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## Contents

	<b>CONCLUSIONS</b>	<b>xii</b>
	<b>EXECUTIVE SUMMARY</b>	<b>xiv</b>
<b>1</b>	<b>MACROECONOMIC ENVIRONMENT</b>	<b>1</b>
1.1	International environment	1
1.2	Economic developments in Slovenia	3
<b>2</b>	<b>HOUSEHOLD SECTOR</b>	<b>6</b>
2.1	Household financial assets	6
2.2	Household financial liabilities	9
<b>3</b>	<b>REAL ESTATE MARKET</b>	<b>11</b>
<b>4</b>	<b>CORPORATE SECTOR</b>	<b>16</b>
4.1	Corporate financing and net indebtedness	16
4.2	Corporate performance and risk by sector	20
<b>5</b>	<b>FINANCIAL SYSTEM</b>	<b>28</b>
5.1	Structure of the financial system	28
<b>6</b>	<b>BANKING SECTOR</b>	<b>30</b>
6.1	Structural features of the banking sector	30
6.2	Risks in the banking sector	34
6.3	Lending activity: in expectation of a reversal	36
6.4	Bank funding	41
6.5	Income risk and income statement	49
6.6	Credit risk	52
6.7	Liquidity risk	69
6.8	Interest rate risk	72
6.9	Currency risk	74
6.10	Bank solvency	75
<b>7</b>	<b>NON-BANKING FINANCIAL INSTITUTIONS</b>	<b>82</b>
7.1	Insurers	82
7.2	Voluntary supplementary pension insurance	87
7.3	Capital market and mutual funds	89
7.4	Leasing companies	95
<b>8</b>	<b>MACRO-PRUDENTIAL SUPERVISION: MONITORING THE IMPACT OF INSTRUMENTS</b>	<b>100</b>
8.1	GLTDF	100
8.2	Limits on deposit rates	106
<b>9</b>	<b>FINANCIAL INFRASTRUCTURE</b>	<b>109</b>
9.1	Payment systems	109
9.2	Securities clearing and settlement systems	110

**List of tables, figures, boxes and abbreviations:****Tables:**

Table 1.1:	European Commission's forecasts of major macroeconomic indicators for Slovenia's main trading partners	1
Table 1.2:	Slovenia's sovereign credit ratings at the major rating agencies	5
Table 4.1:	Corporate financing flows (total, via loans and via trade credits) in EUR million	17
Table 4.2:	Corporate financing in the rest of the world, stock in EUR million and breakdown in percentages	17
Table 4.3:	Corporate financing, stock and breakdown at the end of 2014 in EUR million and percentages	19
Table 4.4:	Selected financial performance indicators by sector, and premiums over the EURIBOR on new loans at the domestic banks	25
Table 5.1:	Overview of the Slovenian financial sector in terms of total assets	29
Table 6.1:	Banks' total assets compared with GDP	30
Table 6.2:	Banking system's balance sheet as at 31 March 2015	31
Table 6.3:	Ownership structure of the banking sector (in terms of equity)	31
Table 6.4:	Market concentration of the Slovenian banking market as measured by the Herfindahl-Hirschman index, and market share of the top three/five banks	32
Table 6.5:	Bank of Slovenia's overview of risks in the Slovenian banking system	34
Table 6.6:	Banking sector income statement	49
Table 6.7:	Bank performance indicators in percentages	52
Table 6.8:	Breakdown of classified claims and non-performing claims by client segment in EUR million and in percentages	54
Table 6.9:	Arrears in classified claims by sector	56
Table 6.10:	Measures to stabilise the banking system adopted by the Slovenian government and Bank of Slovenia in 2013 and 2014	58
Table 6.11:	Stock of non-performing claims in the banking system and claims transferred to the BAMC as at the end of 2014	59
Table 6.12:	Banks' classified claims against non-financial corporations in bankruptcy in EUR million and as a proportion of total claims against non-financial corporations in percentages by sector	60
Table 6.13:	Percentage breakdown of transitions of non-financial corporations between credit ratings	61
Table 6.14:	Coverage of classified claims and non-performing claims by impairments and provisions in EUR million and percentages	62
Table 6.15:	Collateral on non-performing claims by bank group in October 2015 in percentages	66
Table 6.16:	Collateral on non-performing claims by bank group in March 2015 in percentages	66
Table 6.17:	Loans for which banks redeemed collateral in 2014 and the amount of collateral redemptions by type in EUR million	67
Table 6.18:	Average LTV ratio for newly approved loans in percentages	68
Table 6.19:	Proportion of total collateral accounted for by real estate collateral and proportion of newly approved loans accounted for by unsecured loans in percentages	68
Table 6.20:	Loan-to-income (LTI) ratio in percentages	69
Table 6.21:	Net open foreign exchange positions in EUR million	74
Table 6.22:	Stock of, year-on-year growth in and proportion of total loans accounted for by loans in Swiss francs or with a Swiss franc currency clause, in EUR million and percentages	75
Table 6.24:	Breakdown of capital requirements for credit risk on an individual basis in percentages	79
Table 7.1:	Written premium and assets of voluntary supplementary pension insurance providers	88
Table 7.2:	Overview of Slovenia's regulated market	91
Table 7.3:	Performance of leasing companies and sources of funding	99
Table 9.1:	Value and number of transactions in the TARGET2 and SEPA ICT payment systems	109

**Figures:**

Figure 1.1:	Year-on-year growth in quarterly GDP in percentages (left) and commodity price indices, 2005 = 100 (right)	2
Figure 1.2:	Year-on-year growth in inflation as measured by the HICP (left) and required yield on government bonds (right) in percentages	2

Figure 1.3:	Year-on-year growth in GDP in percentages and contributions by components of demand to GDP growth in percentage points (left) and year-on-year growth in value-added by sector at current prices in percentages (right)	3
Figure 1.4:	Saving rate, and ratios of investment and saving to GDP in percentages for Slovenia (left) and for the euro area (right)	3
Figure 1.5:	Net financial position of institutional sectors as percentage of GDP in terms of stock (left) and annual transactions (right)	4
Figure 1.6:	Net financial position against the rest of the world by economic sector (left) and by instrument (right) as a percentage of GDP	4
Figure 1.7:	Public debt, budget deficit, interest payments and gross government investment as a percentage of GDP	5
Figure 2.1:	Disposable income and household final consumption expenditure in EUR billion and percentages (left), and saving, investment and net borrowing of households in EUR billion (right)	6
Figure 2.2:	Household saving rate and investment rate (left) and real growth in gross wages and unemployment rate (right) in percentages	7
Figure 2.3:	Financial assets, liabilities and net financial position as percentages of GDP (left), and breakdown of household financial assets in Slovenia and the euro area in percentages (right)	7
Figure 2.4:	Breakdown of transactions (left) and valuation changes (right) in individual forms of household financial asset in Slovenia in EUR millions and percentages	8
Figure 2.5:	Annual growth in household deposits in percentages	8
Figure 2.6:	Level and distribution of interest rates on new household deposits at Slovenian banks of up to 1 year (left) and more than 1 year (right) in percentages	9
Figure 2.7:	Annual growth (left) and breakdown of stock of loans to households by type (right) in percentages	9
Figure 2.8:	Interest rates on new consumer loans (left) and housing loans (right)	10
Figure 2.9:	Household debt servicing burden from bank loan repayments as percentage of disposable income	10
Figure 3.1:	Year-on-year growth in prices of used and new-build residential real estate in Slovenia (left), and basic housing price index (2010 = 100) (right) in percentages	11
Figure 3.2:	Year-on-year growth in commercial real estate (office) prices (left) and number of transactions included in the calculation of average price and growth therein (right) in percentages	12
Figure 3.3:	Year-on-year growth in advertised apartment prices (left) and gap by which advertised prices exceed transaction prices per square metre (right) in percentages	12
Figure 3.4:	Ratio of housing prices to annual moving average of net monthly wages for Ljubljana in percentages (left) and housing affordability index (2004 = 100) (right)	13
Figure 3.5:	P/E ratio (left), and ratio of actual prices to underlying prices of housing in Ljubljana calculated on this basis (right)	14
Figure 3.6:	New loans to the construction sector (left) and new housing loans to households (right) in EUR million	14
Figure 4.1:	Corporate borrowing by sector (left) and by instrument (right), annual moving total of flows in EUR million	16
Figure 4.2:	Corporate financing flows in the rest of the world, annual moving total of flows in EUR million	17
Figure 4.3:	Stock of corporate loans from the rest of the world by foreign creditor's sector (left) and for selected sectors (right) in EUR million	18
Figure 4.4:	Corporate debt-to-equity ratio (left) and comparison of corporate indebtedness with the euro area in 2013 (right) in percentages	18
Figure 4.5:	Corporate financial assets by sector (left) and by instrument (right), annual moving total of flows in EUR million	20
Figure 4.6:	Total profit and loss and net profit (left) and total profit and loss by sector in 2013 and 2014 (right) in EUR billion	20
Figure 4.7:	Percentage of total assets in the sector accounted for by firms in bankruptcy by year of initiation of bankruptcy proceedings*	21
Figure 4.8:	Number of bankruptcy proceedings initiated against firms overall (left) and by sector (right)	21
Figure 4.9:	Number of legal entities (left) and sole traders and private individuals pursuing a registered economic activity (right) with outstanding past-due liabilities from court enforcement orders and tax debt and their average daily amount of outstanding past-due liabilities in EUR million	21
Figure 4.10:	Leverage in percentages (left) and net financial debt to EBITDA in years (right) in selected sectors in 2008, 2013 and 2014	22
Figure 4.11:	Leverage in percentages (left) and net financial debt to EBITDA in years (right) by corporate size in 2008, 2013 and 2014	22

Figure 4.12:	Distribution of the net financial debt to EBITDA indicator for selected sectors (left) and in terms of corporate size (right) in 2008, 2013 and 2014	23
Figure 4.13:	Leverage (left) and net financial debt to EBITDA ratio (right) for most-indebted firms and remaining firms in 2014	23
Figure 4.14:	Net financial debt in 2014 and excess debt with regard to debt servicing capacity in EUR billion	24
Figure 4.15:	Concentration of excess debt in 2014 in EUR billion (left) and excess debt by sector in EUR billion and ratio of excess debt to net financial debt by sector in percentages (right)	24
Figure 4.16:	Concentration of excess debt in 2013 in EUR billion (left) and excess debt by sector in EUR billion and ratio of excess debt to net financial debt by sector in percentages (right)	24
Figure 4.17:	Leverage in percentages at all firms, SMEs and all firms excluding those undergoing insolvency proceedings (left) and net financial debt to EBITDA in years at all firms and SMEs (right) by year	26
Figure 4.18:	Leverage by corporate size (left) and leverage of all firms and SMEs and ratio of net financial debt to EBITDA for SMEs with net financial debt by sector (right)	26
Figure 4.19:	Proportion of total financial liabilities accounted for by financial liabilities to banks for large enterprises and SMEs (left) and proportion of non-current and current financial liabilities to banks accounted for by SMEs (right) by year in percentages	26
Figure 4.20:	Concentration of excess debt at SMEs in 2013 and 2014 in EUR billion	27
Figure 5.1:	Structure of the financial sector in terms of financial assets (left) and ratio of financial assets, liabilities and net position to GDP by financial sub-sector (right) in percentages	28
Figure 5.2:	Breakdown of the Slovenian financial sector's financial assets (left) and liabilities (right) in percentages	28
Figure 5.3:	Breakdown of equity by owner sector in Slovenia and the euro area (left) and ownership structure of the financial sector (right) in percentages	29
Figure 6.1:	Market shares of banks under majority foreign ownership and under majority domestic ownership in terms of total assets in percentages	32
Figure 6.2:	Breakdown of bank investments (left) and year-on-year growth in loans prior to creation of impairments (right) in percentages	36
Figure 6.3:	New corporate loans (left) and household loans (right) by maturity, 12-month moving sums, in EUR million	37
Figure 6.4:	Demand for loans as measured by survey: corporates (left) and households (right)	37
Figure 6.5:	Credit standards as measured by survey for corporate loans (left) and household loans (right)	38
Figure 6.6:	Factors affecting the level of credit standards in corporate lending	39
Figure 6.7:	Interest rates on corporate loans in Slovenia and the euro area and spread between them on loans of up to EUR 1 million (left) and more than EUR 1 million (rights) in percentages and percentage points	39
Figure 6.8:	Premiums over the reference interest rate on higher-risk and average corporate loans according to the bank lending survey (left) and on realised new loans (right)	40
Figure 6.9:	Interest rates on housing loans in Slovenia and the euro area and spread between them: housing loans (left) and consumer loans (right) in percentages and percentage points	40
Figure 6.10:	Loan terms and conditions in Slovenia, across the euro area and in selected euro area countries: collateral requirements and the size of the loan or credit lines	40
Figure 6.11:	Loan terms and conditions in Slovenia, across the euro area and in selected euro area countries: loan maturity	41
Figure 6.12:	Loan terms and conditions in Slovenia, across the euro area and in selected euro area countries: loan margin (spread over a relevant market reference rate) on average loans and non-interest rate charges	41
Figure 6.13:	Changes in total assets and wholesale funding (left) and net changes in funding on the wholesale markets (liabilities to foreign banks and issued debt securities) and with the Eurosystem (right) in EUR million	42
Figure 6.14:	Breakdown of the Slovenian banking system's funding (left) and by bank group (right) in percentages	43
Figure 6.15:	Maturing of liabilities to foreign banks by maturity interval (left) and proportion of banks' total liabilities accounted for by liabilities from Eurosystem instruments (right) in percentages	43
Figure 6.16:	Year-on-year growth in deposits by the non-banking sector (left) and proportion of total liabilities accounted for household deposits (right) by bank group in percentages	45
Figure 6.17:	Breakdown of deposits by the non-banking sector by sector (left) and increase in household deposits by bank group in EUR million (right)	45
Figure 6.18:	Year-on-year growth in household deposits by bank group (left), and breakdown of household deposits (right) in percentages	46
Figure 6.19:	LTD ratio for the non-banking sector by bank group in percentages	47

Figure 6.20:	Average costs of bank debt funding by primary source/instrument (left) and by bank group (right) in percentages	47
Figure 6.21:	Net interest margin on interest-bearing assets by bank group in Slovenia (left) and distribution of net interest margin by quartile in Slovenia (right), 2008 to March 2015	50
Figure 6.22:	Nominal change in categories of gross income, net income, impairment and provisioning costs in EUR million, 2008 to March 2015	51
Figure 6.23:	Disposal of banks' gross income in percentages (left) and movement in ROE and impact of four factors on the direction of the movement in ROE; breakdown of ROE (right)	51
Figure 6.24:	Growth in classified claims (CC) and non-performing claims in percentages and absolute amounts in EUR million	53
Figure 6.25:	Non-performing claims by bank group and client group in November 2013 (left) and March 2015 (right) in EUR million	53
Figure 6.26:	Arrears of more than 90 days as a proportion of the banks' classified claims by bank group (left) and client segment (right) in percentages	54
Figure 6.27:	Arrears of more than 90 days as a proportion of the banks' total classified claims by client segment (left) and impact of the transfers to the BAMC on the reduction of the proportion of non-performing claims by client segment (right) in percentages	55
Figure 6.28:	Proportion of non-performing claims against non-residents accounted for by individual countries (left) and proportion of non-performing claims accounted for by non-residents before the transfers to the BAMC (right) in percentages	55
Figure 6.29:	Percentage more than 90 days in arrears by sector	56
Figure 6.30:	Arrears of more than 90 days by corporate size (left) and proportion of claims more than 90 days in arrears by corporate size (right) in EUR million and percentages	57
Figure 6.31:	Concentration of debtors more than 90 days in arrears (left) and concentration by number of banks with exposure to the top 50 debtors with arrears of more than 90 days (right), March 2015	58
Figure 6.32:	Non-performing claims at the banks and claims at the BAMC	59
Figure 6.33:	Number of bankruptcy proceedings initiated at year end (left) and classified claims against corporates in bankruptcy with regard to year of initiation of bankruptcy proceedings (right)	60
Figure 6.34:	Activity and deviation in percentages	61
Figure 6.35:	Growth in classified claims and impairments (left) and growth in classified claims more than 90 days in arrears, non-performing claims and impairments for non-performing claims (right) in percentages	62
Figure 6.36:	Coverage of non-performing claims more than 90 days in arrears by impairments by bank group (left) and by client segment (right) in percentages	63
Figure 6.37:	Ratio of unimpaired non-performing claims to capital (left) and coverage of non-performing claims by impairments and provisions (right) in EUR million and percentages	63
Figure 6.38:	Loans more than 90 days in arrears: proportion of all loans (left) and coverage by impairments (right) in EU countries in percentages	64
Figure 6.39:	Change in proportion of loans more than 90 days in arrears in EU countries by year in countries with the highest proportions, falling (left) and rising (right) in percentages	64
Figure 6.40:	Ratio of net non-performing claims (minus impairments) to capital in EU countries in percentages	65
Figure 6.41:	Coverage of the banks' total classified claims (left) and coverage of non-performing claims (right) by collateral in percentages	65
Figure 6.42:	Write-offs of financial assets at banks in EUR million	68
Figure 6.43:	Daily liquidity ratios for the first and second buckets of the liquidity ladder in percentages	70
Figure 6.44:	Liquidity ratios for the first bucket (0 to 30 days; left) and the second bucket (0 to 180 days; right) of the liquidity ladder by bank group, monthly averages	70
Figure 6.45:	Changes in the stock of marketable secondary liquidity (monthly averages in EUR millions) and ratio of marketable secondary liquidity to total assets in percentages	71
Figure 6.46:	Claims, liabilities and net position of commercial banks vis-à-vis the Eurosystem in EUR million and proportion of the pool of eligible collateral that is free (left) and stock of unsecured loans of Slovenian banks placed and received on the euro area money market (right)	72
Figure 6.47:	Average repricing period for interest rates in months (left) and difference between the average repricing period for interest rates by bank group in months (right)	73
Figure 6.48:	Gap between interest-sensitive assets and interest-sensitive liabilities by individual bucket in EUR million	74
Figure 6.49:	Banking system's basic capital adequacy ratios on an individual basis in percentages	76

Figure 6.50:	Overall capital adequacy (left) and common equity Tier 1 capital ratio (right) by bank groups in percentages	77
Figure 6.51:	Ratio of book capital to total assets on an individual basis in percentages, monthly figures	77
Figure 6.52:	Structure of regulatory capital (left) and structure of common equity Tier 1 capital (right) on an individual basis across the banking system in percentages	78
Figure 6.53:	Ratio of capital requirements to total assets (left) and breakdown of capital requirements (right) on an individual basis in percentages	79
Figure 6.54:	Capital adequacy (left) and Tier 1 capital ratio (right) compared with the EU, figures by bank group on a consolidated basis in percentages	80
Figure 6.55:	Capital adequacy (left) and Tier 1 capital ratio (right) for euro area countries, figures on a consolidated basis for June 2014 in percentages	80
Figure 6.56:	Distribution of the ratio of book capital to total assets (left) and ratio of capital requirements to total assets (right) for EU Member States, figures on a consolidated basis in percentages	81
Figure 6.57:	Risk weights by type of credit exposure on an individual basis (left) and distribution of the ratio of risk-weighted assets to total assets on a consolidated basis for EU Member States (right) in percentages	81
Figure 7.1:	Gross written premium by type of insurance in EUR million (left scale) and annual growth in percentages (right scale)	82
Figure 7.2:	Insurance companies' gross written life insurance premium in EUR million (left scale) and annual growth in percentages (right scale)	83
Figure 7.3:	Growth in total assets in percentages (left) and result from ordinary activities in EUR million (right) of insurance companies and reinsurance companies	83
Figure 7.4:	Surplus of available capital over minimum capital requirements at insurance companies and reinsurance companies in percentages	84
Figure 7.5:	Claims ratio for major types of insurance	85
Figure 7.6:	Growth in net insurance technical provisions and assets for general insurance and life insurance (left), and coverage of net insurance technical provisions by assets covering technical provisions for general insurance (right) in percentages	85
Figure 7.7:	Structure of insurers' assets covering mathematical provisions (left) and assets covering technical provisions other than mathematical provisions (right) in percentages	86
Figure 7.8:	Proportion of the insurance sector's total investments accounted for by foreign investments in percentages	86
Figure 7.9:	Breakdown of written credit insurance premium in percentages	87
Figure 7.10:	Written premium and claims paid in EUR million (left), and claims ratio for credit insurance (right)	87
Figure 7.11:	Structure of investments by voluntary supplementary pension insurance providers	88
Figure 7.12:	Year-on-year change in domestic (left) and foreign (right) stock exchange indices in percentages	89
Figure 7.13:	Market capitalisation on the Ljubljana Stock Exchange in EUR billion, and annual turnover ratios (left) and issuance of corporate bonds and commercial paper, net values and number of issues (right)	90
Figure 7.14:	Monthly net inward investments by non-residents (left) and outward investments by residents (right) in EUR million	92
Figure 7.15:	Annual change in the average unit price of mutual funds and the SBI TOP in percentages (left) and net cash flows into mutual funds in EUR million (right)	93
Figure 7.16:	Percentage breakdown of mutual fund investments (left) and regional percentage breakdown of investments in foreign shares by the entire other financial intermediaries sector (right)	93
Figure 7.17:	Investment funds' assets under management per capita, comparison with euro area	94
Figure 7.18:	New leasing business in EUR millions and proportion accounted for by real estate leasing in percentages (left), and annual growth in new business in percentages (right)	95
Figure 7.19:	Breakdown of new equipment leasing business (left) and real estate leasing business (right) in percentages	96
Figure 7.20:	Stock of non-financial corporations' leasing business by sector for equipment leasing (left) and real estate leasing (right) in EUR million, and proportion of stock more than 90 days in arrears	97
Figure 7.21:	Stock of leasing business more than 90 days in arrears in EUR million (left) and ratio of leasing business to gross fixed capital formation (right) in percentages	98
Figure 7.22:	Growth in the stock of leasing business and bank loans to the non-banking sector (left) and ratio of leasing business to bank loans to the non-banking sector (right) in percentages	98
Figure 8.1:	Number of banks failing to meet GLTDF $\geq 0\%$ or GLTDF $\geq 40\%$ in the wake of a positive annual increase in deposits	101

Figure 8.2:	LTD ratio of banking system and bank groups (left) and excluding effects of recovery, i.e. excluding Factor banka and Probanka, and excluding the transfer of non-performing claims to the BAMC (right)	102
Table 8.1:	Level and decline of LTD ratio of banking system and bank groups, basic indicator and excluding effects of recovery, i.e. excluding Factor banka and Probanka, and excluding the transfer of non-performing claims to the BAMC	102
Figure 8.3:	Distribution of LTD ratio of individual banks (left) and comparison of LTD ratio (loans before impairments excluding government sector) with distribution across other euro area countries (right) in terms of 20th/33rd/66th/80th percentile	103
Figure 8.4	GLTDF of banking system and bank groups (left) and excluding Factor banka and Probanka and exemptions related to the transfer of non-performing claims to the BAMC and write-offs (right)	103
Figure 8.5:	Annual changes in the LTD ratio (left) and changes in the first two months of the year (right) and contribution of individual components of loans to or deposits by the non-banking sector to the change in the LTD ratio for the banking system and the bank groups	104
Figure 8.6:	Number of banks with a positive annual increase in loans to or deposits by the non-banking sector and loans to and deposits by the private non-banking sector (left) and annual increase in new long-term corporate loans (right)	104
Figure 8.7:	Percentage breakdown of the banking system's liabilities (left) and breakdown of quarterly increase in deposits by sector in EUR million (right)	105
Figure 8.8:	Shortfall in liquid investments to meet the fourth corrective measure (LR2) by bank group, in EUR million	105
Figure 8.9:	Shortfall in liquid investments to meet the third corrective measure, the adjusted LR2 (left) and the second corrective measure, the adjusted LR1 (right) by bank group, EUR million	106
Figure 8.10:	Average interest rates on deposits at Slovenian banks and savings banks (excluding bank branches) by five maturity buckets (left), and distribution of interest rates on deposits by households and non-profit institutions serving households with a maturity of up to 1 year in the euro area (right), January 2012 to March 2015 in percentages	107
Figure 8.11:	Distribution of interest rates on deposits of 3 to 6 months (left) and 6 months to 1 year (right) at Slovenian banks excluding branches and ceiling on maturity bucket (average daily EURIBOR plus premium), January 2012 to March 2015, in percentages	107
Figure 9.1:	TARGET2-Slovenija: domestic and cross-border payments; value in EUR billion (left axis) and the number in thousand (right axis) and SEPA ICT: value in EUR billion (left axis) and the number in million (right axis)	110
Figure 9.2:	Concentration of the number of transactions in the TARGET2-Slovenija and SEPA ICT systems (Herfindahl-Hirschman Index; left) and proportion of total number of transactions accounted for by the five largest participants excluding the Bank of Slovenia (right)	110
<b>Boxes:</b>		
Box 4.1:	Financing and indebtedness of SMEs	25
Box 6.1:	Impact of the introduction of the Single Supervisory Mechanism for the Slovenian banking system	33
Box 6.2:	Developments in loan terms on corporate loans in Slovenia, across the euro area and in selected euro area countries	40
Box 6.3:	Government and Bank of Slovenia measures to stabilise the banking system	58
Box 6.4:	Non-performing claims in EU countries	64

**Abbreviations:**

AJPES	Agency of the Republic of Slovenia for Public Legal Records and Related Services
SMA	Securities Market Agency
ISA	Insurance Supervision Agency
RTGS (system)	Real-Time Gross Settlement
BRIC	Brazil, Russia, India, China
BoS	Bank of Slovenia
CCBM	Correspondent Central Banking Model
OFIs	Other financial institutions
TARS	Tax Administration of the Republic of Slovenia
BAMC	Bank Asset Management Company
DS	Debt securities
AMCs	Asset management companies
ECB	European Central Bank
ECBC	European Covered Bond Council
EFAMA	European Funds and Asset Management Association
EFTA	European Free Trade Association
EIOPA	European Insurance and Occupational Pensions Authority
EMF	European Mortgage Federation
EMU	Economic and Monetary Union
EONIA	Euro OverNight Index Average (weighted average interest rate for overnight credit)
ERM2	Exchange Rate Mechanism 2
ESCB	European System of Central Banks
EU16	Euro area
EU27	EU Member States
EU3	European Union Member States prior to enlargement of 1 May 2004 that are not members of the euro area (Denmark, Sweden, UK)
EU8	Poland, Hungary, Czech Republic, Slovenia, Slovakia, Estonia, Latvia, Lithuania
EURIBOR	Interbank interest rate at which representative banks in the euro area offer deposits to one another
Eurostat	Statistical Office of the European Communities
EU-SILC	European Union Statistics on Income and Living Conditions
Fed	Board of Governors of the Federal Reserve System
FESE	Federation of European Securities Exchanges
SMARS	Surveying and Mapping Authority of the Republic of Slovenia
ICs	Investment companies
IFs	Investment funds
CSCC	Central Securities Clearing Corporation
TR	Turnover ratio
Leaseurope	European Federation of Leasing Company Associations
LJSE	Ljubljana Stock Exchange
LJSEX	Former Ljubljana Stock Exchange index calculated for entire market until October 2010
LTI	Loan-to-income ratio
LTV	Loan-to-value ratio
IMF	International Monetary Fund
IFRS	International Financial Reporting Standards
MTS Slovenia	Part of the Euro MTS electronic trading platform for euro-denominated government and para-government benchmark bonds
NUTS	Nomenclature of territorial units for statistics
OECD	Organisation for Economic Co-operation and Development
P/E	Price-to-earnings ratio
PID	Authorised investment company (privatisation fund)
SBI 20	Former Slovenian stock market index
SBI TOP	Blue-chip index at Ljubljana Stock Exchange
SI O/N	Interest rate on unsecured interbank euro-denominated overnight deposits concluded between Slovenian credit institutions and euro area credit institutions
SKD	Standard classification of economic activities (national version)
Slonep	Slovenian real estate portal (www.slonep.net)

SAS	Slovenian Accounting Standards
HFRS	Housing Fund of the Republic of Slovenia
SORS	Statistical Office of the Republic of Slovenia
S&P	Standard and Poor's
AUP	Average unit price of a mutual fund
MF	Mutual fund
Vzajemci.com	Portal of Slovenian mutual funds (www.vzajemci.com)
WFE	World Federation of Exchanges
BAS	Bank Association of Slovenia
Z-Doh	Personal Income Tax Act
AMC	Association of Management Companies
SLA	Slovenian Leasing Association
PDII	Pension and Disability Insurance Institute

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

## CONCLUSIONS

The main features of the development of systemic risks in the financial system in 2014 were gradual but increasingly convincing economic growth and the corresponding revival of the business cycle on one hand, and the very slow and uncertain reversal in the financial cycle on the other. The stabilisation of the macroeconomic situation is an important prerequisite for the renewed revival of financial activity on the part of the banks and other segments of the financial sector such as leasing companies, investment firms and insurers.

The continuation of the domestic economic recovery, which is still primarily based on corporate export activity and insufficiently based on growth in domestic consumption and private investment, will be a significant factor in easing the corporate financial restructuring process. The aforementioned process has been particularly intensive over the last three years, during which corporate leverage has declined by 23 percentage points to a more acceptable 112%. Since the very outbreak of the financial crisis, the decline in leverage has been driven primarily by a reduction in debt-related liabilities, and only to a significantly lesser extent by an increase in equity. To date this has constrained corporates in the increased investment activity that is vital for more stable economic growth. Corporates increased their position as net creditors to other sectors in financial transactions until 2013 inclusive, which hindered the economic recovery. It was only last year that corporates began reducing their current surplus financial position, despite a net negative annual financial flow, which continued for the third consecutive year. Corporates paid down an additional EUR 1.7 billion of debt to Slovenian banks last year, and an additional EUR 0.3 billion to foreign banks, which is merely confirmation of the process of bank disintermediation with regard to the corporate sector, which is not an attribute of Slovenian banks alone. However, the deleveraging process will slow in the coming period due to the economic recovery. Slovenian corporates' debt servicing capacity improved significantly last year, as the net financial debt to EBITDA ratio declined on account of the doubling of the real sector's net profits. Despite their improving debt servicing capacity, corporates must ensure a more sustainable debt-to-equity ratio in the future than in the pre-crisis period.

The financial crisis did not hit all corporate segments equally. While large enterprises were under greater financial stress during the first phase of the crisis until 2012, which was reflected in a higher average value of bank debt at firms in bankruptcy, the SME segment has been hit hard by the crisis more recently. Some 74% of the total excess debt of the corporate sector is concentrated in the SME segment, which is partly attributable to claims against small corporates mostly being excluded as a systemic option in the transfer of non-performing claims from banks to the BAMC in late 2013 and the final quarter of 2014. This indicates that SMEs have been considerably more successful in deleveraging than large enterprises during the crisis, but remain limited in terms of bank financing. The proportion of long-term bank loans intended primarily for financing investment that was accounted for by SMEs increased last year, although the stock of loans declined further. SMEs need more options for equity financing via alternative financial institutions or via the capital market, which would facilitate new investments for this corporate segment and would contribute to a reduction in excess debt through the generation of higher profits. It is generally true for Slovenian corporates that their continued adjustments in leverage must rely more heavily on additional equity financing in the future and less on reducing their debt. It was the reduction of corporate debt that led to a deterioration in the liquidity of the real sector in the past, and thus a deterioration in the quality of the banking system's credit portfolio. A shift in structure of corporate financing in the direction of an increasing proportion of equity will reduce corporate sensitivity to adverse shocks in the financial sector.

A shift in the structure of funding also took place in the banking sector, albeit significantly more slowly than in previous years. The LTD ratio for the non-banking sector stabilised at 88% in the second half of last year and the first quarter of 2015, which was partly attributable to the implementation of the macro-prudential instrument of restrictions on the ratio between the annual change in the stock of loans to the non-banking sector to the annual change in deposits by the non-banking sector (GLTDF) in mid-2014. This macro-prudential instrument is one of the rare attempts to restrict the financial cycle during the period of contraction that has proven to be relatively successful in meeting its targets. Additional changes in the structure of the banks' funding are nevertheless anticipated in the future. Economic recovery will bring a reduction in the proportion of the banks' total liabilities accounted for by deposits by non-financial corporations, while household deposits will grow very slowly in the context of historically low deposit rates, and occasionally their volatility will actually increase. Nevertheless, the banks are not expected to be exposed to an increase in liquidity risk in the current situation of high excess liquidity. The ECB's non-standard monetary policy measures are providing the banks with a relatively affordable and stable source of liquidity, as well as the opportunity to increase lending activities. Slovenian banks did not exploit such opportunities to any great extent last year.

Credit risk has been diminishing since the final quarter of last year. This was attributable not solely to the transfer of non-performing claims to the BAMC in the final quarter of 2014, but also to the autonomous process of improving the quality of the credit portfolio. The transfer of non-performing claims to the BAMC last year reduced the proportion of non-performing claims more than 90 days in arrears by almost 3 percentage points, while other processes contributed to an additional decline to 11.4% in March 2015. The process of reducing the proportion of claims more than 90 days in arrears would have been even faster were the banks not facing a contraction in turnover as a result of low credit demand, particularly from households, and the banks' reluctance to take up new credit risk. This is evidenced in the banks' tighter credit standards, which are only slowly being relaxed in individual categories. The quality of claims remains poorest in the segments of exposures to non-

residents and corporate exposures, although the proportion of the latter is significantly lower than before the recovery of part of the banking system, at 17.8%. Within the corporate sector, the quality of the SMEs portfolio is relatively poorer, which presents a greater challenge in terms of resolution owing to its greater granularity. This corporate segment was also not involved in the systemic resolution of non-performing loans in part of the banking system, for which reason it is reasonable to expect that the banks will dedicate more activities to this part of the portfolio with the aim of restructuring and resolving the corresponding debt. Another important factor in the normalisation of the credit supply is the further reduction of the proportion of non-performing loans in the banks' portfolio, as a larger figure diminishes the banks' willingness to lend, for reason of higher impairment costs, less readiness to lend to marginal customers, and higher expenditure of capital.

Income risk is one of the rare forms of risk that is increasing at the banks. Despite a temporary rise in the net interest margin last year, the profitability of the banking system is limited due to low market interest rates, the contraction in the banks' turnover and the high proportion of non-performing claims in the portfolio. Last year's fall in deposit rates ensured a rise in net interest income, which will decline in the current year as a result of the fall in lending rates, the large proportion of investments in deposits at foreign banks and the large proportion of investments in government securities. Low interest rates are forcing the banks to seek higher-yielding forms of investment, and also to compete via low lending rates for lower-risk customers. The banks thus face the search for new business models in funding and the establishment of stable lending growth. Only adjustments of this type will allow the banks to cover their funding costs in the long term, and to achieve a satisfactory level of internal capital generation. Only banks that are able to successfully tailor their business models and streamline their operations will be successful in the single banking market in the conditions of single banking supervision.

Low interest rates in 2014 led to an increase in interest rate risk at the banks. The banks have become more exposed to the risk of a rise in interest rates on account of the lengthening of the average asset interest rate repricing period as the proportion of assets accounted for by investments in securities with a longer repricing period increases and the proportion accounted for by loans declines. After a long period of falling interest rates, the effectiveness of interest rate risk management at the banks has risen in importance, as the probability of further cuts in interest rates has diminished considerably, while the probability of future increases in interest rates has risen.

The Slovenian banking system's solvency risk declined last year, although the differences between banks widened. The recovery of part of the banking system brought an increase in the amount of capital, while the transfer of non-performing claims to the BAMC reduced the stock of exposures with the highest risk weight. After the recapitalisation of two banks in the final quarter of the previous year, the banking system's overall capital adequacy on a consolidated basis rose to above the average of banks across the EU, although this was not the case at the small banks. The banks will also need to maintain high capital ratios because of the new European regulations, which introduce additional capital buffers to mitigate cyclical or structural systemic risks. The contraction of capital requirements via a reduction in lending activity and the withdrawal of banks into lower-risk but lower-yielding investments is becoming an unsustainable model, and the adaptation of business models to the new circumstances and the new regulatory requirements is one of the main challenges facing the banks in the future.

While the bank recovery and resolution process, together with the improving macroeconomic situation, contributed significantly to the banking system's greater resilience to unexpected shocks, low interest rates brought changes to other segments of the financial sector. Non-banking financial intermediaries, such as leasing companies, are regaining importance. On the saving side, an increase was recorded in investments in investment funds and other assets. Regulation and control over the aforementioned intermediaries continues to lag significantly behind the banking sector.

## EXECUTIVE SUMMARY

The situation in the banking system was more stable at the beginning of 2015 than it was in the period prior to the start of the bank recovery and resolution process. In addition to the positive effects of the aforementioned process, improvements in the macroeconomic environment and favourable expectations for both Slovenia and the euro area also contributed to the more favourable risk assessment. Income risk is moving to the fore as credit risk diminishes. The former had previously been primarily impacted by credit risk, but this year the main factor is low reference interest rates and the unfavourable changes in the structure of the banking system's investments in the direction of lower-risk but lower-yielding investments.

Credit risk remains one of the major risks in banking system, albeit at a lower level than a year ago. The decline in the stock and proportion of non-performing claims (claims more than 90 days in arrears), the latter reaching 11.4% in March, was largely attributable to additional transfers to the BAMC in the final quarter of last year, although an autonomous flow reducing such claims has been evident since the second half of the year.

In the wake of the restructuring of claims against firms with good prospects and, to a lesser extent, the write-off of non-performing claims and redemption of collateral, the banks face challenges in the resolution of non-performing claims against SMEs. This segment of the portfolio already accounts for 64% of all non-performing claims against corporates, and is notable for its poor quality compared with claims against large enterprises. Another segment that in terms of stock has remained unchanged for some time but is increasing in relative terms is non-performing claims against non-residents, which now account for a quarter of the banking system's total non-performing claims, double the figure before the bank recovery and resolution process was begun.

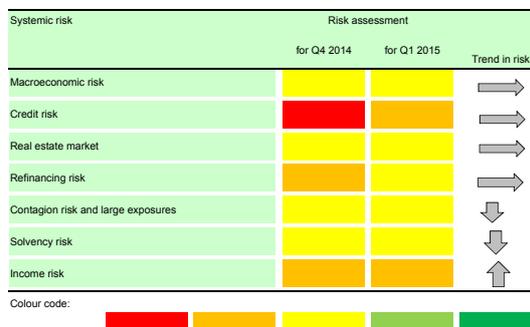
As a result of increasing coverage by impairments, which had reached 64% by March, and the extensive recapitalisation of the banks between December 2013 and December 2014, the banking system's resilience to potential major losses has improved significantly. The ratio of non-performing claims for which impairments have not been created to the banking system's capital has fallen from 106% in November 2013 to 35%, primarily at the large domestic banks. The ratio remains unfavourable at the small domestic banks, which have not yet attained a sufficient level of capital adequacy.

Overall capital adequacy and the Tier 1 capital ratio improved further last year, the former to 17.9% and the latter to 17.2%, and were significantly above the EU average. The improvement is primarily the result of the recapitalisation of Abanka and Banka Celje, and a reduction in capital requirements, for the most part on account of the transfer of the two banks' claims to the BAMC, which reduced exposures with the highest risk weight.

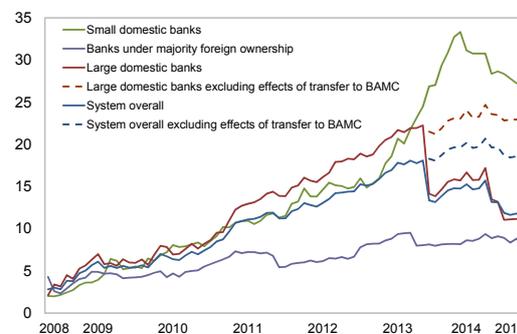
In the context of diminishing solvency risk for the banking system overall and for the large domestic banks in particular, the small domestic banks remain exposed to the aforementioned risk, despite an improvement in 2014.

The contraction in capital requirements as a result of the further

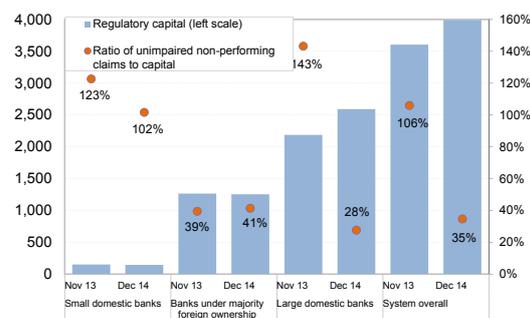
### Bank of Slovenia's assessment of key risks to the Slovenian banking system



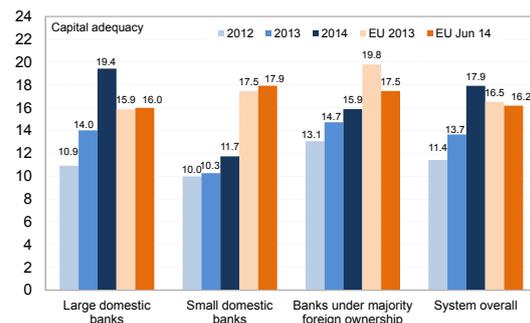
### Proportion of the banks' classified claims more than 90 days in arrears by bank group, in percentages



### Ratio of non-performing claims for which impairments have not been created to capital



### Overall capital adequacy compared with the EU, figures on a consolidated basis in percentages



decline in the banks' lending activities was also a factor in last year's improvement in capital adequacy. Several indicators in recent months point to a possible reversal in lending to the non-banking sector. The stock of new corporate loans, particularly long-term loans, has begun to increase. Bank interest rates began falling rapidly and are approaching the euro area average, which is increasing their competitiveness and could result in the return of part of the corporate demand for loans that is currently directed towards the rest of the world. Corporate demand for loans has been strengthening since the beginning of last year, or for an even longer period in the case of demand from large enterprises according to bank survey figures. Households remain reluctant to undertake additional borrowing. Consumer loans to households have continued to record negative growth, despite an improvement in household confidence, although the contraction has begun to cease. Growth in housing loans is positive. The relatively small stock of household debt and the small proportion of non-performing loans in this customer segment are creating space for increased lending.

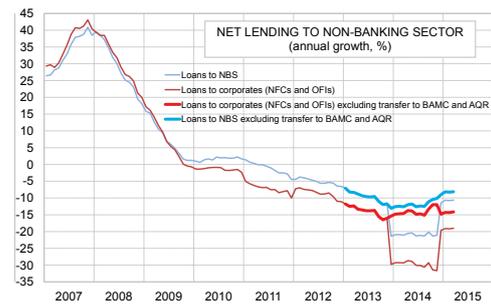
The contraction in lending activity in an environment of low interest rates is reducing the banks' ability to generate income. The banks responded to falling deposit rates with a lag by beginning to cut lending rates, which could have an adverse impact on the banking system's income in the short term, but in the long term could encourage increased lending, including to customers that have been financing themselves in the rest of the world under more favourable terms. Due to their risk aversion, the banks are maintaining a significant portion of their investments in lower-risk but lower-yielding investments, mostly government bonds. The decline in credit risk also entails a decline in expected impairment costs compared with previous years, and consequently a smaller impact on income, although given the relatively high proportion of non-performing claims the actual impact on income will be significant.

Last year the banks operated with a higher net interest margin, as a result of the transfer of non-performing claims to the BAMC and the sharper fall in deposit rates compared with lending rates. For lending to strengthen, interest rates on loans need to fall faster, although this has a negative impact on profitability in the wake of the contraction in lending. Risk aversion is redirecting the banks towards lower-risk but lower-yielding investments. In the search for yield the banks could begin taking up excessive risk in other areas. The room for further cuts in liability interest rates is limited, as rates have fallen below those across the euro area. The keys to maintaining a higher margin and managing income risk in the future will be credit growth and further reductions in the proportion of the banks' investments accounted for by non-performing loans.

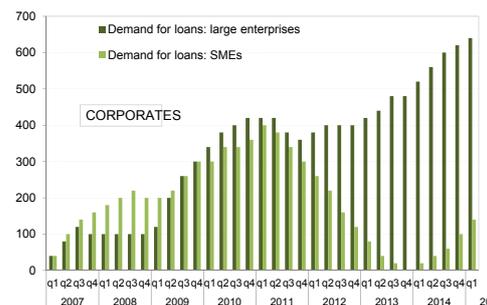
Corporate indebtedness remains a sharp limiting factor in lending growth, although the level of indebtedness has declined sharply in recent years. The debt-to-equity ratio is still above the euro area average at 120%, although in terms of the ratio of debt to GDP Slovenian corporates are among the least-indebted. Additional deleveraging that is based solely on reductions of debt could have an adverse impact on the development of the corporate sector.

Corporate debt servicing capacity as measured by the ratio of financial debt to EBITDA increased, as a result of a decline in debt and higher profits in 2014. Deleveraging has been

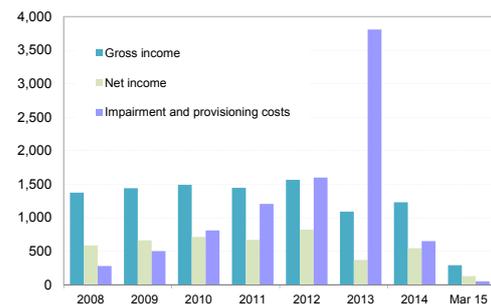
### Year-on-year growth in loans, in percentages



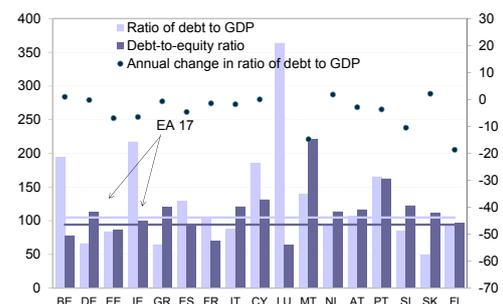
### Corporate demand for loans, survey figures, quarterly change



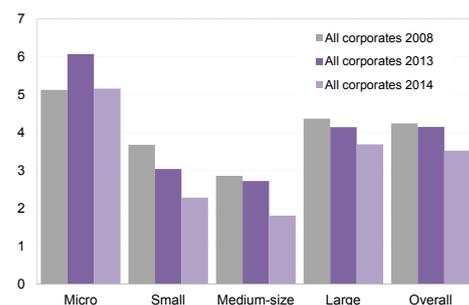
### Nominal gross and net income and impairment and provisioning costs, in EUR million



### Comparison of corporate indebtedness across the euro area in 2013



### Net financial debt to EBITDA by corporate size, in years



pronounced in all segments of the corporate sector, although SMEs are notable for their above-average leverage. However, they are simultaneously in a better position in terms of the ratio of financial debt to EBITDA than the large enterprises, because a large proportion of their debt pertains to operating activities, and not to financing activities. More than half of all SMEs have no financial debt, and are capable of servicing potential debt provided that they have a positive cash flow.

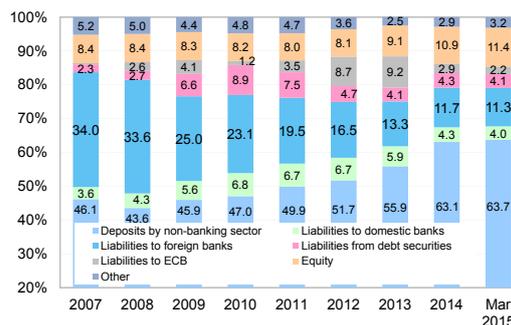
The banks' deleveraging on the wholesale markets in the context of their reluctance to raise new bank funding was a major factor in the contraction in turnover and lending activity in previous years. This process slowed sharply last year, and funding structure is now similar to that seen prior to the period of extensive borrowing by the banks in the rest of the world: the proportion accounted for by loans raised at foreign banks declined from 36% prior to the outbreak of the crisis to 15.4% in March, while the proportion of funding secured from the ECB has declined from its peak of 8.7% at the end of 2012 to just 2.2%. Refinancing risk has diminished as a result, while the banks under majority domestic ownership have also succeeded in borrowing on the wholesale markets after an extended period. The banks are becoming more vulnerable in their maintenance of a stable funding structure than they are with respect to refinancing risk.

The most stable resource, which is increasing in relative importance, is deposits by the non-banking sector, household deposits in particular. They were up 4.7% in March, although the rate of growth is gradually slowing. With interest rates low and falling, the proportion of deposits accounted for by sight deposits is increasing, which is increasing their mobility, but is also reducing the banks' stability of funding. Interest rates on short-term deposits have for some time been below the euro area average, while the proportion that they account for, excluding sight deposits, declined from 25% to 20% in March of this year. It is a positive that the proportion accounted for by long-term deposits has remained stable, at around 30%. There is an increasing likelihood that households will seek higher-yielding alternative investments, which to a certain extent is being realised via increased net payments into mutual funds, as growth in bank deposits slows.

The option of bank funding with the Eurosystem via the targeted longer-term refinancing operation (TLRTO), the aim of which is to encourage lending activity, has mostly not been exploited by Slovenian banks. The funding raised was also not used for lending; the motive for the borrowing was merely lower funding costs. The reason for the banks' lack of interest in ECB funding and in offering deposits to the government, which is placing its funds with banks in the rest of the world, is the high liquidity of Slovenian banks. The excess liquidity is being directed into purchases of securities and not into lending. The proportion of total assets accounted for by marketable secondary liquidity increased to 17% last year, or EUR 7.4 billion. Participation in the quantitative easing programme is also modest for the moment, as a result of the limited opportunities to place excess liquidity in profitable investments.

Interest rate risk at the banks increased in 2014. The difference between the average repricing periods for asset and liability interest rates is still widening. It stood at 8.4 months in December 2014, having lengthened by 1.8 months over the year. In an environment of extremely low reference

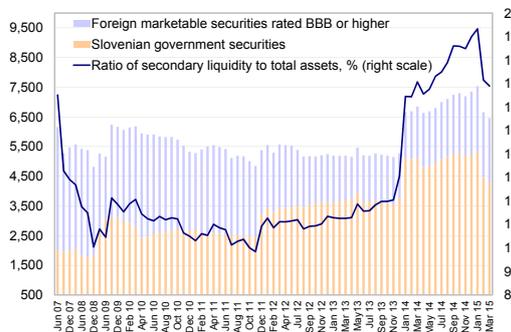
Breakdown of funding, in percentages



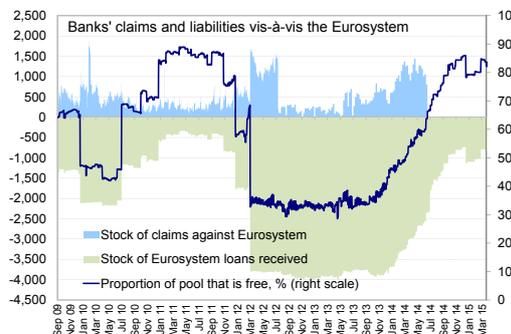
Breakdown of household deposits at banks, in percentages



Stock of marketable secondary liquidity (monthly averages in EUR millions) and ratio of marketable secondary liquidity to total assets in percentages



Banks' claims and liabilities vis-à-vis the Eurosystem, in EUR million



interest rates, the banks have become more exposed to the risk of a rise in interest rates on account of a change in balance sheet structure: on the investment side in the direction of an increase in the proportion with a longer average repricing period and also lower yields, and in the direction of an increased proportion of short-term funding on funding side. The 3-month EURIBOR has averaged 2.81% over the last 20 years, which is sharply in excess of the current level of reference interest rates (the 3-month EURIBOR has averaged just 0.27% over the last three years, while the 6-month EURIBOR has averaged 0.41%).

The real estate market revived in 2014 after several years of stagnation. The volume of transactions in the residential real estate market increased by almost a third, while the volume in commercial real estate also strengthened. Prices of residential real estate have fallen sharply over the last three years, but the fall in prices has slowed in recent months. The housing over-valuation indicators suggest an end to the fall in real estate prices and the potential gradual reversal in price trends in the future. The lack of construction of new-build housing in recent years could also be a factor in this process, in the wake of increased demand. The fall in prices of housing is still outpacing the fall in rents, and landlords' returns from the rental of real estate last year were again the highest of the last nine years, as they had been in 2013. Actual selling prices are still a fifth higher on average than the long-term sustainable prices, despite the falls.

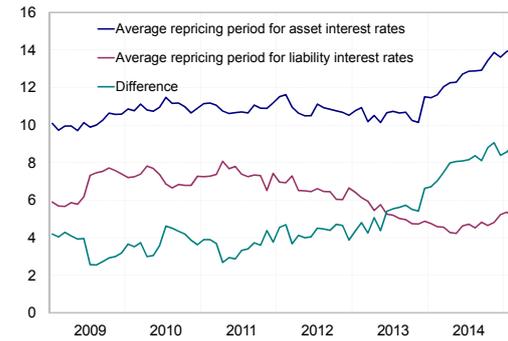
The recovery of economic activity was reflected to a lesser extent in the performance of leasing companies last year. Leasing business was up 14.7%, as real estate leasing increased by 47% and equipment leasing increased by 7%. Another indication of the favourable impact of the economic recovery after several years of decline was the increase in business in leasing of machinery and production equipment and leasing of commercial vehicles. The stock of leasing business nevertheless declined by 10.4%. The ratio of leasing loans to bank loans is less than 14%, an indication of the relatively limited opportunities for corporates and households to finance themselves via leasing companies. Leasing is nevertheless well-developed as an alternative form of financing in Slovenia: across the euro area the figure is 3.6%.

Non-financial corporations entail higher credit risk for leasing companies than other customers, owing to the higher exposures and the higher proportion of non-performing claims. Liabilities more than 90 days in arrears accounted for 13.1% of non-financial corporations' liabilities at the end of 2014, up from 9.5% a year earlier.

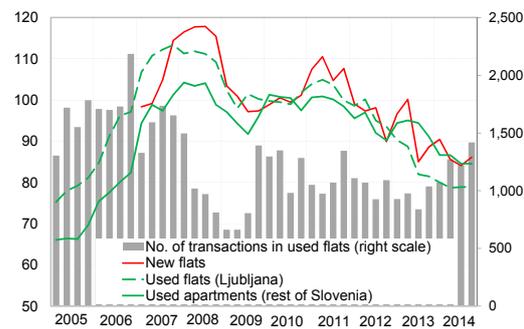
The completion of the sale of five firms had a major impact on developments on the domestic stock market last year, as prices and volume on the Ljubljana Stock Exchange both increased. The SBI TOP rose sharply by 28% over the first nine months of the year, although the trend reversed towards the end of the year. The positive net inflow into investment funds is confirmation that confidence is returning to investors. The low interest rates at banks is giving investors additional incentive to seek higher-yielding investments. As yields of government bonds have fallen, corporates have also looked to the capital markets for financing alongside sovereigns, including bond issues on foreign markets, although this primarily remains an option for established firms.

The positive developments on the domestic capital market are

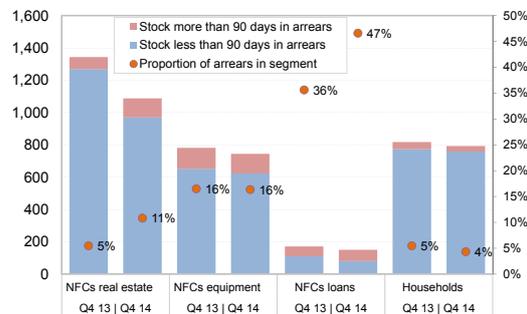
Average repricing period for interest rates, in months



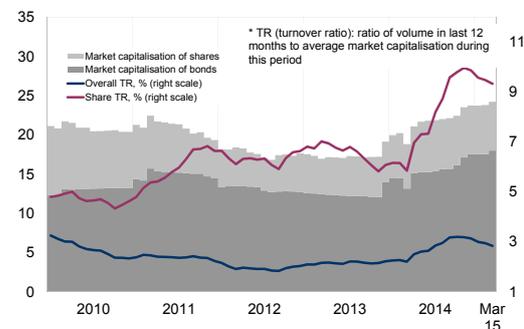
Transactions in housing and basic housing price index (2010 = 100)



Stock of leasing business with non-financial corporations more than 90 days in arrears (2010 = 100)



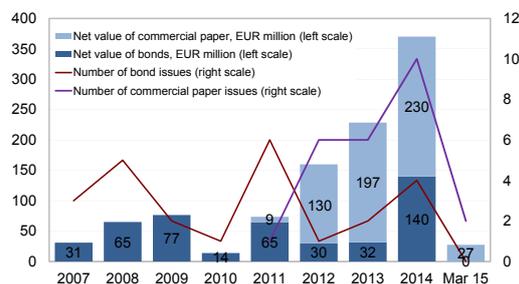
Market capitalisation on the Ljubljana Stock Exchange in EUR billion, and annual turnover ratios



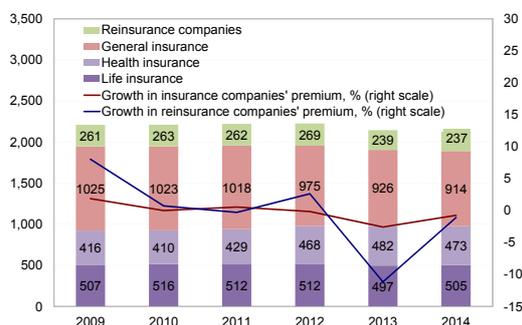
primarily temporary in nature, and the risks to the Slovenian capital market remain or are increasing. The delisting of the privatised firms from the stock exchange will bring an additional deterioration in the situation on the market: liquidity will fall further, and total market capitalisation and volume on the stock exchange will not be sufficient to ensure that it functions smoothly, which could endanger the existence of the domestic organised capital market. This would vastly reduce the alternative options of corporate financing.

The more favourable economic environment was also partly reflected in the performance of insurers. Gross written premium declined further, but the performance indicators were more favourable than in the previous year. Low interest rates remain the principal risk to insurers, which is limiting the returns on the most important segment of investments, namely debt securities. Insurers hold 51% of their investments in securities of domestic issuers. The figure was down 2.3 percentage points on a year earlier, although the figure for Slovenian government debt securities was up. In the context of interest rates remaining low, the provision of the guaranteed returns and problems with the reinvestment of maturing investments will present a great challenge for insurers. The insurance stress tests otherwise revealed that Slovenian insurers are well prepared for the introduction of Solvency II.

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



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



# 1 MACROECONOMIC ENVIRONMENT

## Summary

Macroeconomic risks in the euro area stabilised last year, which has been reflected in easier and cheaper access to the financial markets. Economic activity in the euro area is nevertheless still fluctuating significantly, and some uncertainties and risks remain. The economic outlook improved in Slovenia and in the euro area. As a result of an improvement in the international environment and the increased competitiveness of the Slovenian economy, Slovenia recorded relatively high economic growth of 2.6% in 2014. The key factors in economic growth were exports and government investment, while the contribution made by consumption remains weak. Economic growth in Slovenia is forecast at just over 2% for 2015, and there are also signs of positive trends in employment and growth in real gross wages. In light of the recovery and resolution of the banking system and the expected ongoing fiscal consolidation, Slovenia's outlook was upgraded to stable by the rating agencies. Moody's also upgraded Slovenia's sovereign rating in early 2015.

