the main source of financing for the small banks in particular, and after the outbreak of turmoil on the financial markets they took the lead in offering higher interest rates on short-term and long-term deposits by non-banking sectors. The short-term interest rate on new deposits rose by 69 basis points

between August 2007 and March 2008 to 4.50%, compared with a rise of 72 basis points to 4.47% at the large banks. The rise in interest rates on long-term deposits was larger at the small domestic banks, where rates rose by 86 basis points to 5.02%, compared with a rise of 63 basis points to 4.77% at the large banks.

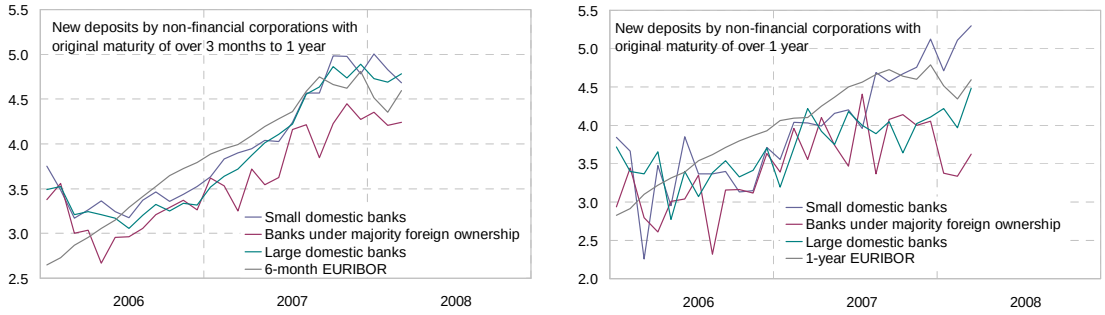
In setting interest rates on deposits by non-banking sectors, banks generally follow the movement of the EURIBOR market rate. Here the main exception, particularly in long-term interest rates, is the banks under majority foreign ownership, which have less-competitive interest rates.

Figure 6.25: Interest rates on new deposits by non-banking sectors in percentages



Source: Bank of Slovenia

Figure 6.26: Interest rates on new deposits by non-financial corporations in percentages



Source: Bank of Slovenia

In their short-term interest rate offers the banks under majority domestic ownership are mainly competing for large depositors. Immediately after the outbreak of turmoil on international financial markets the banks under majority domestic ownership briefly raised their short-term interest rates for large depositors above the 6-month EURIBOR, while the small domestic banks also set their long-term rates similarly. There was an increase in the amount of long-term deposits by households and OFIs in 2007. Among the domestic banks, the small banks were more successful in attracting deposits from the household sector with more favourable rates, increasing their new deposits by 66% in 2007, compared with the increase of 27% recorded by the large banks. The situation was the reverse for new deposits from OFIs. The large banks, which increased their interest rates on new deposits in this segment by 1.24 percentage points, tripled their deposits, while the small banks doubled their deposits by increasing rates by 1.1 percentage points.

A more-active deposit rate policy to attract deposits by non-banking sectors in the prevailing conditions was both expected and justified. However the segmentation and relatively high spread in deposit rates among the groups of banks are introducing the additional risk of rapid switching between banks by large depositors, as the encouragement of saving is a more long-term process. In conditions of more difficult liquidity management at banks, the rapid and unpredictable switching of large depositors between banks could worsen liquidity risk.

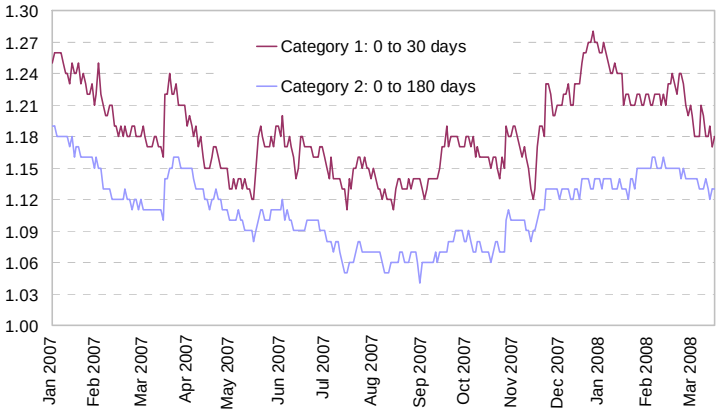
6.6.2 Liquidity coefficients

Instability on financial markets resulted in a low Category 1 liquidity coefficient.

The deterioration of the banking sector's liquidity, primarily in the second half of 2007, was also reflected in changes in liquidity coefficients. Following a significant increase in the average Category 1 liquidity coefficient at the beginning of the year by 0.11 to 1.26 as

the result of an amendment to the regulation on the minimum requirements for ensuring an adequate liquidity position at banks, the coefficient decreased gradually until the end of the third quarter. The banking sector's lowest daily coefficient was 1.11 at the end of August. Due to a lack of confidence, resulting in the increased prudence of banks on international financial markets, some Slovenian banks found it more difficult to obtain longer-term sources. With the easing of conditions on financial markets towards the end of the year, the average Category 1 liquidity coefficient improved, reaching 1.25 at the beginning of 2008.[50]

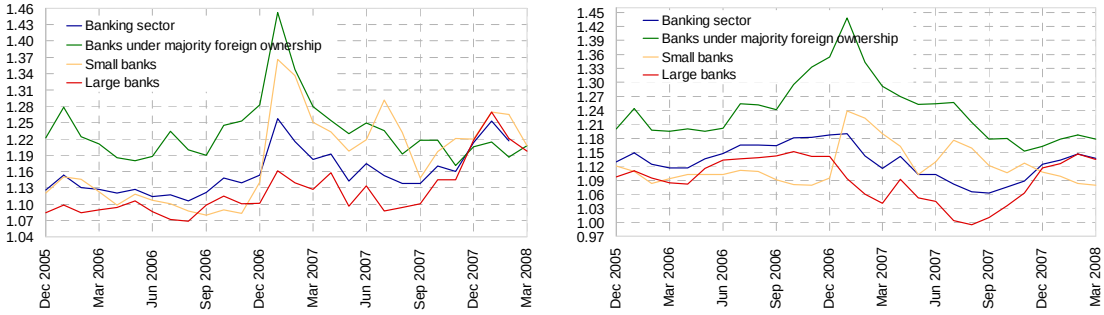
Figure 6.27: Daily liquidity coefficients for Categories 1 and 2 of liquidity ladder



Source: Bank of Slovenia

The banks under majority foreign ownership recorded the largest decrease in the average liquidity coefficient (down 0.24 to 1.21 at the end of 2007) by optimising liquidity during the year. The group of large domestic banks had the lowest Category 1 liquidity coefficient (1.09) while the interbank market was affected by a lack of confidence, reflecting their sluggish response to changing conditions.

Figure 6.28: Liquidity coefficients for Categories 1 (left) and 2 (right) of liquidity ladder by individual bank groups, monthly averages



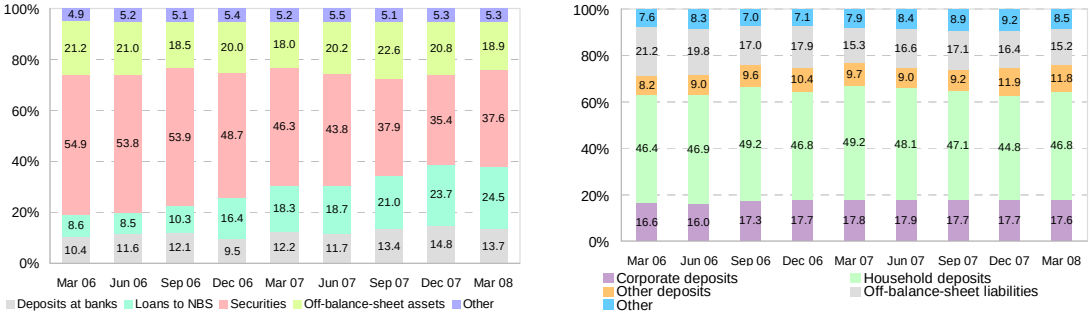
Source: Bank of Slovenia

Change in the structure of claims in the form of a decrease in the proportion of securities in favour of an increase in loans.

There are structural changes, primarily arising from claims with a residual maturity of up to 30 days, in the calculation of the average Category 1 liquidity coefficient. Securities, whose proportion decreased by 13.3 percentage points in 2007 alone to 35.4%, represent the majority of these claims. Banks also financed very high lending growth by restructuring assets. This method was particularly important for those banks which encountered difficulties in obtaining foreign sources of financing during the period of uncertainty on interbank markets.

[50] Following the amendment to the regulation, the Category 2 liquidity coefficient is of an informative nature only, and must be reported by banks to the Bank of Slovenia.

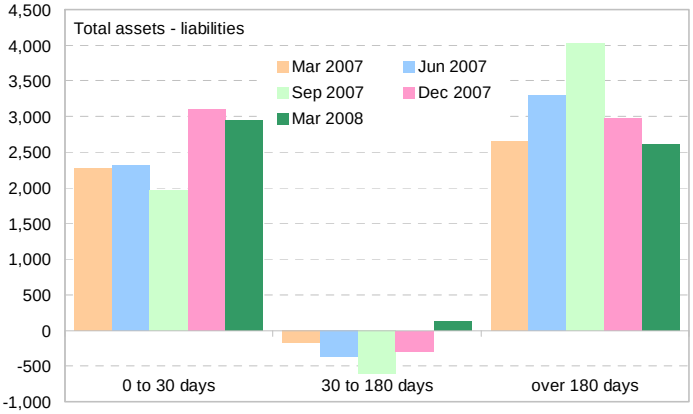
Figure 6.29: Structure of assets (left) and liabilities (right) taken into account in the calculation of the Category 1 liquidity coefficient (with a residual maturity of up to 30 days) in percentages



Source: Bank of Slovenia

The liquidity gap, calculated as the difference between total assets and liabilities defined in the liquidity ladder methodology, was long for the category with a residual maturity of up to 30 days. Notwithstanding residual maturity, this category includes first-class investments in government securities and foreign marketable securities rated BBB or higher. As a result the latter are reflected in a short gap for the category with a residual maturity of over 30 and up to 180 days. The closing of the long liquidity gap in Category 3 of the liquidity ladder in the last six months points to the problem of more difficult long-term refinancing, which is the result of a lack of interbank confidence on international financial markets.

Figure 6.30: Liquidity gap as the difference between total assets and liabilities defined in the liquidity ladder methodology in EUR million



Source: Bank of Slovenia

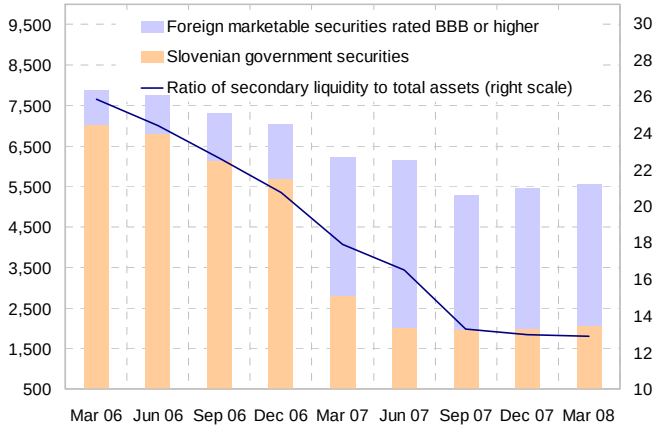
6.6.3 Other structural liquidity indicators

Decreasing secondary liquidity as a proportion of banks' total assets.

The changing structure of secondary liquidity[51] was reflected at the beginning of 2007 in a significant decrease in securities due to maturing of Bank of Slovenia bills and also in an increase in foreign marketable securities rated BBB or higher. Secondary liquidity as a proportion of total assets stood at 12.9% in March 2008.

[51] 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. Bank of Slovenia bills were also included in Slovenian government securities, up to and including March 2007.

Figure 6.31: Changes in the amount of secondary liquidity (monthly averages in EUR million) and as a proportion of total assets in percentages



Note: Secondary liquidity is calculated from liquidity ladder data as the sum of the monthly average of Slovenian government securities (taking into account Bank of Slovenia bills, up to and including March 2007) and foreign marketable securities rated BBB or higher.
Source: Bank of Slovenia

Structural liquidity indicators deteriorated in 2007.

Structural liquidity indicators, which reflect selected ratios in balance sheet items, deteriorated again in 2007, in part due to the situation on financial markets in the second half of the year. Banks obtained additional sources to meet high credit demand by increasing borrowing in the rest of the world and partly by reducing investments in debt securities. Decreasing coverage of loans to non-banking sectors by deposits is also driving banks in this regard. The domestic banks, which following the outbreak of turmoil on international markets have more difficulty in ensuring reliable long-term resources from the rest of the world, are more exposed to risk.

The coverage of loans to non-banking sectors decreased by 16.8 percentage points to 69%.

Among the selected structural liquidity indicators, the ratio of deposits to loans to non-banking sectors deteriorated most in 2007, falling by 16.8 percentage points to just 69%. Very high year-on-year growth in loans to non-banking sectors alongside low growth in deposits was the major contributing factor. The coverage decreased most at the small banks under domestic ownership, where the stock of deposits was lower than the stock of loans for the first time. At the end of the year the banks under majority foreign ownership had the lowest coverage at 43.7%. Other structural liquidity indicators for the banking system, such as the ratio of short-term deposits to short-term loans to non-banking sectors, the ratio of liabilities to foreign banks to loans to non-banking sectors and the proportion of debt securities in total assets, also deteriorated in 2007. The exception is the proportion of total deposits by non-banking sectors accounted for by the deposits of the 30 largest depositors, which remained unchanged with regard to 2006.

Table 6.24: Selected ratios in balance sheet items that define bank liquidity in percentages

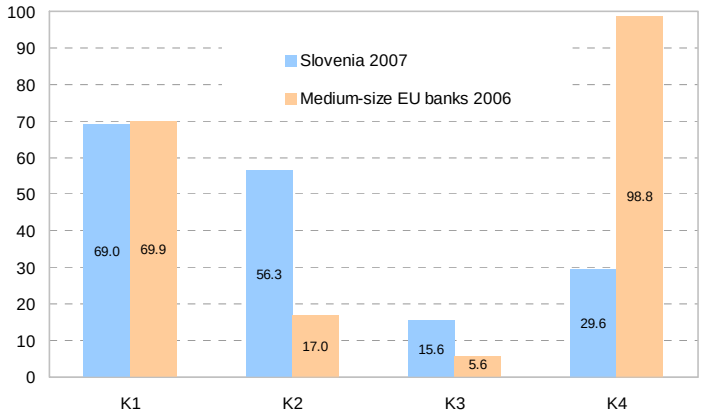
(%)		Large banks	Small banks	Banks under majority foreign ownership	Total
Ratio of deposits by non-banking sectors to loans by non-banking sectors	2004	124.9	147.8	83.7	114.9
	2005	109.7	135.9	69.1	99.2
	2006	98.6	120.9	54.2	85.8
	2007	81.2	88.2	43.7	69.0
	Mar 2008	80.2	85.8	39.9	66.6
Ratio of short-term deposits to short-term loans to non-banking sectors	2004	187.7	144.1	147.8	172.1
	2005	154.1	132.2	138.4	146.9
	2006	122.6	112.0	117.6	119.8
	2007	117.9	98.0	89.5	107.6
	Mar 2008	115.9	95.6	82.9	104.1
Ratio of liabilities to foreign banks to loans to non-banking sectors	2004	25.8	9.0	55.8	33.1
	2005	40.3	9.5	76.1	48.9
	2006	42.6	9.1	72.9	49.5
	2007	43.1	43.3	66.0	51.0
	Mar 2008	42.2	43.9	67.7	51.4
Ratio of liabilities to foreign banks to total assets	2004	13.4	4.3	34.4	17.9
	2005	21.4	4.8	46.6	26.9
	2006	24.1	5.1	50.6	29.9
	2007	27.0	23.9	52.3	33.9
	Mar 2008	26.6	24.8	54.8	34.7
Ratio of debt securities to total assets	2004	29.8	29.2	21.2	27.5
	2005	28.6	30.8	19.2	26.2
	2006	24.5	20.4	13.1	20.7
	2007	20.3	14.0	6.6	15.6
	Mar 2008	19.9	13.5	6.4	15.1
ECB liquidity indicator (ratio of cash and claims to liabilities to banks)	2004	70.4	136.9	35.5	58.0
	2005	48.0	86.5	30.3	41.3
	2006	43.9	116.3	25.1	38.2
	2007	30.7	70.7	16.9	29.6
	Mar 2008	32.3	67.7	13.6	28.2
Proportion of total deposits by non-banking sectors accounted for by the 30 largest depositors[1]	2004	16.1	29.5	24.8	19.9
	2005	19.4	31.4	20.7	21.2
	2006	20.3	32.7	19.9	21.9
	2007	21.1	27.9	20.9	21.9
	Mar 2008	22.4	28.0	18.3	22.3

Note: [1] For 2004 the 30 largest depositors included deposits by banks, so for that year the 30 largest depositors to deposits by banks and non-banking sectors ratio is calculated.
Source: Bank of Slovenia

Comparison of structural liquidity indicators with the EU average.

Although in 2006 the level of coverage of loans by deposits by non-banking sectors was equal to the average of EU Member States, the pace at which this ratio is decreasing remains relatively high. The only EU Member States where the ratio of deposits to loans decreased more than in Slovenia were Latvia, Malta and the Czech Republic. The ratio of liabilities to banks to loans to non-banking sectors and the proportion of debt securities in total assets remain above-average. In contrast the ECB liquidity indicator (the ratio of cash and claims against banks to liabilities to banks) is three times higher on average in the EU than in Slovenia.

Figure 6.32: Comparison of liquidity indicators for the Slovenian banking sector and medium-size EU banks



Note: K1 – Ratio of deposits by non-banking sectors to loans to non-banking sectors.
K2 – Ratio of liabilities to banks to loans to non-banking sectors.
K3 – Proportion of debt securities in total assets.
K4 – Ratio of the sum of cash and claims against banks to liabilities to banks.
Sources: Bank of Slovenia, ECB (EU Banking Sector Stability)

Box 6.5: Banks' exposure to structured instruments

There has been a significant increase in investments in structured securities with the development of credit risk transfer instruments and the rapid growth in securitisation in the banking sector in recent years. Structured securities are complex instruments, typically debt instruments, whose returns are linked to changes in or repayment of other instruments or assets. There are two major groups of structured instruments: structured credit instruments and instruments tied to market variables (interest rates, share indices, exchange rates, etc.).

The volume of investments in structured credit securities has risen sharply on a global scale with the introduction of the so-called "originate-to-distribute" business model. Loans (or other investments) approved by banks are not maintained in the balance sheet until their maturity. Instead banks sell them or establish a pool of assets, based on which they issue debt securities which are repaid with income from the pledged pool of assets. An issue is frequently divided into several tranches, which differ in terms of subordination, and thus level of risk. The equity tranche is subordinated to all other tranches. Losses only affect the highest rated tranche (AAA) when cash flows are insufficient for the repayment of lower tranches. Therefore the highest rated tranches have significantly lower returns and are considered very safe. Given their high credit rating, investments in these instruments were very attractive for banks because they resulted in higher returns than traditional debt instruments. As recent events have shown, investors placed too much trust in the credit rating of these types of securities and underestimated their actual risk. Generally credit rating agencies do not differentiate between the credit ratings of structured securities and traditional debt securities, although in practice, the credit ratings of structured instruments can be downgraded by several grades at one time, which is less typical for traditional debt instruments.

These instruments were very attractive for investors due to the associated returns and the possibility to select the risk category of the investment in which their funds are invested. For issuing banks, these instruments primarily represent a reduction in exposure to credit and other risks and the acquisition of new sources for further growth in operations. One of the problems relating to these types of instruments is seen in a lack of transparency and the fact that market participants are unaware of the ultimate bearer of risk, which results in increased uncertainty and a lack of confidence in the event of tightened conditions on the market. Structured instruments, in particular instruments from securitisation, were one of the major channels of contagion between banks during the turmoil on financial markets in the second half of 2007. Although the source of the problems was an increased number of defaults on sub-prime mortgage loans in the USA, these problems fed through to Europe due to the investments of European banks in credit risk transfer instruments issued by American banks, and several large European banks were faced with large write-downs and losses.

Uncertainty was that much higher because banks had very large off-balance sheet exposures to companies (structured investment vehicles – SIV), through which risks were transferred from their own balance sheets. This gave the impression that risks had been transferred from the banking sector. These companies finance themselves by issuing very short-term commercial paper, while the majority of their investments are represented by structured securities. Banks provide liquidity support to these companies via credit lines. Such companies can be established and managed by banks. Even when primarily independent companies are involved, banks represent the major investors in their commercial paper. These companies were not included in the consolidated financial statements of banks. Disclosures of the off-balance sheet items of banks are very limited, and thus the actual exposure of banks to these types of companies was unclear.

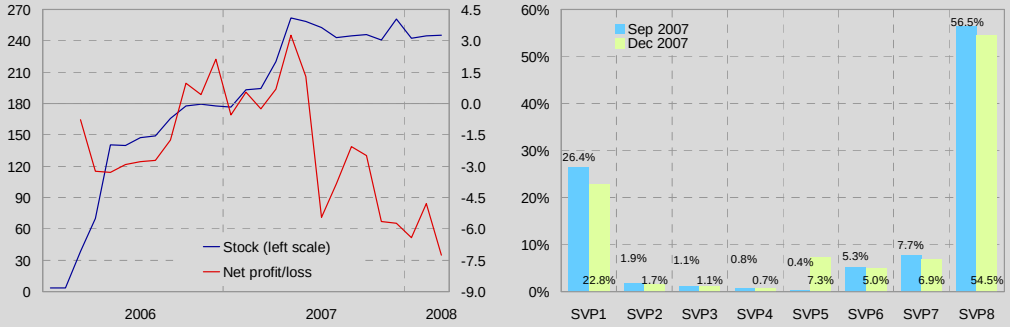
When difficulties arose on financial markets, these companies were faced with refinancing problems due to the highly short-term nature of their liabilities. They also had problems valuing their investments at fair value due to the lack of liquidity in the market. As a result, banks transferred off-balance sheet liabilities back to their balance sheets due to reputation risk should these companies be allowed to collapse and due to the stockpiling of investments which could not be securitised. The write-downs and losses which resulted surprised market participants, and were reflected in a decrease in the availability of financial sources due to a lack of confidence.

Slovenian banks began investing in structured securities in 2006. Banks stated that these investments were more to familiarise themselves with new forms of investments, and thus the amounts were not large. Banks mostly classify structured instruments as investments in financial assets recognised at fair value through profit or loss. The stock of these investments stood at EUR 260.9 million at the end of 2007. Debt securities represent EUR 223 million of this amount, or 3.1% of investments in securities and 0.5% of the banking sector's total assets. The loss arising from financial assets recognised at fair value through profit or loss amounted to EUR 5.7 million at the end of 2007, and had risen to EUR 7.2 million by the end of March 2008.

Given the fact the banks also include structured financial instruments in other categories (held for trading and available for sale) and the fact that accounting data does not provide information on the type of structured instruments, banks were sent a survey during the height of uncertainty on financial markets in September 2007 and again at the beginning of 2008. Based on survey responses from banks, the total exposure of banks to structured financial instruments stood at EUR 252.8 million at the end of 2007 (EUR 242.2 million in September 2007). According to these figures, the loss arising from structured financial instruments amounted to EUR 14.8 million at the end of 2007. This however is largely the effect of valuation at market prices, and the loss was not actually realised.

The exposure of Slovenian banks to structured instruments from securitisation, which were affected most by turmoil on financial markets, was minimal, amounting to EUR 4.3 million of investments in collateralised debt obligations (CDO). In addition to instruments from securitisation, Slovenian banks also hold investments in credit linked notes (CLN), totalling EUR 57.5 million. The total volume of credit instruments represents a minor proportion (24.5%) of Slovenian banks' exposure to structured financial instruments. The largest proportion of Slovenian banks' investments in structured instruments (54.5%) at the end of 2007 was linked to a basket of shares, an investment fund or an index. Bonds with built-in options represent another significant proportion of the portfolio, at 19.2%. According to both surveys, carried out in September 2007 and February 2008, the volume and proportion of investments in structured securities at Slovenian banks has not changed significantly since the outbreak of the financial crisis.

Figure 6.33: Banks' investments in financial assets recognised at fair value through profit or loss and net gains and loss from these types of investments in EUR million (left) and the breakdown of investments in structured securities (SVP) according to figures from September and December 2007 (right)



Note: SVP1 – CLN
SVP2 – collateralised debt obligations (CDO)
SVP3 – floating/fixed rate bonds
SVP4 – step-up bonds
SVP5 – range floaters
SVP6 – capped, floored, collared floating rate notes
SVP7 – callable step-up bonds
SVP8 – high yield basket bonds.

Sources: Bank survey, Bank of Slovenia

6.7 Credit Risk

Credit growth was once again very high in 2007, but the current figures for 2008 indicate a gradual slowdown. Coverage of classified claims by impairments declined, but this does not necessarily indicate a reduction in credit risk at banks. High credit growth distorts the

real picture of the credit rating structure of claims which, with the slowdown in credit growth, is expected to deteriorate. Although the small domestic banks account for the highest proportion of non-performing claims and have the lowest coverage by impairments, the proportion of their classified claims with repayment arrears exceeding 90 days is low.

Banks have increased the dispersion of exposure between sectors and branches and thus reduced exposure to credit risk caused by sector concentration. While accelerated growth in borrowing was most notable in construction and amongst non-residents, banks assess agriculture as the highest risk sector and sole proprietors as the highest risk branch.

The following factors contributed to increased exposure to credit risk in 2007: lower standards for housing loans, a higher proportion of unsecured loans and loans to non-banking sectors with securities collateral, high growth in exposure to the rest of the world, particularly the countries of the former Yugoslavia and an increasing number of large exposures, particularly at the banks under majority foreign ownership.

Credit standards

The small domestic banks recorded the highest increase in credit growth.

With high credit growth and an increased volume of operations, banks' exposure to credit risk has risen. Of all the bank groups, the small banks recorded the highest increase in credit growth, largely due to the entry of a new bank to the banking system. Last year growth in loans to non-banking sectors by the banks under majority foreign ownership was significantly higher than growth in loans by the large domestic banks.

In an autumn survey, banks forecasted a decrease in credit growth in 2008, which has been in part confirmed by current figures from the beginning of 2008. In terms of accessibility to sources, tightening in lending can be initially expected at the domestic banks, which already decreased their liabilities to foreign banks at the beginning of this year. However foreign banks still represent an important source for financing the credit growth of domestic banks.

Table 6.25: Year-on-year growth in loans to non-banking sectors by bank groups in percentages

	2003	2004	2005	2006	2007	Mar 08
	Loans to non-banking sectors					
Large banks	15.6	16.7	21.4	21.6	33.9	31.9
Small banks	9.2	20.5	24.7	31.5	48.6	41.5
Banks under majority foreign ownership	20.8	30.8	36.2	33.7	40.0	45.5
Total	16.3	21.0	26.1	26.4	37.4	37.4

Source: Bank of Slovenia

Loan-to-income (LTI) ratio

A higher proportion of loans for which the loan instalment exceeds 50% of the borrower's income.

Based on survey results regarding banks' business policy, it is evident that the average LTI ratio increased slightly in 2007. Although the actual proportion of newly approved loans on which the instalment exceeds one-third of the borrower's income decreased, the proportion of loans with the highest ratio (i.e. above 50%) increased. This proportion rose for new housing loans and new consumer loans.

Table 6.26: Loan-to-income (LTI) ratio

	Average maximum LTI under bank's business policy	Actual proportion of newly approved housing loans with		Actual proportion of newly approved consumer loans with	
		LTI >= 33%	LTI >= 50%	LTI >= 33%	LTI >= 50%
2006	56.3	71.5	17.0	60.7	9.3
2007	56.6	69.2	20.8	60.4	10.5

Note: LTI is the ratio between the loan instalment and the borrower's income.
Source: Bank survey

Maturity of new loans

Lengthening of housing loan maturities and a higher proportion of short-term consumer loans.

Taking into account the maturity of new loans, credit standards were reduced in 2007, particularly for housing loans. There was an increase in the proportion of new housing loans with a maturity of over 20 years, at the expense of a decreasing proportion of loans

with a maturity of between 10 and 20 years. Banks tightened standards for consumer loans, the average maturity of which was shortened. There was a 9.3 percentage point increase in the proportion of newly approved short-term loans, primarily at the expense of a decreasing proportion of loans with a maturity of between 1 and 10 years.

Repayment method

A small proportion of bullet loans.

Besides the typical instalment repayment, which is characteristic of the majority of loans to households, some banks also offer borrowers bullet loans where the principal is repaid as a lump sum at maturity. According to survey results, bullet loans to households account for 1.1% of loans to non-banking sectors and 4.8% of all loans to households. More than 75% of bullet loans are short-term.

Very few banks offer bullet loans to households. As a rule, repayment is made from investments which a borrower holds in insurance policies or mutual funds. Several banks offered combined financial products in 2007, in cooperation with selected management companies: leveraged lombard loans.[52] In these types of loans risk is tied to the relatively high concentration of investments in a limited range of investment funds of the same management company, with a higher number of borrowers. Loans for which the principal is repaid at maturity with a capital investment represented 0.1% of all loans to households.

Loan-to-value (LTV) ratio

A higher LTV ratio for new corporate loans and new housing loans secured by real estate collateral.

The average loan-to-value ratio for corporate loans and housing loans secured by real estate collateral increased in 2007. With regard to banks' business policy, this ratio fluctuates between 60 and 85 for corporate loans and between 60 and 80 for housing loans.

The average loan-to-value ratio where securities are used as collateral was also higher in 2007. This ratio is higher for corporate loans and non-housing loans to households. It should be noted that this ratio is higher than for loans with real estate collateral, as securities are typically used in conjunction with other forms of collateral for individual loans.

Table 6.27: Average loan-to-value (LTV) ratio

	Real estate LTV	Securities LTV
	2006	
Corporate loans	63.3	86.7
Non-housing loans to households	53.3	52.9
Housing loans	54.6	214.0
	2007	
Corporate loans	81.4	88.7
Non-housing loans to households	51.5	69.5
Housing loans	60.5	93.0

Note: LTV – ratio of loan to value of collateral used as security.
Source: Bank survey

6.7.1.1 Loan collateral

Structure of collateral for outstanding loans

The form and quality of collateral for approved loans also affects the quality of the credit portfolio, and thus banks' exposure to credit risk. According to survey results, banks had decreased the proportion of unsecured corporate loans by the end of 2007, while the proportion was up slightly for loans to households. Among secured loans, there is a noticeable increase in the proportion of corporate loans with securities collateral, while the proportion of household loans with real estate collateral has increased.[53]

[52] A leveraged lombard loan is a loan in which the borrower may pledge as collateral securities, transferable investment coupons or receivables for payment of the redemption unit value of non-transferable investment coupons. The highest leverage of a loan did not exceed four times the ratio of the loan raised to own funds invested in securities or mutual fund units.

[53] The structure of loans is shown with regard to the form of loan insurance. If a loan has no form of insurance or the only form is a bill of exchange, it is deemed unsecured. If the prevailing form of loan collateral is real estate, the loan is deemed as secured by real estate. If the loan is primarily

Table 6.28: Breakdown of outstanding corporate loans by type of insurance

(%)	Corporate loans	
	2006	2007
Type of collateral		
Secured loans	73.1	73.8
Real estate collateral	22.1	20.4
Insured at insurer	0.1	0.0
Securities or mutual fund units as collateral	6.7	9.7
Other forms of collateral	44.2	43.6
Unsecured loans	26.9	26.2

Source: Bank survey

Table 6.29: Breakdown of outstanding housing loans by type of insurance

(%)	Housing loans	
	2006	2007
Type of collateral		
Secured loans	95.6	95.5
Real estate collateral	50.2	61.7
Insured at insurer	22.2	20.9
Securities or mutual fund units as collateral	0.9	0.3
Other forms of collateral	22.4	12.6
Unsecured loans	4.4	4.5

Source: Bank survey

Structure of collateral for newly approved loans

The proportion of newly approved loans with securities collateral is rising, as is the proportion of newly approved unsecured loans.

The proportion of loans with securities collateral recorded the highest increase in 2007 (by 3.9 percentage points to 12.7%) among newly approved secured loans. This proportion continued to rise, increasing by an additional 1.6 percentage points in the first two months of this year, entirely on account of newly approved loans to non-financial corporations. Due to the high volatility and unpredictability of securities markets, banks are exposed to increased credit risk for loans with this type of collateral due to the increased possibility of a drop in the value of the collateral. The proportion of unsecured loans, including loans secured by bills of exchange, rose by 1.5 percentage points in 2007 to 45.6% of newly approved loans.

Figure 6.34: Breakdown of collateral of new loans to non-banking sectors in percentages

Source: Bank of Slovenia

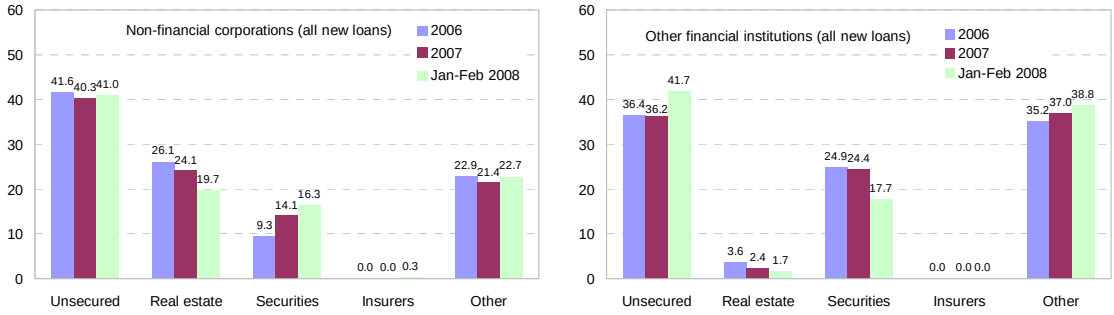
The highest growth was recorded in the proportion of new loans to households and non-financial corporations with securities collateral.

Although other financial institutions still account for the highest proportion of newly approved loans with securities collateral, banks recorded the highest growth in these types of loans in 2007 for non-financial corporations and households. This form of collateral

insured at an insurer, it is classified as insured at an insurer. If the primary form of loan collateral is securities or mutual fund points, it is deemed to be secured in its entirety by this form of collateral. All other loans for which other forms of insurance prevail are classified in their entirety as "other".

accounted for 14.1% of new loans to non-financial corporations, an increase of 4.8 percentage points from the previous year. The increase in the proportion of loans with this form of collateral was even higher for all loans to households (up 6.5 percentage points to 9.2%), where consumer loans (12.1%) and other loans (15.9%) stand out.

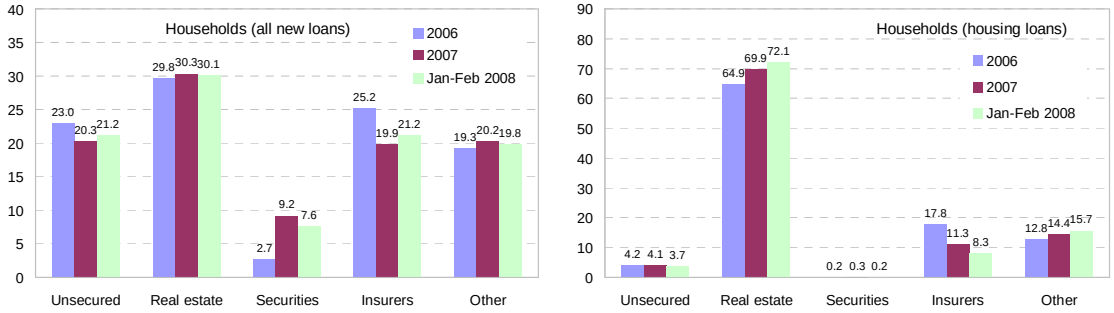
Figure 6.35: Breakdown of collateral of all new loans to non-financial corporations (left) and other financial institutions (right) in percentages



Source: Bank of Slovenia

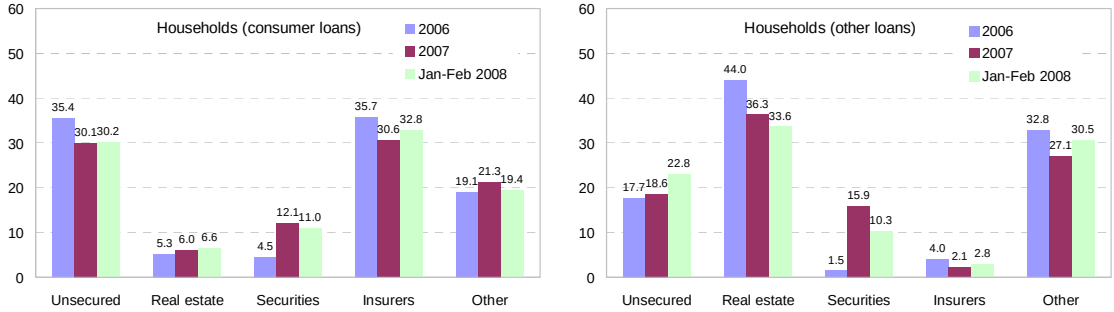
Real estate collateral still accounts for the highest proportion of collateral of all new loans to households. The proportion of real estate collateral was up slightly in 2007. That proportion was up notably for new housing loans, primarily on account of a decreasing proportion of loans insured at insurers.

