BANKA SLOVENIJE
EVROSISTEM

FINANCIAL STABILITY

STABILITY OF THE SLOVENIAN BANKING SYSTEM

DECEMBER 2011

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The December 2011 Stability of the Slovenian Banking System is based on figures and information available at the end of November 2011, except where stated otherwise.

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EXECUTIVE SUMMARY

The negative economic growth in the third quarter of 2011 is an indication that the expectations of a lengthy period of low economic growth in Slovenia could be realised. A number of factors are having an impact on the economic situation in Slovenia, as follows. The first is the extremely adverse situation on the international financial markets. In the autumn of 2011 Slovenia was more dependent on them than at the end of 2010 as a result of the increase in net external liabilities, the adverse financing conditions, and the downgradings of its sovereign debt and certain banks. The second is the excess indebtedness of non-financial corporations in Slovenia. The third is the low capital adequacy of the Slovenian banking system compared with the euro area overall, the increase in the relative proportion of bad investments and the decline in the stock of loans. The fourth is the lack of competitiveness in the Slovenian business environment, and the slow pace of structural reforms.

The decline of EUR 728 million in the banking system's total assets during the first ten months of 2011 was the result of the continuing repayment of debt to foreign banks, in the amount of EUR 1.4 billion. The process of restructuring the banking system's funding continued by means of an increase in government deposits and Eurosystem funding. The increase in deposits by non-banking sectors remains low, although the increase of EUR 168 million in household deposits remains a significant indication of confidence in the Slovenian banking system. On the investment side, the banking system primarily reduced its investments in the form of loans to non-banking sectors, loans to non-financial corporations accounting for EUR 574 million of the decline of EUR 649 million in the former, and investments in securities, which declined by EUR 681 million.

Risks in the Slovenian banking system increased during the first three quarters of 2011 as a result of the continuing increase in credit risk, income risk and refinancing risk. Adverse developments were also seen in interest-rate risk, while there was no significant change in liquidity risk or currency risk.

Credit risk was reflected in a significant deterioration in the quality of the credit portfolio during the first nine months of the year. The proportion of claims more than 90 days in arrears was up 4 percentage points at 11.5%, while the stock of investments being repaid by borrowers more than 90 days in arrears increased to EUR 5.7 billion. Impairments and provisions reached EUR 2.9 billion, or 5.9% of the banks' classified claims. The quality of the banks' investments is weakest in the non-financial corporations sector, and is deteriorating: the proportion of claims more than 90 days in arrears increased by 6.3 percentage points during the first nine months of the year to 18.6%. The quality of claims against sole proprietors and non-residents is also deteriorating. The credit portfolio is deteriorating most rapidly at the large domestic banks, while at the banks under majority foreign ownership the deterioration has stabilised.

The increase in income risk during the first ten months of the year was expressed in the form of a pre-tax loss of EUR 124 million recorded by the banking system. With net interest income declining, the key factor in the operating loss was an increase of 39% in impairment and provisioning costs compared with the same period of 2010.

Income risk is also increasing as a result of the decline in the stock of lending. The stock of loans to non-banking sectors declined by EUR 649 million during the first ten months of the year, the year-on-year rate of growth reaching -2.4%. The main factors in the decline in lending on the loan demand side were the worsening of the European debt crisis, downgradings and higher funding costs, the slowdown in economic growth in Slovenia and its most important trading partners, the adverse situation in certain sectors, the relatively high indebtedness of the corporate sector, payment indiscipline, the adverse situation on the labour market, and a decline in the value and liquidity of eligible collateral for loans that was still available. On the supply side lending activity is being curbed by the reduced stock of funding, high funding costs, the lower capital adequacy of the banking system compared with the euro area overall, and the deterioration in the quality of the credit portfolio. The decline in lending is increasing the banks' income risk, given that new good-quality loans would be the main way of increasing income, and simultaneously ending the trend of declining quality in the credit portfolio. In the situation specific to Slovenia, when non-performing loans remain classed as classified claims for a relatively long time because of the slow pace of proceedings, the adverse impact of the decline in lending eventually increases rapidly, and the indicators of the quality of the credit portfolio remain poor for a long time. An increase in impairments and poor performance by the banking system can again be expected in 2012, and the banks will be unable to recapitalise sufficiently by generating own funds internally.

The spreads between the interest rates of Slovenian banks and those of euro area banks are an additional element of risk connected with low lending activity and with income risk. As at the end of September 2011, the interest rates at Slovenian banks on corporate loans of up to EUR 1 million were 1.7 percentage points higher than the average interest rates at euro area banks. The interest rate spreads can be realised as potential risk in two ways. First, in the event of a reversal in lending activity, additional borrowing will reduce competitiveness in the non-financial corporations sector as a result of an increase in the proportion of relatively costly debt financing. Second, for banks in Slovenia the interest rate spread is one of the key reasons for the potential loss of the best clients. Corporate financing from the rest of the world is on the rise, with corporates primarily borrowing from foreign partners and from foreign financial institutions, which is reducing the potential income for banks in Slovenia.

Refinancing risk has increased. The proportion of the banks' liabilities to the rest of the world maturing within one year increased from 23.3% in October 2010 to 31% in October 2011, as the banks' funding conditions on the international wholesale markets deteriorated. The interest rates on loans raised by the domestic banks in the rest of the world were up 0.3 percentage points over the first ten months of 2011 to stand at 1.9 percentage points over the EURIBOR, while those at the banks under majority foreign ownership stood at 0.8 percentage points over the EURIBOR. Another factor that will act to increase funding costs in 2012 is the downgradings made in autumn 2011 and the increase in the required yield on government bonds. The banks will see EUR 1.8 billion in government deposits mature in the year to October 2012, more than half of the total stock of government deposits. The increase in deposits by non-banking sectors will remain low in 2012, as a result of the discouraging economic situation. Here competing for deposits by raising interest rates could bring the banks an adverse impact on funding costs and could hinder their liquidity management, while at the same time merely resulting in deposits being switched between banks and not an increase in deposits across the whole banking system.

Towards the end of 2011 the Eurosystem began reducing refinancing risk for euro area banks by means of favourable LTROs. The Slovenian banking system's liabilities to the Eurosystem had increased to EUR 0.83 billion by the beginning of December 2011, with just 25% of the pool of eligible collateral for ECB operations having been exploited. Given the size of the pool of free eligible collateral, such Eurosystem funding will remain a significant neutraliser of refinancing risk for Slovenian banks, albeit with two potential limits: the pool of free collateral varies from bank to bank, and is limited in the event of increased need, while the value of the collateral also depends on changes in credit ratings.

Interest-rate risk as measured by the difference between the average repricing periods for asset and liability interest rates increased slightly, to 2.9 months; the banks are more exposed to a rise in interest rates. Exposure increased primarily in the interval of 3 months to 1 year, and decreased in the interval of 1 to 2 years. The small domestic banks are the most sensitive to a rise in interest rates. The risk would be realised in the event of an increase in the risk premium as a result of the worsening of the debt crisis in the euro area and the resulting rise in market interest rates. At the same time the banks' exposure to a rise in interest rates increased significantly as a result of an increase of EUR 2.3 billion in the cumulative negative interest-rate gap in the interval of up to 1 year to EUR 5.1 billion. EUR 2 billion of the increase was concentrated at the large domestic banks; the most important factors were the approach of the maturity date for securities issued in 2009 in the amount of EUR 1.5 billion on the liability side, and a decline of EUR 360 million in investments in debt securities on the asset side. The banks' exposure of a rise in interest rates in the interval of up to 2 years remains relatively high.

Liquidity risk as measured by the first-bucket liquidity ratio remains moderate, and comparable to last year. The first-bucket liquidity ratio at the end of November 2010 was only slightly higher than a year earlier, although the differences between banks widened. During a change in the calculation methodology at the beginning of October the first-bucket liquidity ratio remained below last year's average at all the bank groups. The aforementioned changes were very minor, and the banking system is maintaining an adequate level of liquidity, higher than in 2008.

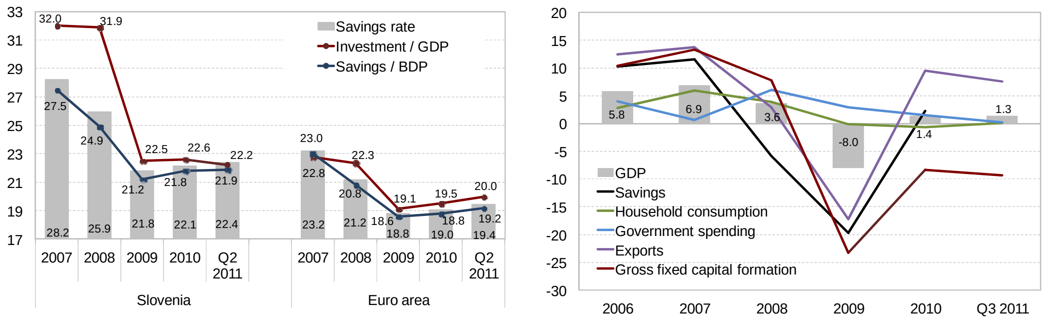
The overall capital adequacy of the Slovenian banking system had increased to 12.1% by September, and Tier 1 capital adequacy to 9.9%. The quality of the banking system's own funds structure improved, as regulatory capital increased and capital requirements declined; the surplus in regulatory capital over the capital requirements increased to 33.8%. This assessment is changing as account is taken of the deterioration in the quality of the credit portfolio, the decline in lending, poor performance, the relatively better solvency at comparable banks in the euro area and the introduction of stricter capital requirements at the EU level in 2012. The challenge for bank owners therefore remains ending the trend of increasing risk and recapitalising the banks in the euro area business environment, where demand for capital will increase sharply.

1 INTER-SECTOR FINANCIAL CLAIMS AND LIABILITIES

The saving ratio and the ratio of investment to GDP remain low as a result of the slowdown in the economic recovery.

The rise in economic growth seen in 2010 ended in the first half of 2011. According to forecasts,[1] expectations of an economic recovery have declined sharply, which has had an impact on business decisions in the real sector and the financial sector and on consumer behaviour. Real year-on-year growth in GDP stood at -0.5% in the third quarter. The ratio of investment to GDP declined, reaching its lowest level during the financial turmoil. The saving ratio increased slightly, and was higher than the average of the other euro area countries. It was nevertheless still a fifth lower than before the crisis, and remains an obstacle to an increase in economic growth in Slovenia.

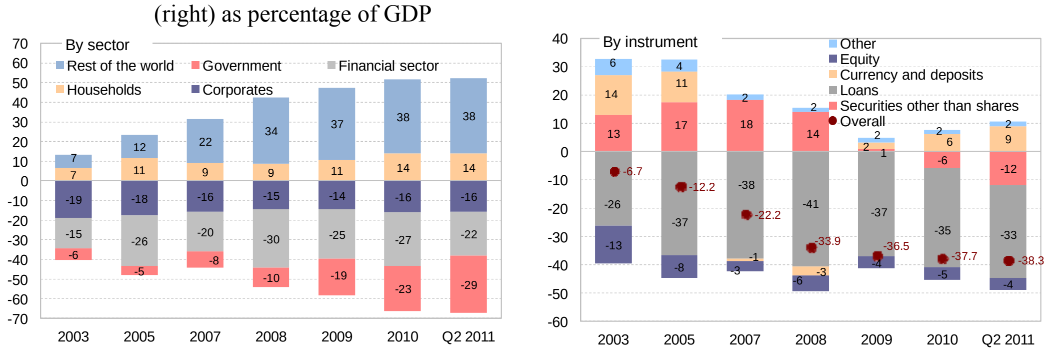
Figure 1.1: Saving ratio[2], ratio of investment and saving to GDP in percentages (left) and annual growth in certain macroeconomic aggregates in constant prices in percentages (right)



Note: The figures for the first three quarters of 2011 are year-on-year growth in each quarter.
Sources: Bank of Slovenia, SORS, ECB

Despite a narrowing of the gap between the ratios of investment and saving to GDP, Slovenia's net financial liabilities to the rest of the world increased by 0.6 percentage points during the first half of 2011 to 38.3% of GDP. The reason was issues of government securities,[3] in the context of the net repayment of banks' liabilities to the rest of the world.

Figure 1.2: Net financial position against the rest of the world by sector and rest of the world's net financial position against the Slovenian economy (left) and net financial position against the rest of the world by financial instrument (right) as percentage of GDP



Note: The financial sector does not include the central bank, while the position against the rest of the world is illustrated for the whole domestic economy.
Source: Bank of Slovenia

Risk exposure on international markets increased as a result of the increase in net external liabilities, the adverse conditions on the markets, and the downgradings of sovereign debt and certain banks.

Exposure to refinancing risk at the level of the national economy increased as a result of a slight increase in net liabilities to the rest of the world, the deterioration in the situation on

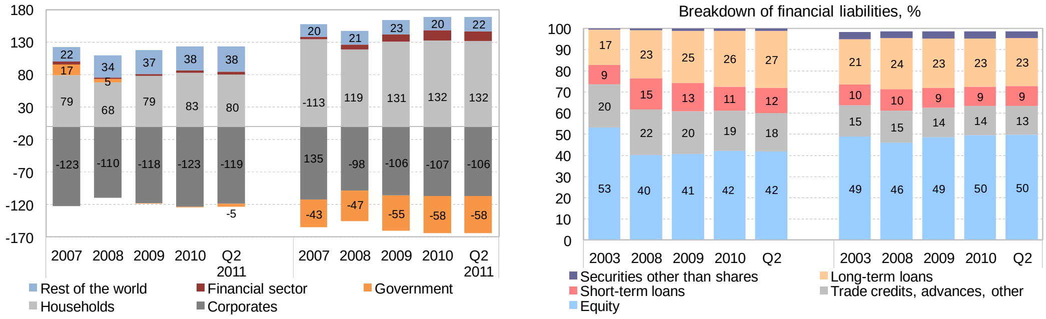
[1] Forecasts of macroeconomic variables from the Price Stability Report, October 2011, Bank of Slovenia.

[2] The saving ratio is an indicator calculated from sector accounts, and represents the ratio of gross saving to gross disposable income. In addition to employee compensation and social security benefits it includes gross earnings from production, other current transfers (e.g. compensation from non-life insurance, income from property such as interest and distributions of corporate earnings), but does not include valuation changes or capital gains.

[3] 2011 saw issues of 10-year government bonds in January and 15-year government bonds in March, both with a nominal value of EUR 1.5 billion. In addition, there were several issues of short-term securities.

international financial markets and the downgradings of Slovenia's sovereign debt and certain banks in September and October.[4] The burden of servicing the debt of the government and the banks is increasing as the risk premiums on interest rates increase. The required yield of Slovenian 10-year bonds exceeded 7% in November. The higher funding costs will likely be reflected in future issues of government securities. More than EUR 1 billion of liabilities matures for payment in early 2012, which the government will mostly replace with the proceeds of an issue of 18-month treasury bills in early December, the required yield on which was 3.99%. Pressures to raise funding costs are gradually being passed through to the banking sector, although they will be moderated by the increase in the amount of ECB funding. The impact on corporates and households will be significant, as a result of the limited resources for lending activity.

Figure 1.3: Net financial position of individual economic sectors as percentage of GDP (left) and percentage breakdown of non-financial corporations' financial liabilities (right)



Sources: Bank of Slovenia, Eurostat

Despite diminishing, the net negative position of the corporate sector in Slovenia is larger than the euro area average.

There was only a slight change in the structure of the net financial positions of individual sectors of the economy in the first half of 2011. The household sector's surplus declined, primarily as a result of a decline in the value of securities held by households, while the increase in bank deposits was also lower. The corporate sector and government sector hold negative financial positions. The government sector increased its liabilities by means of securities issues. The decline in the liabilities of the corporate sector in 2011 was the result of a fall in share prices and the value of other equity, and a lower stock of business-to-business financing, primarily via trade credits between domestic corporates. The corporate sector's financial liabilities were nevertheless more negative than the euro area average.

The proportion of corporates' total financial liabilities accounted for by short-term and long-term loans is increasing, while the proportion accounted for by trade credits is declining, as a result of the decline in economic activity, domestic demand and the lack of liquidity. The proportion of corporates' total financial liabilities accounted for by equity is changing, and remains less than in the euro area overall.

[4] On 26 September 2011 the rating agency Moody's downgraded Slovenia's sovereign debt from Aa2 to Aa3, and placed it on watch for possible further downgradings. At the same time it downgraded SID banka and government-guaranteed NLB and Abanka bonds to the same ratings. Four banks (NLB, NKBM, Abanka and SID) were classed as rating under review. It announced on 9 November 2011 that it was downgrading Factor banka's government-guaranteed eurobonds to the same rating as the sovereign debt. On 28 September 2011 the rating agency Fitch downgraded Slovenia's sovereign debt from AA to AA- with a negative outlook. One day later it downgraded seven banks (NLB, NKBM, Abanka, Gorenjska banka, Banka Celje, Probanka and Banka Koper). On 19 October 2011 the rating agency Standard & Poor's downgraded Slovenia's sovereign debt from AA to AA-. It also downgraded Deželna banka (DBS) by one step to AA-.

2 BANK ASSESSMENTS OF DEMAND FOR LOANS AND CREDIT STANDARDS IN SLOVENIA AND THE EURO AREA[5]

Loans to corporates

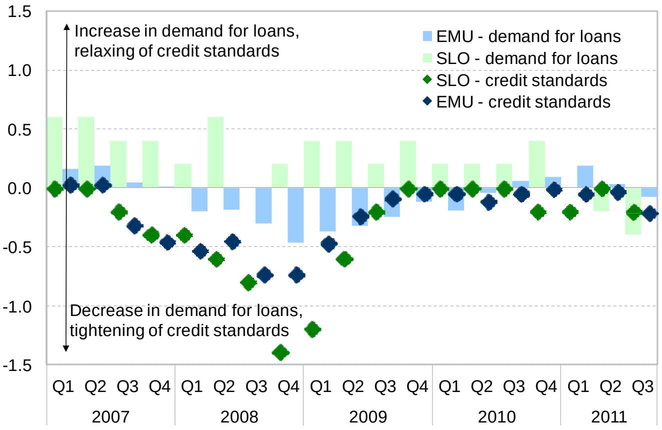
The decline in corporate demand for loans was largest in the third quarter of 2011.

According to a survey of lending by Slovenian banks based on ECB methodology, corporate demand for loans declined during the first three quarters of 2011. In the third quarter, when the decline was greatest, the main factors according to the banks were a decline in demand from large enterprises and a decline in demand for long-term loans. Other possible factors in the decline in demand in the second and third quarters cited individually were the choice of other sources of corporate financing, including loans by competitor banks, and low investment in capital expenditure. However, the responses were not unequivocal. In some cases there were reports of increased demand in the first half of the year for the purpose of debt restructuring and for financing inventories and working capital.

The gentle tightening of credit standards and loan terms in 2011 was significantly lower than in 2008 and 2009.

The credit standards[6] for corporate loans tightened in the first and third quarters of 2011, but to a significantly lesser extent than in the period of tightening in 2008 and 2009. In the first half of the year the gentle tightening focused on large enterprises, while in the third quarter the banks cited a low capital position, difficulties in accessing funding, competition from other banks, and expectations in connection with the sector in question or with economic activity. In all three quarters some banks reported a tightening of lending terms, in particular the margins on higher-risk loans and increased collateral requirements.

Figure 2.1: Corporate demand for loans and credit standards



Source: ECB, Bank of Slovenia

Loans to households

Demand for housing loans declined sharply in the third quarter of 2011 in Slovenia and in the euro area overall.

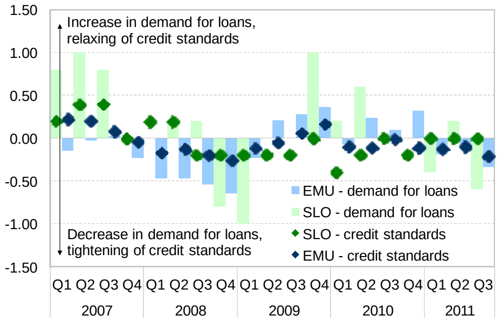
Households' demand for housing loans declined in 2011. Among the reasons cited by the banks for the largest decline in demand for housing loans in the last two and a half years were an increased lack of consumer confidence and the use of other sources of financing. In contrast to banks in the euro area, Slovenian banks did not tighten their credit standards for housing loans. The difference was particularly evident in the third quarter, when banks in the euro area sharply tightened their credit standards and reported a significant decline in demand for housing loans.

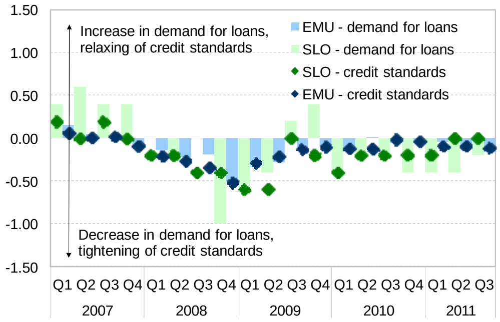
There was also a decline in demand for consumer loans. There was no significant change in the credit standards for approving consumer loans, although the margins on higher-risk loans did increase slightly.

[5] Five Slovenian banks take part in the survey. Methodological limitations mean that the results for Slovenia and for the euro area as a whole are not directly comparable, and the substantive conclusions are less solid than in quantitative analyses.

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

Figure 2.2: Household demand for housing loans (left) and consumer loans (right) and change in credit standards





Source: ECB, Bank of Slovenia

3 CHANGES IN BALANCE SHEET STRUCTURE

3.1 Factors in the decline in total assets

The decline in the banking system's total assets that began in early 2010 continued in 2011. Year-on-year growth in total assets stood at -1.9% at the end of October 2011. Total assets declined by EUR 728 million during the first ten months of the year. The decline in growth in total assets is continuing to coincide with a decline in growth in loans and a decline in securities, and the banks' debt repayments on the wholesale markets.

Table 3.1: Banking system's balance sheet as at end of 2009, 2010 and October 2011

	Stock			Increase on	Growth on	Y-o-Y
	2009	2010	Oct. 2011	Dec 2010	Dec 2011	Growth
	EUR million			EUR million	rate, %	
Assets						
Cash and balances with central bank	1,454	1,121	1,175	54	4.8	44.8
Loan	39,618	39,265	38,985	-280	-0.7	-1.1
to banks	5,708	4,815	5,184	369	7.7	7.9
to non-banking sectors	33,910	34,450	33,801	-649	-1.9	-2.4
of which:						
corporates (NFCs)	20,165	19,766	19,193	-574	-2.9	-4.7
households	7,886	8,646	8,845	199	2.3	4.0
government	735	1,162	1,154	-8	-0.7	6.7
OFIs	2,719	2,584	2,360	-224	-8.7	-8.5
Financial assets / securities	8,876	8,274	7,592	-681	-8.2	-12.0
Other	1,665	1,660	1,839	179	10.8	8.9
Liabilities						
Financial liabilities to Eurosystem	2,100	581	810	229	39.4	-25.2
Liabilities to banks	15,933	15,213	13,672	-1,542	-10.1	-8.6
of which to foreign banks	13,024	11,721	10,315	-1,406	-12.0	-12.9
Liabilities to NBS (deposits)	23,570	23,509	24,236	727	3.1	3.7
of which to NFCs	3,825	4,035	3,900	-134	-3.3	0.8
of which to households	13,801	14,292	14,460	168	1.2	2.4
of which to government	3,990	3,030	3,463	433	14.3	9.2
of which to OFIs	1,124	1,282	1,558	277	21.6	17.1
Debt securities	3,435	4,498	4,121	-377	-8.4	-6.9
Subordinated liabilities	1,550	1,585	1,547	-37	-2.4	-3.1
Equity	4,295	4,118	4,295	177	4.3	-0.1
Other	729	815	911	96	11.8	9.6
Total assets	51,612	50,319	49,591	-728	-1.4	-1.9

Source: Bank of Slovenia

The largest factor in the decline in total assets in 2011 was the banks' continuing repayment of debt on the wholesale markets.

The banks' repayments of debt in the rest of the world amounted to EUR 1.4 billion during the first ten months of the year, EUR 0.2 billion more than last year. During the same period the banks made repayments of EUR 0.38 billion via issued securities, having borrowed just under EUR 1 billion in the same period the previous year. The banks' net repayments of debt on the wholesale markets amounted to EUR 1.78 billion during the first ten months of the year, EUR 1.59 billion more than in the same period the previous year. Government deposits were the main factor in the moderate increase in deposits by non-banking sectors. The net increase in household deposits was low, and is a reflection of the adverse situation on the labour market and the slow growth in household income. In the autumn the banks increased their borrowing at the ECB.

The decline in loans in 2011 was primarily the result of a decline in loans to non-financial corporations.

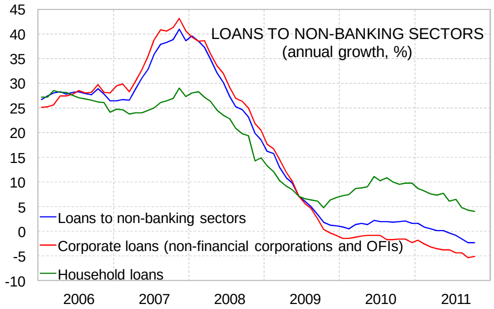
Loans to non-banking sectors declined by EUR 649 million over the first ten months of the year, primarily as a result of declines of EUR 574 million in loans to non-financial corporations and EUR 224 million in loans to OFIs. Growth in loans to households is slowing. The net increase in such lending during the first ten months of 2011 was just a third of the comparable value the previous year.

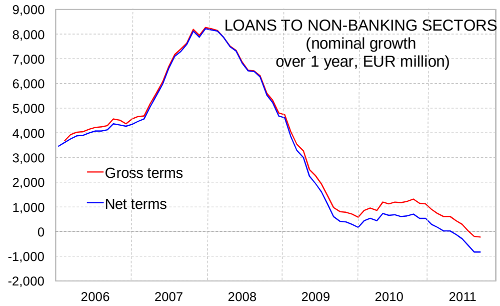
3.2 Stalled lending and changes in the structure of the banking system's investments

The year-on-year contraction in loans to non-banking sectors stood at EUR 830 million in October, year-on-year growth reaching -2.4%.

Having begun growing again in 2010, loans to non-banking sectors saw a renewed deterioration in 2011. The stock of loans contracted for the first time since Slovenia's independence. The annual increase in loans to non-banking sectors has been negative since June, the year-on-year contraction reaching EUR 830 million in October. Even in gross terms, excluding impairments, the nominal year-on-year increase in loans has been negative since September, the year-on-year contraction reaching EUR 220 million in October. Year-on-year growth in loans to non-banking sectors stood at -2.4%.

Figure 3.1: Year-on-year growth in loans to non-banking sectors and to individual segments in percentages (left) and gross and net (including impairments) nominal increase in loans to non-banking sectors in EUR millions (right)



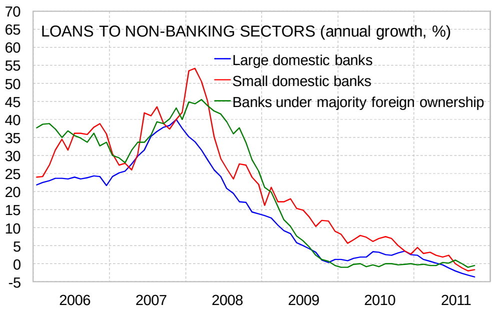


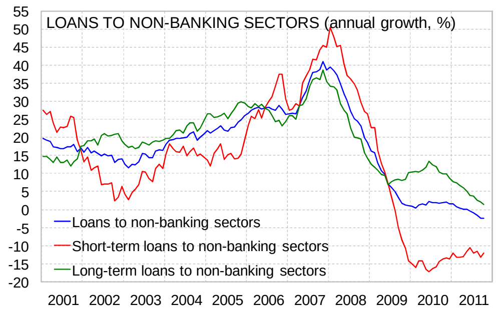
Source: Bank of Slovenia

Year-on-year growth in short-term loans stood at -12% in October 2011.

In the maturity breakdown, the stock of short-term loans to non-banking sectors recorded a particular decline, year-on-year growth reaching -12% in October. Year-on-year growth in long-term loans is slowing, but nevertheless remains positive, reaching 1.5% in October.

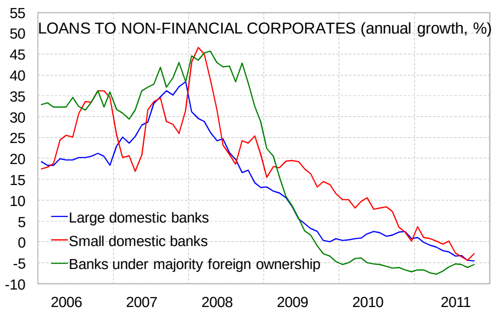
Figure 3.2: Year-on-year growth in loans to non-banking sectors by bank group (left) and by maturity (right) in percentages

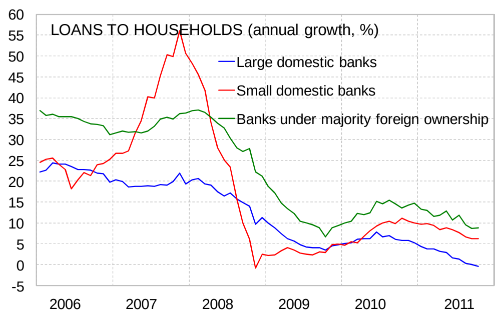




Source: Bank of Slovenia

Figure 3.3: Year-on-year growth in loans to non-financial corporations (left) and to households (right) by bank group in percentages





Source: Bank of Slovenia

The stock of loans to non-financial corporations and OFIs recorded the largest decline.

