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FINANCIAL STABILITY
AND MACRO-PRUDENTIAL POLICY

STABILITY OF THE SLOVENIAN BANKING SYSTEM

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The December 2015 Stability of the Slovenian Banking System is based on figures and information available by mid-December 2014, except where stated otherwise.

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

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1 SYNTHETIC OVERVIEW OF RISKS IN THE BANKING SYSTEM

The bank recovery and resolution process begun in 2013 has contributed to a significant reduction in risk in the banking system. The banks continued the process of balance sheet contraction last year, despite the improvement in the domestic macroeconomic situation. This was conditioned on the liability side of the balance sheet by a fifth consecutive year of net repayments of liabilities on the wholesale markets, albeit at a significantly slower pace than in 2013, and by the early repayment of liabilities to the Eurosystem. On the other side growth in loans to non-financial corporations remains sharply negative, although there are signs of a gradual stabilisation. The reasons for last year's contraction in corporate loans were more or less unchanged from 2013: the relatively high leverage in the corporate sector was reduced very slowly and limited creditworthy demand, and the banks remained reluctant to take up additional credit risk with tightened credit standards, despite the improvement in capital adequacy ratios. The structure of bank funding likewise remains unstable, and will be adjusted further in the year ahead. The improvement in the macroeconomic situation in 2014 helped ease the corporate financial recovery, with the anticipated further revival of the business cycle. However, this will only be reflected in the financial cycle gradually and with a lag, even though it is increased credit growth that would have the most beneficial impact on bank performance and on an improvement in the quality of the credit portfolio. In the wake of the pronounced improvement in capital adequacy after the measures of December 2013, it should be noted that the maintenance and improvement of capital adequacy relies primarily on a reduction in lending activity and adjustments to the risk structure of bank investments, and the corresponding decline in capital requirements. More so than growth in capital, additional requirements to increase capital adequacy could result in a further contraction in loans and thus a renewed deterioration in the quality of the banks' credit portfolio. Credit risk remains high and very significant, although the resolution of non-performing claims is stabilising the situation. There needs to be a focus on the banks' income risk, which is increasing in an environment of low interest rates, contracting balance sheets, aversion to the take-up of credit risk and increased corporate financing in the rest of the world. Refinancing risk and macroeconomic risk are declining for the banks.

Credit risk remains high but is gradually stabilising. Non-performing claims (classified claims more than 90 days in arrears) rose during the first months of the year, but subsequently stabilised. They rose again in September and fluctuated downwards in October. The proportion of non-performing claims declined by 2.5 percentage points in October to 13.2% as a result of the transfer of claims from Abanka to the BAMC, although the figure fluctuated downwards even without the effect of the transfer. Non-performing claims also declined in absolute terms in 2014 in the corporate sector in particular, although the contraction in bank lending activity meant that this was not reflected in an improvement in the quality of the credit portfolio. A declining trend has been seen in accommodation and food service activities and in transportation since the beginning of 2014. The instability of non-performing claims and the upward fluctuations suggest that the risk of a further deterioration in the banks' credit portfolio remains high. The quality of the credit portfolio of non-residents is notably low: it was not subject to resolution via transfer to the BAMC, and is dependent on the economic recovery in the countries of the western Balkans in particular. The persistence of the financial crisis is increasing the likelihood of non-performing claims spreading to new sectors of the economy. Three sectors accounted for 82% of total non-performing claims as late as 2012, while concentration was down in 2014 when five sectors accounted for 93% of the total. The proportion of non-performing claims accounted for by SMEs was up last year to stand at 39% of total non-performing claims against corporates. This indicates the urgency of more active measures by the banks themselves to resolve non-performing claims by means of sale, faster write-offs, etc., and greater risk segmentation of borrowers in the approval of new loans.

Activity in corporate restructuring and the adoption of measures to further reduce non-performing claims at the banks could significantly contribute to the management of credit risk and an improvement in the quality of bank investments. The deleveraging and restructuring of over-indebted corporates is proceeding slowly. December's Bank of Slovenia guidelines for the creation of impairments and provisions for claims against corporates with which a master restructuring agreement has been concluded were adopted for the purpose of speeding up corporate restructuring and more actively including the banks in these processes.

A recovery in economic activity could contribute to improvement in corporates' financial position, liquidity and operating results. Increased lending activity would contribute to the improved quality of bank investments. However, the level of corporate indebtedness and under-capitalisation (as measured by leverage) is relatively high, while maintaining tightened credit standards acts to limit new credit growth. The deepening of the decline in corporate loans came to a halt in 2014. The aforementioned loans were down 30% in year-on-year terms over the first ten months of the year, or by 11% excluding the effects of measures to stabilise the banking system. The most recent survey figures (BLS) show that (estimated) corporate demand for loans increased in 2014 after a long period of decline, and that the banks' credit standards are not being tightened further, which is increasing the likelihood that the contraction in loans to non-financial corporations will begin to slow in the upcoming period. Negative growth in consumer loans to households also persists, while year-on-year growth in housing loans stood at 1.3% in October 2014. Loans to households remain the least risky segment of the banks' credit portfolio and, in the context of rising consumer confidence, represent a potential source for improving the quality of the banks' overall credit portfolio.

Income risk is rising. Given the high realisation of credit risk, there is a high likelihood of the additional creation of impairments and provisions, and consequently a rise in income risk at the banks. Income risk is on the rise despite an improvement in performance and a higher net interest margin. Although the banks' net interest income was up 11% in year-on-year terms over the first ten months of the year, interest income has been adversely affected by the contraction in loans. An environment of low interest rates and the question of whether the banks will be able to generate sufficient income to cover operating costs and impairment costs place additional pressure on the banks' income risk. The effect of cuts in reference interest rates is passed through primarily to the banks' deposit rates, while lending rates on new transactions are declining very slowly. The retention of high spreads over average euro area interest rates is encouraging creditworthy customers to seek financing in the rest of the world, and could result in the loss of a source of bank income over the longer term.

A policy of aversion to take up credit risks is refocusing the banks on less risky, but less profitable investments. The proportion of the banks' total assets accounted for by securities has risen to stand at 24% in October 2014. The banks' greater focus on government bonds is additionally increasing income risk on account of potential sovereign downgradings or a renewed loss of confidence on the international financial markets in the more vulnerable countries of the euro area.

Refinancing risk declined in 2014 as debt repayments to the rest of the world were intensified. Most banks, particularly those under majority domestic ownership, have already repaid the majority of their debt raised on the wholesale markets. The restoration of confidence in the domestic banks has seen household deposits returning to the banking system. This positive development was particularly notable at the large domestic banks, which in 2013 had seen the largest fall in savers' confidence and decline in household deposits. The banks will remain exposed to the risk of a less-stable funding structure as a result of the projected low rates of growth in household deposits over the next two years.

Expected moderate growth in wages in the context of a slight increase household spending, declining deposit rates and households' renewed interest in alternative forms of investment indicate that growth in deposits will be modest in the future. ECB policy indicates that the funding it provides continues to be a sufficient source of liquidity. However, the banks' perception regarding the sufficiency of creditworthy demand and the stability of other sources of funding continues to hinder the placement of such funding in corporate loans.

Macroeconomic risk: the strengthening of economic growth, largely as a result of the favourable dynamics in exports, and the improvement in the situation on the labour market have brought an improvement in the macroeconomic situation in Slovenia, while the banks are seeing a decline in macroeconomic risks. There nevertheless remains a risk of lower-than-forecast GDP growth, as a result of the uncertain economic recovery in certain euro area countries and the potential rise in geopolitical tensions in Ukraine and the Middle East. Domestic economic growth remains primarily based on foreign demand, which could lose momentum, given the uncertainty of the economic recovery in key trading partners. In 2014 households maintained their financial surplus at the level of the end of the previous year, having slightly increased their consumption as income has risen and indebtedness has declined. In a situation of favourable growth in the export sector and deleveraging of the economy, the current account surplus is being reflected in high net saving by the private sector.

Table 1.1: Overview of risks in the Slovenian banking system

Systemic risk	Risk assessment for H1 2014	H2 2014	Trend of change in risk	Comment
Macroeconomic risk			↓	Better-than-expected economic recovery, primarily on account of exports in the content of increased foreign demand; high level of investment in the infrastructure; improving conditions on the labour market despite persistently high unemployment.
Credit risk			→	Continuing increase in the proportion of non-performing claims; low quality of the credit portfolio of non-residents; contraction in lending.
Financing risk			↓	Slower but still rapid decline in the LTD ratio; large portion of liabilities from LTROs repaid; high liquidity ratios and proportion of the pool of eligible collateral that is free; sufficient liquidity, but structural funding remains unstable.
Contagion risk and large exposure			→	Contagion risk has declined in the recent period, both in terms of size and in terms of the number of possible transmissions of contagion. The fall was the result of a decline in net classified claims between banks. Large exposure to the government and sovereign ratings.
Solvency risk			→	Government-funded recapitalisation of banks at the end of 2013. Urgent need for owners with strong capital backing.
Income risk			↑	Contraction in balance sheets and persistently high impairment costs; negative or very low interest rates, increased corporate financing in the rest of the world and on the capital markets; the increase in lower-risk and less profitable investments is the result of increased aversion to take up credit risk.

Colour coding:

Note: The Bank of Slovenia is developing its *Overview of risks*, which focuses primarily on the banking system with the aim of providing information on systemic risks and vulnerabilities in the banking system based on quantitative indicators. It includes indicators that illustrate the development of key banking and macroeconomic risks. The levels of risk for each individual risk are presented in the table.

2 ECONOMIC TRENDS AND THE MACROECONOMIC ENVIRONMENT

The relatively high economic growth over the first three quarters of 2014 is primarily the result of an increase in net exports and investment.

The recovery in economic activity continued over the first three quarters of 2014, wherein foreign demand and gross investment contributed the most. The latter was to a large extent the result of an increase in investment in the infrastructure, particularly at the local level, which was in part financed by EU funds. Exports also made their traditionally significant contribution to GDP growth as the result of solid foreign demand and Slovenia's improved cost competitiveness. Imports also continue to strengthen, which alongside the cooling of the economies of major trading partners could reduce the contribution of net export to GDP growth in the final quarter of 2014 and in 2015. The above described economic trends significantly reduce macroeconomic risks for the financial system.

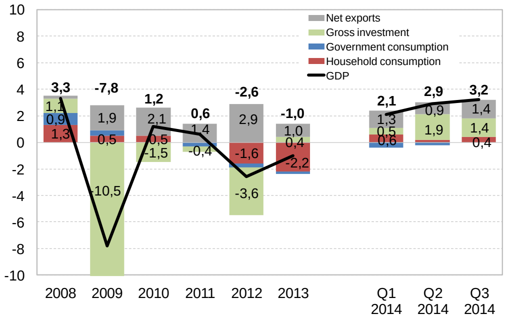
Table 2.1: European Commission's autumn 2014 forecasts of major macroeconomic indicators for Slovenia's main trading partners

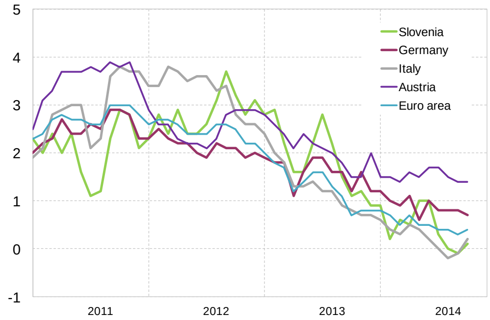
	Real GDP				Unemployment rate				Inflation			
	2013	2014*	2015*	2016*	2013	2014*	2015*	2016*	2013	2014*	2015*	2016*
EU	0,0	1,3	1,5	2,0	10,8	10,3	10,0	9,5	1,5	0,6	1,0	1,6
Euro area	-0,5	0,8	1,1	1,7	11,9	11,6	11,3	10,8	1,4	0,5	0,8	1,5
Germany	0,1	1,3	1,1	1,8	5,3	5,1	5,1	4,8	1,6	0,9	1,2	1,6
Italy	-1,9	-0,4	0,6	1,1	12,2	12,6	12,6	12,4	1,3	0,2	0,5	2,0
Austria	0,2	0,7	1,2	1,5	4,9	5,3	5,4	5,0	2,1	1,5	1,7	1,8
France	0,3	0,3	0,7	1,5	10,3	10,4	10,4	10,2	1,0	0,6	0,7	1,1
Croatia	-0,9	-0,7	0,2	1,1	17,3	17,7	17,7	17,3	2,3	0,2	0,6	1,1
Slovenia	-1,0	2,4	1,7	2,5	10,1	9,8	9,2	8,4	1,9	0,4	1,0	1,5

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

Economic growth has strengthened, despite continuing fiscal consolidation, and has had the positive effect of a reduction in the number of unemployed. According to expectations, the latter will be seen in an increase in household consumption, which will mitigate certain internal and external risks somewhat in the future.

Figure 2.1: Year-on-year growth in GDP in percentages and contributions by components of consumption to GDP growth in percentage points (left) and year-on-year growth in inflation as measured by the HICP in percentages (right)



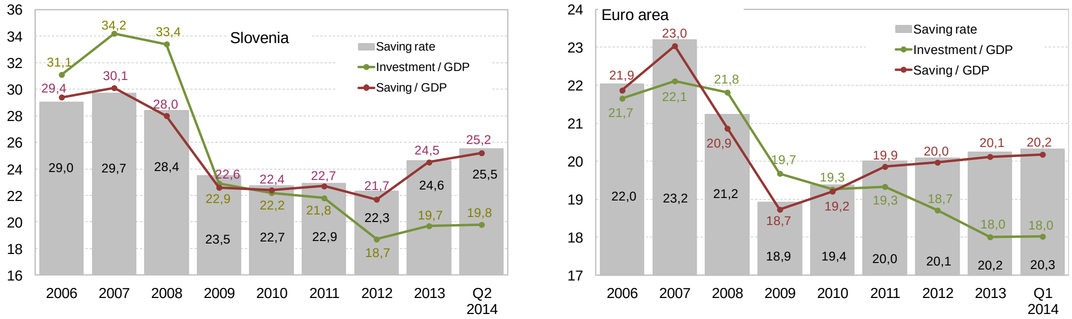


Sources: SORS, Eurostat

Geopolitical tensions between Ukraine and Russia, and the cooling of economic activity in major EU countries represent the most significant risks for Slovenian exports in the future.

Economic activity in Slovenia is highly dependent on developments in the euro area, to which a significant portion of exports is earmarked. Geopolitical tensions between Ukraine and Russia could pose a risk for exports, and thus threaten the economic recovery in Slovenia. External economic shocks could have an adverse impact on the normalisation of access to the international financial markets, and thus slow the restructuring of certain corporates. The cooling of economic activity in major trading partners and potential corrections on the financial markets could also pose a risk to Slovenian exports. More restrictive monetary policy could be expected sooner rather than later in the US and UK, as the risk of low inflation in the euro area is significant. Sustained low inflation could be reflected in weaker consumption due to consumers' expectations regarding lower prices in the future and the resulting postponement of purchases. Falling commodity prices, particularly energy prices, have had a significant impact on this year's low inflation.

Figure 2.2: Saving rate and ratio of investment and saving to GDP in percentages for Slovenia (left) and the euro area (right)

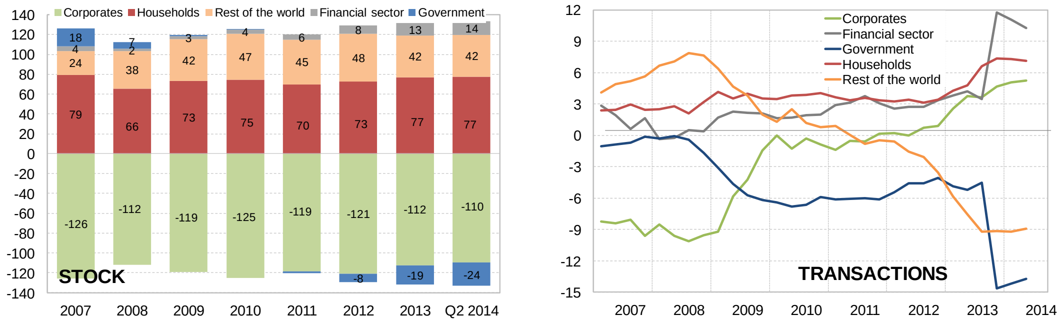


Sources: Bank of Slovenia, SORS, ECB, Eurostat

The difference between savings and investments is still growing.

The ratio of saving to GDP has risen in Slovenia since 2012 and exceeded one quarter in the first half of 2014. The saving rate in the national economy, i.e. the ratio of saving to disposable income, is also on the rise. On the other hand, the ratio of investment to GDP stagnated in the first half of 2014 and remains below one fifth, as the result of the previously mentioned over-indebted corporate sector and its reluctance to invest. The saving-investment gap continues to widen and stands at 5.4% of GDP. A similar trend in saving and investment can be seen in the euro area, where the surplus in saving over investment is considerably smaller, at just over 2%.

Figure 2.3: Net financial position of economic sectors in terms of stock (left) and annual transactions (right) as a percentage of GDP



Note: Annual transactions are calculated as four-quarter moving sums.
Sources: Bank of Slovenia, SORS

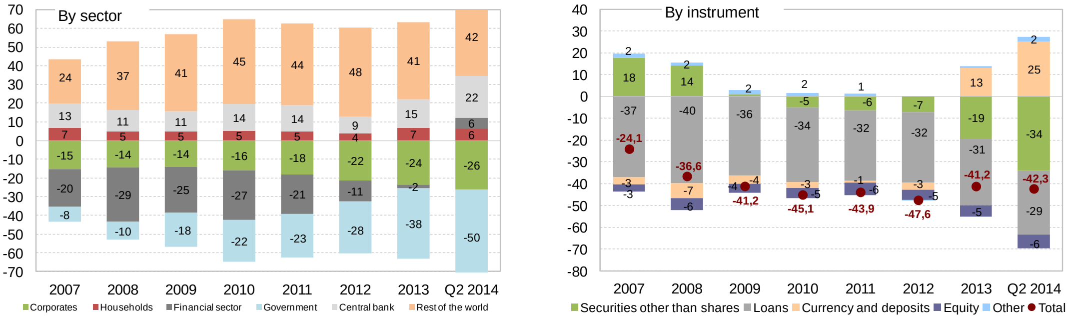
Both corporates and households maintain a net positive position in terms of transactions.

Slovenia's net financial liabilities to the rest of the world remained unchanged over the first half of 2014 at 42% of GDP. Corporates continue to make debt repayments to other sectors, while maintaining their atypical position of net creditors. This is seen on the one hand as corporates' continued reluctance to invest and poor access to long-term sources of financing, and as the continuation of the deleveraging process and prudence in liquidity management on the other hand. The net positive position of households also remains high as the result of a persistently high saving rate and the resulting lower consumption. Due to the effects of the government-financed recapitalisation of five banks at the end of 2013, the government's net negative position widened considerably, while the net positive position of the financial sector improved.

The government and corporate sectors are increasing their net external debt, while that of the banking sector continues to decline.

The government sector's net debt to the rest of the world rose during the first half of 2014 to stand at 50% of GDP due to a new bond issue in the rest of the world. The banks are making early repayments of three-year long-term funds to the ECB, which mature in early 2015, and continue the process of deleveraging vis-à-vis foreign banks. Corporates are also increasing their net financial liabilities to the rest of the world as the result of borrowing. Completion of the restructuring of the banking system is expected to bring easier access by corporates to sources of financing on the domestic market and a gradual reduction in their net financial position vis-à-vis the rest of the world. However, corporate restructuring will play a key role by ensuring a stable structure of financing with reduced leverage and increased capital.

Figure 2.4: 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

Households' net liabilities to the rest of the world from equity remain very low, at 6% of GDP. Given the considerably limited availability of domestic capital, foreign capital, particularly in the form of direct investment, represents a highly underutilised opportunity to secure an important source of corporate financing. There was a notable rise in net debt to the rest of the world in the form of bonds and commercial paper during the first half of 2014, as the result of borrowing by the government sector and certain major Slovenian corporates with access to such financing.

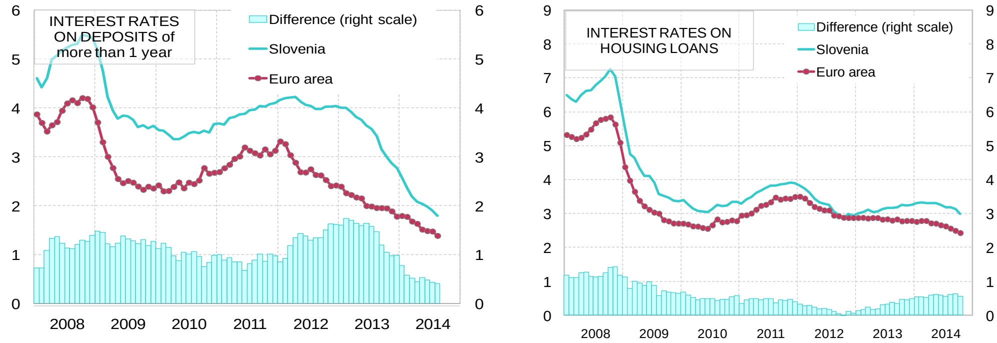
Foreign capital in the form of direct investment in Slovenia continues to represent a highly underutilised opportunity.

2.1 Households

Households in Slovenia remain less indebted than other sectors and do not pose any major systemic risk to the banking system. On the contrary, they represent an interesting sector for the banks due to the lower level of credit risk associated with this sector. The only non-banking sector to record growth in bank lending since the outbreak of the crisis is the household sector, which is deemed a less-risky sector se preveč ponavlja – enkrat bi lahko uporabili: because of the low level of non-performing claims. The banks can be expected to focus more activities on retail banking in the future due to the relatively low level of household indebtedness.

The relative low level of indebtedness and risk associated with households increases their attractiveness in terms of bank lending.

Figure 2.5: Interest rates on new household deposits of more than one year (left) and interest rates on newly approved housing loans (right)



Sources: Bank of Slovenia, ECB

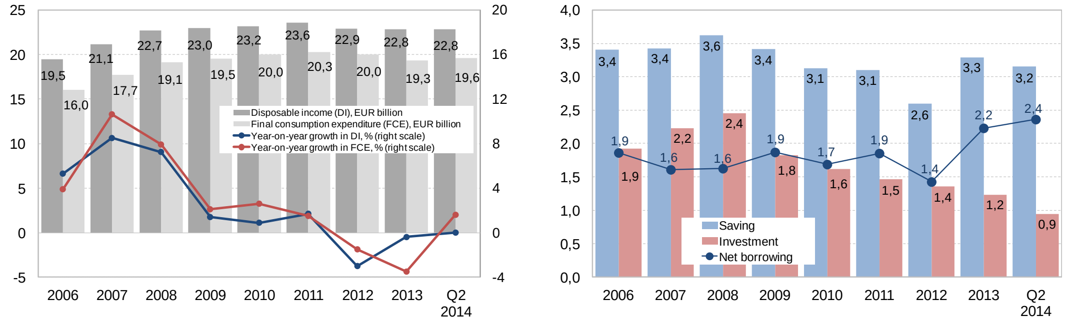
Low interest rates on household deposits could encourage households to increase consumption and investment activities. Interest rates on deposits with a maturity of up to one year fell from 1.5% to 0.9% over the first three quarters of 2014, while rates on deposits with a maturity of more than one year fell from 2.8% to 1.7%. Real interest rates on deposits remain positive in the context of low inflation rates. However, if interest rates persist at such low levels over a longer period, we can expect a portion of household deposits to be redirected to consumption or more profitable investments over the medium term. This could have positive effects on the capital markets, while representing a certain risk for households due to the search for higher returns and increased variability in the prices of various types of assets. The positive effect for the banking system would be seen in an increase in the scope of household lending and the resulting increase in interest income, which has fallen since the outbreak of the crisis. Despite the fall in interest rates on deposits, interest rates on newly approved housing loans have not fallen and are persisting above 3%.

Falling interest rates on household deposits could encourage households to increase consumption and investment activities.

The decline in household disposable income has come to a halt, while consumption is on the rise.

The unemployment rate is falling gradually in the context of the improving economic situation in Slovenia. After falling for two years, there was a notable stagnation in household disposable income during the first half of 2014. Household investment has continued to decline this year, in part due to the uncertain conditions on the real estate market. A large portion of real estate that was transferred to the BAMC is not being sold, which has further dampened the market and increased expectations of a continued fall in prices.

Figure 2.6: 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)

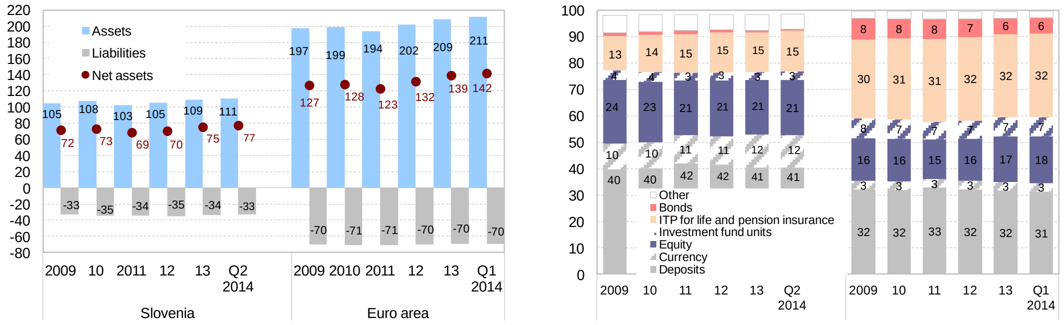


Source: Bank of Slovenia desni graf ni preveden – problem z linkom

At EUR 28.5 billion or 77% of GDP, net financial assets are considerably lower than the euro area average.

Household assets and liabilities remained at a similar level to 2013 during the first half of 2014. Household liabilities totalled EUR 12.2 billion or 33% of GDP, which is significantly lower than their euro area counterparts (70% of GDP). Assets stood at EUR 40.7 billion at the end of June 2014, while the net financial assets of Slovenian households totalled EUR 28.5 billion or 77% of GDP. That proportion is about half of the figure for the net financial assets of euro area households, meaning that the contingency financial reserves of Slovenian households are considerably lower. As a rule, a large portion of Slovenian households' assets are in the form of real estate, around 80% of which is owned by households (compared with the euro area average of around 60%).

Figure 2.7: Financial assets, liabilities and net financial position as percentages of GDP (left), and breakdown of Slovenian and euro area households' financial assets in percentages (right)



Sources: Bank of Slovenia, SORS, ECB

Deposits and currency account for more than 50% of total household assets in Slovenia.