Figure 6.36: Breakdown of collateral of all new loans to households (left) and housing loans to households (right) in percentages



Source: Bank of Slovenia

Figure 6.37: Breakdown of collateral of all new consumer loans (left) and other loans to households (right) in percentages



Source: Bank of Slovenia

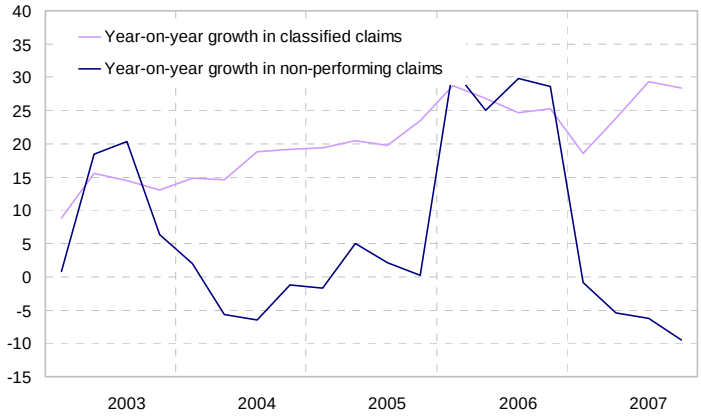
Portfolio quality

The quality of the banking sector's portfolio improved in 2007, but this does not necessarily mean a reduction in credit risk. With an increasing stock of classified claims, the coverage of classified claims by impairments decreased, as did non-performing claims (D and E) as a proportion of all classified claims. However, given high credit growth and economic optimism, these indicators could be underestimated.

The improved quality of the credit portfolio which does not necessarily mean reduced exposure to credit risk.

Given high economic and credit growth and the decrease in the proportion of non-performing claims, it is too early to talk about a turnaround in the credit cycle in 2007. According to the forecast of banks from the autumn survey, credit growth could gradually slow in 2008 in conjunction with a slowdown in economic growth.

Figure 6.38: Year-on-year growth in classified and non-performing claims in percentages



Source: Bank of Slovenia

The stock of classified claims stood at EUR 40.5 billion at the end of 2007. While year-on-year growth in classified claims amounted to 28.4%, non-performing claims were down 9.4%.

The coverage of classified claims by impairments decreased 0.7 percentage points to 3.2%.

The optimistic assessment of the quality of claims in 2007 was reflected in a decrease in the coverage of classified claims by impairments of 0.7 percentage points to 3.2%. The largest decrease in coverage was recorded by claims classified B and D. The difference between the average level of risk of claims, measured by the ratio of impairments to classified claims, at the domestic banks (3.6%) and at the banks under majority foreign ownership (2.4%) indicates a relatively higher level of prudence on the part of the domestic banks with regard to credit risk management. With the emergence of instability on financial markets, increased prudence of Slovenian banks can be expected in the assessment of customers' creditworthiness, as well as an increase in the creation of impairments given the deteriorating operating conditions of borrowers.

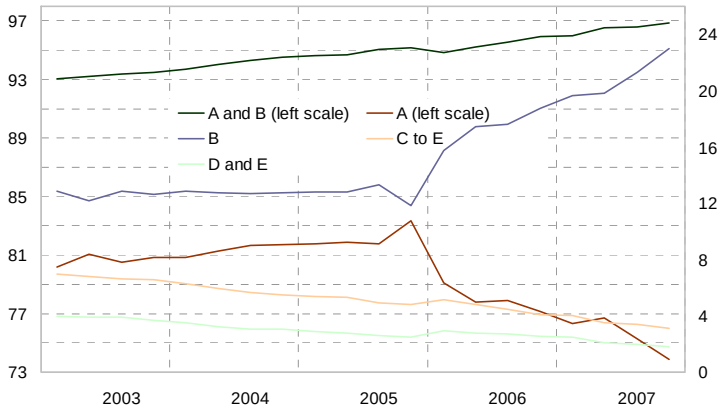
Table 6.30: Breakdown of classified claims and coverage of claims by impairments and provisions

	31 December 2006			31 December 2007		
	Classified claims	Impairments	Coverage of claims by impairments (%)	Classified claims	Impairments	Coverage of claims by impairments (%)
Total (EUR million)	31,581	1,234	3.9	40,542	1,311	3.2
	Structure (%)			Structure (%)		
A	77.1	7.1	0.4	73.9	8.5	0.4
B	18.8	28.6	6.0	23.0	33.7	4.7
C	1.6	9.6	24.0	1.4	10.0	23.9
D	1.2	20.1	66.4	0.7	14.3	65.7
E	1.4	34.6	100.0	1.1	33.4	100.0

Source: Bank of Slovenia

The proportion of claims rated A declined by 3.2 percentage points to 73.9%, as reflected in an increase of claims rated B. Nevertheless lower-risk loans (A and B) as a proportion of classified assets increased for the third straight year, reaching 97%. The latter was the result of a decrease in the proportions of bad claims (C to E) and non-performing claims (D and E). The proportion of non-performing claims fell by 0.8 percentage points to 1.8%.

Figure 6.39: Percentage of total classified claims rated A and B, C to E (bad claims) and D and E (non-performing claims)

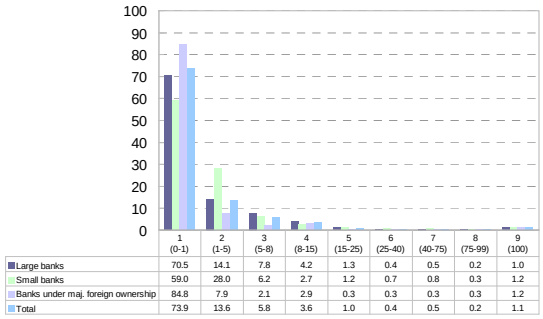


Source: Bank of Slovenia

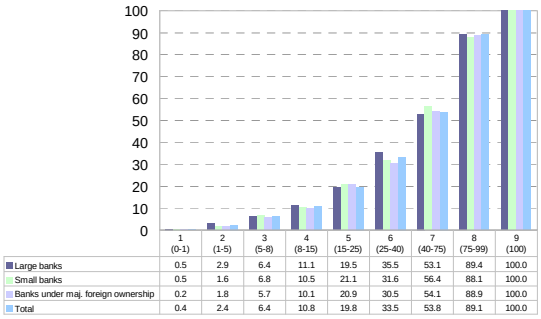
Greater prudence in rating claims can be seen from data from the end of 2007 at the small domestic banks. Just 59% of classified claims are included in the first, lowest-risk category, a decrease of 23.9 percentage points from the end of 2006. As a consequence, 28% of the small banks' claims are classified in the second credit rating category, which is significantly higher than at the large domestic banks and the banks under majority foreign ownership. The small banks still stand out in terms of the proportion of non-performing claims (D and E), for which they create the relatively lowest proportion of coverage by impairments in the amount of 83.6%, compared to the large banks (84.6%) and the banks under majority foreign ownership (91%). The proportion of non-performing claims has declined in all bank groups, amounting to 2.3% at the small banks, 1.7% at the large domestic banks and 1.8% at the banks under majority foreign ownership.

The small banks stand out with the lowest proportion of the highest rated claims and the highest proportion of non-performing claims.

Figure 6.40: Breakdown of classified claims (left) and average coverage of classified claims by impairments (right) by bank group for the end of 2007 in percentages



	1 (0-1)	2 (1-5)	3 (5-8)	4 (8-15)	5 (15-25)	6 (25-40)	7 (40-75)	8 (75-99)	9 (100)
Large banks	70.5	14.1	7.8	4.2	1.3	0.4	0.5	0.2	1.0
Small banks	59.0	28.0	6.2	2.7	1.2	0.7	0.8	0.3	1.2
Banks under maj. foreign ownership	84.8	7.9	2.1	2.9	0.3	0.3	0.3	0.3	1.2
Total	73.9	13.6	5.8	3.6	1.0	0.4	0.5	0.2	1.1



	1 (0-1)	2 (1-5)	3 (5-8)	4 (8-15)	5 (15-25)	6 (25-40)	7 (40-75)	8 (75-99)	9 (100)
Large banks	0.5	2.9	6.4	11.1	19.5	35.5	53.1	89.4	100.0
Small banks	0.5	1.6	6.8	10.5	21.1	31.6	56.4	88.1	100.0
Banks under maj. foreign ownership	0.2	1.8	5.7	10.1	20.9	30.5	54.1	88.9	100.0
Total	0.4	2.4	6.4	10.8	19.8	33.5	53.8	89.1	100.0

Source: Bank of Slovenia

Days past due in loan repayment

Taking into account days past due in the repayment of loans, the quality of the banking sector's credit portfolio is relatively poorer than the structure of classified claims and the coverage of claims by impairments. There are no arrears in 93.4% of banks' classified claims. The proportion of claims repaid more than 30 days in arrears is 3.9%, while 2.7% of classified claims are repaid more than 90 days in arrears.

Taking into account days past due, the quality of the credit portfolio is relatively poorer.

In terms of irregular debt repayment, banks are most exposed to credit risk in the corporate and non-resident sectors. Banks experience arrears in repayment of more than 90 days for 2.3% of classified claims against corporates and 5.5% of claims against non-residents.

Table 6.31: Breakdown of classified claims as at 31 December 2007 by sectors with regard to the number of days past due

	Classified claims		No delay	Up to 30 days	31-90 days	91-180 days	Over 180 days
Total (EUR million)	40,542		37,874	1,109	492	114	953
			Structure (%)				
Corporates including OFIs	58.3	100.0	93.5	3.0	1.1	0.3	2.0
Households and sole proprietors	18.8	100.0	98.2	0.5	0.2	0.3	0.8
Non-residents	17.4	100.0	87.7	3.7	3.0	0.3	5.2
Government	2.5	100.0	99.3	0.5	0.0	-	0.2
Banks and savings banks	2.8	100.0	89.0	7.0	-	-	4.0
Central bank	0.2	100.0	95.6	4.4	-	-	-
Other	0.1	100.0	100.0	-	-	-	-
Total	100.0		93.4	2.7	1.2	0.3	2.4

Source: Bank of Slovenia

Large banks are most exposed to credit risk arising from payment delays.

The large banks are most exposed to credit risk due to irregular repayments, with 7.9% of claims in arrears, and 3.2% of classified claims repaid more than 90 days in arrears. The small banks and the banks under majority foreign ownership have the lowest proportion of claims more than 90 days in arrears in their credit portfolio, at 1.8%.

Table 6.32: Breakdown of classified claims as at 31 December 2007 by individual bank groups with regard to the number of days past due

	Classified claims	Non past due	Up to 30 days	31-90 days	91-180 days	Over 180 days
Total (EUR million)	40,542	37,874	1,109	492	114	953
		Structure (%)				
Small banks	100.0	94.4	3.0	0.9	0.2	1.6
Banks under majority foreign ownership	100.0	95.4	1.2	1.6	0.2	1.6
Large banks	100.0	92.2	3.6	1.1	0.3	2.9

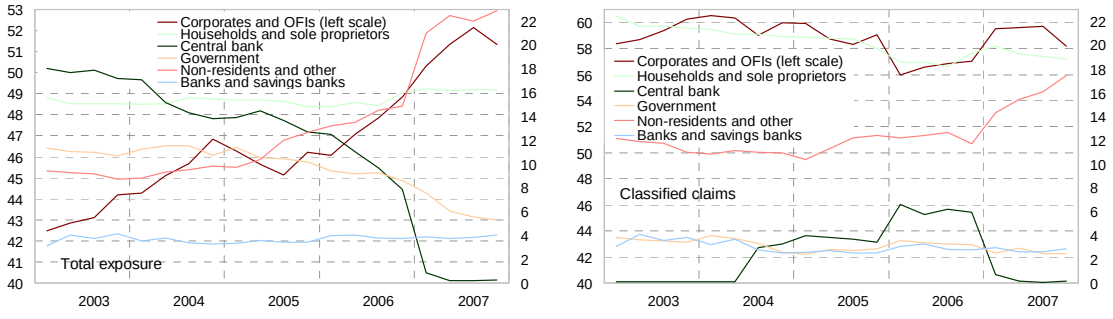
Source: Bank of Slovenia

Portfolio diversification

Increasing exposure to corporates and non-residents at the expense of the central bank and government.

The process of the increase in the banking sector's total exposure to corporates and non-residents continued in 2007, while exposure to the central bank and government decreased. The structural proportion of exposure to non-residents was up 7.1 percentage points from the end of 2006 to 22%. The main factor in this regard was the 93% year-on-year growth in classified claims against this sector. Total exposure to corporates amounted to 52.1%, up 3.3 percentage points from a year earlier.

Figure 6.41: Percentage breakdown of bank exposure (left) and classified claims (right) by sector



Source: Bank of Slovenia

Banks are most exposed to the manufacturing and financial intermediation sectors.

The increased dispersion of banks' exposure to individual sectors led to a reduction in the banking sector's exposure to credit risk arising from sector concentration in 2007. With regard to the breakdown of classified claims by sector, which takes into account the new standard classification of activities, banks are still most exposed to the manufacturing and financial intermediation sectors. However the proportions relating to these sectors decreased slightly in 2007. This decrease resulted in an increase in exposure to the construction and non-resident sectors.

Table 6.33: Breakdown of classified claims by sector in percentages

	Proportion of classified claims (%)				
	2003	2004	2005	2006	2007
Agriculture and mining	0.8	0.7	0.7	0.6	0.6
Manufacturing	16.9	16.7	16.6	15.1	14.5
Electricity, gas and water	2.0	1.6	1.4	1.3	1.3
Construction	5.1	5.5	5.7	5.8	6.6
Trade	12.8	13.4	13.1	11.9	11.1
Transport and storage	5.7	5.2	4.9	4.7	4.6
Hotels and restaurants	1.5	1.4	1.5	1.6	1.5
Information and communications	1.9	2.0	1.4	1.5	1.6
Financial intermediations	11.0	13.5	14.8	17.9	13.6
Real estate	1.0	1.1	1.3	2.1	2.3
Professional and other business activities	4.0	3.9	4.3	4.3	4.6
Public services	4.1	3.4	3.4	4.0	3.4
Households	18.7	18.2	17.3	16.8	16.5
Sole proprietors	0.2	0.1	0.2	0.2	0.2
Foreign non-financial organisations	3.0	3.7	4.2	5.3	9.2
Foreign financial organisations	7.7	6.9	7.8	6.2	8.2
Other	3.6	2.8	1.2	0.6	0.2
Total (EUR million)	17,150	20,427	25,209	31,581	40,542
Herfindahl-Hirschman index	1,098	1,125	1,138	1,136	1,047

Source: Bank of Slovenia

Accelerated growth in classified claims in the construction and non-resident sectors.

In 2007 year-on-year growth in classified claims rose 3.1 percentage points to 28.4%, as the result of accelerated growth in classified claims in most sectors. The accelerated growth in construction, as the fourth most important sector in the credit portfolio, is noteworthy. Classified claims against non-residents more than doubled.

Table 6.34: Year-on-year growth in classified claims by sector in percentages

	Year-on-year growth in classified claims (%)				
	2003	2004	2005	2006	2007
Agriculture and mining	24.7	16.6	19.8	12.6	19.6
Manufacturing	23.1	17.8	22.6	14.2	22.7
Electricity, gas and water	-17.4	-7.0	12.8	12.4	32.4
Construction	23.1	27.0	29.5	26.3	47.2
Trade	17.8	24.1	20.7	13.9	20.0
Transport and storage	8.3	7.1	16.6	20.8	26.6
Hotels and restaurants	7.1	14.4	30.9	32.7	16.0
Information and communications	-3.5	25.4	-15.2	33.9	35.7
Financial intermediations	36.4	46.3	36.2	51.7	-2.8
Real estate	25.3	26.7	47.2	99.4	44.7
Professional and other business activities	20.5	15.9	37.1	25.0	37.0
Public services	0.4	-0.1	25.1	45.3	9.0
Households	7.9	15.8	17.8	21.4	26.3
Sole proprietors	3.9	-4.2	50.8	25.0	30.5
Foreign non-financial institutions	49.4	45.5	40.1	58.2	120.8
Foreign financial institutions	-5.5	6.8	40.1	-0.7	69.5
Other	-11.3	-8.0	-46.7	-34.2	-56.1
Total (EUR million)	13.1	19.1	23.4	25.3	28.4

Source: Bank of Slovenia

Due to the rapid growth in classified claims, banks continue to optimistically assess the quality thereof, which was reflected in a decrease in the coverage of classified claims by impairments by 0.7 percentage points to 3.2%.

Banks classify sole proprietors as the highest risk branch and agriculture as the highest risk sector.

Banks continue to classify sole proprietors as the highest risk branch and agriculture as the highest risk sector with regard to coverage of claims by impairments. Despite the banks' increased exposure to the construction, real estate and non-resident sectors, the

coverage of these claims by impairments has decreased. A notable decrease in coverage in the non-resident branch was seen at the banks under majority foreign ownership, where non-residents were classified as the highest risk branch by these banks at the end of 2006 with coverage of 18%.

Table 6.35: Breakdown of risk of classified claims in 2007 by bank groups in percentages (coverage of claims by impairments)

	Banking sector	Large banks	Small banks	Banks under majority foreign ownership
Sole proprietors	13.4	20.2	8.9	5.2
Agriculture and mining	6.7	6.5	15.3	4.0
Manufacturing	5.1	6.2	5.4	2.7
Hotels and restaurants	4.5	5.8	7.2	2.3
Professional and other business activities	4.0	4.1	5.2	3.2
Construction	3.9	4.0	4.8	3.0
Households	3.9	4.1	2.9	3.7
Trade	3.5	4.1	5.8	2.2
Foreign non-financial institutions	3.3	3.3	1.7	5.3
Real estate	3.0	4.1	3.5	1.2
Information and communications	2.0	2.4	5.8	0.9
Financial intermediation	1.4	1.9	1.0	0.7
Electricity, gas and water	1.4	1.4	4.0	0.5
Transport and storage	1.3	1.5	1.5	1.0
Public service	1.1	1.7	1.8	0.4
Foreign financial institutions	0.1	0.1	0.3	0.1
Total	3.2	3.6	3.8	2.4

Source: Bank of Slovenia

Exposure to the rest of the world

A 90% increase in banks' total exposure to the rest of the world was recorded in 2007.

The total exposure of Slovenian banks to the rest of the world increased by nearly 90%, and stood at EUR 11.1 billion at the end of 2007. The proportion of exposure to EU Member States increased most (by 4.6 percentage points) in this period, partly due to the entry of Romania and Bulgaria to the Community.

Bank's total exposure to the countries of the former Yugoslavia more than doubled.

The high growth in banks' total exposure to countries of the former Yugoslavia has continued, as banks finance Slovenian companies expanding to these markets as well as other regional non-financial organisations. Total exposure more than doubled in 2007 to EUR 2.7 billion. This has lead to increased exposure to credit risk due to the unpredictability and volatility of these markets. Slovenian banks are most exposed to Serbia, Montenegro and Croatia.

Table 6.36: Total banking sector exposure to country groups in percentages

	Proportion (%)		
	2005	2006	2007
EU	67.8	62.6	64.8
EFTA	4.8	4.4	3.2
Former Yugoslav republics	16.8	20.6	24.4
CEFTA[1]	1.0	1.3	
Other	9.6	14.8	7.6
Total (EUR million)	4,868	6,447	11,154

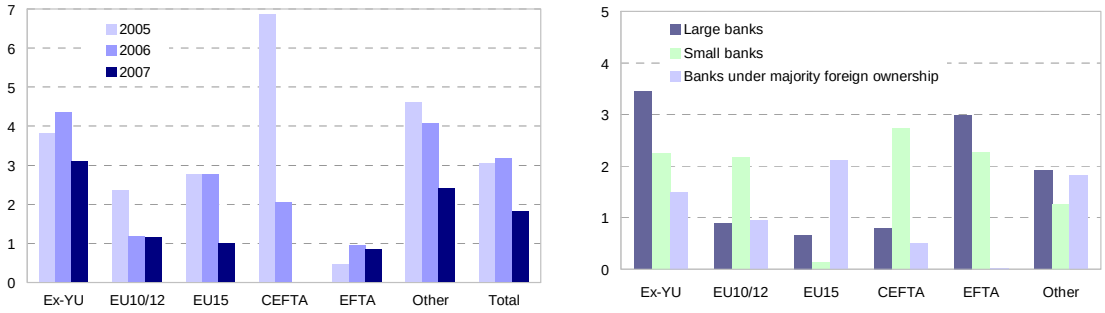
Note: [1]Until 2006 these figures only include Romania and Bulgaria, which joined the EU in 2007.

Source: Bank of Slovenia

The proportion of impairments for claims against the rest of the world decreased by 1.4 percentage points to 1.8%.

Banks were very optimistic in their assessment of the quality of claims against all groups of countries, as the coverage of classified claims by impairments decreased by 1.4 percentage points to 1.8%. The latter means that, according to banks' assessments, claims against the rest of the world bear significantly less risk compared to claims against domestic entities, whose coverage stood at 3.2% at the end of 2007.

Figure 6.42: Coverage of classified claims by impairments for banking sector (left) and for bank groups at the end of 2007 (right) by country groups in percentages



Note: Until 2006 these figures only include Romania and Bulgaria, which joined the EU in 2007.
Source: Bank of Slovenia

The percentage of impairments for claims against countries of the former Yugoslavia decreased for all bank groups.

The risk of claims against the countries of the former Yugoslavia decreased for all bank groups, as the coverage of these claims by impairments was down 1.3 percentage points from the end of 2006 to 3.1%. The small banks and the banks under majority foreign ownership recorded the largest decrease in the percentage of coverage. The large banks still assess this region as the highest risk, although their percentage of coverage was also down slightly. The small domestic banks created the highest impairments for claims against EFTA countries, while the banks under majority foreign ownership did so for claims against the EU15.

Box 6.6: Exposure to Balkan countries[1]

One of the contributing factors to the high credit growth of banks in 2007 was the high growth in their exposure to the rest of the world, particularly to Balkan countries. Exposure to Balkan countries was up 112.5% year-on-year in 2007, and doubled in all three groups of banks. There were several factors that contributed to the sharp increase in lending to entities in Balkan countries. The expansion of operations to the region by both banks and non-banking sectors led to an increase in the level of financing of subsidiaries. Furthermore, economic conditions were relatively favourable in all Balkan countries. Economic growth in 2007 was lowest in Macedonia at 4.4%, and highest in Serbia at 7.2%. Inflation in all countries, with the exception of Bulgaria, Romania and Serbia, was below the Maastricht criteria. Inflation was highest in Bulgaria in 2007 at 7.6%. Another significant factor was the limiting of credit growth by the Croatian central bank, which has led Croatian entities to look for sources of financing at foreign banks.

The total classified claims of Slovenian banks against Balkan countries stood at EUR 2.5 billion at the end of 2007, representing 6.2% of all classified claims. This proportion doubled compared to March 2006. Claims against the Balkan countries account for 36% of classified claims against the rest of the world. This proportion is 40% at the large and small banks under domestic ownership. Claims against Croatia, Serbia and Montenegro represent 78% of classified claims against the Balkan countries. The proportion of exposures to Serbia and Montenegro is increasing rapidly, while the proportion of exposure to Croatia is stable.

The majority, or 90%, of classified claims against Balkan countries are classified as claims at amortised cost, i.e. standard credit relations. The proportion of off-balance sheet claims is slightly higher against countries where Slovenian banks have major subsidiaries. In these countries (e.g. Macedonia) the proportion of claims against financial corporations is also higher. In contrast, claims against non-financial corporations represent 99% of classified claims against Croatia.

Table 6.37: Classified claims against Balkan countries (left) and coverage of classified claims by impairments in percentages (right)

	Jun 2006	Dec 2006	Jun 2007	Dec 2007
	Classified claims (EUR million)			
Total	28,789	31,773	35,665	40,784
Rest of the world	3,495	3,642	5,432	7,041
Balkan countries	941	1,193	1,844	2,535
	Year-on-year growth rate (%)			
Total	27.1	25.5	23.9	28.4
Rest of the world	41.4	20.0	55.4	93.3
Balkan countries	76.4	72.4	96.1	112.5
Structure of classified claims against Balkan countries (%)				
Croatia	35.8	30.1	33.7	38.0
Bosnia and Herzegovina	18.1	16.3	17.5	14.2
Serbia and Montenegro	31.9	39.9	39.9	40.0
Macedonia	7.7	7.9	5.0	4.0
Bulgaria	5.9	4.9	3.3	3.5
Romania	0.6	0.9	0.6	0.4

	Dec 2006	Dec 2007	Change
All classified claims	3.9	3.2	-0.7
Claims against the rest of the world	3.2	1.8	-1.4
Balkan countries	4.2	3.1	-1.2
Croatia	4.8	3.4	-1.5
Bosnia and Herzegovina	5.0	3.2	-1.8
Macedonia	1.0	0.9	-0.1
Serbia and Montenegro	4.4	3.0	-1.3
Bulgaria	2.3	1.7	-0.6
Romania	0.8	2.4	1.6

Source: Bank of Slovenia

Banks attributed the same level of risk to classified claims against the Balkan countries as they do to the aggregate of classified claims. The coverage of classified claims against the Balkan countries by impairments stood at 3.1% at the end of 2007, down 1.2 percentage points from a year earlier. Banks assess claims against Croatia as the highest risk.

In 2007 there was a significant decrease in the coverage of classified claims against the Balkan countries by impairments at all three groups of banks, especially at the small banks and the banks under majority foreign ownership. The latter in particular create an extremely low percentage of impairments for claims against the Balkan countries, with coverage amounting to just 1.5%.

Table 6.38: Coverage of classified claims by impairments by bank groups in percentages

	All classified claims			Classified claims against the rest of the world			Classified claims against Balkan countries		
	Dec 2006	Dec 2007	Change	Dec 2006	Dec 2007	Change	Dec 2006	Dec 2007	Change
Large banks	4.2	3.6	-0.6	2.8	1.9	-0.9	4.4	3.4	-1.1
Small banks	4.1	3.6	-0.4	2.5	1.3	-1.2	4.0	2.4	-1.7
Banks under majority foreign ownership	3.2	2.4	-0.8	4.5	1.8	-2.7	3.1	1.5	-1.6

Source: Bank of Slovenia

If we compare banks with regard to classified claims against the Balkan countries as a proportion of all classified claims and the pace at which this proportion increases, and if we compare the coverage of claims against the Balkan countries with impairments and the deviation of this coverage from the coverage of total claims at individual banks, we find that three banks are noteworthy. These banks have either a high proportion of claims against entities from the Balkan region or this proportion is increasing rapidly, and they create very few impairments for claims against this region compared to other banks.

[1] Countries of the former Yugoslavia as well as Bulgaria and Romania are taken into account. The figures for Serbia and Montenegro are combined for the sake of comparability with past figures.

Large exposures

The highest level of the number and sum of large exposures in 2007.

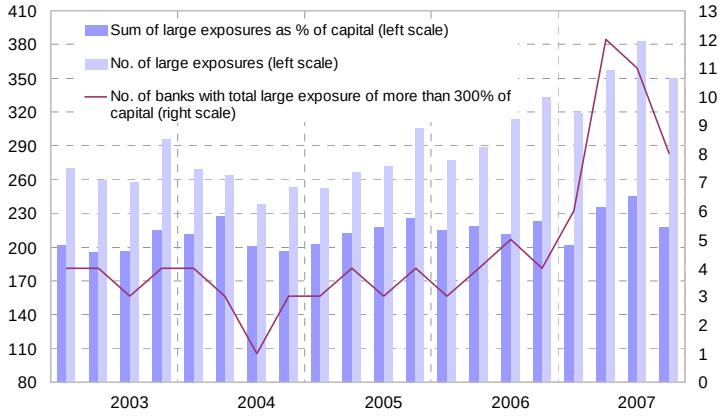
Both the number and sum of large exposures reached their highest levels in recent years during 2007. The number of large exposures, which reached a high of 383 at the end of the third quarter, stood at 350 at the end of the year, an increase of 17 from the previous year. A similar trend was seen in the sum of large exposures, measured as a proportion of capital, which fell from its high of 245% at the end of the third quarter to 217%, down 5.6 percentage points from the end of 2006.

A high number of banks with a sum of large exposures exceeding 300% of capital.

The number of banks with a sum of large exposures exceeding 300% of capital had tripled by the end of the first half of 2007. The banks under majority foreign ownership and the small domestic banks were noteworthy in this regard. By the end of the year the number of these banks had fallen to 8, primarily on account of the group of small domestic banks. There were no large domestic banks with a sum of large exposure exceeding 300% of capital.

The increase in banks' large exposures to customers is partly driven by the financing of mergers and acquisitions in the corporate sector, which increased significantly this year in terms of the number and value thereof. In this regard the small banks, which have a lower amount of capital and are dependent on the performance of the clients to which they have large exposures, are most exposed to credit risk.

Figure 6.43: Sum and number of banking sector's large exposures

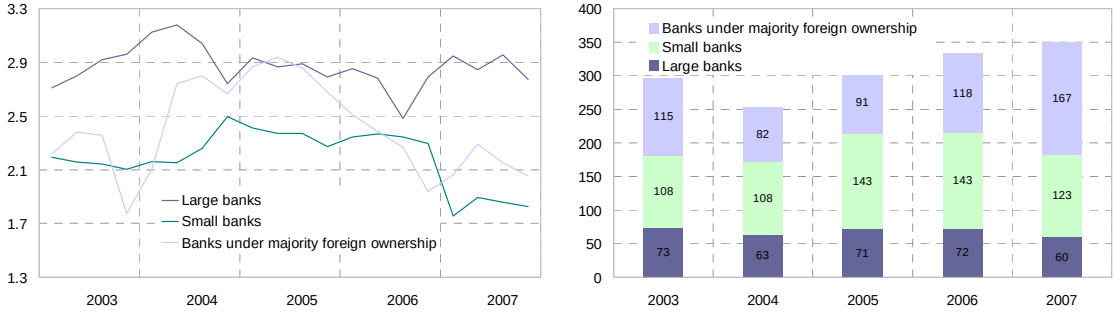


Source: Bank of Slovenia

The number of large exposures increased at the banks under majority foreign ownership.

In 2007 only the banks under majority foreign ownership increased their exposure to credit risk, measured by larger exposures. The average size of large exposures was up 0.2 percentage points from the end of 2006, while the number of large exposures rose by 49.

Figure 6.44: Average size of large exposures as a percentage of regulatory capital (left) and number of large exposures (right) by bank groups



Source: Bank of Slovenia

6.8 Interest-Rate Risk

The effects of turmoil on financial markets have not been seen in the difference between the average repricing periods for asset and liability interest rates.Interest-rate risk measured by this indicator decreased in 2007. Banks remain exposed to the risk of rising interest rates.

In contrast the effects of turmoil on financial markets are more clearly reflected in indicators which show a more short-term perspective of interest-rate risk. The effects of uncertainty on financial markets were very evident in the fluctuation of the 1-year cumulative interest-rate gap. Due to difficulties in obtaining long-term sources of financing and the redirection to shorter maturities, the 1-year interest-rate gap closed significantly, the first time in February and more notably in August 2007. The gap shortened primarily in the category of 1 to 3 months, and closed in the category of 6 months to 1 year during the last months of the year. The cumulative 1-year interest-rate gap indicates a reduction in banks' exposure to interest-rate risk in 2007. According to this indicator, banks are also exposed to the refinancing risk.

There were no significant changes in the currency breakdown of interest-sensitive items. The interest-rate gaps by individual currencies indicate the exposure of banks to interest-rate risk mostly in the domestic currency, while exposure in Swiss francs is also increasing.

Mismatching between items tied to reference interest rates increased in 2007. Substantially long positions in items tied to the 3- and 6-month EURIBOR expose banks to the interest-rate risk of lower interest income in the event of falling reference interest rates.

Two key segments of embedded option risk are changes in sight deposits and prepayments. Interest-rate risk arising from core household deposits is decreasing, as the proportion of core deposits in this segment is very high and has stabilised in the last two years. In the corporate sector, the proportion of core deposits is decreasing, which results in increased interest-rate risk for banks. On the asset side, the proportion of items with a prepayment option, particularly in the debt securities segment, is increasing.

6.8.1 Average repricing periods for interest rates

The difference between the average repricing periods for asset and liability interest rates continued to decrease in 2007.

Interest-rate risk measured by the difference between the average repricing periods for asset and liability interest rates, estimated based on a sample of banks, decreased throughout the majority of 2007. At the end of the year the average repricing period for asset interest rates was 6.8 months longer than the average repricing period for liability interest rates. At the end of 2006 the aforementioned difference was 12.2 months. Banks continue to be exposed to the risk of rising interest rates, but to a lesser extent than in past years.

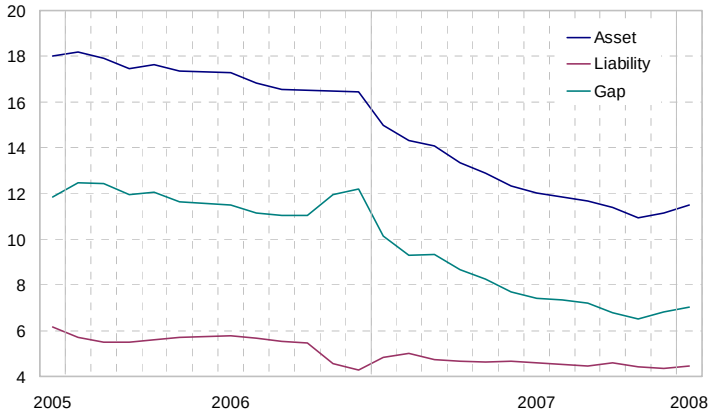
High credit growth contributed to a reduction in the average repricing period of asset interest rates.

Credit growth was exceptionally high in 2007, particularly in the segment of loans to corporates and in the segment of short-term loans. High growth in new loans means an increasing proportion of loans tied to variable interest rates, and thus a reduction in the average repricing period for asset interest rates. At the end of 2007 the average repricing period for asset interest rates stood at 11.1 months, compared to 16.5 months at the end of 2006. This trend reversed in December, and the average repricing period for asset interest rates lengthened at a large number of banks. The same trend continued in January 2008.

The average repricing period for liability interest rates remained stable throughout 2007.

Despite the tightening of conditions on international financial markets, which has limited Slovenian banks' access to sources at foreign banks and forced them to focus on more short-term sources (e.g. repos), the average repricing period for liability interest rates remained very stable throughout 2007. The period was 0.1 months longer at the end of 2007 than at the end of 2006. This is a reflection of an increasing proportion of short-term loans raised in the rest of the world with a fixed interest rate, and the fact that banks raised several larger syndicated loans and long-term loans in the final quarter of 2007, which contributed to maintaining the average repricing period for liability interest rates.

Figure 6.45: Average repricing period for asset and liability interest rates (months)



Source: Bank of Slovenia

Indicators of the average repricing period for asset and liability interest rates place more emphasis on the long-term assessment of interest-rate risk, as items with a longer period

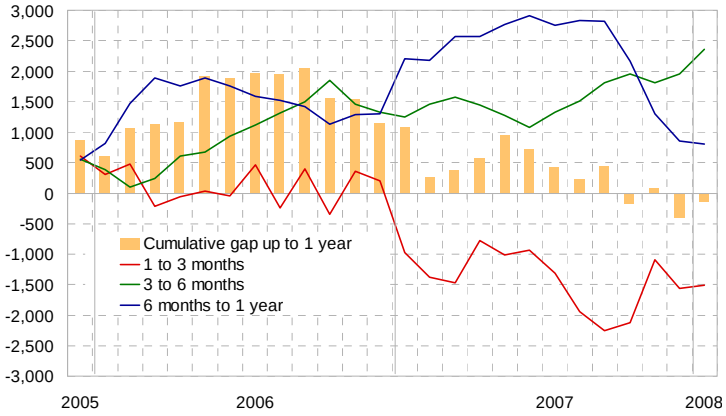
until the next repricing of interest rates or a longer residual maturity receive a larger weight in the calculation of indicators. Therefore other indicators, which provide a more short-term assessment of interest-rate risk, are presented below.

6.8.2 Interest-rate gap

In contrast to the average repricing period for asset and liability interest rates, which did not respond to tightened conditions on foreign financial markets, an analysis of the interest-rate gaps of up to 1 year indicates that events on foreign markets affected Slovenian banks.

The interest-rate gap in the category of 1 to 3 months became notably negative during months of increased uncertainty on financial markets.

Figure 6.46: Gap between interest-sensitive assets and liabilities by individual time intervals in EUR million



Source: Bank of Slovenia

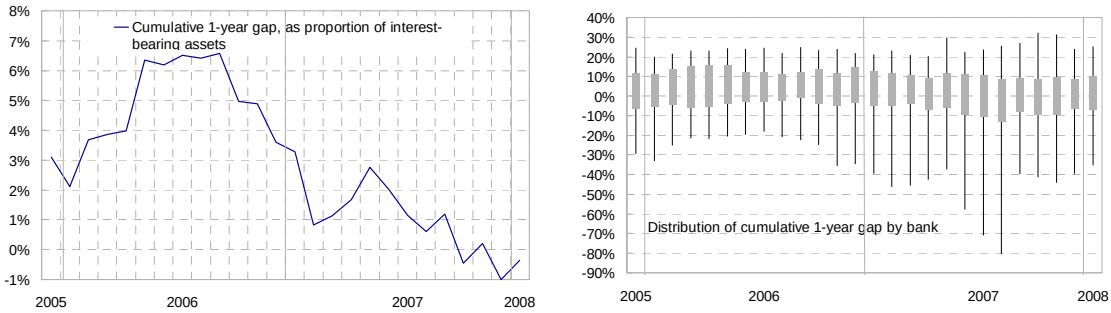
An analysis of the interest-rate exposure of banks by time intervals of up to 1 year (excluding sight deposits) indicates that, following stable levels in 2006, the gap between assets and liabilities with a residual maturity of 1 to 3 months became significantly negative in the first months of 2007, amounting to EUR -1.5 billion in March. The gap shortened further in the period from August to October (EUR -2.25 billion in September) when conditions on foreign financial markets were tightest. When conditions began to ease in November, the gap closed to the level seen in the first half of 2007, but remained considerably more negative than in 2006. Banks are exposed to the interest-rate risk of refinancing in this maturity category of interest-sensitive assets and liabilities.

Banks' dependence on the shortest-term sources has decreased somewhat in recent months. Banks have focused on obtaining sources with a longer maturity, as seen in the significant closing of the gap in the category of 6 months to 1 year.

The fact that conditions have not yet completely settled is also indicated by the 1-year cumulative gap as a percentage of interest-bearing assets which reached its lowest level in December 2007 (-1%), while the highest level was achieved in the period from May to September 2006 when it fluctuated between 6.2% and 6.6%. The distribution of the 1-year cumulative gap by banks indicates a significant shortening of the gap at some banks, initially in February and March and most notably in August 2007.

The fact that conditions have not yet completely settled is indicated by changes in the 1-year cumulative gap which reached its lowest level in December 2007.