## 1.1 International environment

Economic growth in the euro area was positive last year, primarily as a result of increased household consumption and growth in exports, while investment consumption remains weak. At 0.9%, economic growth was nevertheless weak, particularly in Slovenia's five most important trading partners,<sup>1</sup> of which only Germany recorded significant positive economic growth. The economic sentiment and confidence indicators in early 2015 were above their long-term averages, which underpinned the European Commission's forecasts of spring 2015. These envisage stronger economic growth in the euro area in the coming years, including in Slovenia's most important trading partners. The improved economic outlook was attributable to the easing of the situation on the financial markets, the fall in oil prices and the improvement in relatively competitiveness in the wake of the weak euro.

**The euro area again recorded positive economic growth in 2014, primarily as a result of increased household consumption and growth in exports.**

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

	Real GDP				Unemployment rate				Inflation			
	2013	2014	2015*	2016*	2013	2014	2015*	2016*	2013	2014	2015*	2016*
EU	0.0	1.4	1.8	2.1	10.9	10.2	9.6	9.2	1.5	0.6	0.1	1.5
<b>Euro area</b>	-0.4	0.9	1.5	1.9	12.0	11.6	11.0	10.5	1.4	0.4	0.1	1.5
Germany	0.1	1.6	1.9	2.0	5.2	5.0	4.6	4.4	1.6	0.8	0.3	1.8
Italy	-1.7	-0.4	0.6	1.4	12.1	12.7	12.4	12.4	1.3	0.2	0.2	1.8
Austria	0.2	0.3	0.8	1.5	5.4	5.6	5.8	5.7	2.1	1.5	0.8	1.9
France	0.3	0.4	1.1	1.7	10.3	10.3	10.3	10.0	1.0	0.6	0.0	1.0
Croatia	-0.9	-0.4	0.3	1.2	17.3	17.3	17.0	16.6	2.3	0.2	0.1	1.3
<b>Slovenia</b>	-1.0	2.6	2.3	2.1	10.1	9.7	9.4	9.2	1.9	0.4	0.1	1.7

Note: Shaded area signifies the European Commission forecasts.

Source: European Commission spring forecast

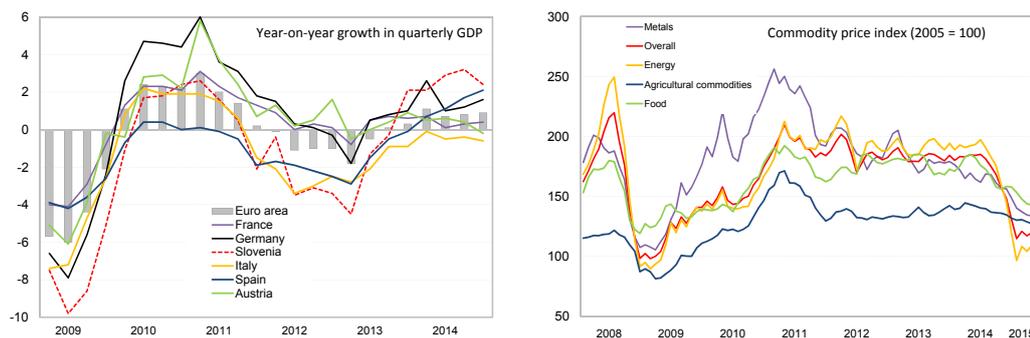
The forecast improvement in the economic situation will have a favourable impact on economic growth in Slovenia. Economic activity in the EU is nevertheless still fluctuating significantly, and there remains specific uncertainty with regard to the effects of current economic policy (ECB quantitative easing, establishment of the European Fund for Strategic Investments, Capital Markets Union).

There remain geopolitical tensions in the international environment, in connection with the Ukraine conflict. The risk is being reflected directly in Slovenian firms' exports to Russia, and indirectly in reduced exports by Slovenia's major trading partners. The risk of a renewed deterioration in country risk increased again in light of the uncertain political developments in Greece following elections, although the risk of contagion for other members of the euro area is now lower. This has been reflected in easier and cheaper access to international financial markets.

**Contagion risk between countries is diminishing, which has been reflected in easier and cheaper access to international financial markets.**

<sup>1</sup>The EU remains Slovenia's most important export market. It accounts for just over three-quarters of exports. Slovenia's main trading partners in 2014 were Germany (19.9% of total exports), Italy (11.8%), Austria (9.0%), Croatia (7.7%) and France (5.1%).

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

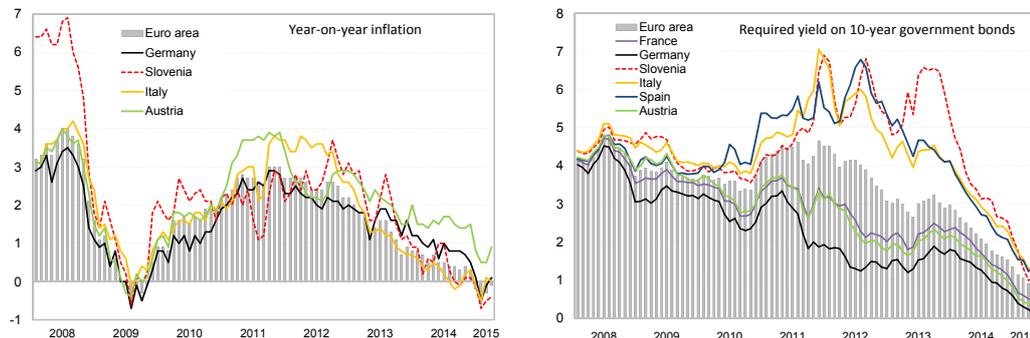


Note: GDP figures are not seasonally adjusted.  
Sources: Eurostat, IMF database

**The risk of low inflation and persistently high unemployment were the arguments behind new non-standard measures by the ECB, which are already showing positive effects.**

Lower commodity prices are having a favourable impact on economic activity; in particular the fall in energy prices is reducing operating costs for firms and is increasing consumer purchasing power. Other deflationary factors in Slovenia are weak domestic demand and the process of the internal adjustment of relative prices, which is being reflected in a reduction in unit labour costs. Alongside high unemployment across the euro area, the risk of low inflation is one of the major arguments for the ECB’s implementation of non-standard measures. In 2014 and early 2015 the ECB maintained its expansionary monetary policy, and used new non-standard measures with the aim of stabilising inflation expectations and encouraging bank lending activity. The effects of the ECB measures are being reflected in a fall in the required yields on bonds, which is allowing Slovenian government bonds to be refinanced at more favourable interest rates.

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



Source: Eurostat

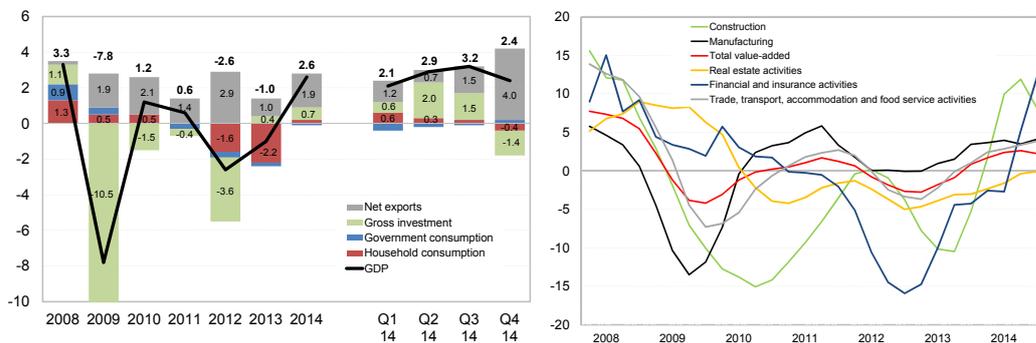
Excess liquidity and the search for higher returns mean that investors are also increasingly purchasing corporate bonds and commercial paper, which is being reflected in lower corporate borrowing costs. Lending to non-financial corporations was still declining in 2014 and early 2015 in Slovenia and across the euro area, albeit at a slower pace. As the stock of bank lending declined, economic growth was supported by firms’ internal financing and issues of debt securities.

## 1.2 Economic developments in Slovenia

GDP growth in 2014 reached its highest level since the outbreak of the economic crisis in Slovenia at 2.6%. The growth was the result of the improvement in the international environment, the stabilisation of the financial markets, the improved competitiveness of the Slovenian economy and the beginning of the recovery and resolution of the banking system. The key factors in economic growth were exports and government investment, investment in public infrastructure in particular. The main factors in the last year's rise in exports were the strengthening of foreign demand and the improvement in exporters' competitiveness, while the contributions made by household consumption and government consumption remained modest. Value-added has been increasing in year-on-year terms in most sectors since the beginning of 2014. Growth was particularly pronounced in manufacturing; after a long decline the trend reversed in the construction sector, while the majority of other sectors also strengthened.

**GDP in Slovenia recorded its highest growth since the outbreak of the economic and financial crisis, primarily as a result of growth in exports and government investment.**

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

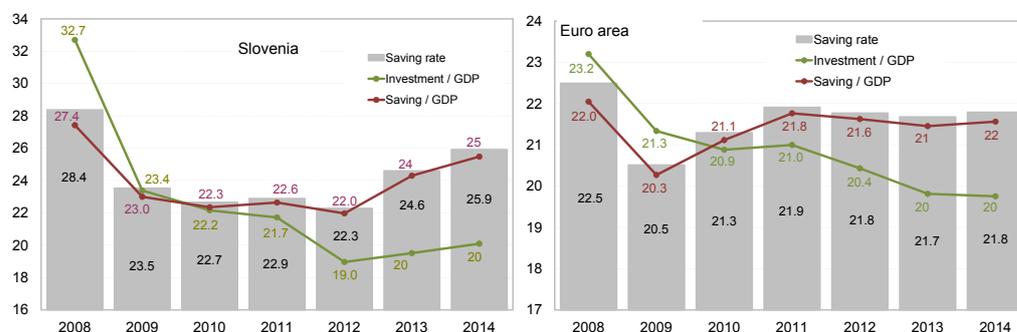


Source: SORS

Economic growth in Slovenia is forecast at just over 2% for 2015, with exports remaining the primary driver. According to the forecasts, investment will continue to account for a significant proportion, as private-sector investment for a larger proportion than last year, while final demand is also expected to gradually strengthen. The improvement in the situation on the labour market and the forecast real growth in disposable income will bring higher growth in private consumption, although households remain cautious for the moment. As a result of the ongoing fiscal consolidation, which commits Slovenia to reducing the budget deficit, government consumption is forecast to record a decline similar to that in 2014. The improvement in the economic situation is also being reflected in falling unemployment, which in Slovenia remained below the euro area average in early 2015, but was still high at 9.4%.

**Economic growth in 2015 is forecast at just over 2%, according to forecasts by domestic and foreign institutions.**

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



Sources: SORS, ECB

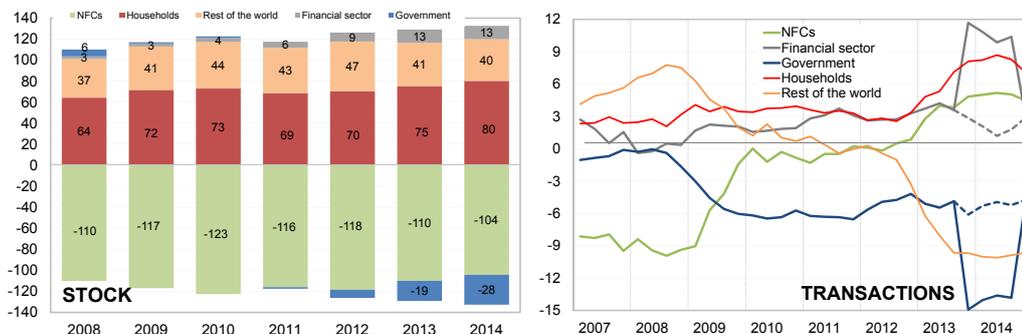
Slovenia has a high surplus of saving over investment compared with the euro area average, as a result of the continuing reluctance to invest and the relatively large saving rate. The saving-investment gap in Slovenia is continuing to widen, and stood at 5.4% of GDP in 2014. The ratio of investment to GDP has been declining in the euro area since 2011, while saving is stagnating by contrast; the saving-investment gap is thus significantly narrower than in Slovenia at just under 2%.

**The saving-investment gap in Slovenia is continuing to widen, and is significantly larger than the euro area average.**

**Both corporates and households have maintained net positive positions in terms of transactions, although they are no longer increasing.**

Corporates remain net creditors to other sectors in current transactions, having become so at the end of 2012. Households also remain cautious, and are maintaining a high saving rate and modest consumption, although the trend of increase in the net positive position reversed downwards at the end of 2014. This is in line with rising consumer confidence and the slight increase in final household consumption. As a result of the bank recapitalisations at the end of 2013 and in 2014, the government sector's net negative position widened significantly, albeit only temporarily, while the net positive position of the financial sector increased.

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



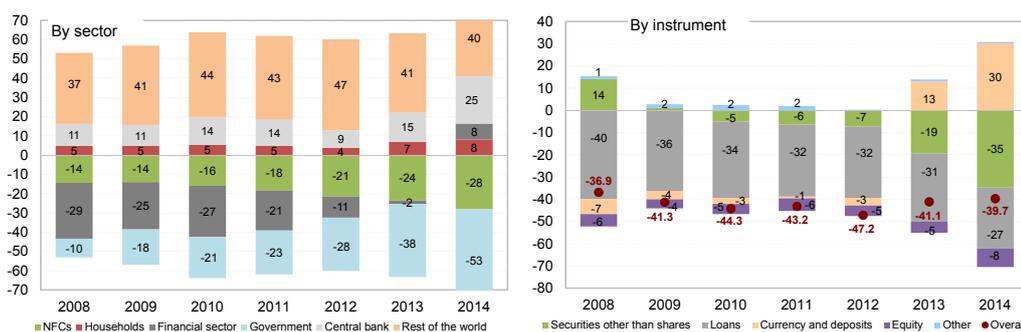
Note: Annual transactions are calculated as four-quarter moving sums. Transactions excluding the effects of the recapitalisations at the end of 2013 are illustrated in dotted lines for the financial sector and the government sector.

Sources: Bank of Slovenia, SORS

**Financial liabilities to the rest of the world have increased at corporates since the outbreak of the crisis, an indication of the still-limited access to domestic bank financing and the search for alternatives.**

Slovenia's net financial liabilities to the rest of the world amounted to 40% of GDP last year. The banking sector continued to actively pay down debt to the rest of the world, as it reduced its long-term liabilities at the ECB and continued repaying debt to foreign banks. This was done more slowly than in previous years, the dependence on this funding having declined sharply. By contrast, corporate debt to the rest of the world has increased since the outbreak of the economic and financial crisis, an indication of the still-limited access to domestic bank financing and the consequent growth in borrowing in the rest of the world. Larger Slovenian corporates also finance themselves via issues of commercial paper and bonds to foreign investors. The growth in such borrowing was very pronounced in 2014 as a result of the sharp fall in the prices of this financing. Government debt to the rest of the world also increased sharply as a result of issued government securities.

Figure 1.6: Net financial position against the rest of the world by economic sector (left) and by instrument (right) as a percentage of GDP



Source: Bank of Slovenia

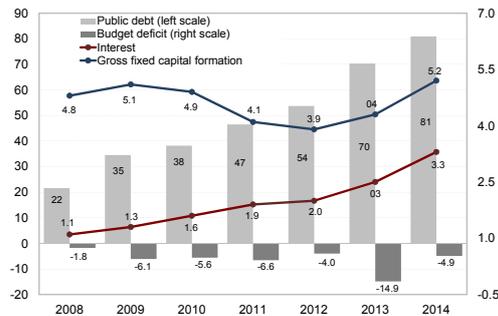
**Foreign equity remains low, and is still an unexploited option for obtaining significant corporate financing.**

Foreign equity remains low at 8% of GDP, and is still an unexploited option for obtaining significant corporate financing and for reducing over-leveraging. Several major firms were nevertheless successfully sold in 2014, an indication of the opportunity for increasing the inflow of foreign capital into Slovenia. The net financial position against the rest of the world in currency and deposits also began increasing at the end of 2013, and continued to do so in 2014. A large part of the increase pertains to the central bank, but the government sector and the banking sector also increased their claims. Another factor in the increase in the government sector's holdings of currency and deposits in the rest of the world was the excess liquidity at domestic banks.

Slovenia's public debt increased significantly in 2014 and stood at 81% of GDP at the end of the year. The general government deficit amounted to 4.9% of GDP in 2014, which raised interest costs to 3.3% of GDP. In light of the pronounced fall in the required yield on government bonds, interest costs can be expected to decline in 2015, although the public debt will increase further, given the budget deficit of 2.9% of GDP forecast for the year. The ongoing fiscal consolidation and reduction in the budget deficit to below 3% of GDP also remain dependent on the implementation of structural reforms. The fiscal measures to date have restored some confidence in greater stability, which has also been reflected in the upgrading of Slovenia's sovereign credit rating.

**The success of the ongoing fiscal consolidation remains dependent on the adoption of appropriate fiscal reforms and the implementation of structural reforms.**

Figure 1.7: Public debt, budget deficit, interest payments and gross government investment as a percentage of GDP



Source: SORS

The improvement in the economic situation and the increased confidence brought an improvement in the outlook for Slovenia at the largest rating agencies last year and in early 2015. Moody's upgraded Slovenia's sovereign credit rating from a speculative Ba1 to an investment-grade Baa3, while S&P and Fitch changed their outlooks to stable. The principal reason is the stabilisation of the banking system via the comprehensive recapitalisation of the largest banks and the establishment of the BAMC. The rating agencies nevertheless caution that challenges remain in banking, primarily as a result of the ongoing process of deleveraging in the real sector and the potential deterioration in claims. The rating agencies also highlight the stabilisation of the public debt and further fiscal consolidation measures as positive factors. Another major factor in the upgrading was the intensification of privatisation activities.

**Moody's upgraded Slovenia's sovereign credit rating in early 2015, while S&P and Fitch changed their outlooks to stable last year.**

Table 1.2: Slovenia's sovereign credit ratings at the major rating agencies

Agency	Credit rating	Outlook	Last change
Standard and Poor's	A-	stabilni	19 Dec 2014
Moody's	Baa3	stabilni	21 Jan 2015
Fitch Ratings	BBB+	stabilni	2 May 2014

Source: Ministry of Finance

## 2 HOUSEHOLD SECTOR

### Summary

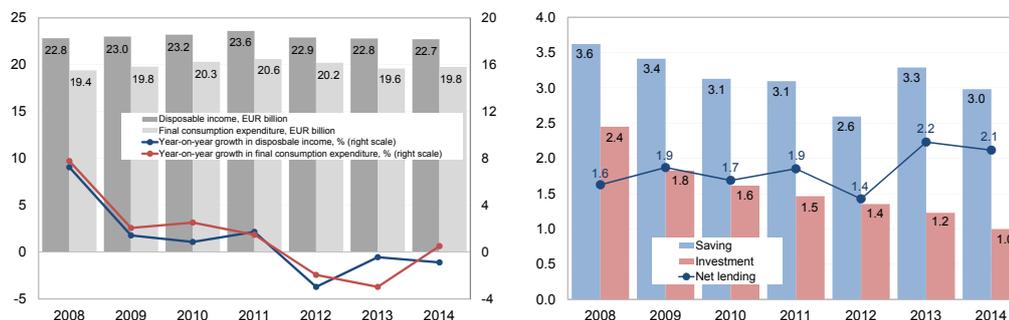
Households in Slovenia remain relatively less indebted and do not pose any major systemic risk to the banking system. There was no significant increase in the proportion of non-performing claims against households, despite a rise in the number of personal bankruptcies. Household deposits increased in 2014 as disposable income stagnated, following their partial withdrawal from domestic banks in 2013. Household financial assets increased to EUR 40 billion in 2014, while financial liabilities remained at EUR 12.2 billion, which was reflected in an increase in the household sector's net financial assets. With the improvement in the economic situation, the increase in real gross wages and the fall in liability interest rates, household consumption and investment activities could be expected to increase in the future. As returns on borrowing increased and interest rates fell, the household debt servicing burden entailed by loan repayments declined in 2014.

### 2.1 Household financial assets

**Household disposable income in 2014 remained similar to the previous year, while consumption increased by less.**

Households' gross disposable income remained at a similar level in 2014 for the third consecutive year, despite the increase in real gross wages and the fall in the unemployment rate. A decline in net social transfers was the main factor acting to reduce disposable income. Given the significant level of uncertain forms of employment (temporary employment and work via staffing agencies), final consumption expenditure increased only slightly. Households thus predominantly remain cautious and reluctant to consume, and are maintaining a high gross saving rate.

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

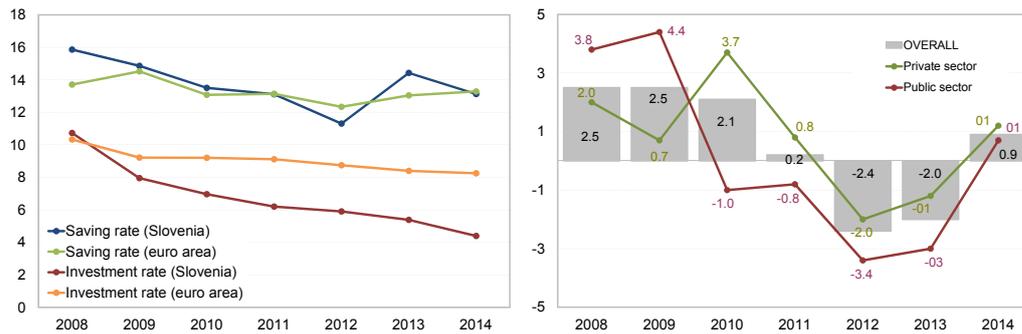


Source: SORS

**After two years of decline, real gross wages increased in the public sector and the private sector.**

The saving rate of Slovenian households is comparable to the average rate across the euro area, while the investment rate is significantly lower and is still declining. Given the rise in the consumer confidence indicator as a result of the more optimistic forecasts for the unemployment rate, economic growth in Slovenia and the financial position in households, household consumption and investment can be expected to increase this year. The figures showing relatively low household indebtedness, which allows for increased consumption at little risk, are also encouraging in this regard. After two years of decline, the average real gross wage increased in the public sector and the private sector. This is coinciding with the recovery of the labour market, and an increase in labour productivity.

Figure 2.2: Household saving rate and investment rate (left) and real growth in gross wages and unemployment rate (right) in percentages

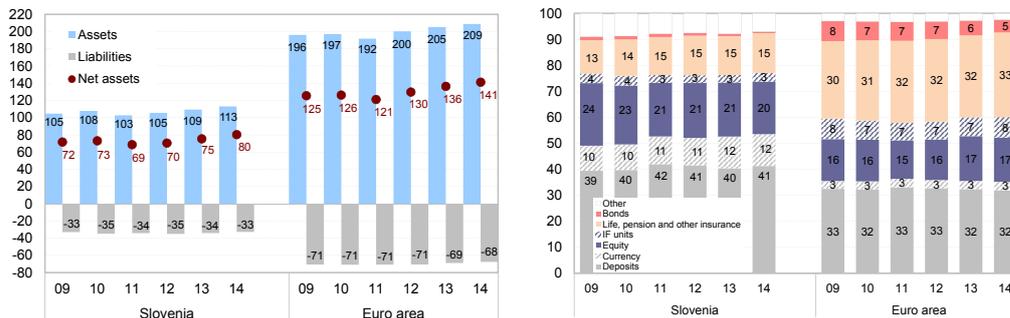


Sources: SORS, ECB

Household financial assets increased by EUR 2.55 billion in 2014 to EUR 42 billion, while financial liabilities remained at EUR 12.2 billion. The household sector's net financial assets thus increased to EUR 29.8 billion, or 80% of GDP. The figure is approximately half of that across the euro area. The breakdown of household financial assets in Slovenia in 2014 remained similar to the previous year: the proportion accounted for by currency and deposits remains high, and higher than the euro area average. The difference between the breakdowns is particularly notable in life insurance, pension insurance and other insurance. While the various forms of insurance currently account for a small proportion of assets, the figure can be expected to increase owing to demographic changes and reductions in pension payments from the mandatory state system.

**The proportion of household assets accounted for by various forms of insurance in Slovenia is half the euro area average.**

Figure 2.3: Financial assets, liabilities and net financial position as percentages of GDP (left), and breakdown of household financial assets in Slovenia and the euro area in percentages (right)

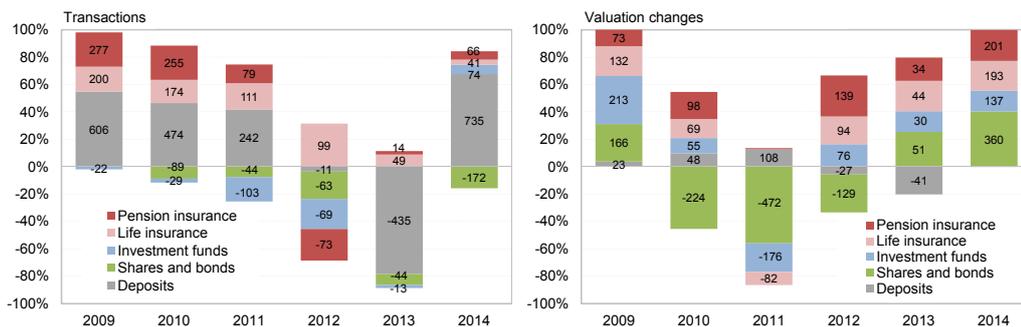


Sources: Bank of Slovenia, ECB

After two years of decline, growth in household deposits increased significantly in Slovenia in 2014. As shares and bonds recorded an increase in value of EUR 360 million, households sold a proportion of these assets as a result of the sale of numerous firms in 2014 and for reason of profit-taking. By contrast, the net flow of household investments into mutual funds increased for the first time since the outbreak of the economic and financial crisis, which was attributable to positive developments on the capital markets. The expectations of the launch of a programme of quantitative easing by the ECB were a significant factor. The value of all forms of household financial asset other than deposits increased as a result of the general improvement in the economic situation.

**Revaluations brought an increase in all forms of household financial asset in 2014 other than deposits.**

Figure 2.4: Breakdown of transactions (left) and valuation changes (right) in individual forms of household financial asset in Slovenia in EUR millions and percentages

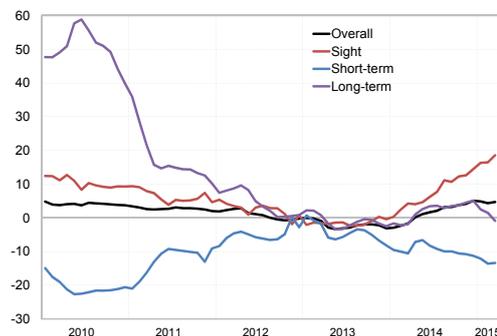


Source: Bank of Slovenia

**Household deposits at Slovenian banks rose again in 2014 after two years of decline.**

Household deposits in the Slovenian banking system increased by EUR 729 million in 2014. One of the most significant factors in the increase was the return of deposits to the Slovenian banking system, which was partly attributable to the favourable impact of the bank recovery and resolution process begun at the end of 2013. The increase in bank deposits was significantly larger than their outflow in 2013, which in light of the small changes in disposable income suggest that the funds have other sources. Households received some of the funds in the form of proceeds from the sale of corporate shares. Proceeds of over EUR 70 million were received in 2014 from the privatisation of large firms alone. In addition, households still hold equity in firms undergoing the privatisation process, the estimated value of which is just over EUR 150 million. These funds could be moved into deposits, primarily in the short term, although the diminishing returns on these investments could also have an impact on household decision-making.

Figure 2.5: Annual growth in household deposits in percentages

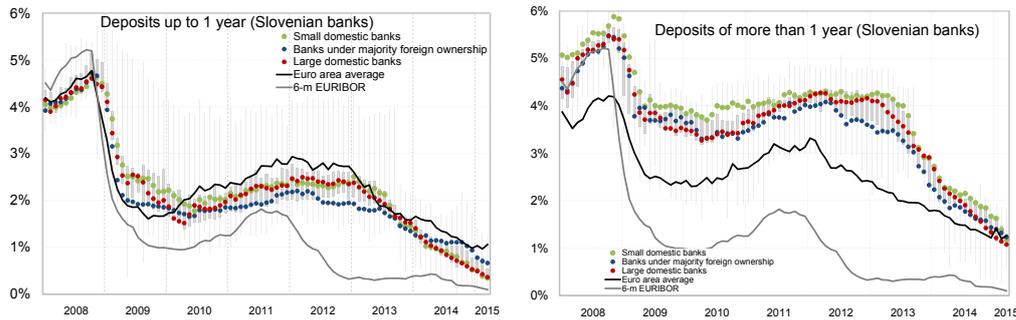


Source: Bank of Slovenia

**The majority of new household deposits in 2014 were not fixed-term deposits, but merely sight deposits. This is an indication of the continuing caution of households.**

Average interest rates on household deposits of more than 1 year began falling in 2013, reaching 2.8% by the end of that year, and 1.1% in March 2015. Average interest rates on household deposits of up to 1 year also fell, from 1.5% at the end of 2013 to 0.4% in March 2015. Average interest rates on deposits of up to 1 year are still significantly lower than the overall euro area average, while average interest rates on long-term deposits are at a comparable level after a major decline. The interest rate spreads between banks narrowed at the end of 2013, particularly after the wind-down of two small banks. In terms of maturity, sight deposits are recording the fastest growth, although long-term deposits of more than 1 year are also maintaining positive growth. The increase in sight deposits in the wake of falling returns on bank saving suggest that a certain proportion of deposits are likely to be more mobile in the future.

Figure 2.6: Level and distribution of interest rates on new household deposits at Slovenian banks of up to 1 year (left) and more than 1 year (right) in percentages



Source: Bank of Slovenia

The fall in interest rates and the improvement in the economic situation, particularly on the capital markets, could in the medium term lead to a portion of household deposits being switched into higher-yielding investments. Given the current low inflation rate (or deflation) in Slovenia, real interest rates are relatively attractive, but as inflation rises alternative forms of investment will become more attractive. The situation on the real estate market is normalising, partly as a result of the activities of the BAMC, which could encourage investment in this market. According to the bank lending survey, the banks are expecting increased demand for housing loans in the coming months, which could however entail increased risks for the banks as a result of a contraction in deposits. The search for higher-yielding alternative investments could also entail certain risks, given the higher price volatility of various forms of asset.

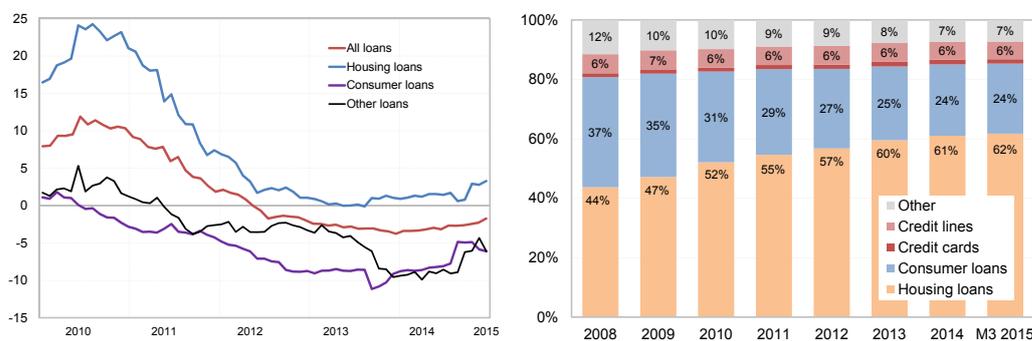
**In the medium term some deposits could be switched into higher-yielding investments, which could have beneficial effects for corporates and for banks.**

## 2.2 Household financial liabilities

Household financial liabilities amount to 33% of GDP, or 54% of annual disposable income. The indebtedness of Slovenian households is relatively low, given that the euro area average figure is around 107%. Households held EUR 8.38 billion of loans from Slovenian banks at the end of March 2015, of which EUR 374 million or 4.3% were non-performing claims<sup>2</sup>. Non-performing claims increased by approximately EUR 22 million in 2014, as a result of a sharp rise in the number of personal bankruptcies. There were more than 4,000 such bankruptcies last year, approximately four times the average of previous years. The main factor was a change in legislation, whereby it is no longer necessary to pay an advance when filing a petition to initiate personal bankruptcy. The number of personal bankruptcies continued to rise in early 2015.

**Household financial liabilities are among the lowest in the EU, and as a ratio to annual disposable income are half of the euro area average.**

Figure 2.7: Annual growth (left) and breakdown of stock of loans to households by type (right) in percentages



Source: Bank of Slovenia

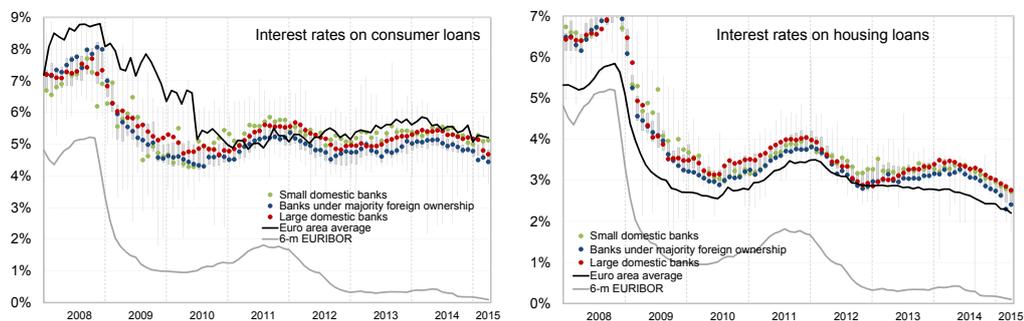
Growth in housing loans has been positive throughout the period since the outbreak of the crisis, while other loans had moved into negative growth by 2011. The negative growth was particularly pronounced for consumer loans, as a result of the deterioration in the economic position during the crisis and the maintenance of high credit standards by the

**Growth in housing loans remains positive, while consumer loans are still contracting.**

<sup>2</sup>The figure does not include sole traders. Including sole traders, the proportion of non-performing claims would be approximately 1 percentage point higher.

banks. A slowdown in the negative growth could however be seen in 2014, which coincided with the improvement in the economic situation and the financial position of households. The fall in average interest rates also suggests that a positive growth trend can be expected in consumer loans.

Figure 2.8: Interest rates on new consumer loans (left) and housing loans (right)



Sources: Bank of Slovenia, ECB

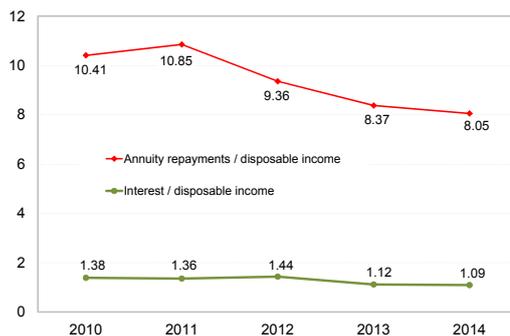
**Interest rates on housing and consumer loans have been falling since the beginning of 2014.**

Average interest rates on housing loans stood at 2.5% in March 2015, down 0.9 percentage points on the end of 2013. This fall was the result of the stabilisation of the banking system in 2014 and the falling cost of bank funding, which was also reflected in a fall in interest rates. Average interest rates on consumer loans fell to 4.4% in March 2015 (down 0.7 percentage points on the end of 2013). They were lower than the euro area average (5.2% in March 2015), while interest rates on housing loans were 0.5 percentage points higher than the euro area average. The fall in asset interest rates is increasing the affordability of loans to households and, in particular, SMEs.

**The loan repayment burden on disposable income is continuing to fall.**

The debt servicing burden on household disposable income from housing loans and consumer loans again declined slightly last year. Households earmarked an average of 8.05% of their disposable income for loan annuity repayments, of which 1.09% was for interest payments. The decline in the debt servicing burden on disposable income from loan repayments was expected, given the maintenance of disposable income at the same level and the decline in the stock of household debt. The decline in the debt servicing burden placed on income by loan repayments was also the result of falling asset interest rates. This trend could reverse in the future in the event of a faster increase in household indebtedness and rises in interest rates, as the majority of long-term loans have variable interest rates and relatively high premiums over the reference interest rates.

Figure 2.9: Household debt servicing burden from bank loan repayments as percentage of disposable income



Source: Bank of Slovenia

### 3 REAL ESTATE MARKET

#### Summary

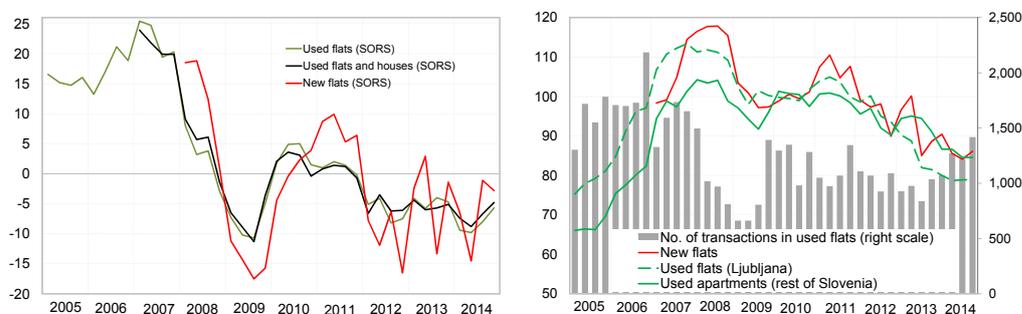
The real estate market revived in 2014 after several years of stagnation. The volume of transactions in the residential real estate market increased by almost a third, while the volume in commercial real estate also strengthened. The increase demand and willingness to buy was also attributable to prices of residential real estate, which have fallen sharply over the last three years. After four years of annual decline, new housing loans increased last year, an indication of gradual stabilisation and an end to the falls in real estate prices. The housing over-valuation indicators suggest an end to the fall in real estate prices and the potential gradual reversal in price developments on the real estate market in the future. Last year's ratio of prices to rents was the lowest of the last three years, while after several years of improvement the affordability of used flats in Ljubljana began deteriorating in the second half of 2014. The lack of construction of new-build housing in recent years could also be a factor in the reversal in the price trend on the real estate market, in the wake of increased demand. The possibility of renting foreclosed real estate from unsettled loan relations could enable the rental market to function better.

#### Residential real estate market

According to SORS figures, average prices of flats and houses fell by 6.5% last year. The pace of the fall slowed over the year. Prices of used flats in the final quarter of last year were down 5.7% in year-on-year terms, while prices of new-build flats were down 2.8% according to survey figures, having fluctuated during the year. Prices of residential real estate have fallen sharply over the last three years. Prices of used flats in Slovenia in the final quarter of 2014 were down 23.1% on their peak in the first quarter of 2008, while prices of new-build flats were down 26.9% on their peak in the third quarter of 2008. According to the figures of the Surveying and Mapping Authority of the Republic of Slovenia (SMARS), the average price of used flats in Slovenia stood at EUR 1,460 per m<sup>2</sup> in 2014. The highest price of EUR 2,020 per m<sup>2</sup> was in Ljubljana, while the lowest price of EUR 1,040 per m<sup>2</sup> was in Celje.

**Prices of flats and houses have fallen sharply over the last three years, which contributed to the revival of the real estate market in 2014.**

Figure 3.1: Year-on-year growth in prices of used and new-build residential real estate in Slovenia (left), and basic housing price index (2010 = 100) (right) in percentages



Source: SORS

Prices of flats and houses have fallen sharply over the last three years, which contributed to the revival of the real estate market in 2014. Liquidity on the real estate market increased again last year, after several years of decline. Last year's volume of transactions in used flats and houses was up almost a third on the previous year. A particularly notable increase in volume of 44.7% was recorded by used flats in Ljubljana, where prices had also fallen most, namely by 30.4% between their peak in the final quarter of 2007 and the final quarter of 2014. Volume in new-build flats also increased last year, by 10%, which was partly attributable to the sale of foreclosed residential real estate from unsettled loan relations to banks.

**Last year's volume of transactions in used flats and houses was up almost a third on the previous year.**

With coordinated policy and improvements in legislation on the rental market, the possibility of renting foreclosed real estate from unsettled loan relations and rent-to-buy, with a focus on non-profit letting of flats for young people and young families, could also contribute to greater liquidity on the real estate market. This could enable a better-functioning and larger rental market. A well-functioning rental market could have a positive impact on construction, increased population mobility, and more equal regional development, and is one of the foundations for the stable functioning of the real estate market in the long term.

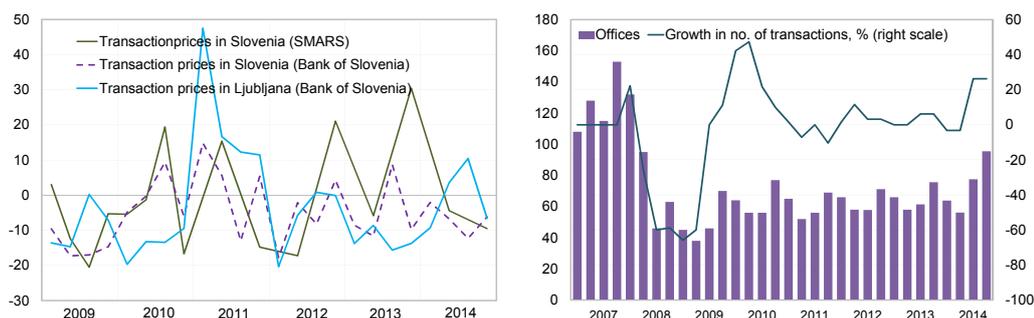
**The possibility of renting foreclosed real estate in the banks' portfolio, with a focus on the non-profit letting of flats for young people and young families, would help the real estate market to function better.**

## Commercial real estate market

**Average office prices fell by 7% in 2014, as the volume of transactions in commercial real estate strengthened sharply.**

Average office prices fell by 7% last year. Office prices in the final quarter of 2014 were down 6.2% in year-on-year terms, and were down 32.8% on their peak in the third quarter of 2008. Office prices in Ljubljana fell by 6.6% in the final quarter of 2014, and were down 35% on their peak in the second quarter of 2008. Growth in prices of commercial real estate fluctuates markedly, primarily as a result of the low liquidity and of the heterogeneity of commercial real estate on the market. According to SMARS figures, the volume of transactions in commercial real estate<sup>3</sup> strengthened sharply in 2014, primarily as a result of public sales from bankruptcy estates. Given the rise in corporate bankruptcies over the last two years, sales of this type can be expected to account for a significant proportion of volume in the future.

Figure 3.2: Year-on-year growth in commercial real estate (office) prices (left) and number of transactions included in the calculation of average price and growth therein (right) in percentages



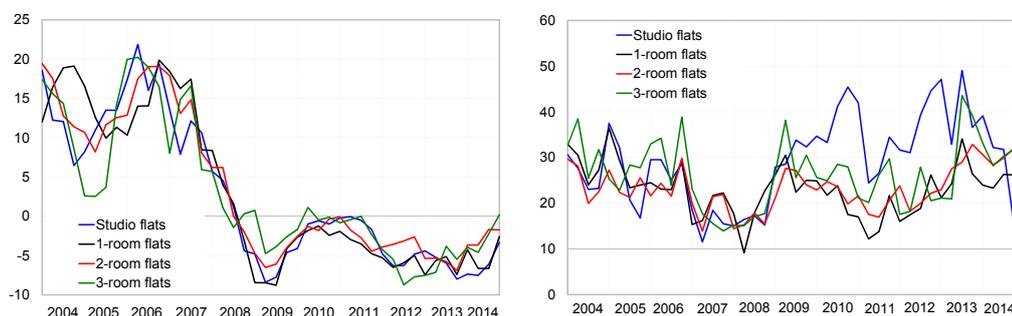
Note: Due to improvements in methodology, the figures for growth in office prices differ slightly from those published in previous issues of the Financial Stability Review. The distribution of the number of transactions by quarter is estimated on the basis of the SMARS's half-yearly and annual figures.

Sources: SMARS, Bank of Slovenia calculations

Indicators of over- and under-valuation of residential real estate<sup>4</sup>**Advertised prices were more than a quarter higher on average than selling prices of used flats in Ljubljana in 2014.**

Advertised prices of used flats in Ljubljana fell in 2014 for the sixth consecutive year, the fall ranging from 2.6% on three-room apartments to 6.1% on studio apartments. The fall in advertised prices of flats for sale slowed at the end of last year, while advertised prices of flats to let rose slightly. Advertised prices were 28.9% higher on average than selling prices of used apartments in Ljubljana. The gap, which indicates the over-valuation of used apartments, narrowed, having reached its widest level in recent decades in 2013.

Figure 3.3: Year-on-year growth in advertised apartment prices (left) and gap by which advertised prices exceed transaction prices per square metre (right) in percentages



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

<sup>3</sup> Commercial real estate includes commercial buildings, offices and premises for pursuing wholesale and retail trade, accommodation and food service activities and other service activities.

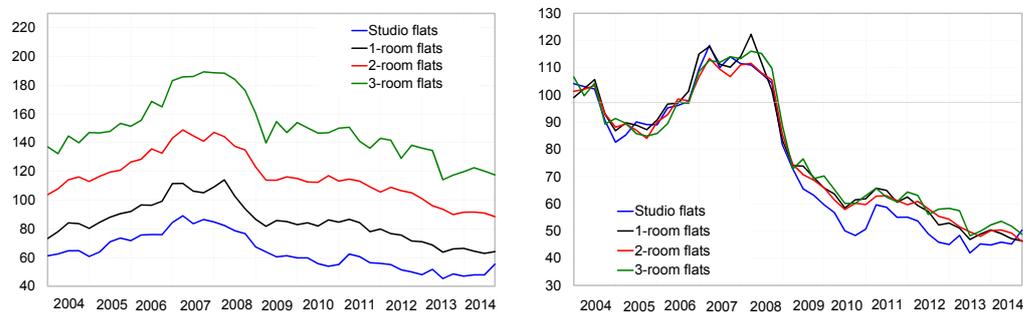
<sup>4</sup> Due to improvements in methodology, the figures for prices of used flats differ slightly from those published in previous issues of the Financial Stability Review. The figures for the final quarter of 2014 are provisional.

Housing affordability in Ljubljana as measured by the ratio of used flats prices to the annual moving average of net monthly wages improved last year for the seventh consecutive year. Purchasing a flat required an average of three fewer monthly wage payments than a year earlier. Housing affordability in Ljubljana began to deteriorate in the second half of 2014: purchasing a flat required an average of one more monthly wage payment than a year earlier, which could indicate the stabilisation of real estate prices or an end to the falls in real estate prices.

Similarly, the housing affordability indicator that takes account of loan terms also indicates a deterioration in affordability. This improved overall last year, but began deteriorating in the second half of the year. The deterioration was primarily attributable to a year-on-year rise in average prices of used studio flats and three-room flats, and the shortening of the average maturity of housing loans to 18.5 years. The fall in variable interest rates on housing loans had a positive impact on housing affordability.

**The affordability of used flats in Ljubljana as measured by the ratio of prices to wages began deteriorating in the second half of 2014.**

Figure 3.4: Ratio of housing prices to annual moving average of net monthly wages for Ljubljana in percentages (left) and housing affordability index (2004 = 100)<sup>5</sup> (right)



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

The price to rent (P/E) ratio for housing in Ljubljana again declined slightly last year, real estate prices having fallen more on average than rents. The exception was studio flats, which saw a rise in the ratio. The over-valuation of housing has diminished significantly since 2007. The average P/E ratio last year was a fifth higher than the underlying ratio,<sup>6</sup> while before the crisis in the first quarter of 2007 it was a half higher than the underlying ratio. Actual selling prices for the majority of housing last year were just over a fifth higher on average than the long-term sustainable prices, two-room flats recording the largest gap.

Real estate owners' returns from the rental of real estate last year were again the highest of the last nine years, as they had been in 2013, and averaged 6.6% of the market value of the real estate for used flats. The relatively high return is an indication of the imbalances on the real estate market. Another indication of imbalances is the increase in the burden placed on tenants by housing costs from 15.2% in 2008 to 25.8% in 2013, thereby reaching the euro area average.<sup>7</sup>

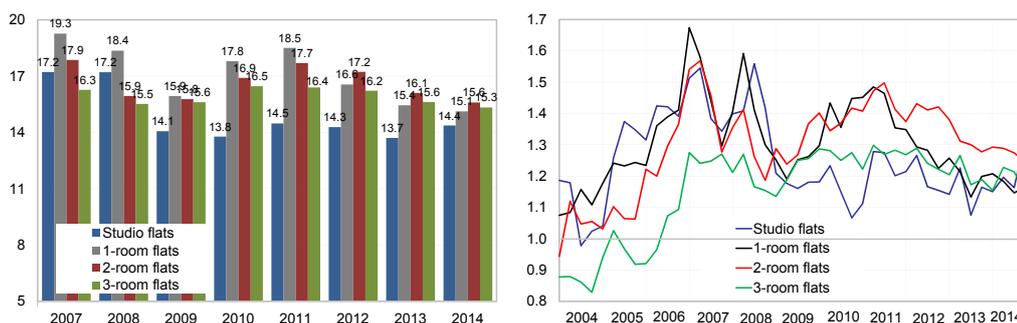
**The housing over-valuation indicators suggest the stabilisation of real estate prices and the potential gradual reversal in price trends on the real estate market in the future.**

<sup>5</sup>The housing affordability index is calculated as the ratio of the price of used housing and the annual moving average of net monthly wages, taking account of loan terms (2004 = 100), under the assumption that the purchase of the housing is financed entirely by a loan, subject to terms of approval (maturity, interest rate) calculated as an average for the banking system.

<sup>6</sup>The calculation of underlying housing prices on the basis of the ratio of housing prices to rents (P/E ratio) takes account of the average P/E ratio between 1995 and 2003. A more accurate calculation of the underlying price would require the calculation of the average P/E over a longer, more stable period of 10 to 15 years. The short time that the Slovenian housing market has functioned normally and for which data series are available makes this impossible. A change in the baseline period would also lead to a change in the underlying P/E ratio. The aforementioned limitations should be taken into account in the interpretation.

<sup>7</sup>Source: Eurostat, SILC; percentage of total population of tenants.

Figure 3.5: P/E ratio (left), and ratio of actual prices to underlying prices of housing in Ljubljana calculated on this basis (right)



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

Supply and demand factors on the real estate market

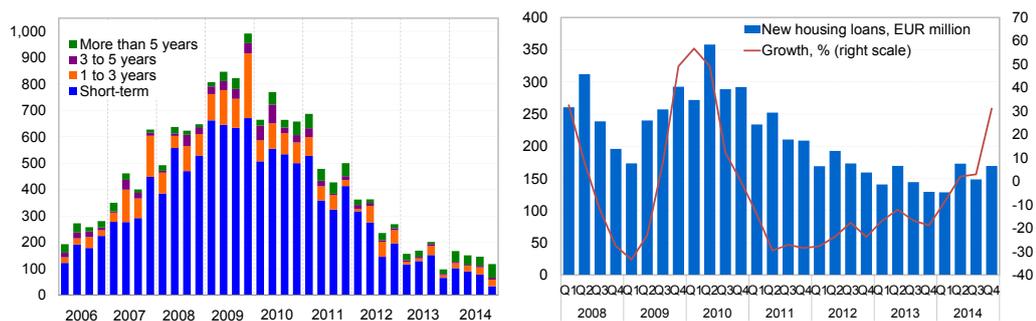
**Last year’s growth in the volume of transactions on the real estate market has also been reflected in an increase in new loans for purchasing housing.**

Growth in the volume of transactions on the real estate market is being reflected in an increase in new loans for purchasing housing. After three years of decline, new housing loans last year were up 6.1% on the previous year, and in the final quarter were up almost a third. The positive growth in new housing loans continued in the early part of this year. This is the first increase in new housing loans in the last four years, which in the wake of households’ increased demand and willingness to purchase suggest that prices of residential real estate will rise in the future.

Year-on-year growth in the stock of housing loans stood at 0.8% at the end of 2014, the lowest figure in the last decade, but it began rising again in the early part of this year, reaching 2.8% in March. The rise in the Swiss franc in the early part of this year increased the debt servicing burden of Slovenian households. Although households have not been borrowing in Swiss francs since 2009, residual Swiss franc debt still accounts for 14% of the stock of housing loans to households, down from a third in 2008.

The LTV ratio for new housing loans (the ratio of the loan to the value of the collateral) across the banking system in 2014 remained unchanged from the previous year at 67%. The average LTV ratio fell by 3 percentage points to 64% at the banks under majority foreign ownership and savings banks, and by 2 percentage points to 53% at the small domestic banks. Only the large domestic banks recorded a rise, of 2 percentage points to 71%. The LTV ratio for the stock of housing loans remains low at 53%.

Figure 3.6: New loans to the construction sector (left) and new housing loans to households (right) in EUR million



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

**The lack of construction of new-build housing in recent years could be a factor in bringing the fall in real estate prices to an end or even a rise in prices.**

The banks have been reluctant to lend to the construction sector in recent years. New loans to the construction sector have fallen sharply over the last five years. The banks approved or rescheduled EUR 580 million of new loans for construction firms in 2014, less than a fifth of the high recorded in 2009. The number of new buildings for which building permits were issued is also falling: it was down 7.4% in 2014. The volume of transactions in building land also declined. The construction confidence indicators otherwise reveal increased confidence, although growth in investment in housing remains negative.

As lending to the construction sector, the number of buildings for which a building permit has been issued, and gross investment in housing have all declined, the supply of new-build residential real estate has also declined. The supply of unsold housing built in the years at the outbreak of the crisis is also diminishing. Given the lack of construction of new-build housing in recent years, increased demand on the real estate market could be a factor in bringing the fall in real estate prices to an end or even a rise in prices.

## 4 CORPORATE SECTOR

### Summary

The economic recovery is seeing a reduction in leverage at non-financial corporations and an improvement in debt servicing capacity. The debt-to-equity ratio declined from 122% in the previous year to 112% last year, while the ratio of net financial debt to EBITDA declined from 5.9 to 5.2. Excessive debt also declined, and this development was evident in all sectors. Corporate financing at domestic banks has been declining since 2012, and business-to-business financing has also declined over the last two years. Slovenian corporate indebtedness as measured by the debt-to-equity ratio remains higher than the euro area average, despite a significant decline over the last two years. At the same time the indebtedness indicator as measured by the ratio of corporate debt to GDP is below the euro area average. This indicates that the actual level of indebtedness of the Slovenian corporate sector is not problematic; only the financing structure is inappropriate, as it lacks equity. The stock of corporate loans in 2014 was down almost a quarter on its peak of 2008, while the stock of equity remained at almost the same level.

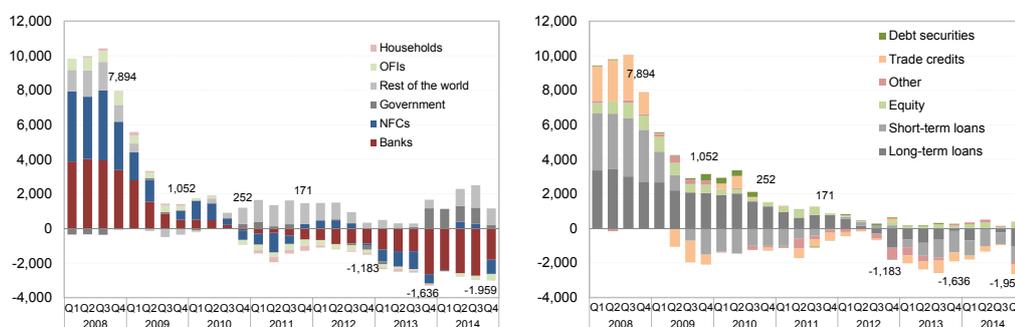
### 4.1 Corporate financing and net indebtedness

#### Corporate financing flows

#### Corporate financing at domestic banks is still declining.

The flow of financing at Slovenian corporates was negative for the third consecutive year, in the amount of EUR 1,959 million. Corporate financing at domestic banks is still declining: corporates made net debt repayments totalling EUR 5,984 million over the last four years. Corporate debt to domestic banks was reduced by EUR 1,814 million in 2014 via loan repayments, debt-to-equity conversions and write-offs. Business-to-business financing in Slovenia has also declined sharply over the last two years: it amounted to EUR 818 million in 2014. Corporates have only maintained a positive financing dynamic with the government sector and the rest of the world. Corporates increased their financing in the rest of the world, both debt and equity, by EUR 945 million last year.

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



Source: Bank of Slovenia

#### Repayments of business-to-business lending continued last year, to domestic and foreign corporates.

Corporates also saw a contraction in business-to-business financing over the last two years, both domestically and in the rest of the world. Net loans repayments between corporates in Slovenia amounted to EUR 42 million, less than in the previous year, while net repayments of loans to the rest of the world increased to EUR 312 million. Only long-term loans recorded a contraction, of EUR 462 million, while short-term loans actually increased by EUR 150 million. Last year corporates also reduced their financing at suppliers and customers via trade credits and advances. Corporates made net repayments of EUR 313 million in trade credits and advances to domestic corporates last year, and repayments of EUR 201 million to the rest of the world. The contraction in trade credits between corporates is also an indication of a lack of confidence, a reluctance on the part of corporates to take up credit risk in respect of other corporates, and the fear of a loss of financing and declining liquidity.

#### Corporates strengthened the inflow of equity from the rest of the world last year, mostly from EU Member States.

Corporates increased their financing last year via successful issues of debt securities in the amount of EUR 288 million, while equity was also strengthened by the inflow of EUR 1,227 million from the rest of the world, mostly from EU Member States. The overall inflow of equity of domestic origin to corporates was negative in the amount of EUR 827 million. Households recorded net sales of their equity holdings in corporates, partly in the privatisation processes.

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

	Flows			Stock			Growth
	2012	2013	2014	2012	2013	2014	2014
	(EUR million)						(%)
Total	-1,183	-1,636	-1,959	85,895	82,202	79,230	
growth, %	-790.3	38.3	19.8	-1.6	-4.3	-3.6	-3.6
ratio to GDP, %				238.6	227.4	212.7	
Loans	-937	-1,387	-1,946	32,883	29,160	26,240	-10.0
- business-to-business	-137	-241	-42	4,261	3,963	3,623	-8.6
- from banks	-815	-2,605	-1,683	18,986	14,226	11,362	-20.1
- from NMFIs	-163	-9	-251	2,251	2,172	1,883	-13.3
- from rest of the world	143	560	-312	6,481	7,004	7,262	3.7
of which: from corporates <sup>1</sup>	296	-19	235	1,469	1,498	2,187	46.0
from foreign banks (excluding IFIs)	-152	50	-331	3,064	3,056	2,975	-2.7
from IFIs <sup>2</sup>	27	505	-226	1,916	2,426	2,199	-9.3
Trade credits	161	-518	-546	11,813	11,222	10,758	-4.1
- business-to-business	-11	-427	-313	6,381	6,028	5,723	-5.1
- from rest of the world	267	-94	-201	4,523	4,298	4,158	-3.3

Note: <sup>1</sup>The figures for 2013 include two major transactions with international financial institutions. The figures for 2014 include two major transactions and revaluations with corporates in the rest of the world. Growth in the stock of loans from the rest of the world was positive in 2014, while flows were negative; the increase in the stock was attributable to a revaluation as a result of the reclassification of one entity as a non-financial corporation (previously an OFI).