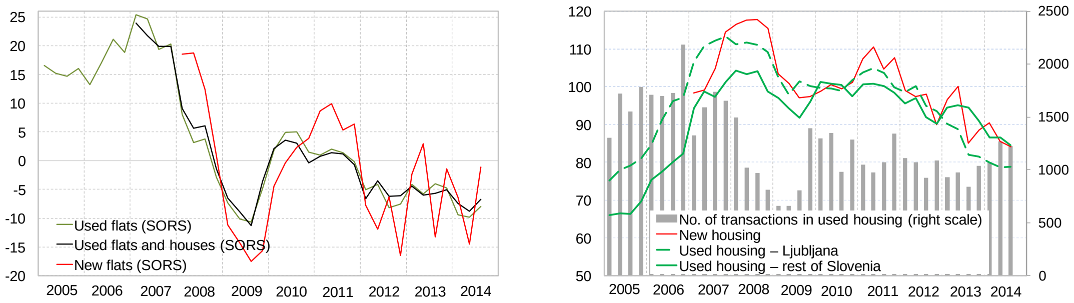
The structure of household financial assets was unchanged during the first half of 2014. Despite the previously mentioned low interest rates on deposits, the latter were up by EUR 570 million over the first three quarters of 2014, primarily as the result of a return to bank deposits owing to the restoration of confidence. At 41%, deposits account for the largest proportion of assets, which is a reflection of the lack of alternatives and the conservative nature of Slovenian households.

2.2 Real estate market

The prices of flats and houses were down sharply in 2014. After falling for five years, transactions in used flats and houses were up by nearly one half.

According to figures from the Statistical Office of the Republic of Slovenia (SORS), the fall in housing prices in 2014 was the sharpest in the last five years. Prices were down 5.4% in year-on-year terms in the third quarter of 2014 and down one quarter on their peak recorded in the third quarter of 2008. Prices of used housing were down 8.0%, while the prices of new-build housing, which according to survey figures have fluctuated sharply for two years, were down 1.1%. In the context of the recovery in economic activity in 2014, liquidity on the real estate market improved following a three-year decline. Transactions in used flats and houses were up 43.2% in year-on-year terms during the third quarter of 2014. Transactions in new-build flats and houses continues to decline, and were down nearly one quarter in the third quarter of 2014. According to provisional figures from the Surveying and Mapping Authority of the Republic of Slovenia (SMARS), transactions in commercial real estate were up by more than one half during the first six months of 2014.

Figure 2.8: Growth in prices of used and new-build housing in Slovenia (left), and the basic housing price index (2010 = 100) (right) in percentages



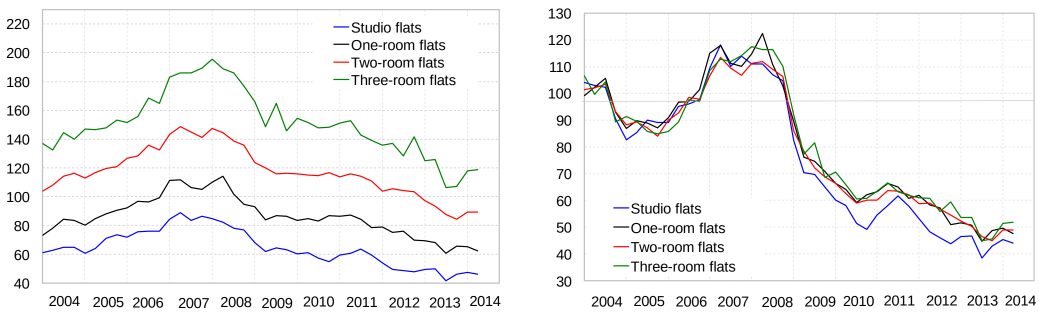
Sources: SORS, SMARS, TARS

Indicators of over- and under-valuation of housing

Housing affordability in Ljubljana, as measured by the ratio of used housing prices to the annual moving average of net monthly wages and taking into account lending terms, improved on average in year-on-year terms during the first half of 2014,[1] but not as notably as the previous two years. Purchasing a flat required an average of five fewer monthly wage payments than a year earlier.

Housing affordability improved during the first half of 2014, but not as notably as the previous two years.

Figure 2.9: Ratio of housing prices to annual moving average of net monthly wages for Ljubljana in percentages (left) and housing affordability index (2004 = 100) (right)



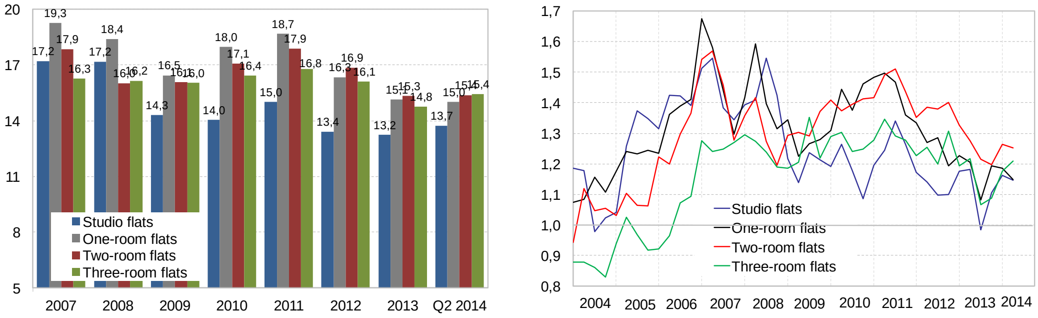
Sources: Bank of Slovenia, SMARS, Slonep, SORS, Bank of Slovenia calculations

Real estate prices approached underlying prices on average considerably in 2013, while the over-valuation of housing was up again during the first half of 2014. The housing price to rent (P/E) ratio in Ljubljana deteriorated relative to the 2013 average during the first half of 2014, real estate prices having fallen more on average than rents. The reduction in the over-valuation of housing thus slowed over the same period.

The reduction in the over-valuation of housing slowed during the first half of 2014.

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

Figure 2.10: Ratio of housing prices to rents (P/E) (left), and ratio of actual prices to underlying prices of housing[2] in Ljubljana calculated on this basis (right)



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

Following a three-year decline, newly approved housing loans to households were up 2.1% in year-on-year terms in the second quarter of 2014 and up 6.6% in the third quarter. The loan-to-value (LTV) ratio for newly approved housing loans (the ratio of the loan to the value of the collateral) is declining across the banking system. It stood at 70% in 2012, 67% in 2013 and 65% in the second quarter of 2014. Having been one fifth below the euro area average in the period 2009 to 2011, the LTV ratio rose to the euro area average in 2012.[3]

[2] 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 ratio over a longer, more stable periodof at least 10 to 15 years. The short time that the Slovenian housing market has functioned normally makes this impossible. A change in the baseline period would also lead to a change in the underlying P/E ratio. The aforementioned limitations should be taken into account in the interpretation.

[3]The ESRB Handbook on Operationalising Macro-prudential Policy in the Banking Sector (https://www.esrb.europa.eu/pub/pdf/other/140303_esrb_handbook.pdf). In the period 2009-2010, LTV is based on the bank survey and is calculated as an average LTV ratio for loans with real estate collateral.

3 CONTRACTION IN THE BANKS' BALANCE SHEETS

The contraction in the banking system's total assets continued for the fifth consecutive year in 2014, but at a slower pace than the previous two years. The contraction on the funding side in previous years coincided with the banks' debt repayments on the wholesale markets in the rest of the world, while the pace of debt repayments to the Eurosystem accelerated last year. The largest decline on the asset side was in loans to the non-banking sector, while less profitable investments in more liquid assets and securities were up.

The banking system's total assets declined by EUR 1.1 billion during the first ten months of last year. The contraction is slowing.

Table 3.1: Banking system's balance sheet as at 31 October 2014

	2008	2013	Oct. 2014	Increase in 2014 until October	Growth on Dec. 2013	Year-on-year Growth
	EUR million			EUR million	%	
Assets						
Loans to the non-banking sector	33.718	24.338	22.234	-2.104	-8,6	-21,3
….non-financial corporations	20.260	11.508	9.829	-1.679	-14,6	-32,1
…..households	7.558	8.467	8.351	-116	-1,4	-2,9
Financial assets / securities	7.327	7.615	9.068	1.453	19,1	32,7
Other	1.547	1.132	1.122	-10	-0,9	-30,6
Liabilities						
Financial liabilities to Eurosystem	1.229	3.727	818	-2.910	-78,1	-79,2
Liabilities to foreign banks	16.098	5.348	4.406	-941	-17,6	-21,2
Liabilities to non-banking sector (deposits)	20.883	22.550	25.014	2.464	10,9	-0,6
…to households	13.407	14.365	14.922	557	3,9	3,8
…to government	1.879	1.657	3.015	1.358	82,0	-28,7
Debt securities	1.276	1.657	1.709	51	3,1	-1,5
Subordinated liabilities	1.568	248	250	2	0,6	-68,6
Equity	4.010	3.670	4.096	426	11,6	49,0
Other	814	762	970	208	27,4	10,9
Total assets	47.948	40.344	39.277	-1.067	-2,6	-9,4

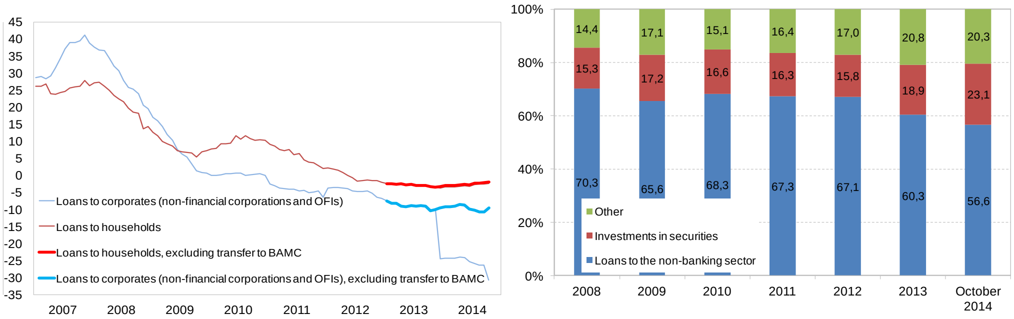
Source: Bank of Slovenia

3.2 Reasons for low credit growth

The stock of Slovenian banks' loans contracted further in 2014. Year-on-year growth in corporate loans before the creation of impairments was -31% in October 2014. This includes the effects of institutional factors such as the transfer of non-performing loans to the BAMC from NLB, NKBM and Abanka, and the initiation of the orderly wind-down process at Probanka and Factor banka. Year-on-year growth was -10% excluding the aforementioned institutional factors. Loans to households prior to the creation of impairments have contracted at an annual rate of 3% over the last two years. The transfer to the BAMC had a small impact on this sector (0.5 percentage points), as the transferred claims of sole traders accounted for just a small proportion of all transferred claims. Growth in household loans has remained negative this year, but primarily in terms of consumer loans, while growth in housing loans has remained low but positive.

Year-on-year growth in corporate loans was -31% in October 2014.

Figure 3.1: Year-on-year growth in loans prior to the creation of impairments (left), and the breakdown of banks' investments (right) in percentages



Source: Bank of Slovenia

Demand for loans is gradually turning positive.

The reasons for the contraction in loans on the demand side lie in weak corporate creditworthiness and reluctance to raise new loans. Recent positive changes can be seen nevertheless on the demand side. This is indicated by the survey on demand for loans and credit standards, based on which estimated demand for corporate loans rose in 2014 following a three-year decline.

A shift in demand is also confirmed by the survey on non-financial corporations' demand for loans (October 2014), which indicates a smaller contraction in credit demand during the first half of 2014 than in previous years. According to the aforementioned survey, non-financial corporations' total demand for loans fell by 15.6% in 2013, while the contraction was less severe during the first half of last year, at 5.6%, in the context of a recovery in economic activity. Non-financial corporations' demand for loans for the restructuring of existing debt was up by one third in 2013, while demand for loans for current operations and investment continued to decline, by 29.1% and 13.4% respectively. The most frequent reasons given by the banks and savings banks for the rejection of loans were the client's disagreement with terms and poor credit ratings, at 21.6% and 21.0% respectively in 2013. The banks are attributing increasing importance to adequate loan collateral, the reason for the rejection of loans being "inadequate collateral" having risen from 6.0% in 2010 to 13.8% in 2013.

Corporate leverage, measured as the debt-to-equity ratio, is only gradually declining and remains a significant limiting factor in terms of corporate creditworthiness.

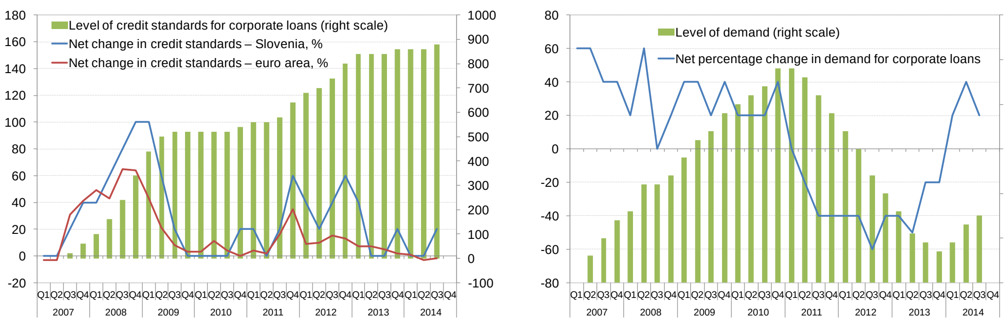
Household demand for loans remains low this year. Demand for housing loans is linked in part to expectations of a continuing decline in real estate prices, in particular due to the expected activities of the BAMC, which could have a significant impact on the supply of housing should it enter the market. Consumer loans reflect the continued uncertainty of households and thus greater prudence in borrowing.

Credit supply has been more of a limiting factor than demand over the most recent period.

Alongside low credit demand, credit supply has also been a recent limiting factor. Credit standards for corporate loans tightened over the entire crisis and are currently at a very low level. Slovenian banks tightened credit standards more than their euro area counterparts on average during the crisis. This is a reflection of the Slovenian banks' considerable aversion to take up additional credit risk and the redirecting of loans to less-risky clients, in particular households, and other forms of investment.

In addition to the banks' aversion to take up credit risk, unstable sources of funding also represent a limiting factor. An increasing amount of funding is in the form of short-term sources, which present a significant limiting factor in the funding of long-term loans. The banks are thus investing a portion of those funds in securities. The stock of securities rose by 24% between the end of 2008 and October 2014 to account for 23.1% of the banks' total assets. Funding raised at the ECB does not represent a stable source, as the banks cannot rely on such sources over the long term.

Figure 3.2: Credit standards for corporate loans (left) and corporates' demand for loans (right), in percentages

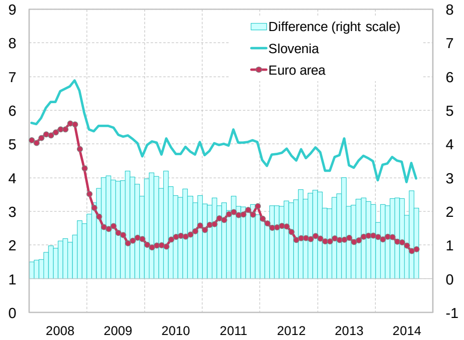


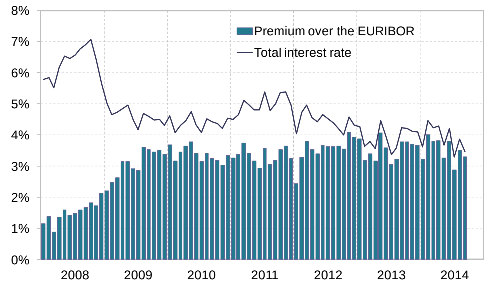
Source: Bank of Slovenia

Corporates are raising an increasing number of loans in the rest of the world, largely as the result of the higher interest rates at Slovenian banks.

The lack of competitiveness in the Slovenian banks' supply is also seen in a rising proportion of loans raised by non-financial corporations abroad. That proportion stood at 27% in September 2014, an increase of 12 percentage points relative to 2008. Creditworthy corporates would rather raise loans in the rest of the world under more favourable conditions and at lower interest rates. The latter are, on average, more than 2 percentage points higher on corporate loans of more than EUR 1 million at the Slovenian banks than at their euro area counterparts. The sample of corporates would have to be the same for a direct comparison of financing conditions at the domestic banks and banks in the rest of the world. Nevertheless, the differences indicate that the interest rates of Slovenian banks are uncompetitive. Another indication of this is the very high premium over the EURIBOR, which averages 3 percentage points on newly approved long-term corporate loans. This is a reflection of the risk associated with clients on the one hand and the banks' unwillingness to take up credit risk on the other. For the banks, a relatively high premium facilitates increased differentiation and thus the more affordable financing of good clients.

Figure 3.3: Comparison of interest rates with the euro area on corporate loans of more than EUR 1 million (left) and the interest rate and premium over the EURIBOR on newly approved long-term corporate loans (right), in percentages and percentage points



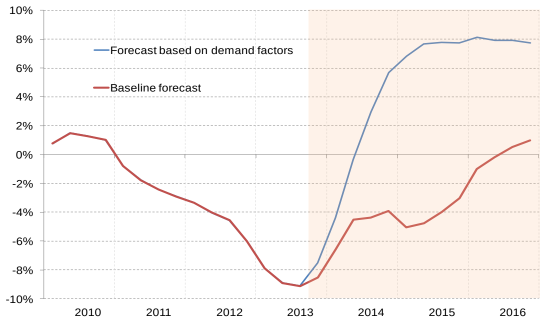


Source: Bank of Slovenia

According to forecasts, weak but positive growth in gross loans to the non-banking sector is expected in 2016.

The recovery in economic activity is expected to be accompanied by a gradual reversal in the credit cycle and weak growth in loans to the non-banking sector prior to the creation of impairments in 2016. Prior to that, positive growth is expected in loans to households prior to the creation of impairments in 2015. The aforementioned sector represents less risk and is thus more acceptable for the banks. In contrast to loans prior to the creation of impairments, growth in loans to the non-banking sector following the creation of impairments will remain negative over the entire forecast horizon (until 2016). The reason lies in additional impairment costs that will be created by the banks due the still relatively high probability of default. Alongside the baseline forecast, which takes into account loan supply and demand factors, an assessment was also made of growth in loans based solely on demand and macroeconomic factors, which indicates significantly more favourable trends. The reasons on the part of corporates for the gap between the forecasts are weak creditworthiness, low credit ratings and reluctance on the part of corporates to raise new loans. Meanwhile the main limiting factors on the part of the banks are the structure and maturity of funding sources, tightened credit standards and an aversion to take up credit risk. An additional positive effect in the coming years could derive from the banks' participation in the ECB's targeted longer-term refinancing operations (TLTROs). A direct effect on lending is expected from the latter owing to the increased stock of available funding, even more so than the GLTDF, which is linked to growth in deposits. The primary aim of the GLTDF is to contribute to the stabilisation of the funding structure and slow the contraction in lending.

Figure 3.4: Comparison of the baseline forecast of corporate loans prior to the creation of impairments with the forecast taking account of demand factors alone, in percentages



Source: Bank of Slovenia

3.3 Changes in the structure of bank funding

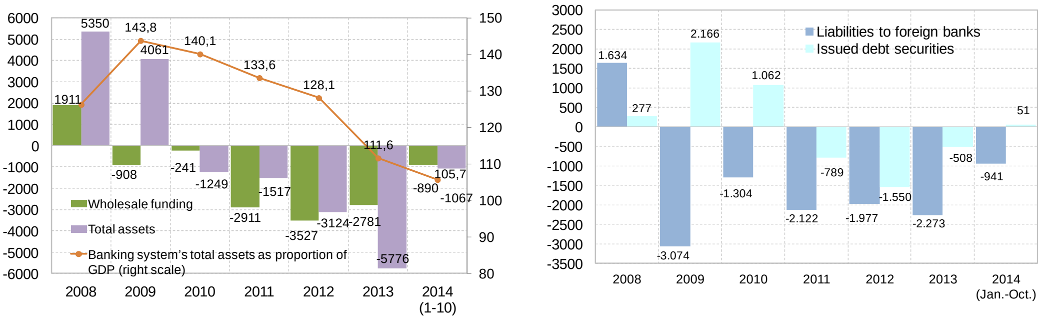
Since the outbreak of the crisis, the banks have repaid debt to the rest of the world that accumulated prior to the outbreak. The repayment of wholesale funding in particular over the last four years is reflected in the contraction in the banking system's total assets. This was most intensive in 2013 when measures to stabilise the banking system were adopted. The banks' debt repayments to the Eurosystem were most intensive in 2014. By the end of 2014 the banks had repaid the majority of liabilities from 3-year LTROs. Refinancing risk has declined due to the intensive repayment of liabilities to banks in the rest of the world in recent years. The importance of wholesale funding in terms of the banks' total assets has declined over the same period. The banks have become more focused on securing deposits from the non-banking sector on the local market. Household deposits recorded growth again in 2014, as the banks had more than compensated for the decrease in deposits in 2013 by the end of last October. The problem of an unstable structure of funding persists in the context of a decrease in refinancing risk, as no major growth in deposits by the non-banking sector is expected in the future as an alternative to wholesale funding.

3.3.1 Slower pace of banks' debt repayments to the rest of the world and a reduction in refinancing risk

The structure of funding has changed significantly in recent years.

The process of restructuring the Slovenian banking system's funding has been in progress since the outbreak of the crisis. The banking system made debt repayment to foreign banks of EUR 11.6 billion from the end of 2008 to the end of October 2014. Total net debt repayments on the wholesale markets, with debt securities issued by the banks taken into account, amounted to EUR 11.3 billion. Taking into account the peak of borrowing in the rest of the world in October 2008, net debt repayments to banks in the rest of the world during the aforementioned period totalled EUR 12.6 billion, and to EUR 11.9 billion taking into account all wholesale funding. The amount of net debt repayments in the context of total wholesale funding thus reached one third of Slovenian GDP. The proportion of total assets accounted for by wholesale funding, which at the outbreak of the crisis was more than a third of total bank funding in Slovenia, had fallen below 16% by October 2014.

Figure 3.5: Changes in total assets and changes in wholesale funding in EUR million (left) and net changes in stocks on the wholesale markets with respect to instrument in EUR million (right)



Source: Bank of Slovenia

The proportion of total assets accounted for by deposits by the non-banking sector is close to two thirds.

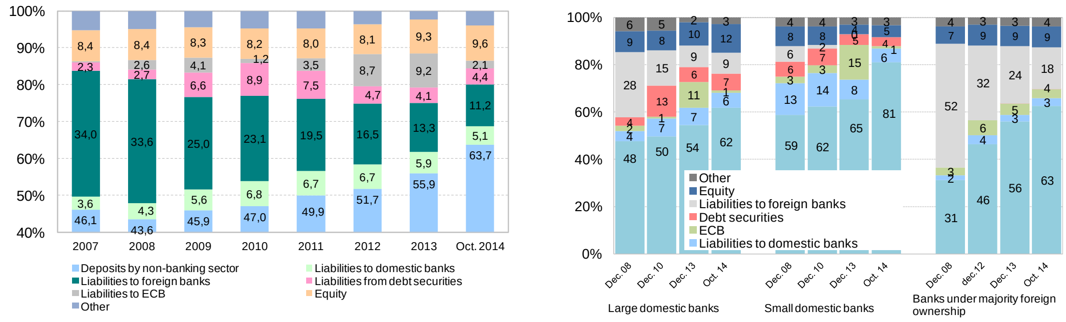
The proportion of total assets accounted for by deposits by the non-banking sector is close to two thirds, household deposits accounting for 38% of total assets. The proportion of total assets accounted for by deposits by the non-banking sector has risen by 20 percentage points since the outbreak of the crisis, while the proportion accounted for household deposits has risen by 10 percentage points. The stock of deposits by the non-banking sector rose by EUR 4.1 billion from the outset of the crisis in 2008 until the end of October 2014 compared with an increase of EUR 1.5 billion in household deposits, while total assets contracted by EUR 8.7 billion over the same period.

Differences in the breakdown of funding between the bank groups

Changes in the situation on the wholesale markets and the banks' intensive debt repayments to the rest of the world resulted in adjustment to the bank funding structure. The most intensive reduction in liabilities to the rest of the world was made by banks under majority foreign ownership, half of whose total assets were accounted for by sources from the rest of the world at the outbreak of the crisis. The proportion of the aforementioned bank group's total assets accounted for by deposits by the non-banking sector has become comparable with the group of large domestic banks this year, while that proportion remains well above average at the small domestic banks.

All bank groups have significantly reduced the proportion of total assets accounted for by wholesale funding.

Figure 3.6: Breakdown of the Slovenian banking system's funding (left) and by bank group (right) in percentages



Source: Bank of Slovenia

The banks under majority foreign ownership, in particular, continue to make debt repayments to the rest of the world. As early as 2013 the aforementioned bank group accounted for more than half of the entire banking system's repayments to the rest of the world, while that proportion stood at four fifths of all repayments at the end of October 2014. Alongside shorter maturities, that high proportion was also driven by the fact that the banks under majority domestic ownership had already made intensive debt repayments in previous years and thus reduced their debt to the rest of the world significantly. Having accounted for more than one half of the funding of the banks under majority foreign ownership prior to the crisis, foreign banks accounted for less than one fifth of funding in October 2014.

The banks under majority foreign ownership made the highest debt repayments to the rest of the world in 2014.

Household deposits are becoming an increasingly important source of funding for the banking system, accounting for 60% of all deposits by the non-banking sector and 38% of total assets. Household deposits accounted for nearly 41% of the large domestic banks' total assets in October 2014, compared with 56% at the small domestic banks and 29% at the banks under majority foreign ownership.

Household deposits remain the most important source of bank funding.

Government deposits, which in previous years accounted for an above average proportion of the banks' total assets, have become less important following their conversion to equity at the end of 2013, while the temporary above average increase in such deposits due to short-term liquidity management by the Ministry of Finance is only reflected in an increase in liquid forms of bank investments.

The proportion of bank funding secured from the ECB declined sharply in 2014. The banks began the intensive repayment of liabilities to the ECB, particularly following the ECB's measures in June and September. Most notable in this regard are the banks under majority domestic ownership, where the proportion of such funding had fallen to the pre-crisis level by the end of October 2014.

The importance of funding secured from the ECB fell sharply until the end of last October to reach a level comparable to the pre-crisis period.

Refinancing risk

The pace of the banks' debt repayments slowed significantly last year. The bank's net debt repayments on the wholesale markets totalled EUR 0.8 billion over the first ten months of 2014, a significant decrease relative to the previous year when debt repayments totalled EUR 2.8 billion. Pressure to refinance liabilities to the Eurosystem eased in 2014, the proportion and stock of refinancing of liabilities to banks in the rest of the world in shorter maturity buckets having increased.

a) Maturing liabilities to foreign banks

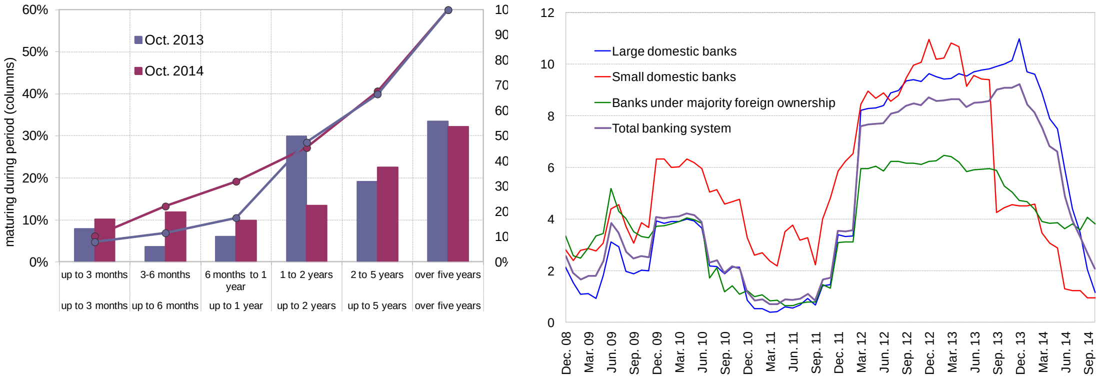
Intensive debt repayments on the international wholesale market in previous years reduced the short-term pressure on refinancing in 2013. With maturity nearing and in the absence of the roll-over of funding in the rest of the world,[4] the proportion of

The proportion of debt to the rest of the world maturing within one year was higher in October 2014 than a year earlier.