Figure 6.47: Cumulative 1-year gap of the banking sector as a proportion of interest-bearing assets (left) and distribution of banks (right)



Source: Bank of Slovenia

The 1-year interest rate gap indicates that banks' exposure to interest-rate risk was very low at the end of 2007. More than interest-rate risk, this indicator points to increased liquidity risk and possible refinancing difficulties for banks.

6.8.3 Basis risk

Gaps by currencies

Growth of 26% in interest-sensitive assets and liabilities.

Interest-sensitive assets at the end of 2007 stood at EUR 40.1 billion, while interest-sensitive liabilities stood at EUR 38 billion. Growth in both assets and liabilities fluctuated at around 26%.

There were no significant changes in the currency breakdown of interest-sensitive items. The proportion of items in Swiss francs is increasing.

There were no significant changes in the currency breakdown of interest-sensitive items in 2007. Interest-sensitive assets in the domestic currency represented 93.2% of total interest-sensitive assets, while that proportion stood at 94.1% on the liability side. Both proportions are just over 1 percentage point lower than at the end of 2006. The proportion of items in Swiss francs increased by nearly 2 percentage points in 2007 in the structure of both interest-sensitive assets and liabilities, primarily at the expense of items in euros and US dollars.

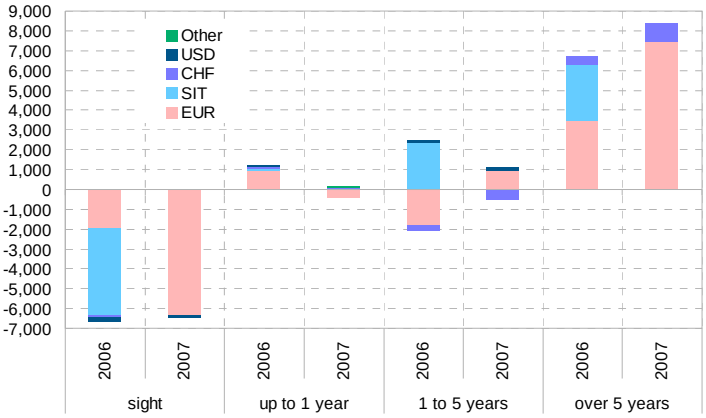
Since items in different currencies are not typically tied to changes in the same interest rates, the differences in the currency breakdown of interest-sensitive assets and liabilities indicate banks' exposure to interest-rate risk (basis risk). Similar to the 1-year cumulative gap, gaps by currencies indicate a decrease in interest-rate risk in 2007 in the category of up to 1 year, while exposure increased in the category of residual maturity of more than 5 years.

In the category of up to 1 year, the net interest-rate position[54] decreased by EUR 1.5 billion, entirely on account of items in euros. While the net position was long at the end of 2006, it had become short in the amount of EUR 324 million by the end of 2007.

In the category of 1 to 5 years, there were no significant changes in the total net position: the position is long and increased by EUR 200 million in 2007 due to the position in the domestic currency. There is a notable shortening of the position in Swiss francs in this category. With the increase in the proportion of loans tied to the Swiss franc exchange rate, banks have also focused more attention on obtaining sources in this currency.

The net position in the category with a residual maturity of more than 5 years lengthened to approximately the same extent that the position in the category of up to 1 year shortened. The position in domestic currency was longer by approximately EUR 1.2 billion. The position in Swiss francs was longer by an additional EUR 440 million, meaning that the position in this currency nearly doubled from 2006.

Figure 6.48: Currency breakdown of net interest-rate positions by individual categories of residual maturity in EUR million



Source: Bank of Slovenia

[54] The difference between interest-sensitive assets and liabilities.

Gaps by type of reference interest rate

Interest-rate risk arising from mismatching in relation to reference interest rates increased in 2007.

An additional source of interest-rate risk is the mismatch in the structure of interest-sensitive assets and liabilities, in relation to the reference interest rate. Banks' exposure to interest-rate risk due to this type of mismatching increased further in 2007. The proportion of items tied to a reference interest rate was up 16 percentage points to 60% on the asset side, while this proportion increased by just over 6 percentage points to 38% on the liability side. The gap between the proportion of interest-sensitive assets and liabilities tied to a reference interest rate increased to 22 percentage points in 2007.

Most items are tied to the 6-month EURIBOR.

The most frequently used reference interest rate is the EURIBOR of varying maturities. Items tied to the EURIBOR represent more than 90% of interest-sensitive assets and liabilities tied to reference interest rates. Both assets and liabilities are most frequently tied to the 6-month EURIBOR.

The second most important reference interest rate is the Swiss franc LIBOR. Various maturities of this reference interest rate represent more than 7% of interest-sensitive assets and more than 6% of interest-sensitive liabilities linked to reference interest rates.

Banks hold long net positions in key reference interest rates.

Given the significantly higher proportion of assets tied to reference interest rates than liabilities, banks hold long net positions in all of the most frequently used reference interest rates. The longest net position at 12.6% of interest-sensitive assets is achieved by banks in items tied to the 6-month EURIBOR. The position for items tied to the 3-month EURIBOR lengthened the most in 2007. In past years, banks held a net short position for these items.

The positions for items tied to the Swiss franc LIBOR and the tolar indexation clause are relatively balanced.

Table 6.39: Structure of interest-sensitive assets and liabilities by reference interest rate

(%)	Interest-sensitive assets				Interest-sensitive liabilities			
	Dec 05	Dec 06	Dec 07	Feb 08	Dec 05	Dec 06	Dec 07	Feb 08
Stock (EUR million)	28,019	31,922	40,144	41,241	25,986	30,222	38,016	38,832
	Structure (%)							
Reference interest rates	35.3	43.9	59.8	60.6	26.2	31.6	38.2	38.5
TOM	7.2	4.3	1.4	1.2	3.8	2.1	0.9	0.8
Other	57.5	51.7	38.8	38.2	70.0	66.2	60.9	60.7
	Proportion of tied items accounted for by individual reference rates (%)							
EURIBOR								
1 month	15.1	17.7	19.5	19.2	2.2	7.7	23.2	21.7
3 month	20.9	21.3	22.9	22.4	36.7	46.5	24.7	28.1
6 month	41.5	42.4	45.9	46.5	54.3	36.2	41.2	39.1
1 year	2.6	2.4	2.2	2.2	1.3	1.4	1.3	1.4
Swiss franc LIBOR								
1 month	0.5	0.7	1.1	1.2	0.0	0.0	0.2	0.2
3 month	1.1	1.1	1.9	2.0	1.7	0.9	2.5	2.5
6 month	1.9	2.7	2.6	2.7	0.4	1.5	1.6	2.0
1 year	1.0	1.6	1.5	1.6	0.8	2.0	1.9	2.0
CB interest rate	8.1	4.9	0.1	0.2	0.0	0.0	0.0	0.0
Other	7.3	5.0	2.3	2.1	2.6	3.8	3.5	3.0

Note: The CB interest rate is the interest rate for 60 day Bank of Slovenia tolar bills, and the ECB's refinancing rate since 2007.
Source: Bank of Slovenia

Table 6.40: Interest-rate gap as a percentage of interest-sensitive assets

	Total net position			Net position by category, Dec 2007			
	Dec 2005	Dec 2006	Dec 2007	Sight	Up to 1 year	Over 1 up to 5 years	Over 5 years
EURIBOR							
1 month	4.8	5.5	3.3	0.0	3.6	-2.6	2.2
3 month	-1.5	-4.6	4.8	0.1	2.1	-0.2	2.8
6 month	1.5	7.8	12.6	0.2	5.4	0.4	6.5
1 year	0.6	0.6	0.9	0.0	-0.2	0.1	1.0
Swiss franc LIBOR							
1 month	0.2	0.3	0.6	0.0	0.3	0.1	0.1
3 month	0.0	0.2	0.2	0.0	0.1	-0.3	0.4
6 month	0.6	0.8	1.0	0.0	0.0	-0.3	1.2
1 year	0.2	0.1	0.2	0.0	0.0	-0.3	0.5
60 day tolar bills	2.8	2.2					
TOM	3.7	2.3	0.5	0.1	-0.4	0.3	0.5

Source: Bank of Slovenia

Long positions in the majority of reference interest rates expose banks to the interest-rate risk of lower net interest income in the event of falling reference interest rates.

6.8.4 Embedded option risk

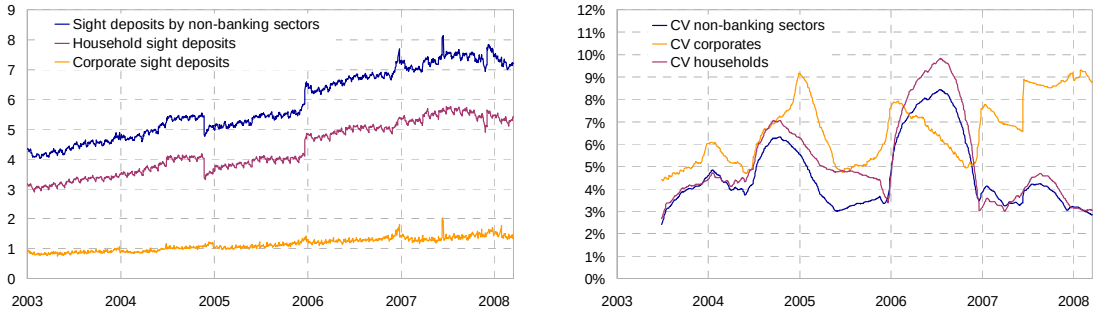
Options in contractual relations between a bank and its clients represent another source of interest-rate risk. This means that a client has the option, but the not the obligation, to settle its liabilities or claims to a bank before maturity or in cases when maturity is not defined in advance. Examples include the withdrawal of a sight deposit that has no predetermined maturity or the prepayment of a loan. The latter primarily increases in a period of falling interest rates, when non-banking sectors refinance at lower interest rates. Banks are thus exposed to the reinvestment risk.

Sight deposits

Slowdown in the growth of sight deposits in 2007 and a sharp decrease in the coefficient of variation for household sight deposits.

Growth in sight deposits slowed sharply in 2007. Due to difficulties borrowing on international financial markets in the second half of 2007, banks focused more attention on collecting deposits from non-banking sectors. By offering higher interest rates, banks were primarily attempting to collect deposits with a maturity of more than 90 days. After year-on-year growth of 12.5% in 2006, non-banking sectors' sight deposits grew by just 2.9% year-on-year in 2007. The year-on-year growth in sight deposits by households was even lower at 1.3%. In addition, the coefficient of variation of household sight deposits fell sharply in 2007, while the coefficient of variation of corporate sight deposits remains high.

Figure 6.49: Changes in sight deposits in EUR billion (left) and their coefficients of variation (right) by individual sectors



Source: Bank of Slovenia

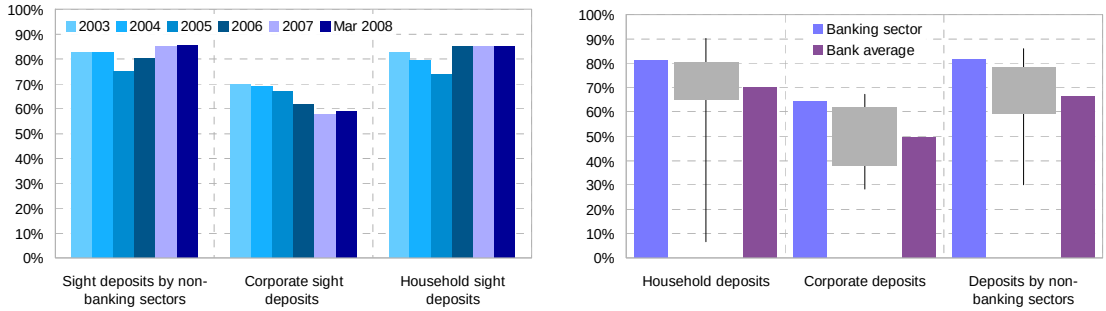
The proportion of household core deposits in 2007 was high at 85%.

The proportion of core deposits measured by the simple indicator of the ratio of the minimum to maximum daily stock of sight deposits in a period of 12 months[55], has

[55] Due to a lack of data, the indicator is derived from stocks and not from flows of deposit withdrawals, which would be more appropriate.

remained high at 85% for households over the last two years. The aforementioned ratio is declining for the corporate sector.

Figure 6.50: Changes in the proportion of core deposits of the banking sector by individual sectors (left) and the average proportion of core deposits for the period from January 2003 to March 2008 for the banking sector, distribution of banks and bank average



Source: Bank of Slovenia

Since 2003 the average proportion of core deposits[56] has been 81.2% for the household sector, and 64.4% for the corporate sector. However the differences between individual banks are very large, particularly for households, where the proportion calculated in this manner can be less than 10%. The proportion of core household deposits fluctuates between 65% and 80% at most banks, while the average proportion for the banking sector is 70%. The lowest average proportion of corporate core deposits recorded by one bank was 28.4%. At most banks, this proportion fluctuates between 40% and 60%, while the average proportion for the banking sector is 50%.

Significant differences in the proportion of core deposits at individual banks, particularly in the household sector.

Prepayment option

The second type of option that exposes banks to additional interest-rate risk is the prepayment of loans, and the call (redemption) of debt securities by the issuer or call deposits. The proportion of items with a prepayment option increased primarily on the asset side (by more than 10 percentage points in two years). The proportion of investments in debt securities with a prepayment option is growing faster than in the loan segment. At the end of 2007, 42.3% of bank investments in debt securities carried an early redemption option, compared with just 21.4% at the end of 2005.

The proportion of asset items with a prepayment optionincreased by more than 10 percentage points in two years.

On the liability side, the proportion of items with an early redemption option is significantly lower and considerably more stable. Approximately one-third of liability items have an early redemption option. Nearly all call deposits have this option, while the proportion fluctuates at around 25% for all other deposits.

On the liability side, the proportion of items with a prepayment option is lower and more stable.

Table 6.41: Percentage of items with a prepayment option in individual balance sheet categories

	Assets	Loans	Debt securities	Liabilities	Call deposits	Other deposits
Dec 2005	51.8	64.6	21.4	32.3	98.1	24.5
Dec 2006	56.5	65.5	30.7	32.4	98.9	23.4
Dec 2007	62.1	66.6	42.4	34.6	99.0	25.0
Jan 2008	62.7	67.1	42.3	34.9	99.3	25.1

Source: Bank of Slovenia

Based on data reported by monetary financial institutions, the percentage of items for which prepayment is actually invoked is minimal. The highest proportion is for call deposits at around 1%, while the proportion is less than 0.1% for other items.

Based on bank surveys, the proportion of prepayments for household loans was 7.9% in 2007, up 1 percentage point from the previous year.

[56] Due to a lack of data, the indicator is derived from balances and not from flows of deposit withdrawals, which would be more appropriate.

6.9 Exchange-Rate Risk

Exchange-rate risk for banks has decreased with the introduction of the euro. Despite the decrease in the proportion of foreign currency items following the introduction of the euro, these items have achieved extremely high growth. Most significant is the increase in items in Swiss francs at the expense of dollar items.

The direct exposure of banks to exchange-rate risk measured as the ratio of the net open position to regulatory capital remains low. The highest net open positions of banks are in US dollars and Swiss francs. The amounts are relatively small, but banks are exposed to the risk of appreciation of both currencies against the euro.

Lending to non-banking sectors in Swiss francs or with a Swiss franc currency clause remains one of the segments of banking operations with the highest growth rate. This phenomenon is also spreading to other sectors, whereas it was limited primarily to households and housing loans in the past. Conditions for borrowing in Swiss francs are not as favourable as they were in the past. The reference interest rate has risen. In the first three months of 2008, the appreciation of the Swiss franc against the euro increased the indebtedness of borrowers with loans tied to the Swiss franc exchange rate. Banks transfer exchange-rate risk to customers through foreign currency loans or loans with a currency clause. However they expose themselves to additional credit risk in the event of unfavourable fluctuations in the exchange rate and reference interest rate. This is not only due to the reduced ability of borrowers to settle their obligations to banks, but also because the credit exposure of banks measured in euros increases with each percent of appreciation of the Swiss franc against the euro.

6.9.1 Currency breakdown of banks' balance sheets

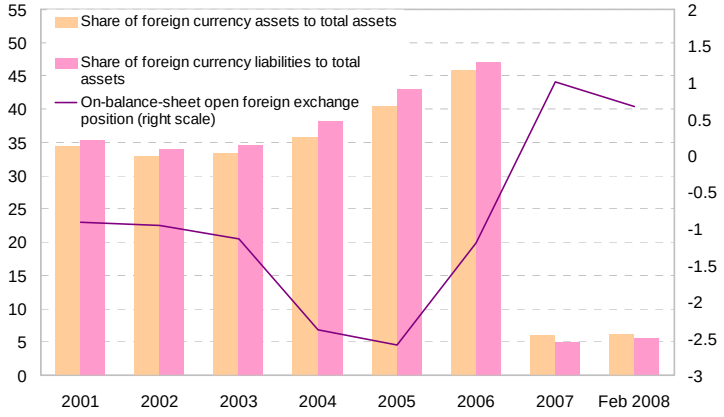
Decrease in the foreign exchange sub-balance with the introduction of the euro; the on-balance-sheet foreign exchange position has become long.

The proportion of foreign currency items fell sharply with the introduction of the euro. In February 2008 the proportion of foreign currency assets fluctuated at a level of 6%, while the proportion of foreign currency liabilities accounted for just over 5% of banks' total assets. With the shift of items in euros from the foreign exchange sub-balance, the short foreign exchange position became long due to the rapid growth of loans in Swiss francs and the increased exposure to countries of the former Yugoslavia and new EU Member States. At the end of 2007 the on-balance sheet open foreign-exchange position represented 1% of total assets. The position closed slightly in the first months of 2008, and stood at 0.7% at the end of February.

Very high growth in foreign currency items; approximately 60% in 2007.

Despite the decrease in foreign currency items as a proportion of total assets following the introduction of the euro, these items have achieved extremely high growth. While year-on-year growth in foreign currency items, excluding euros, fluctuated around 30% in 2006, these items achieved growth of approximately 60% in 2007 on both the liability and asset sides. Even higher growth has been recorded in 2008. At the end of February, year-on-year growth in foreign currency liabilities stood at 71%.

Figure 6.51: Share of foreign currency liabilities and foreign currency assets in total assets and on-balance-sheet open foreign exchange position in percentages



Source: Bank of Slovenia

Items linked to the Swiss franc exchange rate achieve high growth.

Most significant is the increase in items in Swiss francs at the expense of US dollar items. In February 2008 the stock of items in Swiss francs was 120.8% higher year-on-year on the assets side and 133.9% higher on the liability side. In addition to the rapid growth of liabilities in Swiss francs, the search for less expensive sources of financing can also be seen in items in Japanese yen, although the proportion of the latter is very small.

In the currency breakdown of assets, banks are more exposed to new EU Member States than to countries of the former Yugoslavia.

Table 6.42: Currency breakdown of assets and liabilities

	December 2006		December 2007		February 2008	
	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
Total foreign curr. excl. euros (EUR million)	1,664	1,418	2,720	2,267	2,947	2,541
Year-on-year growth (%)	36.1	29.8	63.4	59.9	67.0	71.2
Structure of currencies other than euros			(%)			
Global currencies	97.1	99.1	97.5	99.1	97.9	99.4
Swiss franc	58.2	53.1	76.3	72.7	78.2	73.9
Pound sterling	1.3	2.1	1.0	1.4	1.0	1.3
US dollar	36.1	41.7	18.4	23.4	17.2	22.7
Canadian dollar	0.6	1.2	0.5	0.6	0.5	0.6
Yen	0.6	0.1	0.8	0.5	0.6	0.5
Australian dollar	0.4	0.8	0.5	0.5	0.5	0.5
New EU Member States	1.2	0.0	1.6	0.0	1.4	0.1
Scandinavia	0.5	0.4	0.3	0.2	0.3	0.3
Former Yugoslav republics	1.1	0.4	0.5	0.4	0.3	0.3
Other	0.0	0.0	0.1	0.3	0.0	0.0

Source: Bank of Slovenia

6.9.2 Open foreign exchange position

The net open foreign exchange position at the end of 2007 was long in the amount of EUR 28.5 million or 0.9% of regulatory capital.

The net open foreign exchange position had closed considerably by the end of 2007. The position was long and stood at EUR 28.5 million or 0.9% of regulatory capital at the banking sector level in December 2007. The most open positions held by banks were those in investment fund units. The banking sector's position in this item at the end of the year was long in the amount of EUR 74.9 million. In 2007 banks' positions in US dollars opened significantly, with a short net position in the amount of EUR 48.5 million at the end of the year. In the second quarter the long position in Swiss francs became short, and shortened further to EUR 12.1 million by the end of the year.

The open foreign exchange position according to the definition from capital requirements (i.e. the greater of the sum of all long positions and the sum of all short positions by individual currencies) stood at EUR 102.2 million or 3.1% of regulatory capital at the end of 2007.

Table 6.43: Open foreign exchange positions in EUR million

	Net position				Greater of the sum of long and short positions			
	Mar 2007	Jun 2007	Sep 2007	Dec 2007	Mar 2007	Jun 2007	Sep 2007	Dec 2007
Global currencies	-20.8	-22.1	-22.2	-57.4	-41.2	-40.5	-38.7	-65.0
US dollar	-28.6	-21.2	-22.7	-48.5	-32.0	-28.1	-25.9	-50.6
Swiss franc	4.8	-3.6	-4.6	-12.1	10.8	-9.5	-11.7	-13.3
Other (GBP, CAD, AUD, JPY)	3.0	2.7	5.1	3.3	6.1	5.6	6.2	4.4
EEA currencies	-0.5	-1.4	0.4	1.5	-3.1	-4.1	4.7	5.5
Other currencies	19.8	18.3	10.0	9.4	28.2	19.3	18.3	14.2
CIU	84.8	70.6	69.4	74.9	84.8	70.6	69.4	74.9
Total	83.3	65.4	57.6	28.5	135.9	111.1	108.9	102.2
As % of regulatory capital	3.0	2.3	2.0	0.9	4.9	3.9	3.7	3.1

Note: EEA – European Economic Area, i.e. the EU, Iceland and Norway; CIU – foreign currency positions in investment fund units.
Source: Bank of Slovenia

Table 6.44: Open foreign exchange positions by bank groups in EUR million

	Large banks	Small banks	Banks under majority foreign ownership	Total
Global currencies	-46.0	-4.7	-6.7	-57.4
US dollar	-42.4	-4.9	-1.3	-48.5
Swiss franc	-5.6	-0.6	-6.0	-12.1
Other (GBP, CAD, AUD, JPY)	2.0	0.7	0.5	3.3
EEA currencies	0.8	0.4	0.3	1.5
Other currencies	1.5	7.7	0.2	9.4
CIU	72.2	2.5	0.3	74.9
Total	28.4	6.0	-6.0	28.5
As % of regulatory capital	1.3	1.2	-0.9	0.9

Note: EEA – European Economic Area, i.e. the EU, Iceland and Norway; CIU – foreign currency positions in investment fund units.
Source: Bank of Slovenia

Domestic banks hold a long position while banks under majority foreign ownership hold a short net position.

By individual bank groups the total net open foreign exchange position as a proportion of regulatory capital was the same at the large and small banks at the end of 2007. The position was long and represented just over 1% of regulatory capital. The position was short at the banks under majority foreign ownership in the amount of 0.9% of regulatory capital. The most open positions held by banks were those in investment fund units. However this is primarily true for the large banks. All banks with a position in investment fund units held a long position in this item. All banks groups hold short positions in US dollars and Swiss francs, the difference being that the domestic banks hold a shorter position in US dollars, while the banks under majority foreign ownership hold a shorter position in Swiss francs.

6.9.3 Borrowing in Swiss francs

Demand from corporates for loans tied to the Swiss franc exchange rate began to intensify in 2007.

Lending to non-banking sectors in Swiss francs or with a Swiss franc currency clause remains one of the segments of banking operations with the highest growth rate. In past years primarily households borrowed in Swiss francs, particularly for housing purposes. Other sectors, with the exception of other financial institutions (OFI), were relatively reserved with regard to foreign currency borrowing. Demand from corporates for loans tied to the Swiss franc exchange rate began to intensify in 2007. Year-on-year growth in loans to non-financial corporations more than doubled in 2007. As in the past, the majority of approved loans tied to the Swiss franc exchange rate are for households. With some delay the small banks have also entered this lending market.

Table 6.45: Volume and year-on-year growth of loans in Swiss francs and loans with a Swiss franc currency clause

					Households	
	Non-banking sectors	Non-financial corporations	OFIs	Government	All loans	Housing loans
			Stock of loans (EUR million)			
2006	921.4	309.8	65.8	8.1	537.6	402.0
2007	1,982.2	781.6	168.1	7.4	1,025.0	769.5
Feb 2008	2,231.2	872.7	205.3	10.8	1,142.3	861.8
			Year-on-year growth rate (%)			
2006	108.0	71.3	196.1	30.7	130.0	131.3
2007	115.1	152.3	155.4	-7.9	90.7	91.4
Feb 2008	121.9	150.7	181.9	39.5	98.0	100.9

Source: Bank of Slovenia

Table 6.46: Loans tied to the Swiss franc exchange rate by bank groups

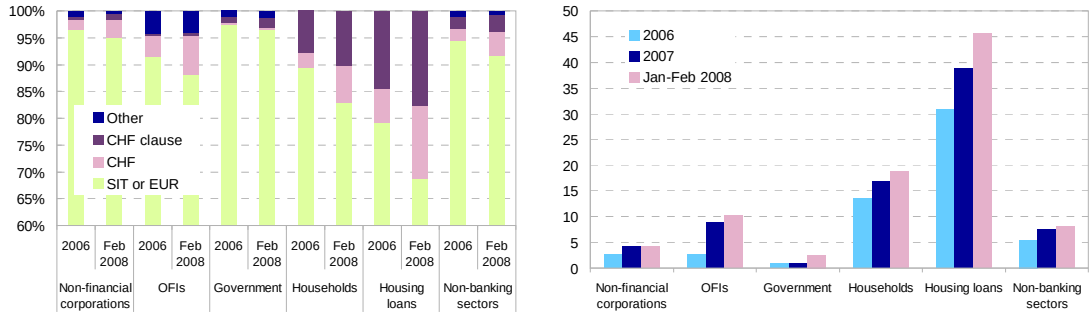
	Year-on-year growth rates (%)		Proportion of all loans to non-banking sectors accounted for by loans tied to Swiss francs (%)		Proportion of loans of the bank group (%)	
	2006	2007	2006	2007	2006	2007
Large banks	101.6	102.7	32.5	30.6	2.6	3.9
Small banks	-0.8	361.6	0.6	1.3	0.3	0.9
Banks under majority foreign ownership	113.5	118.9	66.9	68.1	8.9	14.0
Total	108.0	115.1	100.0	100.0	4.6	7.1

Source: Bank of Slovenia

At the end of February 2008 loans tied to the Swiss franc exchange rate represented 7.7% of all loans to non-banking sectors, up approximately 3 percentage points from the end of 2006. On average in the first two months of 2008, loans tied to the Swiss franc exchange rate represented 8% of new loans to non-banking sectors, up 2.5 percentage points from the 2006 average.

The proportion of loans to non-banking sectors tied to the Swiss franc exchange rate stands at 8%.

Figure 6.52: Currency breakdown of outstanding loans (left) and new loans tied to the Swiss franc exchange rate (right) by individual sectors in percentages

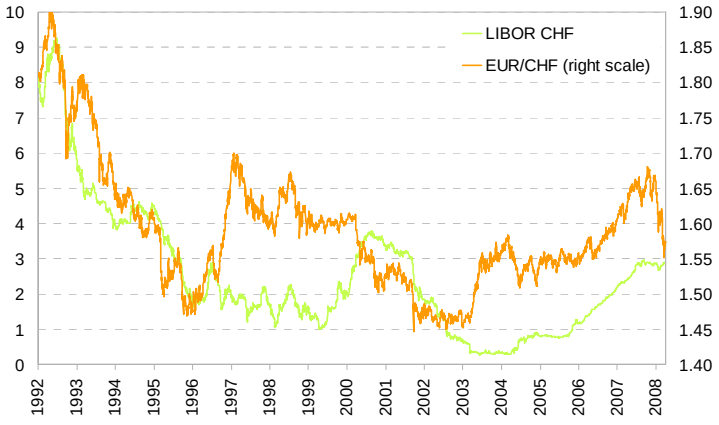


Source: Bank of Slovenia

Given the rapid increase in the proportion of loans tied to the Swiss franc exchange rate and the widening spectrum of borrowers who opt for these types of loans, the conditions for borrowing in Swiss francs are less favourable than they were a few years ago.

Conditions for borrowing in Swiss francs are less favourable than they were in the past.

Figure 6.53: Changes in the euro-Swiss franc exchange rate and the LIBOR reference interest rate for Swiss francs



Source: Bank of Slovenia

The 6-month Swiss franc LIBOR still lags behind the 6-month EURIBOR, but the spread is closing. The spread was highest in 2002, when it reached 2.5 percentage points in August and September. In the last two years the spread has fluctuated between 1.5 and 2 percentage points.

The spread between the Swiss franc LIBOR and EURIBOR has closed.

Besides changing interest rates, changes in the exchange rate also affect foreign currency loans. In recent years the Swiss franc has depreciated against the euro, which has had a

In recent months the exchange rate movement has had an adverse impact on indebtedness in Swiss francs .

beneficial impact on borrowers who raised loans in Swiss francs. In October 2007 the Swiss franc began to appreciate against the euro, in part due to the instability on financial markets and the perception of the Swiss franc as a safe-haven currency. The Swiss franc appreciated 6.7% against the euro in the five month period from the end of October 2007 to the end of March 2008, leading to an increase in the indebtness of borrowers with loans tied to the Swiss franc exchange rate.

The effect of a change to the exchange rate on foreign currency loans is all the more important because, in contrast to a changing interest rate which only affects the repayment of interest, a change to the exchange rate affects the amount of the loan principal and thus the entire loan instalment.

6.10 Bank Solvency

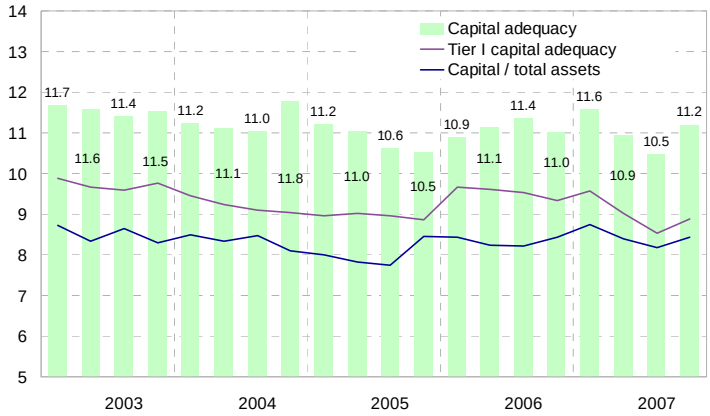
The capital adequacy of banks fluctuated significantly in 2007, but had reached a similar level to that of a year earlier by the end of the year. The capital adequacy did not follow the high growth in loans to non-banking sectors at the majority of banks. There is still a high level of willingness on the part of banks to assume credit risk. This is reflected in an increasing proportion of capital requirements for credit risk and an increasing ratio of capital requirements to total assets. The distribution of banks with regard to capital adequacy continues to polarise. The majority of banks are in the lowest or highest capital adequacy categories.

Because the banks under foreign majority ownership have easier access to capital, particularly compared to the large domestic banks, the majority of capital requirements are met with original own funds, primarily share capital and capital surplus. In contrast the large domestic banks meet a large portion of capital requirements with subordinated instruments in original own funds and additional own funds. Retained earnings also represent an important source for meeting capital requirements for this group of banks.

The problem of a less than optimal structure of capital can be seen at some banks under domestic ownership. The level of subordinated instruments (subordinated debt, hybrid and innovative instruments) exceeds the amount these banks may include in the calculation of capital or is close to the maximum limits defined by the law due to the inability to carry out capital increases and an insufficient level of original own funds. Current conditions on financial markets are rather unfavourable for the recapitalisation of banks, which brings into question the adequacy of the current business policies of individual banks with regard to increasing the level of subordinated instruments, and even more so with regard to lending policies. It is important that banks reinforce the link between their investment policies and capital management policies in the decision-making process, and that the availability of capital play a more explicit role in the definition of banks' investment policies.

6.10.1 Capital adequacy

Figure 6.54: Capital adequacy, Tier 1 capital adequacy and capital to total assets ratio in percentages



Source: Bank of Slovenia

Capital adequacy of the banking sector amounted to 11.2% in 2007, and Tier 1 capital adequacy to 8.9%.

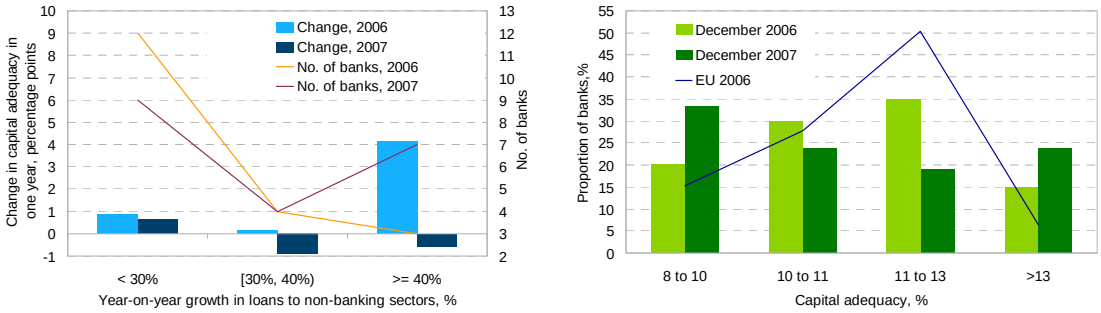
The capital adequacy of the banking sector stood at 11.2% at the end of 2007, up 0.2 percentage points from the end of 2006, after fluctuating significantly during the year. Tier 1 capital adequacy and the capital to total assets ratio followed the fluctuations in capital adequacy throughout the year. The difference being that at 8.9% Tier 1 capital adequacy was 0.4 percentage points lower than at the end of 2006, despite an increase in the final quarter. The capital to total assets ratio remained at the previous year's level of 8.4% at the end of 2007.

The increase in capital adequacy in the first and final quarters of 2007 was the result of high growth in regulatory capital, which rose 13% with regard to the previous quarter in each of the aforementioned quarters. The rapid decrease in capital adequacy in the middle of the year, when banks did not increase capital, was primarily the result of high growth in the volume of operations and an increase in loans as a proportion of the balance sheet at the expense of securities. Growth in capital requirements stood at 30.3% at the end of 2007.

Capital adequacy did not track the rapid growth in loans at the majority of banks.

Capital adequacy did not track the rapid growth in loans to non-banking sectors at the majority of banks.Banks with high growth rates of loans also increased capital adequacy significantly in 2006. In contrast, the banks with the highest growth in loans decreased capital adequacy in 2007. Capital adequacy at banks with growth in loans exceeding 40% was down 0.6 percentage points on average at the end of 2007 from the previous year, and 0.9 percentage points at banks with year-on-year growth in loans of between 30% and 40%.

Figure 6.55: Changes in capital adequacy in 2006 and 2007 with regard to year-on-year growth in loans to non-banking sectors, banks' average in percentage points (left), and distribution of capital adequacy of banks and a comparison with the EU (right)

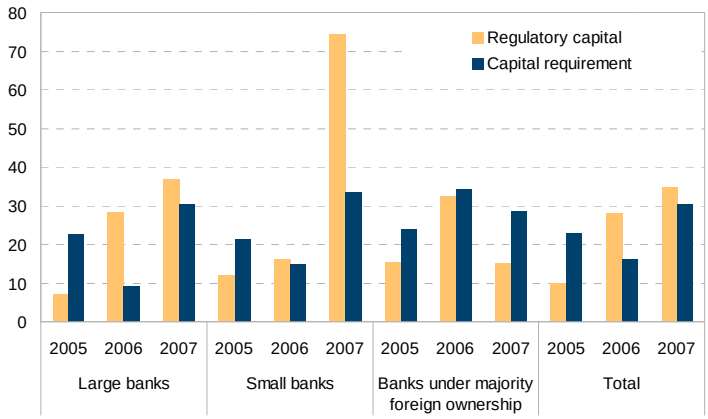


Source: Bank of Slovenia

The distribution of capital adequacy of banks is continuing to polarise.

The distribution of the capital adequacy of Slovenian banks is continuing to polarise. The majority of banks are classified in the lowest (less than 10%) or the highest (more than 13%) capital adequacy categories. The polarisation of banks reached its peak in the third quarter when five banks had a capital adequacy of less than 9%. The increase in capital in the last quarter of 2007 somewhat mitigated the shift of banks to the lowest capital adequacy categories. However the distribution remains in contrast to that of the EU, with the lowest number of banks in the capital adequacy range of 11% to 13%.

Figure 6.56: Year-on-year growth in regulatory capital and capital requirements by bank groups in percentages



Source: Bank of Slovenia

The effects of high credit growth on decreasing capital adequacy would have been even greater had some banks not significantly improved their capital adequacy at the end of the year by increasing capital. In 2007 year-on-year growth in capital requirements only outpaced year-on-year growth in regulatory capital at the banks under majority foreign ownership. At 75% the small banks stand out in terms of high growth in capital.

Capital adequacy has reached the EU average. The small banks and the banks under majority foreign ownership lag behind comparable EU banks.

At the end of 2007, the capital adequacy of the banking sector was close to the EU average; the same was true for the large banks, which are comparable to medium-size EU banks in terms of size. The capital adequacy of the small banks lagged behind the EU average. However this difference was more than halved in 2007 compared to the average capital adequacy of small EU banks. Thus the small banks are nearer to the expected levels when they should achieve a higher capital adequacy than other groups of banks on account of a smaller scope of operations, less diversification and greater sensitivity to changing operating conditions.