Source: Bank of Slovenia

Corporates' loan repayments were larger than their new loans in all creditor sectors in 2012 for the first time, and corporate debt repayments have continued over the last two years. The stock of corporate loans in 2014 was down almost a quarter on its peak of 2008. The stock of business-to-business loans declined by 8.6% last year to EUR 3,623 million, while the stock of bank loans declined by 20.1% to EUR 11,362 million.

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

	Stock at year end			
	2011	2012	2013	2014
Total, EUR million	17,595	18,060	18,728	20,274
growth, %	14.4	2.6	3.7	8.3
	Breakdown, %			
Securities <sup>1</sup>	1.4	1.4	1.3	2.4
Loans	35.4	35.9	37.4	35.8
of which: at banks in rest of the world	17.2	17.0	16.3	14.7
at MFIs <sup>2</sup>	11.2	10.6	13.0	10.8
at corporates in rest of the world	6.3	8.1	8.0	10.8
Equity	36.7	35.9	36.8	39.8
Trade credits and other	24.1	25.0	23.0	20.5

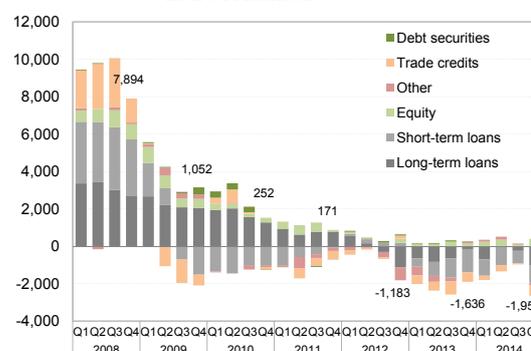
Notes: <sup>1</sup>Securities other than shares.

<sup>2</sup>International financial institutions.

Source: Bank of Slovenia

Corporates partly compensated for the decline in domestic bank and business-to-business financing with financing from the rest of the world. The stock of corporate loans from the rest of the world increased by 3.7% in 2014 to EUR 7,262 million. Loans from the rest of the world now account for a large proportion of corporates' loan financing. They accounted for 28.6% of all corporate loans at the end of last year, up 4 percentage points on a year earlier. The proportion of loans from the rest of the world thereby exceeded its level of 2004, when it stood at more than 20%, although in the following years it declined sharply as a result of the rapid growth in loans at the domestic banks in the pre-crisis period. The large proportion accounted for by foreign loans is also attributable to individual large transactions and revaluations: there were two major transactions and revaluations with corporates in the rest of the world in 2014.

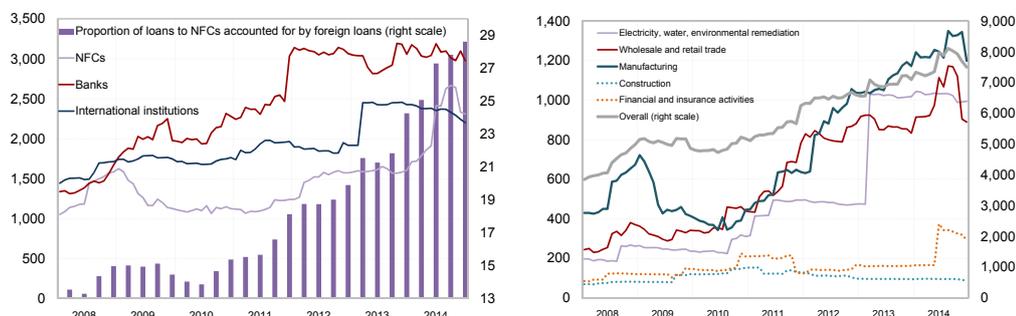
Figure 4.2: Corporate financing flows in the rest of the world, annual moving total of flows in EUR million



**A lack of domestic financing means that loans from the rest of the world account for an increasing proportion of corporate loans.**

Firms in the manufacturing sector, which made the largest contribution to economic growth thanks to their export focus, recorded year-on-year growth of 2.2% in financing in the rest of the world last year. The stock of corporate loans from the rest of the world declined slightly in the second half of the year, primarily as a result of certain major transactions with short maturities in the sectors of manufacturing and wholesale and retail trade.

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



Note: The figures for 2013 include two major transactions with international financial institutions. The figures for 2014 include two major transactions and revaluations with corporates in the rest of the world. Growth in the stock of loans from the rest of the world was positive in 2014, while flows were negative; the increase in the stock was attributable to a revaluation as a result of the reclassification of one entity as a non-financial corporation (previously an OFI).

Source: Bank of Slovenia

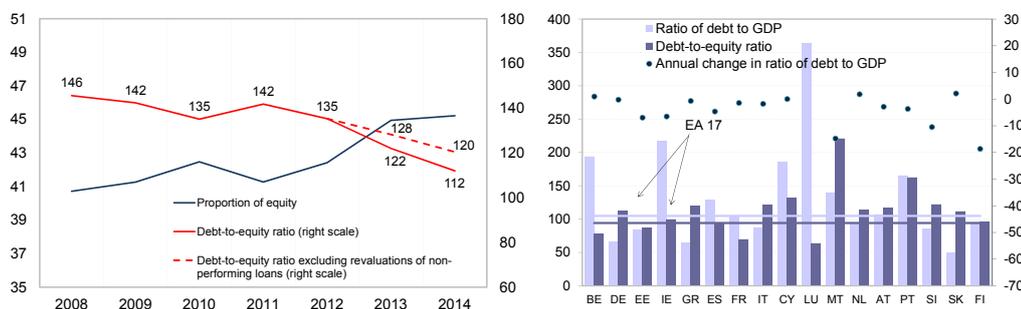
**Financing via commercial paper is increasing.**

Other forms of corporate financing remain modest. Financing via commercial paper is increasing: it amounted to EUR 230 million in 2014, up 19.2% on the previous year. Commercial paper is becoming an increasingly significant source of short-term financing, although the low volume means it does not yet entail an alternative to the more-established forms of corporate financing. Unlike the few successful offerings of commercial paper by large enterprises, SMEs do not have any alternative financing possibilities.

**Corporates have sharply reduced their indebtedness over the last three years. The debt-to-equity financing ratio fell to 112% last year.**

Corporates have sharply reduced their indebtedness over the last three years. The debt-to-equity ratio declined from 122% in the previous year to 112% last year, down 43 percentage points on its peak in 2008. The valuation of non-performing claims against corporates during transfer to the BAMC8 was also a factor in the decline in the ratio. Were corporates to still be disclosing the non-performing loans transferred to the BAMC in the financial accounts statistics at the end of 2014, leverage would have stood at 120% in 2014. Here it should be noted that the majority of corporates whose claims were transferred to the BAMC were in bankruptcy.

Figure 4.4: Corporate debt-to-equity ratio (left) and comparison of corporate indebtedness with the euro area in 2013 (right) in percentages



Source: Bank of Slovenia

Another factor in the deleveraging of Slovenian corporates over the last two years has been the number of corporate bankruptcies. The high debt-to-equity ratio in 2013 was primarily attributable to insolvent firms with negative equity and young firms. An indication of the deleveraging even without the impact of the elimination of firms in bankruptcy from the

<sup>8</sup>Only the net value of corporate liabilities that were transferred from the banks to the BAMC as recognised by the latter were disclosed in the financial accounts statistics. These corporate liabilities are still included in the AJPES figures in their full amount (for corporates that submitted data to AJPES).

indicator is the decline in the debt-to-equity ratio at firms that survived the crisis, i.e. those that operated as going concerns both in 2008 and in 2013. The ratio at such firms fell from 128% to 98% over this period.<sup>9</sup>

Slovenian corporate indebtedness as measured by the debt-to-equity ratio remains higher than the euro area average, despite a significant decline over the last two years. At the same time the indebtedness indicator as measured by the ratio of corporate debt to GDP is below the euro area average. The decline in the ratio of debt to GDP in 2013 was one of the largest in the euro area;<sup>10</sup> initial estimates<sup>11</sup> indicate that the ratio of debt to GDP fell further in 2014 to 74%. This indicates that the actual level of indebtedness of the Slovenian corporate sector is not problematic; only the financing structure is inappropriate, as it lacks equity. Changes in the valuation of capital also have a profound impact on the indicator.

Corporate deleveraging has gone hand-in-hand with the trend of capital devaluation. Reducing the debt-to-equity ratio should be based more on capital growth and less on debt reduction in the future. Corporate equity amounted to EUR 37.4 billion at the end of 2014. To reduce leverage to the euro area average, from 112% at the end of 2014 to 94%,<sup>12</sup> corporates would have to raise equity by almost 20% or EUR 7 billion, assuming debt remained unchanged. An increase in equity of this magnitude would not necessarily be solely the result of investment or corporate recapitalisation, but could also come from capital revaluations, or improved performance and an increase in retained earnings.

Corporates' total debt and equity liabilities amounted to EUR 79.2 billion at the end of last year. Corporates held over EUR 10 billion in debt liabilities to other corporates (loans, trade credits, other liabilities and debt securities), while the stock of bank loans stood at EUR 11.4 billion. Corporate equity amounted to EUR 37.4 billion at the end of last year, Slovenia accounting for the majority (78.4%).

**The ratio of debt to GDP in the Slovenian corporate sector is below the euro area average, while the debt-to-equity corporate financing ratio is less favourable, an indication of the lack of capital.**

Table 4.3: Corporate financing, stock and breakdown at the end of 2014 in EUR million and percentages

	Stock at end of 2014, EUR million					Breakdown, %				
	Debt securities	Loans	Trade credits	Equity	Other claims and liabilities	Debt securities	Loans	Trade credits	Equity	Other claims and liabilities
Total debt and equity liabilities	1,088	26,240	10,758	37,361	3,783	1.4	33.1	13.6	47.2	4.8
Total debt and equity liabilities	1,088	26,240	10,758	37,361	3,783	100.0	100.0	100.0	100.0	100.0
In Slovenia	608	18,977	6,600	29,283	3,488	55.9	72.3	61.3	78.4	92.2
- intra-sectoral	97	3,623	5,723	11,407	854	8.9	13.8	53.2	30.5	22.6
- to banks	176	11,362	2	282	114	16.1	43.3	0.0	0.8	3.0
- to NMFIs	288	1,883	153	1,639	93	26.4	7.2	1.4	4.4	2.5
- to government	19	1,488	350	8,227	1,563	1.7	5.7	3.3	22.0	41.3
- to households	29	617	360	7,660	851	2.6	2.4	3.3	20.5	22.5
In rest of the world	481	7,262	4,158	8,078	295	44.1	27.7	38.7	21.6	7.8

Source: Bank of Slovenia

### Corporate financial assets and net financial position

The annual flow of corporate financial assets was negative in 2014 in the amount of EUR 292 million. Corporates' financial assets in banks increased by EUR 470 million last year, while the largest decline of EUR 818 million was in business-to-business, which are prevalent in the breakdown of corporate financial assets. Trade credits and advances, which in 2008 were an important resource for promoting sales between corporates, and short-term loans continued to record net repayments. The breakdown of financial assets remains relatively unchanged compared with 2013. The large proportion accounted for by financial and trade receivables means that corporates are strongly exposed to credit risk.

**Intra-sectoral financial assets are continuing to decline.**

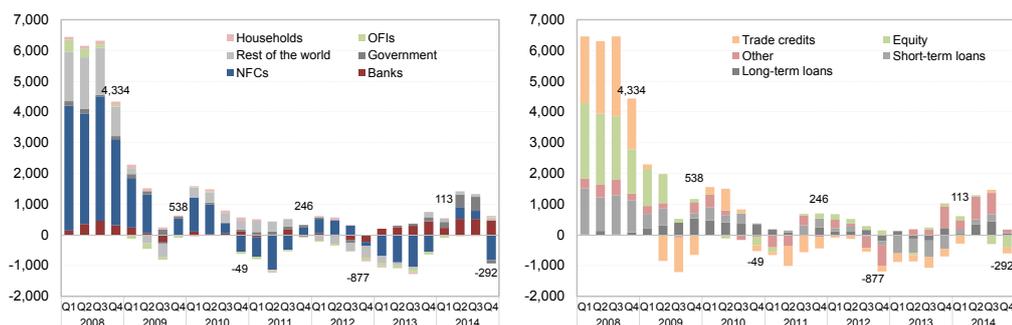
<sup>9</sup> See Stability of the Slovenian Banking System 2015, p 55.

<sup>10</sup> The ratio of debt to GDP fell from 96% in 2012 to 85% in 2013, albeit primarily as a result of the valuation of non-performing loans during the transfer to the BAMC.

<sup>11</sup> The ratio of debt to GDP is provisionally estimated on the basis of data from quarterly financial accounts and quarterly national accounts.

<sup>12</sup> Leverage for the euro area is calculated for 2013 on the basis of unconsolidated financial accounts of non-financial corporations.

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

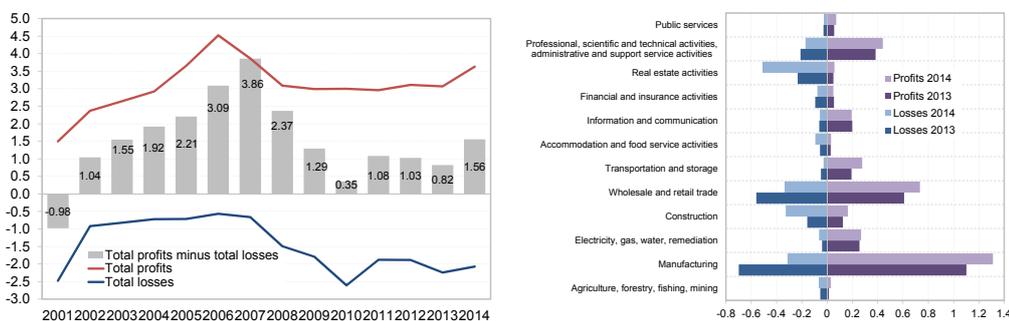


Source: Bank of Slovenia

## 4.2 Corporate performance and risk by sector

The economic recovery brought an improvement in the performance of non-financial corporations in 2014. Corporate net profit almost doubled to EUR 1.6 billion. Having fluctuated around EUR 3 billion since 2008, total profit increased by 18.4% to EUR 3.6 billion last year, while total loss declined by 7.6% last year to EUR 2.1 billion. The most notable increases in total profit in 2014 were recorded by firms in the manufacturing sector (up 19% at EUR 1.3 billion) and in the wholesale and retail trade sector (up 21% at EUR 0.7 billion). These two sectors also recorded the largest decline in total loss last year. Last year's largest increases in net profit were recorded by large enterprises, where net profit almost doubled, while medium-size enterprises increased their net profit by more than a half and small enterprises by 2%. Micro enterprises saw a sharp decline in net profit last year.

Figure 4.6: Total profit and loss and net profit (left) and total profit and loss by sector in 2013 and 2014 (right) in EUR billion



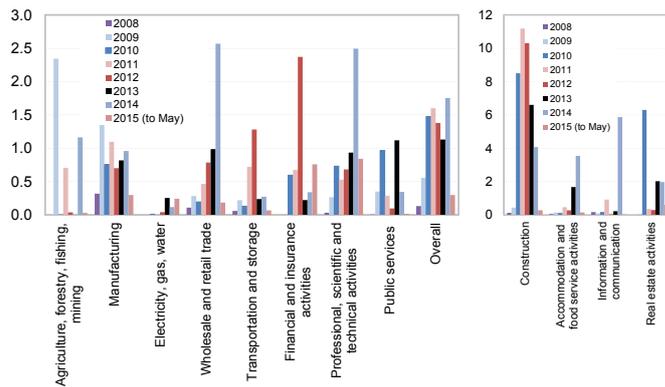
Sources: AJPES, Bank of Slovenia

### Corporate bankruptcies

**The proportion of the total assets of the corporate sector accounted for by firms at which bankruptcy proceedings were initiated increased by almost a half as the number of bankruptcies initiated rose.**

The number of corporate bankruptcies initiated again rose sharply last year. More than 1,300 bankruptcies were initiated in 2014, up more than a third on the previous year. The proportion of the total assets of the corporate sector accounted for by firms at which bankruptcy proceedings were initiated increased by a half. The proportion of total assets accounted for by firms in bankruptcy increased sharply in the sectors of information and communication activities, wholesale and retail trade, and accommodation and food service activities, and remained high in the sectors of construction and real estate activities. By May of this year the financial and insurance activities sector was also notable for the proportion of total assets accounted for by firms in bankruptcy.

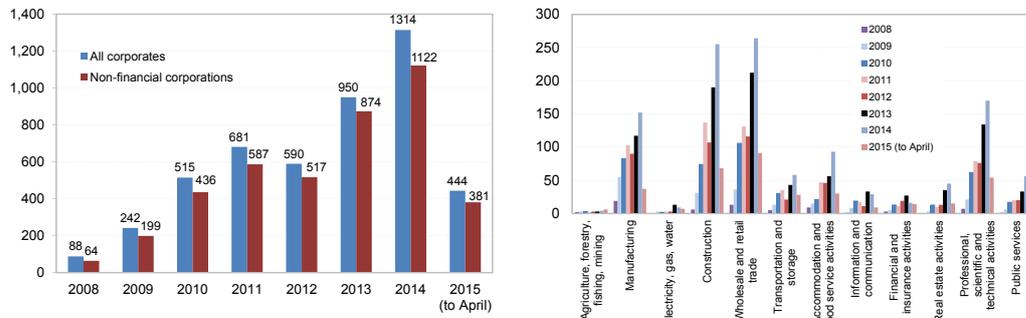
Figure 4.7: Percentage of total assets in the sector accounted for by firms in bankruptcy by year of initiation of bankruptcy proceedings\*



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

Sources: AJPES, Bank of Slovenia, Supreme Court

Figure 4.8: Number of bankruptcy proceedings initiated against firms overall (left) and by sector (right)

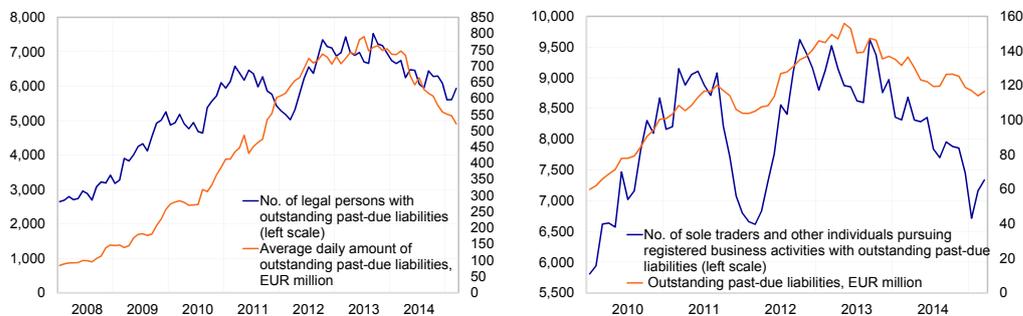


Sources: AJPES, Bank of Slovenia, Supreme Court

The number of firms with outstanding past-due financial liabilities from court enforcement orders and tax debt fell sharply in 2014. There is similar movement in the number of sole traders and other private individuals with outstanding past-due liabilities from court enforcement orders and tax debt. The average daily amount of these liabilities also fell sharply, at legal entities and sole traders alike.

**The number of firms with outstanding past-due financial liabilities fell sharply in 2014.**

Figure 4.9: Number of legal entities (left) and sole traders and private individuals pursuing a registered economic activity (right) with outstanding past-due liabilities from court enforcement orders and tax debt and their average daily amount of outstanding past-due liabilities in EUR million



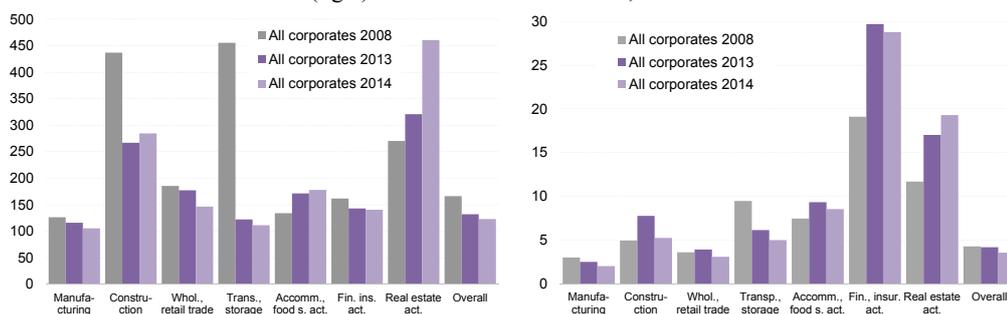
Source: AJPES

Corporate performance in terms of leverage and debt servicing capacity<sup>13</sup>

**Corporate debt servicing capacity is improving: the ratio of net financial debt to EBITDA declined from 5.9 years to 5.2 years last year at firms with net financial debt.**

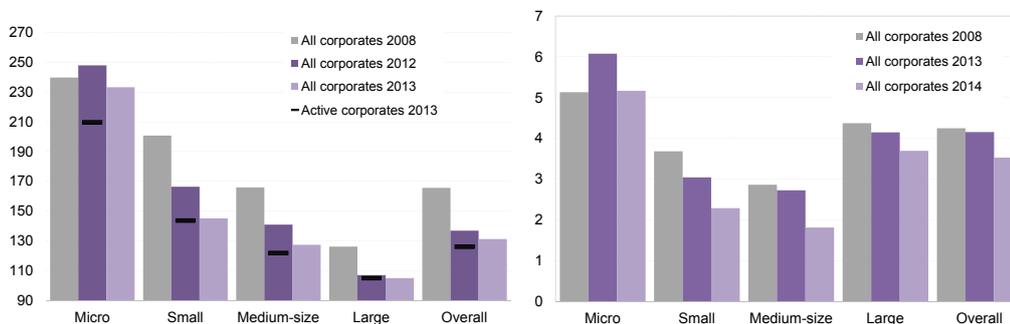
The trend of decline in non-financial corporations' indebtedness has continued. Non-financial corporations' leverage<sup>14</sup> as measured by the debt-to-equity ratio declined from 166% in 2008 to 123% last year. The main factor in the decline in leverage since 2008 was a decline of 21% in debt liabilities, equity having increased by less (7%). The ratio of net financial debt to EBITDA<sup>15</sup> declined from 4.2 to 3.5 last year, an indication of the improved corporate debt servicing capacity, even compared with 2008, when borrowing peaked. Almost half of firms had net financial debt in 2014, and their ratio of net financial debt to EBITDA declined from 5.9 to 5.2 years last year. Indebtedness was lowest last year at firms in the manufacturing sector: their leverage stood at 106%, while their ratio of net financial debt to EBITDA stood at 2 years. Leverage increased last year at firms in the sectors of real estate activities, construction, and accommodation and food service activities. Debt servicing capacity improved last year at firms in the majority of sectors, with the exception of real estate activities.

Figure 4.10: Leverage in percentages (left) and net financial debt to EBITDA in years (right) in selected sectors in 2008, 2013 and 2014



Sources: AJPES, Bank of Slovenia calculations

Figure 4.11: Leverage in percentages (left) and net financial debt to EBITDA in years (right) by corporate size in 2008, 2013 and 2014



Sources: AJPES, Bank of Slovenia calculations

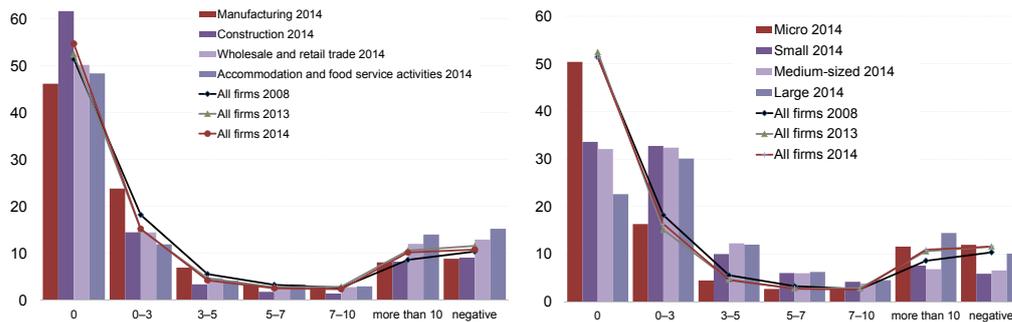
The proportion of firms with high capacity to service financial liabilities increased slightly between 2013 and 2014, while the proportions of firms with no financial liabilities and firms with the lowest debt servicing capacity declined. The proportion of firms with high capacity to service financial liabilities was still down on 2008, while the proportion of firms with the lowest debt servicing capacity (an indicator of more than 10) was up. This has also been reflected in caution and stricter requirements from the banks in their credit standards, alongside less willingness to take up additional risks. Last year firms in the sector of accommodation and food service activities saw higher risk in their repayments of liabilities than firms in the manufacturing sector. There was higher risk in repayments of liabilities by large enterprises than those by SMEs last year.

<sup>13</sup>The calculations in this section have been made on the basis of provisional AJPES data.

<sup>14</sup>The value for leverage calculated here differs from the indicator published in previous sections, which illustrates the ratio of debt to equity in corporate financing on the basis of financial accounts figures (the differences are the result of the differences in the methodology of data capture). In this section leverage is calculated as the debt-to-equity ratio from closing corporate balance sheet figures collated by AJPES.

<sup>15</sup>The net financial debt to EBITDA indicator is measured as the ratio of financial liabilities, less cash and cash equivalents, to cash flows from operating activities. The indicator shows a firm's capacity to regularly service debt (interest and principal), and shows how many years of cash flow the firm needs to repay debt; the lower the ratio, the lower the risk in the repayment of the firm's liabilities.

Figure 4.12: Distribution of the net financial debt to EBITDA indicator for selected sectors (left) and in terms of corporate size (right) in 2008, 2013 and 2014



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

Sources: AJPES, Bank of Slovenia calculations

Corporate indebtedness was concentrated in 2014. Leverage at the 80% least-indebted firms stood at 99% last year, similar to 2013, while leverage at the 90% least-indebted firms stood at 105%, down 10 percentage points on 2013. A similar picture is presented by the net financial debt to EBITDA indicator: it stood at 5.2 for firms with net financial debt, and at 4.1 for firms with net financial debt and positive EBITDA.

**As in 2013, corporate indebtedness was concentrated in 2014.**

Figure 4.13: Leverage (left) and net financial debt to EBITDA ratio (right) for most-indebted firms and remaining firms in 2014



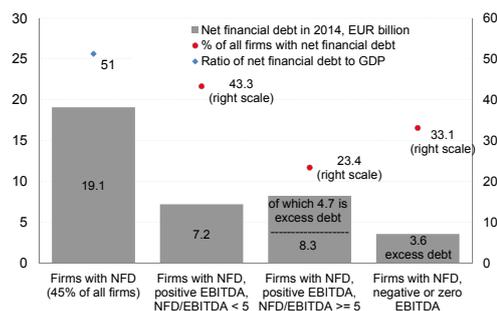
Sources: AJPES, Bank of Slovenia calculations

In 2014, 43% of firms had the capacity to repay their net financial debt in less than five years. Almost half of firms had net financial debt in 2014. In terms of the structure of the net financial debt, EUR 10.8 billion or 57% of the total is sustainable, 3 percentage points more than in 2013. Excess corporate debt,<sup>16</sup> i.e. that proportion of total debt that firms have less capacity to repay, amounted to EUR 8.3 billion or 43% of total net financial debt. Almost half of the net financial debt is subject to necessary restructuring. EUR 3.6 billion of net financial debt also requires operational restructuring: the firms in question were unprofitable in 2014. The EUR 3.6 billion of excess corporate debt that would also require operational restructuring in 2014 was down EUR 0.6 billion on 2013. The total excess debt in 2014 was also down on the previous year, by 13.5%, an indication of the gradual financial recovery of the corporate sector.

**In 2014, 43% of firms had the capacity to repay their net financial debt in less than five years.**

<sup>16</sup> Excess debt is calculated as the excess net financial debt (financial liabilities minus cash) for firms where NFD/EBITDA  $\geq 5$  or NFD/EBITDA = 0 or is negative. The figures exclude three large government-owned firms, and firms undergoing bankruptcy, compulsory composition, or preventive restructuring in the period to May 2015. The calculation of excess debt for 2013 excluded three large government-owned firms, and firms undergoing bankruptcy, compulsory composition, or preventive restructuring in the period to August 2014.

Figure 4.14: Net financial debt in 2014 and excess debt with regard to debt servicing capacity in EUR billion



Note: A figure of 5 or higher for the ratio of net financial debt to EBITDA was applied in the calculation of a firm's capacity to regularly service its debt. According to a bank survey, the majority of banks use the aforementioned figure as a criterion when assessing clients.

Sources: AJPES, Bank of Slovenia calculations

**Excess debt declined last year. The hundred firms with the largest excess debt accounted for almost half of the total excess debt.**

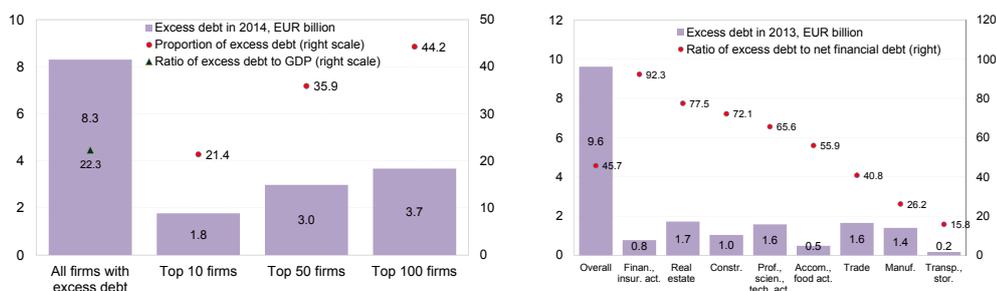
The hundred firms with the largest excess debt accounted for 44% of total excess debt in 2014. Excess debt declined last year, and the decline was evident in almost all sectors, with the exception of real estate activities, where the ratio of net financial debt to EBITDA also deteriorated. The ratio of excess debt to net financial debt varies from sector to sector. Excess debt accounts for 92% of net financial debt in financial and insurance activities, and 78% of net financial debt in real estate activities and in professional, scientific and technical activities and administrative and support service activities, while manufacturing has one of the lowest figures at 26.2%. Firms in the sectors of real estate activities, wholesale and retail trade firms, and professional, scientific and technical activities and administrative and support service activities account for more than a half of total excess debt (EUR 1.9 billion, and EUR 1.4 billion each). Manufacturing firms' excess debt declined by more than a quarter last year, to EUR 1 billion. Excessive debt also declined, and this development was evident in almost all sectors.

Figure 4.15: Concentration of excess debt in 2014 in EUR billion (left) and excess debt by sector in EUR billion and ratio of excess debt to net financial debt by sector in percentages (right)



Sources: AJPES, Bank of Slovenia calculations

Figure 4.16: Concentration of excess debt in 2013 in EUR billion (left) and excess debt by sector in EUR billion and ratio of excess debt to net financial debt by sector in percentages (right)



Sources: AJPES, Bank of Slovenia calculations

The overall ranking of performance indicators in terms of sector is also reflected in the banks' premiums on loans tied to the EURIBOR as the premium for the risk taken up by the bank. Firms in the sectors of accommodation and food service activities, construction, and real estate activities have the highest risk rankings on the basis of selected financial indicators, and also have the highest premiums at the banks.

Table 4.4: Selected financial performance indicators by sector, and premiums over the EURIBOR on new loans at the domestic banks

	Leverage, %	Liquidity ratio, % <sup>1</sup>	Proportion more than 90 days in arrears, % <sup>2</sup>	Net financial debt / EBITDA	Overall ranking <sup>3</sup>	Premiums over EURIBOR, percentage points <sup>4</sup>	Ranking
	Dec 14				2014		
Agriculture, forestry, fishing, mining	166	54.4	19.0	5.5	9	4.7	12
Manufacturing	106	78.7	12.4	2.0	2	3.4	2
Electricity, gas, water, remediation activities	54	101.4	7.5	3.0	1	3.1	1
Construction	285	70.9	45.2	5.2	10	4.5	11
Wholesale and retail trade	146	73.3	18.8	3.1	7	3.5	4
Transportation and storage	111	82.0	3.5	5.0	4	3.6	5
Accommodation and food service activities	178	41.8	22.6	8.5	11	4.2	9
Information and communication	110	93.6	13.8	2.0	3	3.4	3
Financial and insurance activities	140	51.9	12.9	28.8	8	4.2	10
Real estate activities	460	57.8	32.5	19.3	12	3.9	8
Professional, scientific and technical activities, administrative and support service activities	129	84.8	20.6	4.4	6	3.8	6
Public services	137	61.7	10.6	2.9	5	3.9	7
Overall	123	76.3	17.7	3.5		3.5	

Notes: <sup>1</sup> The liquidity ratio is calculated as the percentage ratio of current receivables to current liabilities. A higher ratio represents better liquidity, while for all the other indicators a higher value is less favourable.

<sup>2</sup> Proportion of the banks' classified claims against the sector more than 90 days in arrears.

<sup>3</sup> The overall ranking is calculated from the individual rankings for each indicator, where a higher ranking indicates higher risk.

<sup>4</sup> The premiums refer to those on long-term bank loans tied to the EURIBOR.

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

### Corporate loan repayment burden

According to figures from the annual survey of banks, the debt servicing burden declined last year for the third consecutive year. Payment of principal and interest declined by 26% in 2013 and by 8% in 2014, as a result of corporate deleveraging and the fall in interest rates at banks. The lower debt burden also brought a reduction in interest payments last year. As the stock of corporate borrowing at banks declined, and there was a resulting decline of 7% in the principal servicing burden, interest payments declined by 23%.

#### Box 4.1: Financing and indebtedness of SMEs

SMEs have to date not been subject to the systemic resolution of their indebtedness and their stock of non-performing loans, although they are a significant segment of the Slovenian economy. At the same time the structure of the economy cannot rely solely on SMEs, as large enterprises contribute significantly to the creation of stable economic growth. SMEs<sup>17</sup> accounted for 99% of all firms in 2014, employed 261 thousand people (63% of all employment), and generated 54% of total value-added. The number of SMEs rose by 12% between 2008 and 2014, while the number of large enterprises fell by 20%. Micro enterprises are the most numerous, and account for 94% of all firms.

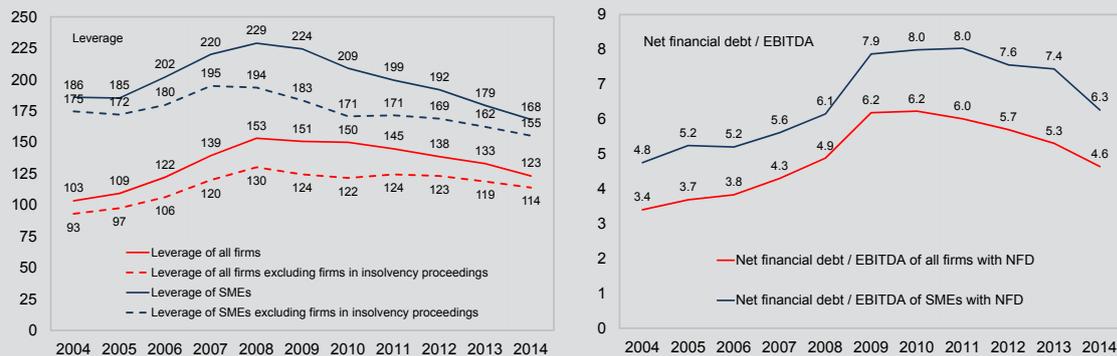
Compared with large enterprises, SMEs are more indebted, although their indebtedness has fallen faster and to a greater extent since 2008 than that of large enterprises. Leverage<sup>18</sup> of all firms stood at 123% in 2014, while that of SMEs stood at 168%. SMEs' leverage in 2014 had fallen below its level of 2004, while large enterprises' leverage in 2014 was still a quarter higher than in 2004. SMEs repay their liabilities at higher risk than large enterprises. The net financial debt to EBITDA ratio<sup>19</sup> at SMEs declined from 7.4 to 6.3 last year, an indication of the improvement in their debt servicing capacity. While more indebted as evidenced by leverage last year, SMEs were more dynamic in their performance and were able to generate earnings by which they increased their debt servicing capacity faster.

<sup>17</sup> Three large government-owned firms, leasing companies and holding companies (Sectors 70.100 and 64.910 under the SKD) were excluded from the analysis. The size of enterprises is defined according to the Companies Act (ZGD-1).

<sup>18</sup> Leverage is calculated as the ratio of financial and operating liabilities to equity.

<sup>19</sup> The net financial debt to EBITDA indicator is measured as the ratio of financial liabilities, less cash and cash equivalents, to cash flows from operating activities.

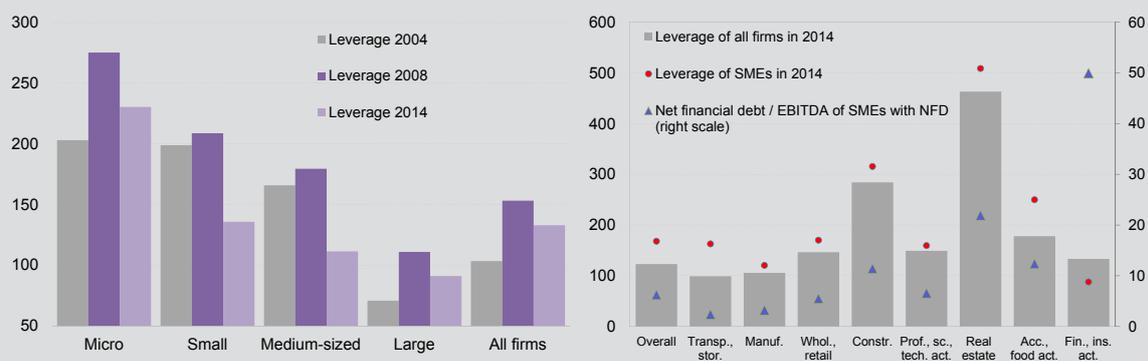
Figure 4.17: Leverage in percentages at all firms, SMEs and all firms excluding those undergoing insolvency proceedings (left) and net financial debt to EBITDA in years at all firms and SMEs (right) by year



Sources: AJPES, Bank of Slovenia calculations

The leverage of all firms and that excluding firms undergoing insolvency proceedings differ greatly. The gap is particularly evident at SMEs, an indication of the importance of improving insolvency proceedings. In terms of the sectoral breakdown, SMEs were most indebted in 2014 in the sectors of real estate activities, construction, and accommodation and food service activities. SMEs' debt servicing capacity in 2014 was lowest in the sectors of financial and insurance activities, real estate activities, accommodation and food service activities, and construction.

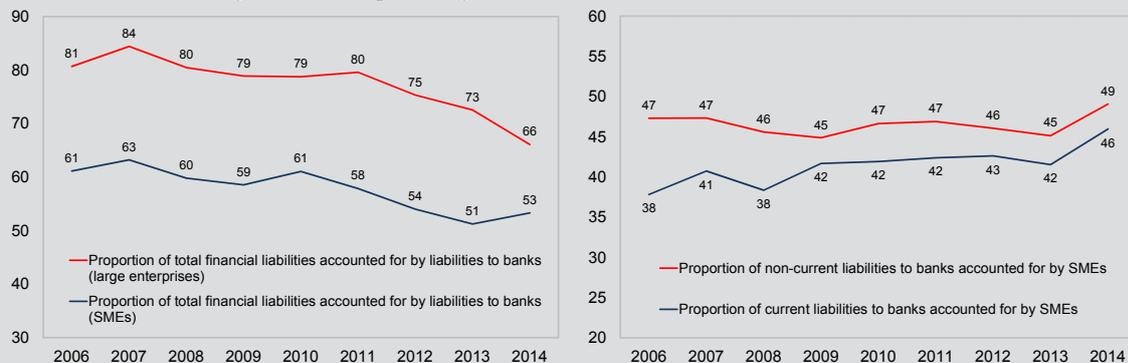
Figure 4.18: Leverage by corporate size (left) and leverage of all firms and SMEs and ratio of net financial debt to EBITDA for SMEs with net financial debt by sector (right)



Sources: AJPES, Bank of Slovenia calculations

Compared with large enterprises, SMEs are more dependent on financing via other firms in the group and other resources than on financing via bank loans. The proportion of total financial liabilities accounted for by financial liabilities to banks stood at 53% at SMEs in 2014 and at 66% at large enterprises, an indication that SMEs have less access to bank financing than large enterprises. Access to bank financing has deteriorated for SMEs during the crisis, although by less than for large enterprises. Large enterprises sharply reduced the proportion of their total financial liabilities accounted for by bank financing last year.

Figure 4.19: Proportion of total financial liabilities accounted for by financial liabilities to banks for large enterprises and SMEs (left) and proportion of non-current and current financial liabilities to banks accounted for by SMEs (right) by year in percentages



Sources: AJPES, Bank of Slovenia calculations

In recent years of the crisis SMEs have directed an increasing proportion of their bank financing into current operations, as evidenced by the rising proportion of short-term bank loans. Last year's bank survey of demand for loans at non-financial corporations also reveals that in recent years demand has only increased for loans for restructuring, while demand for other loans has declined. Large enterprises were hit harder in the early phase of the crisis, when the willingness to lend to corporates was low. SMEs were hit harder in the second phase of the crisis, which was also evident in the number of bankruptcies; corporate solvency deteriorated and with it bank lending. The proportion of long-term bank loans intended primarily for financing investment that was accounted for by SMEs increased last year, although the stock of loans is still declining. SMEs often find it harder to access the long-term financing necessary for the firm's investment and growth.

SMEs accounted for 74% of total corporate excess debt<sup>20</sup> in 2014, almost the same as in 2013. The 100 SMEs with the largest excess debt accounted for more than a third of total excess debt last year. SMEs' excess debt declined from EUR 6.8 billion or 18.9% of GDP in 2013 to EUR 6.0 billion or 16.1% of GDP in 2014. SMEs need organised alternative forms of financing or OFIs to reduce their high dependence on bank loans. SMEs above all need more equity financing options, which would help to reduce excess debt via new investment and the generation of earnings.

Figure 4.20: Concentration of excess debt at SMEs in 2013 and 2014 in EUR billion



Sources: AJPEs, Bank of Slovenia calculations

<sup>20</sup> Excess debt is calculated as the excess net financial debt (financial liabilities minus cash) for firms where NFD/EBITDA  $\geq 5$  or NFD/EBITDA = 0 or is negative. The figures exclude three large government-owned firms, and firms undergoing insolvency proceedings in the period to May 2014 or May 2015 (bankruptcy, compulsory composition, etc.). The indicator shows how many years of cash flow the firm needs to repay its debt; the lower the ratio, the lower the risk in the repayment of the firm's liabilities.

## 5 FINANCIAL SYSTEM

### 5.1 Structure of the financial system

**The assets of the Slovenian financial system declined by 3.7% in 2014. They also declined in terms of the ratio to GDP, which reached 147%. They also declined in terms of the ratio to GDP, which reached 147%.**

The assets of the Slovenian financial system declined by 3.7% in 2014. They also declined in terms of the ratio to GDP, which reached 147%. The financial system is small compared with the euro area overall, where the financial system is equivalent to 652% of GDP. The comparison with the euro area also reveals the relative lack of development in non-bank and non-insurance intermediaries. These manage just 13% of financial assets in Slovenia, compared with 36% in the euro area overall. The banks retain a large proportion of financial assets under management, although their assets are declining owing to the contraction in lending activity.

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



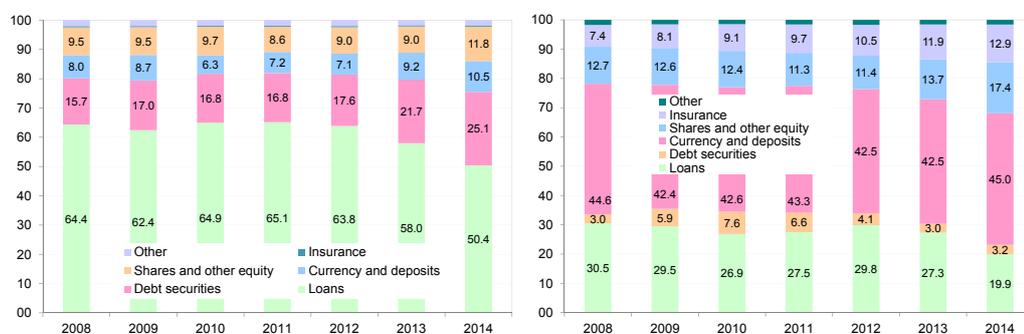
Note: S.122+S.123: Other monetary financial institutions (commercial banks and savings banks, money-market funds [MMFs]); S.124: Non-MMF investment funds; S.125: Other financial intermediaries, except insurance corporations and pension funds; S.126: Financial auxiliaries; S.127: Captive financial institutions and money lenders; S.122+S.129: Insurance corporations and pension funds.

Sources: Bank of Slovenia, ECB, Eurostat, SORS

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

Loans remain the most important form of financial asset in the Slovenian financial system, although the proportion that they account for has declined sharply over the last two years. Loans accounted for half of total financial assets at the end of 2014. As a result of the transfer of non-performing claims to the BAMC in exchange for debt securities, the proportion of financial instruments accounted for by the latter increased significantly to 25%. The proportion of financial liabilities accounted for by loans also declined significantly, as a result of repayments of loans to foreign banks and the withdrawal of banks undergoing restructuring from funding segments of the financial sector. Currency and deposits still account for the largest proportion of financial liabilities, at 45%.

Figure 5.2: Breakdown of the Slovenian financial sector's financial assets (left) and liabilities (right) in percentages

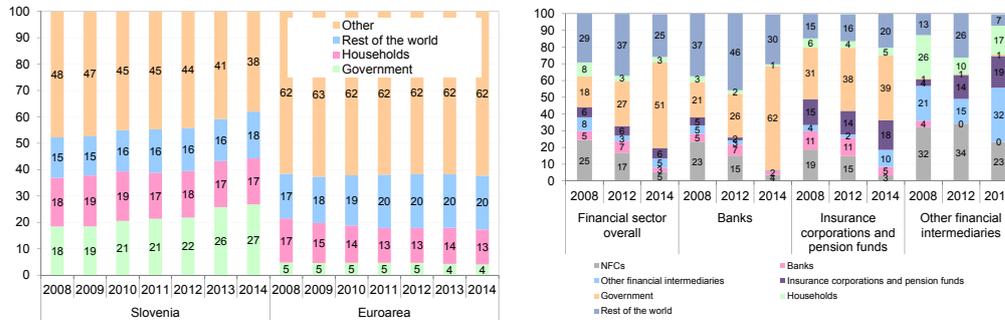


Sources: Bank of Slovenia, ECB, Eurostat, SORS

Alternative sources of financing for the Slovenian economy remain poorly developed, which is reflected in the large proportion of equity in all sectors that is under the direct ownership of households. FDI in equity is still lower in Slovenia than the euro area average. The

proportion of equity held by the general government sector has been gradually increasing since the outbreak of the crisis, and was strengthened further by the bank recapitalisations in December 2013 and April 2014. The general government sector thus directly owned 27% of the equity of all sectors and 51% of the equity of the financial sector at the end of 2014. In light of the commitments made in the restructuring plans of the banks receiving state aid, and the Slovenian government's intention to sell off interests in government-owned firms, the proportion of foreign ownership in Slovenia can be expected to increase.

Figure 5.3: Breakdown of equity by owner sector in Slovenia and the euro area (left) and ownership structure of the financial sector (right) in percentages



Note: Only direct ownership is considered in the ownership structure of the financial sector.

Sources: ECB, SORS (left), CSCC (right)

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

	Total assets, EUR million			Breakdown, %			As % of GDP			Growth, %		
	2012	2013	2014	2012	2013	2014	2012	2013	2014	2012	2013	2014
Monetary financial institutions <sup>1</sup>	46,119	40,344	38,724	72.0	71.0	70.8	128.1	111.6	104.0	-6.3	-12.5	-4.0
NMFIs	17,938	16,477	16,006	28.0	29.0	29.2	49.8	45.6	43.0	-2.5	-8.1	-2.9
insurers	6,790	6,938	7,385	10.6	12.2	13.5	18.9	19.2	19.8	11.2	2.2	6.4
pension companies/funds <sup>2</sup>	1,442	1,431	1,530	2.3	2.5	2.8	4.0	4.0	4.1	-5.0	-0.8	6.9
investment funds	1,835	1,859	2,156	2.9	3.3	3.9	5.1	5.1	5.8	1.0	1.3	15.9
leasing companies	4,842	3,826	2,726	7.6	6.7	5.0	13.4	10.6	7.3	-6.5	-21.0	-28.8
BHs, AMCs, others	3,028	2,423	2,210	4.7	4.3	4.0	8.4	6.7	5.9	-19.8	-20.0	-8.8
Total	64,057	56,821	54,731	100.0	100.0	100.0	177.9	157.2	146.9	-5.3	-11.3	-3.7

Notes: The figures for leasing companies, investment firms, management companies and others are obtained from the AJ PES database of closing accounts based on the SKD 2008 classification of business activities. The figures for leasing companies include all companies included under financial leasing, activity code K64.91, according to the SKD 2008.

<sup>1</sup> Monetary financial institutions do not include the central bank.

<sup>2</sup> The First Pension Fund is included among pension funds.

Sources: Bank of Slovenia, ISA, SMA, AJ PES

## 6 BANKING SECTOR

### 6.1 Structural features of the banking sector

#### Size of the banking sector and changes of status

**A total of 24 credit institutions were operating in Slovenia at the end of 2014.**

At the end of 2014 there were 17 banks operating in Slovenia, seven of which were direct subsidiaries of Eurosystem banks, three savings banks and four branches of foreign banks. The number of credit institutions was up one (a branch) on a year earlier. The Bank of Slovenia received notifications from 13 new credit institutions last year, while four credit institutions withdrew their notifications, taking the total number of credit institutions that had provided notification of cross-border activities in Slovenia to 327 by the end of the year.

**The banks' total assets had declined to 104% of GDP by the end of last year.**

The total assets of all banks and savings banks stood at EUR 38.7 billion at the end of 2014, of which banks and branches of foreign banks accounted for EUR 37.8 billion, while savings banks accounted for EUR 940 million. Banks thus still account for the vast majority of the banking system, and for 97.6% of the total assets of the Slovenian banking system. The banking system's total assets declined last year for the fifth consecutive year to stand at 104% of GDP at the end of the year, down 8 percentage points on the previous year. Last year's decline of EUR 1.6 billion or 4% in total assets was smaller than in the two previous years. The cumulative decline in the banking system's total assets in Slovenia between 2010 and the end of 2014 inclusive was thus EUR 13.3 billion, or almost a quarter. The decline in total assets is slowing.

Table 6.1: Banks' total assets compared with GDP

	2006	2007	2008	2009	2010	2011	2012	2013	2014
Total assets, EUR million	34,080	42,598	47,948	52,009	50,760	49,243	46,119	40,344	38,716
GDP (current prices), EUR million	31,557	35,152	37,951	36,165	36,219	36,869	36,005	36,145	37,247
Total assets as % of GDP	108	121	126	144	140	134	128	112	104
Total headcount at banks	11,832	11,996	12,232	12,188	11,943	11,813	11,498	11,218	10,682

Source: Bank of Slovenia

#### Changes in balance sheet structure

**The banks' total assets contracted last year, albeit by less than in the two previous years.**

Last year's contraction in the banking system's total assets was slower than in the two previous years, but in terms of magnitude was comparable to that three years ago. The main factor on the funding side in last year's contraction in total assets was the banks' debt repayments to the Eurosystem, while in previous years the contraction had coincided with debt repayments on the wholesale markets in the rest of the world.

Table 6.2: Banking system's balance sheet as at 31 March 2015

	Stock			change since Dec 14		year-on-year growth
	2008	2014	Mar 15	EUR million	(%)	
	EUR million			EUR million	(%)	
<b>Assets</b>						
Loans	37,823	26,852	26,393	-459	-1.7	-9.1
to non-banking sector	33,718	21,542	21,441	-100	-0.5	-10.7
of which:						
... to non-financial corporations	20,260	9,181	9,144	-37	-0.4	-18.3
... to households	7,558	8,327	8,383	56	0.7	-0.2
Financial assets / securities	7,327	8,749	8,807	58	0.7	3.9
Other	1,547	1,284	1,289	5	0.4	14.7
<b>Liabilities</b>						
Financial liabilities to Eurosystem	1,229	1,104	854	-251	-22.7	-71.7
Liabilities to banks	18,168	6,221	5,860	-361	-5.8	-19.5
of which to foreign banks	16,098	4,547	4,335	-212	-4.7	-13.6
Liabilities to non-banking sector (deposits)	20,883	24,426	24,356	-69	-0.3	4.7
of which to non-financial corporations	3,728	4,676	4,658	-19	-0.4	8.1
to households	13,407	15,094	15,303	210	1.4	4.7
to government	1,879	2,341	2,076	-265	-11.3	12.2
Debt securities	1,276	1,659	1,584	-75	-4.5	-3.3
Subordinated debt	1,568	249	250	1	0.2	0.6
Equity	4,010	4,198	4,365	167	4.0	13.5
Other	814	859	962	103	12.0	10.3
<b>Balance sheet total</b>	<b>47,948</b>	<b>38,716</b>	<b>38,230</b>	<b>-486</b>	<b>-1.3</b>	<b>-4.8</b>

Source: Bank of Slovenia

The largest decline on the asset side last year was in loans to the non-banking sector, as it had been in previous years, while investments in securities increased. Total assets increased in nominal terms in the first two months of 2015, although the stock of loans to the non-banking sector remained comparable to the end of last year.

### Bank ownership

There was an additional change in the ownership structure of the banking system in 2014, the government recapitalising two banks on the basis of a decision on state aid, bringing the total to six during 2013 and 2014. There had been a significant change in the ownership structure of the banking system in 2013, the government recapitalising five banks on the basis of a decision on state aid to cover losses by means of the interests of existing owners, thereby becoming the sole owner.

**The proportion of the banking sector owned by the government sector increased slightly as a result of two additional bank recapitalisations.**

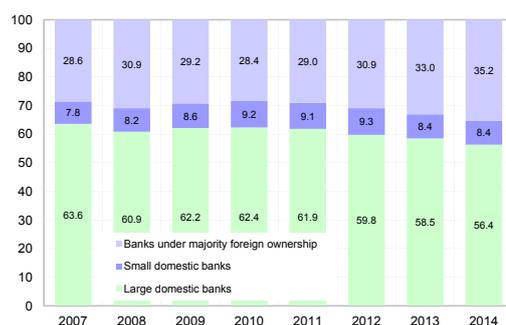
Table 6.3: Ownership structure of the banking sector (in terms of equity)

(%)	2006	2007	2008	2009	2010	2011	2012	2013	2014
Central government	17.9	15.1	17.7	20.5	20.1	22.7	22.8	60.1	63.6
Other domestic entities	44.4	47.2	44.1	43.0	42.9	38.1	35.2	8.0	6.7
Non-residents	37.7	37.8	38.2	36.6	37.1	39.3	42.0	32.0	29.7
non-residents (over 50% control)	27.7	26.8	27.6	26.8	27.9	30.1	33.3	31.6	29.3
non-residents (under 50% control)	10.0	11.0	10.6	9.8	9.2	9.1	8.7	0.4	0.3

Source: Bank of Slovenia

At the end of 2014 there were seven subsidiary banks and four branches under majority foreign ownership, seven banks under full domestic ownership, and three banks under majority domestic ownership. The proportion of equity held by non-residents stood at 29.7%, while the proportion under direct government ownership was 64%, and the proportion held by other domestic owners was 6.7%. The proportion of equity in the banking system held by the government increased by a further 3.5 percentage points in 2014, while the proportion held by non-residents declined by 2.3 percentage points and the proportion held by other domestic owners declined by 1.3 percentage points. The proportion of the banking system held by non-residents as measured by total assets as at 31 December 2014 was 4.4 percentage points higher than the figure as measured by equity, while the proportion held by other domestic persons (excluding the government sector) was 1.3 percentage points higher.

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



Source: Bank of Slovenia

**Concentration in the banking sector****Market concentration in the banking system did not change significantly last year.**

The market shares of the largest banks did not decline last year, but the concentration of the banking market eased slightly. Having declined in previous years, market concentration as measured by the market share of the largest banks and banking market concentration as measured by the Herfindahl-Hirschman index (HHI) remained almost unchanged last year. The market share of the five largest banks has declined by just under 5 percentage points over the last four years, to below 55%.

The concentration of the banking system remains slightly higher in terms of instruments on the funding side than on the lending side, although the gap has narrowed in recent years. The concentration in deposits by and loans to the non-banking sector changed minimally last year relative to the previous year. At 1,096 at the end of 2014, the value of the HHI for deposits by the non-banking sector was still 131 points above the value of the same index for loans to the non-banking sector; the gap has narrowed sharply in recent years. Having diminished for several consecutive years, the concentration in household deposits stopped declining last year.

Table 6.4: Market concentration of the Slovenian banking market as measured by the Herfindahl-Hirschman index, and market share of the top three/five banks

	2008	2009	2010	2011	2012	2013	2014	Change 2013-14
Herfindahl-Hirschman index								
Total assets	1,275	1,262	1,149	1,110	1,041	996	967	-29
Loans to non-banking sector	1,218	1,164	1,122	1,068	1,042	926	953	27
Liabilities to non-banking sector	1,578	1,587	1,471	1,392	1,256	1,096	1,083	-12
Liabilities to banks	1,217	1,047	1,243	1,209	1,179	1,338	1,193	-145
Market share of top 3 banks, %								
percentage points								
Total assets	47.7	47.7	45.7	44.7	43.2	42.6	41.5	-1
Loans to non-banking sector	46.7	46.0	45.9	44.4	42.5	38.0	39.4	1
Liabilities to non-banking sector	55.9	55.7	54.3	53.1	49.7	44.5	43.5	-1
Liabilities to banks	48.0	46.3	53.9	53.6	52.3	55.7	49.3	-6
Market share of top 5 banks, %								
percentage points								
Total assets	59.1	59.8	59.2	58.9	57.1	56.2	54.9	-1.3
Loans to non-banking sector	59.2	58.5	59.0	58.2	56.7	52.9	54.2	1.3
Liabilities to non-banking sector	68.2	67.9	66.7	65.5	62.5	59.6	58.3	-1.3
Liabilities to banks	63.6	61.3	67.9	67.9	67.5	72.2	69.4	-2.8

Source: Bank of Slovenia

**Box 6.1: Impact of the introduction of the Single Supervisory Mechanism for the Slovenian banking system**

The Single Supervisory Mechanism (SSM) began functioning on 4 November 2014 under the aegis of the ECB. The primary mission of the SSM is to restore confidence in European banks and over the long term to build a sound and stable banking system based on standard rules and methodology and a common culture of prudential supervision. The ECB is responsible for the implementation of the SSM in conjunction with all the national banking supervisory authorities in the euro area. Upon the establishment of the SSM certain supervisory powers were transferred from the national level to the European level.