The stock of loans to non-financial corporations and OFIs is contracting in particular. Year-on-year growth in loans to non-financial corporations stood at -4.7% in October, while the rate for loans to OFIs was -8.5%. Growth in loans to households is modest, but is significantly higher than the rates for loans to all non-banking sectors and to non-financial corporations at 4%.

The decline in the stock of loans was largest at the large domestic banks.

The decline in loans to non-banking sectors was largest at the large domestic banks, the year-on-year rate reaching -3.7%. The large domestic banks recorded a decline in the stock of loans to both non-financial corporations and households. The small domestic banks and the banks under majority foreign ownership redirected their lending activity from corporates to households. Growth in loans to households stood at 6.2% at the small domestic banks and 8.9% at the banks under majority foreign ownership in October. The contraction in loans to non-financial corporations was lowest at the small domestic banks, at 2.9%.

Both demand for and supply of loans are limited.

The euro area debt crisis and its consequences are reducing the demand for and supply of loans to non-banking sectors. At the same time the crisis is revealing the problems of the Slovenian economy and banking sector more clearly than if it had occurred during a more favourable economic situation.

Reasons for lower demand for loans:

1. the European debt crisis,
2. downgradings and higher funding costs,

With the expansion of the debt crisis, sovereigns (including Slovenia) and banks are being downgraded. The downgradings are first evidenced in a rise in the required yields on issued debt securities,[7] and then pass through into higher borrowing costs for banks and corporates. High premiums over the reference interest rates are limiting corporate demand for loans.[8] The number of projects that can provide a satisfactory return to cover high financing costs is diminishing.

3. the macroeconomic situation,
4. the situation in the construction sector,

As the crisis has spread to the real sector, economic growth is slowing in Slovenia and in its main trading partners. The trend in new orders has stalled, there is no investment or new construction work, the number of building permits has declined, and volume on the real estate market is again declining.[9] Although the causality is far from simple and runs in both directions, in an adverse and uncertain (macroeconomic) situation demand for loans declines sharply.

5. high corporate indebtedness,
6. payment indiscipline,

The high indebtedness and financial leverage of corporates[10] is reducing their ability to service existing debt and their creditworthiness in raising new loans. The adverse macroeconomic situation and the spread of payment indiscipline is preventing corporates from planning for predictable future cash flows, further reducing their demand for loans.

7. the adverse situation on the labour market (less demand for household loans),

As a result of the adverse economic situation and limited growth, corporates are hiring fewer employees, unemployment is rising and wage growth is limited. Household demand for loans is also therefore down.

8. a decline in the value and liquidity of eligible collateral for loans.

The decline in asset values and liquidity is also having an adverse impact on the demand for and supply of loans. The value and liquidity of real estate and securities have declined. Borrowers thus have less collateral available for loans, which is reducing their creditworthiness. At the same time the banks are redeeming collateral or demanding additional collateral for existing loans.

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7 The premium on 2-year Slovenian government bonds over the German benchmark reached 294 basis points at the end of October, up from 37 basis points at the end of 2010. It then more than doubled in November alone, peaking at 650 basis points on 14 November. By 25 November it had fallen by 103 basis points to 547 basis points, the required yield reaching 5.93%. The movement in the premium on 10-year government bonds was similar, albeit with a slight delay. The premium increased from 122 basis points at the end of 2010 to 508 basis points at the end of November. The required yield on 10-year government bonds exceeded 7% in November, reaching 7.34% on 25 November.

8 The premiums over the EURIBOR on new short-term and long-term corporate loans stood at 3.7 percentage points and 3.5 percentage points respectively in October. These figures were each up 0.2 percentage points on the end of 2010. The interest rate on new corporate loans tied to the EURIBOR stood at 5.4% in October. The spreads between the interest rates on corporate loans in Slovenia and in the euro area overall are narrowing, although primarily as a result of rising interest rates in the rest of the world.

9 GDP in the third quarter was down 0.5% in year-on-year terms. Economic growth stood at 0.8% in year-on-year terms over the first ten months of the year, while the amount of construction put in place was down 27.2%, the number of building permits was down 6%, the corresponding floorspace was down 14% and transaction volume in old housing was down 10.5%.

10 Leverage as measured by the ratio of debt capital to equity stood at 139.3% in the middle of 2011, up 2.5 percentage points on the end of 2010.

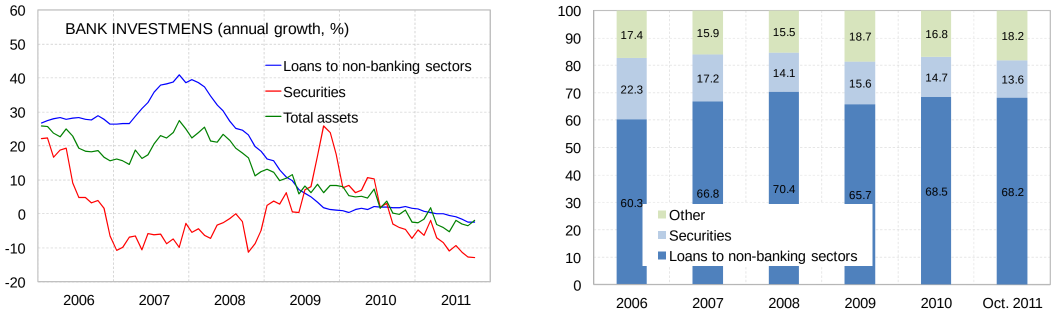
The supply of loans is also being limited by the decline in funding and the rise in funding costs, low capital adequacy and the deterioration in the quality

Growth in loans to non-banking sectors is also being curbed on the supply side. There are four main reasons for this. The first is the limited amount of funding. The international financial markets are frozen as a result of a lack of trust between banks. Banks are only partly rolling over debts as they mature, and the stock of funding for lending growth is therefore declining. There is also less funding as a result of low growth in deposits by non-banking sectors.[11] The second is high funding costs. As a result of the worsening of the debt crisis and the downgradings of sovereign debt and banks, the required yields on issued securities are rising. The risk premium is also increasing, in the form of higher premiums over the reference interest rate. The third is that the core Tier 1 capital ratio of the Slovenian banking system is lower than the euro area average, 11 banks recording a ratio of less than 9%. The figure of 9% has been established at EU level as the criterion of sufficient capital adequacy. Bank owners have less ability to provide additional capital in the adverse economic situation. The banks are reducing leverage by reducing their turnover and risk. They are therefore focusing on loans to households and the government sector, where the risk weights are lower. Fourth, the banks are also limiting lending growth because of the deterioration in the quality of the credit portfolio, which is putting a heavier burden on capital via an increase in risk weights and higher impairment costs, which have a negative impact on capital via the operating result.

Bank rationing is being reflected in credit standards and lending terms, surplus demand and a higher flow of financing from the rest of the world.

The banks are acting selectively in lending to non-financial corporations. This is being reflected in tightened credit standards and lending terms. The banks are maintaining premiums over the reference interest rates that are higher than the euro area average.[12] At the same time they are limiting exposure to individual economic sectors, although not necessarily in keeping with the situation in the sectors in question. Particularly worthy of note are the high growth in classified claims against the construction sector, which stood at 3% in year-on-year terms in September, and the year-on-year contraction of 2.1% in classified claims against the manufacturing sector.[13] A survey of corporates reveals the level of surplus demand for loans to be increasing. This could partly be demand from corporates that are not sufficiently creditworthy and are trying to raise loans at several banks. However, the number of bank offers being rejected by corporates on the grounds of over-demanding terms or unfavourable prices is also increasing. The annual flow of financing to non-financial corporations from the rest of the world is also increasing, and has reached a level similar to that seen before the worsening of the financial turmoil and is at the level from the end of 2009. By losing these clients the Slovenian banking system is missing an opportunity to improve the quality of the credit portfolio and to increase income.

Figure 3.4: Year-on-year growth in bank investments (left) and ratios to total assets (right) in percentages



Source: Bank of Slovenia

The banks are reducing the stock of investments in securities even more than loans to non-banking sectors. In October it was down EUR 681 million on the end of 2010, the year-on-year contraction reaching 12.0%. The largest decline was recorded by financial assets held for trading, year-on-year growth in which stood at -35.6%. Only financial assets held to maturity recorded a year-on-year increase, at 5.7%. The stock of debt securities was down EUR 570 million over the first ten months of the year at EUR 6.6

[11] Year-on-year growth in liabilities to foreign banks stood at -13.4% in October, year-on-year growth in liabilities from issued securities at -6.9% and year-on-year growth in deposits by non-banking sectors at 3.7%.

[12] According to the figures for September, the spread between interest rates on corporate loans in Slovenia and those in the euro area overall ranges from 1.7 to 2.1 percentage points.

[13] The lowest year-on-year growth in classified claims against individual sectors is being recorded by information and communication activities (-8.6%), wholesale and retail trade (-3.6%) and manufacturing (-2.1%), while the highest rates are being recorded by electricity, gas and water (5.1%), construction (3%) and agriculture (2%).

billion, equivalent to 13.3% of total assets, down 1 percentage point on the end of 2010.[14] This figure differs significantly from the figures at EU banks of comparable size. The ratio of debt securities to total assets stood at 17.1% at medium-size EU banks and 18.6% at small banks at the end of 2010.

3.3 Comparison of interest rates between Slovenian bank groups and euro area banks

Asset interest rates for corporates

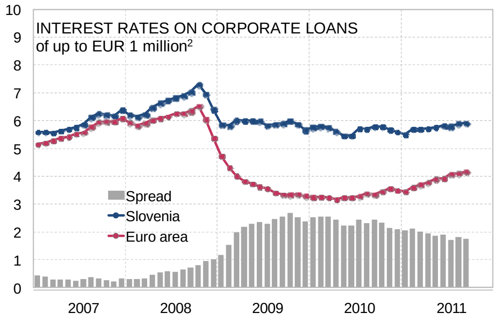
Slovenian banks' interest rates on corporate loans were higher than the euro area average, although the spread has narrowed in 2011.

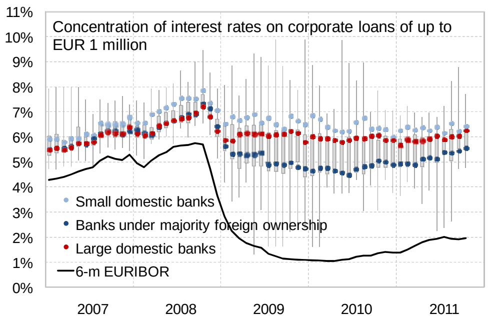
Slovenian banks' average interest rate on corporate loans of up to EUR 1 million remained 1.7 percentage points higher than the average at euro area banks at the end of September, although the spread had narrowed by 0.4 percentage points in 2011. The spread on corporate loans of more than EUR 1 million narrowed by the same amount over the same period, to 2.1 percentage points. The trend of narrowing interest rate spreads between Slovenia and the euro area average has been seen since the beginning of 2010, as a result of the rise in interest rates in the euro area. The banks under majority foreign ownership have lower interest rates than the domestic banks, although the spread has narrowed overall this year. The small domestic banks' interest rates remain the highest in relative terms, while the spread between the large domestic banks and the banks under majority foreign ownership in the segment of corporate loans of more than EUR 1 million stood at just 0.2 percentage points at the end of October, its lowest value since the end of 2008. There are several reasons for the interest rate spreads between the bank groups and with euro area banks overall.

The laxity of lending terms in the pre-crisis period is preventing the banks from making larger cuts to corporate lending rates.

1) During the period of high economic growth Slovenian banks took up higher risks, which they failed to take sufficient account of in calculating the risk premium, as a result of which corporate lending rates were lower. Given the significant deterioration in the quality of the credit portfolio as a result of the economic crisis, the need to create impairments rose sharply. This has had a major impact on performance, as a result of which the domestic banks are deciding not to cut asset interest rates as much as euro area banks overall. This behaviour is raising corporate financing costs, which in the crisis situation is having an adverse impact on competitiveness and is reducing the economic activity of already over-indebted corporates.

Figure 3.5: Interest rates on corporate loans of up to EUR 1 million in percentages: comparison with the euro area (left) and distribution at Slovenian banks (right)

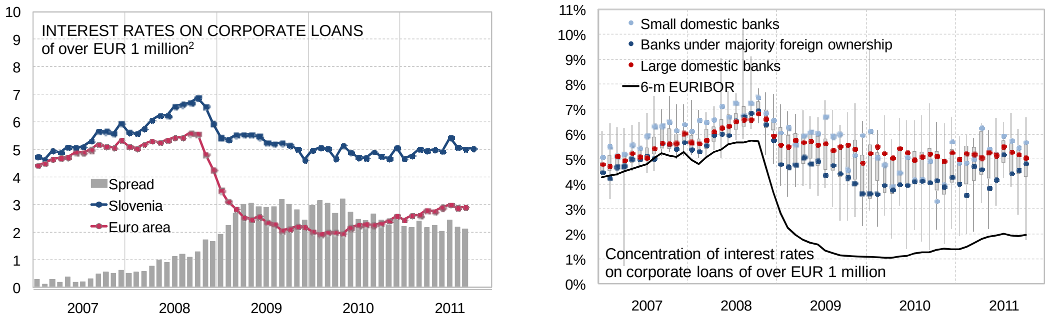




Source: Bank of Slovenia

[14] The ratio of investments in all securities to total assets declined by 1.1 percentage points over the first ten months of the year to 13.6%.

Figure 3.6: Interest rates on corporate loans of more than EUR 1 million in percentages: comparison with the euro area (left) and distribution at Slovenian banks (right)



Source: Bank of Slovenia

Slovenian banks' funding is more expensive on average than that of banks in the euro area.

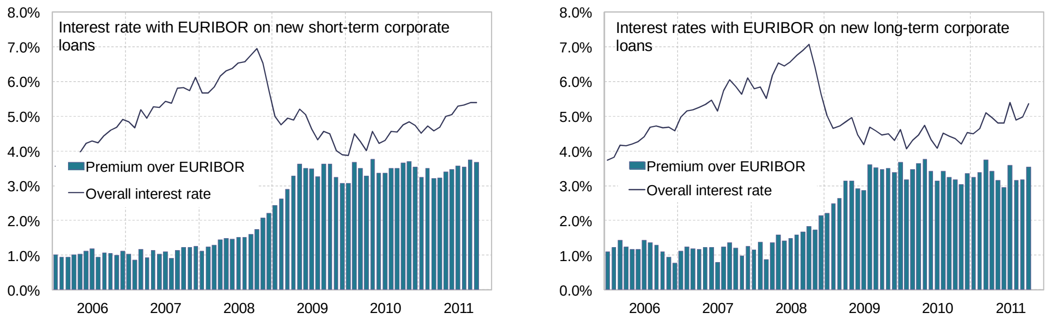
2) The funding costs in the rest of the world of the banks under majority domestic ownership have been rising since the middle of 2008. As a result of the worsening debt crisis, Slovenian banks find it harder to access funding on the international market than larger euro area banks. Because the situation on the financial markets deteriorated significantly in the third quarter of 2011, the funding costs of the banks under majority foreign ownership entirely approached those of the domestic banks at the end of October. Given their limited access to funding in the rest of the world, the domestic banks are trying to increase deposits by non-banking sectors in particular. The banks under majority foreign ownership are trying to do the same, as their access to funding from their parent banks has diminished significantly as a result of the parents' own funding difficulties. The domestic banks succeeded in increasing deposits by non-banking sectors by just EUR 78 million during the first ten months of the year, while the banks under majority foreign ownership attracted EUR 652 million. This can partly be explained by the increased marketing activity by the banks under majority foreign ownership. In November the Austrian central bank recommended that banks in the Austrian system should maintain a ratio of 1.1 between new loans and deposits in all the markets where they do business. In addition, long-term deposits, which are an important source of funding for the domestic banks, are more expensive in Slovenia than in the euro area overall.

3) Slovenian banks are less cost-effective, their operating costs in 2010 having amounted to 1.8% of total assets according to ECB figures, 0.1 percentage points more than the euro area average. The aforementioned indicator had improved by 0.1 percentage points from 2008 in both Slovenia and the euro area overall.

Given the increased risk, the banks have begun charging corporates significantly higher premiums than during the pre-crisis period.

4) Slovenian corporates are more indebted than the euro area average, which is reducing their creditworthiness. Given the increased risk, the banks have begun charging corporates significantly higher premiums than during the pre-crisis period. In addition, they have begun assessing both projects and clients more conservatively. There has been no change in the premiums since the middle of 2009, and they averaged 3.6 percentage points at the end of October 2011. At the same time interest rates have gradually risen as a result of a rise in the reference interest rates.

Figure 3.7: Premiums over the EURIBOR and overall interest rate for new short-term (left) and long-term (right) corporate loans in percentages



Source: Bank of Slovenia

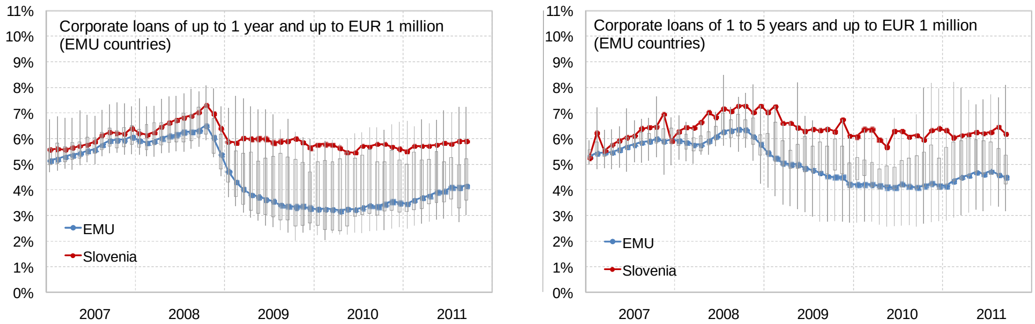
5) Another reason for the higher premiums on Slovenian banks' corporate loans is the long and expensive bankruptcy proceedings in the country, which reduces the percentage of bank claims recovered. In addition, the process of selling shares and participating

interests as part of the redemption of collateral is also difficult and lengthy. Low demand as a result of the adverse economic situation is one of the factors in this.

Long-term interest rates on corporate loans are 1.7 percentage points higher than the euro area average.

Slovenian banks were in the highest interest rate quartile in 2011. The spread between the highest and lowest interest rates on loans of up to EUR 1 million in different countries stood at 4.2 percentage points at the end of September 2011. The interest rates at Slovenian banks were 1.3 percentage points lower than those of the country with the highest rates. The spread was wider for longer maturities of 1 to 5 years, at 4.9 percentage points. The interest rates on long-term loans at Slovenian banks were almost 2 percentage points lower than those of the country with the highest rates, but were 1.7 percentage points higher than the euro area average. Financing via bank loans is the prevalent method of corporate financing in Slovenia, for which reason interest rates are an important element of competitiveness. There remains the possibility that larger, better-performing corporates will be more active in seeking loans in the rest of the world.

Figure 3.8: Distribution of interest rates on corporate loans in the euro area for loans of up to 1 year (left) and of 1 to 5 years (right) in percentages



Source: Bank of Slovenia

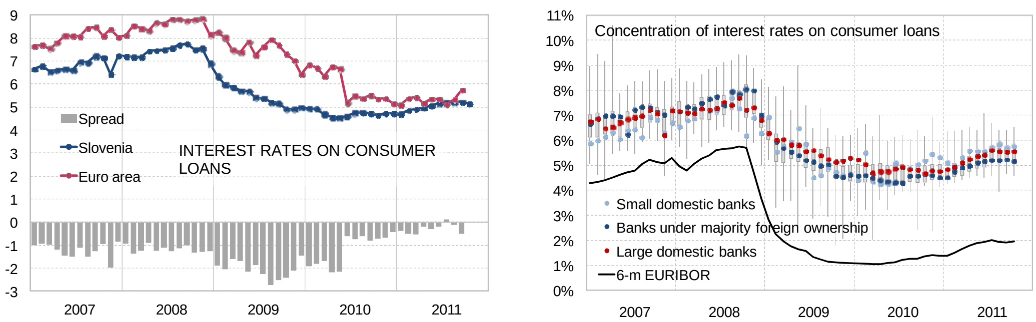
Asset interest rates for households

Interest rates on consumer loans in Slovenia and the euro area overall are almost identical.

The interest rate spread on household loans between Slovenian banks and euro area banks overall is narrower. In previous years Slovenian banks had lower interest rates on consumer loans than euro area banks overall, but in 2011 the rates virtually equalised at around 5.2%. The spread between Slovenian banks and euro area banks in interest rates on housing loans has remained around 0.5 percentage points since the middle of 2009.

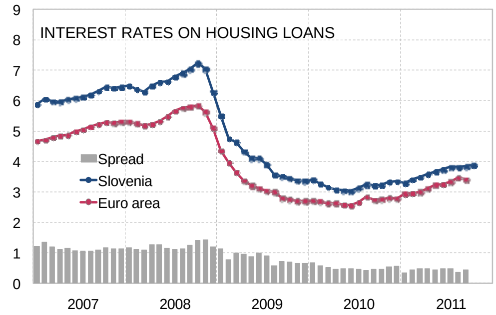
The spreads between the interest rates of Slovenian banks on household lending are also smaller. The distribution is much denser than for corporate loans. This is particularly true of housing loans, where the spread between the banks with the highest and lowest interest rates stood at 1.4 percentage points in October. The interest rate on housing loans at the banks under majority foreign ownership is 0.2 percentage points lower than that at the large and small domestic banks, for which reason their higher lending activity is no surprise.

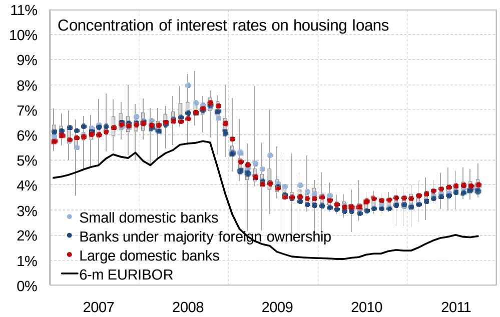
Figure 3.9: Interest rates on consumer loans in percentages: comparison with the euro area (left) and distribution at Slovenian banks (right)



Source: Bank of Slovenia

Figure 3.10: Interest rates on housing loans in percentages: comparison with the euro area (left) and distribution at Slovenian banks (right)





Source: Bank of Slovenia

Liability interest rates

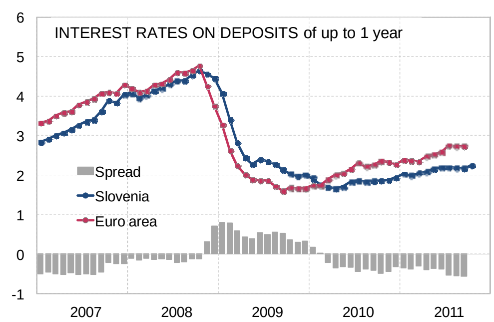
Interest rates on long-term household deposits were 1.8 percentage points higher than short-term rates at the end of October.

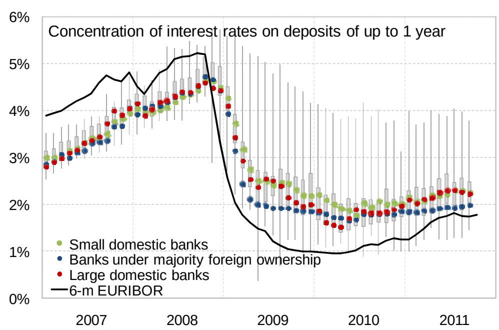
The breakdown of deposits by non-banking sectors changed radically during the financial turmoil. In 2008 long-term deposits accounted for just 10% of all deposits on average, but by the end of October 2011 this figure had risen to almost 33% when original maturity is taken into account. Households accounted for 60% of deposits by non-banking sectors, of which 30% were long-term deposits. The proportion accounted for by long-term household deposits in terms of residual maturity is significantly lower, at 5.6%, but is gradually increasing. The reason for the change in the maturity breakdown of deposits was the higher interest rates on long-term deposits, which were 1.8 percentage points higher than short-term rates for households at the end of October. The problems of the banks in Slovenia in accessing long-term funding in the rest of the world has meant that interest rates on household deposits of more than 1 year have been 1 percentage point higher than at banks in the euro area since the beginning of 2010. In this way the banks are trying to encourage saving over longer periods. Interest rates on deposits of up to 1 year are approximately 0.6 percentage points lower than the euro area average.

The widening distribution of interest rates on long-term deposits is a reflection of the banks' fiercer competition for long-term funding.

The spread between the banks with the highest and lowest rates on household deposits of up to 1 year has remained high this year, averaging 2.6 percentage points, approximately double the average in 2007 and 2008. The spread between the highest and lowest rates on deposits of more than 1 year widened sharply in the third quarter, to 2.7 percentage points. The widening distribution of interest rates on long-term deposits is a reflection of the banks' fiercer competition for long-term funding in the domestic deposits market. Interest rates among the fourth quartile of banks are rising in particular, which could inject additional instability into the banking system in the event of deposit switching by clients that are most responsive to changes in interest rates. This would inflict additional uncertainty on the banks in the management of funding and liquidity, without bringing a significant increase in total deposits. The small domestic banks offered the highest interest rates on household deposits of up to 1 year and of more than 1 year, while the banks under majority foreign ownership offered the lowest.

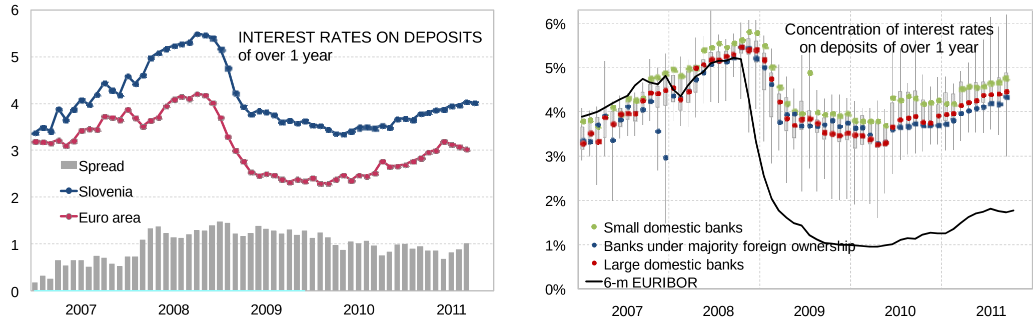
Figure 3.11: Interest rates on household deposits of up to 1 year in percentages: comparison with the euro area (left) and distribution at Slovenian banks (right)





Source: Bank of Slovenia

Figure 3.12: Interest rates on household deposits of more than 1 year in percentages: comparison with the euro area (left) and distribution at Slovenian banks (right)

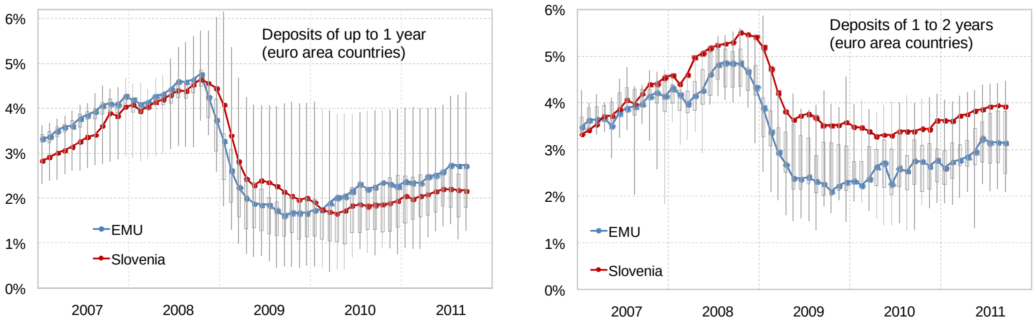


Source: Bank of Slovenia

Higher interest rates in 2011 did not bring an increase in household saving at the domestic banks.

Despite the higher interest rates, the increase in household deposits in 2011 at the domestic banks has been smaller than at the banks under majority foreign ownership. The banks under majority foreign ownership recorded an increase of EUR 140 million in deposits during the first ten months of the year, compared with an increase of just EUR 28 million at the domestic banks. The ratio was approximately balanced in 2010. This year interest rates have not been the sole factor in deposit switching. Other likely factors are concerns over security and confidence, and the lower lending rates available at the banks under majority foreign ownership. In the majority of cases banks require clients to transfer their business to the bank before approving loans, or the clients opt to do so themselves. It was the banks under majority foreign ownership that recorded the highest growth in housing loans in the past.