Table 6.47: Capital adequacy by groups of banks and comparison with the EU

	2005	2006	Sep 2007	Dec 2007
Large banks	10.5	11.0	10.5	11.5
Small banks	10.8	10.9	12.7	14.3
Banks under majority foreign ownership	10.5	11.1	9.4	9.3
Slovenian banking sector	10.5	11.0	10.5	11.2
EU banking sector	11.4	11.1		

Sources: Bank of Slovenia, EU Banking Sector Stability

6.10.2 Capital

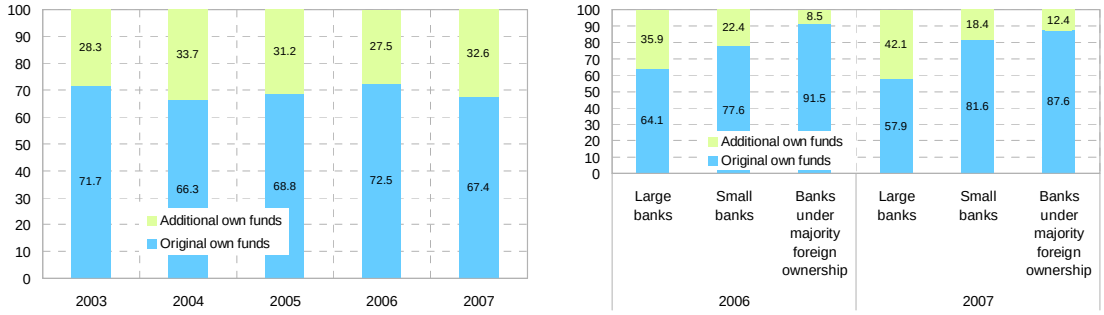
An increasing proportion of additional own funds in the structure of capital.

At the end of 2007 the regulatory capital of the banking sector stood at EUR 3.48 billion. Banks have focused a considerable amount of attention on increasing capital due to the tightening of conditions on international financial markets, rapid growth in capital requirements and preparations for the introduction of the new capital framework, which will mean higher capital requirements for the majority of Slovenian banks in the first phase. Capital prior to deductions increased by EUR 1.1 billion, in nearly equal amounts of original own funds and additional own funds. Since the basis for original own funds is significantly higher than that of additional own funds, growth in additional own funds, at 62%, was almost twice as high as the growth in original own funds. As a consequence, the proportion of additional own funds in the structure of capital prior to deductions increased by 5.1 percentage points to 32.6%.

The banks under majority foreign ownership are in a more favourable position than the large domestic banks. Due to the concentrated structure of active owners, these banks can meet capital requirements via capital increases, and thus achieve the highest proportion of original own funds amongst all bank groups. The large domestic banks meet a significant portion of capital requirements through subordinated instruments, and thus have a proportion of additional own funds in the structure of capital prior to deductions that is more than twice as high as other groups of banks.

The banks under majority foreign ownership have easier access to capital and thus meet the majority of their capital requirements with original own funds.

Figure 6.57: Structure of capital prior to deductions for the banking sector (left), and by groups of banks (right) in percentages



Source: Bank of Slovenia

Original own funds

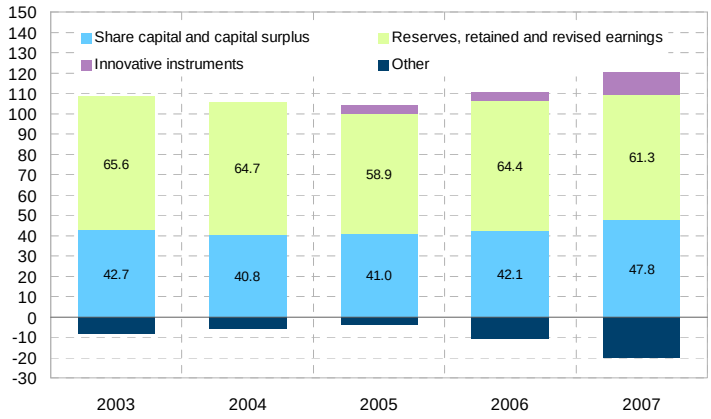
At the end of 2007 the original own funds of the banking sector amounted to EUR 2.77 billion. Relative to the previous year, this was EUR 587.7 million or 27% higher. Original own funds increased primarily on account of a EUR 403.5 million increase in share capital and capital surplus. Capital increases were carried out by half of all banks. The majority of the capital increases were carried out in the second half of 2007 and in the first months of 2008. Of the total amount of EUR 167.8 million,[57] the large banks accounted for around 6%, while the remainder was accounted for by the small banks and the banks under majority foreign ownership in approximately equal proportions.

In 2007 original own funds increased by 27%, primarily on account of share capital and capital surplus.

Innovative instruments, which increased by EUR 210.8 million in 2007, play an increasingly important role in the structure of original own funds.

The volume of innovative instruments increased by EUR 210.8 million.

Figure 6.58: Components of original own funds in percentages



Source: Bank of Slovenia

The third important source for increasing original own funds derives from profit reserves and retained and revised earnings, which were up EUR 291.8 million from 2006. However the contribution from earnings was almost 30% lower than in 2006. This indicates that banks have yet to fully implement the Bank of Slovenia's recommendation to earmark a higher portion of profit for increasing capital.

Retained earnings are an important source for increasing original own funds.

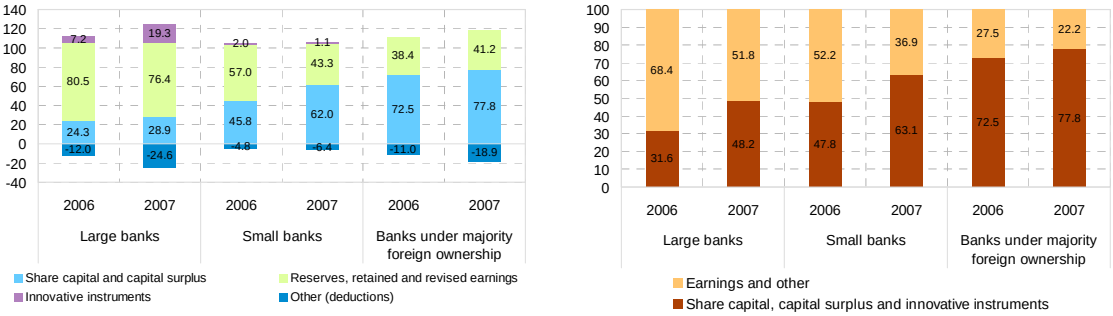
[57] Capital increases in 2007 amounted to EUR 99.5 million. An additional EUR 68.2 million in capital increases were carried out in the first months of 2008.

The category "other", which includes original own fund deductions, was significantly higher than the previous year (up EUR 318.5 million from 2006). Undisclosed impairments and provisions,[58] which stood at EUR 219.5 million or 7.9% of original own funds, represent the majority of the aforementioned amount. This amount was up EUR 80 million from 2006, when these impairments and provisions accounted for 6.5% of original own funds. The surplus from innovative instruments and deductions arising from intangible assets also represent a significant portion of deductions.

The banks under majority foreign ownership have considerably easier access to capital than the large banks.

A comparison of the structure of original own funds by bank groups clearly shows that the banks under majority foreign ownership have considerably easier access to capital, particularly when compared with the large banks under domestic ownership.

Figure 6.59: Components of original own funds by groups of banks in percentages



Source: Bank of Slovenia

Share capital and capital surplus represented 77.8% of original own funds at the banks under foreign ownership at the end of 2007, while that proportion was 28.9% at the large banks. The situation at the small banks is somewhat easier, as their demand for capital is smaller. In addition, their ownership structure is less dispersed than that of the large banks. Share capital and capital surplus represented 62% of original own funds at the small banks.

The large domestic banks are also meeting capital requirements through rapid growth in innovative instruments.

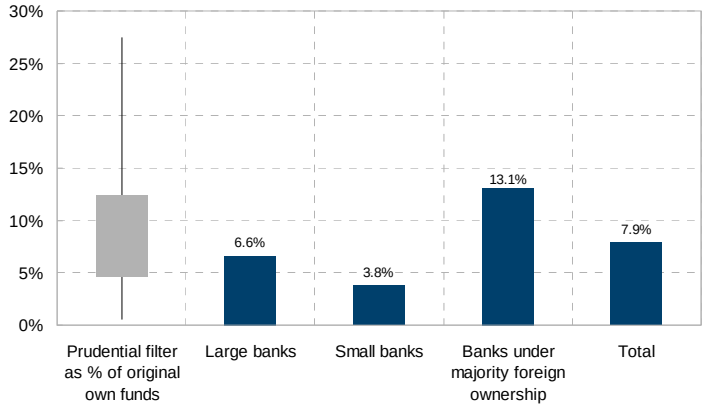
The large domestic banks are also meeting their capital requirements through rapid growth in innovative instruments. Taking into account the sum of innovative instruments, share capital and capital surplus, the proportion of these items in the original own funds of the large banks is still 30 percentage points lower than that of the banks under majority foreign ownership. Furthermore, innovative instruments at the large banks already represent 19% of original own funds, and therefore cannot be fully taken into account in the calculation of original own funds.[59]

A larger burden on capital via undisclosed impairments is characteristic of the banks under majority foreign ownership. The proportion of undisclosed impairments as a percentage of original own funds among banks varies significantly. Undisclosed impairments represent 13% of the original own funds at the banks under majority foreign ownership, while the proportion is considerably lower in other groups of banks.

[58] Undisclosed impairments and provisions are an original own fund deduction item arising from the difference between actual declared impairments in group assessments of financial assets and legally defined impairments under the regulation on the assessment of losses for credit risk. This is a so-called prudential filter.

[59] In order for banks to take all innovative instruments into account in the calculation of original own funds, and so that no bank would exceed the legally prescribed limit of 15%, the banking sector would need to increase original own funds via capital increases and increased profits in an amount exceeding EUR 860 million.

Figure 6.60: Deductions arising from undisclosed impairments (prudential filter) as a proportion of original own funds by groups of banks



Source: Bank of Slovenia

When increasing capital, the large domestic banks are highly dependent on profit reserves and retained earnings, which represent 76% of original own funds. These components represent slightly more than 40% of original own funds in other groups of banks. Like the banks under majority foreign ownership, the large banks have significant deductions from original own funds. With the deteriorating operating conditions of banks and the associated decrease in profits, the large domestic banks will encounter problems in increasing original own funds from retained earnings.

Additional own funds

Year-on-year growth in additional own funds amounted to 62%.

At the end of 2007 additional own funds taken into account in the calculation of capital adequacy reached EUR 1.34 million. Year-on-year growth in additional own funds reached 62%, the highest year-on-year growth to date. Additional own funds increased on account of hybrid instruments and subordinated debt.

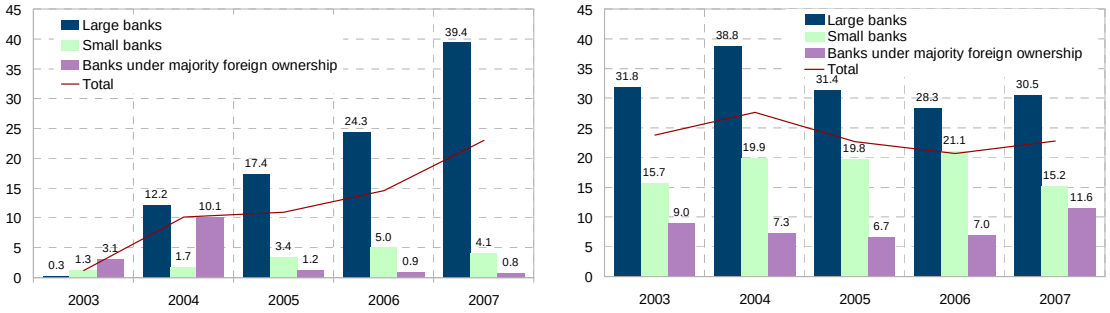
The volume of hybrid instruments doubled in 2007. Large banks accounted for the majority of the increase.

Hybrid instruments, together with the surplus from innovative instruments and cumulative preference shares, totalled EUR 636 million at the end of 2007. This represents an increase of 100.1% relative to 2006. Primarily the large banks, which account for 98% of the increase, meet their capital requirements in this manner. The volume of hybrid instruments also increased at the small banks (by 47%). As a result, the ratio of hybrid instruments, the surplus from innovative instruments and cumulative preference shares to original own funds rose sharply (by 15.1 percentage points) in 2007 in the group of large banks, while the ratio in other groups of banks is decreasing.

Subordinated debt is approaching the maximum limit at some banks.

At the end of 2007 the subordinated debt of the banking sector stood at EUR 630.3 million, representing year-on-year growth of 39.7%. The banks under domestic ownership, particularly the large banks, are restricted when increasing subordinated debt by the amount of original own funds. The entire banking sector has achieved a ratio of subordinated debt to original own funds of 22.8%, while that ratio stands at 30.5% at the large banks. In 2007 one bank could not take into account the full amount of subordinated debt, as it exceeded the limit of 50% of original own funds. The ratio of subordinated debt to original own funds exceeded 40% at four other banks. Approaching the maximum limit hampers the ability of banks to increase capital adequacy through subordinated debt.

Figure 6.61: Ratio of hybrid instruments, surplus from innovative instruments and cumulative preference shares to original own funds (left), and the ratio of subordinated debt to original own funds (right) in percentages

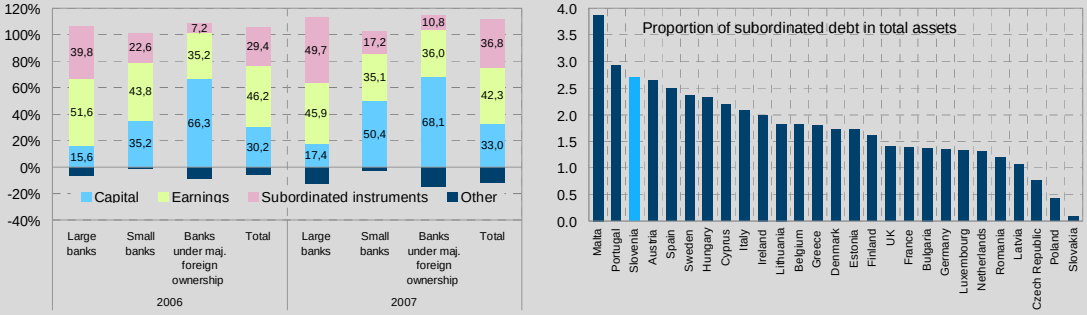


Source: Bank of Slovenia

Box 6.7: Problem in the structure of capital of the banks under domestic ownership

Slovenian banks meet a large portion of capital requirements with subordinated instruments.1. Subordinated instruments represent 36.8% of the banking sector's capital prior to deductions for capital investments. The proportion of subordinated instruments is highest at the large banks, where a 10 percentage point increase was recorded in 2007 alone, and where subordinated instruments already represent one half of capital. The fact that Slovenian banks meet a significant portion of capital requirements with subordinated instruments can also be seen in an indirect comparison with other EU Member States. Only in Portugal and Malta does subordinated debt represent a higher proportion of total assets than in Slovenia.

Figure 6.62: Structure of capital prior to deductions by groups of banks (left) and subordinated debt as a proportion of total assets of the banking sector of individual EU Member States (right)



Sources: Bank of Slovenia, EU Banking Sector Stability

The importance of a low proportion of subordinated instruments in the structure of capital is particularly evident in less favourable conditions, when it allows banks to respond faster to the conditions that have arisen and have more options in terms of increasing capital to meet capital requirements. In conditions when access to capital is limited or the costs associated therewith increase, banks do not need to search for the highest quality and most expensive (and most remissive) forms of capital. It is important, particularly for the banks under domestic ownership, that more attention be given to providing a sufficient base in the form of share capital and retained earnings, thereby increasing manoeuvring room to increase capital with subordinated instruments.

In 2007 Slovenian banks further accelerated already high credit growth, with growth at some domestic banks surpassing that of the banks under majority foreign ownership, which can meet increasing capital requirements relatively quickly with a capital increase from parent banks. The banks under domestic ownership have also issued subordinated instruments in expectation of increases in share capital. Delays occur in the execution of the announced capital increases due to the diversified ownership structure and in the case of some banks with a significant proportion of less active owners. Given high credit growth and increasing capital requirements, banks are faced with a less than optimal structure of regulatory capital. Capital requirements are met with debt instead of capital. Furthermore banks are unable to take into account the entire amount of previously raised subordinated instruments, or are faced with limitations regarding further increases in the volume of these types of instruments due to an insufficient level of original own funds.

Current conditions on financial markets provide another important lesson. If banks require a great deal of time to carry out a capital increases, significant changes could occur on financial markets in the interim period. There has been increased demand for capital and a sharp fall in the share prices of banks in the last six months as a result of problems with write-downs and losses at banks across the world. This means a wider range of acceptable investments for investors

in bank shares and increased competitive pressures for Slovenian banks which are planning capital increases this year. Banks are therefore exposed to the risk that the volume of funds collected could be lower than originally foreseen.

Failure to carry out capital increases to the extent planned could bring into question the adequacy of the business policies of individual banks, both in terms of increasing subordinated instruments, and even more so with regard to accelerated credit growth without sufficient capital. This indicates that the risk of banks' strategies and business policies is significantly higher than acknowledged in their survey responses.

It is important that banks reinforce the link between their investment policies and capital management policies in the decision-making process. Despite pressure from owners, a bank cannot expand its operations for the purpose of strengthening profits and increasing profitability if the same owners do not provide the necessary capital when the bank has reached the limit regarding the volume of subordinated instruments. The thinking at banks must be refocused so that the availability of capital more directly determines their investment policies.

[1] Subordinated instruments include subordinated debt, hybrid and innovative instruments.

Deductions in regulatory capital

Deductions stemming from capital investments were 47% higher in 2007.

Further consolidation activities were carried out within the Slovenian banking sector in 2007. Slovenian banks also continued to expand operations in the former Yugoslavia. The deductions stemming from capital investments, which lower the amount of original own funds and additional own funds in the calculation of capital adequacy, amounted to EUR 623 million in 2007. This represents an increase of 47% compared to the previous year. Two-thirds of the increase is from the investments of banks in other financial institutions that individually represent more than 10% of the bank's capital. Furthermore a somewhat broader range of deductions was defined as of 2007.

6.10.3 Capital requirements

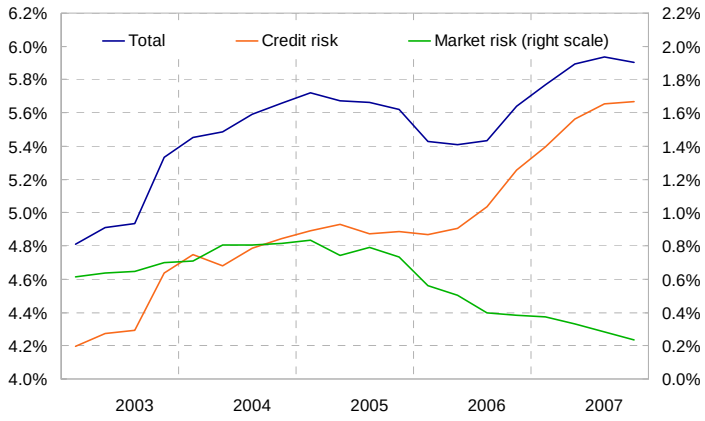
There is still a high level of willingness on the part of banks to assume credit risk.

The ratio of capital requirements for credit risk to total assets continued to increase rapidly in 2007. This ratio rose 0.4 percentage points and stood at 5.67% at the end of 2007. The significantly higher growth in capital requirements for credit risk (34.3%) compared to growth in total assets (24.6%) indicates there is still a high level of willingness on the part of banks to assume credit risk.

Negative growth in capital requirements for market risks on account of debt instruments.

Growth in capital requirements for market risk was negative for the second consecutive year. Capital requirements for market risks, including exchange-rate risk, decreased by 40% in 2006. Banks were no longer required to meet capital requirements for exchange-rate risk for items in euros in the second half of 2006. Capital requirements for market risks decreased by an additional 25% in 2007, largely on account of capital requirements for debt securities.

Figure 6.63: Ratio of capital requirements to total assets

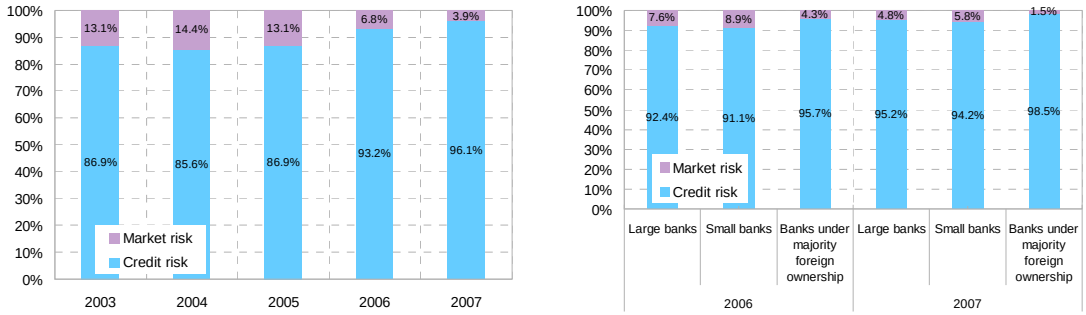


Source: Bank of Slovenia

Capital requirements for credit risk account for 96.1% of all capital requirements.

In 2007 banks were primarily focused on increasing credit growth in lending and on increasing loans as a proportion of total assets at the expense of debt securities. As a result the proportion of capital requirements accounted for by capital requirements for credit risk increased to 96.1%. The banks under majority foreign ownership achieve the highest proportion of capital requirements for credit risk, at 98.5%.

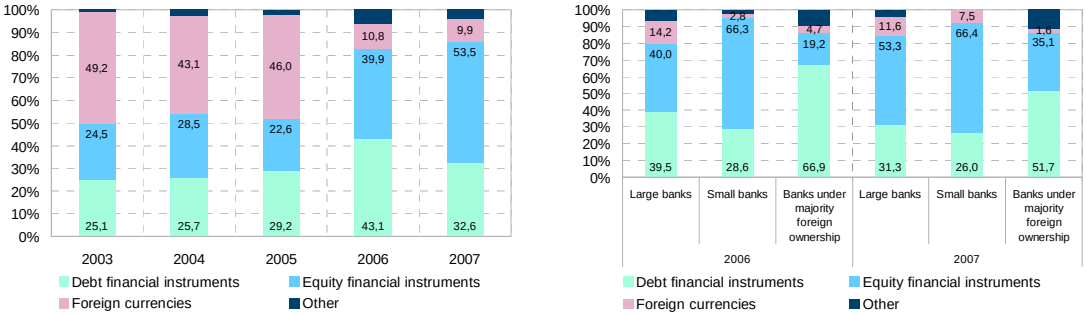
Figure 6.64: Breakdown of capital requirements of the banking sector (left) and groups of banks (right) in percentages



Source: Bank of Slovenia

Banks' actions to increase the volume of loans at the expense of debt securities are also evident in the change in the structure of capital requirements for market risks. In 2007 the most notable decrease was in capital requirements for debt instruments at all groups of banks, while there was also a large increase in capital requirements for exchange-rate risk at the small banks.

Figure 6.65: Breakdown of capital requirements for market risks of the banking sector (left) and groups of banks (right) in percentages



Source: Bank of Slovenia

Box 6.8: Impact of Basel II

In 2008 Slovenian banks began to fully comply with the rules of the new European capital framework for credit institutions and investment companies, known as Basel II. Within its three-pillar arrangements, Basel II introduces important changes in both the calculation of capital requirements, and risk management at banks. The first pillar, which defines approaches for calculating capital requirements, broadens the spectrum of risks from credit and market risk to operational risk. The aim of the second pillar is to reinforce the link between risks and the capital of banks. Within this framework, a bank will assess and the supervisor will verify and evaluate the necessary internal capital to cover all significant risks to which the bank is or could be exposed to in its operations. The third pillar is intended to strengthen market disciplines and define the minimum extent of information that banks must disclose publicly. The scope of the regulation itself indicates the complexity of the new framework.

The **first pillar** provides banks with the possibility of choosing between two approaches for calculating capital requirements for credit risk: the standardised approach (SA) and the internal ratings-based approach (IRB).

In contrast to the previous framework (Basel I), in which a risk weight was only dependent on the type of exposure, risk weights of individual exposures in the new capital framework for calculating capital requirements for credit risk under the standardised approach are defined taking into account the existence and level of a credit rating for a specific exposure issued by nominated external credit assessment institutions (ECAI). Fitch Ratings and Moody's Investors Service are considered eligible ECAIs in Slovenia. The range of weights is considerably broader (from 0% to 150%), and the categorisation of exposures more detailed. At 75% in the new framework, the risk weight for retail banking has been decreased compared to the previous framework and may be further decreased to 35% if an exposure is collateralised with residential real estate and additional conditions are met. In collateralisation with commercial real estate, the weight may be decreased to 50%.

The IRB approach is an entirely new concept compared to the previous framework. Banks are more familiar with clients with whom they have long-standing business relationships than are credit assessment institutions, and therefore may take

own credit assessments into account. A bank must receive prior authorisation from a supervisory institution to use the IRB approach. Compared to the standardised approach, the IRB approach facilitates the use of considerably more risk categories, and thus a more precise distinction between various levels of risk exposure. Banks may choose between a basic or advanced IRB approach. In the basic approach, a bank only assesses the probability of default (PD), and applies legally defined values for other categories. In the advanced IRB approach, a bank uses own estimates for loss given default (LGD), maturity value (M) and for the conversion factor (CF), in addition to probability of default (PD).

The first pillar includes an entirely new definition for calculating capital requirements for operational risk, for which a bank may choose between the basic indicator, standardised and advanced measurement approaches. In the basic indicator approach, the capital requirement is defined as 15% of the three-year average of the sum of net interest and net non-interest income. The calculation is similar in the standardised approach, except that the bank's activities are divided into eight business lines. The percentage for defining the capital requirement varies by business line and amounts to 12%, 15% or 18%. Under the advanced measurement approach, a bank calculates the capital requirement based on an internal operational risk measurement system, for which the supervisor's authorisation is required.

The new European capital framework focuses a great deal more attention on credit protection and redefines the capital requirement for credit risk in securitisation. There are no significant changes in the calculation of capital requirements for market risks.

Within the **second pillar**, banks must establish an Internal Capital Adequacy Assessment Process (ICAAP) with regard to their own risk profile. The supervisor's task is to verify and evaluate the adequacy of the ICAAP. The supervisor expects and may request that banks operate above the prescribed minimum capital requirement and must take timely steps to prevent capital from falling below the minimum level.

Within the **third pillar**, banks[1] subject to disclosure requirements must publish on their websites, together with the audited annual report, information regarding their risk management policy and objectives, subjects included in disclosures, capital, minimum capital requirements and the process of assessing internal capital adequacy, credit, market and operational risks, interest-rate risk items in the banking book, securitisation, advanced approaches and credit protection.

Preparation of Slovenian banks for the new capital framework

In 2007 the Bank of Slovenia monitored the progress of banks during the implementation of the new European capital framework. The first and second sets of examinations were carried out from April to June 2007 and from September to November 2007, respectively. During the first set of examinations, banks were primarily focused on compliance with first pillar requirements. During the second set of examinations, most banks were systematically and comprehensively embarking on the implementation of the second pillar, and preparing draft documentation regarding disclosures within the third pillar.

In the scope of the **first pillar** all banks, except one, selected the standardised approach for the calculation of capital requirements for credit risk. Banks were primarily focused on categories for which they expect the greatest savings in capital requirements (retail banking, exposures collateralised with real estate and the public sector). In the first phase, ECAI assessments will be used primarily for the government and institutions. Due to extensive quantitative and qualitative conditions for credit protection, banks will initially take limited advantage of the possibility of applying lower risk weights as a result of protection, and will focus on some of the largest exposures, for which taking credit protection into account will have the greatest effect on decreasing capital requirements.

The majority of banks selected basic indicator approaches for market risks. One bank is also using internal models. Most banks will not be required to calculate capital requirements for exchange-rate risk. Nevertheless, several banks have decided to calculate capital requirements. Banks will primarily calculate exposure to counterparty credit risk according to the marking-to-market method.

Initially most banks will use the basic indicator approach to calculate capital requirements for operational risk, most with the intention of transitioning to the standardised approach in the period from 2010 to 2012. In 2008 five banks will already use the standardised approach, while one bank will use the advanced measurement approach (AMA).

Six more banks intend to transition to advanced measurement approaches for calculating capital requirements for credit and operational risks[2] in the coming years.

With regard to the **second pillar**, banks have prepared the first internal assessments of capital and capital requirements. For most banks internally assessed capital requirements are between 4% and 11% higher than first pillar capital requirements, while some banks deviate from this interval. The majority of banks used an add-on method, while only a small number of banks used an economic capital method. Most banks included interest-rate risk, liquidity risk, strategic risk and concentration risk among those risks subject to additional capital requirements. Very few banks take into account the results of stress tests, and even fewer take into account the impact of economic cycles. Many banks use the

calculation defined by law in the internal assessment of capital. Among items which increase internally assessed capital, banks primarily took into account current profits and deductions arising from the difference between actual provisions for collectively assessed financial assets and those defined by law.

With regard to the **third pillar**, banks have prepared rather general draft documents regarding disclosures. Banks will have to provide disclosures for the 2007 financial year in areas where the new capital framework is already in force (capital, market risks and the risk management system).

Simulation

Banks have carried out an assessment of the calculation of capital requirements under the new European capital framework for the situation as at 30 June 2007. The capital requirements for most banks increased based on this simulation. At the banking sector level, capital requirements would be 6.5% higher, with the largest increase at the small banks (9.3%) and the smallest increase at the banks under majority foreign ownership (3%). The increase derives primarily from the introduction of capital requirements for operational risk, which would represent 7% of all capital requirements based on simulations. According to these assessments capital requirements for credit risk would decrease slightly at the banking sector level. However the effects vary greatly by individual banks. The banks under majority foreign ownership expect the largest decrease in capital requirements for credit risk, while these capital requirements would increase for the small banks. Capital requirements for credit risk increase at banks where retail banking represents a minor proportion. Banks have also determined that capital requirements will increase considerably for items which represent a significant portion of assets, such as exposures to institutions, undrawn approved credit lines and the management of assets of pension companies.

Table 6.48: Comparison of capital requirements according to the new and old capital frameworks based on data as at 30 June 2007, increase in capital requirements, structure and changes in structure of capital requirements by groups of banks

	Growth in Basel II / Basel I capital requirements (%)				Change in structure (percentage points)			
	All banks	Large banks	Small banks	Banks under maj. foreign ownership	All banks	Large banks	Small banks	Banks under maj. foreign ownership
Total capital requirements	6.5	7.4	9.3	3.0				
Credit risk and counterparty risk	-1.0	-0.3	1.2	-3.5	-6.6	-6.7	-6.8	-6.2
Operational risk					7.0	7.1	7.6	6.3
Market risks incl. exchange-rate risk	0.0	0.2	0.0	-1.4	-0.3	-0.4	-0.8	-0.1
	Structure of Basel I capital requirements (%)				Structure of Basel II capital requirements (%)			
Credit risk and counterparty risk	94.5	93.8	91.1	98.0	87.9	87.1	84.3	91.8
Operational risk	0.0	0.0	0.0	0.0	7.0	7.1	7.6	6.3
Market risks incl. exchange-rate risk	5.5	6.2	8.9	2.0	5.1	5.8	8.2	1.9

Source: Bank of Slovenia

Based on the simulation of the new capital framework with data as at 30 June 2007, the capital adequacy of the banking system in mid-2007 would decrease by 0.7 percentage points to 10.2%. The largest decrease (1.1 percentage points) would be seen at the small banks. However this group of banks would maintain the highest level of capital adequacy. The capital adequacy of the banks under majority foreign ownership would decrease by just 0.3 percentage points taking into account the new capital framework. This group of banks would however have a capital adequacy of less than 10%. While only one bank had a capital adequacy of less than 9% according to data from the end of June 2007, five banks would have a capital adequacy of less than 9% taking into account the new capital framework.

Table 6.49: Capital adequacy according to the new and old capital framework based on data as at 30 June 2007

	All banks	Large banks	Small banks	Banks under majority foreign ownership
Capital adequacy under Basel I (%)	10.9	10.9	12.6	10.0
Capital adequacy under Basel II (%)	10.2	10.2	11.5	9.7
Change in capital adequacy (p.p.)	-0.66	-0.75	-1.07	-0.29

Source: Bank of Slovenia

Cyclical nature of capital requirements

At the initiative of the Committee of European Banking Supervisors (CEBS), banks completed a survey regarding the impact of Basel II on banks and the cyclical nature of capital requirements. Banks assess that Basel II will encourage growth in investments that are less burdensome for banks in terms of capital requirements, e.g. an increased focus on retail operations. Basel II will affect the pricing policies of banks, which will be more adapted to levels of risk. Banks will be increasingly focused on credit protection. Basel II will affect banking operations in terms of rationalising the use

of capital, and gradually impact activities in the areas of securitisation and credit derivatives. Basel II brings a great deal of incentive to develop internal models and implement them in the decision-making process.

Banks assess that the new capital framework is more pro-cyclical, particularly with regard to the IRB approach. Most cyclical is the assessment of probability of default, while other parameters are less cyclical. Currently the credit rating systems of banks are still based largely on the approach of assessing debtor risk at a specific point in time, and less on the approach of assessment throughout the economic cycle. However systems are supplemented with indicators which partly take into account a longer timeframe. According to the assessments of banks, the greatest impact of the economic cycle will be on exposures to corporates which require the most capital, and to a lesser extent, to institutions, as well as on retail banking. Banks will mitigate the effects of the cyclical nature of Basel II capital requirements by diversifying their portfolios and ensuring an adequate level of internal capital. Most banks under domestic ownership have a contingency plan in place in the event of a sharp deterioration in (macroeconomic) conditions, while the banks under majority foreign ownership are included in the plans of parent banks.

The banks under majority foreign ownership are characterised by the fact that they can rely on existing owners to raise capital for the purpose of covering capital requirements. The banks under domestic ownership, whose ownership structure is more diverse, depend primarily on raising subordinated debt to ensure capital adequacy. In general banks are less willing to increase capital through acquisitions from new shareholders, by decreasing dividends, by decreasing capital requirements via the limiting of credit growth, through increased selectivity in choosing borrowers or by selling investments. They are least inclined to securitisation and the transfer of credit risk.

Banks assess that their capital management policy will effect the amount of lending, and even more so the quality of their portfolios and credit protection. They also believe that Basel II has a positive impact on banks' awareness of the link between lending and the use of capital and, as a consequence, on the link between the two aforementioned processes in their decision-making.

[1] The lesser extent of disclosures is defined for significant subsidiary banks.
[2] The IRB approach for credit risk and the AMA for operational risk.

7 NON-BANKING FINANCIAL INSTITUTIONS

7.1 Insurers

7.1.1 Features of insurers' business and comparison with the EU

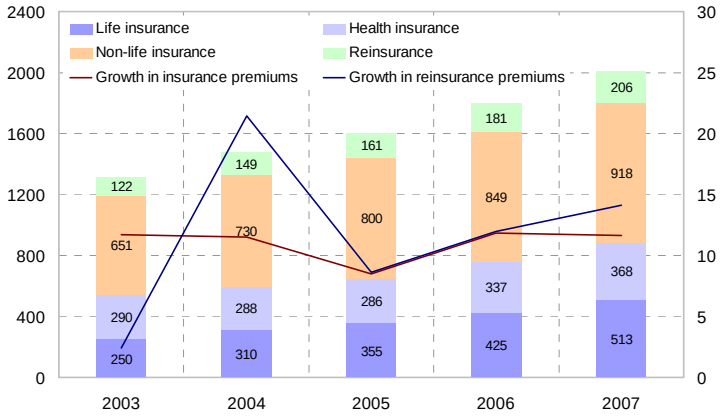
The largest decline in concentration was in the life and health insurance market.

At the end of 2007 there were 14 insurance companies, two reinsurance companies and three branches of foreign insurers operating in Slovenia. With the exception of pension companies[60], concentration in the insurance sector declined last year in all segments, particularly in the area of life and health insurance. However the market of specific types of insurance remains highly concentrated. The market share of the largest insurance company in terms of collected premium declined by 1.6 percentage points to 39.4%, while that of the largest reinsurance company remained unchanged. The largest non-life insurance company covers 37.6% of the non-life insurance market, the largest life insurance company has 43.9% of the life insurance market, and the largest health insurance company has 61.6% of the health insurance market.

Insurance companies further improved their performance in 2007.

Insurers performed extremely well in 2007. The gross collected premium of insurance companies increased by 11.6% to EUR 1,799 million. Net technical provisions increased by 10.3%, while their coverage by the assets covering technical provisions increased to 131.6%. The improved performance of insurers was also seen in an improved return on equity[61], which rose to 10.1%. The gross collected premium of reinsurance companies was up 14% to EUR 206 million. Their ROE, calculated from net profit in the first nine months of the year was down 6.7 percentage points from the same period in 2006 to 3.5%.

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



Source: ISA

Growth in gross collected premium was virtually unchanged in 2007 at 11.6%.

Growth in gross collected premium was virtually unchanged in 2007. Growth of 21% in gross collected premium from life insurance was the main factor in maintaining relatively high growth. Growth in non-life insurance premiums increased to 8.1%, while growth in health insurance premiums declined to 9.2%. The proportion of total collected premium accounted for by life insurance increased to 29%, and the proportion accounted for by health insurance remained at 21%, while the proportion accounted for by non-life insurance, excluding health insurance, declined to 51%.

The total collected premium of insurers reached 5.4% of GDP in 2007, or EUR 891 per capita, which is three times lower than collected premium per capita in the EU27. The proportion of total collected premium accounted for by life insurance is rising, but is still

[60] This is primarily the result of the transformation of the First Pension Company into the holding company Prva Group, within which the Prva osebna zavarovalnica provides pension insurance services.

[61] For insurers and reinsurance companies the ROE is calculated from profits after tax.

less than half of the of the EU27 average, where it represents 65% of total collected premium. As a result faster development in the area of life insurance can still be expected, although growth in collected premium will likely slow somewhat due to uncertainties on financial markets.