All European banks are classed either as significant institutions or less significant institutions in accordance with set criteria. A total of 123 banks and banking groups were classed as significant institutions; their supervision is entirely the direct responsibility of the ECB. A major role in conducting supervision at the operational level at the significant institutions belongs to the Joint Supervisory Team (JST) of ECB coordinators and representatives of the national supervisor. The national supervisory authority participates directly in all supervisory activities at significant institutions, but does not take decisions at the national level.

The remaining banks are classed as less significant institutions. Their supervision is conducted in accordance with the rules and methodology of the SSM. Supervisory data is also regularly submitted to the ECB for less significant banks, briefings are given of the supervisory findings of the national supervisor, consultations can be held on the issue of measures with a material impact on a bank, but the final decision rests with the national supervisory authorities, except in certain exceptional cases.

More than half of the Slovenian banking system is under the direct supervision of the ECB. According to the criterion of the three largest banks in terms of total assets as at 30 September 2013, three Slovenian banks (NLB, NKBM and SID banka) were classed as significant and were therefore included in direct supervision by the ECB. These banks underwent the comprehensive assessment in 2014. In light of SID banka's special business model as a development and export bank, and its special status under the capital directive with regard to prudential rules, in July 2014 the ECB took the decision to complete the comprehensive assessment at the bank but then to remove it from the group of significant institutions. At the same time it took the decision to include UniCredit Banka Slovenija as the third Slovenian bank in the SSM, and in the future the bank will be under the ECB's direct supervision on a solo basis. The bank will therefore be included in the group of euro area banks at which a comprehensive assessment will be undertaken in 2015. In addition to these three banks, there are five other Slovenian banks that are members of banking groups established in euro area countries that are also classed as significant. These banks were included in the comprehensive assessment on a consolidated basis within the framework of their corresponding parent banks in 2014. The other ten Slovenian banks are classed as less significant, and their supervision remains the responsibility of the Bank of Slovenia.

## 6.2 Risks in the banking sector

### A further stabilisation of the situation in the banking system, in the context of increased income risk.

The bank recovery and resolution process begun in 2013 has contributed to a significant reduction in risk in the banking system. In the wake of pronounced improvement in the banks' capital adequacy and liquidity in December 2013, the additional transfer of non-performing claims to the BAMC in the final quarter of 2014, and the economic recovery, the situation in the banking system is stabilising. Credit risk remains significant, given the high proportion of non-performing claims in individual institutional and economic sectors. However, the underlying dynamic in the proportion of non-performing claims has been declining since October, despite the contraction in turnover. The banks' income risk is increasing, which is attributable to the fall in interest rates, in addition to the contraction in turnover and the banks' aversion to taking up risks. Additional pressure on income will come from the effects of quantitative easing via falls in the required yields on government bonds. The risk to the refinancing of maturing liabilities will diminish further, although funding structure could remain unstable.

Table 6.5: Bank of Slovenia's overview of risks in the Slovenian banking system

Systemic risk	Risk assessment		
	for Q4 2014	for Q1 2015	Trend in risk
Macroeconomic risk			→
Credit risk			→
Real estate market			→
Refinancing risk			→
Contagion risk and large exposures			↓
Solvency risk			↓
Income risk			↑

Colour code:

### The quality of the credit portfolio is improving as a result of the transfers to the BAMC and the autonomous reduction of non-performing claims.

**Credit risk:** The banks' recovery measures, corporate restructuring activities and the increased stability of the economic recovery are making significant contributions to the management of credit risk at the banks. After the transfer of non-performing claims from Abanka and Banka Celje to the BAMC, the proportion of non-performing claims (classified claims more than 90 days in arrears) declined by 3.8 percentage points to 11.9% in the final quarter of 2014, and declined further to 11.4% by March.

### Certain indicators suggest the possibility of a reversal in bank lending activity, which would contribute to the further improvement in the banks' credit portfolio.

The stock of non-performing claims began falling in the second half of last year, although the contraction in turnover was faster, for which reason the underlying dynamic in the proportion of non-performing claims during this period remained relatively stable, and an improvement as measured by the proportion of non-performing claims was only evident in the final part of the year. The banks' aversion to taking up credit risk and the reluctance of the corporate and household sectors to take on new investments have also been significant limiting factors in credit growth. Many banks are constrained by restructuring plans in which the banks committed themselves, prior to the completion of privatisation, to further contractions in turnover or high required returns on new business that in the event of further falls in interest rates they will find it very difficult to achieve. Bank lending activity is showing a reversal in the trend and a slowdown in the contraction in lending to the non-banking sector, while new long-term corporate loans and new housing loans to households are increasing, several banks have positive growth in loans, banks are recording greater credit demand, and the volume of transactions on the real estate market is also increasing. These trends suggest the possibility of a gradual reversal in lending dynamics, which as new customers with better credit ratings are attracted would help to improve the quality of the credit portfolio, in the wake of the autonomous reduction in non-performing claims already evident. Credit risk is therefore assessed as material and high, particularly in certain segments, namely exposures to non-residents, to SMEs and to the construction sector, albeit with favourable outlooks.

**Solvency risk:** The recovery of the banking system brought an increase in the amount of capital, while the transfer of non-performing claims to the BAMC reduced the stock of exposures with the highest risk weight. After the recapitalisation of Abanka and Banka Celje at the end of 2014, the banking system's overall capital adequacy stood at 19.4% (17.9% on a consolidated basis), thereby exceeding the euro area average according to the latest figures. It is the large domestic banks in particular that have attained high capital adequacy, while the small domestic banks lag in this process. Some banks are still to undergo the requisite recapitalisations. At the same time the effective allocation of existing capital and the ability to generate internal capital will be necessary for the future stability of capital adequacy. The maintenance of high capital ratios will also be required by new European regulations, which have introduced additional macro-prudential instruments, including counter-cyclical capital buffers that will tighten capital requirements for banks during economic booms, which are then relaxed when the credit cycle reverses.

**Refinancing risk:** Refinancing risk increased further. In addition to a pronounced reduction in liabilities to the Eurosystem, the banks reduced their liabilities to foreign and domestic banks in 2014, which has continued in 2015. The early part of 2015 saw a sharp fall in required yields on government bonds before the beginning of government securities purchases by the ECB and the national central banks. In the two weeks before the beginning of quantitative easing (23 February to 9 March), the required yield on 10-year Slovenian government bonds fell by 0.5 percentage points to 0.87%. The historic low in required yields on government bonds entails easier access to and lower costs of financing, not just for the government, but also for banks and corporates.

The banks are facing excess liquidity, while the ECB's non-standard measures will provide an additional source of liquidity in the future. The restoration of confidence in the domestic banks has seen household deposits returning to the banking system, the large domestic banks in particular, while the savings banks have maintained high growth in deposits for some time now. The LTD ratio for the non-banking sector is also showing signs of stabilisation. However, the large proportion of government securities on bank balance sheets and falling asset yields entail additional pressure on the banks' liability interest rates in the need to maintain the interest margin. Here the banks have little room for manoeuvre in making additional cuts in deposit rates. Rates on new deposits of up to 1 year have been below the euro area average for some time now. The positive spread on deposits of more than 1 year is declining, and reached just 0.2 percentage points last December. Further cuts in deposit rates could increase the attractiveness of alternative forms of investment for households.

The unstable funding structure and projected weak growth in deposits (in the wake of low growth in wages and a slight increase in consumption) remain a key vulnerability, which in the context of modest creditworthy demand does not give sufficient certainty of the process of financial intermediation proceeding smoothly.

**Income risk:** Despite an improvement in the net interest margin and cost efficiency, the banking system recorded a pre-tax loss of EUR 113 million in 2014 as impairment costs remained relatively high, although this was the lowest loss of the last five years. The additional falls and dispersion of deposit rates between banks opened the space for cuts in lending rates. Lending rates on new corporate loans of up to EUR 1 million fell by 1.1 percentage points in 2014, the fall picking up pace in the early months of 2015. In the context of the continuing sharp contraction in lending activity, this entailed a decline in interest income. The banks succeeded in mitigating the effect on net interest income in 2014 by sharply reducing interest expenses, by cutting deposit rates and replacing more expensive funding with cheaper funding.

In the event of the further contraction of turnover in an environment of low interest rates, which in light of the effects of quantitative easing are likely to fall further, the diminishing capacity to generate income means that income risk is becoming a key risk for the banks. The maintenance of a large spread between average interest rates across the euro area and domestic lending rates is further encouraging creditworthy customers to switch to financing in the rest of the world, which could cause the long-term loss of this source of income for the banks. Lower required yields on government bonds and consequently on other assets, which will reduce the returns on assets, are exposing the banks to increased interest rate risk, which in the event of a rise in the refinancing rate at the ECB would make it even more difficult for the banks to operate profitably. The policy of aversion to the take-up of credit risk is redirecting the banks towards lower-risk, lower-yielding investments. In the search for yield the banks could begin taking up excessive risk in other areas.

**Solvency risk diminished last year, although the differences between the banks widened.**

**Refinancing risk diminished, as additional debt repayments were made to the Eurosystem and the rest of the world.**

**The environment of low interest rates entails a challenge for the banks in maintaining interest margins, and in maintaining a stable funding structure, which is largely reliant on deposits by the non-banking sector.**

**The fall in asset interest rates and lending activity in the context of the persistent relatively high proportion of non-performing claims is increasing income risk at the banks.**

**Macroeconomic risks:** The macroeconomic situation in Slovenia has been improving, primarily as a result of favourable export dynamics. Domestic economic growth remains primarily based on foreign demand, which is subject to various risks related to geopolitical developments in oil-producing countries, and to the uncertainty of the economic recovery in the main trading partners. Government investment co-financed by the EU is the main factor in domestic demand. The end of the current financial perspective entails a risk to the continuation of the investment cycle, which is currently being driven by the government sector alone.

### 6.3 Lending activity: in expectation of a reversal

The contraction in lending activity of several years' duration began to slow towards the end of 2014, and several indicators suggest a possible reversal in lending to the non-banking sector. The negative rates of growth have been slowing, and after several years of decline new loans begun increasing in the second half of the year. A survey of credit standards reveals a positive trend in corporate demand for loans. The fall in interest rates, which on corporate loans has tracked the movement of liability interest rates with a lag of one year, picked up pace in the early part of the year. The spread with interest rates across the euro area is significantly smaller than a year and a half ago, which is increasing the competitiveness of domestic banks. The banks' credit standards remain a major limiting factor on the supply side, having been tightened more than other euro area countries since the outbreak of the crisis.

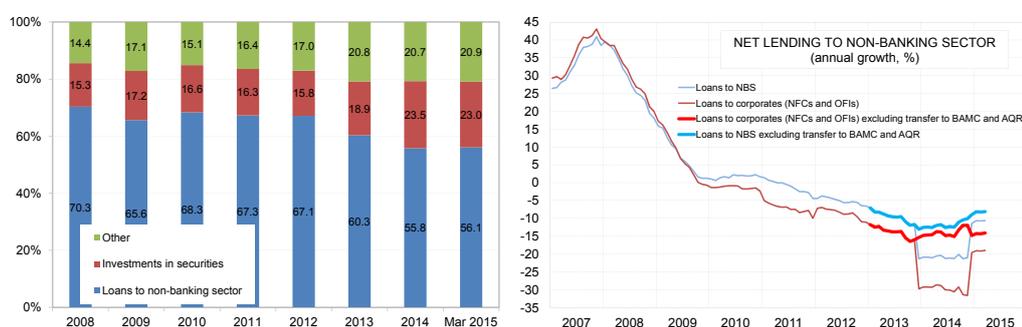
#### 6.3.1 Structure of and developments in bank investments

**The proportion of the banks' total assets accounted for by loans to the non-banking sector has declined by 14.2 percentage points since 2008.**

The banks' balance sheet structure shifted in 2014 and early 2015 in the direction of increased investments in securities. The proportion of total assets that they account for has increased by 7.7 percentage points since 2008 to stand at 23.0%, while the proportion accounted for by loans to the non-banking sector declined by 14.2 percentage points to stand at 56.1%. The recovery measures were a significant one-off factor in this change: in exchange for non-performing claims the banks received BAMC bonds, which accounted for around 4% of the banking system's total assets at the end of 2015. These investments also reflect the short-term nature of the banks' funding, which is constraining them from granting the long-term loans that their customers want.

The banks have the option of redeeming government bonds within the framework of the expanded securities purchase programme launched by the ECB in March. Should they decide to take up this option, it remains uncertain what they do with the funding thus obtained. They could opt for further deleveraging by repaying liabilities to domestic and foreign banks, for purchases of other securities or for an increase in lending. Given the existing high liquidity, the likelihood that banks would direct additional liquidity into lending to the non-banking sector is small.

Figure 6.2: Breakdown of bank investments (left) and year-on-year growth in loans prior to creation of impairments (right) in percentages

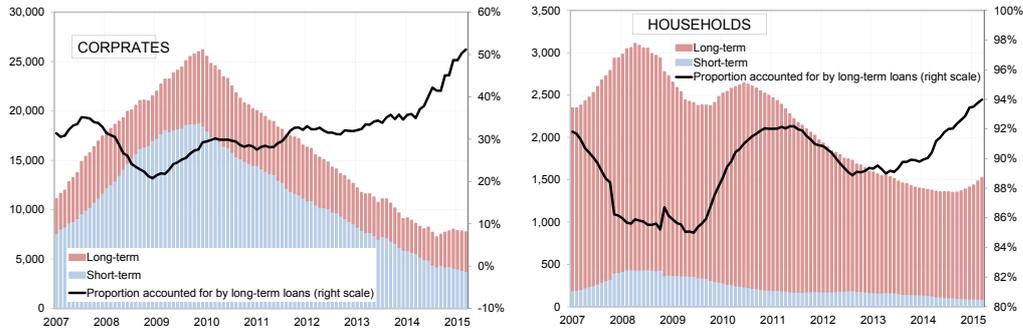


Source: Bank of Slovenia

The stock of loans to the non-banking sector continued to decline in 2014 and the first quarter of 2015. Year-on-year growth in loans to the non-banking sector stood at -10.7% in March 2015. Excluding the effect of institutional factors (the transfer of non-performing claims from Abanka and Banka Celje to the BAMC and the two banks undergoing the orderly wind-down process), year-on-year growth would stand -7.1%. The contraction in loans is therefore gradually diminishing.

There are significant differences between individual types of loan: corporate loans (to NFCs and OFIs) were down 18.3% in year-on-year terms in March 2015, or by 13.3% if the effects of the transfer of claims to the BAMC and the two banks undergoing the orderly wind-down process are excluded. Further evidence of the potential for a reversal in lending activity described in the introduction is that in 2014 and the early months of 2015 new long-term corporate loans began replacing new short-term loans. The stock of the former is increasing for the first time since 2010, the rate of growth reaching 12% in March, while the stock of new short-term loans is continuing to decline.

Figure 6.3: New corporate loans (left) and household loans (right) by maturity, 12-month moving sums, in EUR million



Source: Bank of Slovenia

The stock of household loans, on which the transfers to the BAMC had an insignificant impact, approached zero growth in March, after a long period of contraction. The dynamics in household loans vary greatly with regard to the type of loans. Housing loans have grown throughout the crisis period, the rate standing at 2.8% in March, the highest figure since May 2012. The stock of consumer loans is continuing to decline, although the rate of decline in recent months has been slower than last year. New long-term loans have been recording positive growth since September 2014. Year-on-year growth in new long-term household loans stood at 37% in March 2015. Growth is higher for housing loans, the year-on-year rate reaching 58% in March. The relatively low indebtedness of households and the small proportion of non-performing claims in this customer segment are opening space for greater lending, although there is a strong limiting factor in demand, which reflects households' low appetite for taking up risks.

**The stock of new long-term corporate and household loans is increasing again, after a long period of decline.**

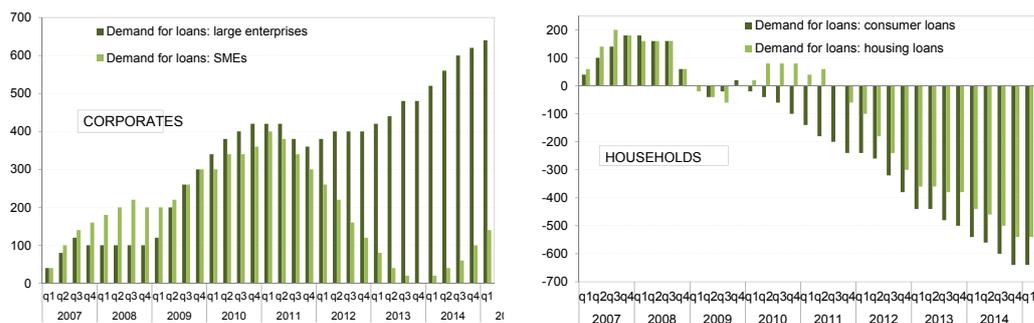
The lending activity of the savings banks is recording exceptionally high growth in all borrower sectors, non-financial corporations in particular: their size means they cannot compensate for the persistently low lending activity of larger credit institutions. High lending activity could expose the savings banks to credit risk, which will not potentially materialise until some time in the future.

### 6.3.2 Credit demand

Corporate credit demand as evidenced by the bank lending survey has been increasing for some time. The improvement in demand is particularly evident at large enterprises, where banks (with minor fluctuations in the interim) have seen increased demand since the third quarter of 2011, while this has only been evident at SMEs since the first quarter of 2014, after a break of two and a half years. However, an increasing proportion of credit demand is being directed to the rest of the world.

**Corporate credit demand is continuing to grow, but households remain restrained.**

Figure 6.4: Demand for loans as measured by survey: corporates (left) and households (right)



Source: Bank of Slovenia

In contrast to corporates, households remain restrained in their demand for loans, consumer loans in particular. However, in the first quarter of 2015 the banks recorded no decline in demand for both housing and consumer loans, after a significant period when this was not the case.

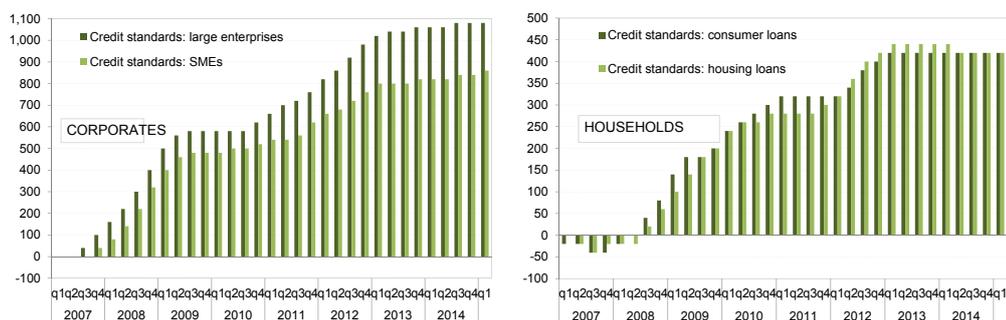
### 6.3.3 Credit supply

**The level of the banks' credit standards on corporate loans is significantly higher than on household loans. They have stopped tightening credit standards.**

Developments in credit supply can be monitored via credit standards as described by the banks in the bank lending survey.

The banks' credit standards<sup>21</sup> on corporate loans remain high, despite a gradual end to their tightening, particularly for large enterprises. The banks have greater appetite for lending to households, which is confirmed by their more relaxed credit standards on household loans. They have remained unchanged on both housing loans and consumer loans for the fourth consecutive quarter.

Figure 6.5: Credit standards as measured by survey for corporate loans (left) and household loans (right)



Source: Bank of Slovenia

The end to the tightening of credit standards and the forecasts for their relaxation in the next quarter are further evidence of the previously described potential for a reversal in lending activity. The results of the bank lending survey at euro area level have also been identified as a leading indicator of growth in loans in ECB research<sup>22</sup>

Of the balance sheet and cost factors that are purely supply-side factors,<sup>23</sup> the banks attributed the relaxation of credit standards in the last year to the improvement in their liquidity and capital positions. The large quantity of cheap market funding was only reflected in the banks' responses in the first quarter of 2015. Risk perception also began contributing to a relaxation of credit standards in this period. Of the various risk components, general economic activity and the situation in individual sectors and at individual corporates was adversely affecting the level of credit standards, while the contribution made by risk in relation to required collateral remains unchanged. Strengthened competition is acting to relax credit standards.

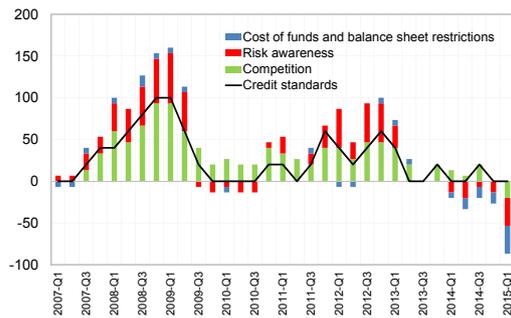
Irrespective of the negative contribution made to the relaxation of credit standards by all three components, the standards remain unchanged for now. The banks are clearly remaining highly risk-averse and have maintained the high credit standards put in place in the crisis period, even though they judge that all the factors affecting credit standards included in the survey should start contributing to the relaxation of credit standards.

<sup>21</sup> Credit standards are internal guidelines for loan approval that banks adopt before deciding on a particular loan and its terms. They express the banks' preferences and requirements with regard to the type of loan, the sector, the geographical origin of the borrower, the collateral, etc. Loan terms and conditions (see the box for more on loan terms and conditions in Slovenia and the euro area) relate to the attributes of a specific loan that the bank is willing to approve. They encompass price terms (the spread over a relevant market reference rate), terms relating to the stock of loans (size of the loan or credit line, collateral requirements), and other terms (maturity).

<sup>22</sup> De Bondt, Maddaloni, Peydró and Scopel: The euro area bank lending survey matters: empirical evidence for credit and output growth, Working Paper No. 1160, February 2010.

<sup>23</sup> In contrast to "competition" and "risk perception".

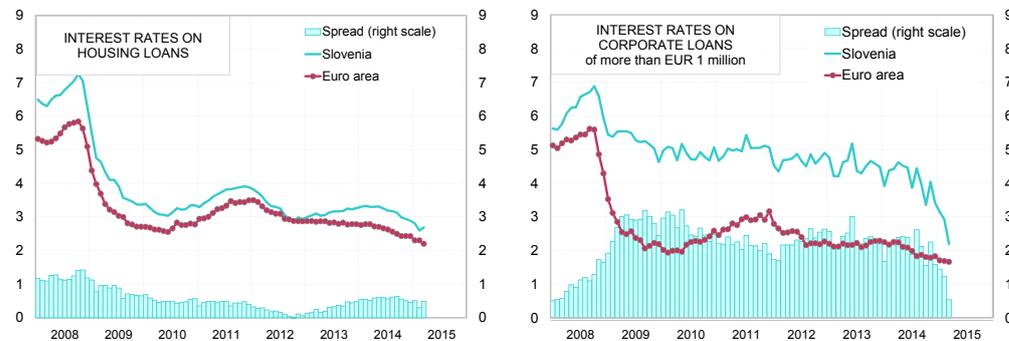
Figure 6.6: Factors affecting the level of credit standards in corporate lending



Source: Bank of Slovenia

The results of the bank lending survey and the developments in interest rates reveal Slovenian banks to have the strictest loan terms for corporate loans in the euro area, comparable only to those in Portugal. The developments in loan terms on household loans are entirely comparable to other euro area countries.

Figure 6.7: Interest rates on corporate loans in Slovenia and the euro area and spread between them on loans of up to EUR 1 million (left) and more than EUR 1 million (rights) in percentages and percentage points

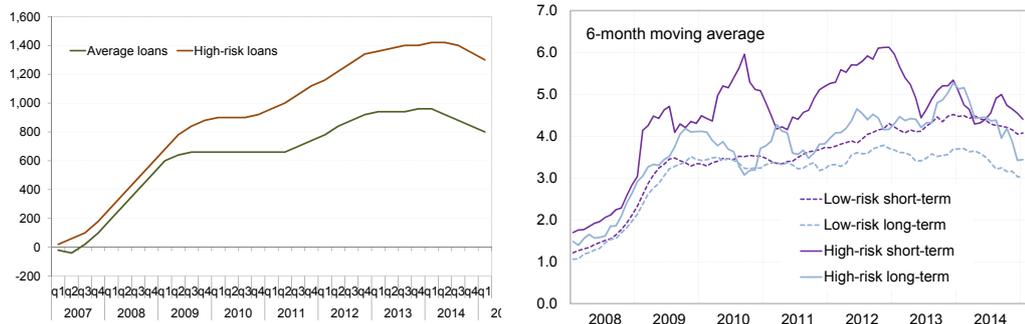


Source: Bank of Slovenia

The same conclusion could also be drawn on the basis of analysis of the movement of interest rates. The premiums over the EURIBOR on corporate loans remain above the average euro area premiums, despite a fall. The situation described is partly attributable to differences in the customer risk levels, but also reflects the banks' unwillingness to lend, as the bank lending survey makes evident.

The bank lending survey reveals that it was only in 2009 when the crisis fully hit the real sector that the banks began differentiating premiums for loans of different risks in earnest. This is confirmed by the movement in the premiums over the reference interest rates on loans assessed as high-risk or low-risk. The spread between the premiums on high-risk and low-risk loans began widening in early 2009, although the rescheduling by which the banks provided corporates with lower financing costs to allow them to at least partly repay high-risk loans meant that it fluctuated significantly and occasionally turned negative. The banks should make even greater use of premium differentiation for loans of varying risk, and should actively adjust the premiums over the reference interest rate and other loan terms to the risk of the individual borrower throughout the credit cycle. In the current situation this would facilitate lending to lower-risk projects and borrowers.

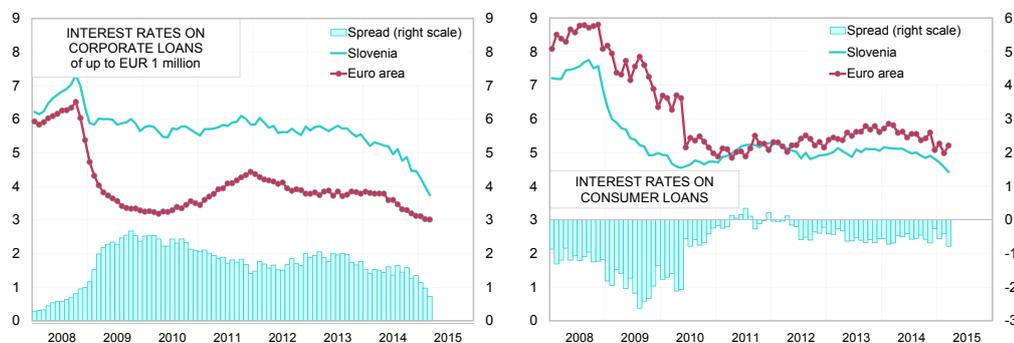
Figure 6.8: Premiums over the reference interest rate on higher-risk and average corporate loans according to the bank lending survey (left) and on realised new loans (right)



Source: Bank of Slovenia

Interest rates on household loans remained entirely comparable to those in other euro area countries.

Figure 6.9: Interest rates on housing loans in Slovenia and the euro area and spread between them: housing loans (left) and consumer loans (right) in percentages and percentage points



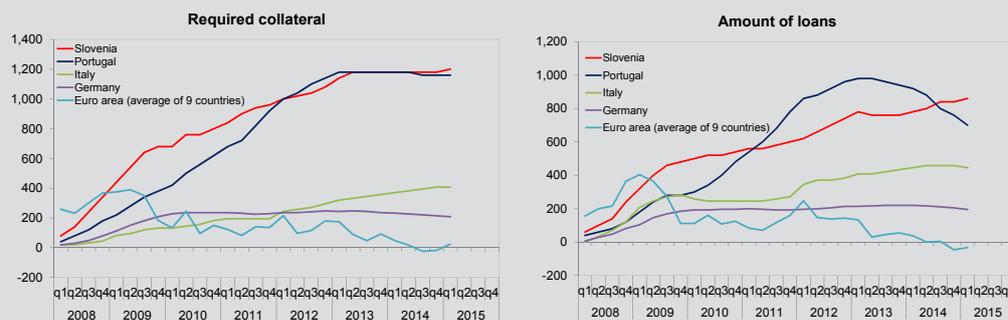
Source: Bank of Slovenia

It has recently been evident that the fall in market interest rates, which in the past had been limited to the banks' liability interest rates, has begun to be reflected in a fall in asset interest rates.

**Box 6.2: Developments in loan terms and conditions on corporate loans in Slovenia, across the euro area and in selected euro area countries**

Since 2008 loan terms and conditions in Slovenia have been tightened more with regard to collateral requirements and the size of the loan or credit line than the euro area average. It is a similar case with regard to loan margin (spread over a relevant market reference rate) and non-interest rate charges, although in contrast to collateral requirements and the size of the loan or credit line these have recently been seen to undergo a relaxation. By contrast, the tightening of loan maturities was at a level comparable to other euro area countries.

Figure 6.10: Loan terms and conditions in Slovenia, across the euro area and in selected euro area countries: collateral requirements and the size of the loan or credit lines

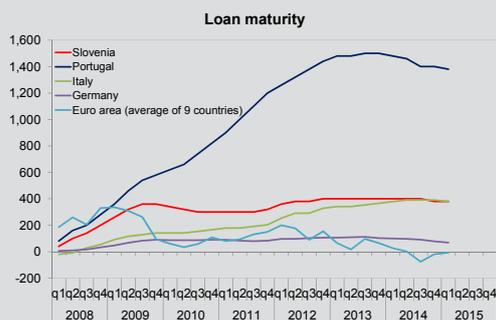


Source: Bank of Slovenia

With regard to loan terms and conditions as determined by the euro area's bank lending survey, there is no direct comparability in certain countries, as the survey does not investigate the actual level of loan terms and conditions, but instead monitors their change with regard to the previous period. It is thus unknown what level loan terms and conditions were at in the initial period. The data nevertheless provides interesting guidance with regard to the developments in loan terms and conditions over the last six years, which could to a certain extent explain the differences in the rates of growth in loans and interest rates in individual euro area countries. They also suggest which through loan terms and conditions Slovenian banks could modify their lending policies.

Slovenia is notable for a gradual but sustained increase in the collateral requirements and a reduction in corporate loan amounts over the entire period. The two factors are also significant in explaining the redirection of some demand to the rest of the world. In contrast to other terms and compared with other euro area countries, there has been no easing in the described loan terms in recent times. A general easing of the two loan terms is evident across the euro area.

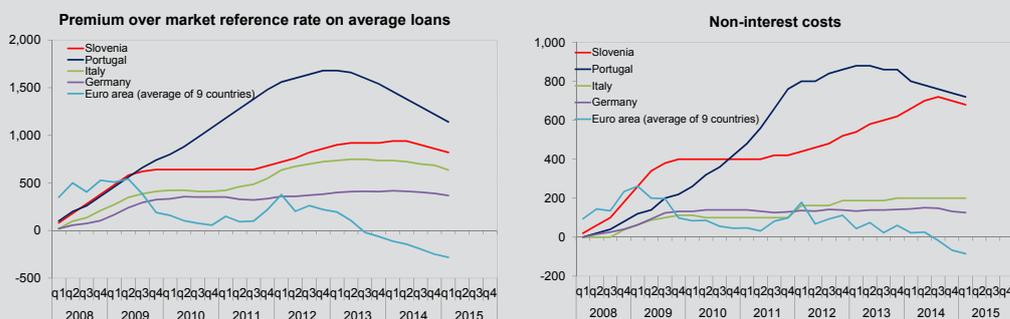
Figure 6.11: Loan terms and conditions in Slovenia, across the euro area and in selected euro area countries: loan maturity



Source: Bank of Slovenia

By contrast, the developments in loan maturity are comparable to the developments in other euro area countries, these having remained relatively stable since 2009. The data for new loans actually indicates a lengthening of their maturities.

Figure 6.12: Loan terms and conditions in Slovenia, across the euro area and in selected euro area countries: loan margin (spread over a relevant market reference rate) on average loans and non-interest rate charges



Source: Bank of Slovenia

After a period of rises, the spread over a relevant market reference rate on average loans began falling, as in other euro area countries. The banks also increased their non-interest rate charges as of mid-2010 in parallel with the spreads, but a decline has been evident in these over the last two quarters.

The data presented reveals that the two countries that were hit hardest by the crisis recorded above-average tightening of their loan terms and conditions.

## 6.4 Bank funding

In the wake of significant debt repayments on the wholesale markets in previous years and a decline in the residual debt maturing for refinancing, the banks have seen a sharp decline in refinancing risk. At the same time refinancing risk has increased in shorter maturity buckets. The pressure on the refinancing of liabilities to the Eurosystem also declined sharply last year. The breakdown of funding, deposits by the non-banking sector and the stock of wholesale funding on bank balance sheets in particular, is gradually becoming similar to that before the period of the banks' increased borrowing in the rest of the world. The most stable and most important source of bank funding is deposits by the non-banking sector, households in particular, although sight deposits are increasing in relative importance in

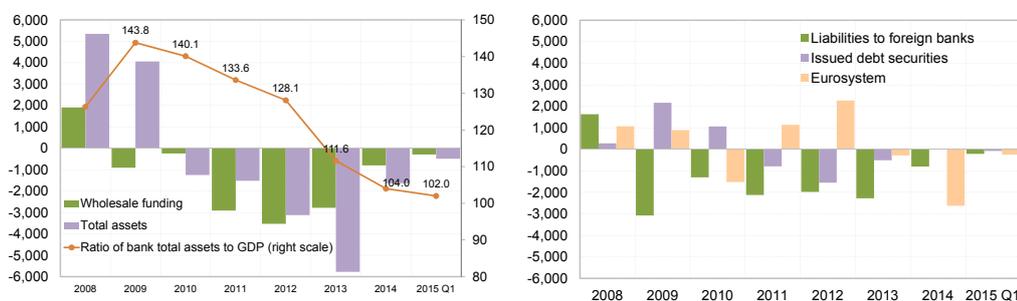
the breakdown owing to low interest rates. Despite a sharp decline in the stock of wholesale funding at banks, there has recently been a slight improvement in the positive rate of renewal of wholesale funding in the rest of the world.

### 6.4.1 An end to the bank deleveraging process

**The banks' debt repayments on the wholesale markets have been the largest factor in the contraction of the banking system's balance sheet total in recent years.**

The process of restructuring the Slovenian banking system's funding has been underway for several years now. After the outbreak of the crisis the banks began reducing their accumulated debt to the rest of the world, which had arisen in the years before the crisis when the banks had obtained rapid and extensive funding on the wholesale markets to finance credit growth and increases in turnover. The banking system made debt repayments to foreign banks of EUR 11.7 billion between the end of 2008 and the end of March 2015. Together with debt securities issued by the banks, total net debt repayments on the wholesale markets amounted to EUR 11.5 billion, or a third of Slovenia's annual GDP. The proportion of the Slovenian banking system's total liabilities accounted for by wholesale funding, which before the crisis stood at 36%, had declined to 15.5% by March 2015, as funding fell from EUR 17.4 billion at the end of 2008 to EUR 5.9 billion at the end of March 2015.

Figure 6.13: Changes in total assets and wholesale funding (left) and net changes in funding on the wholesale markets (liabilities to foreign banks and issued debt securities) and with the Eurosystem (right) in EUR million



Source: Bank of Slovenia

**Early repayments of debt to the ECB were the largest factor in the contraction in total liabilities last year.**

The repayment of funding raised at the ECB was the largest factor in the contraction in the banks' total liabilities in 2014. After the ECB's measures of June and September, the banks began the intensive early repayment of liabilities to the ECB, the proportion of total liabilities that they account for declining to below its pre-crisis level by March 2015.

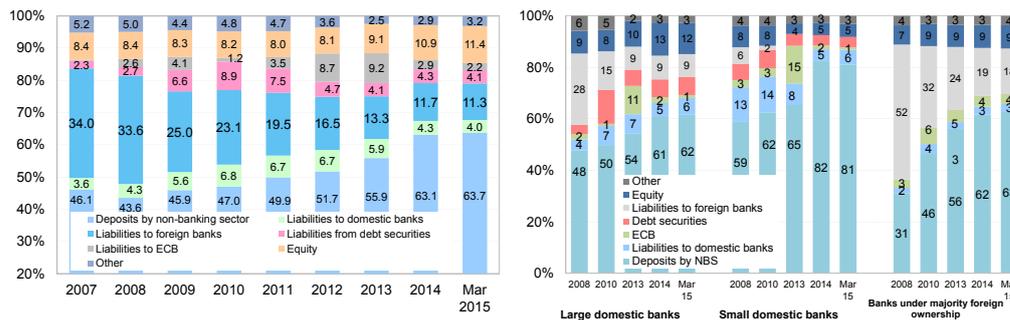
**The banks are forecasting a minimal contraction in total assets this year, and an increase in 2016.**

The contraction in the banking system's total assets is slowing. It stood at just over 4% last year, significantly less than in the previous years. In their answers with regard to turnover and funding (the banks submitted the data to the Bank of Slovenia in this year's spring survey), the banks are forecasting a contraction in total assets (of 2%) in 2015 and growth of 1.3% in 2016. In their funding plans the banks do not envisage any major changes in deposits by the non-banking sector, and practically no change in the stock of funding with the Eurosystem. They are still forecasting a decline in wholesale funding on their balance sheets, of a further 20% in 2015, and 2% in 2016.

**The importance of deposits by the non-banking sector to bank funding is increasing. The proportion of total liabilities accounted for by wholesale funding declined sharply at all the bank groups.**

The breakdown of bank funding has changed intensively in recent years as a result of the change in the situation on international financial markets and the banks' adjustments to the new situation. The proportion of total liabilities accounted for by deposits by the non-banking sectors approached 64% across the banking system, up 20 percentage points on the outbreak of the crisis. The largest increase in this figure was at the banks under majority foreign ownership, where it has doubled since the outbreak of the crisis.

Figure 6.14: Breakdown of the Slovenian banking system’s funding (left) and by bank group (right) in percentages



Source: Bank of Slovenia

While the large domestic banks repaid the majority of their funding from the rest of the world in previous years in their intensive deleveraging, the banks under majority foreign ownership are continuing to make debt repayments to the rest of the world, having had the largest proportion of funding from the rest of the world at the outbreak of the crisis. The proportion of total liabilities accounted for by liabilities to foreign banks at the banks under majority foreign ownership declined to less than a fifth. It should however be noted that the pace of deleveraging slowed sharply last year as the amount of maturing debt declined.

**The banks under majority foreign ownership made the largest debt repayments to the rest of the world in 2013 and 2014.**

**Decline in refinancing risk on the wholesale markets and at the ECB**

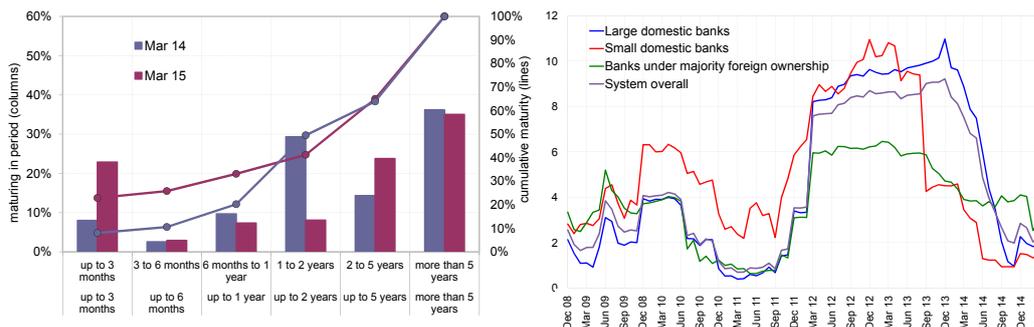
**a) Maturing liabilities to foreign banks**

In the absence of new funding in the rest of the world, and the merely partial rollover of this funding<sup>24</sup> on one hand, and the limited opportunities for further growth in deposits, as refinancing risk has diminished so the risk of an unstable funding structure has increased in the context of low deposit rates.

Pressure on refinancing gradually declined as the banks repaid debt on international wholesale markets. The proportion of liabilities maturing within one year increased in the short term. The banks will see EUR 1.870 billion or EUR 32% of total debt to the rest of the world mature by the end of March 2016, while a year earlier the figure had stood at 20%, equivalent to EUR 1.257 billion of debt to foreign banks.

**The proportion of debt to the rest of the world maturing within one year was higher in March 2015 than a year earlier.**

Figure 6.15: Maturing of liabilities to foreign banks by maturity interval (left) and proportion of banks’ total liabilities accounted for by liabilities from Eurosystem instruments (right) in percentages



Source: Bank of Slovenia

The banks under majority foreign ownership remain slightly more exposed to refinancing risk at shorter maturities. The banks under majority foreign ownership will see EUR 776 million or 34% of their total debt mature within one year, compared with around 30% or EUR 767 million at the large domestic banks. The small domestic banks will see

<sup>24</sup> According to the banks’ figures (PORFI) for February 2015, between March 2014 and March 2015 the banks under majority foreign ownership succeeded in rolling over their liabilities to banks in the rest of the world to a small extent (by 26%), while the small domestic banks failed to roll over funding in the rest of the world. The large domestic banks rolled over the aforementioned funding in full, although the stock of debt maturing within one year had been relatively small a year earlier, and NLB issued a 3-year bond in the interim (in July). The rollover of funding across the banking system in the year to the end of March stood at 54%, up on the most recent comparable figure (last October).

**Compared with the domestic banks, the banks under majority foreign ownership have a larger proportion of liabilities of up to 1 year maturing.**

their entire debt of EUR 120 million mature within three months. The banks under majority domestic ownership are slightly more exposed to refinancing risk at maturities of 1 to 3 years. The large domestic banks will see EUR 0.8 billion of debt mature in the interval of 1 to 3 years, while the banks under majority foreign ownership will see EUR 0.7 billion of debt mature. Compared with March of last year, a significantly smaller proportion of the liabilities in the interval of 1 to 2 years will mature. EUR 456 million of debt in this maturity bucket, or 8% of the total, is maturing, compared with last March's figures of EUR 1.8 billion or 29% of total debt to banks in the rest of the world.

#### **b) Bank funding from the Eurosystem**

**The banks had repaid more than 90% of liabilities from the Eurosystem's 3-year LTROs by the end of 2014.**

Refinancing risk in connection with liabilities to the Eurosystem declined sharply last year. After the ECB's measures of last June in particular, and in expectation of the exploitation of the TLTRO, the banks began faster repayments of the 3-year LTRO maturing in the first quarter of 2015. They did not have any problems with the early repayments, having sufficient liquidity at their disposal. Of the total of EUR 3,699 million from the 3-year LTRO of 2012, the banks had made early repayments of EUR 3,312 million or 90% by the end of 2014. They continued making repayments in 2015: the banks repaid EUR 268 million at final maturity in February.

**The banks only obtained significant funding from the Eurosystem at the second TLTRO auction held in December 2014.**

Slovenian banks only obtained funding to any great extent in the second of the ECB's targeted longer-term refinancing operations (TLTROs), which it began in the autumn of 2014. The banks' participation in the first TLTRO auction was modest: they obtained just EUR 75.5 million of funding. The majority of the banks participated in the second TLTRO auction on 11 December 2014, obtaining EUR 631 million of new loans in total. The banks' response to the third TLTRO auction was minimal, as they obtained just EUR 25 million of an estimated potential funding of EUR 2 billion. The lack of participation by the banks was expected, in light of their sufficient excess liquidity. The total borrowing at the three TLTRO auctions was EUR 731.4 million, which increased Slovenian banks' total liabilities to the Eurosystem to EUR 854 million by the end of March 2015, or just over 2% of their total liabilities.

The proceeds of the TLTROs<sup>25</sup> have to date not been earmarked for financing credit growth, but they are the cheapest source of funding for the banks. The banks may draw down more funding from the TLTRO in June 2015.

#### **6.4.2 Deposits by the non-banking sector**

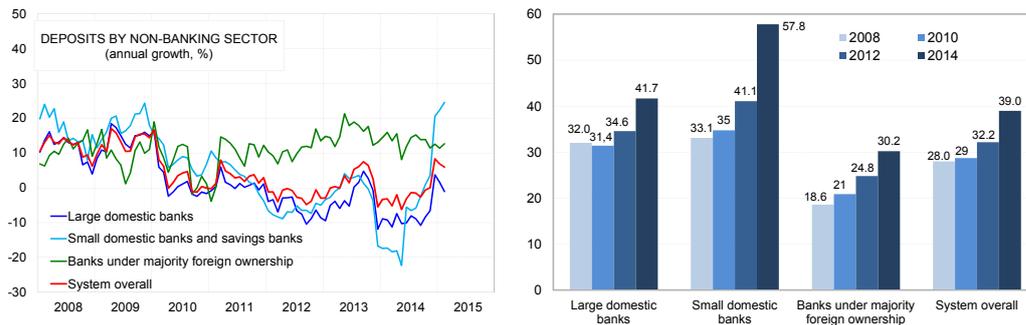
##### **Importance of deposits by the non-banking sector in bank funding**

**The proportion of total liabilities accounted for by deposits increased at all the bank groups.**

The importance of deposits by the non-banking sector in bank funding is increasing. Deposits by the non-banking sector were very solid at the end of 2014, and were up a relatively high 8.3% or EUR 1,875 million in year-on-year terms. Deposits by the non-banking sector increased in nominal terms in all segments last year, household deposits in particular. The relatively high year-on-year growth at the end of the year was mostly the result of a base effect from December 2013, when certain government deposits at the large domestic banks were converted into equity.

<sup>25</sup> There are eight operations in total. The banks will be able to undertake additional borrowing every quarter until June 2016, depending on their new lending. The final date for repaying all the TLTROs is 26 September 2018.

Figure 6.16: Year-on-year growth in deposits by the non-banking sector (left) and proportion of total liabilities accounted for household deposits (right) by bank group in percentages



Source: Bank of Slovenia

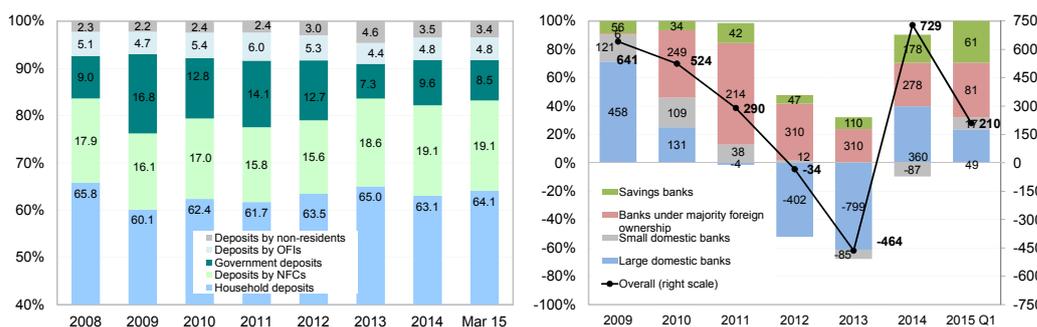
The proportion of total liabilities accounted for by deposits by the non-banking sector has increased by 20 percentage points since the outbreak of the crisis, while the proportion accounted for household deposits has increased by 11 percentage points. The stock of deposits by the non-banking sector rose by EUR 3.4 billion between the outbreak of the crisis in 2008 and the end of March 2015, of which household deposits accounted for EUR 1.9 billion, while total liabilities contracted by EUR 9.7 billion over the same period.

While deposits by the non-banking sector have increased, it should be noted that the proportion accounted for by sight deposits has increased in all sectors in recent years. This figure increased by 16 percentage points between December 2008 and March 2015, to 49%. The increase in the proportion of deposits by the non-banking sector accounted for by sight deposits is an indication of the relative stability of the funding structure, when investors are holding their investments in the most liquid forms, either as a result of a need for liquidity or in the search for alternative investments.

Year-on-year growth in household deposits has been positive since April 2014. The large increase in household deposits in 2014 was the result of their return to the banks after the partial withdrawal in 2013.<sup>26</sup> The banks had compensated for this outflow, after the previous year's recovery measures by the Ministry of Finance and the Bank of Slovenia, by last summer, and household deposits increased solidly in late 2014 and the first two months of 2015. Year-on-year growth in deposits slowed slightly this year, from just over 5% at the end of last year to 4.7% in March.

**Year-on-year growth in household deposits slowed slightly in the early months of 2015.**

Figure 6.17: Breakdown of deposits by the non-banking sector by sector (left) and increase in household deposits by bank group in EUR million (right)



Source: Bank of Slovenia

Household deposits remain the most important source of funding for the banking system: in recent years they have mostly accounted for more than 60% of deposits by the non-banking sector, the figure reaching 63% in March 2015. The proportion of total liabilities accounted for by household deposits has increased by 11 percentage points since the outbreak of the crisis, and had reached 40% by the end of March 2015. Household deposits accounted for nearly 43% of the large domestic banks' total liabilities in March 2015, compared with 58% at the small domestic banks and 31% at the banks under majority foreign ownership.

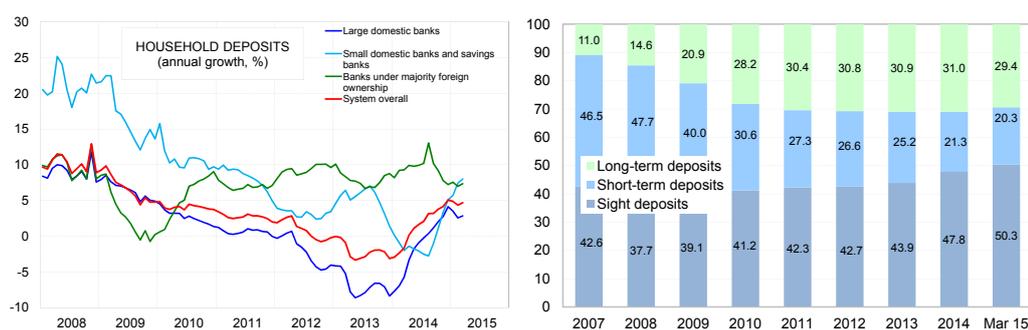
**The importance of household deposits to bank balance sheets is increasing.**

<sup>26</sup>The withdrawal of deposits was attributable to the developments related the Cyprus crisis, and the uncertainty later in the year before the adoption of the bank recovery measures.

**Increase in the proportion of household deposits accounted for by sight deposits.**

The average maturity of all deposits by the non-banking sector and of household deposits is shortening, as a result of the increasing proportion of sight deposits. Last year's overall increase in household deposits of EUR 729 million consisted of an increase of EUR 911 million in sight deposits, an increase of EUR 225 million in long-term deposits, and a decline of EUR 408 million in short-term deposits (excluding sight deposits). A similar trend continued in the first three months of this year. The proportion of long-term deposits is relatively stable, and has exceeded 30% for several years now. As a result of the sharp fall in interest rates at banks (interest rates on short-term deposits have been below the euro area average for a long time now, while rates on long-term deposits have been below the euro area average since February of this year), households have diminishing motivation to arrange longer-term deposits. Despite the increase in household deposits, the maturity breakdown is relatively unfavourable, and no changes can be expected in the future in the situation of low interest rates.

Figure 6.18: Year-on-year growth in household deposits by bank group (left), and breakdown of household deposits (right) in percentages



Source: Bank of Slovenia

**High liquidity means that the banks have little interest in increasing government deposits.**

The increase in corporate deposits, which measured around EUR 0.5 billion in each of 2013 and 2014, was most likely the result of corporates financing more investments with their own savings. Corporates have also created liquidity reserves in recent times, which is reflected in the main increase at banks being in the form of sight deposits. With the economic recovery, the stock of corporate deposits at banks will begin to decline.

Having increased in the initial years of the crisis, government deposits declined sharply at the end of 2013 after the conversion into equity, then began increasing temporarily in 2014 as a result of current liquidity management by the Ministry of Finance, whose pre-financing policy occasionally brings fluctuations in its assets at banks. Given the excess liquidity and the relatively short maturity of this funding, the banks have little interest in government funds, for which reason the government is placing them with banks in the rest of the world and directly with the Bank of Slovenia. The stock of government deposits will remain reasonably stable in the future, but there is also expectation of further short-term fluctuations in these deposits.

**The breakdown of bank funding is becoming comparable to that before the period of rapid borrowing.**

The rapid increase in the stock of wholesale funding in the past has proven to only allow for the temporary expansion of loans and balance sheets. The banks only temporarily mitigated the contraction in total assets via funding from the ECB in the past, in particular via the longer-term operations in 2012. The case is similar for government deposits, which immediately increased in the initial years of the crisis, then in December 2013 were largely converted into equity. The most stable and most important source of bank funding is deposits by the non-banking sector, households in particular, although sight deposits are increasing in relative importance in the breakdown owing to low interest rates, which from the perspective of maturity is an indication of unstable funding structure. Even if a larger proportion of the deposits in the long-term segment were to increase, the banks would not be able to use this funding alone to finance any reversal in lending cycle to a sufficient extent. The increase in the proportion of total liabilities accounted for by deposits means that the breakdown of bank funding has become entirely comparable to that before the period of rapid borrowing in the rest of the world by the banks.

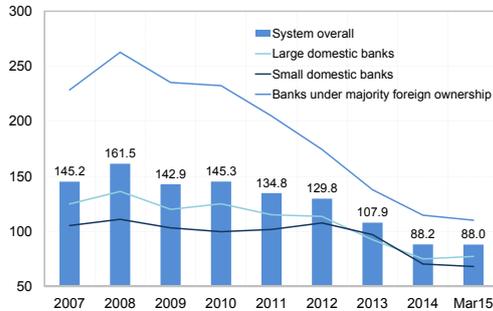
**Loan-to-deposit ratio**

The LTD ratio for the non-banking sector has been declining for several consecutive years in parallel with the banks' debt repayments on the wholesale markets, although the decline has now stabilised. The LTD ratio fell below 90% at end of last year and in the early part of this year, which is comparable to the first quarter of 2015. The banks under majority

foreign ownership have recorded the sharpest decline in this indicator of the sustainability of funding since the end of 2008, by 152 percentage points to 110%, while the March figures were 77% at the large domestic banks and 68% at the small domestic banks. There were several factors in the decline in the indicator: the increase in deposits by the non-banking sector on the financing side, and on the lending side the decline in loans and, at the large domestic banks, the transfers of claims to the BAMC at the end of 2013 and in the final quarter of 2014, which amounted to EUR 2.4 billion in total at the four banks.

**The declining LTD ratio for the non-banking sector stabilised in late 2014 and early 2015, and is comparable to that in 2004.**

Figure 6.19: LTD ratio for the non-banking sector by bank group in percentages



Source: Bank of Slovenia

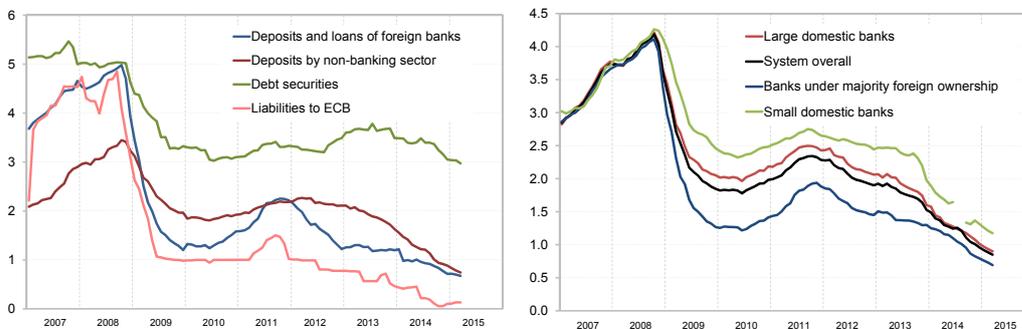
### 6.4.3 Cost of bank debt funding

The banks' average debt funding costs are falling. The fall in the cost of debt funding last year and in the first quarter of this year was mostly the result of falling interest rates on deposits by the non-banking sector. Funding costs fell more than at other groups at the domestic banks where deposits are prevalent in the funding structure.

**Debt funding costs had fallen below 1% by the end of 2014.**

Average debt funding costs in the banking system fell below 1% at the end of last year, and had reached 0.85% by March. The fall amounted to 0.68 percentage points between December 2013 and March 2015. The average interest rate on deposits by the non-banking sector fell particularly sharply during this period, by 0.88 percentage points to 0.75%.

Figure 6.20: Average costs of bank debt funding by primary source/instrument (left) and by bank group (right) in percentages



Source: Bank of Slovenia

The cost of funding raised at banks in the rest of the world in the form of loans and deposits fell by less over this period than did that of deposits, by 0.5 percentage points. The average costs of the two types of funding had almost equalised by the end of the first quarter of 2015 as a result of the fall in the cost of bank funding via deposits. The cost of funding via issued debt securities also fell slightly, to below 3%. These are the most expensive source of bank debt funding, but their importance on the balance sheet has declined in recent years.

**The fall in costs is primarily the result of a fall in funding costs for deposits by the non-banking sector.**

At 0.74%, the average cost of deposits by the non-banking sector is less than a tenth higher than the interest rates on funding at banks in the rest of the world. The banks cut interest rates on deposits by the non-banking sector in 2013 and 2014. During this period the banks faced a decline in interest income owing to the deterioration in the credit portfolio and the contraction in lending activity. Recently the banks have mitigated the pressures on the side of interest income by reducing interest rates on deposits by the non-banking sector. This adjustment in interest rates is limited, as investor behaviour in the context of such low interest rates is hard to predict.

**The banks mitigated the adverse developments in income caused by the contraction in lending activity by reducing funding costs in the form of deposits by the non-banking sector.**

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

**The spreads between the individual bank groups are diminishing.**

There was no significant change last year in bank funding via debt securities, which are the most expensive source of debt funding, but the early repayment of the 3-year LTRO and debt raised via the cheapest form of funding meant that average funding costs fell by less than they would otherwise have done. Additional favourable effects in the form of a fall in average funding costs are nevertheless expected in 2015, insofar as the banks opt for more financing via the TLTRO, given the low cost of this funding.

Relative to the other bank groups, the banks under majority foreign ownership maintain the lowest funding costs via deposits by the non-banking sector. They averaged 0.69% in March 2015. The comparable figures were 0.90% at the large domestic banks, and 1.18% at the small domestic banks. The spreads between the bank groups have diminished over the last two years.<sup>27</sup> The same is true for the overall debt funding costs. The aforementioned bank group has lower funding costs than the other two groups owing to the lower level of interest rates on deposits and the higher proportion of less-expensive liabilities to banks in the rest of the world, while there are no issued debt securities on the balance sheet, which are the most expensive source of funding.

