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Abbreviations:

AIC	Authorised Investment Companies
APLRRS	Agency for Public Legal Records and Related Services
AMC	Association of Management Companies
BS	Bank of Slovenia
CCI	Chamber of Commerce and Industry of Slovenia
CEFTA	Central European Free Trade Agreement
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CSCC	Central Securities Clearing Corporation
ECB	European Central Bank
EFAMA	European Funds and Asset Management Association
EFTA	European Free Trade Association
EMU	Economic and Monetary Union
ERM II	Exchange Rate Mechanism 2
ESCB	European System of Central Banks
EURIBOR	Euro Interbank Offered Rate

EUROSTAT	Statistical Office of the European Communities
EU3	Members of the EU prior to the May 2005 enlargement who are not members of the euro area
EU10	New EU member-states as of 1 May 2004
EU12	Members of the euro area
EU13	EU member-states not members of the euro area
EU25	EU member-states
FCBs	Bank of Slovenia foreign currency bills
HFRS	Housing Fund of the Republic of Slovenia
IC	Investment company
IF	Investment fund
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
ISA	Insurance Supervision Agency
LEASEUROPE	European Federation of Leasing Company Associations
LJSE	Ljubljana Stock Exchange
LTV	Loan to value
MCs	Management companies
MFs	Mutual funds
NHHS	National Housing Saving Scheme
OECD	Organisation for Economic Cooperation and Development
OFOs	Other financial organisations
OSM	Official Secondary Market
PDII	Pension and Disability Insurance Institute
PIX	Index of investment funds
RTGS	Real-Time Gross Settlement
SBI 20	Slovenia's main stock market index
SCA	Standard Classification of Activities
SCIS	Standard Classification of Institutional Sectors
SITIBOR	Slovenia's interbank interest rate on tolar time deposits as formed on the domestic interbank money market
SLA	Slovenian Leasing Associations
SLONEP	Slovenian real estate web portal (www.slonep.net)
SLU	Savings and loan undertaking
SMA	Securities Market Agency
SORS	Statistical Office of the Republic of Slovenia
TARS	Tax Administration of the Republic of Slovenia Sitibor
TBs	Bank of Slovenia tolar bills
VEP	Mutual fund unit price
Vzajemci.com	Slovenian mutual fund web portal (www.vzajemci.com)



CONCLUSIONS

With the introduction of the euro on 1 January 2007, Slovenia will formally conclude the process of European integration that began by signing the Europe Agreement in June 1996. Ensuring macroeconomic stability while meeting the Maastricht convergence criteria was one of the key elements of the transitional period, during which the Slovenian financial system simultaneously evolved into a system capable of functioning within the wider economic environment of the EMU. This year's Financial Stability Report examines the progress made, and at the same time draws attention to certain risks in the financial system that will still be of significance in the months leading up to the introduction of the euro, and even after, when the euro has become Slovenia's currency. The aim of the report is, on the basis of the available data, to assess the stability of the financial system, particularly the banking sector, and to draw attention to any risks that could adversely affect several financial institutions and thus hinder effective financial intermediation.

The favourable economic conditions in Slovenia and the improvement in economic conditions in the EU helped the Slovenian financial system to continue its successful integration into international financial flows, increasing exposure to foreign financial markets. In particular banks continued to rapidly expand their borrowing abroad, their debt accounting for half of the loans raised abroad by the Slovenian economy. Lower interest rates abroad meant that these sources of financing were more favourable to banks in price terms than the collection of deposits on the domestic market. This is increasing the banking system's sensitivity to changes on international financial markets, and thus represents a more variable source of financing than household deposits. Among the non-monetary financial intermediaries, having mainly financed themselves with foreign loans for a number of years now, the leasing companies are particularly dependent on conditions on foreign loan markets.

The process of the nominal convergence of Slovenian interest rates with interest rates in the euro area continued in 2005. The decline in bank interest rates brought increased growth in loans to non-banking sectors, particularly households. By contrast, low deposit rates at banks mean that households moved their money into investments with a higher return, albeit at higher risk. The proportion of household financial assets accounted for by bank deposits fell, while those of investments in mutual funds and investments in foreign securities rose. The proportion of outward investments made in higher-risk equities rose rapidly last year, to account for a proportion equal to that of investments in debt securities. The introduction of the euro will eliminate exchange-rate risk from almost 60% of outward investments, although market risk will remain.

Domestic financial institutions investments in the rest of the world doubled last year. Outward direct investments in banks and mutual funds rose particularly rapidly. Portfolio restructuring meant that the proportion of domestic mutual fund investments held in foreign securities rose to 40%, partly reducing the effect of adverse movements on the domestic capital market. While mutual fund investments in securities on more dynamic financial markets such as Asia and eastern Europe were increasing, their investors' exposure to market risks and exchange-rate risks were increasing indirectly.

The spread between foreign and domestic interest rates encouraged companies to borrow in foreign currency at domestic banks. This was reflected in further shortening of the corporate sector's open foreign exchange position, primarily in euros, compared with the previous year, which has increased exposure to exchange-rate risk in the short term. However the imminent introduction of the euro is reducing this risk. The rapid growth in corporate borrowing at banks has increased their financial gearing. The anticipated rise in interest rates over the next medium-term period will reduce this growth, which is an important source of capital increase. A continuing trend of increasing financial gearing and falling profitability could lead to a deterioration in credit solvency in the corporate sector.

Bank profitability improved in the context of favourable economic conditions and strong lending demand. At the same time the trend of decreasing credit risk continued, which was seen in the diminishing proportion of bad loans in the banking system's portfolio. Despite the decrease in credit risk, the pro-cyclical behaviour of banks, which is being further encouraged by the introduction of international financial reporting standards, means that the reduced lending growth could be reflected in a deterioration in the quality of the credit portfolio. During a period of relatively low interest rates and fierce competition in lending, there is increasing likelihood of a lowering of banks' credit standards or insufficient charging of risk premiums. Another factor in the potential increase in credit risk at banks is the transfer of interest-rate risk and exchange-rate risk to the non-financial sector, which in the event of realisation would be seen as an increase in credit risk at banks.

Bank exposure to interest-rate risk, which is becoming one of the most significant risks faced by banks, increased in 2005. The difference between the average period for a change in lending rates and the average period for a change in deposit rates increased last year owing to the lengthening of the average maturity of loans and the decline in the proportion of long-term deposits by non-banking sectors. After the introduction of the euro, the majority of the interest rates tied to any of the current reference rates will track the changes in ECB interest rates at their own pace, with the exception of interest rates index-linked to the TOM base rate, which will continue to depend of the movement of past inflation in Slovenia.

Bank exposure to exchange-rate risk decreased last year. It will decrease further with the introduction of the euro, as the majority of the banking system's balance sheet items are denominated in this currency. The fastest-increasing part of foreign currency exposure is bank exposure to exchange-rate risk caused by changes in the tolar exchange rate of the Swiss franc.

After several years of declining capital adequacy at banks, a change in the way in which currency-risk-adjusted items are calculated and the imminent introduction of the euro will have a beneficial impact on capital adequacy in 2006. However, the improvement in capital adequacy will not be the result of lower risk in bank operations, but rather the result of institutional factors, which could even increase banks' willingness to assume additional risks and form the basis for additional lending growth.



Mitja Gaspari
Governor

SUMMARY

Financial stability is defined as a situation in which the components of the financial system, such as financial markets, financial institutions and financial infrastructure, function without disruption, and in which each component of the financial system provides the greatest possible degree of flexibility in responding to any shocks that may occur. This operational definition is applied in the analytical part of the Financial Stability Report. Section 1 examines the economic conditions faced by banks and other financial institutions in 2005. It then describes the financial changes characteristic of the household and corporate sectors. The financial decisions of both macroeconomic sectors had a significant impact on the financial flows with the rest of the world and between the domestic financial intermediaries, which was also reflected on the Slovenian capital market. The report continues with an examination of bank operations in the previous year, and detailed analysis of changes in the financial risks faced by banks during their operations. The final section of the report describes the operations of other non-bank financial institutions, such as insurance companies, investment funds and leasing companies, and financial infrastructure.

The favourable economic conditions in Slovenia in 2005, seen in relatively high economic growth (3.9%), the successful reduction of inflation to 2.3%, the stable tolar/euro exchange rate, and the maintenance of a modest budget deficit with the current account more or less in balance, had a positive effect on the performance of financial system institutions.

By maintaining high yet sustainable growth in consumption of 3.2%, including an expansion of real estate purchases, the household sector contributed to the increase in demand for consumer and housing loans. In 2005 the net debt of Slovenian households at banks increased to almost 13% of GDP, compared with 9.4% of GDP at the end of 2003. With the increase in debt came a significant change in the structure of the more important forms of household financial assets. Household bank deposits fell to below 59% of total financial assets. The proportion accounted for by investments in shares and bonds also decreased. By contrast, the proportion accounted for by financial assets in the form of investments in mutual funds increased to 8.1%, the proportion of investments in life insurance to 7.9%, and the proportion of investments in supplementary pension insurance to 3.4%. Among the fastest-growing household investments were those made abroad, which in one year increased from 0.8% to 2.0% of total financial assets. Both processes – the increase in household debt and the change in the structure of household financial assets – were influenced by the historically low levels of bank interest rates, and falling prices of securities on the Ljubljana Stock Exchange.

On the basis of high (34%) growth in the turnover on the real estate market, which in 2005 reached as much as 78% of the total turnover on the Slovenian capital market, it can be assumed that for a certain segment of investors purchases of real estate have become an important alternative to financial investments. This growth is mostly driven by the sustained rise in real estate prices; in Ljubljana, for instance, last year alone housing prices increased by between 11.3% and 14.2%, depending on size. High housing price growth in excess of 10% a year has been seen since 2003; the price to earnings ratio of housing in Ljubljana already suggests that smaller flats in particular are overvalued. However, the real estate market is dominated by certain economic and institutional factors, which will probably cause a further rise in housing prices in the near future. By contrast, the organised capital market fell: the SBI 20 was down 5.6% in 2005.

The increased demand for loans, corporate as well as household, was encouraged by low interest rates and fiercer competition between banks. Last year growth in corporate loans increased further, reaching 22% by the end of the year, with companies borrowing mainly in foreign currency, owing to the imminent introduction of the euro and the favourable foreign currency interest rates, which on average over the year were 2.9 percentage points lower on foreign currency investment loans, and 0.2 percentage points lower on short-term loans with a foreign currency clause than on comparable loans in tolar. Foreign currency corporate loans rose by 55.3%, last year, while tolar loans fell by 5%, which affected the currency structure of corporate borrowing. As the result of the favourable foreign currency interest rate for loans from Slovenian banks compared with the average euro area interest rate in the first three quarters of 2005, companies obtained a relatively larger proportion of foreign currency loans from domestic banks than abroad. This led to a significant change in the structure of the corporate lending market: last year the proportion of foreign currency loans obtained abroad by companies fell from 33% to just 15% of the total net increase in loans. Increased borrowing from Slovenian banks led to a relatively high increase in net corporate debt in Slovenia, from 21% of GDP in 2004 to almost 25% of GDP in 2005.

As a result of the high growth in corporate lending, companies' financial gearing increased by 9 percentage points in 2004 to 109.7%, with the largest increases coming in the sectors of construction and trade, where financial and operating liabilities were 2.7 and 1.7 times higher than capital respectively. With rising interest rates, this will lead to an increase in interest expenses, and consequently to lower corporate profits, which is an important source of capital increase. A continued trend of increasing gearing and decreasing profitability at companies could weaken their creditworthiness. Despite declining growth in claims and liabilities, the former grew at a rate 5.3 percentage points higher than that of the latter. Companies' open foreign exchange position against the rest of the world and domestic banks continues to shorten: in 2004 it amounted to 11% of total assets, or almost 24% of capital, compared with 21% of capital in the previous year. The shortening of the open foreign exchange position is increasing companies' exposure to exchange-rate risk. Exporting companies rely on the natural hedge against exchange-rate risk, while other companies only protect themselves against this type of risk to a lesser extent. However, the imminent introduction of the euro is reducing this risk.

Along with the favourable economic conditions, increasing growth in lending to non-banking sectors led to a further increase in bank profitability. In 2005 the banking system's pre-tax profit rose by 11% in real terms to SIT 63.9 billions, bringing an increase in ROE for the third successive year. As a result of an expansion in turnover banks managed to achieve almost 5% growth in net interest income, despite the continued decline in the net interest margin, which by the end of the year had reached a relatively low 2.53%. However, the proportion gross income accounted for by net interest income is still decreasing, and currently stands at 56.7%; at the same time the proportion of net non-interest income is increasing, particularly the proportion of net income from financial transactions. Consequently, the structure of banks' gross income is becoming increasingly sensitive to current economic conditions and growing competition between banks in charges for their services.

The banking system's increased pre-tax profit last year was also the result of the moderate growth in operating costs and relatively low growth in provisioning costs, which at 12.5% was significantly behind the 24% growth in classified claims. Last year the proportion of gross income accounted for by operating costs fell below 60%, while the proportion of net provisions remained relatively low at 16.4%, similar to that in 2004. Both these methods for increasing profit are only temporary, as changes in banking regulations (the introduction of the IFRS, the implementation of the CAD directive), and above all introduction of the euro, are expected to bring an increase in operating costs in 2006, while the decrease in provisioning costs is mainly the result of favourable economic conditions and the introduction of the IFRS.

High growth in lending to non-banking sectors (24.2%) and low growth in deposits by non-banking sectors (8.7%) are bringing significant changes in the structure of the banking system's balance sheet. Banks are increasingly compelled to finance their increased lending activity by borrowing abroad, and only partly by reducing their investments in securities. In one year the proportion of the latter decreased by less than 1 percentage point, while the proportion of liabilities to foreign banks in 2005 increased by 9 percentage points to 27% of total assets. Last year, when all Slovenian banks were borrowing abroad at an average interest rate of 2.5%, these sources were more favourable in terms of price than collecting deposits on the domestic retail market. However, rapid growth in banks' liabilities to the rest of the world is increasing their dependence on the situation on foreign financial markets, as increases in foreign interest rates are immediately reflected in more expensive sources of financing and consequently lower net interest income. Furthermore, resources obtained on the interbank market are more variable than collected household deposits.

This change in the structure of the balance sheet was felt most strongly by the banks under majority foreign ownership, and increasingly by the large domestic banks. Relatively easy access to financing from parent banks enabled banks under majority foreign ownership to achieve above-average growth of 37.7% in lending to non-banking sectors. This led to an increase of 2.6 percentage points in their market share in the banking system to 22.7%, primarily at the expense of a reduction of 2.1 percentage points in the market share of the large banks to 67%.

The results of the survey confirm banks' expectations regarding further borrowing abroad and reducing the proportion of non-bank deposits. According to their assessments, the most important risks remain credit risk and interest-rate risk. Banks are particularly aware of the increased competition and rising operational risks, which is the consequence of institutional changes. These survey results are very similar to the Bank of Slovenia's own assessments.

In favourable economic conditions and in the context of high demand for loans, the trend of reducing credit risk at banks continued. This is confirmed not only by the low growth in net provisioning, but also by the favourable changes in the structure of total classified assets. The proportion of claims given the lowest-risk A rating recorded the largest increase, expanding by 1.6 percentage points to account for 83.4% of the total portfolio. The proportion of B-rated claims decreased the most, by 0.9 percentage points, while the decrease in claims rated C to E was less pronounced. The ratio of special provisions to total classified assets fell by 0.5 percentage points to 4.6% as a result of the increase in the proportion of lower-risk claims. Improvements in the structure of classified claims were most visible in the banks under majority foreign ownership, which also achieved the highest lending growth. Furthermore, in 2005 the credit rating structure of loans, which account for three-quarters of all classified claims, improved for the fourth consecutive year. Adjustments to loans were reduced to 4.4% of the total. In the majority of industries and market segments loan quality improved, with the exception of the sectors of mining, health and other public services. Banks continue to rate loans to non-residents and sole proprietors as the highest risk, followed by loans to the sectors of agriculture, hotels and catering, and trade.

In addition to the improved credit rating structure of loans, the quality of loan insurance also improved. In 2005, the proportion of new loans at the eight largest banks that were unsecured fell by 2 percentage points to 61.4%. The highest proportion of loans are those with real estate collateral (12.8%), while 5.2% of loans are insured with securities. These two forms of insurance experienced the highest growth. By contrast, the proportion of loans insured with insurers fell slightly to 2.5% of all new loans at the eight largest banks, and the proportion of loans insured with sureties fell to 6.4%. In the context of the high growth in housing loans, which last year exceeded 45%, the proportion of new housing loans secured with a mortgage increased by 10.4 percentage points to 42%. Furthermore, the results of the bank survey show that the average loan-to-value ratio (LTV) increased to 59%, ranging from 50% to 70% at individual banks.

In contrast to the improvements in loan insurance and the reduction in credit risk, concentration in banks' credit portfolio increased. There was an increase in total large exposure expressed as a percentage of capital to 227%, and in the number of large exposures to 305, which are the highest figures in the last five years.

Despite the trend of decreasing credit risk, the pro-cyclic behaviour of banks means that any reversal in the economic cycle would relatively quickly be reflected in a deterioration in the credit portfolio, which would in turn reduce banks' returns. The introduction of the IFRS, which in accounting for the impairment of claims and off-balance-sheet liabilities are based on the concept of realised losses, will additionally contribute to the more pronounced pro-cyclic changes in the quality of the portfolio. The current very favourable risk structure of total classified assets should not give grounds for excessive optimism, since it would start deteriorating should the relatively high lending growth begin to weaken.

An additional factor of potential increase in credit risk at banks is the transfer of interest-rate risks and exchange-rate risks to the non-financial sector. This increases the systemic risk for the entire economy, since the corporate and household sectors are not adequately equipped for determining, assessing and managing interest-rate and exchange-rate risks.

In contrast to decline in credit risk, bank exposure to interest-rate risk increased in 2005. The difference between the average period of change in lending rates and deposit rates lengthened by 10% to 6.6 months. This is primarily the result of the lengthening of average loan maturity periods and the shortening of the average maturity of non-banking sector deposits. Banks are relatively rapidly expanding the proportion of new loans with a variable interest rate: last year the percentage of new loans with a variable interest rate was 57%, up 16 percentage points from 2004. Last year the banking sector was more exposed to a rise in interest rates, since interest expenses would increase faster than interest income as a result of the period of change in deposit rates being shorter than that of lending rates. In addition to the time imbalance between changes in lending and deposit rates, interest-rate risk was affected by the increase of SIT 20 billions in the difference between average interest-bearing assets and liabilities to SIT 430 billions in 2005.

The expected introduction of the euro in 2007 will not affect the level of interest-bearing assets or liabilities. However, the introduction of the euro will lead to a change in interest-rate risk because of the indexation of certain interest rates with the TOM base rate. The SITIBOR reference interest rate will be replaced with the EURIBOR reference interest rate. The majority of interest rates linked to one of the reference rates will track the changes in ECB interest rates at their own pace, with the exception of those index-linked to the TOM base rate, which will still depend on the movement of inflation in Slovenia. The change in interest-rate risk after the introduction of the euro will be the result of the fact that the interest-rate-sensitive assets indexed by the TOM base rate are almost double the amount of the interest-rate-sensitive liabilities indexed by the TOM base rate.

The exposure of banks to exchange-rate risk measured by the openness of the foreign exchange position fell in 2005 from 23.4% to 21.7% of regulatory capital. The long open foreign exchange position, and consequently exposure to exchange-rate risk, will be further reduced with the introduction of the euro, as around 90% of banks' foreign currency balance-sheet items are in euros. Exposure to exchange-rate risk partly increased as the result of changes in the Swiss franc exchange rate owing to the rapid growth in balance-sheet items with a foreign currency clause tied to the Swiss franc. In the banking sector overall, the proportion of items with a foreign currency clause tied to the Swiss franc increased from 4% to 12% last year; this proportion was even higher in the group of banks under majority foreign ownership, where it stood at 14.5%. Banks transferred the greater part of the risk associated with changes in the Swiss franc exchange rate to their clients through loans with a foreign currency clause tied to the Swiss franc. Borrowers who obtained this type of loans as a rule do not enjoy a natural hedge, while the variability in the Swiss franc exchange rate was greater than the variability in the euro exchange rate over the last ten years.

In 2005 bank liquidity as measured by the average annual liquidity coefficient remained at the level of the previous year. The coefficients improved slightly in the second half of the year following the amendment of the Bank of Slovenia's regulation on the minimum level of liquidity. However, certain indirect liquidity indicators deriving from balance-sheet maturity structure show that, viewed over a longer timeframe, bank liquidity is not as good as it was last year. Higher growth in lending to non-banking sectors coupled with low growth in deposits and the shortening of average maturity periods is intensifying banks' dependence on sources of financing obtained on the interbank market, and particularly on sources borrowed from foreign banks. The concentration of the largest depositors increased, and the volume of secondary liquidity decreased. Preparations for the adoption of the euro, the introduction of international accounting standards and the implementation of the CAD directive are also increasing operational risks at banks.

Changes in banks' risks reflected in the growth in risk-adjusted assets, and slower growth in regulatory capital, resulted in a decline in capital adequacy by 1.2 percentage points to 10.6% in 2005. The decline in banks' capital adequacy was mostly driven by high growth in lending, growth of more than 52% in capital investments, and banks' reluctance to increase their capital in the expectation of higher capital adequacy after the introduction of the IFRS at the beginning of 2006. The five-year trend of decline in the proportion of total risk-adjusted assets accounted for by credit-risk-adjusted items was reversed in 2005: this proportion increased by 1.4 percentage points, alongside a decline in the items adjusted for exchange-rate risks and market risks.

In 2006 capital adequacy was positively affected by the change in the calculation of currency-risk-adjusted items, and is expected to improve further with the introduction of the euro. Bank balance-sheet items expressed in euros will become domestic currency items, which will reduce capital requirements for foreign exchange risks. However, it needs to be stressed that expected improvement in capital adequacy will therefore not be the result of less risk-incurring behaviour by

banks, but of institutional factors, which might even increase banks' willingness to assume additional risks and will serve as the basis for further growth in lending without recapitalisation.

Similar to the improvements in banks' performance in 2005 were the improvements in the performance of insurers. After three years of decrease, last year insurers increased their net profits as a result of improved performance on the non-life and life insurance market. The performance of health insurance remained negative in the amount of SIT 2.1 billions. The improvement in the claims ratio was boosted primarily by a 12% improvement in non-life insurance claims and an 8% improvement in life insurance claims. The health insurance claims ratio deteriorated last year. Last year insurers and reinsurance companies increased their collected premium by 9%.

The proportion of more profitable and riskier investments in the structure of life insurance investments and assets covering mathematical provisions has increased over the last few years. The proportion of investments in debt securities and deposits at banks, which are regarded as the safest form of investment, fell by 4 percentage points in 2005, but still remains at the very high level of 82%. As with assets covering mathematical provisions, insurers displayed a significantly more conservative investment policy in other assets covering technical provisions than insurers in euro area countries. Slovenian insurers achieved greater geographical diversification in their investments: last year the proportion of investments in foreign securities increased from 19% to 24%, which had a positive effect on reducing the dependence of coverage of technical provisions by investments on returns on the domestic stock market. Voluntary supplementary pension insurance providers were slightly less successful, as their proportion of investments in foreign securities remained at the 2004 level of 15%.

The proportion of bank loans to households secured with insurers continues to decrease. Last year this proportion fell by 20 percentage points to 40% of total loans to households. The proportion of total collected premium accounted for by loan insurance premiums remains low at 2.6%. The claims ratio for insurance of consumer loans rose last year to 0.72, but the claims ratio for insurance of housing loans fell considerably, from 0.54 to 0.26. These developments suggest a successful reduction in potential systemic risks as the result of the transfer of credit risks from banks to insurers.

In 2005 investment fund assets increased by just 6%, as a consequence of the less encouraging conditions on the domestic capital market. At the end of 2005 investment companies had 63% of their investments in domestic shares, which increased their sensitivity to the return on securities on the domestic capital market. The adverse effect on mutual funds of the fall in securities prices on the Ljubljana Stock Exchange was not so marked, owing to a rapid increase in the proportion of foreign investments. In 2005 mutual funds increased their proportion of foreign investments by 23 percentage points to 40%. For this reason their annual return of 7% was higher than the return of Slovenia's stock market index the SBI 20, which was negative at -5.6%, although considerably lower than the return in 2004. Last year's fall in the SBI 20 was partly the result of changes in mutual funds' regional investment structure. In 2005 the proportion of the market capitalisation of shares on the stock exchange accounted for by mutual funds' shares rose by 2 percentage points to 6.7%, but this rise was primarily the consequence of the conversion of investment companies. The impact that mutual funds have on the domestic capital market is expected to diminish further in the future, as the proportion of foreign investments in their investment structure will continue to increase.

1 ECONOMIC TRENDS AND THE INTERNATIONAL ENVIRONMENT

1.1 The International Environment

Global economic growth gradually increased last year, and stood at 4.3% according to IMF estimates. Economic growth in the euro area fell by 0.6 percentage points in 2005 to 1.4%. The world's other two major economies both grew faster than the euro area. Economic growth was 3.5% in the USA and 2.5% in Japan last year. As in previous years, growth in central and eastern Europe was faster than in western Europe.

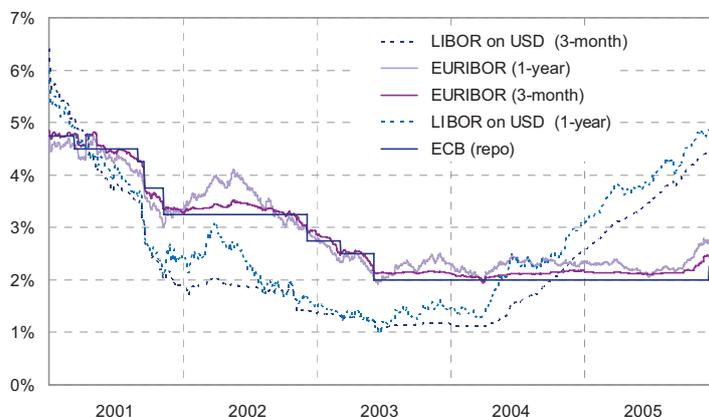
Last year economic growth in the euro area was behind growth in the USA and Japan.

Inflation in the euro area averaged 2.2% in 2005, thus remaining at a similar level to the previous year. Inflation in the USA rose again by 0.7 percentage points last year to 3.4%. The rise in oil prices remains a significant risk factor for rising inflation. Oil averaged USD 54 per barrel in 2005, up 42% from 2004. There were a number of factors in this rise: rapid growth in demand, the hurricanes in the Gulf of Mexico, and geopolitical factors in oil-producing countries. Oil again breached USD 60 per barrel in the early part of 2006.

Inflation in the euro area remained moderate despite rapid growth in oil prices.

Last year the Fed continued with the interest rate rises that it began in June 2004. It raised its key interest rate by 2 percentage points in 2005 to 4.25%. The reasons for the interest rate rise were the improvement in economic growth, which no longer required any encouragement from low interest rates, signs of overheating in the real estate market, and the presence of inflationary pressures. Interest rates in the euro area were unchanged for most of the year. After more than two years of no change, in December 2005 the ECB raised its key interest rate by 0.25 percentage points to 2.25%. The rise was expected, and was the result of inflationary pressures originating in the rapid growth in oil prices and also in high liquidity. The ECB raised its key interest rate by 0.25 percentage points again in March 2006.

Figure 1.1: Leading interest rates: LIBOR and ECB refinancing rate in percentages



Source: Bank of Slovenia

The euro depreciated against the dollar last year, falling 12.8%. The euro's fall against the dollar was mostly the result of the differences in interest rates between the two monetary zones. This exchange rate movement had an adverse impact on import prices in the euro area, which additionally contributed to inflation alongside the rapid rise in oil prices.

The euro depreciated against the dollar last year.

1.2 Inflation Trends and Economic Activity in Slovenia

The process of the gradual fall in inflation continued in Slovenia in 2005. Year-on-year inflation had fallen to 2.3% by the end of the year. Slovenia met the Maastricht inflation criterion for the first time in November 2005. The fall in inflation was primarily the result of a further fall in core inflation, which more than compensated for the relatively high growth in energy prices. As in the previous year, last year's fall in inflation was sustainable, with all the major macroeconomic equilibria being maintained: there was a moderate current account deficit of 1.1% of GDP in 2005, the general government deficit was 1.8%

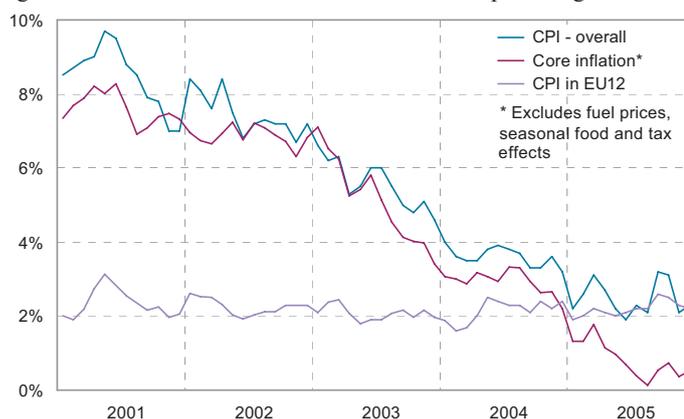
The gradual fall in inflation continued.

of GDP, and general government debt remained low at 29.1% of GDP according to ESA95 methodology.

The coordinated action by the Bank of Slovenia and the Slovenian government contributed to the fall in inflation.

The coordinated action by the Bank of Slovenia and the Slovenian government was again significant in reducing inflation in 2005. The Bank of Slovenia's monetary policy maintained interest rates at a level in keeping with exchange rate stability, and attempted to prevent potential inflationary pressures from arising on the side of demand. The government curbed price growth by making counter-cyclical adjustments to excise duties on liquid fuels, thus mitigating the transmission of high oil prices on world markets into domestic prices. Its policy of managing administered prices prevented costs from automatically feeding through into price formation.

Figure 1.2: Inflation in Slovenia and the EU in percentages



Source: Bank of Slovenia

Price movements in recent months indicate that inflation will stabilise at a level slightly above 2%. The factors that will affect the movement of inflation in the months ahead remain the same as last year. Any further increase in oil prices and strengthening of the dollar against the euro could have an adverse impact on inflation from abroad, while the main risk factor in the domestic environment is possible excessive spending caused by low interest rates. Movements in prices in the non-tradable sector, administered prices and slower growth in wages and social transfers will also be of significance to the movement of inflation in the future.

Table 1.1: Annual growth in GDP and GDP components in percentages

(%)	2001	2002	2003	2004	2005	2005			
						Q1	Q2	Q3	Q4
Real GDP	2.7	3.5	2.7	4.2	3.9	2.8	5.4	3.6	3.7
Household spending	2.7	1.8	3.0	3.1	3.2	2.9	3.8	3.4	2.8
Government spending	3.9	3.2	1.6	2.9	3.0	2.0	3.1	3.2	3.9
Investment spending	-4.3	4.0	10.1	9.2	-3.0	-1.5	-8.0	-4.4	2.0
Exports of goods and services	6.3	6.7	3.1	12.5	9.2	8.8	9.6	9.5	8.8
Imports of goods and services	3.0	4.8	6.7	13.2	5.3	6.8	1.6	5.9	7.2
Net exports ¹	1.8	1.1	-2.2	-0.8	2.3	1.2	4.8	2.2	0.9

Note: ¹ Percentage points.

Source: SORS, Bank of Slovenia, own calculations

Economic growth in Slovenia last year was the second-highest in the last five years.

Economic growth in Slovenia was relatively good in 2005 at 3.9%, but down 0.3 percentage points from the previous year. The largest contribution of 2.3 percentage points to this growth was made by net exports. Growth in domestic consumption was lower last year than in the previous year. The reason was the real decline in investment spending. The change in inventories acted as a brake on real GDP growth, while growth in investment spending only increased significantly in the final quarter of 2005. Growth in investments in plant and equipment was particularly low, while investments in buildings grew slightly more than in 2004. Household spending continued to grow at a relatively lively pace of 3.2% last year.

Economic growth in 2006 will depend primarily on exports.

Economic growth in 2006 should be similar to that in the previous two years, while inflation should stabilise at just over 2%. However, in addition to domestic conditions and the exercise of economic policy, economic growth and inflation depend on external factors such as economic growth in Slovenia's major trading partners, and the movement of oil prices on world markets. Other external factors that have an impact on inflation are commodities

prices and the movement of the euro/dollar exchange rate. Given the importance of net exports to economic growth, economic recovery in the EU remains key. Higher exports could gradually revive investment activity in Slovenia.

The lively growth in household spending is tied to increased purchases of consumer durables. With a stable exchange rate and low interest rates, consumption has been relatively lively for some time now. Despite the fear that increased consumption under altered circumstances could increase the pressure on the balance of payments, this has so far not occurred. Increased household debt could even act to limit consumption in the future, household debt having risen sharply in the last three years. Growth in government spending rose to 3% last year, but because of public finance restrictions it cannot have a significant impact on economic growth.

After Slovenia joined the ERM II in June 2004 monetary policy began to focus on meeting the criterion of exchange rate stability, which has placed the principal burden of reducing inflation on fiscal policy and incomes policy. Given the current inflation trends, it is certain that by early summer 2006, when the two years of membership of the ERM II have passed, Slovenia will meet all the criteria for introducing the euro at the beginning of 2007.

Financial transactions with the rest of the world

There was a moderate current account deficit last year of 1.1% of GDP. The deficit of EUR 301 millions was half that in 2004, when it stood at 2.1% of GDP. With domestic consumption lively and the terms of trade deteriorating, which brought a sharp acceleration in merchandise imports in the second half of 2005, the record high surplus in trade in services, an increase in the surplus in transfers and smaller net outflows of labour and capital income were all positive factors in current account.

After two consecutive years of relatively low net financial inflows, these reached 5.5% of GDP again in 2005. The private sector contributed to this, the government reducing its external debt in line with its strategy of domestic borrowing. The increase in net financial inflows originated in private sector borrowing abroad, mainly by banks. Outward portfolio investments by the private sector remained high.

Table 1.2: Net balance of payments flows in EUR millions

	2002	2003	2004	2005
1. Current account	344	-81	-544	-301
as % of GDP	1.5	-0.3	-2.1	-1.1
2. Financial account	1,099	149	411	1,506
as % BDP	5.4	0.6	1.6	5.5
Capital transfers	-163	-164	-116	-137
Outward FDI	1,538	-118	221	-27
Investments in foreign securities	-117	-173	-221	-322
Net trade credits	-41	-58	-31	12
Net loans abroad	718	979	1,391	2,292
Bank deposits	130	428	236	1,012
Other	-620	-733	-852	-645
3. Foreign exchange reserves	-1,443	-68	133	-1,205
as % of GDP	6.9	0.3	-0.5	4.4

Source: Bank of Slovenia, own calculations

In the financial account, the largest rise in claims against the rest of the world was recorded by outward portfolio investments. They rose by just under one-third last year to EUR 649 millions, exceeding other types of investment for the first time. Outward portfolio investments rose rapidly in 2004 primarily as a result of changes in the structure of the domestic financial market. The high inflows of money into mutual funds were at first directed towards domestic securities until the abolition of restrictions in the amount of investments in foreign securities. This was followed in 2005 by rapid growth in investments in foreign securities and foreign mutual funds, particularly in the second half of the year. Growth in loans to the rest of the world was also relatively rapid. The volume of trade credits remained similar to that in the previous year.

Among liabilities to the rest of the world, the large volume of borrowing abroad increased significantly in 2005, the total financial inflows into the private sector rising by 56% last year. Direct borrowing abroad by companies was less significant last year than in previous

No additional pressures or imbalances are expected in the balance of payments despite relatively lively consumption.

A moderate current account deficit.

Increased net financial inflows originated in private sector borrowing abroad.

Outward portfolio investments are prevalent on the claim side of the financial account.

years. Inward FDI by non-residents was lower last year than in 2004, while outward portfolio investments by the private sector increased.

The tolar lending market continued to contract.

While the currency structure of the lending market had shifted towards foreign currency loans and away from tolar loans even in 2004, in 2005 this trend intensified. Foreign currency lending to non-banking sectors is growing in importance for banks in comparison with tolar lending. In 2004 foreign currency loans accounted for 80.6% of the net increase in loans to companies¹ at Slovenian banks. In 2005 there even a net repayment of tolar borrowing by companies in the amount of SIT 42.6 billions.

Banks compensated for weak domestic saving by non-bank sectors by borrowing abroad.

Slovenian banks intensified even further their borrowing from banks abroad last year. These sources of financing were used to compensate for relatively weak saving by domestic non-banking sectors, thus securing resources for increased domestic lending to non-banking sectors.

Table 1.3: Net loans to banks and companies inside and outside Slovenia in SIT billions

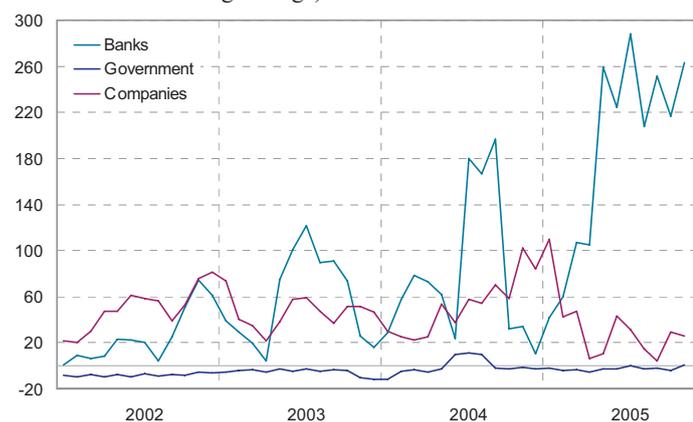
(SIT billions)	2001	2002	2003	2004	2005
Companies and OFOs in Slovenia	235.8	140.4	341.7	362.9	497.1
of which tolar	142.4	11.7	158.1	70.5	-42.6
of which foreign currency	93.4	128.7	183.6	292.4	539.6
Companies and OFOs abroad	108.1	136.0	124.7	168.7	71.3
Banks abroad	33.1	76.0	154.4	230.2	568.2
Total (companies and banks)	377.0	352.4	620.7	761.9	1136.6

Source: Bank of Slovenia

There was a shift in the structure of corporate financing towards borrowing at domestic banks.

In addition there was a decline in direct borrowing at foreign banks by companies in 2005. The ratio between corporate financing inside and outside Slovenia shifted sharply towards the former last year. Even in 2004 approximately two-thirds of companies' net new loans were raised inside Slovenia. In 2005 only 12.5% of corporate borrowing came from outside Slovenia. At almost SIT 500 billions, the net increase in loans to companies was SIT 134 billions more than the previous year's. Although corporate borrowing at banks in Slovenia recorded relatively high growth last year, the total amount of financing obtained inside and outside Slovenia by companies rose only slightly. Slovenian banks and companies were able to borrow abroad at relatively favourable interest rates last year. On average banks concluded agreements for long-term foreign currency loans at an interest rate of 2.5%, and companies at 3.4%.

Figure 1.3: Bank, corporate and government liabilities to the rest of the world (3-month moving average) in EUR millions



Source: Bank of Slovenia

Country risk and the spread in the yield on Slovenian eurobonds and German government bonds

There were no further changes in the country risk rating last year.

Slovenia has been upgraded by rating agencies in recent years. The last upgrade was made before Slovenia joined the ERM II. The reasons for Slovenia's improved credit rating lie in its relatively good macroeconomic position. With a well-diversified, open economy, and balanced public finances and balance of payments, at the end of 2005 Slovenia met all the

¹ Corporate borrowing at domestic banks involves a change in loan stock, while corporate borrowing at banks abroad involves flows from the financial account.

Maastricht criteria for joining the euro area, with the exception of two years of participation in the ERM II. The rating agencies' expectations that the rapid fall in inflation in Slovenia would soon see it join the euro area have been confirmed as accurate.

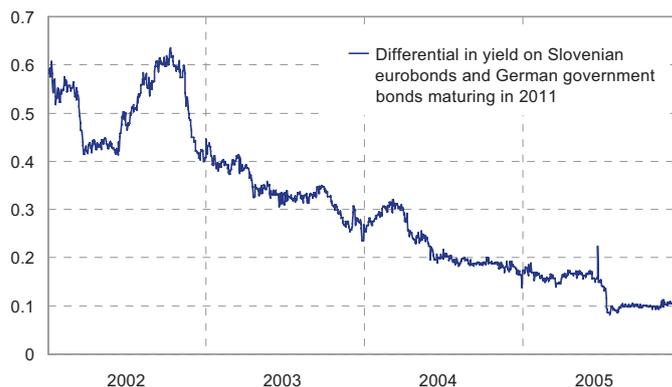
S&P last published a rating for Slovenia on 11 July 2005, holding it at AA-/A-1+. The report again cites factors acting to further reduce the risk rating, and factors acting in the opposite manner. Among the former S&P cites the commitment to fiscal prudence reflected in a low general government deficit and debt, the relatively balanced position in the balance of payments and the net external debt, political stability and the consensus about reform. The weaknesses were the low level of GDP in comparison with other comparable countries with an AA rating, low competitiveness caused by relatively high wages, the low level of foreign investment and the progress in privatisation.

The trend of a decreasing risk premium expressed as the spread between the yield on Slovenian eurobonds and German government bonds has been seen for a lengthy period, since the end of 2002. The premium fell below 0.2 percentage points in the second half of 2004, and has stalled at approximately 0.1 percentage points since the second half of 2005. The basic reasons for the decline in the premium are the same as those for the upgrading in country risk.

There is a falling trend in the country risk premium, and it has now fallen to just over 0.1 percentage points over German government bonds.

The country risk premium for Slovenian eurobonds, which stood at 0.109 percentage points in December 2005, was lower than the country risk premiums of the other new EU member-states for the majority of the year. At the end of 2005, Slovenia's risk premium was comparable to that of Estonia, 0.131 percentage points. The spread with other comparable countries is slightly higher: at the end of the year it was 0.244 for Hungary, 0.207 for Cyprus and 0.205 for Poland.

Figure 1.4: Country risk premium for investments in domestic eurobonds maturing in 2011 in percentage points



Source: Bank of Slovenia

The spread between the yield on domestic tolar government securities and euro-denominated German government bonds,² which reflects exchange-rate risk in addition to country risk, ranged from 1.0 to 0.4 percentage points. In January the spread was 1.0 percentage points, but this had fallen below 0.5 percentage points by December 2005.

The premium including exchange-rate risk in addition to country risk is also falling.

² The comparison is between the interest rates on 10-year government bonds, which are those used when judging the Maastricht criteria.

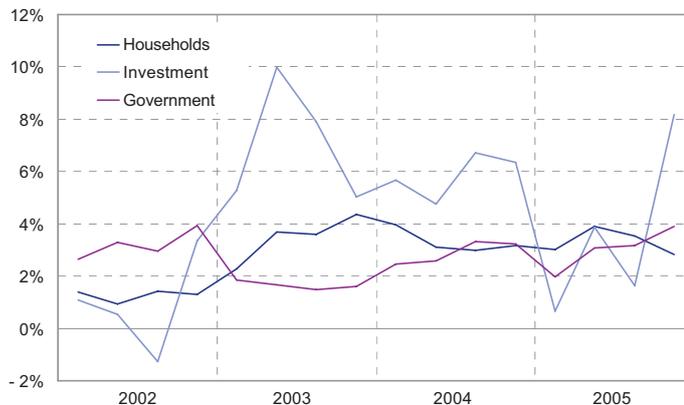
2 HOUSEHOLD SECTOR

2.1 Consumer Spending

Growth in consumer spending 3.3% in 2005.

Over the last three years consumer spending has been relatively dynamic, with growth between 3.2% and 3.4% over that period. In 2005 it was 3.3%. There have been a number of factors affecting this vigorous recent growth in household spending. The nominal convergence of domestic interest rates led to bank interest rates falling quickly in the run up to Slovenia joining the ERM II. They remained low until 2006, which acted as a disincentive to household saving at banks, a fact reflected in the weak growth in deposits; it did however encourage borrowing. The increased spending has led to household borrowing increasing since 2003, gradually but consistently.

Figure 2.1: Year-on-year growth in domestic spending in percentage



Source: Bank of Slovenia

2.2 Household Borrowing at Banks

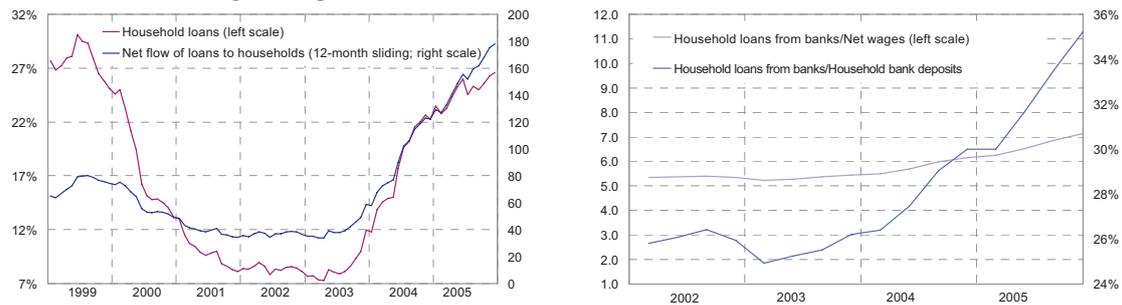
Household borrowing rose last year.

Year-on-year growth in lending to households increased throughout the year, as it did in 2004, and had reached 26.6% by the end of the year. Housing loans represented 60% of the net increase in lending to households, and reached almost SIT 180 billions last year. In December last year the growth in housing loans to households was almost 20 percentage points above overall growth in household loans, and their proportion in the overall structure grew by 5 percentage points to 35.1%. The relatively dynamic economic growth, historically low interest rates and the rather low levels of existing household borrowing all contributed to the growth in household loans. A further contributory factor in the increased household borrowing was the banks becoming more flexible in the consumer and housing loans they offered.

Net household savings at banks declined.

Given widespread expectations that interest rates will remain relatively low in 2006, banks will be encouraged, at least for another year, to focus on loans to households, where the margins are higher. Competitive pressures in the household loans segment are expected to continue rising, but at a slower rate than in previous years. The third series of the National Housing Saving Scheme (NHSS) matures at the start of 2006, but the positive market conditions mean most savers are not taking out loans under the NHSS scheme conditions. Nevertheless the scheme maturing will increase the potential for borrowing, and increase the overall volume of loans. A key factor in the anticipated decline in growth in loans to households in the second half of 2006 is likely to be the increasing debt ratio. In 2005 debt expressed as the ratio of household loans to wages reached the highest level in the last six years. On average households required over eight months of wages to repay their loans. With wage growth slowing, the net household debt ratio is expected to increase even more.

Figure 2.2: Net flow in SIT billions and growth in household loans and borrowing from banks in percentages

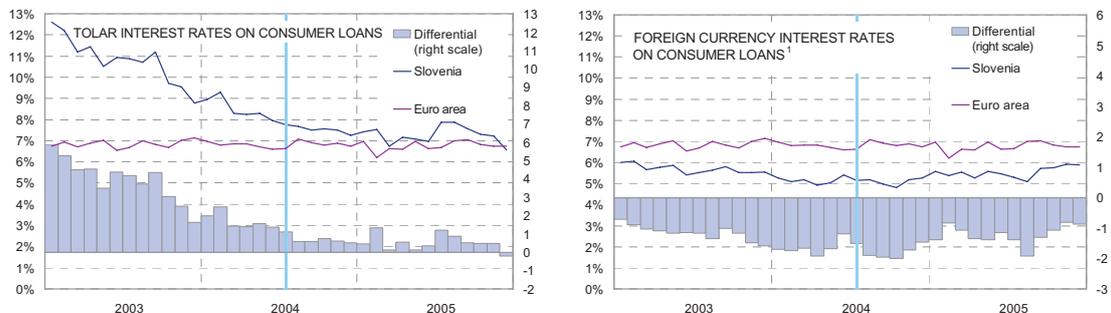


Source: Bank of Slovenia

Foreign currency loans increased significantly within the currency structure for borrowing, up to 9.5% at the end of 2005. Foreign currency loans represented 40.2% of the net increase in household loans, which is significantly more than in 2004 (7.5%).

Convergence of interest rates on consumer loans

Figure 2.3: Comparison of Slovenian interest rates for consumer loans with euro area interest rates in percentages



Note: ¹ Includes interest rates for foreign currency loans and interest rates for loans with a foreign currency clause.

Source: Bank of Slovenia

A comparison of interest rates for consumer lending in Slovenia and the euro area indicates that the process of convergence in nominal tolar interest rates slowed after the first half of 2004. On average last year the spread was 0.5 percentage points, while in 2004 it was 1.2 percentage points. At the end of 2005, the gap had almost completely closed.

In fact, foreign currency consumer loans in Slovenia are available with even more favourable interest rates than consumer loans in the euro area. The spread between interest rates in Slovenia and the euro area was 1.2 percentage points in 2005, which reflects the continuation of the aggressive household lending policy in Slovenia, particularly from foreign banks.

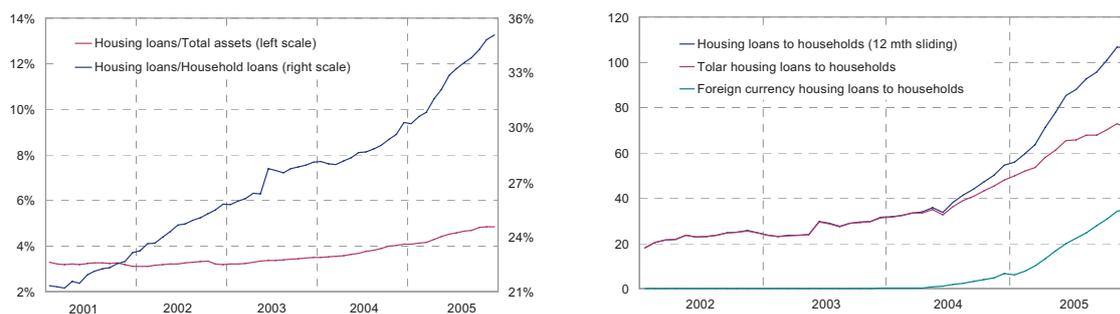
Household borrowing from banks in the form of housing loans

At the end of 2005 housing loans accounted for 4.8% of the banking system's total assets, and 35.1% of all household lending. Compared to the previous year, there was a significant increase in the volume of housing loans, particularly in foreign currency, in 2005.

At the end of 2005 tolar loans were still the largest group in the currency structure of housing loans at 36.7%. They were followed by loans with a foreign currency clause in euros (35.7%), loans in euros (14.6%) and loans with a currency clause in Swiss francs (12.7%). However, the currency structure of loans approved in the last eight months of 2005 moved strongly towards loans with a foreign currency clause in euros (31.5%), loans in euros (30.9%) and loans with a currency clause in Swiss francs (24.8%). At present loans in Swiss francs are more favourable because they are being offered with lower interest rates. If the ECB and Swiss central bank maintain the spread in interest rates, the proportion of new housing loans in Swiss francs and loans with a Swiss franc currency clause will probably increase. Loans in Swiss francs however do transfer foreign exchange risk to households, which could lead to large delays or even defaults in the repayment of housing loans, should the Swiss franc appreciate against the euro.

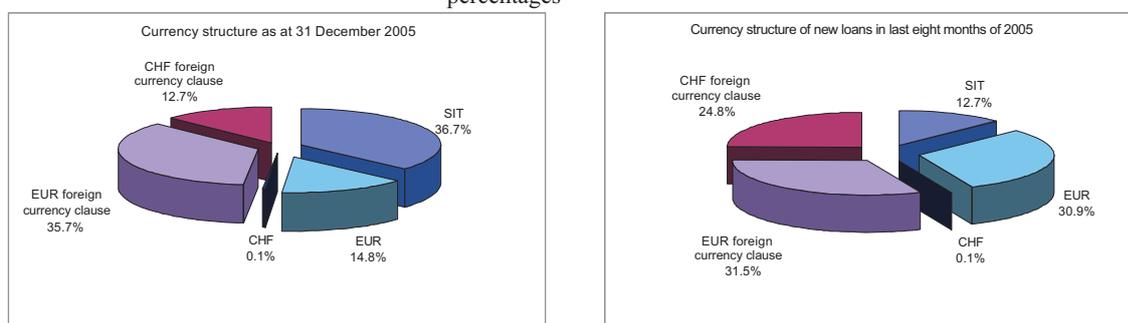
The rate at which the spread between euro area and tolar interest rates and tolar interest rates on household lending converged began to slow last year.

Figure 2.4: Housing loans as proportion of total assets and total household lending in percentages and year-on-year changes in household loans in SIT billions



Source: Bank of Slovenia

Figure 2.5: Currency structure of housing loans as at 31 December 2005 and currency structure of new housing loans in final eight months of 2005 in percentages



Source: Bank of Slovenia

Lengthier terms to maturity were being offered on housing loans.

The main criterion for banks in the approval of housing loans is the ratio of the monthly loan repayment to the borrower's income. The reduction in interest rates and extended maturity of new loans has increased the number of households that can meet bank criteria and take out higher loans in order to buy a home. Easier access to housing loans is the main reason for the rapidly increasing borrowing and increased demand on the housing market.

Table 2.1: Original term to maturity of newly approved housing loans by year at eight largest banks in percentages

(%)	up to 5	5 to 10	10 to 15	15 to 20	over 20
2003	3.0	19.7	52.8	20.1	4.4
2004	3.2	18.6	46.7	20.8	10.6
2005	2.2	13.0	35.0	24.2	25.6

Source: Bank of Slovenia

Box 2.1: National Housing Saving Scheme (NHSS)

In 1999, via the Housing Fund of the Republic of Slovenia (HFRS), the government began using the National Housing Saving Scheme (NHSS) as an instrument of housing policy to exert a positive influence on long-term saving and to expand the amount of long-term housing credit available. In accordance with the National Housing Saving Scheme Act (Official Gazette of the Republic of Slovenia, Nos 86/2000 and 79/2001-Const. Court Dec.) four tenders (of five in total) have already been issued for savings within the NHSS. In November 2004 the Housing Fund published a new (sixth) tender to select a bank to participate in the NHSS for 2004, but banks were not prepared to participate given the terms of the tender. Changing circumstances meant this form of lending was less attractive to banks and households. For banks the interest rates that they would have to pay savers under the terms of the scheme were too high compared to market prices, and there was also an obligation for them to repay the premiums to the government if the saver does not opt to take out a housing loan after the saving period ends. Competition on the market has led to changes in the conditions under which NHSS savers can take out loans from banks.

Table 2.2: Saving in NHSS schemes on 31 December 2005 in SIT millions

	Saving term	Number of savers	Volume of funds saved			Total
			Payments	Premiums	Interest	
NHSS scheme ¹	5 years	36,935	40,342	2,610	4,562	47,514
	10 years	5,997	9,119	773	1,909	11,801
Total		42,932	49,461	3,383	6,471	59,314
Total (%)	5 years	86.0	81.6	77.2	70.5	80.1
Total (%)	10 years	14.0	18.4	22.8	29.5	19.9

Note: ¹ Schemes 3, 4 and 5 and the remainder of Schemes 1 and 2.

Source: Bank of Slovenia

Maturity of NHSS schemes in 2005 and anticipated end to third five-year scheme in spring 2006

On 27 November 2005 the second five-year NHSS matured, for which the balance of money paid in by savers (money paid in, not including accrued premiums, revaluations and interest) at the end of October 2005 came to SIT 17.6 billions, or SIT 23 billions together with the premiums.

In the period up to 31 December 2005 the banks approved NHSS-based loans worth SIT 13.9 billions³, just 7.4% of all housing loans made to households. Meanwhile banks not participating in the NHSS (mainly Austrian banks) were aggressively increasing their market share in housing loans to households from 10.6% to 44% between 2000 and the end of 2005. Year-on-year growth in housing and long-term loans to households by banks not participating in the NHSS were significantly higher than year-on-year growth achieved by banks participating in the NHSS.

The third five-year NHSS matured in the first half of April 2006. The total value of saved funds (money paid in excluding accrued premiums, revaluation and interest) in the third scheme on 28 February 2006 was SIT 16.9 billions.⁴ It is estimated that households will take out SIT 4 billions in loans on the basis of the third scheme, or 23.5% saved funds.⁵ Savers needing more funds to purchase housing will take out loans from banks operating outside the NHSS.

The impact of the third scheme on the banking system will be far less than that of the first scheme, as the third is significantly smaller than the first, as was the second.

The failure of the scheme to meet its purpose in resolving the housing financing issue necessitated changes in the NHSS conditions.

Amendments to the NHSS Act

Table 2.3: Comparison of NHSS saving conditions under previous act and amended act

	Previous Act	Amended Act
Interest rate on savings:		
for 5 years	TOM + 1.65%	Interest rate set at 75% of market yield on government bonds in domestic currency with fixed interest rate and maturity over 9 years and six months
for 10 years	TOM + 3.00%	
Saving period	5 and 10 years	from 5 to 10 years
Loan with 10 year repayment	TOM+2.45% (5 years)	interest rate on saving + 1 percentage point
Loan with 20 year repayment	TOM+3.80% (10 years)	
Premium for annual saving	1 mth. instllmt/ 1/12 ann. paymt., or 1.25 of mth. instllmt. for 10-year saving	1/24 of annual payment
Eligibility for premium	regular payment of 12 installments	regular payment of 10 to 12 installments
Loan repayment period	double the saving period	double the saving period
Changes in interest rate	in case of large changes to interest rates on financial market (interest spread stays the same)	interest rate fixed for one year period
Subsidised loan repayment	No	for young families seeking to purchase first housing with income per family member not exceeding half average wage in Slovenia

Source: Bank of Slovenia, HFRS

³ Loans from the first and second scheme worth SIT 12.5 billions and bridging loans worth SIT 1.4 billions.

⁴ According to the figures as at 31 December 2005, the total value of saved funds (money paid in, real interest, revaluated interest and premiums) for the third five-year saving scheme was SIT 20 billions.

⁵ The percentage is calculated from the ratio of NHSS loans taken out (as at 31 December 2005) and money paid in from the first and second schemes, excluding accrued premiums, revaluation and interest.

On 1 March 2006 the new Act Regulating the National Housing Saving Scheme and Allowances for Young Families That Are First-Time Buyers entered into force, which changed the saving schemes into purpose-specific schemes. The conditions for acquiring premiums have also changed, and according to the new act will be tied to a specific purpose for saved funds or loans, while the interest rates on the savings and loans have also been changed, and the revaluation abolished. The amended act changed the provisions on the savings period so that saving will be possible for a period of five to a maximum of ten years. Savers will be entitled to a premium at the end of a one-year saving period, if they pay in at least ten monthly payments during the saving year instead of all 12, as in the previous five schemes. At the same time the value of the premium will be halved.

The amended act included a new title on allowances for young families buying their first home. Any young family that is seeking to acquire their first home by buying or building and whose income per family member does not exceed half the average wage in Slovenia in the past year will be entitled to subsidies that are not related to saving in the scheme. According to the new act, young families will receive EUR 160 per year per family member in financial assistance for the first four years, and EUR 100 per family member for the following four years. A four-member young family will therefore receive EUR 4,160 euro in state aid towards purchasing housing over a period of eight years.

2.3 Forms of Financial Assets and Net Household Borrowing at Banks

Household financial assets last year increased to 62.8% of GDP.

Household financial assets, which comprise bank deposits, household claims in the form of equity and debt securities, investments in mutual fund investment coupons, life insurance and voluntary supplementary pension insurance held by households,⁶ rose by 8.5% in 2005.

Households still hold the majority of their financial assets in bank deposits, although the proportion of the total that they account for is still decreasing. In 2005 it fell by 1.7 percentage points to 58.7%. The second-most important form of saving also fell last year by 3.6 percentage points, i.e. investments in domestic shares and bonds. The importance of alternative forms of financial assets are increasing. Last year their proportion increased by 5.3 percentage points to 21.4%.

Table 2.4: Forms of household financial assets in SIT billions

	Household deposits at banks	Shares and bonds	Mutual funds	Investments abroad	Life insurance	Supplementary pension insurance	Total financial "assets"
Dec. 00	1,274	468	10.7	0.7	-	-	1,753
Dec. 01	1,731	603	14.7	1.4	123.8	6.2	2,480
Dec. 02	1,944	727	55.4	4.6	179.0	24.7	2,935
Dec. 03	2,097	804	93.1	12.1	221.9	48.9	3,277
Dec. 04	2,292	891	210.2	29.0	276.0	95.4	3,793
Dec. 05	2,418	817	331.9	81.5	326.2	141.9	4,117

Source: CSCC, SMA, Bank of Slovenia, ISA, AMC

Table 2.5: Structure of household financial assets and household financial assets as proportion of GDP in percentages

	Household deposits in banks	Shares and bonds	Mutual funds	Investments abroad	Life insurance	Supplementary pension insurance	Total "assets" Proportion	Total "assets" as % of GDP
Dec. 00	72.7	26.7	0.6	0.0	-	-	100	40.8
Dec. 01	69.8	24.3	0.6	0.1	5.0	0.2	100	51.7
Dec. 02	66.2	24.8	1.9	0.2	6.1	0.8	100	54.8
Dec. 03	64.0	24.5	2.8	0.4	6.8	1.5	100	56.4
Dec. 04	60.4	23.5	5.5	0.8	7.3	2.5	100	60.7
Dec. 05	58.7	19.9	8.1	2.0	7.9	3.4	100	62.8

Source: CSCC, SMA, Bank of Slovenia, ISA, AMC

⁶ Only the household financial assets listed above are included, and not real estate or holdings of foreign cash and other forms of financial assets, included in financial accounts. Liabilities do not include liabilities from leasing or liabilities from various forms of lending from companies other than banks.

At the end of 2005 household financial assets were equivalent to 62.8% of GDP, up 2.1 percentage points over the previous year. Financial assets were equivalent to 138.2% of annual disposable household income⁷, up 5 percentage points from last year. Bank loans represented the majority of liabilities disclosed by households. The liabilities do not include liabilities from leasing and household borrowing from lenders other than banks.

Table 2.6: Bank loans and deposits in SIT billions

	Household loans from banks (1)	Household deposits at banks (2)	Net household savings at banks (2-1)	Net savings as % of GDP
Dec. 00	419.2	1273.6	854.4	19.9
Dec. 01	453.3	1730.9	1277.6	26.6
Dec. 02	490.1	1944.1	1454.0	27.1
Dec. 03	548.7	2097.4	1548.7	26.6
Dec. 04	671.0	2291.7	1620.7	25.9
Dec. 05	849.3	2417.8	1568.5	23.9

Source: Bank of Slovenia

Significantly weaker growth in deposits compared to growth in household loans led to net household bank deposits falling last year by 2 percentage points to 23.9% of GDP. The average growth in household loans last year was three times the average growth in household deposits.

Convergence of interest rates on bank deposits

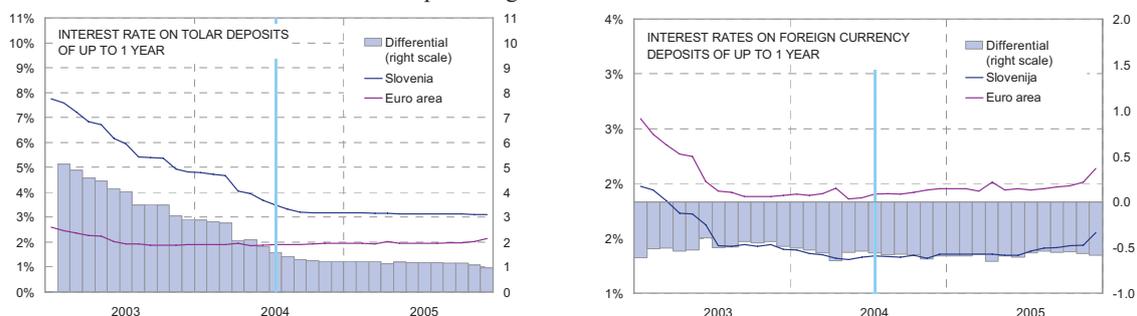
As with lending rates, in recent years there has also been significant nominal convergence in interest rates on bank deposits.

For short-term tolar deposits, which are predominant among bank deposits (93% of all deposits), the level of interest rates moved near 3% from the end of summer 2004, and remained at that level until the end of 2005. On average Slovenian interest rates on short-term tolar deposits were 1.2 percentage points above those in the euro area. At the end of the year the gap fell to below 1 percentage point. The spread between domestic and foreign interest rates on foreign currency deposits with the same maturity in 2005 remained similar to the previous year, but the average level of -0.6 percentage points is not sustainable in the long-term.

After the level of tolar interest rates at domestic banks for deposits of more than 1 year stabilised around 4% after Slovenia joined the ERM II, there was a slowdown in the rate at which interest rates in this part of the market fell. By the end of 2005, interest rates on long-term deposits had fallen to around 3%, while the spread between tolar interest rates on long-term deposits and interest rates in the euro area fell last year on average by 0.6 percentage points to around 1 percentage point. In the final months of 2005 the spread fell to below 1 percentage point. In contrast the negative spread between interest rates on long-term deposits in Slovenia and the euro area reduced throughout last year and was positive by the end of the year.

There was a positive spread between interest rates at home and in the euro area for tolar deposits, and a negative spread for foreign currency deposits.

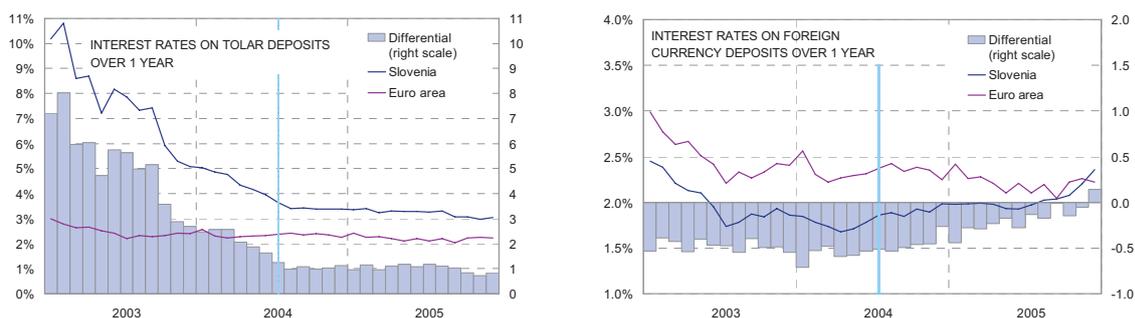
Figure 2.6: Comparison of Slovenian interest rates on deposits of up to 1 year with interest rates in euro area in percentages



Source: Bank of Slovenia

⁷ Disposable household income comprises net wages paid, other employment earnings and social transfers.

Figure 2.7: Comparison of Slovenian interest rates on deposits of more than one year with interest rates in euro area in percentages



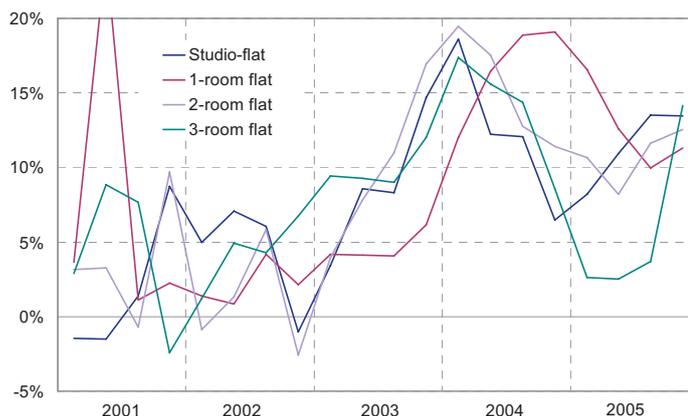
Source: Bank of Slovenia

2.4 Real Estate Market

Regional differences in the rate of price growth narrowed, but the differences in real estate price levels are still large.