[4] According to the banks' figures (PORFI), between October 2013 and October 2014 only 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 8%), while the small domestic banks failed to roll

liabilities with a shorter maturity (i.e. up to one year) rose in 2014. The banks will see EUR 1.872 billion or EUR 32% of total debt mature in the year until the end of October 2015, while a year earlier the figure stood at 17.5%, equivalent to EUR 1.2 billion of debt to foreign banks.

Figure 3.7: Maturing of liabilities to foreign banks by maturity interval (left) and proportion of banks' total assets accounted for by liabilities from Eurosystem instruments (right) in percentages



Source: Bank of Slovenia

The banks under majority foreign ownership are somewhat more exposed to refinancing risk vis-à-vis the rest of the world at shorter maturities.

The banks under majority foreign ownership are somewhat more exposed to refinancing risk at shorter maturities. That bank group will see EUR 843 million or 34% of its total debt mature within the period of one year, compared with around 28% or EUR 908 million of debt at the large domestic banks. In that respect, the majority of large domestic banks have nearly repaid their debt to the rest of the world, and future maturities do not represent any significant burden for them. The banks under majority domestic ownership are somewhat more exposed to refinancing risk at longer maturities.

b) Bank funding from the Eurosystem

The banks had repaid more than 80% of liabilities from the Eurosystem's 3-year LTROs by the beginning of December 2014.

The stock of liabilities to the Eurosystem was down sharply last year. By the beginning of December 2014, the banks had made early repayments of EUR 3,044 million or 82% of liabilities totalling EUR 3,699 million from 3-year LTROs concluded in the first quarter of 2012. The sharp reduction and early repayments by the banks were primarily a reflection of the ECB's measures in June and September 2014.

The banks secured EUR 631 million in funding from the Eurosystem at the second TLTRO auction held in December 2014.

The banks' participation in the ECB's first auction of targeted longer-term refinancing operations (TLTROs) was modest, the banks having secured merely EUR 75.5 million in funding. The majority of banks participated in the second TLTRO auction on 11 December 2014, where they raised new loans totalling EUR 631 million. The banks participated in the aforementioned operation primarily due to the low price of funding and for precautionary reasons. Taking into account additional early repayments from the 3-year LTRO and following the above described operation, the stock of liabilities to the ECB totalled EUR 1.1 billion. Bank funding secured via TLTROs improves the long-term liquidity position of the banks, but is not a sustainable source of funding.

It is unlikely that funding secured via the TLTRO will be primarily earmarked to fund credit growth. In light of the anticipated further contraction in lending to the non-banking sector over the next two years and the banks' surplus liquidity, the banks' primary objective in participating in the TLTRO will be obtaining long-term funding at a favourable price that they can earmark for replacing other funding. Nevertheless, the effects from the TLTRO could contribute in part to an improvement in lending activity.

Wholesale bank funding does not provide a long-term stable business model.

Wholesale funding does not provide the banks a long-term stable business model. Likewise the banks only temporarily mitigated the contraction in total assets via funding from the ECB, in particular following the execution of long-term operations in 2012. That contraction would thus have been even greater due to the banks' failure to roll over funding on the wholesale markets. The same is true for government

over funding in the rest of the world. The large domestic banks rolled over the aforementioned funding in full. The main factor, however, was the fact that the stock of debt with a maturity of up to one year was small a year earlier, while NLB issued a 3-year bond in July.

deposits, the increase in which was temporary in the past. Fluctuations in 2014 were to a great extent in line with state budget needs, and government deposits do not represent a stable source of funding for banking operations. Nevertheless, the banking system was characterised by a slight improvement in the trend of wholesale funding in 2014, as the banks recorded a positive rollover rate on the wholesale funding markets in the rest of the world. The rollover rate for such liabilities stood at 18% for the banking system as a whole last October. The banks under majority domestic ownership succeeded in rolling over such funding in the rest of the world via the issue of bonds by NLB, while the banks under majority foreign ownership rolled over merely 8% of such liabilities.

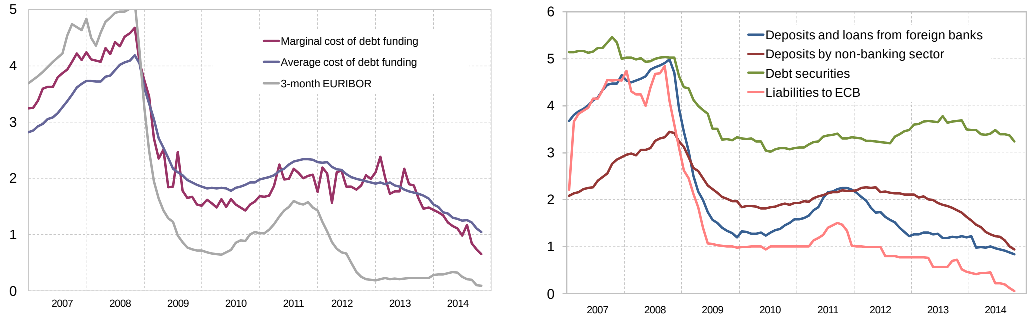
Cost of bank debt funding

The cost of debt funding declined in 2014 due to falling interest rates on deposits by the non-banking sector.

The average cost of bank debt funding continues to decline. The declining cost of debt funding is primarily the result of falling interest rates on deposits by the non-banking sector. Funding costs thus fell most sharply at the domestic banks, where the proportion of funding accounted for by deposits is relatively high.

The average cost of the banks' debt capital declined by 0.49 percentage points over the first ten months of 2014 to 1.04%. The average interest rate on deposits by the non-banking sector fell by 0.69 percentage points to 0.94% over the same period. That rate was still above 2% in the first quarter of 2013. Issued debt securities represented the most expensive source, but their importance in terms of the structure of funding has declined in recent years.

Figure 3.8: Average cost of debt funding overall (left) and average debt funding cost for banks by primary source/instrument (right) in percentages

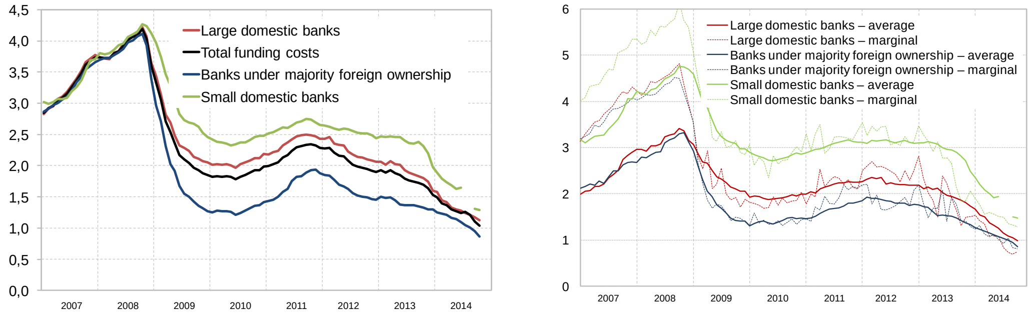


Source: Bank of Slovenia

The cost of funding via the ECB and banks in the rest of the world have also declined.

Slovenian banks have decreased interest rates on deposits by the non-banking sector over the last two years owing to the low net interest margin and efforts to improve operating results, and due to the low level of interest rates on the international financial markets. The banks thus attempted to improve their cost competitiveness and relieve the pressure on their relatively low interest margins. Another major factor in the decline in the average cost of debt funding in 2014 was a decline in bank funding via issues of debt securities, which are the most expensive source of debt funding in relative terms. Borrowing via the cheapest form of bank funding (i.e. liabilities to the ECB) has declined. However, favourable effects from this source of funding are expected in 2015.

Figure 3.9: Average cost of debt capital by bank group (left) and average and marginal cost of bank funding via deposits by the non-banking sector by bank group (right) in percentages



Source: Bank of Slovenia

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

In October 2014 the banks under majority foreign ownership recorded the lowest cost of funding via deposits by the non-banking sector, at 0.85% (compared with 0.98% at the large domestic banks and 1.225% at the small domestic banks). The same is true for the total cost of debt funding.

3.3.2 Slow growth in deposits by the non-banking sector

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

Positive growth in household deposits.

Deposits by households and the non-banking sector have been characterised over the last three years by a changing dynamic. While 2012 and 2013 were characterised by the switching of deposits between individual bank groups and a nominal decrease in household deposits, growth in household deposits in 2014 compensated for the outflows recorded in 2013 following the previous year's remedial measures implemented by the Slovenian government and the Bank of Slovenia, primarily due to an increase in deposits at the large domestic banks. The negative year-on-year growth in total deposits by the non-banking sector in October 2014 at the domestic banks is the result of a base effect from December 2013, when a portion of government deposits were converted to equity, and due to the initiation of the ordinary wind-down process at two smaller banks in autumn 2013.

Deposits of the non-banking sector rose by EUR 2.5 billion over the first ten months of the year, the stock being comparable with a year earlier. Government deposits contributed most to the increase. The increase in the aforementioned deposits, however, was driven by the issue of government bonds and the fact that such funds are not invested in the banks for an extended period but primarily to pre-finance budget expenditure.

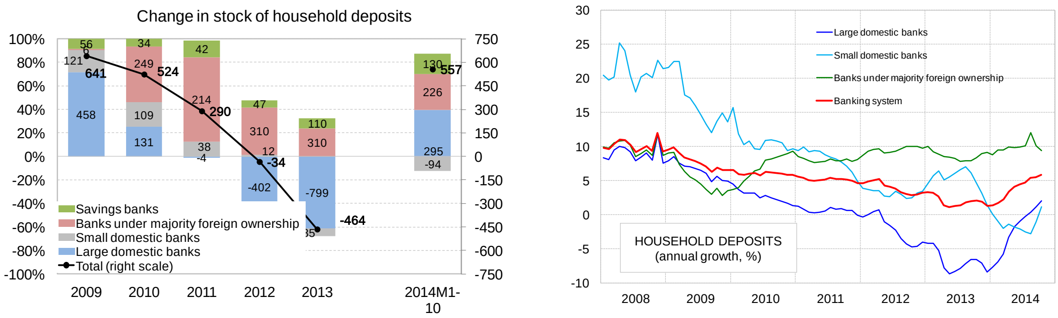
The proportion of deposits by non-banking sector accounted for by sight deposits is rising.

The proportion of deposits by the non-banking sector accounted for by sight deposits rose in previous years on account of growth in the sight deposits of corporates and households. The proportion of total deposits by the non-banking sector accounted for by sight deposits has increased by close to 15 percentage points over the last five years of the financial crisis, i.e. between September 2009 and September 2014, to 45.4%.

More subdued growth in household and corporate deposits can be expected in the future.

The high growth in household deposits this year has been the result of the restoration of confidence in the banks following the withdrawal of deposits in 2013 in the wake of the Cyprus crisis and the uncertainty surrounding the results of the stress tests of Slovenian banks. Growth in deposits can be expected to slow in the coming years. A similar slowing of growth in corporate deposits is expected, which in 2014 is due to the fact that corporates are financing current operations and minor investment in part via internal savings. The increase in corporate deposits is also likely due to the creation of sufficient liquidity reserves during a period of difficult access to sources of financing at the domestic banks.

Figure 3.10: Increase in household deposits by bank group (left) in EUR million and percentages, and year-on-year growth in household deposits by bank group (right) in percentages



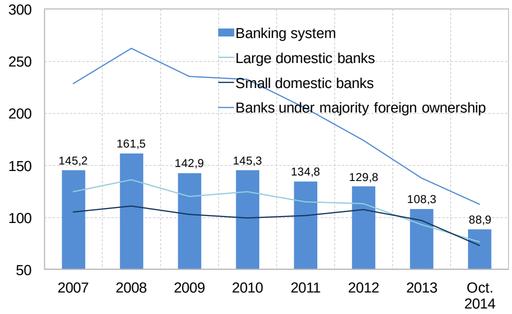
Source: Bank of Slovenia

Loan-to-deposit ratio

Several factors have resulted in a sharp decline in the LTD ratio for the non-banking sector in recent years.

The indicator of the sustainability of bank funding, defined as the loan-to-deposit ratio for the non-banking sector, has declined by 73 percentage points since the outbreak of the crisis to stand at 89% in October 2014. The banks under majority foreign ownership recorded the sharpest decline in the aforementioned indicator over that period, by 150 percentage points to stand at 113%, while the loan-to-deposit ratio stood at 76.5% at the large domestic banks and 73.5% at the small domestic banks. In addition to factors on the funding side, the contraction in the stock of loans also contributed to the decline in the ratio, as did the transfer of claims to the BAMC at the large domestic banks.

Figure 3.11: LTD ratio for the non-banking sector by bank group in percentages



Source: Bank of Slovenia

4 INCOME RISK

The banks are still exposed to a high level of income risk, which is rising due to the contraction in lending activity, the sustained deterioration in the quality of the credit portfolio and low interest rates. The banks have temporarily compensated for declining interest income due to the contraction in lending by decreasing liability interest rates and reducing interest expenses, and have thus recorded positive growth in net interest income. The stock of less risky but also less profitable investments is increasing due to the banks' increased aversion to take up risks. This includes the loss of some good clients who are turning their search for sources of financing to the rest of the world. An environment of low interest rates and the question of whether the banks will be able to generate sufficient income to cover operating costs and impairment costs place additional pressure on the banks' income risk.

Credit growth and the proportion of the banking system's total loans accounted for by non-performing loans will have a significant impact on the extent of the banks' income risk in the future. The banks will only be able to generate a sufficient level of interest income by increasing the stock of quality loans. Persistently high credit risk means a potential increase in impairment and provisioning costs, and thus increased income risk for the banks.

Income statement and income risk

The banking system operated at the break-even point over the first ten months of last year. The banks generated a pre-tax profit of just EUR 2 million.

The banks' net interest income was up 11% in year-on-year terms over the first ten months of last year. Interest income is being adversely affected by the contraction in loans. Interest expenses are also declining as a result of decrease in liability interest rates. At the same time, the banks generated growth in non-interest income of nearly 8% over the first ten months of last year. The banking system's gross income was thus up by a tenth relative to the same period the previous year. The banking system overall recorded a pre-tax profit until the end of September. That profit was reduced significantly with the creation of additional impairments in October and will turn to a loss by the end of 2014.

Table 4.1: Income statement for the period January to October 2014

	2012	Breakdown	2013	Breakdown	2014	Breakdown	Year-on-year growth
EUR million, % growth	Jan.-Dec.	%	Jan.-Dec.	%	Jan.-Oct.	%	Oct. 2014/Oct. 2013
Interest income	1.944		1.501		1.123		-14,1
Interest expenses	-1.058		-793		-429		-37,0
Net interest	886	56,6	708	64,9	694	67,4	10,9
Non-interest income	679	43,4	383	35,1	336	32,6	7,6
Gross income	1.566	100,0	1.091	100,0	1.029	100,0	9,8
Operating costs	743	47,4	721	66,1	560	54,5	-5,1
Net impairments and provisioning	1.599	102,2	3.809	349,1	467	45,4	-66,5
Pre-tax profit	-776	-49,6	-3.439	-315,2	2	0,2	100,2
Taxes	22		-147		-12		…
Net profit	-754		-3.586		-10		…

Source: Bank of Slovenia

Several factors led to the continuation and realisation of high income risk in 2014. Despite sold growth in net interest income, the banks' interest income was down by nearly a third by the end of October in year-on-year terms. This was the result of a decline in lending, high impairment costs on loans and lower interest rates. Following a sharp fall in interest rates on deposits by the non-banking sector to record low levels, the banks can expect even fewer additional favourable effects in the future.

The main factors in the still elevated income risk are the fall in interest income and persistently high impairment and provisioning costs in the banking system.

The banks have recorded a moderate decrease in operating costs for several years already. We can expect a certain negative effect on the growth in operating costs in the future due to costs associated with the implementation of institutional changes and new regulations. This involves the creation of a rescue fund and new deposit guarantee scheme in the Slovenian banking system, and regulatory costs associated with the Single Supervisory Mechanism (SSM).

Net interest margin

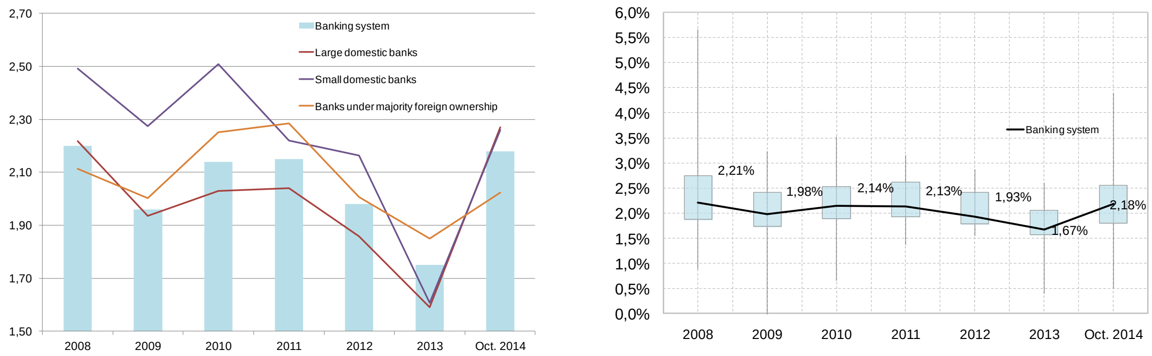
The decline in the net interest margin in the Slovenian banking system, which lasted several years, came to a halt at the end of 2013. The net interest margin rose in 2014. The following factors led to the increased interest margin: a) the exclusion of a

Liability interest rates fell more than asset interest rates in 2014.

portion of non-performing claims from the balance sheets of banks where stabilisation measures were implemented; b) falling liability interest rates and the resulting fall in interest expenses; and c) the contraction in total assets.

Average effective asset and liability interest rates fell over the first ten months of last year relative to the end of 2013. The average interest rate on loans had fallen by 0.32 percentage points by the end of October to stand at 3.25%, while the average interest rate on deposits was down 0.57 percentage points to stand at 1.01%.[5]

Figure 4.1: Net interest margin on interest-bearing assets by bank group in Slovenia (left) and distribution of net interest margin by quartile in Slovenia (right) in the period 2008 to 2014



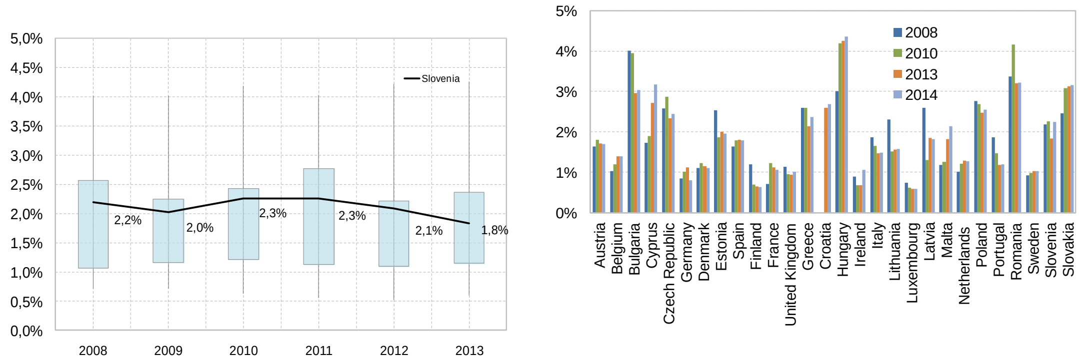
Source: Bank of Slovenia

The net interest margin declined at both groups of domestic banks in 2014.

The net interest margin has fallen faster at the banks under majority domestic ownership than at the banks under majority foreign ownership in recent years due to the rising proportion of non-performing loans in the banks' balance sheet and the decline in lending. The net interest margin of the domestic banks was up sharply in 2014 due to the transfer of non-performing claims to the BAMC, which resulted in a reduction in the proportion of the banks' total assets accounted for by non-performing loans, and due to a significant fall in interest rates on deposits by the non-banking sector.

Comparison of the net interest margin with EU countries6

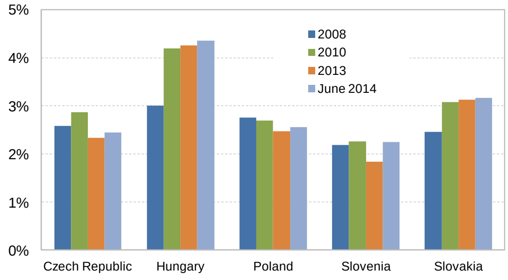
Figure 4.2: Net interest margin on total assets in the EU27 – distribution by quartile (left) and net interest margin on total assets by EU country (right)



Source: ECB (SDW, CBD data)

[5]Includes the non-banking sector and banks.
[6]ECB, CBD data for 2014

Figure 4.3: Net interest margin calculated on total assets in Slovenia and selected countries in Central Europe inpercentages



Source: ECB (SDW, CBD data)

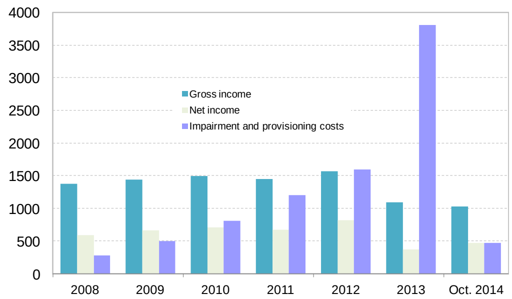
Slovenia's net interest margin is lower than that of comparable Central European countries.

In terms of the net interest margin calculated on total assets for EU27 countries between 2008 and 2014, the Slovenian banking system lay in the two central quartiles of the distribution throughout the period. The Slovenian banking system's margin ranked 12th out of 28 countries in 2013. However, the comparison with the EU overall includes banking systems that are predominantly investment banking-oriented and those that are predominantly commercial banking-oriented. At 1.8%, the net interest margin of the Slovenian banking system was more than 1 percentage point lower than the margin of certain Central European countries in 2013: the combined average margin for Poland, the Czech Republic, Slovakia and Hungary was 3%. The Slovenian banking system's low net interest margin was a major factor in the decline in wholesale funding on the international financial markets.

Impairment and provisioning costs

Despite an improvement due to resolution measures and stabilisation in 2014, the quality of the credit portfolio still represents a high level of income risk for the banking system. Impairment and provisioning costs were down sharply over the first ten months of 2014 relative to the same period the previous year, and continued to account for slightly less than half of the gross income generated by the banks. The banking system's net income, calculated as gross income less operating costs (i.e. income before impairment and provisioning costs), as a proportion of gross income stood at 46% at the end of October 2014. This was comparable with the period 2008 to 2011[7] and higher than the years prior to the crisis. It was higher at the large domestic banks and banks under majority foreign ownership, at 47% and 48% respectively, and lowest at the small domestic banks, at 37.5%.

Figure 4.4: Nominal change in categories of gross income, net income, impairment and provisioning costs, and profit/loss in EUR million in the period 2008 to 2014



Source: Bank of Slovenia

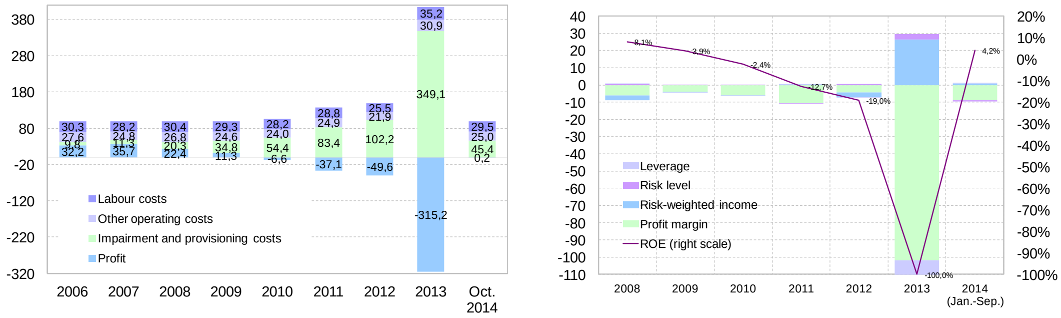
Impairment and provisioning costs still account for a high proportion of the banks' gross income.

Impairment and provisioning costs were down at all bank groups over the first ten months of 2014, most notably at the small domestic banks. The proportion of generated profit accounted for by such costs is relatively high at all bank groups. At the end of October that figure stood at 24% at the small domestic banks, exceeded one third at the banks under majority foreign ownership (36%) and was more than one half at the large domestic banks (55%). The latter is primarily the result of a further rise in impairment costs during the transfer of non-performing claims from Abanka to the BAMC in October 2014. The proportion of the banking system's gross income

[7] Net income as a proportion of gross income in 2012 and 2013 is not comparable with other years due to large fluctuations in non-interest income.

accounted for by impairment and provisioning costs fell in December 2013 following the transfer of non-performing claims from NLB and NKBM to the BAMC, and rose again following the transfer of a portion of Abanka's claims to the BAMC.

Figure 4.5: 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

If the movement in the banks' ROE is analysed by breaking down profitability into four components (profit margin, risk-weighted income, risk level and leverage), we find that risk-weighted income and leverage contributed to an increase in the banking system's profitability over the first nine months of last year,8 as the ratio of gross income to risk-weighted assets and the ratio of average total assets to own funds increased. Profit margin and risk level contributed to a decrease in profitability. Profit margin, i.e. the ratio of profit to gross income, was relatively low, but positive, while risk level, i.e. the ratio of risk-weighted assets to total assets, decreased due to the more rapid contraction in loans than in total assets.

Risk-weighted income and leverage contributed to an increase in profitability over the first ten months of last year.

Table 4.2: Bank performance indicators in percentages

	End of period					
%	2009	2010	2011	2012	2013	Oct. 2014
Profitability						
Financial intermediation margin*	2,88	2,88	2,87	3,23	2,44	3,10
ROA	0,32	-0,19	-1,06	-1,60	-7,70	0,01
ROE	3,87	-2,30	-12,54	-19,04	-100,00	0,06
Interest margin on interest-bearing assets	1,98	2,14	2,13	1,93	1,67	2,18
Net interest income / operating costs	64,42	56,99	55,28	91,48	53,14	59,87
Operating costs						
Labour costs / average assets	0,84	0,81	0,83	0,82	0,86	0,91
Other costs / average assets	0,71	0,69	0,71	0,71	0,76	0,77
Quality of assets						
Impairments of financial assets measured at amortised cost / gross assets	3,00	4,18	5,88	8,05	10,72	9,88

Note: [1] Gross income/average assets
Source: Bank of Slovenia

[8]Data regarding the banks' risk-weighted assets and capital requirements were available until September 2014 at the time of the writing of this report. Data regarding the level of capital requirements are calculated on the basis of the new CRR since 2014, inclusive.