<sup>27</sup>The narrowing spread in average funding costs via deposits by the non-banking sector is a reflection of the faster fall in interest rates on deposits by the non-banking sector at the domestic banks compared with the banks under majority foreign ownership. In 2013 the average spread in interest rates on deposits by the non-banking sector between the large domestic banks and the banks under majority foreign ownership stood at fully 0.45 percentage points (compared with just 0.15 percentage points in March 2015), while the spread between the small domestic banks and the banks under majority foreign ownership stood at 0.91 percentage points (compared with 0.51 percentage points).

## 6.5 Income risk and income statement

### Summary

Income risk in the banking system is increasing. The banks are operating with a high net interest margin, and have been improving cost efficiency for several years now. However, last year's increase in the margin was primarily the result of the transfer of non-performing claims from bank balance sheet to the BAMC, and the sharp fall in liability interest rates. In 2014 the banks were still recording relatively high impairment and provisioning costs, although these are falling in 2015. Despite the gradual stabilisation and the anticipated recovery in lending activity, in an environment of reduced interest rates the banks will have to cut interest rates on loans, which could entail a persistent fall in their interest income. The room for further cuts in liability interest rates is limited, as rates have fallen below those across the euro area. Given their aversion to taking up risk, the banks are maintaining a relatively high level of low-risk, low-yielding investments in securities. In the long term the banks can only generate a higher level of income and appropriate profitability by expanding lending.

### Operating result and income risk

The growth in net interest income in 2014 was primarily the result of a decline in interest expenses. The banks' net interest income in 2014 was up 17.5% in year-on-year terms. Interest income and interest expenses both declined, although at 38% the decline in the latter outpaced the decline in the former by 26 percentage points. The negative dynamic was attributable to the reduced stock of investments and liabilities, and to lower interest rates, albeit with differing impacts. The decline in interest income was primarily attributable to the decline in lending activity, while the decline in interest expenses was attributable to the sharp and rapid fall in liability interest rates. The banks recorded growth of 4% in non-interest income and 13% in gross income. Having operated at a profit over the first three quarters of the year, the banking system first moved to break-even in October and November and then into loss as a result of the additional impairments and provisioning incurred during the transfer of claims from one of the domestic banks to the BAMC and as a result of additional impairments at the other banks at the end of the year.

**The banks recorded a loss last year, but moved back into profit in the first quarter of 2015.**

The decline in interest income and interest expenses continued in the first quarter of 2015: the former was down 22% on the same period last year, while the latter were down 42%, and the banking system's gross income was down 7%. Non-interest income was also down on last year, by 8%, although it currently accounts for just a third of gross income. The banks recorded a profit of EUR 78 million in the first quarter, as all the bank groups generated a profit. Impairment and provisioning costs were down on last year, and accounted for 18% of the disposal of gross income.

Table 6.6: Banking sector income statement

	Amount, EUR million				Growth, %				Ratio to gross income, %			
	2012	2013	2014	Mar 15	2012	2013	2014	Mar 15	2012	2013	2014	Mar 15
Net interest	886	708	832	192	-12.9	-20.1	17.5	-6.3	56.6	64.9	67.6	66.0
Non-interest income	679	383	399	99	58.3	-43.6	4.1	-8.3	43.4	35.1	32.4	34.0
of which net fees and commission	339	339	346	83	-2.0	0.0	2.0	-2.1	21.7	31.1	28.1	28.5
of which net gain/loss from financial assets and liabilities held for trading	-2	-3	7	-31	...	...	...	...	-0.2	-0.3	0.6	-10.7
Gross income	1566	1091	1231	292	8.2	-30.3	12.8	-7.0	100	100	100	100
Operating costs	743	721	686	162	-4.4	-2.9	-4.9	-1.2	47.4	66.1	55.7	55.7
labour costs	400	384	366	90	-4.0	-3.8	-4.8	-2.4	25.5	35.2	29.7	30.8
Net income	823	370	545	129	22.8	-55.0	47.2	-13.4	52.6	33.9	44.3	44.3
net impairments and provisioning	1599	3809	650	52	32.5	138.1	-82.9	-43.0	102.2	349.1	52.8	17.7
of which impairments and provisioning at amortised cost	1201	2903	524	28	26.4	141.8	-81.9	-58.8	76.7	266.1	42.6	9.5
Pre-tax profit	-776	-3439	-105	78	-44.7	-342.9	96.9	31.9	-49.6	-315.2	-8.6	26.7
corporate income tax	22	-147	-8	-8	...	...	...	...	1.4	-13.4	-0.7	-2.8
Net profit	-754	-3586	-113	70	...	...	...	...	-48.2	-328.6	-9.2	23.9

Source: Bank of Slovenia

The high income risk in the banking system in the first quarter of 2015 was attributable to the persistent contraction in lending and the fall in asset interest rates. Both are preventing the generation of stable bank income, and are increasing income risk at the banks. The sharp fall in liability interest rates is gradually coming to an end; interest rates on new deposits by the non-banking sector are lower than the euro area average, for which reason there

**The main indicators of still-elevated income risk are the fall in net interest income and last year's persistently high impairment and provisioning costs in the banking system.**

is no expectation of additional favourable effects in the form of any reduction in interest expenses. Any favourable effects on the banks' net income can only be expected in the event of the additional switching of deposits with longer maturities into sight deposits, albeit to a very limited extent.

Credit growth and the proportion of the banking system's total loans accounted for by non-performing loans will be the key to managing the banks' income risk in the future. Costs from the realisation of credit risk have declined recently. Impairment and provisioning costs accounted for a smaller proportion of the disposal of gross income in the early months of 2015.

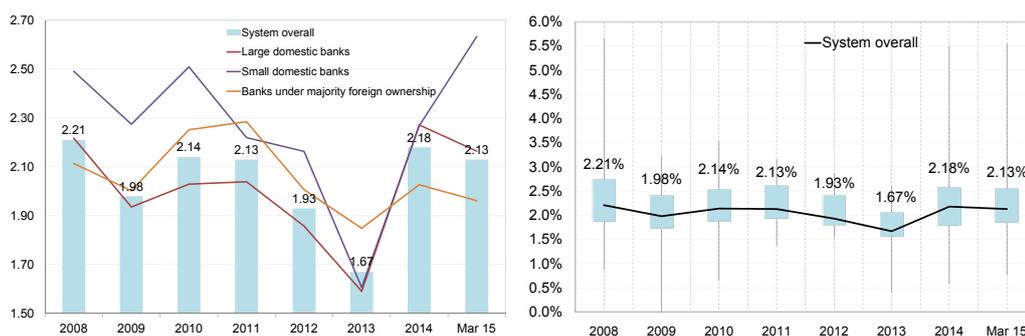
#### Net interest margin

The net interest margin improved in 2014, and remained comparable to last year in the first quarter of this year. The improvement in the interest margin was attributable to the following: a) the exclusion of a portion of non-performing claims from the balance sheets of banks where stabilisation measures were carried out in 2013 and 2014; b) the fall in liability interest rates and the resulting fall in interest expenses; and c) the contraction in total assets.

**Liability interest rates fell by more than asset interest rates in 2014 and the first quarter of 2015.**

Both average asset and liability interest rates fell in 2014 and the first quarter of 2015. The fall in average lending rates between December 2013 and March 2015 amounted to 0.48 percentage points, while the fall in deposit rates amounted to 0.8 percentage points. Interest rates on loans averaged 3.1% in March 2015, while interest rates on deposits averaged 0.78%. The interest spread narrowed by 0.3 percentage points during this period to reach 2.3 percentage points in March 2015.<sup>28</sup>

Figure 6.21: Net interest margin on interest-bearing assets by bank group in Slovenia (left) and distribution of net interest margin by quartile in Slovenia (right), 2008 to March 2015



Source: Bank of Slovenia

**Increase in the net interest margin in 2014.**

The net interest margin improved at all the bank groups last year, although the improvement was larger at the large domestic banks than at the banks under majority foreign ownership. The net interest margin of the domestic banks increased sharply last year as a result of a reduction in the proportion of the banks' total assets accounted for by non-performing loans, and the significant fall in interest rates on deposits by the non-banking sector, while the main factor at the banks under majority foreign ownership was the fall in liability interest rates. The banking system's net interest margin per interest-bearing assets stood at 2.13% of GDP in the first quarter of 2015.

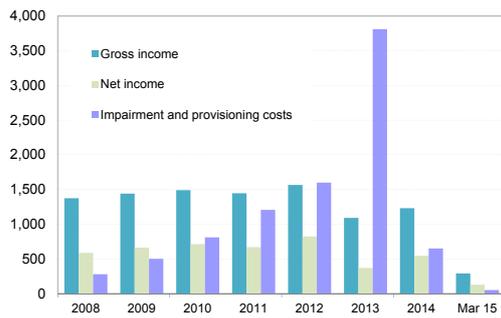
#### Impairment and provisioning costs and operating costs

**Impairment and provisioning costs accounted for just over half of the disposal of the banks' gross income last year.**

The credit portfolio improved in 2014 after the adoption of the recovery measures. Last year's impairment and provisioning costs were down significantly on the previous year, although it should be noted that they were very high in the previous year owing to the large impairments and the principal of the claims transferred to the BAMC. Impairment and provisioning costs nevertheless accounted for slightly more than half of the disposal of the gross income generated by the banks in 2014 (53%). The banks' net income, i.e. income before impairment and provisioning costs, amounted to 44% of gross income last year, exceeding the pre-crisis figure. The figure stood at 46% at the large domestic banks, 43% at the banks under majority foreign ownership, and just over a third at the small domestic banks.

<sup>28</sup> Includes the non-banking sector and banks.

Figure 6.22: Nominal change in categories of gross income, net income, impairment and provisioning costs in EUR million, 2008 to March 2015

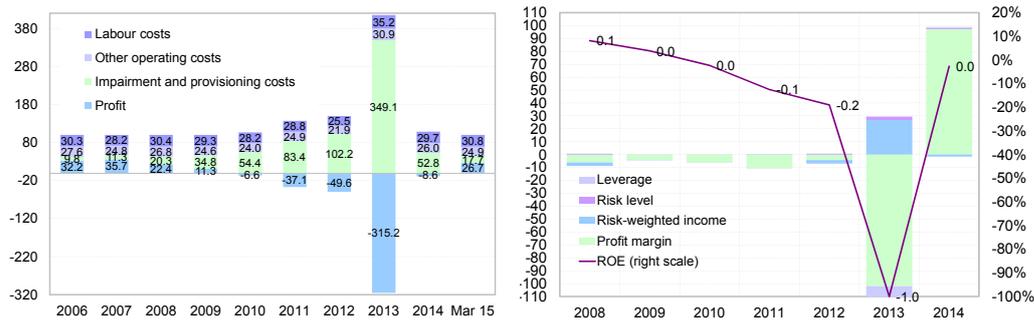


Source: Bank of Slovenia

The trend of declining impairment and provisioning costs continued in the first quarter of 2015. Impairment costs in the first quarter of this year were down 43% on the same period last year, and accounted for a relatively small proportion of the disposal of the banks' gross income (less than a fifth), comparable to the pre-crisis period. However, it should be noted that these costs are lower in the early part of the year than in later months. The large domestic banks had the highest proportion of the disposal of gross income accounted for by impairment and provisioning costs (59%), followed by the banks under majority foreign ownership (46%) and then the small domestic banks (36%). The corresponding figure did not exceed 20% at any of the bank groups in the first quarter of this year.

**The trend of declining impairment and provisioning costs continued in the first quarter of 2015.**

Figure 6.23: Disposal of banks' gross income in percentages (left) and movement in ROE and impact of four factors on the direction of the movement in ROE; breakdown of ROE (right)



Source: Bank of Slovenia

The banks have been reducing their operating costs since the final quarter of 2011. Operating costs have been declining at the banks despite the added burdens placed on them, such as the implementation of new banking regulations (the CRD IV and the CRR), the introduction of the Single Supervisory Mechanism (SSM), the creation of the bank resolution fund, and the implementation of the ITS. Operating costs fell by close to 5% last year, most notably at the large domestic banks (8.3%), and by a similar amount in the first quarter of this year (4%). The banks under majority foreign ownership were the only group to record a slight increase in operating costs last year and this year. The two largest bank groups have comparable CIRs, which illustrates the ratio of operating costs to gross income: 54% at the large domestic banks and 57% at the banks under majority foreign ownership. The small domestic banks are notable for a higher CIR of 66%.

**A decline in the banking system's operating costs.**

If the movement in the banks' ROE is analysed by breaking down profitability into four components (profit margin, risk-weighted income, risk level and leverage), it is found that only risk-weighted income acted to increase profitability in 2014,<sup>29</sup> while the other components acted to reduce it. Profit margin, i.e. the ratio of profit to gross income, was negative on account of the loss generated by the banking system, while risk level, i.e. the ratio of risk-weighted assets to total assets, declined as a result of the faster contraction in loans and the additional transfer of loans from bank balance sheets to the BAMC. Leverage also declined, as the banking system's total assets contracted again last year, while equity increased as a result of recapitalisations.

<sup>29</sup> Figures for the banks' risk-weighted assets and capital requirements were available until December 2014 at the time of the writing of this report. The figures for capital requirements have been calculated on the basis of the new CRR as of 2014 inclusive.

Table 6.7: Bank performance indicators in percentages

(%)	2008	2009	2010	2011	2012	2013	2014	Mar 2015
ROA	0.67	0.32	-0.19	-1.06	-1.60	-7.70	-0.26	0.82
ROE	8.15	3.87	-2.30	-12.54	-19.04	-97.30	-2.67	7.54
Costs / gross income	57.27	53.95	52.22	53.68	47.43	66.04	55.74	55.67
Interest margin on interest-bearing assets	2.21	1.98	2.14	2.13	1.93	1.68	2.18	2.13
Interest margin on total assets	2.08	1.88	2.02	2.02	1.83	1.59	2.09	2.03
Non-interest margin	0.93	1.00	0.86	0.85	1.40	0.85	1.01	1.06
Financial intermediation margin	3.01	2.88	2.88	2.87	3.23	2.44	3.10	3.09

Note: <sup>1</sup>Gross income / average assets

Source: Bank of Slovenia

## 6.6 Credit risk

### 6.6.1 Quality of the credit portfolios of banks and savings banks

#### Summary

Positive changes in the structural quality of the credit portfolio have been evident since the second half of last year. The proportion of non-performing claims as measured by arrears of more than 90 days first stabilised, then began to decline in the final quarter, even without the impact of the transfers from Abanka and Banka Celje to the BAMC. They accounted for 11.4% of classified claims in March. Non-performing claims have been declining in absolute terms, which has not been fully reflected in a decline in the proportion that they account for, as a result of the ongoing process of the contraction of bank portfolios. The banks' total classified claims in March were at their lowest level since 2007, at EUR 36.9 billion.

The coverage of non-performing claims by impairments and provisions has been rising over the years, and reached 64% in March 2015. In the wake of the improved coverage and the bank recapitalisations, the coverage of unimpaired non-performing claims by capital improved significantly, particularly at the large domestic banks, and with it the banks' robustness against unexpected losses.

Although at a lower level than before the bank recovery process began, the quality of claims remains worst in the corporate sector: 17.8% of corporate claims were more than 90 days in arrears in March 2015. Within the corporate segment the quality of claims against SMEs is significantly worse, the corresponding figure standing at 26.8% in March. This presents a bigger challenge to their resolution, given their small size and granularity. The banks will have to intensively restructure this part of the portfolio. The increased proportions of non-performing claims can be attributed to the banks' willingness to lend, as a result of an increase in expected impairments and the impact on profitability and thus on equity. There is also little willingness on the part of the banks to lend to clients with lower credit ratings.

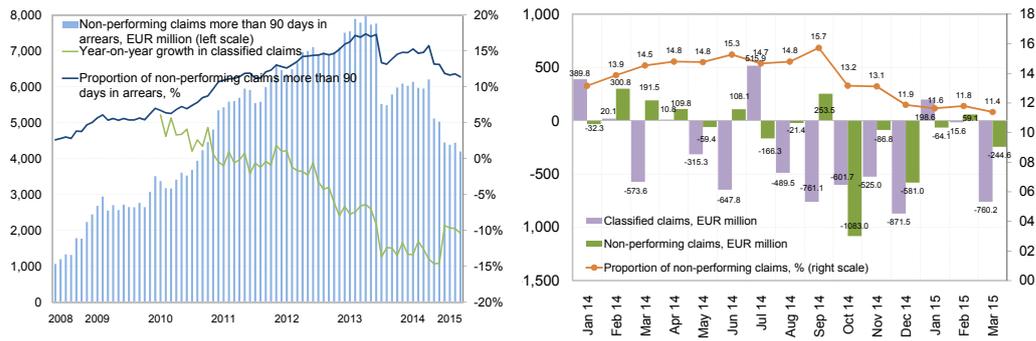
Non-performing claims against non-residents remain significant in the banking system's credit portfolio: they account for 17.2% of classified claims against this sector. Non-residents more than 90 days in arrears are concentrated in five countries, as a result of the actions of banking groups whose parent banks are established in Slovenia. Of the stock of EUR 4.2 billion in non-performing claims in March, claims against corporates accounted for EUR 2.6 billion, of which SMEs accounted for two-thirds, while claims against non-residents account for a further EUR 915 million.

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

**The banks have seen a gradual autonomous improvement in the quality of the credit portfolio since the second half of 2014.**

The proportion of non-performing claims declined from 18.1% before the beginning of the recovery of the banking system to 11.4% in March 2015, or to 10% if Probanka and Factor banka, the two banks undergoing orderly wind-down, are excluded. After the first transfer of non-performing claims to the BAMC in December 2013, the proportion stabilised around 14.8% between May and August last year, but after increasing in September the figure has been declining again since the second transfer of non-performing claims to the BAMC. The stock of non-performing claims declined by EUR 3.1 billion in 2014. The improvement in the quality of the portfolio was the product not only of the transfers to the BAMC, which did make a key contribution to this process, but also of the autonomous decline in non-performing claims as a result of activities at the banks aimed at reducing them. The slow pace of the decline in the proportion of non-performing claims was partly attributable to the faster contraction in the banks' turnover and the resulting decline in the proportion of good clients in the portfolios.

Figure 6.24: Growth in classified claims (CC) and non-performing claims in percentages and absolute amounts in EUR million

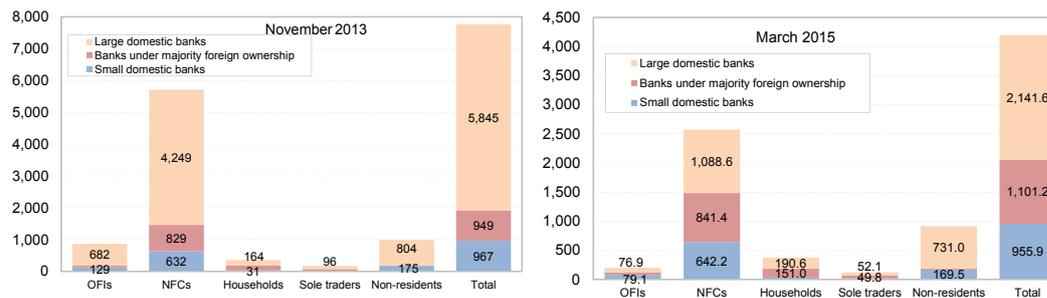


Source: Bank of Slovenia

The banks' classified claims amounted to EUR 36.9 billion in March 2015, the lowest level since 2007, and down EUR 4.4 billion on December 2013. The decline in the stock of claims against good clients, i.e. those rated A or B, also continued to decline. The stock of claims against clients rated A or B and the proportion of the banks' claims that they account for increased slightly in early 2015, which is a positive sign given the changes in lending activity. The decline in classified claims at the end of last year was attributable to the transfer of non-performing claims to the BAMC, first from Abanka in the amount of EUR 1 billion, and second from Banka Celje in the amount of EUR 0.4 billion.

**The banking system's classified claims have reached their lowest level since 2007.**

Figure 6.25: Non-performing claims by bank group and client group in November 2013 (left) and March 2015 (right) in EUR million



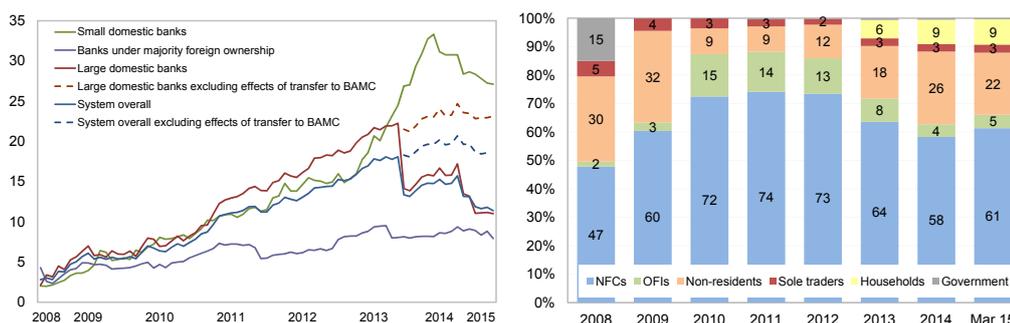
Note: <sup>1</sup>Households representing other households, sole traders not included.

Source: Bank of Slovenia

Non-performing claims at the large domestic banks still account for almost half of the banking system's non-performing claims, despite the transfer of non-performing claims from the three largest banks. Had there been no transfer to the BAMC, the proportion of classified claims at the large domestic banks accounted for by non-performing claims would be even higher, assuming no other change in conditions, at 23.1% in March 2015 instead of 11%, which would be reflected in a figure of 18.4% across the system. The largest figure for non-performing claims at a single bank group is at the small domestic banks, although in the event of the excluding of the two banks undergoing orderly wind-down, which account for 66% of the non-performing claims in this group, the proportion of non-performing claims would be reduced from 27.1% to 13.6%.

**Had there been no transfer to the BAMC, non-performing claims would account for 18.6% of classified claims assuming no other change in conditions.**

Figure 6.26: Arrears of more than 90 days as a proportion of the banks' classified claims by bank group (left) and client segment (right) in percentages



Note: <sup>1</sup>Non-performing claims against households have been recorded since January 2013.  
Source: Bank of Slovenia

**Non-performing claims against corporates accounted for 61% of the banking system's total nonperforming claims in March 2015.**

The transfers of non-performing claims to the BAMC were carried out in the sectors of NFCs, OFIs and sole traders. Despite a transfer in the total amount of EUR 1.4 billion, corporates still account for a significant proportion of the banks' non-performing claims: they accounted for 61% of all non-performing claims in the banking system in March 2015, down 11 percentage points since before the first transfer to the BAMC at the end of 2013. The stock of classified claims is continually declining. It stood at EUR 14.5 billion in March 2015. The contraction in turnover is concealing the actual decline in non-performing claims against this sector. The stock declined continually between May and December, by a total of EUR 418 million, excluding the transfers to the BAMC. Non-performing claims against corporates declined by a further EUR 18 million in the first quarter of 2015, but as a proportion remained at a similar level to the end of last year. They amounted to EUR 2.6 billion, down from EUR 5.7 billion in November 2013, when they accounted for 28.1% of classified claims against corporates.

Households (without sole traders), which account for 23% of classified claims in the banking system, are a less problematic sector of the credit portfolio, whose proportion of non-performing claims remains at a very low level. Household claims more than 90 days in arrears accounted for 4.3% of classified claims in this sector in March 2015.

Table 6.8: Breakdown of classified claims and non-performing claims by client segment in EUR million and in percentages

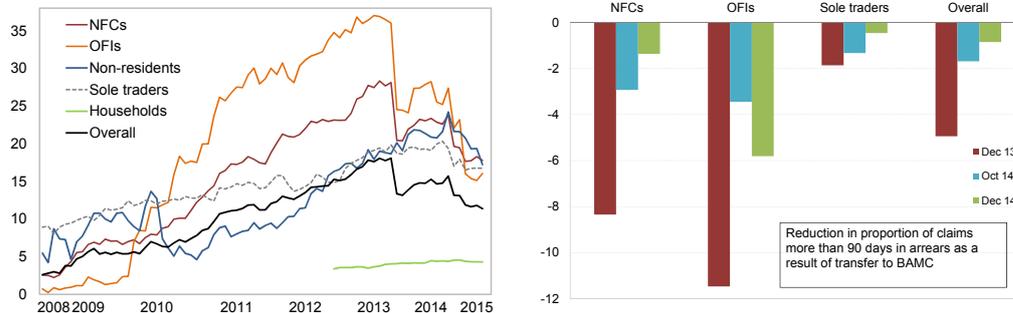
	Classified claims						Claims more than 90 days in arrears					
	EUR million			Proportion, %			EUR million			Proportion, %		
	Dec 13	Dec 14	Mar 15	Dec 13	Dec 14	Mar 15	Dec 13	Dec 14	Mar 15	Dec 13	Dec 14	Mar 15
NFCs	17,155	14,663	14,460	41.7	39.1	39.2	3,508	2,590	2,572	20.4	17.7	17.8
OFIs	1,851	1,243	1,239	4.5	3.3	3.4	454	199	199	24.5	16.0	16.1
Households	9,525	9,330	9,384	23.0	24.9	25.5	505	498	494	5.3	5.3	5.3
sole traders	794	722	715	1.9	1.9	1.9	149	119	120	18.7	16.5	16.7
other households	8,730	8,608	8,669	21.1	23.0	23.5	356	378	374	4.1	4.4	4.3
Non-residents	5,050	5,519	5,313	12.2	14.7	14.4	1,016	1,137	916	20.1	20.6	17.2
Government	3,524	3,411	3,339	8.3	9.1	9.1	35	24	16	1.0	0.7	0.5
Banks and savings banks	2,644	1,960	1,813	6.4	5.2	4.9	1	0	2	0.1	0.0	0.1
Central bank	1,516	1,306	1,273	3.7	3.5	3.5	0	0	0	0.0	0.0	0.0
Other	52	51	50	0.1	0.1	0.1	0	0	0	0.0	0.0	0.0
<b>Total</b>	<b>41,316</b>	<b>37,484</b>	<b>36,871</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>5,520</b>	<b>4,448</b>	<b>4,199</b>	<b>13.4</b>	<b>11.9</b>	<b>11.4</b>
Excluding Factor banka d.d. and Probanka d.d.							4,811	3,802	3,569	12.1	10.5	10.0

Source: Bank of Slovenia

The proportion of the banking system's claims against non-residents more than 90 days in arrears has been increasing since 2011: the stock of EUR 0.9 billion in March 2015 accounted for 22% of the banking system's total non-performing claims. This figure has almost doubled since before the transfers to the BAMC, while the actual stock has declined by 7%. Non-performing claims against non-residents were not subject to transfer to the BAMC, and have therefore increased sharply as a proportion of the banks' non-performing claims, despite the decline in their stock. The large domestic banks accounted for 88% of non-performing claims against non-residents in March 2015, their stock having increased until September 2014. Since October 2014 the stock of non-performing claims against non-residents has been declining. This bank group faces an extremely heavy burden from its portfolio of non-performing claims against non-residents, which account for 34% of all non-

performing claims at the group; this gives warning that the banks have been too slow in resolving this part of the portfolio.

Figure 6.27: Arrears of more than 90 days as a proportion of the banks' total classified claims by client segment (left) and impact of the transfers to the BAMC on the reduction of the proportion of non-performing claims by client segment (right) in percentages



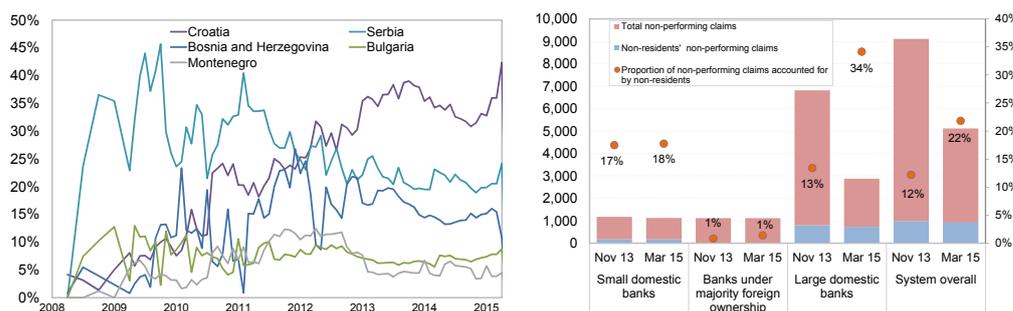
Note: <sup>1</sup>Households representing other households, sole traders not included.  
<sup>2</sup>Non-performing claims against households have been recorded since January 2013.  
Source: Bank of Slovenia

Dividing the bank credit portfolio into two markets, domestic and foreign, non-performing claims against clients from Slovenia accounted for 78% of non-performing claims in March 2015. In terms of the geographical origin of clients from the rest of the world, there is evidently a high concentration in five countries, which increased throughout 2014, from 15.2% of non-performing claims in December 2013 to 19.8% in March 2015. Non-performing claims against clients from Croatia, Serbia, Bosnia and Herzegovina, Bulgaria and Montenegro accounted for 91% of non-performing claims against non-residents, which is also a reflection of the actions of the banking groups of parent banks established in Slovenia.

**Non-performing claims against clients from five countries accounted for 91% of non-performing claims outside Slovenia in March 2015.**

Non-performing claims against OFIs in the amount of EUR 0.2 billion were also transferred to the BAMC in 2014. The transfer reduced the stock of these claims by EUR 0.6 billion and the proportion of these claims by 9.4 percentage points. Non-performing claims against OFIs amounted to EUR 0.2 billion in March 2015, or 16.1% of classified claims against OFIs, a profound unburdening of this segment of the portfolio, where the figures had been EUR 0.8 billion or 36% before the beginning of the bank recovery process.

Figure 6.28: Proportion of non-performing claims against non-residents accounted for by individual countries (left) and proportion of non-performing claims accounted for by non-residents before the transfers to the BAMC (right) in percentages



Source: Bank of Slovenia

**Classified claims more than 90 days in arrears (non-performing claims) by sector**

After the first transfer of non-performing claims to the BAMC in 2013, there was a notable change in the concentration of non-performing claims by sector. The sectors of construction, manufacturing and wholesale and retail trade accounted for 71% of non-performing claims in 2012. Following the first transfer in December 2013, the figure fell to 66%, and four sectors then had a significant role in non-performing claims (the sector of professional, scientific and technical activities and administrative and support service activities in addition to the aforementioned sectors). Concentration had declined further by March 2015, construction, manufacturing and wholesale and retail trade accounting for 63% of non-

performing claims. In addition, the sectors of professional, scientific and technical activities and administrative and support service activities and real estate activities were notable in terms of non-performing claims.

Table 6.9: Arrears in classified claims by sector

	Classified claims			Classified claims more than 90 days in arrears			Proportion of classified claims more than 90 days in arrears		
	Dec 13	Dec 14	Mar 15	Dec 13	Dec 14	Mar 15	Dec 13	Dec 14	Mar 15
Agriculture, forestry, fishing, mining	239	208	198	39	39	33	16.4	19.0	16.8
Manufacturing	4,732	3,994	3,935	748	493	489	15.8	12.4	12.4
Electricity, gas, water; remediation activities	1,068	1,063	1,118	48	79	71	4.5	7.5	6.3
Construction	1,927	1,490	1,444	967	674	649	50.1	45.2	44.9
Wholesale and retail trade	3,183	2,607	2,612	596	490	482	18.4	18.8	18.5
Transportation and storage	1,836	1,676	1,631	141	58	62	7.1	3.5	3.8
Accommodation and food service activities	505	427	422	167	96	110	33.0	22.6	26.0
Information and communication	451	483	456	61	66	62	13.6	13.8	13.7
Financial and insurance activities	406	282	278	116	36	74	28.6	12.9	26.8
Real estate activities	814	789	766	186	252	236	23.3	32.5	30.8
Professional, scientific and technical activities, administrative and support service activities	1,631	1,318	1,278	406	271	272	25.1	20.6	21.3
Public services	363	327	322	34	35	31	9.4	10.6	9.5
Overall	17,155	14,664	14,459	3,508	2,590	2,572	20.4	17.7	17.8

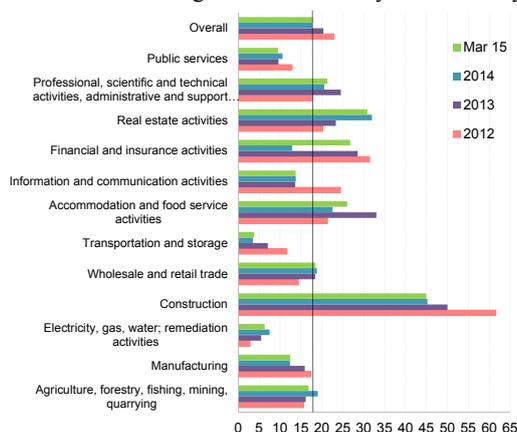
Source: Bank of Slovenia

**A decline in non-performing claims against corporates was seen in the majority of sectors, albeit in the context of a sharp contraction in bank lending activity.**

Non-performing claims against corporates in the sectors of manufacturing and wholesale and retail trade were transferred to the BAMC in large volumes in 2014. After the transfer of EUR 225 million of non-performing claims against the manufacturing sector and an autonomous decline, the proportion of non-performing claims declined by 4.7 percentage points by the end of March, to 12.4%. Despite a transfer of EUR 195 million, non-performing claims against the wholesale and retail trade sector remained high at 18.5% of the total, although the stock has declined over the last six months. Despite the persistently high proportion of non-performing claims in the sectors of manufacturing and wholesale and retail trade, which together account for 45% of classified claims against corporates, a trend of decline in the stock has been evident. The majority of sectors saw a decline in non-performing claims against NFCs last year.

After the transfers of non-performing claims to the BAMC in 2014 in the amount of EUR 128 million, construction remains a significantly high-risk sector, where 44.9% of claims against the sector are non-performing (classified claims more than 90 days in arrears), the large domestic banks continuing to account for the majority of the non-performing claims. The trend of increase in the proportion of non-performing claims in the sector of real estate activities that had been evident since 2010 continued for the first seven months of 2014. The proportion reached 40% in July, thus approaching the figure in the construction sector, since when it has been declining. In terms of the stock of non-performing claims, they accounted for 9.2% of total non-performing claims against corporates. Despite a decline last year, the accommodation and food service activities sector continues to have a relatively large proportion of non-performing claims, although the stock of EUR 110 million entails a relatively small burden for the banking system.

Figure 6.29: Percentage more than 90 days in arrears by sector



Sources: Bank of Slovenia, AJPES

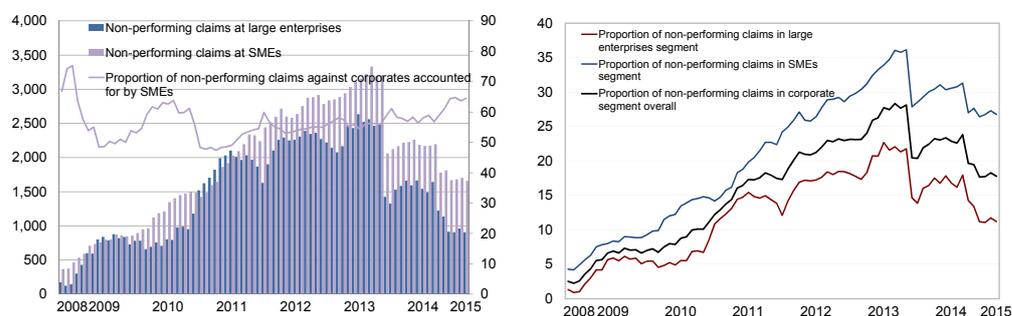
The proportion of non-performing claims in most sectors is above the overall average for the corporate sector, which stood at 17.8% in March. The exceptions are the sectors that had very low stocks of classified claims, such as public services, information and communication activities, transportation and storage, and electricity, gas and water supply. The proportion of non-performing claims in manufacturing also declined over the years, although the sector's large size means that it is one of the biggest in terms of the stock of non-performing claims, but it was always below-average in terms of the proportion of non-performing claims in the corporate sector. Non-performing claims against this sector formed part of the transfer to the BAMC in 2014, and there was a large volume of forborne claims in the sector, which further reduced the stock of non-performing claims as measured by arrears of more than 90 days.

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

In the itemisation of the corporate sector in terms of corporate size, there was an increase in non-performing claims against SMEs<sup>30</sup> until the first stage of the recovery of the banking system, whereby the banks were exposed to a larger number of clients with non-performing claims and increasing difficulty in credit risk management. Since the outbreak of the financial crisis, non-performing claims against SMEs have increased significantly faster than those against large enterprises. Non-performing claims against SMEs accounted for 65% of total non-performing claims against corporates in March 2015. Classified claims against SMEs accounted for 43% of classified claims against the corporate sector before the first transfer, the figure remaining unchanged until March 2015. Since improving as a result of the transfers to the BAMC, the quality of claims against SMEs has shown similar developments to that of the remainder of the portfolio. The proportion of non-performing claims against SMEs in bankruptcy was 36%, while the corresponding figure for large enterprises was 44%.

**Since the outbreak of the financial crisis, non-performing claims against SMEs have increased significantly faster than those against large enterprises.**

Figure 6.30: Arrears of more than 90 days by corporate size (left) and proportion of claims more than 90 days in arrears by corporate size (right) in EUR million and percentages

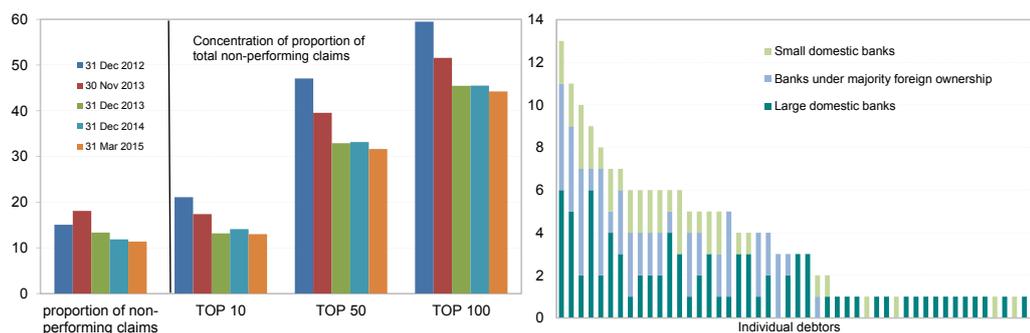


Sources: Bank of Slovenia

There is also a high concentration of non-performing claims, as the top 50 clients with arrears of more than 90 days account for 31.6% of non-performing claims. The concentration is lower than before the transfers to the BAMC, when it stood at just under 40%, as to a great extent it was larger debtors that were included in the transfers. The larger clients with arrears of more than 90 days had exposures at several banks, the large domestic banks in particular, which requires increased coordination by creditors in the resolution of claims against the largest debtors or in potential restructuring processes. However, compared with February 2014 there was greater dispersion across the banking system: 18 of the 50 largest debtors with arrears of more than 90 days were indebted to five or more banks, compared with 29 a year earlier.

<sup>30</sup>SMEs comprise micro, small and medium-sized enterprises, where corporate size is based on the definition set out in Article 55 of the ZGD-1H. For corporates that have ceased publishing their financial statements, their last known size is taken into account throughout the subsequent existence of their exposure in the banking system.

Figure 6.31: Concentration of debtors more than 90 days in arrears (left) and concentration by number of banks with exposure to the top 50 debtors with arrears of more than 90 days (right), March 2015



Source: Bank of Slovenia

**Box 6.3: Government and Bank of Slovenia measures to stabilise the banking system**

The government recapitalised two banks in October and December 2014 on the basis of a decision on state aid. Certain non-performing claims at the two banks were simultaneously transferred to BAMC. The measures were similar to those taken in December 2013 to stabilise the banking system. At that time the government recapitalised NLB d.d., NKBM d.d., and Abanka Vipava d.d., and two smaller banks, Factor banka d.d. and Probanka d.d., which have been undergoing orderly wind-down since September 2013, via the conversion of government deposits and via the acceptance of Slovenian government securities in the banks' portfolios. The subordinated instruments were written off at the same time (bail-in), and some of the non-performing claims of NLB d.d. and NKBM d.d. were transferred to the BAMC.

In October 2014 the government additionally recapitalised Abanka Vipava d.d. via Slovenian government securities, and the bank transferred some of its non-performing claims to the BAMC in exchange for BAMC bonds. In December the government recapitalised Banka Celje via securities and cash, and the bank transferred some of its non-performing claims to the BAMC in exchange for government-guaranteed BAMC bonds. The bank's subordinated liabilities were terminated before the recapitalisation.

The government recapitalised the banks in the total amount of EUR 3.6 billion over the two years. Non-performing claims totalling EUR 4.9 billion in gross terms were transferred from the banks' balance sheets to the BAMC, the banks receiving bonds in the amount of EUR 1.6 billion in exchange.

The recovery measures strengthened the banks in capital terms. The stabilisation of the situation in the banking sector reduced the required yields on Slovenian government bonds and stabilised the country's sovereign credit rating, and thus its access to the financial markets. The restoration of confidence in the banking system in the months following the adoption of the government and Bank of Slovenia measures was evident in the increase in household deposits.

Table 6.10: Measures to stabilise the banking system adopted by the Slovenian government and Bank of Slovenia in 2013 and 2014

Government and Bank of Slovenia measures	Recapitalisation		Write-off of subordinated debt		Transfer of claims to BAMC*				Receipt of BAMC bonds	
	2013	2014	2013	2014	2013		2014		2013	2014
Change, EUR million					gross	net	gross	net		
1) Active banks <sup>1</sup>	2,769	433	-441	-92	-3,317	-1,835	-1,555	-605	1,012	551
2) Banks undergoing orderly wind-down <sup>2</sup>	445		-64							
	Recapitalisation		Write-off of subordinated debt		Transfer of claims to BAMC*				Receipt of BAMC bonds	
Total, all banks	3,647		-597				-4,873 -2,440		1,563	

Note: <sup>1</sup>NLB d.d., NKBM d.d., Abanka Vipava d.d., Banka Celje; <sup>2</sup>Factor banka d.d., Probanka d.d.

Source: Bank of Slovenia

The transfers to the BAMC mostly comprised non-performing claims against the sectors of NFCs and OFIs, of which almost half were against corporates in bankruptcy. The majority (61%) of non-performing claims against corporates were held by the BAMC as at the end of 2014, the other 39% having remained in the banking system. The first figure was higher at large enterprises and corporates in bankruptcy, while a higher proportion (56%) of non-performing claims against SMEs remained in the banking system. The largest proportion transferred to the BAMC was recorded by non-performing claims against OFIs, at 77%. Claims against other sectors were not transferred, which increased their relative proportions of the banks' non-performing claims, thereby adding to the urgency of resolving this part of the portfolio.

Table 6.11: Stock of non-performing claims in the banking system and claims<sup>31</sup> transferred to the BAMC as at the end of 2014

	Corporates <sup>1</sup>				OFIs	Non-residents	Households	Other	Total
	Total	SMEs	Large	Other <sup>2</sup>					
At banks	2,709	1,775	914	20	199	1,137	378	25	4,448
At BAMC	4,259	1,991	2,202	66	666	-	-	-	4,925
Total	6,968	3,766	3,116	86	865	1,137	378	25	9,374
Proportion at BAMC, %	61.1	52.9	70.7	77.0	77.0	-	-	-	52.5

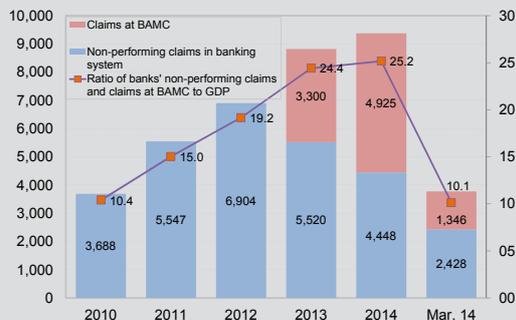
Note: <sup>1</sup>“Corporates” includes non-financial corporations from Sector S.11 and sole traders with a registration number; <sup>2</sup>“Other” mostly includes corporates in bankruptcy.

Sources: Bank of Slovenia, BAMC

The non-performing claims in the banking system and the claims transferred to the BAMC included almost EUR 2 billion of claims against corporates with which a master restructuring agreement (MRA) has already been signed, while more than EUR 1.7 billion of claims against corporates are already undergoing the restructuring process or the definition of the manner and conditions of restructuring. The restructuring of the majority of these claims is expected to be completed by the end of 2015.

Non-performing claims in the banking system and the claims at the BAMC were equivalent to 25% of GDP in December 2014, while claims covered by MRAs amounted to 10.1% of GDP.

Figure 6.32: Non-performing claims at the banks and claims at the BAMC



Note: Non-performing claims at the banks comprise claims more than 90 days in arrears. Claims at the BAMC include all the claims transferred from banks, including those less than 90 days in arrears.

Sources: Bank of Slovenia, BAMC

<sup>31</sup> Claims less than 90 days in arrears were also transferred to the BAMC.

### Classified claims more than 90 days in arrears (non-performing claims) against corporates in bankruptcy proceedings and personal bankruptcies

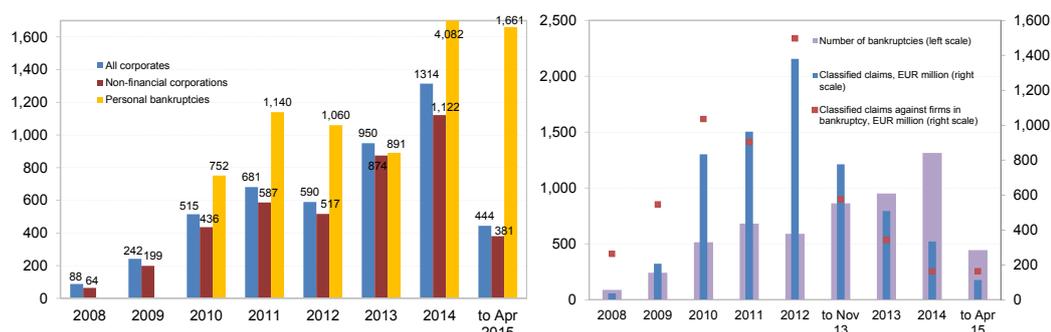
The number of corporates in bankruptcy proceedings is still rising, which has been reflected in the banking system's credit portfolio: the proportion of classified claims in the corporate portfolio accounted for by clients rated D or E stood at 29.9% in December 2014, up 1.6 percentage points on December 2013.

The banks' exposure to corporates in bankruptcy constitutes the largest risk of claims being lost or only partly repaid. The number includes corporates in the sectors of non-financial corporations, OFIs and sole traders, but does not cover non-resident corporates.<sup>32</sup>

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

<sup>32</sup> It includes all corporates established in Slovenia to which banks were exposed as at 31 March 2015 that were undergoing personal bankruptcy proceedings or corporate bankruptcy proceedings.

Figure 6.33: Number of bankruptcy proceedings initiated at year end (left) and classified claims against corporates in bankruptcy with regard to year of initiation of bankruptcy proceedings (right)



Sources: Bank of Slovenia, AJPES

The transfers to the BAMC in 2014 reduced the stock of classified claims against corporates in bankruptcy by EUR 125 million relative to December 2013. Claims against corporates in bankruptcy accounted for 43.9% of non-performing claims against corporates in December 2014, up 7.9 percentage points on the end of 2013.

Table 6.12: Banks' classified claims against non-financial corporations in bankruptcy in EUR million and as a proportion of total claims against non-financial corporations in percentages by sector

	Classified claims against firms in bankruptcy, EUR million				Proportion of classified claims in sector accounted for by firms in bankruptcy, %				Proportion of non-performing claims in sector accounted for by firms in bankruptcy, %			
	2012	2013	2014	Mar 15	2012	2013	2014	Mar 15	2012	2013	2014	Mar 15
Agriculture, mining	12	3	6	8	3.9	1.3	3.1	3.8	24.3	8.1	16.1	22.7
Manufacturing	368	205	137	154	6.3	4.3	3.4	3.9	36.3	27.3	27.8	31.6
Electricity, gas, water, remediation	3	5	4	24	0.2	0.4	0.4	2.2	7.2	9.4	5.6	34.2
Construction	1,256	588	531	493	38.4	30.1	35.2	33.8	62.4	60.1	78.8	76.0
Wholesale and retail trade	157	169	191	196	4.0	5.3	7.3	7.6	27.6	28.7	38.9	40.7
Transportation and storage	136	89	28	31	6.9	4.7	1.6	1.8	59.4	65.9	47.7	49.1
Accommodation and food service activities	12	31	34	35	1.8	6.1	8.0	8.4	8.2	18.5	34.8	31.4
Information and communication	16	7	9	9	2.5	1.4	1.8	2.0	10.2	10.7	13.3	14.3
Financial and insurance activities	65	32	3	3	8.0	7.9	1.1	1.1	25.4	27.7	8.9	4.2
Real estate activities	41	57	62	63	3.9	7.0	9.3	9.8	19.3	29.9	24.6	26.8
Professional, scientific and technical activities, administrative and support service activities	108	75	127	145	5.6	4.7	9.8	11.6	32.8	18.7	46.7	53.2
Public services	3	2	5	5	0.7	0.5	1.6	1.6	5.6	5.7	14.8	16.3
Overall	2,178	1,262	1,137	1,166	9.8	7.3	7.8	8.1	43.0	36.0	43.9	45.3

Source: Bank of Slovenia

**The proportion of non-performing claims accounted for by corporates in bankruptcy remains high in certain sectors.**

The largest increase in classified claims against corporates in bankruptcy in 2014 was recorded by the sector of professional, scientific and technical activities and administrative and support service activities, where it increased by EUR 52 million to EUR 127 million as the proportion of non-performing claims against the sector accounted for by corporates in bankruptcy increased by 28 percentage points to 46.7%. In the construction sector the stock of claims against corporates in bankruptcy and the stock of non-performing claims both declined, although the decline was more rapid in the latter, for which reason corporates in bankruptcy accounted for 78.8% of the banks' residual non-performing claims against the construction sector after the most recent transfer to the BAMC. The largest decline in claims against corporates in bankruptcy was recorded by the manufacturing sector, by EUR 68 million to EUR 137 million in December 2014 and to EUR 154 million in March 2015, or 31.6% of non-performing claims against the sector.

The number of personal bankruptcies by private individuals rose sharply last year, the trend continuing this year. The four-fold rise in the number of personal bankruptcies in 2014 was additionally attributable to a change in legislation with the abolition of an advance payment for filing a petition for bankruptcy proceedings. The number of bankruptcies in the first quarter of 2015 had already exceeded the number recorded in the whole of 2013. The

household<sup>33</sup> segment nevertheless remains the lowest risk: the proportion of non-performing claims in the segment stood at 4.3% in March 2015.

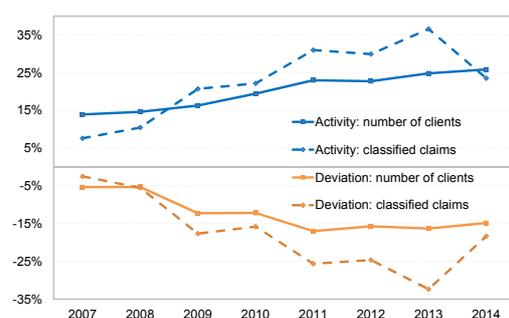
### Transitions of non-financial corporations between credit ratings

The quality of the banking system's credit portfolio as measured by debtor credit ratings deteriorated slightly in the segment of non-financial corporations in 2014. The proportion of classified claims against corporates accounted for by clients rated D or E stood at just under 30% at the end of 2014, despite the transfer of certain non-performing claims from Abanka and Banka Celje, up 1.7 percentage points on a year earlier. The proportion accounted for by clients rated A or B increased by 2.6 percentage points over the same period to 59.9%. Between November 2013, when non-performing claims peaked, and the end of 2014, classified claims against clients rated D or E declined by EUR 1.6 billion. In relative terms, the proportion that they account for remained around 30%, despite the transfers to the BAMC. Non-performing loans are therefore still a significant burden on bank balance sheets in the segment of non-financial corporations.

Further changes in the client ratings breakdown can be expected as a result of a change in Bank of Slovenia regulations, where clients who only occasionally fall more than 90 days into arrears must be assigned a D rating, which will further reduce the proportion of clients rated C.<sup>34</sup>

Activity<sup>35</sup> and deviation<sup>36</sup> as measured by classified claims declined in 2014. The indicators measuring the transitions of clients between credit ratings remained at a similar level to the previous year. This means that in 2014 the banks regraded fewer corporates in terms of exposure than in the previous year. Compared with the pre-crisis period, the two indicators remain at high levels.

Figure 6.34: Activity and deviation in percentages



Source: Bank of Slovenia

The transition matrix for 2014 illustrates a similar breakdown of transitions between credit ratings to that in 2013. Improvements are evident in the transitions from the B rating, both upgradings and downgradings, and in the larger proportion of upgradings from the C rating. By contrast, the proportion of downgradings from A to lower ratings increased. The transition matrix for 2014 still reveals the breakdown of transitions to be significantly worse than was evident before the crisis and in the early years of the crisis. The intensity of downgrading is nevertheless slower than in previous years.

**The breakdown of transitions between credit ratings in 2014 was similar to that in the previous year.**

Table 6.13: Percentage breakdown of transitions of non-financial corporations between credit ratings

Transition matrix 2013						Transition matrix 2014							
		2013							2014				
		A	B	C	D	E			A	B	C	D	E
2012	A	80.2	14.9	3.2	1.2	0.5	2013	A	78.7	16.6	3.1	1.3	0.4
	B	8.0	71.0	13.9	5.5	1.7		B	11.3	70.2	13.2	4.1	1.1
	C	1.6	7.6	56.9	19.6	14.3		C	2.9	9.3	53.1	26.0	8.7
	D	0.3	1.6	2.9	56.7	38.6		D	0.6	0.8	2.6	62.3	33.8
	E	0.1	0.2	0.3	4.2	95.2		E	0.1	0.1	0.2	2.7	97.0

Source: Bank of Slovenia

<sup>33</sup> Households representing other households, sole traders not included.

<sup>34</sup> Amendment to the Regulation on the assessment of credit risk losses of banks and savings banks, February 2015.

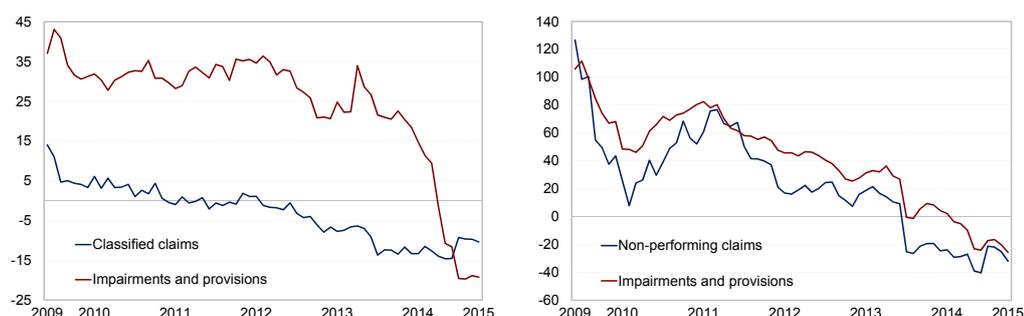
<sup>35</sup> Activity illustrates the proportion of corporates whose credit ratings changed.

<sup>36</sup> Deviation is calculated as the number of clients whose credit ratings improved less the number of clients whose credit ratings deteriorated, relative to the number of clients who have a credit arrangement with the same bank in the current and previous year.

## Coverage by impairments and provisions

The developments in classified claims have been tracked by developments in impairments and provisions. Additional impairments and provisions in the amount of EUR 1 billion were created over the first eleven months of 2013, as a result of the asset quality review and the increase in capital brought by recapitalisation. The creation of impairments and provisions in 2014 was not at the same level as in the previous year, which was evident in a sharper decline in the year-on-year comparisons of impairments and classified claims.

Figure 6.35: Growth in classified claims and impairments (left) and growth in classified claims more than 90 days in arrears, non-performing claims and impairments for non-performing claims (right) in percentages



Source: Bank of Slovenia

**A record level of coverage of claims by impairments and provisions was achieved this year.**

Impairments and provisions of non-performing claims continually increased between 2007 and November 2013, when they reached a record high of EUR 3.9 billion. The stock of impairments and provisions gradually increased over the first ten months of 2014, until the transfer to the BAMC, when the stock declined by EUR 0.6 billion to EUR 3.1 billion, and to EUR 2.7 billion in December during the second transfer, since when it has remained at this level. Coverage of non-performing claims by impairments has been increasing over the years, and stood at 64% in March 2015, up 6.9 percentage points on December 2013 after the first transfer of non-performing claims to the BAMC.

Table 6.14: Coverage of classified claims and non-performing claims by impairments and provisions in EUR million and percentages

	Coverage of total classified claims by impairments, %				Coverage of claims more than 90 days in arrears by impairments, %			
	Dec 12	Dec 13	Dec 14	Mar 15	Dec 12	Dec 13	Dec 14	Mar 15
NFCs	11.5	17.1	16.2	16.3	39.2	50.6	57.0	58.3
OFls	24.9	26.9	14.4	14.2	64.1	76.5	69.0	68.2
Households	3.9	4.5	4.3	4.5	-	65.2	67.3	70.8
sole traders	9.1	13.5	14.6	15.2	43.3	51.6	56.4	58.7
other households	3.3	3.7	3.7	3.8	-	70.9	70.6	74.5
Non-residents	10.4	22.4	38.6	40.8	42.6	71.0	72.9	74.7
Government	0.2	0.5	0.6	0.7	5.3	28.4	30.9	37.9
Banks and savings banks	1.2	1.2	0.5	0.5	12.2	0.8	0.6	27.7
Total coverage	8.7	12.2	10.9	11.1	42.7	56.8	60.7	63.7
	Total classified claims				Total arrears of more than 90 days			
EUR million	47,876	41,329	37,484	36,871	6,904	5,520	4,448	4,199
	Total impairments				Impairments for arrears of more than 90 days			
EUR million	4,170	5,054	4,076	4,109	2,949	3,133	2,698	2,674

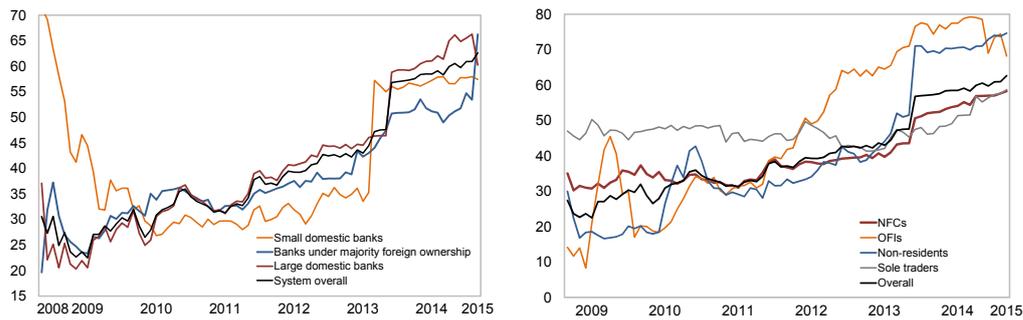
Source: Bank of Slovenia

The indicator of the coverage of non-performing claims by impairments and provisions does not take direct account of the debtor's collateral for the claim, although this is taken into account in the individual approach to the creation of impairments and provisions at banks.