Figure 3.13: Distribution of interest rates on household deposits in the euro area of up to 1 year (left) and of 1 to 2 years (right) in percentages



Source: Bank of Slovenia

The spread between the highest and lowest interest rates on household deposits of up to 2 years in the euro area is narrowing, but is nevertheless more than double that recorded before the crisis. The spread on deposits of up to 1 year stood at 3.1 percentage points at the end of September, 0.9 percentage points more than on deposits of 1 to 2 years. Slovenian banks are located in the third quartile in terms of deposits of up to 1 year, but in the highest quartile in terms of deposits of 1 to 2 years. The highest interest rates on household deposits are in Cyprus, Greece and Portugal. The level of interest rates in each euro area country is a reflection of the financial problems that they are facing, which engenders a response from financial assets.

3.4 Bank funding

The process of debt repayment in the rest of the world by the banks continued in 2011.

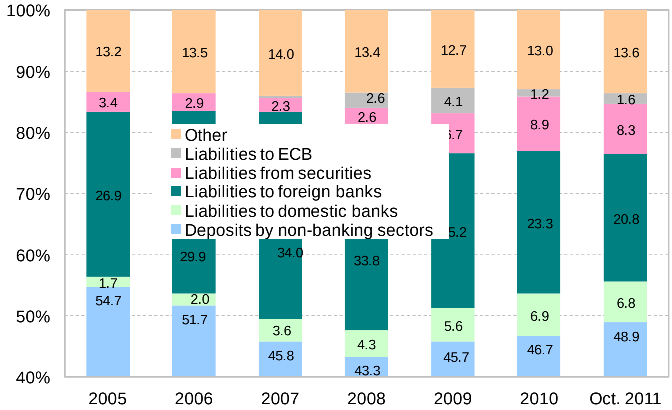
The process of debt repayment in the rest of the world by the banks continued in 2011. Year-on-year growth in liabilities to foreign banks stood at -13% in October, while year-on-year growth in liabilities from issued securities stood at -7.9%. The banks repaid EUR 1.4 billion of debt in the rest of the world during the first ten months of the year, and EUR 0.38 billion on the basis of issued securities. Funding via the ECB also declined further in 2011 after the maturity of the third 12-month LTRO at the end of 2010. It began to increase again in November, when the first 12-month LTRO of 2011 was offered to banks.

Year-on-year growth in deposits by non-banking sectors stood at 3.7% in October, although the rate for household deposits was just 2.4%. The largest contribution to the increase of EUR 0.7 billion in deposits by non-banking sectors during the first ten months of the year came from government deposits, which were up EUR 0.43 billion. The net increase in household deposits over the same period was just EUR 168 million, the lowest figure in recent years.

There was a notable stagnation in household deposits at the domestic banks, and a switch in deposits by non-financial corporations from the large domestic banks to the banks under majority foreign ownership. The reasons for clients switching banks do not lie solely in the differences in interest rates on deposits; there are other factors such as diversification.

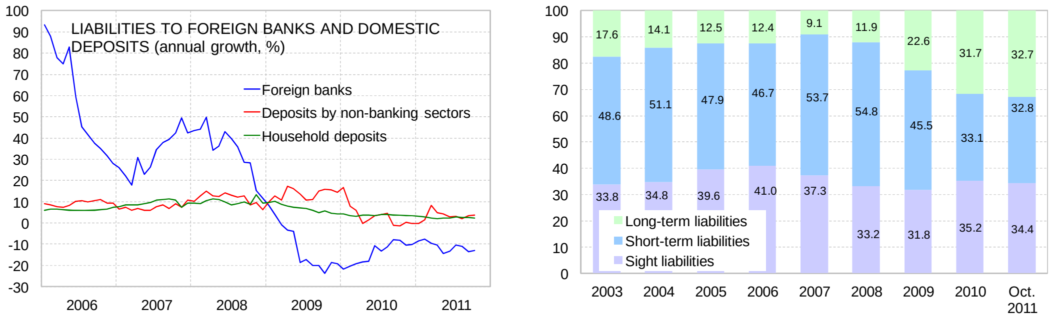
The maturity breakdown of deposits in 2011 was little changed from 2010. The proportion of household deposits accounted for by long-term deposits was up 2 percentage points during the first ten months of the year at 30%. There was a more evident trend of increase in deposits in 2011 than in the previous year, as a result of the higher interest rates on long-term deposits. It should nevertheless be noted that the proportion accounted for by long-term deposits in terms of residual maturity was significantly lower, at 5.6%. The overall increase in household deposits of EUR 168 million consisted of a decline of EUR 345 million in short-term deposits and an increase of EUR 513 million in long-term deposits and sight deposits, the first by EUR 352 million and the second by EUR 162 million. The proportion of household deposits accounted for by short-term deposits thus declined by 3.6 percentage points during the first ten months of the year to 27.9%.

Figure 3.14: Breakdown of bank funding in percentages



Source: Bank of Slovenia

Figure 3.15: Year-on-year growth in bank funding (left) and maturity breakdown of deposits by non-banking sectors (right) in percentages



Source: Bank of Slovenia

Differences in breakdown of funding between the bank groups

The relative importance of deposits as funding is increasing, despite low growth.

As a result of debt repayment in the rest of the world by the banks, the relative importance of the individual sources of funding is changing according to the ownership and size of the banks. Deposits by non-banking sectors accounted for 52% of total liabilities at the large domestic banks at the end of October, and for 60% at the small domestic banks. The importance of deposits is increasing at the banks under majority foreign ownership, the proportion of total liabilities that they account for having risen by 4 percentage points during the first ten months of 2011. The vast majority of the net increase in household deposits was generated by the banks under majority foreign ownership. The crisis in recent years has also brought a decline in liabilities to foreign banks at the banks under majority foreign ownership. They accounted for 43% of total liabilities in October 2011, down 9 percentage points on the end of 2008. A notable feature at the large domestic banks was the decline in wholesale funding, i.e. liabilities to foreign banks and issued debt securities, during this period. The proportion of total liabilities that they account for declined from a third before the crisis to a quarter at the end of October 2011. Household deposits remain the most important funding for the domestic banks, accounting for a third of total liabilities and around 60% of deposits by non-banking sectors. Further decline in wholesale funding and increased competition for deposits by non-banking sectors can again be expected in the coming year.

Table 3.2: Ratios of individual forms of funding to total liabilities by bank group

(%)	Large domestic banks	Small domestic banks	Banks under majority foreign ownership	Banking system
	Liabilities to foreign banks			
2007	29.0	6.2	52.3	34.0
2008	27.7	6.8	52.3	33.8
2009	16.8	3.5	48.9	25.2
2010	15.0	1.7	47.8	23.3
Oct. 2011	12.8	2.1	43.1	20.8
	Deposits by non-banking sectors			
2007	49.3	59.0	34.6	45.8
2008	47.8	56.7	31.1	43.3
2009	49.6	59.2	33.7	45.7
2010	49.8	60.3	36.0	46.7
Oct. 2011	51.5	60.2	40.1	48.9
	Household deposits			
2007	31.9	30.6	20.8	28.6
2008	32.0	30.6	18.6	27.7
2009	30.3	30.3	18.2	26.7
2010	31.4	31.7	20.9	28.4
Oct. 2011	32.1	33.7	21.7	29.2
	Issued debt securities			
2007	2.8	6.5	0.0	2.3
2008	3.5	6.4	0.0	2.6
2009	10.0	5.2	0.0	6.7
2010	13.2	7.8	0.0	8.9
Oct. 2011	12.3	7.4	0.0	8.3
	Liabilities to Eurosystem			
2007	0.3	0.8	0.5	0.4
2008	2.1	3.0	3.3	2.6
2009	3.9	6.4	3.7	4.1
2010	0.9	3.1	1.2	1.2
Oct. 2011	1.4	3.9	1.5	1.6

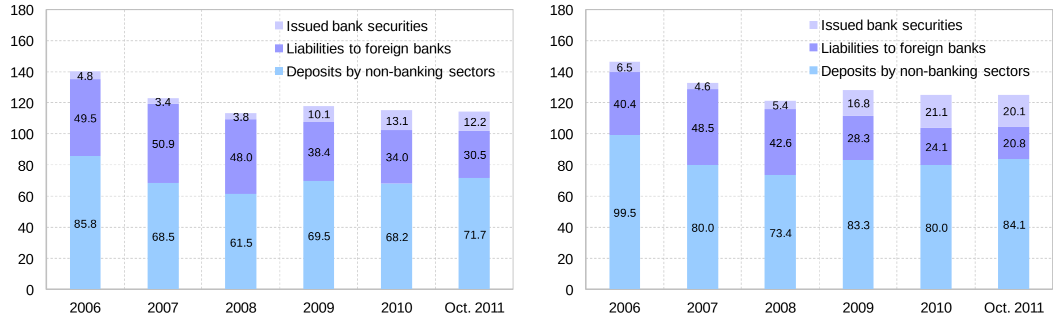
Source: Bank of Slovenia

Changes in coverage of loans to non-banking sectors by the main sources of funding

Coverage of loans by deposits slightly improved between the end of 2010 and October 2011.

Coverage of loans to non-banking sectors by deposits by non-banking sectors improved slightly over the first ten months of the year. In the context of weak growth in deposits, another factor in the improvement was the decline in the stock of loans to non-banking sectors. Coverage of loans by liabilities to foreign banks declined to around 30%, having reached 50% before the crisis.

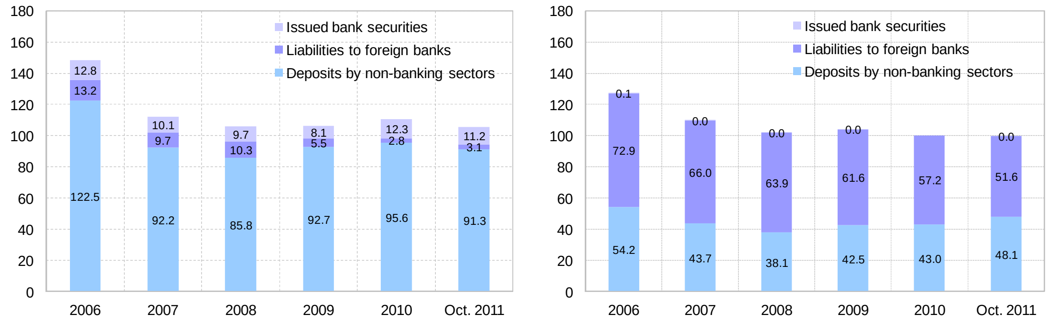
Figure 3.16: Coverage of loans to non-banking sectors by funding in the banking system overall (left) and at the large domestic banks (right) in percentages



Source: Bank of Slovenia

The coverage of loans by various sources of funding is also an indication of the importance of a particular form of funding to the various bank groups in the past, as these ratios change very slowly, despite the change in circumstances on the financial markets. Coverage of loans by deposits by non-banking sectors is notable at the large domestic banks, and stood at 84% at the end of October. There was a similar situation at the small domestic banks, where coverage stood at 91%. The banks under majority foreign ownership recorded the lowest coverage of loans by deposits by non-banking sectors, at 52%. Coverage of loans by issued debt securities stood at 20% at the large domestic banks and 11% at the small domestic banks at the end of October, having recorded no significant change in recent months.

Figure 3.17: Coverage of loans to non-banking sectors by funding at the small domestic banks (left) and at the banks under majority foreign ownership (right) in percentages

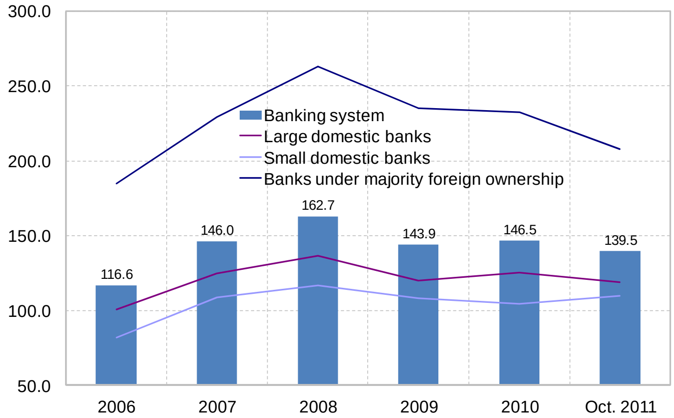


Source: Bank of Slovenia

Loan-to-deposit ratio

The LTD ratio, the ratio of loans to non-banking sectors to deposits by non-banking sectors, is a reflection of the importance of the funding that the banks obtain from their clients to fund lending to non-banking sectors. The rise in this indicator in the years before the crisis was a reflection of the banks' increased dependence on the situation on the financial markets, the banks having funded a large portion of their lending activity via the wholesale markets, i.e. via borrowing and/or securities issues. A lower ratio is a reflection of the long-term sustainability of funding, which is the result of greater focus on the details of bank funding. This was a feature at the domestic banks, as the ratio at the banks under majority foreign ownership was double that at the domestic banks in October. However, the downward trend evident at the banks under majority foreign ownership means a new focus on the attraction of deposits, and is an element in the increase in competition between the banks in this area.

Figure 3.18: Breakdown of bank funding in percentages



Source: Bank of Slovenia

3.5 Bank funding costs

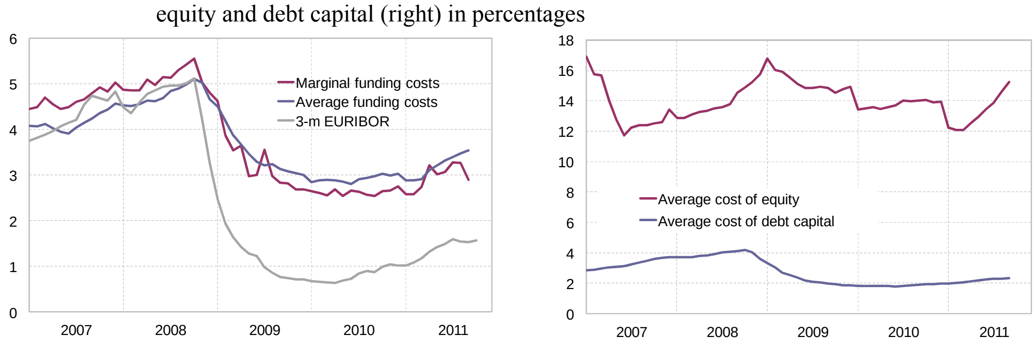
The rise in funding costs in 2011 was the result of the rise in market interest rates.

Average bank funding costs were up 0.5 percentage points during the first ten months of the year at 3.6%. In September 2011 they were up 0.7 percentage points on the low recorded in June 2010. Even in 2010, the rise in funding costs was the result of the rise in market interest rates and an increase in the proportion accounted for by more expensive forms of funding.[15] The rise in market interest rates was the main factor in the rise in 2011.

The 3-month EURIBOR rose by 0.55 percentage points during the first ten months of the year. The rise in average funding costs was almost the same as the rise in interest rates on the financial markets. The breakdown of funding improved slightly in 2011. The proportion of funding accounted for by the wholesale financial markets in the rest of the world declined slightly. At the same time the proportion accounted for by ECB funding also declined, which raised bank funding costs.

After the ECB's key interest rate was cut on 9 November 2011, interest rates on the international financial markets fell slightly. The end to the rise in market interest rates and the anticipated switch from issued bank securities to ECB funding will have a beneficial impact on bank funding costs.

Figure 3.19: Average and marginal bank funding costs (left) and average costs of equity and debt capital (right) in percentages



Sources: Bank of Slovenia, LJSE

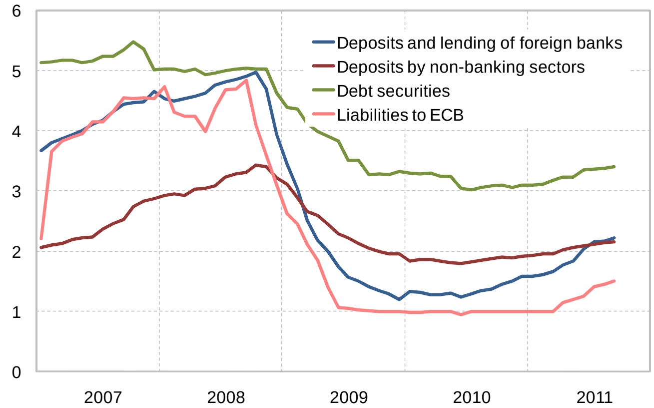
The largest rise in the cost of debt funding was recorded by liabilities to foreign banks.

Equity funding is the most expensive, the price reaching 15.3% in September, up 1.3 percentage points on December 2010. The rise was the result of the fall in bank share prices. The rise in market interest rates in 2011 was tracked by all forms of debt funding. Issued debt securities remain the most expensive form of debt funding, at a cost of 3.4%,

[15] The bank funding included in the calculation accounted for 93% of the banking system's total liabilities (September 2011). The funding costs are calculated on a pre-tax basis. The costs of debt capital are estimated on the basis of movements in interest rates on deposits by non-banking sectors, liabilities to the rest of the world (bank loans and deposits, ECB, other sectors) and debt securities (including subordinated debt securities). The costs of equity are estimated by means of a two-stage dividend discounting model for banks whose shares are listed on the Ljubljana Stock Exchange.

followed by deposits by non-banking sectors, at a cost of 2.2%. The average cost of bank funding in the rest of the world recorded the largest rise in 2011, up 0.6 percentage points at 2.2%. In the third quarter the interest rate on liabilities to foreign banks began to slightly exceed the average cost of bank funding via deposits by non-banking sectors. The cost of Eurosystem funding fluctuated around 1.5% in September.

Figure 3.20: Average cost of bank debt funding in percentages



Source: Bank of Slovenia

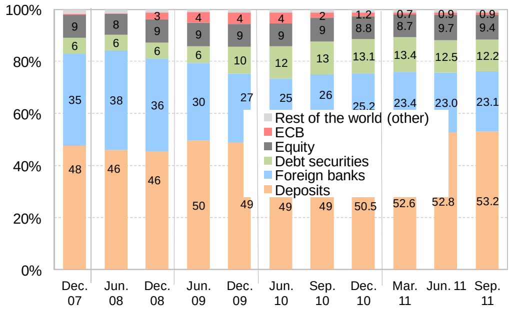
Bank funding via securities issues declined in 2011.

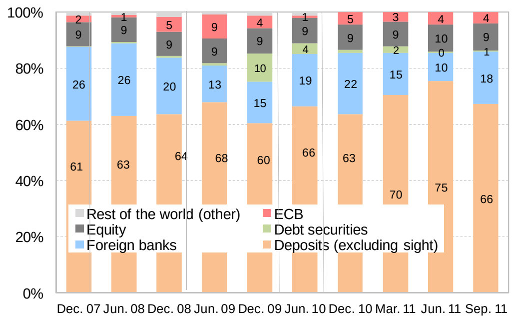
In the first two years of the crisis the larger Slovenian banks compensated for the loss of funding at foreign banks by means of issued debt securities. In 2011 the banks made repayments of securities issues, the least cost-effective form of funding. The reasons were the worsening of the situation on the financial markets, and the high cost of the government guarantee.

The banks will compete to attract household assets.

With household saving weakening as a result of the duration of the crisis, the banks will compete more actively to attract deposits. The persistence of the uncertain situation in the economy has not had any significant impact recently on saving. However, a major factor in saving is the low growth in disposable income, as a decline in disposable income while saving remains the same or even declines slightly could actually increase the saving ratio.

Figure 3.21: Breakdown of stock (left) and flows (right) of bank funding on half-yearly and quarterly basis in percentages





Source: Bank of Slovenia

Differences in funding costs between bank groups [16]

The banks under majority foreign ownership have the most favourable breakdown of funding in cost terms.

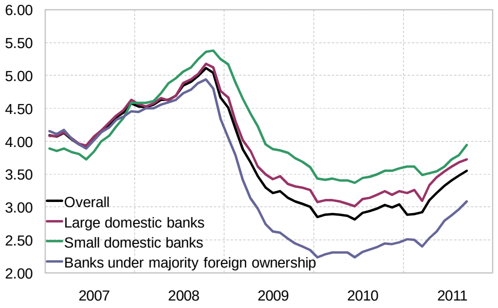
The lowest average funding costs in September 2011 were recorded by the banks under majority foreign ownership, at 3.1%, followed by the large domestic banks, at 3.7%. The difference between the two groups narrowed during the year. The banks under majority foreign ownership have the most favourable breakdown of funding in cost terms, as a result of the prevalence of funding at banks in the rest of the world. These liabilities account for more than half of their total funding. The small domestic banks have the highest funding costs, at 3.9%. However, this bank group recorded the smallest rise in funding costs in 2011, as a result of which the differences between the banks narrowed.

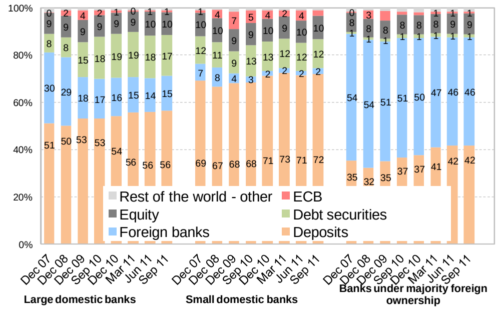
[16] Given the limited number of bank shares listed on the Ljubljana Stock Exchange, the assessment of equity costs is the same for all the bank groups. The differences in bank funding costs arise solely in the differences in the cost of debt capital and the proportion of debt capital in the funding at each bank group.

A decline in the proportion of funding accounted for by wholesale funding at banks and an increase in the proportion accounted for by deposits.

The largest decline in the funding breakdown during the crisis has been recorded by funding at foreign banks, the figure falling to 23%. The proportion of bank funding accounted for by issued securities increased until the first quarter of 2011, but then began to decline. This was partly the result of action by the banks, via prepayments of their own securities.

Figure 3.22: Average funding costs (left) and breakdown of funding (right) by bank group in percentages





Sources: Bank of Slovenia, LJSE

The proportion of funding accounted for by deposits by non-banking sectors at the banks under majority foreign ownership is increasing, but remains less than at the other two bank groups.

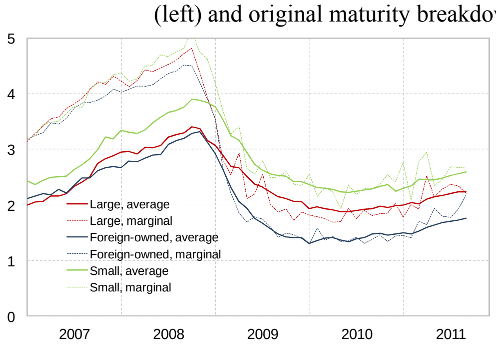
Despite negligible growth in deposits in 2011, the proportion of funding accounted for by deposits increased at all the bank groups. Deposits by non-banking sectors are growing in importance even at the banks under majority foreign ownership, the proportion of funding that they account for increasing by 15 percentage points over the last two years to 42%. The proportion accounted for by deposits is nevertheless still significantly lower than at the other two bank groups, as a result of the prevalence of funding at the parent banks in the rest of the world. The figure stood at 56% at the large domestic banks and 72% at the small domestic banks.

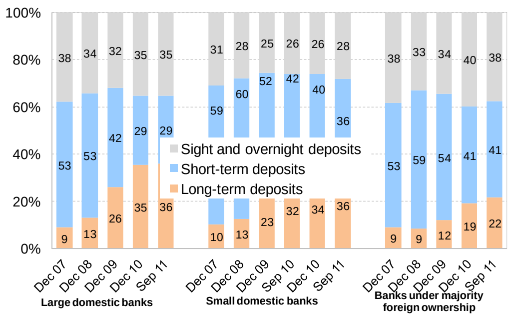
There are relatively large differences between the bank groups in the cost of funding via deposits by non-banking sectors. The small domestic banks had the highest such funding costs in September, at an average cost of 2.6% during the month, followed by the large domestic banks with an average cost of 2.2%, and then the banks under majority foreign ownership with an average cost of 1.8%.

The average costs of deposits by non-banking sectors rose at all the bank groups. In September the average cost was up 0.25 percentage points on December 2010 at the large domestic banks, up 0.35 percentage points at the small domestic banks, and up 0.29 percentage points at the banks under majority foreign ownership. The higher interest rates at the domestic banks are the result of the higher proportion accounted for by long-term deposits and the higher interest rates offered.

The largest increases in the cost of funding at banks in the rest of the world were recorded by the banks under majority foreign ownership and the large domestic banks, at 0.7 percentage points and 0.6 percentage points respectively. The banks under majority foreign ownership recorded an average cost of 2.1% for funding at banks in the rest of the world in September, while the figure for the large domestic banks was 2.4%.

Figure 3.23: Average and marginal funding costs for deposits by non-banking sectors[17] (left) and original maturity breakdown of deposits (right) by bank group





Source: Bank of Slovenia

[17] Shows the overall interest rate, irrespective of maturity and holder sector.

The cost of issued bank securities increased by a third of a percentage point in 2011. The cost at the large domestic banks stood at 3.9% in September, 0.4 percentage points more than at the small domestic banks, while the banks under majority foreign ownership did not utilise debt securities issues for funding purposes.

Despite the previous rise in funding costs and the uncertain situation on the financial markets, the rise in bank funding costs is expected to stop, at least temporarily. The reasons are the cut in the ECB's key interest rate, the fall in the EURIBORs on the financial markets, and the expectation that given the extremely adverse situation on the financial markets the banks will make more use of LTROs at the ECB, which has the lowest funding cost. Thanks to the longer maturity of the LTROs, ECB funding will significantly mitigate the pressures on the funding side.

3.6 Adjustments in bank funding costs

The banks' dependence on wholesale funding will continue to decline.

The banks will continue to adjust the funding breakdown to the situation on the financial markets and to the higher funding costs. They will reduce their dependence on wholesale funding, i.e. liabilities to foreign banks and issued securities. They will refocus on basic banking services, and will devote greater attention to deposits by non-banking sectors. The stock of liabilities to the ECB will increase. Limited growth in loans to non-banking sectors is also expected. In light of the forecasts for 2012, the proportion of total liabilities accounted for by liabilities to foreign banks and issued securities will be down 5.3 percentage points on 2010. An increase in the proportion accounted for by deposits by non-banking sectors will compensate for the majority of the decline. This proportion is forecast to rise by just over 3 percentage points, so that deposits by non-banking sectors will account for just over half of the banking system's total liabilities in 2012.

Table 3.3: Breakdown of liabilities in percentages and change in percentage points

	Proportion of total assets			Difference		
	Dec. 2010	Oct. 2011	Forecast Dec.2012	Oct. 2011 Dec. 2010	Dec. 2012 Oct. 2011	Dec. 2012 Dec. 2010
Liabilities to ECB	1.2	1.6	2.5	0.5	0.9	1.4
Liabilities to domestic banks	6.9	6.8	6.7	-0.2	-0.1	-0.2
Liabilities to foreign banks	23.3	20.8	20.5	-2.5	-0.3	-2.8
Debts securities	8.9	8.3	6.5	-0.6	-1.9	-2.5
Deposits by non-banking sectors	46.7	48.9	49.8	2.2	0.9	3.1
Equity	8.2	8.7	9.2	0.5	0.6	1.0
Other	4.8	5.0	4.8	0.2	-0.1	0.1

Source: Bank of Slovenia

The banks will increase their stock of liabilities to the ECB.

Like in the first wave of the financial turmoil following the collapse of Lehman Brothers, when Slovenian banks sharply increased their liabilities to the ECB and the proportion of total liabilities that they account for peaked at 4.2%, the banks can again be expected to significantly increase their liabilities to the ECB.

4 INCOME STATEMENT AND BANK PERFORMANCE INDICATORS

The banking system recorded a loss of EUR 124 million during the first ten months of 2011, down EUR 211 million on the same period the previous year. Net interest income during the first ten months of the year was down 1.3% on the same period the previous year. The decline in net interest income was the result of interest expenses rising faster than interest income. Net non-interest income was comparable to that recorded in the same period of 2010 (down 0.9%).

Income risk

Income risk remains high as a result of the realisation of credit risk caused by the continuing adverse economic situation and corporate difficulties. As a result of the deterioration in the quality of the credit portfolio, impairment and provisioning costs during the first ten months of the year were up 39% on the same period the previous year. Their ratio to gross income increased to 58.7%, albeit partly as a result of the decline in gross income.