5 CREDIT RISK

5.1 Quality of the credit portfolios of banks and savings banks

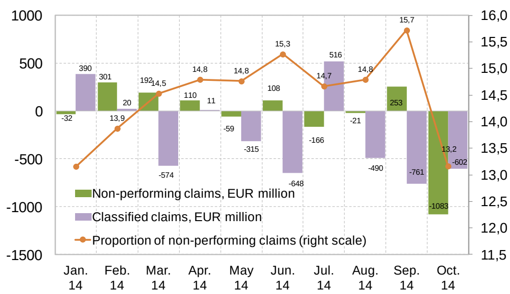
Credit risk remained the most significant systemic risk in the banking system again in 2014, although it is limited primarily to the banks under majority domestic ownership. Non-performing claims, defined as those more than 90 days in arrears, accounted for 13.2% of the banks' total classified claims in October. The transfer of non-performing claims to the BAMC reduced the proportion of non-performing claims significantly at the system level. However, that reduction would have also been seen in October 2014 without the effect of the aforementioned transfer. The coverage of non-performing claims by impairments stood at 60% at the end of October, as 62% of total impairments were created to cover those claims. The most significant deteriorations in the portfolio were seen in the sectors of non-financial corporations, non-residents and OFIs. There is a notable rise in non-performing claims by sector, as the concentration of arrears in the credit portfolio has spread from three sectors with a significant proportion of arrears of more than 90 days to five sectors. There is also a considerable concentration of non-performing claims, as the top 50 clients with arrears of more than 90 days account for 38.3% of non-performing claims. These are primarily non-financial corporations registered in Slovenia or the rest of the world, while 28.7% of the top 50 defaulters are in bankruptcy. Claims against bankrupt corporates accounted for 47.4% of non-performing claims in October, up on the figure in 2013. The further development of credit risk will depend on the banks' activities aimed at the more prompt resolution of the remaining non-performing investments by means of sales, restructuring, write-downs and, where justified, the conversion of claims into equity, and above all on a recovery in lending growth.

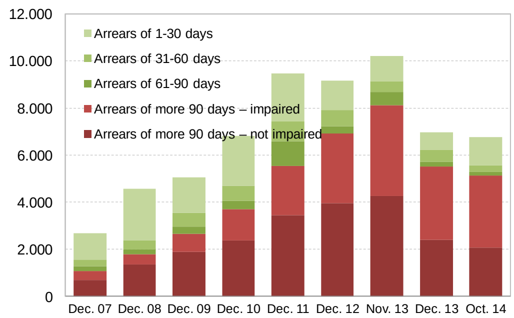
5.1.1 Classified claims more than 90 days in arrears (non-performing claims)

Non-performing claims accounted for 13.2% of the banks' total classified claims.

Classified claims more than 90 days in arrears reached EUR 5.1 billion in October, equivalent to 13.2% of the banks' total classified claims. After rising during the first months of 2014, non-performing claims stabilised from June on, but rose again in September. The proportion of non-performing claims declined by 2.5 percentage points in October to 13.2%, but also fluctuated downwards even without the effect of the transfer, as the effect of the transfer from Abanka was 1.7 percentage points. The estimated effect of the transfer from Banka Celje at the end of 2014 is a reduction in the proportion of non-performing claims by 0.8 percentage points. Excluding Factor banka and Probanka, that proportion was down 1.3 percentage points in October 2014.

Figure 5.1: Growth in classified claims (CC) and non-performing claims in percentages (left) and claims in arrears by interval in EUR million (right)



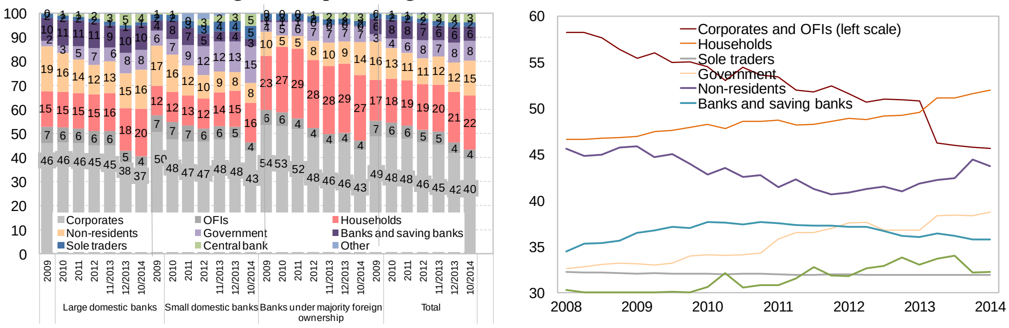


Source: Bank of Slovenia

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

The deterioration in the quality of the credit portfolio in 2014 was more the result of a decrease in the stock of classified claims than growth in non-performing claims. The classified claims of banks and savings banks have been declining since the middle of 2012, as a result of the decline in the banks' lending activity and the resolution of non-performing investments. Classified claims have declined primarily owing to the transfer of non-performing investments to the BAMC: following the first transfer in December 2013 in the gross amount of EUR 3.3 billion and the second transfer in October 2014 in the amount of EUR 1.1 billion. The banks' classified claims amounted to EUR 38.9 billion in October, the lowest level since 2007. They peaked at EUR 50 billion between 2010 and 2012.

Figure 5.2: Breakdown of the banks' classified claims by bank group and by client segment in percentages



Source: Bank of Slovenia

Primarily classified claims against corporates were down, as a reflection of the transfer of claims to the BAMC.

Primarily claims against corporates were down relative to 2012, by EUR 6.7 billion or 6.6 percentage points as a proportion of the portfolio, as a reflection of the transfer of non-performing claims to the BAMC. Non-performing claims from the aforementioned sector in the amount of EUR 2.8 billion were transferred in the first tranche, while claims totalling EUR 874 million were transferred in the second tranche.

On the contrary, the stock of investments was up by EUR 0.5 billion or 3.3 percentage points relative to 2012 in the sector of non-residents, although absolute growth in investments vis-à-vis non-residents was only recorded at the banks under majority foreign ownership. The aforementioned increase was in part a reflection of an increase in overnight investments at parent banks in the rest of the world. The large domestic banks' investment in the rest of the world were down in absolute terms. However, notable growth in the relative proportion of the aforementioned investments has been seen since December 2013, as this part of the non-performing portfolio was not subject to transfer to the BAMC.

Table 5.1: Breakdown of classified claims by client segment in terms of number of days in arrears in the settlement of liabilities to banks, with the effects of the transfer to the BAMC, in EUR million and percentages

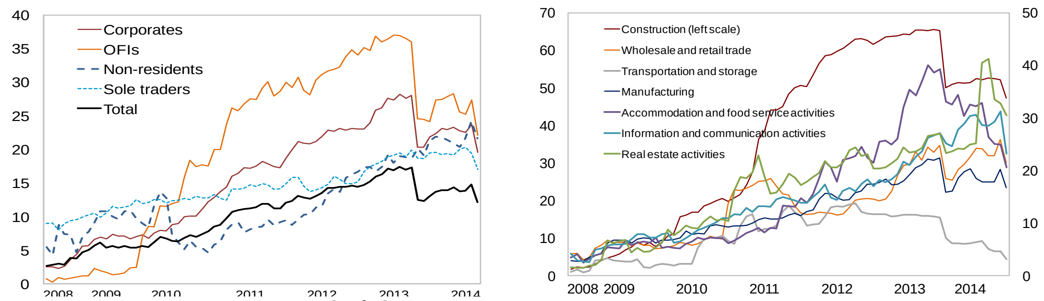
	Classified claims				Proportion of claims more than 90 days in arrears in client segment							
							Change in December				Change in October	
	Nov. 13	Dec. 13	Sep. 14	Oct. 14	Nov. 13	Dec. 13	Total	excluding effect of transfer	Sep. 14	Oct. 14	Total	excluding effect of transfer
Total, EUR million	44.879	41.329	39.465	38.864	8.117	5.520	-2.597	35	6.204	5.116	-1.088	-346
							%					
Corporates	45,4	41,7	41,3	39,6	28	20,4	-7,6	0,7	23,7	19,6	-4,1	-1,2
OFIs	5,3	4,5	4,3	3,8	36	24,5	-11,5	0,0	27,4	22,1	-5,3	-1,8
Household sector [1]	21,4	23,0	23,8	24,2	5,4	5,3	-0,1	0,1	5,6	5,5	-0,1	0,1
sole traders	1,9	1,9	1,9	1,9	19,9	18,7	-1,2	0,7	19,4	17,0	-2,4	-1,0
households [1]	19,5	21,1	21,9	22,3	4,1	4,1	0,0	0,0	4,4	4,6	0,2	0,2
Non-residents	11,8	12,2	13,7	14,6	18,7	20,1	1,4	1,5	24,2	21,6	-2,6	-2,6
Government	6,8	8,3	8,7	8,2	0,9	1,0	0,1	0,1	0,8	0,9	0,1	0,2
Banks and saving banks	6,0	6,4	5,8	6,0	0,1	0,1	0,0	0,0	0,4	0,1	-0,3	-0,3
Central bank	3,0	3,7	2,2	3,5	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Other	0,2	0,1	0,1	0,1	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Total	100,0	100,0	100,0	100,0	**18,1**	**13,4**	**-4,7**	**0,2**	**15,7**	**13,2**	**-2,6**	**-0,9**

Source: Bank of Slovenia

The proportion of non-performing claims was down in the highest-risk client segments relative to November 2013: by 13.9 percentage points at OFIs, by 8.5 percentage points at non-financial corporations and by 2.9 percentage points at sole traders. With October's transfer to the BAMC, the proportion of non-performing claims was down 5.3 percentage points at OFIs relative to the previous month, and down by 4.1 percentage points at non-financial corporations and 2.4 percentage points at sole traders.

In terms of the deteriorating quality of the portfolio, OFIs and non-residents continue to stand out with proportions of non-performing claims of 22.1% and 21.6% respectively. Non-performing claims have also risen against sole traders in the last two years. However, this client segment does not pose a major risk to the average quality of the banks' investments due to their low exposure to this segment. The highest concentration of total non-performing claims is seen in the corporate sector, at EUR 3 billion or 59% of all non-performing claims. Credit risk thus represents the prevailing risk for the banks. Both non-financial corporations and OFIs were included in the transfer to the BAMC.

Figure 5.3: Arrears of more than 90 days as a proportion of the banks' total classified claims by client segment (left) and by most significant sectors (right) in percentages



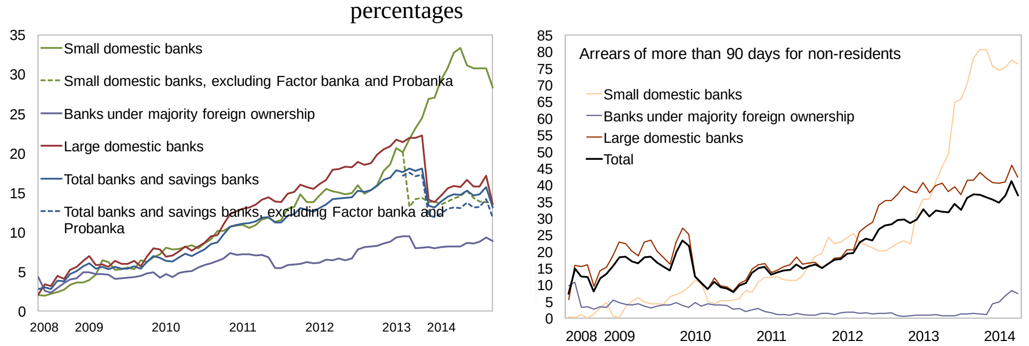
Source: Bank of Slovenia

The proportion of non-performing claims in the sectors of accommodation and food service activities and transportation and storage was down in 2014, independent of the transfer to the BAMC.

The proportion of non-performing claims in the corporate sector declined to 19.6% in October. Contributing most to the decline from 28% in November 2013 were transfers from three banks to the BAMC. However, even without the effect of those transfers, the stock of non-performing claims against corporates was down in absolute terms, particularly between May and August 2014. Both the stock and proportion of non-performing claims were down in the sectors of accommodation and food service activities and transportation and storage.

Construction remains a high-risk sector, even following transfers to the BAMC, as 47.6% of claims are more than 90 days in arrears. A significant change can be seen in the real estate activities sector relative to the previous year, as the proportion of claims in arrears has risen by 20.1 percentage points since the end of 2010. One notable change following the transfer is a reduction in the concentration of arrears by sector: the sectors of construction, manufacturing and wholesale and retail trade accounted for 82.2% of arrears more than 90 days in 2012. Following the first transfer in December 2013, four sectors have played a significant role in arrears (the sector of professional, scientific and technical activities in addition to the previously mentioned sectors). In October 2014 five sectors with a high proportion of non-performing claims accounted for 93.3% of all arrears of more than 90 days (including the sector of real estate activities).

Figure 5.4: Arrears of more than 90 days as a proportion of total classified claims by bank group (left) and for the non-resident segment (right) in percentages



Source: Bank of Slovenia

Non-performing claims have risen sharply over the last year at the small domestic banks (arrears of more than 90 days at Factor banka and Probanka alone account for 65% of the small domestic banks' arrears) to peak at 33.3% around the middle of the year, thereby overtaking the proportion of non-performing claims at the large domestic banks. Excluding Factor bank and Probanka, the quality of this bank group's credit portfolio is relatively better than at the large domestic banks, and demonstrated a trend of improvement in 2014, particularly after June.

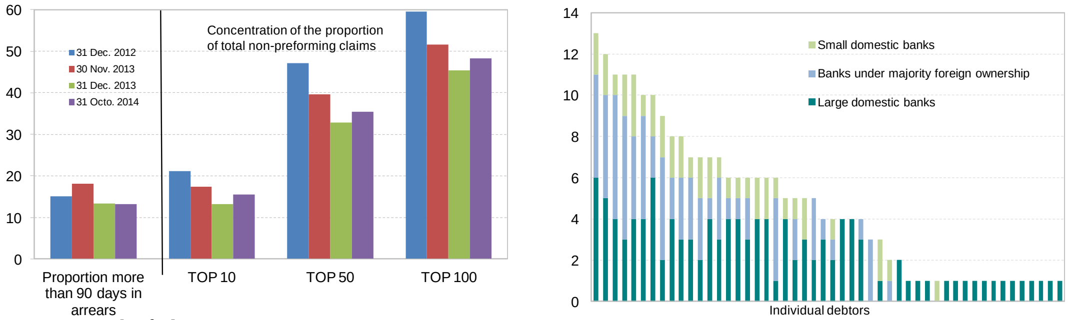
Despite the high proportion of non-performing claims at the small domestic banks, the latter account for 19.5% of the banking system's total non-performing claims, while the large domestic banks account for 56% of the banking system's non-performing claims in October. The quality of the portfolio of the banks under majority foreign ownership in October was similar to that in the middle of 2013.

The importance of non-performing claims against non-residents in the portfolio of the large domestic banks is increasing.

The highest proportion of non-performing claims is recorded by non-residents at both the small and large domestic banks, primarily as the result of the operations of members of banking groups on foreign markets, particularly on the markets of south-eastern Europe. The quality of the portfolio of non-residents has deteriorated by 5 percentage points relative to 2012, while classified claims have remained at almost the same level in nominal terms. Claims against non-residents were not subject to transfer to the BAMC. Their relative importance in terms of the non-performing claims of the large domestic banks has thus increased significantly: from 13% in November 2013 to 30% in October 2014, while the stock of the aforementioned claims has risen considerably less, by 7%.

There is also a high concentration of non-performing claims, as the top 50 clients with arrears of more than 90 days account for 38.3% of non-performing claims. These are primarily non-financial corporations registered in Slovenia or the rest of the world. Corporates in bankruptcy account for 28.7% of the top 50 defaulters. Half of the top 50 defaulters are indebted to at least five banks, which requires increased coordination by creditors in the resolution of claims against the largest defaulters or in potential restructuring processes.

Figure 5.5: 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, October 2014



Source: Bank of Slovenia

With the transfer of non-performing claims to the BAMC, which primarily included large domestic enterprises, the proportion of clients with arrears of more than 90 days was concentrated at small and medium-sized enterprises[9] (SMEs). Non-performing claims against SMEs accounted for 39.2% of total non-performing claims against corporates in October 2014, while that proportion stood at just 28.7% in the context of a higher stock prior to the first transfer.

Transitions of non-financial corporations between credit ratings

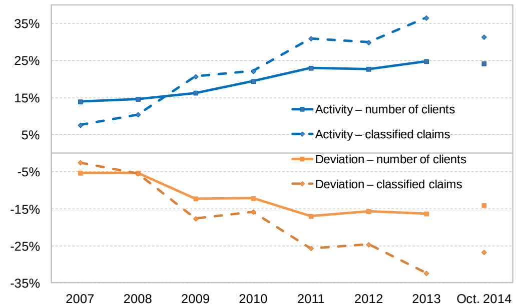
The quality of the banks' credit portfolio continued to deteriorate in 2014, but to a lesser extent than the previous year, while the rate of deterioration remains quite high

The quality of the banks' credit portfolio continued to deteriorate in 2014, but to a lesser extent that the previous year. Activity[10] and drift[11] were down slightly in October 2014 compared with the end of 2013, but remain at relatively high levels. Contributing significantly to this is the calculation period, which included the end of 2013 when certain clients were downgraded following the comprehensive review of the banking system. Because this mostly involved clients to which the banks had large exposures, this had a considerable impact on indicators calculated on the basis of classified claims. The calculation also includes the transfer of non-performing claims from Abanka to the BAMC carried out in October 2014. Drift was 2.2 percentage points higher in September 2014, before the transfer from Abanka was completed, meaning that the unfavourable trend of a deteriorating portfolio would have continued

[9]SMEs include micro, small and medium-sized enterprises, the size of enterprises being defined based on the definition set out in Article 55 of the ZGD-1H.
[10] Activity illustrates the proportion of corporates whose credit ratings changed.
[11]Drift is calculated as the number of clients whose credit ratings improved minus 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.

in 2014 without the active resolution of the banks' non-performing portfolio via the transfer to the BAMC.

Figure 5.6: Activity and drift in percentages



Note: Activity and drift for October 2014 were calculated for the period October 2013 to October 2014.
Source: Bank of Slovenia

Changes in the credit portfolio are analysed in detail based on transition matrices. The transition matrices for the period December 2013 to September 2014 and for the same period a year earlier are compared as they are not impacted by the transfer of non-performing claims to the BAMC. The comparison indicates that the transition matrix for 2014 is better on average than the matrix for 2013. The improvement in 2014 is even more notable when comparing transition matrices that are weighted by exposure. The lower proportion of transitions of clients to lower, higher-risk credit ratings is a shift in the right direction. However, that proportion remains relatively high compared with the pre-crisis period and with the period following the outbreak of the crisis, and means the continued accumulation of non-performing loans in the banks' balance sheets.

Table 5.2: Proportion of transitions of non-financial corporations between credit ratings, taking into account the number of clients, in percentages

December 2012 – September 2013

		September 2013				
		A	B	C	D	E
December 2012	A	83,1	13,0	2,8	0,9	0,3
	B	7,2	76,0	11,7	4,1	0,9
	C	1,2	6,4	65,6	17,5	9,3
	D	0,2	0,9	2,6	61,6	34,7
	E	0,0	0,1	0,3	3,2	96,4

December 2013 – September 2014

		September 2014				
		A	B	C	D	E
December 2013	A	84,7	12,9	1,4	0,9	0,2
	B	9,2	78,5	8,6	3,0	0,7
	C	2,3	7,1	60,5	23,5	6,6
	D	0,6	0,6	1,9	65,7	31,2
	E	0,1	0,0	0,1	2,1	97,7

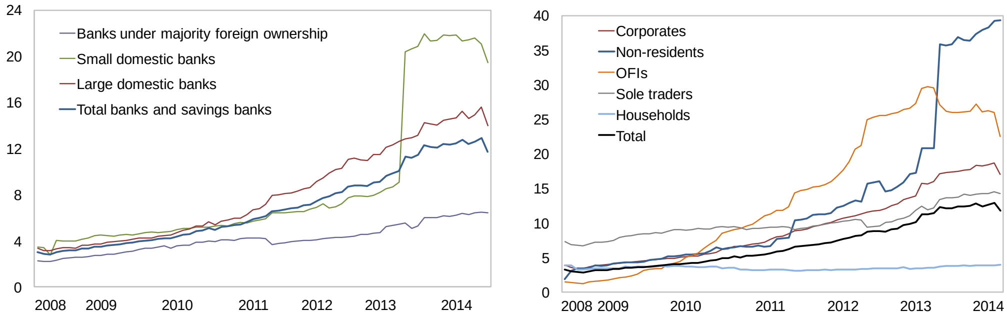
Source: Bank of Slovenia

Coverage by impairments

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

The banks assess potential losses for claims more than 90 days in arrears and create additional impairments accordingly. The proportion of non-impaired claims more than 90 days in arrears was down 21.5 percentage points following the transfer to the BAMC. Contrary to classified claims, impairments and provisions rose constantly from 2007 until the third quarter of 2013, since which time they have remained at around EUR 5 billion. The stock of impairments and provisions decreased to EUR 4.6 billion with the transfer to the BAMC in October 2014. Despite little previous change in the stock of impairments and provisions, coverage by impairments and provisions rose to a record level of 12.9% owing to the contraction in the credit portfolio. That figure then fell by 1.2 percentage points following last October's transfer to the BAMC.

Figure 5.7: Coverage of classified claims by impairments by bank group (left) and by client segment (right) in percentages

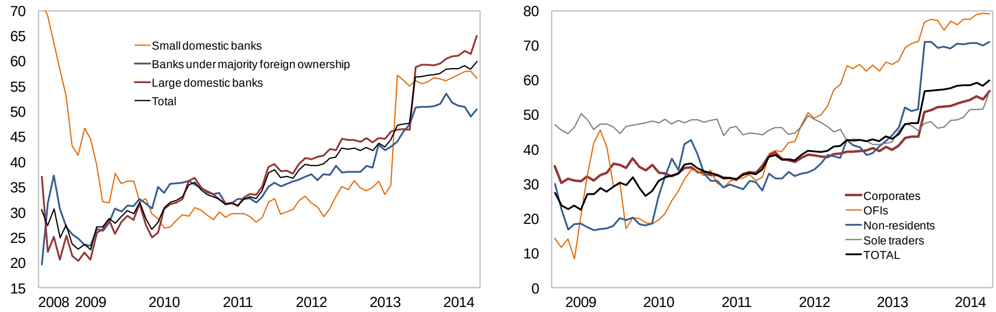


Source: Bank of Slovenia

Primarily the sector of non-residents saw an increase in impairments in 2014, by 17 percentage points. This is a reflection of the above-average risk of this sector. The small domestic banks recorded the sharpest increase in impairments. The aforementioned bank group includes Probanka and Factor banka, which have been undergoing the orderly wind-down process since September 2013. Impairments at the small domestic banks have risen by EUR 337 million relative to 2012, most notably at the two previously mentioned banks. Coverage by impairments had risen by an additional 2.5 percentage points by the end of October 2014 in the context of a contraction in the stock of classified claims. The banks under majority foreign ownership also recorded an increase in impairments in 2014. At 6.4%, however, coverage by impairments remains significantly lower than at the other bank groups.

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

Figure 5.8: Coverage of non-performing claims more than 90 days in arrears by impairments by bank group (left) and by client segment (right) in percentages



Source: Bank of Slovenia

Of the banks' total impairments, 62% are earmarked for covering non-performing claims more than 90 days in arrears. The indicator of the coverage of claims more than 90 days in arrears by impairments does not take into account credit protection in the form of collateral pledged by the debtor. The coverage of claims more than 90 days in arrears by impairments increased throughout the year, reaching 60% in October.

Some 62% of total impairments are earmarked for covering non-performing claims.

The small domestic banks have the highest coverage by impairments, as the latter rose sharply at Factor banka and Probanka when the orderly wind-down process was initiated in September 2013. Those impairments now account for 68.3% of the small domestic banks' total impairments. As a result, coverage in this bank group has risen by 21.3 percentage points to stand at 56.6%. At 46%, the other two bank groups recorded similar levels of coverage of non-performing claims prior to the transfer to the BAMC. The coverage of non-performing claims increased by 18.6 percentage points at the large domestic banks in 2014 to stand at 65%, and by 3 percentage points at the banks under majority foreign ownership to 50.4%.

Table 5.3: Coverage of total classified claims and non-performing claims more than 90 days in arrears in percentages

	Coverage of total classified claims by impairments, %				Coverage of claims more than 90 days in arrears by impairments, %			
	dec.11	dec.12	dec.13	okt.14	dec.11	dec.12	dec.13	okt.14
Corporates	8,8	11,5	17,1	17,0	38,2	39,2	50,6	56,9
OFIs	14,4	24,9	26,9	22,5	38,7	64,1	76,5	79,1
Household sector	3,6	3,9	4,5	4,5	-	-	65,2	58,9
sole traders	8,8	9,1	13,5	14,2	43,7	43,3	51,6	56,8
households	3,0	3,3	3,7	3,9	-	-	70,9	71,1
Non-residents	6,6	10,4	22,4	39,3	32,9	42,6	71,0	71,0
Government	0,1	0,2	0,5	0,7	3,3	5,3	28,4	38,9
Banks and savings bank	0,5	1,2	1,2	0,6	12,1	12,2	0,8	0,5
Total coverage	6,6	8,7	12,2	11,7	37,8	42,7	56,8	59,9
	Total classified claims				Total claims more than 90 days in arrears			
Total, EUR million	49.466	47.876	41.329	38.864	5.547	6.904	5.520	5.116
	Total impairments				Total impairments more than 90 days			
Ratio to GDP, %	3.249	4.170	5.054	4.557	2.097	2.949	3.133	3.066

Sources: Bank of Slovenia

The coverage of non-performing claims in individual portfolio segments indicates which client segments bear higher risk, taking into account the quality of collateral. The coverage of non-performing claims is highest in the sector of OFIs, where it reached 79% in October 2014.

Collateralisation of claims

The banks reduce their exposure to credit risk by securing collateral that is redeemed the moment a bank recognises that a claim cannot be repaid in full without the redemption of collateral. The value of collateral received also impacts the amount of impairments and provisions required for a particular claim. In the banking system overall, the proportion of classified claims accounted for by unsecured claims exceeds one half. The total value of collateral received (measured at fair value) covers 91.5% of classified claims. However, the aforementioned figure does not exclude collateral valuations in excess of the value of the claim against the individual 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 (for example, real estate may be pledged as collateral at several banks, taking into account seniority and the proportion of repayment).