**Coverage by impairments is increasing in the majority of sectors.**

The coverage of non-performing claims in individual portfolio segments indicates which client segments bear higher risk, taking account of collateral quality. Impairments of non-performing claims increased in most client segments; they increased by 1.3 percentage points in the corporate segment, simultaneously with the decline in collateral values. An increase was also evident in the sectors of sole traders and non-residents, where impairments are equivalent to 75% of non-performing claims.

Figure 6.36: Coverage of non-performing claims more than 90 days in arrears by impairments by bank group (left) and by client segment (right) in percentages



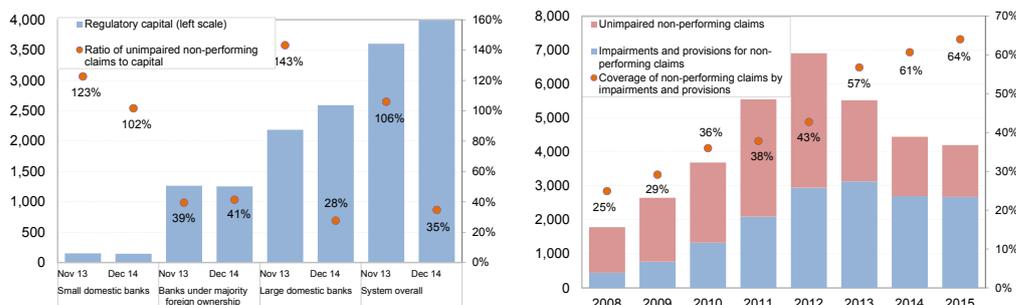
Note: <sup>1</sup> Excludes impairments for households.  
 Source: Bank of Slovenia

The banks under majority foreign ownership recorded the largest increase in impairments in 2014. Coverage by impairments and provisions at the banks under majority foreign ownership stood at 63.5% in March 2015, up 10 percentage points on the end of 2013. The small domestic banks recorded a sharp increase in impairments and provisions from September 2013; the aforementioned bank group includes Probanka and Factor banka, which have been undergoing the orderly wind-down process since September 2013. The impairments created by the two aforementioned banks accounted for 13.7% of the banking system’s total impairments for non-performing claims, and for 65.9% of impairments at the small domestic banks. Excluding these two banks, the banking system’s coverage of non-performing claims would stand at 64.7%.

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

At the large domestic banks there was a discernible increase in impairments and provisions over the entire year until the transfer of non-performing claims to the BAMC, when the stock of impairments and provisions declined. However, as a result of the simultaneous decline in non-performing claims and impairments during the transfer to the BAMC, coverage of non-performing claims at the large domestic banks increased throughout the year, and reached 66.2% in March 2015.

Figure 6.37: Ratio of unimpaired non-performing claims to capital (left) and coverage of non-performing claims by impairments and provisions (right) in EUR million and percentages



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

Banks with a higher proportion of non-performing claims have a lower tendency and capacity to approve new loans, as non-performing claims require higher impairments and provisioning, which reduce profitability and interest income. Non-performing claims also place a heavier burden on capital from the perspective of the weighting of risk-weighted assets. In the event of lower coverage by impairments and provisions and lower collateral, they require more capital than performing claims, having been assigned a higher weight in capital requirements. Banks with a higher proportion of non-performing claims are also more averse to lending to clients with a lower credit rating, for which reason these corporates have difficulty in accessing loans.

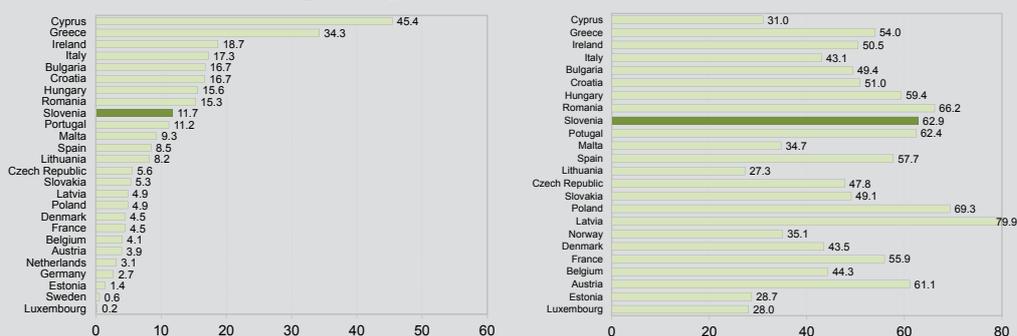
A comparison of unimpaired non-performing claims before and after the recapitalisations reveals that the large domestic banks saw a significant change in coverage of non-performing claims by regulatory capital, which in addition to the injection of capital was also the result of the transfer of non-performing claims to the BAMC. The small domestic banks remain undercapitalised with regard to the stock of unimpaired non-performing claims in their portfolio.

**Box 6.4: Non-performing claims in EU countries**

Numerous banking systems around Europe saw a deterioration in the quality of the credit portfolio after the outbreak of the financial crisis. Despite the acute relevance of this issue, existing databases do not allow for a consistent comparison between countries, as there is no harmonised definition of non-performing claims that could be applied when the national figures are published. The most comprehensive database, which prescribed reporting under a standard definition, is the IMF’s Financial Soundness Indicators, which encompass all the countries of the world. The definition of non-performing claims refers to arrears of more than 90 days and is restricted to loans, in contrast to the Bank of Slovenia’s approach, which includes all classified claims more than 90 days in arrears in non-performing claims. The majority of countries nevertheless report using their specific national definitions, which prevents proper methodological comparisons. Some countries only report on a net basis (minus impairments), some only report for larger banks or banking groups, and some only report for domestic banks or domestic clients.

The data for Slovenia is taken from the aforementioned IMF database, albeit in the narrower segment of loans instead of total classified claims.

Figure 6.38: Loans more than 90 days in arrears: proportion of all loans (left) and coverage by impairments (right) in EU countries in percentages



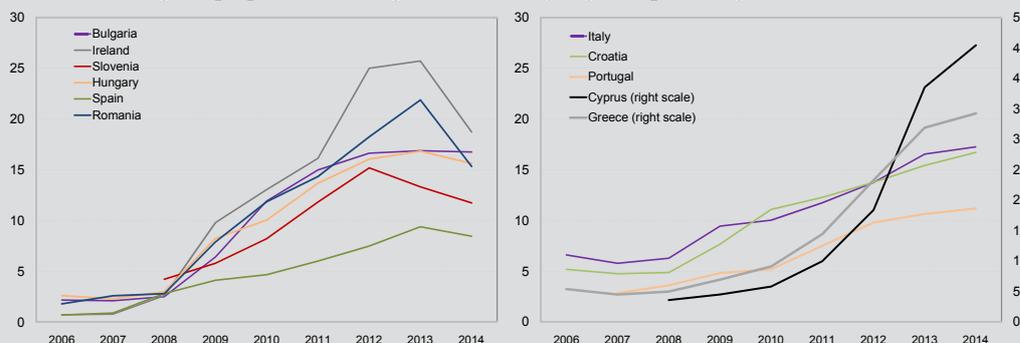
Source: IMF (FSIs)

Eight EU countries reported that the quality of their credit portfolio was worse than that of Slovenia in the final quarter of last year (the figures are for September or December 2014). Until last September, before the most recent transfers to the BAMC, Slovenia was comparable to Romania, Hungary, Bulgaria and Croatia in terms of the proportion of non-performing loans, while after the most recent transfers and the autonomous decline in non-performing claims it has moved away from these countries and reduced its proportion of claims more than 90 days in arrears.

In terms of coverage of loans more than 90 days in arrears by impairments, Slovenia has one of the best coverage rates in the EU, behind Latvia, Poland and Romania, and similar to Austria and Portugal. Of the countries with a higher proportion of non-performing loans, only Romania has created more impairments than Slovenia, while Hungary is at a similar level.

Given the limited comparability between countries, a better indicator than the absolute value is the change over time, which distinguishes countries in the upper section of the distribution of the indicator in terms of trends in recent years. Slovenia is in the group of countries that have succeeded to a greater or lesser degree in improving the quality of their bank assets in the last year or two. It is also however in the group of countries with a high proportion of non-performing claims and a trend of further increase. All the illustrated countries had a relatively low indicator of non-performing claims in the years before the outbreak of the financial crisis: the first group averaged 3%, and the second group around 5%.

Figure 6.39: Change in proportion of loans more than 90 days in arrears in EU countries by year in countries with the highest proportions, falling (left) and rising (right) in percentages

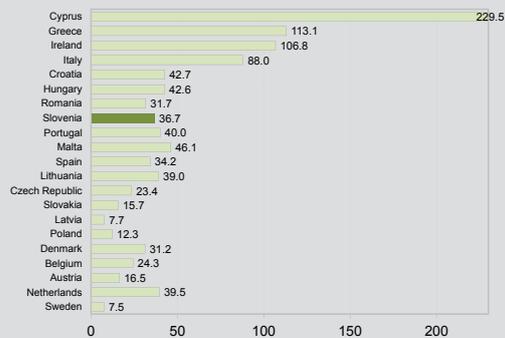


Source: IMF (FSIs)

Slovenia is in a significantly better position when compared with other countries in terms of coverage of net non-

performing claims (minus impairments) by capital. This is attributable to the high coverage by impairments illustrated above, and to the high level of the capitalisation of the banks after the measures to stabilise the banking system. Slovenian banks' net non-performing claims, i.e. the unimpaired portion of their non-performing claims, are equivalent to a third of the capital in the banking system, while in three countries (Cyprus, Greece and Ireland) the stock of capital is insufficient to cover the claims. According to this criterion, four other countries (Portugal, Malta, Lithuania and the Netherlands) that otherwise report a better-quality credit portfolio than Slovenia disclose a worse ratio of unimpaired non-performing claims to capital. In the group of countries with a higher proportion of non-performing loans than Slovenia, Romania ranks below Slovenia in terms of this criterion, while the other countries are above it.

Figure 6.40: Ratio of net non-performing claims (minus impairments) to capital in EU countries in percentages

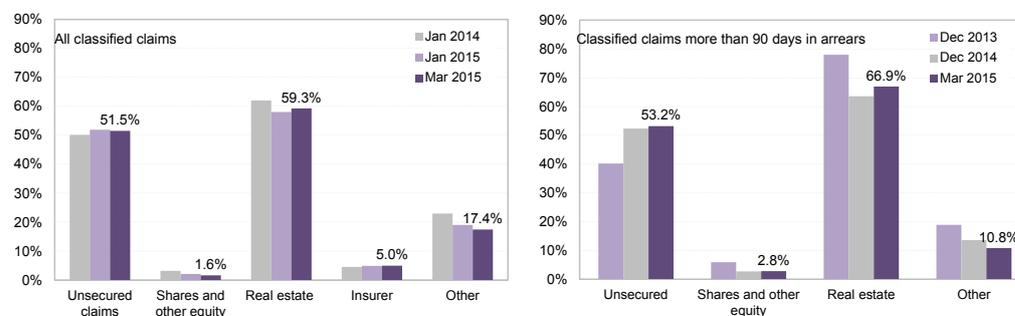


Source: IMF (FSIs)

### Loan collateral

In the banking system overall, the proportion of classified claims accounted for by unsecured claims exceeds one half. This proportion has been increasing since 2012, and is larger for non-performing claims. The value of all forms of credit protection is declining, other than insurance with insurers, which accounts for a small proportion of credit protection. The total value of collateral received (measured at fair value) is equivalent to 80.6% of non-performing claims, down 21.2 percentage points on February 2014.<sup>37</sup>

Figure 6.41: Coverage of the banks' total classified claims (left) and coverage of non-performing claims (right) by collateral in percentages



Source: Bank of Slovenia

The large domestic banks had the highest proportion of unsecured claims, at 58.4%. During the transfer of certain non-performing claims to the BAMC the aforementioned bank group also transferred the corresponding collateral, thereby increasing the proportion of unsecured claims in the portfolio. The proportion of unsecured non-performing claims has also increased at all bank groups relative to the end of 2013, while the total value of collateral has also declined. The savings banks and the banks under majority foreign ownership are also notable in this respect, alongside the large domestic banks.

**The proportion of unsecured non-performing claims has risen at all bank groups relative to the end of 2013, while the total value of collateral has declined.**

<sup>37</sup>The calculation does not exclude collateral valuations in excess of the value of the claim against a particular client, which could distort the picture of undervalued collateral relative to the claims that it secures. It also does not exclude collateral that is taken into account multiple times for different claims or even at different banks (e.g. real estate may be pledged as collateral at several banks, taking into account seniority and the proportion of repayment, minus previous liability values).

Table 6.15: Collateral on non-performing claims by bank group in October 2015 in percentages

	Comparison of credit protection <sup>2</sup> with classified claims more than 90 days in arrears, %						
	Classified claims, EUR million	Unsecured <sup>1</sup>	Shares, equity and mutual fund units as collateral	Commercial real estate as collateral <sup>3</sup>	Housing as collateral <sup>3</sup>	Other forms	Total value of collateral <sup>3</sup>
Savings banks	7.2	31.7		53.8	83.3	1.4	138.5
Small domestic banks	916.4	45.6	5.5	66.6	19.8	16.2	108.1
Banks under majority foreign ownership	950.1	49.9	2.6	50.7	11.7	21.0	86.1
Large domestic banks	1,951.0	58.4	1.7	54.4	5.3	3.3	64.7
Overall	3,824.7	53.2	2.8	56.4	10.5	10.8	80.6

Notes: <sup>1</sup> The figure includes unsecured claims and claims secured with forms of credit protection that are not taken into account in the banks' calculation of impairments and provisions (e.g. collateral in the form of bills of exchange).

<sup>2</sup> Collateral is stated at fair value.

<sup>3</sup> With regard to collateral in the form of real estate, several banks may register a mortgage on the same real estate. In such cases the value of the mortgage at each successive bank is reduced by the value of the claims of banks with seniority in the possible redemption of the collateral. The collateral value is thus multiplied, both for these forms of collateral and as an aggregate.

Source: Bank of Slovenia

A high proportion of unsecured claims can be seen in client segments with a high proportion of non-performing claims, such as non-residents and OFIs, for which reason the banks are exposed to higher credit risk in these segments.

Table 6.16: Collateral on non-performing claims by bank group in March 2015 in percentages

	Comparison of credit protection <sup>2</sup> with classified claims more than 90 days in arrears, %							
	Classified claims, EUR million	Unsecured <sup>1</sup>	Shares, equity and mutual fund units as collateral	Commercial real estate as collateral <sup>3</sup>	Housing as collateral <sup>3</sup>	At insurer	Other forms	Total value of collateral <sup>3</sup>
NFCs	2,630	50.8	3.0	60.1	11.5	0.0	13.8	88.6
OFIs	141	83.0	3.2	21.1	3.3		3.8	31.4
Households	120	38.0	0.0	79.9	38.7	0.2	15.3	134.1
Sole traders	120	38.0	0.0	79.9	38.7	0.2	15.3	134.1
Non-residents	916	56.5	2.6	49.1	5.3		2.8	59.8
Government	16	99.2		1.2	0.3			1.4
Banks and savings banks	2	100.0						
Overall	3,825	53.2	2.8	56.4	10.5	0.0	10.8	80.6

Notes: <sup>1,2,3</sup> See previous table. The table does not include the household sector.

Source: Bank of Slovenia

### Real estate remains the prevailing form of collateral.

The prevailing form of collateral remains real estate. Commercial real estate is the prevailing form of collateral at corporates, with an LTV ratio of 56.4%. Collateral in the form of real estate has been impacted by the lower volume of trading in real estate, which actually improved in 2014, and the fall in real estate prices since 2008, which has been reflected in a significant decline in the proportion of collateral accounted for by commercial real estate. The figure was down 10.1 percentage points on February 2014. The collateral value of claims is declining, which is being reflected in increased requirements for additional impairments and provisions at the same level of credit risk.

## 6.6.2 Resolution of banks' non-performing claims

### Survey figures on collateral redemptions owing to clients' inability to repay claims

According to survey figures, the banks were less intensive in redeeming collateral for corporate loans in 2014 than in the previous year, the volume of loans for which the collateral was redeemed declining by 60% in year-on-year terms. The banks redeemed collateral for claims in the amount of EUR 404 million in 2014, as loans secured by commercial real estate were the most redeemed. In 2014 the success rate in the repayment of claims from redeemed collateral stood at 34%, up 12 percentage points on the previous year, despite the decline in the real estate market. Collateral was redeemed in 2014 for only 5.3% of non-performing claims against corporates in terms of the stock at the end of 2014, when the transfers to the BAMC had already been carried out. The average period of collateral redemption at banks

where this data is available was slightly shorter for corporate loans secured by commercial real estate than for loans secured by residential real estate (20 months compared with 29 months).

Compared with 2013 the banks were more active in redeeming collateral for housing loans: the volume of loans for which redemption was undertaken doubled to EUR 7.5 million. The ratio of the value of the redeemed collateral to the secured loan value remained at the same level as in 2013, at 60%. However the success rate in the redemption of collateral was significantly better for residential real estate, despite the fall in prices on the real estate market: it was up 4.2 percentage points on 2013 at 60.7%.

Table 6.17: Loans for which banks redeemed collateral in 2014 and the amount of collateral redemptions by type in EUR million

	Bank deposits and irrevocable government guarantees	Shares, equity, debt securities and mutual fund units	Commercial real estate	Residential real estate	At insurer	All forms of credit protection
Corporate loans						
Loan amount	14.1	222.6	94.8	65.0	8.0	404.6
Value of redeemed collateral	5.1	72.1	35.0	18.3	7.6	138.1
Housing loans to households						
Loan amount	0.0	0.0	0.2	6.1	1.2	7.5
Value of redeemed collateral	0.0	0.0	0.1	3.7	0.7	4.5
Non-housing loans to households						
Loan amount	0.2	0.7	0.0	0.2	8.8	9.9
Value of redeemed collateral	0.2	0.5	0.0	0.1	8.3	9.0
Total loans						
Loan amount	14.3	223.3	95.0	71.4	18.1	422.0
Value of redeemed collateral	5.3	72.5	35.1	22.1	16.6	151.6

Source: Bank of Slovenia

### Claim forbearance

If it becomes likely that a client will not settle its obligations to a bank in full due to a deterioration in its financial position, assuming no changes in other conditions, a bank may amend the repayment terms set out at the time that the claim in question was approved. Business decisions of this type are defined as claim forbearance. The highest proportion of claims were forborne by means of the extension of the deadline, the deferral of repayment, or the extension of the deadline in combination with reductions in the interest rate and/or other costs.

The banks reported forborne claims in the amount of EUR 4.1 billion in March 2015, 76% of which were rated D or E, and 32% of which were already more than 90 days in arrears, an indication that forbearance has not been successful in these cases. According to survey figures, the banks are forecasting a reduction of EUR 221 million in non-performing claims from forbearance.

Claim forbearance is primarily used by the large domestic banks, which accounted for 71% of the stock of forborne claims in March 2015. The high concentration of forborne claims in the banking system was evident in the sectors of manufacturing and construction, which accounted for 38% of the stock of forborne claims.

### Write-offs of financial assets at banks

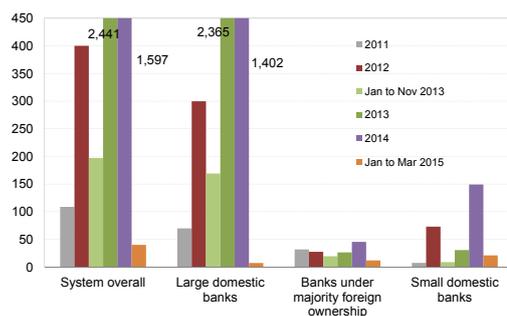
The banks are writing off unsecured claims against debtors more than one year in arrears or in bankruptcy proceedings, and claims secured by real estate collateral more than four years in arrears or for which the bank in question did not receive any payment from the redemption of collateral over the same period.<sup>38</sup> There was nevertheless no significant increase in write-offs, except during the transfers to the BAMC, which raised write-offs to EUR 2.4 billion in 2013 and EUR 1.6 billion in 2014. Last year's largest write-offs of EUR 0.8 billion came in October during the transfer of claims from Abanka to the BAMC, 3.3 times the total amount of write-offs in the preceding nine months. According to survey figures, the banks are forecasting a reduction of EUR 328 million in non-performing claims from write-offs in 2015, an indication that write-offs of non-performing claims will not be a significant element of the resolution of the banks' non-performing portfolio in the future.

**There were EUR 4 billion of forborne claims in the banks' credit portfolios in October 2014.**

**The large domestic banks recorded the highest proportion of write-offs of non-performing claims, as a result of the transfers of non-performing claims to the BAMC.**

<sup>38</sup>Regulation amending the regulation on the assessment of credit risk losses of banks and savings banks (Official Gazette of the Republic of Slovenia, Nos. 29/12 and 12/14)

Figure 6.42: Write-offs of financial assets at banks in EUR million



Source: Bank of Slovenia

The large domestic banks accounted for 88% of all write-offs, as a result of the transfer of non-performing claims from Abanka and Banka Celje to the BAMC. The aforementioned two banks wrote off EUR 1.1 billion in total, of 80% of the large domestic banks' write-offs. There was also a large increase in write-offs at the small domestic banks in 2014: they totalled EUR 145 million at Factor banka and Probanka alone, which accounted for 97% of the small domestic banks' write-offs.

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

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

#### The LTV ratio on corporate loans increased.

Last year the banks slightly eased their terms on new loans relative to 2013, taking the LTV ratio to 114% on corporate loans and 124.3% on consumer loans, but left the ratio unchanged on housing loans at 66%. The ratio is lower when only loans for which a bank requested collateral are taken into account, but was still slightly stricter than in the previous year at 54%. The LTV ratio rose from 118% to 124% on consumer loans, and from 94% to 114% on corporate loans.

Table 6.18: Average LTV ratio for newly approved loans in percentages

	All loans		Secured loans only	
	2013	2014	2013	2014
Corporate loans	94.3	114.0	56.2	56.3
Consumer loans	118.2	124.3	69.5	74.4
Housing loans	66.7	66.1	55.2	54.3

Note: LTV is the ratio of the loan amount to the value of the pledged collateral.

Source: Bank of Slovenia

The proportion of newly approved loans that were unsecured also increased last year. The housing loan segment has the lowest proportion of unsecured loans, at 17.9%. There was an increase in the proportion of collateral in the form of real estate on all loans.

Table 6.19: Proportion of total collateral accounted for by real estate collateral and proportion of newly approved loans accounted for by unsecured loans in percentages

	Proportion of secured new loans with real estate collateral, %		Proportion of new loans that are unsecured, %	
	2013	2014	2013	2014
Corporate loans	65.2	67.2	40.4	50.7
Consumer loans	19.3	15.5	41.2	40.1
Housing loans	85.6	82.3	17.1	17.9

Note: LTV is the ratio of the loan amount to the value of the pledged collateral.

Source: Bank of Slovenia

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

Under the banks' business policies, the maximum allowable ratio of the monthly loan repayment instalment to the borrower's monthly income (LTI ratio) for the banking system overall increased slightly last year from 53.7% to 54.3%. The LTI ratio at the banks depends on several factors: type of loan, type of collateral, repayment period, and the absolute amount of the applicant's income, where the legally defined minimum wage, which must remain after all of the borrower's deductions for loans, represents an additional limiting factor.

The average actual LTI ratio was significantly lower. It was 27% for housing loans, down slightly on the previous year. The LTI ratio for consumer loans was down 1.7 percentage points at 18%. This indicates the banks' aversion to taking up additional credit risk in new operations, and increased caution on the part of households with respect to additional borrowing.

Table 6.20: Loan-to-income (LTI) ratio in percentages

	Average maximum LTI with regard to bank business policy	Average LTI on new loans		Actual proportion of new housing loans with		Actual proportion of new consumer loans with	
		housing loans	consumer loans	LTI >= 33%	LTI >= 50%	LTI >= 33%	LTI >= 50%
2013	53.7	29.5	18.6	31.5	10.2	17.1	4.7
2014	54.3	27.4	17.9	28.6	9.7	15.0	5.0

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

Source: Bank survey

## 6.7 Liquidity risk

### Summary

The Slovenian banking system's liquidity risk diminished in 2014. The banks are faced with high excess liquidity, which has been reflected in a historically high first-bucket liquidity ratio, a significant improvement in the second-bucket liquidity ratio, an increase in the proportion of total assets accounted for by marketable secondary liquidity, high excess reserves at the banks, and a high proportion of the pool of eligible collateral at the Eurosystem that is free.

Despite the good liquidity position, the banks are exercising caution in taking up new risks, and are directing the excess liquidity more into securities purchases and short-term placements with banks in the rest of the world than into new lending. It is unlikely that any significant change will be brought by the quantitative easing programme, in which the participation of Slovenian banks is for the moment modest. It is forecast that the option of managing the excess liquidity on the euro area's interbank money markets will remain limited, particularly for the domestic banks. At the same time the Slovenian interbank market remains inactive. The constraints on the management of excess liquidity in the future is exposing the banks to increased liquidity risk.

### 6.7.1 Liquidity indicators

Slovenian banks have faced high excess liquidity since the end of 2013. This has mostly been attributable to the implementation of the measures to stabilise the banking system, the banks' reluctance to take up new risks, which has been reflected in modest lending, and the constraints on their liquidity management.

The excess liquidity has been reflected in high levels of various liquidity indicators. The first-bucket liquidity ratio averaged a high 1.59 in 2014, and increased further to 1.61 in the first quarter of 2015. The slightly larger fluctuation in the first-bucket liquidity ratio in the second half of 2014 was attributable to the early repayments of the 3-year LTRO, the recapitalisation of two large domestic banks, and the renewed borrowing by Slovenian banks in the ECB's TLTRO.

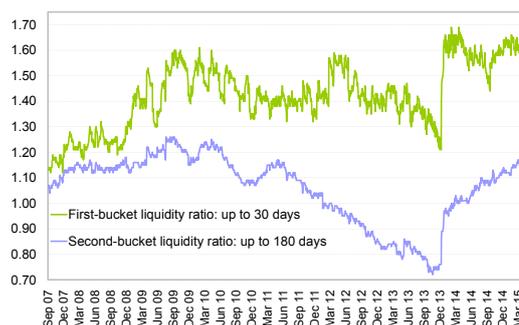
**The first-bucket liquidity ratio remained high.**

In addition to the aforementioned factors, the gradual improvement in the second-bucket liquidity ratio was attributable to the increased short-term placement of funds with banks in the rest of the world. The second-bucket liquidity ratio fluctuated around 1.14 in the first quarter of 2015, up 0.33 on its average of 2013.

**The second-bucket liquidity ratio increased gradually in 2014.**

**The maximum allowable LTI ratio rose slightly last year.**

Figure 6.43: Daily liquidity ratios for the first and second buckets of the liquidity ladder in percentages

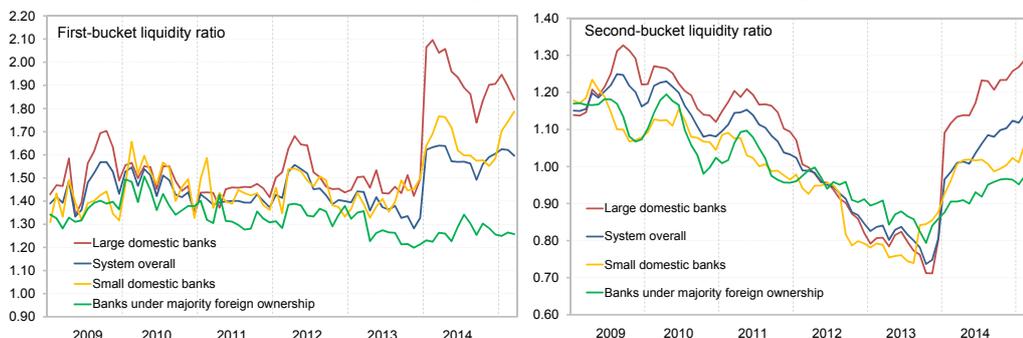


Source: Bank of Slovenia

**The ratio of marketable secondary liquidity to total assets stood at 17%, above its level from before the outbreak of the financial crisis.**

The domestic banks maintained the first-bucket liquidity ratio at record high levels, while the banks under majority foreign ownership have continued to maintain a lower first-bucket liquidity ratio. This is an indicator of their liquidity management policy, and not of a weaker liquidity position. By contrast, the increase in the second-bucket liquidity ratio has been equally gradual at all the bank groups, on account of the aforementioned factors.

Figure 6.44: Liquidity ratios for the first bucket (0 to 30 days; left) and the second bucket (0 to 180 days; right) of the liquidity ladder by bank group, monthly averages



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

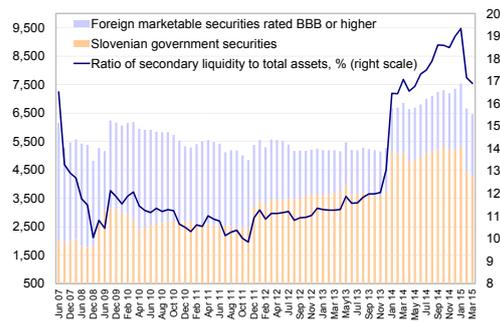
Source: Bank of Slovenia

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

The large stock of marketable secondary liquidity is a reflection of the banks' management of excess liquidity, in addition to their favourable liquidity. Excess liquidity was directed more into securities purchases in 2014 than into lending. The stock of marketable secondary liquidity increased by EUR 686 million last year to EUR 7.4 billion. The decline of EUR 0.9 billion in the first quarter of 2015 to EUR 6.5 billion was the result of the rebooking of BAMC securities as other domestic securities, which are not a component of marketable secondary liquidity. At the same time the fall in the stock of marketable secondary liquidity was attributable to the maturing of the RS68 Slovenian government bonds, which the banks partly replaced in mid-March with purchases of new 20-year Slovenian government bonds. The ratio of marketable secondary liquidity to total assets stood at 17% in March, thus remaining above its level from before the outbreak of the financial crisis.

The aforementioned removal of BAMC bonds from secondary liquidity slightly reduced the concentration of secondary liquidity in favour of foreign marketable securities rated BBB or higher, which accounted for 33% of the total in March 2015. The still-high proportion of Slovenian government securities entails higher exposure to liquidity risk on account of a potential sovereign downgrading. The small domestic banks remain the most exposed to this risk: Slovenian government securities account for 88% of their secondary liquidity, or 17% of total assets.

Figure 6.45: Changes in the stock of marketable secondary liquidity (monthly averages in EUR millions) and ratio of marketable secondary liquidity to total assets in percentages



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

Source: Bank of Slovenia

The good current liquidity of Slovenian banks in 2014 was also reflected in their high reserves. They averaged EUR 1.2 billion in 2014, exceeding the reserve requirements by almost 500%. This ranked Slovenian banks well above average in the euro area, where excess reserves averaged around 100%. The banks had slightly reduced their excess reserves by the end of March 2015 as a result of the payment of EUR 191 million into the resolution fund, but their excess current liquidity nevertheless remains high.

**Slovenian banks' excess reserves were five times higher than reserve requirements in 2014.**

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

Slovenian banks significantly reduced their liabilities to the Eurosystem by EUR 2.9 billion between the beginning of 2014 and the end of the first quarter of 2015 to EUR 0.8 billion. After the abolition of the fixed-term deposits and the introduction of a negative interest rate on the ECB's deposit facility, the banks directed their excess liquidity into securities purchases, short-term placements with parent banks and, to a great extent, the early repayment of liabilities to the Eurosystem from the 3-year LTROs.

**Slovenian banks sharply reduced their liabilities to the Eurosystem in 2014.**

The banks only partly compensated for the maturity of the 3-year LTRO in the first quarter of 2015 in the first three TLTROs. Of the estimated total of EUR 2,899 million in available funding, they borrowed just 25%. The banks' motivation for participating in the tenders were more along the lines of cheap funding than the need for liquidity. Should the banks strengthen their lending activity in the future, thereby responding to improved credit demand, greater interest could be expected in their participation in the following quarterly TLTRO tenders.

**The banks borrowed 25% of potential funding in the three TLTROs.**

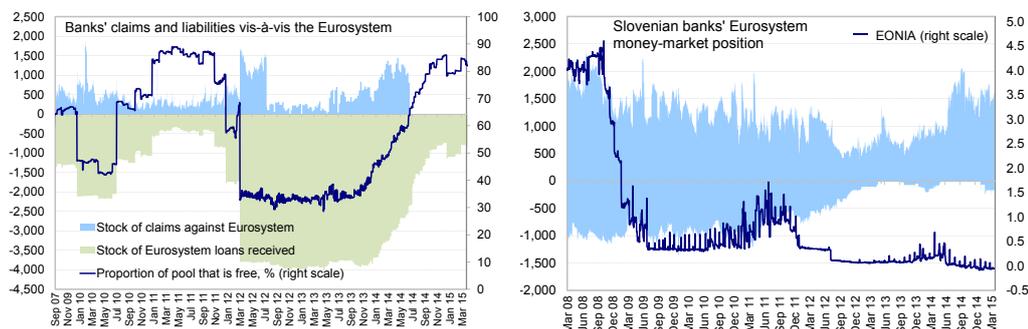
As a result of their favourable liquidity position and the smaller need for additional borrowing at the Eurosystem, Slovenian banks significantly reduced the pool of eligible collateral at the Eurosystem by EUR 1.7 billion between the beginning of 2014 and the end of March 2015 to EUR 4.7 billion. In so doing they either removed assets from the pool or did not replace maturing assets with new assets. The average proportion of the pool of eligible collateral that is free increased by 40 percentage points to a high 84%, as significant repayments of liabilities to the Eurosystem were made over the same period.

**The average proportion of the pool of eligible collateral that is free increased to a high 84%.**

In the first half of March 2015, as part of its non-standard measures, the ECB launched a programme of purchases of euro area government, agency and institutional bonds (the PSPP) with the aim of increasing liquidity and encouraging lending growth. The Bank of Slovenia purchased EUR 265 million of Slovenian government bonds in the first month. In light of the high excess liquidity and the constraints on its management, the response from Slovenian banks was modest, as expected. Increased sales of eligible securities within the framework of this programme could be expected from Slovenian banks were they to begin more intensive lending to the non-banking sector.

**A modest response by Slovenian banks to the quantitative easing programme.**

Figure 6.46: Claims, liabilities and net position of commercial banks vis-à-vis the Eurosystem in EUR million and proportion of the pool of eligible collateral that is free (left) and stock of unsecured loans of Slovenian banks placed and received on the euro area money market (right)



Source: Bank of Slovenia

**The banks under majority foreign ownership manage their liquidity on the unsecured euro area money market.**

Slovenian banks further strengthened their position as net creditors on the unsecured euro area money market in the second half of the year as a result of the aforementioned developments. The stock of net claims increased by EUR 0.5 billion between December 2013 and March 2015 to stand at EUR 1.3 billion. The prevailing role belongs to the banks under majority foreign ownership, which manage their excess liquidity by adjusting their stocks of short-term placements with their parent banks in the rest of the world. For the domestic banks the option of managing their liquidity on this market is relatively limited. Given that the entire Eurosystem faces excess liquidity, which the quantitative easing programme will only increase further, there is no expectation that the situation for the domestic banks in this market will change significantly in the future. There is also no expectation of a revival of the Slovenian interbank market, which maintained its stock of deposits received and granted at a modest EUR 140 million last year.

## 6.8 Interest rate risk

### Summary

Interest rate risk at the banks increased in 2014. The difference between the average repricing periods for asset and liability interest rates is still widening. It stood at 8.4 months in December 2014, having lengthened by 1.8 months since December 2013. The banks became more exposed to the risk of a rise in interest rates. The difference widened primarily as a result of a lengthening of the average repricing period for asset interest rates, while the average repricing period for liability interest rates remained at the same level as a year earlier. This was primarily attributable to changes in the banks' balance sheet structure. There was a decline in the proportion accounted for by loans, which have a shorter repricing period, in favour of investments in securities with a longer repricing period. In 2014 interest rate risk increased most at the large domestic banks, which are also the most exposed to a rise in interest rates.

Interest rate risk increased significantly after the exchange of non-performing claims for BAMC bonds, which have a longer average repricing period than the transferred claims. Exposure to interest rate risk is assessed as acceptable, but is increasing on account of the low interest rates and negative reference interest rates. The banks hedge against interest rate risk and a potential rise in interest rates by means of interest rate derivatives.

Between December 2013 and December 2014 the cumulative interest rate gap of up to 1 year between interest-sensitive assets and liabilities widened by EUR 2 billion to a negative gap of EUR 2.9 billion. All the bank groups recorded a negative interest rate gap.

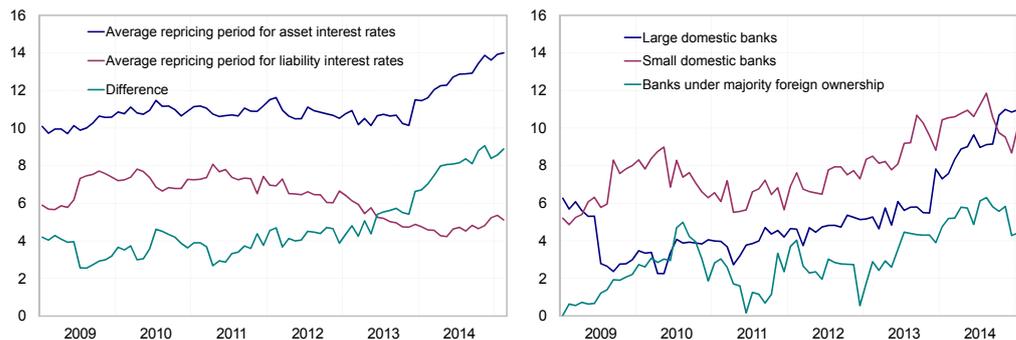
#### 6.8.1 Average repricing period for interest rates

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

Interest rate risk as measured by the difference between the average repricing periods of asset and liability interest rates stood at almost 8.9 months in February 2015, compared with 6.6 months at the end of 2013. The average repricing period for asset interest rates in December 2014 was 13.6 months, while the average repricing period for liability interest rates was almost 5.2 months. The average repricing period for asset interest rates increased to 14 months in the early part of 2015, while there was no significant change in the average repricing period for liability interest rates. The difference between the average repricing

periods for asset and liability interest rates widened by 1.8 months between December 2013 and October 2014. The main factors in the lengthening of the average repricing period for asset interest rates by 2.1 months were the lengthening of the average repricing period for interest rates on loans granted, and the breakdown of investment. The proportion of the banks' total assets accounted for by loans granted is declining, while the proportion accounted for by debt securities is increasing. The key factor in the shortening of the average repricing period for liability interest rates by 0.4 months was the significant increase in the average repricing period for borrowings via loans. However, this effect was almost neutralised by the decline in the proportion of total liabilities that they account for, in favour of deposits, which have a shorter average maturity.

Figure: 6.47 Average repricing period for interest rates in months (left) and difference between the average repricing period for interest rates by bank group in months (right)



Source: Bank of Slovenia

The difference between the average repricing periods for asset and liability interest rates widened at the large domestic banks and the banks under majority foreign ownership between December 2013 and December 2014. The increase was significantly larger at the large domestic banks, at almost 3 months, while the increase at the banks under majority foreign ownership was 0.4 months. The difference diminished by a negligible 0.1 months at the small domestic banks. Interest rate risk increased at all the bank groups in the first two months of 2015, primarily as a result of at the small domestic banks (by 1.2 months) and at the banks under majority foreign ownership (by 1 month).

**An increase in interest rate risk at the large domestic banks and the banks under majority foreign ownership.**

The average repricing period lengthened at all the bank groups on both the asset and liability sides. The largest increase in the average repricing period for asset interest rates occurred at the large domestic banks, at just over 3 months. This was attributable to longer maturities on loans granted. The largest increase in the average repricing period for liability interest rates was at the small domestic banks, at just under 2 months. This was attributable to shorter maturities on deposits taken. The average maturity on borrowings via loans lengthened in 2014, although the negative impact of the shortening of deposit maturities prevailed as the proportion of total liabilities that they account for increased.

The large domestic banks are most exposed to the risk of a rise in interest rates, while the banks under majority foreign ownership are least exposed. The former had the largest difference between the average repricing periods of asset and liability interest rates at the end of 2014, at 10.9 months, while the latter had the smallest, at 4.3 months.

The interest rate environment (the 3-month EURIBOR has averaged just 0.27% over the last three years, while the 6-month EURIBOR has averaged 0.41%) in combination with the increased proportion of short-term funding is additionally increasing interest rate risk at the banks in the event of a rise in interest rates. Clients are particularly exposed to the risk of a rise in interest rates when concluding loan agreements with a variable interest rate, while fixed-rate loans expose the banks to this type of risk, which they manage by hedging against interest rate risk. The 3-month EURIBOR has averaged 2.81% over the last 20 years, which is sharply in excess of the current level of reference interest rates. When entering into variable-rate loans the banks must take account of the likelihood of a rise in interest rates and the potential consequences for clients, and must adjust their assessment of clients' creditworthiness accordingly.

### 6.8.2 Interest rate gap

The cumulative interest rate gap of up to 1 year between interest-sensitive assets and liabilities was negative in the amount of EUR 2.9 billion at the end of 2014, having been negative in the amount of EUR 923 million in December 2013. The main factor in the

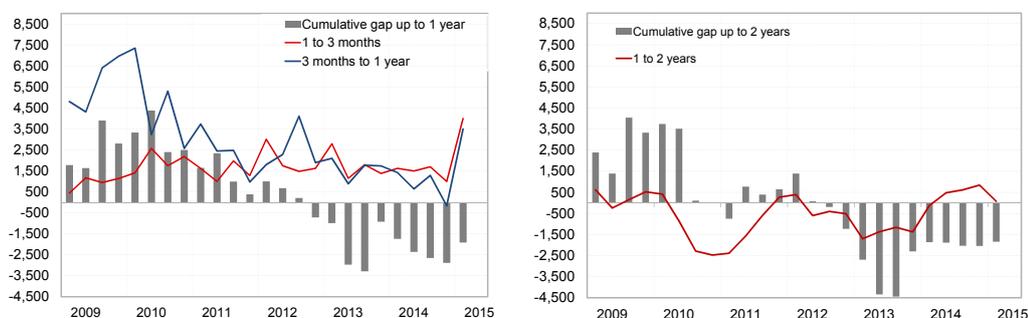
**All the bank groups have a negative cumulative interest rate gap.**

change was interest-sensitive assets with an interest rate repricing period of less than 1 year, which declined by EUR 3.2 billion between December 2013 and December 2014, while interest-sensitive liabilities declined by EUR 1.2 billion. The cumulative interest rate gap of up to 1 year narrowed to a negative gap of EUR 1.9 billion over the first two months of 2015. All the bank groups recorded a negative interest rate gap before hedging against interest rate risk is taken into account. The banks under majority foreign ownership had the smallest gap, at barely EUR 88 million, while the large domestic banks had the largest, at EUR 2 billion.

The cumulative gap of up to 2 years narrowed from a negative gap of EUR 2.3 million in December 2013 to a negative gap of EUR 2.0 billion in December 2014. The cumulative interest rate gap of up to 2 years was negative in the amount of EUR 1.8 billion in the early part of 2015. All the bank groups recorded a negative gap in this bucket. The banks under majority foreign ownership again had the smallest negative gap, at EUR 109 million, and the large domestic banks had the largest, at EUR 1.2 billion.

Despite the slight lengthening of the average repricing period for liability interest rates in the previous year, the long-term trend suggests the gradual shortening of the average maturity on bank funding in the future, as a result of which the banks' sensitivity to interest rate risk will increase further. This will require the banks to be active in their management and hedging against a potential rise in interest rates.

Figure 6.48: Gap between interest-sensitive assets and interest-sensitive liabilities by individual bucket in EUR million



Source: Bank of Slovenia

## 6.9 Currency risk

**Currency risk remained low in 2014.** Currency risk at Slovenian banks remains low, and less material than other types of risk. The net open foreign exchange position amounted to EUR 11.6 million or 0.3% of the banks' regulatory capital at the end of 2014. The large banks were most exposed to currency risk, with a long net foreign exchange position of EUR 16.3 million. In relative terms, i.e. as a ratio to regulatory capital, currency risk is highest at the small domestic banks, with a ratio of 0.9%. The net open foreign exchange positions were predominantly long. The banks were thus exposed to the risk of a fall in currencies against the euro.

Table 6.21: Net open foreign exchange positions in EUR million

	2012	2013	2014			
			System overall	Large domestic banks	Small domestic banks	Banks under majority foreign ownership
Global currencies	15.7	0.0	-1.5	5.1	0.4	-7.1
US dollar	5.9	3.6	0.6	3.3	-0.2	-2.5
Swiss franc	6.8	-4.5	-3.2	0.9	0.2	-4.3
other (GBP, CAD, AUD, JPY)	3.1	0.9	1.1	1.0	0.4	-0.3
EEA currencies	-14.2	0.9	5.3	4.8	0.2	0.3
Other currencies	27.7	8.6	7.8	6.3	0.5	1.0
<b>Total, EUR million</b>	<b>29.3</b>	<b>9.5</b>	<b>11.6</b>	<b>16.3</b>	<b>1.2</b>	<b>-5.8</b>
<b>As % of regulatory capital</b>	<b>0.7</b>	<b>0.3</b>	<b>0.3</b>	<b>0.6</b>	<b>0.9</b>	<b>-0.5</b>

Note: EEA: European Economic Area, i.e. EU, Iceland, Norway and Liechtenstein.

Source: Bank of Slovenia

**The stock of Swiss franc loans increased as the aforementioned currency appreciated.**

The stock of loans to the non-banking sector in Swiss francs or with a Swiss franc currency clause was up just under EUR 70 million over the first two months of 2015. This was attributable to the measure by the Swiss central bank of 15 January 2015, as it ended the policy of holding the Swiss franc to at least 1.20 against the euro. After this measure the Swiss franc rose by 14.5%, stabilising around 1.05 against the euro. The stock of Swiss franc loans expressed in euros consequently increased. In Swiss franc terms, i.e. excluding exchange rate differences, the stock of loans to the non-banking sector in Swiss francs declined by CHF 70 million over the first two months of 2015. Despite the change, the proportion of total loans to the non-banking sector accounted for by Swiss franc loans stood at just 4.1% in February 2015, and does not entail significant risk for the banks.

Table 6.22: Stock of, year-on-year growth in and proportion of total loans accounted for by loans in Swiss francs or with a Swiss franc currency clause, in EUR million and percentages

	Non-banking sector	Non-financial corporations	OFIs	Government	Households	
					All loans	Housing loans
Stock of loans, EUR million						
2011	1,588.0	288.5	130.5	5.5	1,163.6	1,031.8
2012	1,346.4	227.4	93.4	4.8	1,020.9	923.8
2013	1,118.6	151.9	81.1	4.0	881.6	809.5
2014	1,036.7	103.7	145.6	3.4	784.0	734.3
Feb 2015	1,104.5	102.9	164.8	3.7	833.1	779.8
Year-on-year growth, %						
2011	-15.0	-32.8	-2.9	-9.2	-10.4	-8.6
2012	-15.2	-21.2	-28.4	-12.5	-12.3	-10.5
2013	-16.9	-33.2	-13.2	-16.3	-13.6	-12.4
2014	-7.3	-31.7	79.6	-16.0	-11.1	-9.3
Feb 2015	-5.4	-22.2	3.5	-5.6	-4.4	-2.7
Proportion of total loans accounted for by individual sector, %						
2011	4.3	1.3	4.6	0.4	12.3	19.9
2012	3.8	1.1	3.5	0.3	11.0	17.5
2013	3.6	1.0	3.8	0.2	9.9	15.2
2014	3.9	0.8	9.0	0.2	8.9	13.7
Feb 2015	4.1	0.8	10.2	0.2	9.4	14.3

Source: Bank of Slovenia

The rise in the Swiss franc against the euro increased the loan repayment burden on borrowers that raised loans in Swiss francs or with a Swiss franc currency clause. The impact fell primarily on households, which account for 75% of all Swiss franc loans, and are mostly not hedged against exchange rate volatility. The biggest issue is housing loans, which are usually long-term and were mostly raised at a time when the Swiss franc to euro exchange rate was significantly more favourable. The increased loan repayment burden is increasing the banks' credit risk in this loan segment. The banks under majority foreign ownership account for the largest proportion of all loans in Swiss francs or with a Swiss franc currency clause (64%).

**The rise in the Swiss franc increased the loan repayment burden on borrowers, primarily households.**

## 6.10 Bank solvency

Summary<sup>39</sup> The Slovenian banking system's solvency risk declined last year, although the differences between banks widened. The improvement in the banking system's solvency position was reflected not merely in higher capital ratios, which exceeded the euro area average according to the latest figures, but also in a strengthened capital structure, a higher ratio of capital to total assets and a slight improvement in the breakdown of capital requirements for credit risk.

Alongside the continuing decline in lending activity, the main factors in the improvement in capital adequacy were the recapitalisation of Abanka and Banka Celje, and the transfer of their non-performing claims to the BAMC in the final quarter of 2014. The largest improvement in capital adequacy was consequently recorded by the large domestic banks, while the small domestic banks and savings banks remain the most exposed to solvency risk.

The maintenance of a stable capital position will be a significant challenge for the banks in the future, particularly in light of the gradual introduction of changes and instruments of new European banking regulation in the form of the CRR. The further contraction in capital

<sup>39</sup>The latest figures included in this section were from 20 April 2015.

requirements via the reduction in lending activity and the retreat into safer, lower-yielding investments will not help to improve the banks' capital positions. The banks will have to adjust their business models so that in the given economic situation they are able to generate capital internally, thereby taking advantage of the potential opportunities to improve capital optimisation.

### 6.10.1 Capital adequacy

**The new legal basis brought a series of changes to European banking legislation.**

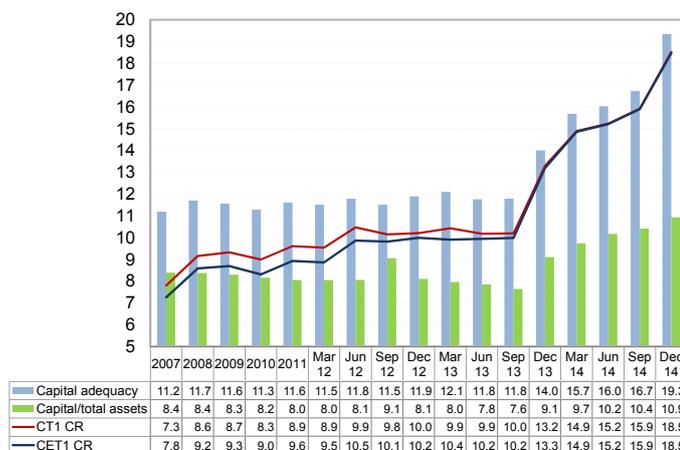
The new Capital Requirements Regulation (CRR) entered into force in early 2014, and has introduced a series of changes and innovations in the area of capital and capital requirements. The main purposes of the new legal basis for banking operations in the EU were to increase capital quality, to increase the level of capital and to increase the transparency of banking operations.

Individual categories of solvency are illustrated in this section below in time series. It should be noted that the values have been calculated according to the new CRR as of March 2014 inclusive. Because the comparability of the figures with those for the period to December 2013 inclusive is very limited owing to the change in legal basis, analysis of certain categories of solvency will be based primarily on the period between March and December 2014.

**An improvement in capital adequacy as a result of recapitalisations and the transfer of non-performing claims to the BAMC.**

The banking system's capital adequacy ratios improved significantly in 2014 as a result of an increase in capital and also a contraction in capital requirements. The main reason was the continuing implementation of measures to stabilise the banking system, within the framework of which two additional recapitalisations and transfers of non-performing claims to the BAMC were carried out. Overall capital adequacy increased by 3.6 percentage points between March and December 2014 to 19.3%. The core Tier 1 capital ratio (CT1 CR) and the common equity Tier 1 capital ratio (CET1 CR) also increased by the same amount over the same period, by 3.6 percentage points to 18.5%. That these two ratios are equal is a reflection of the maintenance of a high-quality capital structure at Slovenian banks.

Figure 6.49: Banking system's basic capital adequacy ratios on an individual basis in percentages



Source: Bank of Slovenia

**The differences between the bank groups widened last year. The large domestic banks recorded the largest increase in overall capital adequacy.**

The banking system's capital adequacy improved at the aggregate level, while the differences between the bank groups widened further. The large domestic banks were notable for their pronounced increase in capital ratios. Overall capital adequacy at this bank group increased by 5.8 percentage points between March and December 2014 to 22.3%. The increase was attributable to the increase in capital brought by the recapitalisations of Banka Celje d.d. and Abanka d.d. in the final quarter, and the transfer of their non-performing claims to the BAMC, which reduced capital requirements. As in previous years, the decline in capital requirements was the result of a further contraction in lending activity.

The banks under majority foreign ownership have continued to record a steady but much more measured increase in overall capital adequacy. However, in contrast to the domestic banks the increase in their capital adequacy was the result of a larger contraction in capital requirements as lending continued to decline, compared with the decline in capital. They are less exposed to solvency risk than the domestic banks owing to the maintenance of a better-quality credit portfolio, better capital optimisation, and their owners' more active role in solvency management.

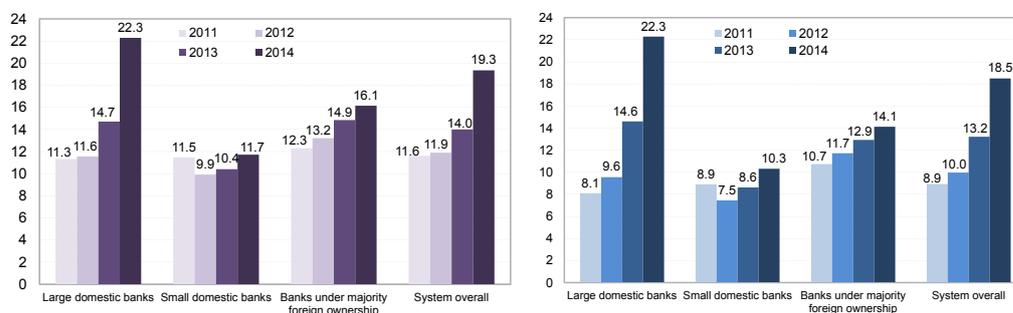
The small domestic banks and savings banks remain the most exposed to solvency risk. Their overall capital adequacy improved slightly in 2014, but at 11.7% remains significantly behind the average for the banking system. Last year's increase in capital adequacy was the result of minor recapitalisations at three of the five banks in the group and, to a lesser extent, a decline in capital requirements. However, the banks in the group did not succeed last year in significantly improving the quality of the portfolio as measured by the proportion of claims more than 90 days in arrears, which at 14.6%<sup>40</sup> remains slightly above the average for the banking system. At the same time they are maintaining a low ratio of capital to total assets, which exposes them to higher solvency risk given the persistent capital weakness of their owners.

**The small domestic banks remain the most exposed to solvency risk.**

The banks will also be exposed to a greater need for capital in the future by the gradual introduction of the requirements of the CRR and macro-prudential instruments. This will be particularly significant for the domestic banks, which do not have the capital support of parent banks. Maintaining a stable solvency position at individual banks will therefore depend to a great extent on the tailoring of their business models to the current economic situation, thereby allowing them to optimise their existing capital and to generate internal capital.

**Capital optimisation and the generation of internal capital will be significant factors in the stability of capital adequacy.**

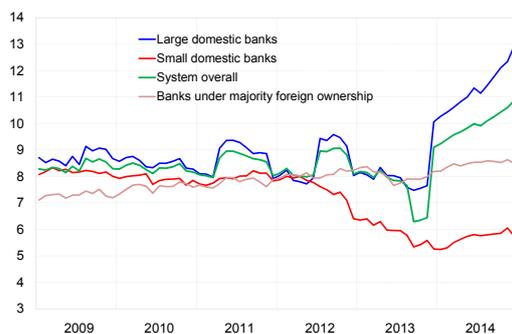
Figure 6.50: Overall capital adequacy (left) and common equity Tier 1 capital ratio (right) by bank groups in percentages



Note: The figures for the banking system in 2014 do not include the two banks undergoing the orderly wind-down process. The figures for the small domestic banks do not include the two aforementioned banks in 2013.

Source: Bank of Slovenia

Figure 6.51: Ratio of book capital to total assets on an individual basis in percentages, monthly figures



Note: The figures for the banking system in 2014 do not include the two banks undergoing the orderly wind-down process. The figures for the small domestic banks do not include the two aforementioned banks as of September 2013.

Source: Bank of Slovenia

## 6.10.2 Capital structure

The Slovenian banking system's stock of regulatory capital increased by up EUR 330 million between March and December 2014 to EUR 3,991 million. The banks recorded an increase in their stock of common equity Tier 1 capital (CET1), which improved the quality structure of regulatory capital. The proportion accounted for by original own funds had reached a high 95.8% by the end of 2014.

<sup>40</sup> Excluding the two banks undergoing the orderly wind-down process.

**An increase in capital primarily as a result of the recapitalisations of two large domestic banks.**

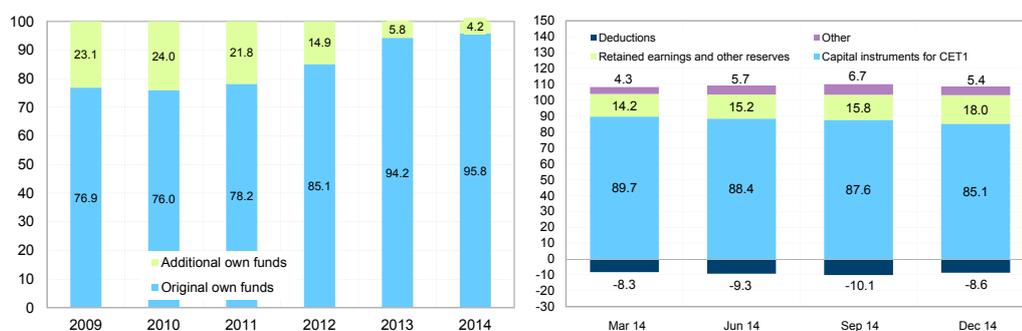
The first reason for the increase in CET1, which is the highest-quality and largest component of capital, was the recapitalisation of six banks, of which two large domestic banks included in the recovery process stand out in terms of the amount of new capital. Another reason for the increase in capital was the profit recorded by certain banks. As a result of higher growth in items related to earnings and other reserves, the proportion of CET1 that they account for increased.