Table 4.1: Income statement for first ten months of 2011

	2009	Breakdown	2010	Breakdown	2011	Breakdown	Annual growth
EUR million unless stated	Jan-Dec	%	Jan-Oct	%	Jan-Oct	%	in Oct 2011 in %
Interest income	2,055		1,711		1,837		7.4
Interest expenses	1,017		845		984		16.3
Net interest	1,038	70.4	865	71.0	854	70.9	-1.3
Non-interest income	437	29.6	353	29.0	350	29.1	-0.9
of which net fees and commission	343	23.3	285	23.4	286	23.8	0.5
of which net gains/losses from financial assets and liabilities held for trading	-49	-3.3	-37	-3.0	-12	-1.0	-66.3
Gross income	1,474	100.0	1,218	100.0	1,204	100.0	-1.2
Operating costs	766	51.9	623	51.2	622	51.7	-0.3
of which labour costs	413	28.0	345	28.3	338	28.1	-1.9
Net impairments and provisioning	810	54.9	508	41.7	706	58.7	39.0
of which net impairments of financial assets at amortised cost and provisioning	639	43.3	446	36.6	597	49.6	33.9
Pre-tax profit	-101	-6.9	87	7.1	-124	-10.3	-243.3
Taxes	-3		18		-20		…
Net profit	-98		69		-104		…

Source: Bank of Slovenia

In light of the decline in net interest and high loan impairment costs, the banks remain strongly exposed to income risk.

The stagnation in turnover meant that the banks generated insufficient income to operate at a profit. As a result of the realisation of credit risk they will be exposed to significant income risk in the future. The decline in the stock of loans, which is reducing the banks' flow of interest income, will also act to raise income risk. The rise in funding costs is also having an adverse impact on net interest income. It will not be possible to fully pass the higher costs through to bank loans, given the low demand. The beneficial impact of funding restructuring brought by the decline in the proportion accounted for by issued securities and the increase in the proportion accounted for by ECB funding will only lead to a slight temporary fall in costs. Growth in non-interest income is also limited, as the amount of income from fees and commission is to a great extent dependent on lending activity, while income from trading remains dependent on developments on the capital and foreign exchange markets.

Given high impairment and provisioning costs, poor performance by the banking system can again be expected in 2012, and the banks will be unable to recapitalise sufficiently by generating own funds internally.

Net interest income and interest margin

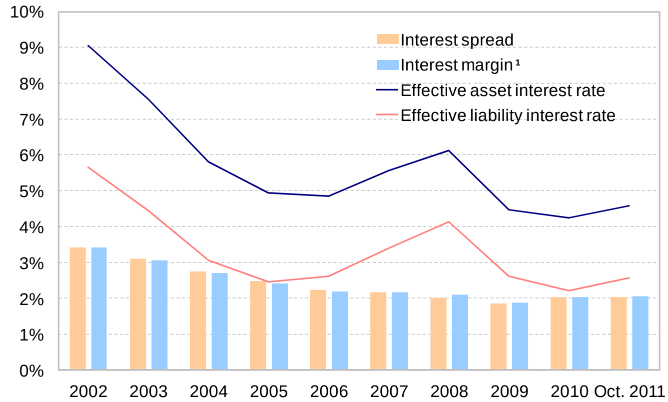
With net interest recording negative growth and total assets declining, the interest margin in the banking system remained almost unchanged in 2011. It stood at 2.05% during the first ten months of the year, measured against total assets. The decline in net interest is the result of a larger increase in interest expenses (16.3%) than in interest income (7.4%).

The increase in interest expenses and income was primarily the result of higher interest rates.

Average effective asset and liability interest rates have increased by the same amount in 2011.

Average effective asset and liability interest rates have increased by almost the same amount this year: 0.35 percentage points and 0.36 percentage points respectively. The spread therefore remained the same as last year, at 2 percentage points.

Figure 4.1: Movement in average asset and liability interest rates, interest spread and interest margin on interest-bearing assets



Note: [1]The value for October is calculated cumulatively for the period of January to October 2011.
Source: Bank of Slovenia

Differences in the generation and disposal of gross income by bank group

Only the banks under majority foreign ownership recorded positive growth in net interest income during the first ten months of the year, at 2.6%. The largest decline in net interest income was recorded by the small domestic banks, at 15.5%. At the same time the small domestic banks also recorded the largest decline in net non-interest income, at 14.3%, and they continue to record the largest proportion of gross income accounted for by net interest, at 76%. This is an indication of their greater relative dependence on interest-related business.

Table 4.2: Generation and disposal of the banking system's gross income by individual bank group

	Year-on-year growth, %								Ratio to gross income, %							
	Large domestic banks		Small domestic banks		Banks under majority foreign ownership		Banking system		Large domestic banks		Small domestic banks		Banks under majority foreign ownership		Banking system	
	Dec. 10	Oct. 11	Dec. 10	Oct. 11	Dec. 10	Oct. 11	Dec. 10	Oct. 11	Dec. 10	Oct. 11	Dec. 10	Oct. 11	Dec. 10	Oct.	Dec.	Oct. 11
Net interest	9.9	-1.0	19.6	-15.5	11.8	2.6	11.3	-1.3	68.4	69.0	74.0	75.9	73.4	73.7	70.4	70.9
Non-interest income	-12.4	1.9	-25.1	-14.3	-3.8	-3.7	-11.5	-0.9	31.6	31.0	26.0	24.1	26.6	26.3	29.6	29.1
Operating costs	0.0	-2.6	3.2	-2.4	-0.7	5.1	0.1	-0.3	51.6	49.8	50.4	58.1	53.2	53.7	51.9	51.7
Impairments and provisioning	67.1	47.8	24.7	4.5	61.8	21.9	62.1	39.0	64.8	71.9	43.4	43.0	37.9	35.9	54.9	58.7
Profit	-305.7	-6315.9	-52.2	-106.8	-45.3	-44.2	-163.0	-243.3	-16.4	-21.7	6.2	-1.2	8.9	10.4	-6.9	-10.3

Source: Bank of Slovenia

The realisation of income risk is most pronounced at the banks under majority domestic ownership.

Credit risk was realised to the greatest extent at the large domestic banks. Impairment and provisioning costs at the large domestic banks during the first ten months of the year were up 48% on the previous year, compared with increases of 22% at the banks under majority foreign ownership and 4.5% at the small domestic banks.

The banks under majority foreign ownership recorded a pre-tax ROE of 3.8% during the first ten months of 2011, while that of the domestic banks was negative, at -6.3%. The financial intermediation margin stood at 2.87% at the domestic banks and 3.04% at the banks under majority foreign ownership. The domestic banks recorded an interest margin of 2% during the first ten months of the year, two tenths of a percentage point lower than the interest margin at the banks under majority foreign ownership. At 1.63%, the ratio of operating costs to average assets at the banks under majority foreign ownership was slightly higher than at the domestic banks, where it was 1.46%.

Table 4.3: Bank performance indicators during the first ten months of 2011 in percentages

	End of period			
(%)	2009	2010	Oct. 10	Oct. 11
Profitability				
Financial intermediation margin*	2.87	2.87	2.85	2.89
ROA	0.32	-0.20	0.20	-0.30
ROE	3.85	-2.36	2.43	-3.47
Interest margin on interest-bearing assets	1.99	2.13	2.14	2.17
Net non-interest income / operating costs	64.45	57.01	56.63	56.26
Operating costs				
Labour costs / average assets	0.84	0.80	0.8	0.8
Other costs / average assets	0.70	0.69	0.7	0.7
Quality of assets				
Impairments of financial assets measured at amortised cost / gross assets	3.02	4.20	3.9	5.1

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

5 LIQUIDITY RISK

Liquidity risk as measured by the first-bucket liquidity ratio remains moderate, and comparable to last year. The first-bucket liquidity ratio at the end of November 2011 was only slightly higher than a year earlier, although the differences between banks widened. During a change in the calculation methodology at the beginning of October,[18] the first-bucket liquidity ratio remained below last year's average at all the bank groups. The aforementioned changes were very minor, and the banking system is maintaining an adequate level of liquidity, higher than in 2008.

The banking system's ratio of secondary liquidity to total assets declined to 10.1%, mostly as a result of a decline in Slovenian government securities. In light of the decline in liabilities to the Eurosystem, the proportion of the pool of eligible collateral that is free was higher than in the previous year. At the same time, the distribution of the free pool of eligible collateral between banks was wider.

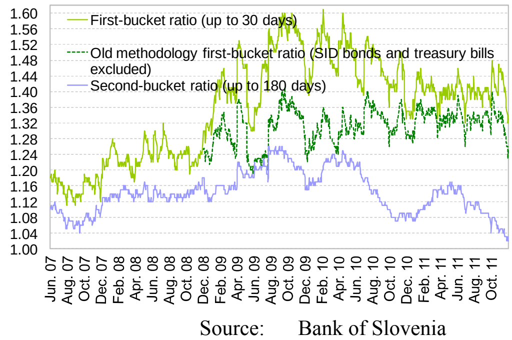
On the international market for unsecured euro area loans, Slovenian banks increased their net claims against foreign banks during the first eleven months of the year by EUR 601 million to EUR 246 million. The change was the result of a decline of EUR 447 million in borrowings from the rest of the world in the form of loans, while loans granted to the rest of the world increased by EUR 154 million. The decline in loans from the rest of the world was particularly pronounced in the second half of 2011, as a result of the growing lack of confidence on the European interbank market.

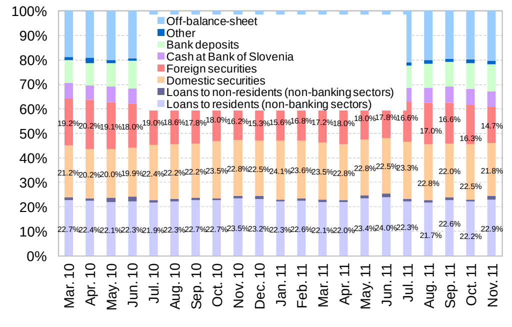
Liquidity ratios

The average first-bucket liquidity ratio in 2011 was lower than in the previous year.

The first-bucket liquidity ratio averaged 1.40 over the first eleven months of 2011, down 0.07 on last year's average. Following the change in calculation methodology at the beginning of October, November's first-bucket and second-bucket liquidity ratios were below last year's averages. The main factor on the investment side in the decline in the first-bucket liquidity ratio was a decline in investments in securities. On the funding side, liabilities to banks and savings banks also declined as a result of debt repayments, while liabilities to the Eurosystem declined as a result of the maturing of liabilities obtained in LTROs in 2010. At the same time there was an increase in deposits by non-banking sectors, most notably government deposits. Liabilities to the Eurosystem had increased again to EUR 834 million by the end of October, as a result of the banks' participation in a 12-month LTRO. According to the latest information, the banks are to participate in a further auction for a 3-year LTRO at the end of December, which is becoming a significant external source of funding in light of the malfunctioning international financial markets.

Figure 5.1: Daily first-bucket and second-bucket liquidity ratios (left) and breakdown of assets included in the calculation of the first-bucket liquidity ratio (right) in percentages





Source: Bank of Slovenia

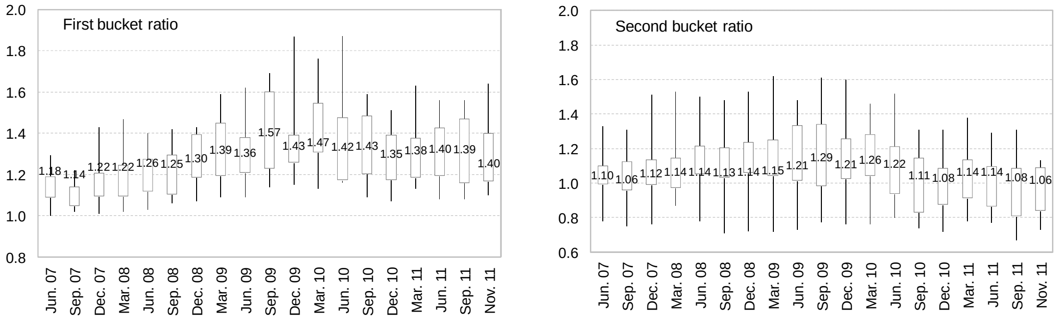
In the context of a relatively high first-bucket liquidity ratio, the differences between the banks widened.

The differences in the first-bucket liquidity ratio between the banks widened. There was a similar situation with regard to the distribution of the second-bucket liquidity ratio. This

[18] The change in the methodology for calculating the ratio entered into force on 1 October 2011 with the Resolution amending the resolution on minimum requirements for ensuring an adequate liquidity position (Official Gazette of the Republic of Slovenia, Nos. 28/07, 55/07, 83/07 and 74/11). On the liability side, the weight of sight deposits by households and non-financial corporations was reduced from 50% to 40%. Similarly, the weight in the second-bucket liquidity ratio was reduced from 45% to 35%.

recorded the largest decline, primarily as a result of a decline in corporate loans and investments in securities.

Figure 5.2: Distribution of first-bucket (left) and second-bucket (right) liquidity ratios, monthly averages

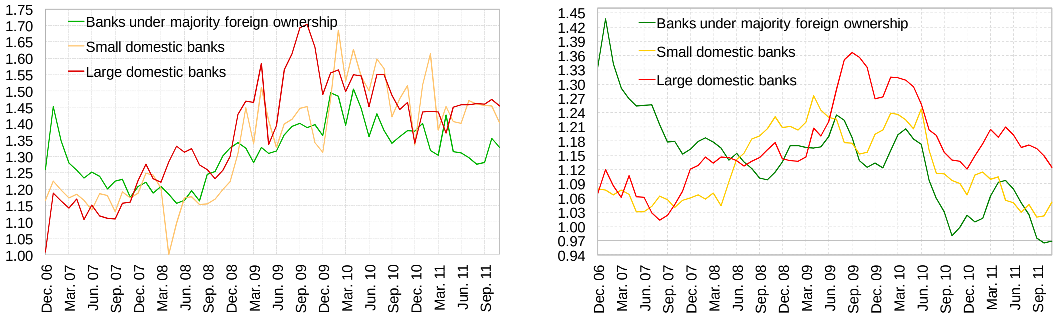


Source: Bank of Slovenia

The small domestic banks recorded the highest first-bucket liquidity ratio.

The average first-bucket liquidity ratio declined at all bank groups this year, the banks under majority foreign ownership recording the largest decline of 0.08 to 1.33. This was primarily the result of an increase in deposits by non-banking sectors and off-balance-sheet items.

Figure 5.3: First-bucket liquidity ratio (up to 30 days; left) and second-bucket liquidity ratio (up to 180 days; right) by bank group, monthly averages

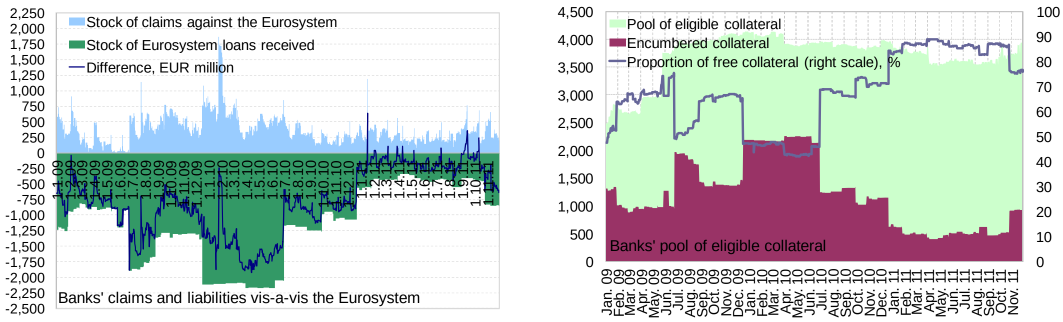


The net debt at the Eurosystem began to increase in May and August as a result of the banks' participation in auctions for 3-month and 6-month LTROs. The net liabilities increased primarily at the end of October as a result of the banks' participation in the auction for a 12-month LTRO. They averaged EUR 492 million in November, or 1% of the banking system's total liabilities. This was significantly less than in 2009 and the first half of 2010, when the net debt stood at 1.7% and 2.9% of total liabilities respectively.

The pool of eligible collateral at the Eurosystem that is free was relatively high in 2011, but the differences between the banks widened.

The pool of eligible collateral at the Eurosystem amounted to EUR 3,823 million at the end of November. The proportion of this collateral that is free stood at 75.8%. Despite the high proportion of free collateral at the level of the banking system overall, the differences between the banks and savings banks had widened by the end of the year. Extraordinary 3-year LTROs have been announced for the end of December 2011 and the end of the February 2012.

Figure 5.4: Commercial banks' claims, liabilities and net position vis-à-vis the Eurosystem in EUR millions (left), and pool of eligible collateral at the Eurosystem in EUR millions (right)



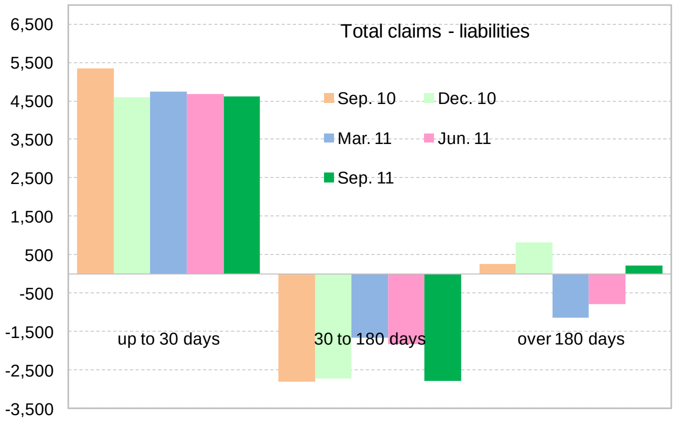
Source: Bank of Slovenia

Liquidity gap

The negative gap in the second bucket widened in the third quarter of 2011.

November's large liquidity gap in the bucket with residual maturity of up to 30 days was almost unchanged from the end of the previous year, at EUR 4,627 million. After diminishing in the first quarter, the negative gap in the bucket with maturity of 30 to 180 days widened again in the third quarter to reach its level from the start of 2011. The reason was the banks' participation in the extraordinary 3-month and 6-month LTROs at the ECB in August.

Figure 5.5: Liquidity gap as the difference between total assets and total liabilities defined in the liquidity ladder methodology in EUR millions



Source: Bank of Slovenia

The stock of secondary liquidity at the banks at the end of October was down EUR 320 million on the end of 2010 at EUR 5 billion. The decline was primarily the result of a decline in Slovenian government securities. The banking system's ratio of secondary liquidity to total assets stood at 10.1% in October, one of the lowest figures to date.

6 REFINANCING RISK

Refinancing risk for Slovenian banks remains high owing to the uncertainty on the European financial markets. Debt repayments by the banks to the rest of the world in 2010 and 2011 resulted in a contraction in the banking system's total assets. This can be expected again in 2012, as the banks will be highly exposed to refinancing risks for the following reasons. First, the maturity structure of liabilities to foreign banks shortened notably in 2011. Some 23.3% of the banks' liabilities to the rest of the world had a maturity of up to 1 year in October 2010[19], compared with 31% in October 2011. A total of EUR 4.1 billion of the banking system's liabilities to the rest of the world mature over a period of up to 1 year (until October 2012). Half of this amount is accounted for by the banks under majority domestic ownership and half by the banks under majority foreign ownership. Second, EUR 1.8 billion in government deposits held by the banks (of total deposits amounting to EUR 3.5 billion) mature in the 1 year period to October 2012. Bank funding conditions on the international financial markets also tightened in 2011, and will only gradually normalise.

The ECB's longer-term refinancing operations with a maturity longer than 1 year have a favourable impact in terms of replacing maturing sources. Liabilities to the Eurosystem rose from EUR 0.25 billion at the end of 2010 to EUR 0.83 billion at the beginning of December. ECB sources are justifiably becoming an important neutraliser of the refinancing risk faced by the banks. However, (additionally) downgraded sovereign credit ratings could result in a decline in the value of the pool of eligible collateral for ECB operations, which would in turn result in the tightening of access by the banks to Eurosystem sources. Funding conditions tightened in the rest of the world in 2011. Outlooks for 2012 are made worse by the fact that a large portion of liabilities of European countries and banks mature next year.

The interest rates on loans raised by the domestic banks in the rest of the world were up 0.3 percentage points over the first ten months of 2011 to stand at 1.9 percentage points over the EURIBOR, and up 0.4 percentage points on loans raised by the banks under majority foreign ownership to stand at 0.8 percentage points over the EURIBOR. The maturity breakdown of maturing liabilities to the rest of the world is similar at all bank groups. Around one third of liabilities mature in the period of up to 1 year. Bank funding costs rose in 2011 owing to rising interest rates on the financial markets. The rise in costs was also affected by the downgrading of sovereign credit ratings in September 2011 and the resulting rise in the required yields on government bonds. On the other hand, the increased volume of sources secured from the ECB drives down those costs.

6.1 Sources of bank funding on the wholesale markets and at the ECB

a) Government deposits at banks

More than one half or EUR 1.8 billion in government deposits held by the banks will mature between October 2011 and October 2012.

The government has become an important source of funding for the banks during the crisis, such that it deposited a portion of funds from the pre-financing of budget expenditure at the banks. Government deposits account for 14% of the deposits by non-banking sectors. According to figures for the end of October 2011 and taking into account residual maturity, EUR 1.8 billion in government deposits mature in the period of up to 1 year. The large domestic banks account for EUR 1 billion of the aforementioned amount. A cumulative total of EUR 2.2 billion of Slovenian banks' liabilities to the government mature in the period of up to 2 years.

Government deposits are a relatively important source of funding for the banks under majority domestic ownership. In October 2011 liabilities to the government accounted for 11.3% of total assets at the small domestic banks, 7.7% at the large domestic banks and 4.2% at the banks under majority foreign ownership.

The Ministry of Finance issued 18-month treasury bills in the amount of EUR 0.907 billion on 6 December 2011. The funds raised were placed at the banks with a shorter maturity.

[19] According to figures for the end of October 2011.

Table 6.1: Maturing liabilities from government deposits at banks (October 2011)

(%)	Cumulative maturing of government deposits				Maturity breakdown of liabilities			
	Large domestic banks	Banks under majority foreign ownership	Small domestic banks	Banking system	Large domestic banks	Banks under majority foreign ownership	Small domestic banks	Banking system
Total, EUR million	**2,424**	**605**	**469**	**3,499**				
Up to 3 months	32.8	79.2	30.7	40.6	32.8	79.2	30.7	40.6
3 to 6 months	35.7	80.5	35.5	43.4	2.9	1.2	4.8	2.9
6 months to 1 year	42.9	81.6	52.0	50.8	7.1	1.1	16.4	7.3
1 to 2 years	56.0	85.2	68.8	62.8	13.1	3.6	16.8	12.0
Over 2 years	100.0	100.0	100.0	100.0	44.0	14.8	31.2	37.2
Total					100.0	100.0	100.0	100.0

Source: Bank of Slovenia

b) Issue of bank securities on the financial markets

Bank funding by means of securities issues was very modest in 2011 compared with the previous two years. The banks repurchased certain issued bonds early. The only issue worthy of note is the issue of debt securities by SID banka, which increased its issue of euro bonds in March by EUR 350 million and carried out a private issue of bonds in the amount of EUR 150 million in October.

Banks made early repurchases of bonds in 2011.

The banks were more active in partial early repurchases of bonds, which totalled EUR 840 million in 2011. SID banka made a partial early repurchase of SI01 bonds in the amount of EUR 305 million in April. NLB and Abanka made partial early repurchases of government-backed bonds. NLB's initial repurchase of EUR 296 million was carried out in July, followed by EUR 88.5 million in September, while Abanka's repurchase in September was in the amount of EUR 149.4 million. The reasons for the early repurchases lie in the cost of the associated government guarantee of close to 1 percentage point and liquidity management by the banks.

c) Bank funding via Eurosystem operations

Slovenian banks' liabilities to the Eurosystem totalled EUR 829 million at the beginning of December 2011, of which EUR 437 million was accounted for by long-term operations.

Slovenian banks' liabilities to the Eurosystem totalled EUR 829 million at the beginning of December 2011. Bank liabilities of EUR 184 million mature by the end of December 2011 on the basis of September's 3-month LTRO, for a total of EUR 227 million together with a main refinancing operation and a 1-month LTRO. Bank liabilities to the Eurosystem totalling EUR 166 million mature in the first quarter of 2012. Prior to that, an additional 3-year LTRO will be executed at the end of December. Thus, the Eurosystem is responding to the tightened conditions on the financial markets. Comparatively speaking, this source of funding is very favourable for Slovenian banks in terms of cost and maturity, which in the context of a significant proportion of unused eligible collateral for ECB operations facilitates increased funding from the Eurosystem in 2012.

d) Maturing bank liabilities to the rest of the world

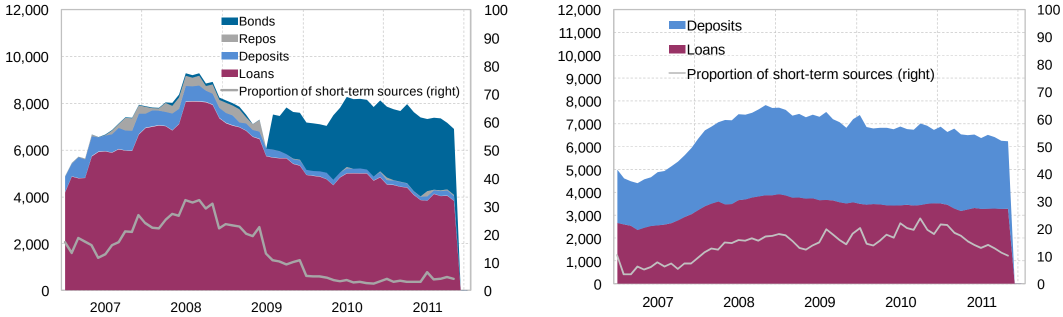
The banks have succeeded in rolling over only a portion of maturing liabilities on the wholesale markets in the rest of the world. Over the 1-year period from September 2010 to September 2011, the banks under majority domestic ownership rolled over 38% of maturing liabilities to foreign banks, while that proportion stood at 86% for the banks under majority foreign ownership.

The domestic banks and the banks under majority foreign ownership reduced their liabilities to foreign banks.

The domestic banks reduced their liabilities to foreign banks by 15% or EUR 739 million over the first ten months of 2011, excluding liabilities from issued bonds. Including issued bonds, liabilities to foreign banks were down EUR 950 million over the first ten months of the year. Both short-term and long-term liabilities are declining in the stock of the domestic banks' liabilities to the rest of the world. Short-term funding at foreign banks had dried up to a great extent back in 2009, when maturing short-term loans were no longer rolled over in their entirety.

The banks under majority foreign ownership reduced their liabilities to foreign banks by EUR 640 million or 10% in 2011 relative to the end of 2010. The proportion of short-term funding is higher at the banks under majority foreign ownership than at the domestic banks, primarily owing to a high proportion of short-term deposits, but more than halved in 2011.

Figure 6.1: Stock of funding at foreign banks in EUR million, and the proportion of short-term sources for the banks under majority domestic ownership (left) and the banks under majority foreign ownership (right) in percentages



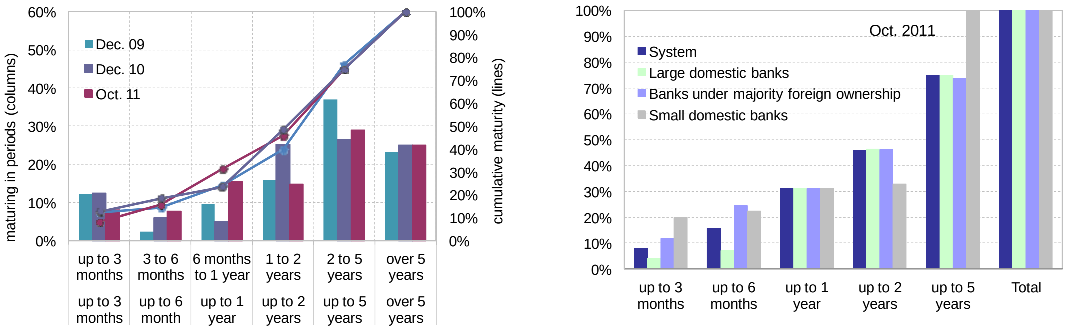
Source: Bank of Slovenia

The breakdown of maturing liabilities to the rest of the world was less favourable in October 2011 than at the end of 2010. Liabilities with a maturity of up to 1 year account for 31.1% of total liabilities to foreign banks, compared with 23.3% at the end of 2010. The majority of those liabilities are the bonds of large domestic banks maturing in the third quarter of 2012. Maturing liabilities to foreign banks are the same at these bank groups over the same period (at just over 30%), the difference being that the burden on the banks under majority foreign ownership and the small domestic banks is greater over the next six months, while the burden on the large domestic banks is greater over the second half of the next 1-year period.

The average maturity of liabilities has shortened owing to maturing bonds in 2012.

The average maturity of liabilities lengthened notably at the large domestic banks with the issue of bonds in the total amount of EUR 2 billion in the third quarter of 2009, and further in the first half of 2010 with the issue of EUR 750 million in bonds. If the banks fail to roll over maturing liabilities in the amount of EUR 1.6 billion in 2012, which is likely given the sharp increase in the required yield on Slovenian government bonds, the breakdown of liabilities to the rest of the world will deteriorate significantly.