Table 7.1: Total gross collected premium and gross collected premium from life insurance expressed in various categories for Slovenia in 2007 and for selected countries in 2006

	Slovenia	EU15	EU27	Greece	Portugal	Germany	UK
Total premium, EUR billion	1.80	1,082.17	1,106.22	4.33	13.51	162.87	333.55
Per capita, EUR	891	3,305	2,667	390	1,327	1,943	5,156
As % of GDP	5.4	9.3	9.0	1.8	9.0	6.7	16.5
Life insurance premiums (EUR billion)	0.51	707.92	717.93	2.27	9.21	75.57	248.50
Per capita, EUR	254	2,198	1,758	205	902	906	4,098
As % of total premium	28.5	65.4	64.9	52.5	68.2	46.4	74.5
As % of GDP	1.5	6.2	5.9	0.9	6.1	3.1	13.1

Note: Figures for Portugal are for 2005.
Sources: ISA, Swiss Re, own calculations

Life insurance and contractual integration of insurers with banks

The proportion life insurance tied to mutual fund units is growing rapidly.

Life insurance continued to increase in importance in 2007, with insurers collecting 28.5% of total gross premium through life insurance. The total assets of life insurance accounted for 51% of the total assets of insurers at the end of 2007. The importance of life insurance investments tied to mutual fund units continues to rise rapidly, although at a slower pace. The proportion of total collected premium accounted for by life insurance premiums in which policyholders assume the investment risk has risen to 45%. The proportion of life insurance assets in favour of policyholders assuming the investment risk increased by 7.7 percentage points to 25.3%, and already exceeds the figure of 23.6% in the euro area from 2006.

Table 7.2: Collected premium in EUR million and number of policyholders for life insurance and pension insurance provided by insurers

	2004	2005	2006	2007	2004	2005	2006	2007
Life insurance total					Growth rates (%)			
Premium (EUR million)	310	355	425	513	24.0	14.7	19.7	20.6
Number of policyholders	852,955	926,306	986,803	1,140,435	15.4	8.6	6.5	15.6
Unit-linked life insurance					Proportion of life insurance (%)			
Premium (EUR million)	57	80	173	231	18.3	22.5	40.8	45.0
Number of policyholders	96,313	154,886	216,122	309,009	11.3	16.7	21.9	27.1
Voluntary supplementary pension insurance								
Premium (EUR million)	15	15	18	47	4.8	4.3	4.3	9.1
Number of policyholders	37,455	39,623	42,413	121,611	4.4	4.3	4.3	10.7

Source: ISA

The proportion of investment risks assumed by households in life insurance products is increasing.

High returns on capital markets and relatively low interest rates contributed to high demand for life insurance with investment risk in 2007. The introduction of the IFRS in 2007 and preparation for the introduction of Solvency II have further stimulated insurers to transfer risk to policyholders, who assume an increasing share of risks. Continued development of demand for unit-linked life insurance will likely come under increasing pressure from uncertainties on capital markets, due to which a temporary slowdown in demand for these types of products can be expected, with a shift to lower-risk forms of life insurance with a guaranteed principle, or a guarantee of the principle and returns already achieved.

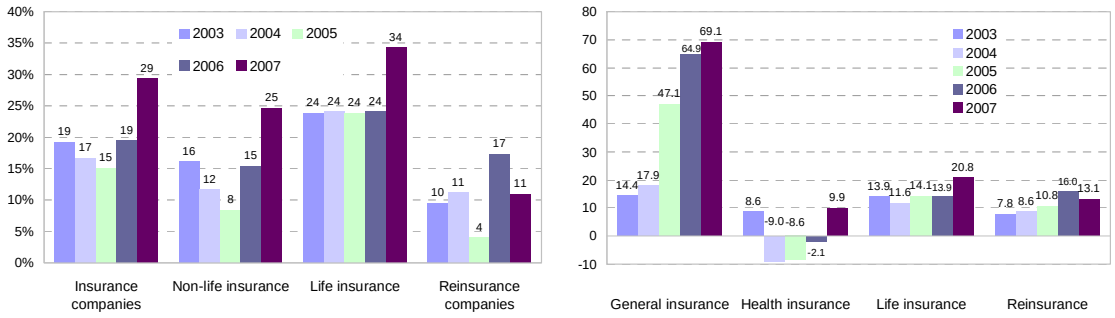
The banking system's ties with insurers in the marketing of insurance products, particularly life insurance, continue to increase. The value of transactions concluded rose by 81% in 2007 to EUR 111 million, while the proportion of the banking system's fees and commissions from insurance policies remains relatively negligible at 0.9%.

Financial statements of insurers

Growth in total assets of insurers increased by 29% in 2007.

The total assets of insurance companies increased by 29% in 2007 to EUR 4.55 billion. The high growth in total assets is driven not only by the increase in total gross premium collected, but also by expansion abroad, particularly to Balkan markets and high growth in the value of financial investments in shares and investment funds. Growth in total assets of both non-life insurance and life insurance has risen sharply. At 34%, the latter was particularly high. The total assets of reinsurance companies increased by 11% in the first nine months of 2007 to EUR 408 million.

Figure 7.2: Growth in total assets in percentages (left) and result from ordinary activities in EUR million (right) of insurance companies and reinsurance companies[62]



Source: ISA

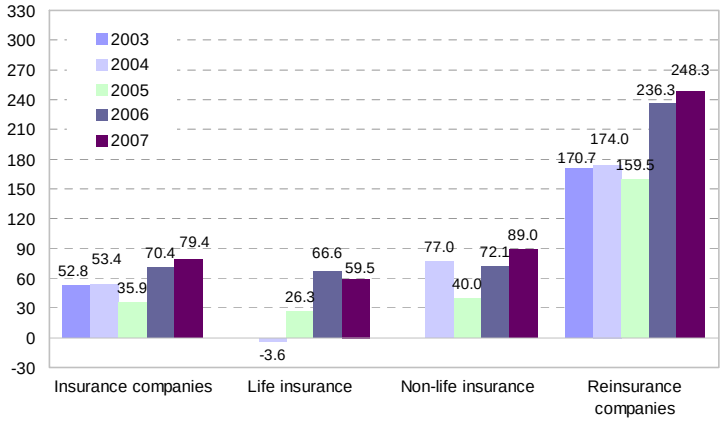
The net profit of insurers improved significantly.

The net profit of insurers increased by 84.7% in 2007 to EUR 95 million. This was on account of improved results in all three major insurance types and a significant increase in revenues from investments, which were a reflection of high returns on capital markets in the past.

The improved solvency of insurance companies is partly the result of the transfer of equalisation provisions to capital.

Insurance companies began applying International Financial Reporting Standards (IFRS) as of 1 January 2007, and transferred equalisation provisions, which were not created for credit insurance, to capital. This was reflected in the improved solvency of insurance companies. The surplus of disposable capital over the required minimum capital of insurers increased to 79% in the first three quarters of 2007. The surplus of disposable capital over the required minimum capital rose sharply in non-life insurance, while the relative surplus in life insurance decreased slightly.

Figure 7.3: Surplus of disposable capital over required minimum capital at insurance companies and reinsurance companies [63] in percentages



Source: ISA

[62] Figures for reinsurance companies are for the end of the third quarter of 2007.
[63] The 2007 figures relate to September.

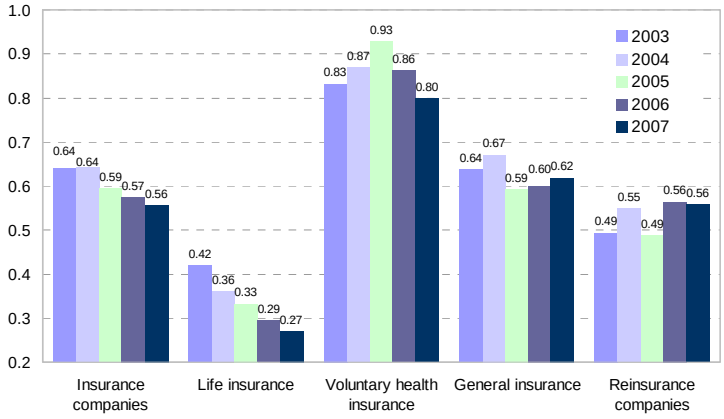
7.1.2 Stability of the insurance sector

Underwriting risk

The claims ratio of insurers improved marginally.

The claims ratio at insurance companies as measured by the ratio of gross claims paid to gross collected premium improved marginally in 2007. The improvements in the claims ratio for health insurance and life insurance were primarily the result of collected premium growing faster than claims paid. The deterioration in the claims ratio for non-life insurance was largely the result of natural disasters which were reflected in a deterioration of the claims ratio for fire and natural disaster insurance and insurance of other damage to property. The level of retained risk at insurance companies for non-life insurance remained at 82%. The greatest risk in the area of non-life insurance remains the possibility of the occurrence of natural disasters.

Figure 7.4: Claims ratio for major types of insurance



Source: ISA

Investment risk

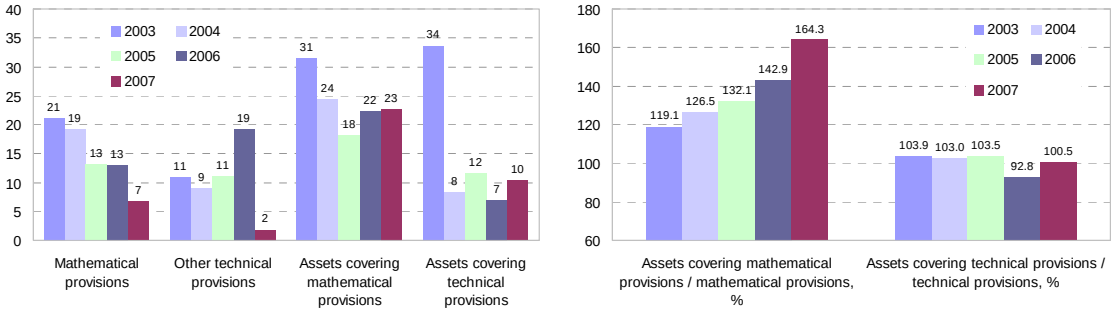
The coverage of technical provisions by the assets covering technical provisions improved.

Assets covering technical provisions increased by 17.5% in 2007 to EUR 3,356 million, or 10% of GDP. In 2007 growth in life insurance investments again significantly outstripped growth in non-life insurance investments, which was reflected in the proportion of assets covering technical provisions accounted for by assets covering mathematical provisions increasing to 61%.

The coverage of net technical provisions by assets covering technical provisions increased by 8.2 percentage points to 131.6%. This was primarily the result of the improvement in the coverage of mathematical provisions by assets covering mathematical provisions in life insurance (up 21 percentage points to 164%), as well as the improvement in the coverage of other technical provisions by assets covering other technical provisions (up slightly less than 8 percentage points to 100.5%). The investment risk of insurance companies declined in 2007 according to this indicator, particularly in the area of life insurance. Coverage once again exceeded 100% in the area of non-life insurance.

The rapid growth in investments of assets covering technical provisions in 2007 was largely influenced by relatively high returns on capital markets. Increased uncertainty on capital markets represents risk for insurers. They should not however encounter major problems, at least in the area of life insurance, due to the high coverage of technical provisions by assets covering technical provisions.

Figure 7.5: Growth in net provisions and assets for life insurance and non-life insurance (left), and coverage of technical provisions by assets covering technical provisions (right) in percentages



Sources: ISA, own calculations

The proportion of the most conservative investments of insurers continues to decrease.

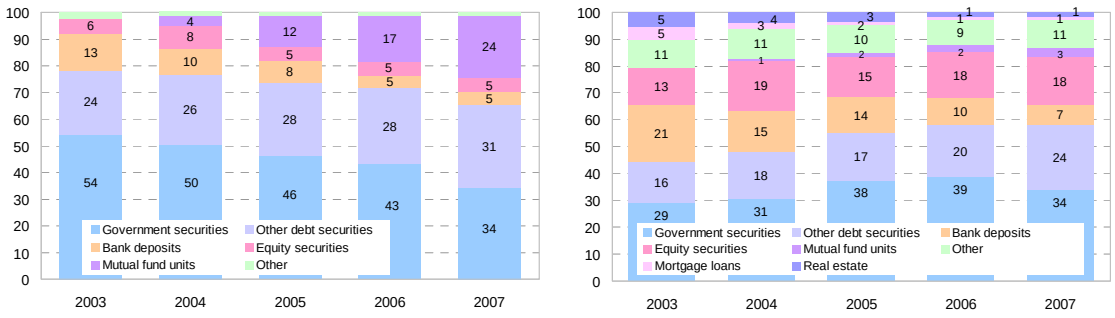
The trend of a decrease in the proportion of the most conservative investments of insurers in deposits and government and other debt securities continued in 2007. The proportion of total investments of insurance companies accounted for by these forms of investment declined by nearly 5 percentage points to 68%. The most significant decline (7.3 percentage points) was seen in the proportion of investments in government securities, while the proportion of other debt securities rose by 4 percentage points. The proportion accounted for by equities remained unchanged, while the proportion of investments in mutual fund units increased by 4.5 percentage points to 15.6%. The investment policy of Slovenian insurers remains more conservative compared to euro area insurance companies. The proportion of assets invested in the safest investment forms was 18 percentage points higher in Slovenia at the end of 2007 compared to the euro area at the end of 2006.[64]

The introduction of Solvency II, with risk-weighted capital requirements, will stimulate insurers to restructure investment portfolios by increasing the proportion of debt securities and decreasing the proportion of equities, which is already happening at the EU level.[65] Slovenian insurers will likely decrease the proportion of the safest forms of investments in the future also due to the rapid development of life insurance. The difference in the breakdown of investments of Slovenian and euro area insurance companies will decrease.

Rapid growth in the proportion of mutual funds units in the breakdown of life insurance investments.

The proportion of life insurance investments accounted for by investments in mutual fund units continued to increase in 2007 (by 6.3 percentage points to 23.5%). This is the result of rapid growth in life insurance premiums collected in which the policyholders assume the investment risk. The proportion of government securities decreased by 9 percentage points, while the proportion of debt securities increased by 3 percentage points. The proportion of the safest forms of investments covering mathematical provisions decreased by more than 6 percentage points to 70%.

Figure 7.6: Structure of insurance companies' assets covering mathematical provisions (left) and assets covering technical provisions other than mathematical provisions (right) in percentages



Source: ISA

[64] Source: CEIOPS. Figures for Greece are not included in the calculation of the euro area average.
[65] Potential impact of Solvency II on financial stability. ECB, 2007.

The proportion of the assets covering technical provisions other than mathematical provisions accounted for by deposits and government securities has decreased, while the proportion of other debt instruments has increased. The proportion of the safest investment forms has not decreased significantly.

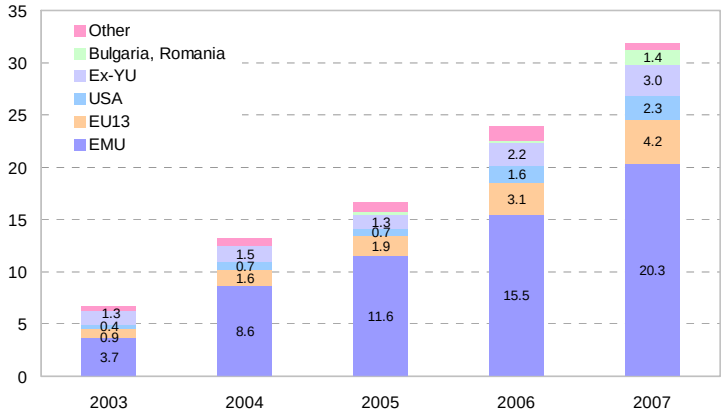
The regional diversification of insurers' investments has increased.

The regional diversification of insurers' investments continued in 2007, on account of the early repurchase of government bonds, the introduction of the euro and the associated elimination of exchange-rate risk and the convergence of interest rates. The proportion of assets covering mathematical provisions (in life insurance) accounted for by foreign securities increased by 7 percentage points to 37.5%. The proportion of assets covering technical provisions other than mathematical provisions accounted for by foreign securities increased by 6.5 percentage points to 17.9%.

The proportion of the insurance sector's investments in foreign securities increased to 31.9% in 2007.

The entire insurance sector increased its investments in the rest of the world in 2007 by 63% to EUR 1,662 million. Thus the proportion of all insurance sector investments accounted for by investments in the rest of the world increased by 7.9 percentage points to 31.9%. The majority (72%) of investments in the rest of the world were in debt securities, while equities accounted for the remaining 28%. The proportion of the latter increased by 2 percentage points in 2007. There was no significant change in the regional breakdown of investments in foreign securities during 2007. At 82.4%, investments in EU27 member-states still account for the largest proportion, followed by investments in the debt securities of Japanese, US and Swiss issuers. The proportion of foreign equities accounted for by investments in EU27 member-states increased by 2 percentage points to 67.5%, while the proportion of investments in the capital markets of the former Yugoslavia was down slightly to 27.5%.

Figure 7.7: Proportion of the insurance sector's investments in the rest of the world in percentages



Source: ISA

The insurance sector's exposure to the countries of the former Yugoslavia rose sharply in 2007.

In terms of value, the insurance sector's exposure to the countries of the former Yugoslavia increased by 68.7% to 3% of total insurance sector investments, primarily due to the purchase of local insurance institutions. Given the relative lack of development of local insurance markets, there are significant opportunities for the expansion of operations. There is however increased risk linked to political uncertainty in the region.

The exposure of the insurance sector's investments to US capital markets rose to 2.3% of total investments in 2007. However, based on the relatively low exposure to US capital markets, limited direct exposure to larger European insurance companies[66] and the relatively more conservative investment strategy of the Slovenian insurance sector compared to the EU, the Slovenian insurance sector's exposure to the sub-prime mortgage market is assessed as negligible. This fact is confirmed by Insurance Supervision Agency data, according to which the structured credit instruments of insurance companies and reinsurance companies accounted for just 0.73% or less than EUR 32 million of total investments.

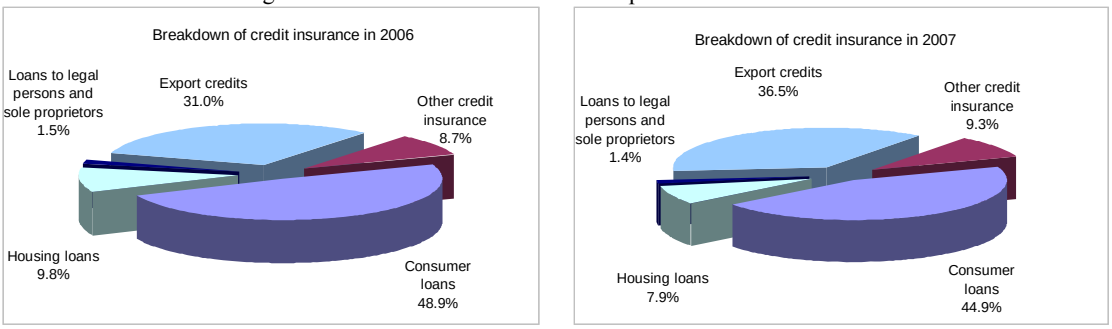
[66] ECB: Financial Stability Review, December 2007.

7.1.3 Influence of insurers on the stability of the banking sector through credit insurance

The importance of credit insurance continues to diminish.

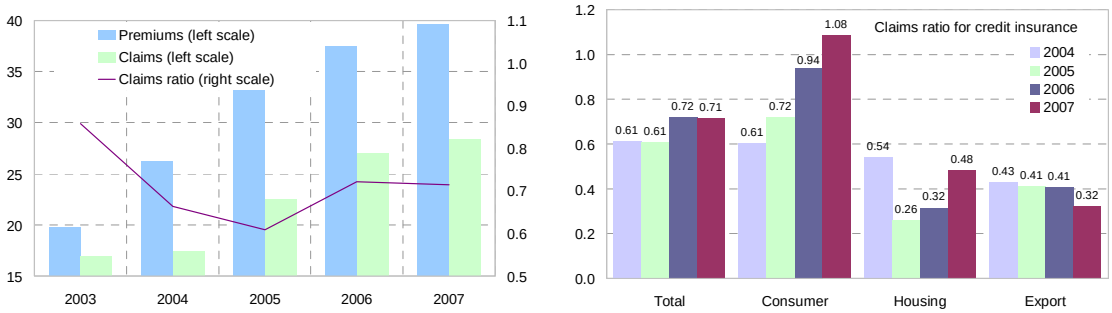
The importance of credit insurance continues to diminish. At 6%, growth in collected premium from credit insurance was outstripped by growth in total collected premium of the insurance sector. This was reflected in the decrease in the proportion of credit insurance to 2.2% of total collected premium. The ratio of the sum insured for credit insurance at Slovenian insurance companies to loans to non-banking sectors declined by 5.5 percentage points to 21.1%, or EUR 5.9 billion, while the ratio of total credit insurance for housing loans, consumer loans and loans to sole proprietors to total household loans declined by 3.6 percentage points to 9.1% or EUR 585 million. In the breakdown of collected premium from credit insurance, the proportion of insurance for consumer and housing loans decreased, while the proportion of insurance for export credits increased.

Figure 7.8: Breakdown of collected premium from credit insurance



Source: ISA

Figure 7.9: Collected premium and paid claims in EUR million, and claims ratios for credit insurance



Source: ISA

The claims ratios for consumer and housing loans have deteriorated.

Despite virtually no change in the overall claims ratio for credit insurance, there were significant changes for specific types of credit insurance in 2007. The claims ratio for export credits improved to 0.32, while the claims ratios for consumer loans and housing loans deteriorated. This was expected given rising interest rates and the fact that the importance of this type of insurance for housing and consumer loans is decreasing. The deteriorating claims ratio for consumer loans is particularly evident, as gross collected premium were down 14.7% in 2007, while gross claims paid were up 30%. The claims ratio thus increased to 1.08. A decrease in gross collected premium of 2.7% and an increase in gross claims paid by 12.1% is reflected in the increase of the claims ratio for housing loans to 0.48.

Despite the deterioration of the claims ratios for housing and consumer loans, the risk for insurance companies remains negligible due to the diminishing importance of household loans insured at insurance companies.

7.2 Voluntary Supplementary Pension Insurance

The importance of voluntary supplementary pension insurance is growing gradually.

The number of policyholders covered by voluntary supplementary pension insurance increased by 5.9% in 2007 to almost 487,000. Collected premium was up 7.9% from 2006, at EUR 220 million, while assets were up 22%, at EUR 956 million, or 2.85% of GDP.[67] Due to the uncompetitive returns of voluntary supplementary pension insurance, its importance is growing only gradually.

The transformation of one pension company into an insurance company is reflected in a change in the structure of premium collected, the number of policyholders and collected premium by the type of voluntary supplementary pension insurance provider.

Pressure on the compulsory pension and disability insurance treasury eased somewhat in 2007 due to favourable economic developments. The ratio of policyholders at the Pension and Disability Insurance Institute (PDII) to the number of pensioners increased to 1.62 in 2006, while growth in the average pension has lagged behind growth in the net average wage. There was an increase of 0.3 years to 59.2 in the average age of new pension recipients.

Table 7.3: Voluntary supplementary pension insurance providers: number of policyholders, collected premium and assets

	2003	2004	2005	2006	2007
Number of policyholders	212,060	404,885	427,645	459,764	486,816
Structure (%)					
Mutual pension funds	16.8	50.7	49.3	48.0	47.4
Insurers	21.6	9.5	9.3	9.2	23.3
Pension companies	61.6	39.8	41.4	42.8	29.3
Earned premium (EUR million)	94	179	182	204	220
Structure (%)					
Mutual pension funds	24.1	51.6	46.3	44.1	43.2
Insurers	15.8	8.3	8.3	9.0	21.2
Pension companies	60.1	40.1	45.3	46.9	35.6
Assets (EUR million)	204	398	592	783	956
Structure (%)					
Mutual pension funds	25.0	38.0	40.6	43.0	45.9
Insurers	18.2	13.1	11.5	10.9	12.3
Pension companies	56.8	48.9	47.8	46.1	41.8

Sources: ISA, SMA

A low return on investments in the second pension pillar is a key factor limiting the development of these types of old-age savings.

In the future demographic trends will have an unfavourable impact on the sustainability of the pension system. The unfavourable demographic trends can only be mitigated by extending the active work period. The expected decrease in pensions opens the door to an increased role for the second and third pension pillars. The government is stimulating household savings in the second pension pillar by providing tax relief. However this is not the most attractive form of savings due to the low returns on old-age savings and high returns achieved on capital markets in the past. The average annual return achieved by insurance and pension companies from voluntary supplementary pension insurance investments was 5.5% in 2007, while the growth in mutual pension fund unit prices was 4.1%. Taking into account annual inflation of 5.6%, these returns were ex post low.

The reason for such low returns remains the legally prescribed minimum guaranteed return[68], which is linked to the average annual interest rate on long-term government securities, and is reflected in a conservative investment policy. Despite several significant changes in the breakdown of investments, the investment policy of Slovenian voluntary supplementary pension insurance providers is still considerably more conservative than the investment policy of pension funds in the euro area.

[67] Excluding the First Pension Fund of the Republic of Slovenia.
[68] The minimum annual guaranteed return stood at 1.62% in December 2007.

Table 7.4: Pension fund assets and the structure in selected European countries in percentages at the end of 2006/2007

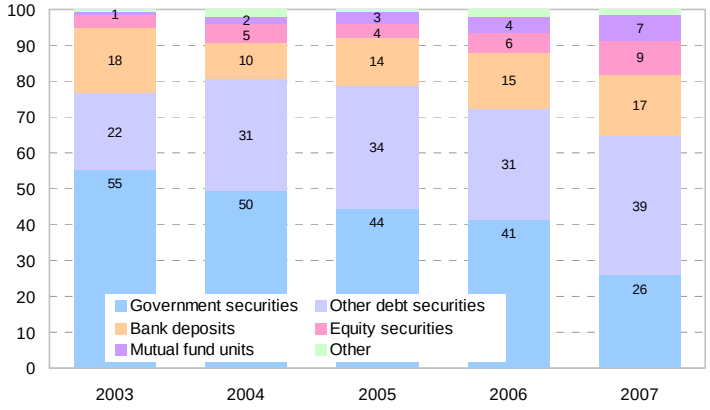
	Slovenia[1]	EMU[2]	Portugal	Germany	UK
Pension fund investments (EUR billion)	1	1,176	21	98	1,460
As % of GDP	2.8		13.6	4.2	77.1
Structure (%)					
Cash and deposits	17	3	5	3	2
Debt securities	65	37	34	32	19
Shares	9	46	30	34	39
Mutual fund units	7	3	22	0	20
Loans	0	6	0	26	0
Other	1	5	9	6	19

Note: [1] The figures for Slovenia are for 2007, figures for EMU countries are for 2006, while figures for the United Kingdom are for 2005.
[2] Excludes France, Luxembourg, Greece and Ireland.
Sources: ISA, SMA, OECD Pension Markets in Focus, November 2007, Issue 4

The conservativeness of investments of voluntary supplementary pension insurance providers diminished, while the proportion of foreign investments rose.

The conservativeness of the investment strategy of voluntary supplementary pension insurance providers diminished in 2007. The early redemption of Slovenian government bonds, the introduction of the euro and the associated elimination of exchange-rate risk, as well as the convergence of interest rates resulted in a decrease in the proportion of government securities by 15 percentage points to 26%, an increase in the proportion of other debt securities by 8 percentage points to 39% and an increase in investments in the rest of the world by 10 percentage points to 31%. The proportion of investments in government and other securities and deposits decreased by 6 percentage points to 82%. The proportion of investment in equity securities rose to 9%, while the proportion of investments in mutual funds units increased to 7%.

Figure 7.10: Structure of voluntary supplementary pension insurance providers' investments in percentages



Sources: ISA, SMA

Low returns on investments in the second pension pillar, which were comparable to interest rates on long-term bank deposits in 2007, and higher returns and a broad range of competitive financial products diminish the attractiveness of this type of old-age saving. Several steps are necessary to increase the attractiveness of the second pension pillar, including: increasing competition between voluntary supplementary pension insurance providers; enabling policyholders to switch between pension plans in accordance with their age and propensity for risk; considering the extension of tax relief for voluntary supplementary pension insurance payments to a wider group of old-age saving providers and abolishing certain legal restrictions.

7.3 Investment Funds

Investment fund assets exceeded EUR 4 billion by the end of 2007.

At the end of the third quarter of 2007, investment funds represented 9% of the financial assets of Slovenian households (up five percentage points from six years earlier),

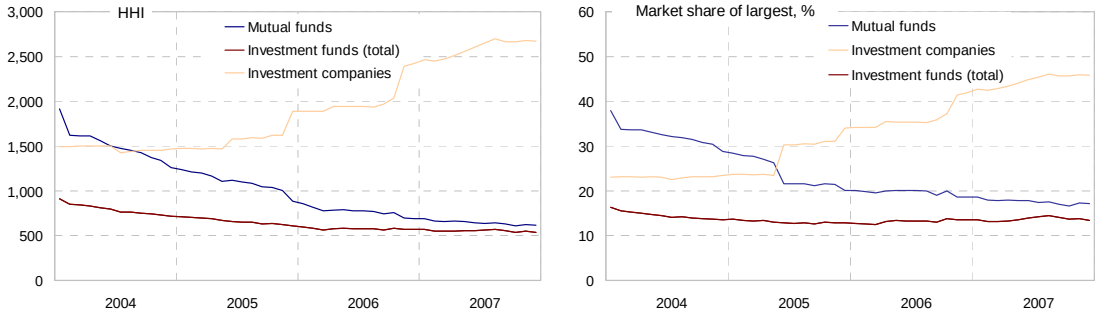
achieving a proportion comparable with that of euro area households. However given the low financial depth of the Slovenian economy, investment funds as a proportion of GDP (just over 10%) are one-half of that in the euro area. In 2007 the assets of Slovenian investments funds rose 45% to over EUR 4 billion, equivalent to more than one-third of household bank deposits. Despite turmoil on global financial markets in the second half of the year, weighted mutual fund unit prices achieved annual growth of 28%, while the PIX index was up 45%. Investment funds recorded net inflows of nearly EUR 500 million in 2007, or 16% of assets at the end of the year. This represents the largest net annual inflow to date. Mutual funds continue to increase as a proportion of investment fund assets, already exceeding 70%.

Table 7.5: Overview of investment funds

	2001	2002	2003	2004	2005	2006	2007
				Assets (EUR million)			
Investment funds	2,349	2,163	1,833	2,086	2,220	2,845	4,138
Mutual funds	61	233	389	877	1,385	1,929	2,924
Net annual inflows	6	120	108	339	138	163	470
Investment companies	-	578	894	1,209	835	916	1,213
Authorised investments companies (PIDs)	2,287	1,352	550	-	-	-	-
Annual turnover	221	358	254	250	149	166	124
				Structure (%)			
Mutual funds	3	11	21	42	62	68	71
Investment companies	-	27	49	58	38	32	29
Authorised investments companies (PIDs)	97	63	30	-	-	-	
				Growth rate (%)			
Investment funds	-3.7	-7.9	-15.3	13.8	6.4	28.1	45.4
Mutual funds	37.6	278.9	66.9	125.7	57.9	39.3	51.6
Investment companies			54.7	35.3	-30.9	9.7	32.4
VEP	23.1	54.3	17.1	17.8	7.2	18.8	28.0
PIX	4.4	71.9	23.5	33.8	-12.2	28.3	45.0

Sources: SMA, LJSE, own calculations

Figure 7.11: Market concentration of investment funds



Note: Management company mutual funds Market concentration of management companies in terms of mutual fund assets under management.
Source: SMA

The market concentration of investment funds has not changed significantly.

To a great extent, the growth in the assets of investment companies in 2007 was the result of high returns on the domestic capital market in the first three quarters, where investment companies still invest approximately 57% of assets, whereas the assets of mutual funds are much more regionally diversified, with just 28% invested in Slovenia. Direct competition for domestic mutual funds is represented by foreign funds where, according to some estimates, domestic investors' assets accounted for 28% of the assets of domestic mutual funds at the end of 2007 (12.6% taking into account only those funds that are officially marketed in Slovenia).69 Ten new domestic mutual funds (mostly equity funds) were established in 2007, bringing the number to 109 at the end of the year.

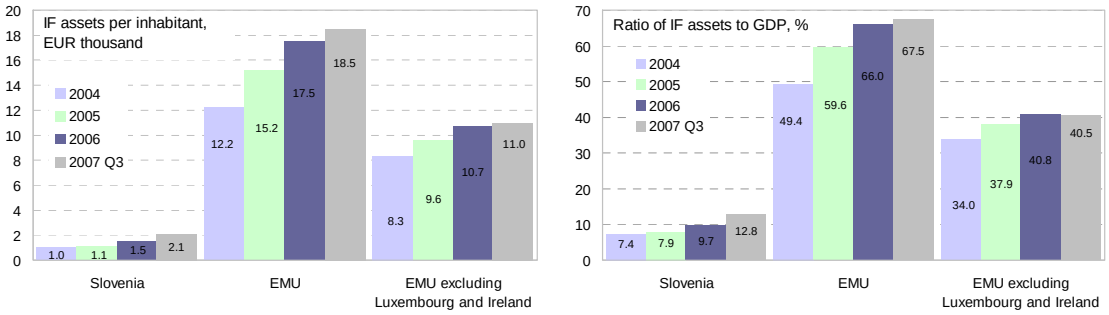
[69] Only those investments in foreign mutual funds made via domestic stock brokers (brokerage houses and banks) are included. For funds that are officially marketed in Slovenia, figures are selected with regard to the available ISIN of these funds, where a portion of assets could be invested outside the official market. All foreign funds are selected from foreign securities with regard to the CFI code EU (E-equities, U-units).

Approximately 30 new foreign funds were officially marketed. At the end of 2007 there were already more than 260 funds and sub-funds being officially marketed in Slovenia.

The financial sector represents a more important investor in units/shares of investment funds in the euro area than in Slovenia.

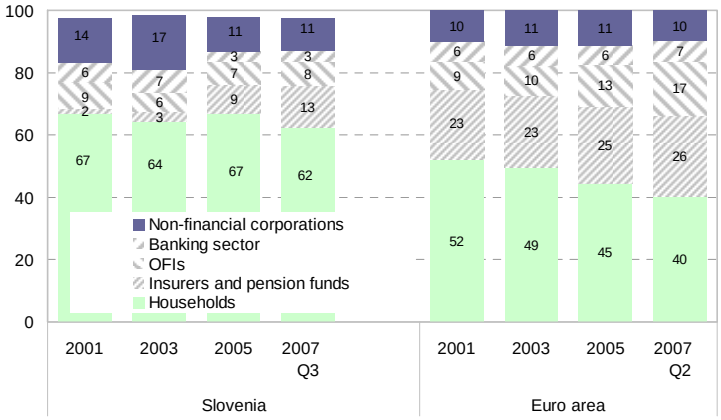
The total assets of domestic investment funds reached EUR 2,100 per capita at the end of 2007. This remains well below the euro area average of EUR 11,000 per capita. This figure does not take into account Luxembourg and Ireland which have several registered funds marketed outside the euro area. In addition to the lower level of depth of financial intermediation in the Slovenian economy compared to that of the euro area, significantly less interest from financial corporations in investment funds in Slovenia with regard to the euro area also drives the low level of investment fund assets per capita and as a proportion of GDP. In Slovenia just under one-quarter of investment fund assets are held by financial corporations. In the euro area one-half of investment fund assets are held by financial corporations. Of this amount, insurance companies and pension funds account for the highest proportion (26%). There is also a noticeable increase in the proportion of investment funds held by the insurance sector in Slovenia. This is primarily the result of increased interest in unit-linked life insurance. The considerably higher amount of funds collected from pension insurance in the euro area also affects the higher proportion of the insurance and pension sector among holders of investment fund units, as pension funds frequently invest a significant portion of assets in investment funds in order to improve diversification.

Figure 7.12: Comparison between Slovenia and the euro area in per capita investment fund assets in EUR thousand (left) and assets as a proportion of GDP (right)



Sources: ECB, SMA, Eurostat, SORS

Figure 7.13: Breakdown of investment fund units/shares by ownership in percentages



Note: The units/share of all investment funds (investment companies and mutual funds), both domestic and foreign, are taken into account. At the end of September 2007, these units/shares represented 16% of GDP in Slovenia, and 49% of GDP in the euro area at the end of June 2007.

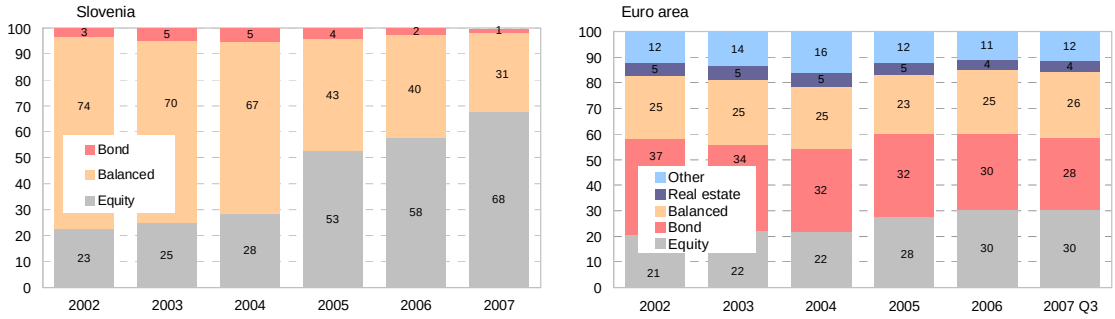
Sources: Bank of Slovenia, ECB

In 2007 equity funds once again generated the highest interest among investors in Slovenia.

In 2007 equity funds as a proportion of assets increased by 10 percentage points in Slovenia as the result of favourable valuations on capital markets and the high correlation between returns and net inflows and new inflows into equity funds (84% of total net

inflows in 2007).[70] With regard to types of funds, the structure of Slovenian funds is significantly different from that of the euro area, where the proportion of investment fund assets accounted for by equity funds is less than half of that in Slovenia. A comparison of the structure indicates a lack of funds with a conservative investment strategy in Slovenia. This is the result of the aforementioned high appetite for risk of Slovenian investors, who opt for alternatives to bank deposits, and their inexperience, i.e. experience limited to favourable trends on capital markets in recent years. Driven by the continued high demand for equity funds, managers primarily created these types of funds. Of the 10 newly created funds in 2007, 8 were equity funds. Turmoil on world financial markets and uncertain conditions on the markets of the former Yugoslavia could result in increased demand for low-risk bond and money market funds.

Figure 7.14: Comparison of the breakdown of mutual fund assets by type of fund in Slovenia (left) and Europe (right) in percentages



Note: Only mutual funds are taken into account in the figures for Slovenia, while the figures for the euro area also include other investment funds. Money market funds are not included although, according to some data, they accounted for approximately 16% of total investment fund assets in Europe at the end of 2006 (source: EFAMA).