Table 6.23: Stock of and growth in components of regulatory capital in EUR million and percentages on an individual basis, under the old and new regulations

	Old regulation			New regulation (CRR)				Change, Mar-Dec 14		Change, Dec 13 - Dec 14	
	Stock, EUR million			Stock, EUR million				Change, Mar-Dec 14		Change, Dec 13 - Dec 14	
	2011	2012	2013	Mar 14	Jun 14	Sep 14	Dec 14	(%)	(EUR million)	(%)	(EUR million)
Regulatory capital	4,361	4,196	3,657	3,661	3,664	3,679	3991	9.0%	330	9.1%	334
Tier 1 capital (T1)	3,606	3,604	3,462	3,475	3,481	3,502	3822	10.0%	347	10.4%	360
Common equity Tier 1 capital (CET1)	3,352	3,524	3,452	3,469	3,475	3,496	3816	10.0%	347	10.6%	364
Additional Tier 1 capital (AT1)	-	-	-	6	6	6	6	0.2%	0	-	-
Tier 2 capital (T2)	1,130	645	219	186	183	177	169	-9.4%	-17	-23.0%	-50
Capital requirements	3,004	2,827	2090	1,867	1,828	1,759	1651	-11.6%	-217	-21.0%	-439

Source: Bank of Slovenia

Figure 6.52: Structure of regulatory capital (left) and structure of common equity Tier 1 capital (right) on an individual basis across the banking system in percentages



Source: Bank of Slovenia

### 6.10.3 Capital requirements

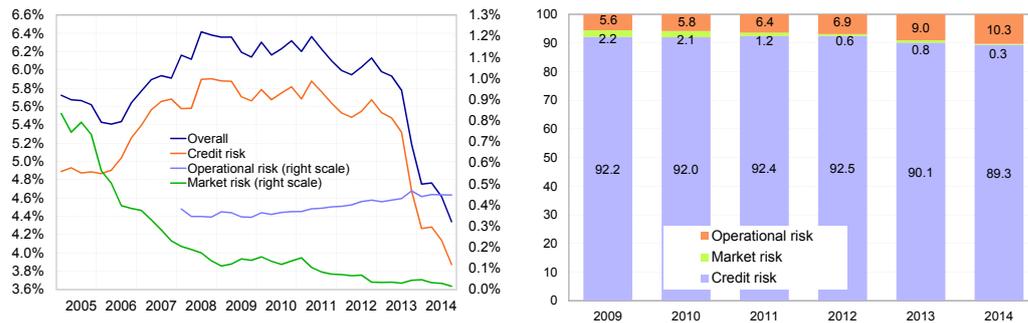
**A decline in capital requirements as a result of the transfer of non-performing claims to the BAMC and the contraction in lending activity.**

Capital requirements declined by EUR 439 million in 2014 to stand at EUR 1,651 million. The decline was slower than in the previous year, but the two reasons for the decline remained the same. The first was the transfer of non-performing claims from two large domestic banks to the BAMC as part of the process to stabilise the banking system. The second reason for the decline in capital requirements was the further contraction in lending to the non-banking sector, which slowed in 2014.

**The ratio of capital requirements to total assets is declining.**

The ratio of capital requirements to total assets began declining sharply after the initial implementation of measures to stabilise the banking system. During this period, from September 2013 to the end of 2014, the ratio declined by 1.4 percentage points to 4.3%, which still exceeds the comparable European average. As capital requirements declined there was no significant change in their breakdown. Capital requirements for credit risk remain the largest component, accounting for 89.3% of total capital requirements. Capital requirements for market risk remain minimal, while capital requirements for operational risk declined by 9.8% to stand at EUR 170 million.

Figure 6.53: Ratio of capital requirements to total assets (left) and breakdown of capital requirements (right) on an individual basis in percentages



Source: Bank of Slovenia

Capital requirements for credit risk declined by EUR 418 million in 2014 to stand at EUR 1,475 million at the end of the year, equivalent to 3.9% of total assets. In terms of stock, the largest decline was in capital requirements for corporates and retail banking, at EUR 342 million in total, but they nevertheless remained the prevailing components of capital requirements for credit risk, accounting for 61% of the total. The main reason for the decline in the aforementioned components was the contraction in lending, while in the corporate class the risk weight for SMEs has also been reduced by the new CRR.

**Changes in the breakdown of capital requirements for credit risk also attributable to the new CRR.**

There was a significant change in the breakdown of capital requirements for credit risk in 2014, comprising a sharp increase of EUR 101 million in those for exposures in default to EUR 187 million, and a significant decline of EUR 127 million in those for items associated with particularly high risk to EUR 43 million. There were four factors in these changes. First, the new CRR reclassified economic entities in bankruptcy from full-risk exposures to exposures in default, thereby allowing the use of a lower risk weight.<sup>41</sup> Second, exposures in default are no longer determined with regard to the individual exposure, but instead are determined with regard to all the obligor's exposures. Retail exposures are the exception. Third, the deterioration in the quality of the credit portfolio. Fourth, the transfer of non-performing claims at the two large domestic banks to the BAMC in the final quarter of 2014.

Table 6.24: Breakdown of capital requirements for credit risk on an individual basis in percentages

	Old methodology				New regulation (CRR)							
	2013		System overall		Mar 14				Dec 14			
	Large domestic banks	Small domestic banks	Banks under majority foreign ownership	System overall	Large domestic banks	Small domestic banks	Banks under majority foreign ownership	System overall	Large domestic banks	Small domestic banks	Banks under majority foreign ownership	System overall
Capital requirements for credit risk, EUR million	1,085	167	632	1,883	965	91	619	1,675	809	87	577	1,475
Breakdown of capital requirements for credit risk, %												
General government, international organisations	0.7	1.6	1.0	0.9	0.7	1.4	2.2	1.3	1.4	2.7	2.0	1.7
Institutions	13.1	1.9	2.7	8.6	8.0	1.5	2.6	5.7	10.0	1.6	2.6	6.6
Corporates	38.3	28.7	45.5	39.9	34.1	22.5	39.6	35.5	33.5	19.5	34.4	33.1
Retail banking	21.5	23.9	33.8	25.7	22.5	35.2	32.2	26.7	25.4	35.4	30.4	27.9
Exposures secured by real estate	2.6	8.3	4.9	3.9	2.7	10.3	6.5	4.5	3.5	13.0	7.5	5.6
Exposures in default	4.4	7.6	4.1	4.6	12.0	11.9	8.5	10.7	13.8	17.0	10.5	12.7
Exposures associated with particular high risk	9.6	21.9	4.0	9.0	11.9	10.9	4.7	9.2	4.1	1.6	1.6	2.9
Other	9.9	6.2	4.0	7.5	8.0	6.4	3.8	6.4	8.3	9.3	11.0	9.4

Source: Bank of Slovenia

<sup>41</sup> Economic entities in bankruptcy, which until the change in banking regulations were classed as full-risk exposures, had to be assigned a risk weight of 150% by banks. Following their transfer to exposures in default, entities in bankruptcy can now be assigned a risk weight of 100%, provided that impairments of at least 20% have been created for them.

**The banks have potential for improvements in capital optimisation.**

There remains potential for improvements in capital optimisation. The banks have maintained a low proportion of capital requirements for exposures secured by real estate, to which they could apply lower risk weights provided that certain conditions are met, thereby easing the burden on capital. The risk weight is 35% for exposures secured by residential real estate and 50% for exposures secured by commercial real estate. The poor exploitation of these options is related to the failure to meet the requisite conditions and, to a great extent, the establishment of the valuation assessment and monitoring process for real estate and the related costs. The banks under majority foreign ownership have an advantage here, thanks to the support of their parent banks.

**6.10.4 Comparison of capital adequacy with the EU (consolidated figures)**

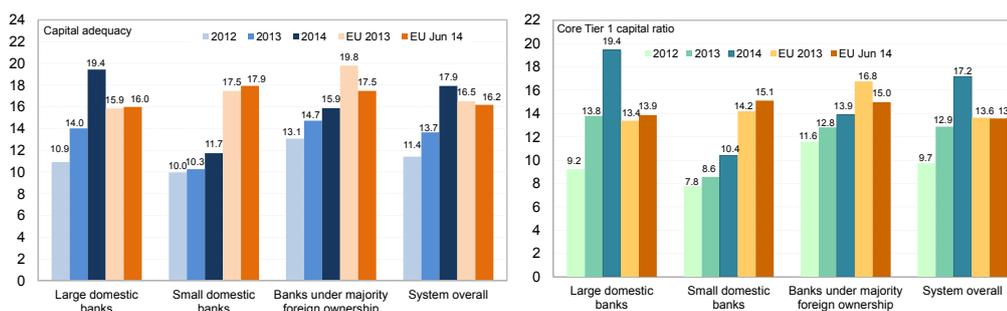
**The banking system's solvency ratios exceeded the latest figures for the EU average.**

The banking system's overall capital adequacy and Tier 1 capital ratio on a consolidated basis each increased by 3 percentage points between March and December 2014, the former to 17.9% and the latter to 17.2%. They significantly exceeded the latest corresponding figures for EU Member States overall. The large domestic banks are notable for their above-average capital ratios. The reasons for the increases are the same as for capital adequacy on an individual basis, as described above.

**The overall capital adequacy of small domestic banks remained far behind the EU in 2014.**

The small domestic banks remain the most vulnerable, as they did on an individual basis. Their solvency ratios improved slightly in 2014, which did not significantly narrow the gap with average capital adequacy at comparable banks across the EU. Steady growth in overall capital adequacy continued at the banks under majority foreign ownership, thereby narrowing the gap with average capital adequacy at comparable banks across the EU.

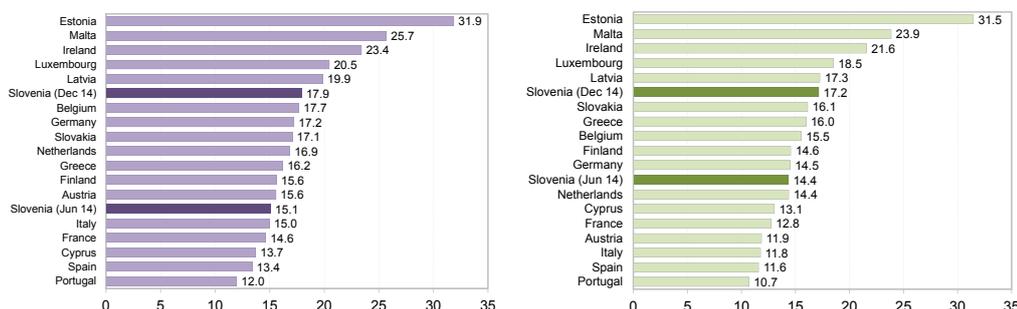
Figure 6.54: Capital adequacy (left) and Tier 1 capital ratio (right) compared with the EU, figures by bank group on a consolidated basis in percentages



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

Sources: ECB (SDW), Bank of Slovenia

Figure 6.55: Capital adequacy (left) and Tier 1 capital ratio (right) for euro area countries, figures on a consolidated basis for June 2014 in percentages

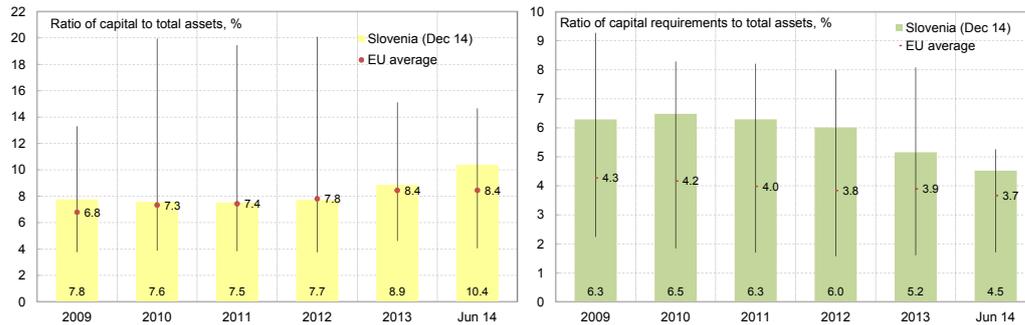


Sources: ECB (SDW), Bank of Slovenia

**The ratio of book capital to total assets increased to 10.4% in 2014.**

The ratio of book capital to total assets at Slovenian banks, which remains a significant solvency indicator alongside the capital adequacy ratios, improved by 1.5 percentage points in 2014 to 10.4%. The banks have thus maintained their ratio of capital to total assets above the latest figures for the EU average. However, the ratio of capital requirements to total assets is still increasing in comparative terms. Total assets have been declining in recent years owing to the banks' unwillingness to take up new risks, which has been reflected in a contraction in lending and a decline in capital requirements. The ratio of capital requirements to total assets at Slovenian banks stood at 4.5% at the end of 2014.

Figure 6.56: Distribution of the ratio of book capital to total assets (left) and ratio of capital requirements to total assets (right) for EU Member States, figures on a consolidated basis in percentages

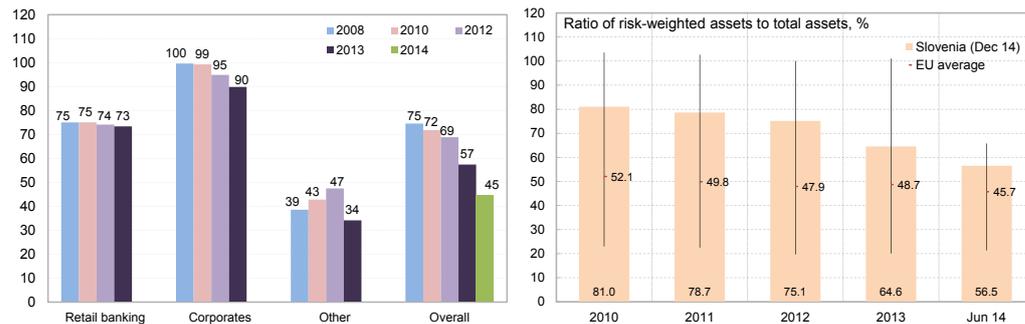


Sources: ECB (SDW), Bank of Slovenia

The reason that Slovenian banks' capital requirements are still high compared with other EU Member States remains risk weights, although they have been gradually declining in recent years. This is a consequence either of the actual structure of the credit portfolio, i.e. its quality, or the banks' constraints in optimising the use of capital owing to the use of the standardised approach to risk assessment. Alongside the generation of internal capital, better capital optimisation by the banks will be a significant factor in maintaining a stable level of capital adequacy.

**Higher capital requirements, partly as a result of higher risk weights.**

Figure 6.57: Risk weights by type of credit exposure on an individual basis (left) and distribution of the ratio of risk-weighted assets to total assets on a consolidated basis for EU Member States (right) in percentages



Note: The risk weight (left figure) is calculated as the ratio of risk-weighted assets for credit risk to the total credit exposure for each class of credit exposure, expressed as a percentage. The weight for December 2014 is calculated as the ratio of the banking system's total risk-weighted assets to its total exposure, expressed as a percentage.

Sources: ECB (SDW), Bank of Slovenia

## 7 NON-BANKING FINANCIAL INSTITUTIONS

### 7.1 Insurers

#### Summary

The gradual recovery of the domestic economy was partly reflected in the performance of the insurance sector, which recorded a reversal in the negative trend last year even as gross written premium continued to decline. The ROA and ROE performance indicators improved for both insurance companies and reinsurance companies.

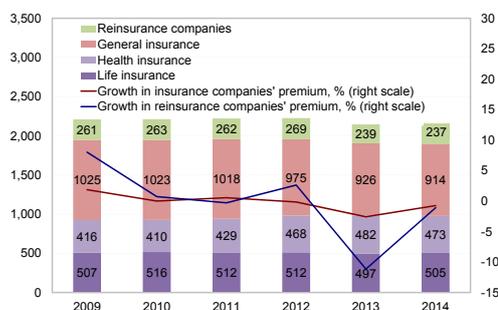
The period of low interest rates has nevertheless continued, and is the most significant risk for the insurance sector. The low return earned by insurers' primary investment class, investments in long-term securities with a fixed yield, is a risk to insurers owing to the difficulty in achieving a sufficient yield on insurance products with a guaranteed return, and a risk to the reinvestment of coupons received and maturing bonds. In the wake of weak economic activity and falling inflation, key interest rates remain low. There remains a macroeconomic risk to insurers, although it is diminishing with the economic recovery.

The insurance stress tests<sup>42</sup> conducted last year revealed that Slovenian insurers are well prepared for the introduction of Solvency II. The ISA additionally says that the domestic insurers' management of the risks deriving from their basic business activities is good. The insurance sector's increased sensitivity to market risks is also manageable, and does not endanger the payment of liabilities from insurance policies.

#### 7.1.1 Features of insurers' performance

The number of insurance companies and reinsurance companies remained unchanged last year at 14 and two respectively. The market share of the largest insurance company in terms of written premium declined further by 1 percentage point last year to 31%. The largest insurance company covers 34% of the life insurance market and 30% of the general insurance market. The market share of the largest reinsurance company in terms of written premium remained at its level of 2013, at 56%.

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



Source: ISA

**There was a significant correction last year in the negative trend of growth in gross written premium.**

The slight improvement in the economic situation has a positive impact on the trend of decline in the gross written premium of the insurance companies and, in particular, the reinsurance companies. There were corrections in the negative rate of growth of 10 percentage points at the latter and 2 percentage points at the former, which are attributable to the increased confidence in the domestic economy. The insurance companies recorded a slight increase in gross written premium in life insurance alone, where it was up 1.6%. The international rating agencies stabilised their outlooks for Slovenia last year, which is having a beneficial impact on the collection of premium from the rest of the world by the reinsurance companies. Slovenia was upgraded by one rating agency in the early part of this year.

<sup>42</sup>The European Insurance and Occupational Pensions Authority (EIOPA) conducted an insurance stress test. The results were published on the EIOPA's website (<https://eiopa.europa.eu/Pages/Financial-stability-and-crisis-prevention/Stress-test-2014.aspx>).

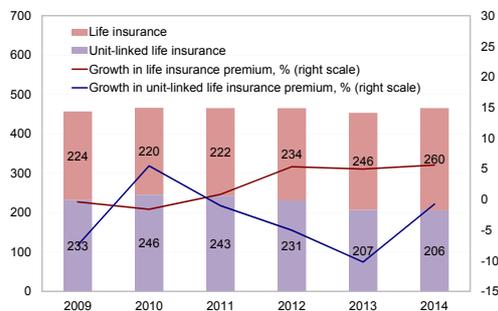
**Life insurance**

The slight increase in life insurance premium was attributable to the improvement in the macroeconomic situation. Life insurance total assets amounted to EUR 4.1 billion at the end of 2014, or 62% of insurers' total assets. Last year saw the continuation of the trend of increasing premium from traditional forms of life insurance and declining premium from unit-linked life insurance. The proportion of total written premium accounted for by life insurance strengthened to 26.7% last year, but nevertheless remains inside its long-term average.

The proportion of life insurance premium accounted for by traditional insurance was up 2 percentage points last year, while the proportion accounted for by unit-linked life insurance declined by 0.9 percentage points. The negative trend in the latter slowed and slightly corrected, partly as a result of the improved situation on the capital markets. Life insurance premium written via banks amounted to EUR 61.6 million in 2014. This marketing channel thus accounted for 12.2% of insurers' written life insurance premium, up 2 percentage points on 2013. The positive trend on the stock markets in Slovenia and in the rest of the world could be a factor in an increase in demand for unit-linked life insurance in 2015.

**A renewed increase in the proportion of traditional insurance and a decline in the proportion of unit-linked life insurance.**

Figure 7.2: Insurance companies' gross written life insurance premium in EUR million (left scale) and annual growth in percentages (right scale)

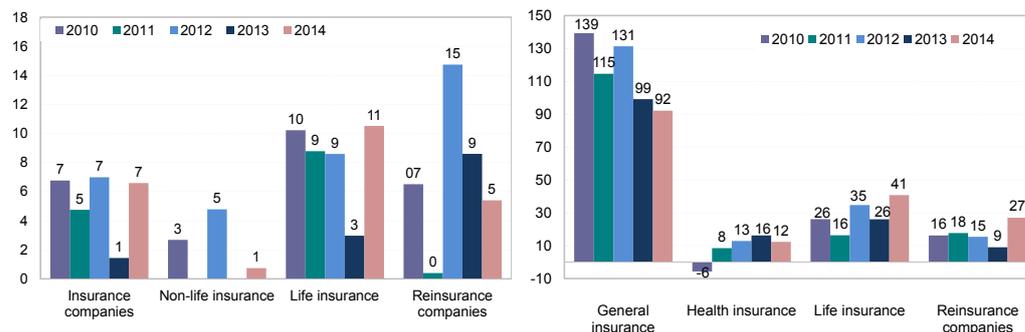


Source: ISA

**Insurance companies and reinsurance companies recorded growth in total assets<sup>43</sup>**

Insurance companies' total assets increased by 6.6% in 2014 to EUR 6.6 billion, while reinsurance companies' total assets increased by 5.4% to EUR 800 million. General insurance total assets increased by 0.7% over the same period to EUR 2.5 billion, while life insurance total assets increased by 10.5% to EUR 4.1 billion.

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



Source: ISA

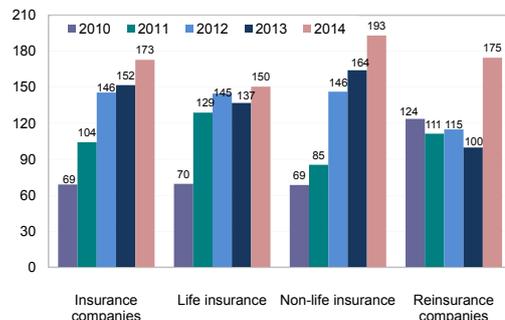
Insurers generated a net profit of EUR 133.8 million in 2014, up 31.4% in year-on-year terms. Insurers' profitability indicators were up relative to the previous year. ROE stood at 10.7% in 2014, compared with 8.7% in the previous year. The improvement in the domestic environment had a beneficial impact on the performance of insurance companies and reinsurance companies, which last year avoided the major problems with write-offs and impairments that they had had in the previous year.

<sup>43</sup>The figures used in this section are based on insurers' financial statements for 2014, which at the time of use had not been audited.

**The majority of insurers passed the insurance stress test.**

The capital adequacy of insurance companies and reinsurance companies according to applicable legislation is high. This was confirmed by the recent insurance stress test conducted by the EIOPA. When the results were released, the ISA, which had participated in the project, stated that only two insurance companies failed to meet the capital adequacy requirements under Solvency II,<sup>44</sup> and that the issue had already been resolved to a certain extent. Solvency II will not apply to insurance companies and reinsurance companies whose annual gross written premium does not exceed EUR 5 million and whose total insurance technical provisions do not exceed EUR 25 million.

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



Source: ISA

Given the stable situation on the capital markets and insurers' positive performance, there was no need for additional recapitalisation last year.

**The environment of low interest rates represents a great challenge for insurers.**

The environment of weak economic growth and low interest rates represents a great challenge for insurers. The primary investment class for insurers, investments in bonds, had low returns last year. The required yields, most notable on government bonds, fell further this year in response to the ECB's quantitative easing. The required yield on 10-year German government bonds stood at 0.21% at the end of March of this year, having stood at 1.55% a year earlier. The required yield on 10-year Slovenian government bonds fell from 3.58% to 1.12% over the same period. As long as interest rates remain low, insurers will face difficulties in ensuring a sufficient yield on insurance products with a guaranteed return and in reinvesting coupons received and maturing bonds.

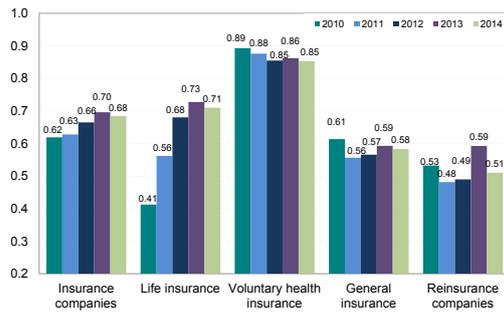
**7.1.2 Stability of the insurance sector****Underwriting risk**

The claims ratio at insurers as measured by the ratio of gross claims paid to gross written premium fell by 0.02 index points in 2014 to stand at 0.68. This was the first fall after four years of increase. The fall in the claims ratio at insurers was primarily the result of a decline in gross claims paid.

A rise in premiums and a decline in claims resulted in an improvement in the claims ratio for life insurance. The claims ratio for life insurance improved by 0.02 index points last year to stand at 0.71. There was a significant decline in written premium and claims paid in voluntary health insurance and general insurance. General insurance recorded a decline in claims paid, even though the number of mass claims in the region rose last year.

<sup>44</sup>The introduction of Solvency II on 1 January 2016 will bring significant changes in the calculation of solvency capital. Changes are also expected in insurers' investment policies, which will emphasise debt financial instruments with higher credit ratings and shorter maturities.

Figure 7.5: Claims ratio for major types of insurance



Source: ISA

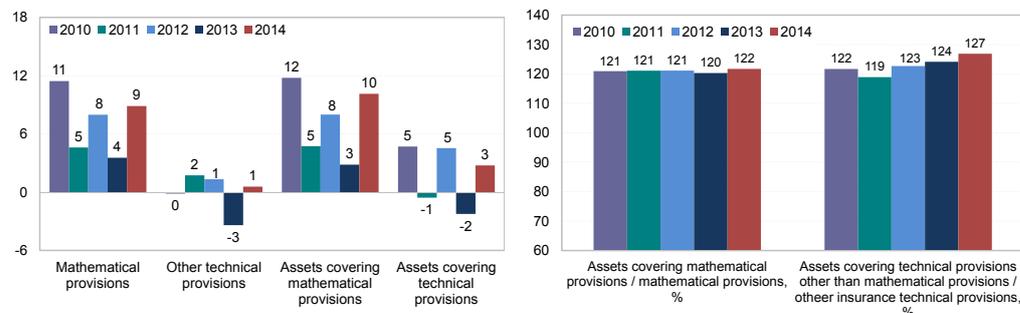
The business of the reinsurance companies is highly diversified in geographic terms. The improvement in the reinsurance companies' claims ratio was attributable to a 15% decline in claims paid, as written premium contracted by just 1.1%. Slovenian insurers again faced loss events caused by natural disasters last year, albeit to a lesser extent than in 2013. The risk of extraordinary events, natural disasters and extreme weather conditions has been rising in recent years.

The proportion of insurers' risk retained in general insurance amounted to 78.1% in 2014.

### Investment risk

Assets covering technical provisions rose by 7.6% last year to EUR 5,359 million, or 14.4% of GDP. The coverage of net insurance technical provisions by assets covering technical provisions increased from 121.6% to 123.3% last year. The coverage of mathematical provisions by assets covering mathematical provisions for life insurance and health insurance increased by 1.4 percentage points over the same period to 121.7%. This indicates that insurers' liabilities are covered by assets. The Insurance Act sets out the types of permitted assets.

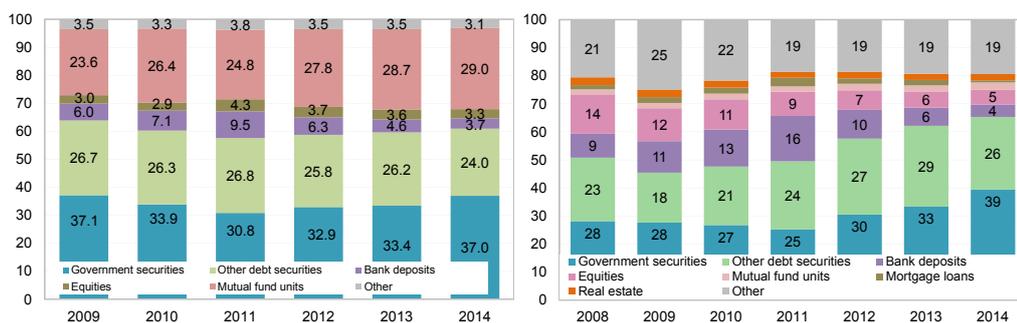
Figure 7.6: Growth in net insurance technical provisions and assets for general insurance and life insurance (left), and coverage of net insurance technical provisions by assets covering technical provisions for general insurance (right) in percentages



Sources: ISA, Bank of Slovenia calculations

In the breakdown of life insurance and general insurance investments last year, the proportion accounted for by deposits and exposures to other debt financial instruments continued to rise last year. The contraction in deposits was attributable to the fall in deposit rates, while the contraction in other financial instruments was the result of the harmonisation of investments with Solvency II. In accordance with Solvency II, the insurers increased their holdings of government financial instruments to which the 0% capital requirement for sovereign financial instruments of EEA countries applies. The proportion of investments accounted for by foreign financial instruments also increased.

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



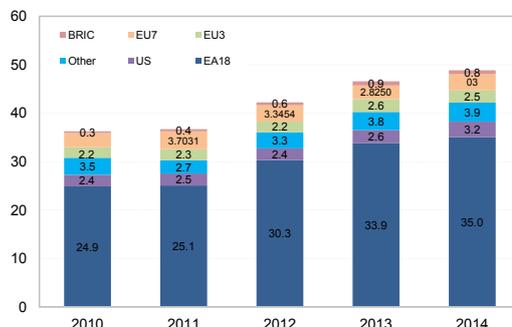
Source: ISA

**Exposure to domestic issuers remains high.**

The proportion of the total investments by the insurance sector, including pension companies, accounted for by investments in the securities of domestic issuers stood at 51% at the end of 2014, down 2.3 percentage points on the previous year. Net purchases of foreign debt securities and foreign equities amounted to EUR 182.3 million and EUR 107.8 million respectively last year. Purchases of debt securities and equities were diversified across various countries. The largest net purchases of debt financial instruments were recorded by instruments registered in Luxembourg, in the amount of EUR 58.8 million, while the largest net purchases of equities were recorded by instruments registered in Ireland, in the amount of EUR 37.7 million.

The insurance sector increased its exposure to the government sector in Slovenia. Slovenian government financial instruments accounted for 32.3% of the insurance sector's investment portfolio, or EUR 2.2 billion at the end of 2014. Year-on-year growth in bank deposits was negative in December 2014 in the amount of 10%. Low returns were the main factor in the continuing decline in the insurance sector's exposure to deposits.

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

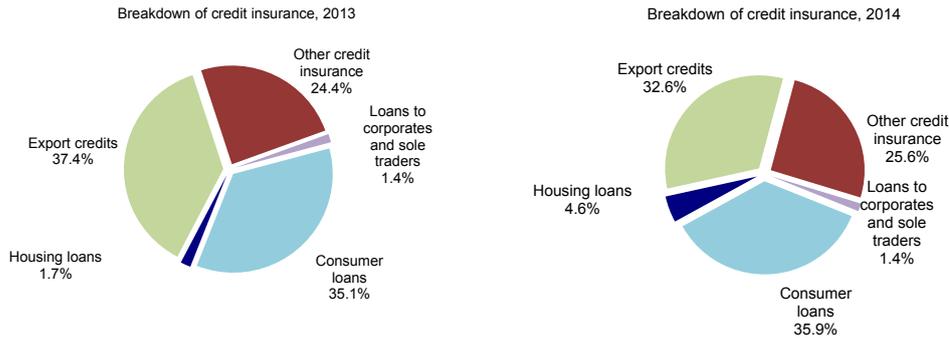


Source: Bank of Slovenia

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

The proportion of insurers' total written premium accounted for by credit insurance remained unchanged at 2.3% in 2014, and at 3.0% as a proportion of written general insurance premium. This form of insurance does not account for a significant proportion of written insurance premium. Written credit insurance premium in 2014 was down 2.2% on the previous year at EUR 42.2 million. Credit insurance claims paid declined by 20.2% to EUR 23.8 million. The decline in claims was the main factor in an improvement in the claims ratio, which stood at 0.56 last year, while growth in premiums slowed slightly.

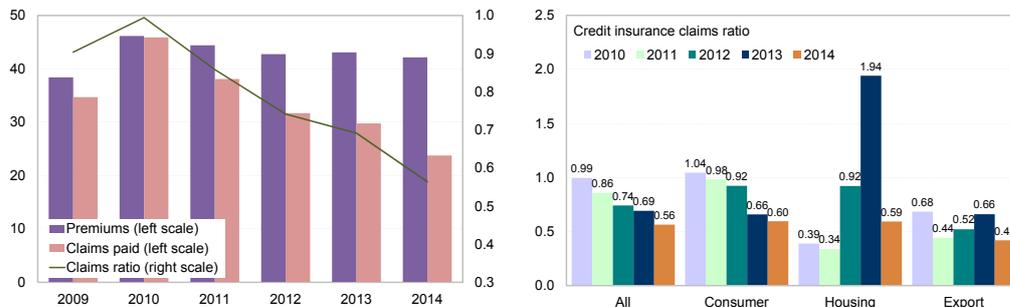
Figure 7.9: Breakdown of written credit insurance premium in percentages



Source: ISA

The claims ratio declined last year in all areas of credit insurance. Credit insurance claims paid also declined in all areas, while written premium for credit insurance of housing loans increased by 168% to EUR 1.9 million, primarily on account of fears that the weather damage of previous years would be repeated. Written premium for consumer loans remained unchanged at EUR 15.1 million, while written premium for export credits declined by 15% to EUR 13.7 million.

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



Source: ISA

Slovenian insurers' sum insured in credit insurance was down 2.5% on the previous year to stand at EUR 6.8 billion at the end of 2014. The sum insured for export credits in 2014 was down 4.8% relative to the previous year, at EUR 3.8 billion. The sum insured for credit insurance on housing loans stood at EUR 117.7 million at the end of 2014, up 8.8% on 2013. The sum insured for credit insurance on consumer loans stood at EUR 392.5 million at the end of 2014, up 6.5% on 2014.

## 7.2 Voluntary supplementary pension insurance

As in 2013, when the Fiscal Balance Act was adopted, there was a sharp fall in the gross written premium of voluntary supplementary pension insurance providers last year. The aforementioned law envisaged a reduction in premiums for supplementary pension insurance for civil servants by the end of 2014.

There is a pronounced trend of ageing population in Slovenia. This represents a risk to financial stability owing to the increased risk of unsustainable fiscal policy. The number of old-age pensioners and recipients of old-age pensions increased by 2.0% and 1.7% respectively last year, the lowest annual increase in the last decade. This was largely attributable to the introduction of the Pension Insurance Act (the ZPIZ-2) in 2012. Last year the average age of new pension recipients rose from 60.8 to 60.9 for men, and from 58.3 to 58.9 for women. The tax revenue generated by the PDII during the 2014 financial year was up 0.6% on 2013. Tax revenue accounted for 67% of its total revenues, transfer revenue for 32.3% and other revenue for 0.7%. The proportion accounted for by tax revenue<sup>45</sup> recorded the largest increase, of 0.9 percentage points, as a result of an increase in revenues from social security contributions.

**The trend of increase in the number of old-age pensioners was at its weakest of the last ten years.**

<sup>45</sup>The data source is the PDII's annual report for 2014.

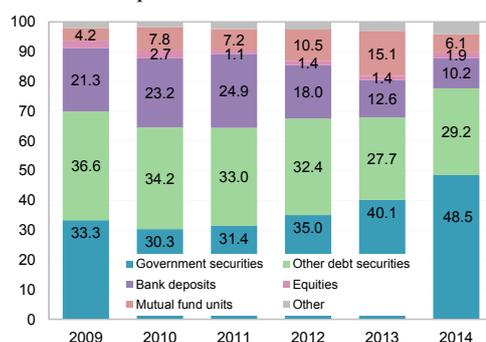
Table 7.1: Written premium and assets of voluntary supplementary pension insurance providers

	2009	2010	2011	2012	2013	2014
Written premium, EUR million	231	233	231	230	200	168
Breakdown, %						
mutual pension funds	46	46	45	46	38	30
insurers	21	21	21	23	29	32
pension companies	33	33	33	31	33	38
Assets, EUR million	1,528	1,794	1,846	1,801	1,788	1,935
Breakdown, %						
mutual pension funds	42	42	44	47	49	49
insurers	21	21	21	22	22	23
pension companies	36	36	35	31	29	28

Sources: ISA, SMA

The ZPIZ-2 provided for the establishment of an umbrella pension fund to allow a life cycle policy to be pursued. The umbrella pension fund consists of three sub-funds that differ in terms of investment policy. One of the three sub-funds will continue to pursue an investment policy of ensuring the minimum guaranteed return. Only one company obtained an SMA authorisation to operate an umbrella pension fund in 2014. As a result there was no significant change last year in pension funds' investment policy in the direction of increased exposure to equities.

Figure 7.11: Structure of investments by voluntary supplementary pension insurance providers



Sources: ISA, Bank of Slovenia

**All supplementary pension insurance providers generated a return higher than the guaranteed return last year.**

The ratio of supplementary pension insurance assets to GDP stood at 5.2% at the end of 2014. The largest declines in the structure of investments by supplementary pension insurance providers relative to 2013 were recorded by the proportion accounted for mutual fund units, which was down 9 percentage points, and the proportion accounted for by bank deposits, which was down 3 percentage points. The proportion accounted for government financial instruments increased by 9 percentage points.

The minimum guaranteed return stood at 1.5% in 2014, and has remained unchanged this year. All supplementary pension insurance providers generated a return higher than the guaranteed return last year. The average annual return achieved by insurers and pension companies from voluntary supplementary pension insurance investments stood at 7.5% last year. Only one company exceeded an annual return of 10%. The year-on-year change in the average unit price of mutual pension funds stood at +6.8%.<sup>46</sup>

<sup>46</sup> The average is based on a calculation that takes account of six pension companies and seven mutual pension funds.

### 7.3 Capital market and mutual funds

#### Summary

The successful completion of the sale of five firms, three of which were on the SSH's<sup>47</sup> list of firms for sale, had a positive impact on domestic stock market developments last year. The sale of individual firms and the speculation associated with privatisation encourage growth in prices and volume on the Ljubljana Stock Exchange. This was also attributable to the improvement in the domestic economic climate. However, the trend of growth on the Ljubljana Stock Exchange reversed towards the end of the year, primarily as a result of new speculation over the continuation of the privatisation process and the strengthening of geopolitical risks.

The positive net inflow into investment funds is confirmation that confidence is returning to investors. This is also attributable to the extremely low interest rates on bank deposits, which are encouraging owners of capital to take up higher risk for higher returns. The improvement in the macroeconomic situation and the ECB's non-standard monetary measures have also improved the financing situation. Premiums on government bonds fell further. Alongside the government sector, corporates increasingly opted for financing on the capital markets last year. Some also succeeded in borrowing via bond issues on foreign markets.

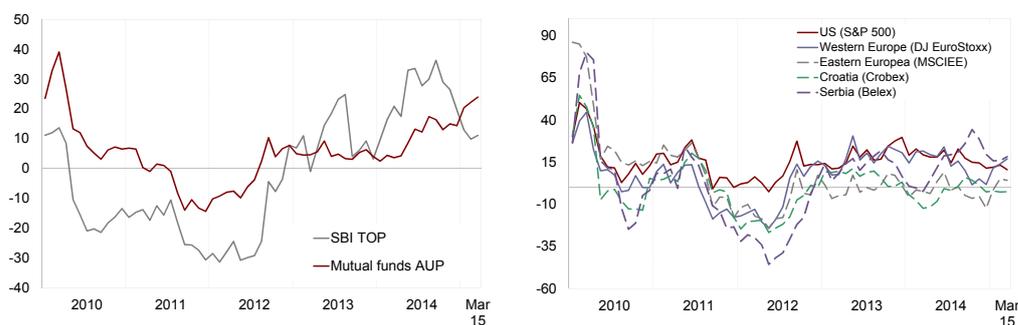
**The improvement in the macroeconomic environment improved the conditions for alternative forms of financing.**

Despite the positive developments on the domestic capital market, which are primarily temporary in nature, the risks to the Slovenian capital market remain or are increasing. The delisting of privatised firms will further worsen the situation on the stock exchange. Market liquidity will fall further, and total market capitalisation and volume on the stock exchange will not be sufficient to ensure that it functions smoothly, which could endanger the existence of the domestic capital market. This would vastly reduce the alternative options of corporate financing. With the exception of individual well-established Slovenian firms, the option of securing debt financing on the foreign capital market is limited primarily to the government. The low liquidity on the domestic capital market and the small volume on the stock exchange are increasing the sensitivity of shares to any announcements with regard to the continuation of the privatisation process for government-owned firms. Market share prices are being driven more by speculative behaviour by individual investors than by economic factors, which is impacting corporate performance.

#### Developments on the capital market

The SBI TOP displayed a trend of pronounced growth over the first nine months of last year, but this did not last for the whole year. Demand for shares strengthened when the sale of the first firm from the list of government-owned capital assets for sale was officially completed. The SBI TOP peaked at 839.4 points in early October, up 28% on the end of 2013.

Figure 7.12: Year-on-year change in domestic (left) and foreign (right) stock exchange indices in percentages



Sources: LJSE, Bloomberg

The positive growth slowed in the final quarter of last year as a result of geopolitical tensions in eastern Europe and the continuation of the Greek crisis. The key share indices on established markets recorded mixed returns last year. In the US, the NASDAQ and the

**The SBI TOP ended last year up 19.6%.**

<sup>47</sup>There were still 12 firms for sale on the SSH list at the end of 2014. From the original SSH list, Helios d.d., Fotona d.d. and Aerodrom Ljubljana d.d. have all been sold. Letrika d.d. and Mercator d.d. were also sold last year, while Pivovarna Laško was sold in early 2015.

S&P were up 13.4% and 11.4% respectively. The DJ EuroStoxx,<sup>48</sup> the representative index for western Europe, recorded a positive return of just 1.9%, while the MSCIEE index for eastern Europe was down 12.3%. The domestic market was affected in the second half of the year by the early parliamentary elections, which triggered renewed speculation with regard to the continuation of the privatisation process. Although the SBI TOP lost 55.3 points in the final quarter of last year, it ended the year up 19.6%. The launch of quantitative easing by the ECB in the first quarter of this year mainly brought growth to western European stock markets, while the domestic stock market remains at its levels of the beginning of the year. The key factor in the stagnation on the domestic stock exchange was speculation with regard to the continuation of the privatisation process.

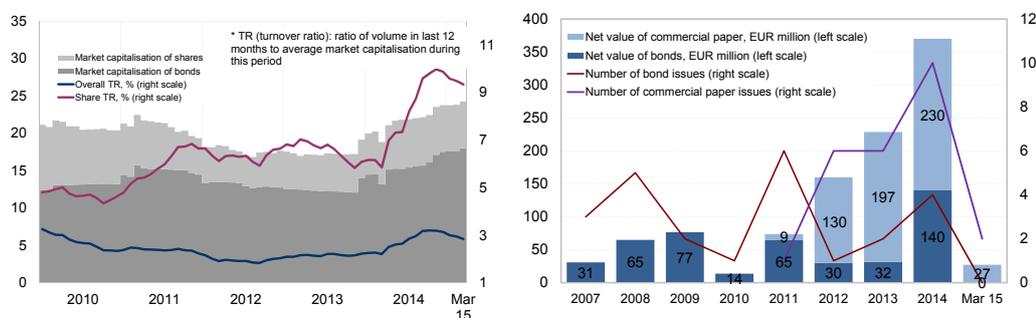
**The volume of trading in shares doubled last year, while the volume of trading in bonds declined.**

The total volume of trading on the Ljubljana Stock Exchange in 2014 was up 75.2% on the previous year, while the volume in the first quarter of 2015 was down 29% in year-on-year terms. Last year's growth was primarily attributable to increased trading in shares on the prime and standard markets that were directly involved in the sale process. The volume of trading in shares doubled last year, and accounted for 88.6% of the total volume on the Ljubljana Stock Exchange.

The market capitalisation of shares on the Ljubljana Stock Exchange amounted to EUR 6,214 million at the end of 2014, up 20.1% in year-on-year terms. The majority of the sold firms are still listed on the exchange, but their volume of trading is minimal. Were all the sold firms to have been delisted by the end of last year, the market capitalisation of shares would have amounted to EUR 5,560 million, up just 7.4% on the previous year.

The market capitalisation of bonds on the Ljubljana Stock Exchange amounted to EUR 17,520 million at the end of 2014, up 25.5% on the previous year. Like the share market, the Slovenian bond market also suffers from low liquidity, and is concentrated to trading in just a few bonds. The most heavily traded bond alone accounted for 41.6% of the total volume of trading in bonds. The volume of trading in bonds declined by 20% and accounted for 10.1% of total volume, while the volume of trading in short-term debt financial instruments (primarily commercial paper) doubled to EUR 9.2 million, although they only accounted for 1.3% of total volume.

Figure 7.13: Market capitalisation on the Ljubljana Stock Exchange in EUR billion, and annual turnover ratios (left) and issuance of corporate bonds and commercial paper, net values and number of issues (right)



Source: LJSE

**The government issued bonds in the amount of EUR 5.5 billion in 2014.**

The government issued five bonds with a nominal value of EUR 1 billion (EUR 5.5 billion in total) in 2014, two of the bonds having been issued in the rest of the world with a total nominal value of USD 3.5 billion. The government issued RS59 and RS62 bonds with a total nominal value of EUR 230.8 million for the purpose of bank recapitalisations.

Money-market instruments on the domestic capital market established themselves in 2014 as an alternative source of debt financing for the government and corporate sectors, including firms not listed on the Ljubljana Stock Exchange. The government issued 28 treasury bills with a nominal value of EUR 1,578 million last year, down 26.8% on the nominal value of issues in the previous year.

**Issuance of commercial paper increased by 20% last year. Unlisted firms were among the issuers.**

The fall in required yields on corporate bonds allowed firms to make more concerted use last year of financing via the issue of corporate bonds or commercial paper on the Ljubljana Stock Exchange. By issuing commercial paper, firms are diversifying their short-term debt financing and balancing the fluctuations in their generation of free cash flow. Last year saw

<sup>48</sup> The DJ EuroStoxx includes large enterprises and SMEs in 12 euro area countries (Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain).

the issue of ten such instruments in the total amount of EUR 230 million, up 19.2% on the previous year. They included five firms not listed on the stock exchange. Only one unlisted firm issued commercial paper in 2013, an indication that commercial paper is increasingly becoming an established source of short-term financing, partly as a result of the relatively high lending rates offered by Slovenian banks.

Five non-financial corporations took advantage of the favourable situation on the bond market last year. Four firms opted for issues on the domestic market in the total amount of EUR 141 million, 4.3 times the size of the issues in the previous year. For the first time in five years a non-financial corporation also borrowed on foreign markets. Petrol issued a 5-year bond at a fixed annual coupon rate of 3.25%. NLB and SID banka also had successful bond placements on foreign markets. The first issued a 3-year bond with a fixed interest rate of 2.875% and a nominal value of EUR 300 million, while the second issued a 3-year bond with a fixed interest rate of 2.25% and a nominal value of EUR 96.8 million.

Despite the slightly livelier developments on the Ljubljana Stock Exchange, the risks to the domestic capital market remain. Last year's increase in volume is a short-term consequence of the privatisation process that began in earnest last year. Assuming that the sale of government-owned capital assets will continue this year, the period of increased volume can be expected to continue, but upon the completion of the sales volume is likely to decline significantly, thereby further worsening the overall liquidity of the Ljubljana Stock Exchange. Sales of individual firms meant that the proportion of market capitalisation accounted for by non-residents jumped by just under 10 percentage points to end the year at 25.4%.

**Five firms took advantage of the favourable situation on the bond market to issue bonds with a total nominal value of EUR 141 million.**

**The increased volume is primarily attributable to the privatisation process.**

Table 7.2: Overview of Slovenia's regulated market

	2009	2010	2011	2012	2013	2014	Q1 2015
Shares							
Market capitalisation							
amount, EUR billion	8.5	7.0	4.9	4.9	5.2	6.2	6.2
as % GDP	23.9	19.7	13.5	13.9	14.7	16.7	16.7
annual growth, %	-0.1	-17.3	-30.3	0.8	5.3	20.1	9.0
proportion held by non-residents, %	7.2	10.0	12.3	13.6	15.5	25.4	24.5
Volume							
amount, EUR million	719.8	360.8	394.5	302.9	299.4	608.1	73.9
as % GDP	2.0	1.0	1.1	0.9	0.8	1.6	0.8
annual growth, %	-24.4	-49.9	9.3	-23.2	-1.1	103.1	-20.6
Annual change in SBI TOP, %	15.0	-13.5	-30.7	7.8	3.2	19.6	11.1
Bonds							
Market capitalisation							
amount, EUR billion	10.8	13.2	14.5	12.7	14.5	17.5	18.0
as % GDP	30.6	37.2	40.0	36.1	41.2	47.0	48.3
annual growth, %	59.2	21.9	9.6	-11.9	15.6	20.7	36.4
Volume							
amount, EUR million	156.3	108.9	59.6	55.4	86.1	69.0	8.3
as % GDP	0.4	0.3	0.2	0.2	0.2	0.2	0.1
annual growth, %	-39.2	-30.3	-45.3	-7.0	55.4	-19.8	-64.5

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

Sources: LJSE, SORS

The sale of firms is reducing the range of financial instruments available on the Ljubljana Stock Exchange, which is threatening its existence and the existence of an institutionalised Slovenian capital market. The unhappy outlook for the Ljubljana Stock Exchange is the main reason that the owner is examining various scenarios that could have a decisive impact on its future. Here it should be noted that there is no advanced economy country that lacks an institutionalised capital market.

**The sale of firms is reducing the range of financial instruments available on the Ljubljana Stock Exchange, which could threaten its existence in the long term.**

#### Investment links with the rest of the world

Non-residents' demand for domestic financial instruments increased last year. They purchased bonds and shares alike. Non-residents made net purchases of EUR 1,857.3 million in bonds in 2014, having recorded net sales of bonds in the amount of EUR 547.5 million in the previous year. The increase in net investments in bonds was primarily attributable to the issue of two government bonds in April and November of last year, when the government borrowed an additional EUR 2 billion on the domestic market.

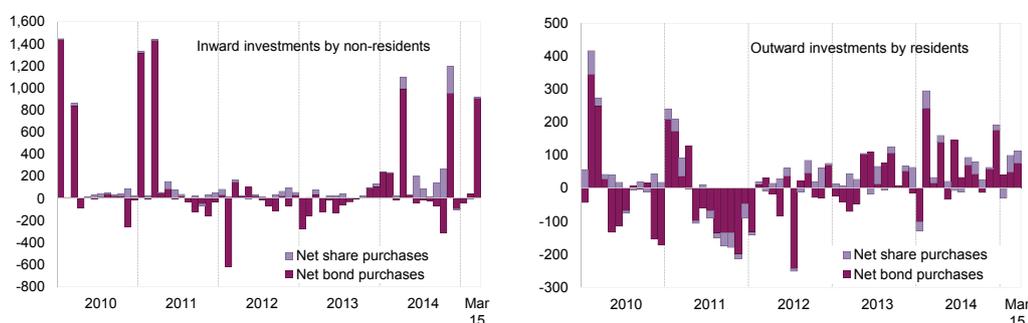
**Non-residents increased their net flow into shares 4.7-fold last year.**

As a result of privatisation, non-residents increased their investments in shares, which were 4.7 times higher than the previous year at EUR 1,073.6 million. The increase in the net flow was primarily the result of the actual execution of transactions during the sale of individual firms, and was less a form of speculative purchasing that could significantly increase volume on the Ljubljana Stock Exchange before the completion of the sales. According to the Slovenian Sovereign Holding, procedures for the sale of seven additional firms are now in progress in 2015<sup>49</sup>

The positive mood on foreign capital markets saw residents continue to increase their investments in the rest of the world last year. The net flow of outward investments amounted to EUR 945.8 million, 1.9 times the figure in 2013. The net flow into shares declined by 23.2% in year-on-year terms to EUR 169.7 million, while the net flow into bonds increased by 2.9 times to EUR 776.1 million.

The largest purchasers of foreign securities were the commercial banks, which invested EUR 588.9 million in foreign markets, or 62% of total outward investment, followed by insurance corporations, pension funds and investment funds with investments of EUR 198.1 million, EUR 91.1 million and EUR 52.0 million respectively.

Figure 7.14: Monthly net inward investments by non-residents (left) and outward investments by residents (right) in EUR million



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

Sources: CSCC, Bank of Slovenia, own calculations

### Investment funds

The mutual funds' assets under management stood at EUR 2,155.7 million at the end of 2014, up 15.9% in year-on-year terms. The increase was the result of a rise of 14.5% in the weighted average unit price. After two years of net withdrawals from the domestic funds in the total amount of EUR 200 million, the domestic mutual funds recorded net inflows of EUR 39.5 million last year. The trend strengthened in the first quarter of this year, as net inflows amounted to EUR 66.7 million. Inflows into equity funds from households were particularly prominent in February and March.

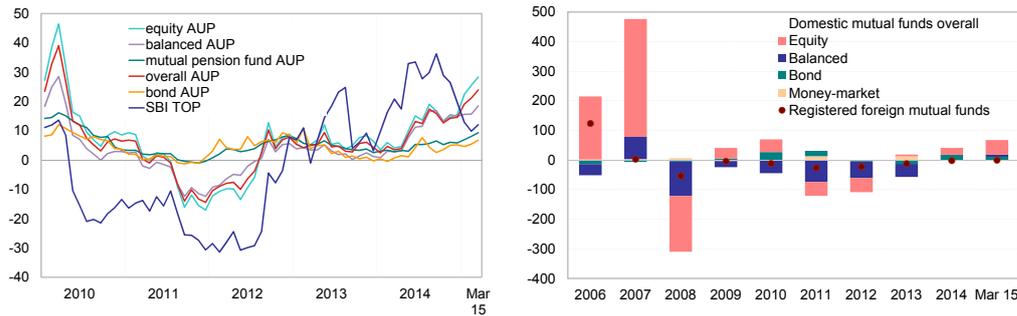
**Households recorded the largest net inflows into investment funds last year, and have continued to record large inflows this year.**

Last year's largest net inflows into investment funds were recorded by households, at EUR 71.6 million. In 2013 they had sold EUR 12.6 million of mutual fund assets owing to a loss of confidence in mutual funds and the stagnation of disposable income. A positive trend in inflows was also recorded by other financial intermediaries and pension funds, which made net payments of EUR 4.1 million and EUR 4.3 million respectively into investment funds, having recorded minimal net inflows into funds in 2013.

The majority of other sectors requested net withdrawals from investment funds in 2014. The largest net withdrawals were recorded by insurance corporations and commercial banks in the amount of EUR 18.5 million and EUR 9.4 million respectively.

<sup>49</sup> Sale procedures are underway at the following firms: Adria Airways, Aero, Elan, Cinkarna Celje, NKBM, Telekom Slovenije and Žito.

Figure 7.15: Annual change in the average unit price of mutual funds and the SBI TOP in percentages (left) and net cash flows into mutual funds in EUR million (right)

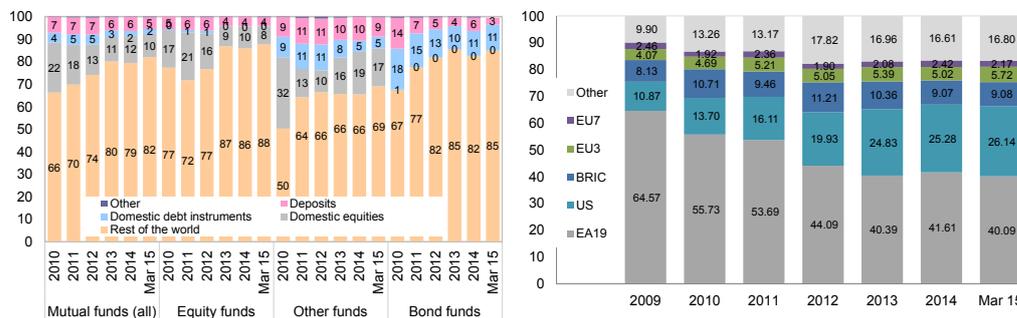


Sources: SMA, LJSE, Bank of Slovenia

The positive mood on the foreign capital markets meant that investors, households in particular, were more risk-inclined. There were net inflows of EUR 22.9 million into equity funds and EUR 18 million into bond funds, while the majority of net withdrawals in the amount of EUR 1.5 million were made from safer, but less-profitable balanced funds.

The consolidation of the mutual funds continued in 2014 and early 2015. The number of investment fund management companies remained unchanged, but the number of funds fell from 117 to 113, as a result of funds being merged into existing funds. Two new funds were established during this period. The management of six funds was transferred to another investment fund management company in the first quarter of 2015, which means that the actual number of investment fund management companies has fallen to nine.

Figure 7.16: Percentage breakdown of mutual fund investments (left) and regional percentage breakdown of investments in foreign shares by the entire other financial intermediaries sector (right)



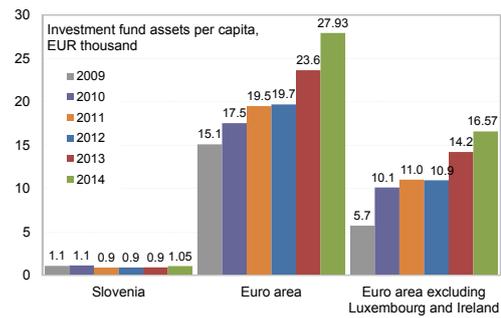
Sources: SMA, Bank of Slovenia

**Comparison of Slovenian investment funds with the euro area**

The domestic mutual funds’ assets under management per capita stood at EUR 1,050 at the end of third quarter of 2014. The euro area average was significantly higher, at EUR 27,930. Excluding Luxembourg and Ireland as key countries of domicile for the issue of investment funds, the average for the remainder of the euro area is EUR 16,570. Assets under management at investment funds across the euro area at the end of 2014 were up 18.1% in year-on-year terms, while assets under management at the domestic mutual funds were up 15.5% in the comparable period. The environment of low interest rates is forcing investors to seek higher returns, which is being reflected in increased demand for higher-risk forms of saving. The environment of low interest rates is expected to last at least until the end of the implementation of the ECB’s non-standard monetary measures, which will further increase demand for higher-risk forms of saving such as equity funds.

That assets under management per capita at investment funds across the euro area are higher is attributable to the better awareness of investments on the capital markets, more effective management of investment funds, and the higher average consumer purchasing power.

Figure 7.17: Investment funds' assets under management per capita, comparison with euro area



Note: Includes units/shares of all investment funds (investment companies and mutual funds), both domestic and foreign.