Figure 6.2: Maturing of liabilities to foreign banks by maturity interval (left) and by bank group (right) in percentages



Source: Bank of Slovenia

Table 6.2: Maturing of liabilities to foreign banks by maturity interval (left) and by bank group (right) in percentages

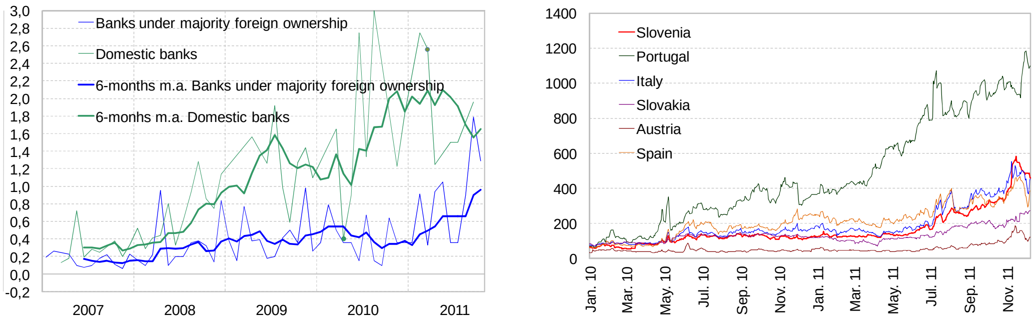
	Cumulative maturing of liabilities to foreign banks				Maturity breakdown of liabilities			
	Banking system	Large domestic banks	Banks under majority foreign ownership	Small domestic banks	Banking system	Large domestic banks	Banks under majority foreign ownership	Small domestic banks
Total, EUR million	13,158	6,645	6,245	267				
				Breakdown, %				
Overnight, sight	0.8	1.3	0.4	0.2	0.8	1.3	0.4	0.2
Up to 1 month	3.3	3.3	2.9	13.9	2.5	2.0	2.5	13.7
1 to 3 months	8.0	4.1	11.7	19.9	4.7	0.8	8.9	5.9
3 to 6 months	15.7	7.2	24.6	22.5	7.7	3.1	12.9	2.6
6 months to 1 year	31.1	31.2	31.0	31.0	15.3	24.0	6.4	8.5
1 to 2 years	45.9	46.3	46.1	33.0	14.8	15.1	15.1	2.0
2 to 3 years	51.8	50.2	54.2	33.0	5.8	3.9	8.1	0.0
3 to 4 years	70.0	70.6	68.1	100.0	18.3	20.4	13.9	67.0
4 to 5 years	74.9	75.0	73.8		4.9	4.4	5.6	
5 to 7 years	84.8	77.1	92.3		9.9	2.1	18.5	
7 to 10 years	88.3	78.6	98.3		3.6	1.5	6.0	
10 to 15 years	93.7	87.4	100.0		5.3	8.9	1.7	
15 to 20 years	100.0	100.0			6.3	12.6		
Over 20 years								
Total					100.0	100.0	100.0	100.0

Source: Bank of Slovenia

Premiums over the EURIBOR have risen for both the domestic banks and the banks under majority foreign ownership in 2011.

Funding conditions at banks in the rest of the world have tightened. Premiums over the EURIBOR are approaching 3 percentage points for certain transactions. The premiums on loans to domestic banks have fluctuated between 1.2 percentage points and 3 percentage points in 2011 (the 6-month average having stood at 2 percentage points). The banks under majority foreign ownership have borrowed in 2011 with premiums of between 0.4 percentage points and 1.8 percentage points (the 6-month average having risen from 0.4 percentage points at the end of 2010 to 1 percentage point in October).

Figure 6.3: Premiums over the EURIBOR on loans raised in the rest of the world with respect to majority ownership and the 6-month moving average (left), and movement in premiums on 10-year Slovenian government bonds over German bonds and the bonds of selected countries in basis points (right)



Source: Bank of Slovenia

e) Premiums on 10-year Slovenian government bonds over German bonds

The expansion of the euro area debt crisis and the downgrading of credit ratings affect Slovenian banks' funding conditions. The three major rating agencies downgraded Slovenia and several banks in September and October. In doing so, they left open the possibility of further downgrades owing to deteriorating conditions within the banking system, delays in the implementation of structural reforms and fiscal imbalance.

The premiums on Slovenian government bonds over German bonds rose.

Premiums on 10-year Slovenian government bonds over German bonds averaged 128 basis points in the first quarter of 2011, an average increase of 26 basis points relative to 2010. The premiums rose sharply until the end of the second quarter of 2011 and reached 254 basis points at the end of September, up 153 basis points on last year's average. The premiums for all comparable countries rose in the third quarter; however, the premiums on Slovenian 10-year government bonds in particular tracked the premiums on Spanish and Italian bonds very closely.

The premiums on 10-year Slovenian government bonds rose sharply at the end of October, and exceeded the value of comparable Italian and Spanish securities at the beginning of November. From the beginning of November through the first 10 days of

December, the average premium on 10-year Slovenian government bonds was 422 basis points above the comparable German bond. In addition to the failure to implement structural reforms and the downgrading of Slovenia, the rise in premiums is also partly the result of other factors that are not a reflection of the underlying economic conditions in Slovenia.

7 CREDIT RISK

The deterioration in the quality of the credit portfolio continued in 2011. Corporate lending has come to standstill, in particular to sectors that stand out with positive economic growth. In contrast, relative exposure to sectors facing problems in settling their liabilities, and in particular to corporates involved in drawn-out bankruptcy procedures, is rising. Corporate indebtedness, as a key limiting factor for new borrowing at banks, remains high. Current corporate financing in the rest of the world has returned to the pre-crisis level. Thus, Slovenian banks are losing potential income and missing opportunities to improve the quality of the portfolio through investments in healthier sectors of the economy.

The pace of deterioration in the quality of the portfolio is particularly notable in the construction sector. This indicates that a portion of the portfolio is subject to value adjustments that will have a negative effect on the banks' operating results. In contrast, a positive effect has been seen from the economic recovery in the manufacturing sector, where growth in longer arrears has come to a halt in recent months.

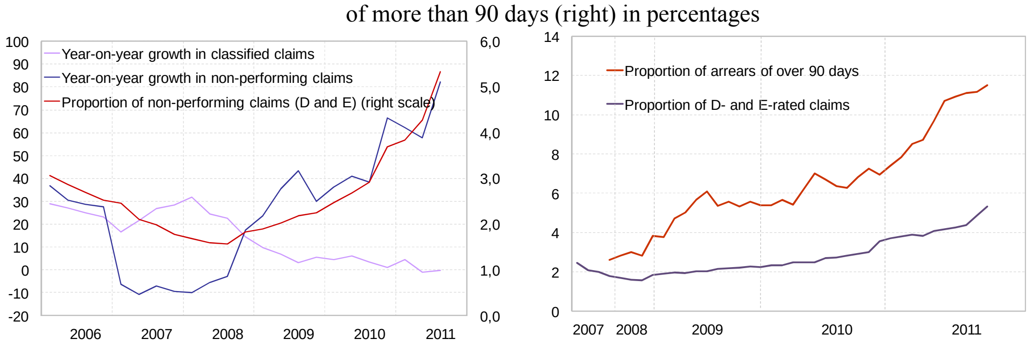
7.1 Quality of the credit portfolio

The proportion of classified claims settled more than 90 days in arrears rose to 11.5% over the first nine months of 2011.

The deterioration in the banks' credit portfolio continued in 2011. The proportion of clients settling their liabilities in arrears has risen, despite the economic recovery in the first half of 2011. The proportion of classified claims settled more than 90 days in arrears reached 11.4% over the first nine months of 2011, an increase of 4 percentage points on the end of 2010. The stock of liabilities settled more than 90 days in arrears reached EUR 5.7 billion.

The value of the banks' classified claims has stagnated at around EUR 50 billion since June 2010, while the proportion of those claims that the banks reclassify to non-performing claims is rising. Year-on-year growth in non-performing claims reached 80% in September 2011, those claims accounting for 5.33% of all classified claims. Further growth in non-performing claims and impairments can be expected owing to accelerated growth in longer arrears, in particular where the value of collateral is declining. Impairments and provisions reached EUR 2.9 billion over the first nine months of 2011, accounting for 5.9% of the banks' classified claims.

Figure 7.1: Growth in classified and non-performing claims (left), and the proportions of classified claims accounted for by D- and E-rated claims and by arrears of more than 90 days (right) in percentages



Source: Bank of Slovenia

Table 7.1: Ratings breakdown of classified claims and coverage of claims by impairments and provisions

	31.12.2009			31.12.2010			30.9.2011		
	Classified claims	Impairments	Coverage of claims by impairments, %	Classified claims	Impairments	Coverage of claims by impairments, %	Classified claims	Impairments	Coverage of claims by impairments, %
Total, EUR million	49,257	1,823	3.70	49,766	2,422	4.87	49,905	2,933	5.88
	Breakdown, %			Breakdown, %			Breakdown, %		
A	70.48	7.1	0.4	70.65	5.7	0.4	66.39	3.9	0.3
B	24.71	30.7	4.6	21.34	20.0	4.6	23.47	16.6	4.2
C	2.57	16.2	23.3	4.32	22.3	25.1	4.81	21.1	25.7
D	1.46	24.8	62.9	2.89	35.5	59.8	4.65	46.9	59.3
E	0.79	21.3	100.0	0.80	16.5	100.0	0.68	11.5	100.0

Source: Bank of Slovenia

The quality of the portfolio of non-financial corporations is deteriorating.

The quality of the banks' investments is the lowest in the sector of non-financial corporations. The proportion of claims settled more than 90 days in arrears rose to 18.6% over the first nine months of 2011, an increase of 6.3 percentage points on the end of 2010. The deterioration in this portion of the portfolio has not eased, primarily owing to the continuing pace of failures in the construction sector. Among individual client segments, the only segment in which the quality of the portfolio is deteriorating faster than at non-financial corporations is in the segment of other financial organisations, where the proportion of arrears of more than 90 days was 2.6 times higher in September than at the end of 2010.

Arrears are growing at sole proprietors and non-residents.

The quality of investments in the segment of sole proprietors is deteriorating. Arrears of more than 90 days reached 14.3% in this client segment in September. The likelihood of a further deterioration in this portion of the portfolio is high owing to the complex business links with large corporations and the weak negotiating power of sole proprietors. Arrears in this client segment are frequently a reflection of payment indiscipline and financial difficulties faced by stronger business partners.

After improving in 2010, the quality of claims against non-residents deteriorated in 2011. The arrears of non-residents of more than 90 days have risen by 3 percentage points to 8.3%. Investments in foreign non-financial organisations accounted for 60% of claims against non-residents in September.

The proportion of classified claims accounted for by claims more than 90 days in arrears is slightly higher than shown in the table, because the arrears of households are not included. These arrears are nevertheless still low, but contribute an additional 0.5 percentage points to total arrears of more than 90 days owing to the size of this client segment. Arrears in this segment will likely rise further if the economic crisis deepens again.

Table 7.2: Arrears in the settlement of liabilities to banks by client segment

	Classified claims			Proportion of classified claims in arrears for client category						
					total arrears			arrears of over 90 days		
	Dec. 09	Dec. 10	Sep. 11		Dec. 09	Dec. 10	Sep. 11	Dec. 09	Dec. 10	Sep. 11
Total, EUR million	49,757	50,291	50,528		5,108	6,857	8,829	2,690	3,711	5,736
							%			
Corporates	50.4	49.9	49.2	100.0	12.6	21.1	28.1	6.6	12.3	18.6
OFIs	5.2	4.8	4.5	100.0	6.6	19.0	25.6	2.2	6.8	17.7
Household sector [1]	19.0	20.3	20.6	100.0	11.8	9.8	-	3.8	4.0	-
sole proprietors	1.9	2.0	2.0	100.0	20.7	20.9	25.0	11.9	12.6	14.3
households [1]	17.1	18.3	18.6	100.0	10.7	8.6	-	2.8	3.1	-
Non-residents	15.7	12.7	12.8	100.0	18.9	12.6	12.9	10.9	5.3	8.3
Government	3.1	4.1	4.2	100.0	2.3	1.3	6.0	0.1	0.1	1.0
Banks and savings banks	6.5	7.5	7.6	100.0	1.4	1.4	1.1	0.4	0.2	0.7
Central bank	0.0	0.6	0.8	100.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.1	0.1	0.4	100.0	0.0	0.0	0.0	0.0	0.0	0.0
Total	100.0	100.0	100.0	100.0	10.3	13.6	17.5	5.4	7.4	11.4

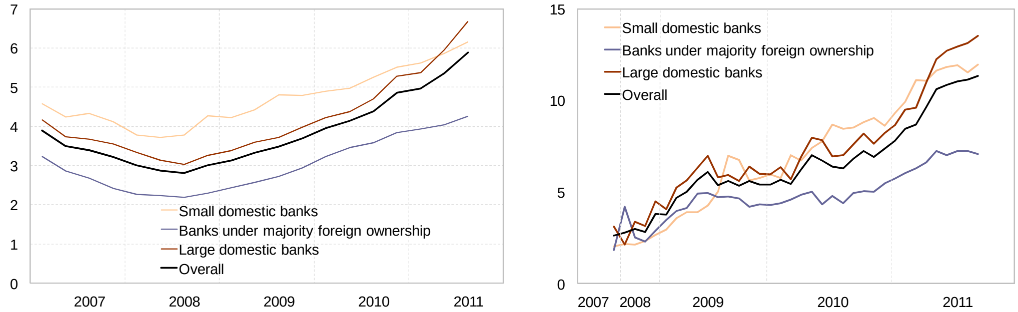
Note: [1]The figures for 2009 and 2010 for households are estimated on the basis of figures from the bank survey. The assessment is also taken into account in the aggregate of households.

Source: Bank of Slovenia, bank survey

Arrears of more than 90 days are rising fastest at the large domestic banks.

The credit portfolio is deteriorating most rapidly at the large domestic banks. The proportion of classified claims accounted for by arrears of more than 90 days in this bank group reached 13.5%, and continues to rise without showing any sign of slowing. The deterioration in the quality of the portfolio has slowed at other bank groups in recent months, and even halted at the banks under majority foreign ownership. The proportion of classified claims accounted for by arrears of more than 90 days has stabilised at the banks under majority foreign ownership at 7.1%, and has fluctuated at around 12% at the small domestic banks in recent months. Similar relationships among the bank groups are also seen in a comparison of the coverage by impairments and provisions, the difference being that those proportions continue to rise at all bank groups.

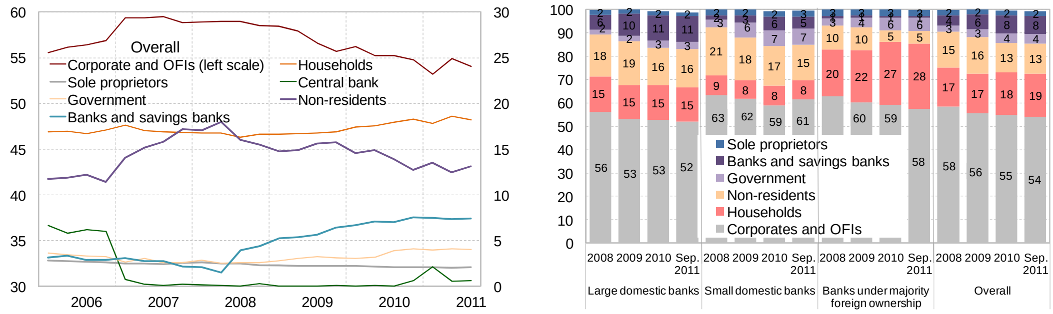
Figure 7.2: Coverage of classified claims by impairments (left) and the proportion of banks' classified claims more than 90 days in arrears (right) by bank group in percentages



Source: Bank of Slovenia

Differences in the quality of the portfolio are the result of different structures of the banks' portfolios, but also due to the varying qualities of clients within an individual segment. The proportion of the banks' portfolio accounted for by investments in corporates continued to decline in 2011, while the proportion of investments in households rose. Worthy of particular note in this respect are the banks under majority foreign ownership, which increased the proportion of their investments accounted for by households to 28% over the first nine months of the year, significantly more than the banks under majority domestic ownership.

Figure 7.3: Breakdown of classified claims by sector and total (left) and by bank group (right) in percentages



Source: Bank of Slovenia

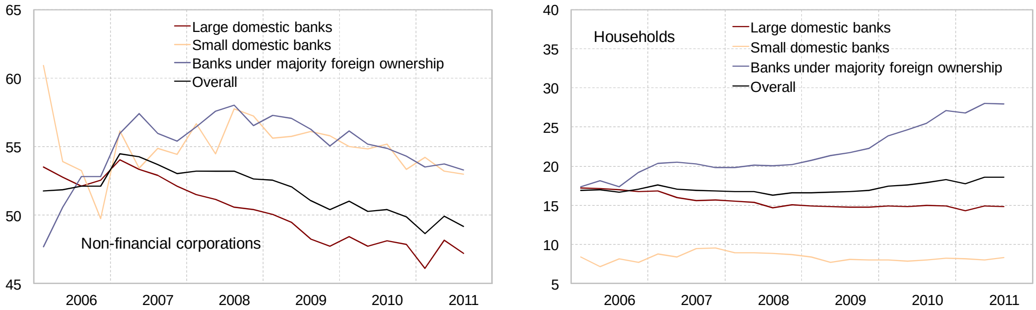
The quality of the portfolio of non-financial corporations is worst at the large domestic banks and continues to deteriorate.

All banks groups, except the small domestic banks, reduced their exposure to non-financial corporations in 2011, but not necessarily to problematic investments in the same sector. Due to the inability to settle liabilities, investments of the lowest quality, which burden the portfolio long after bankruptcy proceedings are initiated, remain on the banks' balance sheets. The large domestic banks have the lowest proportion of non-financial corporations in the structure of their portfolio, but have the highest proportion of claims more than 90 days in arrears of all bank groups. The proportion of non-financial corporations' arrears of more than 90 days at the large domestic banks reached 22.5% in September, double the amount at the banks under majority foreign ownership.

The deterioration in the portfolio of non-financial corporations has slowed at other bank groups.

The banks under majority foreign ownership have the lowest proportion of longer arrears, despite the highest relative proportion of non-financial corporations in the breakdown of classified claims. The quality of this portion of the portfolio has begun to improve at the small domestic banks in recent months. The proportion of the small domestic banks' claims against non-financial corporations more than 90 days in arrears has fallen since May 2011, and fell from its high of 17.6% to 16.3% by the end of September.

Figure 7.4: Proportion of the banking system's classified claims accounted for by non-financial corporations (left) and households (right) by bank group in percentages



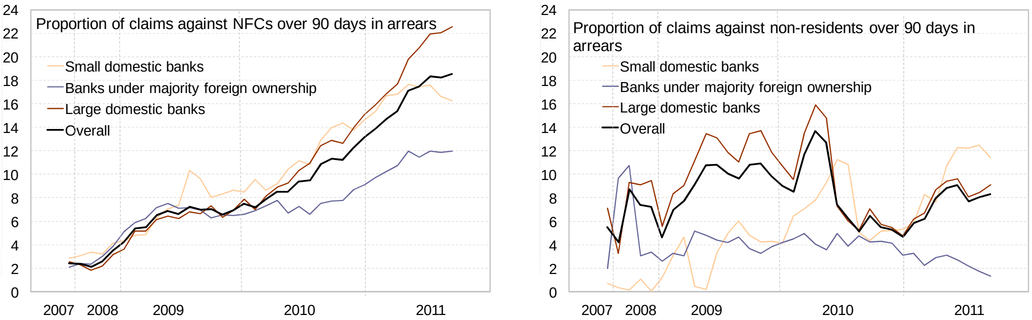
Source: Bank of Slovenia

The quality of claims against non-residents is deteriorating at the banks under majority domestic ownership.

Individual bank groups differ significantly in terms of the quality of the portfolio of non-residents. The risk associated with non-residents is low at the banks under majority foreign ownership and is diminishing. The majority of claims against non-residents at these banks are in the form of short-term investments in foreign financial institutions (primarily in parent banks). In addition to the low level of risk, the proportion of the banks' investment portfolio accounted for by non-residents is also low.

Exposure to non-residents remains high at the banks under majority domestic ownership, despite a decline in recent years: the proportion of all classified claims accounted for by classified claims against non-residents is 15% at the small banks and 16% at the large banks. Around two thirds of investments are earmarked for non-financial corporations. Non-residents' arrears of more than 90 days were up sharply in 2011 at the small domestic banks, accounting for 11.4% of classified claims against this client segment. Claims against non-residents are also rising at the large domestic banks, with a high level of longer arrears.

Figure 7.5: Claims more than 90 days in arrears as a proportion of banks' classified claims against non-financial corporations (left) and non-residents (right) by bank group in percentages



Source: Bank of Slovenia

7.2 Non-financial corporations

The expected slowdown in economic growth could contribute to the further deterioration of the portfolio of non-financial corporations in the coming period. Declining growth in the euro area is already affecting the dynamic of domestic economic activity, particularly in the manufacturing sector. Export orders are declining and the economic climate is becoming more pessimistic. Among the factors limiting corporate operations is the growing relevance of the uncertain economic conditions. Financing difficulties remain one of the most significant inhibiting factors to corporate operations in Slovenia.

The financing of non-financial corporations in Slovenia is at its lowest level.

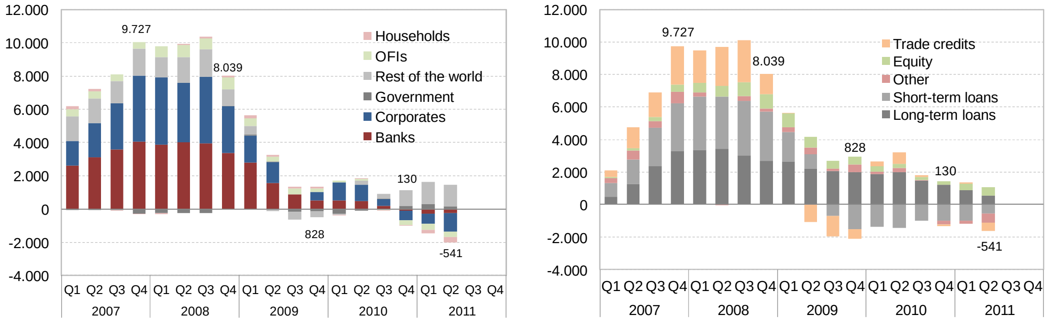
The flow of corporate financing has contracted significantly in the last year and a half.[20] Financing via banks has come to a virtual standstill, and is largely limited to maintaining the existing level of debt, with a high proportion of clients unable to service their debt.

[20] According to revised figures for 2010, the flow of non-financial corporations' financing for the entire year was revised downwards from the previously published EUR 501 million to merely EUR 130 million.

The banks are extremely cautious when approving new loans, and have tightened their credit standards. The results of a survey on demand for loans indicate that corporate excess demand for loans in 2010 and the first half of 2011 increased. The banks are refusing to approve loans owing to low client credit ratings and the unpromising nature of projects, while corporates are also increasingly refusing loans because they do not agree with the terms set by the banks. The banks' responses also indicate that corporate demand for loans for investments was up in 2010, while demand for loans to finance current operations was down, which is the result of economic growth during the same period and the rationalisation of corporate operations. The rising rate of loan rejection is also in part linked to the rejection of loan approval requests and the search for loans at several different banks.

Business-to-business financing, which in the early stages of the crisis mitigated the drop in bank financing, has almost completely dried up in the last year and a half. Indebtedness between corporates is declining, while loans and trade credits are no longer being approved in the context of modest domestic demand, or are being repaid to the extent permitted by the liquidity situation at individual corporates.

Figure 7.6: Financing flows of non-financial corporations by sector (left) and instrument (right) annual moving total of flows in EUR million

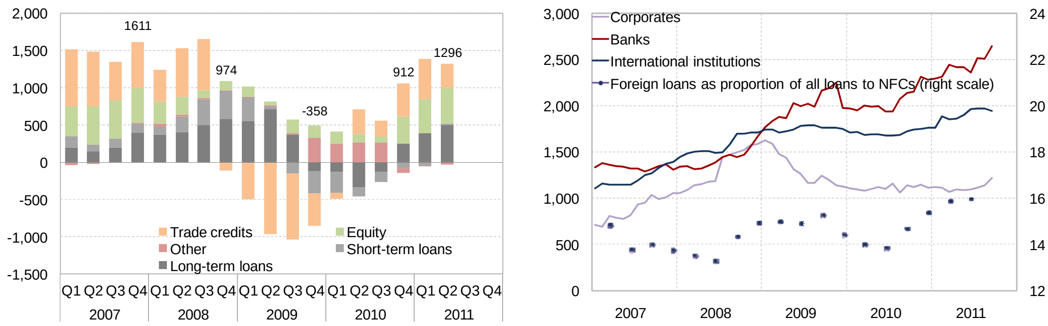


Source: Bank of Slovenia

Financing from the rest of the world is on the rise, with corporates borrowing from foreign partners and from financial institutions.

Corporates have largely turned to the rest of the world in the context of a lack of financing sources in Slovenia. The increased financing flow from the rest of the world derives from two sources: on the one hand, financing via trade credits and loans, approved by foreign partners and accompanied by an increase in the volume of trade with the rest of the world, is on the rise. At the same time, an increasing number of loans are being raised at foreign banks and international institutions as the result of the search for alternative sources of financing. The total flow of financing from the rest of the world reached the pre-crisis level in the second quarter, the sum of the previous four quarters having reached EUR 1.3 billion.

Figure 7.7: Financing of non-financial corporations in the rest of the world: financing flows (left), annual moving total of flows in EUR million, and the stocks of loans from the rest of the world by foreign creditor's sector (right) in EUR million



Source: Bank of Slovenia

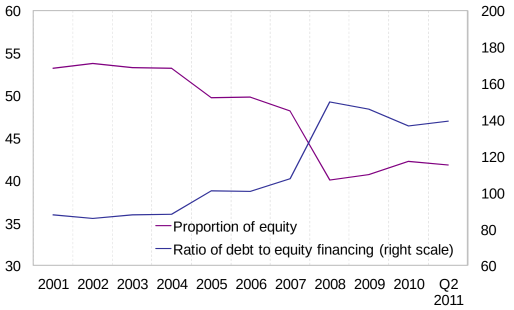
Loans from the rest of the world represent a smaller proportion[21] of total corporate financing via loans, but are rising. Loans to corporates from the rest of the world accounted for 16% of all corporate loans in the second quarter of 2011, up 2 percentage

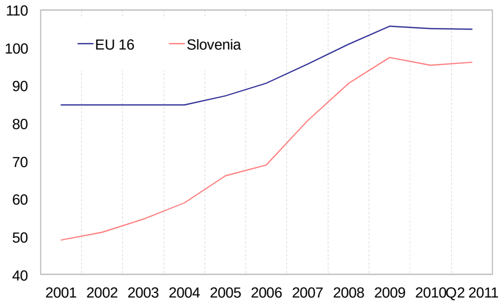
[21] The proportion of all corporate loans accounted for by loans from the rest of the world stood at more than 20% in 2004, but fell notably in the years leading up to the crisis in the context of rapid growth in loans at domestic banks.

points on the previous year. Corporates that finance themselves via foreign loans include those who have already reached maximum exposure limits in Slovenia, and those who are able to raise loans in the rest of the world under more favourable conditions on account of their solid financial position. Euro area interest rates on corporate loans remain around 2 percentage points lower on average than the interest rates at Slovenian banks. For the banks this means the departure of clients to more competitive offers, a loss of income and the loss of good clients.

Corporates with a weak financial position are more dependent on financing from domestic banks. Particularly worrisome in this regard is the position of smaller, still-healthy corporates, whose liquidity is under threat due to payment indiscipline. It is crucial that such corporates continue to receive sources of financing for promising programmes in order to bridge these difficulties and maintain production.

Figure 7.8: Corporate debt-to-equity ratio (left) and increase in ratio of corporate debt to GDP in Slovenia and the euro area (right)





Source: Bank of Slovenia

Corporate leverage remains high.

Despite severely limited financing, the indebtedness of non-financial corporations has not changed significantly. The high leverage of Slovenian corporates remains only slightly below the peak level achieved in 2008, at 139.3%. Corporates are poorly protected against unexpected losses due to their relatively low level of capital. Corporates are under threat from a renewed devaluation and the resulting higher leverage, even if they reduce their debt financing, owing to deteriorating conditions on the financial markets. Because the banks are not willing to continue financing highly indebted corporates, the latter remain in their balance sheets without major opportunities to improve their financial positions via new projects and to begin servicing their debts, without improving the structure of equity financing.