Table 5.4: Collateral on the banks' classified claims by client segment in October 2014 in percentages

	Classified claims, EUR million	Comparison of collateral [2] with classified claims, %						
		Claims excluding pledged property [1]	By shares, participating interests and mutual fund	By commercial real estate [3]	By residential real estate [3]	At insurer	Other forms of collateral	Total value of collateral [3]
Corporates	16.260	40,6	4,7	64,9	6,9	0,1	42,1	118,6
OFIs	1.270	73,7	3,2	6,8	1,4	0,0	24,1	35,6
Household sector	9.399	25,4	0,3	13,6	99,1	20,2	10,2	143,3
Households	8.662	25,3	0,3	4,1	102,5	21,7	8,5	137,0
Sole traders	736	25,8	0,1	125,3	58,3	3,2	30,6	217,5
Non-residents	5.669	82,2	1,1	18,9	1,6	0,0	8,0	29,6
Government	3.883	86,7		2,2	0,1		12,9	15,2
Banks and saving b	2.333	96,1	0,1	0,1	0,0		3,9	4,1
Other	50	100,0						
Total	38.864	52,1	2,3	33,6	27,2	4,9	23,6	91,5

Notes: [1] The figure includes unsecured claims and claims secured with forms of collateral that are not taken into account in the banks' calculation of impairments and provisions (e.g. collateral in the form of bills of exchange).
[2] Collateral is stated at fair value.
[3] With regard to collateral in the form of real estate, several banks may register a mortgage on the same real estate. In such cases the value of the mortgage at each successive bank is reduced by the value of the claims of banks with seniority in the possible redemption of the collateral. 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: non-financial corporations, non-residents and OFIs. The prevailing form of collateral remains real estate, where commercial real estate is the prevailing form of collateral at corporates with an LTV ratio of 64.9%, while that ratio is 102.5% for households. Collateral in the form of real estate is impacted by lower turnover in real estate, which actually improved in 2014, and the fall in real estate prices since 2008. In this way, the value of collateral is declining, which is reflected in an increase in impairments for specific claims.

Table 5.5: Collateralisation of non-performing claims by bank group in October 2014 in percentages

	Classified claims, EUR million	Comparison of collateral 2 with classified claims, %						
		excluding pledged property 1	participating interests and mutual fund	By commercial real estate 3	By residential real estate 3	At insurer	Other forms of collateral	Total value of collateral 3
Savings banks	7,0	35,0		120,5	86,3		1,5	208,3
Small domestic banks	959,0	42,2	5,9	67,1	20,1	0,0	19,9	113,0
Foreign banks	1.080,9	53,8	3,6	44,5	12,0	0,0	23,5	83,7
Large domestic banks	2.674,8	49,6	5,3	57,1	4,3	0,0	10,3	77,2
Total	4.721,7	49,1	5,0	56,4	9,4	0,0	15,3	86,1

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

The banks under majority foreign ownership have the highest proportion of unsecured claims, followed by the large domestic banks, which transferred their non-performing claims to the BAMC, resulting in an increase in the proportion of unsecured claims. 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 also declined.

5.2 Resolution of banks' non-performing claims

Classified claims against bankrupt clients, restructured claims and write-offs

The number of bankruptcies rose over the first ten months of 2014 compared with 2013, and is 2.2 times higher than in 2012. The banks' exposure to corporates in bankruptcy constitutes the largest risk of claims being lost or only partially repaid. The number includes corporates in the sectors of non-financial corporations, OFIs and sole traders, but does not cover non-resident corporates.[12]

Figure 5.9: Number of bankruptcy proceedings initiated at year end

Source: Bank of Slovenia

The banks' exposure to corporates in bankruptcy has declined following transfers to the BAMC.

Classified claims against clients in bankruptcy increased by EUR 166 million relative to the end of 2013. The stock of claims against corporates in bankruptcy fell by EUR 1.3 billion from November to December 2013 owing to the transfer to the BAMC, mostly notably in the construction sector where the proportion of bankrupt corporates fell by 12.6 percentage points. The proportion of classified claims against construction corporates in bankruptcy recorded the highest growth in 2014, by 8.8 percentage points, and against corporates from the sector of professional, scientific and technical activities, by 6.2 percentage points. Claims against bankrupt corporates accounted for

[12] It includes all corporates established in the Republic of Slovenia to which banks were exposed as at 31 October 2014 that were undergoing personal bankruptcy proceedings or corporate bankruptcy proceedings initiated prior to 20 December 2014.

47.4% of non-performing claims against corporates in October, an increase of 11.4 on the end of 2013.

Table 5.6: 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 corporates in bankruptcy, EUR million			Proportion of total classified claims of sector, %			Proportion of non-performing claims by sector, %		
	2012	2013	okt.14	2012	2013	okt.14	2012	2013	okt.14
Agriculture, mining	12	3	6	3,9	1,3	3,0	24,3	8,1	30,2
Manufacturing	368	205	176	6,3	4,3	4,2	36,3	27,3	25,1
Electricity, gas and water	3	5	6	0,2	0,4	0,5	7,2	9,4	7,0
Construction	1.256	588	623	38,4	30,1	38,8	62,4	60,1	82,0
Wholesale and retail trade	157	169	289	4,0	5,3	11,0	27,6	28,7	50,8
Transportation and storage	136	89	34	6,9	4,7	1,9	59,4	65,9	63,1
Accommodation and food service activities	12	31	36	1,8	6,1	8,3	8,2	18,5	39,8
Information and communication	16	7	20	2,5	1,4	3,9	10,2	10,7	30,1
Financial and insurance activities	65	32	26	8,0	7,9	8,2	25,4	27,7	37,8
Real estate activities	41	57	62	3,9	7,0	8,2	19,3	29,9	23,5
Professional, scientific and technical activities	108	75	146	5,6	4,7	10,9	32,8	18,7	46,7
Public services	3	2	5	0,7	0,5	1,5	5,6	5,7	16,3
Total	2.178	1.262	1.428	9,8	7,3	9,4	43,0	36,0	47,4

Source: Bank of Slovenia

When a documented assessment has been provided by more than half of the banks in terms of exposure to a corporate or by an independent advisor stating that greater repayments can be ensured on the basis of the operational, ownership or financial restructuring of the corporate than in bankruptcy and that continuation as a going concern can be facilitated, a bank is obliged[13] to begin restructuring activities without delay. If several banks are included in the restructuring process, they must mutually sign a binding agreement on further restructuring steps, known as a master restructuring agreement (MRA). The Bank of Slovenia has drawn up guidelines for creating impairments and provisions for exposures to restructured clients aimed at encouraging banks to take a more active role in the restructuring of over-indebted but otherwise prospective corporates and to monitor the commitments set out in MRAs more efficiently, and thus improve the quality of the banks' credit portfolios and operating results. There were 30 such restructuring cases in November 2014 in the total amount of EUR 1.8 billion, with six additional restructuring agreements on the brink of being signed. The most frequent forms of restructuring are the divestment of assets and/or operations, the extension of the deadline or deferral of the repayment of claims and conversion of claims into an investment in the equity in the debtor.

The banks' credit portfolios included EUR 4 billion in restructured claims in October 2014.

If it becomes likely that a client will not settle its obligations to a bank in full due a deterioration in its financial position, assuming no changes in other conditions, a bank may make a business decision to amend the repayment terms set out at the time the claim in question was approved. Each such amendment is recorded as aid to the client or as a restructured loan. The banks recorded restructured claims in October 2014 in the amount of EUR 4 billion. Of that amount, 43% of claims are rated D or E, while 35.9% of restructured claims are already more than 90 days in arrears, an indication that restructuring was not successful. The highest proportion of claims were restructured by extending the deadline or deferring repayment, and a combination of the former with the cutting of the associated interest rate and/or other costs.

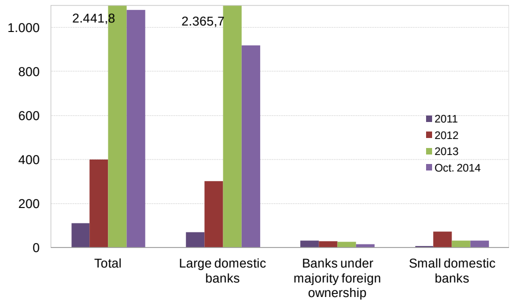
The small domestic banks recorded the highest proportion of write-offs of non-performing claims, as a result of the orderly wind-down process at Factor banka and Probanka.

The Bank of Slovenia's aim was to expedite the write off of non-performing claims by allowing the banks to write 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. Despite this, there was no significant increase in write-offs, except during transfers to the BAMC: write-offs totalling EUR 2.3 billion were made in December 2013 and totalling EUR 0.8 billion in October 2014, or 3.3 times the total amount of write-offs in the preceding nine months. The large domestic banks made 85% of all write-offs due to the transfer of non-performing claims from Abanka d.d. to the BAMC, while a large amount of write-offs were also made by the small domestic banks, EUR 140

[13] Subsection 2.1.2.3 of Appendix 1 to the Regulation on risk management and implementation of the internal capital adequacy assessment process for banks and savings banks (UL RS, No. 25/2014).

million by Factor banka and Probanka alone, representing 97% of write-offs by the small domestic banks.

Figure 5.10: Write-offs of financial assets at banks in EUR million



Sources: Bank of Slovenia

The banks were recapitalised in the amount of EUR 3.6 billion in 2013 and 2014. In addition, non-performing claims in the gross amount of EUR 4.9 billion (net amount of EUR 2.4 billion) were transferred to the BAMC in exchange for bonds issued by the latter in the amount of EUR 1.6 billion.

Table 5.7: Measures to stabilise the banking system adopted by the Slovenian government and Bank of Slovenia

Measures by the Slovenian government and Bank of Slovenia.	Recapitalisation		Write-off of subordinated debt		Transfer of claims to the BAMC*				Receipt of BAMC bonds	
	2013	2014	2013	2014	2013		2014		2013	2014
Previous changes, EUR million					Gross value	Net value	Gross value	Net value		
1) Active banks[1]	2.769	433	-441	-92	-3.317	-1.835	-1.555	-605	1.012	551
2) Banks undergoing the orderly wind-down process	445		-64							
	Recapitalisation		Write-off of subordinated debt		Transfer of claims to the BAMC*		Gross	Net	Receipt of BAMC bonds	
Total of all banks in 2013 and 2014		3.647		-597			-4.873	-2.440		1.563

Note:[1] NLB d.d., NKBM d.d., Abanka Vipa d.d. and Banka Celje.
[2] Factor banka d.d. and Probanka d.d.
Sources: Bank of Slovenia

Bank of Slovenia guidelines for creating impairments and provisions for exposures to restructured clients as a micro-prudential measure

Despite the transfers to the BAMC and the reduction in non-performing claims in specific segments of the credit portfolio, the quality of the latter remains unfavourable and, in addition to credit risk, represents considerable income risk and insolvency risk for the banks. With the intention of encouraging the banks to take a more active role in the restructuring of over-indebted but otherwise prospective corporates and the resulting improvement in the quality of the portfolio, the Bank of Slovenia drew up guidelines for creating impairments and provisions aimed at encouraging banks to gradually release impairments and provisions on restructured corporate exposures whenever MRAs are reached with such clients. Corporates must consistently fulfil their obligations under such agreements as a condition for the release of impairments. As a micro-prudential measure, the aforementioned guidelines were coordinated in advance with the Slovenian Institute of Auditors and the audit firms that audit the banks.

Following the signing of an MRA, a bank is obliged to regularly monitor the financial position of the corporate in question, the cash flows its generates and the fulfilment of commitments from an approved restructuring plan. Based on all available information at specified time intervals, a bank assesses whether impairments and/or provisions vis-à-vis a debtor may be reduced by a certain amount. If a corporate meets the criteria stated below, a bank may release a portion of impairments and/or provision vis-à-vis the debtor in question as follows: up to 20% of impairments and provisions three months following the conclusion of an agreement, up to 40% after six months, up to 60% after nine months and up to 80% after one year. The opposite applies if the corporate begins to settle its obligations in arrears, i.e. the bank must increase impairments and/or provisions.

The criteria that must be met at each time interval for a potential reduction in impairments are as follows:

- a possible moratorium on the repayment of debt has already expired and the corporate regularly repays all liabilities to the bank;
- generated cash flows are in line with planned cash flows;
- divestment is proceeding according to the plan agreed in the MRA; and
- the corporate is meeting its commitments from the MRA.

In addition, a bank must verify the fulfilment of the following additional criteria at certain time intervals:

- three months following the signing of the MRA: whether the corporate has obtained additional financing for working capital, advances, or new guarantee potential;
- six months following the signing of the MRA: whether the corporate was recapitalised by the existing owners or the potential conversion of part of the owners' claims into equity in the debtor;
- nine months following the signing of the MRA: whether commercially unnecessary assets (real estate or financial assets) and/or unprofitable or commercially unnecessary lines of business were sold, resulting in a significant deleveraging; and
- 12 months following the signing of the MRA: entry of a new portfolio or strategic investor; change in the business model; an increase in market share in the core line of business.

The release of impairments and provisions would encourage the banks, via improved operating results, to take a more active role in the financial restructuring of corporates, which represents an impediment to a recovery in lending activity, higher economic growth and a reduction in the banks' non-performing claims.

6 OTHER RISKS

6.1 Liquidity risk

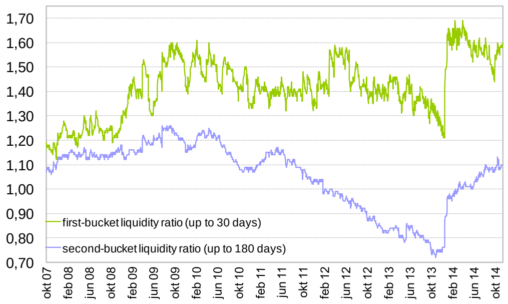
The liquidity of the Slovenian banking system improved in 2014 relative to the previous year, which has been reflected in a relatively high first-bucket liquidity ratio, in a high proportion of the pool of eligible collateral at the Eurosystem that is free, and in a higher proportion of total assets accounted for by marketable secondary liquidity. The expectation is that Slovenian banks' participation in the ECB's targeted longer-term refinancing operations (TLTROs) will further increase surplus liquidity. It is anticipated that there will be no significant change in the manner in which surplus liquidity is managed. Given the banks' cautious behaviour and lack of appetite for taking up additional risks, lending activity will not strengthen sharply. Poorer access to international financial markets and the non-functioning of the Slovenian interbank market are restricting Slovenian banks in their liquidity management, which is exposing them to greater liquidity risk in the future.

Liquidity indicators

Liquidity risk is low. The first-bucket liquidity ratio is high.

The liquidity risk of the Slovenian banking system was relatively low at the end of 2014. The banks had high surplus liquidity at their disposal. The first indicator of the favourable liquidity position is the high first-bucket liquidity ratio. After increasing sharply last December as a result of the bank recapitalisations and the BAMC bonds received, it remained high this year, despite a small decline. It declined by 0.06 between January and October 2014, to 1.56. There were two main factors in the movement in the ratio during this period: changes in deposits by the government sector, which primarily made overnight placements at three banks, and the early repayment of liabilities to the Eurosystem from the 3-year LTRO.

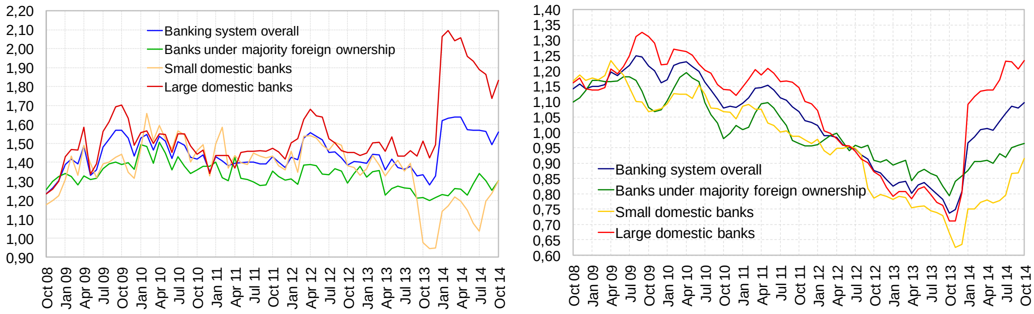
Figure 6.1: Daily liquidity ratios for the first and second buckets of the liquidity ladder



Source: Bank of Slovenia

These two factors were also the main reasons for the significant decline in the first-bucket liquidity ratio at the large domestic banks of 0.23 over the first ten months of the year to 1.83. Although this was the largest decline recorded by the different bank groups, the first-bucket liquidity ratio at the large domestic banks remains significantly higher than the average for the banking system overall owing to the recapitalisations in December.

Figure 6.2: Liquidity ratios for the first bucket (0 to 30 days; left) and the second bucket (0 to 180 days; right) of the liquidity ladder by individual bank group, monthly averages



Source: Bank of Slovenia

The second-bucket liquidity ratio stood at 1.10.

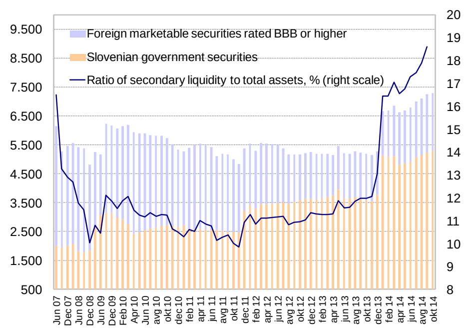
The relatively good liquidity position of Slovenian banks is also reflected in the second liquidity indicator, the second-bucket liquidity ratio, which increased by 0.13 over the period in question to 1.10. Alongside the repayment of liabilities to the Eurosystem, another factor in the increase was the strengthened short-term placement of surplus liquid assets with banks in the rest of the world.

Growth in marketable secondary liquidity[14] is the next indicator of the favourable liquidity position of Slovenian banks. At the same time this is a reflection of their liquidity management methods, which reveal the banks' reluctance to take up the additional credit risk to which they would be exposed were the surplus liquidity to be directed towards increased lending.

The proportion of total assets accounted for by marketable secondary liquidity increased to 18.6%.

The stock of marketable secondary liquidity increased by EUR 634 million between January and October 2014 to EUR 7.3 billion. The proportion of total assets that they account for increased by 2.1 percentage points to 18.6%, owing to the contraction in total assets. The breakdown of secondary liquidity changed over the first ten months of the year, with a shift towards foreign marketable securities rated BBB or higher, but it nevertheless remains relatively concentrated. Slovenian government securities still accounted for 73% of the banking system's total secondary liquidity in October 2014. This exposes the banks to increased liquidity risk in the event of a sovereign downgrading. Of the bank groups, the small domestic banks are the most exposed to this risk: Slovenian government securities accounted for 87% of their secondary liquidity, which represented 18.6% of their total assets in October 2014.

Figure 6.3: Changes in the stock of marketable secondary liquidity (monthly averages in EUR million) 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

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

Management of surplus liquidity

The banks are managing surplus liquidity cautiously, and are averse to taking up new risks.

The methods by which Slovenian banks manage their surplus liquidity is an indication of their cautious behaviour and aversion to taking up new credit risk. Until early June 2014 the domestic banks in particular placed their surplus liquidity with the Eurosystem via 1-week fixed-term deposits, while the banks under majority foreign ownership placed it with their parent banks in the rest of the world via short-term deposits.

Slovenian banks' sharply strengthened their net creditor position on the euro area money market.

With the abolition of fixed-term deposits and the introduction of a negative interest rate on the ECB's deposit facility within the framework of the aforementioned measures, the banks further strengthened their placements with banks in the rest of the world. This was reflected in a sharp strengthening of their position as net creditors on the euro area unsecured money market. Slovenian banks' net claims in this market increased by EUR 793 million between January and October 2014 to EUR 1.5 billion. The fact that Slovenian banks have practically no liabilities in this market is an indication of their limited options for managing liquidity. Given that the entire Eurosystem is simultaneously facing large surplus liquidity, there is no expectation that the situation on international markets will change for Slovenian banks.

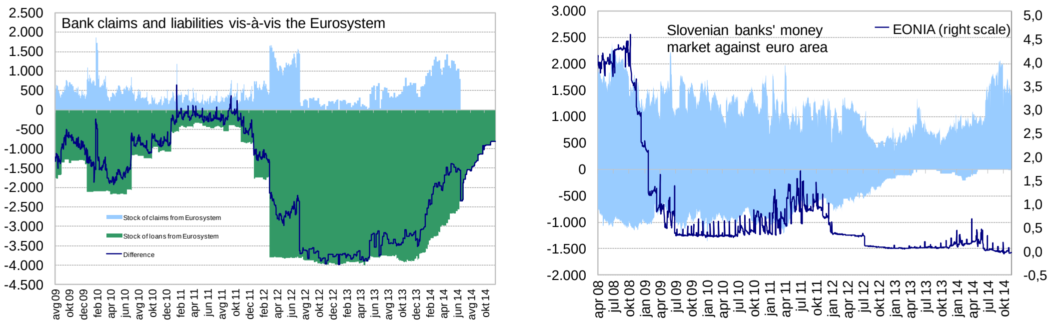
The banks had made early repayments of 80% of the liabilities from the 3-year LTRO by the end of October.

By contrast, the measures taken by the ECB encouraged Slovenian banks, particularly those under domestic ownership, to speed up their early repayment of liabilities from the 3-year LTRO at the Eurosystem, which otherwise mature in the first quarter of 2015. Slovenian banks reduced these liabilities by EUR 2.9 billion over the first ten months of 2014 to EUR 0.8 billion, having thereby repaid 80% of the funding obtained in the 3-year LTRO auctions. Over half of the banks have repaid these liabilities in full.

The proportion of the pool of eligible collateral that is free increased sharply to 84%.

This sharply increased another of the liquidity indicators, namely the proportion of the pool of eligible collateral at the Eurosystem that is free, which increased by 38 percentage points to 84%. The total pool declined by EUR 1.2 billion over the first ten months of the year to EUR 5.2 billion, in the wake of good bank liquidity and early repayments of the 3-year LTRO.

Figure 6.4: Claims, liabilities and net position of commercial banks vis-à-vis the Eurosystem in EUR million (left) and stock of unsecured loans of Slovenian banks placed and received on the euro area money market in EUR million, and movement in the EONIA in percentages (right)



Source: Bank of Slovenia

Future bank liquidity

The banks obtained EUR 631 million by participating in the second TLTRO.

As expected, the banks strengthened their liquidity in mid-December 2014 by participating in the second auction of the ECB's TLTRO. While Slovenian banks' participation in the first such auction in September of this year was modest (they obtained just EUR 75.5 million), 12 Slovenian banks participated in the second auction, obtaining a total of EUR 631 million of funding. They thereby took up 70% of the estimated potential funding that they could have obtained. The motives for obtaining this funding were the banks' prudence, and the cost advantages of the funding.

There is no expectation of significant changes in the management of surplus liquidity in the near future.

Although the purpose of these operations is to encourage lending to the real economy, there is no expectation of a significant increase in lending activity by Slovenian banks. Certain banks will use the funding to make the final early repayments of the 3-year LTRO, while others will continue the surplus liquidity management described above. This means that the funds will partly be diverted into securities, while the banks under majority foreign ownership in particular will strengthen their short-term placements with parent banks in the rest of the world. There is no expectation of a revival of volume on the Slovenian interbank market, and the possibilities of greater activity on the international financial markets also remain limited.

A significant factor that will affect the long-term liquidity position of Slovenian banks is their ability to maintain an appropriate, more-stable funding structure. Borrowing at the Eurosystem is not a reliable source in the long term. Maintaining deposits by the non-banking sector as the primary and most important source of funding will be a major challenge for the banks in the wake of the significant fall in liability interest rates.

6.2 Interest rate risk

The banks became more exposed to the risk of a rise in interest rates. The difference between the average repricing periods for asset and liability interest rates widened by 2.3 months between December 2013 and October 2014. The difference widened as a result of a lengthening of the average repricing period for asset interest rates and a shortening of the average repricing period for liability interest rates. Both were a consequence of changes to the banks' balance sheet structure.

The large domestic banks recorded the largest increase in interest rate risk between December 2013 and October 2014. It is still the case that the small domestic banks are most exposed to the risk of a rise in interest rates.

Exposure to interest rate risk is assessed as acceptable, although it is increasing along with the increase in the banks' investments in government securities with a fixed interest rate. Certain banks hedge against interest rate risk by means of interest rate derivatives.

6.2.1 Average repricing period for interest rates

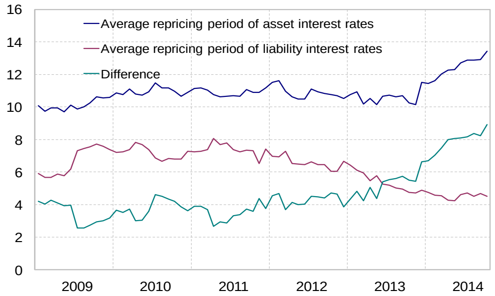
Interest rate risk has risen at all the bank groups.

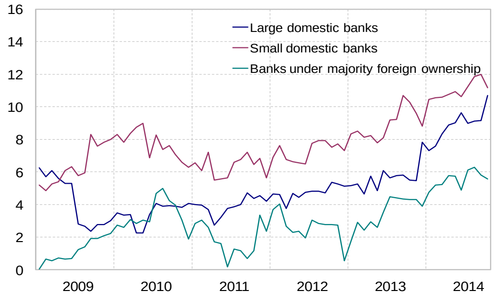
Interest rate risk as measured by the difference between the average repricing periods of asset and liability interest rates stood at almost 9 months in October 2014. The average repricing period for asset interest rates was 13.4 months, while the average repricing period for liability interest rates was almost 4.5 months. The difference between the average repricing periods for asset and liability interest rates widened by 2.3 months between December 2013 and October 2014. The main factors in the lengthening of the average repricing period for asset interest rates by 2 months were the lengthening of the average repricing period for interest rates on loans granted and investments in debt securities. In addition, the proportion of the banks' total assets 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 increase in the proportion of total liabilities accounted for by deposits, and the decline in the proportion accounted for by loans. Deposits have a shorter average maturity than loans.

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

The difference between the average repricing periods for asset and liability interest rates widened at all the bank groups between December 2013 and October 2014. The largest increase was at the large domestic banks, at almost 3 months. The key factor in the change was on the investment side. It was the lengthening of the average maturity of loans granted and of debt securities. In addition, there was an increase in the proportion of the banks' total assets accounted for by debt securities, which have a longer average repricing period than loans granted.

Figure 6.5: 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)





Sources: Bank of Slovenia

All the bank groups recorded a shortening of the average repricing period for liability interest rates, the banks under majority foreign ownership recording the largest shortening of half a month. The reason was shorter maturities on deposits taken. The average maturity on loans raised lengthened, but there was a negative effect overall, as deposits account for a greater proportion of the balance sheet than loans raised.

It is still the case that the small 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 have the largest difference between the average repricing periods of asset and liability interest rates, at 11.2 months, while the latter have smallest, at 5.6 months.