In past years there has been diverse movement on the Slovenian real estate market in both residential and commercial properties. In 2005 there was a reduction in the regional differences seen between Ljubljana and surroundings and the rest of the country in the rate at which residential real estate prices were growing. The difference in the prices of housing between the Ljubljana urban region⁸ and the rest of Slovenia nevertheless remained relatively large⁹.

Figure 2.8: Year-on-year rise in advertised housing prices in Ljubljana in percentages



Source: SLONEP, own calculations

The rapid growth in housing prices in Ljubljana eased somewhat in the second half of 2004 before increasing again towards the end of 2005, when year-on-year price growth rose above 10%. The fastest growth in recent years was recorded by smaller dwellings, particularly 1-room flats, the prices for which increased by 19.1% in 2004. The largest increase in price growth in 2005 was recorded for larger dwellings, prices of which rose by over 14%. Office prices did not change significantly in 2005, after considerable volatility in past years on the commercial real estate market in Ljubljana. Prices were up by 5.5%. There were also significant differences in price levels between the capital and its surroundings. Housing prices in the Ljubljana surroundings grew faster than prices in the capital itself throughout most of 2005. The very high housing prices in Ljubljana, led to higher demand from households for real estate in the city surroundings.

Regional differences in price levels in 2005 again increased somewhat in comparison with the previous year. This applies above all to the comparison in housing prices between Ljubljana and the Ljubljana urban region, and the average for the rest of the country.

⁸ The geographical division according to housing prices is made at SKTE level 2, where the Ljubljana region is the same as the Central Slovenia region at SKTE level 3, while the rest of Slovenia includes 11 level 3 regions. The Ljubljana urban region is further divided into the city of Ljubljana and the surroundings.

⁹ The exceptions are tourist resorts on the Slovenian coast and some areas near ski resorts.

Table 2.7: Year-on-year growth in real estate prices in percentages

	2001	2002	2003	2004	2005	2005 I	2005 II	2005 III	2005 IV
Growth in advertised prices for housing and offices in Ljubljana (%)									
Studio-flat	8.7	-1.1	14.7	6.5	13.5	8.2	10.9	13.5	13.5
1-room flat	2.2	2.1	6.2	19.1	11.3	16.6	12.6	10.0	11.3
2-room flat	9.7	-2.6	17.0	11.4	12.6	10.7	8.2	11.6	12.6
3-room flat	-2.4	6.8	12.0	8.6	14.2	2.6	2.5	3.7	14.2
Offices	-0.8	12.7	5.9	5.5	5.5	0.2	0.9	2.7	5.5
Growth in transaction prices of housing (%)									
Flats - Ljubljana - city					12.7	11.9	11.4	9.0	12.7
Flats - Ljubljana - surroundings					7.3	14.3	18.4	14.7	7.3
Flats - Ljubljana urban region (SKTE 2)					11.1	12.0	12.1	9.4	11.1
Flats - rest of Slovenia (SKTE 2)					11.7	5.8	10.9	10.8	11.7

Source: SLONEP, Tax Administration of the Republic of Slovenia, Bank of Slovenia, own calculations

Table 2.8: Index of regional differences in housing prices¹⁰

	Slovenia	Ljubljana urban region	Ljubljana - city	Ljubljana - surroundings	Rest of Slovenia
2004	100.0	145.8	158.3	102.4	75.2
2005	100.0	148.0	160.8	106.2	75.5

Source: Tax Administration of the Republic of Slovenia, Bank of Slovenia

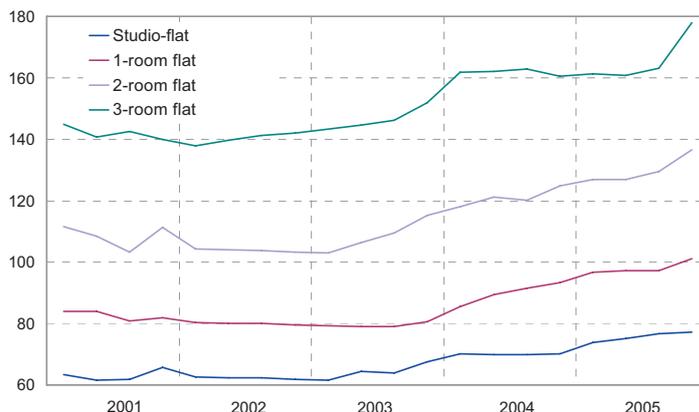
Price level sustainability

The sustainability of housing prices depends on the ratio of current prices to fundamental prices, i.e. prices justified by economic and institutional fundamentals. Given that the available data is for a relatively short period, we calculated two indicators for price sustainability on the Ljubljana real estate market¹¹. The two indicators are housing affordability and the price to rent ratio, on the basis of which the fundamental housing price was calculated.

Housing affordability, expressed as the ratio of Ljubljana housing prices to monthly net wages (12-month moving average), started to fall after 2002 due to rapid growth in housing prices that was not matched by growth in net wages. The largest fall in affordability was for 2-room and 1-room flats, followed by 3-room flats and studio flats. In 2005 the rapid growth in prices led to access to larger flats or housing being reduced most. At the end of 2005 purchasing a 2-room flat in Ljubljana required 33 average monthly wages more than at the end of 2002. The reduction in affordability of housing was mitigated by the fall in interest rates and the lengthening of the average maturity of housing loans.

Housing affordability has fallen since the end of 2002.

Figure 2.9: Ratio of Ljubljana housing prices to average net monthly wages in Ljubljana (12-month moving average)



Source: SLONEP, Tax Administration of the Republic of Slovenia, Bank of Slovenia, own calculations

¹⁰ Regional differences in price levels for years given are calculated from the average prices for specific quarters.

¹¹ Using the values for these indicators alone one cannot speak of a bubble on the real estate market. Limits relating to quality have to be taken into account in interpreting the data.

Price to rent ratio is increasing.

Last year housing rents in Ljubljana grew more slowly than housing prices, similarly to 2004. The price to rent ratio was slightly higher than in 2004. There is a significant higher ratio for smaller flats. At the end of 2005 purchasing a studio flat in Ljubljana was equivalent to over 18 annual rents (compared to just over 17 in 2004), a 1-room flat was equivalent to just under 20 annual rents (under 18 in 2004), a 2-room flat just over 16 annual rents (under 16 in 2004), and just over 16 annual rents for a 3-room flat (15 in 2004).

Figure 2.10: Year-on-year growth in 12-month moving average for prices and rents of 1-room flats in percentages and price to rent ratio (P/E) in Ljubljana

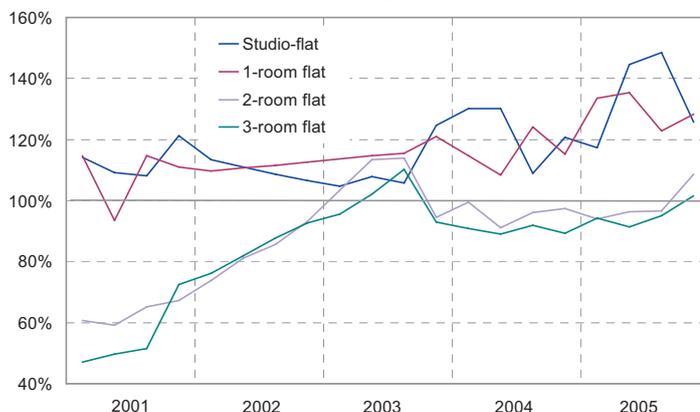


Source: SLONEP, own calculations

P/E indicator shows smaller flats are overpriced.

In calculations of the fundamental housing prices based on the price to rent (i.e. earnings) ratio (P/E)¹² we took the average P/E value for the period 1995 to 2000¹³ and used the rents data for 2001-2005 to calculate the fundamental prices. The actual prices for smaller flats significantly exceed the fundamental price. The size of the discrepancy increased somewhat in 2005. Since 2002 the actual price of larger flats has generally been below the fundamental price, only slightly exceeding that price in the final quarter of 2005.

Figure 2.11: Ratio of actual to fundamental price, calculated using the price to rent ratio for Ljubljana in percentages



Source: SLONEP, own calculations

Given the large increase in the house price to net wages ratio and the actual to fundamental price ratio, we assess that smaller flats in Ljubljana are overpriced. That can not be stated for larger flats, as their market price has been below the fundamental price since 2002.

¹² In calculations of the P/E indicator for the real estate market the price (P) was the average price per square metre of a flat while the earnings (E) were the annual rent per square metre. The fundamental price is the real estate value that should, given the economic and institutional fundamentals, be sustainable in the long-term. It is calculated by multiplying the average value for the P/E indicator over a set past period, by the annual rent per square metre.

¹³ A more accurate calculation of the fundamental price would take into account a longer, more stable period of at least 10 to 15 years in calculating the P/E average. This is not possible given the short period for which figures are available and the brevity of time for which the Slovenian real estate market has actually functioned. The restrictions mentioned must be taken into account when interpreting results, although one could expect over a longer period at most a lower average P/E ratio and higher overvaluation of flats using this indicator.

Factors affecting real estate prices

In recent years there has been a growing imbalance between supply and demand for flats, which has led to increased prices due to the inflexibility in supply in the short-term. Supply on the real estate market can only slowly adapt to demand, for which reason housing prices in the short-term can significantly deviated from a long-term balanced level. After an extended period of rising real estate prices, in the last two years Slovenia has seen a certain response from the supply side, which can be seen from the high year-on-year growth in gross investment in residential buildings in 2004 and 2005, the higher number of building permits issued and the higher number of completed flats in 2004 compared to 2003. In future we can therefore in all likelihood expect an increased supply of new flats, which should lead to the growth in prices calming. However, one must remain aware of the restrictions arising from the capacity of the construction sector and the insufficient supply of suitable land with planning permission. According to some assessments, Slovenia can only look forward to a maximum annual increase of 8,000 dwellings per year, through new construction and reconstruction of older housing.¹⁴ One objective of the National Housing Programme for 2000 to 2009 was to build at least 10,000 dwellings per year, which will be very difficult to achieve. This is confirmed by the large gap between the planned number from the National Housing Programme and the actual number of newly constructed flats.

Response from supply side to imbalance between supply and demand for housing.

Table 2.9: Housing stock, number of completed dwellings, building permits issued and gross investment in housing

	1999	2000	2001	2002	2003	2004	2005
Estimate of housing stock							
Number of dwellings ¹	709,825	716,402	722,924	730,064	736,420	743,424	
Number of dwellings per 1000 inhabitants	357	360	363	366	369	372	
New constructions, extension and change of purpose							
Number of new dwellings	5,446	6,751	6,715	7,265	6,567	7,004	
Number of new dwellings per 1000 inhabitants	2.74	3.39	3.37	3.64	3.29	3.51	
Floor area (m ²)	607,468	745,194	778,817	824,608	746,517	761,430	
Building permits issued							
Number of dwellings	5,634	5,339	5,168	5,080	6,122	7,002	7,003
Floor area (m ²)	685,650	636,424	606,262	597,366	711,385	793,200	861,179
National Housing Programme from 2000							
Planned number of dwellings		6,200	6,550	6,950	7,400	7,950	8,550
Growth rate (%)							
Gross investment in housing	14.3	-4.0	7.0	8.5	-8.0	15.7	20.5

Note: ¹Housing stock includes inhabited dwellings and temporarily uninhabited dwellings for permanent use.

Source: SORS, National Housing Programme, own calculations

The size of the existing housing stock of course has a significant impact on housing supply. In Slovenia the number of dwellings per 1,000 inhabitants in 2002 was 336 units, significantly below the EU15 average, which was 490¹⁵ dwellings per 1,000 inhabitants. The number of dwellings per 1,000 inhabitants should approach the EU level as available household income increases. In Slovenia the number of dwellings per 1,000 inhabitants is increasing, and the net average annual increase in the housing stock¹⁶ between 1999 and 2004 was 3.25 dwellings per 1,000 inhabitants. In 2002, 3.64 dwellings were built per 1,000 inhabitants in Slovenia, which is less than in most of the EU15, but more than in most of the ten new member states. Given the current net increase in the number of dwellings per 1,000 inhabitants compared to the EU15 countries, is not high enough for there to be talk of convergence in this sector. As Slovenia's per capita GDP continues to catch up with the EU average, demand for housing will increase, which will lead to further price pressures if the number of newly constructed dwellings is insufficient.

Growth in number of dwellings is too slow.

On the housing demand side, the reduction in inflation and increase in competition between banks has been expressed in lower interest rates and an increase in the supply of long-term housing loans. The falling trend in tolar interest rates on housing loans seen in 2004 continued into 2005. The average tolar interest rate on housing loans was 1.2 percentage

Increased supply of housing loans at lower interest rates.

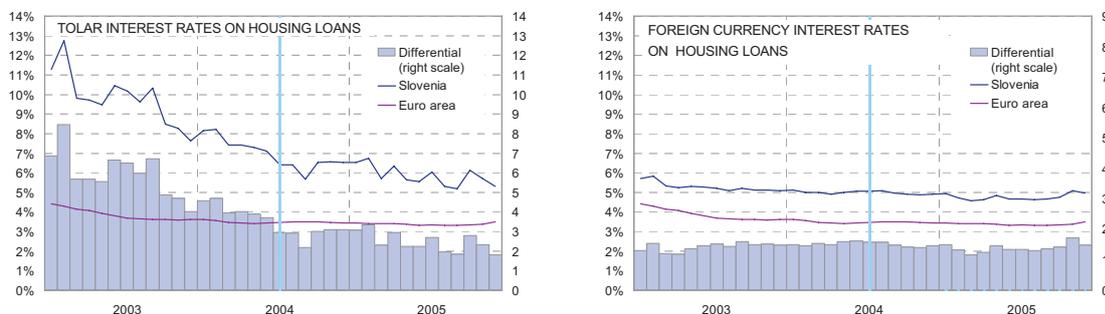
¹⁴ Banovec T.: *Ali imamo v Sloveniji preveč ali premalo stanovanj? Poslovanje z nepremičninami: 16. tradicionalni posvet* (Does Slovenia have too much or too little housing? Slovenian Real Estate Market and Property Management: 16th Traditional RE Conference (Conference Proceedings)). Ljubljana: CCIS, 2005.

¹⁵ Housing Statistics in the European Union 2004, 2005, and own calculations.

¹⁶ The net increase is the difference between the number of newly constructed dwellings and the reduction in the housing stock.

points lower by the end of 2005 than at the end of 2004. Foreign currency interest rates on housing loans were somewhat lower than in 2004 throughout most of 2005, but in the final two months of 2005 they did return to the level seen throughout most of 2004, largely because of the ECB raising its interest rates in December.

Figure 2.12: Comparison of Slovenian interest rates for household housing loans with euro area interest rates in percentages

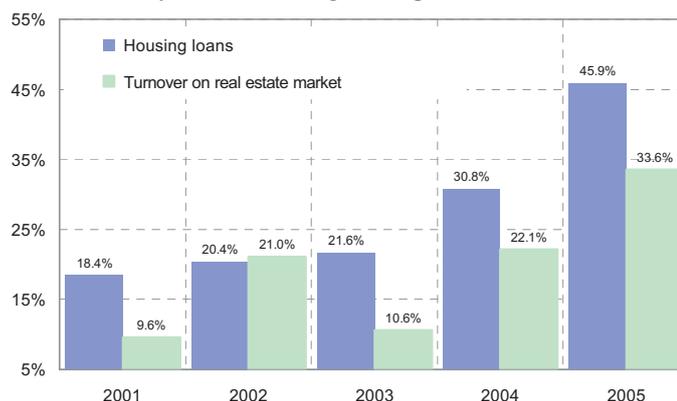


Source: Bank of Slovenia

Turnover on real estate market up by 34%.

In 2005 year-on-year growth in housing loan volume increased further, passing 45% by the end of the year. The continuation of these trends over a longer period could, without any matching growth in housing supply, lead to a significant gap between housing prices and their fundamental value. The higher growth in housing loans has also had an impact on the volume of real estate trading by households, which increased by 33.6% in 2005.

Figure 2.13: Year-on-year growth in housing loans and the volume of real estate trading by households¹⁷ in percentages



Source: Bank of Slovenia, Nepremičninski informator 2005/XII (CCIS et al.), own calculations

Institutional factors affecting real estate prices.

A further reason for the rise in trading volume and the growth in prices is the projected increase in VAT on new flats from 8.5% to 20% in 2008. Households have already anticipated expected increases in the price of new dwellings, which has been seen in the rising prices for older housing. The future change in the tax treatment of new dwellings will in all likelihood contribute to rises in prices in 2006.

Tax relief for housing purchases has an important effect on the amount of demand for housing, and in combination with the extremely small renting market encourages house ownership over renting.¹⁸ The continued reduction in the average number of people per household despite the relatively stable population is a further factor in strengthening demand. Between 1991 and 2002 the average household size fell from 3 to 2.8 members, which is still significantly above the EU15 average, which was 2.3 in 2002. The reduction

¹⁷ The turnover is estimated on the basis of data on the 2% real estate sales tax payments. For 2005 the evaluation was made by comparing turnover in the first three quarters of 2005 with turnover in the first three quarters of 2004. The sale of new dwellings is not included in real estate turnover. In the following section the turnover on the real estate market relates to transactions made by households.

¹⁸ For 15 years after purchasing a house, buyers can make use of tax relief for sums paid for housing. The sums paid include their own funds and the principal and interest on a housing loan. The tax relief is a maximum of 4% of the taxpayer's taxable base. Furthermore, flat and house owners can use general tax relief to further reduce their taxable base by up to 2% of payments relating to the maintenance of housing and residential buildings.

in average household size is expected to continue, and should cancel out the impact of a falling population and the proportion of the population in the 30 to 44 year-old age band, where the demand for housing is greatest.

The planned introduction of a property tax should, to some extent, reduce the imbalance between supply and demand, as it should increase the supply of housing to buy and to rent, and will probably also reduce demand to some extent, particularly for the larger, more heavily taxed flats. Furthermore the tax should also have some impact on improving the supply of vacant land with planning permission. Collecting property tax will first of all require a suitable legal basis for establishing a register of real estate and records on the real estate market. There will have to be a mass appraisal of real estate to determine general market valuations, which can then be used to set the taxable base. The tax level should be low, this is the reason why the reduction in the gap supply and demand on the housing market, due to property tax, will be of long duration.

There is no data on the volume of purchases by non-residents on the real estate market, but according to reporting by real estate agencies, these transactions still represent a small proportion of turnover. Demand from non-residents somewhat strengthened last year, again according to data from real estate agencies. Non-residents mainly look for real estate in tourist areas and older buildings in rural areas. In future we can expect higher demand for real estate in Slovenia from non-residents, due to the probable slowdown or even negative price growth in some European countries with overpriced real estate. This can already be seen with British buyers, who are among the most common foreign buyers of Slovenian real estate alongside Austrians and Italians, according to real estate agents.

Increased demand from non-residents.

Based on analysis of supply and demand factors, we assess that the past development on the real estate market is sustainable and there is no danger of a sudden fall in real estate prices. The rapidly falling interest rates and lengthening maturity of loans in recent years has through an increased volume of housing loans in combination with a number of other factors led to rapid growth in house prices. Recently supply has been up, but the capacity of the construction sector and the current availability of land with planning permission does not permit the increase in the number of new constructions needed for supply to exceed demand for housing in the near future and cause prices to come down. Based on factors affecting supply and demand for housing we expect the rate of price growth to ease, but there does remain the risk that the continued rapid increase in housing loans and an insufficient supply of housing will foster continued price growth.

Buying housing as an alternative financial investment

In the past three years housing in Slovenia, or at least in Ljubljana, the capital, has been a relatively profitable investment. The growth of prices and income from rents have covered not only the payment of monthly repayments on loans, but have also offered further income to owners over the period 2003 to 2005.

Investment in housing proves profitable.

To illustrate the attractiveness of purchasing a dwelling as an investment, each year from 2003 to 2005 we calculated the return on an investment in a 2-room flat in Ljubljana, assuming that an individual finances the purchase exclusively with a loan or their own funds. If at the start of the year an individual decided to invest in a 2-room flat financed entirely by a housing loan,¹⁹ the return²⁰ was positive for all three years. To evaluate an investment in housing we took monthly rents and the increased value of the housing for the individual year (unrealised capital gain) into account as revenue, while the expenses included monthly loan repayments. If an individual financed the purchase of a flat with their own funds, we calculated the return taking into account monthly rent and increased value of the property for an individual year, and also taking into account the opportunity cost (in the amount of the average annual interest rates for time deposits over one year), to produce an indicator of the return on investment in housing. This is comparable to the returns on other financial investments, where the calculation of the return included the same opportunity cost as above. Buying a flat in order to rent it out (buy-to-lease) proved to be a better investment, with the exception of 2004, when the growth in securities on the capital market measured using the SBI 20 recorded a higher level of return.

¹⁹ The loan-to-value ratio (LTV) is actually set below 100%, which requires the purchaser to invest their own funds as well.

²⁰ The return is calculated using the discounted net present value method.

Table 2.10: Return on investment in a flat in Ljubljana taking into account loan repayments and comparison of return with other forms of financial investment (using discounted net present value)²¹ in percentages

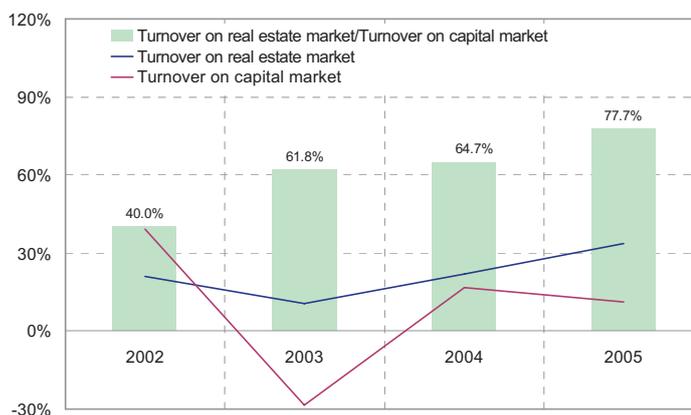
(%)	Purchase of housing		Investing own funds			
	with a loan		Housing	Capital market indices		
	TOM+r	SIOM		SBI20	BIO	VEPVS
2003	11.63	12.82	26.84	9.85	-1.37	9.37
2004	3.53	4.49	17.33	19.82	-0.04	13.15
2005	3.93	4.01	16.94	-8.36	-2.08	4.09

Source: SLONEP, Tax Administration of the Republic of Slovenia, Bank of Slovenia, own calculations

Gap between turnover on real estate and capital markets falls.

Buying a flat was and remains a very attractive alternative financial investment, particularly after the negative experiences on the Slovenian stock market in 2005. After a lengthy period of increasing prices, households treat housing as a very safe and profitable form of long-term investment. In the last two years there has been faster growth in turnover on the real estate market, significantly exceeding the rate of growth on the capital market in 2004 and 2005. While growth in turnover on the real estate market accelerated, growth in turnover on the organised capital market fell somewhat in 2005. This reduced the gap between turnover on the real estate market and on the capital market from SIT 140 billions in 2004 to just under SIT 98 billions in 2005. In 2005 the turnover on the real estate market reached 78% of that on the capital market, while in 2002 it had been just 40%.

Figure 2.14: Year-on-year growth in turnover on capital and real estate markets and real estate to capital market turnover ratio in percentages



Source: Nepremičninski informator 2005/XII (CCIS et al.), LJSE, own calculations

Large increase in newly approved housing loans.

The rise in turnover on the real estate market is largely explained by the large volume of newly approved housing loans. Over the whole of 2005, banks approved 59% more housing loans than in 2004. Most real estate purchases by households were undoubtedly financed by loans taken out with banks and own funds. Some funds from time deposits and the securities market were therefore transferred to the real estate market. Some households increased their investment in real estate due to the low interest rates, the fall in the value of securities, and the high return on investments in real estate. There is no specific data on buy-to-lease purchases, but for the reasons set out above we expect this sector to expand in the future.

²¹ Calculations for a 60m2 flat in Ljubljana. Housing prices at start of year used to calculate return..

Table 2.11: Changes in time deposits and alternative financial investments by households, turnover on real estate and capital market and changes in volume of housing loans

	2002	2003	2004	2005
	(SIT billions)			
Change in stock of household time deposits excluding sight deposits	151.9	61.1	127.3	-102.4
Change in stock of alternative household financial investments	239.7	184.1	319.5	192.5
Turnover on capital market	475.2	339.9	396.7	440.8
Turnover on real estate market	189.9	210.1	256.5	342.6
Change in stock of housing loans	24.7	31.7	54.5	102.5
	Growth rate (%)			
Household time deposits excluding demand deposits	14.0	4.9	9.8	-7.2
Alternative household financial investments	32.1	18.7	27.3	12.9
Turnover on capital market	39.2	-28.5	16.7	11.1
Turnover on real estate market	21.0	10.6	22.1	33.6

Source: Bank of Slovenia, Vzajemci.com, Nepremičninski informator 2005/XII (CCIS et al.), ISA, LJSE, own calculations

Box 2.2: Impact of real estate price movement on financial stability

The real estate market is characterised by pro-cyclical movement due to the strong correlation between changes in real estate prices and the credit cycle, owing to debt financing for the purchase and construction of housing. As yet there are no bond issues in Slovenia to cover mortgage loans. Nevertheless, on the basis of a new mortgage bonds and municipal bonds act, mortgage banking will be developed in Slovenia, the main feature of which is that banks' lending capacity increases with the growing value of real estate covered by mortgage. Even in a banking system without mortgage banks, rising property prices lead via the wealth effect to higher creditworthiness for borrowers, and to improvements in bank assets, which in the terms of available funds became more inclined to approve loans. Finally in a phase of economic expansion there is often a relaxation in lending standards that leads to excesses or to overly favourable loans being approved. While real estate prices rise, if banks have sufficient funds, there is an increased credit availability and hence additional demand for real estate. This leads to prices increasing further. The opposite scenario develops when prices begin to fall on real estate markets and the reduced volume of bank loans leads to further falls in prices.

Nominal interest rates, which depend on inflationary expectations, have an effect on the availability of housing loans and indirectly on demand on the real estate market. The nominal interest rate when a loan is approved is important. The higher the nominal interest rate at the moment that the loan is taken out, the higher the nominal value of the monthly repayment (if the loan amount remains the same). For a given wage, the nominal repayment amount to nominal wage ratio is higher when nominal interest rates are higher. If the nominal repayment to income ratio is an important criterion for loan approval, households find it harder to access housing loans when inflation is higher.

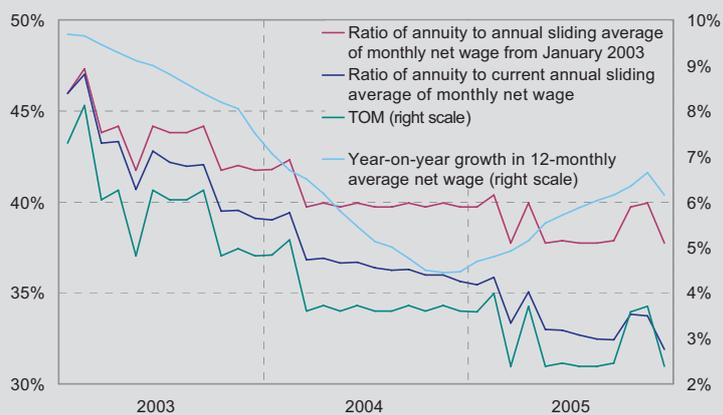
The most important criterion for granting loans in Slovenia is the nominal repayment to monthly income ratio. The amortisation schedule includes calculation of monthly payments based on the current nominal interest rate. If the nominal interest rate is high, the monthly repayment will be higher, restricting access to housing loans.

Including housing or real estate prices in the calculation of inflation during a period where house prices rise while all other remains the same, would increase inflation and hence the nominal interest rate. Access to housing loans would drop and the growth in housing prices would tail off. The opposite would occur in the event of falling prices, as inflation and the nominal interest rate would fall, which would increase access to housing loans and reverse the falling prices. Including a real estate or housing price index in the CPI would have a counter-cyclical effect on the real estate market, which is desirable in terms of preventing real estate bubbles or mitigating their consequences.

The Figure 2.15 indicates how reducing inflation and interest rates increases the accessibility of housing loans. The ratio of the initial repayment amount (when a new housing loan is taken out in a specific month) to the 12-month moving average for the average monthly net wage largely fell in line with inflation since January 2003. Taking into account the nominal growth in monthly average net wages, this ratio fell even more quickly.

Including real estate prices in inflation calculations also affects repayment capacity for existing loans. The increase in real estate prices is expressed in higher annuities, via higher inflation and interest rates. In the past most loans approved in Slovenia had a principal that was revalued in line with the TOM base rate. Increases in inflation would reflect in a higher nominal value for repayment instalments, but would not threaten the household's capacity to repay a housing loan, as the housing loan approval policy was very conservative in the past. By the end of 2005, the proportion of total household housing loans accounted for by loans with a principal linked to the TOM base rate was just 27.3%.

Figure 2.15: Ratio of repayments on 10-year housing loan of SIT 5 millions to 12-month moving average for net average monthly wage in percentages



Source: Bank of Slovenia, SORS, own calculations

3 CORPORATE SECTOR

3.1 Financing of Companies at Domestic Banks and Net Borrowing by Companies

Corporate lending

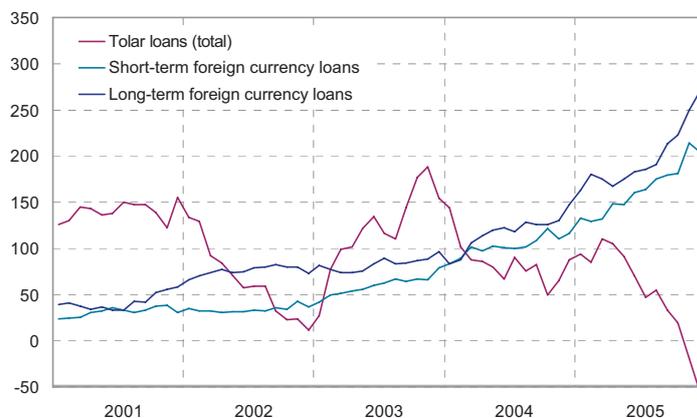
Corporate borrowing started its increase in 2003, with relatively high growth of 20.1% on average maintained in 2004, before increasing further in 2005 to 23.1%. The continued growth in corporate borrowing from domestic banks last year was due to the relatively high level of economic growth persisting, and changes in the method of financing moving from borrowing abroad to domestic borrowing.²² While in 2004 the proportion of net corporate borrowing from banks abroad in the net borrowing figures was still one-third, last year it more than halved to 14.5%. Despite the higher growth in borrowing from banks in Slovenia, total corporate borrowing via loans, i.e. inside Slovenia and abroad, did not change significantly. The increase in net borrowing amounted to SIT 491 billions in 2005, while it was just under SIT 510 billions in 2004.

Table 3.1: Net corporate borrowing inside and outside Slovenia in SIT billions

	2001	2002	2003	2004	2005
	(SIT billions)				
Corporate borrowing from domestic banks	228.7	115.7	314	341.1	419.9
Of which in tolar	139.9	6.7	138.8	77.3	-54
Of which in foreign currency	88.8	109	175.2	263.8	473.9
Corporate borrowing abroad ¹	108.1	136	124.7	168.7	71.3
Short-term	-2.7	-2.9	16.3	-7.3	21.9
Long-term	110.7	138.9	108.4	176	49.4
Total	336.8	251.7	438.7	509.8	491.2
	(%)				
Borrowing structure	100	100	100	100	100
Domestic	68	46	72	67	85
Abroad	32	54	28	33	15
Currency structure	100	100	100	100	100
Tolar	41.5	2.7	31.6	15.2	-11.0
Foreign currency	58.5	97.3	68.4	84.8	111.0

Note: ¹Includes other financial organisations (OFOS).
Source: Bank of Slovenia

Figure 3.1: Net corporate borrowing from domestic banks (12-month moving average) in SIT billions



Source: Bank of Slovenia

²² The figures for borrowing abroad involve flows, while the figures for loans from Slovenian banks involve changes in loan stock.

Companies make net tolar repayments as the tolar lending market contracts.

The replacement of sources of financing abroad with foreign currency loans from domestic banks further strengthened last year. The increased foreign currency lending was due to the falling interest rates offered by domestic banks; at the same time the banks were borrowing abroad. Corporate foreign currency lending grew last year with a year-on-year rate of 55.3%, while the growth in tolar-denominated loans to companies was negative, down 5.0%. The increased foreign currency lending is a reflection of the spread between tolar and foreign currency interest rates, and the anticipated introduction of the euro in 2007.

Corporate borrowing from banks

Table 3.2: Corporate loans and deposits at banks in SIT billions

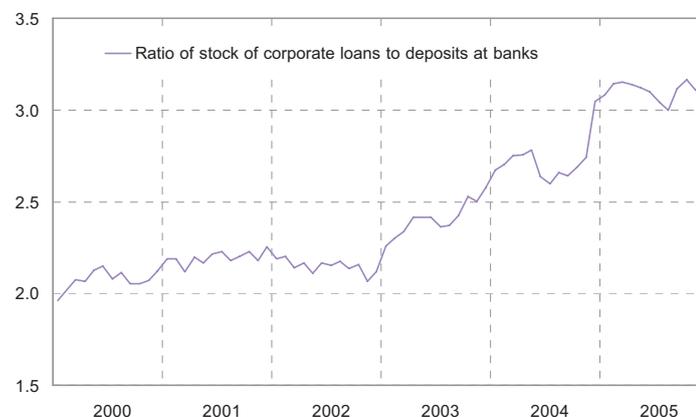
	Corporate loans (1)	Corporate deposits (2)	Net corporate borrowing at banks (1-2)	Net borrowing (as % of GDP)
Dec. 00	938.3	441.8	496.6	11.5
Dec. 01	1167.1	517.7	649.3	13.5
Dec. 02	1282.8	605.0	677.9	12.7
Dec. 03	1596.9	619.6	977.3	16.8
Dec. 04	1938.0	636.2	1301.8	20.8
Dec. 05	2357.9	744.6	1613.4	24.6

Source: Bank of Slovenia

Net corporate borrowing at banks rises as proportion of GDP.

The relatively strong economic growth, the transition from companies borrowing abroad to borrowing in Slovenia, and increased financial gearing by companies all led to net corporate borrowing at domestic banks increasing significantly from 2003 to 2005. The ratio of corporate loans at banks to corporate bank deposits exceeded 3 in 2004, and remained a little above that level last year. Net corporate borrowing at banks has been increasing as a proportion of GDP for some time. In the last five years net corporate borrowing increased by over 13 percentage points, while in the last year alone it increased by 3.8 percentage points to 24.6%, which is an expression of the fact that corporate debt financing has been predominantly from banks in Slovenia.

Figure 3.2: Ratio of corporate loans at banks to corporate bank deposits



Source: Bank of Slovenia

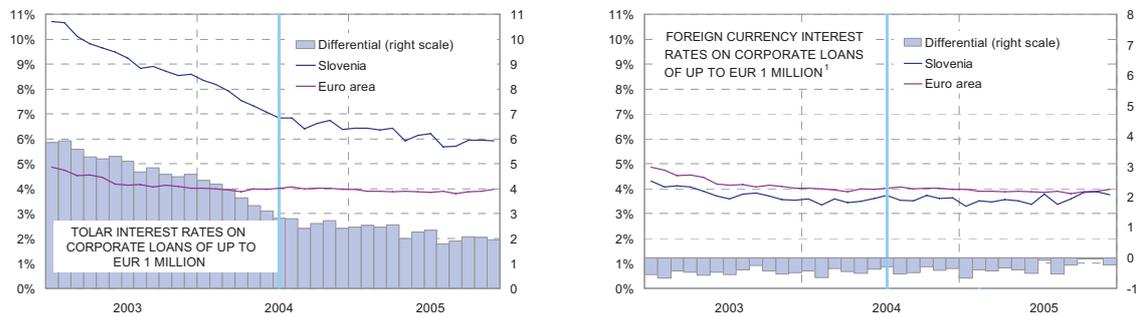
3.2 Comparison of Domestic and Foreign Interest Rates on Corporate Lending

Decline in interest rates in Slovenia slows down.

Comparing interest rates on tolar loans and on loans with a foreign currency clause with interest rates in the euro area indicates that the spread between rates fell fastest up until Slovenia's entry into the ERM II. Later on the rate at which the spread closed slowed, as the reduction in interest rates in Slovenia itself slowed.

Convergence of interest rates on corporate loans

Figure 3.3: Comparison of interest rates on loans in Slovenia and the euro area in percentages and percentage points



Note: ¹ Includes interest rates for foreign currency loans and interest rates for loans with a foreign currency clause.
Source: Bank of Slovenia, own calculations

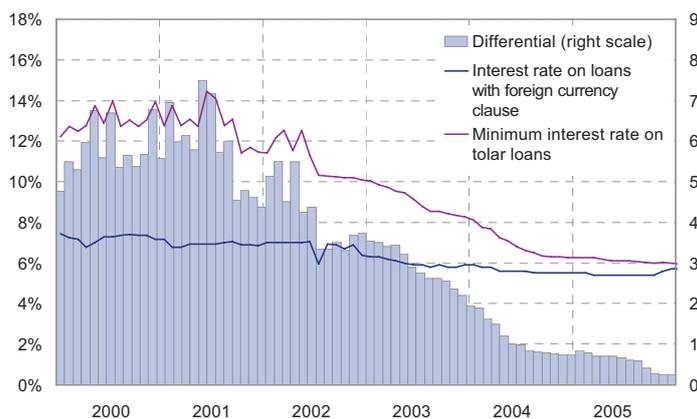
Up until the middle of 2004 the trend was towards nominal convergence of interest rates. After Slovenia joined ERM II the spread between interest rates on tolar loans in Slovenia and interest rates in the euro area was below 3 percentage points, while in the second half of 2005 it was down to 2 percentage points.

However, the interest rates offered by Slovenian banks on foreign currency loans to companies over the last three years were actually even lower than the interest rates banks were offering their customers within the euro area. The exception was the final quarter of last year, when the interest rates were almost identical. The reason was the increased competition between banks. After lowering the net interest margin, banks had to track trends in interest rates abroad.

Lending rates for companies in Slovenia and abroad

Domestic foreign currency lending was very prevalent in 2004, though just under one-fifth of corporate borrowing at domestic banks was still in tolar. In 2005 foreign currency lending prevailed to such an extent that companies were making net repayments of tolar loans at domestic banks. Last year, 56% of domestic foreign currency loans were long-term loans. Long-term loans were still prevalent in net corporate borrowing abroad, representing 69% of the net flow of loans.

Figure 3.4: Comparison between corporate financing costs for short-term tolar loans at minimum interest rate and loans with foreign currency clause from Slovenian banks in percentages



Source: Bank of Slovenia

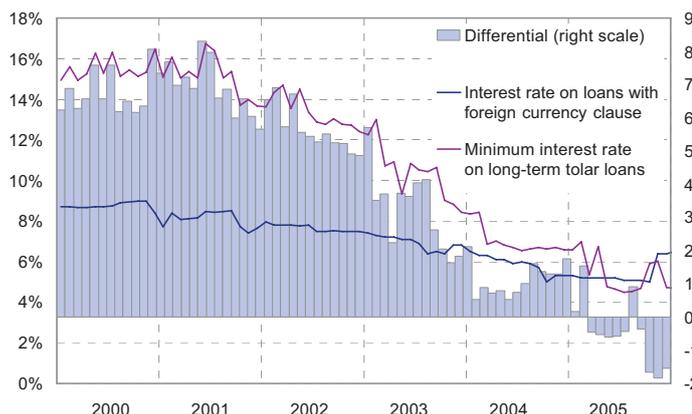
After the relatively rapid reduction in the spread between the minimum interest rate for short-term tolar loans and the interest rate for loans with a foreign currency clause slowed down in the run up to ERM II entry in July 2004. After this interest rate spread had declined to below 1 percentage point in September 2004, it went on to fall to just 0.2 percentage points by the end of 2005.

Spread between short-term tolar interest rates and interest rates with currency clause falls to 0.2 percentage points.

Despite the low interest rate spread, last year companies directed their short-term borrowing towards foreign currency loans, in part due to the relatively stable tolar/euro exchange rate and the growing expectations of a relatively rapid introduction of the euro in 2007.

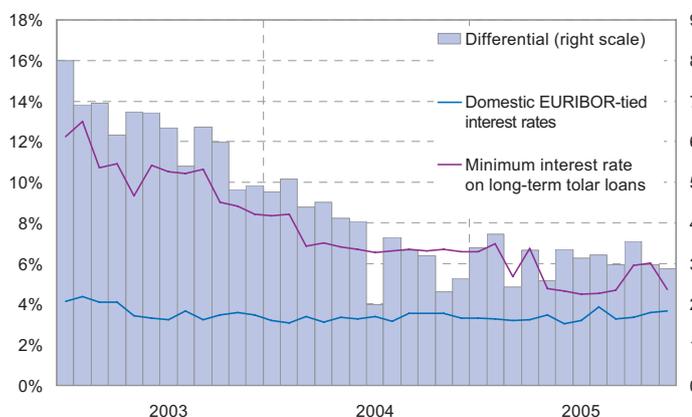
The spread between the minimum tolar interest rate for long-term loans and for loans with a foreign currency clause continued to reduce owing to falling tolar interest rates. At the end of December 2005, the spread was negative at -1.7 percentage points. Despite long-term tolar interest rates falling below the rate for loans with a foreign currency clause, this did not affect the form of corporate borrowing.

Figure 3.5: Comparison between corporate financing costs for long-term tolar loans at minimum interest rate and loans with foreign currency clause from Slovenian banks in percentages



Source: Bank of Slovenia

Figure 3.6: Comparison between actual corporate financing costs for long-term tolar loans and EURIBOR-tied foreign currency loans from Slovenian banks in percentages



Source: Bank of Slovenia

Interest rates for foreign currency loans in Slovenia were 2.9 percentage points below tolar interest rates.

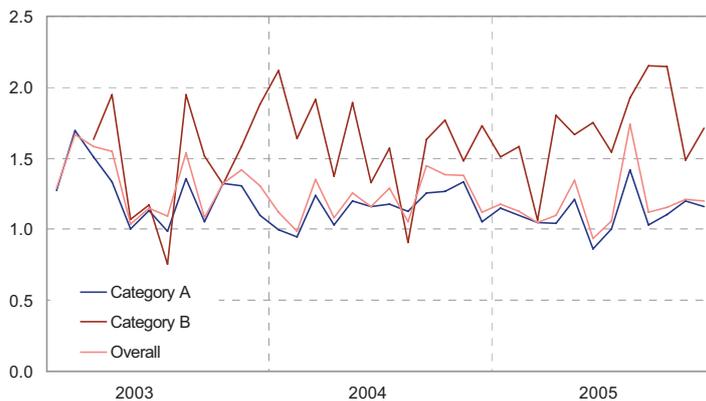
Most corporate borrowing takes the form of foreign currency loans. A comparison of interest rates on agreements concluded for long-term tolar loans and foreign currency loans tied to the EURIBOR at Slovenian banks indicates²³ that at the end of 2005 companies had borrowed domestically at an interest rate of just 3.7%, or 2.9 percentage points lower than for long-term tolar loans (6.6%). Compared to December 2004 the foreign currency interest rate increased by 0.4 percentage points to 3.7%, which is slightly more than the increase in the 3-month EURIBOR (0.3 percentage points). The interest rate spread between the two forms of borrowing over all of last year was 3.1 percentage points on average, a fall of 0.6 percentage points compared with 2004. In 2005 foreign currency borrowing at Slovenian banks and corporate borrowing abroad was at almost equally favourable terms (3.4%).

²³ Calculation of actual interest rates for concluded loan agreements based on reporting from eight largest banks.

In addition to the lower interest rates on foreign currency loans compared to tolar loans, two major factors have led to the increasing prevalence of foreign currency borrowing compared to tolar borrowing in recent years: they are the relatively stable tolar/euro exchange rate, and the entry into ERM II, which has gone hand-in-hand with the clear expectations among companies that the introduction of the euro is imminent.

Risk premiums for domestic foreign currency loans in terms of borrower's credit rating

Figure 3.7: Risk premiums over EURIBOR for foreign currency loans for investments and customer credit rating in percentage points



Source: Bank of Slovenia

The level of risk premiums for long-term loans in the final three years has been relatively stable, with the exception of premiums on loans to B-rated customers, where there was a slight increase after mid-2005. On average the risk premium in 2005 was 1.2 percentage points over the 3-month EURIBOR, similarly to the previous two years. For Category A the average risk premium last year ranged from 0.9 to 1.4 percentage points, an average of 1.1 percentage points, which did not represent a change on 2004. Last year the average risk premium for Category B was 1.7 percentage points, ranging from 1.1% to 2.2%. The variation for this group was greater than for Category A. Last year the risk premium for Category B increased by 0.1 percentage points, which could be a sign of banks becoming stricter in their risk assessments when approving long-term loans.

Risk premium for debt credit ratings remain stable, except for foreign currency loans to high-risk customers.

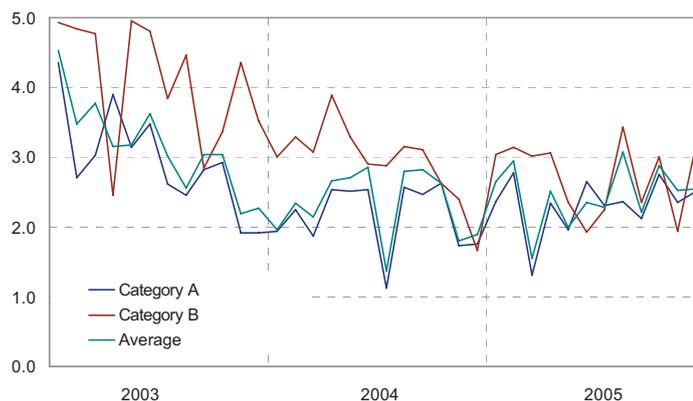
The movement of premiums over the EURIBOR for short-term foreign currency loans remained stable. The Category A premium last year was one percentage point, the same as in 2004. For Category B it was 1.3 percentage points, falling by 0.1 percentage point last year. At 1.4 percentage points over the EURIBOR, the overall premium for C, D and E was similar. On average over the last three years, the overall average for the credit risk premium was 1.1 percentage points, and did not change.

Risk premium for domestic banks' tolar loans in terms of borrower's credit rating

Movements were also relatively stable for risk premiums on the long-term tolar lending market in 2005. On average the risk premium increased by 0.2 percentage points to 2.5 percentage points over the 3-month SITIBOR²⁴ last year. The average premium for A-rated customers in 2005 was 2.3 percentage points, which was not a significant change on the premium in 2004 (2.2. percentage points). The Category B premium last year fell by 0.2 percentage points to 2.7 percentage points, while the premium for the remaining rating categories together (C, D and E) fell by 0.7 percentage points to 3.9 percentage points. The movement in premiums was slightly more variable than for long-term foreign currency loans, and the spread was from 1.6 to 2.9 percentage points.

²⁴ Three-monthly SMOM to July 2003.

Figure 3.8: Risk premiums over 3-month SITIBOR for tolar loans for investments, by customer credit rating in percentage points



Source: Bank of Slovenia

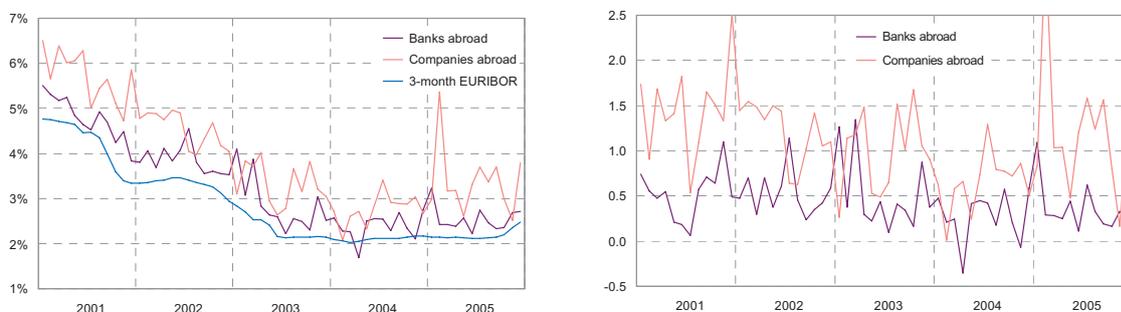
The risk premium in the short-term tolar loan sector is over 1 percentage point lower than the long-term tolar loan risk premium at 1.2 percentage points. Compared to the average, the premium fell a further 0.4 percentage points over the SITIBOR for short-term tolar loans in 2004. Last year it was 1.2 percentage points for Category A, 1.6 percentage points for Category B, and 2.1 percentage points for C, D and E. The premium value for the short-term sector of tolar loans reflects a relatively low variability, ranging from 1.1 to 1.6 percentage point on average.

Risk premiums over EURIBOR for financing of Slovenian banks and companies abroad

Banks retained a low premium over EURIBOR in 2005 for borrowing abroad, while premiums for companies fell.

As in 2004, banks borrowed abroad at more favourable rates than companies in 2005. On average last year the interest rates for banks raising funds abroad was 2.5%, an increase of 0.1 percentage points compared to 2004. On average last year companies borrowed abroad at 3.4%, with the interest rate on such loans increasing by 0.7 percentage points compared to 2004. Last year the interest rate for the corporate sector on long-term foreign currency loans abroad was similar to that at domestic banks at 2.4%, while in 2004 the spread was 0.7 percentage points in favour of corporate borrowing abroad. In relation to borrowing abroad, last year the proportion of banks raising funds abroad increased again. This led to banks increasing the extent to which they intermediated between foreign banks and domestic companies. The lower risk in the banking sector compared to the corporate sector and borrowing from parent banks meant that banks had access to sources of financing at very favourable interest rates. Last year the average premium over the 3-month EURIBOR for long-term bank loans raised abroad increased by 0.1 percentage points to 0.4 percentage points. On average long-term corporate loans were 0.5 percentage points over the EURIBOR at 1.2 percentage points. This indicates that banks had a very good credit rating abroad.

Figure 3.9: Foreign interest rates on long-term loans for Slovenian banks and Slovenian companies and change in risk premium over 3-month EURIBOR for long-term loans taken out by Slovenian banks and companies in percentage points



Source: Bank of Slovenia

3.3 Corporate Assets and Liabilities Structure

The rate of growth in the total assets of Slovenian companies gradually slowed between 2001 and 2004, owing to the reduction in inflation. Real growth in Slovenian companies' total assets fell to 1.8% in 2002, before returning to its 2001 level of 4.1% in 2003. In 2004 real growth in total assets reached 5.5%, without any major changes in the breakdown of principal asset items in company balance sheets, as current assets continued to expand their proportion at the expense of fixed assets. Last year the growth in the proportion of long-term financial investments, which had started in 1998, came to an end, as their volume increased by just 7%, which is 18.3 percentage points less than in 2003. Companies invested far more in intangible assets. In 2004, companies increased the value of goodwill by more than seven times compared to 2003, taking the proportion of goodwill to overall intangible assets to a high 37.4% in 2004; the proportion of intangible assets nevertheless remains low. The increase in the proportion of current assets in 2004 came from short-term financial investments and inventories. They grew by 13.2% in 2004 due to Slovenia joining the European Union, and the consequent introduction of customs duties for the countries of the former Yugoslavia.

Corporate assets structure starting to favour shorter-term assets.

Table 3.3: Structure and year-on-year growth of corporate assets in percentages

	2001	2002	2003	2004	Growth rate (%)			
					2001	2002	2003	2004
Assets (SIT billions)	11,623.8	12,683.6	13,806.2	15,030.8	11.5	9.1	8.9	8.9
	Structure (%)							
Fixed assets	65.3	64.7	64.3	63.8	11.9	8.0	8.1	8.1
Intangible assets	2.1	2.2	2.2	3.4	49.8	11.1	8.8	69.6
Tangible assets	76.8	73.9	70.0	69.1	5.7	4.0	2.5	6.6
Long-term financial investments	21.1	24.0	27.8	27.5	37.9	22.6	25.3	7.0
Current assets	34.2	34.9	35.3	35.8	10.9	11.2	10.1	10.4
Inventories	25.0	24.4	23.9	24.5	6.2	8.4	8.0	13.2
Operating receivables	51.9	51.1	50.2	49.6	9.0	9.5	8.2	9.1
Short-term financial investments	17.4	18.6	19.5	20.3	20.8	18.8	15.7	15.0
Bank balances, cheques and cash	5.7	5.9	6.4	5.5	22.1	15.6	17.7	-4.1
Deferred expenses and accrued revenues	0.5	0.4	0.5	0.5	11.9	6.9	15.7	8.4

Source: APLRRS, own calculations

Companies have an increasing volume of short-term financial and operating receivables and liabilities on their balance sheets. The trend of the previous few years towards increasing maturity length for receivables came to an end in 2004. The increased growth in short-term liabilities compared to the growth in short-term receivables led to a slight deterioration in the corporate liquidity ratio from 82.6% in 2003 to 82.1% in 2004.

Companies' liquidity coefficient deteriorated in 2004.

Table 3.4: Breakdown of financial and operating receivables and liabilities by maturity in percentages

(%)	1999	2000	2001	2002	2003	2004
Financial and operating receivables						
Long-term	33.1	33.8	38.3	40.3	43.0	42.3
Short-term	66.9	66.2	61.7	59.7	57.0	57.7
Financial and operating liabilities						
Long-term	35.0	36.6	39.9	41.1	39.7	41.2
Short-term	65.0	63.4	60.1	58.9	60.3	58.8
Financial and operating receivables/liabilities						
Long-term	76.0	74.3	77.4	80.9	87.4	83.7
Short-term	71.8	68.5	74.2	79.2	94.7	85.8
Short-term	78.2	77.6	79.6	82.1	82.6	82.1

Source: APLRRS, own calculations

With the exception of financial and operating liabilities, in 2004 lower or even negative growth was recorded by most principal liability items compared to the previous year. After the rapid reduction in financial and operating liabilities between 2000 and 2003, their volume again increased. The 14% growth came mainly from companies' long-term and short-term financial liabilities to banks and short-term operating liabilities to suppliers. The proportion of debt financing (mainly at banks) increased compared to 2003 by 2.5 percentage points to 55.4%, while the proportion of equity financing fell by 2 percentage points to 46.4%. This indicates that companies have started to redirect their preferred financing method towards debt financing. The growth in long-term financial

Companies have started to redirect towards debt financing.

and operating liabilities to subsidiaries and associates was either low or negative. The low growth was replaced by growing short-term liabilities to both types of companies.

Table 3.5: Year-on-year growth in individual categories of corporate liabilities in percentages

(%)	1999	2000	2001	2002	2003	2004
Capital	11.6	11.2	8.1	8.3	10.3	4.5
Provisions	12.4	1.2	4.3	-4.1	1.4	-0.4
Financial and operating liabilities	16.9	21.0	15.3	10.8	7.4	14.0
Accrued expenses and deferred revenues	13.7	5.1	22.3	-1.9	21.7	-6.9

Source: APLRRS, own calculations

Companies in the sectors of manufacturing, trade and real estate have the highest volume of financial and operating liabilities on their balance sheets. Companies in these sectors are also the highest borrowers from banks. The breakdown of liabilities by sector has not changed significantly in the last five years. In 2004 companies in the sectors of hotels and catering, financial intermediation, real estate services, agriculture and mining increased their financial liabilities the most. While hotels and catering, agriculture and mining still remain behind other sectors in terms of total liabilities, financial and real estate companies increased their proportion of total liabilities. This matches bank exposure by sector. Banks were most exposed to companies in the manufacturing, trade and real estate sectors.

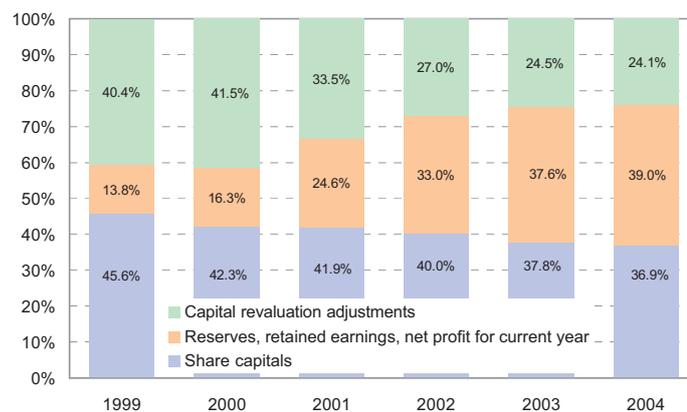
Table 3.6: Financial and operating liabilities by sector in percentages

	2001	2002	2003	2004	Growth rate (%)			
					2001	2002	2003	2004
Corporate financial and operating liabilities (SIT billions)	5,633.5	6,242.9	6,705.8	7,645.7	15.3	10.8	7.4	14.0
	Structure (%)							
Agriculture, forestry, fishing and mining	1.2	1.2	1.3	1.4	8.7	8.9	15.6	20.3
Manufacturing	24.1	24.0	26.0	25.1	11.4	10.3	16.2	10.0
Electricity, gas and water	6.4	5.9	5.1	4.5	1.3	3.5	-7.0	0.1
Construction	5.9	6.0	6.5	6.6	7.6	13.4	16.2	14.9
Trade	22.7	22.4	22.1	22.5	11.8	9.2	6.1	15.9
Hotels and catering	1.5	1.6	1.6	1.9	14.4	20.5	9.3	31.2
Transport and communications	11.0	10.8	7.6	7.8	23.1	8.2	-23.8	17.2
Financial and business services, real estate	12.0	12.9	14.0	15.1	11.4	19.6	16.3	22.8
Public services ¹	15.2	15.1	15.6	15.2	39.8	10.3	11.2	10.4

Note: ¹ Public services includes: public administration, defence, social security, education, healthcare, social care, and other public, collective and personal services.

Source: APLRRS, own calculations

Figure 3.10: Corporate capital structure in percentages



Source: APLRRS, own calculations

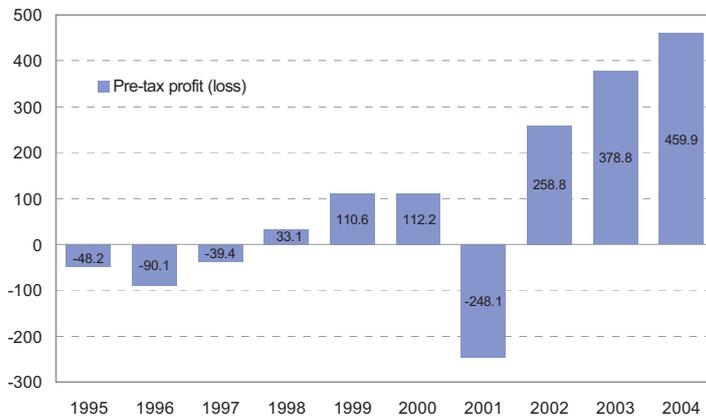
Share capital no longer has prevalent position in corporate capital.

Changes in corporate capital structure continued in 2004. The proportion of reserves, retained earnings and net profit for the current year increased again, mainly at the expense of low growth in share capital. In 1996 share capital represented almost 60% of company capital. This fell at a steady rate over the period 1996 to 2004, and by 2004 it no longer represented the largest proportion of companies' capital.

Despite lower growth than in 2003, the positive operating results continued in 2004, which is a reflection of the favourable economic conditions. At the level of the national economy the difference between the profits of successful companies and the losses of unsuccessful companies increased by 21.4%, with aggregate profits exceeded aggregate losses by SIT 460 billions. This is confirmed by the continued positive economic cycle in 2004. Positive operating results enabled companies to increase debt financing in the financing structure.

Companies continue with successful results in 2004.

Figure 3.11: Gap between pre-tax profits of successful companies and losses of unsuccessful companies in SIT billions



Source: APLRRS, own calculations

3.4 Corporate Financial Gearing

In 2001 total financial gearing by companies exceeded 100%, which means that the volume of financial and operating liabilities exceeded capital, with the highest level reached in 2004 (109.7%). Construction and trade companies have the highest financial gearing, with financial and operating liabilities respectively almost 2.7 times and 1.7 times higher than their capital, and increasing from year to year. This means that companies in these sectors are relatively more exposed to a number of different risks. The coverage of liabilities by capital is also rapidly decreasing in the hotels and catering sector, where the debt to capital ratio has been growing since 2000. The stable gearing level was broken in the manufacturing sector as in 2004 it grew by 9.1 percentage points to 84.1%, almost reaching its 1997 level. Although in 2004 companies in this sector had the lowest growth in debt over the preceding five years, a 1.9-per cent reduction in capital contributed to the rise in financial gearing.

Total corporate financial gearing reaches its highest ever level in 2004.

Table 3.7: Financial gearing by sector in percentages

	1999	2000	2001	2002	2003	2004
	Financial gearing – financial and operating liabilities/Capital (%)					
Agriculture, forestry, fishing and mining	23.2	30.7	41.4	46.0	54.9	63.0
Manufacturing	69.8	71.9	72.4	72.3	75.0	84.1
Electricity, gas and water	31.5	35.5	49.7	48.5	42.3	41.5
Construction	193.4	205.7	201.5	233.6	253.0	268.2
Trade	161.1	160.6	159.2	161.7	157.0	171.8
Hotels and catering	51.3	50.8	55.2	62.8	65.1	80.9
Transport and communications	65.6	99.8	106.9	117.7	82.7	88.0
Financial and business services, real estate	88.2	92.8	67.0	69.2	70.6	77.7
Public services	593.7	611.3	751.8	768.5	761.5	720.5
TOTAL	86.9	94.5	100.9	103.2	100.5	109.7

Source: APLRRS, own calculations

3.5 Companies' Positions Against the Rest of the World

In 2004 growth in liabilities and receivables against the rest of the world fell considerably, which did not have an impact on the breakdown of balance sheet items disclosing dealings with the rest of the world.

Growth of just 5.9% in liabilities was due to low growth in almost all principal liabilities items that disclose dealings with the rest of the world. The very high growth in non-residents' capital in 2003 was followed by growth of just 8.2%, which was the lowest in the 2000-2004 period. Growth in short-term financial leasing was 18.4 percentage points lower, while there was even negative growth recorded by long-term financial leasing. This also reduced its proportion in the structure of liabilities to the rest of the world.

Table 3.8: Structure and year-on-year growth in liabilities to the rest of the world in percentages

	2001	2002	2003	2004	Growth rate (%)			
					2001	2002	2003	2004
Liabilities to the rest of the world (SIT billions)	1,433.8	1,669.0	2,023.9	2,143.7	24.5	16.4	21.3	5.9
	Structure (%)							
Non-residents' capital	25.3	26.2	33.2	33.9	33.4	20.8	53.6	8.2
Long-term liabilities	32.3	32.6	29.1	27.4	24.8	17.5	8.2	-0.2
Short-term operating liabilities	36.3	35.2	31.5	32.4	17.3	13.0	8.4	8.9
Short-term financial liabilities	5.8	5.6	5.8	5.9	35.8	12.3	26.1	7.7
Accrued expenses and deferred revenues from the rest of the world	0.4	0.4	0.4	0.4	17.1	20.9	38.3	9.0

Source: APLRRS, own calculations

The volume of loans and financial leasing abroad increased in 2004 by just 0.7%, with long-term debt to the rest of the world falling, and short-term debt increasing by less than 8%. Reduced borrowing from unrelated companies is partially a consequence of increased lending by banks to non-banking sectors. Companies continue to mainly borrow abroad from unrelated companies. Over 81% of such borrowing is in the form of long-term loans, but their maturity is gradually declining. This has mainly been due to reductions in maturity for borrowing from foreign parent companies over the last year, while the volume of loans taken out with subsidiaries fell by 45%.

Table 3.9: Breakdown and year-on-year growth in loans and financial leasing drawn from non-residents, by maturity and source, in percentages

	2001	2002	2003	2004	Growth rate (%)			
					2001	2002	2003	2004
Loans and financial leasing drawn from non-residents (SIT billions)	479.8	566.8	662.2	666.6	24.4	18.1	16.8	0.7
	Structure (%)							
Long-term	83.1	83.7	82.3	81.1	22.2	18.9	15.0	-0.9
Subsidiaries	0.5	0.7	0.4	0.2	-85.5	54.2	-36.5	-45.2
Parent (controlling) companies	17.7	18.3	21.5	16.2	79.2	22.9	34.8	-25.1
Unrelated companies	81.8	81.0	78.2	83.6	19.6	17.8	10.9	6.0
Short-term	16.9	16.3	17.7	18.9	36.0	14.3	26.3	7.9
Subsidiaries	3.2	4.5	6.6	2.8	72.7	59.9	84.3	-53.6
Parent (controlling) companies	20.4	18.8	16.7	21.1	66.5	5.1	12.2	36.2
Unrelated companies	76.4	76.7	76.7	76.1	28.5	14.8	26.4	7.0

Source: APLRRS, own calculations

Slovenian companies turn into exporters of capital.

Growth in companies' receivables against the rest of the world was 5.3 percentage points higher than growth in liabilities, but was still below half of the average growth in receivables from 2001 to 2003. Almost two-thirds of receivables against the rest of the world were generated by companies' operations, though that proportion is falling at the expense of higher financial investments abroad. The volume of financial investments abroad doubled from 2001 to 2004, although growth in 2004 was only 12%. In 2004 Slovenian companies therefore became exporters of capital.

Majority of receivables still arise from loan exposure to subsidiaries.

Over the period 2000 to 2004 companies increased their financial investments abroad by over four times, with growth being lowest last year. The predominate proportion of assets, which companies hold in foreign shares, increased last year, at the expense of negative growth in the financing of subsidiaries or unrelated companies abroad. There was a change in the recipients of loans taken out in 2004, with the proportion of parent companies increasing, mainly due to the volume of loans to unrelated companies halving. The majority of company receivables still arise from loan exposure to their subsidiaries.

Table 3.10: Structure and year-on-year growth in receivables against the rest of the world in percentages

	2001	2002	2003	2004	Growth rate (%)			
					2001	2002	2003	2004
Receivables against the rest of the world (SIT billions)	721.0	880.7	1,095.5	1,218.3	23.5	22.2	24.4	11.2
	Structure (%)							
Real estate abroad	2.8	2.8	3.1	2.5	3.0	24.0	34.6	-8.3
Financial investments abroad	20.0	25.3	32.1	32.4	47.1	54.4	58.1	12.0
Receivables from operations abroad	76.0	69.8	63.4	63.2	19.4	12.2	12.9	10.8
Other assets	1.2	2.0	1.4	1.9	17.9	114.4	-15.8	55.2

Source: APLRRS, own calculations

Table 3.11: Structure and year-on-year growth in financial investments abroad in percentages

	2001	2002	2003	2004	Growth rate (%)			
					2001	2002	2003	2004
Financial investments (SIT billions)	144.3	222.8	352.1	394.4	47.1	54.4	58.1	12.0
	Structure (%)							
Loans	22.6	28.0	33.5	23.7	4.4	91.0	89.0	-20.7
Subsidiaries	70.9	60.2	41.6	40.2	-5.7	62.3	30.3	-23.3
Parent (controlling) companies	17.5	28.2	16.9	35.1	28.1	208.6	13.3	64.5
Unrelated companies	11.6	11.5	41.5	24.7	65.9	89.5	580.0	-52.8
Shares	72.0	69.9	63.9	71.0	60.2	49.8	44.5	24.5
Other	5.3	2.1	2.6	5.3	191.4	-39.2	98.8	124.8

Source: APLRRS, own calculations

Foreign exchange risk indicators for companies

Companies whose receivables against the rest of the world are not equal to their liabilities to the rest of the world have an open foreign exchange position, and are exposed to risks associated with changes in foreign exchange rates. Export companies that generate a large amount of revenue from exports have an implicit form of risk protection (a natural hedge). This largely involves companies in manufacturing, but also those involved in transport and communications, trade, and hotels and catering.