Table 7.3: Banks' classified claims against non-financial corporations by sector, structure and year-on-year growth, in EUR million and percentages

	Loans to non-financial corporations[1]				Classified claims against non-financial corporations					
	Total, EUR million	Growth, EUR million	Breakdown, %		Total, EUR million	Breakdown, %	Change in breakdown, percentage points		Year-on-year growth, %	
	Sep. 11	Sep. 11/ Dec. 10	2010	Sep. 11	Sep. 11	Sep. 11	2010	Sep. 11	2010	Sep. 11
Agriculture, forestry, fishing, mining	271	-28	1.4	1.3	320	1.3	0.1	0.0	5.2	2.0
Manufacturing	5,543	-82	26.6	26.3	6,433	25.9	-0.1	-0.3	-0.5	-2.1
Electricity, gas, water, remediation	703	39	3.1	3.3	1,042	4.2	0.0	0.2	1.2	5.1
Construction	2,623	143	11.7	12.5	3,526	14.2	1.1	0.5	8.9	3.0
Wholesale and retail trade	3,821	-148	18.7	18.1	4,549	18.3	-0.3	-0.5	-1.6	-3.6
Transportation and storage	2,052	-139	10.4	9.7	2,242	9.0	0.2	0.2	2.1	1.6
Accommodation and food service activities	689	18	3.2	3.3	732	2.9	0.1	0.0	2.2	0.1
Information and communication activities	443	-45	2.3	2.1	607	2.4	-0.1	-0.2	-3.0	-8.6
Financial intermediation	1,555	112	6.8	7.4	1,644	6.6	-0.9	-0.1	-11.8	-1.7
Real estate activities	1,177	49	5.3	5.6	1,225	4.9	-0.1	0.0	-1.4	-0.3
Professional, scientific and technical activities	1,747	-41	8.4	8.3	2,065	8.3	-0.1	0.0	-1.6	-0.7
Public services	429	3	2.0	2.0	470	1.9	0.2	0.0	10.3	-2.6
TOTAL	21,053	-118	100.0	100.0	24,854	100.0			0.0	-0.9

Note:[1] Loans are in gross amounts, excluding impairments.
Source: Bank of Slovenia

Bank loans to the manufacturing sector are declining.

The stock of bank loans to non-financial corporations was slightly lower in gross terms in September 2011 than at the end of 2010. The manufacturing sector, which has achieved relatively high economic growth in the last year and a half, has also remained without new loans. Corporates from the manufacturing sector have maintained a level of financing at the domestic banks similar to the end of 2009. Prior to the start of the recovery, growth in gross loans to the manufacturing sector totalled EUR 81 million in 2010, while loans to those corporates fell by approximately the same amount over the first nine months of 2011.

Growth in loans to sectors with the lowest quality claims continues.

The stock of loans to non-financial corporations rose only to those corporates from the sectors with lowest quality claims: construction, financial intermediation and real estate activities. This is a reflection of the need to restructure financing. At the end of 2010 some 24.6% of the banks' classified claims were accounted for by the three aforementioned sectors, compared with 25.7% nine months later. The opposite is true for exposure to the manufacturing sector, which has recorded the highest recent real growth, where the proportion of classified claims was down 0.1 percentage points in 2010 and by an additional 0.3 percentage points over the first nine months of 2011. This contributes to the continuing deterioration in the quality of the portfolio of non-financial corporations.

Table 7.4: Increases in loans by sector in EUR million

	Manufacturing	Construction	Wholesale and retail trade	Transportation and storage	Accommodation and food service activities	Financial intermediation	Real estate activities	scientific and technical activities	Non-financial corporations (total)
2006	581.7	313.0	180.1	236.3	53.6	238.7	294.9	241.0	2,302.6
2007	695.3	616.8	717.7	349.3	84.4	750.9	285.0	553.3	4,516.6
2008	962.0	416.6	720.2	321.1	118.3	253.6	244.5	162.8	3,439.5
2009	46.2	240.3	-184.6	228.5	73.1	-429.4	22.6	63.2	240.5
2010	80.6	182.9	54.4	125.7	10.1	-21.4	-34.4	-25.1	417.7
Q1-Q3/11	-81.8	143.0	-147.6	-139.0	17.7	111.6	49.4	-40.6	-118.1

Note: Loans are in gross amounts, excluding impairments.
Source: Bank of Slovenia

The quality of claims against corporates from the construction sector has fallen sharply.

Claims settled more than 90 days in arrears accounted for 18.6% of classified claims against non-financial corporations in September. Standing out significantly in this respect are corporates from the construction sector, whose arrears exceeding 90 days reached 44% of classified claims against the aforementioned sector. That proportion stood at 19.3% at the end of 2010. Further deterioration in this portion of the banking system's portfolio can be expected, as total arrears of the construction sector reached 61% in September. There is little likelihood that these claims in arrears will be repaid given the poor position and weak prospects for this sector. The banks' exposure to construction corporates is high: the construction sector ranks third in terms of size, accounting for 14.2% of all classified claims against non-financial corporations, while recording the highest total growth in classified claims in 2010 and 2011.

Table 7.5: Arrears of non-financial corporations by sector

	No. of corporates with arrears in Sep. 11	Proportion of corporates at banks with arrears, %			Average no. of days in arrears	Proportion of classified claims of corporates in arrears in bank portfolio, %			
		Total	With arrears over 90 days			Total	Arrears of over 90 days		
		Sep. 11	Dec. 10	Sep. 11		Sep. 11	Dec. 09	Dec. 10	Sep. 11
Agriculture, forestry, fishing, mining	48	21.1	13.0	14.0	486	15.8	5.5	4.9	10.0
Manufacturing	853	20.7	12.7	13.7	362	21.7	6.3	9.3	11.0
Electricity, gas, water, remediation	46	13.8	4.1	6.3	148	6.6	0.8	1.5	3.0
Construction	1014	33.5	20.7	26.6	300	61.2	7.7	19.3	44.0
Wholesale and retail trade	1357	20.0	13.5	15.2	508	20.3	5.1	13.2	15.4
Transportation and storage	330	23.2	17.5	18.4	205	22.1	1.9	6.0	12.2
Accommodation and food service activities	287	27.1	18.3	20.2	326	22.4	7.9	6.5	13.5
Information and communication activities	177	12.4	7.3	8.7	434	35.9	1.8	23.1	28.7
Financial intermediation	43	26.4	11.7	19.6	358	27.9	21.6	17.1	20.5
Real estate activities	178	26.1	13.2	17.9	322	30.9	4.8	10.3	17.6
Professional, scientific and technical activities	704	13.6	8.1	9.8	440	31.2	7.6	18.8	22.5
Public services	154	11.7	6.9	8.2	194	15.1	2.2	3.2	5.9
Total	5,192	20.2	12.7	14.9	354	28.3	6.6	12.3	18.6

Source: Bank of Slovenia

The large domestic banks stand out in particular in terms of high exposure to construction corporates, accounting for 16.4% of classified claims against non-financial corporations. This bank group also stands out with the lowest quality claims against the construction sector, with 50.6% of claims more than 90 days in arrears. In addition to an exceptionally poor portfolio of construction corporates, the large domestic banks have an above-average proportion of non-performing claims against the majority of other sectors. In addition to the construction sector, very large differences between bank groups can be seen in the financial intermediation sector, where nearly 29% of the large domestic banks' claims are more than 90 days in arrears, while that proportion is significantly lower at the other bank groups, at around 9%.

The large domestic banks stand out in terms of the proportion of claims more than 90 days in arrears in all sectors.

Table 7.6: Breakdown of banks' classified claims and the proportion of liabilities to banks settled more than 90 days in arrears by bank group and by sector at the end of September 2011 in percentages

	Breakdown of classified claims, total NFCs = 100				Proportion of arrears of over 90 days within sector			
	Banking system	Large domestic banks	Small domestic banks	Banks under majority foreign ownership	Banking system	Large domestic banks	Small domestic banks	Banks under majority foreign ownership
Agriculture, forestry, fishing, mining	1.3	1.2	1.4	1.5	9.7	8.6	10.3	11.2
Manufacturing	25.9	27.4	24.7	23.5	11.1	12.3	9.8	8.9
Electricity, gas, water, remediation	4.2	3.7	3.4	5.3	3.0	4.7	3.0	0.8
Construction	14.2	16.4	14.5	10.1	44.0	50.6	27.5	31.0
Wholesale and retail trade	18.3	16.4	20.9	21.0	15.2	19.2	13.0	10.3
Transportation and storage	9.0	9.5	2.2	9.9	12.2	16.0	35.0	4.4
Accommodation and food service activitie	2.9	3.0	2.1	3.0	13.7	13.6	29.7	11.0
Information and communication activities	2.4	2.5	1.1	2.6	28.5	39.1	28.2	10.3
Financial intermediation	6.6	6.7	9.2	5.9	20.8	28.7	9.0	9.3
Real estate activities	4.9	4.1	5.7	6.2	16.8	21.2	15.5	11.8
Professional, scientific and technical activ	8.3	7.2	13.1	9.0	22.5	22.7	25.6	21.2
Public services	1.9	1.9	1.6	2.0	5.8	5.1	7.6	6.6
Total	100.0	100.0	100.0	100.0	18.5	22.5	16.3	12.0

Source: Bank of Slovenia

Standing out in the portfolio of the small domestic banks, with high proportions of claims more than 90 days in arrears, are the sectors of transportation and storage (35%), accommodation and food service activities (29.7%) and professional, scientific and technical activities (25.6%). On average, the quality of the portfolio of non-financial corporations deteriorated less at the small domestic banks in 2011 than at the other bank groups. The proportion of claims more than 90 days in arrears was up 2.3 percentage points at the small banks (compared with increases of 3.3 percentage points at the banks under majority foreign ownership and 8.6 percentage points at the large domestic banks).

The quality of the portfolio of non-financial corporations deteriorated least at the small domestic banks.

Arrears in the settlement of liabilities are lower in almost all sectors at the banks under majority foreign ownership than at the domestic banks. The likely reason is the consistent collection of debts before corporate liquidity problems escalate. The exposure of the banks under majority foreign ownership to the most problematic sectors has been below average in recent years.

Table 7.7: Coverage of classified claims by impairments and proportions of non-performing claims of non-financial corporations by sector

	Impairments of classified claims, EUR million		Coverage of classified claims by impairments, %		Classified claims rated D and E		
					EUR million	as proportion of total classified claims, %	
	2010	Sep. 2011	2010	Sep. 2011		2010	Sep. 2011
Agriculture, forestry, fishing, mining	22	22	6.5	7.1	16	4.5	5.1
Manufacturing	371	417	5.8	6.5	371	4.1	5.8
Electricity, gas, water, remediation	14	16	1.4	1.5	5	0.5	0.5
Construction	297	501	8.6	14.3	447	7.0	12.7
Wholesale and retail trade	315	341	6.8	7.6	306	4.5	6.8
Transportation and storage	72	124	3.1	5.6	117	1.0	5.2
Accommodation and food service activities	31	38	4.5	5.3	30	2.9	4.2
Information and communication activities	51	67	7.7	11.1	20	2.1	3.4
Financial intermediation	169	199	11.2	12.2	206	10.5	12.6
Real estate activities	68	84	5.8	7.3	73	3.8	6.3
Professional, scientific and technical activities	205	269	9.8	13.2	297	7.2	14.6
Public services	15	17	3.3	3.6	7	1.5	1.5
Total	1,629	2,096	6.6	8.5	1,897	4.7	7.7

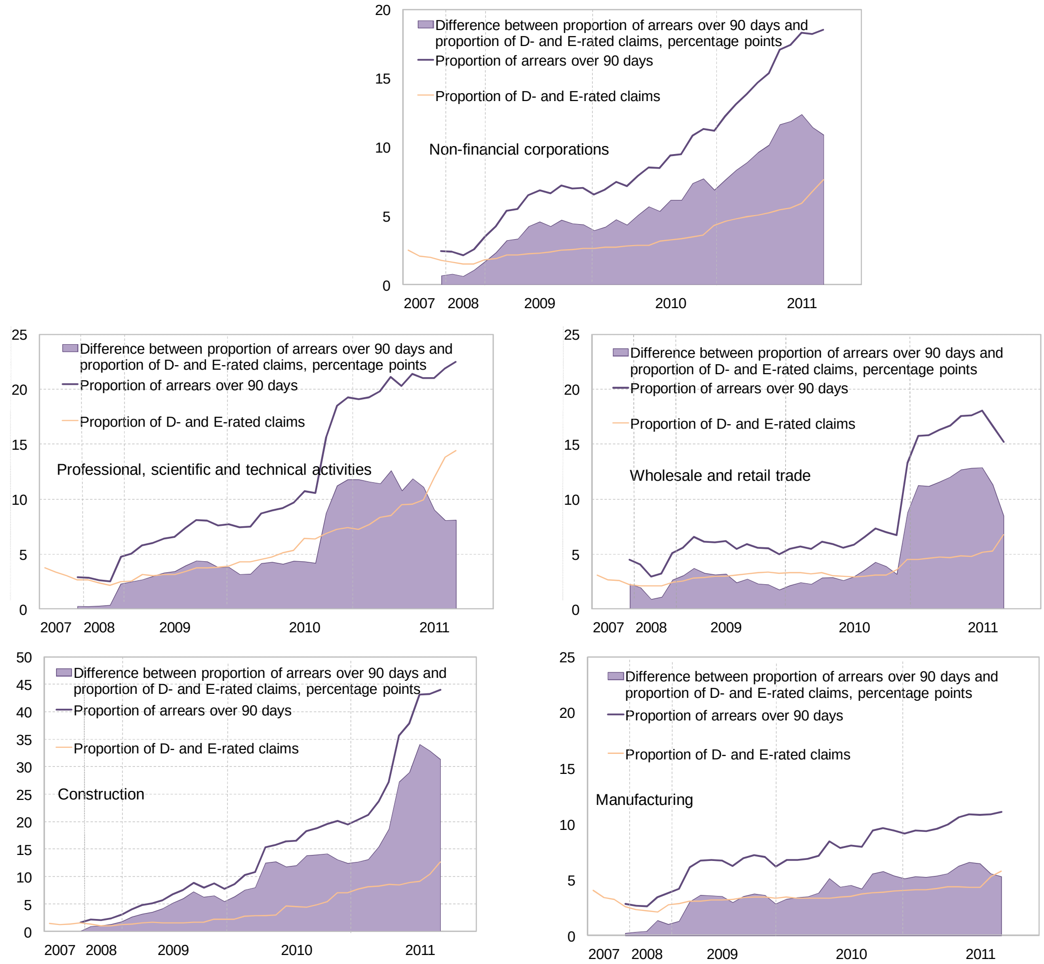
Source: Bank of Slovenia

The proportion of non-performing claims (D- and E-rated claims) rose to 7.7% over the first nine months of

The banks downgraded 3% of classified claims against non-financial corporations to non-performing claims owing to the deterioration in the quality of claims against the aforementioned client segment, bringing the proportion of non-performing claims against non-financial corporations to 7.7% (the proportion of the overall portfolio accounted for by non-performing claims is 5.33%.).

Growth in non-performing claims was highest over the first nine months of 2011 in the sector of professional, scientific and technical activities, where the highest proportion among all sectors, of 14.6%, was achieved at end of September. The portfolio in this sector began to deteriorate significantly already in the final months of 2010, while the downgrading of claims followed with a nearly one-year delay.

Figure 7.9: Difference between the arrears of non-financial corporations of more than 90 days and the proportion of non-performing claims by bank group in percentages



Note: The figures were previously quarterly, but are monthly from March 2009.
Source: Bank of Slovenia

An increase in the downgrading of claims is also seen in other sectors, for the most part with a several month delay with respect to the actual deterioration in the quality of the portfolio, which is initially seen as an increase in clients' arrears in the settlement of liabilities. The growth in non-performing claims in the sectors of manufacturing and wholesale and retail trade coincides with an easing or even a decrease in arrears, which indicates that the actual situation is reflected with a significant delay in an increase in non-performing claims.

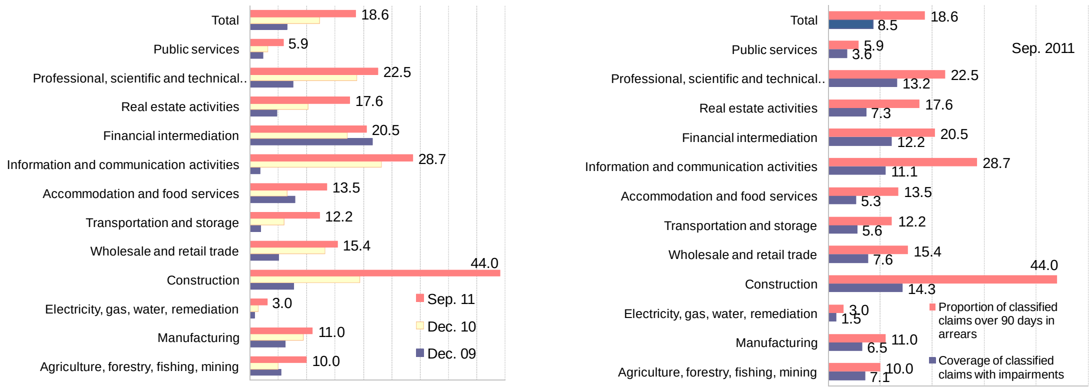
The gap between impairments created and the quality of the portfolio is significant in certain sectors.

In addition to the sector of professional, scientific and technical activities, the banks' highest proportions of non-performing claims are at corporates from the sectors of construction and financial intermediation, at 12.7% and 12.6% respectively. The construction sector stands out with an enormous gap between the proportion of non-performing claims and the proportion of claims settled more than 90 days in arrears. For this reason, continued reconciliation with the actual situation can be expected, with a significant impact on the volume of impairments created and the banks' operating results.

A large gap between the quality of the portfolio and impairments created can also be seen in the sector of information and communication activities. The quality of the banking system's portfolio deteriorated rapidly in this sector in the second half of 2010, while the proportion of non-performing claims remained low at 3.4%. The banks are able to cover the majority of the imbalance between claims with longer arrears and impairments via collateral received. If the value of the aforementioned collateral changes or if the collateral is difficult to redeem, a portion of this difference will be reflected in an increase in impairments.

Indicators of the quality of the credit portfolio and non-performing claims as a proportion of classified claims will improve very slowly or will remain unfavourable next year. The estimated default rates of clients will also exceed expected growth in loans, which further increases the proportion of non-performing claims. With the lengthening of arrears in the settlement of liabilities, the banks will downgrade claims to non-performing claims, which thus remain a part of total classified claims.

Figure 7.10: Claims more than 90 days in arrears as a proportion of banks' classified claims against non-financial corporations in percentages (left) and comparison of claims more than 90 days in arrears with impairment and provisions as proportions of classified claims (right) by sector in percentages



Source: Bank of Slovenia

Box 7.1: Analysis of the credit risk associated with non-financial corporations on the basis of client credit ratings and arrears in the repayment of loans

The quality of the banking system's credit portfolio can be analysed on the basis of different measures of credit risk. This analysis uses the credit ratings of non-financial corporations and their arrears in the repayment of loans. Clients' arrears are independent of how the banks assess their credit ratings. The definitions and proportions of non-performing loans also differ with respect to the two aforementioned measures. On the basis of credit ratings, D- and E-rated claims against clients are considered non-performing, while on the basis of arrears, loans repaid more than 90 days in arrears are considered non-performing claims against clients.

This analysis includes non-financial corporations that were indebted to at least one Slovenian bank in the period from 2000 to September 2011 and are not in bankruptcy proceedings, and for which balance sheet and income statement data are available. The primary focus of the analysis is on the period from 2007 on, for which data regarding client arrears in the repayment of loans is available.

The credit rating structure began to deteriorate to a greater extent in 2009 owing to the significant deterioration in macroeconomic conditions. This negative trend continued in 2010 and most notably over the first nine months of 2011, when the proportion of lowest risk clients (rated A and B) fell by 3.3 percentage points relative to the end of 2010, while the proportion of bad clients (rated D and E) rose by 3.1 percentage points to 10.2% over the same period.

Table 7.8: Credit rating structure of non-financial corporations in the period from 2007 to September 2011 in percentages

	2007	2008	2009	2010	Sep. 2011
A	57.35	57.93	53.65	51.44	47.35
B	32.72	31.68	32.97	33.94	34.78
C	5.23	6.06	7.52	7.50	7.67
D	3.40	3.15	4.36	4.64	5.67
E	1.30	1.18	1.50	2.48	4.53
Total number of clients-bank units	28,318	29,876	30,633	31,524	32,811

Source: Bank of Slovenia

Arrears in the repayment of loans also indicate the credit portfolio deteriorated most notably in 2011, when the proportion of non-financial corporations with arrears of more than 90 days rose by 3.1 percentage points to 9.6% over the first nine months.

Table 7.9: Breakdown of arrears in the repayment of loans from 2007 to September 2011 in percentages

	2007	2008	2009	2010	Jun. 2011
0 days	93.14	90.88	89.35	88.11	84.53
1 - 90 days	3.42	4.99	5.05	5.41	5.91
Over 90 days	3.44	4.13	5.61	6.47	9.57
Total number of client-bank units	27,118	28,598	29,472	30,447	31,625

Note: The number of client-bank units is lower than in the credit rating structure, as data regarding arrears in the repayment of loans are not available for certain clients.
Source: Bank of Slovenia

Although nearly two years have passed since the height of the economic crisis, the banking system's credit portfolio continues to deteriorate. The reason lies primarily in the slow economic recovery, which hinders the operations of corporates, particularly the operations of overly indebted corporations. The latter, together with other reasons, means that there is no growth in new loans that would improve the quality of the credit portfolio. Having an additional impact is the banks' greater willingness to assume risks during a period of high lending growth which, in combination with stalling economic growth, leads to the deterioration of the credit portfolio. The pro-cyclical behaviour of the banks, which are more pessimistic in their assessment of clients in poor economic conditions, also affects in part the downgrading of clients. The increase in the proportion of bad clients on the basis of arrears, which are independent of how the banks assess credit risk, indicates that the main source of the deterioration of the credit portfolio are difficulties in the real sector. This is also confirmed by an increase in the number of bankruptcy proceedings initiated against legal entities, which amounted to 233 in the second half of 2010, to 306 in the first half of 2011 and to 158 in the third quarter of 2011.

Table 7.10: Credit rating structure for the same non-financial corporations at an individual bank in percentages

	2007	2008	2009	2010	Sep. 2011
A	61.72	61.00	55.55	52.16	47.27
B	31.78	30.79	32.08	32.09	32.78
C	3.82	5.25	7.23	7.92	8.57
D	2.08	2.30	4.08	5.03	6.16
E	0.60	0.67	1.06	2.80	5.22
Total (number)	17,528	17,528	17,528	17,528	17,528

Source: Bank of Slovenia

The credit ratings of clients who had a lending arrangement with same bank from 2007 to September 2011 have deteriorated over time. The proportion of A- and B-rated clients declined by 13.5 percentage points over the entire period, while the proportion of D- and E-rated clients rose by 8.7 percentage points. The deterioration in the credit rating of the same clients is to be expected, as several factors arise over the long term that increase the likelihood that the risk associated with a particular customer will be realised. The banks typically assign new clients higher credit ratings, as these clients have yet to incur arrears. A more significant deterioration in the credit ratings of the same clients began in 2009 with the escalation of the economic crisis and the accompanying pessimism shown by the banks in assessing clients. This trend continues in 2011, when the proportion of A-rated clients declined by 4.9 percentage points over the first nine months of the year, while the proportion of D- and E-rated clients rose by 3.6 percentage points.

Table 7.11: Probability of transitions between credit ratings in percentages

Average transition matrix, 2001-2008

		Current year				
		A	B	C	D	E
Previous year	A	90.76	7.07	1.33	0.60	0.24
	B	9.47	80.48	6.02	3.70	0.33
	C	4.04	11.53	72.05	10.28	2.09
	D	2.45	3.85	4.21	81.11	8.38
	E	1.93	1.26	0.97	2.13	93.72

Transition matrix, 2009

		2009				
		A	B	C	D	E
2008	A	87.09	9.41	2.16	0.97	0.37
	B	3.83	81.90	9.32	4.53	0.42
	C	1.13	9.90	71.07	15.70	2.19
	D	0.46	4.58	5.80	79.24	9.92
	E	0.00	0.54	0.42	1.68	97.06

Transition matrix, 2010

		2010				
		A	B	C	D	E
2009	A	87.60	9.19	1.91	0.85	0.45
	B	7.28	81.16	6.92	4.17	0.47
	C	1.77	14.11	63.79	15.13	5.20
	D	0.52	2.80	6.74	62.45	27.49
	E	0.81	0.00	0.40	2.42	96.37

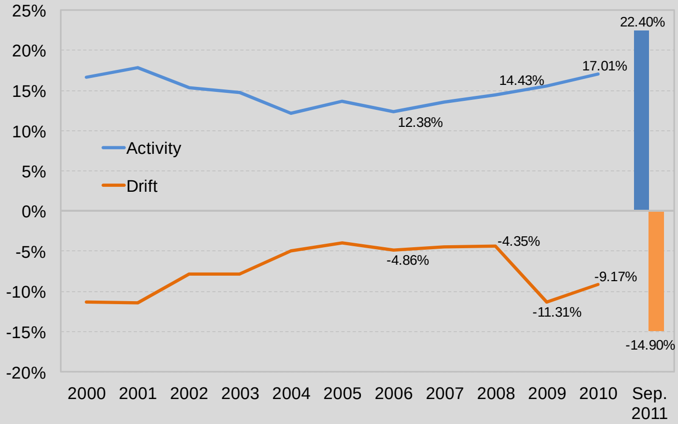
Transition matrix, September 2010-September 2011

		Sep. 2011				
		A	B	C	D	E
Sep. 2010	A	81.28	14.38	2.09	1.58	0.67
	B	7.60	77.82	7.66	5.32	1.60
	C	0.97	10.86	60.86	16.12	11.20
	D	0.08	1.64	3.83	53.99	40.45
	E	0.21	0.83	0.83	3.13	95.00

Source: Bank of Slovenia

The proportion of transitions of non-financial corporations between credit ratings rose in 2010 relative to 2009, which indicates that the banks' uncertainty in assessing client credit ratings remains significant. Despite an increase in the proportion of corporates transitioning between credit ratings, the negative drift[1] has fallen slightly, from 11.3% to 9.2%. This means that in 2010 the credit rating deteriorated for a smaller number of corporates or improved for a greater number of corporates compared with 2009. This trend did not continue in 2011. The drift stood at 14.9% in September 2011, a significant increase on the drift for 2010.

Figure 7.11: Activity[2] and drift[1] in percentages



Note: Activity and drift were calculated for a 1-year period in September 2011.
Source: Bank of Slovenia

Default rates calculated on the basis of credit ratings and corporate arrears are presented below. The default rate on the basis of credit ratings is calculated as the proportion of clients that migrate from A, B or C credit ratings to D and E ratings. A similar approach is used in the calculation on the basis of arrears, where the default rate is defined as the proportion of clients who had arrears of less than 90 days in the previous year and arrears of more than 90 days in the current year.

Table 7.12: Default rates on the basis of credit ratings and corporate arrears in the repayment of liabilities in percentages

	2008	2009	2010	Sep. 2011
Based on credit ratings[1]	1.92	3.47	3.90	5.90
Based on arrears[2]	2.76	3.93	3.98	5.83

Note: The default rate was calculated for a 1-year period in September 2011.
[1] Proportion of clients who migrated from A, B or C credit ratings to D or E ratings.
[2] Proportion of clients who had arrears of less than 90 days in the previous year and arrears of more than 90 days in the current year.
Source: Bank of Slovenia

The corporate default rate rose in the period from 2008 to September 2011 on the basis of both credit ratings and arrears. This means that the banks are downgrading an increasing number of clients to D and E ratings, or that an increasing number of clients have begun to repay loans more than 90 days in arrears owing to difficult operating conditions. The default rate also indicates that the credit portfolio deteriorated most significantly in 2011.

[1] The drift illustrates whether a larger number of corporates were downgraded (negative drift) or upgraded (positive drift).
[2] Proportion of corporates whose credit rating was amended.

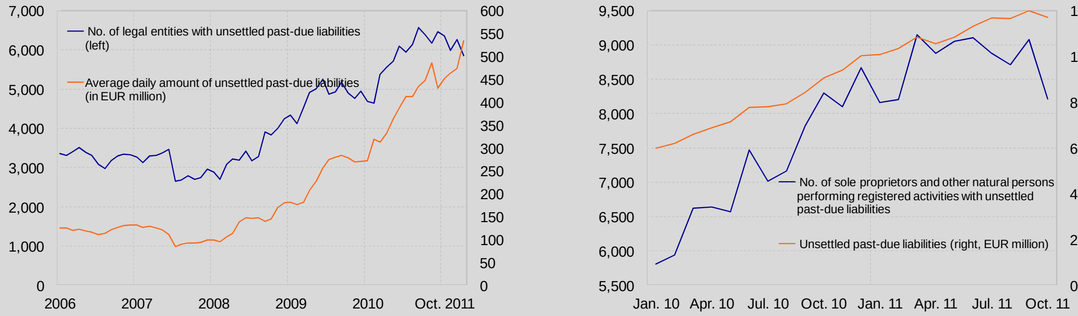
Box 7.2: Growing past-due corporate financial liabilities

The growing problem of corporate insolvency is reflected in an increase in arrears and the failure to settle due financial liabilities to banks, the government, employees, and other corporates and business partners. The adverse position of corporates in 2011 is illustrated by figures regarding the settlement of liabilities to banks, tax liabilities and regarding the number of bankruptcy proceedings. The rise in the number of legal entities with unsettled past-due liabilities has stalled, but the number remains high.