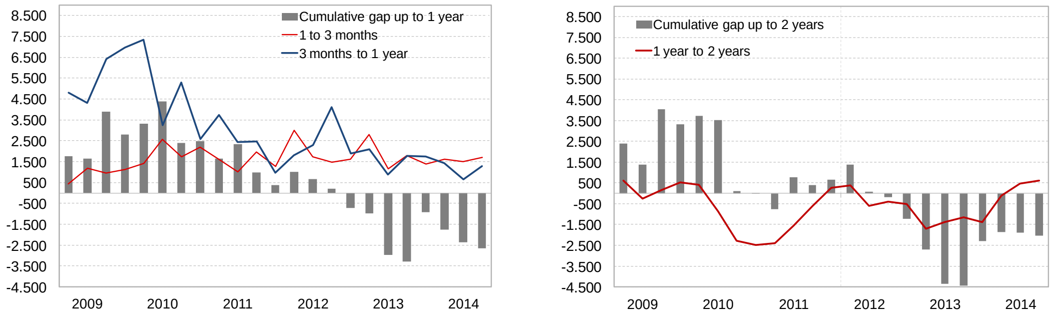
6.2.2 Interest rate gap

All the bank groups have a negative 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 2.7 billion at the end of the third quarter of 2014, having been negative in the amount of EUR 922.9 billion in December 2013. The main factor in the change was interest-sensitive assets with an interest rate repricing period of less than 1 year, which declined by EUR 1.8 billion between December 2013 and September 2014. There was no significant change in interest-sensitive liabilities over the same period. All the bank groups recorded a negative gap before hedging against interest rate risk is taken into account. The banks under majority foreign ownership had the smallest gap.

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 October 2014. All the bank groups recorded a negative gap in this bucket.

Figure 6.6: Gap between interest-sensitive assets and liabilities by individual bucket in EUR million



Sources: Bank of Slovenia

7 BANK SOLVENCY

The solvency risk of the Slovenian banking system as measured by capital ratios declined over the first nine months of 2014, but remains significant. Individual banks, primarily small domestic banks, remain capitally weak, and are therefore more exposed to solvency risk. In addition, the banks faced comprehensive reporting and methodological changes in the early part of the year, as a result of the introduction of the CRR and the CRD IV into European banking legislation.

Despite the improvement in the macroeconomic situation, the maintenance and improvement of capital adequacy continues to rely primarily on a reduction in lending activity and the corresponding decline in capital requirements. Any requirement to increase capital adequacy is therefore reflected more in a contraction in loans than in an increase in capital. The deterioration in the credit portfolio, which in 2014 was more the result of the contraction of the portfolio than an increase in non-performing claims, is reducing the banks' income and diminishing the opportunity to generate internal capital. Relatively low profitability means that the banks remain less attractive to foreign investors, which is an additional factor in the contraction in balance sheets. The banks, particularly those where capital support from the owners is weak, will have to adjust their business models to aim at capital optimisation and more intensive generation of internal capital, which will allow them to secure a more stable capital position in the future.

7.1.1 Capital adequacy

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

On 1 January 2014 the new CRR (Capital Requirements Regulation)[15] entered into force, which constitutes a new legal basis for banking in the EU, and has introduced a series of innovations in the area of capital and capital requirements. The three main purposes of the new regulation are: first, to increase the quality of capital via stricter criteria for capital instruments and the harmonisation of capital deduction items; second, to increase the amount of capital via higher requirements for capital ratios; and third, to increase the transparency of banking, thereby providing comprehensive, high-quality information to market participants.

Individual categories of solvency are illustrated 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 September 2014.

The capital adequacy ratios improved. The Tier 1 capital ratio and the CET1 ratio equalised.

The solvency risk of the banking system[16] as measured by the overall capital adequacy ratio declined over the observation period of 2014, but remains significant. Overall capital adequacy stood at 16.7% at the end of September, up 1 percentage point on March. Slovenian banks meet their capital adequacy requirements via the highest-quality forms of capital, which is reflected in the small gap between overall capital adequacy and the other capital ratios, namely the Tier 1 capital ratio and the common equity Tier 1 capital ratio (the CET1 ratio). The values of the two categories increased by 1 percentage point between March and September 2014, equalising at 15.9%.[17]The rise in the solvency ratios was primarily the result of a large decline in capital requirements, while the actual increase in regulatory capital was small.

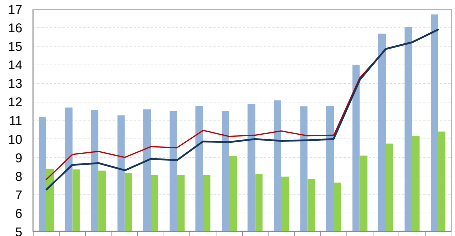
There was a smaller increase in the ratio of book capital to total assets, which stood at 10.4% at the end of September. The increase was primarily the result of a contraction in total assets, and only to a lesser extent an increase in capital.

[15] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.

[16] The Slovenian banking system includes two banks that have been undergoing the orderly wind-down process since September 2013 and that ought to be solvent, but are not required to fulfil minimum capital requirements. They are therefore entirely excluded from the analysis of solvency as of 2014, and have been excluded from the small domestic banks since September 2013 in the analysis by bank groups.

[17] The minimum capital requirements that the banks must meet after the end of the transition period under the new CRR are 8% for overall capital adequacy, 6% for the Tier 1 capital ratio, and 4.5% for the CET1 ratio.

Figure 7.1: Basic capital adequacy ratios of the banking system in percentages



	2007	2008	2009	2010	2011	Mar 12	Jun 12	Sep 12	Dec 12	Mar 13	Jun 13	Sep 13	Dec 13	Mar 14	Jun 14	Sep 14
CA	11,2	11,7	11,6	11,3	11,6	11,5	11,8	11,5	11,9	12,1	11,8	11,8	14,0	15,7	16,0	16,7
Capital/TA	8,4	8,4	8,3	8,2	8,0	8,0	8,1	9,1	8,1	8,0	7,8	7,6	9,1	9,7	10,2	10,4
T1CR	7,8	9,2	9,3	9,0	9,6	9,5	10,5	10,1	10,2	10,4	10,2	10,2	13,3	14,9	15,2	15,9
CET1	7,3	8,6	8,7	8,3	8,9	8,9	9,9	9,8	10,0	9,9	9,9	10,0	13,2	14,9	15,2	15,9

Source: Bank of Slovenia

Solvency risk is lower at all the bank groups.

Solvency risk declined at all the bank groups between March and September, the large domestic banks recording the largest decline. This was also the result of the recapitalisation of the three largest banks in the amount of EUR 2,769 million, and the transfer of non-performing claims to the BAMC in the amount of EUR 3,317 million in December 2013. Their overall capital adequacy ratio increased by 1.4 percentage points between March and September to 17.8%. The Tier 1 capital ratio and the CET1 ratio reached the same values, a reflection of the highest quality of capital structure of all the bank groups.

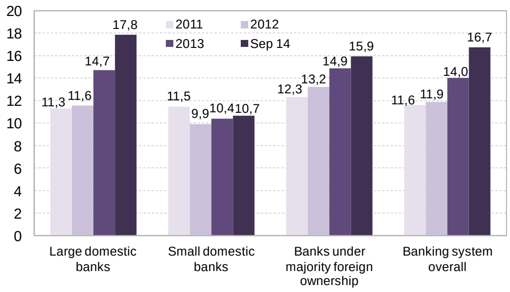
The small domestic banks are the most exposed to solvency risk.

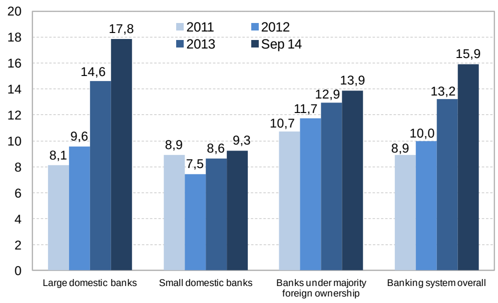
The small domestic banks remain the most exposed to solvency risk of all the bank groups, and are still the weakest in capital terms. Their overall capital adequacy ratio increased by 0.2 percentage points between March and September to 10.7%, and remains significantly below the banking system average. EUR 78 million of new capital would be required for all of the banks in this group to reach this capital adequacy figure, were their capital requirements to remain unchanged.

An improvement in profitability and the ability to generate internal capital will contribute to a capital position that is stable in the long term.

The reduction of capital requirements via a reduction in lending activity and a reluctance to take up new risks remain the main drivers of the maintenance or increase of capital adequacy at all the bank groups. Although the macroeconomic situation in Slovenia is improving, the decline in loans remains a significant obstacle to the generation of internal capital by the banks. Each requirement for an increase in capital adequacy at the banks is generally reflected more in a contraction in lending activity, and less in a direct increase in capital. Continuing adjustments of this type are leading to a deterioration in the structure of the banks' portfolio. In addition, Slovenian banks remain less attractive to foreign investors, primarily on account of their weak profitability, which is an additional factor in the contraction in balance sheets. The banks, particularly those where capital support from the owners is weak, will have to target their banking strategies and business models more on the continual improvement of profitability, which will allow them to generate internal capital, thereby securing a stable capital position.

Figure 7.2: 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

7.1.2 Capital structure

Most changes introduced at the European level by the new CRR are in the calculation and structure of capital for capital adequacy, the purpose of which is to increase the amount, quality and transparency of capital. Each of the basic categories of capital (CET1, AT1 and T2)[18] contains positive elements in the form of capital instruments and other items and negative elements in the form of deduction items for example, which under the new methodology have been expanded in terms of both number and scope.

A modest increase in regulatory capital.

The stock of Slovenian banks' regulatory capital amounted to EUR 3,679 million at the end of September 2014, up just EUR 18 million on March. The highest-quality category of capital, and also the prevailing form, is CET1. This increased by EUR 27 million over the observation period to EUR 3,496 million, and accounts for 95% of regulatory capital.

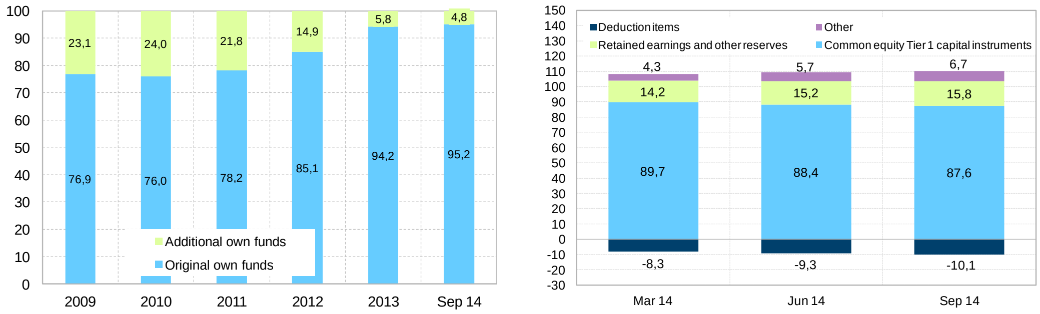
Capital instruments meeting all the conditions for the highest-quality form of capital constitute the largest proportion of CET1. The banks recorded a profit over the first nine months of the year, which was reflected in an increase in the proportion of items related to bank earnings.

Table 7.1: Stock and growth in components of regulatory capital in EUR million and percentages, under the old and new regulations

	Old regulation			New regulation - CRR						
	Stock, EUR million			Stock, EUR million			Sep 14/Mar 14		Sep 14/Dec 13	
	2011	2012	2013	mar.14	jun.14	sep.14	y-o-y growth	EUR million	y-o-y growth	Increase, EUR million
Regulatory capital	4.361	4.196	3.657	3.661	3.664	3.679	0,5%	18	-0,6%	22
Tier 1 capital (T1)	3.606	3.604	3.462	3.475	3.481	3.502	0,8%	27	-1,1%	40
Common equity Tier 1 (CET1)	3.352	3.524	3.452	3.469	3.475	3.496	0,8%	27	-1,3%	44
Additional Tier 1 (AT1)	-	-	-	6	6	6	-1,6%	0	-	-
Tier 2 capital (T2)	1.130	645	219	186	183	177	-4,9%	-9	23,7%	-42
Capital requirements	3.004	2.827	2090	1.867	1.828	1.759	-5,8%	-108	18,8%	-331

Source: Bank of Slovenia

Figure 7.3: Structure of regulatory capital (left) and structure of common equity Tier 1 capital (right) across the banking system in percentages



Source: Bank of Slovenia

7.1.3 Capital requirements

The decline in capital requirements has continued.

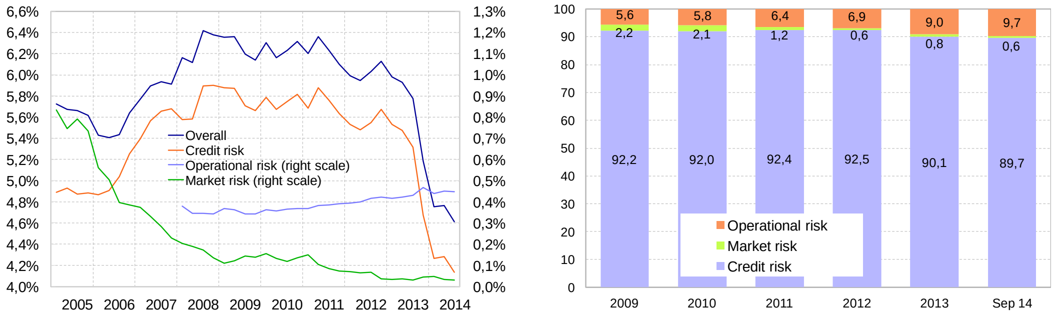
The decline in capital requirements continued in 2014, albeit at a slower pace than in the previous year, when the bank recovery and resolution process began. Capital requirements declined by EUR 331 million over the first three quarters of 2014 to EUR 1,759 million. Alongside the effect of the exclusion of the two banks undergoing the orderly wind-down process, the main factors in the decline were the ongoing contraction in lending activity and regulatory changes.[19]

The ratio of capital requirements to total assets declined by 0.6 percentage points to 4.6%, as capital requirements declined by more than the contraction in total assets. To

[18] CET1 = common equity Tier 1 capital; AT1 = additional Tier 1 capital; T2 = additional Tier 2 capital.
[19] The latter did not have a significant impact on the structure of capital requirements, for which reason the latest available figures for September 2014 are compared with the figures for December 2013, thereby exposing the more significant regulatory changes.

a great extent this was the result of an increase in the proportion of the banks' total assets accounted for by investments in securities, and a decline in the proportion accounted for by loans. Capital requirements for credit risk continue to account for the majority of total capital requirements (89.7%), while the proportion accounted for by capital requirements for market risk remains negligible. Capital requirements for operational risk declined by 9.6% to stand at EUR 171 million.

Figure 7.4: Ratio of capital requirements to total assets (left) and breakdown of capital requirements (right) in percentages



Source: Bank of Slovenia

Exposures to corporates and retail exposures continue to account for the majority of capital requirements.

Capital requirements for credit risk declined by EUR 307 million to stand at EUR 1,576 million. The decline in lending activity was reflected most in a decline in capital requirements for exposures to corporates and retail exposures, which were down EUR 261 million in total. Capital requirements for exposures to corporates and retail exposures nevertheless still account for fully 62% of the capital requirements for credit risk. The capital requirements for both the aforementioned exposures and for exposures secured by real estate also declined because of regulatory changes. Under the new requirements of the CRR, banks define exposures to SMEs separately in the aforementioned exposures, to which they can apply lower capital requirements. The purpose of this innovation is to encourage lending activity to this sector.

An increase in exposures in default owing to a deterioration in the quality of the credit portfolio and methodological changes.

In the breakdown of the capital requirements for credit risk, there was a sharp increase of EUR 151 million in those for exposures in default to EUR 237 million, while those for items associated with particularly high risk declined by EUR 107 million to EUR 63 million. The deterioration in the quality of the credit portfolio in the first nine months of the year was the first reason for the increase in exposures in default. Another factor in the aforementioned changes was the change in the requirements of the CRR relative to the previous regulations. The first was the reallocation of economic entities in bankruptcy from items associated with particularly high risk to exposures in default. The second innovation was the method of defining exposures in default, as these are now determined at the level of the total exposure of an obligor, and not with regard to the individual exposure (for retail banking they may still be determined at the level of the individual exposure).

Table 7.2: Breakdown of capital requirements for credit risk in percentages

	Old methodology				New regulation - CRR							
	2013				Mar 14				Sep 14			
	Large domestic banks	Small domestic banks	Banks under majority foreign ownership	Banking system overall	Large domestic banks	Small domestic banks	Banks under majority foreign ownership	Banking system overall	Large domestic banks	Small domestic banks	Banks under majority foreign ownership	Banking system overall
Capital requirement for credit risk, EUR million	1085	167	632	1883	965	91	619	1675	889	90	597	1576
	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	1,1	2,5	2,1	1,5
Institutions	13,1	1,9	2,7	8,6	8,0	1,5	2,6	5,7	9,2	1,6	4,1	6,8
Corporates	38,3	28,7	45,5	39,9	34,1	22,5	39,6	35,5	32,1	21,7	41,4	35,0
Retail banking	21,5	23,9	33,8	25,7	22,5	35,2	32,2	26,7	23,3	35,2	30,6	26,8
Secured by real estate	2,6	8,3	4,9	3,9	2,7	10,3	6,5	4,5	3,1	10,9	6,8	4,9
Exposures in default	4,4	7,6	4,1	4,6	12,0	11,9	8,5	10,7	17,9	17,7	10,3	15,0
Exposures associated with particularly high risk	9,6	21,9	4,0	9,0	11,9	10,9	4,7	9,2	6,1	1,7	1,2	4,0
Other items	9,9	6,2	4,0	7,5	8,0	6,4	3,8	6,4	7,2	8,6	3,4	5,8
Exposures associated with particularly high risk and exposures in default	13,9	29,5	8,1	13,6	23,9	22,7	13,2	19,9	24,0	19,4	11,5	19,0

Source: Bank of Slovenia

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

Slovenian banks meet their capital adequacy requirements through higher-quality capital.

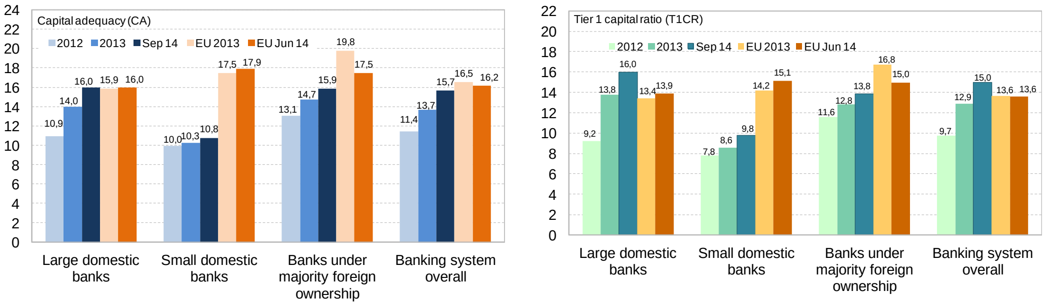
The overall capital adequacy of the Slovenian banking system on a consolidated basis stood at 15.7% at the end of September 2014, up 2 percentage points on the previous December, just before the introduction of the new CRR. Despite the increase, the capital adequacy of Slovenian banks remains below the latest available EU average figure. This is not the case of the Tier 1 capital ratio, which at Slovenian banks had increased to 15.0% by the end of September, thereby exceeding the EU average by 1.4 percentage points. This is a reflection of Slovenian banks meeting their capital adequacy requirements through the highest-quality forms of capital.

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

Solvency indicators improved at the large domestic banks and the banks under majority foreign ownership, while small domestic banks remain the most vulnerable in terms of capital, as they do on a solo basis. In contrast to the other two bank groups, the capital adequacy ratios of the small domestic banks declined over the first nine months of the year. This widened the gap with the solvency indicators of the comparable bank group across the EU. For each of the small domestic banks to achieve the average overall capital adequacy of the comparable bank group across the EU, in the context of unchanged capital requirements they would have to increase their capital by a total of EUR 64 million.

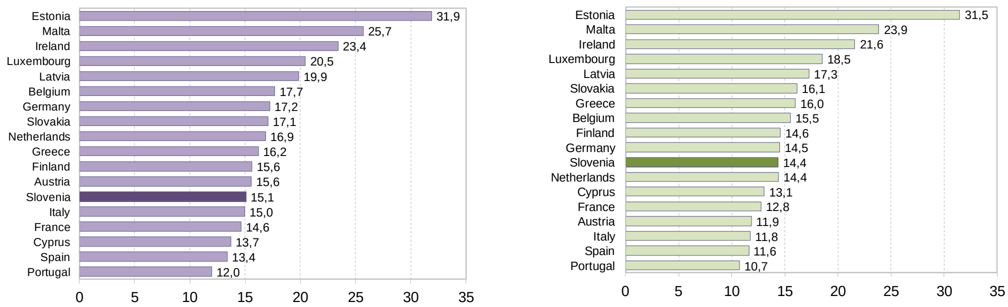
The banks under majority foreign ownership remain slightly below the average of the comparable bank group across the EU. For each of the banks in this group to achieve the comparable EU average figure, they would require EUR 128 million of fresh capital.

Figure 7.5: 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 7.6: Capital adequacy (left) and Tier 1 capital ratio (right) for euro area countries, figures on a consolidated basis for June 2014 in percentages

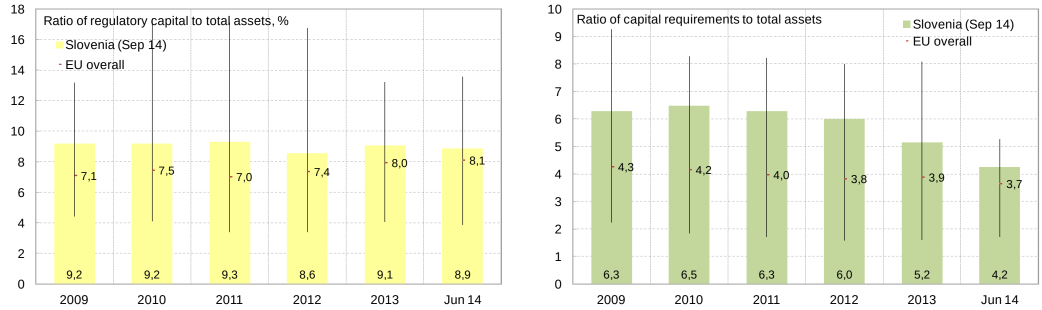


Sources: ECB (SDW), Bank of Slovenia

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

The ratio of regulatory capital to total assets remains an important solvency indicator alongside the capital adequacy ratios. The ratio at Slovenian banks declined to 8.9% over the first nine months of the year, capital having declined more than total assets. In addition to Slovenian banks having a higher ratio of regulatory capital to total assets than the EU average, their ratio of capital requirements to total assets of 4.2% remains higher than the EU average of 3.7%. However, the ratio of capital requirements to total assets has declined over the last two and a half years, as a result of the banks' aversion to taking up risks.

Figure 7.7: Distribution of the ratio of regulatory capital to total assets (left) and the ratio of capital requirements to total assets (right) for EU Member States, figures on a consolidated basis in percentages

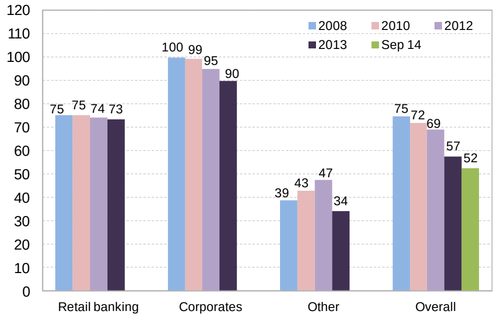


Sources: ECB (SDW), Bank of Slovenia

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

Although Slovenian banks' capital requirements declined over the first nine months of 2014 as a result of the aforementioned factors, they remain relatively high compared with other European countries. The reason is that the banks remain most exposed to corporates and retail banking, for which the weights remain relatively high, despite reductions in recent years. The proportion accounted for by exposures secured by real estate, to which the banks could apply lower weights, thereby reducing capital requirements, remains low, at 4.9%. In addition, Slovenian banks are also limited by the use of the standardised approach. A contraction in lending activity ought not to remain the driver of reductions in capital requirements, i.e. the method for maintaining capital ratios at an adequate level. Optimisation of the use of capital and the re-establishment of internal capital generation is a prerequisite for long-term stability in the solvency position of Slovenian banks.

Figure 7.8: Risk weights by types of credit exposure in percentages



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

Source: Bank of Slovenia

8 MACRO-PRUDENTIAL SUPERVISORY MEASURES

With the adoption of the Guidelines for macro-prudential policy the Bank of Slovenia has put into place an operational framework for macro-prudential policy and the macro-prudential supervision of the banking system. The guidelines define the ultimate objective and intermediate objectives of macro-prudential policy, the instruments for which the Bank of Slovenia will have a legal basis to be able to use them, and the principles that the Bank of Slovenia will uphold within the framework of the decision-making process. The guidelines put in place a link

1. between indicators and other tools for identifying systemic risks and the intermediate objectives,
2. and between the intermediate objectives and the instruments of macro-prudential policy that allow the intermediate objectives to be met.

The ultimate objective of macro-prudential policy is to contribute to safeguarding the stability of the entire financial system, including strengthening the resilience of the financial system and preventing and reducing the build-up of systemic risks, thereby ensuring the financial sector’s sustainable contribution to economic growth.

The intermediate objectives of the Bank of Slovenia’s macro-prudential policy in the area of the macro-prudential supervision of the banking system are:
1) mitigating and preventing excessive credit growth and excessive leverage;
2) mitigating and preventing excessive maturity mismatch and illiquidity;
3) limiting the concentration of direct and indirect exposures;
4) limiting the systemic impact of misaligned incentives with a view to reducing moral hazard;
5) strengthening the resilience of financial infrastructures.

The macro-prudential instruments that the Bank of Slovenia is already using are GLTDF and caps on deposit rates.

8.1 GLTDF

GLTDF is the ratio of the annual change in the gross stock of loans to the non-banking sector (before impairments) to the annual change in the stock of deposits by the non-banking sector. The instrument gives a bank the option of either meeting the GLTDF requirements, which limits the pace of the reduction in the LTD ratio for the non-banking sector, or increasing liquidity buffers. The instrument thus contributes in meeting the intermediate objective of mitigating and preventing excessive maturity mismatch and illiquidity.

8.1.1 Structure of the instrument

Minimum requirements for GLTDF:

- for a bank with a positive annual inflow in deposits by the non-banking sector, GLTDF >= 0%, i.e. there is no contraction in lending;
- in the second year of the instrument’s application, the requirement is tightened such that GLTDF >= 40%.

Corrective measures:

- 1st corrective measure: a requirement at quarterly level for the banks with positive quarterly inflow of deposits such that GLTDFq >= 40%, and GLTDFq >= 60% in the second year.
- Should the bank fail to meet the minimum requirements for GLTDF and the requirements for GLTDFq, its requirements with regard to liquidity ratios are tightened each subsequent quarter, whereby it must meet:
    - 2nd corrective measure: a first-bucket liquidity ratio excluding the pledged amount of the pool of eligible collateral at the Bank of Slovenia (hereinafter: "LR1 excl. pBSp") of at least 1,
    - 3rd corrective measure: a second-bucket liquidity ratio including the pledged amount of the pool of eligible collateral at the Bank of Slovenia (hereinafter: "LR2 incl. pBSp") of at least 1,

- 4th corrective measure: a second-bucket liquidity ratio (hereinafter: LR2) of at least 1.

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.