Companies rely on "natural hedge" against foreign exchange risk.

Table 3.12: Open foreign exchange position, export revenues as a proportion of sales revenues and ROA in percentages

(%)	Open foreign exchange position against the rest of the world/Assets				Export revenues/Sales revenues				ROA			
	2001	2002	2003	2004	2001	2002	2003	2004	2001	2002	2003	2004
	Agriculture, forestry, fishing and mining	-0.6	-0.9	-0.7	-1.4	4.9	4.9	5.0	5.3	-19.3	-0.5	0.0
Manufacturing	-2.6	-1.5	-5.6	-4.1	54.8	55.9	57.7	58.5	2.4	3.6	3.9	4.1
Electricity, gas and water	-4.8	-5.1	-3.5	-3.1	4.7	1.2	3.8	5.4	-30.2	0.9	1.6	1.6
Construction	-0.9	-1.6	-2.4	-2.2	4.1	5.3	4.8	5.4	1.3	0.3	1.7	1.2
Trade	-11.1	-11.0	-10.0	-9.1	9.5	10.5	10.3	10.2	2.7	2.7	3.7	3.8
Hotels and catering	-2.3	-2.2	-2.9	-2.2	9.2	9.3	9.0	8.0	-1.0	-0.1	1.2	-0.3
Transport and communications	-11.9	-12.4	-8.6	-6.8	27.6	27.5	26.9	27.8	0.9	-0.2	2.1	2.5
Financial and business services, real estate	-5.4	-6.7	-4.9	-5.6	14.3	14.1	13.7	12.8	-0.8	2.3	2.2	3.7
Public services	-8.3	-9.9	-13.4	-14.1	23.9	22.8	22.1	16.2	0.6	0.7	0.9	1.3
TOTAL	-6.2	-6.3	-6.7	-6.2	27.3	28.0	28.2	28.3	-2.1	2.0	2.7	3.1
	Open foreign exchange position against the rest of the world and domestic banks/Assets											
TOTAL	-8.0	-8.6	-10.1	-11.0								

Source: APLRRS, own calculations

The balance-sheet and off-balance-sheet open foreign exchange position for companies remained open in 2004, but was significantly lower than the previous year. The off-balance-sheet position against the rest of the world changed and was short again, opening further. The replacement of companies' borrowing abroad by borrowing from domestic banks in foreign currency has largely continued, as the short open foreign exchange position for companies was again very wide. This increased companies' overall open foreign exchange position (against the rest of the world and domestic banks), which amounted to 11% of total assets. The overall open foreign exchange position amounted to 23.6% of corporate

Companies replace borrowing abroad with borrowing foreign currency at domestic banks.

capital (compared with 20.9% in 2003). Between 2000 and 2004 the corporate open foreign exchange position against the rest of the world opened up by almost 60%, while the open foreign exchange position against domestic banks increased by over four times.

Open foreign exchange position against the rest of the world closes slightly in 2004.

The open foreign exchange position of companies against the rest of the world closed somewhat compared to previous year. This amounted to 6.2% of total assets or 13.4% of corporate capital. Companies have a short foreign exchange position in all sectors, with the position against the rest of the world closing slightly over the last year. However, this was not the case for companies in the public administration, agriculture, fishing, mining and real estate sectors, whose short foreign exchange positions opened further.

4 THE SLOVENIAN FINANCIAL SYSTEM

4.1 Structure of the Slovenian Financial System

The deepening of the financial intermediation process in Slovenia is continuing. The total financial assets of all Slovenian sectors increased by 18 percentage points to 326% of GDP, a figure that is just 43% of the ratio of financial assets to GDP in the euro area in 2000 (760% of GDP). The reasons the ratio of financial assets is lower in Slovenia are that the Slovenian financial system only started to develop significantly 15 years ago, and because (according to 2002 figures) around 82% of the population lives in a dwelling that they own or part-own, meaning households have a high level of real estate. In line with the financial intermediation process deepening, the total assets of financial institutions amounted to 146% of GDP by 2005.

Financial intermediation process continues to deepen in Slovenia.

Low interest rates have led to a significant migration of savings from bank deposits into alternative investments, such as investment in mutual funds, life and pension insurance and investments in foreign securities. Despite this, provisional figures indicate that the proportion of the total assets of non-monetary financial institutions in the overall financial system in 2005 remained at 27%, the same level as in 2003. The reason lies in the rapid growth in the total assets of monetary institutions in 2005, as a consequence of higher lending activities, financed by borrowing abroad.

Banking sector still dominates the financial system.

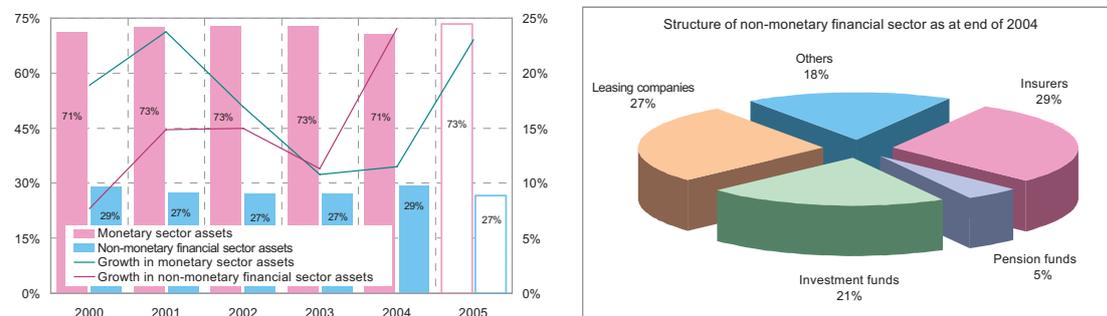
Table 4.1: Slovenian financial system – total assets, number of institutions

	Total assets (SIT billions)		Structure (%)		Proportion GDP (%)		Number of institutions	
	2004	2005	2004	2005	2004	2005	2004	2005
Monetary financial institutions ¹	5,711	7,018	71	73	92	107	22	25
Non-monetary financial institutions	2,369	2,546	29	27	38	39		
Insurers ²	684	783	8	8	11	12	15	16
Pension funds	114	161	1	2	2	2	11	11
Investment funds	500	532	6	6	8	8	44	59
Leasing companies ^{3,4}	642	642	8	7	10	10	24	19
BHS, MCs and other ⁴	428	428	5	4	7	7	-	-
Total	8,080	9,564	100	100	131	146		

Notes: ¹ Monetary financial institutions do not include the central bank.
² The latest figure for the total assets of reinsurance companies is for the end of the third quarter of 2005.
³ The number of Slovenian Leasing Association members is taken as the number of leasing companies.
⁴ Total assets according to figures for the end of 2004.

Source: Bank of Slovenia, ISA, SMA, AMC, SLA, APLRRS

Figure 4.1: Structure and year-on-year growth of the monetary and non-monetary financial sector in percentages



Note: Total assets for leasing companies and some non-monetary financial institutions according to figures from the end of 2004. The correct figures for annual growth in total assets for the non-monetary financial sector and the structure of the financial sector for 2005 are therefore not available.

Source: Bank of Slovenia, ISA, SMA, AMC, SLA, APLRRS

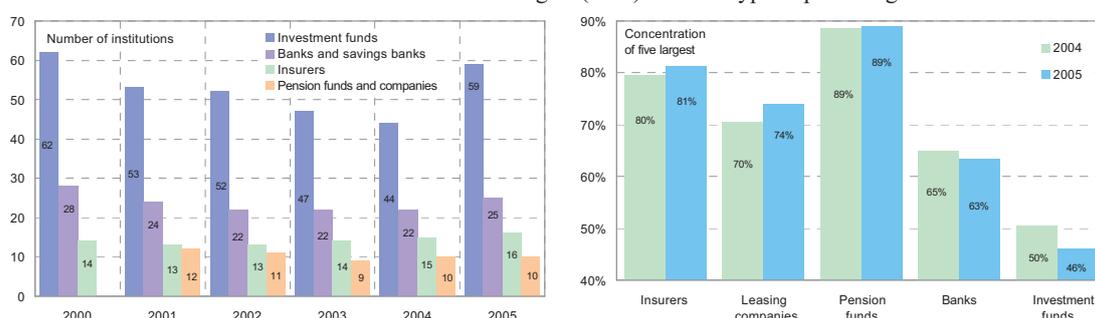
By the end of 2004 the proportion of total assets held by non-monetary financial institutions had increased to almost 30%, as the growth in total assets for the non-monetary sector was 24%, while it was just 11.5% for monetary institutions. The high growth in the non-

monetary financial sector in 2004 was largely due to growth in the total assets of leasing companies, other non-monetary financial institutions²⁵ and pension funds, while growth in the total assets of insurers and investment funds was a moderate 15%. By contrast, in 2005 growth in the total assets of the monetary sector, at 23%, was significantly greater than in the insurance sector (14%), or the investment fund sector (6.4%). We can expect the proportion of non-monetary institutions in 2005 to be lower than in 2004.

Growth in investment and pension funds and life insurance investments expected.

Insurers were the largest group in the structure of non-monetary financial institutions with almost 30% of total assets, followed by leasing companies (27%), and investment funds (21%). Although growth in investment fund assets slowed in 2005, mainly due to the domestic capital market performing poorly, we can expect their proportion of overall financial institutions to significantly increase in the future owing to them increasing the proportion of foreign investments in their assets structure, increased offers from foreign funds, and also due to households seeking alternative investments to replace bank deposits. The long-term unsustainable state of the current pension system means we can also expect further development of voluntary supplementary pension insurance and hence the strengthening of pension funds and life insurance.

Figure 4.2: Number of individual types of financial institutions and market concentration of the five largest (CC5) for each type in percentages



Note: The CC5 index is calculated in terms of total assets, with the exception of leasing companies, for which it is calculated in terms of volume of transactions concluded. Insurers include two reinsurance companies; their total assets are for the end of the third quarter of 2005. Pension funds figures do not include the First Pension Fund, as it is a closed fund and no more payments are expected.

Source: Bank of Slovenia, ISA, SMA, AMC, SLA, APLRRS

Market concentration differs significantly according to type of financial institutions.

The market concentration figures differ significantly according to financial institution type. While the CC5 in the insurance sector, leasing companies and pension funds represent 70% to 90% overall and are increasing, the CC5 in banking sector and investment fund sector represent 45% to 65% and that proportion has been falling over the last two years owing to significant competition in both sectors. Mutual funds have been developing rapidly, their number increasing by 18 in 2005 alone. These are facing stiff domestic competition and growing foreign competition, as by the end of March 2006 there were 113 non-resident mutual funds operating in Slovenia, in addition to 68 domestic ones. On the banking and insurance market more and more European banks and insurers are registering to provide services in Slovenia; according to March 2006 data, 108 banks had already registered with the Bank of Slovenia, and 313 European insurers, including branches, had registered with the Insurance Supervision Agency.

4.2 Integration within Slovenia's Financial System

Greater integration needed between financial institutions.

Increasing foreign competition both in terms of the number of financial institutions and the diversity of financial products that they offer means that it is expected more cross-ownership and other forms of integration to be made between different types of financial institution, to make the domestic financial system more competitive. At the end of 2005, the domestic financial sectors directly managed just 18% of the domestic financial system,²⁶ banks first

²⁵ The growth in the total assets of leasing companies and other non-monetary financial institutions may also be the consequence of reclassifying companies from one institutional sector to another (according to Classification of Institutional Sectors) or from one activity to another (according to NACE).

²⁶ The proportion is lower than in 2004 due to the re-classification of Capital Fund from the other financial intermediaries sector (S.123) to general government (S.13). For 2004 the proportion of the financial system owned by general government thereby increased from 18% to 23%, while the proportion owned by other financial intermediaries fell from 10% to 4% and by the financial sector from 24% to 18%.

with 8%, followed by insurers with 5% and other financial intermediaries with 4%. However in recent years there has been an increasing trend for contractual collaboration between banks, insurers and management companies. There are more and more combined financial products on the market, such as life insurance linked to investment funds, investment deposits and such like. Furthermore, banking networks are being increasingly used to conclude various forms of personal insurance, as well as purchasing mutual fund coupons.

In April 2006 Slovenia adopted the Financial Conglomerates Act, which defines the consolidated supervision required for financial groups. The act was needed because of the growing integration of the domestic economy with the rest of the world, which will lead to greater capital consolidation in the domestic financial sector. Integration between financial sectors and the various financial products can contribute to the reallocation of risk between the sectors and to the creation of new risks. More integration between financial institutions means a higher possibility of infection. Dispersing risk across the financial system reduces the risk concentration in an individual group of financial institutions and hence the realisation of risk, with the damage caused by risk realisation being greater in such cases. Various supervisory bodies for individual financial sectors – insurers, banks, institutions on the securities market – and their varied forms of oversight may lead to additional reassignment of specific activities with financial groups, to avoid the stricter requirements of regulators in a specific sector.

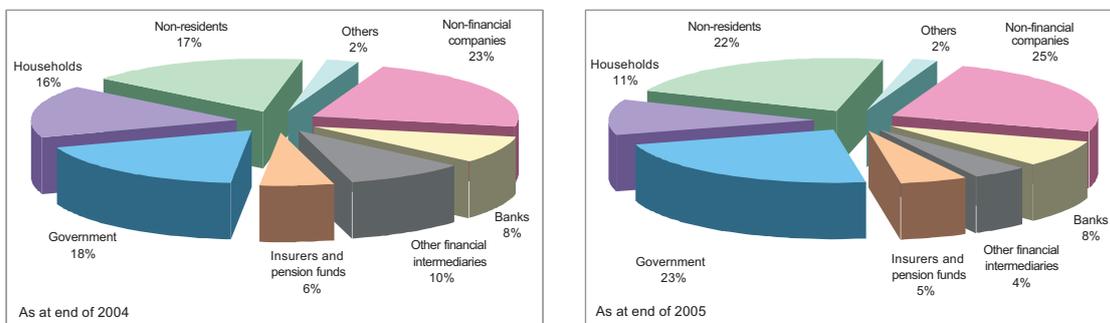
Financial Conglomerates Act adopted in April 2006.

Cross-ownership in the financial sector

The ownership structure of the financial sector changed a great deal in 2005 compared with the previous year. The proportion of the financial system owned by non-residents increased to 22%, and the proportion that was corporate-owned also increased (to 25%), while the proportion owned by households fell to 11%, due mainly to the transformation of investment companies into mutual funds. The government remains an important financial system owner with 23%, including the Capital Fund and Slovenian Reimbursement Fund, with 23% in the banking sector and 54% in the insurance sector. The data from different periods on the proportion of shares issued that are state-owned is not directly comparable due to the re-classification of Capital Fund from the other financial intermediaries sector (S.123) to the general government sector (S.13). At the end of 2005 non-residents were an important group of owners, holding 36% of the banking sector, and 10% of the insurance sector.

Proportion of financial system owned by non-residents increased to 22% in 2005.

Figure 4.3: Ownership structure of Slovenian financial sector in percentages



Note: Only direct ownership is considered in the data.
Source: CSCC, own calculations

At the end of 2005, banks directly controlled a relatively low proportion of the domestic financial system, just 8%. Their capital investments include 40% in domestic financial institutions, of which over half is in banks, and 40% in foreign financial institutions, primarily banks in the former Yugoslav republics. Expectations that non-monetary financial institutions will increase in importance has led to banks favouring cross-ownership deals with them. This allows them to exert greater influence over the financial market and increase their non-interest income.

Banks directly manage 8% of domestic financial system.

At the end of 2005 the banking sector held roughly similar equity interests in individual financial sectors, with 8% in the banking sector itself, 8% in the other financial intermediaries sector, which includes management companies and leasing companies, and 7% in the insurance sector, which includes insurers and pension funds. Banks are still relatively poorly represented in the ownership structure of the other two financial sectors, with 2% of other financial intermediaries, and 3% of the insurance sector. In 2005 banks mainly increased their capital investments in leasing companies, while slightly lowering their investments in management companies.

Banks still poorly represented in ownership structure of other financial sectors.

Banks hold an equity interest of over 50% in six out of 15 management companies, which manage around 40% of all investment fund assets. In 2005 management companies under the majority ownership of banks were more successful than other management companies,²⁷ gaining 52% of net inflows into all funds, and generating a return of 10%, which was 4 percentage points higher than for other mutual funds.

Table 4.2: Capital investments by banks in other financial and non-financial institutions at end of 2005

	Banks' capital investment (SIT millions)	Proportion of bank capital investment (%)	Number of institutions with bank capital investment				Total	Number of all institutions
			up to 5%	5 - 25%	25- 75%	75 - 100%		
Domestic banks and savings banks	30,175	22.7	6	-	5	-	11	25
Insurers	4,889	3.7	5	-	2	-	7	16
Pension companies	1,119	0.8	1	1	2	-	4	4
Management companies	6,023	4.5	-	-	2	4	6	15
Leasing companies	10,821	8.1	-	2	1	6	9	19
Others	79,108	59.5						
Total	132,965	100						

Note: The number of active members of the Slovenian Leasing Association is taken as the number of leasing companies. Banks also have capital investments in one of the nine leasing companies that is not a member of the association. Other includes around 65% of investments in foreign banks.

Source: Bank of Slovenia

In 2005 the transaction volume of the seven leasing companies that are under majority bank ownership and are Slovenian Leasing Association Companies members increased to over one quarter of all transactions by association members. Austrian and French banks maintain a large capital presence on the Slovenian leasing market, as do international corporations focused primarily on car financing. The three leasing companies in the association that are owned by non-resident banks with subsidiaries or branches in Slovenia increased their transaction volume to half of all transactions concluded by association members.²⁸

Insurance sector showed little interest in seeking direct capital investment in banking sector.

Direct cross-ownership between Slovenian banks and the insurance sector is relatively weak, and did not change significantly compared with 2004. Banks have investments in all four pension funds, but less than 10% in two of them, and as well as in seven of the 16 insurers, but less than 5% in five of them. Three of the six mutual pension funds are managed by banks, and together they account for just under 6% of total mutual pension fund assets. The insurance sector is still relatively passive in seeking direct capital investments in the banking sector. Only one insurer holds a direct capital investment in a bank, but there is a high level of contractual collaboration between banks and insurers.

Other forms of integration in the financial sector

Reduction in bank deposits except for pension funds.

Investment integration between financial institutions is also found, both in terms of investments in bank deposits and debt securities, and credit integration. The proportion of domestic bank deposits held by non-monetary financial institutions remained at a similar level to the previous year, with SIT 300 billions, or 8% of all non-banking sectors deposits at Slovenian banks. Except for pension funds, which are looking for safer forms of investment owing in part to guaranteed returns, in 2005 non-monetary financial institutions reduced the proportion of their investments held in bank deposits, largely due to the low returns.

Banks increase financing by issuing debt securities.

Debt securities still account for a major proportion of the investment structure, especially for pension funds at 78% (44% in government bonds, 34% in other bonds) and in the structure of insurer investments, at over 61% (40% in government bonds, 21% in other bonds).²⁹ These proportions are similar to the 2004 figures. The proportion of investments in domestic bonds by investment funds fell to 15% in 2005, which is largely due to the rise in foreign investments. Of the financial institutions, banks mainly finance themselves by issuing bonds. In 2005 the value of bank bonds issued increased by almost 30% to SIT

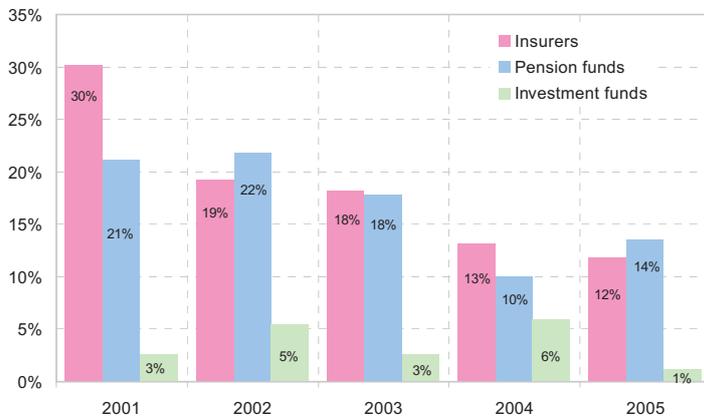
²⁷ Custodian services offered by banks for investment funds further promoted partnerships between management companies and banks. Four banks now have Bank of Slovenia authorisation to provide such services.

²⁸ Leasing services in Slovenia are not yet regulated by a separate law, and in the event of disputes the relevant provisions of the Code of Obligations apply. Given the importance of leasing services to the Slovenian financial system, it would be sensible to have specific regulations for the activities of leasing companies.

²⁹ Includes investments in foreign and domestic bonds.

242 billions, while the value of bonds issued by the insurance sector remained at SIT 12 billions. The banking sector and insurance sector remain the two most important owners of bank bonds, each holding 30%.

Figure 4.4: Proportion of assets invested in bank deposits by insurers, pension funds and investment funds in percentages



Source: ISA, SMA, AMC

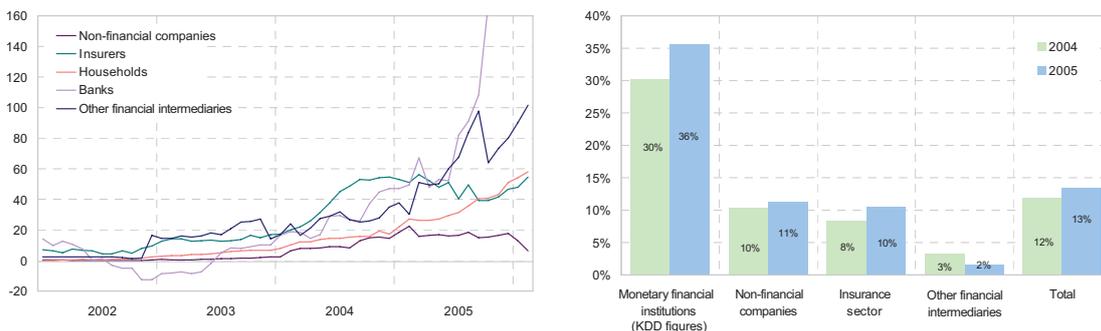
In 2005 the proportion of loans issued by domestic banks to non-monetary financial institutions increased by SIT 75 billions to SIT 200 billions, over 5% of all bank loans issued to the non-banking sectors. Most of this was loans to leasing companies. Given that leasing companies are not supervised, the question must be raised within the context of bank credit risk of how leasing companies manage their own credit risk, and whether banks are indirectly exposing themselves to greater credit risk in this way.

Integration of the financial sector with the rest of the word

In 2005 outward investments by domestic financial institutions rose significantly – by SIT 305 billions – owing to the state of the domestic capital market, as well as the deepening of financial intermediation, and institutional changes. Financial institutions were responsible for 78% of the investment made abroad by residents, which totalled SIT 730 billions. This is 116% up on 2004. In the second half of 2005 there was a large increase in outward investments by the banking sector, which was mainly due to the increase in capital investment and the abolition in the middle of July 2005 of the mandatory subscription to foreign currency bills at the Bank of Slovenia in relation to the foreign exchange minimum.

Banks increase investments in foreign securities by SIT 177 billions in 2005.

Figure 4.5: Year-on-year change in investments in foreign securities by individual sector in SIT billions (left) and proportion of non-residents in ownership of individual sectors in percentages (right)



Source: CSCC, Bank of Slovenia, own calculations

According to figures from the Central Securities Clearing Corporation, in 2005 non-residents' investments in domestic financial institutions rose to 22%, primarily in the banking and insurance sector. At the end of 2005 non-residents also held 0.8% of bonds issued by financial institutions.

Borrowing abroad by non-monetary financial institutions increased by 23% in 2005, to almost SIT 645 billions. This is nearly one-quarter of all borrowing abroad by the Slovenian economy, and 2.2 times more than borrowing by non-monetary financial institutions at domestic banks. It largely comprises the debts to the rest of the world of other financial intermediaries, primarily leasing companies. Loans taken out abroad by the banking sector increased in 2005 by 74%, to one-half of all loans taken out by the Slovenian economy abroad.

Borrowing by financial institutions from the rest of the word increasing.

4.3 Financial Intermediation and Euro Area Comparison

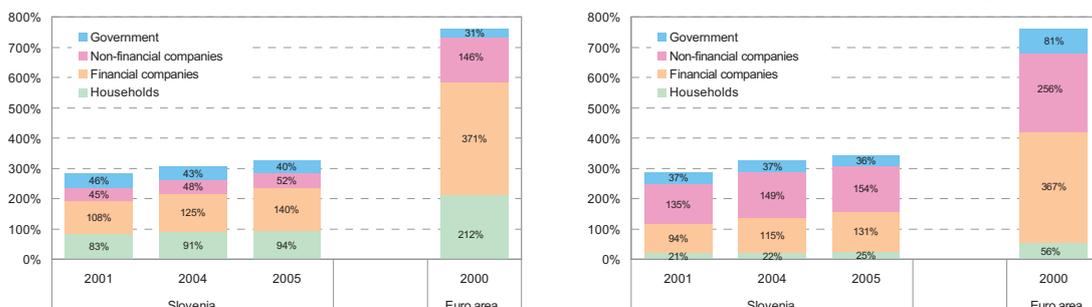
Financial assets rose to 326% of GDP in 2005.

Relatively speaking, the Slovenian financial system does not boast great depth compared to the euro area, based on the ratio of financial assets to GDP. The deepening of financial intermediation has increased the ratio of financial assets and liabilities to GDP. In 2005 the ratio of financial assets to GDP increased by 18 percentage points to 326%, while the ratio of financial liabilities to GDP increased by 21 percentage points to 345%. Given the decisive role played by the banking sector in its economy, Slovenia can be defined as a traditional banking economy, though financial intermediaries are becoming more and more important.

Role of financial intermediaries growing.

The positive net financial position for households – almost 70% of GDP at the end of 2005 – indicates the net negative financial position of the corporate sector, at over 100% of GDP. The total net negative position of the domestic economy (19% of GDP) is financed via the rest of the world. The negative net position of the overall domestic economy has been growing for the last five years. Financial companies were strongest as measured by financial assets, which were worth 140% of GDP, while non-financial companies had financial liabilities of 154% of GDP, followed by financial companies with 131% of GDP. The proportion ascribed to financial companies in the assets breakdown increased to 43%, and to 38% in the breakdown of liabilities. These figures indicate the important role played by financial intermediaries in the Slovenian economy.

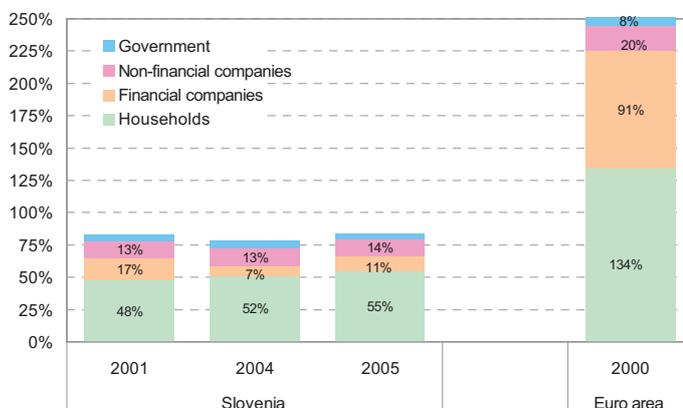
Figure 4.6: Ratio of financial assets (left) and financial liabilities (right) to GDP for individual sectors in Slovenia and the euro area in percentages



Source: Bank of Slovenia, Report on Financial Structures, ECB, December 2002

Financial intermediation represents one quarter of all financial assets, equivalent to 84.4% of GDP. Assets from intermediation are defined in accordance with the financial instrument, and include bank deposits, the technical provisions of insurers and investment fund units or shares. The volume of assets from intermediation only increased slightly in 2005. Given the increasing importance of financial intermediaries, we can expect them to continue growing.

Figure 4.7: Ratio of financial assets from intermediation to GDP for individual sectors in Slovenia and the euro area in percentages



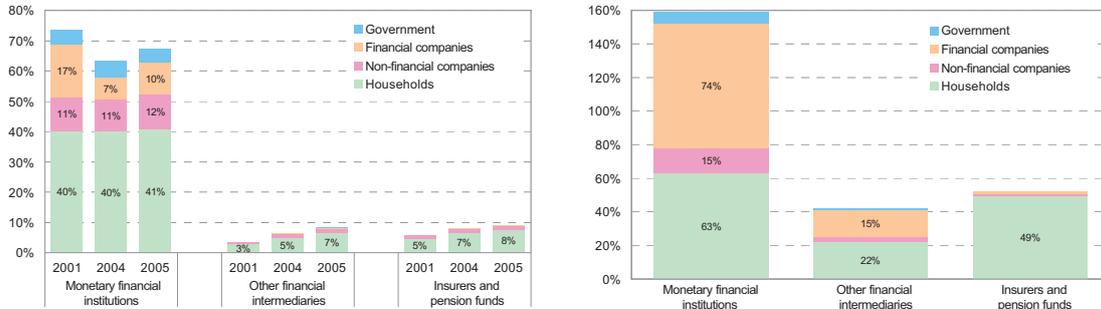
Source: Bank of Slovenia, Report on Financial Structures, ECB, December 2002

Proportion of bank deposits in financial intermediation assets now falling.

In the last five years there has been a clear movement of assets towards pension funds, insurers and investment funds. Within the structure of assets from financial intermediation, the proportion of bank deposits is falling, by 2 percentage points in 2005 to 79%, while

the proportion of investment fund units or shares increased by almost 2 percentage points to 10%, and the proportion of technical provisions increased by just under 0.5 percentage points to over 10%. A similar trend can be seen in the euro area, where by the end of 2000 bank deposits accounted for just under 63% of financial assets from intermediation, while the remaining 37% divided between technical provisions (21%) and other financial intermediaries' assets (16%).

Figure 4.8: Ratio of financial assets for individual sectors from intermediation to GDP for Slovenia (left) and the euro area (right), according to intermediation type in percentages



Source: Bank of Slovenia, Report on Financial Structures, ECB, December 2002

It is clear that the banking sector's role is falling compared to other financial intermediaries. However, the fact that banks are attempting to involve themselves actively in the life insurance and investment fund segments can be seen as development towards potential changes in banking sector activities. The fact is that banks are losing their role in traditional banking activities such as collecting deposits and lending, although these remain important pillars of the Slovenian banking system.

Traditional role of the banking sector diminishing.

Given the reallocation of financial intermediation assets from deposits to investment funds and to life and pension insurance funds, the sensitivity of household assets, as well as household spending, to movements in the capital markets could well increase. Life and pension fund assets as well as of investment funds are mainly long-term, so the impact of short-term capital fluctuations on household spending is limited. The proportion of such funds in financial intermediation assets was still relatively low at the end of 2005 at 20%.

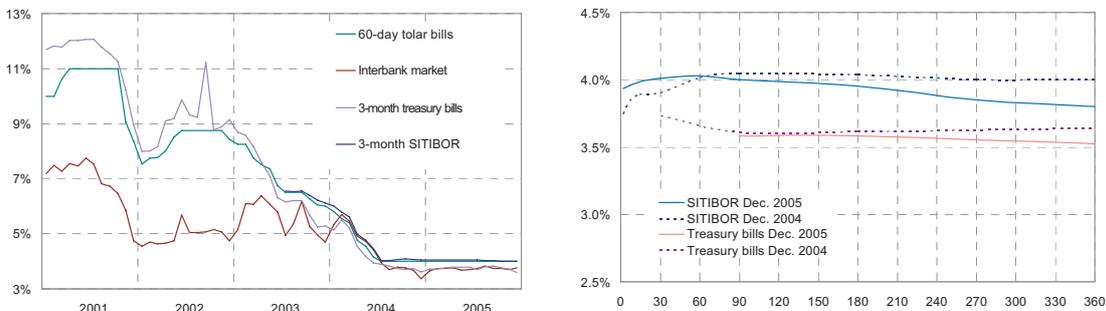
4.4 Domestic Financial Markets

4.4.1 Money market

After Slovenia joined the ERM II, interest rates on the money market remained more or less the same. The interest rates reached in the final quarter of 2004, were little changed in 2005.

Interest rates on money market show little change.

Figure 4.9: Interest rates on certain Bank of Slovenia and government instruments, money market interest rates and yield curve in percentages



Source: Bank of Slovenia

The interest rate on the money market last December was 0.4 percentage points higher than December 2004, at 3.8%. On average last year the interest rate on the money market fell by 0.7 percentage points to 3.7%. After a jump of 0.4 percentage points to 3.8% in the

Yield curve on money market negative.

first quarter of 2005, the interest rate on the interbank market remained between 3.7% and 3.8% for the rest of the year. At the start of 2005 interest rates also increased at auctions for treasury bill with a maturity of 1 to 12 months. For all except 1-month treasury bills, interest rates only fell below the December 2004 level at the final auction of 2005. The change in interest rates on Slovenian treasury bills was almost entirely in line with changes in interest rates on the money market.

In September 2005 the Ljubljana Stock Exchange set up a secondary market for trading in government securities (TUVL) in collaboration with the Ministry of Finance, where trading is carried out through appointed market-makers. This new system has increased the liquidity of treasury bills and government bonds and eradicated the need for 1-month treasury bills. The Ministry of Finance issued the final series of 1-month treasury bills on 1 December.

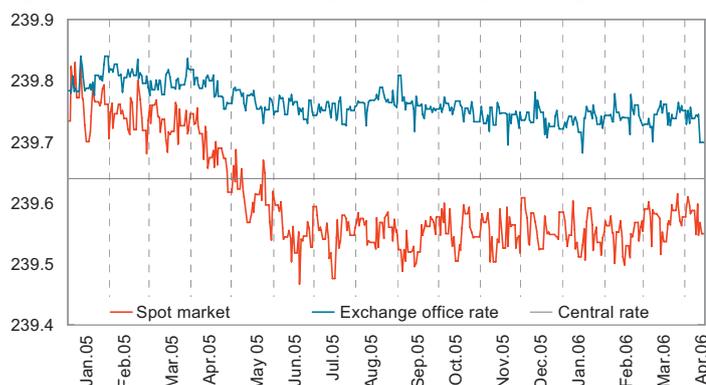
Interest rates on treasury bills were around 3.5% for all maturities at the end of last year. Compared to December 2004 the yield curve on longer maturities fell further. This indicates the very high expectations that inflation will continue to fall. The time structure for interest rates on the interbank market, SITIBOR, fell last year for maturities ranging from 3 months to 1 year inclusive. The interest rates actually increased for shorter maturities. The SITIBOR interbank interest rate curve was also downward-sloping, like the treasury bill yield curve.

Exchange rate deviation from central rate negligible.

Last year demand exceeded supply on the foreign exchange market by EUR 1,229 millions. In the first quarter of 2005 supply and demand for foreign currency remained more or less even, but for the rest of the year supply exceeded demand, particularly in June and July (by EUR 534 millions). On the spot market foreign currency supply amounted to EUR 2,809 millions, while on the forward market banks recorded net sales of foreign currency throughout. Over the entire year banks made net foreign exchange sales of EUR 1,250 millions. Demand for foreign currency at exchange offices exceeded supply by EUR 240 millions. In 2005 the Bank of Slovenia made an outright purchase from banks of EUR 1,731 millions of foreign currency, while reducing the net stock of foreign exchange swaps by EUR 272 millions and the stock of foreign currency bills by EUR 737 millions. The Bank of Slovenia therefore reduced the potential supply of foreign exchange on the markets by EUR 722 millions.

The surplus supply on the foreign exchange market only slightly found expression in changes in the tolar/euro market exchange rate, the largest deviation on the spot market from the central rate not exceeding 0.1%.

Figure 4.10: Tolar/euro exchange rate on foreign exchange markets



Source: Bank of Slovenia

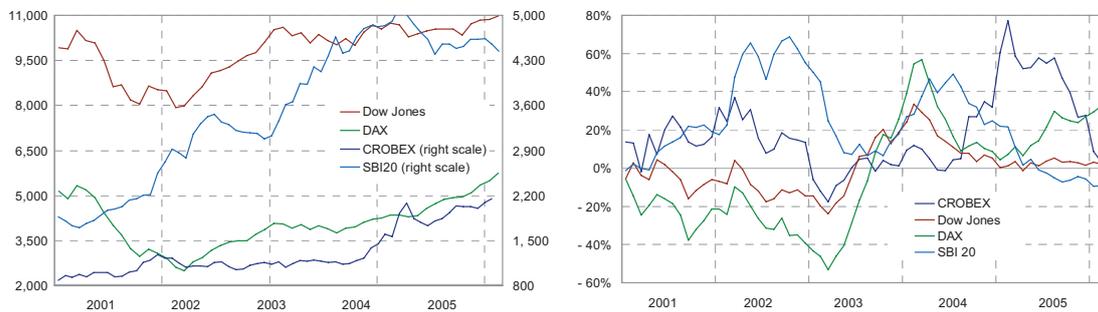
4.4.2 Capital market

SBI 20 fell by 5.6% in 2005. Investments abroad increasing.

In contrast to events on most European capital markets, after several years' growth the Slovenian Stock Exchange Index (the SBI 20) recorded a fall in 2005 of 5.6% year-on-year, which in tandem with the low interest rates, strengthened the outflow of domestic financial assets abroad. Investors, including investment funds, insurers and banks, experienced the negative impact of the bear market in 2005 in the shape of a loss on capital profits on domestic investments. The Slovenian capital market lacks a sufficient number of blue-chip companies with a high market capitalisation and high trading liquidity. There are still no large financial institutions, banks or insurers listed on the Ljubljana Stock Exchange. The turnover ratio of shares is around 14%, while on more developed markets in western Europe such as the Vienna stock exchange turnover ratio is 35% and as much as 134% on the

Frankfurt stock exchange.³⁰ Existing market conditions mean individual investors could hypothetically make use of, whether intentionally or not, the possibility of manipulating the share price through a relatively small volume of transactions.

Figure 4.11: Foreign stock market indices: absolute values (left) and year-on-year growth in percentages (right)



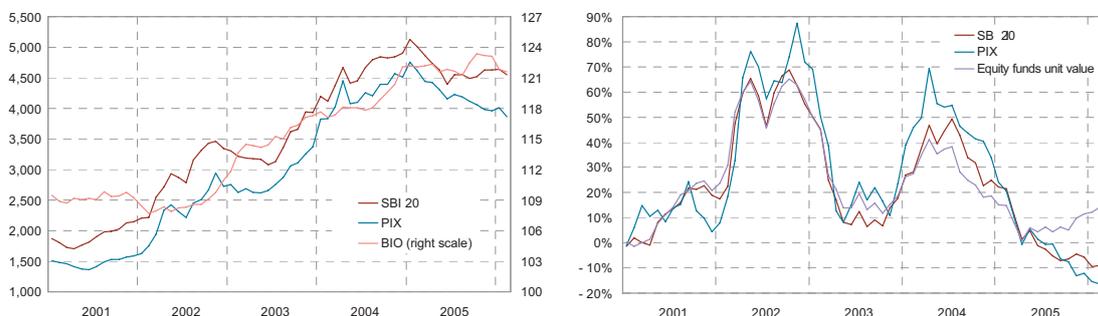
Source: LJSE, Reuters, Zagreb Stock Exchange

Events on the domestic capital market

Slovenian companies still finance themselves with bank loans and occasional closed recapitalizations and private placements of securities, and there were also no public offerings of securities on the primary market in 2005.³¹ Bonds worth SIT 134 billions were issued by seven banks and four non-financial companies in 2005 in private placements. The last public offering of bonds where the issuer was not the government was in 2003, while the last public share offering was in 2000. The large supply of shares from privatisation is somewhat problematic for the development of the primary equities market, as is the fact that only shares from better-rated issuers reach a price higher than their book value on the secondary market. The government issued three series of bonds in a total value of SIT 413 billions on the domestic market in 2005, while bonds worth SIT 191 billions matured and were repaid early.

Slovenian primary securities market remain rather underdeveloped.

Figure 4.12: Slovenian stock market indices: absolute values (left) and year-on-year growth (right) in percentages



Source: LJSE, Vzajemci.com, own calculations

At the end of March 2006, the SBI 20 had already fallen by an annual equivalent of 8.5%. The reverse in fortunes on the Ljubljana Stock Exchange in 2005 was mainly due to the redirection of domestic investor demand abroad, as well as forecasts of lower operating results for companies. Some uncertainty among investors was also caused by changes in tax legislation. The amended income tax legislation for 2006 should encourage investment in securities, as the current synthetic method of taxing capital gains and interest will be replaced by a scheduled taxation. Capital gains will be taxed at 20% under the new system. After 2008 when the income tax relief on interest comes to an end, capital gains will be taxed in the same way as bank interest for income tax purposes.³²

New income tax legislation encourages investment in securities.

³⁰ Turnover ratio figures for 2004. For Slovenian shares this is calculated as the annual turnover divided by the market capitalisation at the end of the year. Turnover ratios for the German and Viennese Stock Exchanges taken from World Federation of Exchanges website.

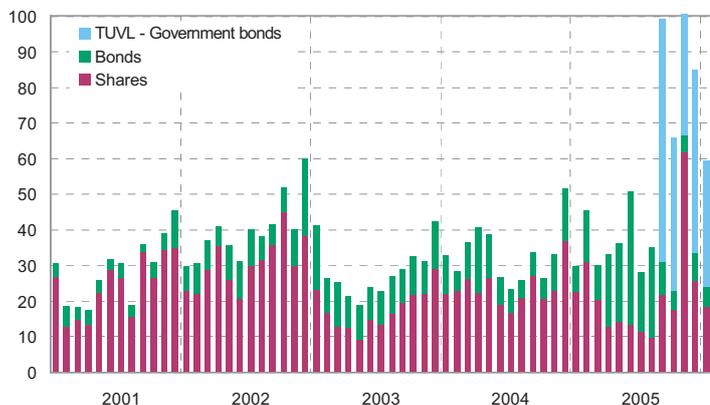
³¹ Under the relevant legislation, companies can carry out private placements of securities, which may then be listed on the organised market.

³² The Act Amending the Personal Income Tax Act has introduced scheduled rather than synthetic taxation of capital gains, dividends and interest. Capital gains will be taxed at 20% (regardless of tax bracket), with each five-year period of capital ownership reducing the tax level by 25% (15% after five years, 10% after 10 years, 5% after 15 years, 0% after 20 years). Interest above SIT 300,000 will be taxed annually at a rate of 15% in 2006, again 15% in 2007 but over SIT 150,000 and after 2008 it will be taxed at 20%.

Impact of events on domestic capital market on banks.

The volume of management and brokerage transactions by stockbrokers for foreign markets reveals an increase of almost 20% in the first three quarters of 2005. Bank commissions from securities trading for customers saw a 35% increase in 2005 despite events on the domestic market, and already account for 4.2% of all fees and commissions. The large price fall on the domestic capital market could threaten the quality of bank loans with securities collateral, although the proportion of total household loans that they account for was 1% at SIT 9.3 billions, and only increased by 0.13 percentage points compared with 2004. Loans with securities collateral accounted for 7% of total loans to companies at SIT 212 billions.

Figure 4.13: Monthly trading on the Ljubljana Stock Exchange in SIT billions



Source: LJSE

Trading in shares fell and trading in bonds rose on the Ljubljana Stock Exchange in 2005.

In 2005 trading in securities on the Ljubljana Stock Exchange increased by 11% and reached SIT 441 billions, while market capitalisation increased by 5% to SIT 3,210 billions. The importance of the domestic organised share market to the Slovenian economy is still relatively low, given a market capitalisation of shares equivalent to 28% of GDP. As a traditional bank-based economy, Germany's market capitalisation amounts to 45% of GDP.³³ The decline of 9% in the market capitalisation of shares listed on the Ljubljana Stock Exchange and the decline of 8% in trading volume were due to the decreased number of listed shares (for 30 shares), as well as the fall in their prices.³⁴ The market capitalisation of shares on the Ljubljana Stock Exchange at the end of 2005 amounted to SIT 1,761 billions.

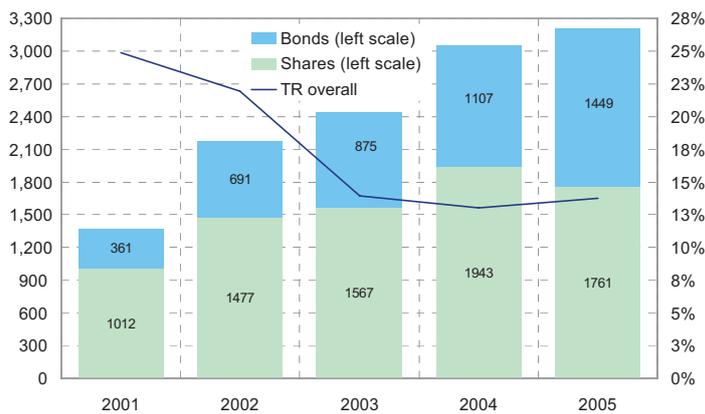
In contrast to shares, the market capitalisation of bonds increased by 31% in 2005 to 23% of GDP, and trading volume increased by 58% (not including trading on TUVL). Trading in bonds amounted to SIT 180 billions in 2005, and market capitalisation to SIT 1,449 billions. The bond market increased in importance on the Ljubljana Stock Exchange with the introduction of the TUVL: the secondary market in government securities. In the final four months of 2005, 58% of total trading on the Ljubljana Stock Exchange was on this market³⁵.

³³ The figures for Germany relate to the Frankfurt Stock Exchange at the end of 2003, while the Slovenian figures refer to the end of 2005.

³⁴ At end of 2005, there were 227 securities (112 shares) listed on the organised market (the official and the semi-official market), or almost 22% of all securities (12% of shares) registered with the Central Securities Clearing Corporation. Valuing shares registered with the Central Securities Clearing Corporation at market value, or book value where that is not possible, around 40% of the value of shares registered with the Central Securities Clearing Corporation was listed on the Ljubljana Stock Exchange at the end of 2005.

³⁵ The market maker segment (TUVL), special segment for trading in securities issued by Republic of Slovenia, was organised at the Ljubljana Stock Exchange in conjunction with the Ministry of Finance. The objective of the market is to develop a secondary market in government securities that will increase their liquidity and facilitate more transparent pricing. It is a wholesale market (minimum transaction value SIT 30 millions) with only government securities listed (bonds and treasury bills), with a standardised method of determining the amortisation schedule. Trades are made exclusively via official liquidity providers selected by the Ministry of Finance according to set criteria, who also appear on the primary market as primary dealers. At present six primary dealers have been selected, five banks and one brokerage house.

Figure 4.14: Market capitalisation and turnover ratio on Ljubljana Stock Exchange in percentages



Note: The turnover ratio does not include trading on the TUVL market.
Source: LJSE

Insufficient liquidity and the limited depth of the domestic capital market is also reflected in high market concentration. In 2005, the five most-liquid shares accounted for almost 50% of trading (not including the TUVL market), and at the end of the year had a 42% share in total market capitalisation.³⁶ In 2005 the Ljubljana Stock Exchange attempted to influence liquidity and made the Slovenian capital market more attractive to international portfolio investments by adopting new market rules introducing a range of innovations. Increasing liquidity on the capital market will urgently require a greater number of active domestic and foreign institutional investors, and the listing of new companies, particularly banks, insurers and telecommunications companies on the stock market.

Insufficient liquidity and limited depth of Ljubljana Stock Exchange.

Box 4.1: Institutional changes on the Slovenian capital market in 2005

The new Ljubljana Stock Exchange rules introduced a special stock market listing called the prime market for elite shares. At the end of March 2006 there were seven of these shares listed. This listing is for companies that excel in terms of their liquidity, size and transparency of operations. They must meet international reporting standards, which makes the Slovenian securities market more attractive to international investors, and raises the profile of the company on the international scene. Auction trading was introduced for less-liquid shares, which allows supply and demand to be concentrated and reduces share price fluctuation. The new rules allow the investment coupons of mutual funds to be listed on the Ljubljana Stock Exchange.

The Act Amending the Securities Market Act (ZTVP-1B), adopted in March 2006, also opened up the ownership of the Ljubljana Stock Exchange. Previously shareholders of Ljubljana Stock Exchange had to be as members as brokerage houses and banks. This also made it possible for the Ljubljana Stock Exchange to be involved in cross-ownership integration with other European capital markets. The amendments to the act were an attempt to improve the transparency of trading in marketable securities outside the organised market by introducing mandatory reporting on transactions. The greater transparency in trading in non-marketable securities means that the stock exchange is authorised to provide technical services for trading in non-marketable securities.

³⁶ A comparison with the Frankfurt Stock Exchange for 2004 indicates a higher concentration on the Frankfurt Stock Exchange. The comparison was made on 5% of the most-capitalised shares, which included 34 shares on the Frankfurt and 7 from Ljubljana Stock Exchange. The Frankfurt Stock Exchange had a 77% trading concentration and 73% market capitalisation concentration, while Ljubljana Stock Exchange had 56% trading concentration and 50% market capitalisation concentration. Source: World Federation of Exchanges website.

Investment integration with the rest of the world³⁷

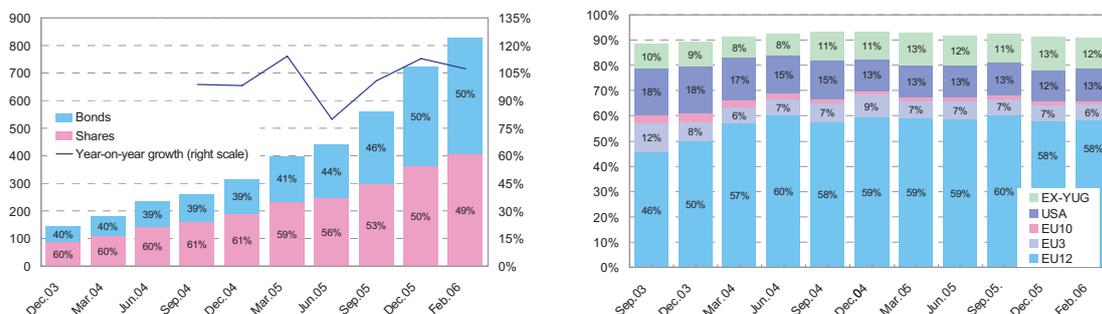
Increased integration of the Slovenian economy with rest of the world through investments in equity and debt securities.

In investment terms, 2005 saw the increased integration of the Slovenian economy with the European Union in particular, owing to outflows of domestic investment to the rest of the world, especially shares, as well as inflows from non-resident investors in Slovenian securities, particularly bonds. The deepening of financial intermediation and the lack of depth and liquidity in the domestic capital market led to investments by residents in foreign securities increasing by around 110% in 2005, or by SIT 410 billions, to SIT 725 billions. The value of non-residents' investments in domestic securities increased by around 25% or SIT 143 billions, to SIT 719 billions.

Investments in the rest of the world already represent 15% of investments in domestic securities.

At SIT 830 billions, outward investments already represented 15% of all resident investments by the end of February 2006 in domestic securities,³⁸ which is 8 percentage points more than one year before. The regional exposure of domestic investors therefore fell compared to past years. Of the outward investments, investments in shares have increased more than investments in bonds. At the end of February 2006, half of all foreign investments were in shares. The reasons for the growth in outward investments are the state of the domestic capital market and the desire of domestic investors for higher returns and the tendency towards greater regional dispersion to reduce exposure to a single economy. The advancing integration of the Slovenian economy with the rest of the world also leads to a greater potential for risk to be transferred to Slovenia from EU countries, the USA economy, the Balkans and the rest of the world.

Figure 4.15: Outward investments by residents in SIT billions (left), and regional structure in percentages (right)



Note: Residents' outward investments include portfolio and some capital investments. EU10, EU12, EU3.
Source: Bank of Slovenia

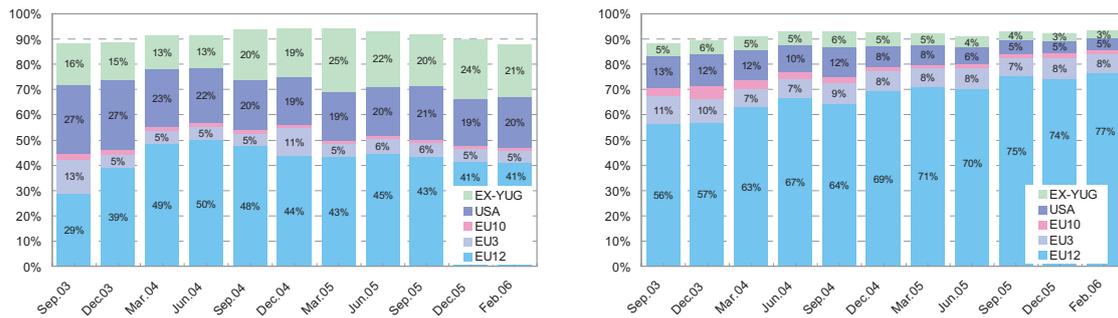
After the euro is introduced, there will be no foreign exchange risk for 60% of investments in foreign securities.

The introduction of the euro will eliminate foreign exchange risk on almost 60% of all foreign investments by domestic investors. The foreign exchange risk will mainly decrease for investments in foreign bonds, as over three-quarters of bonds held by residents are from euro area countries. The figure for investments in shares is around 40%, primarily for securities from German, French, Austrian, Dutch and Irish issuers. Slovenian investors are quite exposed to the USA equities market (20% of investments in foreign shares), and hence also to changes in the dollar exchange rate, and the equities markets of the former Yugoslavia (21% of investments in foreign shares at the end of February 2006), while 5% of exposure is to the UK capital market and the pound.

At the end of 2005 the value of bonds issued by residents abroad amounted to SIT 443 billions, almost 20% lower than one year before, due to one bond maturing. The government is the major domestic issuer of bonds abroad at 80%, with the other bonds issued by banks. About 11% of domestic securities issued abroad are owned by residents. Some debt securities are issued by foreign banks denominated in tolar. At the end of February 2006 the available figures indicate that securities of this kind with a nominal value of SIT 56 billions had been issued, which is SIT 3 billions less than one year previously. Over half of these were owned by residents. Nevertheless, the introduction of the euro in Slovenia will mean that these securities will also be converted from tolar into euros.

³⁷ Investments in this section refers only to investments in equity and debt securities, excluding investments in entities other than public limited companies.
³⁸ Investments by residents in foreign securities include portfolio and some capital investments, while residents' investments in domestic securities include portfolio and capital investments.

Figure 4.16: Regional breakdown of investments by residents in foreign shares (left) and bonds (right) in percentages



Source: Bank of Slovenia

Investments by non-residents in Slovenian securities issued in Slovenia are increasing more slowly than investment by residents in securities abroad. The reasons for this include the low level of investment in foreign securities in residents' portfolios in the past. The net inflow from non-residents in 2005 was high, reaching SIT 123 billions, which is SIT 90 billions more than in the previous year. However the inflow was not sufficient to threaten the stability of the capital market. Investments by non-residents have a positive impact on the domestic capital market's liquidity, which is one of its major weak points. The proportion of investors in Slovenian securities that are non-resident is relatively low at 12%, as is the proportion non-residents represented in overall share trading on the organised market in 2005, at 8.3%.

In 2005 net inflows from non-residents into Slovenian securities were worth SIT 123 billions.

Figure 4.17: Inward investments by non-residents in SIT billions (left) and regional breakdown in percentages (right)



Note: Investments by non-residents in Slovenian securities include portfolio and capital investments.

Source: CSCC, own calculations

Recently there has been more interest from non-residents in Slovenian debt securities, and net purchases of debt securities were prevalent in the breakdown of net inflows from non-residents in 2005, amounting to 70%. Investments in shares are still the predominant form of non-resident investment, representing over 80% of the total. The proportion of government bonds owned by non-residents in 2005 grew by 5 percentage points to over 8%, and moved to 12% in the first quarter of 2006. The reason for the greater interest shown by non-residents in Slovenian bonds over the past year may well be speculation that an additional lowering of risk premiums on Slovenia's entry into the euro area could lead to higher bond prices and higher capital gains. Some foreign investors could also have a pre-determined proportion of their portfolio set aside for an individual region and may then have moved to government bonds after one of eurobonds matured in May 2005.

Non-residents mainly interested in Slovenian debt securities.

The Slovenian capital market is not very attractive to foreign portfolio investors due to its small size, and this did not change when Slovenia joined the European Union. However, the merger and acquisition processes occurring around Europe can be expected to lead to a gradual increase in the proportion of non-resident strategic investors in Slovenia's largest companies. Particularly recently there has been an increase in interest from non-residents for market-listed shares³⁹.

³⁹ At the end of 2005 over 52% of public limited companies registered with the Central Securities Clearing Corporation had some foreign participation. In 78% of these the participating interest was less than 10 per cent. Non-residents held a majority interest in 12% of these companies, and an interest of over 90% in 5% of all companies with a non-resident ownership component (five banks, three insurers, and 14 non-financial companies).

5 BANKING SECTOR

5.1 Banks and Saving Banks

Banks have a dominant role in the financial intermediation sector, and are increasing in importance even further. The banking system's total assets exceeded nominal GDP for the first time in 2005. The proportion of the banking system owned by non-residents increased. Market concentration in the banking system is continuing to decrease. There has been an increase in the focus by banks under majority foreign ownership on the segment of deposits by non-banking sectors, and a decrease in concentration in this segment.

Size and structure of the financial market

The total assets of monetary financial institutions exceeded GDP for the first time in 2005.

The total assets of monetary financial institutions exceeded GDP for the first time in 2005. Total assets stood at SIT 7,018 billions at the end of the year, equivalent to 107% of GDP. The ratio of total assets to GDP is still a long way behind the EU average, which stood at 280% in 2004, but it is rising extremely quickly. In 2005 it was 17.1% higher compared to the previous year. The high growth is the result of high growth in the total assets of monetary financial institutions, which amounted to 22.9% in 2005, while growth in nominal GDP was 4.9%.

Table 5.1: Total assets of monetary financial institutions compared with GDP

	2001	2002	2003	2004	2005
Total assets (SIT billions)	3,954	4,623	5,123	5,711	7,018
GDP, current prices (SIT billions)	4,800	5,355	5,814	6,251	6,558
Total assets (as % of GDP)	82.4	86.3	88.1	91.4	107.0
Ratio of growth in total assets to GDP growth	2.0	1.5	1.3	1.5	4.7

Note: Includes the total assets of banks, savings banks, and savings and loan undertakings.
Source: Bank of Slovenia

The total assets of the entire financial sector, which in addition to monetary financial institutions includes the central bank and non-monetary financial institutions, reached 172% of GDP in 2005. Banks remain the most important segment of the financial sector, accounting for 62% of it. The central bank is next in importance, with 15%. Among non-monetary financial institutions, insurers have the greatest importance, accounting for 7% of the financial sector.

Table 5.2: Structure of financial sector and GDP equivalents in percentages

	As % of GDP					As % of financial sector				
	2001	2002	2003	2004	2005	2001	2002	2003	2004	2005
Central bank	23.8	29.9	28.9	25.9	25.8	17.3	20.2	19.3	16.7	15.0
Monetary financial institutions	82.4	86.3	88.1	91.4	107.0	60.0	58.2	58.8	58.9	62.3
Banks	80.8	85.1	87.0	90.8	106.4	58.9	57.4	58.0	58.6	62.0
Savings banks/savings and loan undertakings	1.6	1.2	1.1	0.5	0.6	1.2	0.8	0.7	0.3	0.3
Non-monetary financial institutions	31.1	32.0	32.9	37.9	38.8	22.7	21.6	21.9	24.4	22.6
Insurers	7.0	8.2	9.0	9.8	11.9	5.1	5.5	6.0	6.3	7.0
Others ¹	24.1	23.9	23.9	28.1	26.9	17.5	16.1	15.9	18.1	15.7
Total	137.2	148.3	149.9	155.1	171.7	100.0	100.0	100.0	100.0	100.0

Note: ¹ The 2005 figures use the 2005 figures for pension funds and investment funds, and the 2004 figures for leasing companies, brokerage houses, management companies and others.

Source: Bank of Slovenia

Changes of status

Number of banks, savings banks, and savings and loan undertakings.

The process of bringing the operations of savings and loan undertakings into line with the Banking Act ended in 2005. Of the two savings and loan undertakings that existed in 2004, one ceased to operate and the other was transformed into a savings bank. There were three savings banks in operation last year. One new bank and one branch were established, taking the number of banks to 22, of which three are branches of foreign banks.

One of the existing branches is intending to convert into a subsidiary bank. The number of subsidiary banks in Slovenia is significantly greater than the number of branches, and the same is true for other new EU member-states. In the ten new EU member-states, there were five times more subsidiary banks than branches in 2004. While the number of subsidiary banks is increasing in these countries, in the older EU member-states the

number of subsidiary banks fell by 62 or 14% between 2001 and 2004. The number of branches is increasing in the older EU member-states, the total being considerably higher than the number of subsidiary banks, in contrast to the new EU member-states.

The reason for this duality in the foreign banks behaviour could be that they prefer to establish branches in more developed countries for reasons of efficiency. In the new EU member-states, where they see a greater potential for growth, they optimise risks by establishing subsidiaries. Subsidiaries of foreign banks come under the deposit guarantee scheme of the host country, which transfers the risks in the event of the bank failing also to domestic banks. Based on certain indicators examined in the proceeding chapters, we establish that foreign banks present in Slovenia are prepared to assume greater risks than domestic banks, particularly with the aim of increasing market share, even at the expense of profitability.

Foreign banks establish subsidiaries in Slovenia and other new EU member-states, but establish branches in more developed countries.

Table 5.3: Number of branches and subsidiary banks in Slovenia, new EU member-states and EU15

	Branches			Subsidiary banks		
	2001	2004	Change	2001	2004	Change
Slovenia	1	2	1	4	5	1
New EU member-states	21	27	6	112	121	9
EU15	582	594	12	448	386	-62

Source: ECB (EU Banking Structures, October 2005)

By the end of March 2006, a total of 108 European banks had registered the direct pursuit of their business activities in Slovenia with the Bank of Slovenia since the country joined the EU. The largest numbers are from Austria, the UK and Germany. The majority are authorised to provide all or majority of banking services. Among the banks with more specialized services that notified the Bank of Slovenia are banks involved in lending and guarantees, and banks offering asset and securities management and securities issues.

Registration by European banks of the direct pursuit of their business activities in Slovenia with the Bank of Slovenia.

Bank ownership

After three years with no major changes in the ownership structure of the Slovenian banking system, there was an increase of almost 3 percentage points in the proportion under foreign ownership in 2005. This increase was entirely the result of an increase in the holdings of non-residents that control more than 50% of an individual bank. The proportion under foreign ownership increased, while the proportion owned by the government and other residents decreased, which to a great extent was the result of new banks being established and recapitalisations, with practically all the foreign banks having carried out recapitalisations in 2005.

An increase in the proportion of the banking system owned by non-residents.

Table 5.4: Ownership of banking sector (in terms of equity) in percentages

(%)	2002	2003	2004	2005
Government in narrower sense	20.3	19.4	19.1	18.1
Other residents	47.2	48.2	48.6	46.8
Non-residents	32.5	32.4	32.4	35.1
Non-residents (over 50% control)	15.7	16.6	16.5	19.6
Non-residents (under 50% control)	16.8	15.8	15.9	15.5

Note: Relative proportions of ownership⁴⁰.

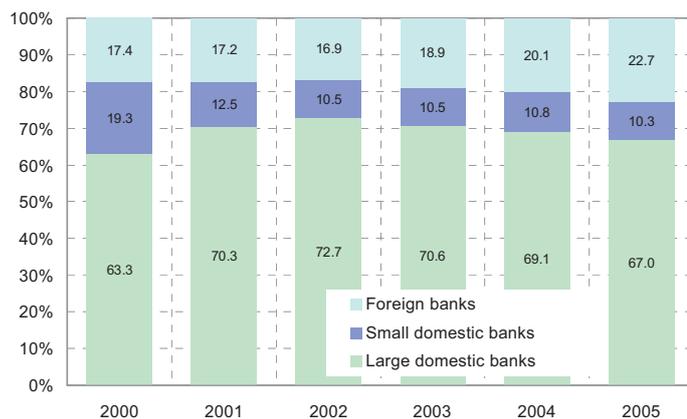
Source: Bank of Slovenia

In the analysis below, banks are divided into three groups: large domestic banks, small domestic banks and foreign banks. The same division as in the previous year is used for reasons of comparability. A bank is deemed large or small by virtue of its total assets. All banks under majority foreign ownership are deemed foreign banks, irrespective of size. Other banks are classified according to the differences in their total assets. In both cases, whether nominal or relative differences are considered, it is reasonable to class the top six (domestic) banks as large banks, and the others as small banks⁴¹.

⁴⁰ If for example the ownership of a bank is divided equally between non-residents and the government, 50% of the bank's capital will be deemed to be owned by the government, and 50% by non-residents.

⁴¹ The controlling interest is taken into consideration, and thus SKB, Ba-Ca, Raiffeisen Krekova banka, Hypo Alpe Adria Bank, Kaertner Sparkasse, Volksbank, Bawag, BKS and Zveza bank are classed as foreign banks. The large domestic banks are NLB, NKBM, Abanka, Banka Koper, Banka Celje and Gorenjska banka. The small domestic banks are Probanka, PBS, DBS, Banka Domžale, Factor banka, Koroška banka and Banka Zasavje. This classification is used throughout the section on the banking sector.

Figure 5.1: Market shares of foreign banks, large domestic banks and small domestic banks in terms of total assets in percentages



Source: Bank of Slovenia

Concentration in the banking sector

Concentration in the Slovenian banking system continues to decrease, measured both in terms of total assets and individual segments of services for non-banking sectors. Thus Slovenia is also converging on conditions in the euro area in terms of concentration. Concentration remains relatively high, but the differences are rapidly diminishing, partly because concentration has been increasing in the euro area in recent years.

Table 5.5: Market concentration of Slovenian banking market as measured by Herfindahl-Hirschman index and market share of the top three/five banks

	2000	2001	2002	2003	2004	2005
Herfindahl-Hirschman index						
Total assets	1,265	1,655	1,664	1,552	1,472	1,388
Total assets (euro area)	508	544	553	581	600	
Lending to non-banking sectors	1,147	1,500	1,470	1,393	1,310	1,273
Lending to households	1,040	1,475	1,441	1,369	1,274	1,255
Liabilities to non-banking sectors	1,229	1,682	1,689	1,607	1,570	1,460
Liabilities to households	1,211	1,784	1,829	1,810	1,725	1,678
Liabilities to banks	2,033	2,130	1,723	1,379	1,278	1,290
Market share of top three banks (%)						
Total assets	46.7	53.6	55.4	53.3	51.9	50.3
Lending to non-banking sectors	43.4	51.1	52.9	52.5	50.5	48.7
Liabilities to non-banking sectors	47.0	55.0	56.7	55.7	55.3	54.1
Liabilities to banks	59.1	60.2	56.5	51.7	48.6	48.9
Market share of top five banks (%)						
Total assets	59.5	66.3	67.2	65.5	64.0	63.4
Lending to non-banking sectors	60.0	66.2	67.1	66.2	63.7	62.3
Liabilities to non-banking sectors	63.1	70.9	71.3	70.6	68.9	67.3
Liabilities to banks	62.0	64.6	61.8	60.1	59.8	62.3

Sources: Bank of Slovenia, ECB (Report on EU Banking Structure, ECB, November 2004, October 2005)

The changes in concentration indicate that the foreign banks are refocusing from liabilities to banks toward liabilities to non-bank sectors.