Sources: ECB, SMA, Eurostat, SORS

Investment funds also face competition from other financial products. The European Commission has called for enhanced financial literacy.

Mutual funds also face competition from other investment products, which vary considerably with regard to mode of operation. In addition to life insurance with investment risk, alternative investments include certificates, which are known to Slovenian investors primarily by the fact that foreign banks have begun issuing certificates tied to Slovenian shares. However at EUR 47 million at the end of 2007 (less than 2% of mutual fund assets), household investments in foreign derivatives are negligible compared to investments in mutual funds. Given that there is an increasingly broad range of investment products available to small investors which are sold via similar channels (frequently banks) and the fact that the differences between these products are becoming increasingly blurred, the European Commission published a Green Paper on Retail Financial Services in the Single Market in May 2007, aimed at identifying the difficulties faced by consumers in the field of retail financial services.[71] At the same time, the ECOFIN Council proposed that the European Commission examine the consistency of EU legislation linked to various retail investment products (i.e. life insurance with investment risk, investment funds, certain structured products and certificates) to facilitate a coherent approach to safeguarding investors and to avoid ambiguity associated with the sale of these products.[72] At the end of 2007 the European Commission also issued a Communication on Financial Education aimed at improving individuals' understanding of financial products and their financial literacy.[73] To improve financial literacy, the Commission also created the website Dolceta[74], which offers consumer education for adults and includes a financial services module. Based on the White Paper on Enhancing the Single Market Framework for Investment Funds from the end of 2006[75], the European

[70] The conversion of investment companies is also a contributing factor to the high proportion of equity funds. The conversion of the authorised investment companies (the so-called PIDs) created the 11 investment companies in Slovenia. One of the PIDs converted directly into a balanced mutual fund. By March 2008, four of the 11 investment companies had converted into mutual funds: three equity funds and one balanced fund. The aforementioned five mutual funds held almost 30% of the total assets of mutual funds at the end of 2007.

[71] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52007DC0226:EN:NOT.

[72] http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ecofin/94033.pdf.

[73] http://ec.europa.eu/internal_market/finservices-retail/capability/index_en.htm.

[74] Development of On-Line Consumer Education Tools for Adults (www.dolceta.eu).

[75] Commission of the European Communities. White Paper. White Paper on Enhancing the Single Market Framework for Investment Funds. Brussels, 2006.

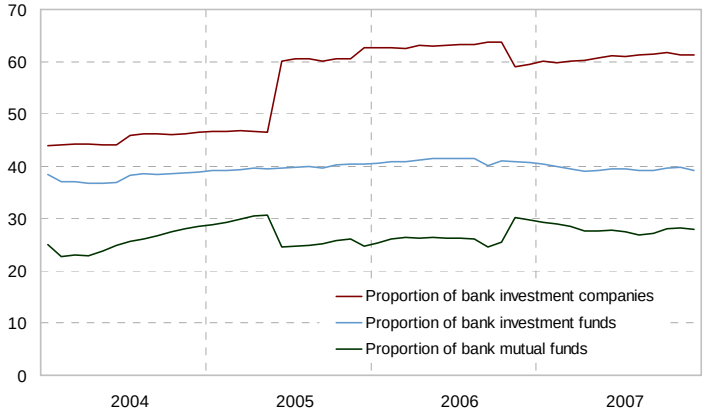
Commission released initial guidelines outlining possible adjustments to the UCITS Directive in March 2007.[76]

Interaction of investment funds and the banking sector

Slovenian banks were late in offering non-banking financial products.

The banking sector's distribution network is extremely important for European investment funds. In terms of assets, approximately 50% of funds used a banking distribution channel in 2005.[77] Slovenian banks were quite late in employing their distribution network to market non-banking investment products. They were ultimately forced to do so by stiff competition and a declining interest margin. In 2007 more than one-quarter of net payments into mutual funds were carried out via banks, compared to just 11% a year earlier.[78] As a result banks collected double the amount of commissions in 2007 compared to last year. However at 2%, their proportion of total commissions collected remains negligible. In the initial phase, when households are not yet accustomed to distinguishing investment products in terms of risk, the use of a bank distribution network could result in the transfer of the risk of confidence between investment products, i.e. between investment fund units and bank deposits.[79] The delayed interest of the domestic banks in offering non-standard banking-financial services is also reflected in their low level of ownership participation in management companies. At the end of 2007 banks accounted for a significant share in the ownership structure at just 5 of 14 management companies. This means that the fund structure in Slovenia bears significantly more risk than that of the euro area, as banks are typically more prudent when creating investment products. Due to the recent tightening of financing conditions on global financial markets, we can expect banks to demonstrate less interest in providing non-banking financial services, as they will attempt to substitute foreign sources by financing through domestic savings, i.e. by attracting funds via deposits.

Figure 7.15: Percentage of assets of investment funds, and separately for investment companies and mutual funds managed by management companies under majority bank ownership



Source: SMA

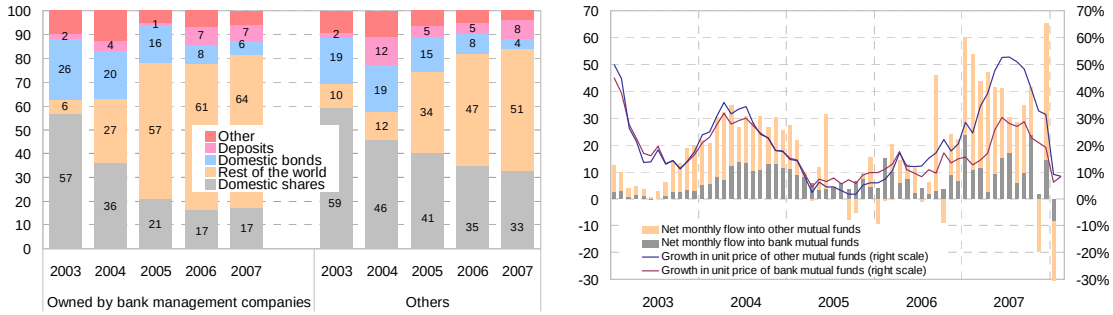
The proportion of assets managed by management companies under majority bank ownership remains approximately 40%.

The proportion of domestic investment fund assets managed by management companies under majority bank ownership is approximately 40%. This proportion is significantly higher among investment companies (3 companies) than among mutual funds (41 funds), which confirms the late response of banks in offering non-banking financial products. In 2007 mutual funds under majority bank ownership received 31% of total net inflows into mutual funds, or 13 percentage points less than in 2006. One reason is the high demand for Balkan funds in 2007 (37% of total net inflows); management companies under

[76] http://ec.europa.eu/internal_market/investment/legal_texts/index_en.htm#whitepaper.
[77] Current Trends in the European Asset Management Industry. Report Lot 1. Zentrum für Europäische Wirtschaftsforschung GmbH – ZEW/OEE. Mannheim, 2006.
[78] The numerator includes net inflows into domestic and foreign funds via banks, while the denominator only includes net inflows into domestic funds.
[79] In addition to their own points of sale and the bank distribution channel, management companies also use internet sales, while cooperation with insurance companies through the sale of unit-linked life insurance is increasingly important. An SMA authorisation is required for the direct marketing of foreign mutual funds, but not for the marketing of foreign mutual funds via unit-linked life insurance.

majority bank ownership managed only one of five funds with an investment strategy focused on the Balkan markets. That fund was not created until August 2007. During the year the weighted annual returns of other mutual funds were considerably higher than bank funds. However the returns of both types of funds were virtually equal in February 2008 due to a bearish trend on the capital markets of the former Yugoslavia. A comparison of the investment structure of both types of funds indicates that bank funds still have a significantly higher proportion of foreign investments. Management companies under majority bank ownership restructured several major funds following the relaxation of the legal limit of 10% on investments in the rest of the world at the end of 2002,[80] thus avoiding difficulties associated with portfolio restructuring.

Figure 7.16: Comparison of mutual funds managed by management companies under majority bank ownership and others: breakdown of investments in percentages (left), and annual growth in unit prices in percentages and net monthly inflows in EUR million (right)



Sources: SMA, own calculations

At EUR 108 million at the end of 2007, or less than 0.5% of bank credits to non-banking sectors, management companies' direct borrowing from the domestic banks was low and frequently short-term, relating to the liquidity needs of investment funds. Management companies purportedly have open credit lines at the domestic banks. According to certain data at the end of September 2007, this amount was only EUR 40 million.

7.3.1 Mutual funds

The value of mutual fund assets increased by 50% in 2007.

Slovenian mutual funds recorded very favourable results in 2007, with assets increasing by more than 50%, and reaching EUR 1,460 per capita. The positive atmosphere on the domestic capital market and on global capital markets in the first half of the year contributed to growth in assets, attracting EUR 470 million in new net payments. The weighted annual return on mutual fund unit prices in 2007 was 28%, the highest return recorded since 2002. Figures for 2007 indicate a high correlation between monthly net inflows and the monthly weighted returns of mutual funds, with the correlation coefficient reaching 0.69. Although the negative atmosphere on global capital markets towards the end of 2007 also affected the Slovenian capital market, the latter again achieved positive returns in December as the result of the sale of the state's 49% stake in Nova kreditna banka Maribor (NKBM). This resulted in a sharp increase in net inflows in December, and was also due to excess funds originally paid for the purchase of NKBM shares, which resulted in net outflows in November.

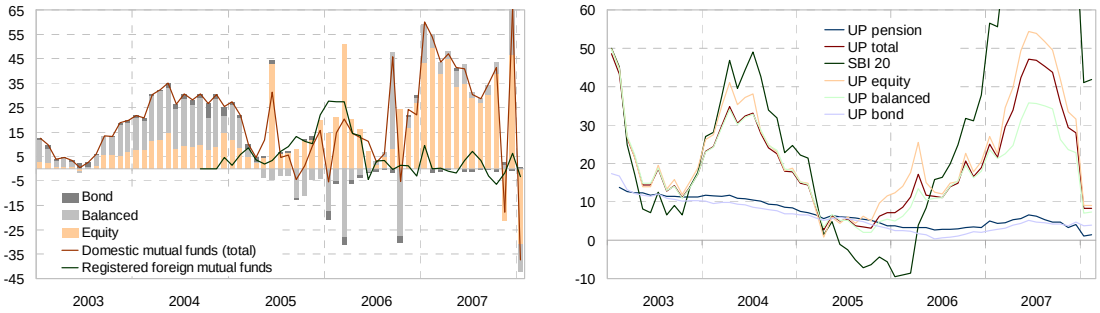
Demand for Balkan funds was again high in 2007.

In contrast to 2006 when both balanced and bond funds recorded negative net inflows, only bond funds recorded net outflows (EUR 6 million) in 2007. In 2007 mutual funds with an investment strategy focused on the markets of the former Yugoslavia, accounting for 37% of total inflows, were again of particular interest to investors. The high correlation between net inflows and returns and the negative sentiment on markets of the former Yugoslavia associated with uncertain political conditions in the region, primarily since the last quarter of 2007, indicate that demand for Balkan funds could wane. The level of demand for Balkan funds seen in 2007, despite continuous warnings that these markets are less developed, illiquid and thus carry high risk, confirm the fact that Slovenian investors can be largely separated into two groups. The first group is more

[80] The Investment Funds and Management Companies Act (the ZISDU-1; Official Gazette of the Republic of Slovenia, No. 110/2002) of 2002 removed the 10% legal limit on investments funds' investments abroad under the condition of prior reconciliation. The deadline for compliance was two years, i.e. until the end of 2004.

conservative and finds it difficult to choose investments as alternatives to bank deposits. The second group opts for extremely high-risk investments and primarily chases past returns, without regard to risk or the fund's performance over the longer term. This is an indication of Slovenian investors' lack of financial experience.

Figure 7.17: Net monthly inflows by type of mutual fund in EUR million (left) and annual growth in unit prices and the SBI 20 in percentages (right)

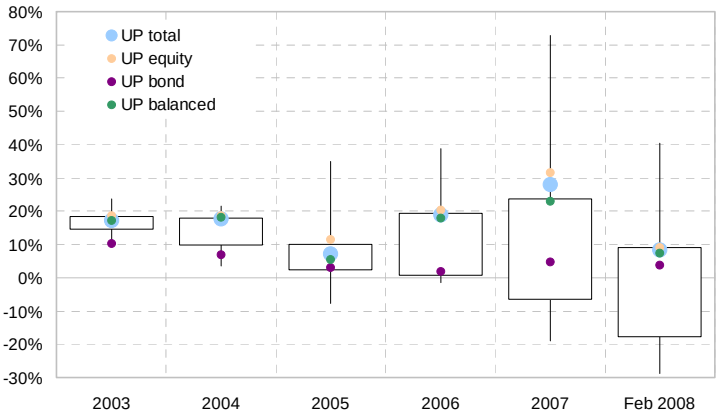


Sources: SMA, LJSE, Bank of Slovenia, own calculations

The differences in the annual returns of funds were significant in 2007.

The increasing sector specialisation and regional diversification of mutual fund is resulting in greater differences in the returns of individual funds. On the other hand, a higher correlation between capital markets associated with turbulence on global capital markets, and in Eastern Europe with the issue of certificates tied to baskets of shares from these markets, results in decreased variability in returns between individual funds. At the end of 2006 the standard deviation of the annual returns of all mutual funds stood at 9.3 percentage points, while the standard deviation at the end of 2007 and the end of February 2008 was 16.2 percentage points and 12.6 percentage points, respectively. The variety of mutual funds gives investors greater flexibility to adapt to their own specific characteristics. On the other hand however, it presents investors with a much more difficult decision and requires a certain awareness of the characteristics of the markets where the majority of assets are invested, particularly when investing in funds which are specialised in terms of region and sector. In addition to financial education, the quality of investment advice will become increasingly important in the future.

Figure 7.18: Classification of mutual funds in terms of annual return at year end in percentages



Note: As the funds have been classified according to annual return at the end of the year, only those funds in existence for at least one year are included. The figure shows the variation in annual returns between funds, and the relative standing of particular types of fund compared with mutual funds overall. The rectangles represent the 50% of mutual funds whose annual returns are higher than the bottom quartile of the funds, and lower than the top quartile.

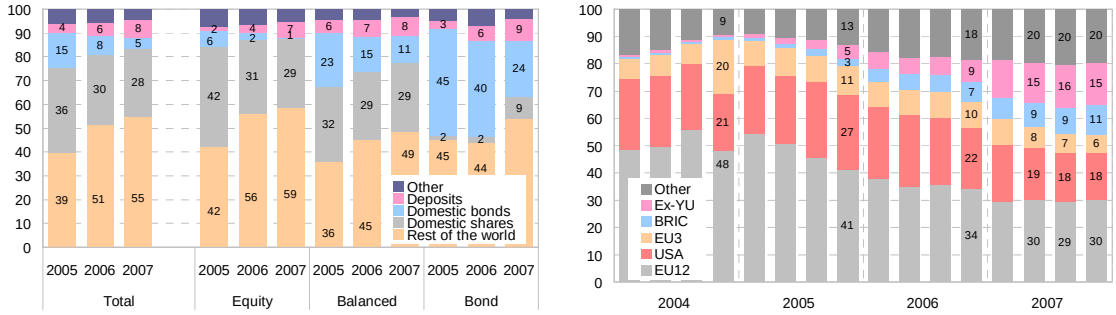
Sources: SMA, own calculations

The regional diversification of domestic fund investments increased in 2007.

At the end of 2007 approximately 55% of domestic mutual fund assets were regionally diversified foreign investments. The proportion of investments in euro area countries fell to 30%, as did the proportion of investments in the US (to 18%), while investments in the capital markets of the former Yugoslavia and other emerging markets increased. The

currency risk assumed by investors in mutual funds increases with the decreasing proportion of investments in the euro area. Greater diversification of investment in terms of region and sector also mean greater risk diversification. However investments in emerging capital markets and currency risk result in an increase in the total risk of mutual funds.

Figure 7.19: Breakdown of mutual fund investments (left) and the regional breakdown of investments in foreign shares by the other financial intermediaries sector (right) in percentages



Note: EU3: UK, Denmark, Sweden; BRIC: Brazil, Russia, India, China; Ex-YU: former Yugoslav republics.
Source: SMA

Liquid assets of mutual funds.

In the last few months of 2007, mutual funds increased liquid assets as a proportion of investments due to tightened conditions on capital markets and due to a strong correlation between the returns of funds and the payment of possible larger outflows from funds. In November 2007 mutual funds recorded their highest monthly net outflows (EUR 18 million) since 2000. Net outflows from funds continued, with the exception of December (the sale of NKBM), in January (EUR 37.4 million) and February (EUR 4.7 million) 2008. In accordance with the law, mutual funds are permitted to temporarily suspend the redemption of units[81], in the event of larger sell-offs on markets and the inability of managers to sell shares quickly due to pressures from investors following pay-outs.

Table 7.6: Liquid assets of mutual funds as a proportion of total assets at the end of the month

(%)	Bond	Balanced	Equity	Money-market	Total	Balkan
Jun 2007	26.0	11.3	8.8	97.6	10.2	8.3
Jul 2007	24.0	12.3	9.8	97.0	11.2	10.7
Aug 2007	24.4	11.1	9.2	96.4	10.3	11.4
Sep 2007	22.8	11.0	8.7	97.5	10.0	11.5
Oct 2007	21.2	9.7	9.3	97.5	9.8	9.7
Nov 2007	24.8	14.8	10.8	97.8	12.7	10.2
Dec 2007	24.0	12.3	10.0	98.0	11.3	11.5
Jan 2008	24.4	11.1	10.0	98.5	11.1	15.3

Note: Liquid assets include cash, deposits, money market instruments and government bonds. Data for Balkan mutual funds are estimated since November.
Source: SMA

Mutual funds with an investment strategy focused on the Balkans

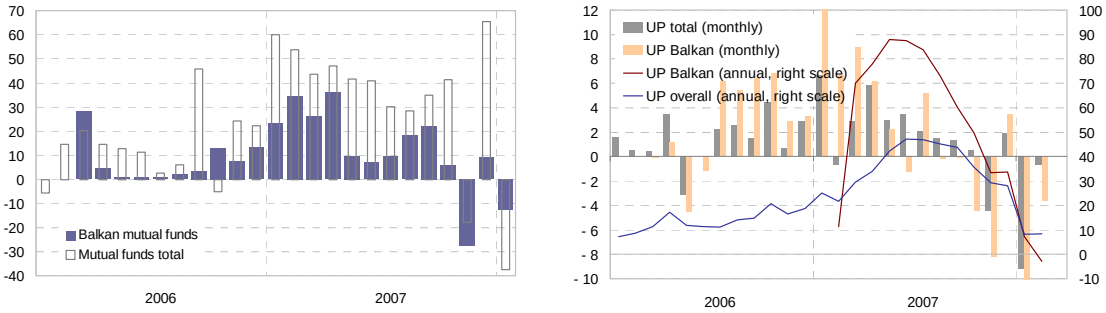
"Balkan funds" account for 10% of the assets of domestic mutual funds.

At the end of 2007 funds with an investment strategy focused on the markets of the former Yugoslavia represented more than 10% of mutual fund assets and accounted for 37% of total inflows. In November net outflows from "Balkan funds" (EUR 27 million) were well above the total monthly outflows from funds, and represented 33% of total monthly net outflows in January. Pressure on the liquid assets of funds due to the redemption of units, which is strongly linked to the negative returns of these funds,

[81] Pursuant to Article 82 of the Investment Funds Act (the ZISDU-1-UPB1; Official Gazette of the Republic of Slovenia, No. 26/2005), mutual funds may temporarily suspend the redemption of their units in exceptional cases if special circumstances so require (i.e. liquidity problems) due to the safety and interests of investors. Based on the aforementioned Act, the SMA issued a resolution defining in detail the cases or circumstances, procedures and other conditions that must be fulfilled when a mutual funds wishes to suspend the redemption of units (Official Gazette of the Republic of Slovenia, No. 80/2003).

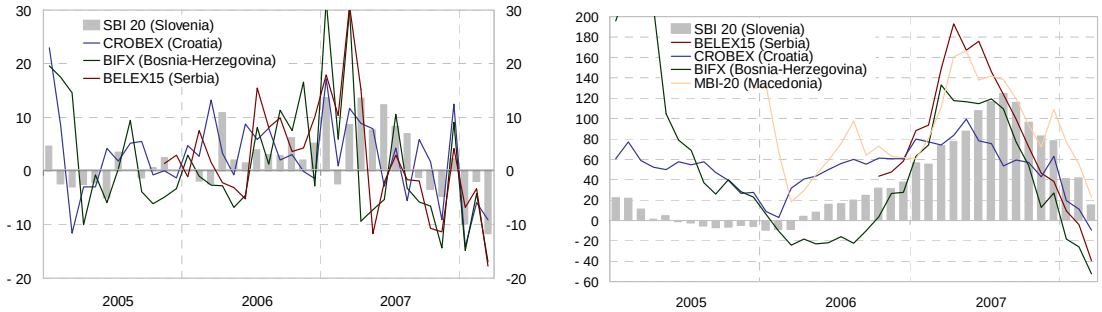
motivated managers to increase the proportion of available liquid assets. These were estimated to account for 15% of investments at the end of January 2008. In "Balkan funds" there is a strong correlation between net inflows and their returns: the correlation coefficient for three funds, which exist since the beginning of 2006, fluctuates at around 0.6. In the event of a sharp drop in share prices, a high correlation between net inflows and the returns of funds increases the risk that mutual funds will not be capable of repaying investors who wish to withdraw. This risk increases primarily when mutual funds invest in narrowly segmented, less liquid capital markets, and in the case of a low proportion of liquid assets in total assets. It should be pointed out that an excessive proportion of liquid assets is not optimal for mutual funds in terms of operation.

Figure 7.20: Comparison of "Balkan funds" with all domestic mutual funds in terms of net flows (left) and the annual and monthly returns on mutual fund unit prices (right) in percentages



Note: Data for "Balkan mutual funds" are estimated since November.
Sources: SMA, own calculations

Figure 7.21: Monthly (left) and annual (right) growth rates of selected stock exchange indices in the countries of the former Yugoslavia



Sources: LJSE, Bloomberg, websites of stock exchanges of the former Yugoslavia

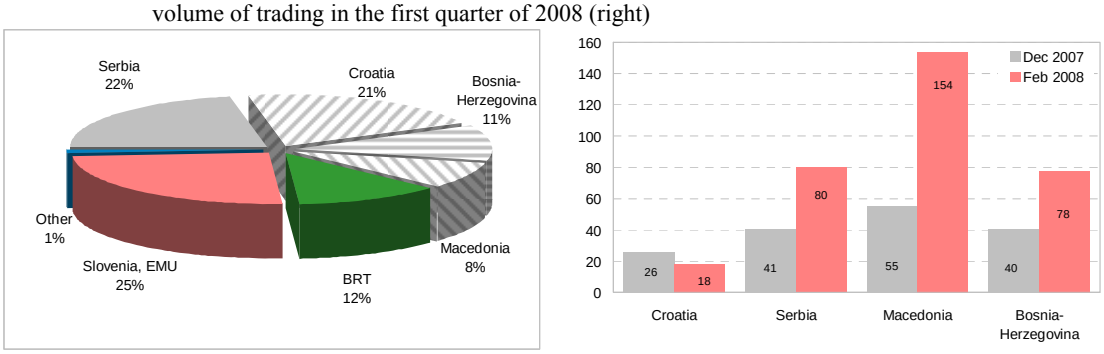
The markets of the former Yugoslavia present risks primarily due to low liquidity and financial depth.

The markets of the former Yugoslavia present risks primarily due to low liquidity and less favourable conditions in the event of a drop in share prices, or in an extreme case, the inability of investors to reduce their exposure to these markets. With the exception of December, most markets of the former Yugoslavia recorded negative monthly growth rates from September 2007 to March 2008. The future development of these capital markets, particularly those of Serbia, Macedonia and Bosnia and Herzegovina, are largely dependent on the political uncertainty associated with Kosovo's declaration of independence. The annual asset turnover ratios for the shares on these markets are considerably lower than on the Ljubljana Stock Exchange. At the end of 2007 the proportions of "Balkan fund" assets on the individual capital markets of the former Yugoslavia in the market capitalisation of shares were low, and did not exceed 0.5%. The proportions of assets in the average monthly trading volume of shares on the aforementioned individual capital markets were quite high in 2007, ranging from 26% in Croatia to 55% in Macedonia. These proportions were significantly higher during increased trading in the first three months of 2008, when the liquidity on certain markets fell further.

It is unlikely that funds would be forced to sell the majority of their assets in a single month. In an extreme case the Serbian, Macedonian and Bosnian markets, where domestic "Balkan mutual funds" held nearly 40% of their investment (an additional 22% in Croatia), could pose problems in terms of liquidity. The investment structure of domestic

"Balkan funds" is relatively well diversified between the countries of the former Yugoslavia. However the interdependence between the capital markets of this region is quite high.[82] Net outflows from these funds in the future are mostly dependent on developments on these markets, and broader political and economical developments in the region.

Figure 7.22: Estimated regional breakdown of investments of five mutual funds that invest in the Balkan region, end of February 2008 (left) and the proportion of their assets at the end of 2007 in the average monthly volume of trading in the 2007 and at the end of February 2008 in the average monthly volume of trading in the first quarter of 2008 (right)



Note: BRT – Bulgaria, Romania, Turkey.
Sources: websites of management companies and the stock exchanges of the former Yugoslavia

7.3.2 Investment companies

At more than EUR 1 billion, the market capitalisation of the seven investment companies accounted for 84% of investment companies' assets at the end of 2007. Their market values thus remain lower than their book values, although the diminishing of discounts was significant in 2007 due to increased demand from investors as the legal deadline for conversion (2011) approaches.[83] This is also encouraging an increase in the proportion of investments accounted for by marketable assets, as only the appropriate investment structure will allow the converted investment companies to compete with existing mutual funds. At 57%, investment companies have a significantly higher proportion of domestic investments than mutual funds, indicating their greater dependence on the domestic capital market. Similar to mutual funds, investment companies are also increasing the regional diversification of their assets: the proportion of foreign investments had already reached 22% by the end of 2007.

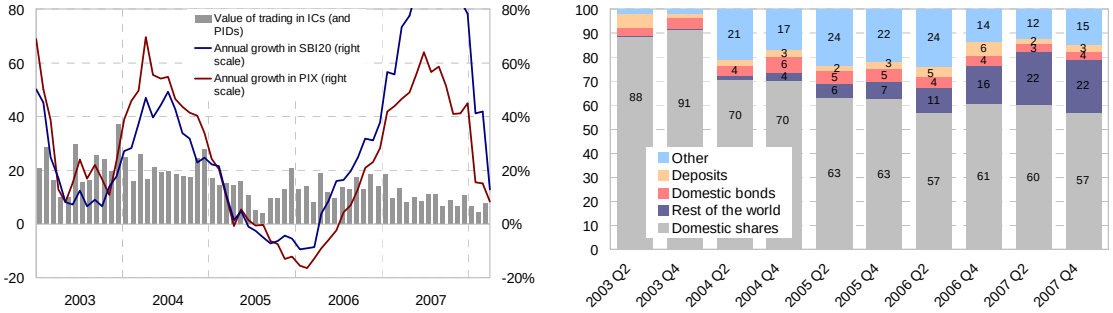
[82] Correlation coefficient of monthly returns from the beginning of 2007 to March 2008.

	Serbia	Croatia	Macedonia	Bosnia and Herzegovina	Slovenia	Eastern Europe
Serbia	1.00					
Croatia	**0.67**	1.00				
Macedonia	**0.68**	**0.53**	1.00			
Bosnia and Herzegovina	**0.82**	**0.74**	**0.53**	1.00		
Slovenia	**0.62**	**0.69**	**0.63**	**0.56**	1.00	
Eastern Europe	0.11	0.34	-0.03	0.20	0.25	1.00

Sources: LJSE, Bloomberg, websites of stock exchanges of the former Yugoslavia

[83] Investment companies can avoid conversion into mutual fund status if the shareholders so decide at a general meeting with votes representing three-quarters of the capital, which given the fractured ownership will be difficult to achieve. The law also stipulates that mutual funds can charge withdrawing investors a penalty charge of 20% in the first year after conversion and 10% in the second year, at a minimum in the amount of the proportion of non-marketable assets. Prices on the stock exchange in the period before conversion are expected to approach the book value, at least up to the percentage of the penalty charge.

Figure 7.23: Monthly value of investment companies' trading in EUR million, and annual growth in the PIX and SBI 20 in percentages (left), and breakdown of investment company investments in percentages (right)



Sources: SMA, LJSE

7.4 Leasing companies

The volume of leasing business increased by 34% in 2007. Real estate leasing accounts for 31%.

Despite turbulence on global financial markets in the second half of the year, 2007 was another successful year for Slovenian leasing companies. This success was linked primarily to high economic growth in Slovenia. At EUR 2,5 billion, leasing companies achieved 34% annual growth in the volume of leasing business.[84] The stock of leasing business was EUR 4.2 billion at the end of 2007, achieving nearly 15% of the stock of loans to non-banking sectors. The proportion of leasing business accounted for by the leasing of real estate rose to 31%. In addition to a booming new constructions market, the high annual growth of 41% was also driven by changes in tax legislation that have equalised leasing with bank loans.[85] Stiff competition amongst leasing companies and from favourable bank loans resulted in decreasing margins, where there is increasingly less manoeuvring room. Among members of the leasing association [86], the largest leasing company accounts for nearly 36% of leasing business.

Consumer leasing accounts for 20% of the volume of total leasing business.

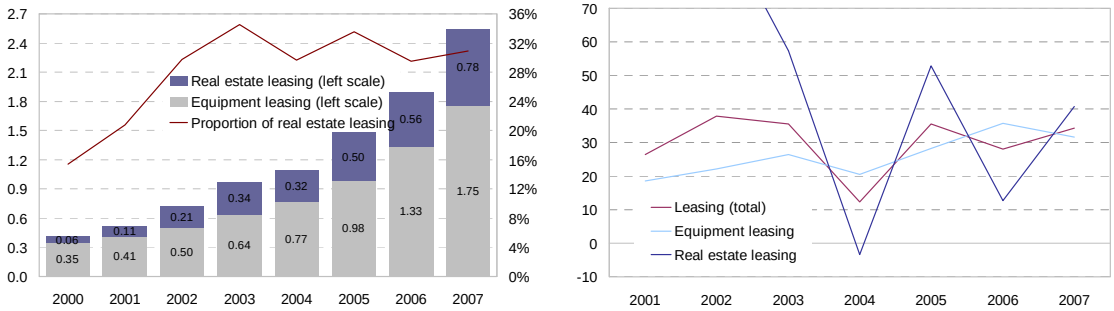
The leasing of vehicles is predominant in the leasing of equipment. The leasing of cars (up 2 percentage points to 45% in 2007) accounts for the highest proportion, followed by the leasing of commercial vehicles at 23%. At 43%, the leasing of office building accounts for the largest proportion of real estate leasing, followed by other real estate leasing at 24% (an increase of 5 percentage points in 2007), which includes the leasing of land for construction. This coincides with an increased number of building permits issued in 2007. Leasing companies also expect increased demand for leasing from consumers, who currently account for slightly less than 20% of the volume of leasing business in 2007.

[84] The increase in the stock of leasing transactions was partly the result of the inclusion of new members in the Unicredit Leasing Association, whose market share was more than 4% in 2007.

[85] The new VAT Act (ZDDV-1; Official Gazette of the Republic of Slovenia, No. 117/06), which entered into force in November 2006, offered leasing companies the choice in the method of accounting for VAT on the costs of financing, i.e. on interest. It can be accounted as before, by including the value of the subject of the leasing and the costs of financing (interest) in the taxable base, or by not including the latter in the taxable base, thus lowering it. In this case the leasing companies must disclose the costs of financing separately from the value of the merchandise.

[86] In 2007, leasing companies established a leasing committee within the Bank Association of Slovenia, thus abolishing the previous Slovenian Leasing Association.

Figure 7.24: Approved leasing business in EUR billion and the proportion accounted for by real estate leasing (left), and annual growth in leasing business in percentages (right)

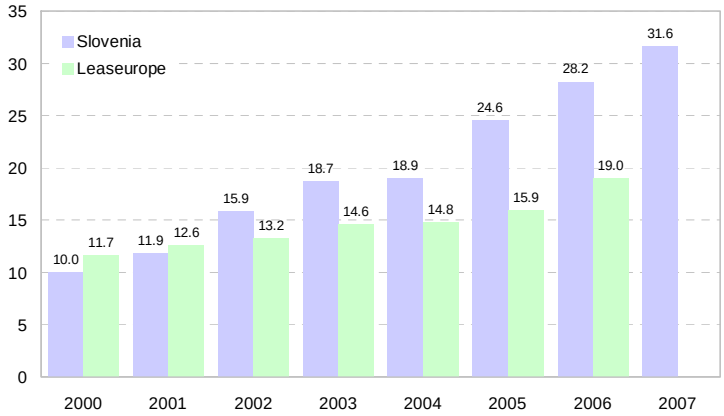


Source: SLA

The European leasing market also had an encouraging year in 2006.[87] Leasing business increased by 13.8%, if the countries which joined the European leasing association in 2006 are excluded.[88] Countries of Eastern and Central Europe once again recorded the highest growth in new business (approximately 35%), which coincides with the lower level of economic development in these countries, meaning there is greater opportunity for growth in leasing than in more developed economies. At just under 16% of the European leasing market, real estate leasing is considerably less important than in Slovenia.

The European leasing market achieved encouraging growth in 2006.

Figure 7.25: Ratio of leasing business to gross investments in percentages



Note: The Leaseurope figures include all European Union member-states with the exception of Luxemburg, Ireland, Cyprus, Malta and Greece, plus Norway, Switzerland, Romania, Ukraine, Bosnia and Herzegovina, Russia and Serbia. Gross investments include capital expenditure but exclude investments in housing for reason of comparability with the Leaseurope figures.
Sources: SLA, SORS, Leaseurope

Leasing activities are closely linked to economic growth. The importance of leasing to the Slovenian economy has increased in recent years, as evidenced by the ratio of leasing business to gross investment (the leasing penetration rate), which had already exceeded 28% in 2006 and is significantly higher than the European average. Given expectations of a future economic slowdown, it can also be expected that leasing activities, primarily those associated with financing the purchase of equipment, will also decrease. Higher prices and the associated lower real income of households could result in more cautious vehicle purchases. Expectations regarding growth in real estate leasing remain high, linked in part to increased supply for real estate. This trend however is highly dependent on developments on the real estate market and interest rates, as well as the trend of real

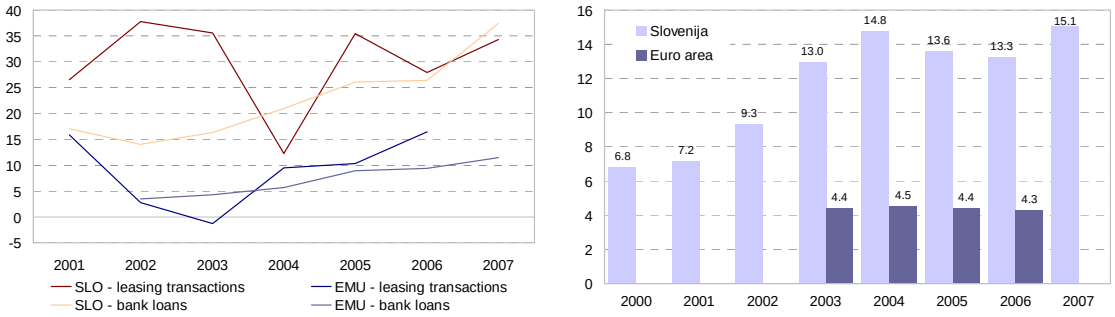
The ratio of leasing business to gross investments exceeded 31% in 2007.

[87] The Leaseurope figures include all European Union member-states with the exception of Luxemburg, Ireland, Cyprus, Malta and Greece, plus Norway, Switzerland, Romania, Ukraine, Bosnia and Herzegovina, Russia and Serbia.
[88] In 2006, Lithuania, Latvia Ukraine and Serbia joined the European leasing association. Also taken into account are figures of individual national automobile rental associations, which joined the European association in 2006.

household income. In more developed economies, the growth of the real estate market frequently tracks growth of the banking sector.

Annual growth in the volume of leasing business and in bank loans approved to non-banking sectors remains higher in Slovenia than in the euro area, primarily as the result of catching up economically. The proportion of stock of leasing business in bank loans to non-banking sectors is also considerably higher in Slovenia, increasing 2 percentage points in the last year. This could be the result of longer-term leasing agreements associated with the higher proportion of real estate leasing, and to some extent due to increased interest in leasing following recent turmoil on world financial markets.

Figure 7.26: Annual growth in the volume of leasing business concluded and bank loans granted to non-banking sectors (left) and ratio of leasing loans to bank loans (right) in percentages



Note: The figures for the volume of leasing business in the euro area do not include Luxembourg, Ireland or Greece.
Sources: SLA, Bank of Slovenia, Leaseurope, ECB

Many leasing companies are owned by domestic and foreign banks.

Several leasing companies are owned by domestic and foreign banks, which facilitates financing.[89] This cross-ownership indicates the complementary nature of bank loans and leasing activities, which is in part confirmed by the relatively even trend in the annual rates of growth in bank loans to non-banking sectors and the volume of leasing business. Leasing provides businesses and private individuals an alternative way of financing, and thus a comprehensive range of financial services from individual financial groups. The advantage that leasing loans have over banking loans is evident in more-adaptable and less-demanding loan approval conditions. At the same time, leasing provides for greater price competitiveness as the title to the subject of the leasing remains with the lessor until the final instalment is received. Leasing loans therefore do not require additional collateral. Leasing companies which are part of a large banking and financial group have easier access to the monitoring of their clients' operations, have a more extensive marketing network, and also benefit from the recognition and reputation of the entire financial group. As members of larger financial groups, some leasing companies are preparing for the more active marketing of their products through bank branches. New financial products are also being created in combination with leasing and saving in mutual funds managed by the group to which they belong.

Performance of Slovenian leasing companies

Lower growth in profits was recorded in 2006.