Six banks failed to meet the minimum requirements at the end of June, falling to five at the end of September. Five banks had to meet the first corrective measure, i.e. more stringent requirements for GLTDFq on quarterly basis, in the third quarter. Two of the banks met the requirements, while three banks had to meet the second corrective measure as of November, i.e. the first-bucket liquidity ratio excluding the pledged amount of the pool of eligible collateral. All three banks met the aforementioned ratio as at the end of September.

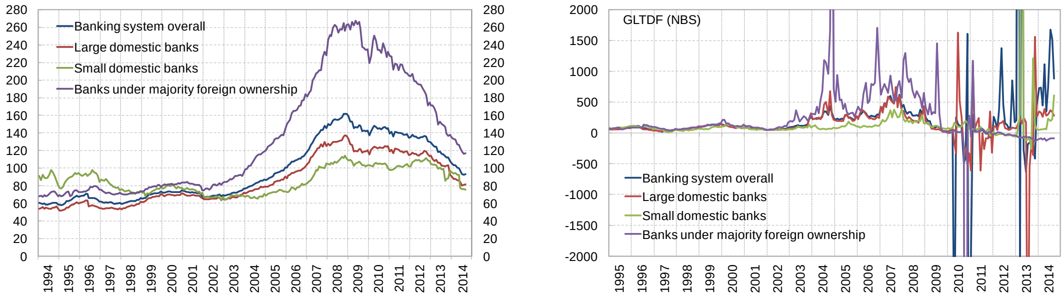
8.1.2 Review of the impact of the instrument

The developments in GLTDF and other variables on which the instrument can have an impact on the basis of the anticipated transmission mechanism are illustrated below. However, the responses and effects of the illustrated variables cannot be ascribed solely to GLTDF, as other factors are also having an impact: the ECB's non-standard measures (TLTRO), the bank recovery and resolution process and the economic recovery.

LTD and GLTDF

The decline in the ratio of net loans after impairments to deposits by the non-banking sector (the LTD ratio) slowed compared with the same period last year. The developments in GLTDF at the large domestic banks and at the banks under majority foreign ownership are also more stable.

Figure 8.1: LTD ratio (left) and GLTDF (right) for the banking system and bank groups in percentages



Note: GLTDF is calculated at the level of individual bank groups without any exclusions.
Sources: Bank of Slovenia

The LTD ratio for the banking system overall stood at 93% at the end of September 2014, down 15 percentage points on December 2013. The decline in the LTD ratio over the first nine months of the year was 91% of the decline in the ratio over the same period of the previous year for the banking system; the corresponding figure at the banks under majority foreign ownership was 78%.

Table 8.2: Decline in the LTD ratio this year compared with the same period last year, in percentage points

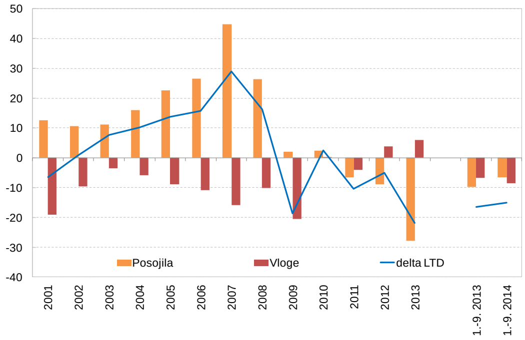
		Banking system overall	Large domestic banks	Small domestic banks	Banks under majority foreign ownership
			LTD, %		
	Sep 14	92,9	81,5	75,2	116,7
	Dec 13	107,9	92,4	97,0	137,9
			Change in LTD, percentage points		
over nine months	Dec 13 - Sep 1	-15,0	-10,9	-21,8	-21,2
	Dec 12 - Sep 1	-16,6	-12,0	-22,2	-27,3
ratio to last year's decline		90,8%	91,0%	98,3%	77,6%
over three months	Jun 14 - Sep 14	-4,0	-3,1	-2,0	-6,6
	Jun 13 - Sep 13	-5,9	-4,5	-15,3	-5,5
ratio to last year's decline		67,1%	68,9%	12,8%	119,3%

Sources: Bank of Slovenia

Contribution by loans to and deposits by the non-banking sector

Despite the persistently rapid decline in the LTD ratio, positive developments were seen this year in the contribution made by individual components to the decline in the LTD ratio. Compared with the same period last year, the decline in the LTD ratio this year is based more on an increase in deposits, and less on a contraction in lending.

Figure 8.2: Contribution to the change in the LTD ratio by loans to and deposits by the non-banking sector, in percentage points

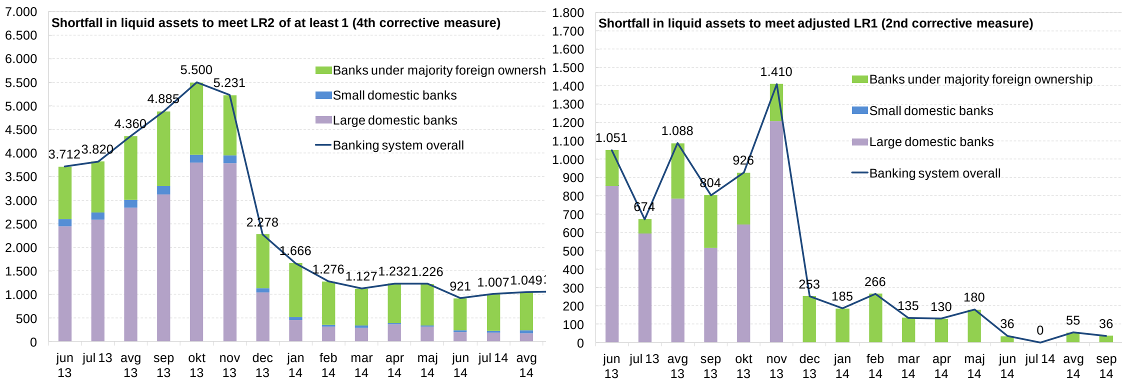


Sources: Bank of Slovenia

Liquidity ratios

In the early months of the year 2014 the banks reduced the shortfall in liquid investments to meet the LR2 (4th corrective measure), while in recent months they reduced the shortfall in liquid investments to meet the adjusted LR1 (2nd corrective measure).

Figure 8.3: Shortfall in liquid investments to meet the LR2 (4th corrective measure; left) and adjusted LR1 (2nd corrective measure; right) in EUR million



Sources: Bank of Slovenia

8.2 Limits on deposit rates

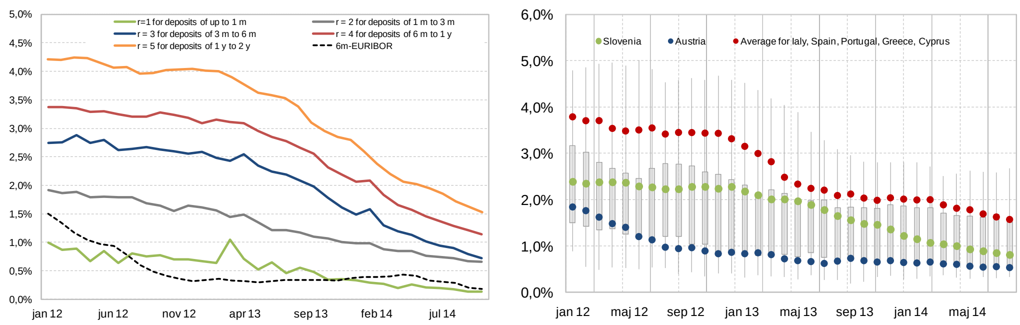
Introduction The Bank of Slovenia introduced an instrument in March 2012 to limit deposit rates. The aforementioned measure is part of the ICAAP-SREP process and defines a premium on capital requirements for new deposits by the private non-banking sector where the realised deposit rate exceeds the ceiling 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.

The **reason** for the implementation 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. Between December 2010 and December 2013 there was no significant change in the nominal value of deposits by the private non-banking sector, which remained at EUR 21 billion. 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 premium on risk-based capital requirements was approved at the 458th meeting of the Governing Board of the Bank of Slovenia on 28 February 2012. The premium on capital requirements for profitability risk from liability interest rates has been taken into account within the framework of the internal capital adequacy assessment process (ICAAP-SREP process) since March 2012. For a detailed description of the methodology, see the Financial Stability Review, May 2014 (p 38).

Figure 8.4: Average interest rates on deposits at banks and savings banks (excluding bank branches) by five maturity buckets20 (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 area21 (right), for January 2012 to October 2014 in percentages



Sources: Bank of Slovenia and SDW

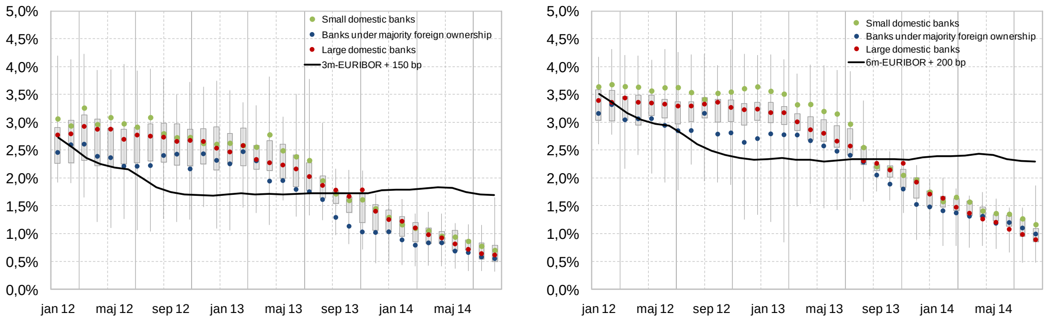
Effects of the instrument: In 2013 the banks began cutting the interest rates on deposits of all maturity buckets that are subject to the instrument. The trend of falling interest rates continued in 2014. The average interest rate on deposits that are subject to the instrument declined by 1.7 percentage points between January 2013 and

[20] 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.

[21] Austria, Belgium, Cyprus, Germany, Estonia, Spain, Finland, France, Greece, Italy, Luxembourg, Latvia, Malta, Netherlands, Portugal, Slovenia and Slovakia.

October 2014. With the exception of a single bank, all the banks recorded a decline in the average interest rate. There has also been a notable 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. In addition, the ratio of interest rates on deposits at commercial banks to the ceiling stipulated by the instrument is currently not restricting the banks in their adjustment of interest rates on deposits.

Figure 8.5: Distribution of interest rates on deposits of 3 to 6 months (left) and 6 months to 1 year (right) at Slovenian banks excluding branches (average daily EURIBOR plus the premium), for January 2012 to October 2014 in percentages



Sources: Bank of Slovenia

A comparison of the average liability interest rates in Slovenia with the average liability interest rates across the euro area reveals (1.) that average interest rates on household deposits in Slovenia fell more sharply than in other countries. By September 2014 the average interest rate on household deposits of up to 1 year was just 0.3 percentage points above the corresponding rate in Austria, the spread having stood at 1 percentage point a year earlier. The spread on deposits of 1 to 2 years narrowed from 2.2 percentage points in September 2013 to 1 percentage point in September 2014. (2.) Although average interest rates on corporate deposits of 1 to 2 years are falling, they remain among the highest in the euro area.

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 played the main role in the lowering of deposit rates.

APPENDICES

1 CORPORATE FINANCING AND INDEBTEDNESS

Summary

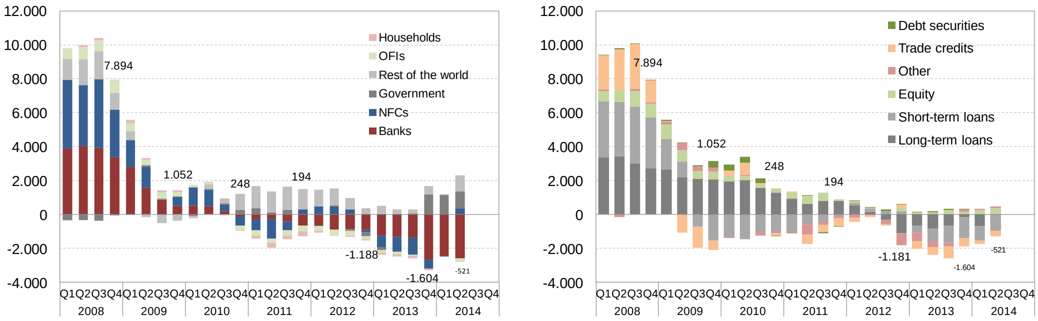
The contraction in corporate financing at the domestic banks continued in 2014. Loans from the rest of the world account for an increasing proportion of corporates' loan financing. There is a high concentration of over-leveraged corporates: the 100 firms with the largest excess debt accounted for almost half of the excess debt in 2013. Above-average leverage is typical of a certain type of firm. Leverage was high in 2013 at 131%, primarily on account of firms without equity and new firms. Leverage stood at 98% at firms that survived the crisis.

Corporate financing flows

The contraction in financing at the domestic banks continued in 2014.

The contraction in financing at the domestic banks continued in 2014. The annual flow of corporate financing was still negative in the second quarter of 2014, in the amount of EUR 521 billion. Other sources of financing strengthened: corporate financing from the rest of the world increased by EUR 953 million, while business-to-business financing in Slovenia increased by EUR 353 million. Corporates reduced their financing at suppliers and customers via trade credits and advances by EUR 321 million. The inflow of equity into corporates strengthened by EUR 359 million.

Figure 1.1: Corporate borrowing by sector (left) and by instrument (right), annual moving total of flows in EUR million



Note: The use of annual moving flows means that the figures for 2014 include the transfer of non-performing claims at the end of last year (as a result of the transfer to the BAMC, there was an additional decline in corporate debt at the domestic banks, and an increase in loans in the general government sector).
Source: Bank of Slovenia

Table 1.3: Corporate financing flows (total, via loans and via trade credits) in EUR million

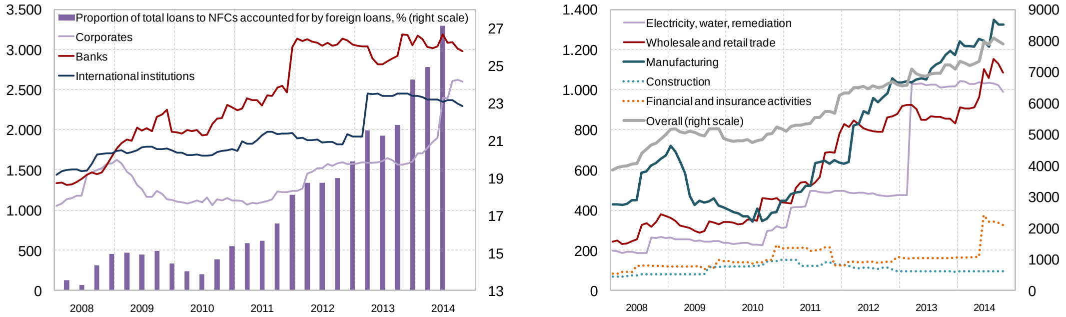
	Flows			Stock			Growth
	2012	2013	Q1Q22014	2012	2013	Q22014	Q22014
	EUR million						%
Total	-1.188	-1.604	272	86.064	82.384	83.262	
growth, %	-711,1	35,1	-133,5	-1,6	-4,3	-4,3	-2,1
Loans	-944	-1.392	-132	33.010	29.281	29.318	-9,2
- business-to-business	-137	-241	250	4.261	3.963	4.233	11,4
- from banks	-846	-2.606	-488	19.090	14.329	13.575	-26,6
- from non-monetary financial institutions	-163	-9	-10	2.251	2.172	2.026	-11,3
- from the rest of the world	167	555	109	6.503	7.021	7.704	13,3
- of which: from foreign corporates	296	-19	306	1.469	1.498	2.282	50,8
- from foreign banks[1]	-152	50	-120	3.064	3.056	3.177	12,8
- from international financial institutions	27	505	-75	1.916	2.426	2.351	-3,0
Trade credits	155	-510	-190	11.842	11.243	11.094	-2,8
- business-to-business	-29	-410	-156	6.420	6.072	5.931	-4,2
- from the rest of the world	276	-94	-100	4.524	4.298	4.224	-2,0

Note: 1 The figures for 2013 include two major transactions with international financial institutions. The figures for the second quarter of 2014 include two major transactions with corporates in the rest of the world.
Sources: Bank of Slovenia

Corporate loans from the rest of the world are still increasing, particularly from corporates in the rest of the world in 2014.

Loans from the rest of the world account for an increasing proportion of corporates' loan financing. Loans to corporates from the rest of the world accounted for 27% of all corporate loans in the second quarter of 2014, up 6 percentage points on the previous year. Manufacturing firms increased their loan financing in the rest of the world for the fourth consecutive year, recording year-on-year growth of 17% over the first three quarters of 2014.

Figure 1.2: Stock of corporate loans from the rest of the world by foreign creditor sector (left), and for selected sectors (right) in EUR million



Note: The figures for 2011 include a major transaction between a foreign owner and firms established in Slovenia for property management. The figures for 2013 include two major transactions with international financial institutions. The figures for the second quarter of 2014 include two major transactions with corporates in the rest of the world.

Source: Bank of Slovenia

There was a particular increase in exporters'[22] borrowing in the rest of the world. The proportion of exporters' loans raised in the rest of the world increased from 24% in 2008 to 52% in 2013. There was a notable increase of a quarter in the proportion of the stock of loans from corporates in the rest of the world accounted for by exporters to 69%, and an increase of 12 percentage points in the corresponding proportion of the stock of loans from banks in the rest of the world to 37%. The proportion of all firms that are classed as exporters increased over the same period from 44% in 2008 to 50% in 2013. Firms have been increasingly involved in foreign trade in recent years, and many firms that in 2008 were not exporters ceased operations in the interim.

[22] Exporters are defined as firms that generated at least 25% of their operating revenues on foreign markets according to the AJPES figures for 2008 or 2013.

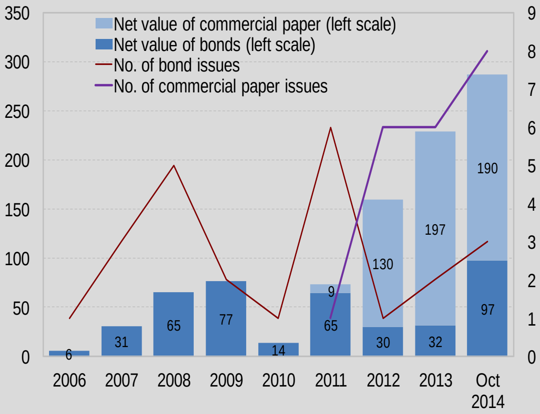
Box 1.1: **Corporate borrowing on the capital market**

The corporate sector's traditional heavy dependence on financing via bank loans means that Slovenia's financial market is poorly developed. It is only since 2011 that firms have begun intensively issuing commercial paper, as a result of the increased difficulty in accessing traditional financing in the form of bank loans. Issuance of corporate bonds stagnated over this period. It was only in 2014 that interest in new bond issues on the domestic and foreign markets strengthened.

Thanks to the expansionary monetary policy adopted by the ECB in June 2014, the required yields on government bonds of euro area countries are falling. Required yields on corporate bonds are also falling, which is additionally encouraging domestic firms to seek alternative sources of financing.

Firms have continued issuing commercial paper in 2014, thereby diversifying their short-term debt financing and balancing the fluctuations in the generation of free cash flow. When issuing commercial paper, firms borrow directly on the short-term money market. Eight such instruments were issued in the first ten months of the year, with a total nominal value of EUR 190 million. Three firms rolled over issues from 2013. The nominal value of the rolled-over short-term borrowing amounted to EUR 120 million. Four firms not listed on the stock exchange also opted for issues. In 2013 there was only one such firm, an indication that commercial paper is increasingly becoming a prominent source of short-term financing.

Figure 1.2: Net issues of corporate1 bonds and commercial paper in EUR million and number of issues



Sources: KDD, own calculations

Table 1.3: Overview of the number of new bond issues by residents in Slovenia and in the rest of the world, and total nominal value in EUR million

	Issued in Slovenia				Value, EUR million	
	Banks	Financial corporations	Government	NFCs		of which NFCs
2008	5	1	1	5	1.728	50
2009	5	4	3	2	4.222	77
2010	5	2	2	1	2.688	14
2011	2	2	3	6	3.121	65
2012	5	1	0	1	110	30
2013	1	2	0	2	1.045	32
Oct 2014	0	2	2	3	2.951	97
	Issued in the rest of the world					
2008	0	0	0	0	0	0
2009	2	0	0	1	2.300	300
2010	4	0	0	0	1.350	0
2011	2	0	0	0	500	0
2012	1	0	1	0	1.925	0
2013	1	0	3	0	4.295	0
Oct 2014	1	0	5	1	6.114	265

Sources: MoF, CSCC, Bank of Slovenia

Firms that issued bonds also enjoyed a positive response. Three firms issued bonds on the domestic market in the first ten months of the year, the largest issue accounting for 75% of the total. A non-financial corporation had a successful bond issue on the foreign market for the first time in four years; the 5-year bonds were issued at a fixed annual coupon rate of 3.25%. Corporate bonds of the same maturity were issued on the domestic market at a fixed annual coupon rate of 3.85%.

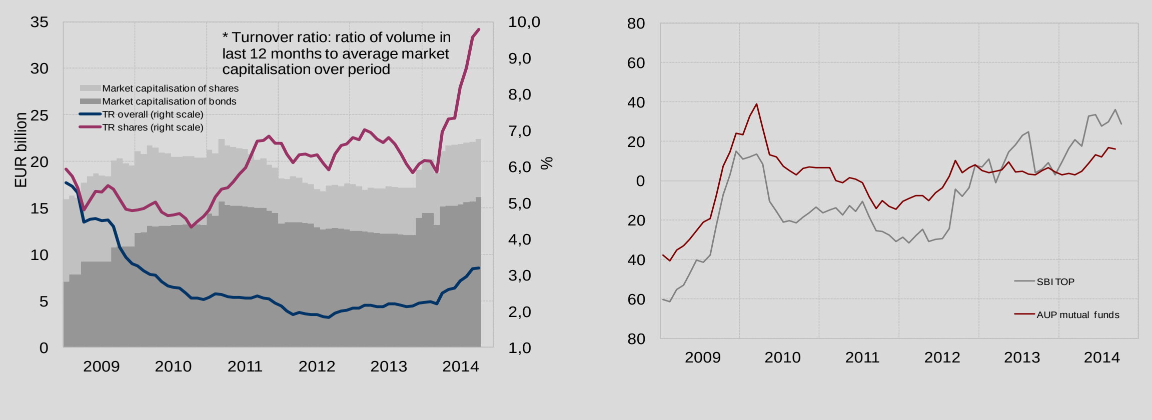
Developments on the domestic capital market

After the confirmation of the new government and the continuation of the privatisation process, the situation on the domestic market stabilised, which had a positive impact on domestic stock market developments. The successful completion of the sale procedure for three of the 15 firms being sold by the SSH additionally contributed to the increased optimism on the stock market.

The SBI TOP ended October at 811.1 points, a year-on-year change of +29%. The turnover ratio increased sharply over the first ten months of the year. Helios, Mercator, Letrika, Cinkarna Celje and Aerodrom Ljubljana were all among the most heavily traded firms in the last six months, as a result of the successful implementation of the privatisation process and the restoration of investors' confidence in the domestic stock market. The volume of trading on the stock exchange is primarily being raised by firms that are the subject of acquisitions.

Judging by the evidence of this year, the privatisation process is having a positive impact on stock market developments, at least from the short-term point of view. In the long term it entails the delisting of the acquired firms from the stock exchange (e.g. Helios). If new firms are not listed on the stock exchange, there will be a drastic fall in the number of issuers, a decline in liquidity and a fall in the number of domestic and foreign investors.

Figure 1.3: Market capitalisation on the Ljubljana Stock Exchange in EUR billion and annual turnover ratios (left), and year-on-year change in domestic stock market indices in percentages (right)



Sources: LJSE, Bloomberg

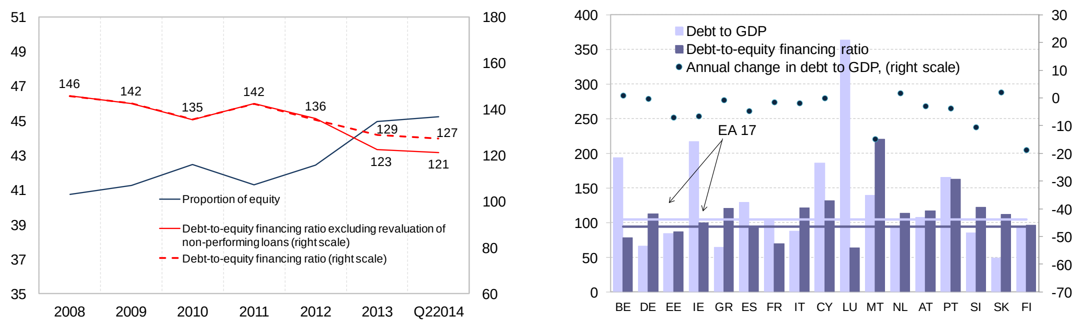
Corporate indebtedness and excess debt

The debt-to-equity ratio in corporate financing declined from 136% to 123% over 2013, including by 8 percentage points in the final quarter alone, primarily as a result of the valuation of non-performing loans in the transfer to the BAMC.[23] Were firms to have disclosed the EUR 3.3 billion of non-performing loans in full in the financial accounts statistics at the end of 2013, leverage would have stood at 129%. The ratio declined further in the second quarter of 2014 to 127%.

The debt-to-GDP ratio in the Slovenian corporate sector is below the euro area average, while the debt-to-equity corporate financing ratio is less favourable, and indication of the lack of capital and the inability to generate capital during the crisis.

The decline in the debt-to-GDP ratio in the Slovenian corporate sector in 2013 was one of the largest in the EU. The ratio 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. The debt-to-GDP ratio in the Slovenian corporate sector was below the euro area average in 2013. This is confirmation that it is not the actual level of indebtedness that is the problem in the Slovenian economy; the problem instead lies in the structure of financing. The debt-to-equity ratio, which reveals the structure of corporate financing, is less favourable. A major problem is the lack of capital, and the insufficient generation of capital through operating activities during the crisis. Changes in the valuation of capital also have a profound impact on the indicator, and cause larger fluctuations over time.

Figure 1.4: Corporate debt-to-equity ratio and level of equity financing (left) and comparison of corporate indebtedness across the euro area in 2013



(right) in percentages

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

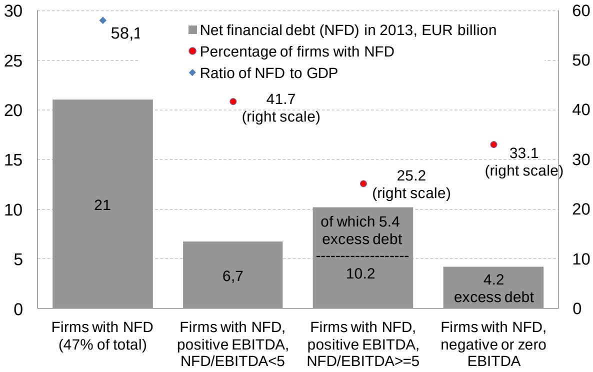
[23] Only the economic value of corporate liabilities that were transferred from the banks to the BAMC and recognised by the latter were disclosed in the financial accounts statistics, i.e. liabilities were reduced by the difference between their gross value and economic value. These corporate liabilities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

The European Commission estimates that the need for further deleveraging (defined as the reduction in the debt-to-GDP ratio in individual sectors) ranges from 10% to 20% of GDP in Slovenia.[24] It also assesses that Slovenian firms are actively deleveraging, in light of the negative net financing flows, while further pressure can be expected for active deleveraging over the short term.[25] In terms of the proportion of total corporate loans accounted for by short-term loans, firms are well-protected against any sudden changes in the short-term financing conditions, the figure having fallen sharply in recent years, from 39% in 2008 to 25% in the second quarter of 2014. The fall in the proportion of short-term financing is an indication of a decline in refinancing risk and a relative decline in problems involving a shortfall of liquidity.[26]

In 2013, 42% of firms had the capacity to repay their net financial debt in less than five years.