The tax liabilities[3] of business entities rose by EUR 50.6 million in the first half of the year to reach EUR 598.2 million, while the number of debtors was up by 577 to reach 11,777. Of the aforementioned amount, 58.4% were legal entities and 41.6% sole proprietors. Among the 19 sectors, construction and manufacturing stand out, accounting for 27,7% and 21.5% of tax liabilities respectively.

AJPES figures regarding unsettled past-due liabilities underestimate the problem of payment indiscipline, as they only include figures from court enforcement orders and from tax liabilities, but not other unsettled past-due liabilities from unpaid invoices between creditors and debtors. Figures for the first 10 months of 2011 indicate that the number of legal entities with unsettled past-due liabilities has started to decline after reaching its peak in the first quarter of the year. Nevertheless, the number remains two times higher than the pre-crisis figure, while the trend of a rising average daily amount of unsettled past-due liabilities continues. A very slight contrast to the aforementioned indicator is seen in the movement of unsettled past-due liabilities of sole proprietors. Also favourable at first glance is the significant decline in the number of entities with unsettled past-due financial liabilities in autumn 2011. However, their number remains at the level recorded at the beginning of 2011 of around 8,200, an increase of 41.3% on a year earlier. The latter is evidence that the poor liquidity of the economy and payment indiscipline have hit small businesses the hardest.

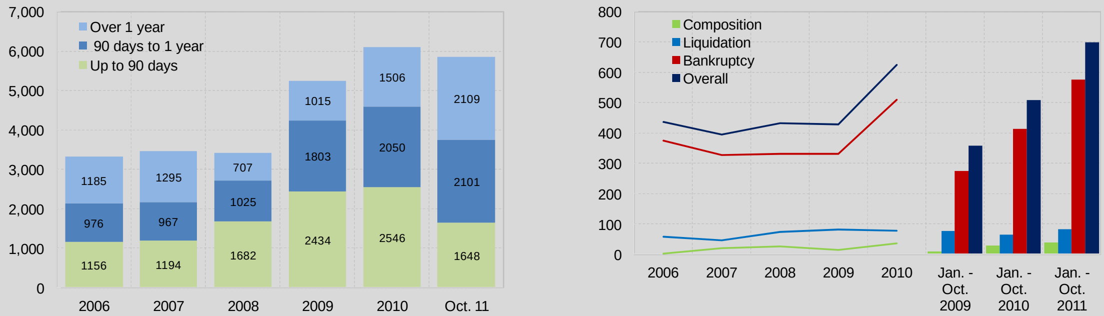
Figure 7.12: Number of legal entities with unsettled past-due liabilities and average daily amount of unsettled past-due liabilities (right) and the number of sole proprietors and other natural persons performing registered activities with unsettled past-due liabilities (right)



Source: AJPES

Although the available figures regarding the number of legal entities according to the unbroken period of unsettled past-due liabilities for 2011 indicate a slight improvement, those figures must be viewed in the context of an increase in the number of bankruptcies, together with a declining number of legal entities. This can also be explained as a reduction in the number of corporates with no future on the market. However, the direct effect of bankruptcies, compositions and liquidations is negative when viewed as a whole. This is particularly true for creditors, whose claims, as a rule, are only partially repaid. Protracted bankruptcy, composition and enforcement proceedings have an additional adverse impact on creditors' liquidity. Thus, creditors, and consequently their business partners, are pulled into a spiral of payment indiscipline. The aforementioned has a negative effect on the competitiveness of Slovenian corporates, and on the Slovenian segment of the single European market and everywhere Slovenian corporates compete with other corporates from environments where payment indiscipline is not widespread. These include Austria and Germany, as extremely important economic partners of Slovenia.

Figure 7.13: Number of legal entities according to the unbroken period of unsettled past-due liabilities (left) and the number of bankruptcy, composition and liquidation proceedings initiated (right)



Source: AJPES

[3] The figures include tax liabilities that exceed EUR 4,000; report of the Tax Administration of the Republic of Slovenia and report of the Customs Administration of the Republic of Slovenia on the balance and changes in tax liabilities as at 30 June 2011.

Box 7.3: Exposure to the debt securities of euro area countries hit hardest by the debt crisis

In October 2011 Slovenian residents held EUR 503.8 million in debt securities from the euro area countries hit hardest by the debt crisis (e.g. Portugal, Ireland, Italy, Greece and Spain; hereinafter: the hardest hit countries). The aforementioned amount represented 9.9% of total investments in foreign debt securities. In the context of the current uncertain conditions on the European market, investments in debt securities of the hardest hit countries are also subject to a constant decline owing to their revaluation. The proportion of investments in debt securities of the hardest hit countries was down 39% over the first ten months of 2011 relative to the same period in 2010, while the proportion of investments in other countries declined by just 3%. Among the hardest hit countries, Slovenian residents are most exposed to Italy and Spain, which account for 50.6% and 27.4% respectively of investments in those countries. A decline in investments in Greece has been observed. Slovenian residents reduced their exposure to Greek debt securities by 6 percentage points relative to

October 2010, and to Spain and Portugal by 3 percentage points, while their exposure to Italy and Ireland was up 9 percentage points and 2 percentage points respectively.

Table 7.13: Exposure of Slovenian sectors to the debt securities of euro area countries hit hardest by the debt crisis; balance at the end of October 2011 in EUR million

	Hardest hit countries in EUR million			Hardest hit countries as proportion of investments in sector, %		
Sector	Bank debt securities	Government debt securities	Other debt securities	Bank debt securities	Government debt securities	Other debt securities
Non-financial corporations	0.1			0.3		
Banks and savings banks	120.1	118.5	11.5	4.5	4.4	0.4
Other financial intermediaries	0.2	1.9	5.1	0.1	1.3	3.6
Ancillary financial services						
Insurance companies and pension funds	65.8	79.3	93.7	3.2	3.9	4.6
Government	0.5	4.6	1.7	0.5	4.7	1.7
Households	0.5	0.1	0.1	0.8	0.3	0.3
Non-profit institutions						
Total	187.1	204.5	112.2	3.7	4.0	2.2

Source: Bank of Slovenia

In October 2011 the banking and insurance sectors together accounted for 97% of all investments by Slovenian residents in foreign debt securities (the banks for 49.7% and insurance corporations for 47.4%). Some 78.5% of the investments of these two sectors were in bank and government debt securities. At 12.5% of total investments in government bonds, the insurance sector was most exposed to the government bonds of the hardest hit countries, followed by the sector of other financial intermediaries excluding insurance corporations and pension funds, at 11.2%. The highest proportion of bank bonds from the hardest hit countries in terms of total investments in bank bonds is accounted for by the banking system at 11.6%, followed by insurance corporations at 9.9%.

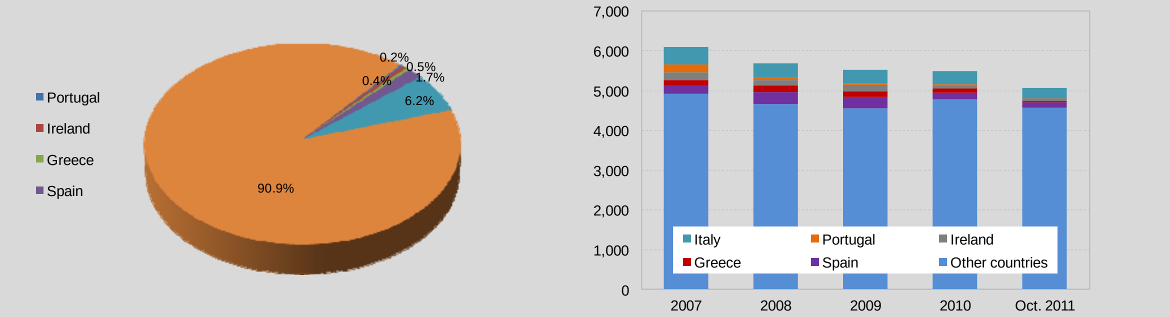
Investments in the hardest hit countries were more unevenly distributed. The banking sector's investments in the debt securities of the aforementioned countries totalled EUR 250 million, with the highest exposure to Italy (69.5%) and to Spain (17.4%). The insurance sector's investments in the hardest hit countries are more evenly distributed: 38.3% in Spain, 32% in Italy, 18.9% in Ireland and 10.3% in Greece. Households are responding to publicly accessible information. More than half of their exposure is to Ireland, which is probably the most stable of the aforementioned countries.

Table 7.14: Exposure of Slovenian sectors to the debt securities of euro area countries and other countries at the end of October 2011 in EUR million

	Euro area debt securities, EUR million			Debt securities of other countries, EUR million		
Sector	Bank debt securities	Government debt securities	Other debt securities	Bank debt securities	Government debt securities	Other debt securities
Non-financial corporations	40	1	11	2		4
Banks and savings banks	750	1,452	33	286	136	34
Other financial intermediaries	15	13	72	11	4	28
Ancillary financial services						
funds	495	405	470	171	232	254
Government	14	29	19	2	22	11
Households	22	2	19	4	2	6
Non-profit institutions	1					
Total	1,338	1,901	624	476	396	338

Source: Bank of Slovenia

Figure 7.14: Regional breakdown of the Slovenian banking sector's investments in bank and government bonds from euro area countries hit hardest by the debt crisis and other euro area countries at the end of October 2011 in percentages (left) and the regional breakdown of residents' investments in the hardest hit countries and other countries in EUR million (right)



Source: Bank of Slovenia

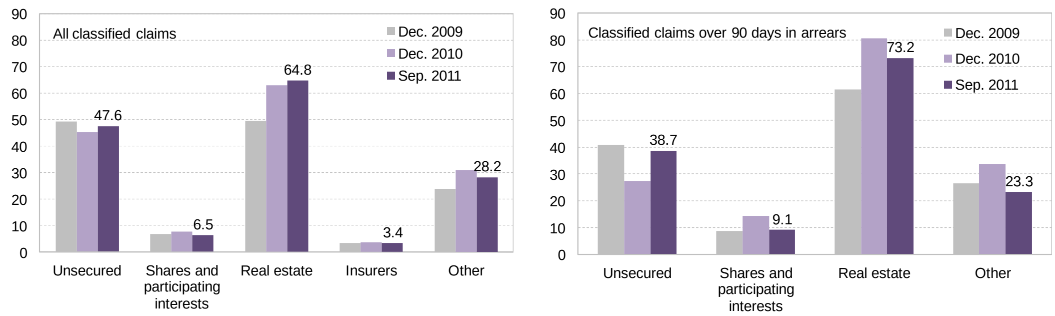
7.3 Loan collateral

7.3.1 Coverage of the credit portfolio by collateral

The proportion of banks' unsecured claims rose to 47.6% in 2011.

Coverage of the banks' credit portfolio by collateral deteriorated in 2011. The proportion of classified claims accounted for by unsecured claims rose to 47.6%, an increase of 2.3 percentage points on the end of 2010. This, however, is the result of increasing exposure to lower-risk sectors, such as the government and banks. The proportion of unsecured claims more than 90 days in arrears was also up, by 11.3 percentage points, to approach the value recorded at the end of 2009. The least secured claims are against the government, and banks and savings banks, which are considered the lowest-risk clients. Excluding the two aforementioned sectors, 36.5% of banks' claims are unsecured, up 0.9 percentage points on the end of 2010.

Figure 7.15: Coverage of banks' total classified claims (left) and coverage of banks' classified claims more than 90 days in arrears (right) by collateral in percentages



Source: Bank of Slovenia

The coverage of classified claims by real estate collateral improved, while coverage by other forms of collateral declined.

At the end of September 2011 the total value of collateral received was 2.9% higher than the value of classified claims, including unsecured claims. Only the coverage of classified claims by real estate collateral improved (by 2 percentage points) relative to the end of 2010, while coverage by all other forms of collateral declined. The risk of a decrease in the value of real estate collateral is rising owing to low economic growth, adverse conditions in the construction sector and declining growth in housing loans. An additional risk to which the banks are exposed via collateral in the form of commercial and residential real estate derives from the established practice of the banks, whereby several mortgages may be entered on the same property with the corresponding adjustments to the value for previously raised loans. The banks without first priority in the event of redemption are in a significantly weaker position. Moreover, the redemption of collateral is difficult when the liquidity situation on the real estate market is poor, while procedures are protracted.

The coverage of claims against households by collateral rose by 4.1 percentage points.

Coverage by real estate collateral improved most in the household sector primarily owing to better collateral on new housing loans. The value of collateral in the form of residential and commercial real estate is 9% higher than the total value of classified claims against households. The coverage of claims by other forms of collateral declined, which can be seen in the fact that the banks have become very selective with regard to collateral. Together with other forms of collateral, the coverage of classified claims against households by collateral rose to 145%, an increase of 4.1 percentage points on the end of 2010.

Table 7.15: Collateral for classified claims by client segment at the end of September 2011 in percentages

	Classified claims, EUR million	Ratio of collateral[2] to classified claims, %						
		Unsecured[1]	Secured: Shares, other equity and mutual fund units	Commercial property[3]	Residential property[3]	Insurer	Other form of collateral	Total collateral[3]
Corporates	24,854.0	36.9	10.1	69.6	6.8	0.0	37.1	123.6
OFIs	2,251.3	55.2	20.1	10.7	2.0	0.0	30.1	62.8
Households	10,426.3	32.4	0.6	15.9	93.3	16.2	19.0	145.0
Non-residents	6,450.0	69.6	4.1	28.8	2.9	0.0	22.6	58.5
Government	2,140.7	73.9		2.0	0.3		28.5	30.7
Banks and savings banks	3,825.8	94.6		0.1	0.0		7.5	7.6
Total	50,527.8	47.6	6.5	41.8	23.1	3.4	28.2	102.9

Note: [1] The figure includes unsecured claims and claims secured with forms of collateral that are not taken into account in banks' calculation of impairments and provisions (e.g. collateral in the form of bills of exchange).
[2] Collateral is stated at fair value.
[3] With regard to collateral in the form of real estate, several banks may enter a mortgage on the same property. In such cases, the value of the mortgage at each successive bank is reduced by the value of the banks' claims with priority in the possible redemption of the collateral. Consequently, the value of these forms of collateral is multiplied both for these forms of collateral and as an aggregate.

Source: Bank of Slovenia

The coverage of claims by collateral is low at non-monetary financial institutions.

Classified claims against corporates are likewise for the most part secured by real estate collateral, which accounts for 76.4% of the total value of classified claims. Households and non-financial corporations are also the only client segments in which the value of all collateral received exceeds the value of classified claims. However, the coverage for corporates fell by 3.7 percentage points relative to the end of 2010. Growth in classified claims with arrears of more than 90 days was 90 percentage points above the average for the entire system at the non-monetary financial institutions. At the same time, collateral for claims against non-monetary financial institutions is quite low, accounting for just 62.8% of the value of classified claims against this sector. The proportion of unsecured claims against non-monetary financial institutions was up by 3 percentage points on the end of 2010 to stand at a high value of 55.2%. The probability of an escalation in problems in collecting the aforementioned claims against this sector will increase in the coming months owing to a rapid increase in arrears. The proportion of unsecured claims against non-residents was up 7.2 percentage points over the first nine months of the year, the largest increase among all sectors. The reason for the high proportion of unsecured claims, which reached nearly 70% at the end of September 2011, is the relatively low level of risk associated with this segment of claims, which relates to banks' subsidiaries in the rest of the world and foreign financial institutions, and to the short maturities of these claims.

Table 7.16: Collateral for classified claims more than 90 days in arrears by client segment at the end of September 2011 in percentages

	Classified claims, EUR million	Ratio of collateral[2] to classified claims, %						
			Secured					
		Unsecured[1]	Shares, other equity and mutual fund units	Commercial property[3]	Residential property[3]	Insurer	Other form of collateral	Total collateral[3]
Corporates	4,606.0	37.2	8.6	62.9	10.0	0.0	25.6	107.2
OFIs	398.6	58.0	29.9	20.5	0.4		13.3	64.1
Households (sole prop.)[4]	146.5	31.2	0.0	101.6	43.8	0.3	26.0	171.7
Non-residents	536.5	34.4	1.7	92.9	8.5		11.8	114.9
Government	22.0	98.5		1.4			1.5	2.9
Banks and savings banks	26.0	100.0						
Total	5,735.6	38.7	9.1	63.3	10.0	0.0	23.3	105.7

Note: [1, 2, 3] The same applies as in the previous table.4 Only sole proprietors are included, as no figures on arrears are available for households.
Source: Bank of Slovenia

The coverage of claims more than 90 days in arrears was down 23.1 percentage points on the end of 2010.

The proportion of classified claims more than 90 days in arrears has risen 11.3 percentage points since the end of 2010 to stand at 38.7%, down slightly on the end of 2009 when it stood at 41%. The coverage of the overall portfolio by collateral declined by 23.1 percentage points over the same period owing to a decline in coverage at corporates of nearly 25 percentage points. The structure of collateral for classified claims more than 90 days in arrears also deteriorated notably at non-monetary financial instruments, where the proportion of unsecured claims was up 18.5 on the end of 2010. Taking into account the fact that the same proportion stood at just 8% at the end of 2009, the banks significantly underestimated the likelihood of such a deterioration in this portion of the portfolio. The main reason for such high growth in the proportion of unsecured claims lies in the structure of collateral in this sector, where financial instruments account for 50% of all collateral. The value of financial instruments has fallen sharply over the last two years, as these financial instruments primarily include shares and participating interests in Slovenian corporates. At the same time, the banks are considerably more conservative in valuing non-marketable financial instruments owing to the low economic growth. In addition, non-monetary financial institutions lack eligible collateral. Coverage by collateral improved in the households sector in 2011 primarily on account of an increase in coverage by commercial real estate. However, the proportion of unsecured claims has risen.

Table 7.17: Collateral for classified claims more than 90 days in arrears by bank group at the end of September 2011 in percentages

	Classified claims in EUR million	Ratio of collateral[2] to classified claims, %						
		Unsecured[1]	Shares, other equity and mutual fund units	Commercial property[3]	Residential property[3]	Insurer	Other form of collateral	Total collateral[3]
Savings banks	2.2	68.9		18.0	78.0	0.4	6.3	102.6
Small domestic banks	469.2	27.5	8.8	96.7	27.2	0.0	25.2	158.1
Foreign banks	1,081.5	34.3	10.1	61.3	19.5	0.0	35.1	126.0
Large domestic banks	4,182.8	41.1	8.9	60.0	5.5	0.0	20.0	94.5
Total	5,735.6	38.7	9.1	63.3	10.0	0.0	23.3	105.7

Note: 1, 2, 3 The same applies as in table 7.15.
Source: Bank of Slovenia

The proportion of unsecured claims more than 90 days in arrears increased most at the savings banks and the large domestic banks in 2011.

The proportion of unsecured claims more than 90 days in arrears increased most at the savings banks and the large domestic banks over the first nine months of 2011 (by 29.8 percentage points and 15.4 percentage points respectively), while coverage at the other two bank groups was virtually unchanged. Primarily coverage by commercial real estate and other forms of collateral were down at the large domestic banks, by 13.7 percentage points and 13.5 percentage points respectively. Overall coverage of claims by collateral at the large domestic banks was down 33.3 percentage points as a result. The small banks and the banks under majority foreign ownership increased their coverage by collateral slightly. The reason for the increase in the proportion of unsecured claims at the large domestic banks lies mainly in this bank group's exposure to certain major clients, whose operations have deteriorated significantly and who lack sufficient eligible collateral.

8 INTEREST-RATE RISK

The banks are exposed to rising interest rates.

Interest-rate risk as measured by the difference between the average repricing periods for asset and liability interest rates increased slightly over the first ten months of 2011. The gap has risen to 2.9 months, increasing the banks' exposure to a rise in interest rates. Exposure increased primarily in the interval of 3 months to 1 year, and decreased in the interval of 1 to 2 years.

The banks' exposure to a rise in interest rates, in terms of interest-rate gaps, rose sharply in 2011. The cumulative interest-rate gap in the interval of up to 1 year was negative at the end of October 2011 in the amount of EUR 5.1 billion, nearly two times the value recorded at the end of 2010.

An analysis by bank group indicates that exposure to a rise in interest rates decreased at the banks under majority foreign ownership. Vulnerability to a change in interest rate increased at the domestic banks. The small domestic banks remain the most vulnerable in relative terms.

Given the movements in interest rates in futures contracts, reference interest rate are expected to fall in 2012. However, the risk premium is rising owing to the euro area debt crisis. This results in a rise in market interest rates, which increases the likelihood of negative effects on the banks' operations on account of interest-rate risk.

8.1 Average repricing period for interest rates

The difference between the average repricing periods for asset and liability interest rates widened slightly in 2011.

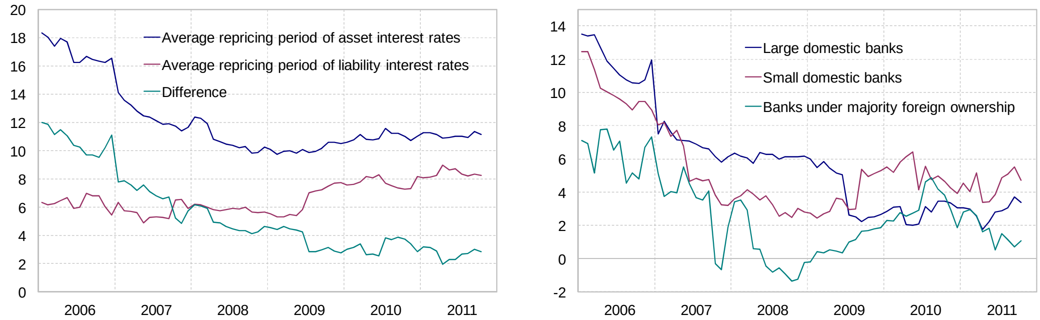
Interest-rate risk as measured by the difference between the average repricing periods for asset and liability interest rates widened slightly over the first ten months of 2011 relative to the end of 2010. The banks are exposed to the risk of rising interest rates. The approaching maturity of debt securities and shorter maturities on funds raised at foreign banks had the greatest impact on the shortening of the average repricing period for liability interest rates until the middle of 2011. At the same time, the increase in long-term deposits and the decrease in short-term and sight deposits have continued. The aforementioned trend has been present since the beginning of 2010 and is closely linked to the difference between short-term and long-term interest rates on deposits, which has averaged around 2 percentage points over this period. The average repricing period of liability interest rates is expected to shorten until the end of the year and in 2012, as access to long-term sources is hampered due to the escalation of the debt crisis.

The average repricing periods for assets and liability interest rates lengthened by 0.5 months over the first ten months of 2011 relative to 2010. In October 2011 the average repricing period for assets interest rates was 2.9 months longer than the average repricing period for liability interest rates, up 0.1 months on the difference at the end of 2010. The reason for the lengthening lies in the increase in the proportion of long-term loans in the maturity breakdown of loans to non-banking sectors, which was typical back in 2009 and 2010.

The banking system's exposure to interest-rate risk could rise slightly in 2012.

The average repricing period for asset interest rates is likely to remain virtually unchanged in 2012, as the proportion of long-term loans has reached an historically high level. Taking into account the fact that the average repricing period for liability interest rates will shorten slightly in 2012 owing to increased difficulty accessing long-term sources, the banking system's exposure to interest-rate risk could rise slightly in 2012.

Figure 8.1: Average repricing period for interest rates in months (left) and the difference between the average repricing period for interest rates by bank group in months (right)



Source: Bank of Slovenia

Interest-rate risk has increased most at the small domestic banks from the end of 2010 until the end of October 2011.

There are significant differences between bank groups in the dynamic of interest-rate risk measured by the difference between the average repricing periods for asset and liability interest rates. The value of this indicator is lowest for the banks under majority foreign ownership, where it stood at 1.1 months at the end of October 2011, down 0.8 months on the end of 2010. The value of the aforementioned indicator was up 0.3 months on the end of 2010 at the large domestic banks, and up 0.8 months at the small domestic banks. The reason for the widening of the gap at the domestic banks lies in the lengthening of the average repricing period for asset interest rates, while the average repricing period for liability interest rates is virtually unchanged since the end of 2010. This means that interest-rate risk has increased slightly at the domestic banks and decreased at the banks under majority foreign ownership. The small domestic banks have been the most exposed to interest-rate risk of all bank groups since the middle of 2009.

8.2 Interest-rate gap

The banks' exposure to a rise in interest rates rose sharply in 2011. The cumulative interest-rate gap in the interval of up to 1 year was negative at the end of October 2011 in the amount of EUR 5.1 billion, an increase of EUR 2.3 billion on the end of 2010. The value of assets with a residual maturity of up to 1 year declined over the same period, while the value of liabilities was up.

The negative interest-rate gap of up to 1 year widened at the large domestic banks.

The negative interest-rate gap of up to 1 year widened most notably over the first ten months of the year at the large domestic banks, by EUR 2 billion to EUR 2.2 billion. The negative gap at the banks under majority foreign ownership widened by EUR 300 million to EUR 2.9 billion. The small domestic banks had a positive interest-rate gap over the same period of EUR 140 million, and were thus not exposed to a rise in interest rates in this segment. The reason for the widening of the gap at the large domestic banks lies primarily on the liability side, where liabilities for issued bonds were up EUR 1.5 billion in the interval of up to 1 year. Investments in debt securities recorded the sharpest decline (of EUR 360 million) on the asset side.

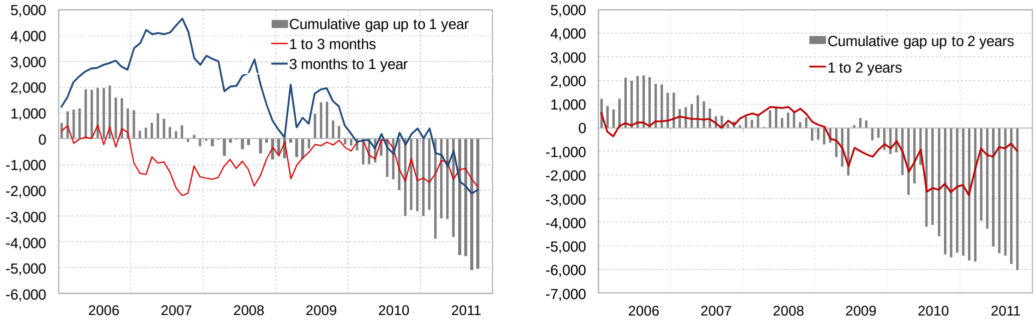
Banks are exposed to a rise in interest rates primarily in the interval of up to 1 year.

The widening of the negative interest-rate gap of up to 1 year is primarily the result of the widening of the negative interest-rate gap of 1 to 3 months by EUR 2.4 billion. Given the trend seen in the second half of 2011, the gap is likely to widen further. Investments for which the interest rate is repriced in an interval of 3 months to 1 year were down EUR 1.4 billion in 2011. Liabilities for issued securities and deposits were up EUR 1.7 billion on the liability side, while the stock of loans raised was down EUR 660 million.

The gap of 1 to 2 years narrowed in 2011.

The negative gap of 1 to 2 years narrowed by EUR 1.5 billion in 2011, thus decreasing interest-rate risk. The reason for the narrowing of the gap lies primarily in the decrease in liabilities for issued bonds and deposits at the large domestic banks of EUR 3.1 billion. At the same time, investments, loans and debt securities were also down, by EUR 950 million. Liabilities for issued securities were down owing to the shortening of the residual maturity of Abanka bonds with a nominal value of EUR 500 million, which mature in September 2012, and NLB bonds with a nominal value of EUR 1.6 billion, which mature in June and July 2012.

Figure 8.2: Gap between interest-sensitive assets and interest-sensitive liabilities by individual bucket in EUR million



Source: Bank of Slovenia

Taking into account the gap of up to 2 years, the Slovenian banking system's exposure to a rise in interest rates is high and rose further, albeit slightly, in 2011. The required yield on the 10-year bonds of the majority of euro area countries is rising, despite cuts in the ECB's key interest rate in November and December by 0.50 percentage points to 1.00%. This means that the risk premium represents the main element in the setting of market interest rates on account of the euro area debt crisis. Increased confidence on the financial markets is crucial for the lowering of market interest rates.

The risk premium is the main factor in the setting of market interest rates on account of the euro area debt crisis.