Competition within the sector and from banks resulted in lower growth in leasing companies' profits in 2006. Leasing companies are competing through greater flexibility in loan approval and lower lending rates, but are limited in this respect. Growth in the total assets of leasing companies slowed in 2006, but increased to a ratio of 12% to bank assets. Foreign sources represent three-quarters of leasing companies' liabilities, but this proportion has been falling since 2004. In line with the decline in leasing companies' liabilities to the rest of the world, their net liability to the rest of the world is also closing in terms of total assets, reaching 68% at the end of 2006, prior to the introduction of the euro.

[89] Slovenian banks already hold stakes in eleven leasing companies, and are the sole owners in eight instances. Of these, six are members of the Slovenian Leasing Association, and they accounted for more than 28% of the total business of the association in 2007. Leasing loans by leasing companies owned by foreign banks accounted for 52% of the association's business in 2007.

Table 7.7: Performance of leasing companies and sources of financing

						Growth rate (%)				
	2002	2003	2004	2005	2006	2002	2003	2004	2005	2006
Total assets (EUR million)	1,414	1,766	2,328	3,171	4,047	24.7	24.9	31.8	36.2	27.6
Capital (EUR million)	109	121	157	224	296	5.7	11.0	29.8	42.4	32.3
Total profit/loss (EUR million)	14	32	37	49	55	-20.6	122.1	14.0	33.7	13.1
ROA (%)	1.13	2.01	1.78	1.78	1.53					
ROE (%)	13.58	27.82	26.23	25.63	21.24					
Financial and operating liabilities (EUR million)	1,273	1,622	2,147	2,931	3,724	35.5	27.4	32.4	36.5	27.1
Liabilities to banks and group companies (%)	76	83	85	83	93	37.5	39.6	35.7	32.7	43.3
Liabilities to the rest of the world (%)	74	79	82	78	74	34.8	35.3	38.0	29.9	20.8
Open foreign exchange position/assets (%)	-66.6	-72.1	-75.5	-72.0	-68.2					

Note: The figures from financial statements include all companies included under K64.91 (Financial leasing) under the NACE Rev.2 (NACE Rev. 1.1: J65.21). Members of the Slovenian Leasing Association classed under K64.91 accounted for 91% of the total assets of the companies in this category as at the end of 2006. For 2006 the final accounts of companies are compiled in accordance with the new Slovenian Accounting Standards (SAS 2006).
Source: AJPES

Leasing companies receive 93% of their financing from banks and group companies. The financing of leasing companies through domestic banks has increased.

In 2006 leasing companies increased financing through the domestic banks significantly. This trend continued in 2007. At EUR 1.5 billion, domestic bank loans to leasing companies represented approximately 35% of leasing companies' liabilities at the end of 2006. This increase is also reflected in a 4 percentage point increase in loans to leasing companies as a proportion of total domestic bank loans to non-banking sectors (7% at the end of 2006). Despite the recent increase in the exposure of banks to leasing companies, the possibility of the transfer of credit risk from leasing companies to the banking sector is limited, as the aforementioned proportion remains relatively low. In addition the recent performance of leasing companies has been good. Banks' exposure is more evident to self-owned leasing companies. Credit risk is significant for both leasing companies and banks. They attempt to mitigate this risk by obtaining or formulating credit ratings of potential lessees. In addition to a slowdown in economic growth, the risk of a continuing rise in interest rates and the associated rising cost of financing for leasing companies could also result in a decrease in future leasing activities.

8 FINANCIAL INFRASTRUCTURE

Within financial systems, shocks from affected institutions can be passed through to other parts of the systems via the financial infrastructure. At the same time, the realisation of risks in the financial infrastructure itself can also result in systemic shock. In order to ensure financial stability and to achieve their primary objective of price stability, it is in the interest of central banks that the financial infrastructure functions smoothly and efficiently. The financial infrastructure also facilitates the implementation of monetary policy. Due to the aforementioned interdependence, one of the central banks' typical functions is the oversight of payment systems and securities clearing and settlement systems. Central banks carry out this function by monitoring, analysing and guiding changes in these systems. At the same time, central banks may be the administrators, clearing and settlement agents and direct participants of these systems.

With the introduction of the euro, the Bank of Slovenia became a full participant in the TARGET system and adapted the Giro Clearing system.

With the introduction of the euro on 1 January 2007, the Bank of Slovenia's real-time gross settlement (RTGS) system for high-value tolar payments was replaced by the TARGET system, intended for the interbank transfer of funds in euros. Similar to the RTGS system, TARGET is also a real-time gross settlement system. Prior to 2007 the Bank of Slovenia, most Slovenian banks and one savings bank were included in the TARGET system through remote participation in the German central bank's RTGS^{plus} system, which was a component of the TARGET system. On 1 January 2007 the Bank of Slovenia became a full participant in the TARGET system, temporarily maintaining the technical manner of inclusion via the German RTGS^{plus} system until migration to the TARGET2 system. At the same time, the Bank of Slovenia began ensuring conditions for Slovenian participants for direct inclusion in the TARGET system. With its own special temporary system it also facilitated the overnight deposit of funds and settlements of net systems in which the Bank of Slovenia itself was a settlement agent. The most important system was the Giro Clearing system for low-value payments. The system's threshold was increased considerably as of 1 January 2007. This resulted in a decrease in the number of transactions in the TARGET/TARGET2 system in 2007.

8.1 Payment systems and risks

The dynamic economic growth in Slovenia in recent years is also reflected in an increase in the value and number of transactions in payment systems. Two systems are of primary importance in Slovenia for systemic stability: the TARGET/TARGET2 and Giro Clearing systems. The total value of transactions in the aforementioned systems exceeded Slovenian GDP by a factor of 10.9 and 1.4, respectively. Taking into account the number of transactions, the TARGET/TARGET2 and Giro Clearing systems represent possible prominent channels for the pass-through of shocks in the financial system.

Table 8.1: Value and number of transactions in the RTGS/TARGET/TARGET2 and Giro Clearing systems

				Year-on-year growth (%)		
	2005	2006	2007	2005	2006	2007
RTGS/TARGET/TARGET2 [1]						
Value (EUR billion)	261.62	317.64	364.68	28.0	21.4	14.8
No. of transactions (million)	1.40	1.57	0.73	2.40	11.60	-53.50
Giro Clearing						
Value (EUR billion)	20.98	22.93	45.71	3.8	9.3	99.3
No. of transactions (million)	49.42	52.11	53.62	1.7	5.4	2.9

Note: [1] Domestic payments.
Source: Bank of Slovenia

In October 2007 the Bank of Slovenia carried out a comprehensive analysis of risks involved in managing the TARGET2-Slovenija system and migrated to the system on 19 November 2007.

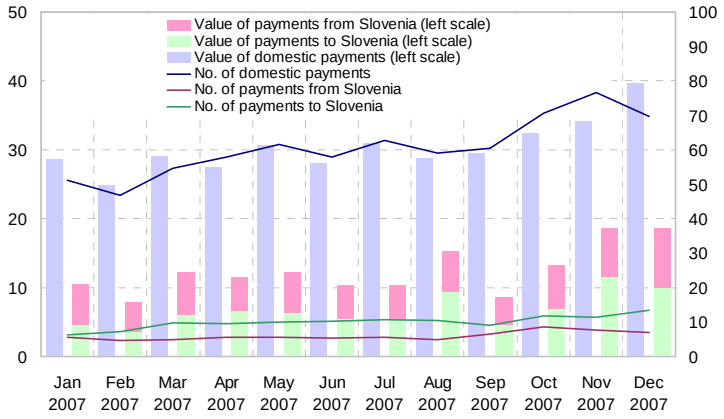
The Bank of Slovenia is the administrator of the TARGET2-Slovenija system. In terms of managing financial infrastructure risks, the migration to the TARGET2 system, which is an upgraded TARGET system, was the biggest challenge in the second half of 2007. In October 2007, following a long period of preparation for the migration, the Bank of Slovenia carried out a comprehensive risk analysis relating to the administration procedures of the TARGET2-Slovenija system. The analysis, carried out using the valid methodology for the TARGET2 system, indicated a low level of risk. The Bank of

Slovenia was in the first group of banks which migrated to the TARGET2 system on 19 November 2007, when the system began to operate as a single shared platform. Since that time the Bank of Slovenia has ensured conditions for the direct inclusion of Slovenian participants in TARGET2. Participants have open accounts in the system on which they make overnight deposits of liquid funds and settle positions from net systems. The Bank of Slovenia's special system ceased to operate with migration to the TARGET2 system.

Due to the small proportion of cross-border payments in the TARGET/TARGET 2 system, the cross-border transfer of risks is relatively limited.

Payments in the TARGET/TARGET2 system are separated into a segment of domestic payments, which replaced the previous RTGS system, and a segment of cross-border payments. Given the value and number of payments, the system is more important for payments within Slovenia. Therefore the cross-border transfer of risks is relatively limited. In 2007 the average monthly number of payments from Slovenia in the TARGET/TARGET2 system was more than 6,000 with a value of EUR 5.7 billion, while the number of payments to Slovenia averaged 9,950 with a value of EUR 6.7 billion. The average monthly number of domestic payments was more than 60,000 with a value of EUR 30.4 billion.

Figure 8.1: TARGET/TARGET2 – domestic and cross-border payments; value in EUR billion (left scale) and number in thousand (right scale)

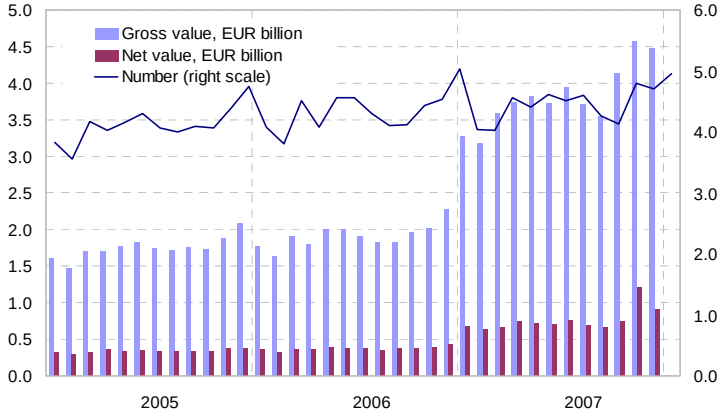


Source: Bank of Slovenia

Giro Clearing is a net payment system.

Giro Clearing is a net payment system in which the Bank of Slovenia is a clearing and settlement agent, and also a system participant. Until 1 January 2007 the system was intended for payments with a maximum value of EUR 8,346. At that time the threshold was increased to EUR 50,000. This resulted in an increase in the monthly values of payments submitted in 2007, compared to the previous year.

Figure 8.2: Monthly value (in EUR billion; left scale) and the number of transactions (in million; right scale) in the Giro Clearing system



Source: Bank of Slovenia

In 2007 operational risk relating to the operation of the Giro Clearing system was effectively mitigated, while its availability was 99.94%.

The Settlement Guarantee Scheme of the Giro Clearing system has never been activated.

Settlement risk in the Giro Clearing system is limited with the obligatory inclusion of participant in the Settlement Guarantee Scheme (SGS), intended to cover the unsettled net liabilities of one or more participants. The SGS is based on a cash fund to which all participants, except the Bank of Slovenia, contribute. The size of the cash funds is determined by the Bank of Slovenia as the highest sum of two net debit positions in an individual clearing cycle in a period of one month. The Bank of Slovenia determines an individual participant's share of the cash fund as the value of its payments as a proportion of the value of all payments submitted to the system (excluding the Bank of Slovenia's payments and positions). If the value of the guarantee increases, the Bank of Slovenia increases the cash fund by directly debiting the accounts held by participants in the TARGET2 system. If a participant (or several participants) does not have sufficient funds on account, they must provide for such by taking a loan from another participant or by taking an intraday loan at the Bank of Slovenia.

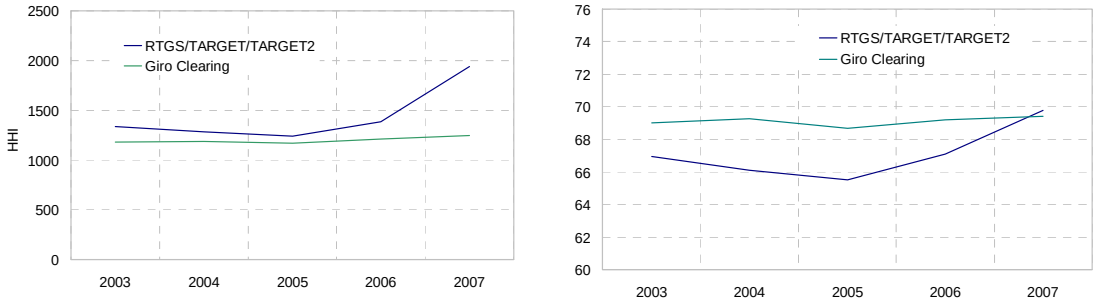
Liquidity risk in the Giro Clearing system is first mitigated with a intraday liquidity loan. If a participant is unable to repay this type of loan by the end of the day, the Bank of Slovenia converts the intraday liquidity loan into a marginal lending facility, which is converted back to an intraday loan on the next TARGET2 system business day. The condition for approval of an intraday loan and marginal lending facility is sufficient assets of the participant in a fund of eligible collateral at the Bank of Slovenia for securing a loan. A participant is temporarily suspended from the Giro Clearing system if it does not ensure the necessary funds within 30 minutes following the receipt of the Bank of Slovenia's request. The Bank of Slovenia activates the SGS by:

- first drawing funds of the failed participant from the SGS cash fund. If this is not sufficient to cover its net debit position, the corresponding share of other participants would be used to cover the difference;
- if the entire SGS cash fund is insufficient to cover the net debit position of the failed participant, it must be supplemented with the funds from the accounts held by other participants in the TARGET2 system. To ensure the necessary short-term liquidity in the TARGET2 system, participants may take an intraday liquidity loan at the Bank of Slovenia, if liquidity could not be obtained in another manner.

To date the SGS has never been activated for the Giro Clearing system.

The concentration of payment transactions by participants, as one indicator of systemic risk, increased in the TARGET/TARGET2 system in 2007. This concentration is further evidenced by the Herfindahl-Hirschman index, while the share of the five largest participants rose by 2.7 percentage points in 2007 compared to a year earlier. The concentration of payment transactions in the Giro Clearing system did not change significantly in 2007.

Figure 8.3: Concentration of the number of transactions in the RTGS/TARGET/TARGET2 and Giro Clearing systems (excluding the Bank of Slovenia) – Herfindahl-Hirschman Index (HHI; left) and proportion of total number of transactions accounted for by the five largest participants (right)



Source: Bank of Slovenia

8.2 Securities settlement systems

Settlement systems are linked to payment systems via the settlement of the financial portion of securities transactions. At the same time securities systems provide financial

collateral (in the form of securities), which payments systems require to function normally.

Prior to the adoption of the euro, the operations of the Central Securities Clearing Corporation were harmonised with ECB standards for the use of securities settlement systems in ESCB credit operations. The establishment of a correspondent central banking model (CCBM) in Slovenia made it possible for Slovenian banks to use cross-border assets as collateral in ESCB credit operations. In August 2007 the Market in Financial Instruments Act came into force, as the transposition of the Markets in Financial Instruments Directive into Slovenian law. With this act oversight of the design and functioning of the securities settlement system was formally transferred to the Bank of Slovenia. In terms of ensuring financial stability, the Bank of Slovenia was already responsible for oversight prior to August 2007 by assessing the CSCC's compliance with ECB standards, and by assessing the rules for administering a central register and operating a settlement system. Following the adoption of the Market in Financial Instruments Act, the Bank of Slovenia began harmonising internal guidelines and methodologies for oversight of the functioning of the settlement system with the provisions of the aforementioned act, taking into account international recommendations and standards.

STATISTICAL APPENDIX

1. Inter-sector financial claims and liabilities

Table 1.1: Inter-sector financial claims and liabilities of sectors of the Slovenian economy at the end of the third quarter of 2007 as a percentage of GDP

(% of GDP)	Claims						
	Domestic sectors					Rest of the	Total
Liabilities	Corporates	Financial sector	Government	Households	Total	world	liabilities
Corporates	77.1	73.2	34.1	34.6	218.9	42.7	261.6
Cash and deposits	0.0	0.0	0.0	0.0	0.0	0.0	
Securities except shares	0.4	1.2	0.1	0.1	1.8	0.0	
Loans	7.7	56.7	0.9	2.5	67.8	10.0	
Equity	44.5	13.7	28.2	27.5	114.0	19.3	
Technical provisions	0.0	0.0	0.0	0.0	0.0	0.0	
Other	24.4	1.5	5.0	4.4	35.4	13.3	
Financial sector	20.6	26.2	11.6	57.2	115.7	70.8	186.5
Cash and deposits	11.3	7.2	4.7	37.0	60.2	25.5	
Securities except shares	0.7	3.1	0.4	0.1	4.3	1.4	
Loans	0.6	8.8	0.0	0.1	9.5	37.8	
Equity	6.0	6.2	5.0	10.4	27.6	5.3	
Technical provisions	1.2	0.6	0.1	9.0	10.9	0.2	
Other	0.9	0.4	1.4	0.5	3.2	0.6	
Government	6.3	13.5	16.1	2.0	37.9	10.3	48.1
Cash and deposits	0.0	0.0	0.0	0.2	0.2	0.0	
Securities except shares	0.4	11.2	0.6	1.0	13.2	8.7	
Loans	0.5	1.7	1.3	0.0	3.5	0.6	
Equity	0.0	0.0	10.7	0.0	10.7	0.0	
Technical provisions	0.0	0.0	0.0	0.0	0.0	0.0	
Other	5.4	0.6	3.6	0.8	10.3	1.0	
Households	3.8	23.5	0.8	0.0	28.1	0.0	28.2
Cash and deposits	0.0	0.0	0.0	0.0	0.0	0.0	
Securities except shares	0.0	0.0	0.0	0.0	0.0	0.0	
Loans	1.1	22.9	0.2	0.0	24.2	0.0	
Equity	0.0	0.0	0.0	0.0	0.0	0.0	
Technical provisions	0.0	0.0	0.0	0.0	0.0	0.0	
Other	2.7	0.7	0.7	0.0	4.0	0.0	
Total	107.9	136.6	62.7	93.8	402.5	123.8	526.2
Cash and deposits	11.3	7.2	4.7	37.2	61.2	25.5	
Securities except shares	1.5	15.5	1.0	1.3	19.6	10.1	
Loans	9.9	90.1	2.4	2.7	105.1	48.4	
Equity	50.6	19.9	43.9	37.9	152.6	24.6	
Technical provisions	1.2	0.6	0.1	9.0	10.9	0.2	
Other	33.4	3.2	10.7	5.7	53.1	15.0	
Rest of the world	28.2	58.3	1.7	16.2	104.5		104.5
Cash and deposits	0.5	12.7	0.0	12.9	26.1		
Securities except shares	0.2	26.2	0.6	0.2	27.2		
Loans	2.9	8.9	0.0	0.0	11.7		
Equity	8.3	9.5	0.7	2.8	21.3		
Technical provisions	0.0	0.1	0.0	0.3	0.3		
Other	16.4	1.0	0.4	0.0	17.8		
Total claims	136.1	194.9	64.5	110.0	507.0	123.8	630.7

Note: The table is based on financial accounts compiled by the Bank of Slovenia. The unconsolidated figures have been restructured into the form of a matrix with the aim of illustrating the underlying mutual financial ties between domestic sectors and the rest of the world.

Source: Bank of Slovenia

Table 1.2: Inter-sector financial claims and liabilities of sectors of the Slovenian economy at the end of 2006 as a percentage of GDP

(% of GDP)	Claims						
	Domestic sectors					Rest of the world	Total liabilities
Liabilities	Corporates	Financial sector	Government	Households	Total		
Corporates	70.1	61.5	29.4	31.4	192.4	40.6	233.0
Cash and deposits	0.0	0.0	0.0	0.0	0.0	0.0	
Securities except shares	0.3	1.1	0.1	0.1	1.6	0.1	
Loans	6.8	48.4	0.9	2.5	58.6	9.8	
Equity	39.4	10.6	23.8	24.4	98.1	18.0	
Technical provisions	0.0	0.0	0.0	0.0	0.0	0.0	
Other	23.6	1.4	4.6	4.4	34.0	12.7	
Financial sector	19.1	32.8	11.5	55.6	119.1	52.4	171.5
Cash and deposits	11.1	10.8	5.2	38.1	65.2	10.9	
Securities except shares	0.8	9.2	0.4	0.2	10.6	1.3	
Loans	0.3	7.0	0.0	0.1	7.4	35.4	
Equity	4.9	4.9	4.5	8.1	22.4	4.1	
Technical provisions	1.1	0.7	0.1	8.7	10.6	0.3	
Other	0.9	0.2	1.4	0.4	2.9	0.3	
Government	5.6	17.9	12.2	2.1	37.8	8.6	46.4
Cash and deposits	0.0	0.0	0.0	0.0	0.0	0.0	
Securities except shares	0.7	15.3	0.9	1.3	18.2	7.0	
Loans	0.2	2.2	1.6	0.0	4.1	0.8	
Equity	0.0	0.0	7.8	0.0	7.8	0.0	
Technical provisions	0.0	0.0	0.0	0.0	0.0	0.0	
Other	4.7	0.4	2.0	0.8	7.8	0.8	
Households	3.8	21.6	0.7	0.0	26.0	0.2	26.3
Cash and deposits	0.0	0.0	0.0	0.0	0.0	0.0	
Securities except shares	0.0	0.0	0.0	0.0	0.0	0.0	
Loans	1.1	20.6	0.2	0.0	21.9	0.2	
Equity	0.0	0.0	0.0	0.0	0.0	0.0	
Technical provisions	0.0	0.0	0.0	0.0	0.0	0.0	
Other	2.7	1.0	0.5	0.0	4.2	0.1	
Total	98.8	134.0	53.9	89.1	377.2	101.8	479.0
Cash and deposits	11.1	10.8	5.2	38.1	66.1	10.9	
Securities except shares	1.7	25.7	1.4	1.6	30.5	8.4	
Loans	8.4	78.3	2.8	2.7	92.2	46.1	
Equity	44.4	15.5	36.0	32.4	128.5	22.1	
Technical provisions	1.1	0.7	0.1	8.7	10.6	0.3	
Other	32.0	3.0	8.4	5.5	49.1	13.9	
Rest of the world	25.0	43.7	1.3	14.4	84.4		84.4
Cash and deposits	0.3	8.1	0.0	11.5	20.0		
Securities except shares	0.1	23.7	0.3	0.1	24.2		
Loans	1.9	5.0	0.0	0.0	7.0		
Equity	7.1	6.0	0.6	2.1	15.8		
Technical provisions	0.0	0.1	0.0	0.3	0.4		
Other	15.5	0.9	0.5	0.3	17.1		
Total claims	123.8	177.7	55.2	103.5	461.6	101.8	563.5

Note: The table is based on financial accounts compiled by the Bank of Slovenia. The unconsolidated figures have been restructured into the form of a matrix with the aim of illustrating the underlying mutual financial ties between domestic sectors and the rest of the world.

Source: Bank of Slovenia

Table 1.3: Inter-sector financial claims and liabilities of sectors of the Slovenian economy at the end of 2005 as a percentage of GDP

(% of GDP)	Claims						
	Domestic sectors					Rest of the world	Total liabilities
Liabilities	Corporates	Financial sector	Government	Households	Total		
Corporates	69.4	54.9	26.6	29.8	180.8	39.6	220.4
Cash and deposits	0.0	0.0	0.0	0.0	0.0	0.0	
Securities except shares	0.3	1.2	0.1	0.1	1.8	0.1	
Loans	7.2	42.4	1.0	2.9	53.5	10.8	
Equity	39.4	9.9	21.1	22.5	92.8	17.6	
Technical provisions	0.0	0.0	0.0	0.0	0.0	0.0	
Other	22.4	1.4	4.4	4.4	32.7	11.1	
Financial sector	18.2	34.5	10.1	54.9	117.6	44.5	162.1
Cash and deposits	11.2	8.9	4.4	39.5	64.0	8.3	
Securities except shares	0.7	15.8	0.5	0.1	17.2	1.2	
Loans	0.3	5.1	0.0	0.2	5.6	31.0	
Equity	4.0	3.6	4.0	7.0	18.5	3.5	
Technical provisions	1.1	0.8	0.0	7.8	9.6	0.3	
Other	0.9	0.3	1.1	0.4	2.7	0.2	
Government	5.0	19.0	11.6	2.0	37.6	8.3	45.8
Cash and deposits	0.0	0.0	0.0	0.1	0.1	0.0	
Securities except shares	0.7	16.1	1.0	1.4	19.2	6.1	
Loans	0.3	2.4	1.8	0.0	4.5	1.3	
Equity	0.0	0.0	4.4	0.0	4.4	0.0	
Technical provisions	0.0	0.0	0.0	0.0	0.0	0.0	
Other	4.0	0.4	4.5	0.5	9.4	0.9	
Households	4.3	18.8	0.7	0.0	23.7	0.3	24.0
Cash and deposits	0.0	0.0	0.0	0.0	0.0	0.0	
Securities except shares	0.0	0.0	0.0	0.0	0.0	0.0	
Loans	1.2	17.6	0.2	0.0	19.0	0.2	
Equity	0.0	0.0	0.0	0.0	0.0	0.0	
Technical provisions	0.0	0.0	0.0	0.0	0.0	0.0	
Other	3.1	1.2	0.4	0.0	4.7	0.1	
Total	97.0	127.3	49.1	86.7	361.6	92.6	454.3
Cash and deposits	11.2	8.9	4.4	39.5	64.9	8.3	
Securities except shares	1.8	33.2	1.6	1.6	38.4	7.4	
Loans	9.1	67.6	3.2	3.0	82.9	43.3	
Equity	43.4	13.5	29.4	29.4	116.0	21.1	
Technical provisions	1.1	0.8	0.0	7.8	9.6	0.3	
Other	30.6	3.3	10.4	5.3	49.8	12.3	
Rest of the world	22.7	42.7	3.7	11.5	80.5		80.5
Cash and deposits	0.2	10.4	0.0	9.8	20.4		
Securities except shares	0.1	24.7	0.3	0.1	25.1		
Loans	2.0	3.3	0.0	0.0	5.3		
Equity	7.6	3.7	0.5	1.2	13.0		
Technical provisions	0.0	0.0	0.0	0.2	0.3		
Other	12.7	0.6	2.9	0.2	16.3		
Total claims	119.8	170.0	52.7	98.2	442.2	92.6	534.8

Note: The table is based on financial accounts compiled by the Bank of Slovenia. The unconsolidated figures have been restructured into the form of a matrix with the aim of illustrating the underlying mutual financial ties between domestic sectors and the rest of the world.

Source: Bank of Slovenia

2. Financial system

Table 2.1: Structure of the financial system

	Total assets (EUR million)		Structure (%)		As % of GDP		No. of institutions	
	2006	2007	2006	2007	2006	2007	2006	2007
Monetary financial institutions[1]	33,929	42,450	72.0	73.2	111.4	126.6	25	27
Banks	33,718	42,195	71.6	72.8	110.7	125.8	22	24
Banks under private ownership	26,211	34,405	55.6	59.4	86.1	102.6	-	-
Domestic	12,604	16,687	26.7	28.8	41.4	49.7	-	-
Foreign	13,607	17,719	28.9	30.6	44.7	52.8	-	-
Banks under gov. ownership	7,507	7,789	15.9	13.4	24.7	23.2	-	-
Savings banks	211	255	0.4	0.4	0.7	0.8	3	3
Non-monetary financial institutions	13,044	15,508	27.7	26.8	42.8	46.2	-	-
Insurers[2]	3,895	4,959	8.3	8.6	12.8	14.8	15	16
pension funds[3]	893	1,001	1.9	1.7	2.9	3.0	11	10
Investment funds	2,845	4,138	6.0	7.1	9.3	12.3	106	116
Leasing companies[4 5]	4,041	4,041	8.6	7.0	13.3	12.0	20	20
BHs, MCs and others[5]	1,370	1,370	2.9	2.4	4.5	4.1	-	-
Total	47,123	57,958	100.0	100.0	154.8	172.8	-	-

Notes: Figures for financial institutions which are not banks, insurers, pension companies or pension and investment funds are obtained from the AJPES database of annual accounts based on the 2008 Standard Classification of Activities.
[1]Monetary financial institutions do not include the central bank. [2]Total assets of reinsurance companies according to figures at the end of the 3rd quarter of 2007. [3]The First Pension Fund is taken into account among pension funds. [4]The number of active members of the Slovenian Leasing Association is taken as the number of leasing companies. [5]Total assets according to figures for the end of 2006.
Sources: Bank of Slovenia, ISA, SMA, SLA, AJPES

Table 2.2: Market concentration of individual types of financial institutions

		Banks		Insurers		Pension funds		Investment funds		Leasing companies	
		2006	2007	2006	2007	2006	2007	2006	2007	2006	2007
HHI	All companies	1,321	1,301	2,599	2,587	1,712	2,068	569	537	1,923	1,701
	Five largest	1,152	1,167	2,550	2,534	1,663	2,058	458	435	1,797	1,566
Share (%)	Five largest	62	60	81	78	89	94	44	42	74	68
	Largest	30	31	47	48	24	29	14	13	39	36

Note: The Herfindahl-Hirschmanov Index (HHI) is calculated in terms of total assets with the exception of leasing companies for which it is calculated in terms of volume of transactions concluded. The term Pension funds does not include the First Pension Fund, which is a closed pension fund that does not envisage further inflows.
Sources: Bank of Slovenia, ISA, SMA, SLA, AJPES

Table 2.3: Financial indicators for individual types of financial institutions

	2003	2004	2005	2006	2007
	Pre-tax profit (EUR million)				
Banks	199.3	234.2	261.2	393.7	513.7
Insurers and reinsurance companies	30.4	22.7	47.2	67.8	100.3
Leasing companies	32.0	37.0	49.0	55.0	
Managment companies	-	17.0	18.0	17.0	
	ROA (%)				
Banks	1.00	1.10	1.00	1.30	1.40
Insurers and reinsurance companies	1.24	0.79	1.45	1.74	2.02
Leasing companies	2.03	1.82	1.79	1.55	
Managment companies	-	13.12	14.01	11.64	
	ROE (%)				
Banks	11.89	12.70	12.70	15.10	16.30
Insurers and reinsurance companies	7.46	4.53	8.66	9.69	11.78
Leasing companies	27.84	26.44	25.57	21.26	
Managment companies	-	20.79	20.24	16.74	

Note: [1] Net profit for the financial year (profit after tax) is taken into account for insurers and reinsurance companies. Data up to the third quarter of 2007 are taken into account for reinsurance companies.
Sources: Bank of Slovenia, ISA, AJPES

Table 2.4: Direct ownership structure of the Slovenian financial system (shares valued at market price or book value) in percentages

	Ownership structure (%)				
ISSUERS / HOLDERS	Banks	Other financial intermediaries	Insurers and pension funds	Corporates	Total
			2004		
Non-financial corporations	25	23	12	26	25
Banks	10	7	7	2	4
Other financial intermediaries	5	12	16	20	17
Insurers and pension funds	3	7	10	2	3
Government	23	0	44	17	17
Households	2	43	1	18	18
Non-resident	30	3	8	10	12
Others	1	4	1	5	5
Total	100	100	100	100	100
			2005		
Non-financial corporations	24	30	14	31	29
Banks	8	8	7	3	4
Other financial intermediaries	2	9	1	11	10
Insurers and pension funds	3	8	10	1	2
Government	23	8	54	23	23
Households	2	34	1	17	16
Non-resident	36	2	10	11	13
Others	2	2	0	3	2
Total	100	100	100	100	100
			2006		
Non-financial corporations	24	29	16	29	28
Banks	8	10	5	3	5
Other financial intermediaries	2	15	1	9	8
Insurers and pension funds	3	6	9	2	3
Government	20	7	56	25	24
Households	2	30	4	18	16
Non-resident	39	1	8	11	15
Others	1	2	1	3	2
Total	100	100	100	100	100
			2007		
Non-financial corporations	17	33	22	33	29
Banks	7	8	6	2	4
Other financial intermediaries	5	16	1	10	9
Insurers and pension funds	3	7	9	2	3
Government	25	1	47	24	23
Households	8	32	6	19	17
Non-resident	34	2	9	11	14
Others	0	2	1	1	1
Total	100	100	100	100	100

Note: The figures for the proportion of issued shares held by the government for 2004 and 2005 are not comparable, as in October 2005 Kapitalska družba was reclassified from the sector of other financial intermediaires (S.123) to the government sector (S.13).

Sources: CSCC, own calculations

3. Banking Sector

Table 3.1: Banking sector's balance sheet: amounts in EUR million and growth rates in percentages

	(EUR million)					Growth rate (%)				
	2003	2004	2005	2006	2007	2003	2004	2005	2006	2007
ASSETS	21,098	23,691	29,287	33,868	42,195	11.0	12.3	23.6	15.6	24.6
1) Cash	590	589	599	1,057	604	-1.3	-0.3	1.9	76.3	-42.9
2) Loans to banks (including BoS)	1,440	2,118	2,872	3,067	4,066	-9.5	47.0	35.6	6.8	32.6
3) Loans to non-banking sectors	10,591	12,810	16,149	20,414	28,046	16.3	21.0	26.1	26.4	37.4
3.1 Currency breakdown										
Domestic currency	7,546	8,349	8,757	9,095	26,433	9.4	10.6	4.9	3.9	190.6
Foreign currency	3,045	4,461	7,392	11,320	1,613	37.7	46.5	65.7	53.1	-85.8
3.2 Maturity breakdown										
Short-term	3,816	4,369	5,219	6,821	9,666	11.4	14.5	19.5	30.7	41.7
Long-term	6,776	8,441	10,931	13,593	18,381	19.3	24.6	29.5	24.4	35.2
3.3 Sector breakdown										
Non-financial corporations	6,664	8,087	9,908	12,364	16,809	24.5	21.4	22.5	24.8	35.9
Household	2,625	3,186	4,078	5,060	6,429	11.8	21.4	28.0	24.1	27.1
Government	592	596	665	574	465	-34.3	0.7	11.6	-13.8	-18.9
Others	710	940	1,498	2,417	4,344	41.2	32.4	59.4	61.3	79.7
4) Financial assets/securities	7,224	6,904	8,243	7,719	7,459	10.9	-4.4	19.4	-6.4	-3.4
4.1 Currency breakdown										
Domestic currency	4,195	3,964	5,406	5,014	6,506	19.4	-5.5	36.4	-7.2	29.7
Foreign currency	2,680	2,545	2,254	2,006	56	1.9	-5.0	-11.5	-11.0	-97.2
4.2 Maturity breakdown										
Short-term	4,396	3,336	3,595	2,101	1,192	9.2	-24.1	7.8	-41.6	-43.3
Long-term	2,479	3,173	4,064	4,919	5,369	17.0	28.0	28.1	21.1	9.1
4.3 Sector breakdown										
Government	2,061	2,508	2,706	2,718	4,283	6.8	21.7	7.9	0.5	57.5
Bank of Slovenia	4,286	3,198	3,501	1,789	0	11.7	-25.4	9.5	-48.9	-100.0
Others	877	1,198	2,037	3,211	3,176	17.6	36.6	70.0	57.7	-1.1
5) Capital investments	294	319	356	427	615	24.5	8.3	11.6	19.9	43.9
6) Other	957	952	931	1,006	1,144	-0.7	-0.6	-2.2	8.0	13.7
LIABILITIES	21,098	23,691	29,287	33,868	42,195	11.0	12.3	23.6	15.6	24.6
1) Liabilities to banks (including BoS)	3,487	4,664	8,397	10,797	15,958	42.9	33.7	80.0	28.6	47.8
Foreign banks	2,949	4,235	7,892	10,112	14,293	51.5	43.6	86.4	28.1	41.3
2) Deposits by non-banking sectors	13,748	14,716	16,018	17,507	19,366	4.6	7.0	8.8	9.3	10.6
2.1 Currency breakdown										
Domestic currency	9,173	9,623	10,716	11,653	18,833	5.2	4.9	11.4	8.7	61.6
Foreign currency	4,574	5,092	5,300	5,853	532	3.5	11.3	4.1	10.4	-90.9
2.2 Maturity breakdown										
Short-term	11,335	12,644	14,017	15,341	17,612	7.5	11.6	10.9	9.4	14.8
Long-term	2,413	2,071	1,999	2,165	1,754	-7.0	-14.2	-3.5	8.3	-19.0
2.3 Sector breakdown										
Non-financial corp. & OFI	3,675	3,888	4,340	4,787	4,804	3.4	5.8	11.6	10.3	0.4
Household	9,086	9,946	10,545	11,322	12,370	8.1	9.5	6.0	7.4	9.3
Government	659	565	867	1,114	1,510	-23.9	-14.3	53.4	28.5	35.6
Others	328	316	266	285	681	3.7	-3.8	-15.6	6.9	139.0
3) Securities	903	939	992	976	963	22.6	4.0	5.7	-1.6	-1.3
3.1 Currency breakdown										
Domestic currency	882	923	973	969	962	23.1	4.6	5.5	-0.4	-0.7
Foreign currency	21	16	19	7	1	4.2	-22.8	17.6	-63.9	-85.1
3.2 Maturity breakdown										
Short-term	86	77	21	8	11	-1.1	-10.7	-73.3	-63.0	49.4
Long-term	816	861	971	968	952	25.8	5.5	12.8	-0.3	-1.7
4) Provisions	423	502	180	184	207	10.6	18.8	-64.1	2.2	12.3
5) Subordinated debt	400	599	709	993	1,470	40.2	49.7	18.4	40.0	48.1
6) Capital	1,749	1,918	2,486	2,841	3,557	10.6	9.7	29.6	14.3	25.2
7) Others	1,292	1,293	1,497	1,546	1,638	9.7	0.1	15.8	3.3	5.9

Notes: Converted to euros at the conversion rate.
The 2006 and 2007 figures are those reported under the IFRS, while those for previous years are based on estimated values in accordance with the IFRS.
Source: Bank of Slovenia

Table 3.2: Banking sector's balance sheet: as a proportion of total assets, and as a proportion of GDP in percentages