Concentration has decreased most in the area of liabilities to non-banking sectors in the last year. The foreign banks and the small banks saw their market shares rise at the expense of the large banks. On the other side, the trend of decreasing concentration in the segment of liabilities to banks interrupted in 2005 (the majority of liabilities to banks are liabilities to foreign banks). This could be an indication that the foreign banks are no longer relying just on financing from the parent banks, and are focusing more on deposits by non-banking sectors.

5.2 Changes in Balance Sheet Structure

The trends begun in the previous year continued in 2005. Last year lending to non-banking sectors increased further, while the average maturity of deposits continued to shorten as they recorded low growth. On the asset side of the banking system's balance sheet, the average maturity of loans increased, which increased the imbalance in the maturity of the asset and liability sides of banks' operations with non-banking sectors. Banks obtained the extra financing needed for the high lending growth of 24.2% by borrowing abroad. In the stable economic conditions, and given the expectation of the imminent introduction of the euro, the shift in the currency structure of the balance sheet towards foreign currency accelerated.

Increased lending to non-bank sectors in 2005 was financed with foreign sources.

Table 5.6: Market shares and growth in total assets and loans to non-banking sectors by individual groups of banks in percentages

	Market shares (%)			Growth rate (%)		
	2003	2004	2005	2003	2004	2005
Total assets						
Large banks	70.6	69.1	67.0	7.8	9.9	19.1
Foreign banks	18.9	20.1	22.7	24.1	19.4	39.1
Small banks	10.5	10.8	10.3	11.8	15.5	17.2
Total	100	100	100	11.0	12.3	22.9
Loans to non-banking sectors						
Large banks	69.4	67.1	64.7	15.6	17.0	19.7
Foreign banks	21.1	23.4	25.9	22.3	34.1	37.7
Small banks	9.5	9.5	9.4	9.2	20.5	22.6
Total	100	100	100	16.3	21.0	24.2

Source: Bank of Slovenia

Table 5.7: Structure and growth in balance sheet items in banking sector in percentages

	Dec. 03	Dec. 04	Dec. 05	Growth rate(%)		
				Dec. 03	Dec. 04	Dec. 05
Total assets (SIT billions)	5,057.5	5,678.5	6,979.9	11.0	12.3	22.9
Assets	Structure (%)					
Cash	2.8	2.5	2.1	-1.3	-0.3	1.8
Lending to banks	6.8	8.9	9.8	-9.5	47.0	34.5
Lending to non-banking sectors	50.2	54.1	54.6	16.3	21.0	24.2
Lending to companies	31.6	34.1	33.8	24.5	21.4	21.7
Lending to households	12.4	13.4	13.8	11.8	21.4	26.0
Lending to government	2.8	2.5	2.2	-34.3	0.7	8.5
Lending to others	3.4	4.0	4.8	41.2	32.4	49.4
Securities	34.0	28.9	28.0	11.2	-4.5	19.0
Bank of Slovenia	20.3	13.5	12.0	11.7	-25.4	9.4
Government and others	13.7	15.4	16.0	10.4	26.5	27.4
Capital investments	1.6	1.5	1.9	17.1	8.3	52.5
Other assets	4.6	4.1	3.7	-0.7	-0.9	10.6
Liabilities						
Liabilities to banks	16.5	19.7	28.4	42.9	33.7	77.3
To foreign banks	14.0	17.9	26.7	51.5	43.6	83.3
Liabilities to non-banking sector	65.1	62.1	54.9	4.6	7.0	8.7
To companies	12.3	11.2	10.7	2.4	2.7	17.0
To households	42.3	41.2	35.5	8.1	9.5	5.7
To government	3.1	2.4	3.0	-23.9	-14.3	53.4
To others	7.5	7.3	5.8	5.5	9.3	-2.1
Liabilities from securities	4.3	4.0	3.4	22.6	4.0	6.7
Other liabilities	1.8	1.5	1.4	-11.8	-8.9	15.0
Provisions	2.0	2.1	2.0	10.6	18.8	16.6
Subordinated debt	1.9	2.5	2.4	40.2	49.7	18.4
Capital	8.3	8.1	7.4	10.6	9.5	12.4

Source: Bank of Slovenia

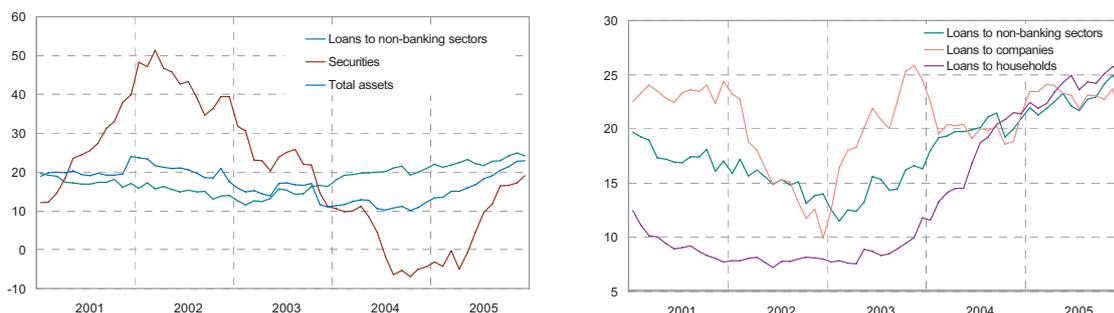
While the largest banks saw their market share decline, foreign banks recorded the largest increase in turnover.

The banking system's total assets reached SIT 6,979.9 billions in 2005, up 22.9% from 2004, or 20.1% in real terms. The market share of large banks continued to decline last year, their share of the banking system's total assets falling by 2.1 percentage points, and their share of lending to non-banking sectors falling by 2.4 percentage points. The foreign banks recorded the largest rise in lending to non-banking sectors (37.7%), and in total assets (39.1%). The other groups of banks recorded significantly slower growth.

Structure of assets

The largest rise in investments in 2005 was recorded by loans to non-banking sectors (34.5%), primarily owing to the increase in bank deposits abroad (41.9%) and the inclusion of the long-term deposit at the Bank of Slovenia in this category.⁴² Despite a significant rise in these types of investment, the proportion of total assets that they account for did not exceed 10%.

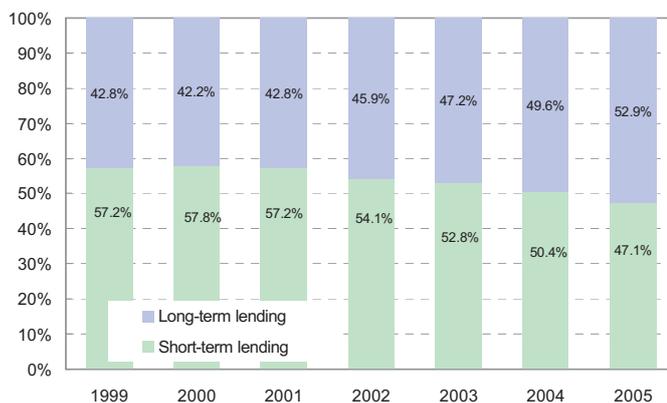
Figure 5.2: Year-on-year growth in bank investments and loans to non-banking sectors in percentages



Source: Bank of Slovenia

In the context of increased competition on the lending market, low interest rates and relatively high economic growth, demand for loans increased further. Loans to non-banking sectors rose by as much as 24.2% last year. As in 2004, long-term loans increased faster than short-term loans. This increased the proportion of total loans to non-banking sectors accounted for by long-term loans to 52.9% at the end of 2005, while the proportions of long-term and short-term loans were equal a year earlier.

Figure 5.3: Proportions of long-term and short-term loans to non-banking sectors in percentages



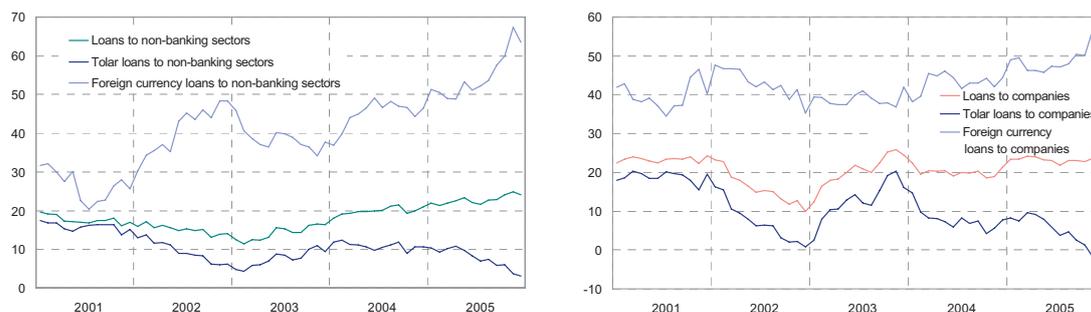
Source: Bank of Slovenia

For the second consecutive year banks focused on households in particular. Growth in loans to households rose by 4.6 percentage points last year to 26%. In absolute terms, the largest increase in investments with non-banking sectors was contributed by loans to non-financial companies (SIT 419.9 billions), where growth was similar to the previous year at 21.7%. Banks significantly increased their loans to other financial organisations in the last two months of 2005, which was reflected in a growth rate of 62.1%. Growth in loans to the government was low.

⁴² Last year banks increased their stock of long-term deposits at the Bank of Slovenia by SIT 47.7 billions to SIT 203.2 billions. These investments began to increase at the end of June 2004, when the central bank offered banks the chance of subscription to the long-term deposit when 270-day tolar bills were abolished.

The continuing increase in growth in foreign currency lending to companies and households in 2005 brought an increase in the proportion of total bank loans to non-banking sectors accounted for by foreign currency loans. By the end of December 2005 it had increased by 11.7 percentage points to 45.9%. The proportion of loans to companies in foreign currency exceed 50% in the first half of 2005, and had passed 56% by the end of the year. The importance of foreign currency lending to households also increased in 2005, foreign currency accounting for more than 40% of the net increase in loans to households. Given the prevalence of tolar household lending in previous years, the proportion of loans to households accounted for by foreign currency loans is still low. It stood at 12.0% in December 2005.

Figure 5.4: Year-on-year growth in tolar and foreign currency loans to non-banking sectors and to companies in percentages

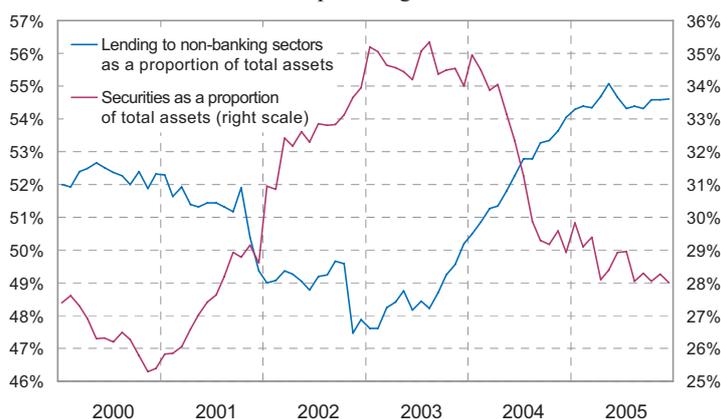


Source: Bank of Slovenia

The decrease in the proportion of total assets accounted for by securities and the increase in the proportion accounted for by loans to non-banking sectors slowed towards the end of 2005. The proportion of total assets accounted for by Bank of Slovenia bills decreased by 1.5 percentage points last year to 12%, significantly less than 2004, when the decrease was 6.8 percentage points.⁴³ In the stock of Bank of Slovenia bills, the proportion accounted for by foreign currency bills increased and that of tolar bills decreased. Since July 2005 regulative changes mean that banks no longer need to subscribe to Bank of Slovenia foreign currency bills, owing to which the stock of these bills fell from SIT 512.7 billions in June 2005 to SIT 323.2 billions at the end of the year. Investments in securities increased primarily as a result of investments in the securities of other issuers. There was an increase of more than 30% in the stock of long-term deposits at the Bank of Slovenia last year. Growth in the banking system's capital investments accelerated last year to reach 52.5% at the end of the year. The rate was significantly lower in previous years: 17.1% in 2004 and 8.3% in 2003.

The increase in the proportion of loans and decrease in the proportion of securities in total assets slowed at the end of 2005.

Figure 5.5: Proportion of total assets accounted for by lending to non-banking sectors and securities in percentages



Source: Bank of Slovenia

⁴³ In addition to higher demand for loans, the asset structure was also influenced by amendments to the regulation on the liquidity ladder relating to the subscribed foreign currency bills and the discontinuation of Bank of Slovenia 270-day tolar bills.

Sources of financing for banks

Growth in deposits by non-banking sectors was sharply outstripped by growth in total assets. Given the low growth in deposits by non-banking sectors, banks were only able to secure sufficient sources of financing to cover demand for lending by increasing their borrowing abroad.

With growth in deposits by non-bank sectors relatively weak, banks financed lending growth by borrowing from banks abroad.

Growth in deposits by non-banking sectors was just 8.7% last year, while growth in household deposits was even lower at 6%. Alongside a decrease of 0.8 percentage points in the proportion of long-term deposits, last year there was an increase of 4.8 percentage points in the proportion of sight deposits, and a consequent decrease of 3.9 percentage points in deposits of up to one year. Given the difference in the return on tolar and foreign currency deposits, growth in tolar deposits outstripped growth in foreign currency deposits. As a result the proportion accounted for by foreign currency deposits decreased by 1.4 percentage points, although foreign currency deposits still account for one-third of total deposits by non-banking sectors. Despite growth in deposits by non-banking sectors lagging behind growth in total assets, these still account for the majority (54.9%) of total assets. However this proportion has fallen by 16.3 percentage points in the last four years.

Figure 5.6: Breakdown of liabilities to non-banking sectors in percentages

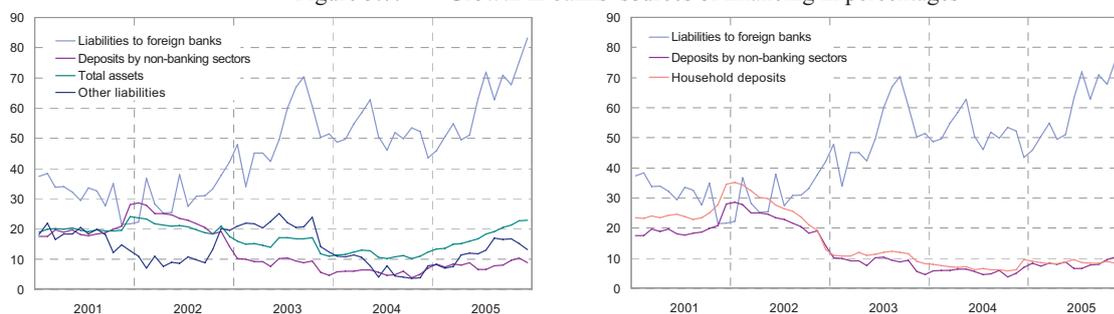


Source: Bank of Slovenia

Growth in other liabilities was behind growth in total assets.

Given the relatively low growth in deposits by non-banking sectors and the high demand for loans, banks were only able to provide for an increase in turnover by increasing their borrowing from banks abroad. Borrowing at banks abroad thus increased further last year, the growth rate reaching 83.3%. Banks used this financing to cover almost two-thirds of the increase in total assets in 2005, compared with a figure of 47% in 2004. There was a net increase of SIT 845.7 billions in liabilities to foreign banks, which accounted for 26.7% of total liabilities at the end of the year. The majority of banks recorded a rise in their debts to foreign banks over the previous year, with the exception of the small banks.

Figure 5.7: Growth in banks' sources of financing in percentages



Source: Bank of Slovenia

Growth in other sources in 2005 was outstripped by growth in total assets. Growth in subordinated debt, which banks can include in the calculation of capital adequacy, fell by 31.3 percentage points from the previous year to 18.4%. Growth in securities issued was also weak at 6.7%. Growth in capital also lagged behind growth in total assets at 12.4%. The increase in capital last year came from the profit that banks distributed to reserves, and from the recapitalisation of seven banks,⁴⁴ whose capital increased by a total of SIT 7.8 billions, a similar figure to 2004.

⁴⁴ One bank was established in 2005.

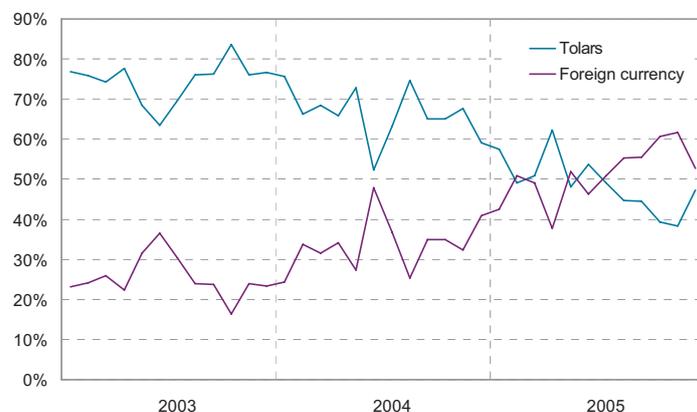
Currency structure of balance sheet

The proportion of assets and liabilities in foreign currency increased more in 2005 than in previous years. The largest factors in the shift in the structure of the banking system's balance sheet towards foreign currency were the approach and rising certainty of the introduction of the euro, the strong demand for loans owing to the relatively favourable economic growth, the low interest rates on foreign currency loans, the low growth in deposits by non-banking sectors and the heavy borrowing abroad by banks.

The proportion of assets and liabilities accounted for by foreign currency continued to increase.

The proportion of assets accounted for by foreign currency increased by 4.8 percentage points, 2.3 percentage points more than in 2004, to 40.7%. The increase in foreign currency lending to non-banking sectors was the main factor in this increase. The increase in foreign currency lending was 11 times the increase in tolar lending to non-banking sectors. The net tolar repayments made by companies were the largest factor in the increase in foreign currency assets. The proportion of the increase in lending to households accounted for by foreign currency also rose last year to approximately 40%. The decrease of 2.7 percentage points in the proportion of securities in foreign currency was primarily the result a change in Bank of Slovenia regulations, with banks no longer being required to subscribe to foreign currency bills as of July 2005.

Figure 5.8: Currency structure of newly approved loans by eight largest banks in percentages



Source: Bank of Slovenia

A similar process of a change in the currency structure also took place on the liability side of the balance sheet. The proportion of liabilities in foreign currency increased by 4.5 percentage points in 2005, 0.8 percentage points more than in 2004, to 42.8%, primarily as a result of bank borrowing abroad. Heavy borrowing abroad meant that growth in total foreign currency deposits (38.0%) significantly outstripped growth in domestic currency deposits (14.9%) last year. The proportion of deposits by non-banking sectors accounted for by foreign currency liabilities fell by 1.4 percentage points to 33.1%. The reason was the lower return on foreign currency deposits than on tolar deposits.

The proportion of total liabilities accounted for by foreign currency was 2.1 percentage points higher than the proportion of foreign currency assets in December 2005. The differential was slightly down from the previous year, when it was 2.4 percentage points. The stability of the differential indicates that the movements on both sides of the balance sheet are in the same direction. The evenness in the change in foreign currency assets and liabilities indicates the active attitude that banks are taking to managing exchange-rate risk.

Table 5.8: Currency structure of banking sector's balance sheet in percentages

	Domestic currency (%)				Foreign currency (%)			
	2002	2003	2004	2005	2002	2003	2004	2005
Assets	67.0	66.6	64.1	59.3	33.0	33.4	35.9	40.7
Cash	90.7	92.0	90.6	89.3	9.3	8.0	9.4	10.7
Lending to banks	19.8	18.3	38.6	35.2	80.2	81.7	61.4	64.8
Lending to non-banking sectors	75.7	71.2	65.2	54.1	24.3	28.8	34.8	45.9
Securities	59.3	62.7	62.4	70.8	40.7	37.3	37.6	29.2
Other assets	92.5	91.7	91.2	83.6	7.5	8.3	8.8	16.4
Liabilities	66.1	65.4	61.7	57.2	33.9	34.6	38.3	42.8
Liabilities to banks	26.8	29.2	23.9	19.8	73.2	70.8	76.1	80.2
Liabilities to non-banking sectors	66.4	66.7	65.4	66.9	33.6	33.3	34.6	33.1
Debt securities	97.3	97.7	98.3	98.1	2.7	2.3	1.7	1.9
Other liabilities	80.1	80.5	71.8	69.0	19.9	19.5	28.2	31.0
Capital	100.0	100.0	100.0	100.0	0.0	0.0	0.0	0.0

Source: Bank of Slovenia

Growth in off-balance-sheet items slightly outstripped growth in total assets, but the ratio between the two was remained similar to that in the previous year.

Off-balance-sheet items and fiduciary operations

Growth in off-balance-sheet items increased last year, and at 25.8% outstripped growth in total assets. More than a half (55.7%) of the increase came from items such as guarantees received, warranties received and government sureties. In recent years off-balance-sheet items have recorded similar growth to total assets, and the ratio between them has not changed significantly.⁴⁵ At 1.36 at the end of 2005, the ratio was similar to the value in the previous year. The proportion of off-balance-sheet items accounted for by the more traditional items such as letters of credit, warranties, and assumed financial liabilities, which include overdrafts and credit lines, continues to decrease. The proportion accounted for by derivatives also decreased last year, while the importance of other off-balance-sheet items including guarantees received, warranties received and government sureties increased.

Table 5.9: Structure of and growth in off-balance-sheet items in banking sector in percentages

	Dec. 03	Dec. 04	Dec. 05	Growth rate (%)		
				Dec. 03	Dec. 04	Dec. 05
Off-balance-sheet items (SIT billions)	6,901.8	7,547.2	9,491.4	13.3	9.4	25.8
	Structure (%)					
Letters of credit	0.9	0.9	0.4	14.1	-55.4	51.2
Guarantees and pledged assets	11.9	11.5	6.7	9.7	-36.5	14.6
Assumed financial liabilities	13.3	13.8	9.8	16.9	-22.4	21.3
Derivatives ¹	23.7	24.6	11.3	17.3	-49.7	37.5
Depo and other securities records	8.3	8.7	12.9	18.9	63.3	30.7
Records of written-off receivables	1.1	1.0	0.4	2.1	-58.0	-14.7
Other off-balance-sheet items	40.8	39.6	58.5	10.0	61.8	24.5
Warranties received	35.0	34.0	38.3	10.0	23.4	19.3
Guaranties and government sureties received	3.3	2.8	3.0	-4.7	19.0	22.5
Others	2.5	2.8	17.2	28.7	569.1	36.5

Note: ¹ Includes swaps with the Bank of Slovenia.

Source: Bank of Slovenia

5.3 Profitability and Performance Indicators

The pre-tax profits of the banking sector stood at SIT 63.9 billions in 2005, an increase of 13.9% in nominal terms and 11.1% in real terms from 2004. The main factors in this were the growth in net interest income, the relatively solid growth in non-interest income, the moderate growth in operating costs, labour costs in particular, and the relatively low growth in provisioning costs, which was significant lower than growth in loans to non-banking sectors.

⁴⁵ The exception was 2001, when derivatives brought an increase of 54% in off-balance-sheet items, 43% more than the increase in total assets in absolute terms.

Table 5.10: Banking sector income statement

	Amount (SIT billions)			Growth rate (%)			As proportion of gross income (%)		
	2003	2004	2005	2003	2004	2005	2003	2004	2005
Net interest	145.7	143.7	150.8	1.6	-1.4	4.9	63.6	59.2	56.7
Non-interest income	83.3	99.1	115.3	2.8	19.0	16.4	36.4	40.8	43.3
Net fees and commissions	54.9	61.9	67.2	1.8	12.7	8.7	24.0	25.5	25.3
Net financial transactions	19.5	30.3	38.7	-8.1	55.3	28.0	8.5	12.5	14.6
Net other income	8.9	6.9	9.4	52.6	-21.8	34.9	3.9	2.9	3.5
Gross income	228.9	242.8	266.1	2.0	6.0	9.6	100	100	100
Operating costs	143.2	147.7	158.4	6.9	3.2	7.2	62.5	60.9	59.5
Labour costs	72.0	77.0	80.6	8.8	6.9	4.7	31.5	31.7	30.3
Net income	85.8	95.0	107.7	-5.2	10.8	13.3	37.5	39.1	40.5
Net provisions	38.0	38.9	43.8	-14.5	2.4	12.5	16.6	16.0	16.4
Pre-tax profit	47.8	56.1	63.9	3.8	17.5	13.9	20.9	23.1	24.0
Taxes	16.4	19.4	12.4	-0.6	17.9	-35.7	7.2	8.0	4.7
Net profit	31.3	36.8	51.5	6.2	17.3	40.0	13.7	15.1	19.3

Source: Bank of Slovenia

Net interest income and interest margin

The proportion of gross income accounted for by net interest income fell by a further 2.5 percentage points in 2005 to 56.7%, its growth rate lagging behind those of non-interest income and gross income. Interest income last year was similar to that in the previous year in nominal terms, while interest expenses fell by 5.1%. These movements reflect the slowdown in the decline in interest rates in 2005.⁴⁶

The reason for the relatively moderate growth in net interest income is the high growth in loans to non-banking sectors, foreign currency loans in particular. There was a rise in cheaper borrowing by companies and, increasingly, also by households⁴⁷ in foreign currency. Interest income from claims against banks rose by SIT 7.9 billions, as a result of growth in deposits at foreign banks and subscription to the long-term deposit at the Bank of Slovenia. The main factors in the decline of SIT 10.3 billions in interest income from securities were the decline in interest rates on Bank of Slovenia bills and the decline in investments in government securities.

Interest rates declined more slowly last year. The interest rate spread also declined.

The decline in deposit rates and the shortening of the average maturity of deposits by non-banking sectors contributed to the decline in interest expenses. The low spread in banks' deposit rates on the various maturities and high economic growth induced companies to shorten their deposit terms. Households also shortened their average deposit maturities, with the opportunity cost of short-term or sight deposits at banks much lower thanks to lower inflation and low interest rates. In part households also switched to alternative forms of investment, including abroad, in comparison with the previous year. By contrast, interest expenses for lending received from banks rose by SIT 7.6 billions last year, as a result of heavier borrowing in foreign currency. These expenses can be expected to rise even further as the amount of borrowing at banks abroad increases. In the long term, borrowing at banks abroad in order to compensate for weak growth in deposits by non-banking sectors is a more expensive and less stable source of financing than taking household deposits.

Table 5.11: Average assets and liabilities interest rates calculated from interest income and expenses, interest spread and interest margin in percentages

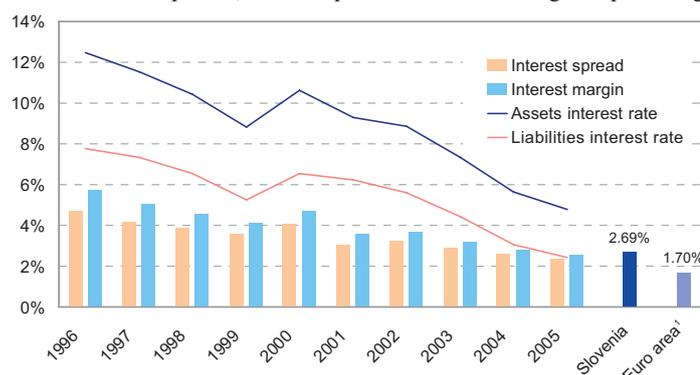
(%)	1999	2000	2001	2002	2003	2004	2005
Average assets rate	8.84	10.61	9.30	8.85	7.34	5.65	4.79
Average liabilities rate	5.26	6.54	6.24	5.60	4.43	3.04	2.42
Interest spread	3.57	4.07	3.06	3.25	2.89	2.60	2.35
Interest margin	4.13	4.72	3.62	3.69	3.23	2.84	2.53

Source: Bank of Slovenia

⁴⁶ The decline in interest income and expenses was significantly greater in 2004. The former fell by 13.6%, and the latter by 23.1%.

⁴⁷ Foreign currency accounted for more than 46% of the net increase in loans to households last year.

Figure 5.9: Average assets and liabilities rates calculated from interest income and expenses, interest spread and interest margin in percentages



Note: The interest margin is shown separately for Slovenia and the euro area in 2004, calculated as the ratio of net interest income to total assets.

¹ The interest margin in the euro area is based on the net interest margins of medium-sized domestic banks.

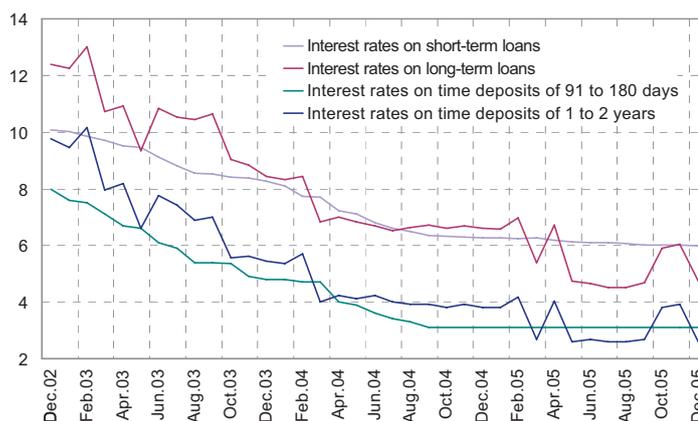
Source: Bank of Slovenia

The decline in effective assets and liabilities rates⁴⁸ slowed last year. Last year lending rates declined more rapidly than deposit rates: lending rates fell by 0.98 percentage points, and passive rates by 0.86 percentage points. The interest spread declined by 0.25 percentage points last year to 2.35%.

Declared interest rates on tolar loans fell more than declared interest rates on deposits by non-banking sectors in 2005. Interest rates on long-term loans and deposits by non-banking sectors fell sharply in the first months of the year, then recorded a slight temporary rise before ending the year at a level similar to the middle of the year. Interest rates on long-term tolar loans fell by 1.9 percentage points and interest rates on deposits fell by 1.2 percentage points last year. Interest rates on short-term loans fell by just 0.3 percentage points last year, while interest rates on short-term deposits remained at the 2004 level.

Interest rates on short-term tolar deposits by non-banking sectors were ex-post positive in real terms for whole year, with the exception of September and October. Despite the decline in the interest margin, banks did not continue to reduce deposit rates. The fall in inflation was the main factor in the interest rates on short-term tolar deposits being positive in real terms. By the end of 2005 the spread between the interest rate on these deposits and inflation had fallen below 1 percentage point.

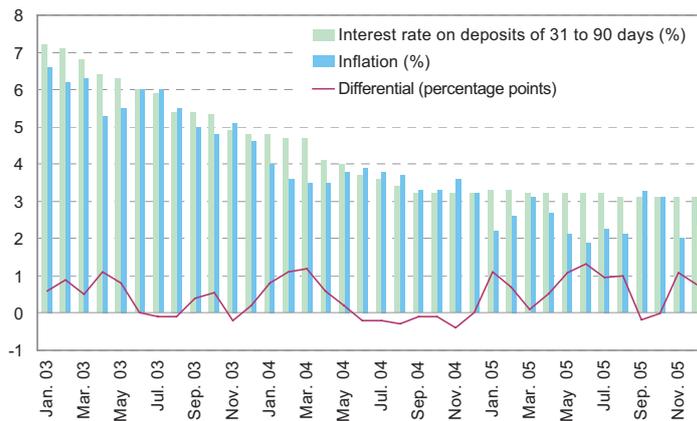
Figure 5.10: Banks' declared interest rates on tolar loans and deposits in percentages



Source: Bank of Slovenia

⁴⁸ Effective assets rates are calculated as the ratio of interest income to interest-bearing assets, while effective liabilities rates are calculated as the ratio of interest expenses to interest-bearing liabilities.

Figure 5.11: Declared interest rates on tolar deposits of 31 to 90 days, and year-on-year inflation rates in percentages



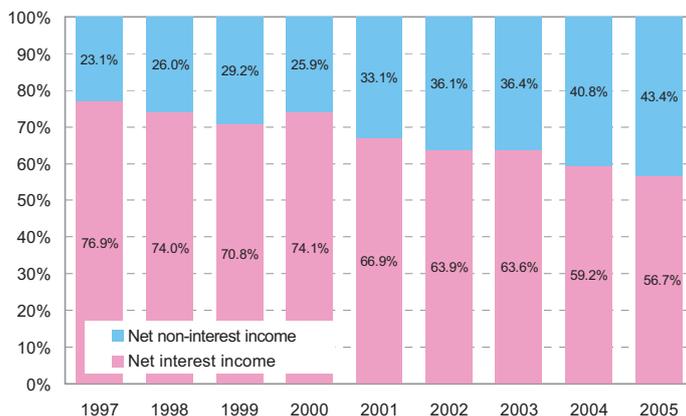
Source: Bank of Slovenia

Net non-interest income

Bank performance is increasingly dependent on the amount of net non-interest income. In 2005 net non-interest income rose by a relatively high 16.4%. The main factor in this rise was growth in net income from financial transactions (28%).⁴⁹ The proportion of gross income accounted for by net income from financial transactions rose for the second consecutive year to reach 14.6%. At 8.7% growth in net fees and commissions was relatively weak, but fees and commissions still account for just over a quarter of gross income, and 58.4% of total non-interest income. The increase in fees and commissions received came primarily from an increase in fees for administrative services for payments in Slovenia and for transactions with the rest of the world. There was a significant decrease in fees and commissions for payments to and from the rest of the world (of 10.4%), while fees and commissions from credit transactions and guarantees granted remained relatively stable. This affected the structure of net fees and commissions, in which there were increases in the proportion accounted for by fees and commissions for administered services and fees and commissions on payments in Slovenia, which account for more than a half of banks' income from this source. Net non-interest income as a proportion of gross income has risen by more than 10 percentage points over the last five years to 43.4%.

Income from net financial transactions made the largest contribution to growth in non-interest income.

Figure 5.12: Ratio of net interest income to net non-interest income in percentages



Source: Bank of Slovenia

⁴⁹ This was primarily the result of an increase of SIT billions in the income of three banks from capital investments in non-subsidiary other financial organisations and other non-subsidiaries. Significantly lower growth was recorded by net revaluation income from securities held for trading (SIT 2.6 billions) and net income from sales of securities (SIT 1.2 billions), while net income from derivatives trading declined by SIT 2.6 billions. Income from capital investments accounts for the largest proportion of net income from financial transactions, followed by income from securities trading and income from foreign exchange trading.

Banks' operating costs

Growth in operating costs rose slightly last year.

After banks had strongly curbed growth in operating costs in the previous year, despite higher growth of 7.2% last year they again fell as a proportion of gross income to below 60%. The large banks recorded the smallest increase in costs last year (4.1%), and the foreign banks the largest (15.8%). The high growth in costs at the latter was the result of faster growth in turnover.

Table 5.12: Breakdown of year-on-year growth in operating costs by types of bank in percentages

(%)	Overall	Large banks	Foreign banks	Small banks
2003	6.9	6.0	10.8	6.7
2004	3.2	1.4	10.4	2.6
2005	7.2	4.1	15.8	11.0

Source: Bank of Slovenia

The proportion of operating costs accounted for by labour costs fell last year.

Labour costs, amortisation/depreciation costs and other costs all increased. However growth in costs was 2.3 percentage points lower than growth in gross income, and even further behind growth in total assets. A number of institutional changes also brought about higher growth in operating costs: the introduction of the IFRS, preparations for the introduction of the euro, and the implementation of the CAD directive. This affected both growth in costs of consultancy services (44.1%), and growth in costs of other services (13.2% in real terms), which alongside labour costs were the largest factors in overall growth in costs. The foreign banks in particular recorded a significant increase in advertising costs. Only three banks recorded a real decrease in operating costs.

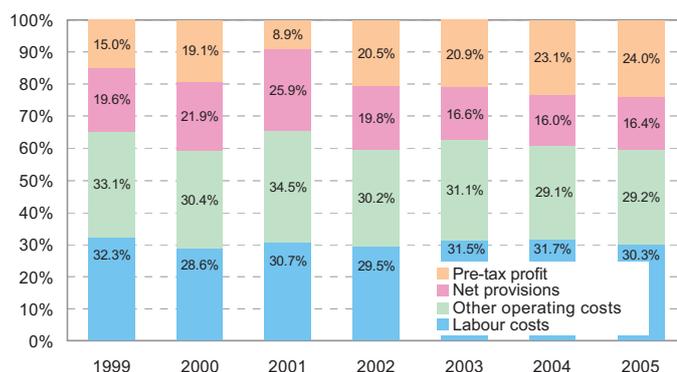
Provisioning costs grew more slowly than loans.

At 4.7% growth in labour costs was lower than overall growth in operating costs, and the proportion that they account for thus fell by 1.2 percentage points to 50.9%. The largest increases in labour costs in 2005 were recorded by gross wages (5.9% in nominal terms or 3.3% in real terms) and employee bonuses. Costs for severance pay and early retirement payouts decreased significantly. All the banks recorded an increase in labour costs, with the exception of three large banks. The coverage of operating costs by net non-interest income rose by 5.7 percentage points to 72.8%. In 2000 this ratio was merely a little over 40%.

Creation of net provisions

Banks also recorded higher profits last year on account of the lower proportion of gross income that was earmarked for provisioning. At 12.5%, growth in net provisioning did not track growth in lending to non-banking sectors (24.2%) or growth in classified assets (24.1%). However the level of provisioning increased relatively evenly over all months, and was higher than in the same months of 2004. Banks created SIT 43.8 billions of net provisions in 2005, SIT 4.9 billions more than in 2004.

Figure 5.13: Composition of disposal of banks' gross income in percentages



Source: Bank of Slovenia

Selected bank performance indicators

Bank profitability remained at the level of previous years, with banks recording moderate growth in operating costs and relatively low growth in provisioning costs.

At 13.8%, return on equity last year was comparable to that achieved in 2004. The same is true of return on assets, which was around 1.0%. Bank profitability remains stable, with banks compensating for both the relatively low growth in net interest income and the growth in operating costs with non-interest income. With growth in total assets significantly outstripping growth in income, banking margins declined again in 2005: the interest margin on interest-bearing assets fell by 0.3 percentage points to 2.53%, the non-interest margin

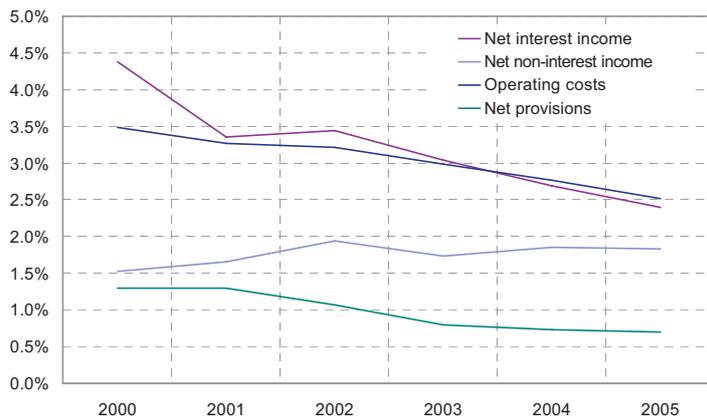
fell by 0.02 percentage points to 1.83%, and the financial intermediation margin fell by 0.4 percentage points to 4.22%.

Table 5.13: Bank performance indicators in percentages

(%)	1999	2000	2001	2002	2003	2004	2005
Return on assets	0.82	1.14	0.45	1.11	1.00	1.05	1.02
Return on equity	7.77	11.36	4.77	13.30	12.47	13.34	13.80
Costs as proportion of gross income	65.39	59.00	65.22	59.68	62.54	60.86	59.53
Interest margin on interest-bearing assets	4.13	4.72	3.62	3.69	3.23	2.84	2.53
Non-interest margin	1.58	1.53	1.66	1.94	1.74	1.85	1.83
Gross income per average assets	5.44	5.94	5.04	5.41	4.77	4.54	4.22

Source: Bank of Slovenia

Figure 5.14: Net interest income, net non-interest income, operating costs and net provisions (as proportion of average assets)



Source: Bank of Slovenia

5.4 Risks in the Banking Sector

Surveys of Slovenian banks⁵⁰ indicate that banks cite the increase of competitive pressures in the sector, not just from other banks, but also from other financial intermediaries, as the largest risk that they face. Interest rates and interest margins are declining as a result. In addition to interest-rate risk, banks are most concerned by credit risk, in particular the possibility of deterioration in creditworthiness of borrowers. Institutional changes are another significant source of risk for banks: the introduction of the IFRS, the introduction of the euro and Basel 2, and changes in tax legislation.

There were 17 banks that participated in the survey conducted in 2005, but in 2006 because of workload brought by preparations for the euro and the introduction of the IFRS we only asked five banks to participate in the survey. Banks defined the key risks that they could face in the coming year, in the year to March 2006 for the first survey, and in the year to March 2007 in the second survey. Banks in the first survey also answered questions on the changes that they expect to be of significance to banks in the next five years.

2005 bank survey

Of the five main groups of risk, banks attributed greatest importance to risks originating in the banking sector, followed by those from financial markets and the regulatory environment. Banks felt that least risk was presented by the macroeconomic environment and bank strategy, or factors connected to each individual bank.

Banks assessed competitive pressures and market saturation as presenting the greatest risks, with new banks continuing to enter the market. Other financial intermediaries, in particular investment funds and insurers, are also increasingly competing with banks.

Competitive pressures in the banking sector are the greatest risk according to a 2005 survey.

⁵⁰ At the proposal of the ECB, all central banks conduct surveys about key risks in the banking sector for the coming year, and occasionally for the next five-year period (Survey on EU banks' main risks for the year ahead). The results for the EU as a whole are presented in ECB material (EU Banking Sector Structure and Financial Stability Report).

Competitive pressures are making it more necessary for banks to expand their business operations and also their efficiency. They are entering new markets and expanding their range of products and services, but are also focusing more on individual segments, in particular the household segment, which is increasing branch network costs. Banks warned of a conflict of interest between commercial objectives and increasing risk.

A decline in interest rates and interest margins, imbalanced positions.

Increased competitiveness is causing declining interest rates and interest margins, which in some segments are lower than the EU average. In addition, banks' interest-rate risk is increasing because of imbalances in their positions with regard to the type of interest rate.

Banks are concerned by the possibility of an increase in credit risk.

The increased competition is also forcing banks to cut their costs and commissions. The opportunities to pursue a conservative risk management strategy and accurate risk pricing are diminishing. As a result banks are concerned by the possibility of increasing credit risk, in particular a deterioration in the creditworthiness of borrowers. They drew attention to the increase in concentration in the lending portfolio, the loss of their best customers (cherry picking), the adequacy of loan collateral and rising debt in comparison with previous periods.

The implementation of the new regulatory requirements is increasing banks' costs, and IT support is becoming a problem.

Of the risks associated with the regulatory environment, the majority of banks cited the introduction of the IFRS and Basel 2, and many banks the introduction of the euro and changes in tax legislation. Banks emphasised the necessity of defining all the changes and requirements at the earliest possible juncture, so that they would have enough time for their preparations. The main risks associated with the regulatory environment are rising costs and information technology. The majority of regulatory changes are realized operationally via IT departments, which are overstretched and are falling behind on other projects. Adapting to new regulatory requirements is thus increasing operational risks in the banking sector.

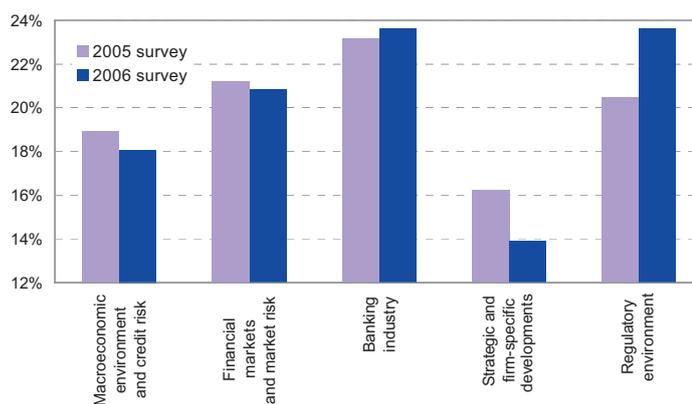
Among macroeconomic conditions, banks emphasised risks affecting exporters. They mentioned economic conditions in the EU, growth in oil prices, interest rates abroad and joining the EMU. Greater integration with the EU is increasing competitive pressures not just in the banking sector, but also in the economy as a whole.

2006 bank survey

2006 brings an increase in risks associated with changes in regulations.

The results of the two surveys are not entirely comparable, mainly because the number of banks that responded in 2006 was significantly lower. Nevertheless, it seems that with the actual introduction of the IFRS and the approaching introduction of the euro and Basel 2 they are focusing more on risks associated with the regulatory environment. Alongside risks associated with the banking sector, banks feel that these are the most important type of risk that they will have to face in 2006.

Figure 5.15: Comparison of results of 2005 and 2006 surveys about main origins of risk for coming year⁵¹



Source: 2005 and 2006 bank surveys

Banks are concerned by rising interest rates and higher interest-rate volatility.

Apart from the rising importance of risks associated with regulations, there is a significant difference between the results of the two surveys with regard to interest rate fluctuations. Given that the level of integration with the European market is constantly increasing, and

⁵¹ Banks ranked five different categories from which risks to their institution originate in order from 5 (most important, i.e. greatest risk) to 1 (least important). The percentage for a particular category is given by the sum of the assessments for the category divided by the sum of all assessments. The percentages thus add up to 100%.

that the nominal convergence of interest rates is virtually complete, banks are primarily concerned by rising interest rates and their volatility.

Competitive pressures remain the key risk originating in the banking sector, while the most important risks at the banks themselves are efficiency and profitability (the risks of higher volatility in profits). Credit risk and economic conditions in the EU remain the two most important risks of those associated with the macroeconomic environment.

Box 5.1: The main challenges for banks over the next five years

In the survey conducted in 2005 banks also answered questions on the challenges or changes that they expect to face in the banking sector in the next five years.

Of the external factors, the greatest impact on banks will come from changes in regulations and membership of the EMU, while technological innovations and economic growth are other important factors.

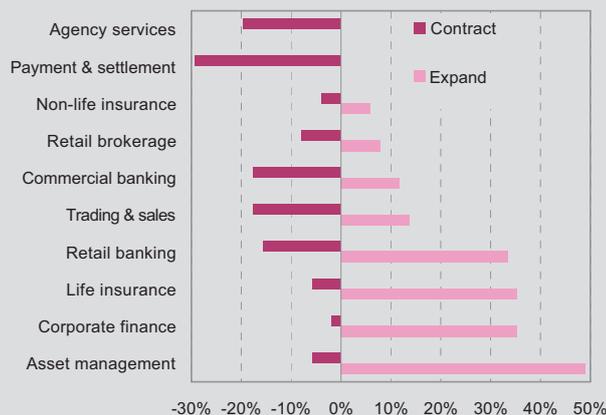
According to banks, the factors that will have the greatest impact on changing trends in the banking sector are competition, the continuing process of consolidation, and the entry of new market participants.

Banks expect competition to increase most in the household segment. Banks are also anticipating increased competition in commercial banking and asset management. Competitive pressures are expected to increase further as more foreign banks enter the Slovenian market. The arrival of banks from the EU is very much expected, but practically no bank anticipates that foreign banks from outside the EU will enter the market. Most banks expect foreign banks to establish branches in Slovenia rather than subsidiary banks. While the number of branches should increase, banks expect the number of banks to decrease as the consolidation process continues. Mergers and acquisitions are most likely in commercial banking, but also in retail banking, life insurance and asset management. Banks expect the links between the various financial intermediaries to strengthen, either in the form of conglomerates or in the form of looser links.

Regarding strategic and firm-specific developments, banks expect changes primarily in the structure of income and sources of financing, and changes in the risk management process.

Net non-interest income is expected to grow in importance in the income structure at the expense of interest income. One of the more important bank policies is greater diversification, both in regional terms and in terms of products and services. Regional diversification will be focused primarily on countries outside the EU, in particular on south-eastern Europe. In addition, banks are aiming to increase income by launching new products and services linked in particular to life insurance and pension insurance, investment funds, private banking, project financing and derivatives. Banks will develop financial centres where they will be able to offer all financial services to their customers at a single site. Banks see the greatest potential for growth in financial services that are not traditional banking services, asset management and life insurance, and in corporate and retail banking. A decline in activities is expected in the two business lines, payments settlements and agency services.

Figure 5.16: Areas where banks expect to see an increase or decrease in activities in the next five years¹

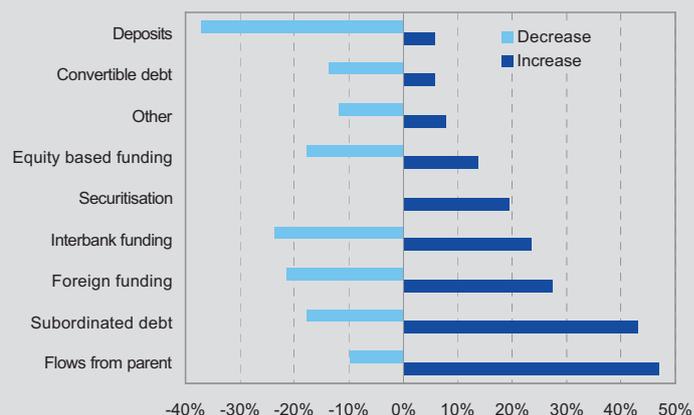


Source: 2005 bank survey

That banks still see strong potential for growth in the domestic market and foreign markets is shown by their responses regarding expected changes in sources of financing. A majority of banks believe that alongside borrowing abroad one of the most important sources of financing will be subordinated debt, which adds to capital adequacy.

At the same time a majority of banks believe that deposits will decline, as low interest rates are making households less inclined to save at banks. Banks will seek the necessary assets at their parent companies and by borrowing abroad.

Figure 5.17: Changes in sources of financing expected by banks over next five years¹



Source: 2005 bank survey

The changes in the risk management process will to a great extent be defined by the changeover to Basel 2, but banks additionally expect there to be an increase in the importance of securitisation and the transfer of risk to other market participants.

¹ Banks chose three categories (three business lines or three sources of financing) where they feel that there will be the largest increase over the next five years, and three where they expect the largest decrease. The categories are given a ranking of 1 (smallest increase/decrease) to 3 (largest increase/decrease). For the banks that merely chose the categories without ranking them, all the categories were assigned a ranking of 2. The percentage scored by a category is the ratio of the total awarded to the category by the banks to the maximum total that an individual category could have scored had it received maximum marks from all the banks. A negative sign was given to the scores for decreases, only for ease of presentation.

Box 5.2: Macro stress tests for the Slovenian banking system

The methodological changes in the macro stress test model and the simulated shocks in risk factors are first examined in a paper. The size of the simulated shocks in the risk factors was limited to the largest historical changes, those occurring with a statistical likelihood of 5% between 1995 and 2004. The results of the macro stress tests under an integrated approach follow. The last part presents the changes in credit risk estimated with the *2003 Model* for 2004,¹ solely for that part of the banking system's credit portfolio that includes loans to companies and sole traders.

Methodological changes in the macro stress test model, and the integrated approach to macro stress tests

The greatest difference from last year's results is to be found in the interest rate scenario, where higher interest rates cause a relatively strong decrease in profit. The difference arises from the changed model, which now takes account of the structure of banks' balance sheets regarding differences in the average maturity of assets and liabilities. Had the previous year's methodology been used, the effect of the shock would have been similar to that in the previous year.

The differences in the absolute responses of particular balance-sheet categories to simulated shocks in comparison with last year's results also arise from the different size of the balance sheet and items in it. In addition, growth in loans this year is not derived from the macroeconomic model, but from econometric equations. Thus it was possible to monitor the direct effect of changes in risk factors on loan growth and the balance-sheet structure. This is why the response of loans to shocks is more evident this year. Greater attention was also paid to the structure of deposits by non-banking sectors and deposits by banks. The figure for total assets is defined by the asset side of the balance sheet, which also determines the need for banks to secure sources of financing.

This year's results differ more significantly in the change in the exchange rate, which is a consequence of the short duration of the shock, which lasts only for one quarter in the current year. Last year the shock occurred in the third quarter, and in the fourth quarter the tolar exchange rate returned to its previous level, which means that the entire effect of the change in valuation was reflected in the first year, and later only the effects of the changed growth rates were evident. In this year's report the shock is simulated in the final quarter, so the effect of the shock is seen in the first year, and the effect of the return of the exchange rate to the pre-shock level is only seen in the following year.

¹ The model of credit risk assessment is part of the piecewise approach, and is not part of the integrated model of macro stress tests.

Table 5.14: Types of shocks, their size and duration for the performance of stress tests

Risk factor	Shock: change from baseline scenario	Duration of shock (quarters)	Post-shock
1) Real GDP	Growth down 2.5 percentage points	IV/05-III/06	trend followed
2) Interest rates	Tolar interest rates up 4 percentage points, foreign currency interest rates up 2 percentage points	IV/05-III/06	returns to pre-shock level
3) Interest margin	Interest margin down 1 percentage point	IV/05-III/06	returns to pre-shock level
4) Tolar appreciation	Exchange rate down 5%	IV/05	returns to pre-shock level
5) Tolar depreciation	Exchange rate up 5%	IV/05	returns to pre-shock level

Results of macro stress tests under the integrated approach

The operating result responds most strongly and most quickly to the simulated change in interest rates and the interest margin. The response to the other simulated shocks – a fall in economic activity and changes in exchange rates – is smaller, and occurs with a delay of one or more quarters. The findings from the stress tests are similar to last year's; no significant deviations can be observed in the size of effects, which implies that the ability of banks to respond to shocks (shock absorption) is not changing significantly.

The effects of the shocks in risk factors were observed with regard to changes in the following categories: the banking system's pre-tax profit, return on equity (ROE), capital adequacy, growth in loans and deposits by non-banking sectors, and the changes in these categories as a proportion of total assets. Given that the durations of individual shocks vary, their effects are treated separately for 2005, 2006 and 2007.

The banking system's operating result responds most strongly to the simulated increase in domestic and foreign interest rates, and to the decrease in the interest margin, which is also true of the response of ROE and capital adequacy. The cumulative decline in profit over the entire forecasting period in the event of an increase in interest rates or a decrease in the net interest margin exceeds the profit for a single year, which is the reason for a decline in capital adequacy of approximately 0.5 percentage points in both 2006 and 2007. The effects of higher interest rates in 2006 are even greater than the effects of a lower net interest margin, despite interest-bearing assets being almost 8% larger than interest-bearing liabilities.

In all the scenarios it can be seen that the longer average maturity of loans means that the response in growth in loans to shocks lasts longer than the response in growth in deposits. Owing to their shorter average maturity, deposits return more quickly towards the values before the simulated shock, so their entire response to the shock is smaller and shorter-lasting. A decline in economic growth and changes in the tolar exchange rate do not have a significant impact on profit. However, the effect of the first shock is longer-lasting, which is also reflected in the greater increase in capital adequacy in 2007.

Table 5.15: Effect of individual shocks on changes in selected bank balance sheet categories measured by changes with regard to baseline scenario

2005									
Shock	Profit (SIT billions)	ROE	Capital adequacy	Growth in loans to non-banking sectors	Loans/TA	Growth in deposits by non-banking sectors	Deposits/TA	Growth in TA	
1) GDP	0.0	0.0	0.01	0.0	0.0	0.0	0.0	0.0	
2) Change in interest rates	-19.4	-4.1	-0.08	-1.0	-0.2	0.0	0.3	-0.6	
3) Fall in interest margin	-14.8	-3.2	-0.06	-	-	-	-	-	
4) Tolar appreciation	0.2	0.0	0.07	-0.7	0.0	-0.7	0.0	-0.7	
5) Tolar depreciation	0.0	0.0	-0.06	0.7	0.1	0.7	0.1	0.5	
2006									
Shock	Profit (SIT billions)	ROE	Capital adequacy	Growth in loans to non-banking sectors	Loans/TA	Growth in deposits by non-banking sectors	Deposits/TA	Growth in TA	
1) GDP	-0.5	0.1	0.09	-2.4	-0.5	0.1	0.7	-1.3	
2) Change in interest rates	-67.2	-12.5	-0.62	-7.1	-1.6	5.6	5.2	-4.0	
3) Fall in interest margin	-47.8	-8.9	-0.44	-	-	-	-	-	
4) Tolar appreciation	-0.2	0.0	0.05	0.5	0.0	0.7	0.1	0.5	
5) Tolar depreciation	0.1	0.0	-0.02	-0.5	0.0	-0.7	0.0	-0.4	
2007									
Shock	Profit (SIT billions)	ROE	Capital adequacy	Growth in loans to non-banking sectors	Loans/TA	Growth in deposits by non-banking sectors	Deposits/TA	Growth in TA	
1) GDP	-3.0	-0.2	0.21	-1.5	-0.9	-0.3	0.9	-0.7	
2) Change in interest rates	-6.1	-0.4	-0.49	0.7	-1.6	-5.1	2.2	0.4	
3) Fall in interest margin	0.0	0.0	-0.48	-	-	-	-	-	
4) Tolar appreciation	0.3	0.0	-0.02	0.5	0.1	0.0	-0.1	0.3	
5) Tolar depreciation	-0.2	0.0	0.03	-0.5	-0.1	0.0	0.1	-0.3	

The findings from the stress tests conducted this time resemble those in the most recent macro stress tests report from February 2005. Banks are primarily exposed to interest-rate risk, while exchange-rate risk and the risk of lower economic growth are relatively less important. Attention should be drawn to the shortening of the open foreign exchange position in the corporate sector, which for banks represents a potential increase in the realisation of credit risk in the event of a depreciation of the tolar.

Assessment of credit risk with a model

In the second part comprising stress tests using a piecewise approach, there was a focus on the assessment of credit risk via the observation of changes in the quality structure of banks' portfolios. In addition to comparing the assessments of the model for the proportion of bad loans in the credit portfolio with the actual situation in 2004, the response of the proportion of bad loans to particular shocks was assessed.

A comparison between the actual structure of the credit portfolio and the assessments of the model shows that the 2003 model forecast a greater proportion of bad loans for 2004 (9.36%) than the actual proportion as assessed by banks themselves (7.18%). In line with the results of the model, 2004 saw a continuation in the lowering of standards for assessing credit risk at banks, which is subordinate to maintaining or increasing market share in the lending market. With regard to changes in the structure of the credit portfolio over a three-year period, it was found that the same customers migrate in the first year from an A credit rating to a B rating, while in the following year the proportion downgraded to a lower credit rating increases. Furthermore, in two successive years, 2002-2003 and 2003-2004, business relationships saw more downgrading from A and B ratings to lower credit ratings. While movement of clients from the A rating to the B rating could be recognised in the 2002-2003 period, in the 2003-2004 period there was greater movement from the A and B ratings to lower credit ratings.

The stress tests show that a rise in the short-term debt ratio of businesses has a significantly greater impact on the banking sector than a deterioration in their liquidity. These results are in line with the test results published in February 2005.

5.5 Credit Risk

Under favourable economic conditions and in the context of strong credit demand, the trend of decreasing credit risk continued. There was an improvement in the credit rating structure of claims and the quality of the insurance. The proportion of unsecured loans fell, while insurance with real estate and securities collateral increased. The number of new loans with several forms of insurance is increasing very rapidly.

Growth in loans was extremely high last year, with the ratio of nominal growth in loans to nominal growth in GDP approaching 5, which indicates the rapid pace of the deepening of the lending market. Banks also focused on segments where they had previously had a lower profile. The concentration of large exposures further increased.

Given banks' pro-cyclical behaviour, a turnaround in the economic cycle would have adverse effects on the quality of the portfolio and on bank profitability.

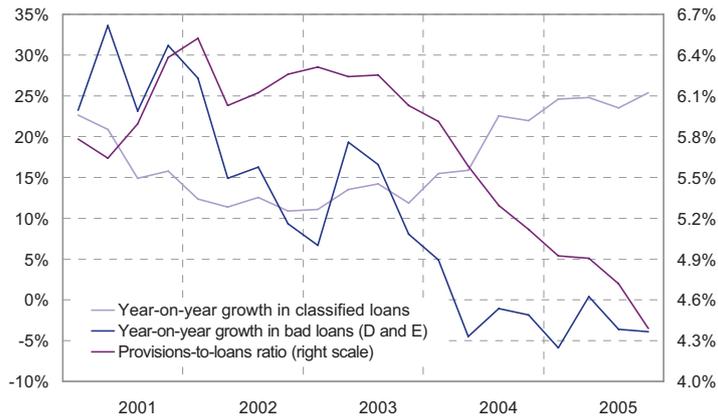
An additional risk factor worthy of attention is the transfer of risks, in particular interest-rate risk and exchange-rate risk, to the non-banking sector. This is increasing banks' exposure to credit risk, but is also bringing an increase in risk from the point of view of the economy as a whole, as the non-banking sector is less capable of identifying and managing risks and is less likely to hedge against risk.

Pro-cyclical behaviour by banks and transfer of risks to non-banking sector

The pro-cyclical behaviour of banks remains a risk factor.

The pro-cyclical nature of banks' behaviour remains one of the key risk factors. Economic growth was still high last year, although lower than in the previous year. The gap between average annual growth in total loans and growth in bad loans increased further. Even in 2003 the rates of average annual growth in total loans and bad loans were equalized, but the gap between the rates was 19.6 percentage points in 2004 and 27.8 percentage points last year. The proportion of total loans accounted for by bad loans fell by 1 percentage point in 2005 to 3.4%. The coverage of loans by provisions (adjustments created) fell by a further 0.7 percentage points in 2005 to 4.4%.

Figure 5.18: Year-on-year growth in classified and bad loans in percentages



Source: Bank of Slovenia

Banks are primarily assessing their customers on the basis of current performance, which reflects the good economic conditions, and under the pressure of competition. Sound knowledge of customers is vital to the successful management of credit risk, even if the amounts of loans are not high. The key to deciding whether to finance individual customers should be in placing a greater emphasis on the entire period of potential exposure to a particular customer and to factors that are known to affect individual customers and increase the risk that they present to banks, such factors can be commodities prices, and exchange rate movements. A longer-term, more future-oriented view of customer quality would allow for greater stability in credit ratings and credit risk in the banking sector, even in less favourable economic conditions.

Another factor that could lead to a future increase in credit risk in the banking sector is the transfer of other types of risk to the non-banking sector. By promoting foreign currency loans with variable interest rates banks are transferring exchange-rate and interest-rate risk to the non-banking sector, thus exchanging these risks for credit risks.

By transferring interest-rate risk and exchange-rate risk to non-bank sectors banks are increasing their exposure to credit risk.

Table 5.16: Growth in foreign currency loans and variable-rate loans, and structure of new loans at eight largest banks in percentages

	Growth in new loans (%)	Growth in new foreign currency loans (%)	Growth in new variable-rate loans (%)
2004	31.1	76.1	67.7
2005	9.0	62.2	54.5
	Amount (SIT billions)	Proportion of new loans (%)	
2004	1,780.5	34.5	38.5
2005	1,941.4	51.3	54.5

Source: Bank of Slovenia

In addition, banks are introducing new, more complex, financial products that combine a loan and an investment in an investment fund.⁵² In such loans the borrower also takes on market risk in addition to the risks associated with the loan. Usually only interest is paid during the lifetime of the loan, while the principal is repaid when the loan matures using the investment part of the product, if sufficient; otherwise borrowers must repay the difference from their own funds. This transfers the majority of the settlement of the principal to a moment far in the future, about which the borrower has no information, which increases the risk of this entire product.

New types of loan are appearing where customers assume the investment risk in addition to more familiar risks.

These products are very advantageous for banks, as they either expand their scope of business and non-interest income or reduce their own exposure to risk, in particular interest-rate and exchange-rate risk. By transferring financial risks to the non-banking sector, banks are increasing their exposure to credit risk, but the latter would only increase in the event of major shocks in interest rates or exchange rates, even in this case part of the risk would remain with the non-banking sector. From the point of view of the economy as a whole, there is an increase in risk in this case, as entities in the non-banking sector, households in particular, are less versed in finance and have little or no hedging against potential risks.

The transfer of risks to non-bank sectors is increasing the entire economy's exposure to risk.

⁵² Instead of investment fund it can include a life insurance.

5.5.1 Portfolio quality and creation of special provisions

An increase in A-rated claims primarily at the account of a decrease in B-rated claims.

Total classified claims increased by 23.4% in 2005, to SIT 6,041.4 billions. The largest increase in the portfolio was recorded by A-rated claims, with the highest credit rating. These claims accounted for 83.4% of the total, up 1.6 percentage points from 2004. In 2004 the increase in A-rated claims was a half of this, 0.8 percentage points, primarily because of a decrease in the highest-risk claims rated C to E. In 2005 B-rated claims recorded the largest decrease of 0.9 percentage points, while the proportion of claims rated C to E decreased by a total of 0.7 percentage points.

Table 5.17: Classification of balance sheet and off-balance-sheet assets of banks and special provisions

	31. Dec. 2004			31. Dec. 2005		
	Classified claims	Special provisions	Coverage of claims by provisions (%)	Classified claims	Special provisions	Coverage of claims by provisions (%)
Total (SIT billions)	4,895.4	255.1	5.2	6,041.4	279.0	4.6
	Structure (%)			Structure (%)		
A	81.7	15.7	1.0	83.4	17.6	1.0
B	12.7	24.9	10.2	11.8	26.3	10.3
C	2.5	12.7	26.7	2.4	13.5	26.4
D	1.4	15.7	57.5	1.1	13.2	57.2
E	1.6	31.0	100.0	1.3	29.1	100.0

Source: Bank of Slovenia

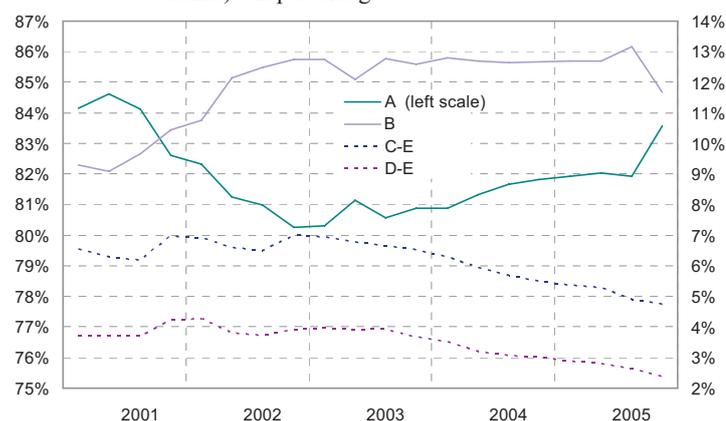
Growth in special provisions was lower than growth in claims.

The amount of special provisions (adjustments to the value of loans and provisions created for A-rated customers) did not follow the rapid growth in classified assets, primarily because growth in provisions was outstripped by growth in claims rated A and C. The special provisions increased by 9.4% last year to SIT 279 billions.

The coverage of classified claims by special provisions fell to 4.6%.

Owing to the increase in the proportion of A-rated claims, for which the lowest provisions are created, and the decrease in the proportion of special provisions for claims rated D and E, the overall coverage of classified assets by special provisions fell by a total of 0.6 percentage points to 4.6%. The coverage by provisions increased only in the rating category B. The largest falls experienced claims rated C and D, by 0.3 percentage points and 0.4 percentage points respectively.

Figure 5.19: Proportion of total classified claims rated A, B, C to E, and D to E (bad claims)⁵³ in percentages



Source: Bank of Slovenia

Differences between banks

The ratings structure of claims improved at all groups of banks in 2005, mostly at the foreign banks and the small banks.