In 2013, 42% 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 2013. The net financial debt to EBITDA ratio, which reveals debt servicing capacity, stood at 5.9 for firms with a net financial debt in 2013 (equivalent to the number of years necessary for a firm to repay its debt from cash flows from operating activities). In terms of the structure of the net financial debt, EUR 11.5 billion or 54% of the total is sustainable. Excess corporate debt,27 i.e. that proportion of total debt that firms have less capacity to repay, amounted to EUR 9.6 billion or 46% of total net financial debt. Almost half of the net financial debt is subject to necessary restructuring. EUR 4.2 billion of net financial debt also requires operational restructuring: the firms in question were unprofitable in 2013.

Figure 1.5: Net financial debt in 2013 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

The hundred firms with the largest excess debt accounted for almost half of the total excess debt.

The excess debt was highly concentrated in 2013. The hundred firms with the largest excess debt accounted for almost half of the total excess debt.[28] 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 (it is primarily unprofitable firms that contribute to the high figures), while manufacturing has one of the lowest figures at 26.2%.

[24] The estimate relates to private non-financial sector indebtedness, whereby 30% of the decline in borrowing relates to households, and 70% to the corporate sector.

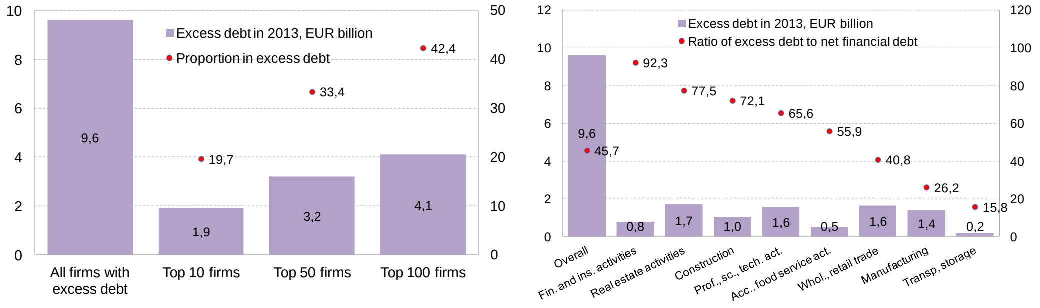
[25] http://ec.europa.eu/economy_finance/eu/forecasts/2014_autumn/box2_en.pdf

[26] European Commission (2014), "Private sector deleveraging: where do we stand?", Quarterly report on the euro area, Vol 12(3)

[27] Excess debt is calculated as the excess net financial debt (financial liabilities minus cash) for firms where NFD/EBITDA >= 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 August 2014. 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.

[28] Firms without equity have a profound impact on overall corporate indebtedness; firms with negative equity accounted for a third of excess debt in 2013.

Figure 1.6: Concentration of excess debt 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

Manufacturing firms (EUR 1.4 billion) and wholesale and retail trade firms (EUR 1.6 billion) account for almost a third of total excess debt. According to figures from a survey of demand for bank loans by non-financial corporations, in 2014 there was a notable trend of a slowdown in negative growth and indeed positive growth in demand for loans in the aforementioned two sectors, albeit primarily loans for restructuring. Fully 70% of corporate demand for loans for restructuring came from the aforementioned two sectors in the first half of 2014. The high demand for loans for restructuring is an indication of firms' problems with debt servicing, although the aforementioned two sectors sharply increased financing from the rest of the world, a reflection of the favourable economic growth in 2014. This is confirmation that relationships with firms with less favourable financial positions are being maintained in the credit portfolio of domestic banks.

Corporate deleveraging between 2008 and 2013

Corporate borrowing increased rapidly before the outbreak of the crisis, peaking in 2008. Having amounted to EUR 7.9 billion in 2008, of which EUR 5.7 billion comprised loans, corporate financing flows fell to just EUR 1 billion the next year. Firms have been making net debt repayments since 2012. Firms entered the crisis highly indebted. Bankruptcies and withdrawals from sectors have both acted to reduce indebtedness in recent years, while indebtedness has also been reduced via reductions in debt relative to equity.

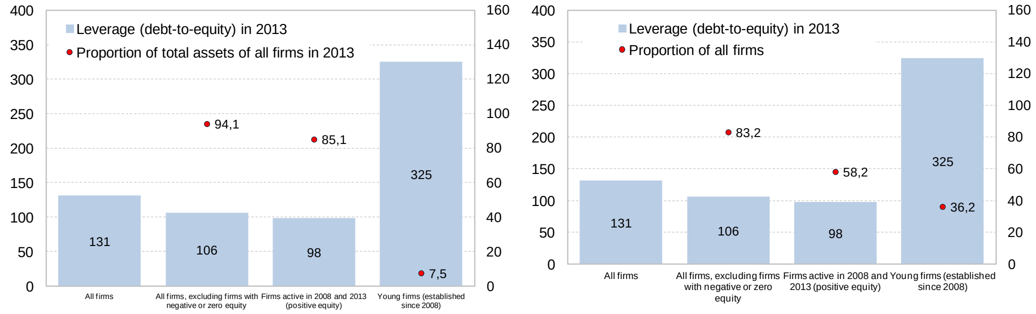
The decline in economic activity brought the collapse of numerous firms on the market. The sectors of construction and wholesale and retail trade are notable for a decline in corporate indebtedness on account of bankruptcies. Construction firms against which bankruptcy proceedings have been initiated since 2007 accounted for 43% of the sector's total assets in 2007. The number of bankruptcies rose sharply in 2013 and 2014.

Leverage was high in 2013 at 131%, primarily on account of firms without equity and young firms. Leverage at firms that existed at the time of the crisis stood at 98% in 2013.

The decline in corporate indebtedness has also been evidenced in a decline in the debt-to-equity ratio. Leverage[29] declined from 166% in 2008 to 131% in 2013. The decline in indebtedness was particularly evident at firms that survived the crisis, i.e. those that operated as going concerns both in 2008 and in 2013.[30] Leverage at these firms declined from 128% to 98%. The main contributions to the high overall leverage of 131% recorded by non-financial corporations in 2013 came from insolvent firms with negative equity and young firms.[31] Firms with negative equity accounted for 16.8% of all firms at the end of 2013. The indebtedness of young firms established during the period of low economic activity since 2008 is also very high: their leverage stands at 325%. The high proportion of young firms (36.2% of the total) is an indication of the large rise in the number of new firms in recent years.

[29] Leverage is measured as the ratio of financial and operating liabilities to equity according to the AJPES figures (and differs from the leverage figures according to financial accounts statistics).
[30] Firms that operated with positive equity in 2008 and 2013, against which bankruptcy proceedings had not been initiated by October 2014.
[31] Young firms are defined as firms that are one to five years old.

Figure 1.7: Leverage and relative size in terms of number of firms (left) and relative size in terms of total assets (right) of various corporate segments in 2013 in percentages

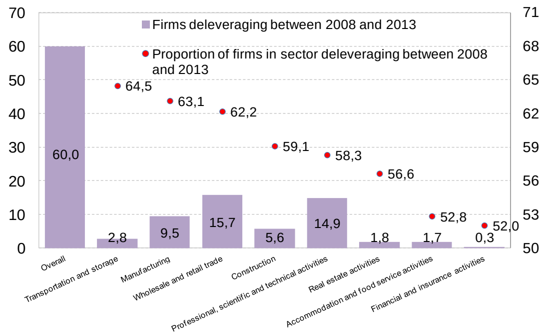


Sources: AJPES, Bank of Slovenia calculations

More than half of all firms recorded a decline in indebtedness between 2008 and 2013. Firms deleveraged not only by reducing debt, but also by increasing equity by a half.

Indebtedness was reduced at 60% of firms that survived the crisis, i.e. those that operated as going concerns both in 2008 and in 2013.[32] Firms that deleveraged between 2008 and 2013 saw their leverage decline from 169% to 79%. In so doing they reduced debt by a third, while increasing equity by a half. The most significant deleveraging was recorded by small (73%) and medium-size firms (68%), while large firms were less prominent (60%).[33] In terms of sector, 65% of firms in transportation and storage and 63% of manufacturing firms deleveraged. Some 59% of construction firms deleveraged, although bankruptcies were a major factor in the decline in leverage in this sector. Over the same period 15.7% of firms in wholesale and retail trade and 14.9% of firms in professional, scientific and technical activities and administrative and support service activities deleveraged.

Figure 1.8: Percentage of firms operating in both 2008 and 2013 accounted for by firms deleveraging over this period by sector



Sources: AJPES, Bank of Slovenia calculations

Firms that deleveraged generate more profit and higher value-added, are more export-oriented, and have less bank debt than firms that did not deleverage between 2008 and 2013.

Firms that deleveraged over this period generate almost double the profit, have higher average EBITDA, having increased it between 2008 and 2013, and are slightly more export-oriented (a higher ratio of exports to operating revenues). Firms that deleveraged are less indebted at banks; average financial liabilities to banks in 2008 and in 2013 were almost a quarter lower than at firms that did not deleverage. Firms that did not deleverage over this period saw a sharp increase in indebtedness. Leverage increased from 83% to 136%, while excess debt stood at 78%, average EBITDA having also fallen.

Firms that deleveraged successfully between 2008 and 2013, when the banks' credit standards became increasingly stricter, are less indebted at banks. This is an indication that the firms that deleveraged successfully were those whose debt was more diversified across different creditors than the firms whose debt was concentrated at banks. Firms that generated less profit and lower value-added, i.e. higher-risk firms, were more indebted at banks in 2008 and in 2013.

[32] This 60% represented almost 30% of all firms operating in 2013, and accounted for 46% of total assets and more than half of total value-added.
[33] Another reason is that there were more heavily indebted firms in 2008 (leverage above a mean of 114%) among SMEs (65%) than among large firms (54%).

A financial system that provides various alternatives and financing instruments contributes to greater diversity in financing, and thereby to greater resilience on the part of the corporate sector to the changing conditions of loan financing at banks. In conditions of stricter credit standards and less risk appetite on the part of the banks during financial crises and macroeconomic uncertainty, firms partly replaced bank loans with other sources of financing.[34] The indebtedness of Slovenian firms is segmented. There are firms that have very high excess debt and need to restructure their debts and operations, and there are also firms that succeeded in reducing their indebtedness during the crisis and strengthened their capital, and that contributed to the growth of the Slovenian economy.

[34] ECB (2014): Deleveraging patterns in the euro area corporate sector. Monthly Bulletin, Feb 2014

2 PERFORMANCE OF LEASING COMPANIES

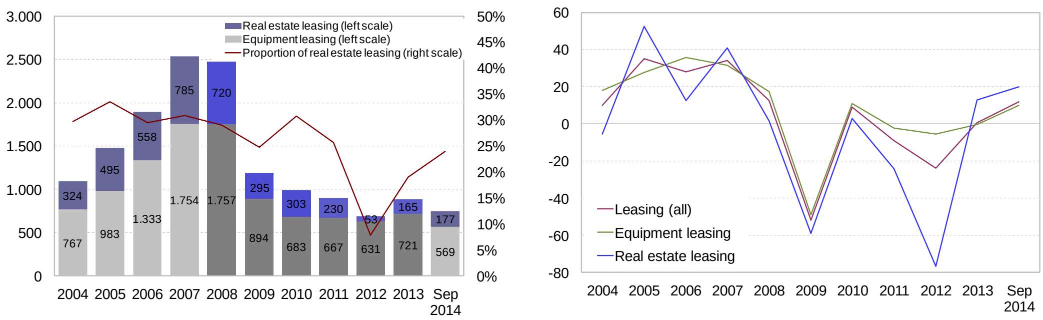
Leasing companies recorded a contraction in the volume of business in 2014, particularly in real estate leasing. On the basis of a survey conducted by Leaseurope, more than half of the leasing companies expected a rise in the volume of business in the second half of the year, with no change in the level of non-performing loans. Domestic leasing companies had expected 2014 to end with gradual improvements, while growth in the volume of business would to a great extent depend on regulations and business policy in the banking sector, with which the domestic leasing sector has a close link.

Leasing business continues to decline, as companies withdraw from the real estate market in particular.

In contrast to the expectations of domestic leasing companies, according to the figures reported to the Bank of Slovenia by the leasing companies,[35] the stock of leasing business contracted by 6% over the first ten months of 2014 to EUR 3.1 billion. The main decline was in real estate leasing, from EUR 1.6 billion to EUR 1.4 billion, while the stock of equipment leasing remained at the level of EUR 1.7 billion. The pace of the contraction in leasing business is slowing: after a decline of 15.6% in 2013, the year-on-year decline stood at 10% in September.

As the stock of business contracts, new leasing business is increasing, an indication of the increased maturing of existing business compared with the previous year. New leasing business amounted to EUR 746 million during the first three quarters of 2014, up 12% on the same period last year. Leasing companies are focusing more on equipment leasing, although demand for real estate leasing is strengthening again. New real estate leasing business in the first three quarters of the year was up 24.3% on the same period of the previous year, while new equipment leasing business was up 7%. New real estate business primarily increased as a result of new loans to non-financial corporations. More than 60% of the contractual value of non-financial corporations' new business in real estate was concluded as finance leases. As in 2013, most new business in equipment leasing involved cars, which accounted for 56% of all new equipment leasing business.

Figure 2.1: New leasing business[36] in EUR million and the proportion accounted for by real estate leasing in percentages (left), and annual growth in new business in percentages (right)



Sources: SLA, BAS, BANK OF SLOVENIA

According to the figures of the leasing committee, new real estate leasing business was up a further 20% in year-on-year terms in September 2014 after a positive adjustment in 2013, while new equipment leasing business was up 10%. Monitoring the performance of leasing companies is important from the point of view of financial stability and monetary policy, as they have business links with the banking system. The planned restructuring of the banking sector means that Slovenian banks' ownership of the leasing sector will decline further in the future.

Leasing of production plant and machinery has been rising again in 2014.

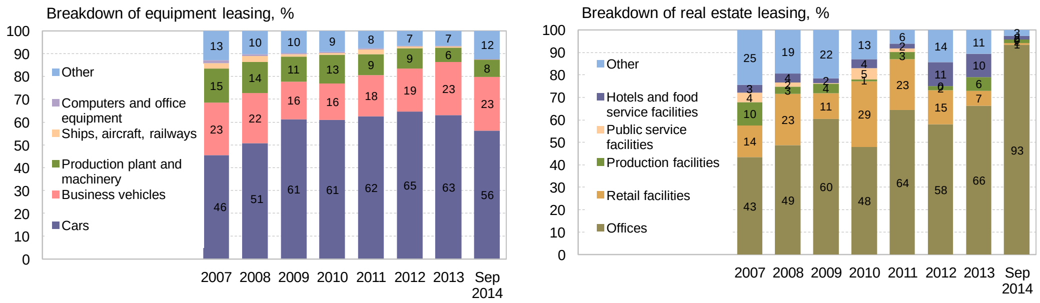
In the wake of the decline in investment in the real economy, the breakdown of equipment leasing by leased asset has changed slightly over recent years. Leasing of

[35] 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.

[36] 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.

production plant and machinery having declined in particular in the period to 2013 inclusive, it rose again slightly over the first nine months of 2014. As in previous years, car leasing is prevalent. The proportion of leasing business accounted for by cars was down slightly by 9 percentage points on its peak in 2012, but nevertheless remains high at 56%. By contrast, the proportion accounted for by equipment not captured under any of the categories and classed under "other" increased by 6 percentage points.

Figure 2.2: Breakdown of new equipment leasing business (left) and real estate leasing business (right) in percentages



Sources: SLA, BAS, Bank of Slovenia

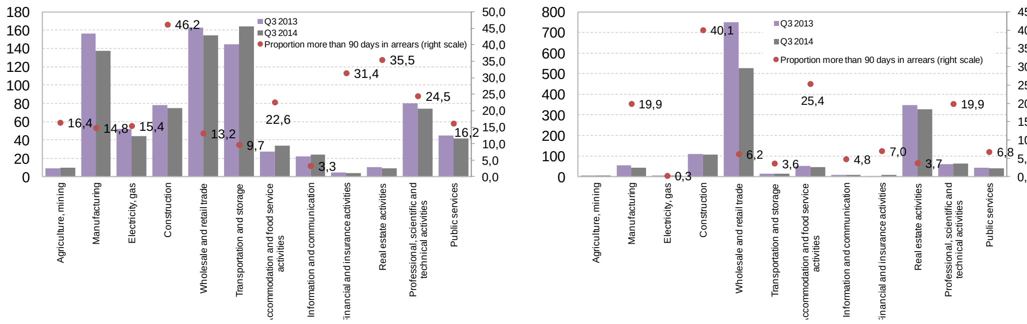
In real estate leasing there was a sharp increase in new business in office buildings, which is attributable to firms opting for sale and lease back of real estate for the purpose of increasing their fresh liquid assets to reduce indebtedness. New leasing business for office buildings amounted to EUR 165 million over the first nine months of the year, up 51% on 2013.

New leasing business for office buildings over the first nine months of 2014 was up 51%.

Leasing business with non-financial corporations accounted for almost two-thirds of the stock of leasing investment at the end of the third quarter of 2014, or EUR 2 billion. Non-financial corporations accounted for 84% of real estate leasing, and 45% of equipment leasing. There was no significant change in these figures in year-on-year terms, as the trend of decline in the stock of leasing business with non-financial corporations continued in the amount of 13%. While the stock of real estate leasing business in the third quarter of 2014 was down in year-on-year terms in almost all sectors, equipment leasing business with firms in the sectors of transportation and storage, accommodation and food service activities, and information and communication activities increased.

Business with non-financial corporations accounts for almost two-thirds of leasing investment.

Figure 2.3: Stock of leasing business with non-financial corporations by sector for equipment leasing (left) and real estate leasing (right) in EUR million, and proportion of claims more than 90 days in arrears in percentages



Note: The proportion more than 90 days in arrears for real estate business is 88.3% in the agriculture and mining sector.
Sources: BANK OF SLOVENIA

The stock of leasing business with households amounted to EUR 802 million at the end of the third quarter, equivalent to 26% of total leasing business, up 3 percentage points in year-on-year terms. Equipment leasing accounts for the majority (91%) of leasing business with households, and for 23% of the total stock of leasing investment. As was the case for non-financial corporations, there was a further contraction in the volume of business with households; the stock of equipment leasing was down 1% in year-on-year terms at EUR 727 million, while the stock of real estate leasing was down 11% at EUR 75 million.

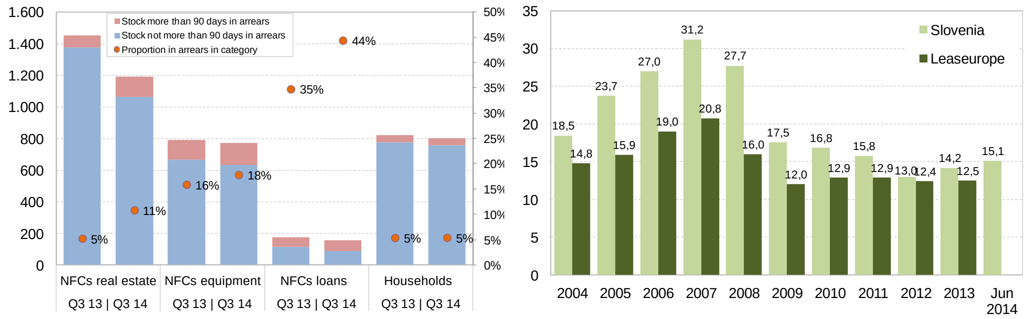
The proportion of non-financial corporations' liabilities that are more than 90 days in arrears increased from 9% to 14% over the period of one year.

Non-financial corporations entail higher credit risk for leasing companies because of the relatively larger exposure and because of the higher proportion of non-performing claims. The proportion of non-financial corporations' liabilities to leasing companies that are more than 90 days in arrears stood at 14% at the end of the third quarter 2014, up from 9% a year earlier. The corresponding figures were 11% for real estate leasing, and 18% for equipment leasing. The most prominent arrears of more than 90 days in real estate leasing are recorded by construction and by accommodation and food service activities. The proportion of liabilities more than 90 days in arrears was up 25 percentage points in year-on-year terms in the construction sector at 40.1%, and up 8 percentage points in the accommodation and food service activities sector at 25.4%. In equipment leasing, the corresponding figure is significant in real estate activities and in professional, scientific and technical activities and administrative and support service activities, in addition to the two aforementioned sectors. The year-on-year changes in the proportion of equipment leasing liabilities more than 90 days in arrears were not as large. The proportion more than 90 days in arrears increased by 2.6 percentage points in the construction sector to stand at 46.2%, and remained unchanged in the accommodation and food service activities sector, while the figures for real estate activities and for professional, scientific and technical activities and administrative and support service activities were up 11 percentage points and 10 percentage points at 36% and 25% respectively. As is the case for households, loans are prevalent in terms of the proportion in arrears at non-financial corporations. The stock of loans in September was down 10% in year-on-year terms at EUR 157 million, while the proportion of liabilities being settled more than 90 days in arrears was up at 44%.

The stock of repossessed leasing assets was down in year-on-year terms.

Despite the increase in claims more than 90 days in arrears, the stock of repossessed leasing assets in September 2014 was down 17% in year-on-year terms at EUR 144 million. Real estate accounted for the majority (93%).

Figure 2.4: Stock of leasing business in arrears by category in EUR million, and proportion of leasing business in arrears (left) and ratio of leasing business to gross fixed capital formation (right) in percentages



Note: The figures for new leasing business in 2014 used in the ratio of leasing business to gross fixed capital formation are taken from reporting to the Bank of Slovenia (previously the BAS), and include non-members of the leasing committee, resulting in a higher ratio than in previous years.

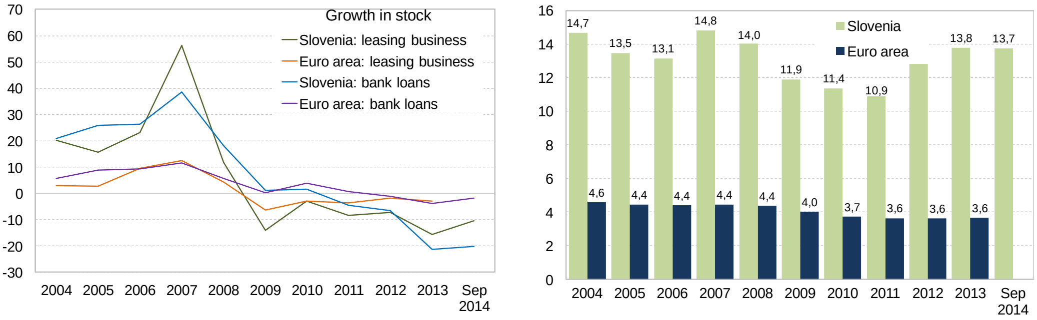
Sources: SLA, BAS, Bank of Slovenia, SORS, Leaseurope

According to Leaseurope figures, new business in the euro area in the first half of 2014 was up 9.3% in year-on-year terms.

New business on the European leasing market was up 0.7% in 2013 at EUR 251.9 billion. The stock of leasing business also increased, by 0.5%, to EUR 723.4 billion. The largest increases in new leasing business were recorded by Poland, Austria and the UK. The situation stabilised in southern Europe (Spain, Portugal and Greece), while business stagnated in Germany, France, Sweden, Belgium and the Netherlands. According to the latest figures announced by Leaseurope, new business in the first half of 2014 was up 9.3% in year-on-year terms at EUR 127 billion. This was attributable to new equipment leasing business, primarily vehicles, while real estate leasing business declined again.

The contraction in bank loans to the non-banking sector is slowing, both in Slovenia and across the euro area. It remains at 20% in Slovenia, while the figure for the euro area was revised to 1.4%. The contraction in domestic leasing business was revised to 10.5%, while no figures are yet available for the euro area.

Figure 2.5: 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

Slovenian leasing companies recorded a loss for the sixth consecutive year (to the end of September 2014). The leasing companies' performance indicators in 2014 suggest an improvement in the situation in the leasing sector compared with 2012 and 2013, although the operating result remains negative. The overall performance of leasing companies was sharply negative, primarily as a result of impairments at the end of 2013. By September 2014 the proportion of assets accounted for by investment property was down 3 percentage points at 23%, while total assets were down 4% on the end of 2013. There were no major impairments recorded during the period in question. Leasing companies' equity increased to EUR 161 million, as ROA and ROE improved simultaneously.

The performance indicators suggest an improvement in the leasing companies' position, although they remain negative.

Table 2.1: Performance of leasing companies and sources of funding

													Growth, %				
	2006	2007	2008	2009	2010	2011	2012	2013	2014 Sept.	2007	2008	2009	2010	2011	2012	2013	2014 Sept.
Total assets, EUR million	3.555	4.748	5.620	5.663	5.427	5.088	4.842	3.826	3.658	33,5	18,4	0,8	-4,2	-6,2	-4,8	-21,0	-10,8
Equity, EUR million	205	234	267	200	205	204	114	5	161	14,2	14,2	-25,2	2,4	-0,3	-43,9	-95,6	27,9
Pre-tax profit/loss, EUR million	43	47	29	-33	-30	-19	-121	-266	-25	8,8	-38,5	-215,3	10,9	34,8	-527,3	119,3	-46,7
ROA, %	2,4	1,1	0,6	-0,6	-0,5	-0,4	-2,4	-6,9	-0,7								
ROE, %	42,1	21,4	11,5	-14,2	-14,6	-9,4	-76,0	-5228,7	-15,4								
Financial and operating liabilities, EUR million	3.330	4.486	5.314	5.427	5.179	4.843	4.681	3.729	3.404	34,7	18,5	2,1	-4,6	-6,5	-3,3	-20,4	-12,4
liabilities to banks and undertakings in group / total assets, %	94	94	95	96	95	95	97	97	93								
Investment property	397	538	560	580	836	929	1.118	1.002	849	35,4	4,1	3,6	44,0	11,2	20,3	-10,3	-24,3
investment property / assets, %	11	11	10	10	15	18	23	26	23								
Finance expenses from impairments and write-downs of financial assets, EUR million	3	2	10	120	167	127	157	192	59								

Note: The figures from financial statements cover leasing companies included in reporting to the Bank of Slovenia (Bank of Slovenia figures for 2013, previously AJPES figures)

Sources: AJPES, Bank of Slovenia