	Proportion of total assets (%)					As % of GDP				
	2003	2004	2005	2006	2007	2003	2004	2005	2006	2007
ASSETS	100.0	100.0	100.0	100.0	100.0	85.4	88.8	103.7	111.2	125.8
1) Cash	2.8	2.5	2.0	3.1	1.4	2.4	2.2	2.1	3.5	1.8
2) Loans to banks (including BoS)	6.8	8.9	9.8	9.1	9.6	5.8	7.9	10.2	10.1	12.1
3) Loans to non-banking sectors	50.2	54.1	55.1	60.3	66.5	42.9	48.0	57.2	67.0	83.6
3.1 Currency breakdown										
Domestic currency	35.8	35.2	29.9	26.9	62.6	30.5	31.3	31.0	29.9	78.8
Foreign currency	14.4	18.8	25.2	33.4	3.8	12.3	16.7	26.2	37.2	4.8
3.2 Maturity breakdown						0.0	0.0	0.0	0.0	0.0
Short-term	18.1	18.4	17.8	20.1	22.9	15.4	16.4	18.5	22.4	28.8
Long-term	32.1	35.6	37.3	40.1	43.6	27.4	31.6	38.7	44.6	54.8
3.3 Sector breakdown										
Non-financial corporations	31.6	34.1	33.8	36.5	39.8	27.0	30.3	35.1	40.6	50.1
Household	12.4	13.5	13.9	14.9	15.2	10.6	11.9	14.4	16.6	19.2
Government	2.8	2.5	2.3	1.7	1.1	2.4	2.2	2.4	1.9	1.4
Others	3.4	4.0	5.1	7.1	10.3	2.9	3.5	5.3	7.9	13.0
4) Financial assets/securities	34.2	29.1	28.1	22.8	17.7	29.2	25.9	29.2	25.4	22.2
4.1 Currency breakdown										
Domestic currency	19.9	16.7	18.5	14.8	15.4	17.0	14.9	19.1	16.5	19.4
Foreign currency	12.7	10.7	7.7	5.9	0.1	10.8	9.5	8.0	6.6	0.2
4.2 Maturity breakdown						0.0	0.0	0.0	0.0	0.0
Short-term	20.8	14.1	12.3	6.2	2.8	17.8	12.5	12.7	6.9	3.6
Long-term	11.7	13.4	13.9	14.5	12.7	10.0	11.9	14.4	16.2	16.0
4.3 Sector breakdown										
Government	9.8	10.6	9.2	8.0	10.1	8.3	9.4	9.6	8.9	12.8
Bank of Slovenia	20.3	13.5	12.0	5.3	0.0	17.3	12.0	12.4	5.9	0.0
Others	4.2	5.1	7.0	9.5	7.5	3.6	4.5	7.2	10.5	9.5
5) Capital investments	1.4	1.3	1.2	1.3	1.5	1.2	1.2	1.3	1.4	1.8
6) Other	4.5	4.0	3.2	3.0	2.7	3.9	3.6	3.3	3.3	3.4
LIABILITIES	100	100	100	100	100	85.4	88.8	103.7	111.2	125.8
1) Liabilities to banks (including BoS)	16.5	19.7	28.7	31.9	37.8	14.1	17.5	29.7	35.5	47.6
Foreign banks	14.0	17.9	26.9	29.9	33.9	11.9	15.9	27.9	33.2	42.6
2) Deposits by non-banking sectors	65.2	62.1	54.7	51.7	45.9	55.6	55.2	56.7	57.5	57.7
2.1 Currency breakdown										
Domestic currency	43.5	40.6	36.6	34.4	44.6	37.1	36.1	37.9	38.3	56.1
Foreign currency	21.7	21.5	18.1	17.3	1.3	18.5	19.1	18.8	19.2	1.6
2.2 Maturity breakdown						0.0	0.0	0.0	0.0	0.0
Short-term	53.7	53.4	47.9	45.3	41.7	45.9	47.4	49.6	50.4	52.5
Long-term	11.4	8.7	6.8	6.4	4.2	9.8	7.8	7.1	7.1	5.2
2.3 Sector breakdown										
Non-financial corp. & OFI	17.4	16.4	14.8	14.1	11.4	14.9	14.6	15.4	15.7	14.3
Household	43.1	42.0	36.0	33.4	29.3	36.8	37.3	37.3	37.2	36.9
Government	3.1	2.4	3.0	3.3	3.6	2.7	2.1	3.1	3.7	4.5
Others	1.6	1.3	0.9	0.8	1.6	1.3	1.2	0.9	0.9	2.0
3) Securities	4.3	4.0	3.4	2.9	2.3	3.7	3.5	3.5	3.2	2.9
3.1 Currency breakdown										
Domestic currency	4.2	3.9	3.3	2.9	2.3	3.6	3.5	3.4	3.2	2.9
Foreign currency	0.1	0.1	0.1	0.0	0.0	0.1	0.1	0.1	0.0	0.0
3.2 Maturity breakdown										
Short-term	0.4	0.3	0.1	0.0	0.0	0.3	0.3	0.1	0.0	0.0
Long-term	3.9	3.6	3.3	2.9	2.3	3.3	3.2	3.4	3.2	2.8
4) Provisions	2.0	2.1	0.6	0.5	0.5	1.7	1.9	0.6	0.6	0.6
5) Subordinated debt	1.9	2.5	2.4	2.9	3.5	1.6	2.2	2.5	3.3	4.4
6) Capital	8.3	8.1	8.5	8.4	8.4	7.1	7.2	8.8	9.3	10.6
7) Others	6.1	5.5	5.1	4.6	3.9	5.2	4.8	5.3	5.1	4.9

Source: Bank of Slovenia

Table 3.3: Banking sector's income statement: amounts in EUR million and growth rates in percentages

	(EUR million)					Growth rate (%)				
	2003	2004	2005	2006	2007	2003	2004	2005	2006	2007
1. Net interest income	608	599	631	690	811	2.9	-1.4	5.4	9.2	17.5
1.1 Interest income	1,382	1,194	1,198	1,421	1,943	-3.8	-13.6	0.3	18.6	36.7
1.2 Interest expenses	774	595	567	731	1,133	-8.4	-23.1	-4.8	29.0	54.9
2. Net non-interest income	326	383	417	526	617	2.9	17.3	9.0	26.0	17.3
2.1 Net fees and commissions	229	258	282	309	335	1.8	12.7	9.1	9.5	8.7
2.2 Net income from trading in financial assets	67	84	71	97	136	-5.9	25.9	-15.7	37.2	39.7
2.3 Net other	30	40	65	120	146	45.7	33.5	60.0	85.7	21.5
3. Gross income (1+2)	934	982	1,049	1,216	1,428	-22.6	5.2	6.8	15.9	17.4
4. Operating costs	591	612	647	702	753	7.4	3.6	5.8	8.5	7.2
Labour costs	304	326	342	367	400	9.5	7.4	5.0	7.3	8.8
5. Net income (3-4)	343	370	401	513	675	-4.1	7.9	8.5	28.0	31.5
6. Net provisions	143	136	140	120	161	-13.3	-5.4	3.2	-14.5	34.6
7. Total costs (4+6)	734	748	787	822	914	2.7	1.8	5.3	4.4	11.2
8. Pre-tax profit (3-7)	199	234	261	394	514	3.8	17.5	11.5	50.7	30.5
9. Taxes	69	81	52	91	102	-0.6	17.9	-35.9	75.5	11.9
10 Net profit (8-9)	131	153	209	303	412	6.2	17.3	36.5	44.6	36.1

Notes: Converted to euros at the conversion rate.
The 2006 and 2007 figures are those reported under the IFRS, while those for previous years are based on estimated values in accordance with the IFRS.
Source: Bank of Slovenia

Table 3.4: Banking sector's income statement: as proportion of gross income and as proportion of total assets in percentages

	Proportion of gross income (%)					Ratio to total assets (%)				
	2003	2004	2005	2006	2007	2003	2004	2005	2006	2007
1. Net interest income	65	61	60	57	57	2.9	2.5	2.2	2.0	1.9
1.1 Interest income	148	122	114	117	136	6.5	5.0	4.1	4.2	4.6
1.2 Interest expenses	83	61	54	60	79	3.7	2.5	1.9	2.2	2.7
2. Net non-interest income	34.9	39.0	39.8	43.3	43.2	1.5	1.6	1.4	1.6	1.5
2.1 Net fees and commissions	25	26	27	25	23	1.1	1.1	1.0	0.9	0.8
2.2 Net income from trading in financial assets	7	9	7	8	10	0.3	0.4	0.2	0.3	0.3
2.3 Net other	3	4	6	10	10	0.1	0.2	0.2	0.4	0.3
3. Gross income (1+2)	100	100	100	100	100	4.4	4.1	3.6	3.6	3.4
4. Operating costs	63	62	62	58	53	2.8	2.6	2.2	2.1	1.8
Labour costs	33	33	33	30	28	1.4	1.4	1.2	1.1	0.9
5. Net income (3-4)	37	38	38	42	47	1.6	1.6	1.4	1.5	1.6
6. Net provisions	15	14	13	10	11	0.7	0.6	0.5	0.4	0.4
7. Total costs (4+6)	79	76	75	68	64	3.5	3.2	2.7	2.4	2.2
8. Pre-tax profit (3-7)	21	24	25	32	36	0.9	1.0	0.9	1.2	1.2
9. Taxes	7	8	5	8	7	0.3	0.3	0.2	0.3	0.2
10 Net profit (8-9)	14	16	20	25	29	0.6	0.6	0.7	0.9	1.0

Source: Bank of Slovenia

Table 3.5: Selected performance indicators for the banking sector

	2003	2004	2005	2006	2007
1) Profitability and margins (%)					
ROA	1.0	1.1	1.0	1.3	1.4
ROE	11.9	12.7	12.7	15.1	16.3
CIR	63.3	62.3	61.7	57.8	52.7
Financial intermediation margin	4.7	4.4	4.0	3.9	3.8
Interest margin (per total assets)	3.1	2.7	2.4	2.2	2.2
Non-interest margin (per total assets)	1.6	1.7	1.6	1.7	1.6
Net interest margin (per interest-bearing assets)	3.4	2.9	2.6	2.4	2.3
Interest spread[1]	4.5	4.3	3.8	3.8	2.3
2) Structure of assets and liabilities (%)					
2.1 Maturity breakdown of loans to non-banking sectors					
Short-term loans/loans	36.0	34.1	32.3	33.4	34.5
Long-term loans/loans	64.0	65.9	67.7	66.6	65.5
2.2 Maturity breakdown of deposits by non-banking sectors					
Short-term deposits/deposits	82.4	85.9	87.5	87.6	90.9
Long-term deposits/deposits	17.6	14.1	12.5	12.4	9.1
2.3 Regional breakdown of loans					
Residents	96.7	96.1	95.4	94.4	92.2
Non-residents	3.3	3.9	4.6	5.6	7.8
2.4 Foreign currency sub-balance					
Foreign currency assets/total assets	33.4	35.9	40.5	45.9	6.0
Foreign currency liabilities/total assets	34.5	38.1	42.9	46.8	4.9
Difference	-1.1	-2.3	-2.4	-0.8	1.1
Foreign currency loans/loans	35.1	38.6	48.7	55.9	6.4
Foreign currency deposits/deposits	40.9	44.5	49.4	53.3	5.9
Foreign currency loans/loans (non-banking sectors)	28.8	34.8	45.8	55.4	5.8
Foreign currency deposits/deposits (non-banking sectors)	33.3	34.6	33.1	33.4	2.7
2.5 Securities					
Securities/loans to non-banking sectors	67.8	53.5	50.4	37.3	26.4
2.6 Breakdown by sector					
Corporate					
Corporate loans/loans to non-banking sectors	66.2	66.5	65.9	66.7	67.5
Foreign currency corporate loans/corporate loans	37.3	44.9	57.0	65.4	3.7
Household					
Household loans/loans to non-banking sectors	24.9	25.0	25.3	24.9	23.1
Foreign currency household loans/household loans	1.0	3.0	11.8	23.2	10.2
Government					
Loans to government/loans to non-banking sectors	5.6	4.7	4.1	2.8	1.7
Non-residents					
Liabilities to foreign banks/total assets	14.0	17.9	26.9	29.9	33.9
3. Asset quality					
Impairments (EUR million)	1,015.2	1,064.5	1,168.7	1,233.8	1,311.1
Classified claims (EUR million)	17,150.7	20,428.1	25,209.1	31,581.0	40,541.6
Impairments/classified claims (%)	5.9	5.2	4.6	3.9	3.2
Non-performing claims/classified claims (%)	3.7	3.0	2.5	2.5	1.8
Impairments for non-performing claims/non-performing claims (%)	81.0	80.1	80.6	84.3	86.4
Non-performing claims/regulatory capital (%)	41.4	33.8	30.8	31.0	20.8
Non-performing claims minus impairments/capital (%)	7.9	6.7	6.0	4.9	2.8
Sum of large exposures/capital (%)	214.1	196.2	226.2	222.9	217.4
4) Interest-rate risk					
Diff. between proportions of interest bearing assets and liabilities (percentage points)	3.5	3.7	3.7	3.7	5.0
Interest-bearing assets/assets (%)	90.3	90.1	90.2	91.3	95.1
Interest-bearing liabilities/liabilities (%)	86.8	86.4	86.5	87.6	90.1
5) Exchange-rate risk (%)					
Open foreign exchange position/regulatory capital	122.5	23.4	21.7	25.8	0.9
6) Liquidity					
Average liquid assets/average short-term deposits by non-banking sectors (%)	8.9	9.7	9.5	9.7	8.4
Average liquid assets/average total assets (%)	4.9	5.3	4.8	4.5	3.6
Category 1 liquidity ratio	1.14	1.11	1.12	1.13	1.18
Category 2 liquidity ratio	1.09	1.10	1.11	1.15	1.11
Proportion of debt securities in total assets (%)	32.6	27.5	26.2	20.8	15.6
7) Solvency and capital structure (%)					
Capital adequacy	11.5	11.8	10.5	11.1	11.2
Original own funds adequacy	9.8	9.0	8.9	9.3	8.9
Additional own funds/original own funds	39.4	50.9	45.3	38.0	48.5

Notes: [1] Spread between the average effective tolar interest rate (until the end of 2006) on loans and deposits by non-banking sectors in the final quarter.
[2] The 2006 and 2007 figures are those reported under the IFRS, while those for previous years are based on estimated values in accordance with the IFRS.

Source: Bank of Slovenia

Table 3.6: Financial stability indicators

(%)	2005	2006	2007
Capital adequacy			
Capital/capital requirements	10.56	11.08	11.19
Original own funds/capital requirements	8.88	9.35	8.89
Non-performing (D- and E-rated) assets net of provisions/capital	5.09	4.86	2.82
Asset quality			
Non-performing (D- and E-rated) assets/total assets	2.90	2.52	1.78
Sector breakdown of loans			
Loans to banks/loans	2.37	2.80	2.84
Loans to central bank/loans	4.28	5.87	0.02
Loans to other financial institutions/loans	3.32	4.00	5.79
Loans to government/loans	3.69	5.11	3.03
Loans to non-financial corporations/loans	53.13	49.93	50.67
Loans to others (domestic sector)/loans	21.12	20.80	20.05
Loans to non residents/loans	12.09	11.49	17.61
Profitability			
ROA (before extraordinary items and taxes)	1.01	1.25	1.36
ROE (before extraordinary items and taxes)	13.78	15.07	15.88
Net interest income/gross income	52.84	52.82	53.3
Non-interest income/gross income	62.40	60.74	56.42
Liquidity			
Liquid assets/total assets	30.33	26.66	18.05
Liquid assets/short-term deposits by non-banking sectors	59.54	56.83	41.9
Sensitivity to market risks			
Net open foreign exchange position/capital	21.71	25.79	0.82

Notes: The table gives the basic financial stability indicators in line with IMF methodology. The indicators for 2005 are calculated on the basis of the SAS, while those for 2006 and 2007 are based on the IFRS. The methodology for calculating liquidity indicators has changed due to the adoption of the euro. Therefore the values for 2005 and 2006 are different than those previously published. The euro is classed as domestic currency in the 2007 figure for net open foreign exchange position/capital.

Source: Bank of Slovenia

4. Insurers

Table 4.1: Total assets and operating results of insurance companies and reinsurance companies

	2003	2004	2005	2006	2007	2004	2005	2006	2007
	(EUR million)					Growth rate (%)			
	Insurers								
Total assets	2,193	2,560	2,946	3,519	4,550	16.7	15.1	19.4	29.3
Non-life insurance	1,293	1,444	1,565	1,806	2,251	11.6	8.4	15.4	24.6
Life insurance	899	1,116	1,381	1,713	2,299	24.1	23.8	24.0	34.2
Results									
Result from non-life insurance excluding health insurance[1]	14.4	17.9	47.1	64.9	69.1	24.5	162.8	37.6	6.5
Result from health insurance[1]	8.6	-9.0	-8.6	-2.1	9.9	-203.7	-4.0	-75.7	-573.4
Result from life insurance[1]	13.9	11.6	14.1	13.9	20.8	-17.0	21.7	-1.2	49.5
Income from investments	84.8	87.9	78.0	74.6	118.7	3.6	-11.2	-4.4	59.1
Expenses from investments	23.9	17.0	18.6	13.1	21.2	-29.0	9.8	-29.7	62.0
Net profit[2]	20.9	13.7	37.6	51.5	95.1	-34.5	217.3	37.2	84.7
ROE (%)	6.26	3.29	8.39	8.74	10.09				
ROA (%)	0.96	0.54	1.27	1.46	2.09				
	Reinsurance companies[3]								
Total assets	277	308	314	368	408	11.2	4.0	17.3	11.0
Results									
Result from non-life insurance excluding health insurance	7.8	8.6	10.8	16.0	13.1	11.3	34.9	47.8	-18.2
Income from investments	17.6	14.4	14.4	15.6	15.6	-18.5	-24.1	8.2	0.0
Expenses from investments	2.1	2.5	2.7	2.4	5.1	17.9	-22.7	-11.4	109.1
Net profit	9.5	9.0	9.7	16.3	5.2	-5.6	19.2	68.4	-68.3
ROE (%)	12.84	10.60	9.87	4.42	3.46				
ROA (%)	3.43	2.92	3.08	14.82	1.26				

Notes: [1] Result from ordinary activities.
[2] Net profit from the accounting period is calculated after taxes.
[3] The 2007 figures relate to September.
Sources: ISA, own calculations

Table 4.2: Capital adequacy of insurance companies and reinsurance companies

						Growth rate (%)			
	2003	2004	2005	2006	2007	2004	2005	2006	2007
	Insurers – total								
Minimum capital requirement (EUR million)	160.5	181.8	200.7	220.1	256.8	13.3	10.4	9.7	16.7
Surplus (EUR million)	84.8	97.1	72.0	155.0	204.0	14.5	-25.8	115.3	31.6
Surplus/minimum capital requirement (%)	52.8	53.4	35.9	70.4	79.4	1.1	-32.8	96.3	12.8
	Life insurance								
Surplus/minimum capital requirement (%)		-3.6	26.3	66.6	59.5				
Original own funds/net technical provisions (%)		5.3	7.8	10.0	12.8				
	Non-life insurance including health insurance								
Surplus/minimum capital requirement (%)		77.0	40.0	72.1	89.0				
Original own funds/net collected premium (%)		22.2	19.6	26.2	63.5				
	Reinsurance companies								
Minimum capital requirement (EUR million)	17.1	18.2	19.3	21.9	25.2	6.8	2.8	7.4	14.9
Surplus (EUR million)	29.1	31.7	30.8	51.8	62.5	8.9	-6.6	102.1	20.8
Surplus/minimum capital requirement (%)	170.7	174.0	159.5	236.3	248.3	1.9	-9.1	88.2	5.1
Original own funds/net collected premium (%)	55.6	81.4	82.6	73.8					

Note: The 2007 figures relate to September.
Sources: ISA, own calculations

Table 4.3: Claims ratios for major types of insurance

	2003	2004	2005	2006	2007
			Insurers		
Total	0.64	0.64	0.59	0.57	0.56
Life insurance	0.42	0.36	0.33	0.29	0.27
Voluntary health insurance	0.83	0.87	0.93	0.86	0.80
Non-life insurance excluding health insurance	0.64	0.67	0.59	0.60	0.62
Liability insurance for motor vehicles	0.57	0.64	0.56	0.54	0.55
Motor vehicle insurance	0.80	0.83	0.71	0.76	0.77
Accident insurance	0.61	0.62	0.52	0.44	0.39
Insurance of other damage to property	0.64	0.72	0.70	0.64	0.76
Fire and natural disaster insurance	0.55	0.52	0.43	0.45	0.60
Credit insurance	0.85	0.66	0.61	0.72	0.71
Other non-life insurance	0.70	0.65	0.63	0.77	0.57
			Reinsurance companies		
Total	0.49	0.55	0.49	0.56	0.56

Source: ISA

Table 4.4: Coverage of technical provisions by the assets covering technical provisions

	2003	2004	2005	2006	2007
Technical provisions (EUR million)	1,651	1,879	2,107	2,314	2,551
Growth rate (%)	15	14	12	10	10
Assets covering technical provisions (EUR million)	1,848	2,150	2,476	2,856	3,357
Growth rate (%)	33	16	15	15	18
Assets covering technical provisions/technical provisions (%)	111.9	114.4	117.5	123.4	131.6
Assets covering technical provisions as a % of GDP	7.6	8.2	9.0	9.6	10.0
Mathematical provisions (EUR million)	763	910	1,031	1,165	1,243
Growth rate (%)	21	19	13	13	7
Assets covering mathematical provisions (EUR million)	926	1,152	1,361	1,665	2,042
Growth rate (%)	31	24	18	22	23
Assets covering mathematical provisions/mathematical provisions (%)	119.1	126.5	132.1	142.9	164.3
Assets covering mathematical provisions as a % of GDP	3.8	4.4	5.0	3.9	6.1
Other technical provisions (EUR million)	888	969	1,077	1,284	1,308
Growth rate (%)	11	9	11	19	2
Assets covering technical provisions less assets covering mathematical provisions (EUR million)	921	998	1,114	1,192	1,315
Growth rate (%)	34	8	12	7	10
Assets covering technical provisions less assets covering mathematical provisions/other technical provisions (%)	103.9	103.0	103.5	92.8	100.5
Assets covering technical provisions less assets covering mathematical provisions as a % of GDP	3.8	3.8	4.1	4.3	3.9

Sources: ISA, SORS, own calculations

Table 4.5: Selected indicators for compulsory and voluntary supplementary pension insurance

						Growth rate (%)				
	2003	2004	2005	2006	2007	2003	2004	2005	2006	2007
	Compulsory pension insurance									
Average no. of policyholders at the PDII	834,049	836,668	845,643	857,922	879,090	-0.3	0.3	1.1	1.5	2.5
Average no. of pensioners[1]	517,751	523,854	531,075	536,887	543,473	1.7	1.2	1.4	1.1	1.2
Ratio	1.61	1.60	1.59	1.60	1.62	-2.0	-0.9	-0.4	0.5	1.2
Average pension (EUR)[2]	428	447	461	484	512	5.1	4.5	3.1	4.9	5.7
Average net wage (EUR)	663	693	736	773	835	7.5	4.5	6.2	5.1	7.9
Ratio	0.64	0.65	0.63	0.63	0.61	-2.2	0.0	-2.8	-0.2	-2.0
Average age of new pension recipients	57.7	58.6	58.8	58.9	59.2	0.0	1.6	0.4	0.2	0.5
Men	59.9	60.6	60.4	60.3	60.7	0.0	1.1	-0.3	-0.1	0.6
Women	55.7	56.6	57.1	57.2	57.4	0.3	1.6	0.9	0.1	0.4
	Voluntary supplementary pension insurance									
No. of voluntary supplementary pension insurance policyholders	212,060	404,885	427,645	459,764	486,816	22.5	90.9	5.6	7.5	5.9
Persons in employment	801,383	807,490	813,558	833,016	864,361	-0.9	0.8	0.7	1.4	3.8
Ratio	0.26	0.50	0.53	0.55	0.56	23.6	89.5	4.9	6.0	2.0
Assets (EUR million)	204	398	592	783	956	106.2	95.2	48.7	32.3	22.0
Assets as a % of GDP	0.8	1.5	2.2	2.6	2.8	89.9	81.5	41.7	21.7	8.2
Assets as a % of the financial assets of households	1.0	1.7	2.4	2.5	2.6	86.9	74.7	36.1	13.3	6.5
Collected premium (EUR million)	94	179	182	204	220	81.8	90.4	2.0	11.9	7.9
Premium as a % of PDII tax revenues	4.2	7.4	7.2	7.5	7.5	67.7	77.7	-3.9	5.5	-0.7

Notes: [1] Includes recipients of any type of pension: old-age, disability, family, widow's, military, farmer's and state.
[2] Includes old-age, disability, family and widow's pensions, less tax prepayment.
Sources: PDII, ISA, SMA, SORS, Bank of Slovenia

5. Investment funds

Table 5.1: Overview of investment funds: assets and net inflows of mutual funds in EUR million and year-on-year returns in percentages

	Mutual funds				(Authorised) investments companies					Total inv. funds	
					Assets						
	Net inflows	Assets		UP - MF	Auth. inv. comp.		Inv. companies		PIX	Assets	
	EUR million	EUR million	Growth	Growth	EUR million	Growth	EUR million	Growth	Growth	EUR million	Growth
2000	5	45	22%	4%	2,393	-4%	-	-	3%	2,438	-
2001	7	61	37%	23%	2,287	-4%	-	-	4%	2,348	-4%
2002	122	231	277%	54%	1,352	-41%	578	-	72%	2,161	-8%
2003	107	389	68%	17%	550	-59%	894	55%	24%	1,833	-15%
2004	339	877	126%	18%	-	-	1,209	35%	39%	2,086	14%
2005	138	1,385	58%	7%	-	-	835	-31%	-12%	2,220	6%
2006	163	1,929	39%	19%	-	-	916	10%	28%	2,845	28%
2007	470	2,924	52%	28%			1,213	32%	45%	4,138	45%
2005Q1	59	938	71%	8%	-	-	1,206	0%	10%	2,143	22%
2005Q2	48	1,194	84%	5%	-	-	884	-26%	1%	2,078	13%
2005Q3	6	1,253	59%	3%	-	-	886	-27%	-6%	2,139	6%
2005Q4	26	1,385	58%	7%	-	-	835	-31%	-12%	2,220	6%
2006Q1	29	1,463	56%	11%	-	-	843	-30%	-13%	2,306	8%
2006Q2	38	1,504	26%	11%	-	-	909	3%	-2%	2,413	16%
2006Q3	55	1,697	35%	15%	-	-	970	9%	13%	2,666	25%
2006Q4	41	1,929	39%	19%	-	-	916	10%	28%	2,845	28%
2007Q1	158	2,281	56%	30%	-	-	1,003	19%	46%	3,284	42%
2007Q2	129	2,692	79%	47%	-	-	1,215	34%	64%	3,907	62%
2007Q3	94	2,914	72%	44%	-	-	1,299	34%	51%	4,213	58%
2007Q4	89	2,924	52%	28%	-	-	1,213	32%	45%	4,138	45%

Sources: AMC, SMA, LJSE, own calculations

Table 5.2: Assets of Slovenian and euro area investment funds in EUR billion and in percentages

		Asset value	Annual	Structure with regard to asset type (%)				
		(EUR billion)	growth (%)	Equity	Bond	Balanced	Real estate	Other
Euro area	2002	3,043	-10.1	20.8	37.3	24.7	5.1	12.1
	2003	3,421	12.4	21.9	34.1	25.0	5.4	13.6
	2004	3,832	12.0	21.9	32.3	24.6	5.1	16.1
	2005	4,791	25.0	27.9	32.1	23.2	4.5	12.3
	2006	5,551	15.9	30.3	29.8	24.8	4.2	10.9
	2007Q3	5,895	6.2	30.5	28.1	25.8	4.0	11.6
Slovenia	2002	0.2	278.9	76.3	0.8	22.8		
	2003	0.4	66.9	74.9	1.5	23.6		
	2004	0.9	125.7	67.6	2.2	30.2		
	2005	1.4	57.9	65.7	2.6	31.7		
	2006	1.9	39.3	68.4	1.5	30.1		
	2007	2.9	51.6	71.3	0.9	27.8		

Sources: Bank of Slovenia, ECB

Table 5.3: Mutual funds: number, assets and net inflows in EUR million and returns in percentages

									Growth rate (%)						
	2000	2001	2002	2003	2004	2005	2006	2007	2001	2002	2003	2004	2005	2006	2007
Number															
Total	18	18	18	20	33	50	99	109	0.0	0.0	11.1	65.0	51.5	98.0	10.1
Equity	4	4	4	6	12	26	72	80	0.0	0.0	50.0	100.0	116.7	176.9	11.1
Bond	3	3	3	3	7	9	9	10	0.0	0.0	0.0	133.3	28.6	0.0	11.1
Balanced	11	11	11	11	14	14	16	17	0.0	0.0	0.0	27.3	0.0	14.3	6.3
Money-market	-	-	-	-	-	1	2	2	-	-	-	-	-	-	0.0
Assets															
Domestic MF (EUR million)	45	61	233	389	877	1,385	1,929	2,924	37.6	278.9	66.9	125.7	57.9	39.3	51.6
Equity (%)	21	20	23	25	28	53	58	68	-2.8	12.2	9.5	14.8	85.4	9.6	17.7
Bond (%)	4	6	3	5	5	4	2	1	70.8	-43.4	45.5	2.0	-18.6	-45.3	-47.4
Balanced (%)	76	74	74	70	67	43	40	31	-2.5	0.2	-5.0	-5.3	-35.5	-7.4	-23.0
Bank (%)	25	26	28	25	28	25	30	28	5.1	5.8	-8.5	13.2	-13.4	20.8	-6.5
Non-bank (%)	75	74	72	75	72	75	70	72	-1.7	-2.0	3.2	-4.4	5.3	-6.8	2.7
Foreign MF (EUR million)	-	-	-	-	7	137	308	367	-	-	-	-	-	119.8	19.4
Net annual inflows															
Domestic MF (EUR million)	7	6	120	108	339	138	163	470	-	-	-9.8	212.2	-59.1	18.1	187.3
Equity (%)	50	18	24	29	36	100	130	84							
Bond (%)	2	27	3	9	7	8	-9	-1							
Balanced (%)	48	55	73	62	58	-11	-23	16							
Bank (%)	9	42	30	20	37	52	44	31							
Non-bank (%)	91	58	70	80	63	48	56	69							
Foreign MF (EUR million)	-	-	-	-	-	97	127	2							
Annual UP growth rate (%)															
Total	4	23	54	17	18	7	19	28							
Equity	2	21	57	19	19	11	20	32							
Bond	11	13	18	10	7	3	2	5							
Balanced	4	25	55	17	18	5	18	23							
Bank	11	20	48	16	18	10	15	19							
Non-bank	1	24	57	17	18	6	20	31							

Note: The figures for foreign mutual funds only include those officially marketed in Slovenia.
Sources: SMA, own calculations

Table 5.4: Breakdown of investments by types of investment funds in percentages

(%)	2001	2002	2003	2004	2005	2006	2007
Mutual funds							
Equity	78	63	59	43	36	30	28
Bond	13	23	21	20	15	8	5
Bank deposits	5	4	2	10	4	6	8
Foreign investments	1	1	9	16	39	51	55
Other	3	9	9	11	6	6	4

Source: SMA

6. Leasing companies

Table 6.1: Comparison of leasing business of members of Slovenian and European leasing associations in percentages

(%)	2001	2002	2003	2004	2005	2006	2007
Slovenian leasing companies							
Growth rate - business	26.5	37.8	35.6	12.3	35.5	28.0	34.3
Leasing business as a proportion of gross investments	11.9	15.9	18.7	18.9	24.6	28.2	31.6
Structure of business							
Real estate leasing	21	30	35	30	33	29	31
Equipment leasing	79	70	65	70	66	71	69
Equipment and real estate leasing by individuals for consumption	20	20	20	22	21	19	20
European leasing companies							
Growth rate - business	9.6	3.1	8.3	8.0	11.6	15.3	-
Leasing business as a proportion of gross investments	12.6	13.2	14.6	14.8	15.9	19.0	-
Structure of business							
Real estate leasing	17.1	19.6	16.6	16.2	17.1	15.8	-
Equipment leasing	82.2	80.4	83.4	83.8	82.9	84.2	-

Note: The Leaseurope figures include all European Union member-states with the exception of Luxemburg, Ireland, Cyprus, Malta and Greece, plus Norway, Switzerland, Romania, Ukraine, Bosnia and Herzegovina, Russia and Serbia. Gross investments include capital expenditure but excludes investments in housing for reason of comparability with the Leaseurope figures.

Sources: SLA, SORS, Leaseurope

7. Capital market

Slovenian capital market

Table 7.1: Overview of the regulated securities market in EUR million and in percentages

	Market capitalisation (EUR million)	Market capitalisation (As % of GDP)	Turnover (EUR million)	Turnover (As % of GDP)	Change in value of securities	Growth rate SBI 20 (%)
2000	4,751	26.3	1,125	5.8	0.237	0.1
2001	5,759	28.6	1,454	7.1	0.252	19.0
2002	9,073	40.5	2,007	8.9	0.221	55.2
2003	10,190	42.0	1,420	5.8	0.139	17.7
2004	12,726	48.6	1,655	6.3	0.130	24.7
2005	13,395	48.5	1,840	6.7	0.137	-5.6
2006	18,838	63.4	1,805	6.1	0.096	37.9
2007	26,696	79.6	3,324	9.9	0.125	78.1

Sources: LJSE, SORS

Table 7.2: Number of issuers and issued securities on the LJSE and at the CSCC

	2003	2004	2005	2006	2007	2003	2004	2005	2006	2007
LJSE						Year-on-year change				
Number of issuers	185	173	148	130	119	-12	-12	-25	-18	-8
Number of MF issued	254	254	227	205	188	-10	0	-27	-22	-8
Equity	136	142	112	102	89	-3	6	-30	-10	-13
Bond	92	101	95	93	89	0	9	-6	-2	-4
Investment companies	26	11	10	7	7	-7	-15	-1	-3	0
Number of members	27	27	27	24	24	0	0	0	-3	0
CSCC						Proportion of issuers and MF from LJSE in CSCC (%)				
Number of issuers	869	853	827	810	803	21	20	18	16	-1
Number of MF issued	1,033	1,030	1,043	1,026	995	25	25	22	20	-3
Equity	886	886	910	889	880	15	16	12	11	-1
Bond	120	133	123	115	112	77	76	77	81	-3
Investment companies	27	11	10	7	7	96	100	100	100	0

Sources: LJSE, CSCC

Table 7.3: Comparison of annual trading volume on the LJSE and annual trading volume outside the regulated market in EUR million and in percentages

	2002	2003	2004	2005	2006	2007	2002	2003	2004	2005	2006	2007
LJSE	(EUR million)						Growth rate (%)					
Total trading volume	1,986	1,420	1,655	1,840	1,805	3,324	38.2	-28.5	16.6	11.1	-1.9	84.2
Shares	1,164	623	931	941	1,451	3,035	17.7	-46.4	49.4	1.0	54.3	109.1
Bonds	461	541	474	749	188	166	114.2	17.3	-12.4	58.1	-74.9	-11.8
Investment companies	358	254	250	149	166	124	62.1	-29.0	-1.4	-40.3	10.9	-25.4
Short-term securities	3	1	0	0	6	0	-	-	-	-	-	-
Unregulated securities market	(EUR million)						Proportion of trading volume on the stock exchange (%)					
Total trading volume	1,071	1,684	975	1,059	-	-	54	119	59	58	-	-
Shares	362	343	295	469	-	-	31	55	32	50	-	-
Bonds	111	133	79	150	-	-	24	25	17	20	-	-
Investment companies	0	0	0	0	-	-	-	-	-	-	-	-
Short-term securities	598	1,209	602	441	-	-	-	-	-	-	-	-

Note: The figure for transactions concluded outside the regulated market comprises only transactions concluded by brokerage houses and banks as final purchasers or vendors of non-marketable securities that must be reported to the Securities Market Agency.

Sources: LJSE, SMA

Investments by residents in the rest of the world

Table 7.4: Investments by residents in securities issued in the rest of the world in EUR million and in percentages

	2001	2002	2003	2004	2005	2006	2007	Feb 08
Growth rate of investments in the rest of the world (%)	96.3	27.3	61.7	119.7	130.5	81.5	77	29
Total investments in the rest of the world (EUR million)	290	370	598	1,313	3,027	5,495	9,755	9,471
	Structure by sectors (%)							
Banks	79	49	38	32	39	41	47.4	48.7
Other financial intermediaries	2	21	24	22	21	21	19.1	18.3
Insurers	16	24	26	29	19	18	17.0	17.9
Households	2	5	8	10	11	12	9.7	8.5
Corporates	1	1	3	6	5	4	2.7	2.5
Other	0	0	1	1	5	4	4.0	4.1

Sources: LJSE, Bank of Slovenia

Investments by non-residents in Slovenia

Table 7.5: Non-residents' volume of trading in securities issued in Slovenia in EUR million and in percentages

	Net purchases of non-residents		Volume of trading in shares by non-residents on regulated market	Proportion of volume of trading in shares on org. market
	Regulated market (EUR million)	Unregulated market (EUR million)	(EUR million)	(%)
1999	-9.5	2.8	13.2	1.19
2000	0.9	35.6	17.9	1.59
2001	18.8	265.0	44.0	3.03
2002	-49.6	1406.6	164.4	8.19
2003	2.2	217.9	49.7	3.50
2004	-1.6	138.5	78.5	4.74
2005	41.4	472.9	90.6	5.91
2006	54.6	758.3	-	-
2007	-40.0	484.7	-	-

Sources: CSCC, Bank of Slovenia, LJSE

Table 7.6: Non-residents' investments in securities issued in Slovenia by sector in EUR million and in percentages

	2004	2005	2006	2007	Feb 08
Growth rate of investments by non-residents (%)	54.2	24.9	38.6	23	28
Total investments by non-residents (EUR million)	2,401	3,000	4,129	5,066	5,794
	Structure by domestic sectors (%)				
Corporates	64	57	52	55.3	41.6
Banks	25	25	24	25.5	24.3
Other financial intermediaries	2	1	0	0.7	1.7
Insurers	2	2	2	2.3	2.2
Government	7	16	22	15.8	29.8

Sources: CSCC, Bank of Slovenia, own calculations