The good macroeconomic conditions (economic growth still high, falling inflation, and low interest rates) are reflected in the rating structures for the claims of all groups of banks. The proportion of A-rated claims increased, primarily on account of a decrease in the proportion of claims classified into one of the riskier ratings categories. The effects of competitive pressures can also be seen, as the small banks and foreign banks, which are gaining market

⁵³ Balance sheet and off-balance-sheet claims are classified in accordance with national regulations. Securities and investments in capital are not classified.

share at the expense of the large banks, recorded a significantly larger increase in their proportion of A-rated claims than the large banks. Both groups recorded an increase of 2.2 percentage points, compared with 1.6 percentage points for the large banks.

Figure 5.20: Structure of classified claims for each group of banks in percentages



Source: Bank of Slovenia

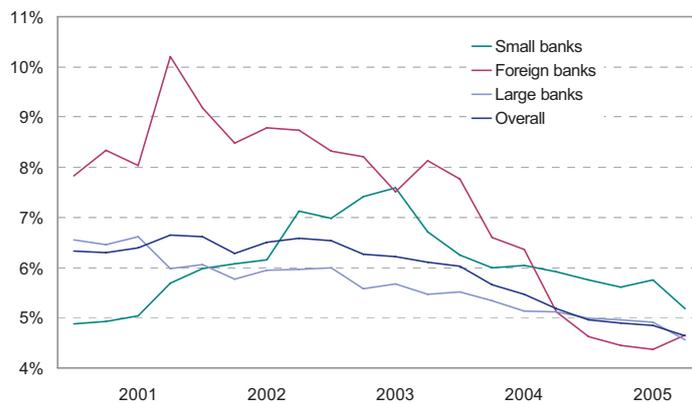
The foreign banks had 91.9% of their claims classified into the best risk category A last year, while at the end of 2001 this proportion was 10 percentage points lower at 82.4%. The changes in the claims rating structure at domestic banks, both small and large, were considerably smaller during this period. There was a slight change in 2003, when the small banks saw their proportion of A-rated claims fall. The proportion of A-rated claims at both groups of domestic banks last year was 1 percentage point higher than in 2001.

Over a longer timeframe above all the foreign banks have improved the ratings structure of their claims.

Further evidence of the rapid improvement in portfolio quality at the foreign banks comes from the proportion of potential losses for classified claims according to bank estimates, which takes all classified claims into consideration, not merely A-rated claims. This proportion is falling at all groups of banks, most rapidly at the foreign banks, where having been 10.2% at the end of 2001 it fell below the level at other banks in 2005 before rising again slightly in the final quarter. At the end of last year only the small banks recorded noteworthy deviation from the system average: they were expecting higher-than-average losses in all rating categories. The proportion of potential losses at the large banks was slightly lower in rating category D, but was the same as the system level in the other categories. For the foreign banks, their potential losses are above-average in category D and below-average in category C.

The potential losses of all the groups of banks fell further in 2005.

Figure 5.21: Potential losses for classified claims at different groups of banks in percentages



Source: Bank of Slovenia

Loans account for three-quarters of all classified assets. Loan quality, as measured by the ratio of special provisions to loans, also improved in 2005. Banks created special provisions for loans in the amount of 4.4% of total loans, compared with 5.1% in 2004.

Loan quality improved. Banks class non-residents and sole proprietors as the highest risks.

Table 5.18: Loan quality by sector in percentages

(%)	Loan quality ¹			
	2002	2003	2004	2005
Agriculture	12.8	11.9	10.3	8.3
Mining	1.5	0.7	0.6	0.9
Manufacturing	8.0	8.0	7.4	7.1
Electricity, gas and water	6.4	6.1	3.7	1.8
Construction	6.6	6.3	4.9	4.3
Trade	8.7	8.6	7.7	6.5
Hotels and catering	10.5	9.5	8.5	7.0
Transport and communications	5.7	6.5	3.1	3.0
Financial intermediation	1.7	1.0	1.1	0.7
Real estate and business services	6.4	6.0	5.3	4.2
Public administration and defence	0.9	0.8	0.8	0.7
Education	4.2	6.3	3.1	2.4
Health	5.4	2.4	2.1	2.2
Other public services	6.8	7.6	4.6	4.7
Households	5.3	4.6	3.9	3.3
Sole proprietors	26.8	24.2	15.6	9.5
Non-residents	25.1	15.9	12.8	9.8
Other	2.0	1.0	1.0	44.0
Overall	6.3	6.0	5.1	4.4

Note: ¹Loan quality = special provisions/loans

Source: Bank of Slovenia

As in previous years, banks class non-residents and sole proprietors as the greatest risk in the lending market, followed by the sectors of agriculture, hotels and catering, trade. The majority of sectors saw their quality improve last year, the sole exceptions being mining, health, and other public services, where there was a slight deterioration in loan quality.

5.5.2 Credit growth

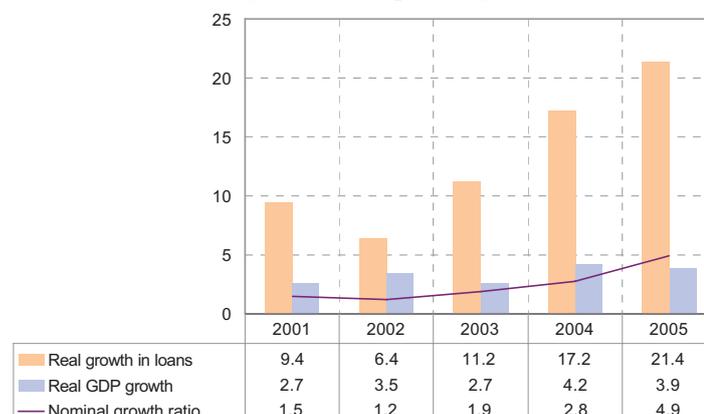
Growth in lending to non-bank sectors was high in 2005 at 24.2%.

The very high ratio of growth in loans to GDP growth indicates the danger of the lending market overheating.

With economic growth remaining relatively high and the nominal convergence of Slovenian interest rates to the level of interest rates in the EU continuing, the strong lending activity seen in the previous year continued last year. Loans to non-banking sectors recorded growth of 24.2% (21.4% in real terms), 3.2 percentage points more than in the previous year.

The deepening of the lending market accelerated significantly more in 2005 than had been expected at first. With inflation at a historic low, and the terms of trade negative owing to high import prices, growth in nominal GDP was just 1 percentage point higher than real GDP growth at 4.9%. The ratio of nominal growth in loans to nominal GDP growth approached 5, indicating a danger of the lending market overheating. Such a high value has never been recorded in the last ten years. Even in the period of high lending growth prior to the introduction of VAT in 1998 and 1999, the ratio of nominal growth in loans to nominal GDP growth never exceeded 2.7.

Figure 5.22: Real growth in loans to non-banking sectors, real GDP growth and the nominal growth ratio in percentages

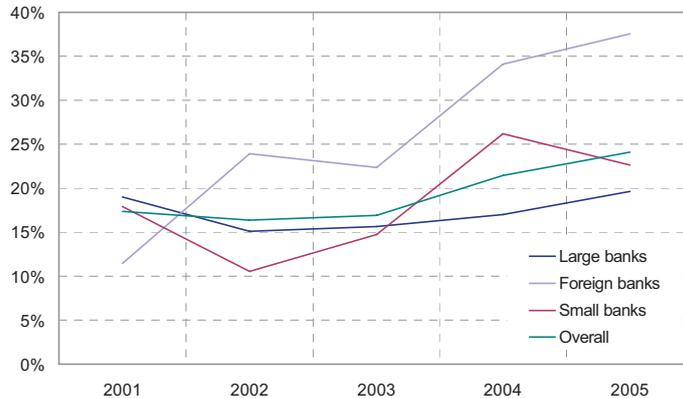


Source: Bank of Slovenia

The proportions among individual banking groups of nominal growth in loans to non-banking sectors were more or less the same in 2005 as in the previous year. The foreign banks continued to record the highest growth: in 2005 the rate was 37.7%, similarly as in the previous year it was around 13 percentage points higher than the banking sector average. The lowest growth in loans to non-banking sectors last year was recorded by the large banks, which at 19.7% was more than 2 percentage points higher than in 2004 but still 4.5 percentage points lower than the system average. Small banks year-on-year growth in loans remained at the system level.

The foreign banks are still recording the highest growth in loans to non-bank sectors.

Figure 5.23: Breakdown of year-on-year growth in loans to non-banking sectors by types of bank in percentages



Source: Bank of Slovenia

With the increase in competition in individual segments and increasing concentration in lending portfolios, banks have begun to focus more on segments where they have previously had a lower profile. Thus in 2005 the highest rates of growth in loans were recorded by sectors to which exposure was lowest. Particularly worthy of note is the growth of close to 50% in loans to sole proprietors and non-residents. Growth in loans to the education, agriculture and mining sectors was also very high. With the exception of loans to non-residents, which account for 4.4%, none of the aforementioned sectors, including sole proprietors, accounts for even 1% of the banking system's lending portfolio.

Table 5.19: Year-on-year growth in loans by sector in percentages

	Growth rate (%)				
	2001	2002	2003	2004	2005
Agriculture	10.4	23.1	19.8	12.1	39.3
Mining	47.7	-6.3	44.0	16.4	36.0
Manufacturing	25.8	14.7	25.3	18.7	18.0
Electricity, gas and water	-8.6	-0.7	-25.9	-6.8	6.9
Construction	16.6	16.2	8.2	34.6	15.1
Trade	21.6	12.1	11.7	21.2	22.5
Hotels and catering	28.2	18.3	6.5	21.6	23.9
Transport and communications	49.5	5.4	6.3	-9.0	9.7
Financial intermediation	12.2	-0.7	-4.0	37.5	35.6
Real estate and business services	16.0	13.5	42.1	28.6	41.8
Public administration and defence	-9.6	36.4	-6.8	-9.8	17.4
Education	0.1	17.1	-35.2	134.9	105.8
Health	30.7	9.6	24.4	43.1	24.8
Other public services	29.3	9.2	9.4	48.0	-10.0
Households	8.2	7.9	10.7	21.2	25.6
Sole proprietors	-32.2	53.2	46.4	-26.7	51.7
Non-residents	11.2	61.0	38.7	45.2	49.5
Other	-6.1	38.5	-4.0	-4.4	-98.0
Overall	15.7	10.9	11.9	22.0	25.4

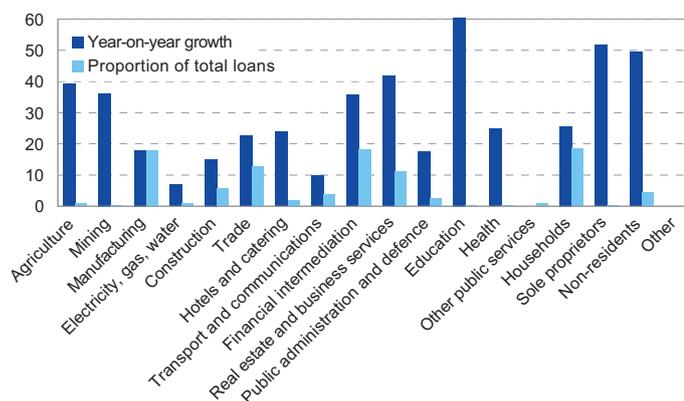
Source: Bank of Slovenia

Among the sectors that account for a significant proportion of the lending portfolio, in 2005 banks recorded very high growth in loans to the sectors of real estate and business services (41.8%) and financial intermediation (35.6%).

High growth in loans to the sectors of financial intermediation, and real estate and business services.

The financial intermediation sector recorded very high growth of 12.7% in value added in 2005. This growth was too high for other sectors to be able to follow. There is a large group of nine sectors where growth in value added is between 3% and 5%, which indicates the continuation of good economic conditions last year. These include the three sectors (real estate and business services, manufacturing, and trade) that together with financial intermediation account for the majority of the banking system's lending portfolio (actually 60%). Growth in loans to the manufacturing and trade sectors (18% and 22.5%) was slightly lower than for the other two sectors, but was still solid, and at the level of the previous year.

Figure 5.24: Year-on-year growth in loans in 2005 and credit portfolio structure in terms of sectors in percentages



Source: Bank of Slovenia

A slowdown in growth in loans to the construction sector.

Last year's growth in loans to the construction sector was considerably lower than in 2004. At 34.6%, growth was particularly high in 2004, as a result of increased demand for the services of construction companies caused by infrastructure projects and the maturity of the first National Housing Saving Scheme. Growth in 2005 returned to the level seen in previous years, at 15.1%.

5.5.3 Large exposures

Concentration in the banking system's credit portfolio is increasing.

High growth in loans to non-banking sectors and slow growth in both balance sheet capital and regulatory capital was reflected in an increase in the number of large exposures.⁵⁴ By the end of 2005 the number of large exposures had risen to 305, the highest number in the last five years. Banks recorded 52 more large exposures than at the end of the previous year, a 21% increase.

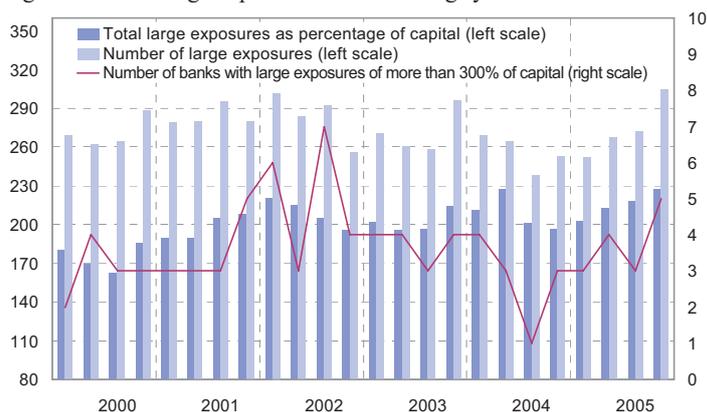
Table 5.20: Total large exposures per regulatory capital in percentages

	2001	2002	2003	2004	2005	2001 - 2005		
						Min	Max	Average
Total large exposures to capital (%)	208	195	214	196	227	189	227	207
Number of large exposures	280	256	296	253	305	238	305	274
Number of banks with large exposures of more than 300% of capital	5	4	4	3	5	1	7	3.8

Source: Bank of Slovenia

⁵⁴ A large exposure is an exposure of a bank to an individual person that reaches at least 10% of the bank's capital. A bank's exposure to an individual person includes balance sheet and traditional off-balance-sheet asset items, including special items for derivatives.

Figure 5.25: Large exposures in the banking system



Source: Bank of Slovenia

Concentration in the banking system's lending portfolio is increasing not just in terms of number, but also in terms of volume. The total of all large exposures was equivalent to 227% of the banking sector's regulatory capital in 2005, up 31 percentage points from the previous year. At five banks the total of large exposures exceeded 300% of their capital.

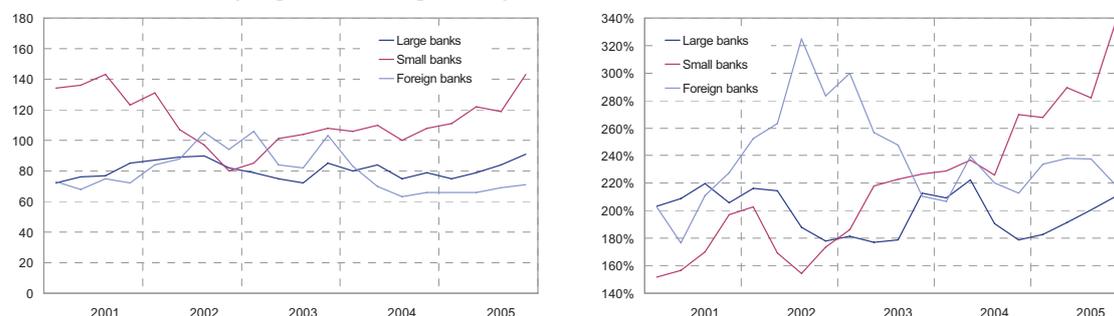
The number of large exposures at banks increased throughout the year, with the small banks recording the largest increase. There was an increase of 35 in the number of large exposures at the small banks, which accounted for 67% of the increase in the sector as a whole. The small banks ended the year with 143 large exposures. Given their smaller capital, the small banks can be expected to have more large exposures. Therefore, during time of higher credit demand, the small banks rapidly reach the threshold of large exposure. Even at the large banks the number of large exposures began to rise rapidly in the second half of the year. They ended the year with 91 large exposures, an increase of 12 from the previous year. In contrast to domestic banks, many of the foreign banks underwent recapitalisations in 2005. The capital increases meant that portfolio concentration decreased considerably, and this has been lowest at the foreign banks for two years now. The foreign banks had 71 large exposures at the end of the year, five more than in 2004.

Increased concentration at the small banks, in terms of both the number and the size of large exposures in relation to capital.

The large banks and foreign banks achieve similar levels for their ratio of total large exposure to regulatory capital. The total of large exposures is equivalent to 210% of regulatory capital at the large banks and 219% at the foreign banks. There was a sharp increase in this ratio at the small banks, where the figure of 336% was 66 percentage points higher than in 2004.

The increase in the number and volume of large exposures, particularly at the small banks, could in the event of a deterioration in the economic conditions increase the likelihood of disruptions to their performance, even if only a few major customers go bankrupt.

Figure 5.26: Number of large exposures and ratio of total large exposures to capital at different groups of banks in percentages



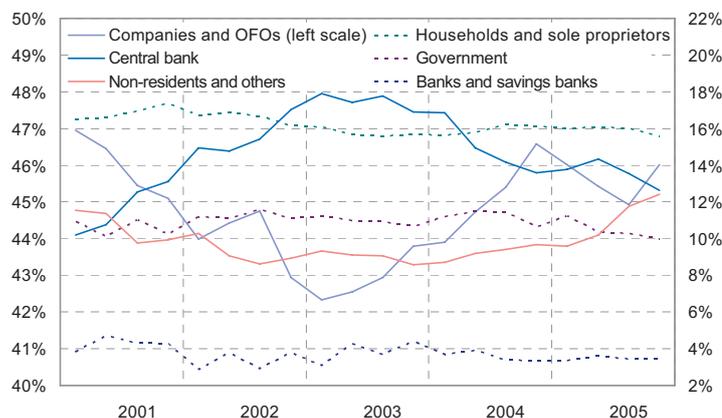
Source: Bank of Slovenia

5.5.4 Portfolio diversification

A decrease in the proportion of exposure to the central bank on account of an increase in exposure to the rest of the world.

In 2005 banks continued to reduce their exposure to the central bank and to increase their exposure to the rest of the world, this to a great extent involving the transfer of funds from central bank securities to foreign securities. Exposure to the two segments had equalised by the end of the year at 12.5% of total exposure.⁵⁵ Banks exposure to companies and other financial organisations (OFOs) has fluctuated around 46% of total exposure since the middle of 2004, while exposures to other segments have been very stable for a longer period.

Figure 5.27: Proportion of total bank exposure accounted for by individual segments in percentages



Source: Bank of Slovenia

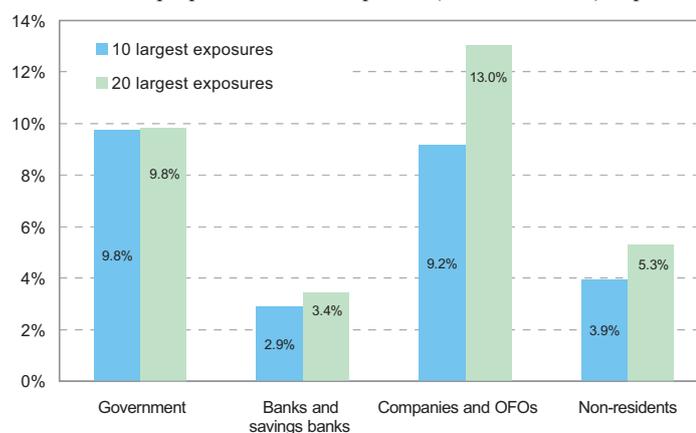
Concentration was highest in bank exposure to the government.

Exposure concentration in 2005 was highest in banks exposures to government institutions, where the proportion accounted for by the 20 largest exposures is only slightly larger than the proportion accounted for by the ten largest. Concentration is lowest for companies and OFOs, with the difference between the proportions of total banks exposure in this segment accounted for by the ten largest and the 20 largest exposures amounting to 3.9 percentage points last year.

Bank exposures to companies are determined more by the sector that the companies operate in than by company size.

The largest banks exposures to companies are not the exposures to the largest companies. The ten companies to which banks are most exposed include only three of the ten largest companies in terms of the size of their total assets. Banks exposures to companies are determined more by the sector that the companies operate in than by company size. The largest exposures are to individual companies in the trade and manufacturing sectors, followed by companies in the real estate and business services sector (including holding companies), the construction sector and the transport and communications sector.

Figure 5.28: 10 and 20 largest exposures of banks to entities of individual segment as proportion of total exposure (December 2004) in percentages



Source: Bank of Slovenia

⁵⁵ In addition to loans, exposure includes securities, off-balance-sheet exposure, claims for interest and other items.

Structure of loans by sector or customer segment

Slovenian banks approve most loans to the sectors of financial intermediation, manufacturing, trade, and real estate and business services. The proportion of loans to households is also large. Figures for the structure of loans by sector indicate that banks have a large proportion of credit exposure to sectors that are cyclical, which increases the banks' sensitivity to credit risk in terms of the phase of the economic cycle.

Slovenian banks approve most loans to sectors closely tied to the phase of the economic cycle.

Table 5.21: Loan structure by sector in percentages

	Proportion of total loans (%)			
	2002	2003	2004	2005
Agriculture	0.7	0.7	0.6	0.7
Mining	0.2	0.3	0.3	0.3
Manufacturing	17.4	19.5	18.9	17.8
Electricity, gas and water	2.0	1.3	1.0	0.8
Construction	5.7	5.5	6.1	5.6
Trade	13.2	13.2	13.1	12.8
Hotels and catering	1.9	1.8	1.8	1.8
Transport and communications	6.4	6.0	4.5	3.9
Financial intermediation	17.4	14.9	16.8	18.2
Real estate and business services	7.2	9.2	9.7	10.9
Public administration and defence	4.5	3.7	2.8	2.6
Education	0.1	0.0	0.1	0.1
Health	0.3	0.3	0.4	0.4
Other public services	1.0	1.0	1.2	0.8
Households	18.8	18.6	18.5	18.6
Sole proprietors	0.2	0.3	0.2	0.2
Non-residents	2.5	3.1	3.7	4.4
Other	0.6	0.5	0.4	0.0
Total (SIT billions)	2,778	3,108	3,791	4,752

Source: Bank of Slovenia

Exposure to the rest of the world

Exposures to foreign banks are the largest exposures to the rest of the world, although exposures to non-residents that are not banks are also increasing.

With Slovenia having joined the EU, Slovenian banks integrating into the European financial system, foreign banks entering the Slovenian market, Slovenian banks expanding to the markets of south-eastern Europe, and bank securities portfolios being shifted from domestic securities to foreign securities, banks exposure to non-residents has begun to rise rapidly. Since the beginning of 2004 exposure to the rest of the world has doubled, and has increased by 58% in the last year alone. At 44.5%, growth in loans to non-residents was almost double the growth in total loans to non-banking sectors. Despite the high growth in loans, the proportion of total exposure to the rest of the world that they account for continued to decrease, reaching 56.5% at the end of the year, down 5.3 percentage points from the previous year.

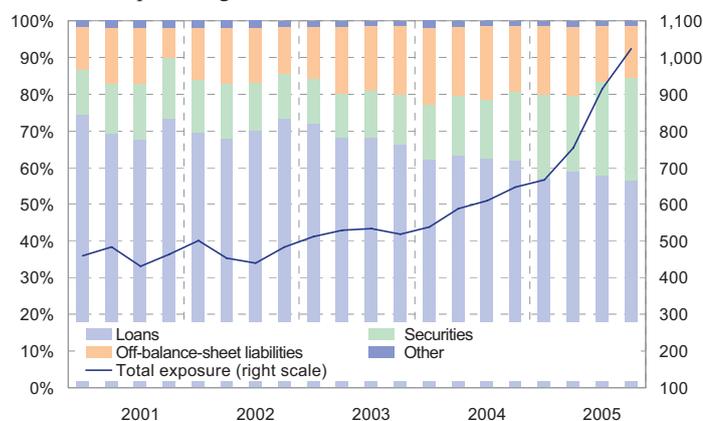
High growth of 58% in exposure to non-residents, in terms of loans, and even more so in terms of securities.

The abolition of mandatory subscription to Bank of Slovenia foreign currency bills as part of the minimum foreign exchange requirements and the resulting restructuring of securities portfolios from foreign currency bills towards foreign securities is the main reason that exposure to the rest of the world in the form of securities increased by 135% in 2005 alone to account for 28% of total bank exposure to the rest of the world at the end of the year, up from 18.8% a year earlier.

Exposure to EU countries accounts for the majority of exposure to the rest of the world (63.5%). However, despite rapid growth of 45% in exposure to the EU, this proportion was almost 6 percentage points lower than in 2004. The second most important market for Slovenian banks are the countries of the former Yugoslavia. Exposure to this region accounts for just under 20% of total exposure to non-residents, and grew by 97% in 2005

alone. The largest increases were in exposure to the Cefta countries (Bulgaria and Romania) 167% in total, and Efta countries (101%), but together they account for less than 7% of total exposure to non-residents.

Figure 5.29: Banks exposure to non-residents in SIT billions and its structure in percentages



Source: Bank of Slovenia

Table 5.22: Banks exposure to country groups in SIT billions

	2001		2002		2003		2004		2005	
	Amount	Proportion (%)	Amount	Proportion (%)						
EU15/25 ¹	338.9	73.1	369.7	76.4	350.1	67.6	448.4	69.3	648.8	63.5
EFTA	26.4	5.7	25.6	5.3	30.9	6.0	28.1	4.3	56.5	5.5
Former Yugoslavia	24.5	5.3	37.7	7.8	65.9	12.7	99.5	15.4	195.7	19.2
CEFTA ²	5.4	1.2	9.5	2.0	12.3	2.4	4.2	0.7	11.3	1.1
Other	68.3	14.7	41.4	8.6	58.9	11.4	66.9	10.3	109.5	10.7
Total	463.5	100.0	484.0	100.0	518.1	100.0	647.2	100.0	1,021.7	100.0

Note: ¹ Figures for 2004 and 2005 relate to the EU25.

² Figures for 2004 and 2005 relate to Bulgaria and Romania only.

Source: Bank of Slovenia

5.5.5 Insurance of new loans

Slow growth in unsecured loans.

A positive change in 2005 was the decline in growth in unsecured loans. In 2005 the eight largest banks approved SIT 1,941 billions of new loans, up 9% in nominal terms from 2004. Growth in loans that have no form of insurance was 1.9% in 2005, compared with 99.6% in 2004. If loans for which bills are issued are classed as unsecured, total growth in unsecured loans in 2005 was 5.7%, compared with 33% in 2004.⁵⁶ The proportion of total new loans at the eight largest banks accounted for by unsecured loans fell by 2 percentage points in 2005 to 61.4%.

New loans with securities collateral are growing fastest.

The greater involvement by non-banking sectors in capital markets and the transfer of their funds from bank deposits to securities is reflected in the structure of insurance for new loans. There was a sharp decrease in 2005 in the amount of new loans insured with bank deposits, while loans with securities collateral, in particular shares and other (not classified) securities, recorded the highest growth. The total amount of new loans with securities collateral grew by 64% last year. This took the proportion of all new loans at the eight largest banks that they account for to 5.2%, having stood at 3.5% in 2004 and 3.6% in 2003.

High growth in new loans with real estate collateral.

The most common collateral for insured loans is real estate. Loans with real estate collateral accounted for 12.9% of total new loans in 2005. At 33.7% the growth rate of new loans with real estate collateral was among the highest. Growth in new loans where real estate collateral was just one of the forms of insurance was particularly high, the total of such loans in 2005 being 49.8% higher than in the previous year.

⁵⁶ Bills were issued for the majority of new loans (52.5%), although the bills were largely promissory notes, which meant that they were acting as a means of payment. Loans where bills are used as collateral are therefore classed as unsecured.

Banks reduce their exposure to the risk of changes in the value of collateral when they issue new loans with several forms of insurance. While the volume of new loans with no more than one insurance fell by 0.1% in 2005, the volume of new loans with several insurances increased by 28.5%. New loans with several insurances accounted for 37.6% of total new loans at the eight largest banks last year, compared with just 27.9% in 2003. The most common combination for insured loans last year was a surety and real estate collateral, which accounted for 0.6% of new loans.⁵⁷ The largest number of insurances for a single loan was six, with nine such loans approved by the eight largest banks.

Lower risk with the increase in loans with several forms of insurances.

Table 5.23: Structure of eight largest banks' new loans in terms of type of insurance in percentages

(%)	All insurance			Single insurance		Multiple insurance	
	2004 structure	2005 structure	Growth 2004-05	2005 structure	Growth 2004-05	2005 structure	Growth 2004-05
Unsecured	9.6	9.0	1.9	14.4	1.9		
Unsecured (bills issued)	53.8	52.5	6.4	57.7	0.1	43.8	23.3
Bonds and central bank bills as collateral	0.1	0.0	-46.0	0.0	-88.4	0.1	6.7
Shares as collateral	1.7	2.9	83.8	1.1	232.5	5.9	61.8
Other securities as collateral	1.7	2.3	49.3	2.0	44.8	2.7	55.0
Movable property as collateral	3.4	3.0	-3.5	1.4	-26.6	5.5	11.3
Real estate as collateral	10.4	12.8	33.7	9.8	19.7	17.7	49.8
Warranties	1.1	0.7	-33.0	0.1	-80.7	1.6	-0.3
Bank deposits and certificates of deposit	1.5	0.8	-38.5	0.9	-30.1	0.7	-50.4
Insurer	2.6	2.5	4.0	3.8	5.0	0.3	-12.8
Surety	7.7	6.4	-8.7	4.1	-27.8	10.2	11.0
Otherwise insured	6.6	7.2	20.3	4.7	-9.1	11.4	54.7
Total (SIT billions)	1,780.5	1,941.4	9.0	1,210.8	-0.1	730.6	28.5

Note: All insurance column includes all new loans, single insurance includes those new loans with no more than one insurance, while multiple insurances includes new loans with at least two insurances.

Source: Bank of Slovenia

In addition to loans insured with bank deposits and certificates of deposit, which were down 38.5% from the previous year, other categories of net loans that were lower in 2005 than in 2004 were new loans insured with warranties and sureties. The former were down 33% in 2005, and the latter 8.7%.

Loans to households

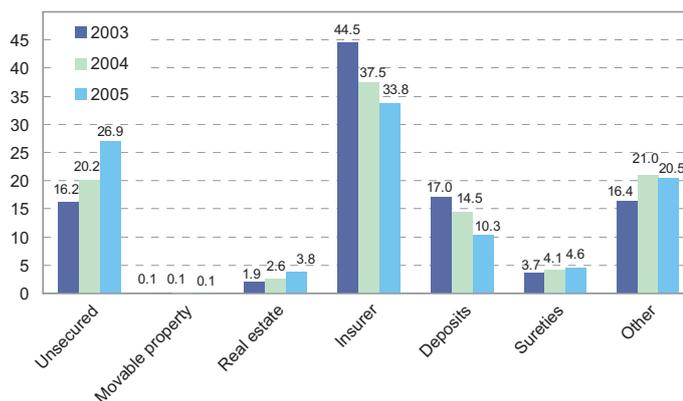
Loans to households accounted for 9% of new loans at the eight largest banks. There are considerable differences between the structure of insurance for consumer loans and for housing loans.

With banks focusing more on the household segment and competition increasing, the quality of insurance for new consumer loans is deteriorating. Approximately one-third of consumer loans were insured with insurers in 2005. This proportion has fallen sharply in the last two years, primarily on account of an increase in the proportion of unsecured loans. These accounted for 26.9% of the total in 2005, 10.7 percentage points more than in 2003. The proportion of consumer loans insured with deposits is also falling, while loans with real estate collateral are increasing rapidly, although these still only accounted for 3.8% of consumer loans in 2005.

With competition increasing, the quality of insurance for consumer loans is deteriorating.

⁵⁷ There were 331 combinations of insurance of various forms in 2005, 47 less than in the previous year.

Figure 5.30: Structure of insurance for new consumer loans at eight largest banks in percentages



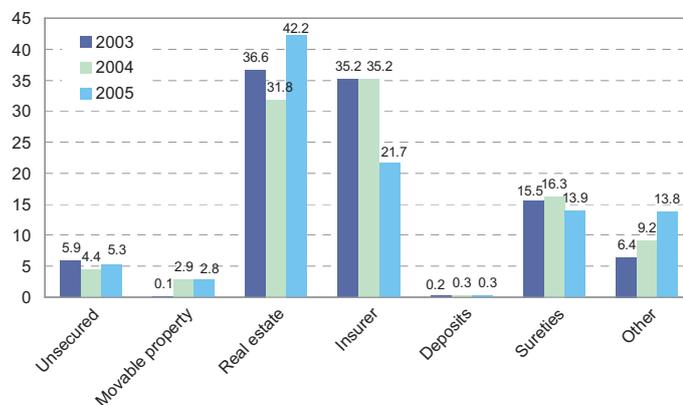
Source: Bank of Slovenia

Housing loans

With the increase in average maturity the proportion of new housing loans with real estate collateral is rising.

Because banks prefer to insure longer-term housing loans with a mortgage on real estate rather than with an insurer, the lengthening of the average maturity of housing loans is also being reflected in the insurance structure. There has been a sharp increase in the proportion of housing loans insured with a mortgage on real estate, this proportion rising by 10.4 percentage points in 2005. A mortgage on real estate was the most common form of insurance for new housing loans at the eight largest banks in 2005, accounting for 42.2%. The proportion of new housing loans insured at insurers fell sharply, by 13.5 percentage points. According to a survey of banks, the proportion of total (new and existing) household loans insured with real estate collateral rose from 18.7% at the end of 2004 to 24.2% at the end of 2005.

Figure 5.31: Structure of insurance for new housing loans at eight largest banks in percentages



Source: Bank of Slovenia

The loan to value ratio for real estate is increasing, with the foreign banks achieving a higher ratio than the domestic banks.

In the survey banks estimate that the loan to value ratio for new housing loans increased from just over 50% in 2001 to 59% in 2005. The loan to value ratio is between 50% and 70% at the majority of banks. However, there are differences between the domestic banks and the foreign banks, in particular the Austrian banks. The loan to value ratio at the domestic banks is just under 57%, while it is 63% at banks under majority foreign ownership (Austrian banks). The loan to value ratio in Slovenia is still lower than in the euro area, where the ratio is estimated at 70% for housing loans.

The rapid growth in housing loans with real estate collateral means that banks' insurance quality is becoming more dependent on price movements on the real estate market. However the loan to value ratio is still relatively low. In addition, banks are combining several forms of insurance for individual loans, so that there is low threat to mortgage loan insurance even in the event of a fall in real estate prices.

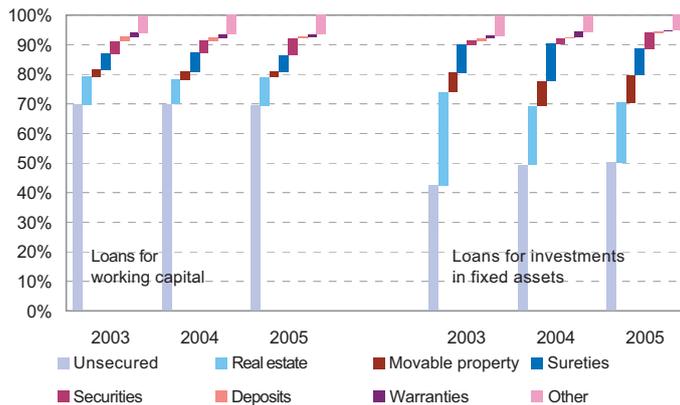
Corporate loans

Loans to companies for working capital account for the majority of new loans: these represented 74% of new loans at the eight largest banks in 2005. These are mostly short-term loans, the vast majority of which are unsecured. The proportion of unsecured loans fell by 0.7 percentage points in 2005, but remains at 70% for new loans for working capital.

More corporate loans are unsecured than household loans.

The majority of new loans for investments in fixed assets are also unsecured (50% in 2005). As these are usually longer-term loans, the use of real estate collateral is of greater importance, and accounted for 20% of these loans in 2005, with movable property collateral and sureties also among the more important forms of insurance, although neither of these accounts for more than 10% of the total.

Figure 5.32: Structure of insurance for new corporate loans at eight largest banks in percentages



Source: Bank of Slovenia

In contrast to household loans, the use of securities as collateral is becoming more common for corporate loans. This form of insurance accounted for less than 1% of new household loans in 2005, but for 5.7% of corporate loans.

The proportion of corporate loans with securities collateral is increasing.

The loan to value ratio for loans with securities collateral is higher than for those with real estate collateral. This is also confirmed by survey results. The average loan to value ratio at the eight largest banks for new corporate loans is 58% for real estate collateral, but 81% for securities collateral.

The loan to value ratio is higher for securities collateral than for real estate collateral.

Structure of insurance for new corporate loans in terms of institutional sector

The structure of new loan insurance varies greatly according to the sector to which the borrower belongs. Companies involved in defence and public administration have by far the highest proportion of unsecured loans from banks. Of the new loans made to this sector in 2005 by the eight largest banks, 74.9% were unsecured. Including the loans insured with bills, 90.5% of all new loans for this sector were unsecured. The sectors of other public services (14.7%) and electricity, gas and water (13%) also have a large proportion of unsecured loans. The institutions and companies in these sectors mostly have government guarantees available to them.

A high proportion of unsecured loans in the sectors of defence and public administration, and electricity, gas and water.

Table 5.24: Breakdown of new loan insurance by sector in percentages

(%)	Unsecured	Unsecured (bills)	Securities	Movable property and real estate	Warranties, deposits and insurer	Sureties	Other
Agriculture	0.4	60.4	8.4	21.5	0.3	7.4	1.6
Mining	8.5	68.4	0.0	20.3	0.1	1.0	1.6
Manufacturing	4.2	62.0	4.2	16.0	0.7	7.0	5.9
Electricity, gas, water	13.0	74.3	0.0	3.1	0.1	4.8	4.6
Construction	1.7	54.8	1.2	20.8	3.2	6.5	11.8
Trade	3.9	64.5	1.3	16.2	1.4	6.3	6.3
Hotels and catering	0.5	45.8	0.2	38.4	1.3	11.0	2.9
Transport and communications	7.2	55.6	0.4	22.5	1.0	7.0	6.2
Financial intermediation	8.2	65.5	6.9	1.2	1.3	1.2	15.8
Real estate and business services	3.5	54.5	19.8	11.9	0.8	4.7	4.8
Public administration and defence	74.9	15.6	0.0	0.5	4.0	5.0	0.0
Education	1.0	70.2	0.0	8.6	2.7	15.7	1.7
Health	3.0	59.0	0.0	20.5	2.7	7.0	7.8
Other public services	14.7	51.4	0.4	9.6	0.6	11.5	11.9

Source: Bank of Slovenia

Banks are approving loans for companies in the hotels and catering sector with real estate collateral and sureties.

The hotels and catering sector has the lowest proportion of unsecured loans. Only 0.5% of new loans to this sector in 2005 were unsecured. Including loans secured with bills, 46.3% of new loans to the hotels and catering sector were unsecured. These companies mostly use real estate collateral when taking new loans, this form of insurance accounting for 36.5% of their new loans in 2005. Sureties, the second-most important form of insurance, accounted for 11% of new loans to companies in the hotels and catering sector.

Apart from hotels and catering, where 38.4% of new loans were insured with real estate or movable property collateral, only in the sectors of transport, storage and communications, construction, health and mining did this proportion exceed 20%. With the exception of the latter, these are also the sectors where the proportion of unsecured loans is lowest.

A high proportion of new loans with securities collateral in the real estate and business services sector.

The real estate and business services sector also has one of the lowest proportions of unsecured loans. This sector has by far the highest proportion of new loans with securities collateral (19.8% in 2005). The proportion is even higher than the proportion of same type of loans to financial intermediation sector, where it reached 6.9% last year.

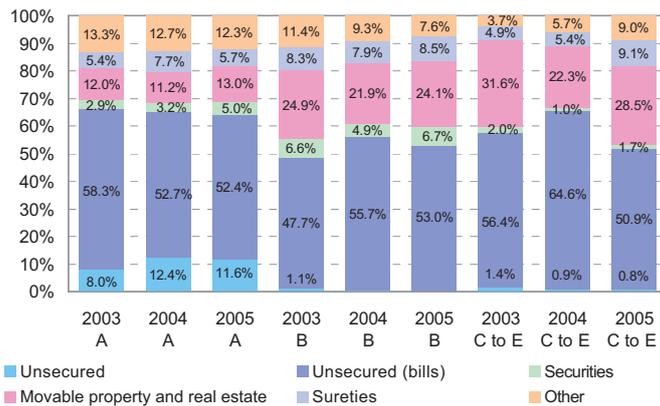
Structure of forms of loan insurance in terms of credit rating

The proportion of unsecured loans decreased in all credit rating categories.

Further evidence that banks are focusing more on the quality of insurance comes from the decline in the proportion of unsecured loans in 2005 in all credit rating categories, with those rated C to E recording the largest decline. At 51.7%, the proportion of unsecured loans in these categories in 2005 was down 13.8 percentage points from the previous year. The proportion of loans insured with bills fell sharply, while the proportion of new loans rated C to E without any form of insurance remained practically unchanged. The fall in the proportion of loans rated A without any form of insurance fell further, by 0.8 percentage points to 11.6%. The proportion of loans in the other categories without any form of insurance is significant lower: 0.1% for B-rated loans, and 0.8% for loans rated C to E.

As the proportion of unsecured loans fell, the proportion of loans with real estate and movable property collateral increased in all rating categories, while there was also an increase in the proportion of bad loans insured with sureties or other forms of insurance.

Figure 5.33: Structure of insurance for new loans at eight largest banks by credit rating categories, 2003 to 2005, in percentages



Source: Bank of Slovenia

5.6 Interest Rate Risk

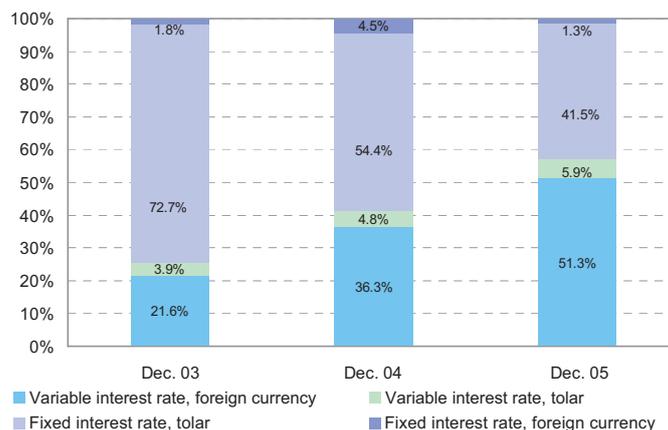
The banking system's exposure to interest-rate risk increased in 2005 primarily as a result of imbalance between the maturity structures of assets and liabilities. The average period of change in assets interest rates lengthened considerably more than of liabilities interest rates, exceeding one year for the first time. Banks are increasing the proportion of items tied to variable interest rates on both sides of the balance sheet, thus reducing their exposure to interest-rate risk. Nevertheless banks are sensitive to changes in interest rates, as in the event of a major rise in interest rates the ability of non-banking sectors to service their debts would fall, increasing the banking system's credit risk.

Interest rate types

The replacement of fixed-interest loans with variable-interest loans continued in 2005 at the same pace as in the previous year.

Further growth in the proportion of new loans with variable interest rates.

Figure 5.34: Breakdown of interest rate types for new loans by eight largest banks in percentages



Source: Bank of Slovenia

The proportion of new loans at the eight largest banks with a variable interest rate rose by 16 percentage points, the same as in the previous year. While variable-interest loans accounted for just one-quarter of new loans at the eight largest banks in 2003, by the end of 2005 the figure was just below 60%.

The proportion of housing loans with a variable interest rate is even higher. In 2005 only 16% of housing loans had a fixed interest rate, with 11% of them being tied to the TOM base rate.

With variable-interest rate housing loans, banks are transferring interest-rate risk to households. However, a rise in interest rates would make it more difficult for households

to make their loan repayments, which would be reflected in an increase in credit risk at banks.

Table 5.25: Breakdown of new housing loans at eight largest banks by type of interest rate in percentages

(%)	Variable interest rate			Fixed interest rate	
	Tolar	Foreign currency	Foreign currency clause	Tolar	Foreign currency
2003	8.6		44.8	46.5	
2004	15.4	14.0	33.5	37.1	
2005	7.5	38.0	38.8	15.5	0.2

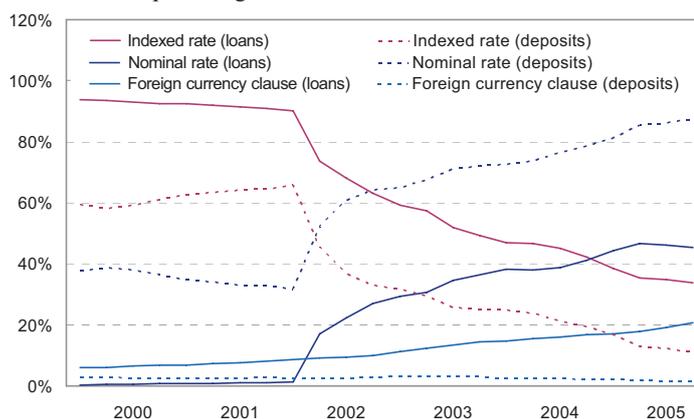
Source: Bank of Slovenia

Almost 90% of new variable-interest rate loans at the eight largest banks are tied to the EURIBOR, mostly the 6-month EURIBOR. Approximately 8% of new variable-interest loans are tied to the LIBOR for the Swiss franc. New loans tied to domestic reference interest rates account for merely a little over 1% of all new variable-interest rate loans at the eight largest banks, a similar proportion to new loans tied to the LIBOR for the dollar.

There is a trend of decline in the proportion of loans tied to the TOM base rate.

Given the long-term nature of loan agreements, the proportion of tolar loans tied to the TOM base rate remains higher than the proportion of deposits with a TOM indexation clause. However the trend is a decline in both. Loans tied to the TOM base rate accounted for 34% of total tolar loans in 2005, but just 11% of deposits. While the proportion of deposits with a foreign currency clause remains relatively stable and negligible, the proportion of loans with a foreign currency clause continues to rise. In 2005 year-on-year growth in the latter was almost 30%, practically double the growth of tolar-denominated loans. Loans with a foreign currency clause already account for more than 20% of tolar loans.

Figure 5.35: Structure of tolar loans and deposits in terms of type of interest rate in percentages



Source: Bank of Slovenia

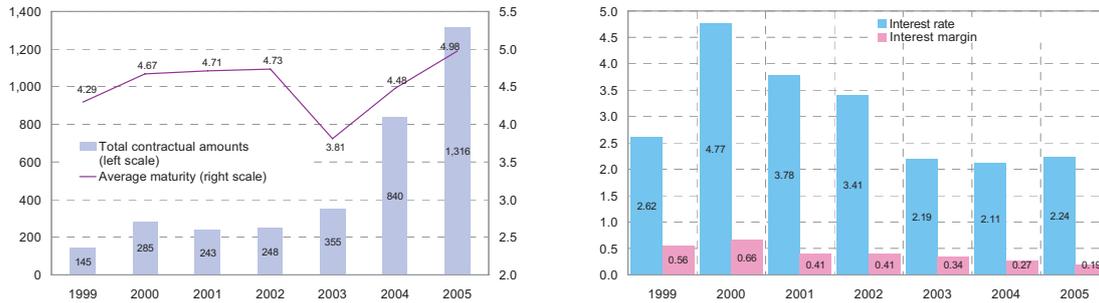
Syndicated loans

Syndicated loans are gaining in importance.

While the foreign banks can obtain financing for their lending activities at their parent banks, the domestic banks (the large banks in particular) have turned towards syndicated loans. After a long period of stability in the volume of syndicated loans, they grew by 137% in 2004, and by a further 57% in 2005. As the average maturity of loans lengthens, banks need for long-term sources of financing is increasing. In two years the average maturity of syndicated loans lengthened by more than 1 year, from 3.8 to 5 years.

The sources of financing that banks are able to obtain also define the conditions under which they approve loans. It is therefore no surprise that almost all syndicated loans are tied to the EURIBOR, mostly the 6-month EURIBOR. The average overall interest rate has remained at a little above 2% for the last three years. The premium on the reference interest rate has fallen considerably, and at 0.19 percentage points is approximately half the level it was in 2003.

Figure 5.36: Total contractual amounts of syndicated loans approved for Slovenian banks in EUR millions and average maturity period in years (left) and average interest rate in percentages and premium over reference interest rate for syndicated loans in percentage points (right)



Source: Bank of Slovenia

Differences between interest-bearing assets and liabilities

Interest-rate risk derives not just from imbalances between the type of interest on assets and liabilities, but also from the difference in the amount of interest-bearing assets and liabilities. Interest-bearing assets averaged SIT 5,965 billions in 2005, up SIT 900 billions or 17.8% from the previous year. Interest-bearing liabilities rose by slightly more in relative terms. They were up 18.9% or SIT 880 billions in 2005 and amounted to SIT 5,534 billions. The difference between average interest-bearing assets and liabilities in 2005 stood at SIT 430 billions, a rise of SIT 20 billions from the previous year.

High growth in interest-bearing assets and liabilities, but no rise in interest-rate risk on this account.

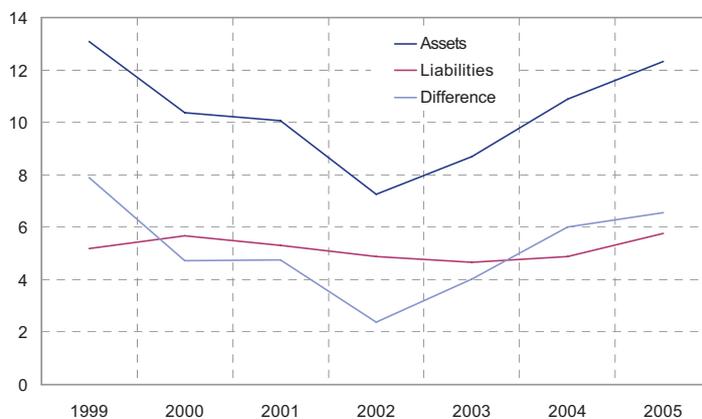
The effect of a permanent change in interest rates of 1 percentage point in 2005 would not have differed significantly from the effect projected in the previous year. The difference between interest-bearing assets and liabilities, which remains slightly above SIT 400 billions, means that a 1 percentage point change in interest rates would be reflected in a change in net interest income of around SIT 4 billions in the same direction. Greater differences would be seen in the short term, which can be explained by the average period of change in interest rates.

Average period of change in interest rates

The rapid growth in loans and lengthening of average maturity is being reflected in the lengthening of the average period of change in assets interest rates. This was extended by a further 1.4 months in 2005 to reach 12.3 months, thus exceeding one year for the first time. The average period of change in liabilities interest rates is also lengthening, the increase of 0.9 months to 5.8 months being attributable in particular to the rapid growth of liabilities to foreign banks. The slow growth in deposits and the shift towards shorter maturities or sight deposits is not having a beneficial effect on the closure of the gap between the average periods of change in assets and liabilities interest rates, which rose by 0.6 months in 2005 to 6.6 months.

The average period for a change in interest rates is lengthening faster on the assets side than on the liabilities side.

Figure 5.37: Average period for change in interest rates in months



Source: Bank of Slovenia

Only one bank still had a longer average period of change in interest rates on the liability side than on the asset side in 2005. Five banks saw the average period of change shorten on

both the asset side and the liability side, while six others saw the average period shorten on the liability side alone. These were mostly the foreign banks and the large domestic banks.

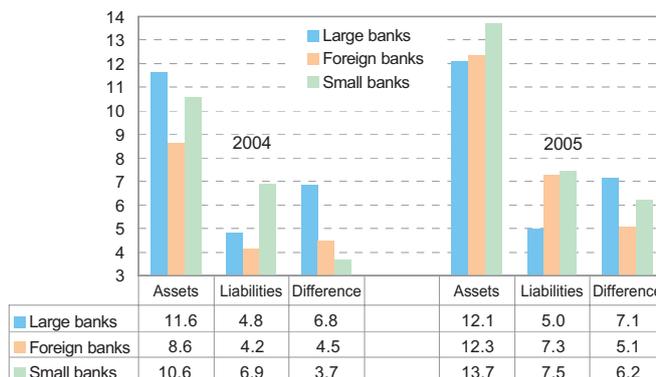
The smaller foreign banks have a particularly long average period of change in interest rates.

There is significant variation within the group of foreign banks. The larger foreign banks, which have been on the market for some time, have similar average periods of changes in interest rate to those of the large domestic banks. The small foreign banks, which are only entering the market, have strong support from their parent banks in securing long-term sources of financing. These banks are focusing on loans to non-banking sectors. Thus a large number of the smallest foreign banks are achieving an average period of change in interest rates that exceeds four years, on either the asset side or liability side, or on both.

The average period of change in assets interest rates at the foreign banks rose by 3.7 months in 2005, while that for liabilities interest rates rose by 3.1 months. The gap between the average periods of change in assets and liabilities interest rates was 0.6 months higher in 2005 at 5.1 months. If the average periods are not weighted with the interest-bearing assets or liabilities at each bank, but merely the ordinary averages are considered, the average period of change in assets interest rates at the foreign banks lengthened by 14.3 months in 2005, while that for liabilities interest rates lengthened by 9.5 months, expanding the gap by almost 5 months.

There was also a sharp lengthening in the average maturity of interest-bearing assets at the small banks: it rose by 3.1 months in 2005, and at 13.7 months was the longest among all groups of banks. The average period of change in liabilities interest rates is also longest at the small banks, but at 7.5 months it is only 0.2 months longer than at the foreign banks. At 7.1 months, the gap between the average periods of change in assets and liabilities interest rates is largest at the large banks. The size of the gap comes from much shorter maturity of interest bearing liabilities compared to other groups of banks: at 5 months it is more than 2 months shorter than at smaller or foreign banks.

Figure 5.38: Average period of change in assets and liabilities interest rates by groups of banks in months



Source: Bank of Slovenia

The banking sector is exposed to a rise in interest rates in the short term.

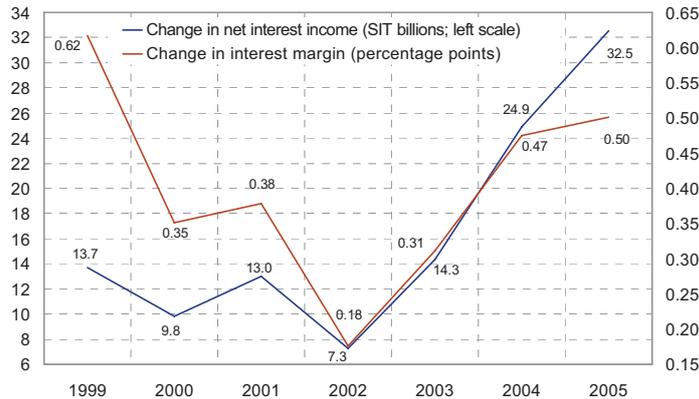
Considering the average period of change in interest rates at the end of 2005, the banking sector is more exposed in the short term to a rise in interest rates. With the period of change in liabilities interest rates considerably shorter than that of assets interest rates, banks' interest expenses would respond sooner to a change in interest rates than interest revenues. In the event of a one-year rise in interest rates by 1 percentage point,⁵⁸ net interest income in one year would fall by nearly SIT 32.5 billions, and the net interest margin by approximately 0.5 percentage points, other conditions remaining the same.

A rise in interest rates by 1 percentage point would reduce net interest income by SIT 32.5 billions (SIT 24.9 billions last year), and the interest margin by 0.5 percentage points (0.47 percentage points last year).

Taking into account the simplified calculation of the average period of change in interest rates for the banking system, the exposure of banks to interest-rate risk therefore increased, as in 2004, given the same rise in interest rates of 1 percentage point, net interest income would have fallen by just SIT 24.9 billions and the interest margin by only 0.47 percentage points.

⁵⁸ Interest rates rise by 1 percentage point and return to the previous level after a period of one year.

Figure 5.39: Change in net interest income and interest margin given 1 percentage point change in interest rates⁵⁹ – fall (rise) in interest rates yields rise (fall) in interest margin and net interest income



Source: Bank of Slovenia

Box 5.3: Change in interest-rate risk during the introduction of the euro

In addition to credit risk and liquidity risk, interest-rate risk is one of the principal risks that banks face in their business activities. The introduction of the euro will bring significant differences in banks' exposure to interest-rate risk. With the introduction of the euro exposures in euros, in tolar with a foreign currency clause in euros and in tolar will all become exposures in euros. When the euro is introduced the SITIBOR will be replaced as a reference interest rate by the EURIBOR. All other contractual reference interest rates will remain unchanged after the introduction of the euro.

The analysis uses interest rate report figures submitted to the Bank of Slovenia by institutions that are obliged to report pursuant to the regulations on reporting by monetary financial institutions. Because banks began reporting under the new requirements in November 2005, the figures used are for the situation as at December 31, 2005. Only interest-sensitive items are considered, and instrument being deemed interest-sensitive if there is a contractually defined interest rate.

A breakdown of the banking system's interest-sensitive asset and liability items in terms of currency and type of interest is given. The time intervals into which the interest-sensitive items are classified are the same as those suggested by the new CAD directive, with an additional category of overnight.¹ Two items of data are taken into consideration when interest-sensitive items are classified into intervals:

- the period for the redefinition of the interest rate²,
- the period remaining to maturity³.

Interest-sensitive items are classified into the shorter of the aforementioned intervals. If there is no figure for the period for the redefinition of the interest rate, the items are classified in accordance with the period remaining to maturity.

The average period for a change in the interest rate is calculated for interest-sensitive asset and liability items. This is considerably shorter for liabilities than for assets. Taking the new time intervals into consideration, the gap between the average period for a change in lending and deposit rates is 11.8 months. Thus the banking sector is more exposed to a rise in interest rates, as banks' interest expenses would respond significantly sooner to a change in interest rates than interest income.

While more than one-half of interest-sensitive asset items are still in tolar, tolar items represent 46.6% of interest-sensitive liabilities. The amount of tolar interest-sensitive items that are index-linked to the TOM base rate on the asset side is double that on the liability side. However, the proportions of interest rates index-linked to the TOM base rate is diminishing on both sides of the balance sheet. There are slightly more interest-sensitive liability items in euros than interest-sensitive asset items in euros. There is a foreign currency clause on 15% of the asset items, but 10% of the liability items. The interest-sensitive liability items in Swiss francs are two-thirds the value of the interest-sensitive asset items. Unlike the foreign currency clause in euros, the foreign currency clause in Swiss francs accounts for more than half of both the asset items and the liability items.

The interest-rate risk for foreign currency items is the same irrespective of whether the instrument is in foreign currency, or if the instrument is in tolar with a foreign currency clause, if the instruments are remunerated using the same reference interest rate. However, interest-rate risk derives not just from imbalances between the type of interest on assets and liabilities, but also from the difference in the amount of interest-sensitive assets and liabilities.

The introduction of the euro will have no impact on the amount of interest-sensitive assets and liabilities. The introduction of the euro will therefore lead to an increase in interest-rate risk deriving from the imbalances between the types of interest

⁵⁹ Interest rates rise by 1 percentage point and return to the previous level after a period of one year.

on assets and liabilities. When the euro is introduced the SITIBOR will be replaced as reference interest rate with the EURIBOR. The movement in other reference interest rates (Slovenian interbank interest rates, interest rates at individual commercial banks, etc.) will track the movement of the EURIBOR as the reference rate. The exception will be interest rates that use the TOM base rate as the reference rate, and interest rates index-linked to the TOM base rate, which will track the movement of inflation in Slovenia.

Interest rates index-linked to the TOM base rate could have a different dynamic to other interest rates, at least in the short term. Other interest rates will move similarly to the EURIBOR, which is expected to increase. However, interest rates tied to the TOM base rate, which represents the 12-monthly average of inflation in Slovenia, will depend on the movement of domestic prices.

Another factor in the increase in interest-rate risk during the introduction of the euro is that there are almost twice as many interest-sensitive assets index-linked to the TOM base rate as there are interest-sensitive liabilities index-linked to the TOM base rate. This could bring about a further decline in banks' interest income. The gap between the average period for changes in lending and deposit rates index-linked to the TOM base rate is 13.7 months, 1.9 months more than the gap between the average period for changes in lending and deposit rates for interest-sensitive items overall.

Table 5.26: Currency structure and average period for change in interest rates⁴ for banking sector

	Currency structure (%)	Average period for change in interest rate (months)
Interest-sensitive assets		18.5
SIT	50.1	24.9
of which index-linked	7.2	27.2
EUR	45.7	12.8
of which foreign currency clause	7.0	30.1
USD	2.3	5.2
of which foreign currency clause	0.0	40.0
CHF	1.7	6.6
of which foreign currency clause	0.9	8.9
Other	0.2	0.8
Interest-sensitive liabilities		6.7
SIT	46.6	5.5
of which index-linked	3.9	13.5
EUR	49.4	8.0
of which foreign currency clause	5.1	19.2
USD	2.4	2.0
of which foreign currency clause	0.0	0.0
CHF	1.3	8.4
of which foreign currency clause	0.8	13.0
Other	0.0	1.3
Interest-sensitive assets - Interest-sensitive liabilities		11.8
SIT	94.5	19.3
of which index-linked	49.5	13.7
EUR	-1.2	4.8
of which foreign currency clause	30.8	10.8
USD	0.6	3.2
of which foreign currency clause	0.0	40.0
CHF	6.7	-1.8
of which foreign currency clause	0.0	-4.1
Other	-0.6	-0.5

¹ There are a total of 14 time intervals, from overnight (the shortest) to over 20 years (the longest)

² The period for the redefinition of the interest rate is the time that elapses between two successive moments for setting the interest rate, which proceeds from the contractually agreed period for the redefinition of the interest rate. In the case of fixed interest rates the field is left blank

³ The period remaining to maturity is defined as the period between the date of the report and the maturity date. For deposits on demand the notice period for the demand is cited, while after the demand is made the period remaining is cited

⁴ The time intervals under the new reporting were used in calculating the average period for a change in interest rates. The mean is used as a weighting for each time interval

5.7 Exchange-Rate Risk

The banking system's exposure to exchange-rate risk measured by the net open foreign exchange position decreased during 2005. As the majority of banks' balance sheet items in foreign currency are denominated in euros, the open foreign exchange position will close significantly with the euro introduction and exposure to exchange rate risk will further decrease.

There are some risk factors, but the majority of them will cease to exist once the euro is introduced, or will be sharply diminished in impact. The first is non-banking sectors' open foreign exchange position against domestic banks, expressed as the ratio of foreign currency loans to deposits. Non-banking sectors hold a short position against domestic banks, which is yet opening. In the event of a major change in the exchange rate (in particular tolar depreciation against euro), banks could see their credit risk rise as a result of non-banking sectors' open foreign exchange position. The second risk factor is the banking system's balance sheet foreign exchange position, which is short and is also opening, in particular with the rapid growth in liabilities to foreign banks. Foreign currency balance sheet items have recorded very high growth in the last year. A risk factor on which the introduction of the euro has no impact is the banking system's exposure to exchange-rate risk caused by the expansion in banks' foreign exchange positions in Swiss francs and in the currencies of former Yugoslav republics.

There are considerable differences between banks. The foreign banks are more willing to assume risks than the other banks. The foreign banks have the more open foreign exchange position, ignoring foreign exchange swaps held with the Bank of Slovenia. This group of banks also has greater exposure in Swiss francs than the other groups. Exposure to exchange-rate risk for items in Swiss francs is greater because the counterparties usually do not have a natural hedge in the form of income denominated in the currency of the loan. In addition, there is considerably more volatility in the Swiss franc exchange rate against the tolar than in the euro/tolar exchange rate. On the other hand, domestic banks are exposed to the former Yugoslavia via capital investments, and will have significantly more open foreign exchange positions than foreign banks after the introduction of the euro.

Open foreign exchange position

The banking system's open foreign exchange position in 2005 remained similar to that in the previous year at SIT 105 billions, or 21.7% of regulatory capital. The large banks slightly lengthened their open foreign exchange position. The open foreign exchange position of the foreign banks shortened by approximately the same amount, while that of the small banks remained at the 2004 level. The movements seen in 2005 continued in a more pronounced manner in the first months of 2006, with the open foreign exchange of the large banks lengthening and that of the foreign banks shortening.

The banking system's open foreign exchange position in 2005 remained similar to that in 2004.

Table 5.27: Open foreign exchange position for different groups of banks

	Amount (SIT billions)			Proportion of capital (%)		
	Dec. 04	Dec. 05	Feb. 06	Dec. 04	Dec. 05	Feb. 06
Open foreign exchange position						
Large banks	102.5	115.1	164.2	34.1	35.7	50.9
Foreign banks	-12.1	-22.5	-42.2	-14.0	-21.7	-40.7
Small banks	12.7	12.8	13.7	24.1	21.6	23.2
Overall	103.0	105.4	135.6	23.4	21.7	27.9

Notes: Branches not included.
The December 2005 figures for regulatory capital are used for February 2006.

Source: Bank of Slovenia

Foreign exchange swaps with the Bank of Slovenia and outright purchases of foreign exchange had a significant impact on the movement of the open foreign exchange position. The Bank of Slovenia made outright purchases of EUR 1,731 millions of foreign exchange in 2005. The net stock of Bank of Slovenia foreign exchange swaps was down by almost SIT 70 billions in 2005. The majority of this decrease was attributable to the foreign banks, which have continued to reduce their stock of swaps with the Bank of Slovenia this year. The small banks also reduced their stock of swaps. In the first two months of this year the foreign banks held just over SIT 1 billions in foreign exchange swaps, while the small banks held no stock of swaps with the Bank of Slovenia. The stock of foreign exchange swaps held by the large banks increased throughout 2005, but an outright purchase from the Bank of Slovenia in December 2005 saw it fall below the level at the end of 2004.

Bank of Slovenia foreign exchange swaps.

Open foreign exchange position after the introduction of the euro

After the introduction of the euro, items denominated in euros will no longer entail any exposure to exchange-rate risk, which will have a significant impact on banks' foreign exchange positions. Taking the figures for December 2005 and February 2006, the elimination of euro items from the foreign exchange position would see the position close entirely at the small banks and the foreign banks to less than 1% of regulatory capital. The position at the large banks would also close significantly, and at SIT 41 billions would

The open foreign exchange position after the euro introduction.

be down two-thirds from its current value as at December 2005. The larger open foreign exchange position of large banks, excluding the euro items, is the result of their capital investments, via which they have significantly expanded their exposure to the former Yugoslavia over the recent period.

Table 5.28: Open foreign exchange position of banks excluding the euro items

	Amount (SIT billions)		Proportion of capital (%)	
	Dec. 05	Feb. 06	Dec. 05	Feb. 06
Large banks	40.9	27.4	12.7	8.5
Foreign banks	-0.8	-0.1	-0.8	-0.1
Small banks	-0.5	-0.3	-0.9	-0.5
Overall	39.6	27.0	8.2	5.6

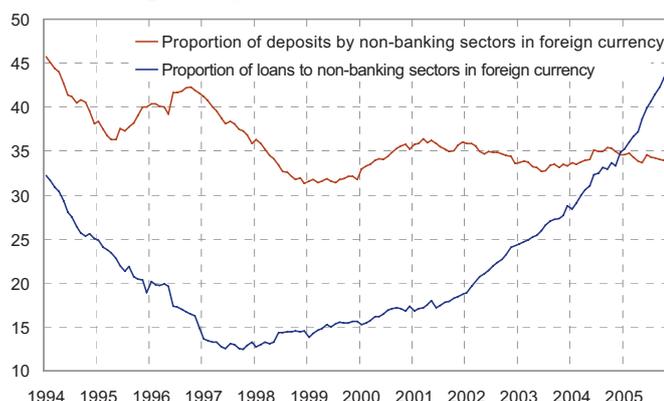
Notes: Branches not included.
The December 2005 figures for regulatory capital are used for February 2006.
Source: Bank of Slovenia

Indirect exposure to exchange-rate risk

The banking system's indirect exposure to exchange-rate risk from non-bank sectors' open foreign exchange position.