Sources: Bank of Slovenia, ECB

## 7.4 Leasing companies

### Summary

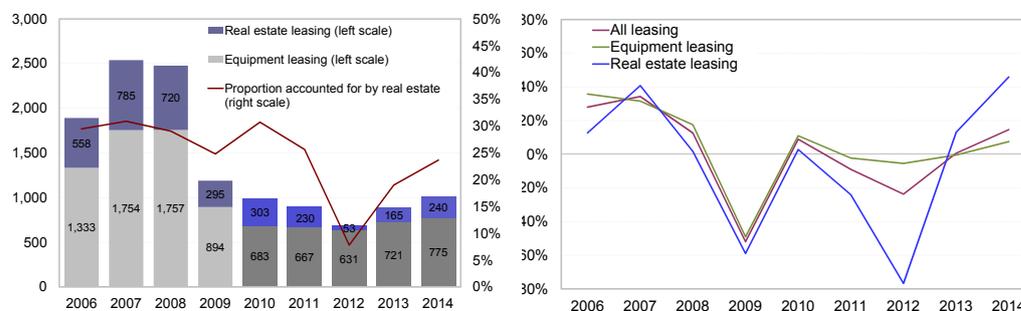
The recovery of economic activity was reflected to a lesser extent in the performance of leasing companies last year. The positive trend in new business seen in 2013 continued in 2014, while the trend of contraction in existing business also continued last year. The proportion of claims more than 90 days in arrears increased, while the operating result remained negative at the majority of leasing companies. Concentration remains high in the leasing sector. Six leasing companies<sup>50</sup> accounted for 70% of all new business, while 70% of the stock of leasing business is divided between eight companies.

**Confirmation of a positive trend in new business, but the majority of leasing companies remain in the red.**

### Leasing companies' turnover

Demand for leasing bottomed out in 2012, since when the situation has improved slightly. New leasing business<sup>51</sup> amounted to EUR 1.02 billion in 2014, up 14.7% on 2013. Real estate leasing business was up 47%, while equipment leasing business was up 7%. Despite the positive growth, new business was well below the record levels of 2007.

Figure 7.18: New leasing business<sup>52</sup> in EUR millions and proportion accounted for by real estate leasing in percentages (left), and annual growth in new business in percentages (right)



Sources: SLA, BAS, Bank of Slovenia

Non-financial corporations are most active in real estate leasing: their new business in the amount of EUR 213.8 million accounted for 80% of all new real estate leasing business. The most prominent segments were the leasing of office buildings and retail facilities, in the total amount of EUR 202.3 million. Households were most active in equipment leasing, and accounted for 53.6% of all new business. Non-financial corporations recorded equipment leasing business of EUR 356.3 million, or 46% of the total. Households and non-financial corporations primarily entered into leasing for cars, commercial vehicles and freight vehicles.

**Non-financial corporations were the most active in real estate leasing, while households were the most active in equipment leasing.**

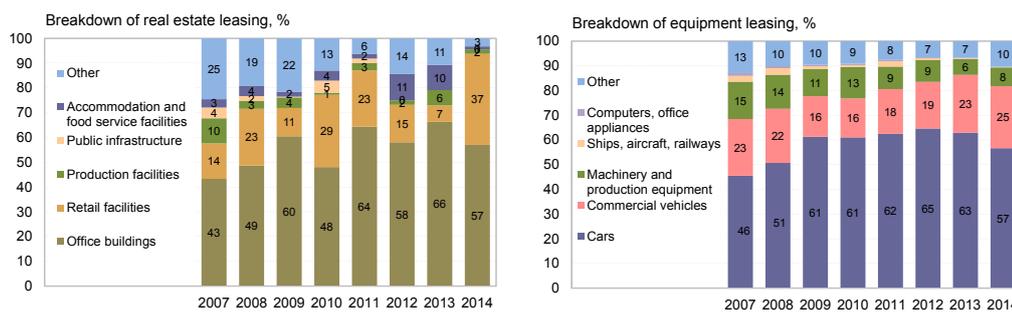
The breakdown of leasing assets changed in 2014, particularly in the area of real estate leasing. The proportion of new business accounted for by retail facilities increased sharply, while the proportions accounted for by office buildings and by accommodation and food service facilities declined. The proportion of equipment leasing business accounted for by machinery and production equipment increased again after several years of decline. The proportion accounted for by commercial vehicles also increased, an indication of the slightly more positive expectations with regard to future economic activity.

<sup>50</sup> On 31 December 2012 the Bank of Slovenia introduced mandatory reporting by companies involved in leasing business. Institutions are selected for mandatory reporting on the basis of the materiality of their business, and must provide quarterly figures; the first reports were submitted for the final quarter of 2012. The analysis of leasing companies has been undertaken on the basis of the data from the new reporting, except where stated that it relates to the figures of the BAS's leasing committee to ensure year-on-year comparability. The Bank of Slovenia received reports from 45 companies involved in leasing business in 2014.

<sup>51</sup> Part of the increase in new real estate business in December was attributable to institutional changes in the reporting by individual companies involved in leasing business.

<sup>52</sup> Leasing business is disclosed at historical cost until 2008 due to the availability of figures, and at financed value since, excluding the financing of inventories since 2010.

Figure 7.19 Breakdown of new equipment leasing business (left) and real estate leasing business (right) in percentages



Sources: SLA, BAS, Bank of Slovenia

**60% of real estate business had a maturity of 1 to 10 years.**

There was no significant change in the average maturity of new equipment leasing business last year. It was mainly agreements of up to 10 years that were approved; 59.6% of the lease agreements had a maturity of up to 5 years. Confidence in the economy and in the real estate market is gradually returning, which is confirmed by the average maturity on real estate business. In 2013, 60.4% of all real estate business had a maturity of up to 1 year. In 2014, as a result of institutional changes in reporting by individual firms, 63.1% of real estate business was approved with a maturity of between 1 and 10 years, while the proportion accounted for by maturities of up to 1 year declined to 16.1%. The LTV ratio as measured by the ratio of approved financing to the value of the leasing asset remained high, at 80.3% for equipment leasing and 98.6% for real estate leasing.

**The stock of leasing business contracted by 10.4% last year.**

The stock of leasing business declined by 10.4% in 2014 to stand at EUR 3.0 billion. Real estate leasing declined by 19.6% to EUR 1.3 billion, while equipment leasing declined by 1.8% to EUR 1.7 billion. The five largest leasing companies covered half of the entire leasing market in terms of the stock of business. The concentration of leasing business is particularly high in real estate leasing. The three largest companies covered 56% of all real estate leasing business in terms of stock, while the three largest companies covered 39% of all equipment leasing business in terms of stock. Despite a decline in the stock of business, financing at leasing companies remains a significant source of financing for corporates.

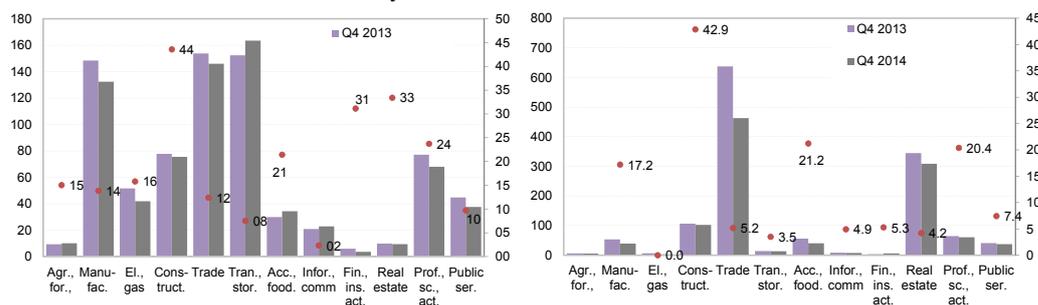
Households accounted for 26.4% of the total stock of leasing business at the end of last year, or EUR 792.8 million. The proportion was up just over 2 percentage points on the end of 2013. The majority (EUR 725.5 million or 24.1% of the total stock) consisted of equipment leasing, primarily cars. The already-low proportion of liabilities more than 90 days in arrears declined further last year to 4%, which confirms the low credit risk of the household sector.

**The largest contraction in the stock of leasing business was recorded by the wholesale and retail trade sector.**

The stock of leasing business with non-financial corporations amounted to EUR 1.8 billion at the end of 2014, or 61.1% of the total stock of leasing business. Non-financial corporations accounted for 83.4% of the total stock of real estate leasing business and 43.9% of the total stock of equipment leasing. The sectors of wholesale and retail trade (EUR 608.6 million), real estate activities (EUR 318.14 million) and construction (EUR 177.8 million) accounted for 60% of non-financial corporations' total stock of leasing business.

The wholesale and retail trade sector's stock of leasing business was down 23% or EUR 182.3 million on the end of the previous year. The majority of the contraction was in real estate leasing. Last year's largest increase in new leasing business was also recorded by the wholesale and retail trade sector, most notably in the segment of office buildings and retail facilities.

Figure 7.20: Stock of non-financial corporations' leasing business by sector for equipment leasing (left) and real estate leasing (right) in EUR million, and proportion of stock more than 90 days in arrears



Note: The proportion more than 90 days in arrears for real estate leasing is 93.7% in the agriculture and mining sector.

Source: Bank of Slovenia

Non-financial corporations entail higher credit risk for leasing companies, owing to the higher exposures and the higher proportion of non-performing claims. The proportion of non-financial corporations' liabilities more than 90 days in arrears had risen from 9.5% to 13.1% by the end of 2014. The sectors of construction, accommodation and food service activities, and professional, scientific and technical activities and administrative and support service activities stand out in terms of liabilities more than 90 days in arrears in real estate leasing, while the sectors of real estate activities and financial and insurance activities are notable in equipment leasing, in addition to the three aforementioned sectors. The largest deteriorations in the situation in equipment leasing were recorded by financial and insurance activities and real estate activities, where the proportion of liabilities more than 90 days in arrears increased by 17.9 percentage points and 6.9 percentage points respectively. The main improvement in investment quality was in public services, where the figure improved by 8.2 percentage points. The largest deteriorations in the situation in real estate leasing were recorded by the sectors of construction, agriculture and mining, and professional, scientific and technical activities and administrative and support service activities, where the proportions of liabilities more than 90 days in arrears increased by 27.2 percentage points to 42.9%, by 8.4 percentage points to 93.7% and by 7.1 percentage points to 20.4% respectively. The sole improvement was recorded by financial and insurance activities, where the proportion of claims more than 90 days in arrears declined by 3.9 percentage points to 5.3%.

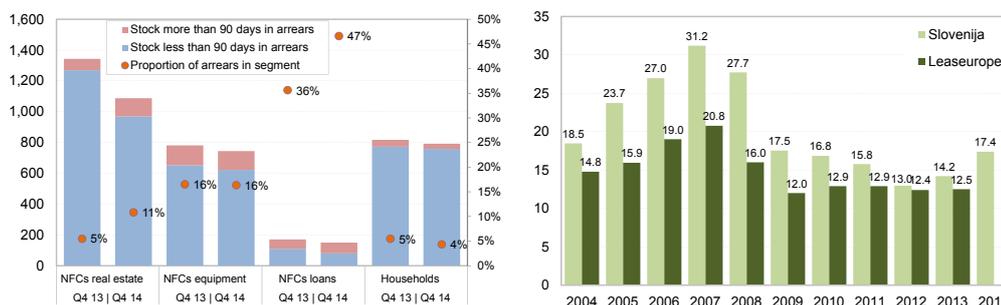
**Arrears at NFCs increased to 13.1%.**

The type of business that prevails at non-financial corporations is finance leasing, which accounts for 62% of the total stock of leasing business with non-financial corporations or EUR 1.1 billion. Operating leasing accounts for 30%, and loans for 8% of all leasing business with non-financial corporations. The last declined by 12% last year to EUR 150 million. Loans have the highest proportion more than 90 days in arrears, at 46.6%. Finance leasing is also prevalent in the household segment: it accounts for 84.6% of the total stock of leasing business with households. Operating leasing accounts for just 1.6% and loans for 13.9% of all leasing business with households. The proportion of leasing business with households more than 90 days in arrears is similar to that for non-financial corporations, at 14.6%.

**Finance leasing is prevalent for NFCs and for households The proportion of arrears is largest in loans.**

The market value of leasing assets repossessed for non-performance of contractual obligations amounted to EUR 131.4 million last year, down 17% on 2013. Real estate accounted for the majority (93.2%).

Figure 7.21: Stock of leasing business more than 90 days in arrears in EUR million (left) and ratio of leasing business to gross fixed capital formation (right) in percentages

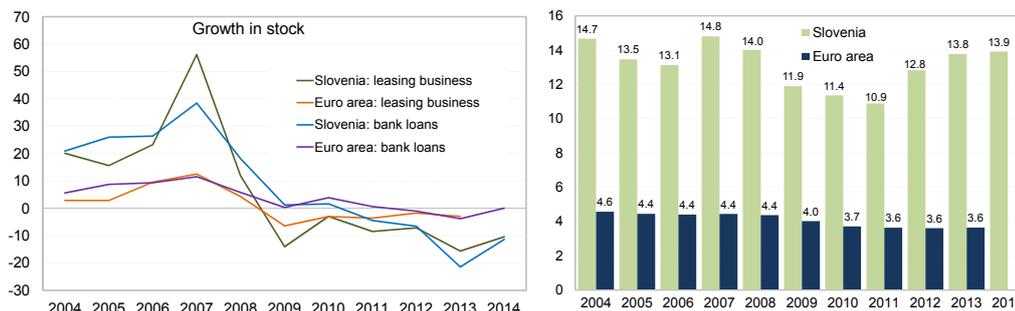


Sources: SLA, BAS, Bank of Slovenia, SORS, Leaseurope

**New business on the European leasing market was up 8.4% in 2014.**

The initial estimates of new business on the European leasing market released by Leaseurope show new business to have increased by 8.4% in 2014, the largest increase in the last seven years. Leasing business increased in all segments. The most notable were vehicles, business equipment and real estate, where the year-on-year rates of growth were 12.4%, 1.0% and 7.6% respectively. Real estate leasing had not recorded positive growth since 2010. At less than 14%, the relatively low ratio of leasing loans to bank loans is an indication of the relatively limited opportunities for corporates and households to finance themselves via leasing companies. Leasing is nevertheless well-developed as an alternative form of financing in Slovenia: across the euro area it accounts for 3.6%.

Figure 7.22: Growth in the stock of leasing business and bank loans to the non-banking sector (left) and ratio of leasing business to bank loans to the non-banking sector (right) in percentages



Sources: SLA, BAS, Bank of Slovenia, ECB

With the economic recovery finance leasing will regain importance in financing, although it should remain more conservative in real estate project financing than during the pre-crisis period, and more cautious in the assessment of corporate credit risk when new leasing business is being concluded.

**Performance of leasing companies**

**Additional recapitalisations were required on account of negative equity and liquidations.**

The performance of leasing companies was negative for the sixth consecutive year. They had EUR 288 million in capital last year in the context of total assets of EUR 3,461 million and a loss in the amount of EUR 50 million. Negative equity and the future liquidation of companies meant that the owners of individual leasing companies had to undertake recapitalisations, even up to EUR 50 million. Leverage improved as indebtedness declined. The debt-to-equity ratio stood at 10.6 at the end of 2014.

It was primarily leasing companies whose primary source of revenue is equipment leasing that were profitable for the second consecutive year. Just under a third of leasing companies are classed as such in terms of total assets. Leasing companies that in previous years had been most involved in the real estate market still had the largest problems, and have not yet succeeded in responding adequately to the change in the business environment.

Slovenian banks provided EUR 721.5 million of funding for leasing companies' investments in 2014, equivalent to 2.9% of total classified claims to the domestic non-banking sector. Classified claims against leasing companies last year were 55% of the 2010 figure.

Table 7.3: Performance of leasing companies and sources of funding

	2008	2009	2010	2011	2012	2013	2014	Growth, %					
								2009	2010	2011	2012	2013	2014
Total assets, EUR million	5,620	5,663	5,427	5,088	4,842	3,826	3,461	0.8	-4.2	-6.2	-4.8	-21.0	-9.5
Capital, EUR million	267	200	205	204	114	5	288	-25.2	2.4	-0.3	-43.9	-95.6	5,569.8
Total profit/loss, EUR million	29	-33	-30	-19	-121	-266	-50	-215.3	10.9	34.8	-527.3	119.3	-81.1
ROA, %	0.6	-0.6	-0.5	-0.4	-2.4	-6.9	-1.5						
ROE, %	11.5	-14.2	-14.6	-9.4	-76.0	-5,228.7	-17.5						
Financial and operating liabilities, EUR million	5,314	5,427	5,179	4,843	4,681	3,729	3,061	2.1	-4.6	-6.5	-3.3	-20.4	-17.9
liabilities to banks and companies in group / total assets, %	95	96	95	95	97	97	88						
Investment property, EUR million	560	580	836	929	1,118	1,002	822	3.6	44.0	11.2	20.3	-10.3	-18.0
investment property / assets, %	10	10	15	18	23	26	24						
Finance expenses from impairments and write-downs of financial assets, EUR million	10	120	167	127	157	192	98						

Note: The figures from financial statements cover leasing companies included in reporting to the Bank of Slovenia (Bank of Slovenia figures for 2014, previously AJPES figures)

Sources: AJPES, Bank of Slovenia

## 8 MACRO-PRUDENTIAL SUPERVISION: MONITORING THE IMPACT OF INSTRUMENTS

The Bank of Slovenia has introduced two macro-prudential instruments to date. In March 2012, within the framework of the interim objective of limiting the systemic impact of misaligned incentives, it introduced an instrument to limit deposit rates. In June 2014, within the framework of the interim objective of mitigating and preventing excessive mismatching in maturity structure and illiquidity, it introduced the GLTDF.

### 8.1 GLTDF

#### 8.1.1 Definition

GLTDF is the ratio of the annual change in the gross stock of loans to the non-banking sector before impairments (gross loans to the non-banking sector) to the annual change in the stock of deposits by the non-banking sector. The instrument gives a bank the option of either meeting the GLTDF requirements, or increasing liquidity buffers.

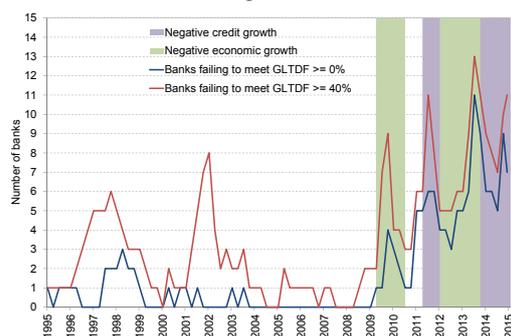
For banks with a positive annual inflow of deposits by the non-banking sector, meeting the minimum requirements would entail them not reducing lending. The minimum requirements place a lower limit on the pace of the decline in the LTD ratio for the non-banking sector. The bank must apply corrective measures should it fail to meet the minimum requirements for GLTDF. The first corrective measure defines stricter requirements for GLTDF<sub>q</sub> at the quarterly level, i.e. for banks with a positive quarterly increase in deposits the expectation is that the quarterly increase in loans to the non-banking sector will reach at least 40% of the increase in deposits by the non-banking sector, i.e.  $GLTDF_q \geq 40\%$ . The first corrective measure thus pushes the bank towards meeting the minimum requirements for GLTDF. The three remaining corrective measures relate to higher requirements with regard to liquidity ratios, and push the bank towards meeting the second-bucket liquidity ratio (LR2).<sup>53</sup> All the corrective measures cease to apply when the bank meets the minimum requirements for GLTDF. The banks first had to comply with the requirements of the regulation at the end of June 2014.

#### 8.1.2 Meeting of minimum requirements in 2014

Six banks failed to meet the minimum requirements at the end of June, five banks at the end of September, and nine banks at the end of December. Although the number of banks with a positive increase in loans was up at the end of 2014, as a result of a positive increase in deposits the number of banks that failed to meet the minimum requirements for GLTDF also increased. By the end of March 2015 the number of banks failing to meet the minimum requirements had fallen from nine to five, according to preliminary calculations. Four banks had to meet corrective measures of higher liquidity ratios in the first quarter of 2015. Because one of these banks began meeting the minimum requirements for GLTDF at the end of the first quarter, and is also recording positive growth in loans in the wake of a positive annual increase in deposits, all the corrective measures ceased to apply to it.

<sup>53</sup> The latter is the ratio of financial assets to financial liabilities with a residual maturity of more than 180 days, and must reach a value of at least 1 under the fourth corrective measure.

Figure 8.1: Number of banks failing to meet GLTDF  $\geq 0\%$  or GLTDF  $\geq 40\%$  in the wake of a positive annual increase in deposits



Source: Bank of Slovenia

### 8.1.3 Amendment of regulation

Under the original version of the instrument, stricter minimum requirements for GLTDF would apply as of the second quarter of 2015, i.e. GLTDF  $\geq 40\%$ , which means that banks would meet the minimum requirements if their annual increase in loans to the non-banking sector amounted to at least 40% of the increase in deposits by the non-banking sector. However, the Regulation on the minimum requirements for ensuring an adequate liquidity position at banks and savings banks (hereinafter: the regulation) was amended at the end of April, and thus the minimum requirements have not been tightened and remain at their previous level. The condition remains that banks with a positive increase in deposits may not reduce their lending, or have to meet higher liquidity ratios if they do reduce lending.

The amendment to the regulation was adopted for the purpose of ensuring that stricter minimum requirements for GLTDF would not limit the effectiveness of the ECB's non-standard measures, and ensuring that interference between the instruments of the two institutions would not pressure banks into taking up excessive risks. Credit growth remains negative, but the trend is reversing. The maintenance of the previous level of the minimum requirements for GLTDF makes it easier for banks to meet them, reduces the need to maintain high liquidity ratios, and gives extra opportunity to develop a more competitive deposit offer. The circumstances in which the banks are doing business have altered significantly. As a result of the ECB's non-standard measures, liquidity could be accessible at a favourable price, and after the recovery of the banking system the banks have high capital adequacy and excess liquidity, while the economic recovery is improving creditworthiness and credit demand. Should the economic recovery and the credit cycle prove to be stable, it is highly likely that it will soon be necessary to set the cap on the GLTDF. Some banks are already recording high growth in loans, which is an additional reason for the minimum requirements for GLTDF not to be tightened.

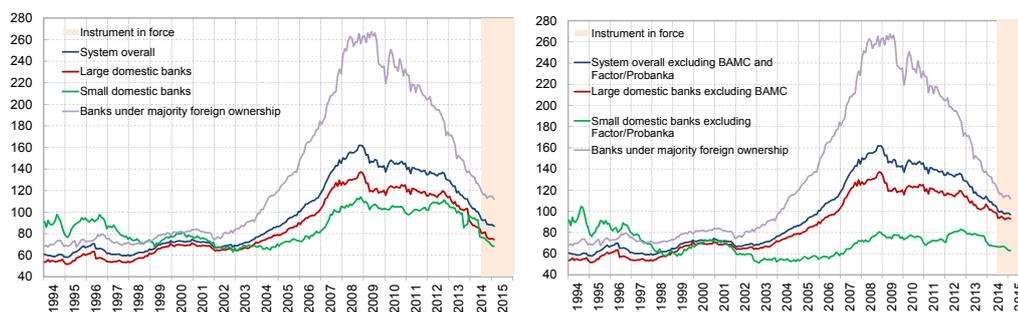
### 8.1.4 Review of the impact of the instrument

The degree to which three predetermined objectives of the instrument have been met and the developments in variables on which the instrument can have an impact on the basis of the anticipated transmission mechanism are examined below. However, the responses and effects of the illustrated variables cannot be ascribed solely to the introduction of GLTDF, as other factors, such as the bank recovery and resolution process, the economic recovery and the ECB's non-standard measures (TLTRO, QE, etc.), are also having an impact.

#### First objective: helping to slow the decline in the LTD ratio

**The decline in the LTD ratio has slowed.** The decline in the loan-to-deposit (LTD) ratio for the non-banking sector has slowed since the introduction of the instrument, having fluctuated around 88% over the fourth months to January, before falling to 87% in February. The banking system's LTD ratio declined by 19.7 percentage points in 2014, which was 90% of the decline in 2013. The LTD ratio declined by 5.3 percentage points over the six months to February 2015, 44% of the decline over the same period a year earlier. The decline in the LTD ratio slowed most at the banks under majority foreign ownership.

Figure 8.2: LTD ratio of banking system and bank groups (left) and excluding effects of recovery, i.e. excluding Factor banka and Probanka, and excluding the transfer of non-performing claims to the BAMC (right)



Source: Bank of Slovenia

Excluding the effects of bank recovery, the LTD ratio has stabilised. The recovery of the banking system (the transfer of non-performing claims from Abanka and Banka Celje to the BAMC and the orderly wind-down process at Factor banka and Probanka) again had a significant impact on developments in the LTD ratio in 2014. The exclusion of these effects reveals that the decline in the LTD ratio stopped entirely or slowed considerably after the introduction of the instrument, both at the level of the banking system and at individual bank groups.

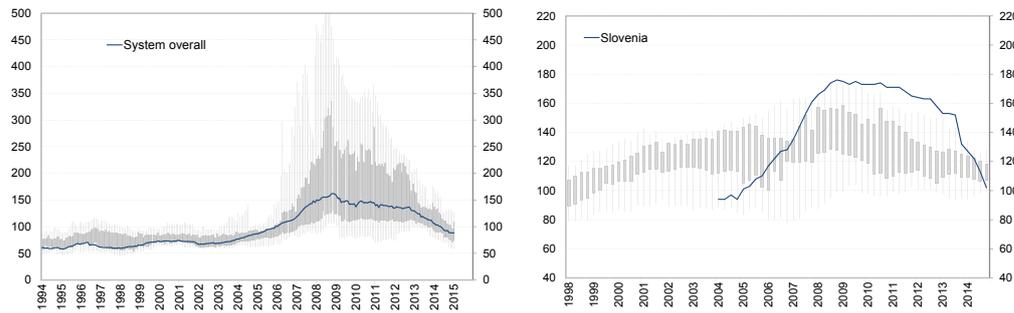
Table 8.1: Level and decline of LTD ratio of banking system and bank groups, basic indicator and excluding effects of recovery, i.e. excluding Factor banka and Probanka, and excluding the transfer of non-performing claims to the BAMC

	System overall		Large domestic banks		Small domestic banks		Banks under majority foreign ownership
	LTD	LTD excluding BAMC and Factor/Probanka	LTD	LTD excluding BAMC	LTD	LTD excluding Factor/Probanka	
1997	60.3	59.9	54.2	54.2	74.9	68.8	71.9
2004	86.9	86.6	79.0	79.0	70.4	54.5	119.2
2008	161.5	161.7	136.3	136.3	111.0	79.6	262.7
2012	129.8	128.7	113.6	113.6	107.7	81.2	174.4
2013	107.9	114.2	92.4	106.7	97.0	71.6	137.9
2014	88.2	98.3	75.0	93.4	70.4	64.5	114.8
Feb 2015	87.0	96.9	74.6	93.0	68.3	63.0	111.8
	Change, percentage points						
1997-2004	26.5	26.8	24.8	24.8	-4.5	-14.3	47.2
2004-2008	74.6	75.1	57.3	57.3	40.6	25.1	143.5
2008-2014	-73.2	-63.5	-61.3	-43.0	-40.6	-15.1	-147.9
2012-2013	-21.9	-14.6	-21.2	-6.9	-10.7	-9.5	-36.5
2013-2014	-19.7	-15.9	-17.3	-13.3	-26.7	-7.1	-23.1
Decline relative to previous year	90.2%	109.4%	81.8%	192.3%	249.4%	74.6%	63.2%
In last year							
Feb 13 - Feb 14	-23.1	-16.4	-22.6	-8.9	-10.2	-11.3	-38.3
Feb 14 - Feb 15	-16.3	-12.1	-13.0	-8.3	-25.7	-4.4	-21.2
Decline relative to previous year	70.3%	73.9%	57.7%	93.5%	251.2%	39.3%	55.5%
In last six months							
Aug 13 - Feb 14	-12.3	-5.6	-14.7	-1.0	-5.0	-10.2	-15.7
Aug 14 - Feb 15	-5.3	-2.4	-6.0	-1.0	-8.0	-3.2	-4.3
Decline relative to previous year	43.5%	44.0%	41.0%	96.2%	159.0%	31.4%	27.4%

Source: Bank of Slovenia

**The distribution of the banks has narrowed.** The differences between the banks in terms of the LTD ratio have diminished significantly, which has been reflected in a narrower distribution of banks, which has approached that of the pre-crisis period. The banking system's LTD ratio had also become low compared with other euro area countries.

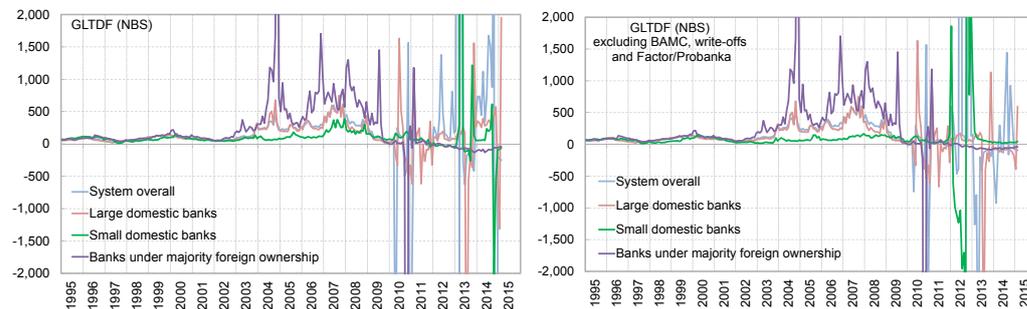
Figure 8.3: Distribution of LTD ratio of individual banks (left) and comparison of LTD ratio (loans before impairments excluding government sector) with distribution across other euro area countries (right) in terms of 20th/33rd/66th/80th percentile



Source: Bank of Slovenia

**GLTDF is becoming more stable at the small domestic banks and the banks under majority foreign ownership.** GLTDF is also showing signs of stabilisation. It is most pronounced at the banks under majority foreign ownership, where the trend has reversed. The indicator remains volatile at the small domestic banks and large domestic banks, although part of the volatility is attributable to measures related to bank recovery. At the small domestic banks excluding Factor banka and Probanka and excluding the exemptions related to the transfer of non-performing claims to the BAMC and write-offs, GLTDF has been increasing since August 2014. It reached 40% in February 2015. The indicator remains volatile at the large domestic banks, even excluding the exemptions.

Figure 8.4 GLTDF of banking system and bank groups (left) and excluding Factor banka and Probanka and exemptions related to the transfer of non-performing claims to the BAMC and write-offs (right)



Source: Bank of Slovenia

### Sustainability of current level of LTD ratio and GLTDF

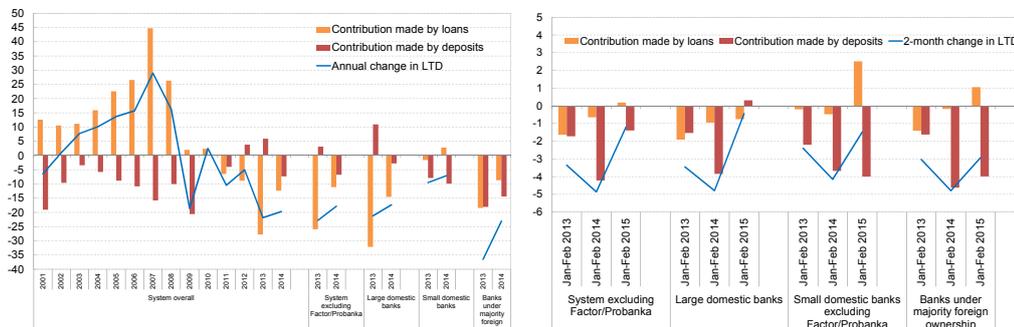
The purpose of the instrument was not to prevent a decline in the LTD ratio, but primarily to slow the pace of the decline. A declining LTD ratio contributes to the stability of bank performance, if it is indicative of reduced dependency on wholesale funding and a higher proportion of stable funding such as deposits by the non-banking sector, in particular household deposits. The decline in the LTD ratio should therefore be based on an increase in deposits, and not on a contraction in lending.

**With the re-establishment of a functioning financial intermediation process, the contribution to the change in the LTD ratio made by loans has become positive, and the contribution made by deposits has become negative as the stock increases.** After 2012 and 2013, when the banks lost deposits and reduced lending to the non-banking sector, the stock of deposits began increasing in 2014, although loans were still declining sharply as a result of the additional transfers to the BAMC. The contribution made by loans also began to increase over the first two months of 2015.

**The contribution made by loans to the change in the LTD ratio has become sharply positive at the small domestic banks, followed by the banks under majority foreign ownership.** The small domestic banks and savings banks are recording significantly higher growth in loans to the non-banking sector than the other bank groups. At the large domestic banks a functioning financial intermediation process has not yet been re-

established: this bank group has again seen a decline in the stock of non-banking sector deposits and loans in early 2015.

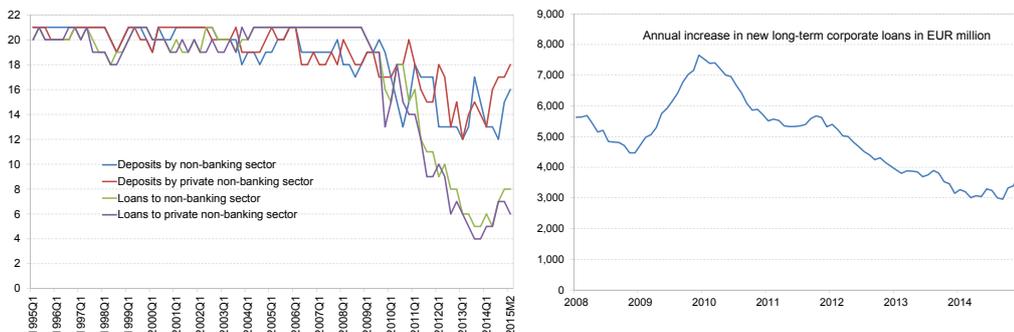
Figure 8.5: Annual changes in the LTD ratio (left) and changes in the first two months of the year (right) and contribution of individual components of loans to or deposits by the non-banking sector to the change in the LTD ratio for the banking system and the bank groups



Source: Bank of Slovenia

A reversal in the trends in bank performance is evident, which is reducing the need for the additional tightening of the minimum requirements for GLTDF. The number of banks with a positive increase in deposits by the non-banking sector rose in late 2014 and early 2015, as did the number of banks with a positive increase in loans. In addition to the contributions made by the components to the change in the LTD ratio, which are normalising, higher growth in loans and deposits, and an increase in new long-term corporate loans and housing loans, according to surveys credit demand is also increasing, which is being confirmed by increased inflows of corporate funding from the rest of the world and from capital markets. The banks have begun to reduce their lending rates more sharply. These factors suggest that the business conditions of the banking system are improving, for which reason the additional tightening of the minimum requirements for GLTDF is not necessary, and the maintenance of the existing requirements is giving support to the current developments in the LTD ratio.

Figure 8.6: Number of banks with a positive annual increase in loans to or deposits by the non-banking sector and loans to and deposits by the private non-banking sector (left) and annual increase in new long-term corporate loans (right)



Source: Bank of Slovenia

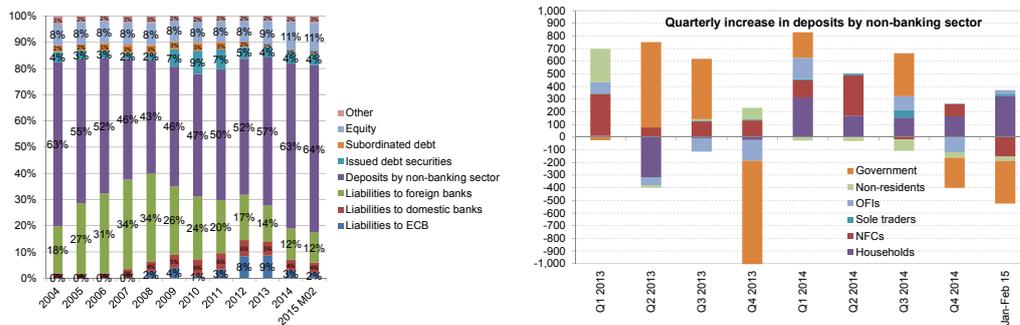
**Second objective: stabilising funding structure**

**The funding structure has not yet stabilised.** During the period of the financial crisis, i.e. as of 2008, the funding structure became very unstable. The proportion of total liabilities accounted for by deposits by the non-banking sector across the banking system increased by 20 percentage points over six years, while the proportion accounted for by liabilities to foreign banks declined by slightly more over the same period, 22 percentage points. Within deposits by the non-banking sector, which account for almost two-thirds of the banking system’s total liabilities, the proportion accounted for by sight deposits, which account for half of all deposits by the non-banking sector, increased sharply.

**It is however notable that the funding structure is moving in the direction of greater stability.** In terms of the proportions of deposits and wholesale funding, the structure of the liability side of the balance sheet became comparable to the structure of the banking system’s funding in 2004, i.e. at the time that Slovenia was just joining the EU, and the

accumulation of the systemic risks of excessive credit growth and leverage was yet to take place. Compared with 2004, the banking system has a higher ratio of equity to total liabilities and a more diversified structure of wholesale funding (liabilities to domestic and foreign banks and to the ECB). The proportion of deposits by the non-banking sector accounted for by long-term deposits is double the figure during the pre-crisis period. The overall outflows of government deposits in the recent period have reflected the banks' diminishing dependence on government deposits. At the same time the quarterly increase in household deposits stabilised at around EUR 150 million in 2014, while the increase strengthened further to exceed EUR 300 million over the first two months of 2015.

Figure 8.7: Percentage breakdown of the banking system's liabilities (left) and breakdown of quarterly increase in deposits by sector in EUR million (right)

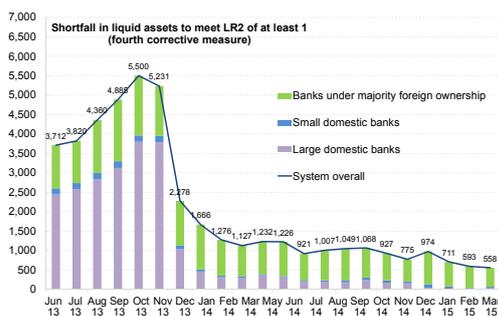


Source: Bank of Slovenia

### Third objective: reducing systemic liquidity risk in funding (LR2)

The banks sharply reduced the shortfall in liquid investments to meet the LR2. The LR2 improved throughout 2014 and early 2015. At the time of the definition of the instrument (October 2013), the shortfall in liquid investments for all banks (excluding Factor banka and Probanka) to meet the second-bucket liquidity ratio (LR2) amounted to EUR 5.5 billion. After the measures in late 2013, the shortfall in liquid investments narrowed to EUR 2.3 billion. The banks were first notified of the introduction of the GLTDF in early December 2013, and by the time of the introduction of the instrument in June 2014 had reduced the shortfall in liquid investments to meet the LR2 by a further EUR 1.4 billion to EUR 921 million. The shortfall in liquid investments to meet the LR2 had further declined by just under EUR 400 million to EUR 560 million by March 2015.

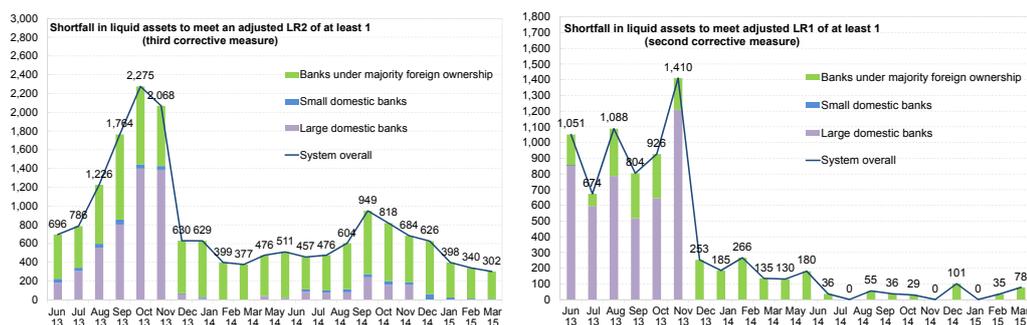
Figure 8.8: Shortfall in liquid investments to meet the fourth corrective measure (LR2) by bank group, in EUR million



Source: Bank of Slovenia

The shortfall in liquid investments to meet the third corrective measure (adjusted LR2) declined to EUR 300 million, while the shortfall to meet the second corrective measure (adjusted LR1) is fluctuating around EUR 100 million. On account of the 3-year LTRO, the residual maturity of which fell below 180 days, in September 2014 the shortfall in liquid investments for all the banks to meet the second-bucket liquidity ratio taking account of the pledged amount of the pool of eligible collateral at the Bank of Slovenia (the adjusted LR2) within the framework of the third corrective measure increased to EUR 950 million. However, by making early repayments of the LTRO the banks had reduced the shortfall in liquid assets to meet the adjusted LR2 to the previous level by the end of the year, and had halved it to EUR 300 million by March 2015.

Figure 8.9: Shortfall in liquid investments to meet the third corrective measure, the adjusted LR2 (left) and the second corrective measure, the adjusted LR1 (right) by bank group, EUR million



Source: Bank of Slovenia

**On the basis of an evaluation of the impact of the instrument, it is assessed that it is important that the instrument remain in force in the future, while additional tightening of the minimum requirements for GLTDF is not necessary.** The instrument is achieving the objectives set. The LTD ratio and funding structure are stabilising. At the same time the banks have sharply increased liquidity buffers (the second-bucket liquidity ratio), while the inflow of alternative financing has strengthened at corporates, which is reducing the systemic liquidity risk of funding. A reversal is evident in the trend in the banks' lending activity, although credit growth remains negative at the level of the banking system. For the process of the recovery of the banking system to continue along its planned path, it is important that the GLTDF instrument remain in force. Because the recovery of lending activity has begun, there is no need for it to be accelerated by tightening the minimum requirements for GLTDF.

## 8.2 Limits on deposit rates

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

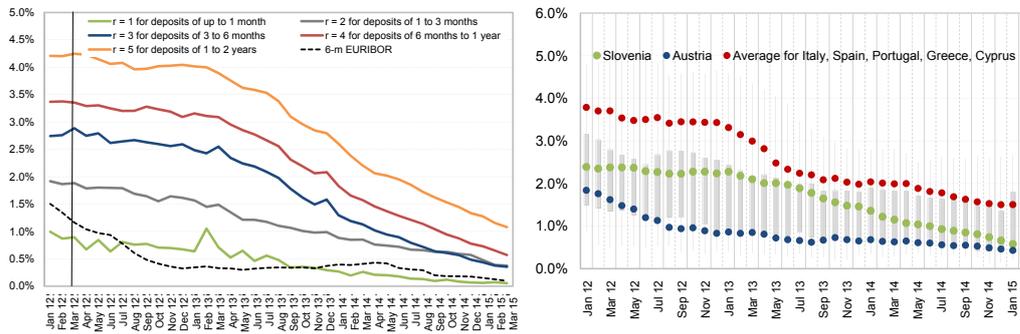
### 8.2.1 Reason for the introduction of the instrument and its objectives

The reason for the introduction of the instrument was the competition between banks for deposits by the non-banking sector by raising deposit rates in 2011 and 2012. The competition between banks was the result of the hindered access to the financial markets by the banks under majority domestic ownership, and the need to reduce the LTD ratio at the banks under majority foreign ownership. The nominal value of deposits by the private non-banking sector, remained at the level of EUR 20 billion in 2011 and 2012, and did not record any significant changes. The rise in deposit rates thus had no significant impact in the form of an increase in the stock of deposits, but to a great extent merely had an impact on deposit switching between banks and a rise in the banks' funding costs.

The objective of the instrument was to limit the excessive raising of liability interest rates on deposits by the private non-banking sector. However, the instrument does not prevent banks from raising interest rates above the ceiling; it merely imposes increased capital requirements for income risk according to the ICAAP-SREP process should they do so.

The methodology for calculating the add-on to risk-based capital requirements was approved at the 458th meeting of the Governing Board of the Bank of Slovenia on 28 February 2012. The add-on to capital requirements for profitability risk from liability interest rates has been taken into account within the framework of the internal capital adequacy assessment process since March 2012. For a detailed description of the methodology, see the Financial Stability Review, May 2014 (p 38).

Figure 8.10: Average interest rates on deposits at Slovenian banks and savings banks (excluding bank branches) by five maturity buckets<sup>54</sup> (left), and distribution of interest rates on deposits by households and non-profit institutions serving households with a maturity of up to 1 year in the euro area<sup>55</sup> (right), January 2012 to March 2015 in percentages

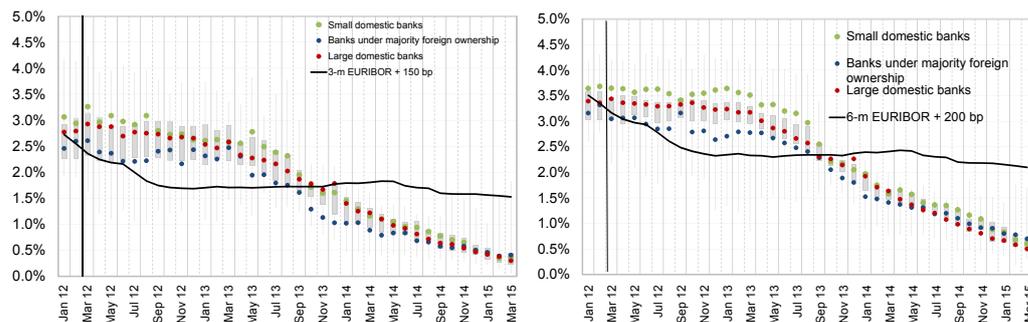


Sources: Bank of Slovenia, Statistical Data Warehouse

### 8.2.2 Effects of the instrument

In 2013 the banks began cutting the interest rates on deposits of all maturity buckets that are subject to the instrument. The trend of falling interest rates has continued in early 2015. The average interest rate on deposits that are subject to the instrument declined by 2 percentage points between January 2013 and March 2015. All the banks reduced their interest rates over the aforementioned period: the largest reduction of 2.4 percentage points was at the small domestic banks, while the smallest reduction of 1.7 percentage points was at the banks under majority foreign ownership. There has also been a significant narrowing of the distribution of interest rates on deposits of all maturity buckets since the second half of 2013, which indicates diminishing competition between the banks with regard to the setting of liability interest rates. Since the beginning of 2014 the ratio of interest rates on deposits at commercial banks to the ceiling stipulated by the instrument has not entailed any constraint on banks in their adjustment of interest rates on deposits. The ceiling is significantly above current interest rates, and is thus not constraining the banks in adjusting deposit rates with regard to their business policies.

Figure 8.11: Distribution of interest rates on deposits of 3 to 6 months (left) and 6 months to 1 year (right) at Slovenian banks excluding branches and ceiling on maturity bucket (average daily EURIBOR plus premium), January 2012 to March 2015, in percentages



Source: Bank of Slovenia

A comparison of the average liability interest rates in Slovenia with the average liability interest rates across the euro area reveals that average interest rates on household deposits in Slovenia fell much more sharply than in other countries. By March 2015 the average interest rate on household deposits of up to 1 year was just 0.1 percentage points above the corresponding rate in Austria, the spread having stood at 0.5 percentage point a year earlier. The spread on deposits of 1 to 2 years narrowed from 1.3 percentage points in March 2014 to

<sup>54</sup> r = 1 for deposits with a maturity of up to 1 month; r = 2 for deposits with a maturity of 1 to 3 months; r = 3 for deposits with a maturity of 3 to 6 months; r = 4 for deposits with a maturity of 6 months to 1 year; r = 5 for deposits with a maturity of 1 to 2 years.

<sup>55</sup> Austria, Belgium, Cyprus, Germany, Estonia, Spain, Finland, France, Greece, Italy, Luxembourg, Latvia, Lithuania, Malta, Netherlands, Portugal, Slovenia and Slovakia.

0.7 percentage points in March 2015. Although average interest rates on corporate deposits of 1 to 2 years are falling, they remain among the highest in the euro area.

The fall in liability interest rates is attributable to the fall in reference market interest rates. The EURIBOR fell significantly on all maturities after the outbreak of the crisis. The 3-month EURIBOR has averaged just 0.27% over the last three years, while the 6-month EURIBOR has averaged 0.41%. The aforementioned reference interest rates were fell by 4.4 percentage points between 2008 and 2014. Another factor in the fall in interest rates was the favourable liquidity in the euro area money market.

In light of the above, it can be concluded that the instrument has contributed to a reduction in deposit rates, although it is assessed that measures aimed at the stabilisation and recovery of the banks and the ECB's non-standard monetary policy measures played the main role in the lowering of deposit rates.

## 9 FINANCIAL INFRASTRUCTURE

### 9.1 Payment systems

Given the size of its total transaction value and its role in providing liquidity for the banking system, the TARGET2-Slovenija system is an important payment system for financial stability in Slovenia. As the national component of the centralised pan-European payment system for individual (gross) settlement of euro payments in real time (TARGET2), it is operated by the Bank of Slovenia. TARGET2 is technologically set up as a single shared platform of the Eurosystem, and thus central bank oversight of the system's functioning and administration is centralised under the aegis of the ECB. Because certain activities in the operation of this payment system are carried out at national level alone, the Bank of Slovenia conducts additional oversight of the administration of the Slovenian component. TARGET2 operated without disruptions and major deviations again in 2014, and its availability was 100%.

The development of the functionality of the TARGET2 payment system continued in 2014 within the framework of Eurosystem activities. A backup network was established, and allows for the transmission of data and the processing of critical payments in the payment system even when the basic network (SWIFT) is inoperable. The constant monitoring of payment flows and changes in the available liquid funds of individual payment system participants by the Bank of Slovenia must also be established within the TARGET2-Slovenija payment system with the aim of identifying potential technical and/or liquidity problems of participants that could disrupt the functioning of the payment system.

Due to the large number of transactions processed daily, the SEPA internal credit transfer (SEPA ICT) payment system operated by Bankart d.o.o. is also important for Slovenia. The system is designed to process retail credit transfers (up to EUR 50,000) in line with the rules of the single euro payments area (SEPA). It functions according to the principles of calculating an individual participant's net claims or net liabilities in the payment system vis-à-vis other participants. The Settlement Guarantee Scheme, which was set up to manage financial risk in the payment system in the event of a participant's inability to settle its liabilities, was again not activated in 2014. The Bank of Slovenia regularly monitored changes in the volume of payments in the SEPA ICT payment system and events that could affect the security and efficiency of the system's functioning. No increases in risk were identified in 2014.

**The TARGET2 payment system's availability was 100% in 2014.**

**A backup network was established to support the functioning of the TARGET2 payment system.**

**The Bank of Slovenia regularly monitors the liquidity of TARGET2-Slovenija participants.**

Table 9.1: Value and number of transactions in the TARGET2 and SEPA ICT payment systems

	Annual					Year-on-year growth, %				
	2010	2011	2012	2013	2014	2010	2011	2012	2013	2014
<b>TARGET2<sup>1</sup></b>										
value, EUR billion	530.1	501.0	642.3	521.0	563.5	4.4	-5.5	28.2	-18.9	8.2
number of transactions, million	0.65	0.65	0.59	0.55	0.54	-3.0	-0.2	-9.0	-6.9	-2.2
<b>SEPA ICT</b>										
value, EUR billion	45.4	46.7	52.0	54.9	56.6	1.2	2.9	11.2	5.6	3.1
number of transactions, million	56.13	64.92	115.96	121.30	122.98	1.8	15.7	78.6	4.6	1.4

Note: <sup>1</sup>Transactions between participants in the TARGET2-Slovenija system (domestic payments).

Source: Bank of Slovenia

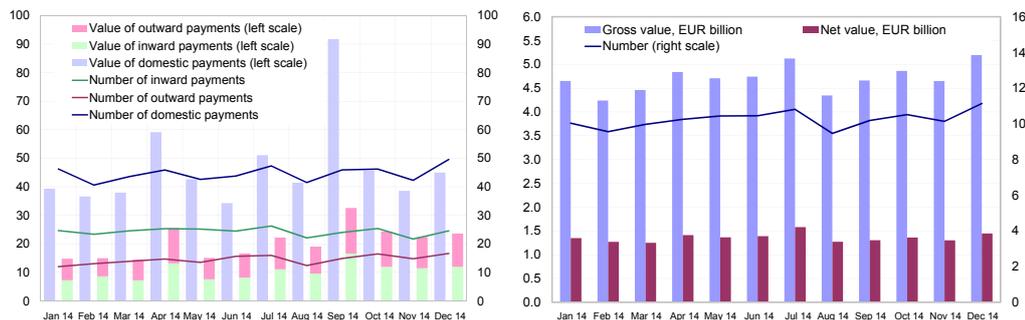
The value of transactions in the TARGET2-Slovenija payment system was up in 2014 but the number of transactions was down, while the number and value of transactions in the SEPA ICT payment system were up. The total value of transactions in the TARGET2-Slovenija and SEPA ICT systems were 15.1 and 1.5 times Slovenia's GDP respectively in 2014.

The increase in the value of transactions in the TARGET2-Slovenija system in September was attributable to a large increase in the average value of transactions from the inward and outward payment of government deposits with participants.

The TARGET2-Slovenija system also facilitates cross-border transactions and thus gives rise to the cross-border transfer of risks, although the volume of these transactions is lower relative to the settlement of domestic payments.

**The increase in the value of transactions in the TARGET2-Slovenija system in September was attributable to a large increase in the average value of transactions from the inward and outward payment of government deposits with participants.**

Figure 9.1: TARGET2-Slovenija: domestic and cross-border payments; value in EUR billion (left axis) and the number in thousand (right axis) and SEPA ICT: value in EUR billion (left axis) and the number in million (right axis)

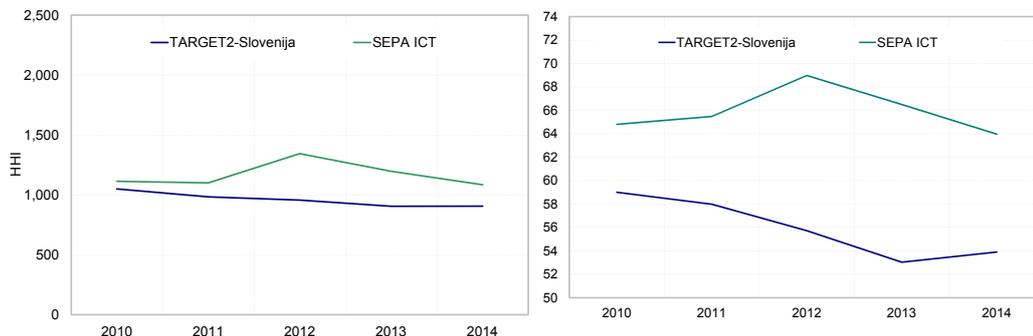


Sources: Bank of Slovenia, Bankart d.o.o.

**There was no significant change in exposure to systemic risk from participation in payment systems in 2014.**

The concentration of the number of transactions by participant as illustrated by the Herfindahl-Hirschman index is an indicator of systemic risk in the payment system. The index of concentration and the share of the five largest participants in the SEPA ICT system declined compared with 2013, while the figures increased slightly in the TARGET2-Slovenija system. There was no significant change in the Slovenian banking environment's exposure to systemic risk from participation in payment systems in 2014. Here it should be noted that systemic risk in the settlement of interbank payments is concentrated in the TARGET2-Slovenija payment system due to the separation of large-value payments from retail payments.

Figure 9.2: Concentration of the number of transactions in the TARGET2-Slovenija and SEPA ICT systems (Herfindahl-Hirschman Index; left) and proportion of total number of transactions accounted for by the five largest participants excluding the Bank of Slovenia (right)



Source: Bank of Slovenia

**9.2 Securities clearing and settlement systems**

**The first comprehensive assessment of the securities settlement system operated by the CSCC has been completed.**

The services of securities clearing and settlement in Slovenia are provided by the Central Securities Clearing Corporation (CSCC), a systemically important institution in the post-trading segment of the securities market that provides for the issuance of securities, the administration of share registers and the management of security holders' accounts. The CSCC also operates a settlement system to settle securities transactions concluded at the Ljubljana Stock Exchange, and to settle transactions concluded outside the regulated market in accordance with the principles of delivery versus payment or delivery free of payment. The Bank of Slovenia also uses this mechanism for collateral in Eurosystem central bank credit operations. In relation to the CSCC the Bank of Slovenia acts as (1) the oversight authority of the securities settlement system operated by the CSCC with the aim of preventing systemic risk arising in the settlement system itself, and (2) a participant in the system with the aim of smoothly managing collateral for Eurosystem central bank credit operations.

As the oversight authority for securities settlement systems, the Bank of Slovenia's activities in 2014 focused on the regular monitoring of changes in the functioning of the CSCC and an assessment of the security and reliability of the functioning of the securities settlement system operated by the CSCC in accordance with Eurosystem oversight standards. With

regard to the regular monitoring of changes in the functioning of the CSCC, within the framework of consultations with the SMA referenced 34.00-0075/15-TK and in accordance with the ZTFI the Bank of Slovenia issued an opinion relating to amendments to the CSCC's rules.

The first comprehensive assessment of the securities settlement system operated by the CSCC with regard to the security and reliability of its functioning was completed in March 2014. It was found that its functioning was regulated in a manner that largely complies with the Bank of Slovenia's oversight requirements, but the CSCC was also issued with recommendations to improve the security and reliability of functioning. On this basis the CSCC took specific measures in 2014 to improve the security and reliability of the functioning of the securities settlement system, and informed the Bank of Slovenia accordingly. The assessment of the CSCC was conducted in conjunction with the SMA, which examined the CSCC's operations in accordance with the ZTFI and the ZNVP. In 2014 the CSCC again functioned without notable deviations from its established schedule of operation. The guarantee fund, which the CSCC would use in the event of participants encountering liquidity problems in the settlement of stock exchange transactions, was not activated during the year.

Furthermore, the Bank of Slovenia specifically assesses the security, reliability and schedule of operation of the securities settlement system with the aim of ensuring uninterrupted collateral management for its own credit operations and those of other Eurosystem central banks. In accordance with the Statute of the ESCB, these operations must be fully secured by means of eligible collateral, including securities registered at the CSCC, to which other Eurosystem central banks have access by means of the correspondent central banking model (CCBM) or via the CSCC's cross-border links with foreign securities settlement systems. For this reason the Bank of Slovenia periodically assesses the compliance of the functioning of the securities settlement system operated by the CSCC with Eurosystem reference standards drawn up from the perspective of central banks as users of central securities depositories' services. In 2014, in conjunction with the ECB, the Bank of Slovenia drew up a (positive) assessment of the securities settlement system operated by the CSCC and the CSCC's cross-border links with foreign securities settlement systems operated by the central securities depositories LuxCSD, Clearstream Banking Luxembourg, Clearstream Banking Frankfurt and Euroclear Bank.

Slovenian banks and savings banks pledged a monthly average of EUR 2,536 million in eligible securities registered at the CSCC as collateral in 2014, down 10.35% on 2013. The use of this form of eligible collateral (which also includes bank loans and cash deposits) remains extensive, its value fluctuating in 2014 between a low of EUR 2,109 million in October and a high of EUR 2,716 million in March. Foreign banks' interest in using securities registered at the CSCC waned in 2014. The average monthly value of Slovenian securities used as collateral for the credit operations of other Eurosystem central banks via the CCBM declined by 27.12% in 2014 to EUR 182.55 million.

**The Bank of Slovenia monitors risk management in the securities settlement system, including from the perspective of collateral management for ESCB central bank credit operations.**

**The use of eligible securities registered with the CSCC as collateral for Eurosystem credit operations remains at a high level.**