The most important, yet difficult-to-measure, risk factor is the banking system's indirect exposure to exchange-rate risk via non-banking sectors. Companies and households have much more imbalanced foreign exchange positions than banks.

Figure 5.40: Proportion of loans to non-banking sectors in foreign currency and proportion of liabilities to non-banking sectors in foreign currency in percentages



Source: Bank of Slovenia

The ratio of foreign currency loans to foreign currency deposits for non-bank sectors rose from 70% to 150% in less than two years.

A look at the proportion of non-banking sectors' loans and deposits in foreign currency shows the imbalance of their foreign exchange positions. While the proportion of deposits by non-banking sectors in foreign currency has been very stable for a long time, partly as a result of the positive spread between tolar and foreign currency interest rates. For the same reason the proportion of loans to non-banking sectors in foreign currency has been rising very rapidly, particularly in the last two years. The ratio of foreign currency loans to foreign currency deposits for non-banking sectors has increased sharply as a result. While foreign currency loans to non-banking sectors were just 70% of foreign currency deposits by non-banking sectors in the middle of 2004, this ratio doubled in less than two years, reaching almost 150% by February 2006.

A major change in the exchange rate, in particular the euro exchange rate, could have a major impact on non-banking sectors, and would be reflected in an increase in credit risk in the banking sector.

Openness of the banking system's foreign exchange position

The banking system's direct exposure to exchange-rate risk is low.

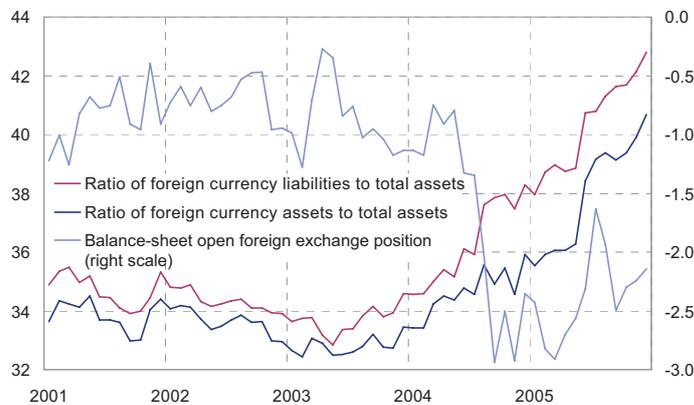
The banking system's direct exposure to exchange-rate risk is not particularly large, which is shown by the closure of the overall foreign exchange position. The exposure to exchange-rate risk will be reduced further by the forthcoming introduction of the euro, as 90% of the foreign currency items in banks' balance sheets are denominated in euros.

However, the banking system's balance-sheet open foreign exchange position is a potential risk factor.⁶⁰ This is significantly more closed than at companies, but has more than doubled in the last two years. After a long period between 2001 and 2003 when the balance-sheet foreign exchange position was relatively closed (short in the amount of 0.5% to 1% of total assets), it shortened sharply in the second half of 2004 and in the early part of 2005, reaching almost 3% of total assets in some months. In addition to high growth in liabilities to foreign banks, year-on-year growth in foreign currency liabilities to non-banking sectors was also high during this period. At the end of 2004 growth in foreign currency liabilities was higher (24.3%) than growth in foreign currency assets (20.6%).

The banking system's open balance-sheet foreign exchange position has shortened sharply in the last two years.

Irrespective of the extremely high growth of 83.3% in liabilities to foreign banks in 2005, the slowdown in growth in foreign currency liabilities to non-banking sectors to 3.9% and the extremely high growth of 63.5% in foreign currency loans to non-banking sectors meant that foreign currency liabilities grew more slowly than foreign currency assets last year. Foreign currency assets were up 39.2% in 2005, while foreign currency liabilities were up 37.5%. The ratio of foreign currency assets to total assets rose by 4.7 percentage points in 2005 to 40.7%, while that for foreign currency liabilities rose by 4.5 percentage points to 42.8%. The open balance-sheet foreign exchange position consequently closed slightly in the second half of 2005, and was short in the amount of 2.1% of total assets at the end of the year.

Figure 5.41: Ratio of foreign currency liabilities and foreign currency assets to total assets, and open balance-sheet foreign exchange position in percentages



Source: Bank of Slovenia

Table 5.29: Year-on-year growth in individual categories of banking system's balance sheet in percentages

(%)	2001	2002	2003	2004	2005
Liabilities to foreign banks	21.7	42.1	51.5	43.6	83.3
Foreign currency liabilities	25.6	12.8	13.2	24.3	37.5
Foreign currency liabilities to non-banking sectors	31.0	6.4	3.5	11.3	3.9
Foreign currency assets	27.5	12.6	12.6	20.6	39.2
Foreign currency loans to non-banking sectors	25.7	48.3	37.7	46.5	63.5

Source: Bank of Slovenia

Balance sheet structure by currency

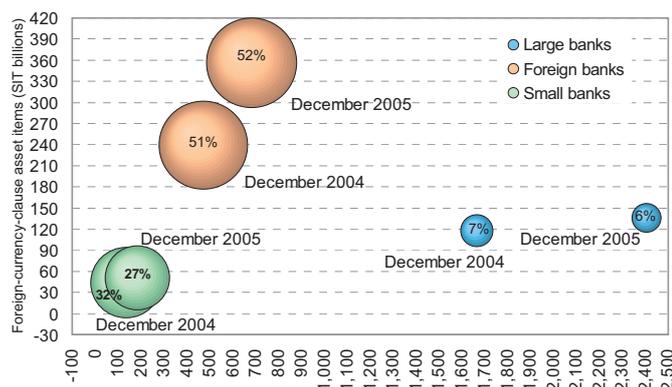
The third risk factor is the shifts in the currency structure of the banking system's balance sheet, in particular the rapid growth in exposure in Swiss francs. The currency structure of the balance sheet also reveals differences in the business policies of the different groups of banks. The foreign banks define the changes and adjustments in supply and are first to offer new products, which the domestic banks then follow with a certain time lag. This is conditioned by the foreign banks' focus on increasing market share on the Slovenian banking market. The foreign banks generally have easier and faster access to capital, which is provided to them by the parent banks to help them expand. As a result, they are more willing to assume risks.

⁶⁰ The open balance sheet foreign exchange position is the difference between foreign currency assets and foreign currency liabilities as a proportion of total assets.

The ratio of items in foreign currency to items with a foreign currency clause is falling at the domestic banks.

The first indicator of the difference in behaviour between the foreign banks and the domestic banks is the ratio of items in foreign currency to items with a foreign currency clause. The foreign banks are recording approximately equal growth in items in foreign currency and items with a foreign currency clause, in excess of 40% in 2005, on both the asset side and liability side of the balance sheet. Items with a foreign currency clause account for more than 50% of items in foreign currency on the asset side at foreign banks, and approximately 10 percentage points less on the liability side. The domestic banks are only recording high growth comparable with that of the foreign banks on items in foreign currency, and this is mainly the large banks, where growth is outstripping that of the small banks. Growth in items with a foreign currency clause at the large banks and the small banks is just one-third to one-half that at the foreign banks. As a result the ratio of items with a foreign currency clause to items in foreign currency is lowest at the large banks, where it stood at 6% in 2005.

Figure 5.42: Ratio of foreign-currency-clause asset items to foreign currency assets items for different groups of banks in SIT billions



Note: The size of the sphere represents the ratio of assets items with a foreign currency clause to items in foreign currency.
Source: Bank of Slovenia

Table 5.30: Currency structure of banking system's balance-sheet items in foreign currency and with a foreign currency clause in percentages

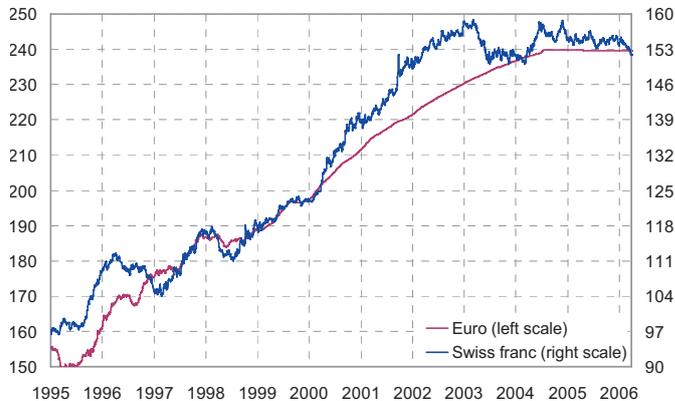
	December 2003		December 2004		December 2005	
	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
Foreign currency						
Structure (%)						
EUR	87.9	88.8	89.2	90.5	89.4	91.5
USD	8.8	8.5	7.3	6.8	6.4	6.0
CHF	1.9	2.0	2.0	1.5	1.9	1.2
Other	1.4	0.7	1.6	1.2	2.4	1.3
Total (SIT billions)	1,756.4	1,822.3	2,272.8	2,406.4	3,273.7	3,455.1
Growth rate (%)	13.3	13.6	29.4	32.1	44.0	43.6
Foreign currency clause						
Structure (%)						
EUR	99.6	99.9	96.6	96.2	88.0	88.8
USD	0.2	0.1	0.0	0.0	0.0	0.0
CHF	0.2	0.0	3.4	3.7	12.0	11.2
Other	0.0	0.0	0.0	0.0	0.0	0.0
Total (SIT billions)	321.3	267.6	400.8	347.7	542.8	440.8
Growth rate (%)	39.8	41.9	24.7	29.9	35.4	26.8

Note: The table includes all asset items minus expected non-payments, all liability items including deferred revenues and accrued expenses, and spot transaction of off-balance sheet items, i.e. Bank of Slovenia foreign exchange swaps are included.
Source: Bank of Slovenia

When taking loans in foreign currency, non-banking sectors have a certain degree of natural hedge against exchange-rate risk in the case of loans in euros. With the projected introduction of the euro at the beginning of 2007, loans in euros will become loans in domestic currency, and will no longer be exposed to exchange-rate risk. The perception of exchange-rate risk diminished well before, as the euro exchange rate has been very stable and predictable for almost two years now.

With regard to loans in Swiss francs, the borrower's income is generally not in the currency of the loan, and the borrower does not have a natural hedge and is exposed to greater exchange-rate risk. Historically there is strong correlation between the tolar exchange rates of the Swiss franc and the euro, but the movement of the two exchange rates can nevertheless differ considerably during certain periods.

Figure 5.43: Movement of tolar exchange rates for Swiss franc and euro

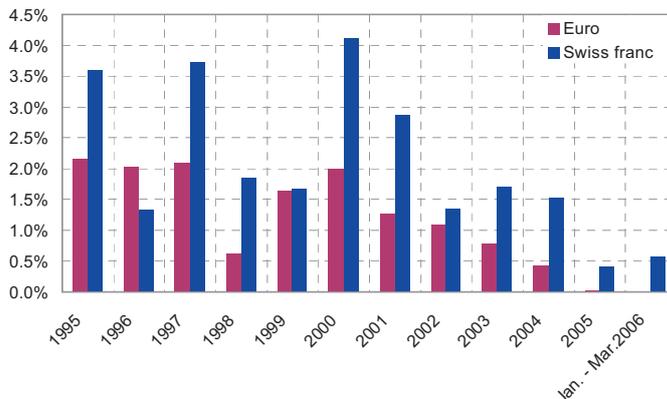


Source: Bank of Slovenia

For loans in Swiss francs, in addition to the currency discrepancy between income and the loan, there is greater risk because the movement of the tolar exchange rate for the Swiss franc is less predictable. The coefficient of variation as measured by the ratio of the standard deviation to the average annual exchange rate has been greater for the Swiss franc exchange rate practically throughout the last ten years than that of the euro exchange rate.

The Swiss franc exchange rate is more volatile than the euro/tolar exchange rate.

Figure 5.44: Coefficient of variation in tolar exchange rates for Swiss franc and euro



Source: Bank of Slovenia

5.8 Liquidity Risk

Bank liquidity as measured by the average of the annual liquidity coefficients in 2005 remained at the same level as in 2004. The coefficients improved slightly in the second half of the year after the amendment of the regulation on the minimum liquidity to be maintained by banks.

However, individual indicators derived from the balance sheet show that bank liquidity, viewed in the long term, is not as favourable as it was in the previous year. The high growth in lending to non-banking sectors in the context of low growth in deposits and a shortening in their average maturity is increasing banks' dependence on the interbank funding, funds from banks abroad in particular. Banks are seeking long-term sources in particular, as the liquidity ladder and foreign currency minimum restrict the financing of loans with short-term loans abroad. The concentration of the largest depositors is increasing, while the volume of secondary liquidity is decreasing.

5.8.1 Liquidity coefficients

The average annual Category 1 and 2 liquidity coefficients remained at the level seen in 2004.

The Category 1 liquidity coefficient, which is the ratio of assets to liabilities maturing in up to 30 days ranged from 1.09 to 1.15 in 2005. It averaged 1.12 over the year, similar to the previous year. The Category 2 coefficient, which covers maturity of up to 180 days, is at a similar level.

Table 5.31: Banking sector's average annual liquidity coefficients

	Overall		Tolar items		Foreign currency items	
	Category 1	Category 2	Category 1	Category 2	Category 1	Category 2
2002	1.07	1.06	0.77	0.96	1.55	1.22
2003	1.13	1.09	0.82	0.92	1.74	1.40
2004	1.11	1.10	0.86	0.99	1.54	1.27
2005	1.12	1.11	0.91	0.98	1.45	1.30
Feb. 2006 ¹	1.13	1.12	0.92	0.98	1.44	1.32

Note: ¹ The figure for February 2006 is the average of the preceding 12 months.

Source: Bank of Slovenia

The Category 1 tolar liquidity coefficient and the Category 2 foreign currency liquidity coefficient rose, while the Category 1 foreign currency liquidity coefficient fell.

Most notable in the comparison of the annual averages is the deterioration of the foreign currency Category 1 coefficient in 2005, primarily because of considerably higher growth in liabilities, which outstripped growth in assets in this part of the liquidity ladder by 7.1 percentage points. The tolar Category 1 and the foreign currency Category 2 coefficients were higher than in 2004. In both cases growth in liquid assets was higher than in 2004, and higher than growth in liabilities, which is particularly the case for the tolar Category 1 coefficient, where growth in assets outstripped growth in liabilities by 5.9 percentage points.

Regulatory changes

With the projected introduction of the euro and the aim of making it easier for banks to switch to the business conditions in the euro area, the Bank of Slovenia continued to adjust the regulation on the minimum liquidity to be maintained by banks.

At the beginning of 2005, serial domestic marketable debt securities were included among the assets included in the calculation of the coefficient, irrespective of the principle of remaining maturity. A provision on foreign currency loans for refinancing was also added at the same time.

A reduction in the mandatory subscription to foreign currency bills.

In the first half of the year the central bank continued with the gradual reduction in the level of mandatory subscription to Bank of Slovenia foreign currency bills as part of the foreign exchange minimum. With the introduction of the euro the Bank of Slovenia will cease issuing bills. The role of central bank securities is already being assumed by other securities, both government securities and first-class foreign securities. The mandatory subscription to foreign currency bills was therefore of diminishing importance. As a result, in 2005 the Bank of Slovenia reduced the level of mandatory subscription to foreign currency bills from 35% to 20%, and then to 10%, before abolishing the requirement entirely in the middle of July. This allowed banks more freedom to manage their securities portfolios.

The elimination of the tolar benefit and weighting of sight deposits.

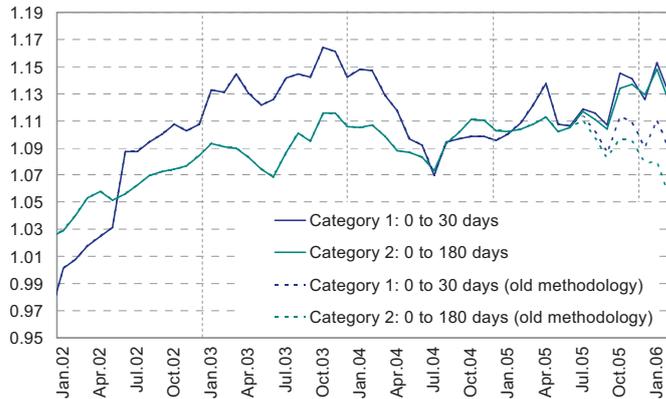
A new minimum liquidity regulation was adopted in the middle of July, its application beginning on 1 January 2006. The abolition of mandatory subscription to foreign currency bills meant that the tolar benefit was also abolished. This was the possibility that banks had of including A-rated tolar investments maturing in more than 180 days in their calculation of the liquidity coefficients for the tolar segment of the liquidity ladder, in the amount of 30% of the subscribed stock of foreign currency bills for Category 1 and up to the subscribed stock of foreign currency bills for Category 2. In addition the new regulation introduces the concept of stable sight deposits. This is the portion of sight deposits that based on past experience will remain unchanged over a longer period, and for which there is no need for banks to secure corresponding liquid assets. Under the new regulation banks can give an 85% weighting to household and corporate sight deposits in Category 1 and a 60% weighting to those in Category 2.

Effects of the changeover to the new minimum liquidity regulation

Even though the new regulation had mandatory application only from 1 January 2006, banks had the possibility of applying it in 2005. Up to the end of the year they could apply the old regulation under which the tolar benefit could be included in the calculation of the liquidity coefficients, but they did not have the possibility of giving weightings to liability items. Eleven banks opted to make an early changeover to calculating their liquidity coefficients under the new regulation.

The changeover to the new minimum liquidity regulation.

Figure 5.45: Liquidity coefficients for Categories 1 and 2 of liquidity ladder based on new and old methodology, monthly averages



Source: Bank of Slovenia

Approximately half of the banks saw a slight decline in their tolar liquidity coefficients as a result of the change in methodology. The weightings given to sight deposits and the consequent reduction in liabilities meant that banks that did not hold a large stock of subscribed foreign currency bills or did not make use of the tolar benefit saw their tolar liquidity coefficients improve. The weightings given to sight deposits entailed an improvement in the foreign currency liquidity coefficients for all banks during the changeover to the new methodology. The banking sector as a whole saw a rise of 3.3% in its liquidity coefficient in Category 1 (up to 30 days) and 4.6% in the coefficient for Category 2 (up to 180 days) in December 2005 owing to the change in methodology. This year, when all banks had changed over to the new methodology, the liquidity coefficient in Category 2 was 7% higher in February.

Changes in liquidity coefficients as a result of the change in methodology.

All the large banks had applied the new regulation before the end of 2005. At the end of the year the effective weighting of sight deposits at the large banks was 85.9% in the category of up to 30 days and 62.4% in the category of up to 180 days. They have remained practically unchanged this year. The effective weighting of sight deposits is slightly higher than prescribed in the regulations because the sight deposits by the government and by non-residents are included in full. The foreign banks were the slowest to change over to the new regulation. This group of banks recorded the highest effective weighting of sight deposits in 2005, at 92% in Category 1 and 79% in Category 2 of the liquidity ladder. Even in this year the effective weighting of sight deposits at the foreign banks remains above that of the system as a whole, which can be attributed in part to the higher proportion of sight deposits held by non-residents.

Effective weighting of sight deposits.

Table 5.32: Effective weightings of sight deposits for different groups of banks in percentages

(%)		Large banks	Small banks	Foreign banks	Overall
0 to 30 days	Dec. 05	85.9	91.7	92.2	87.6
	Feb. 06	85.9	85.7	86.3	85.9
0 to 180 days	Dec. 05	62.4	78.0	79.2	67.0
	Feb. 06	62.3	61.8	63.6	62.4

Source: Bank of Slovenia

Differences between banks

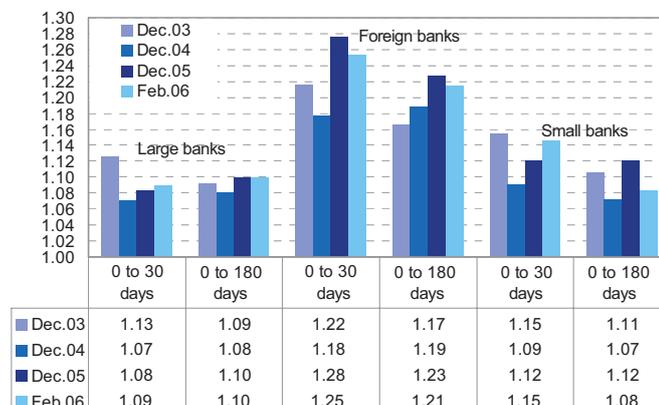
The liquidity coefficients in 2005 were higher than in the previous year at all the different groups of banks. The foreign banks achieved the highest liquidity coefficients in both categories of the liquidity ladder, while the large banks had the lowest coefficients.

The highest liquidity coefficients at the foreign banks, the lowest at the large banks.

Restructuring in the securities portfolio.

The reduction in the requirement to subscribe to foreign currency bills meant that the proportion of foreign currency assets accounted for by foreign currency bills decreased at all but the small banks, which are yet to fully exploit the greater freedom in managing their securities portfolios. All banks recorded a significant increase in their stock of tolar bills, and also moved some of the funds from foreign currency bills into foreign securities. Banks thus recorded high growth in tolar investments, while the rise in foreign currency investments compared to the previous year was lower.

Figure 5.46: Liquidity coefficients for Categories 1 and 2 of liquidity ladder for different groups of banks, monthly averages



Source: Bank of Slovenia

Compared with the other groups of banks, the foreign banks recorded higher growth not only in investment in tolar securities but also in tolar loans to non-banking sectors and in time deposits and sight deposits in Category 1 of the liquidity ladder, while their growth in off-balance-sheet liabilities was negative. The foreign banks were also increasingly active on the interbank market, where they recorded high growth in claims against banks and savings banks. The flow of loans is also beginning to run in the opposite direction, with the Slovenian banks under majority foreign ownership recording high growth in claims against banks abroad.

Domestic banks are also increasing their activities on the interbank market, but mainly on the liability side. Growth in liabilities to domestic banks was high, but growth in liabilities to banks abroad was even higher.

5.8.2 Other liquidity indicators

Liquidity over a longer timeframe is less favourable than last year.

Viewed over a longer timeframe, liquidity is not as favourable as in previous years. In part attention is already being drawn to this by the movement of the liquidity coefficients: were the change of methodology to be excluded, the coefficients would be lower this year, particularly in the category of up to 180 days. Certain other indicators also point to adverse developments in bank liquidity as viewed over a longer timeframe.

Banks are becoming more dependent on sources of financing on the interbank market inside and outside Slovenia.

Given non-banking sectors' higher demand for loans and strong lending activity by banks, the ratio of non-banking sectors' loans to deposits is increasing, as the decline in interest rates means that non-banking sectors are transferring their funds into alternative investments. Furthermore, growth in deposits by non-banking sectors is significantly behind growth in loans, while the average maturity of the loans is lengthening. As a result banks are becoming more dependent on sources of financing on the interbank market, which are more volatile. Should the liquidity in the system deteriorate, this would be reflected more rapidly in the price of financing obtained on the interbank market than in deposits by non-banking sectors. The amount of financing available or access to it could be reduced, even more so given the increasing extent to which Slovenian banks depend on sources of financing from foreign banks. This is particularly the case of the banks under majority foreign ownership, where liabilities to banks abroad in 2005 exceeded liabilities to non-banking sectors by 32%. Even if it is a matter of short-term liabilities to foreign banks, these mostly mature in more than six months, as the proportion of liabilities to banks abroad that Slovenian banks under majority foreign ownership include in the liquidity coefficients is minimal.

The ratio of secondary liquidity to total assets is falling, but more slowly than in 2004.

The ratio of secondary liquidity, i.e. short-term investments in central bank securities, treasury bills and Slovenian and foreign short-term government securities, to total assets continued to fall, albeit more slowly than in 2004. The ratio of secondary liquidity to total

assets was 14% at the end of 2005, down 1.2 percentage points from the end of 2004. Small banks are an exception as their ratio of secondary liquidity to total assets rose slightly in 2005, partly because of the significantly larger proportion of their balance sheets that they hold in the form of bills.

A growing problem for the small banks is the concentration of depositors, which rose sharply in 2005. Deposits by the 30 largest depositors accounted for almost one-half of total liabilities to banks and non-banking sectors in 2005, up from approximately 30% in 2004. The concentration of depositors at the small banks is significantly higher than at the foreign banks, where a concentration of depositors is more expected owing to the greater reliance on the parent banks.

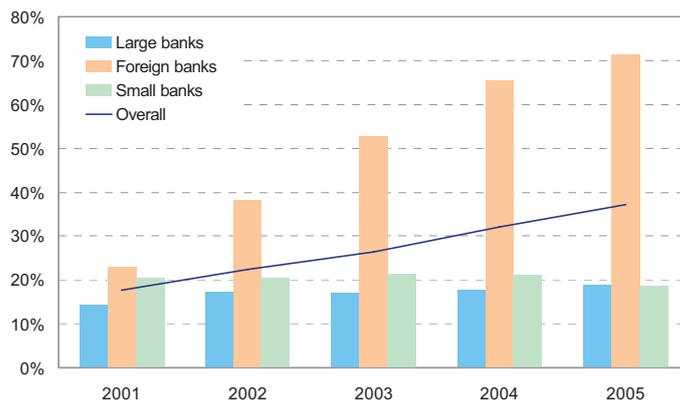
The concentration of depositors is rising, particularly at the small banks, and remains high at the foreign banks.

Table 5.33: Balance sheet ratios illustrating bank liquidity over a longer timeframe

(%)		Large banks	Small banks	Foreign banks	Overall
Ratio of loans to non-banking sectors to deposits by non-banking sectors	2003	72.6	65.7	107.1	77.0
	2004	80.3	67.7	135.4	87.1
	2005	90.3	72.4	162.1	99.4
Ratio of short-term loans to non-banking sectors to deposits of up to 90 days by non-banking sectors	2003	182.2	214.8	173.2	184.0
	2004	138.7	164.2	179.0	147.9
	2005	171.8	185.1	163.9	171.6
Ratio of short-term loans to non-banking sectors to deposits of 90 days to 1 year by non-banking sectors	2003	147.6	167.4	172.4	153.6
	2004	189.3	186.9	325.4	205.3
	2005	204.0	203.2	393.7	226.6
Ratio of liabilities to foreign banks to liabilities to non-banking sectors	2003	15.7	4.9	61.4	21.4
	2004	20.9	6.1	85.3	28.8
	2005	37.3	7.0	132.3	48.5
Ratio of secondary liquidity to total assets	2003	20.9	23.5	24.6	21.9
	2004	14.7	17.6	15.6	15.2
	2005	13.3	18.8	13.8	14.0
Ratio of deposits by 30 largest depositors to total deposits by banks and non-banking sectors	2003	16.7	32.0	28.6	20.7
	2004	15.6	29.5	28.9	19.9
	2005	15.2	48.3	35.0	23.4

Source: Bank of Slovenia

Figure 5.47: Proportion of deposits of 30 largest depositors accounted for by largest depositor in percentages



Source: Bank of Slovenia

The foreign banks remain heavily dependent on a single depositor. The concentration of the largest depositor is increasing, but more slowly than in previous years. The largest depositor accounted for 71.5% of the deposits by the 30 largest depositors at the foreign banks on average in 2005. This was 5.9 percentage points higher than in the previous year. The largest depositor accounted for around 19% of the deposits by the 30 largest depositors on average in 2005 at the large and the small banks: a rise of 1.1 percentage points from 2004 at the large banks, but a fall of 2.4 percentage points at the small banks. At the end of 2005 the deposits by the largest depositor accounted for 24% of all liabilities to banks and non-banking sectors at the foreign banks, 7% at the small banks, and 3% at the large banks.

5.9 Bank Solvency

The banking system's capital adequacy continued to decline in 2005, and the number of banks with low capital adequacy further increased. The main factors in the decline in capital adequacy were the persistently strong lending activity, accelerated growth in capital investments, and banks' reluctance to increase capital owing to expectations of an increase in capital adequacy after the introduction of international accounting standards. There is expected to be an improvement in capital adequacy over the next two years, mainly because of institutional factors. In addition to the introduction of international accounting standards, a change in the methodology for calculating foreign exchange risk adjusted items will have a beneficial impact on capital adequacy in 2006. Capital adequacy will be improved further by the introduction of euro, when items in euros will become items in domestic currency, thus reducing the capital requirements for foreign exchange risk. The improvement in capital adequacy will therefore not be a result of less risky behaviour on the part of banks; on the contrary the effect of the institutional factors could increase their willingness to assume additional risks.

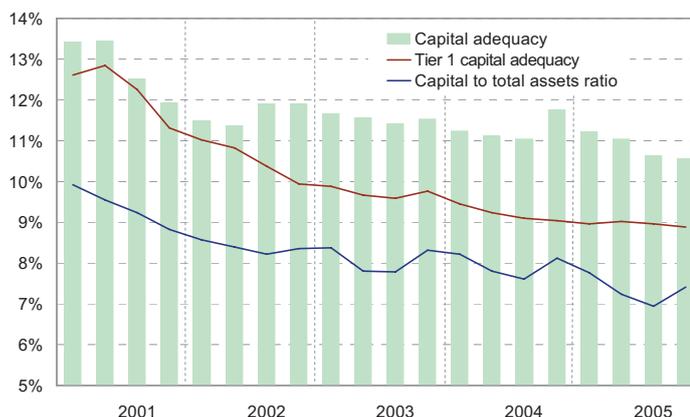
5.9.1 Capital adequacy

The banking system's capital adequacy fell by 1.2 percentage points in 2005 to 10.6%.

The banking system recorded capital adequacy of 10.6% in 2005. It declined throughout the year, ending 1.2 percentage points lower. In recent years there has usually been an improvement in capital adequacy in the second half of the year, primarily through an increase in regulatory capital (recapitalisations, an increase in the level of subordinated debt or hybrid instruments, and an increase in provisions for general banking risk). Given the expectation of the introduction of international accounting standards in 2006, in particular the expectation of an increase in capital with the release of provisions, banks were reluctant to increase their regulatory capital in 2005. This is shown by the ratio of balance-sheet capital to total assets, which even fell below 7% in the third quarter. However, banks continued to record high growth in loans to non-banking sectors, and in addition significantly increased their capital investments.

Tier 1 capital adequacy also declined slightly, but more slowly than overall capital adequacy. Tier 1 capital adequacy is calculated as the ratio of core capital to risk-adjusted assets. It is therefore affected by lending activities, but not by capital investments. Tier 1 capital adequacy stood at 8.9% in 2005, down 0.2 percentage points from the previous year.

Figure 5.48: Capital adequacy, Tier 1 capital adequacy and capital to total assets ratio in percentages



Source: Bank of Slovenia

Differences between banks

Capital adequacy lowest and fastest-declining at the large banks.

The large banks recorded the lowest capital adequacy in 2005 at 10.3%, down 1.6 percentage points from the previous year. The small banks also recorded a significant decline of 0.9 percentage points in capital adequacy to 10.8%. Only the foreign banks succeeded in maintaining their capital adequacy at the level of the previous year, at 11.3%. However, to a great extent this was the result of a newly established bank that commenced to operate in the second half of 2005. Excluding this bank, the foreign banks would also have seen a decline in capital adequacy, which would then be close to the level seen at small banks.

Another factor in the relatively high capital adequacy of the foreign banks was their high growth in regulatory capital, which at 19.7% was more than 9 percentage points higher than growth in the banking sector overall. However, the foreign banks also recorded the lowest growth in total risk-adjusted assets, which at 19.3% was similar to their growth in capital, and therefore there was no significant change in the capital adequacy of this group of banks. The large banks recorded the highest growth in total risk-adjusted assets of 24.1%. Another factor in the decline in capital adequacy at this group of banks was their growth in regulatory capital, which at 7.2% was by far the lowest, 5 percentage points less than at the small banks and 12 percentage points less than at the foreign banks.

Comparing the different groups of banks, it can be seen that by optimising their risk management operations banks are not only reducing their capital adequacy, but also the differences between the banks. While the difference in capital adequacy between the groups with the highest and lowest capital adequacy figures in 2000-2001 (at that time between the large banks and the small banks) was approximately 4.5 percentage points, the difference in 2004-2005 (between the large banks and the foreign banks) was less than 1 percentage point.

The differences between the capital adequacies of the different groups of banks are reducing.

Table 5.34: Capital adequacy for different groups of banks in percentages

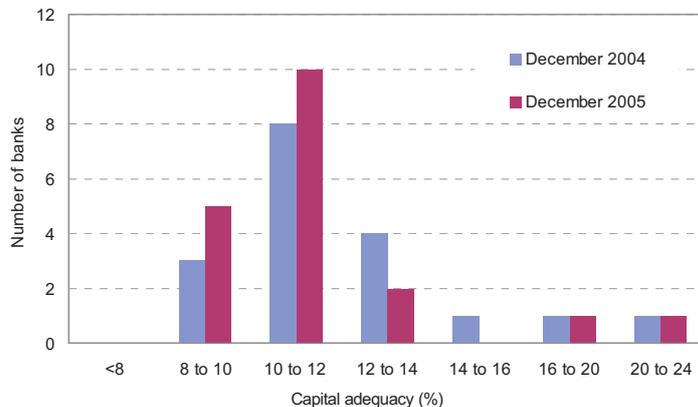
(%)	2000	2001	2002	2003	2004	2005
Large banks	12.2	11.1	11.8	11.3	11.9	10.3
Foreign banks	14.1	12.4	11.2	11.5	11.2	11.3
Small banks	16.7	15.8	13.5	13.2	11.7	10.8
Overall	13.5	11.9	11.9	11.5	11.8	10.6

Source: Bank of Slovenia

The changes in capital adequacy in 2005 were distributed rather asymmetrically. The largest increase was 1 percentage point, while the largest decline in capital adequacy at a single bank was 4.3 percentage points. Only three banks in all had a higher capital adequacy in 2005 than in the previous year: two foreign banks and one small bank. Another foreign bank, which commenced to operate in 2005, can be included in this group. There were 15 banks that saw their capital adequacy decline in 2005, of which four recorded a decline of more than 2 percentage points, and seven a decline of more than 1 percentage point. The distribution in terms of capital adequacy reveals greater concentration of banks with a capital adequacy of 8% to 12%. Only four banks lie outside this group.

The changes in capital adequacy were distributed rather asymmetrically.

Figure 5.49: Distribution of Slovenian banks in terms of capital adequacy



Source: Bank of Slovenia

Comparison with EU

Capital adequacy in the EU stood at 12.3% in 2004, 0.5 percentage points higher than in Slovenia. Compared with the EU overall, capital adequacy in Slovenia is lower for both the banking system as a whole, and also for the different groups of banks, which is primarily the result of the more conservative approach to the calculation of capital adequacy in the regulations. The differences between Slovenia and the EU are smaller for Tier 1 capital adequacy. Tier 1 capital adequacy was around 9% in both Slovenia and the EU in 2004.

Average capital adequacy in the EU is higher than in Slovenia.

Table 5.35: Capital adequacy and Tier 1 capital adequacy in Slovenia and EU for different groups of banks in percentages

(%)	Capital adequacy				Tier 1 capital adequacy			
	2004		2005		2004		2005	
	EU25	EU13	Slovenia	Slovenia	EU25	EU13	Slovenia	Slovenia
Large banks	11.4	12.6			7.9	8.0		
Medium-sized banks	12.5	14.2	11.9	10.3	9.0	10.2	8.9	8.4
Small banks	14.7	17.3	11.7	10.8	12.8	17.3	10.2	9.0
Foreign banks	15.6	16.7	11.2	11.3	12.4	12.3	8.8	10.4
Overall	12.3	13.6	11.8	10.6	8.9	9.2	9.0	8.9

Note: The ECB classes any bank with total assets of more than 0.05% of the consolidated total assets of the EU banking system as a large bank. According to this criterion, there are no large banks in Slovenia.

Source: Bank of Slovenia, ECB: EU Banking Sector Stability, October 2005

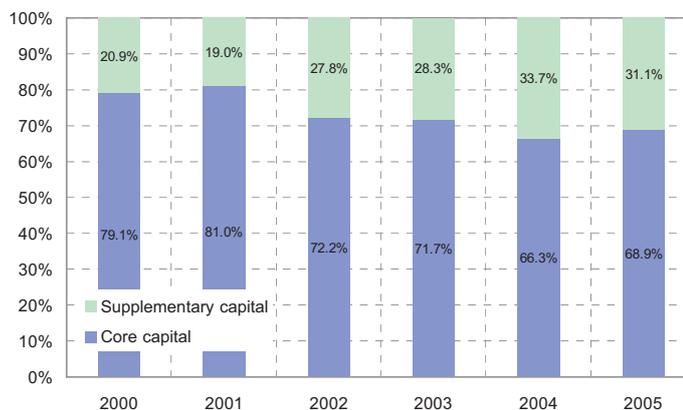
There is considerable variation between the different groups of banks in the EU. Both overall capital adequacy and Tier 1 capital adequacy at the large banks were at the level of the system as a whole in 2004, while capital adequacy at the small banks and the foreign banks (overall and Tier 1) was 2.5 to 4 percentage points higher. In Slovenia the differences between the groups are smaller. None of the groups of banks had a capital adequacy that was more than 1.5 percentage points off the figure for the system as a whole.

5.9.2 Capital

Core capital grew faster than supplementary capital in 2005.

The banking system's regulatory capital stood at SIT 485.3 billions at the end of 2005, up 10.3% from the end of 2004. Banks recorded a significantly larger increase in core capital than supplementary capital in 2005, and the ratio of core capital to total capital before the reductions for capital investments rose by 2.6 percentage points to 68.9% after falling for several years.

Figure 5.50: Banking system's capital structure in percentages



Source: Bank of Slovenia

Core capital

There were three factors in the increase in core capital.

Core capital stood at SIT 408 billions at the end of 2005, up SIT 69.8 billions or 20.7% from the previous year. There were three factors in the increase in core capital.

The foreign banks in particular increased their core capital via share capital and the capital surplus.

The largest increase, of SIT 29 billions, was recorded by subscribed capital and the capital reserves. The foreign banks in particular increased their core capital in this way. Their core capital ended the year up 40.6% or SIT 27.5 billions. More than three-quarters of the increase, or SIT 21.1 billions, was from an increase in subscribed capital and the capital reserves. Seven banks carried out recapitalisations in 2005, of which four were foreign banks, two were large banks, and one was a small bank. The increase in subscribed capital totalled SIT 7.8 billions, with the remainder of the increase – just over SIT 21 billions – coming from an increase in the capital reserves made by share premium. The recapitalisations of the foreign banks accounted for 73% of the total recapitalisation of the banking sector in 2005. This shows that the domestic banks have more difficulty in accessing new capital both because of their diversified ownership and their weaker links with potential investors, particularly in comparison with the foreign banks. The latter usually have highly concentrated ownership: usually a parent bank that is ready to support a strategy of expanding into new markets and increasing market share with the capital increase.

The domestic banks are mainly seeking room to expand their core capital via reserves from profit and retained earnings. These items rose by SIT 20.5 billions during 2005. The good performance by banks was reflected in a significantly higher level of net profit for the current year and retained earnings. These two items together amounted to SIT 4.1 billions in 2005, up SIT 2.5 billions from 2004. Profit reserves were also higher, the increase of SIT 18 billions being similar to that in the previous year.

The domestic banks increased reserves from profit and retained earnings.

In 2005 banks were given the opportunity for the first time to include innovative instruments in their core capital, up to an amount of 15% of core capital. One bank took the opportunity to do so.

In 2005 banks were first given the opportunity to include innovative instruments in their core capital.

Because the introduction of the IFRS in 2006 means that banks no longer create provisions for general banking risk, last year banks curbed the expansion of their general provisions to a minimum. The general provisions were up just 2.7%, compared with a 35.5% increase in the previous year.

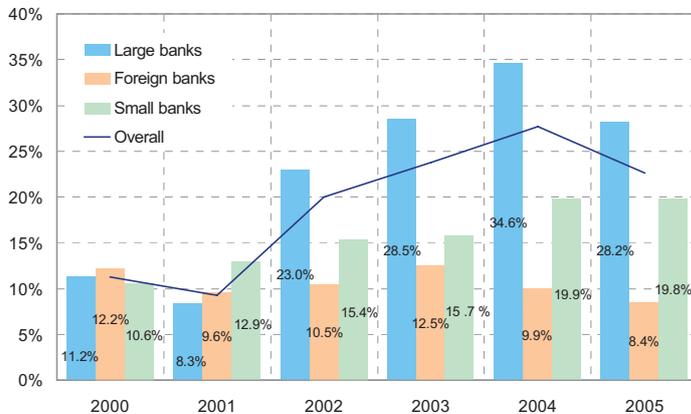
Supplementary capital

The projected introduction of the IFRS could also be said to have had an impact on banks' decisions regarding subordinated debt and hybrid instruments. There was significantly lower increase in supplementary capital in 2005 than in the previous year. It stood at SIT 184.5 billions at the end of the year, up SIT 12.5 billions or 7.2% from the previous year. By comparison, the year-on-year increase in supplementary capital in 2004 was 42%.

The increase in supplementary capital came primarily from hybrid instruments, while the amount of subordinated debt was lower than a year earlier. Subordinated debt totalled SIT 92.2 billions at the end of 2005, down SIT 1.3 billions or 1.4% from the previous year. Eight banks recorded a decrease in subordinated debt in 2005, while three recorded an increase. These banks were divided equally between the different groups of banks. The large banks saw their subordinated debt fall by SIT 3.2 billions, while the foreign banks and the small banks recorded increases, the first in the amount of SIT 1.3 billions and the second in the amount of SIT 0.6 billions.

Banks reduced their subordinated debt in 2005.

Figure 5.51: Ratio of subordinated debt to core capital in percentages



Source: Bank of Slovenia

The decrease in subordinated debt, and even more so the significant increase in core capital, also reduced the problems that banks had in including subordinated debt in the calculation of capital adequacy. In 2004 five banks were unable to include their subordinated debt in full, as it had exceeded the prescribed limit of 50% of core capital. Subordinated debt was more than 40% of core capital at a further three banks. In 2005 there were five such banks, but only at one bank did subordinated debt total more than 50% of core capital, thus preventing the bank from including it in full in the capital adequacy calculation. The overall subordinated debt of the banking sector was equivalent to 22.6% of core capital in 2005, down 5 percentage points from the previous year. The ratio fell at the large banks in particular, by more than 6 percentage points to 28.2%. There was also a slight decline at the foreign banks, which have the lowest ratio of subordinated debt to core capital at 8.4%. There was no change at the small banks, where the ratio remained a little under 20%.

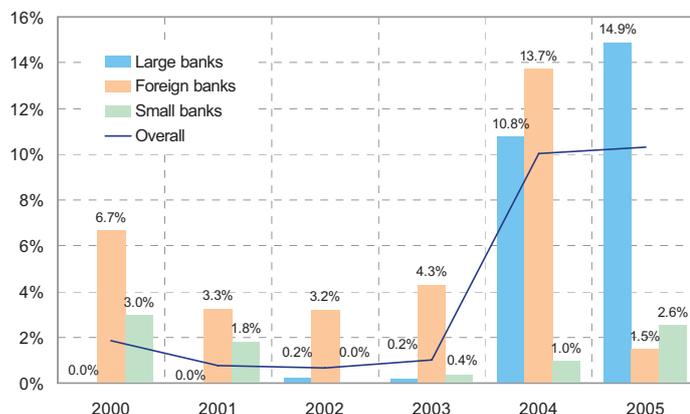
The increase in supplementary capital in 2005 came primarily on account of hybrid instruments. The stock of hybrid instruments in supplementary capital was SIT 42 billions at the end of 2005, equivalent to just under a half (45.5%) of the subordinated debt. The stock of hybrid instruments was up SIT 8 billions or 23.7% from the previous year. The year-on-

Hybrid instruments are equivalent to just under a half of the subordinated debt.

year growth was thus only a little higher than that of core capital, and the ratio of hybrid instruments to core capital thus remained similar to that in the previous year at 10.3%.

The majority of the increase in the stock of hybrid instruments came at the large banks, while the foreign banks recorded a significant decrease. Overall more banks recorded a decrease in the stock of hybrid instruments (three) than an increase (two). There has been a reversal in the situation since 2004, when banks first began using hybrid instruments in earnest and the stock increased by SIT 30.8 billions. At that time four banks increased their stock of hybrid instruments, while only one recorded a decrease.

Figure 5.52: Ratio of hybrid instruments to core capital in percentages



Source: Bank of Slovenia

Deductions from own funds

High growth in capital investments is reducing banks' capital adequacy.

Deductions for capital investments subtracted from the total of core and supplementary capital are following the growth in capital investments. After several years of restraint, banks increased their capital investments by 52.5% in 2005, the highest end of year annual growth since Slovenia's independence. This reduced regulatory capital by SIT 107 billions, 52.8% more than in the previous year. Approximately 90% of the decrease was associated with the large banks.

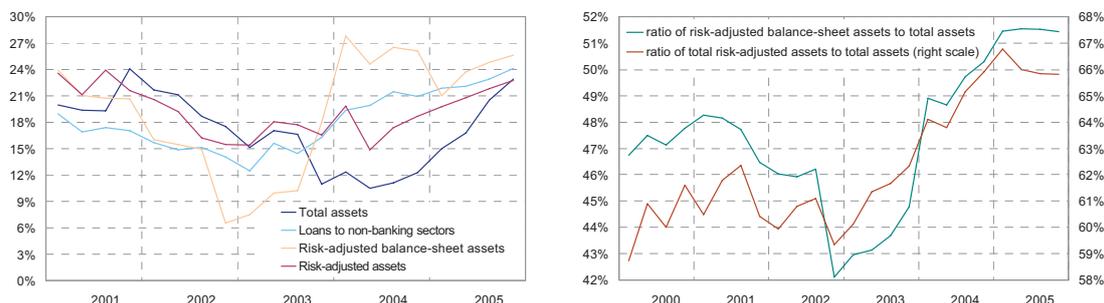
5.9.3 Risk-adjusted assets

The differences between the year-on-year growth rates in total assets, loans to non-banking sectors, risk-adjusted balance-sheet assets and total risk-adjusted assets were very large in 2004. By the end of 2005 the year-on-year growth rates in these categories had converged into a very narrow band of 3 percentage points, between the 22.8% growth recorded by total risk-adjusted assets, and the 25.7% growth in risk-adjusted balance-sheet assets.

Banks maintained the balance sheet structure seen in 2004, and did not increase their focus on higher-risk categories as they did in 2004.

The small differences between the rates of growth in the balance-sheet categories and the risk-adjusted categories indicate that banks have not significantly altered their strategies, or made any important substitutions between lower and higher-risk items on the balance sheet. While in 2004 banks recorded a significant increase in the proportion of the balance sheet accounted for by higher-risk items, i.e. loans to non-banking sectors and loans to banks, both primarily at the expense of lower-risk securities (central bank securities in particular), in 2005 the structural shares remained at the last year levels. Because there were no major shifts in the structure of the balance sheet, risk-adjusted assets grew at approximately the same rate as balance-sheet items, while the ratio of risk-adjusted balance-sheet assets to total assets remained at 51.5% after two years of rapid growth. The trend of an increase in the ratio of total risk-adjusted assets to total assets also reversed in the second half of the year. The ratio ended 2005 just below 66%, as it was at the end of 2004.

Figure 5.53: Year-on-year growth in total risk-adjusted assets, risk-adjusted balance-sheet assets, total assets and loans to non-banking sectors (left), and ratios of risk-adjusted balance-sheet assets and total risk-adjusted assets to total assets (right)



Note: Total risk-adjusted assets include items adjusted for foreign exchange risk and market risk.
Source: Bank of Slovenia

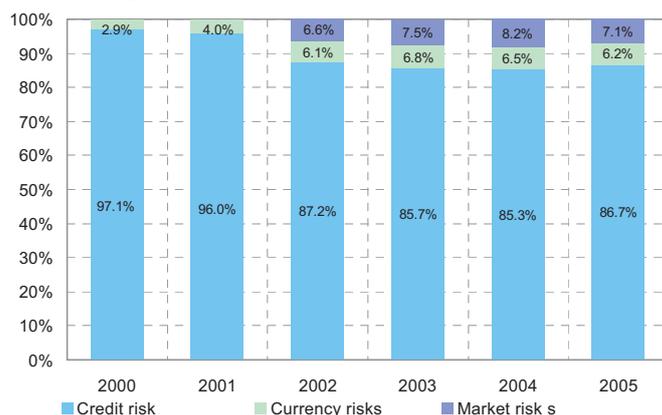
The trend of a decline in the proportion of the banking sector's total risk-adjusted assets accounted for by items associated with credit risk reversed in 2005. The proportion of credit-risk-adjusted items rose by 1.4 percentage points to 86.7%. Risk-adjusted balance-sheet assets recorded particularly high growth of 25.7% in 2005, while growth in risk-adjusted off-balance-sheet assets was 17.9%, and growth in risk-adjusted items for derivatives was negative at -9%. The majority of the increase in the proportion accounted for by credit-risk-adjusted items was the result of a decline of 1.1 percentage points in the proportion of market-risk-adjusted items. The proportion accounted for by foreign exchange-risk-adjusted items also declined by 0.3 percentage points.

Credit risk increased in importance in 2005 at the expense of market risk and foreign exchange risk.

The proportion accounted for by credit-risk-adjusted items increased at the foreign banks in particular, where it rose by 6.3 percentage points to account for 90.9% of the foreign banks' total risk-adjusted assets. The small banks also recorded high growth in the proportion of credit-risk-adjusted items. It rose by 5 percentage points in 2005, but the small banks nevertheless still have the lowest proportion of credit-risk-adjusted items. The increase in the importance of credit risk at the small banks was due to a decline in the importance of market risk, while at the foreign banks it was foreign exchange risk that declined in importance.

The importance of credit risk is increasing at the foreign banks in particular, and also at the small domestic banks.

Figure 5.54: Structure of risk-adjusted assets, plus items adjusted for other risks⁶¹ in percentages



Source: Bank of Slovenia

⁶¹ The large shifts in the structure of the amount of risk-adjusted assets and items adjusted for other risks in 2002 were the result of the introduction of capital requirements for market risk and changes in the capital requirements for foreign exchange risk.

Foreign exchange risk is increasing in importance at the large banks.

The change in the structure of total risk-adjusted assets at the large banks reflects their increased focus on new markets, particularly those in south-eastern Europe. In 2005 the large banks were the only group where the proportion of foreign exchange-risk-adjusted items rose, the increase of 2 percentage points to 6.6% making this share the largest among the different groups of banks. The proportions of both credit-risk-adjusted items and market-risk-adjusted items fell at the large banks in 2005.

Table 5.36: Structure of risk-adjusted assets plus items adjusted for other risks, for different groups of banks, December 2004 and December 2005

	December 2004 (%)			December 2005 (%)			Difference (percentage points)		
	Credit risks	Currency risks	Market risks	Credit risks	Currency risks	Market risks	Credit risks	Currency risks	Market risks
Large banks	86.7	4.6	8.6	86.1	6.6	7.3	-0.6	2.0	-1.3
Foreign banks	84.6	12.8	2.6	90.9	5.9	3.2	6.3	-6.9	0.6
Small banks	78.4	6.0	15.6	83.4	4.7	12.0	5.0	-1.3	-3.7
Overall	85.3	6.5	8.2	86.7	6.2	7.1	1.4	-0.3	-1.2

Source: Bank of Slovenia

Increase in capital adequacy due to institutional factors

Capital adequacy will increase significantly in 2006 and 2007 because of the introduction of the IFRS and the euro.

It is estimated that capital adequacy will also improve in the next two years because of the introduction of the IFRS, which is increasing banks' capital, and also because of the projected introduction of the euro and methodological changes associated with foreign exchange risk, which will decrease the foreign exchange-risk-adjusted items, and thus total risk-adjusted assets. All the above are institutional factors. The expected improvement in capital adequacy will therefore not be the result of less risk-incurring behaviour by banks; on the contrary the effect of all these factors could actually encourage changes in bank behaviour, particularly in the direction of a greater willingness to assume additional or greater risks. A large increase in capital adequacy also provides potential for lending growth. Should due to competitive pressures this potential very rapidly convert into new loans, even at the expense of a decline in the standards for approving new loans and with the introduction of new loan products that would transfer greater risk to the borrower, then this could lead to the lending market overheating.

Box 5.4: The effect of methodological changes and the introduction of the euro on foreign exchange-risk-adjusted items

The projected introduction of the euro in 2007 will bring a significant decrease in foreign exchange risk, as other currencies account for less than 29% of foreign exchange risk-adjusted items. The total of items associated with foreign exchange risk has already been decreasing in 2006, owing to a change in methodology, which is being brought into line with the capital directive. The new methodology no longer distinguishes between items in foreign currency and items with a foreign currency clause. Another change is that the overall position in foreign currency is no longer the total of the absolute values of all short and all long positions, but is equal to the greater of the total of all long positions and the total of all short positions.

Applying the new methodology, on the basis of the figures for December 2005 the total of foreign exchange-risk-adjusted items would decrease by SIT 67 billions, and the capital adequacy of the banking system would be 0.16 percentage points higher. The effect would be relatively evenly distributed between the different groups of banks. Capital adequacy would increase by 0.17 percentage points at the large banks, and by 0.13 percentage points at the foreign banks.

With the introduction of the euro, items in euros will become items in domestic currency, and will no longer be included in the risk-adjusted assets within the currency-risk-adjusted items. Based on the figures for the end of 2005, the introduction of the euro will have most beneficial impact on the foreign banks, which have larger positions in euros. The effect will not be even for the different groups of banks. Based on the figures for December 2005, the elimination of euro items would bring a rise of 0.56 percentage points in capital adequacy at the foreign banks, while the increase will be approximately 0.2 percentage points less at the large banks and the small banks.

Table 5.37: Estimated effect on capital adequacy of change in methodology for calculating foreign exchange-risk-adjusted items and of introduction of euro

	Capital adequacy (%)	Change in capital adequacy caused by change in methodology (percentage points)	Change in capital adequacy caused by elimination of euro items (percentage points)	Capital adequacy after changes (%)
Large banks	10.31	0.17	0.37	10.85
Foreign banks	11.29	0.13	0.56	11.98
Small banks	10.82	0.14	0.36	11.32
Overall	10.56	0.16	0.41	11.13

Source: Bank of Slovenia

Based on the figures for December 2005, the overall effect of the change in methodology and the introduction of the euro will be an increase in capital adequacy of 0.57 percentage points from 10.56% to 11.13%. The total of foreign exchange-risk-adjusted items would decrease by SIT 233 billions. This would mean that in case of unchanged capital adequacy banks' potential for loan growth would increase by the aforementioned SIT 233 billions. Approximately 67% of this potential would be realised at the large banks, 23% at the foreign banks, and 10% at the small banks.

6 NON-BANKING FINANCIAL INSTITUTIONS

6.1 Insurers

6.1.1 Features

Insurers performed better in 2005 than in 2004.

In 2005 insurers performed more successfully than in 2004. Life, non-life and health insurance generated SIT 345 billions in gross premiums, an increase of 9% over the previous year. Reinsurance companies likewise increased their volume of gross premiums by 9% to just under SIT 39 billions. Insurers increased their net technical provisions by 12% to SIT 505 billions, with their coverage by investment of assets covering technical provisions rising again to stand at 117.5%, as compared with 114.4% in 2004. The claims ratio for insurers improved in 2005 to stand at 0.59. The same applies to reinsurance companies, which improved their claims ratio last year to 0.49. Return on equity⁶² for insurers grew markedly to stand at 8.4%, compared with just 3.3% in 2004. A modest improvement in ROE was also observed for reinsurance companies, which recorded returns of 10.9% in the first three quarters of 2005, compared with 10.6% in 2004. Last year insurers' ROA increased to 1.28%, while for reinsurance companies it rose to 3.34%. At the end of 2005 there were 14⁶³ insurers and two reinsurance companies based in Slovenia, and two branches of non-resident insurers.

Concentration remains relatively high.

Concentration in the insurance sector remains at a relatively high level. The market share of the biggest insurance company in terms of collected premium remains on the same level as the previous year, at 43%, while the market share of the biggest reinsurance company fell by five percentage points to 55%⁶⁴. The biggest non-life insurance company covers 40% of the market for non-life insurance, the biggest life insurance company has a 50% market share for life insurance, and the biggest health insurance company holds as much as 80% of the health insurance market.

Table 6.1: Gross premiums collected by insurers in SIT billions, structure and annual growth in percentages

	2001	2002	2003	2004	2005
	Insurance companies				
Premium (SIT billions)	223	255	285	318	345
Growth rate of premium (%)	17	15	12	12	9
Structure of premium (%)					
Life insurance	19	20	21	23	25
Health insurance	26	26	24	22	20
Non-life insurance	55	55	55	55	55
Growth rate (%)					
Life insurance	27	19	13	24	15
Health insurance	16	13	6	-1	-1
Non-life insurance	16	14	12	12	9
	Reinsurance companies				
Premium (SIT billions)		29	29	36	39
Growth rate (%)			2	21	9

Source: ISA

Last year saw a continuation of the 2004 trend for collected premium. The premium collected for voluntary health insurance fell again by 1%, and consequently the proportion of health insurance in collected premium fell to 20%. The growth in collected life insurance premium eased slightly to 15%, but the proportion collected premium that they account for

⁶² For insurers as well as reinsurance companies, ROE and ROA are calculated from profits after taxes.

⁶³ Of the 14 insurers, eight offered both non-life insurance and life insurance (including two that also offered health insurance), three offered only non-life insurance, one exclusively life insurance and two offered only health insurance. At the beginning of 2005 the insurer Slovenica was split into non-life and life divisions, which gave rise to the new insurer Slovenica Življenje. At the end of 2005, the merger of the Slovenica non-life division with Adriatic, another insurer, formed the new insurer Adriatic Slovenica.

⁶⁴ This figure relates to the end of the third quarter of 2005.

rose to 25%. Behind this comes premium collected for motor-vehicle liability insurance (21%) and premium for voluntary health insurance (20%). In 2005 the ratio of collected premium to disposable household income increased again over the previous year and stood at 11.6%. Collected premium per capita grew by just under SIT 173,000. Life insurance premium collected in 2005 amounted to 1.3% of GDP, and rose from SIT 37,200 to SIT 42,600 per capita.

Table 6.2: Total gross collected premium and gross life insurance premium in different economic categories

	2001	2002	2003	2004	2005
Total premium (SIT billions)	222.5	255.5	285.4	318.3	345.4
Per capita (SIT thousands)	111.7	128.0	142.9	159.4	172.6
Proportion of GDP (%)	4.7	4.8	5.0	5.1	5.3
Proportion of disposable income (%)	10.2	10.6	10.9	11.1	11.6
Life insurance premium (SIT billions)	44.5	52.9	59.9	74.2	85.2
Per capita (SIT thousands)	22.3	26.5	30.0	37.2	42.6
Proportion of total premiums (%)	20.0	20.7	21.0	23.3	24.7

Sources: ISA, SORS, own calculations

Comparison of collected premium of Slovenian insurers to collected premium in European countries

The total collected premium of Slovenian insurers in 2004 amounted to 5.1% of GDP, with the gap behind the collected premium as a proportion of GDP in the European Union as a whole (EU25) being reduced to 3.1 percentage points. Slovenia has higher collected premiums as a proportion of GDP than all the new member-states and Greece, but is behind the other member-states.

Life insurance in Slovenia is less developed than in other European countries. At 23.3% in 2004, life insurance still accounted for a relatively small proportion of the total premium collected by insurers. In the EU25 this proportion amounted to 59.3% in 2004. In 2004 the difference between Slovenia and the EU25 in the share of collected life insurance premiums in total collected premium was reduced by 0.8 percentage points to 36%. The same applies to life insurance premiums measured as a percentage of GDP, which in Slovenia grew by 0.1 percentage points to 1.2% of GDP in 2004, which is still far below the EU25 average, where collected life insurance premium as a proportion of GDP remained unchanged in 2004 at 4.9% of GDP. In Slovenia collected life insurance premium is growing more rapidly than in the EU25. In view of the relative lack of development of life insurance compared with the EU, there is still great development potential for life insurance in Slovenia. For this reason we may expect the further growth of collected life insurance premium, and an increase in their share of total collected premium.

The gradual reduction in the life insurance development gap behind the EU25 is continuing.

Table 6.3: Total gross collected premium and gross life insurance collected premium in 2004 in various economic categories in selected European countries

	Slovenia	EU15	EU25	Czech Rep.	Greece	Portugal	Germany	France	UK
Total premium (EUR billions)	1.33	883.21	899.13	3.53	3.63	10.61	153.80	158.58	232.34
Per capita (EUR)	667	2,199	1,874	346	337	1,041	1,840	2,591	3,610
Proportion of GDP (%)	5.1	8.5	8.2	4.1	2.2	7.5	6.9	9.4	12.5
Life insur. prem. (EUR billions)	0.31	527.25	533.25	1.38	1.73	6.30	68.32	104.82	152.64
Per capita (EUR)	156	1,341	1,135	136	161	618	822	1,731	2,569
Proportion of total premium (%)	23.3	59.7	59.3	39.3	47.7	59.4	44.4	66.1	65.7
Proportion of GDP (%)	1.2	5.1	4.9	1.6	1.0	4.5	3.1	6.3	8.9

Sources: ISA, Swiss Re (Sigma: World insurance in 2004, No 2/2005), own calculations

Life insurance and contractual integration of insurers with banks

The increasing importance of life insurance is evident from the rising total assets of life insurance policies, which accounted for 47% of insurers' total assets in 2005. In the previous year the proportion of life insurance in the total assets of insurers was five percentage points less at 42%. In the environment of low interest rates, traditional life insurance became less attractive. Moreover insurers in Slovenia do not offer investment-based life insurance with guaranteed returns, for which reason there is continuing growth in the importance of life insurance with investment risk. Collected premium of life insurance tied to mutual fund units represented 22.5% of all collected life insurance premium at the end of 2005. In March 2006 there were nearly 40 different insurance policies tied to mutual

The importance of life insurance with investment risk is growing.

fund units being offered by nine insurers and one non-resident insurer. The mutual funds involved in investment-based policies are dominated by non-resident and domestic funds whose portfolios comprise primarily foreign securities or an increasing proportion of such securities. For this very reason interest in this type of insurance will in the future depend to a lesser extent on the growth of Slovenian stock market indices and more on events in the global capital markets. This was partly evident last year, when despite the fall in the SBI 20, collected life insurance premium tied to mutual fund units grew by 41% over the previous year, with the number of policyholders rising by 10%.

The proportion of bank commission from brokering life insurance policies remains negligible.

With the growing importance of life insurance as a form of saving, there is also rising interest among banks in brokering the sale of such products, although this still represents a negligible proportion of non-interest income. In March 2006, 12 banks were authorised to broker the sale of insurance policies, with ten banks actually performing such transactions in 2005 and nine such banks in 2004. According to figures from a survey, last year banks generated up to SIT 222 millions commissions by brokering life insurance policies, representing just 0.26% of all fees and commissions made by banks in 2005.

Table 6.4: Collected premiums in SIT millions and number of policyholders with life and pension policies from insurers

	2002	2003	2004	2005	2002	2003	2004	2005
Life insurance total					Growth rates (%)			
Premium (SIT millions)	52,917	59,871	74,230	85,158	-	13.1	24.0	14.7
Number of policyholders	650,954	739,003	852,955	926,306	-	13.5	15.4	8.6
Life insurance tied to investment fund units					Proportion of life insurance (%)			
Premium (SIT millions)	251	4,782	13,576	19,170	0.5	8.0	18.3	22.5
Number of policyholders	6,393	40,264	96,313	96,313	1.0	5.4	11.3	10.4
Voluntary supplementary pension insurance								
Premium (SIT millions)	2,965	3,544	3,533	3,632	5.6	5.9	4.8	4.3
Number of policyholders	37,745	45,801	37,455	39,623	5.8	6.2	4.4	4.3

Source: ISA

Changes in the area of supplementary health insurance

Introduction of equalization scheme system for supplementary health insurance.

In September 2005 the Act Amending the Health Care and Health Insurance Act entered into force, and this introduced changes in the area of voluntary and supplementary health insurance. Under the revised act, supplementary health insurance is provided according to the principles of intergenerational mutuality and gender mutuality among all supplementary insurance holders, while it also abolishes age-based and mathematical provisions, which insurers must return to policyholders by no later than the end of 2007. An important new feature of the act is the introduction of an equalization scheme whereby amongst themselves, insurers that provide supplementary health insurance offset the differences in the costs of health services brought about by the varying structure of policyholders at individual insurers in terms of age and gender. A consequence of the new act is that after 1 March 2006 the premiums for supplementary health insurance are the same for all policyholders at an individual insurer, and discounts are limited to a maximum of 3% in the event of group insurance or lower administrative costs in the payment of premiums. The act will also have an impact on insurers, since the claims ratio or the cost of health services will no longer depend on the structure of policyholders, thereby eliminating the problem of adverse selection among policyholders owing to the need for continual increases in premiums at insurers with the least favourable age and gender structure of policyholders. Although in view of the exceptionally high claims ratio this type of insurance is not that attractive commercially for insurers, through it insurers wish to create a portfolio of policyholders to whom they could also offer other insurance products.

Financial statements and capital adequacy of insurers

Insurers' total assets continue to grow.

The total assets of insurers grew by 15% in 2005 to SIT 706 billions, which is comparable with the growth in 2004 (17%). As expected, there was continued rapid growth in the total assets of life insurance (24%), while growth in non-life insurance fell to 8%. As with non-life insurance, over the last three years a slowdown in the growth of total assets has been recorded by the reinsurance companies, which in the first three quarters of last year showed an increase of 4% to stand at SIT 77 billions.

Marked improvement in non-life insurance results, while health insurance remains negative.

After three years of decrease, last year insurers increased net profits to SIT 9 billions. This was mainly a consequence of improved results from non-life insurance, which recorded a marked improvement in the claims ratio. Life insurance also enjoyed a better performance, while the performance of health insurance remained unchanged and is still negative. Two

insurers that together collected 80.7% of health insurance premiums posted a loss from this form of insurance. As for life insurance, four insurers that together collected 16.5% of all premiums posted losses. In the non-life sector there were only two such insurers, together accounting for 17.5% of all non-life insurance premium collected.

Insurers recorded a fall of 11% in income from investments, a result primarily of interest income being reduced by falling interest rates. Despite the negative return on the Slovenian capital market, measured by the SBI 20, insurers' profits from the disposal of investments rose slightly. The reinsurance companies enjoyed higher profits chiefly for the same reasons as the insurers. At the same time this reflects the relatively favourable geographical diversification of insurer investments, whose profitability is not determined solely by trends on the domestic capital market.

Lower investment income resulted mainly from lower interest rates.

Table 6.5: Total assets and results of insurers and reinsurance companies

	2002	2003	2004	2005	2003	2004	2005
	(SIT billions)				Growth rates (%)		
Insurance companies							
Total assets	440.9	525.4	613.4	706.0	19	17	15
Non-life	266.9	309.9	346.0	375.1	16	12	8
Life	174.0	215.5	267.4	330.9	24	24	24
Results							
Result from non-life ins. less health ¹	4.5	3.5	4.3	11.3	-24	24	163
Result from health insurance ¹	3.7	2.1	-2.1	-2.1	-45	-204	-4
Result from life insurance ¹	3.5	3.3	2.8	3.4	-5	-17	22
Investment income	21.4	20.3	21.1	18.7	-5	4	-11
Investment expenses	3.4	5.7	4.1	4.5	70	-29	10
Net profit ²	8.5	5.0	3.3	9.0	-41	-34	217
ROE (%)	13.17	6.26	3.29	8.40			
ROA (%)	1.95	0.96	0.54	1.28			
Reinsurance companies³							
Total assets	60.6	66.4	74	77	10	11	4
Results							
Result from non-life ins. less health	0.8	1.9	2.1	2.8	139	11	35
Investment income	4.9	4.2	3.4	2.6	-14	-18	-24
Investment expenses	0.3	0.5	0.6	0.5	97	18	-23
Net profit	1.6	2.3	2.2	2.6	42	-6	19
ROE (%)	10.79	12.84	10.60	10.88			
ROA (%)	2.65	3.43	2.92	3.34			

Notes: ¹ Result from ordinary activities.

² Net profit from the accounting period is calculated after taxes.

³ Figures for 2005 relate to September.

Sources: ISA, own calculations

The solvency of insurers deteriorated somewhat last year. The surplus of insurers' disposable capital over the required minimum capital was reduced to 36% in 2005, and stood at SIT 17.3 billions, down from SIT 23.3 billions in 2004. Insurers recorded a reduction in the non-life insurance surplus to 40%, and an improvement in life insurance to 26% of the required minimum capital. The two reinsurance companies continue to record exceptionally high surpluses of disposable capital over the required minimum, standing at 158% at the end of September 2005, which is 16% lower than at the end of 2004. The solvency of the non-life insurers (including health) and reinsurance companies, measured by the relationship between core capital and net collected premium, also points to a slight deterioration in the capital position of non-life insurers to just under 20% and to a marked improvement in the capital position of the reinsurance companies to just over 81%. In 2004 the value of this indicator in the euro area stood at 25% for non-life insurers and 26% for reinsurance companies. The solvency of life insurance companies, measured by the relationship between core capital and net technical provisions, improved last year to 7.8%, while the solvency of life insurance companies in the euro area measured by this indicator stood at 7.2% at the end of 2004.⁶⁵

The capital adequacy of insurers and reinsurance companies fell, but remains at a suitable level.

⁶⁵ ECB

Table 6.6: Capital adequacy of insurers and reinsurance companies

	2002	2003	2004	2005	Growth rates (%)		
					2003	2004	2005
Insurance companies – total							
Required minimum capital (SIT billions)	34.2	38.5	43.6	48.1	12	13	10
Surplus (SIT billions)	11.5	20.3	23.3	17.3	77	14	-26
Surplus/Required minimum capital (%)	33.7	52.8	53.4	35.9	57	1	-33
Life insurance							
Surplus/Required minimum capital (%)			-3.6	26.3			
Core capital/Net technical provisions (in %)			5.3	7.8			
Non-life and health insurance							
Surplus/Required minimum capital (%)			77.0	40.0			
Core capital/Net collected premiums (%)			22.2	19.6			
Reinsurance companies¹⁾							
Required minimum capital (SIT billions)	3.3	4.1	4.4	4.5	24	7	3
Surplus (SIT billions)	8.2	7.0	7.6	7.1	-15	9	-7
Surplus/Required minimum capital (%)	248.6	170.7	174.0	158.1	-31	2	-9
Core capital/Net collected premiums (%)	56.5	55.6	81.4				

Notes: ¹⁾ Figures for 2005 relate to September.

Sources: ISA, own calculations

It may be assumed that part of the deterioration in insurance company solvency is a result of the anticipated introduction of the IFRS in the near future. Slovenia's Companies Act lays down the obligation for all insurers to apply the IFRS from 1 January 2007 at the latest. In line with the international accounting standards the equalization provisions no longer represent technical provisions but, depending on their substance, they will fall under capital items. Under EU rules, equalization provisions are still created for credit insurance. In the current system, equalization provisions are used in Slovenia for the majority of non-life insurance. The calculation of capital adequacy takes into account only those provisions that insurers create through their own judgement and the surplus of equalization provisions over those prescribed. On the basis of the proposed Act Amending the Insurance Act, in the future it will be obligatory in Slovenia to only create equalization for credit insurance, while insurers will have to abolish all other equalization provisions by 1 January 2007 and declare them as part of their capital. This will consequently lead to an increase in the disposable capital of insurers and to higher capital adequacy. In the future the capital adequacy and performance of insurers will be significantly affected by the introduction of Solvency II, which should enter into force around 2011. It will mean that in the future Slovenian insurers will have to strengthen their risk management. Solvency II envisages the possibility of internal models that should be better-adjusted to risk and to the specific operations of individual insurers as the standard model or the uniform method of determining the required capital. Establishing internal models, which will have to be confirmed by the supervisory body, will be very expensive, and for this reason only sufficiently large insurers or financial conglomerates will be able to have them. Insofar as Slovenian insurers will wish to benefit from the advantages of internal models for calculating the required capital, there will be a need for further consolidation in the insurance market and expansion to foreign markets, which will increase their income.

6.1.2 Stability of insurance sector

Underwriting risk

In 2005 insurers achieved the best claims ratio of the last five years.

The claims ratio for insurers, calculated as the ratio of gross claims paid out to gross premium collected, improved last year to 0.59 and was the best it has been for the past five years. The improvement in the claims ratio was boosted primarily by non-life insurance, where the claims ratio fell to 0.59, and partly by life insurance, where the claims ratio fell to 0.33. Last year the health insurance claims ratio deteriorated from 0.87 in 2004 to 0.93. Among the main non-life insurance sectors there was a marked improvement in the claims ratio for insuring motor-vehicle liability (0.56) and insuring land motor-vehicles (0.71), which is a consequence of both the increased gross premium collected and the reduced payment of gross claims. The proportion of retained risk of non-life insurers, measured by the ratio of net collected premium to gross collected premium, remained approximately at the same level as in 2004. Last year the retained risk of Slovenian non-life insurers amounted to 82.8%, and was just over 2 percentage points higher than the retained risk of euro area non-life insurers in 2004.

Table 6.7: Claims ratios for the main types of insurance

	2001	2002	2003	2004	2005
Insurance companies					
Total	0.64	0.63	0.64	0.64	0.59
Life insurance	0.31	0.38	0.42	0.36	0.33
Voluntary health insurance	0.83	0.81	0.83	0.87	0.93
Non-life less health	0.66	0.62	0.64	0.67	0.59
Motor-vehicle liability insurance	0.62	0.57	0.57	0.64	0.56
Land motor-vehicle insurance	0.85	0.80	0.80	0.83	0.71
Accident insurance	0.62	0.62	0.61	0.62	0.52
Other damage to property insurance	0.73	0.65	0.64	0.72	0.70
Fire and natural disaster insurance	0.38	0.31	0.55	0.52	0.43
Credit insurance	0.94	1.03	0.85	0.66	0.61
Other non-life insurance	0.67	0.67	0.70	0.65	0.63
Reinsurance companies					
Total ¹	0.64	0.51	0.49	0.55	0.49

Notes: ¹ The claims ratio for 2001 for reinsurance companies is calculated from figures for the first three quarters.

Source: ISA

Investment risks

Coverage of net technical provisions through investments of assets covering technical provisions increased last year, and at year-end amounted to 117.5%. In this way investment risk was further reduced. Assets covering technical provisions grew by 15% and at the end of the year stood at SIT 593 billions, equivalent to 9% of GDP.

Coverage of technical provisions through assets covering technical provisions improved.

Table 6.8: Coverage of net technical provisions through of assets covering them

	2001	2002	2003	2004	2005
Technical provisions (SIT billions)	286	343	396	450	505
Growth rate (%)	27	20	15	14	12
Assets covering technical provisions (SIT billions)	252	334	443	515	593
Growth rate (%)	27	33	33	16	15
Assets covering tech. prov./Technical provisions (%)	88.0	97.5	111.9	114.4	117.5
Proportion of assets covering technical provisions in GDP (%)	5.2	6.2	7.6	8.2	9.0
Mathematical provisions (SIT billions)	116	151	183	218	247
Growth rate (%)	34	30	21	19	13
Assets covering mathematical provisions (SIT billions)	124	169	222	276	326
Growth rate (%)	36	36	31	24	18
Assets covering math. prov./Mathematical provisions (%)	106.6	112.5	119.1	126.5	132.1
Proportion of assets covering mathematical provisions in GDP (%)	2.6	3.2	3.8	4.4	5.0
Other technical provisions (SIT billions)	170	192	213	232	258
Growth rate (%)	22	13	11	9	11
Assets covering tech. prov. less assets covering mathematical provisions (SIT billions)	128	165	221	239	267
Growth rate (%)	19	29	34	8	12
Assets covering tech. prov. less assets covering math. prov./Other tech. provisions (%)	75.3	85.9	103.9	103.0	103.5
Proportion of assets covering tech. prov. less assets covering math. prov. in GDP (%)	2.7	3.1	3.8	3.8	4.1

Sources: ISA, SURS, own calculations

The higher growth in life insurance premiums over non-life insurance premiums also meant that last year saw continued higher growth in assets covering mathematical provisions compared with assets covering other technical provisions. By the end of 2005 assets covering mathematical provisions were equivalent to 55% of all insurers' assets covering technical provisions. There was an increase in the proportion of net mathematical provisions in all net technical provisions as well as in coverage of net mathematical provisions through assets covering mathematical provisions, with coverage standing at a full 132% at the end of 2005. Coverage of other net technical provisions also exceeded 100% and remained roughly at the same level as at the end of 2004.

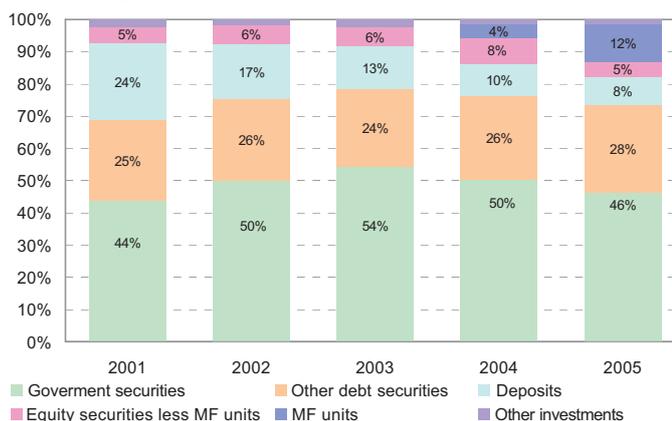
Last year one insurance company started offering a life insurance investment policy, which alongside five foreign funds included a hedge fund. In view of the high risk of hedge funds,

the potential negative experiences of policyholders could contribute to a reduction in demand for other investment policies that do not include such high-risk funds.

The proportion of assets covering technical provisions invested in mutual fund units has gradually increased.

Within the structure of life insurance investments and assets covering mathematical provisions over the past five years there have been shifts towards more profitable and riskier investments. There has been a continued trend of reducing the proportion of government securities and bank deposits, while on the other hand there is a growing proportion of investments in other debt securities and mutual fund units. The proportion of investments in debt securities and bank deposits, which are regarded as the safest form of investment, fell by 4 percentage points in 2005, but still remains at the very high level of 82%. In the euro area countries, except for Greece, debt securities and deposits and cash accounted for just 51% of all life insurance investments at the end of 2004. In 2004 these countries had a markedly higher proportion of life insurance investments in favour of policyholders that take over investment risk, at a level of 21%, while the proportion in Slovenia in all investments of assets covering mathematical provisions last year amounted to just over 10% and grew by 5 percentage points. The proportion of investments in equities other than mutual fund units fell by 3.5 percentage points last year to 4.8%. There was a marked increase in the proportion of mutual fund units, from 4.1% in 2004 to 12% in 2005. The proportion of loans in assets covering mathematical provisions in Slovenia remains negligible, while in the euro area except Greece it stood at just over 7% in 2004.⁶⁶ Within the currency structure of assets covering mathematical provisions there was a modest reduction in investments in euros to 51.8%, while the proportion of investments in tolar rose to 47%. Insurers increased the geographical spread of their assets covering mathematical provisions, with the proportion of investments in foreign securities growing last year to 24%, from 19% in 2004, and this was in line with expectations given the negative return on the domestic stock market as measured by the SBI 20.

Figure 6.1: Structure of insurers' assets covering mathematical provisions in percentages



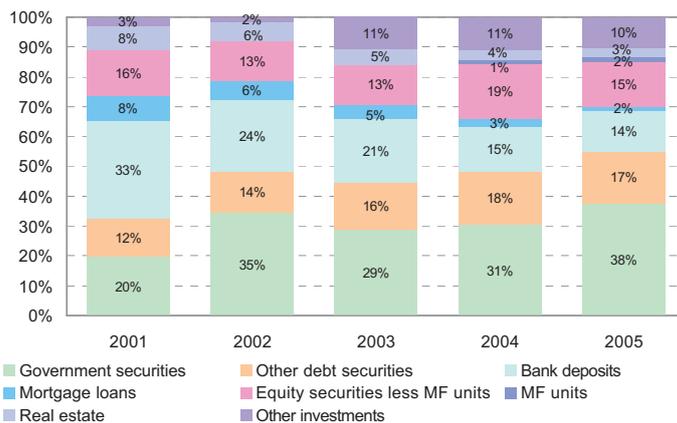
Source: ISA

Investments of assets covering technical provisions without assets covering mathematical provisions in government securities are increasing.

Within the structure of assets covering technical provisions without assets covering mathematical provisions, last year saw a marked increase of 7% in the proportion of government securities to 37.6%, and a fall of 3.7 percentage points in the proportion of equities other than mutual fund units to 14.9%. The proportion of investments in mutual fund units did rise slightly, but it remains relatively small at 1.6%. As with assets covering mathematical provisions, insurers displayed a significantly more conservative investment policy in other assets covering technical provisions than insurers in the euro area.

⁶⁶ Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS)

Figure 6.2: Structure of insurers' assets covering technical provisions without assets covering mathematical provisions in percentages



Source: ISA

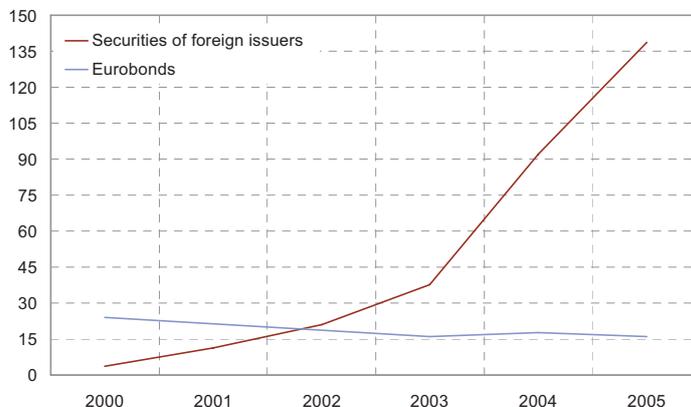
Within the structure of total insurer assets covering technical provisions, government and debt securities and bank deposits accounted for 76% of all investments. The proportion of investments in equities other than mutual fund units fell by 3.7 percentage points to 9.3%. The proportion of investments in mutual fund units increased by 4.7 percentage points to 7.3%.

The proportion of investments by insurers in foreign securities increased from 13% in 2004 to 16.5% in 2005. Insurers held a total of SIT 98 billions in foreign securities (SIT 70 billions in 2004), and SIT 14 billions in Slovenian eurobonds.

The proportion of insurer investments in foreign securities increased from 13% to 16.5%.

At the end of 2005 the entire insurance sector (S.125), which comprises insurers, reinsurance companies and pension funds, held just under SIT 139 billions in foreign securities, representing 14.3% of all the financial assets of the sector. In 2004 this proportion was just 10.1%. Within the structure of investments in foreign securities, relative to 2004 there was a certain shift in favour of equities, their proportion increasing by 7 percentage points to 24%, with debt securities accounting for the remaining 76%. The insurance sector increased the proportion of its equities investments in the EU15, and significantly reduced its exposure to the capital markets of the former Yugoslavia. The investments in shares of issuers from Croatia, Bosnia-Herzegovina, Serbia-Montenegro and Macedonia as a proportion of all investments in foreign securities fell from 33% at the end of 2004 to 21% at the end of 2005. Investments in foreign debt securities at the end of 2005 were again dominated by bonds issued in EU member-states, chiefly Germany (26%), the Netherlands (10%), France (10%), Ireland (8%) and the UK (8%).

Figure 6.3: Investments by the insurance sector (including insurers, reinsurance companies and pension funds) in securities of foreign issuers and eurobonds in SIT billions



Source: Bank of Slovenia

6.1.3 Influence of insurers on the stability of the banking sector through credit insurance

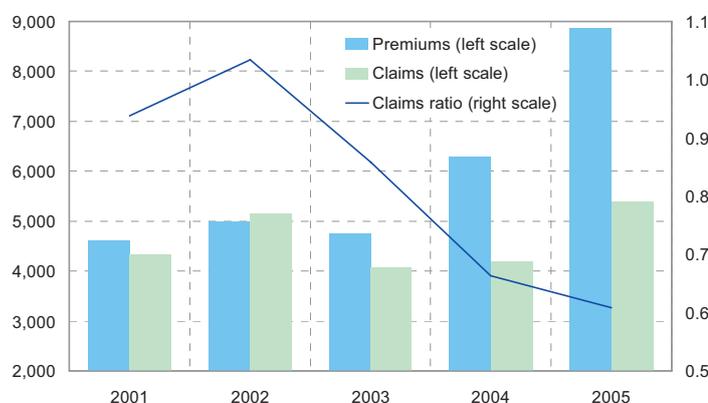
The proportion of household loans insured at insurance companies fell to 40%.

According to survey figures, at the end of 2005 banks had a stock of SIT 361 billions of household loans insured with insurers, up more than SIT 50 billions higher from the end of 2004. Despite the absolute increase of 16.1% in the stock of household loans insured with insurers, the proportion of total household loans that they account for fell by over 20 percentage points to 39.6%. The proportion of collected credit premium in insurers' total collected premium did not change significantly last year, and stood at 2.6%. If for 2004 we count the collected premium for export credits on commercial risk at the SEC (Slovene Export Corporation), then the volume of collected credit insurance premiums increased by 10.6% in 2005.

The claims ratio of credit insurance improved.

The trend of improvement in the claims ratio for credit insurance continued, the figure improving to 0.61 in 2005 from 0.66 in 2004. The change relative to 2004 is primarily technical in nature, since the 2005 calculation also included PKZ, which started to operate on 1 January 2005.⁶⁷ Based on the claims ratio trend we take the view that last year there were no major changes in the threat of systemic risk from bank credit insurance at insurers.

Figure 6.4: Collected premium and paid claims in SIT millions and the claims ratio for credit insurance⁶⁸



Source: ISA

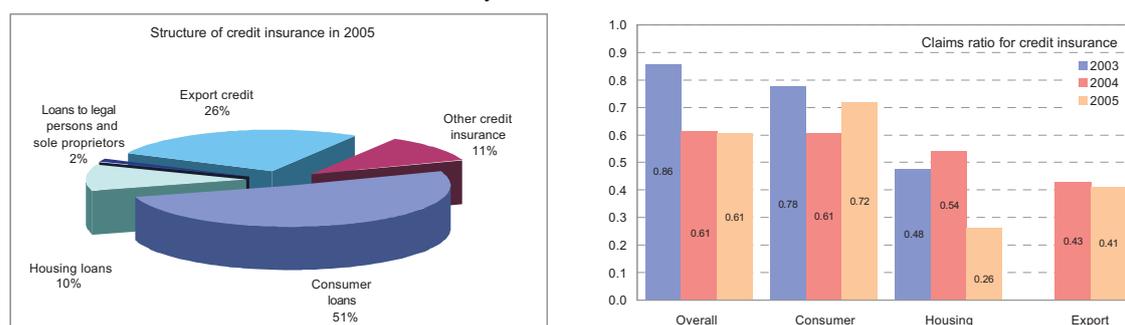
Deterioration of the claims ratio for insurance of consumer loans.

Insurance of consumer loans accounted for the largest share of collected credit insurance premium in 2005, at 51%. After this came export credit insurance at 26%. Premiums collected for insurance of housing loans accounted for 10%. The claims ratio for insurance of consumer loans rose markedly in 2005, from 0.61 to 0.72. The claims ratio for export credit insurance did not change significantly, and stood at 0.41. There was an exceptional improvement, in the claims ratio for insurance of housing loans, which ended a notable trend of deterioration by falling from 0.54 to 0.26. This could be supported by the low level of interest rates and the high growth in housing loans, but in view of the anticipated rise in interest rates our assessment is that in the future the claims ratio for housing loan insurance will again deteriorate. This should not have any serious consequences for the stability of the insurance system, since fewer and fewer new housing loans are insured with insurers. In 2004 a total of 35.2% of all newly approved housing loans from the eight largest banks in the country were still insured at insurers, but last year the figure was just 21.7%.

⁶⁷ Under the Insurance and Financing of International Commercial Transactions Act (Official Gazette of the Republic of Slovenia No 2/04), the Slovene Export Corporation (SEC) may insure international commercial transactions on behalf of the Slovenian state against non-commercial and/or commercial non-marketable risk only, and must keep such business transparently separate from its other business. Indeed the rules governing state aid require that only non-marketable risk may be insured with public support. For this reason the SEC established the Prva kreditna zavarovalnica (PKZ), to which it transferred the insurance of marketable risk.

⁶⁸ Prior to 2005 without taking account of insurance of export credit on commercial risk at the SEC. If the 2004 calculation of the overall claims ratio for credit insurance includes insurance of export credit on commercial risk at the SEC, the claims ratio for 2004 is reduced from 0.66 to 0.615.

Figure 6.5: Structure of collected credit insurance premium in percentages for 2005 and claims ratio over the last three years⁶⁹



Source: ISA

6.2 Voluntary Supplementary Pension Insurance

At the end of 2005 there were already more than 427,000 policyholders with voluntary supplementary pension insurance, representing 53% of the active working population, and in 2005 they paid SIT 43.7 billions in premiums.⁷⁰ The volume of assets collected last year increased by 49% over 2004, and amounted to almost SIT 142 billions. The growth in the number of policyholders eased to stand at 6%, which is in line with expectations, since the exceptionally high growth in 2004 was the result of including public sector employees in the second pension pillar.

The volume of collected voluntary supplementary pension insurance assets rose to SIT 142 billions.

Table 6.9: Indicators for compulsory and voluntary supplementary pension insurance

	2002	2003	2004	2005	Growth rates (%)			
					2002	2003	2004	2005
Compulsory pension insurance								
Average number of PDII policyholders	836,544	834,049	836,668	844,825	-0.6	-0.3	0.3	1.0
Average number of pensioners ¹	509,083	517,751	523,854	531,075	3.4	1.7	1.2	1.4
Ratio	1.64	1.61	1.60	1.59	-4.1	-2.0	-0.9	-0.4
Average pension (SIT) ²	97,542	102,524	107,140	110,498	9.2	5.1	4.5	3.1
Net average wage (SIT)	147,859	158,966	166,066	176,287	9.7	7.5	4.5	6.2
Ratio	0.66	0.64	0.65	0.63	-0.5	-2.2	0.0	-2.8
Average age of new pension recipients								
Men	57.7	57.7	58.6	58.8	0.9	0.0	1.6	0.4
Women	59.9	59.9	60.6	60.4	1.1	0.0	1.1	-0.3
	55.5	55.7	56.6	57.1	0.2	0.3	1.6	0.9
Voluntary supplementary pension insurance								
Number of vol. supp. pension ins. policyholders	173,089	212,060	404,885	427,645	111.4	22.5	90.9	5.6
Active working population	808,596	801,383	807,490	813,100	0.3	-0.9	0.8	0.7
Ratio	0.21	0.26	0.50	0.53	110.8	23.6	89.5	4.9
Assets (SIT millions)	23,722	48,904	95,442	141,890	295.4	106.2	95.2	48.7
Proportion of assets in GDP (%)	0.4	0.8	1.5	2.2	254.3	89.9	81.5	41.7
Proportion of assets in alternative financial investments by households (%)	2.4	4.2	6.4	8.4	199.3	73.7	53.3	31.7
Collected premiums (SIT millions)	12,372	22,487	42,810	43,674	133.9	81.8	90.4	2.0
Proportion of premiums in PDII tax revenues (%)	2.5	4.2	7.4	7.2	113.6	67.7	77.7	-3.9

Notes: ¹ Includes recipients of any type of pension: old-age, disability, family, widow's, military, farmer's and state.

² Includes old-age, disability, family and widow's pensions, minus tax prepayment.

Sources: PDII, ISA, SMA, SORS

In 2005 there was a further reduction in the ratio of the average pension to the average wage, which stood at just under 63%. There was also a modest increase in the average age of new pension recipients. The ratio of tax revenues for the compulsory pension insurance treasury to transfers from the Pension and Disability Insurance Institute to individuals and households deteriorated slightly last year, and stood at 76.9%, but this was markedly

⁶⁹ To calculate claims ratios for 2004 we included the Slovenian Export Corporation, for which reason there is a difference from Figure 6.4.

⁷⁰ Not including the First Pension Fund.

lower than in 1995, when it stood at 95.7%. As in the previous year, the difference was covered by transfer revenues, especially through receipts from the state budget, which have been growing consistently since 1992. Such trends will continue in the future, since the pressure on the pensions treasury will further increase with the retirement of the post-war baby boom generation. For this reason, alongside payments into the compulsory pension insurance treasury, individuals will also need to make additional savings for old age, if they wish to avoid a reduction in their standard of living after retirement. Voluntary additional pension insurance assets at the end of 2005 amounted to 2.2% of GDP, or 8.4% of the assets of alternative financial investments of households, and in recent years this proportion has grown rapidly, which is also partly a consequence of direct or indirect government measures. The ratio of collected premium for voluntary supplementary pension insurance to the tax revenues of the PDI fell slightly last year to 7.2%, which is almost three times what it was in 2002. Under the Collective Supplementary Pension Insurance for Public Servants Act, the state, local authorities and public corporations pay pension premiums into a closed mutual fund for employees in the public sector, and in addition the government uses tax relief to encourage voluntary supplementary pension saving by households.⁷¹

Of the three groups providing pension plans for voluntary supplementary pension insurance in 2005, the highest market share in terms of policyholders was achieved by mutual pension funds with 49%, followed by pension companies with 41%. Within the structure of collected premium, the proportion accounted for by mutual pension funds fell by 6 percentage points during 2005 to 46%, while the proportion accounted for by pension companies rose by 5 percentage points to 45%. Within the structure of collected assets, pension companies continued to hold the largest proportion (48%), although the proportion held by mutual funds (41%), especially after the inclusion of public employees, is consistently growing. The importance of insurers in the market for voluntary supplementary pension insurance continues to diminish.

Table 6.10: Providers of voluntary supplementary pension insurance – number of policyholders, collected premium and assets

	2001	2002	2003	2004	2005
Number of policyholders	81,895	173,089	212,060	404,885	427,645
Structure (%)					
Mutual pension funds	19.4	18.2	16.8	50.7	49.3
Insurance companies	25.1	21.8	21.6	9.5	9.3
Pension companies	55.4	60.0	61.6	39.8	41.4
Collected premiums (SIT millions)	5,289	12,372	22,487	42,810	43,674
Structure (%)					
Mutual pension funds	0.0	0.0	24.1	51.6	46.3
Insurance companies	37.5	24.0	15.8	8.3	8.3
Pension companies	62.5	76.0	60.1	40.1	45.3
Assets (SIT millions)	6,000	23,722	48,904	95,442	141,890
Structure (%)					
Mutual pension funds	19.3	24.8	25.0	38.0	40.6
Insurance companies	27.3	20.0	18.2	13.1	11.5
Pension companies	53.4	55.2	56.8	48.9	47.8

Sources: ISA, SMA

Investment structure of voluntary supplementary pension insurance providers

In the development of voluntary supplementary pension insurance Slovenia lags far behind the euro area in terms of assets collected as a proportion of GDP or market capitalisation of the capital market, with euro area pension fund assets equivalent to as much as 12.7% of GDP at the end of 2004. Slovenia also trails the Czech Republic, where pension fund assets were equivalent to 3.6% of GDP at the end of 2004.

Extremely conservative investment policy among voluntary supplementary pension insurance providers, especially compared with the rest of the world.

There is also a marked difference between those countries with a longer tradition of voluntary pension insurance and Slovenia within the investment structure of voluntary pension insurance assets. In the western European countries pension funds hold a significantly lower proportion of their investments in government and other debt securities and in cash and deposits (Portugal 51%, Germany 32% and the UK 24% at the end of 2004), but a

⁷¹ Tax relief covers the amount of the premium for voluntary supplementary pension insurance paid by the taxpayer, but to a maximum of 24% of the compulsory contributions for pension and disability insurance or 5.844% of the gross annual wage, where there is a ceiling on the tax relief, which in 2005 amounted to SIT 549,000.

greater proportion in shares and mutual fund units (Portugal 45%, Germany 32% and the UK 59%). In Slovenia the proportion of government and other debt securities and cash and deposits amounted to 92%, and the proportion of shares and mutual fund units to just 7%. Within the structure of investments there was an increase in the proportion of mutual fund units and a decrease in the proportion of equities other than mutual fund units, which as with insurers is to a large extent a consequence of the tendency towards a more diversified investment portfolio. Such a structure of investments did offer protection to voluntary pension insurance providers from last year's fall on the Ljubljana Stock Exchange, but at the same time it holds them back from achieving greater returns. The stock of investments in foreign securities increased by SIT 7 billions last year to just over SIT 21 billions, while the proportion of assets that they account for remained unchanged at 15%.

Table 6.11: Pension fund assets in SIT billions and structure in selected European countries in percentages, end of 2004

	Slovenia ¹	EMU ²	Czech Rep.	Portugal	Germany	United Kingdom
Pension funds investments (SIT billions)	142	228,899	747	3,631	20,045	226,179
Proportion of GDP (%)	2.2	12.7	3.6	11.2	3.8	65.1
Proportion of market capitalisation (%) ³	4.4	30.1	22.3	42.3	7.9	48.0
Investment structure (%)						
Cash and deposits	14	-	10	8	3	3
Government bonds	44	-	52	24	3	15
Other bonds	34	-	31	18	27	7
Shares	4	-	6	22	32	43
Mutual fund units	3	-	0	22	-	15
Other	1	-	2	5	36	17

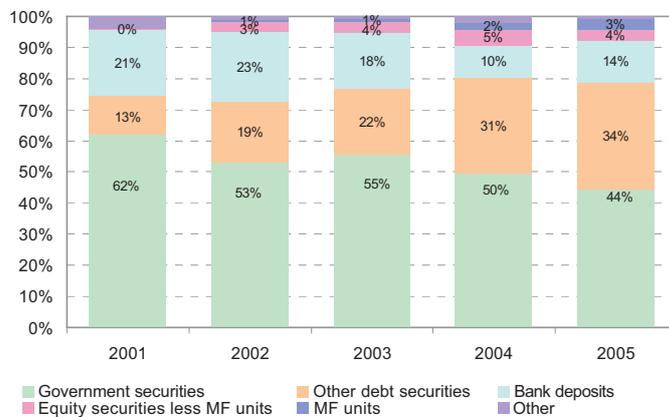
Notes: ¹ All figures for Slovenia relate to the end of 2005.

² Figures are for 2004 and do not include Luxembourg and Finland.

³ Figures are for 2003 except for the euro area, where the figures are for 2002.

Sources: ISA, SMA, OECD Pension Markets in Focus, Newsletter June 2005, Issue 1; Newsletter December 2005, Issue 2

Figure 6.6: Investment structure of voluntary supplementary pension insurance providers in percentages



Sources: ISA, SMA

The main reason for the exceptionally conservative investment policy and the unchanged proportion of investments in foreign securities remains the legally prescribed minimum guaranteed return, which may not be below 40% of the average annual interest rate on government securities with a maturity of more than 1 year. Owing to the fall in interest rates, the minimum guaranteed return in 2005 continued to decline, and at the end of the year stood at 1.11%, compared with 3.65% at the end of 2004. There was also a decline relative to the previous year in the actual returns achieved by voluntary supplementary pension insurance providers. Annual growth in the unit values of mutual pension funds last year amounted to 3.8%, compared with 8.5% in 2004. Returns on voluntary supplementary pension insurance assets under management at insurers and pension companies amounted to between 0.05% and 4.81%, while in 2004 they ranged from 5.4% to 9.3%. In the future it would make sense to consider abolishing the minimum guaranteed return for new pension plans, which would allow the pension plan providers to pursue less conservative investment policies and greater geographical diversification of assets, as well as affording them greater competitiveness in being able to adjust to the demands and wishes of policyholders.

The legally prescribed guaranteed minimum return fell to just 1.11% in 2005.

In view of the relative lack of development of voluntary supplementary pension insurance in Slovenia and the unfavourable age structure of the population, which will put further pressure on the compulsory pension insurance treasury, in the future we may expect growth in collected premium and in the number of policyholders in the second pillar of pension insurance. The latter is particularly likely if voluntary supplementary pension insurance providers pursue less conservative investment policies and increase their returns.

6.3 Investment Funds

Investment fund assets are equivalent to approximately 22% of bank deposits by households.

Investment fund assets increased by just 6% in 2005, primarily as a consequence of the less encouraging conditions on the domestic capital market. At the end of February 2006, at SIT 545 billions they were still equivalent to just over 22% of bank deposits by households, a level similar to last year. With a share of just over 6% of the total assets in the financial system, investment funds are an increasingly important part of it.

In 2005 mutual funds achieved 7% returns, while the investment companies index fell by 12%.

Owing to the transformation of three investment companies into mutual funds in 2005, mutual funds now account for the majority of investment funds, achieving a 63% share at the end of February. The situation last year was also affected by the fall of 5.6% in the SBI 20. At the end of 2005 investment companies still held 63% of their investments in domestic shares. Having increased their proportion of foreign investments by 23 percentage points to almost 40% by the end of 2005, the mutual funds were not as badly affected by the fall in securities prices on the domestic capital market. Their annual return was positive at 7%, although considerably lower than the previous year's level of 18%. Alongside lower returns, fierce competition from non-resident mutual funds was another reason why in 2005 mutual funds achieved just 40% of the net inflows that they had recorded in the previous year.

Table 6.12: Investment fund assets in SIT billions and returns in percentages

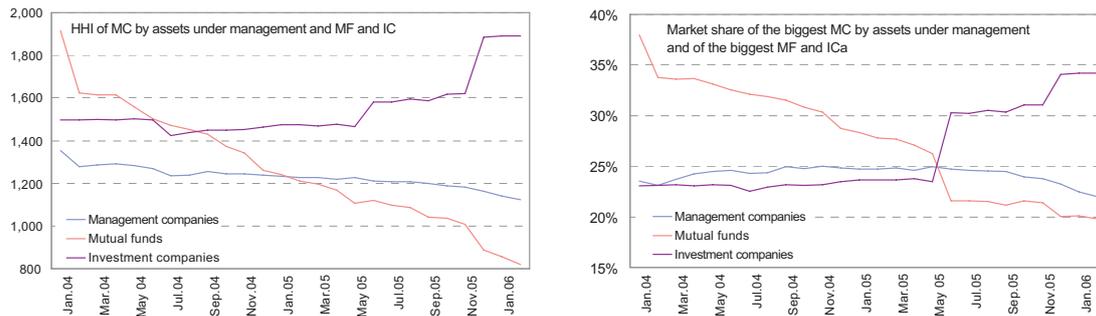
	2001	2003	2004	2005	Feb. 2006	2002	2003	2004	2005
	Assets (SIT billions)					Growth rate (%)			
Investment funds (IF)	563	439	500	532	545	-8.0	-15.2	13.8	6.4
Mutual funds (MF)	15	93	210	332	344	277.4	68.0	125.7	57.9
Investment companies (IC)	-	214	290	200	201	-	54.7	35.3	-30.9
Authorised IC	548	132	-	-	-	-40.9	-59.3	-	-
	Structure (%)								
Mutual funds (MF)	2.6	21.2	42.0	62.4	63.1				
Investment companies (IC)	-	48.8	58.0	37.6	36.9				
Authorised IC	97.4	30.0	-	-	-				
	Growth rate (%)								
Unit value	23.2	17.2	17.8	7.2	8.6				
PIX	4.4	23.5	33.8	-12.2	-16.3				
	Net inflows and stock exchange turnover (SIT billions)								
Net annual MF inflows	2	26	81	33	24	-	-12.3	215.3	-59.1
Annual turnover with (A)ICs	53	61	60	36	35	62.1	-29.0	-1.4	-40.3

Sources: AMC, Vzajemci.com, LJSE, own calculations

The market concentration of management companies in terms of assets under management is falling.

Competition from mutual fund managers increased further in 2005. A total of 17 new mutual funds were established, followed in the first three months of this year by another 18, despite the recent low net inflows. Competition from abroad has also been growing sharply, with non-resident mutual funds taking almost 65% of the net inflows into domestic mutual funds in 2005. By the end of March 2006 there were 68 domestic and 113 non-resident mutual funds being marketed in Slovenia. A consequence of this has been the further reduction in the market concentration of management companies in terms of assets under management. There was again a major decrease in market concentration in the mutual fund sector in 2005, another consequence of the aforementioned transformation of investment companies into mutual funds. The market share of the biggest mutual fund in the two years to February 2006 fell by 14 percentage points to 20%.

Figure 6.7: Market concentration in the investment fund market



Sources: AMC, own calculations

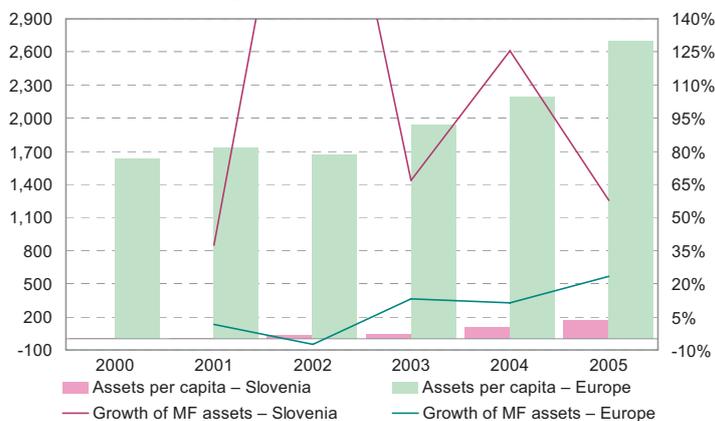
The reasons for establishing new mutual funds and the expectations of additional inflows may be found primarily in the low interest rates, and in new legislation, and thereby the unrestricted potential for investing abroad. Investing abroad allows mutual funds to achieve exemplary returns, despite the unfavourable conditions on the domestic capital market. Moreover, under the new personal income tax legislation, which entered into force in 2005, investment in mutual funds is subject to more favourable taxation than previously, even in respect of bank deposits.⁷² International figures show, however, that at EUR 694 per capita, Slovenia has significantly less mutual fund assets than Europe, which has EUR 11,256 of mutual fund assets per capita.⁷³

Comparison of Slovenian and European investment fund markets

Over the last two years the ratio of Slovenian mutual fund assets per capita to the assets per capita of European mutual funds grew by four percentage points to 6%. Although this is a low ratio, it reflects the process of catching up with the European average from the point of view of the importance of investment funds in financial intermediation. Over the last three years mutual fund assets in Slovenia have recorded an average annual growth rate of 84%, compared with just 16% in Europe overall.⁷⁴

Slovenia is still just beginning to catch up with the EU15 in terms of the importance of investment funds in financial intermediation.

Figure 6.8: Year-on-year growth of mutual fund assets in Europe and Slovenia in percentages and assets per capita in SIT thousands



Notes: The figures for Europe from the European Fund and Asset Management Association (EFAMA) include all EU member-states except Slovenia, Cyprus, Malta, Estonia, Lithuania and Latvia, and also Norway, Switzerland and Liechtenstein. The population figure is from the end of June 2002 for all countries and all periods.

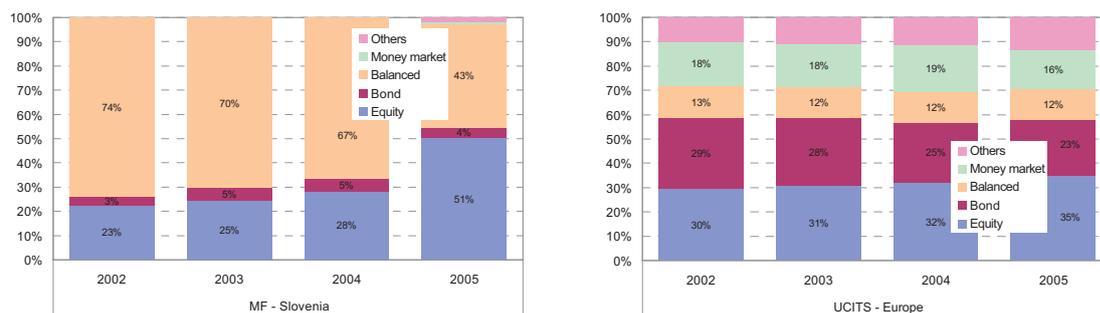
Sources: EFAMA, AMC, Eurostat, own calculations

⁷² Total income from the sale of mutual fund coupons is treated as capital gain, which is taxed in the form of final tax at 20%.

⁷³ The figures for Europe include all EU member-states except Slovenia, Cyprus, Malta, Estonia, Lithuania and Latvia, and also Norway, Switzerland and Liechtenstein. The population figure is from the end of June 2002.

⁷⁴ It should be noted here that the growth in Slovenian mutual funds is also a consequence of the transformation of investment companies. The source of the figures for European fund assets is EFAMA. See previous footnote.

Figure 6.9: Comparison of the structure of mutual funds in Slovenia (left) and Europe/UCITS funds (right) in percentages



Sources: EFAMA, AMC

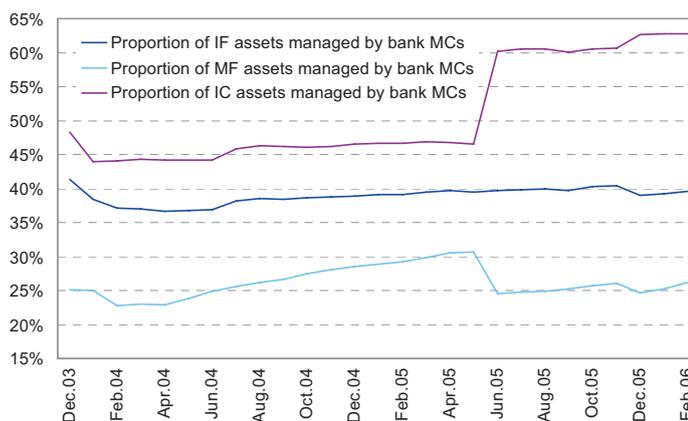
A comparison of the structure of Slovenian and European mutual funds points to the shortfall of bond and money-market funds in Slovenia. Only in 2005 did Slovenia acquire its first money-market fund, which at the end of February accounted for barely 0.3% of mutual fund assets. This could mean that Slovenian households are relatively more inclined towards risk, or that mutual funds in Slovenia are not yet accepted as an alternative for safer investments. Our assessment is that the structure of saving in mutual funds will change further in the future. In 2005 the proportion of equity mutual funds in Slovenia exceeded half of all mutual fund assets, and was also 15 percentage points above the proportion of European equity mutual funds. The reason for this kind of growth lies primarily in the transformation of the investment company holding almost 30% of mutual fund assets prior to transformation into an equity mutual fund.⁷⁵

Cross-ownership in the investment fund sector and banking sector

Complementary activities of bank deposits and investments in mutual funds.

The cross-ownership of banks and management companies is intensifying. Banks hold more than 50% of six of the 15 management companies, and they manage over a quarter of all mutual fund assets and more than 60% of investment company assets.⁷⁶ Although in terms of collecting assets banks and management companies are in competition, on the other hand they complement each other, since their financial products (bank deposits and mutual fund units) satisfy different investor preferences. The low interest rates are an additional stimulus to invest in mutual fund units, which are ideal primarily for long-term investments, which in turn spurs the trend of the decline in the average maturity of bank deposits. Within the structure of non-banking sector deposits, the proportion of long-term deposits of more than 1 year fell by 2.1 percentage points in the two years to the end of 2005 to 6.8%.

Figure 6.10: Proportion of investment funds managed by management companies under majority bank ownership in percentages

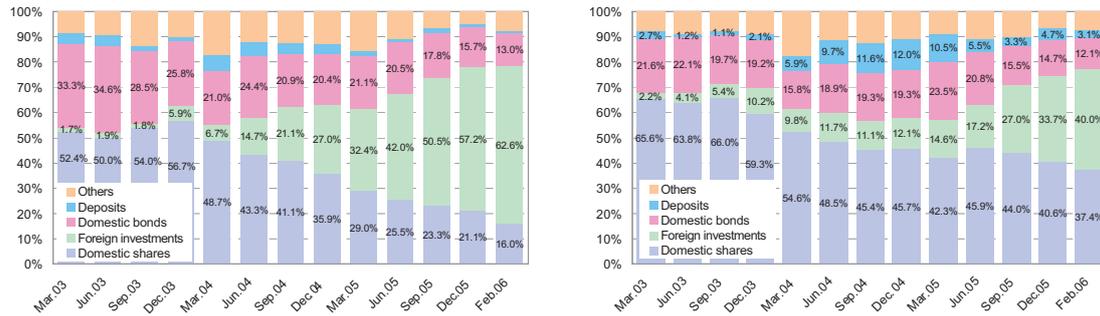


Source: AMC

⁷⁵ This refers to transformation of the investment company Triglav steber I with SIT 64 billions in assets in May 2005.

⁷⁶ The proportion of investment companies managed by management companies that are majority-owned by banks grew by 16 percentage points in the year to February 2006, chiefly owing to the transformation of an investment company into a mutual fund. Prior to the transformation, in May 2005, the proportion of mutual fund assets under management by MCs owned by banks had already grown to more than 30%.

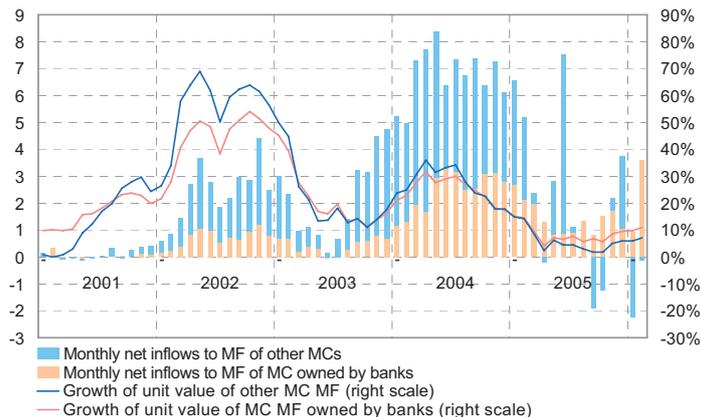
Figure 6.11: Comparison of the structure of mutual fund investments of management companies majority-owned by banks (left) and others (right) in percentages



Sources: AMC, own calculations

In terms of financial figures, the performance of management companies under majority bank ownership and of others was approximately the same.⁷⁷ Their total assets of SIT 31.4 billions were evenly distributed between management companies under majority bank ownership and others. In 2004 management companies generated SIT 9.3 billions in sales revenues, of which 60% went to management companies not owned by banks. Altogether management companies recorded total profits of almost SIT 4 billions; only a little more was recorded at management companies under bank ownership.

Figure 6.12: Comparison of mutual funds of management companies under majority bank ownership and others in terms of net inflows in SIT billions and year-on-year unit value growth rate in percentages



Sources: Vzajemci.com, own calculations

In 2005 management companies under majority bank ownership performed better than other management companies in terms of net inflows into mutual funds and returns. They recorded net inflows of SIT 17.2 billions, thereby exceeding the inflows into other mutual funds⁷⁸ by SIT 1.2 billions, and with returns of 9.6% they outstripped the returns of others by 4 percentage points. The higher returns are primarily a result of the greater proportion of foreign investments. At the end of February 2006 mutual funds of management companies under majority bank ownership held almost 60% of their assets in foreign investments, 22 percentage points more than other funds.

Management companies use a variety of sales channels, with their own sales outlets being complemented by internet sales, and increasingly by sales through banks and insurers, in the form of life insurance investments. In this way banks increase their range of financial products and also their commission earnings. In 2005 mutual fund trades amounting to SIT 46 billions were made via banks, representing an increase of 70% over the previous year.

Better performance in 2005 by mutual funds managed by companies under majority bank ownership.

In 2005 more than SIT 46 billions in mutual fund trades were made through banks.

⁷⁷ ROA for management companies amounted to 13% in 2004 and ROE 18%. These values were calculated on the basis of figures for capital and assets from the end of 2004.

⁷⁸ Here it should be noted that in June 2005 inflows into mutual funds not managed by management companies under majority bank ownership were primarily the result of the payment of dividends from the mutual fund transformed from the investment company.

This also involved the sale of non-resident mutual funds marketed officially in Slovenia.⁷⁹ Banks generated almost SIT 1 billions in commission in this way, or 0.4% of gross income.

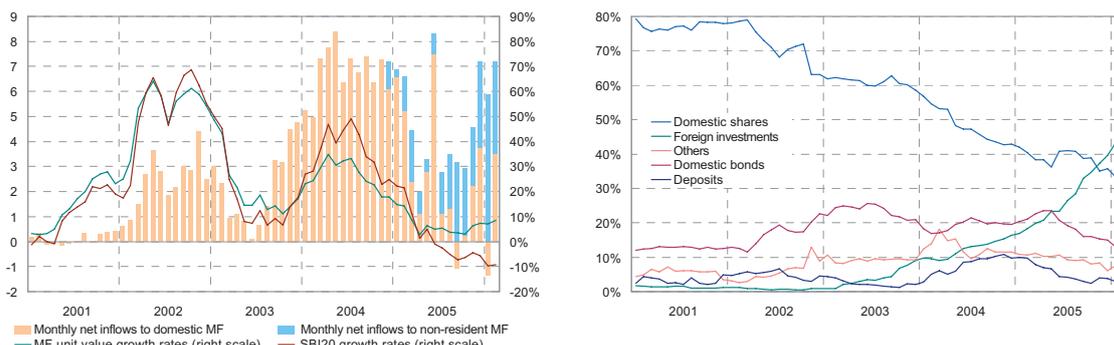
There is no immediate threat of the transfer of risk between management companies and other financial sectors. The level of borrowing by management companies from domestic banks is low, at SIT 6.5 billions at the end of September 2005, which represents barely 0.2% of bank lending to non-banking sectors. Risk may be transferred primarily via the confidence of investors in combined financial instruments such as life insurance with investment risk.

6.3.1 Mutual funds

Mutual funds increased their proportion of investments outside Slovenia to 45%.

Mutual fund assets grew by 58% in 2005 to SIT 332 billions, as a result of both the aforementioned transformation of investment companies, and of the annual net inflows of SIT 33 billions and the annual return on their assets of 7%. At the beginning of 2005, with more than 43% of their investments held in domestic shares, mutual fund returns were still strongly affected by conditions on the domestic capital market. Throughout 2005, however, mutual funds avoided the effects of the domestic capital market by increasing their proportion of foreign investments, and at the end of February 2006 foreign investments accounted for 45% of the total. In this way they achieved greater geographical diversification in their portfolios, and lower dependence on the domestic capital market. The reduced demand for domestic shares compounded the fall in the SBI 20. For this reason the annual mutual fund return in 2005 was considerably higher than the return on the SBI 20, which fell 5.6%.

Figure 6.13: Monthly net inflows to domestic and non-resident MFs in SIT billions, year-on-year unit value growth rates on domestic MFs, year-on-year return of the SBI 20 (left) and structure of domestic MF investments in percentages (right)



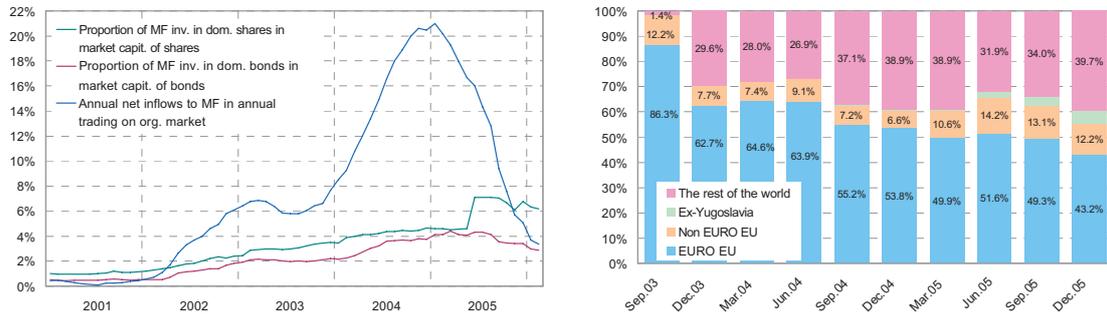
Sources: AMC, Vzajemci.com, LJSE, own calculations

Increased geographical diversification in investments.

The proportion of the market capitalisation of shares on the stock exchange held by mutual funds grew by 2 percentage points in 2005 to 6.7%, but this growth resulted primarily from the transformed investment companies. In the future the effect of mutual funds on domestic capital market trends could be expected to diminish or primarily be negative, since according to expectations the proportion of foreign investments in their structure will increase, something to which they are being pushed by the lack of liquidity and the small choice of securities on the domestic capital market. In this way the dependence of mutual funds on conditions on the domestic capital market will be further reduced and their dependence on conditions on capital markets in the rest of the world will increase. Among foreign investments, there is a diminishing proportion going into EU member-states (43% at the end of 2005), while there are growing investments in the USA (24% at the end of 2005), the former Yugoslav republics (5% at the end of 2005), Japan (5% at the end of 2005), and other countries with great economic potential such as Russia, Korea, China, Brazil, Turkey and India.

⁷⁹ It is interesting to note that SMA authorisation is required for the direct marketing of non-resident mutual funds, while no such authorisation is required for marketing non-resident mutual funds through life insurance linked to investment funds units.

Figure 6.14: MF investments in domestic shares and bonds as a proportion of the entire market capitalisation of shares and bonds on the organised market, annual inflows as a proportion of turnover on the organised market (left) and regional structure of MF investments abroad (right) in percentages

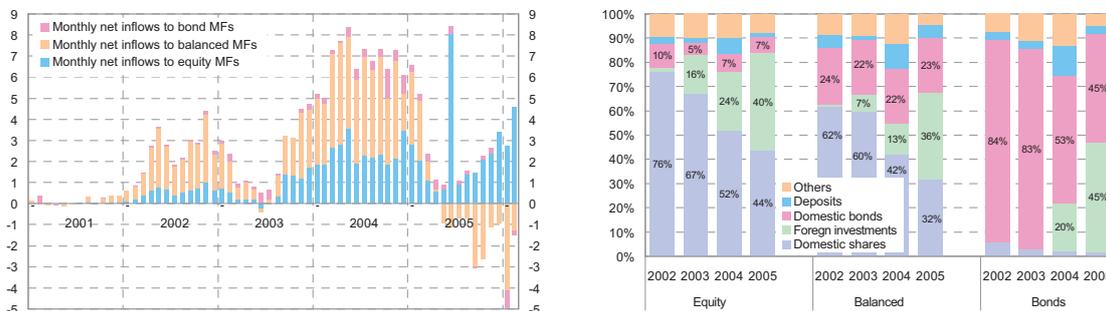


Sources: AMC, Vzajemci.com, Bank of Slovenia, LJSE, own calculations

The recent period has seen the emergence primarily of specialist regional and sector-oriented mutual funds. This year as many as four different management companies have established funds with an investment policy focused on the Balkans and eastern European markets, and through the proximity and their greater familiarity with the Balkan markets they are thereby trying to exploit their advantages over foreign managers in the period of transition. By the end of March 2006 the Slovenian marketplace was offering around 180 mutual funds (68 domestic and 113 non-resident⁸⁰), which represents almost 80% of the securities traded on the Ljubljana Stock Exchange. Competition from non-resident mutual funds is being further stepped up, and in the first two months of this year they recorded net inflows of almost SIT 10 billions,⁸¹ while inflows into Slovenian funds amounted to just over SIT 2 billions. At the end of February non-resident mutual funds held almost SIT 34 billions in assets from Slovenian savers, or 10% of domestic fund assets.

In Slovenia there are already 180 funds trading, accounting for 80% of securities on the organised market.

Figure 6.15: Monthly net inflows into individual types of fund in SIT billions (left) and investment structure in percentages (right)



Sources: Vzajemci.com, AMC, own calculations

A comparison of individual types of Slovenian mutual funds indicates that in 2005 the highest annual returns at 11.5% and also the highest annual amount of net inflows at SIT 27 billions were achieved by equity mutual funds,⁸² whose assets represented half of all Slovenian mutual fund assets at the end of 2005. A tough year was experienced in 2005 chiefly by balanced mutual funds, which recorded net outflows amounting to SIT 3.7 billions, and a 5.5% annual return. The reason lies in their low proportion of foreign investments of 13% at the end of 2004, and thereby their greater dependence on the domestic capital market in 2005. Since the Slovenian capital market is rather non-liquid, in restructuring portfolios they had to be wary of any further reduction in prices through low demand on the domestic market. The importance of bond funds within the structure of all fund assets is still small at 5%, but in part given their development in the more advanced European countries, it is safe to assume that alongside money-market funds they will in the future pose the greatest competition to bank deposits. At the end of 2005 bond mutual funds had

The highest returns and net inflows in 2005 were achieved by equity mutual funds.

⁸⁰ Within this four umbrella funds market 2, 5, 21 and 54 funds, of which two are Slovenian established in Luxembourg and trading in Slovenia.

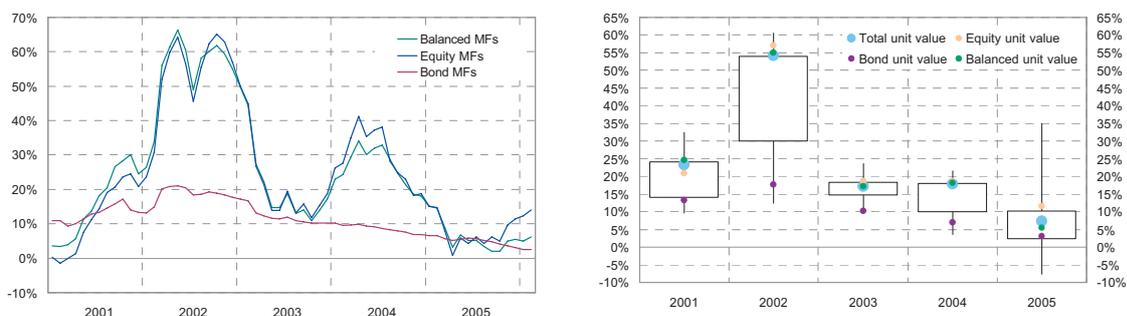
⁸¹ This includes only non-resident mutual funds that are marketed officially in Slovenia.

⁸² In June 2005 around SIT 8 billions in net inflows were recorded as a result of the payment of dividends to the transformed fund from the investment company.

the biggest proportion of foreign investments at 45%. In 2005 they recorded SIT 2.7 billions in net inflows and a 3.1% return on assets, which is a little higher than the annual nominal interest rate for time deposits of more than 1 year of 2.7% at the end of 2005.

The greatest variability in the annual returns of individual mutual funds was in 2002. In 2005 the return of half of the mutual funds ranged from 2% to 10%. The lowest annual return was recorded by an equity fund of Slovenian shares, at -7.6%, and the highest in a global equity fund, at 35%. At the end of 2005, 12 of the 51 mutual funds held less than 20% of their investments abroad, and of these four funds did not invest abroad at all.

Figure 6.16: Annual unit value growth rate of individual types of fund (left) and their ranking at the end of the year (right) in percentages



Notes: The calculation for year-on-year returns takes into account funds that have existed for at least one year. The right figure presents the relative position of year-on-year returns on individual types of mutual fund out of all funds. Year-on-year returns on individual mutual funds have been set out by ranking. The rectangles represent 50% of mutual funds of which 25% had higher and 25% lower returns.

Sources: Vzajemci.com, own calculations

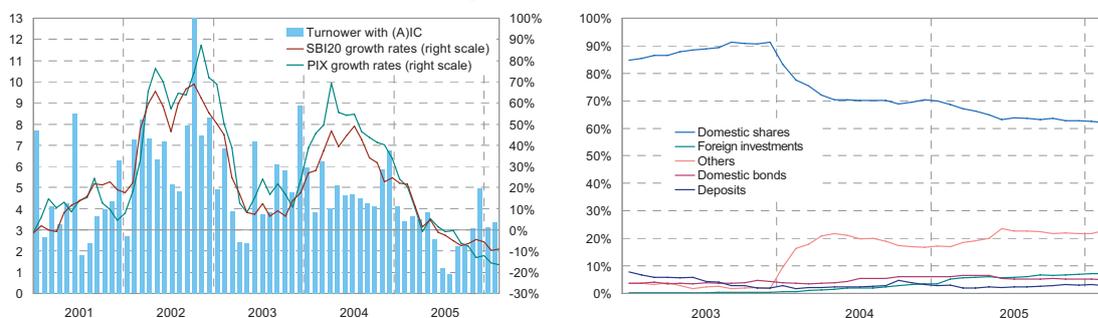
6.3.2 Investment companies

There are just eight investment companies remaining, with SIT 200 billions in assets.

Following the transformation of three investment companies into mutual funds in 2005 there remain eight investments companies, with total assets of SIT 200 billions. The market share of the largest accounts for over a third of all investment company assets. Owing to transformation, the market capitalisation of investment companies has fallen, and at the end of 2005 it represented just 5% of total market capitalisation or 9% of the market capitalisation of shares on the stock exchange. Equally, 2005 saw a reduction in their turnover, which accounted for 6% of total trading on the organised market and 12% of trading in shares.

Given the still-low proportion of investment company assets held in foreign investments, at only just over 7% at the end of February 2006, and the conditions on the domestic capital market in 2005, the average annual growth in the PIX index in 2005 was just under 2%. In the last months of 2005 and the first months of 2006, however, annual growth dipped to -10% and below, and was thus lower than that of the SBI 20. At the end of 2005 only two investment companies held more than 10% of their investments abroad.

Figure 6.17: Year-on-year growth in PIX and SBI 20, monthly investment company turnover in SIT billions (left) and investment structure in percentages (right)



Sources: AMC, LJSE

Under current legislation, investment companies are still governed by the deadline of 2011 for transformation into mutual funds, although they may avoid this if so decided by shareholders at the general meeting with a three-quarters majority. Upon transformation, investment company shareholders will see the value of their shares made equal to their

book value, which is higher than their market value. The law also stipulates that mutual funds may charge investors who withdraw penalty exit fees of up to 20% during their first year after transformation from investment companies, and up to 10% during the second year.

6.4 Leasing Companies

The importance of leasing companies in the financial sector as a whole is growing. The proportion of the financial system's total assets accounted for by leasing companies rose by more than 1 percentage point in 2004 to 8%. Although the proportion of bank loans accounted for by leasing loans fell by 1 percentage point in 2005, it was still high at the end of the year at 14%. Loans by leasing companies from EU member-states⁸³ accounted for just 5% of bank loans at the end of 2004. In addition to strong competition within the sector, the market for leasing services was also faced with fierce competition from bank loans in 2005.

Leasing companies accounted for 8% of the financial system's total assets at the end of 2004.

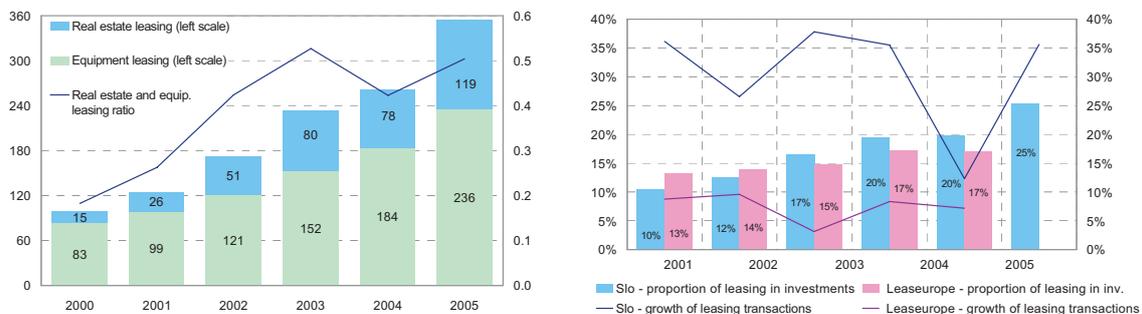
Risks can be transferred between leasing companies and other sectors in the financial system, in particular the banking sector, via business relationships. At the end of 2005, banks held majority or minority interests in eight of the 19 leasing companies that are members of the Slovenian Leasing Association, these eight accounting for more than one-quarter of all the association's leasing business.⁸⁴ It can be concluded from the figures that banks see leasing primarily as a complementary business activity that allows them to be more competitive on the financial services market.

At the end of 2004 liabilities to banks accounted for 27% of leasing companies' total liabilities, which illustrates the significant degree to which they depend on bank sources of financing. However, domestic banks account for approximately only one-half of this. Given the good performance by leasing companies and the low proportion of total bank lending accounted for by leasing companies, which was less than 3% at the end of 2004, it is felt that the possibility of the transfer of credit risk from leasing companies to the banking sector is limited.

Liabilities to banks still account for 27% of leasing companies' total liabilities.

Conditions on the leasing market

Figure 6.18: Volume of leasing business in Slovenia in SIT billions (left) and comparison with Europe (right) in percentages



Notes: The Leaseurope figures includes all the member-states of the European Union with the exception of Cyprus, Ireland, Latvia, Lithuania, Luxembourg and Malta, plus Norway, Switzerland, Romania and Morocco. Gross capital formation exclude investments in housing for reason of comparability with the Leaseurope figures.

Sources: SLA, Bank of Slovenia, Leaseurope, ECB

After recording slightly lower growth in 2004, the leasing market boomed again in 2005, growing by 35%, or SIT 354 billions of new business. The proportion of gross capital formation accounted for by leasing rose by just under 5 percentage points in 2005 to 22%. The decline in interest rates, which slowed in 2005, made leasing companies more

In 2005 leasing companies achieved 35% growth in business.

⁸³ The figures for leasing companies exclude Cyprus, Ireland, Latvia, Lithuania, Luxembourg and Malta, while the figures for bank lending to non-banking sectors exclude Cyprus and Slovakia.

⁸⁴ Two banks that are 100% owners of leasing companies also hold the authorisation to provide financial leasing. Only one of them is actively involved in leasing business, but its proportion of leasing loans as at the end of 2005 was barely 0.5% of the lending by leasing companies.

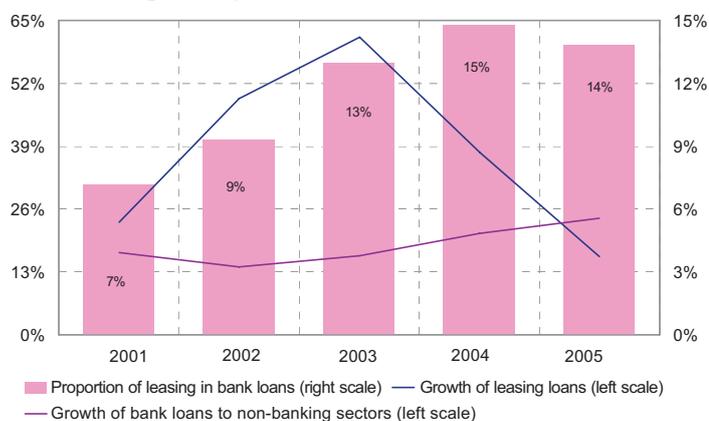
competitive from the point of view of their ability to attract resources, but it also increased the competitiveness of banking services. Tolar interest rates on corporate loans fell by just under 0.5 percentage points to 5.9%, while foreign currency interest rates actually increased by just over 1 percentage point to 3.7%. Despite the greater flexibility that banks have in approving loans, leasing companies are able to compete with them in a certain segment of the lending market with their own adaptability.

Real estate leasing again grew in importance in 2005, with its volume of business 50% that of property leasing. Slovenian leasing companies believe that there is still room for growth in real estate leasing, even though the average proportion of the business of Leaseurope members that it accounted for at the end of 2004 was 13 percentage points lower than in Slovenia.

Leasing loans account for 14% of bank loans.

Despite the high growth in the volume of leasing business, the 16% annual growth recorded by leasing loans in 2005 was 8 percentage points behind the growth in bank loans to non-banking sectors. The proportion of bank loans accounted for by leasing fell to a still-high 14%, equivalent to more than half of the largest bank's market share with regard to lending to non-banking sectors in 2005.

Figure 6.19: Year-on-year growth in bank lending to non-banking sectors and of lending by leasing companies, and leasing loans as a proportion of bank loans in percentages



Notes: Only loans by leasing companies that report to the Slovenian Leasing Association are included.
Sources: SLA, Bank of Slovenia

Performance of leasing companies

The performance of leasing companies was worse in 2004 than in previous years.

Leasing companies did not perform as well in 2004 as they had in the previous year, which was primarily the result of the smaller volume of business in that year. With annual growth of barely 2%, profit reached just under SIT 10 billions. A significant deterioration in ROA and ROE was also brought about in 2004 by the increases of 34% in total assets and 52% in capital. The renewed high growth in leasing business of more than 35% in 2005 points to an improvement in the performance of leasing companies in 2005. The same conclusion could be drawn from the increase in leasing companies' total assets in 2004, in particular items that illustrate their investment in movable property and real estate for subsequent leasing such as tangible assets and inventories, and items that already show an increase in claims against customers such as financial investments and operating receivables.

Table 6.13: Performance of leasing companies and sources of financing

	2001	2002	2003	2004	Growth rates (%)			
					2001	2002	2003	2004
Balance sheet total (SIT billions)	316	387	485	648	30.8	22.7	25.1	33.7
Capital (SIT billions)	27	31	36	54	27.8	15.0	16.0	52.2
Total profit or loss (SIT billions)	4.9	5.2	9.7	9.9	28.5	6.3	88.0	2.0
ROA - return on assets (%)	1.75	1.47	2.23	1.76				
ROE - return on capital (%)	20.43	18.00	29.28	22.05				
Financial and operating liabilities (SIT billions)	260	348	443	588	35.6	33.8	27.2	32.7
Liabilities to the rest of the world (%)	76	76	81	80				
Open foreign exchange position/Assets (%)	-62	-69	-74	-72				

Notes: The figures from the financial statements include all companies classed under J65.21 (financial leasing) in the Standard Classification of Activities. Members of the Slovenian Leasing Association accounted for 89% of the total assets of the companies classed under J65.21 as at the end of 2004. Four companies accounting for 8% of the association's total assets were members of the association at the end of 2004 but were not included under J65.21.

Source: APLRRS

Financial leasing is gaining in importance over operating leasing. Asset items resulting from financial leasing grew by 38% in 2004, compared with a 17% rise in those resulting from operating leasing.⁸⁵ The proportion accounted for by the latter had fallen to just over 32% by the end of 2004. Financial leasing in particular is a competing product for bank loans, as the subject of the lease contract becomes the property of the lessee after the contract ends. As by their very legal nature claims against lessees are insured with a lien on the subject of the leasing, the insurance costs are generally lower than at banks.

Financial leasing is gaining importance.

Leasing companies obtain the majority of their financing abroad, the figure standing at approximately 80% at the end of 2004, while foreign capital accounted for 44% of leasing companies' capital at the end of 2004. Borrowing abroad at parent companies rose by more than SIT 77 billions in 2004, to account for 62% of all liabilities to the rest of the world.⁸⁶ Leasing companies' liabilities to banks rose by 34% in 2004 to almost SIT 160 billions. The rising exposure to exchange-rate risk measured by the ratio of the open foreign exchange position to total assets was halted in 2004. Leasing companies' short foreign exchange position closed slightly in 2004, but was still very high at the end of the year at 72% of their assets. Given the degree to which leasing companies depend on lending from abroad in particular, the potential transfer of their realised risks to domestic banks is relatively small.

Leasing companies obtain financing chiefly from abroad.

⁸⁵ Items treated as resulting from operating leasing are tangible assets and short-term operating receivables, while those resulting from financial leasing are long-term and short-term financial investments and long-term operating receivables.

⁸⁶ With the entry into force of the Corporate Income Tax Act in 2005, interest on loans made by related parties is taxed on the portion of the loan that exceeds four times the invested capital of the related party (it was eight times the invested capital in 2005 pursuant to the transitional provisions), unless the borrower is a bank or insurer.

7 FINANCIAL INFRASTRUCTURE

The financial infrastructure (payment systems and the systems for clearing and settling securities) in the globalised world facilitates growth in the volume of financial flows and ensures the constant connection of those performing transactions. Both increase the importance of efficiency and also of risk management in the functioning of the financial infrastructure, specifically credit, liquidity, systemic, operational and legal risk.

Operating in line with EU and ECB regulations is an element of managing legal risk.

In recent years Slovenia's financial infrastructure has seen intensive regulatory, institutional and operational changes. The processes of Slovenia's integration into the European Union and the European System of Central Banks (ESCB) involved a complicated adjustment in the legal domain based upon the Treaty on European Union and the Protocol on the Statute of the European System of Central Banks and the European Central Bank (ECB). Here the ECB adopted as the standard in inspecting the functioning of the payment systems the Core Principles for Systemically Important Payment Systems, which were designed under the aegis of the Bank for International Settlements (BIS), and on their basis special standards for reviewing the functioning of payment systems for settling payments of smaller value. The European Commission regulates the area of payment systems and systems of clearing and settlement of securities through Directive 98/26/EC on settlement finality in payment and securities settlement systems and through Directive 2002/47/EC on financial collateral arrangements. Relations between payment transaction providers and clients are regulated by Directive 97/5/EC on cross-border credit transfers, Directive 2000/46/EC on the taking up, pursuit of and prudential supervision of the business of electronic money institutions and by Regulation 2560/2001 relating to cross-border payments of up to EUR 50,000. Slovenian legislation is entirely harmonised with these regulations. Consistent implementation of regulations amended in this way forms an integral part of the system of managing risk in the functioning of payment systems and systems of securities settlement in Slovenia

Central banks play an important role in ensuring the undisrupted operation of payment and settlement systems, given both their primary functions (achieving monetary policy goals, ensuring adequate liquidity in the banking system) and the responsibility that they share for the stability of financial systems. At the same time they are a direct component of payment and settlement systems if they function as supervisory institutions of the banking system, and inspectors of the functioning of payment systems for those that they manage, or they operate as settlement agents. The Bank of Slovenia performs all these functions in the tolar payment systems, while at the same time it is incorporated into the pan-European payment systems TARGET and STEP2.

7.1 Payment Systems

The Bank of Slovenia manages the RTGS and Giro Clearing systems.

The Bank of Slovenia manages two payment systems for tolar payments. The first is the system of Real Time Gross Settlements (RTGS) used for urgent payments and payments of over SIT 2 millions. The other system is Giro Clearing for payments valued at up to and including SIT 2 millions. The Bank of Slovenia, 19 banks and three savings banks participate in both systems, while the RTGS system also requires the participation of the Central Securities Clearing Corporation. The two systems are linked in a way that the settlement of positions in the Giro Clearing system is performed via the settlement accounts of RTGS system participants.

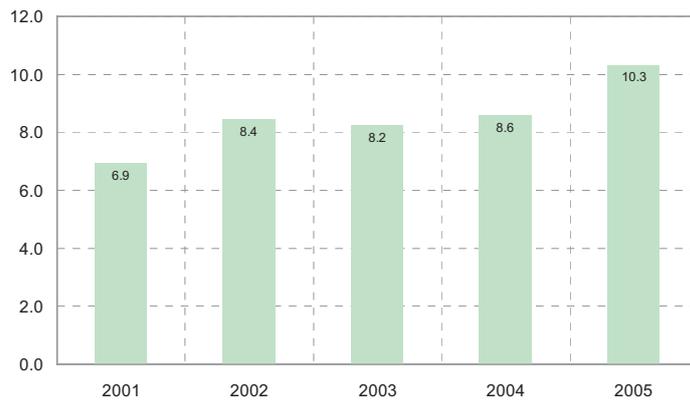
Table 7.1: Value and number of transactions in the RTGS and Giro Clearing systems and growth rates

	2001	2002	2003	2004	2005	Growth rates (%)			
						2002	2003	2004	2005
Value of transactions (SIT billions)									
RTGS	29,153	40,138	43,391	48,774	62,694	37.7	8.1	12.4	28.5
Giro Clearing	3,794	4,462	4,506	4,844	5,027	17.6	1.0	7.5	3.8
Number of transactions (millions)									
RTGS	1.445	1.351	1.264	1.371	1.404	-6.4	-6.5	8.5	2.4
Giro Clearing	48.181	50.486	46.613	48.598	49.419	4.8	-7.7	4.3	1.7

Source: Bank of Slovenia

The total value of transactions in the RTGS system and Giro Clearing showed absolute growth between 2001 and 2005, and also growth relative to GDP. In 2001 it exceeded GDP by a factor of 6.9 and in 2005 by a factor of 10.3.

Figure 7.1: Ratio of the total value of transactions in the RTGS and Giro Clearing systems to GDP



Sources: Bank of Slovenia, SORS

Alongside the two systems managed by the Bank of Slovenia, there are six other payment systems for tolar payments managed by other operators. The Bank of Slovenia is responsible for inspecting them, and for three of them it is also the settlement agent:

- NLB Clearing for transactions between the business accounts of banks in the NLB bank group administered by NLB d.d.,
- Four systems for settling payment card transactions: the first is the Activa system, where the Bank of Koper is the accounting agent for receivables and payables relating to Aktiva payment card products, while the Bank of Slovenia is the settlement agent; the second is the Card Payments Clearing administered by the company Bankart; the third is Visa clearing, which serves to settle receivables and payables for the Visa system performed in tolar (up until March 2006 the settlement agent was Abanka Vipava, and since then this role has been assumed by the Bank of Slovenia); the fourth is MasterCard clearing for the settlement of tolar receivables and payables in the MasterCard system; the Bank of Slovenia is the settlement agent for this system,
- The ATM Clearing system for withdrawals from ATMs at all banks in Slovenia; this network is administered by Bankart, which is also the accounting agent.

In 2005 the total value of tolar payment system transactions exceeded Slovenian GDP by a factor of 10.5. The importance of the individual payment system is reflected by the figures on the number and value of transactions:

Table 7.2: Number and value of payment system transactions in SIT billions for tolar payments in 2005

Payment system	Number of transactions (millions)	Proportion (%)	Value of transactions (SIT billions)	Proportion (%)
RTGS	1.4	1.0	62,694	91.3
Giro Clearing	49.4	36.0	5,027	7.3
NLB Clearing	1.1	0.8	161	0.2
Activa	37.8	27.6	263	0.4
Card Payments Clearing	17.0	12.4	121	0.2
ATM Clearing	30.4	22.2	389	0.6
Total	137.1	100.0	68,655	100.0

Notes: This table does not include figures for payment systems whose accounting agents are outside Slovenia (MasterCard and Visa).

Source: Bank of Slovenia

Risks to the functioning of the tolar payment systems are concentrated in the RTGS system, owing to the high value of individual transactions and the high total value of transactions, the link to the Giro Clearing system, and in particular liquidity risk, since payments are settled in real time. Interbank settlement is based on three sources of liquidity: the balance in the settlement account (including the required reserves), inflows to the settlement account from payments received, and loans taken on the interbank market or from the Bank of Slovenia. Given that banks have guaranteed access to Bank of Slovenia loans, liquidity risk is extremely limited. Credit risk is managed by having interbank settlement performed immediately for each individual payment.

Payment system risks for tolar payments are concentrated in the RTGS system.

In the RTGS system, payments in terms of the number of transactions performed by individual commercial and savings banks are not particularly concentrated, while at the

same time the degree of concentration is falling slightly, with the HHI falling since 2003 from 1337 to 1243 index points. In the same period the proportion of transactions performed by the five biggest banks fell by 1.5 percentage points (from 67% to 65.5%). Taking account of data for 2005 there exists a strong connection between the value of payment transactions performed within the RTGS system and the value of commercial banks' total assets (correlation coefficient of 0.94) and the value of banks' capital, where the correlation coefficient is just a little lower (0.89). This indicates that the risks of the RTGS system have also been reduced through the appropriate division of transactions among participants of the system relative to their total assets and capital power.

Figure 7.2: Concentration of the number of transactions in the RTGS and Giro Clearing systems – Herfindahl-Hirschman index (HHI) – and proportion of total number of transactions accounted for by the five largest banks (excluding the Bank of Slovenia)



Source: Bank of Slovenia.

Risk management in the Giro Clearing system is based on mutual loans and a settlement scheme.

In the Giro Clearing system, liquidity and credit risk are managed through the requirement that participants lacking sufficient funds in their settlement accounts to settle the net debit position immediately take a loan from another participant in the system (including the Bank of Slovenia). In the event of the non-fulfilment of this obligation, liquidity would be ensured by other participants in the system, whereby the Bank of Slovenia would activate the settlement guarantee scheme in which the unsettled liability of one or more participants is divided between other liquid participants. The Bank of Slovenia's exposure to risk as the settlement agent is prevented by first directly charging the settlement accounts of participant debtors and only then approving the settlement accounts of participant creditors. The HHI values (1224 index points in 2003, and 1211 points in 2005), and the share of transactions by the five biggest banks (69% in 2003 and 68.7% in 2005) indicate that the number of transactions between participating commercial banks and savings banks is not particularly concentrated, and that the concentration is showing a token decline. The connection between the value of payment transactions performed in 2005 in the Giro Clearing system and the value of commercial banks' total assets and capital is expressed in almost exactly the same way as in the RTGS system (the value of the correlation coefficients being 0.94 and 0.88 respectively).

7.2 Securities Settlement Systems

In Slovenia there are two systems of settling securities in operation. The first is the CSCC system, which is subject to Bank of Slovenia inspection, while the supervisor is the Securities Market Agency (SMA). The other is the system of settling foreign currency bills at the Bank of Slovenia, which exists only for one of the Bank of Slovenia's monetary policy instruments, and upon incorporation into the European monetary system this will be abolished.

Risk management in the securities settlement system meets the conditions for inclusion in the ESCB.

Two elements are important for the management of risk in the CSCC system of settling securities. The CSCC system of risk management is regulated on the basis of 19 recommendations for securities settlement systems published in November 2001 by the Committee for Payments and Settlements Systems at the Bank for International Settlements and by the technical committee of the International Organisation of Securities Commissions. From the aspect of risk management Recommendation 5 is especially important, since it governs managing the risk of non-fulfilment of monetary obligations by participants in the system. Secondly, in 1998 the European Monetary Institute issued ECB Standards for the use of securities settlement systems in ESCB credit operations. The ESCB has a statutory requirement that all monetary policy credit operations in the ESCB system must have full collateral. Securities used as collateral must be entered in securities settlement systems

that operate in line with the aforementioned European Monetary Institute standards. In cooperation with the ECB, in 2003 the Bank of Slovenia informally assessed the conformity of both Slovenian securities settlement systems to the aforementioned standards, in order to identify and eliminate any possible deficiencies prior to incorporation into the Eurosystem. Based on this assessment certain recommendations were issued, and these have been carried out. The one exception is the recommendation on harmonising working hours with the working hours of the TARGET system, which will be carried out before entry into the Eurosystem. In September 2005 using the same ECB methodology a new, and now formal, assessment of the CSCC system was started, and this will serve as a basis for deciding whether the CSCC system meets the conditions for performing Eurosystem credit operations. The assessment should be concluded in June 2006 with formal confirmation of the suitability of the CSCC system for operation within the ESCB framework.

Collateral for settlement risk in the CSCC system of securities settlement is provided through a guarantee fund in the form of two tolar deposits at the Bank of Slovenia. (Up until 2004 these deposits were held at one of the commercial banks and not at the Bank of Slovenia.) CSCC members use this to provide mutual guarantees for possible unsettled obligations by any one of them. In order to be able to activate collateral in the shortest possible time, the deposits are envisaged as collateral for short-term liquidity loans from the Bank of Slovenia which the CSCC would take out in the event of non-fulfilment of settlement liabilities.



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1. Financial system

Table 1.1 Structure of the financial system

	Total assets (SIT billions)		Total assets (EUR millions)		Structure (%)		As % of GDP	
	2004	2005	2004	2005	2004	2005	2004	2005
Monetary financial institutions ¹	5,711	7,018	23,822	29,293	70.7	73.4	91.4	107.0
Banks, total ²	5,678	6,980	23,686	29,135	70.3	73.0	90.8	106.4
Banks under private ownership	4,358	5,432	18,178	22,672	53.9	56.8	69.7	82.8
– domestic	2,257	2,657	9,414	11,090	27.9	27.8	36.1	40.5
– foreign	2,101	2,775	8,764	11,581	26.0	29.0	33.6	42.3
Banks under state ownership	1,320	1,548	5,508	6,463	16.3	16.2	21.1	23.6
Savings banks and SLUs	33	38	136	159	0.4	0.4	0.5	0.6
Non-monetary financial institutions	2,369	2,546	9,882	10,628	29.3	26.6	37.9	38.8
Insurers ³	684	783	2,855	3,267	8.5	8.2	10.9	11.9
Pension funds	114	161	475	670	1.4	1.7	1.8	2.4
Investment funds	500	532	2,085	2,221	6.2	5.6	8.0	8.1
Leasing companies ^{4,5}	642	642	2,680	2,681	8.0	6.7	10.3	9.8
BHs, MCs and others ⁵	428	428	1,787	1,788	5.3	4.5	6.9	6.5
Total	8,080	9,564	33,704	39,922	100	100	129.3	145.8

Notes: ¹ Monetary financial institutions do not include the central bank.
² The division of banks takes into account the share of ownership relative to total assets.
³ The figure for total assets of reinsurance companies is for the end of the third quarter of 2005.
⁴ The number of active members of the Slovenian Leasing Association is taken as the number of leasing companies.
⁵ Total assets according to data for the end of 2004.

Sources: Bank of Slovenia, ISA, SMA, AMC, SLA, APLRRS

Table 1.2 Market concentration of individual types of financial institution

		Banks		Insurers		Pension funds		Investment funds		Leasing companies	
		2004	2005	2004	2005	2004	2005	2004	2005	2004	2005
HHI	All companies	1,451	1,389	2,605	2,650	1,635	1,677	715	612	1,797	1,992
	Five largest	1,286	1,214	2,536	2,599	1,587	1,632	573	481	1,663	1,852
	Three largest	1,239	1,170	2,479	2,516	1,051	1,181	506	428	1,614	1,798
	Largest	1,053	991	2,228	2,282	441	507	185	164	1,434	1,600
Share (%)	All companies	100	100	100	100	100	100	100	100	100	100
	Five largest	65	63	80	81	89	89	50	46	70	74
	Three largest	52	50	74	74	56	59	39	36	57	60
	Largest	32	31	47	48	21	23	14	13	38	40

Notes: The HHI is calculated in terms of total assets, with the exception of leasing companies, for which it is calculated in terms of volume of transactions concluded. Pension funds do not include the First Pension Fund (PPS), since that is a closed fund that envisages no additional inflows.

Sources: Bank of Slovenia, ISA, SMA, AMC, SLA, APLRRS

Table 1.3 Financial assets and liabilities of individual sectors as a proportion of GDP (Slovenia, euro area) in percentages

		As % of GDP				
		Households	Non-financial companies	Government	Financial companies	Total
FINANCIAL ASSETS						
Slovenia	2001	83	45	46	108	284
	2004	91	48	43	125	308
	2005	94	52	40	140	326
Euro area	2000	212	146	31	371	761
FINANCIAL LIABILITIES						
Slovenia	2001	21	135	37	94	288
	2004	22	149	37	115	324
	2005	25	154	36	131	345
Euro area	2000	56	256	81	367	760
NET POSITION						
Slovenia	2001	62	-90	9	14	-4
	2004	69	-102	6	10	-16
	2005	69	-101	4	9	-19
Euro area	2000	156	-110	-51	5	0

Sources: Bank of Slovenia, ECB (Report on Financial Structures, 2002)

Table 1.4 Financial assets and liabilities of individual sectors from intermediation as a proportion of GDP (Slovenia, euro area) in percentages

		As % of GDP				
		Households	Non-financial companies	Government	Financial companies	Total
FINANCIAL ASSETS						
Slovenia	2001	48	13	5	17	84
	2004	52	13	6	7	78
	2005	55	14	4	11	84
Euro area	2000	134	20	8	91	253
FINANCIAL LIABILITIES						
Slovenia	2001	16	44	6	11	78
	2004	17	53	5	23	98
	2005	20	59	4	32	116
Euro area	2000	51	66	15		

Sources: Bank of Slovenia, ECB (Report on Financial Structures, 2002)

Table 1.5 Financial assets of individual sectors from intermediation by sector as proportion of GDP (Slovenia, euro area) in percentages

		As % of GDP				
		Households	Non-financial companies	Government	Financial companies	Total
MONETARY FINANCIAL INSTITUTIONS (S.122)						
Slovenia	2001	40.2	11.3	4.8	17.2	74.1
	2004	40.1	10.6	5.5	7.1	64.0
	2005	40.8	11.6	4.4	10.3	67.1
Euro area	2000	62.8	15.4	6.8	74.2	159.2
OTHER FINANCIAL INTERMEDIARIS (S.123)						
Slovenia	2001	3.0	0.7	0.0	0.0	3.7
	2004	4.8	1.6	0.0	0.2	6.5
	2005	6.6	1.1	0.1	0.7	8.5
Euro area	2000	22.3	3.2	0.8	15.4	41.7
INSURERS AND PENSION FUNDS (S.125)						
Slovenia	2001	4.5	1.2	0.0	0.0	5.7
	2004	6.7	1.1	0.0	0.1	7.9
	2005	7.7	1.1	0.0	0.1	8.8
Euro area	2000	49.4	1.4	0.1	1.2	52.0

Sources: Bank of Slovenia, ECB (Report on Financial Structures, 2002)

Table 1.6 Direct ownership structure of the Slovenian financial system - valuation of shares by market and book value in percentages

ISSUERS	Ownership structure (%)				Total
	Banks	Other financial intermediaries	Insurers and pension funds	Non-financial companies	
OWNERS					
	2003				
Non-financial companies	26	27	10	30	29
Banks	9	10	2	2	4
Other financial intermediaries	6	11	7	21	18
Insurers and pension funds	3	2	6	2	2
Government	23	0	64	18	19
Households	2	45	2	18	18
Non-residents	30	2	9	6	8
Others	1	3	0	3	3
Total	100	100	100	100	100
	2004				
Non-financial companies	25	23	12	26	25
Banks	10	7	7	2	4
Other financial intermediaries	5	12	16	20	17
Insurers and pension funds	3	7	10	2	3
Government	23	0	44	17	17
Households	2	43	1	18	18
Non-residents	30	3	8	10	12
Others	1	4	1	5	5
Total	100	100	100	100	100
	2005				
Non-financial companies	24	30	14	31	29
Banks	8	8	7	3	4
Other financial intermediaries	2	9	1	11	10
Insurers and pension funds	3	8	10	1	2
Government	23	8	54	23	23
Households	2	34	1	17	16
Non-residents	36	2	10	11	13
Others	2	2	0	3	2
Total	100	100	100	100	100

Notes: The figure for the proportion of government-owned shares is not comparable between the two periods, since in October 2005 there was a reclassification of Capital Fund from the other financial intermediaries sector (S.123) to the government sector (S.13).

Sources: CSCC, own calculations

2. Banking sector

Table 2.1 Balance sheet of the banking sector in SIT billions and EUR millions

	(SIT billions)					(EUR millions)				
	2001	2002	2003	2004	2005	2001	2002	2003	2004	2005
ASSETS	3,877	4,557	5,057	5,678	6,980	17,509	19,790	21,367	23,686	29,135
1) Cash	206	143	141	141	144	931	622	598	588	600
2) Loans to banks (including BoS)	396	381	345	508	682	1,790	1,656	1,458	2,117	2,849
3) Loans to non-banking sectors	1,914	2,182	2,538	3,070	3,812	8,644	9,477	10,723	12,805	15,909
3.1 Currency breakdown										
– toolars	1,557	1,652	1,808	2,001	2,064	7,031	7,175	7,640	8,345	8,615
– foreign currency	357	530	730	1,069	1,748	1,614	2,301	3,083	4,459	7,295
3.2 Maturity breakdown										
– short-term	1,094	1,181	1,340	1,549	1,795	4,943	5,131	5,664	6,459	7,492
– long-term	820	1,001	1,198	1,521	2,017	3,702	4,346	5,060	6,345	8,418
3.3 Sectoral breakdown										
– corporate sector	1,217	1,358	1,699	2,062	2,559	5,497	5,896	7,179	8,602	10,683
– households	521	563	629	764	962	2,354	2,444	2,658	3,185	4,016
– government	159	216	142	143	155	718	938	600	596	647
– others	17	46	68	101	135	75	199	286	422	564
4) Securities	1,109	1,547	1,720	1,643	1,954	5,010	6,719	7,266	6,851	8,158
4.1 Currency breakdown										
– toolars	564	917	1,077	1,025	1,382	2,548	3,982	4,552	4,274	5,768
– foreign currency	545	630	642	618	570	2,463	2,737	2,713	2,578	2,380
4.2 Maturity breakdown										
– short-term	836	1,193	1,288	1,088	1,248	3,777	5,179	5,442	4,537	5,211
– long-term	273	354	432	555	706	1,233	1,539	1,824	2,314	2,948
4.3 Sectoral breakdown										
– government	386	462	494	601	641	1,745	2,008	2,086	2,506	2,676
– Bank of Slovenia	584	920	1,027	766	838	2,638	3,995	4,340	3,197	3,500
– others	139	165	199	275	475	627	716	839	1,148	1,983
5) Capital investments	69	69	81	87	133	311	298	340	364	555
6) Others	182	234	233	230	255	823	1,017	982	961	1,064
LIABILITIES	3,877	4,557	5,057	5,678	6,980	17,509	19,790	21,367	23,686	29,135
1) Liabilities to banks (including BoS)	453	585	836	1,118	1,981	2,045	2,539	3,531	4,662	8,271
– of which foreign	328	467	707	1,015	1,861	1,483	2,026	2,986	4,233	7,766
2) Deposits by non-banking sectors	2,762	3,150	3,294	3,526	3,833	12,473	13,678	13,919	14,709	15,998
2.1 Currency breakdown										
– toolars	1,766	2,091	2,198	2,306	2,565	7,978	9,079	9,288	9,619	10,707
– foreign currency	995	1,059	1,096	1,220	1,267	4,495	4,600	4,631	5,090	5,290
2.2 Maturity breakdown										
– short-term	2,549	2,849	3,001	3,257	3,573	11,512	12,372	12,678	13,585	14,916
– long-term	213	300	294	270	259	961	1,305	1,240	1,125	1,082
2.3 Sectoral breakdown										
– corporate sector	740	852	881	932	1,035	3,343	3,700	3,720	3,887	4,319
– households	1,756	1,979	2,139	2,341	2,475	7,932	8,593	9,035	9,766	10,332
– government	152	208	158	135	208	684	901	667	565	867
– others	114	112	117	118	115	513	485	496	492	480
3) Securities	111	176	216	225	240	501	766	914	938	1,002
3.1 Currency breakdown										
– toolars	94	172	211	221	236	422	746	893	922	984
– foreign currency	17	5	5	4	4	79	20	21	16	19
3.2 Maturity breakdown										
– short-term	46	33	84	68	54	207	144	353	283	226
– long-term	65	143	133	157	186	294	622	561	655	776
4) Provisions	76	92	101	120	140	344	398	428	502	586
5) Subordinated debt	36	68	96	144	170	164	297	405	599	709
6) Capital	342	380	421	461	518	1,545	1,652	1,777	1,922	2,162
7) Others	97	106	93	85	98	438	459	394	354	407

Notes: Converted into euros at the end of year rate.

Source: Bank of Slovenia

Table 2.2 Balance sheet of the banking sector - growth, proportion of total assets and proportion of GDP in percentages

	Growth rate (%)					Proportion of balance sheet (%)					As % of GDP				
	2001	2002	2003	2004	2005	2001	2002	2003	2004	2005	2001	2002	2003	2004	2005
ASSETS	24.0	17.5	11.0	12.3	22.9	100	100	100	100	100	90.1	85.1	87.0	90.8	106.4
1) Cash	109.1	-30.5	-1.3	-0.3	1.8	5.3	3.1	2.8	2.5	2.1	4.8	2.7	2.4	2.3	2.2
2) Loans to banks (including BoS)	8.7	-3.8	-9.5	47.0	34.5	10.2	8.4	6.8	8.9	9.8	9.2	7.1	5.9	8.1	10.4
3) Loans to non-banking sectors	17.0	14.0	16.3	21.0	24.2	49.4	47.9	50.2	54.1	54.6	44.5	40.7	43.7	49.1	58.1
3.1 Currency breakdown															
- toolars	15.2	6.1	9.4	10.6	3.2	40.2	36.3	35.8	35.2	29.6	36.2	30.9	31.1	32.0	31.5
- foreign currency	25.7	48.3	37.7	46.5	63.5	9.2	11.6	14.4	18.8	25.0	8.3	9.9	12.6	17.1	26.6
3.2 Maturity breakdown															
- short-term	15.7	8.0	13.5	15.5	15.9	28.2	25.9	26.5	27.3	25.7	25.4	22.1	23.1	24.8	27.4
- long-term	18.9	22.1	19.7	27.0	32.6	21.1	22.0	23.7	26.8	28.9	19.1	18.7	20.6	24.3	30.8
3.3 Sectoral breakdown															
- corporate sector	24.0	11.5	25.2	21.4	24.1	31.4	29.8	33.6	36.3	36.7	28.3	25.3	29.2	33.0	39.0
- households	7.7	8.0	11.8	21.4	26.0	13.4	12.4	12.4	13.4	13.8	12.1	10.5	10.8	12.2	14.7
- government	5.4	35.8	-34.3	0.7	8.5	4.1	4.7	2.8	2.5	2.2	3.7	4.0	2.4	2.3	2.4
- others	-13.7	175.2	48.2	49.2	33.7	0.4	1.0	1.3	1.8	1.9	0.4	0.9	1.2	1.6	2.1
4) Securities	39.9	39.5	11.2	-4.5	19.0	28.6	34.0	34.0	28.9	28.0	25.8	28.9	29.6	26.3	29.8
4.1 Currency breakdown															
- toolars	51.6	62.6	17.5	-4.9	34.9	14.5	20.1	21.3	18.0	19.8	13.1	17.1	18.5	16.4	21.1
- foreign currency	29.5	15.6	1.9	-3.8	-7.7	14.1	13.8	12.7	10.9	8.2	12.7	11.8	11.0	9.9	8.7
4.2 Maturity breakdown															
- short-term	56.5	42.6	8.0	-15.5	14.8	21.6	26.2	25.5	19.2	17.9	19.4	22.3	22.2	17.4	19.0
- long-term	5.5	29.8	21.8	28.5	27.3	7.0	7.8	8.5	9.8	10.1	6.3	6.6	7.4	8.9	10.8
4.3 Sectoral breakdown															
- government	18.8	19.7	6.8	21.7	6.7	10.0	10.1	9.8	10.6	9.2	9.0	8.6	8.5	9.6	9.8
- Bank of Slovenia	59.9	57.5	11.7	-25.4	9.4	15.1	20.2	20.3	13.5	12.0	13.6	17.2	17.7	12.3	12.8
- others	35.2	18.8	20.6	38.5	72.6	3.6	3.6	3.9	4.8	6.8	3.2	3.1	3.4	4.4	7.2
5) Capital investments	3.3	-0.1	17.1	8.3	52.5	1.8	1.5	1.6	1.5	1.9	1.6	1.3	1.4	1.4	2.0
6) Others	9.0	28.4	-0.7	-0.9	10.6	4.7	5.1	4.6	4.1	3.7	4.2	4.4	4.0	3.7	3.9
LIABILITIES	24.0	17.5	11.0	12.3	22.9	100	100	100	100	100	90.2	85.1	87.0	90.8	106.4
1) Liabilities to banks (including BoS)	13.6	29.1	42.9	33.7	77.3	11.7	12.8	16.5	19.7	28.4	10.5	10.9	14.4	17.9	30.2
- of which foreign	21.7	42.1	51.5	43.6	83.3	8.5	10.2	14.0	17.9	26.7	7.6	8.7	12.2	16.2	28.4
2) Deposits by non-banking sectors	28.0	14.1	4.6	7.0	8.7	71.2	69.1	65.1	62.1	54.9	64.2	58.8	56.7	56.4	58.4
2.1 Currency breakdown															
- toolars	26.4	18.4	5.2	4.9	11.2	45.6	45.9	43.5	40.6	36.8	41.1	39.0	37.8	36.9	39.1
- foreign currency	31.0	6.4	3.5	11.3	3.9	25.7	23.2	21.7	21.5	18.2	23.1	19.8	18.9	19.5	19.3
2.2 Maturity breakdown															
- short-term	29.5	11.8	5.3	8.5	9.7	65.7	62.5	59.3	57.4	51.2	59.3	53.2	51.6	52.1	54.5
- long-term	12.0	41.2	-2.3	-8.2	-3.9	5.5	6.6	5.8	4.7	3.7	4.9	5.6	5.1	4.3	4.0
2.3 Sectoral breakdown															
- corporate sector	23.7	15.1	3.4	5.8	11.0	19.1	18.7	17.4	16.4	14.8	17.2	15.9	15.1	14.9	15.8
- households	35.7	12.7	8.1	9.5	5.7	45.3	43.4	42.3	41.2	35.5	40.8	36.9	36.8	37.5	37.7
- government	-11.5	37.0	-23.9	-14.3	53.4	3.9	4.6	3.1	2.4	3.0	3.5	3.9	2.7	2.2	3.2
- others	20.9	-1.8	5.2	0.4	-2.6	2.9	2.4	2.3	2.1	1.6	2.6	2.1	2.0	1.9	1.8
3) Securities	59.9	59.0	22.6	4.0	6.7	2.9	3.9	4.3	4.0	3.4	2.6	3.3	3.7	3.6	3.7
3.1 Currency breakdown															
- toolars	67.1	83.7	23.1	4.6	6.6	2.4	3.8	4.2	3.9	3.4	2.2	3.2	3.6	3.5	3.6
- foreign currency	30.1	-73.0	4.2	-22.8	17.6	0.5	0.1	0.1	0.1	0.1	0.4	0.1	0.1	0.1	0.1
3.2 Maturity breakdown															
- short-term	81.2	-27.6	152.1	-18.9	-20.2	1.2	0.7	1.7	1.2	0.8	1.1	0.6	1.4	1.1	0.8
- long-term	47.7	120.0	-7.4	18.4	18.4	1.7	3.1	2.6	2.8	2.7	1.5	2.7	2.3	2.5	2.8
4) Provisions	19.1	20.4	10.6	18.8	16.6	2.0	2.0	2.0	2.1	2.0	1.8	1.7	1.7	1.9	2.1
5) Subordinated debt	-7.7	88.8	40.2	49.7	18.4	0.9	1.5	1.9	2.5	2.4	0.8	1.3	1.6	2.3	2.6
6) Capital	8.0	11.2	10.6	9.5	12.4	8.8	8.3	8.3	8.1	7.4	8.0	7.1	7.2	7.4	7.9
7) Others	21.4	8.9	-11.8	-8.9	15.0	2.5	2.3	1.8	1.5	1.4	2.3	2.0	1.6	1.4	1.5

Source: Bank of Slovenia

Table 2.3 Income statement of the banking sector in SIT millions and EUR millions

	(SIT millions)					(EUR millions)				
	2001	2002	2003	2004	2005	2001	2002	2003	2004	2005
1. Net interest income	115,930	143,407	145,678	143,678	150,754	523.6	622.8	615.5	599.3	629.3
1.1 Interest income	298,200	344,145	331,121	286,195	285,942	1,346.8	1,494.5	1,399.0	1,193.8	1,193.5
1.2 Interest expenses	182,270	200,739	185,443	142,517	135,188	823.2	871.8	783.5	594.5	564.3
2. Net non-interest income	57,249	80,975	83,259	99,075	115,332	258.6	351.7	351.8	413.3	481.4
2.1 Net fees and commissions	41,523	53,962	54,907	61,872	67,245	187.5	234.3	232.0	258.1	280.7
2.2 Net financial transactions	20,805	21,205	19,490	30,268	38,731	94.0	92.1	82.3	126.3	161.7
2.3 Net other income	-5,080	5,808	8,862	6,934	9,355	-22.9	25.2	37.4	28.9	39.0
3. Gross income (1+2)	173,179	224,382	228,937	242,753	266,086	782.2	974.4	967.2	1,012.6	1,110.7
4. Operating costs	112,949	133,914	143,169	147,729	158,408	510.1	581.6	604.9	616.2	661.2
- of which labour costs	53,181	66,169	72,015	76,967	80,592	240.2	287.4	304.3	321.0	336.4
5. Net income (3-4)	60,230	90,467	85,768	95,024	107,678	272.0	392.9	362.4	396.4	449.5
6. Net provisions	44,783	44,450	38,006	38,908	43,757	202.3	193.0	160.6	162.3	182.6
7. Total costs (4+6)	157,732	178,365	181,175	186,637	202,165	712.4	774.6	765.5	778.5	843.8
8. Pre-tax profit (3-7)	15,447	46,017	47,762	56,115	63,921	69.8	199.8	201.8	234.1	266.8
9. Taxes	13,521	16,516	16,418	19,357	12,446	61.1	71.7	69.4	80.7	52.0
10. Net profit (8-9)	1,926	29,501	31,345	36,758	51,475	8.7	128.1	132.4	153.3	214.9

Notes: Converted into euros at the end of year rate.
Source: Bank of Slovenia

Table 2.4 Income statement of the banking sector - growth, proportion of total assets and proportion of GDP in percentages

	Growth rate (%)					As proportion of gross income (%)					As proportion of total assets (%)				
	2001	2002	2003	2004	2005	2001	2002	2003	2004	2005	2001	2002	2003	2004	2005
1. Net interest income	-8.1	23.7	1.6	-1.4	4.9	74.1	66.9	63.9	63.6	59.2	3.4	3.4	3.0	2.7	2.4
1.1 Interest income	5.2	15.4	-3.8	-13.6	-0.1	166.5	172.2	153.4	144.6	117.9	8.6	8.2	6.9	5.4	4.5
1.2 Interest expenses	15.8	10.1	-7.6	-23.1	-5.1	92.4	105.2	89.5	81.0	58.7	5.3	4.8	3.9	2.7	2.1
2. Net non-interest income	29.8	41.4	2.8	19.0	16.4	25.9	33.1	36.1	36.4	40.8	1.7	1.9	1.7	1.9	1.8
2.1 Net fees and commissions	9.7	30.0	1.8	12.7	8.7	22.2	24.0	24.0	24.0	25.5	1.2	1.3	1.1	1.2	1.1
2.2 Net financial transactions	44.1	1.9	-8.1	55.3	28.0	8.5	12.0	9.5	8.5	12.5	0.6	0.5	0.4	0.6	0.6
2.3 Net other income	-38.0	-214.3	52.6	-21.8	34.9	-4.8	-2.9	2.6	3.9	2.9	-0.1	0.1	0.2	0.1	0.1
3. Gross income (1+2)	1.7	29.6	2.0	6.0	9.6	100	100	100	100	100	5.0	5.4	4.8	4.5	4.2
4. Operating costs	12.5	18.6	6.9	3.2	7.2	59.0	65.2	59.7	62.5	60.9	3.3	3.2	3.0	2.8	2.5
- of which labour costs	9.2	24.4	8.8	6.9	4.7	28.6	30.7	29.5	31.5	31.7	1.5	1.6	1.5	1.4	1.3
5. Net income (3-4)	-13.7	50.2	-5.2	10.8	13.3	41.0	34.8	40.3	37.5	39.1	1.7	2.2	1.8	1.8	1.7
6. Net provisions	20.3	-0.7	-14.5	2.4	12.5	21.9	25.9	19.8	16.6	16.0	1.3	1.1	0.8	0.7	0.7
7. Total costs (4+6)	14.6	13.1	1.6	3.0	8.3	80.9	91.1	79.5	79.1	76.9	4.6	4.3	3.8	3.5	3.2
8. Pre-tax profit (3-7)	-52.6	197.9	3.8	17.5	13.9	19.1	8.9	20.5	20.9	23.1	0.4	1.1	1.0	1.1	1.0
9. Taxes	7.1	22.2	-0.6	17.9	-35.7										
10. Net profit (8-9)	-90.3	1,432.1	6.2	17.3	40.0										

Source: Bank of Slovenia

Table 2.5 Selected indicators of banking sector performance

	2001	2002	2003	2004	2005
1) Profitability and margins (%)					
- ROA	0.5	1.1	1.0	1.1	1.0
- ROE	4.8	13.3	12.5	13.3	13.8
- CIR	65.2	59.7	62.5	60.8	59.5
- Financial intermediation margin	5.0	5.4	4.8	4.5	4.2
- Interest margin (per total assets)	3.4	3.4	3.0	2.7	2.4
- Non-interest margin (per total assets)	1.7	1.9	1.7	1.9	1.8
- Net interest margin (per interest-bearing assets)	3.6	3.7	3.2	2.8	2.5
- Interest spread ¹	5.0	5.1	4.5	4.3	3.8
2) Structure of assets and liabilities (%)					
2.1 Loans to non-banking sectors					
- Short-term loans	57.2	54.1	52.8	50.1	47.1
- Long-term loans	42.8	45.9	47.2	49.9	52.9
2.2 Deposits by non-banking sectors					
- Short-term deposits	92.3	90.5	91.1	92.3	93.2
- Long-term deposits	7.7	9.5	8.9	7.7	6.8
2.3 Regional breakdown of loans					
- Residents	99.2	98.0	97.4	97.5	96.6
- Non-residents	0.8	2.0	2.6	2.5	3.4
2.4 Foreign currency sub-balance					
- Foreign currency assets/Total assets	34.4	33.0	33.4	35.9	40.7
- Foreign currency liabilities/Total assets	35.3	33.9	34.6	38.3	42.8
- Difference	-0.9	-0.9	-1.1	-2.4	-2.1
- Foreign currency loans/Loans	29.8	32.4	34.9	38.0	48.7
- Foreign currency deposits/Deposits	41.0	39.5	40.5	44.1	49.1
- Foreign currency loans/Loans (non-banking sectors)	18.7	24.3	28.8	34.8	45.9
- Foreign currency deposits/Deposits (non-banking sectors)	36.0	33.6	33.3	34.6	33.1
2.5 Securities					
- Securities/Loans to non-banking sectors	58.0	70.9	67.8	53.5	51.3
2.6 Breakdown by sector					
- Companies					
- Loans to companies/Loans to non-banking sectors	61.0	58.8	62.9	63.1	61.9
- Foreign currency loans to companies/Loans to companies	26.5	32.4	36.9	44.0	56.5
- Households					
- Loans to households/Loans to non-banking sectors	27.2	25.8	24.8	24.9	25.2
- Foreign currency loans to households/Loans to households	0.7	0.7	1.0	3.0	11.9
- Government					
- Loans to government/Loans to non-banking sectors	8.3	9.9	5.6	4.7	4.1
- Non-residents					
- Liabilities to foreign banks/Total assets	8.5	10.2	14.0	17.9	26.7
3) Assets quality					
- Special provisions (SIT billions)	211.3	227.4	243.3	255.1	279.0
- Classified claims (SIT billions)	3,314.8	3,634.7	4,110.0	4,895.4	6,041.4
- Special provisions/Classified claims (%)	6.4	6.3	5.9	5.2	4.6
- D- and E-rated claims/Classified claims (%)	4.3	3.9	3.7	3.0	2.4
- D and E special provisions/D- and E-rated claims (%)	85.4	80.5	81.0	80.1	81.0
- D- and E-rated claims/Capital (%)	50.4	44.0	41.4	33.8	30.1
- D- and E-rated claims minus provisions created/Capital (%)	7.3	8.6	7.9	6.7	5.7
- Sum of large exposures/Capital (%)	208.3	195.3	212.8	196.2	227.0
4) Interest-rate risk					
- Difference between interest-bearing assets and liabilities (percentage points)	7.4	6.6	6.9	7.2	6.2
- Interest-bearing assets/Assets (%)	82.7	85.3	89.2	89.2	85.5
- Interest-bearing liabilities/Liabilities (%)	75.3	78.7	82.4	82.0	79.3
- Difference in average period of change in interest rates (months)	4.7	2.4	4.0	6.0	6.6
- Average period for change in assets interest rates (months)	10.1	7.3	8.7	10.9	12.3
- Average period for change in liabilities interest rates (months)	5.3	4.9	4.7	4.9	5.8
- Proportion of new loans with variable interest rate (%) ²			30.1	38.5	54.5
5) Exchange-rate risk (%)					
- Foreign exchange-risk-adjusted items/Regulatory capital	33.9	51.6	58.6	55.1	58.9
- Open foreign exchange position/Regulatory capital		142.5	122.5	23.4	21.7
6) Liquidity					
- Average short-term investments/Average short-term liabilities (%)	89.3	90.6	93.2	88.4	84.8
- Average liquid assets/Average sight deposits (%)	27.5	30.0	22.0	21.9	23.6
- Category 1 liquidity coefficient ³	0.97	1.07	1.13	1.11	1.12
- Category 2 liquidity coefficient ³	1.02	1.06	1.09	1.10	1.11
- Secondary liquidity as proportion of total assets (%)	18.1	22.7	21.9	15.2	14.0
7) Solvency and capital structure (%)					
- Capital adequacy	11.9	11.9	11.5	11.8	10.6
- Core capital adequacy	11.3	9.9	9.8	9.0	8.9
- Supplementary to core capital	23.5	38.5	39.4	50.9	45.2
- Subordinated debt / Core capital	9.2	20.0	23.8	27.6	22.6
- Hybrid instruments / Core capital	0.8	0.7	1.0	10.0	10.3

Notes: ¹ Difference between the average effective tolar lending rate and non-banking sector deposits in the final quarter of the year.

² Calculated on the basis of reporting by the eight largest banks, year-on-year average.

³ For 2001 the figures are for December, otherwise they are the average for the year.

Source: Bank of Slovenia

Table 2.6 Financial Soundness Indicators in percentages

(%)	2005
Capital adequacy	
Regulatory capital to risk-weighted assets	10.56
Regulatory core capital to risk-weighted assets	8.88
Non-performing loans net of provisions to regulatory capital	5.09
Asset quality	
Non-performing loans to total gross loans	2.90
Sectoral distribution of loans to total loans	
- Deposit-takers loans to total loans	2.37
- Central bank loans to total loans	4.28
- Other financial corporations (OFCs) loans to total loans	3.32
- General government loans to total loans	3.69
- Non-financial corporations loans to total loans	53.13
- Other domestic sectors loans to total loans	21.12
- Non-residents loans to total loans	12.09
Profitability	
Return on assets (before extraordinary items and taxes)	1.01
Return on equity (before extraordinary items and taxes)	13.78
Interest margin to gross income	52.84
Non-interest expenses to gross income	62.40
Liquidity	
Liquid assets to total assets	4.84
Liquid assets to short-term liabilities	8.79
Sensitivity to market risk	
Net open position in foreign exchange to regulatory capital	21.71

Notes: The table shows the values of the Core Set of the IMF's Financial Soundness Indicators.
Source: Bank of Slovenia

Table 2.7 Structure of bank loans by ECB sectors in percentages

	Proportion of all loans (%)			Loan quality (%) ¹		
	Slovenija			Slovenija		
	2003	2004	2005	2003	2004	2005
Consumer cyclical goods	24.6	23.3	23.5	9.0	7.6	6.4
Finance	16.2	18.2	19.8	1.6	1.5	1.1
Natural resources, industry and construction	16.0	16.6	15.2	7.3	5.9	5.0
Consumer non-cyclical goods	8.4	8.4	8.9	6.2	6.2	5.9
Technology, media and telecommunications	3.2	3.1	2.1	7.2	5.9	6.8
Capital goods	2.9	3.0	2.9	3.6	3.5	4.6
Energy	2.5	1.8	1.8	3.6	2.2	1.2
Non-residents	3.1	3.7	4.4	15.9	12.8	9.8
Households	18.6	18.5	18.6	4.6	3.9	3.3
Sole proprietors	0.3	0.2	0.2	24.2	15.6	9.5
Others	4.3	3.2	2.7	0.9	0.8	0.8
Total	100.0	100.0	100.0	6.0	5.1	4.4

Notes: ¹ Quality of loans = provisions formed/loans outstanding.
Source: Bank of Slovenia

3. Insurers

Table 3.1 Gross premium collected by insurers in SIT billions, structure and annual growth in percentages

	2001	2002	2003	2004	2005
Insurance companies					
Premium (SIT billions)	223	255	285	318	345
Growth rate of premium (%)	17	15	12	12	9
Structure of premium (%)					
Life insurance	19	20	21	23	25
Health insurance	26	26	24	22	20
Non-life insurance	55	55	55	55	55
Growth rate (%)					
Life insurance	27	19	13	24	15
Health insurance	16	13	6	-1	-1
Non-life insurance	16	14	12	12	9
Reinsurance companies					
Premium (SIT billions)		29	29	36	39
Growth rate (%)			2	21	9

Source: ISA

Table 3.2 Total gross collected premium and gross life insurance premium in SIT billions in different economic categories

	2001	2002	2003	2004	2005
Total premium (SIT billions)	222.5	255.5	285.4	318.3	345.4
Per capita (SIT thousands)	111.7	128.0	142.9	159.4	172.6
Proportion of GDP (%)	4.7	4.8	5.0	5.1	5.3
Proportion of disposable income (%)	10.2	10.6	10.9	11.1	11.6
Life insurance premium (SIT billions)	44.5	52.9	59.9	74.2	85.2
Per capita (SIT thousands)	22.3	26.5	30.0	37.2	42.6
Proportion of total premium (%)	20.0	20.7	21.0	23.3	24.7

Source: ISA, SORS, own calculations

Table 3.3 Coverage of net technical provisions by assets covering technical provisions in SIT billions and in percentages

	2001	2002	2003	2004	2005
Technical provisions (SIT billions)	286	343	396	450	505
Growth rate (%)	27	20	15	14	12
Assets covering technical provisions (SIT billions)	252	334	443	515	593
Growth rate (%)	27	33	33	16	15
Assets covering technical provisions/Technical provisions (%)	88.0	97.5	111.9	114.4	117.5
Proportion of assets covering technical provisions in GDP (%)	5.25	6.24	7.62	8.24	9.05
Mathematical provisions (SIT billions)	116	151	183	218	247
Growth rate (%)	34	30	21	19	13
Assets covering mathematical provisions (SIT billions)	124	169	222	276	326
Growth rate (%)	36	36	31	24	18
Assets covering mathematical provisions/Mathematical provisions (%)	106.6	112.5	119.1	126.5	132.1
Proportion of assets covering mathematical provisions in GDP (%)	2.58	3.15	3.82	4.42	4.98
Other technical provisions (SIT billions)	170	192	213	232	258
Growth rate (%)	22	13	11	9	11
Assets covering tech. prov. less assets covering mathematical provisions (SIT billions)	128	165	221	239	267
Growth rate (%)	19	29	34	8	12
Assets covering tech. prov. less assets covering math. prov./Other tech. prov. (%)	75.3	85.9	103.9	103.0	103.5
Proportion of assets covering tech. prov. less assets covering math. prov. in GDP (%)	2.67	3.09	3.80	3.83	4.07

Sources: ISA, SORS, own calculations

4. Investment Funds

Table 4.1 Overview of investment funds - assets and net inflows of mutual funds in SIT billions and year-on-year unit value growth rate in percentages

	Mutual funds				Investment companies (including privatisation funds)					Investment funds overall	
	Net inflows	Assets	VEP	Growth	Assets				PIX	Assets	
					PFs	ICs	PIX	Assets		Growth	
	(SIT billions)	(SIT billions)	Growth	Growth	(SIT billions)	Growth	(SIT billions)	Growth	Growth	(SIT billions)	Growth
2000	1.2	11	22%	4%	574	-4%	-	-	3%	584	-
2001	1.8	15	37%	23%	548	-4%	-	-	4%	563	-4%
2002	29.3	55	277%	54%	324	-41%	138	-	72%	518	-8%
2003	25.7	93	68%	17%	132	-59%	214	55%	24%	439	-15%
2004	81.2	210	126%	18%	-	-	290	35%	39%	500	14%
2005	33.2	332	58%	7%	-	-	200	-31%	-12%	532	6%
2004Q1	17.5	131	120%	30%	34	-89%	256	89%	48%	388	-23%
2004Q2	22.5	156	153%	32%	27	-90%	259	71%	55%	414	-15%
2004Q3	21.4	189	159%	24%	7	-97%	286	51%	49%	475	-8%
2004Q4	19.8	210	126%	18%	-	-	290	35%	39%	500	14%
2005Q1	14.2	225	71%	8%	-	-	289	-0%	10%	514	22%
2005Q2	11.4	286	84%	5%	-	-	212	-26%	1%	498	13%
2005Q3	1.4	300	59%	3%	-	-	212	-27%	-6%	513	6%
2005Q4	6.2	332	58%	7%	-	-	200	-31%	-12%	532	6%

Sources: AMC, Vzajemci.com, LJSE, own calculations

Table 4.2 Market concentration in investment fund market

		HHI			Market share of largest (%)		
		MCs	MFs	ICs	MCs	MFs	ICs
2004	Q1	1,286	1,615	1,501	24	34	23
	Q2	1,271	1,502	1,497	25	33	23
	Q3	1,255	1,429	1,450	25	32	23
	Q4	1,237	1,260	1,464	25	29	23
2005	Q1	1,226	1,198	1,469	25	28	24
	Q2	1,211	1,120	1,583	25	22	30
	Q3	1,199	1,042	1,588	24	21	30
	Q4	1,163	886	1,885	23	20	34

Notes: Market concentration of management companies in terms of assets under management.
Source: AMC

Table 4.3 Assets of Slovenian and European investment funds in SIT billions and in percentages

		Assets		Proportion of non-UCITS funds (%)	Structure of open investment funds-UCITS (%)				
		(SIT billions)	Growth (%)		Equity	Bond	Balanced	Money-market	Others
European	2002	985,774	-7	22	30	29	13	18	10
	2003	1,140,137	13	22	31	28	12	18	11
	2004	1,282,178	11	22	32	25	12	19	11
	2005	1,573,012	23	21	35	23	12	16	13
Slovenian	2002	518	-	71	23	3	74	-	-
	2003	439	-15	70	25	5	70	-	-
	2004	500	14	58	28	5	67	-	-
	2005	532	6	38	51	4	43	0	2

Notes: For Slovenia investment companies are included among non-UCITS funds. The figures for Europe from EFAMA include all EU member-states except Slovenia, Cyprus, Malta, Estonia, Lithuania and Latvia, and also Norway, Switzerland and Liechtenstein.

Sources: EFAMA, AMC, Eurostat

Table 4.4 Mutual funds: number, assets, net inflows in SIT billions and unit value growth rate in percentages

	2000	2001	2002	2003	2004	2005	Growth rate (%)				
							2001	2002	2003	2004	2005
NUMBER											
Total	18	18	18	20	33	50	0	0	11	65	52
Equity	4	4	4	6	12	27	0	0	50	100	125
Bond	3	3	3	3	7	9	0	0	0	133	29
Balanced	11	11	11	11	14	14	0	0	0	27	0
ASSETS											
Domestic (SIT billions)	11	15	56	93	210	332	38	279	67	126	58
Equity (%)	21	20	23	25	28	51	34	325	83	159	181
Bond (%)	4	6	3	5	5	4	135	115	143	130	29
Balanced (%)	76	74	74	70	67	43	34	280	59	114	2
Bank (%)	25	26	28	25	28	25	45	301	53	155	37
Non-bank (%)	75	74	72	75	72	75	35	271	72	116	66
Foreign (SIT billions)	-	-	-	-	2	31					
NET ANNUAL INFLOWS											
Domestic (SIT billions)	2	2	29	26	81	33	-5	1,814	-10	212	-59
Equity (%)	50	18	24	29	35	81	-65	2,387	11	273	-5
Bond (%)	2	27	3	9	8	8	1,015	102	189	159	-56
Balanced (%)	48	55	73	62	58	-11	9	2,460	-24	191	-108
Bank (%)	9	42	30	20	37	52	342	1,242	-40	475	-42
Non-bank (%)	91	58	70	80	63	48	-40	2,234	3	147	-69
Foreign (SIT billions)	-	-	-	-	1	21					
GROWTH RATE OF UNIT VALUE (%)											
Total	4	23	54	17	18	7					
Equity	2	21	57	19	19	11					
Bond	11	13	18	10	7	3					
Balanced	4	25	55	17	18	5					
bank	11	20	48	16	18	10					
non-bank	1	24	57	17	18	6					

Notes: Figures for non-resident mutual funds include only those that are marketed officially in Slovenia.

Sources: Vzajemci.com, AMC, own calculations

Table 4.5 Structure of investments by type of investment fund in percentages

(%)	2000	2001	2002	2003	2004	2005
MUTUAL FUNDS						
Shares	79	78	63	59	43	36
Bonds	12	13	23	21	20	15
Bank deposits	2	5	4	2	10	4
Foreign investments	2	1	1	9	16	39
Others	5	3	9	9	11	6
Equity						
Shares	90	91	76	67	52	44
Bonds	3	1	10	5	7	7
Bank deposits	1	4	3	2	7	2
Foreign investments	0	1	2	16	24	40
Others	6	4	9	10	10	8
Bond						
Shares	27	14	6	3	2	2
Bonds	63	67	84	83	53	45
Bank deposits	2	11	3	3	12	3
Foreign investments	0	0	0	0	20	45
Others	8	9	8	11	13	5
Balanced						
Shares	78	80	62	60	42	32
Bonds	12	11	24	22	22	23
Bank deposits	2	5	5	2	11	6
Foreign investments	2	2	1	7	13	36
Others	5	3	9	9	12	4
INVESTMENT COMPANIES						
Shares	-	-	-	91	70	63
Bonds	-	-	-	4	6	5
Bank deposits	-	-	-	2	3	3
Foreign investments	-	-	-	0	4	7
Others	-	-	-	2	17	22

Source: AMC

5. Leasing companies

Table 5.1 Comparison of leasing activities by members of the Slovenian and European Leasing Companies Associations in percentages

(%)	2000	2001	2002	2003	2004	2005
SLOVENIAN LEASING COMPANIES						
Growth in transactions	36.2	26.5	37.8	35.6	12.3	35.6
Leasing transactions as proportion of gross capital formation	10.4	12.5	16.6	19.5	19.8	25.3
Structure of transactions						
real estate leasing	15.4	20.8	29.7	34.5	29.7	33.5
equipment leasing	84.6	79.2	70.3	65.5	70.3	66.4
consumer leasing	24.3	20.1	20.1	20.2	22.2	20.9
EUROPEAN LEASING COMPANIES						
Growth in transactions	8.8	9.6	3.1	8.3	7.2	-
Leasing transactions as proportion of gross capital formation	13.2	13.8	14.9	17.2	17.1	-
Structure of transactions						
real estate leasing	16.0	17.1	19.6	16.6	16.3	-
equipment leasing	84.0	82.2	80.4	83.4	83.8	-

Notes: The Leaseurope figures include all the member-states of the European Union with the exception of Cyprus, Ireland, Latvia, Lithuania, Luxembourg and Malta, plus Norway, Switzerland, Romania and Morocco. Gross capital formation for Slovenia exclude investments in housing for reason of comparability with the Leaseurope figures.

Sources: SLA, SORS, Leaseurope, ECB

6. Capital Market

Slovenian capital market

Table 6.1 Overview of the organised securities market in SIT billions and in percentages

	Market capitalisation (SIT billions)	Market capitalisation as % of GDP	Turnover (SIT billions)	Turnover as % of GDP	Turnover ratio	Growth in SBI 20 (%)
1999	920	23.7	266	6.9	0.289	5.9
2000	1,138	26.8	270	6.3	0.237	0.1
2001	1,380	29.0	348	7.3	0.252	19.0
2002	2,174	40.9	481	9.1	0.221	55.2
2003	2,442	42.5	340	5.9	0.139	17.7
2004	3,050	49.3	397	6.4	0.130	24.7
2005	3,210	51.2	441	7.0	0.137	-5.6

Sources: LJSE, SORS

Table 6.2 Number of issuers and issued securities on the Ljubljana Stock Exchange and number of securities registered at CSCC

	2002	2003	2004	2005	2002	2003	2004	2005
LJSE	Year-on-year change (%)							
Number of issuers	197	185	173	148	-24	-12	-12	-25
Number of securities issued	264	254	254	227	-7	-10	0	-27
Shares	139	136	142	112	-17	-3	6	-30
Bonds	92	92	101	95	16	0	9	-6
Investment companies	33	26	11	10	-6	-7	-15	-1
Number of members	27	27	27	27	-4	0	0	0
CSCC	Proportion of LJSE in CSCC (%)							
Number of issuers	870	869	853	827	23	21	20	18
Number of securities issued	1032	1033	1030	1043	26	25	25	22
Shares	877	886	886	910	16	15	16	12
Bonds	122	120	133	123	75	77	76	77
Investment companies	33	27	11	10	100	96	100	100

Sources: LJSE, CSCC

Table 6.3 Comparison of market capitalisation on the Ljubljana Stock Exchange and value of securities registered at CSCC by market and book value in SIT billions and in percentages

	2002	2003	2004	2005	2002	2003	2004	2005
LJSE	(SIT billions)				Growth rate (%)			
Total market capitalisation	2,168	2,442	3,050	3,210	58	13	25	5
Shares	1,477	1,567	1,943	1,761	46	6	24	-9
Bonds	691	875	1,107	1,449	91	27	26	31
CSCC	(SIT billions)				Proportion of LJSE in CSCC (%)			
Total value	4,602	5,174	5,967	6,217	47	47	51	52
Shares	3,558	3,983	4,502	4,463	42	39	43	39
Bonds	1,044	1,191	1,465	1,754	66	73	76	83

Sources: LJSE, CSCC, own calculations

Table 6.4 Comparison of annual turnover on the Ljubljana Stock Exchange and turnover outside the organised market in SIT billions and in percentages

	2001	2002	2003	2004	2005	2001	2002	2003	2004	2005
LJSE	(SIT billions)					Growth rate (%)				
Total turnover	344	476	340	397	441	37	38	-28	17	11
Shares	237	279	149	223	225	75	18	-46	49	1
Bonds	52	111	130	114	180	-3	114	17	-12	58
Investment companies	53	86	61	60	36	-13	62	-29	-1	-40
Short-term securities	3	1	0	0	0	-	-	-	-	-
OTC MARKET	(SIT billions)					As proportion of stock exchange turnover (%)				
Total turnover	141	257	404	234	254	41	54	119	59	58
Shares	107	87	82	71	112	45	31	55	32	50
Bonds	15	27	32	19	36	29	24	25	17	20
Investment companies	0	0	0	0	0	-	-	-	-	-
Short-term securities	19	143	290	144	106	-	-	-	-	-

Notes: The figure for transactions concluded outside the organised market comprises only transactions concluded by brokerage houses and banks as final purchasers or vendors of non-marketable securities that must be reported to the Securities Market Agency.

Sources: LJSE, SMA

Table 6.5 Investments of stock exchange members from various types of transaction in SIT billions and in percentages

	2001	2002	2003	2004	Sep. 2005
Total in Slovenia (SIT billions)	824	1607	1926	2199	2336
Total abroad (SIT billions)	97	119	163	293	579
	Structure of domestic investments by type of transaction (%)				
BANKS	50.5	58.5	61.1	59.0	58.3
Own investments	26.6	21.5	19.2	22.8	27.4
Managing securities	0.9	1.1	1.3	1.4	1.4
Stockbroking	23.0	35.9	40.6	34.8	29.5
BROKERAGE HOUSES	49.5	41.5	38.9	41.0	41.7
Own investments	1.4	0.7	0.7	0.8	0.5
Managing securities	1.7	1.1	0.7	0.6	0.5
Stockbroking	46.5	39.7	37.6	39.5	40.7

Source: SMA

Investments by residents in the rest of the world

Table 6.6 Investments by residents in securities issued in the rest of the world in SIT billions and in percentages

	Investments in foreign securities issued abroad	Growth (%)	Proportion in shares (%)	Proportion in bonds (%)	Investments in domestic securities issued abroad
	(SIT billions)				(SIT billions)
2000	35	73	11	89	55
2001	70	96	17	83	54
2002	89	27	28	72	60
2003	143	62	40	60	57
2004	314	119	39	61	58
2005	725	131	50	50	49

Sources: LJSE, Bank of Slovenia

Table 6.7 Investments by residents in foreign securities in SIT billions and in percentages

	2000	2001	2002	2003	2004	2005	Jan. 06
Growth in investments abroad (%)	-	96.3	27.3	61.7	119.7	131.2	129.1
Total investments abroad (SIT billions)	35.4	69.6	88.6	143.3	314.7	725.3	780.4
Structure by sector (%)							
Banks	85.9	78.7	48.7	37.9	32.4	38.6	38.7
Other financial intermediaries	0.6	1.9	21.2	23.5	22.0	20.6	21.2
Insurers	10.5	16.2	23.5	26.4	29.3	19.2	18.3
Households	1.8	1.8	5.1	8.4	9.5	11.2	11.7
Non-financial companies	0.6	0.9	1.3	2.6	5.8	4.9	4.5
Others	0.5	0.3	0.2	1.3	0.9	5.5	5.5

Notes: Investments by residents in the rest of the world include portfolio and some capital investments.

Source: Bank of Slovenia

Investments by non-residents in Slovenia

Table 6.8 Trading by non-residents in securities issued in Slovenia in SIT millions and in percentages

	Net purchases by non-residents		Non-residents' turnover in shares on organised market (SIT millions)	Proportion of turnover in shares on organised market (%)
	Organised market (SIT millions)	OTC market (SIT millions)		
1999	-2,270	675	3,163	1.19
2000	208	8,540	4,296	1.59
2001	4,500	63,500	10,556	3.03
2002	-11,895	337,085	39,403	8.19
2003	521	52,207	11,916	3.50
2004	-389	33,185	18,805	4.74
2005	9,911	113,330	21,721	5.91

Sources: CSCC, LJSE, Bank of Slovenia

Table 6.9 Investments by non-residents in securities issued in Slovenia by sector in SIT billions and in percentages

	2004	2005	Feb. 06
Growth in investments by non-residents (%)	54.2	24.9	33.4
Total investments by non-residents (SIT billions)	575.4	718.9	744.9
Structure in terms of domestic sector (%)			
Non-financial companies	63.9	56.6	56.0
Banks	25.3	25.3	26.0
Other financial intermediaries	1.8	0.5	0.4
Insurers	2.2	1.9	1.8
Government	6.6	15.6	15.7

Sources: CSCC, Bank of Slovenia, own calculations