8.3 Basis risk

In October 2011 interest-sensitive assets exceeded interest-sensitive liabilities by EUR 607 million, or 1.2% of the banking system's total assets. This gap has narrowed by 1.4 percentage points since the end of 2010. Interest-sensitive assets declined by 3.4%, while interest-sensitive liabilities were down 1.9%.

Interest-sensitive assets declined by 3.4% relative to the end of 2010, while interest-sensitive liabilities were down 1.9%.

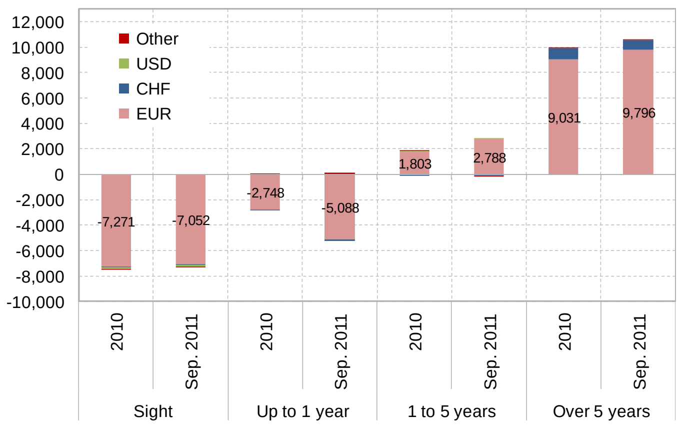
Interest-rate gaps by currency

The banks are primarily exposed to a rise in interest rates in shorter maturity buckets in the domestic currency and in Swiss francs. The situation is the complete opposite in longer maturity buckets. The exceptions are investments in Swiss francs, where the interest-rate gap in the interval of 1 to 5 years remains negative. Exposure to interest-rate risk in other currency is negligible.

There were no major changes in the currency breakdown of interest-sensitive items. Exposure to a rise in interest rates increased primarily in the domestic currency in the interval of up to 1 year, by EUR 2.3 billion, but decreased in longer maturity buckets by EUR 1.8 billion. The proportion of the total net position accounted for by the Swiss franc was down 0.5 percentage points on the end of 2010 to stand at 6.4%, as the banks reduced their volume of transactions in this currency. The proportion accounted for by the US dollar was also down, while the proportions accounted for by other currencies were up.

Exposure to a rise in interest rates increased in the domestic currency in the interval of up to 1 year, but decreased in longer maturity buckets.

Figure 8.3: Currency breakdown of net interest-rate positions by individual bucket of residual maturity in EUR million



Source: Bank of Slovenia

Gaps by types of reference interest rate

The proportion of interest-sensitive items tied to reference interest rates was up on the asset side and down on the liability side.

Another source of interest-rate risk is mismatching in the structure of interest-rate sensitive assets and liabilities with respect to the type of reference interest rate. At the end of October 2011, the proportion of interest-sensitive items tied to reference interest rates was up 0.8 percentage points to just over 63% on the asset side, and down 2 percentage points to nearly 33% on the liability side. The gap between the proportion of interest-sensitive assets and liabilities tied to reference interest rates was up 2.8 percentage points to stand at 30.4 percentage points, an indication of the banks' increased sensitivity to falling reference interest rates.

Table 8.1: Structure of interest-rate sensitive assets and liabilities by reference interest rate in percentages

	Interest-sensitive assets				Interest-sensitive liabilities			
	Dec. 08	Dec. 09	Dec. 10	Oct. 11	Dec. 08	Dec. 09	Dec. 10	Oct. 11
Stock, EUR million	45,440	49,368	46,522	45,214	42,426	46,168	45,239	44,608
Proportion with reference rate, %	65.4	53.0	62.5	63.3	39.2	33.2	34.9	32.9
	Proportion of items tied to a reference interest rate accounted for by individual reference rate, %							
EURIBOR								
1-month	17.4	8.2	6.0	6.7	18.6	10.7	6.0	2.9
3-month	24.0	29.3	29.0	29.4	28.2	31.3	35.2	37.4
6-month	47.0	51.7	54.7	54.0	41.4	46.9	49.8	50.9
1-year	1.9	2.1	1.8	1.5	1.6	0.4	1.1	0.4
Swiss franc LIBOR								
1-month	0.7	0.5	0.4	0.3	0.4	0.3	0.1	0.0
3-month	2.2	1.8	1.5	1.4	3.0	3.3	3.9	4.2
6-month	3.2	3.1	2.8	2.6	3.2	2.4	1.5	1.5
1-year	1.6	1.6	1.5	1.4	1.6	1.2	0.9	0.9
Central bank interest rate	0.1	0.2	1.3	1.8	0.0	2.6	0.0	0.0
Other	1.9	1.5	1.0	0.8	2.1	1.1	1.6	1.7

Source: Bank of Slovenia

Around 92% of interest-rate sensitive assets and liabilities are tied to the EURIBOR.

The most frequently used reference interest rate on both the asset and liability sides is the 6-month EURIBOR. The proportion of assets tied to the 6-month EURIBOR was down, while the proportion tied to the 1-month and 3-month EURIBOR was up.

The proportion of items tied to the second most important reference interest rate, the Swiss franc LIBOR, is declining on the asset side due to repayments and a halt in the approval of new loans tied to the Swiss franc, while the proportion on the liability side is rising. At the end of October 2011, the proportion of items tied to reference interest rates accounted for by the Swiss franc LIBOR was 1 percentage point higher than the proportion on the asset side of 5.7%.

The long positions in key interest rates lengthened in 2011.

The banks lengthened their long position in the majority of key reference interest rates in 2011 (the exception being the 6-month LIBOR). The total net position in the 1-month EURIBOR lengthened most, by 1.6 percentage points. The banking system's exposure to falling interest rates has thus increased, but only with respect to balance sheet items tied to reference interest rates.

Table 8.2: Interest-rate gap in interest-sensitive assets by reference interest rate in percentages

(%)	Overall net position				Net position by bucket, Oct. 2011			
	Dec. 08	Dec. 09	Dec. 10	Oct. 11	Sight	Up to 1 year	1 to 5 year	Over 5 years
EURIBOR								
1-month	4.6	1.0	1.7	3.3	0.0	1.0	0.9	1.4
3-month	5.4	5.8	6.1	6.5	0.1	0.3	0.7	5.4
6-month	15.6	12.8	17.3	17.7	-1.1	3.5	5.8	9.5
1-year	0.7	1.0	0.7	0.8	0.0	0.0	0.2	0.6
Swiss franc LIBOR								
1-month	0.3	0.2	0.2	0.2	0.0	0.1	0.0	0.1
3-month	0.3	-0.1	-0.4	-0.4	0.0	0.0	0.0	-0.5
6-month	0.9	0.9	1.3	1.2	0.0	-0.2	0.0	1.4
1-year	0.5	0.5	0.6	0.6	0.0	0.0	-0.2	0.8

Source: Bank of Slovenia

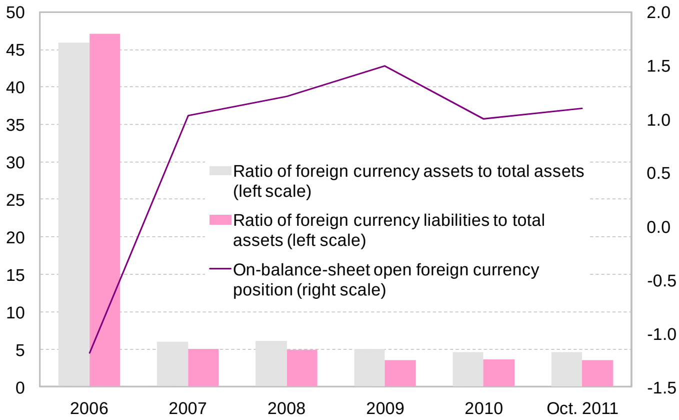
9 CURRENCY RISK

Relatively low currency risk decreased further in 2011.

The Slovenia banking system's currency risk declined over the first nine months of the year. The net long foreign exchange position stood at EUR 19 million or 0.4% of regulatory capital in September 2011. The large banks were most exposed to currency risk, with a long net foreign exchange position of EUR 19.1 million.

The proportion of the banks' total assets accounted for by foreign currency assets and liabilities has not changed significantly in the current year. The on-balance-sheet open foreign exchange position was long in the amount of 1.1% of the banking system's total assets in October 2011.

Figure 9.1: Foreign currency assets, foreign currency liabilities and on-balance-sheet open foreign exchange position as a percentage of total assets



Source: Bank of Slovenia

9.1 Currency breakdown and open foreign exchange position

The banking system's on- and off-balance-sheet foreign exchange items were down 7.5% on the asset side in September in year-on-year terms, and down 7% on the liability side. There was a notable decrease in particular in the proportion of Swiss franc items in the currency breakdown, and an increase in the proportion of items in US dollars, EEA currencies and other currencies. The proportion accounted for by foreign currency collective investment undertaking units was halved, an indication that the banks are shifting their assets from such investments.

Table 9.1: Currency breakdown of on- and off-balance-sheet assets and liabilities

	2009		2010		Sep. 2011	
	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
Total foreign currency other than euros, EUR million	3,383	3,342	3,637	3,572	3,395	3,376
year-on-year growth, %	-14.2	-15.0	7.5	6.9	-7.5	-7.0
Breakdown foreign currency other than euros			(%)			
Global currencies	90.4	92.4	92.3	94.5	91.8	93.1
Swiss franc	61.3	62.4	60.6	62.0	57.7	58.6
Pound sterling	1.8	1.9	1.4	1.4	1.6	1.6
US dollar	25.5	26.3	28.3	29.0	30.7	30.9
Canadian dollar	0.7	0.7	0.5	0.5	0.5	0.5
Japanese yen	0.7	0.7	1.0	1.1	0.7	1.0
Australian dollar	0.4	0.4	0.5	0.5	0.6	0.6
EEA currencies	3.9	3.8	2.7	2.2	3.4	3.3
Other currencies	4.2	3.8	3.5	3.3	4.1	3.5
CIU	1.4	0.0	1.5	0.0	0.7	0.0

Note: EEA: European Economic Area, i.e. the EU, Iceland and Norway; CIU: foreign exchange position in collective investment undertaking units.
Source: Bank of Slovenia

The net open foreign exchange position stood at EUR 19 million or 0.4% of regulatory capital in September 2011.

The net long foreign exchange position declined to EUR 19 million or 0.4% of regulatory capital in September. Contributing most to this was the shortening of the long foreign exchange position in collective investment undertaking units, from EUR 52.6 million at the end of 2010 to EUR 24.2 million in September 2011. The banking system held a net short foreign exchange position in major global currencies, and is therefore exposed to the risk of the appreciation of these currencies. Long net foreign exchange positions were recorded primarily in other currencies and collective investment undertaking units, meaning the banks are exposed to a depreciation in their value. The open foreign exchange position according to the Bank of Slovenia's definition deriving from capital requirements stood at EUR 61.8 million or 1.3% of regulatory capital in September 2011.

Table 9.2: Open foreign exchange positions by currency in EUR million equivalent

	Net position			Larger of sum of long positions and sum of short positions		
	2009	2010	Sep. 2011	2009	2010	Sep. 2011
Global currencies	-28.9	-20.1	-29.5	37.1	32.8	41.2
US dollar	-14.7	-8.4	-1.1	19.1	14.1	7.5
Swiss franc	-12.3	-9.9	-19.0	14.6	13.8	22.0
Other (GBP, CAD, AUD, JPY)	-1.8	-1.8	-9.4	3.4	4.9	11.6
EEA currencies	4.9	20.5	3.0	5.0	20.7	4.3
Other currencies	17.2	11.9	21.2	25.2	11.9	21.5
CIU	48.2	52.6	24.2	48.2	52.6	24.2
Total	41.4	64.9	19.0	86.6	97.9	61.8
As a % of regulatory capital	0.9	1.4	0.4	1.9	2.2	1.3

Note: EEA: European Economic Area, i.e. the EU, Iceland and Norway; CIU: foreign exchange position in collective investment undertaking units.
Source: Bank of Slovenia

The large domestic banks were most exposed to currency risk, with a long net foreign exchange position of EUR 19.1 million, followed by the banks under majority foreign ownership with a short foreign exchange position of EUR 3.2 million and the small domestic banks with a long net foreign exchange position of EUR 3.1 million.

Table 9.3: Open foreign exchange position by bank group, September 2011, in EUR million

	Large domestic banks	Small domestic banks	Banks under majority foreign	Overall
Global currencies	-25.9	0.1	-3.7	-29.5
US dollar	-0.2	-0.1	-0.8	-1.1
Swiss franc	-16.2	-0.3	-2.5	-19.0
Other (GBP, CAD, AUD, JPY)	-9.5	0.5	-0.4	-9.4
EEA currencies	2.5	0.3	0.2	3.0
Other currencies	18.6	2.4	0.2	21.2
CIU	24.0	0.2	0.0	24.2
Total	19.1	3.1	-3.2	19.0
As % of regulatory capital	0.6	0.8	-0.3	0.4

Note: EEA: European Economic Area, i.e. the EU, Iceland and Norway; CIU: foreign exchange position in collective investment undertaking units.
Source: Bank of Slovenia

9.2 Borrowing in Swiss francs

The appreciation of the Swiss franc increases the burden associated with the repayment of Swiss franc loans.

The appreciation of the Swiss franc continued in 2011, thus increasing the burden associated with the repayment of Swiss franc loans and loans with a currency clause tied to the Swiss franc. The greatest impact in this regard was on households who in October 2011 accounted for around 72% of the banking system's loans in Swiss francs or with a currency clause tied to the Swiss franc. Although the banks very rarely approved new loans in Swiss francs, the stock of such loans is only slowly declining due to the appreciation of the Swiss franc. In October 2011 the stock of housing loans expressed in euros was similar to the level recorded a year earlier. Expressed in Swiss francs, the same loans were down 11% in year-on-year terms.

Table 9.4: Stock and year-on-year growth of loans in Swiss francs or with a currency clause tied to the Swiss franc

	Non-banking sectors	Non-financial corporations	OFIs	Government	Households: All loans	Households: Housing loans
	Stock of loans, EUR million					
2009	1,891.4	464.8	173.3	6.4	1,246.9	1,034.9
2010	1,868.1	429.5	134.4	6.0	1,298.2	1,128.3
Oct. 2011	1,640.3	318.2	136.2	5.6	1,180.3	1,049.0
	Year-on-year growth, %					
2009	-21.3	-37.5	-23.5	-13.5	-12.6	-8.1
2010	-1.2	-7.6	-22.5	-6.4	4.1	9.0
Oct. 2011	-6.8	-23.4	7.5	-0.9	-2.7	0.1

Source: Bank of Slovenia

The proportion of loans to non-banking sectors tied to the Swiss franc or with a Swiss franc currency clause is gradually declining, and stood at 4.1% in October 2011. The proportion of all housing loans in Swiss francs or with a currency clause tied to the Swiss franc remains more important in relative terms at 20%.

Table 9.5: Loans tied to the Swiss franc exchange rate by bank group

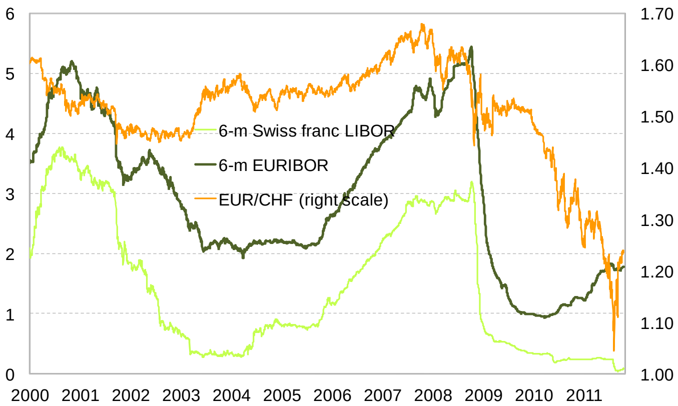
	Year-on-year growth, %		Proportion of total banking system loans tied to Swiss franc, %		Proportion of total loans at bank group, %	
	2010	Oct. 2011	2010	Oct. 2011	2010	Oct. 2011
Large domestic banks	-2.6	-1.0	31.5	32.4	2.4	2.2
Small domestic banks	0.4	-27.7	1.1	0.9	0.6	0.5
Banks under majority foreign ownership	-1.5	-9.1	67.4	66.7	9.9	8.5
Total	-1.2	-6.8	100.0	100.0	4.6	4.1

Source: Bank of Slovenia

The Swiss franc appreciated by 2.5% against the euro in 2011 over the first ten months of the year. The euro/Swiss franc exchange rate has stabilised since 6 September.

The Swiss franc appreciated by 2.5% against the euro over the first ten months of the year, and by 11.1% in year-on-year terms. The main reason for the Swiss franc's appreciation against the euro lies in the public finance problems in certain European countries. Owing to the negative effects of the Swiss franc's appreciation against the euro on the Swiss economy, the Swiss National Bank undertook on 6 September 2011 to purchase unlimited quantities of foreign currencies in order to maintain the euro/Swiss franc exchange rate above 1.2. That measure has stabilised the euro/Swiss franc exchange rate and somewhat reduced the burden associated with the repayment of loans in Swiss francs or with a currency clause tied to the Swiss franc.

Figure 9.2: Swiss franc LIBOR reference interest rate, EURIBOR and movement in the euro/Swiss franc exchange rate



Source: Bank of Slovenia

10 BANK SOLVENCY

The capital adequacy of the Slovenian banking system stood at 12.1% in September 2011, while Tier 1 capital adequacy stood at 9.9%. Both values are higher than at the end of the previous year owing to successful recapitalisations, a contraction in the volume of the banking system's operations and a decrease in capital requirements. In contrast to the domestic banks, the Tier 1 capital adequacy declined slightly at the banks under majority foreign ownership. The differences in capital adequacy between bank groups have widened.

The capital adequacy of the Slovenian banking system is 1.5 percentage points below the average for comparable EU banks. The largest difference is at the small domestic banks, which also have the lowest Tier 1 capital adequacy.

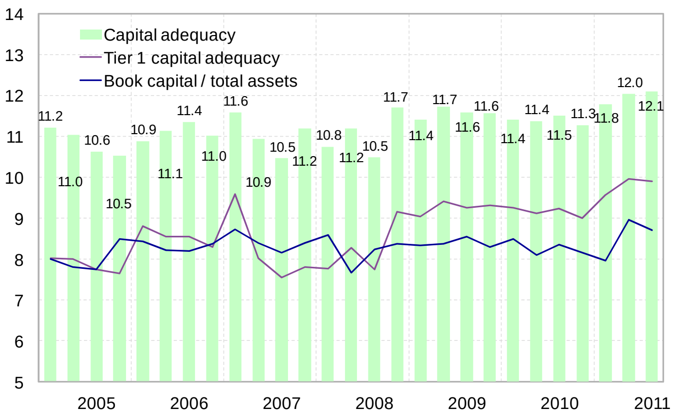
The banking system's capital quality structure has improved. The increase in the highest-quality capital, obtained via recapitalisations by the large domestic banks, has improved the potential for increasing subordinated debt. Regulatory capital stood at EUR 4,696 million at the end of September 2011, up 3.8% on the end of 2010. Capital requirements were down EUR 100 million over the first nine months of the year. The decrease was most notable at the large domestic banks owing to a decrease in capital requirements for credit risk. The large domestic banks recorded the largest increase in the proportion of the highest-quality capital, while reducing capital requirements for credit risk by scaling back lending activity. The domestic banks recorded the sharpest increase in capital requirements for unsettled past-due claims[22] in the scope of total capital requirements for credit risk, a reflection of the continuing deterioration in the quality of that bank group's credit portfolio.

10.1 Capital adequacy

Capital adequacy was up 0.8 percentage points over the first three quarters of 2011 to stand at 12.1%, while Tier 1 capital adequacy was up 0.9 percentage points to stand at 9.9%.

The capital adequacy of the Slovenian banking system stood at 12.1% in September, up 0.8 percentage points on the end of the previous year. Tier 1 capital adequacy was up 0.9 percentage points over the same period, achieving its highest level in recent years at 9.9%. The main factor in the aforementioned change was the recapitalisation of certain banks, while a decrease in capital requirements owing to stagnating lending growth was also a factor. The estimated contribution of the increase in capital to the increase in capital adequacy was 0.43 percentage points, while the contribution of the decrease in capital requirements was 0.36 percentage points. This effect was most evident at the large domestic banks. The ratio of the book value of capital to total assets was up 0.5 percentage points from the end of 2010 to September 2011 to stand at 8.7%. Contributing to declining leverage, in addition to recapitalisations, were banks' debt repayments to the rest of the world and a contraction in loans to the non-banking sectors.

Figure 10.1: Banking system's basic capital adequacy indicators in percentages



Source: Bank of Slovenia

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[22] A past-due claim or item is an exposure where the obligor has defaulted on payment of the full exposure or a part thereof in excess of EUR 100 for more than 90 days.

Table 10.1: Banking system's basic capital adequacy indicators in percentages

	2005	2006	2007	2008	2009	2010	Sep. 2011
Capital adequacy	10.5	11.0	11.2	11.7	11.6	11.3	12.1
Tier 1 capital adequacy	7.6	8.3	7.8	9.2	9.3	9.0	9.9
Book capital / total assets	8.5	8.4	8.4	8.4	8.3	8.2	8.7

Source: Bank of Slovenia

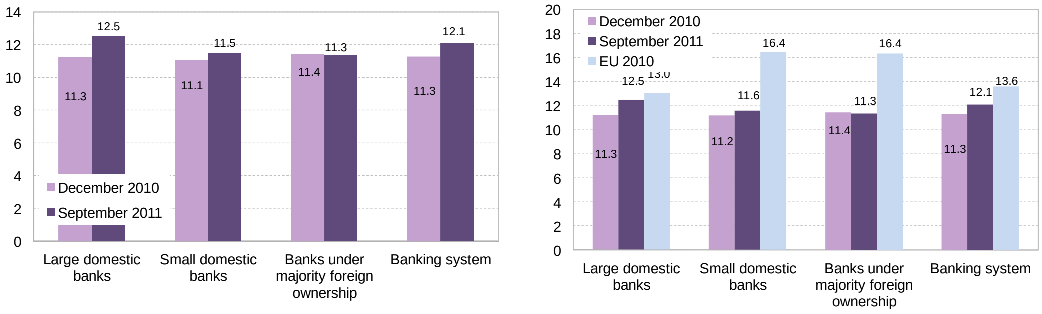
The capital adequacy of the large domestic banks rose to 12.5% over the first nine months of 2011.

The large domestic banks had the highest capital adequacy of all bank groups in September 2011. Their capital adequacy was up 1.2 percentage points to stand at 12.5% owing to recapitalisations, their relatively weak lending activity and the resulting decrease in capital requirements by 5.5%. Only at the banks under majority foreign ownership was capital adequacy lower in September 2011 than at the end of 2010, primarily owing to an increase in capital requirements.

The capital adequacy of the banking system on a consolidated basis is below the EU average.

On a consolidated basis, the capital adequacy of the Slovenian banking system is below the average of comparable EU banks for 2010. The capital adequacy of the banks under majority foreign ownership and the small domestic banks is 5.1 percentage points and 4.9 percentage points respectively below the EU average. Following recapitalisations, the capital adequacy of the large domestic banks is 0.5 percentage points below that of comparable EU banks for 2010.

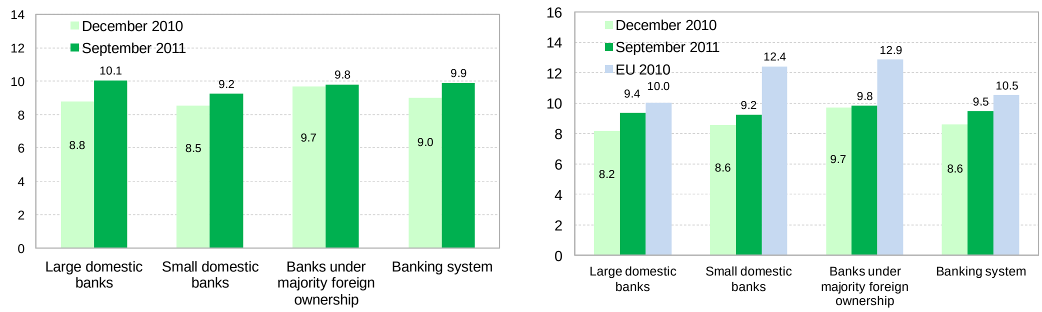
Figure 10.2: Capital adequacy by bank group on an individual basis (left) and on a consolidated basis compare with the EU average (right) in percentages



Sources: Bank of Slovenia, ECB

The Tier 1 capital adequacy of the Slovenian banking system stood at 9.9% in September 2011 and at 9.5% on a consolidated basis, and was higher at all banks groups relative to the end of last year. The large domestic banks recorded the largest increase, of 1.3 percentage points to stand at 10.1%, primarily owing to recapitalisations. Tier 1 capital adequacy on a consolidated basis is lowest at the small domestic banks at 9.2%, which is 3.2 percentage points lower than the capital adequacy of comparable EU banks.

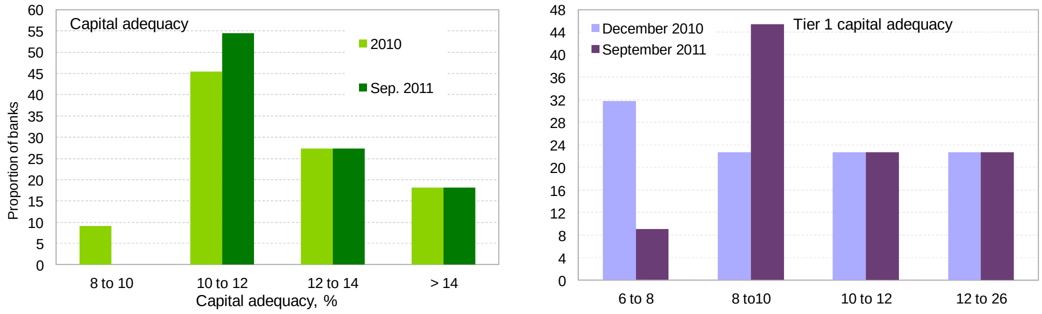
Figure 10.3: Tier 1 capital adequacy by bank group on an individual basis (left) and on a consolidated basis compared with the EU average (right) in percentages



Sources: Bank of Slovenia, ECB

There was a positive shift in the distribution of Tier 1 capital adequacy in all banks groups over the first nine months of the year, most notably at the large domestic banks. In terms of capital adequacy, the most notable improvement came from the complete shift of banks from the interval from 8% to 10% to the interval from 10% to 12%. Improvement was also seen in Tier 1 capital adequacy, where an increase in the proportion of banks in the interval from 8% to 10% was recorded at the expense of a decrease in the proportion of banks in the interval from 6% to 8%.

Figure 10.4: Distribution of the banking system's capital adequacy (left) and Tier 1 capital adequacy (right)



Source: Bank of Slovenia

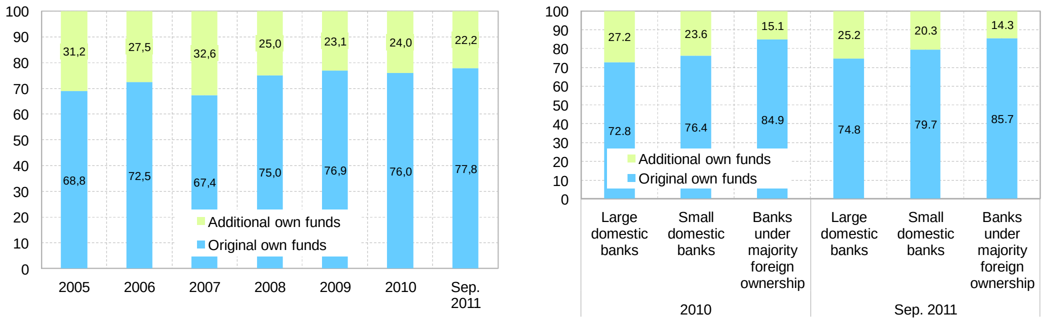
10.2 Structure of capital

The banking system's original own funds stood at EUR 4,271 million in September 2011, an increase of EUR 270 million compared with December 2010 and an increase of 3.8% in year-on-year terms. The aforementioned increase was driven by an increase in share capital and the share premium account.

The capital quality structure improved at all bank groups.

All bank groups contributed to an improvement in the banking system's capital quality structure. The proportion of the banking system's capital accounted for by original own funds prior to deductions was up 1.8 percentage points at the end of the third quarter of 2011 to stand at 77.8%. The large domestic banks contributed most to the increase in original own funds, with an increase in original own funds of 7.8%. Despite the recapitalisations carried out, this bank group continues to have the lowest level of original own funds as a proportion of capital. The banks under majority foreign ownership maintain the highest capital quality structure.

Figure 10.5: Structure of the banking system's capital prior to deductions (left) and by bank group (right) in percentages



Source: Bank of Slovenia

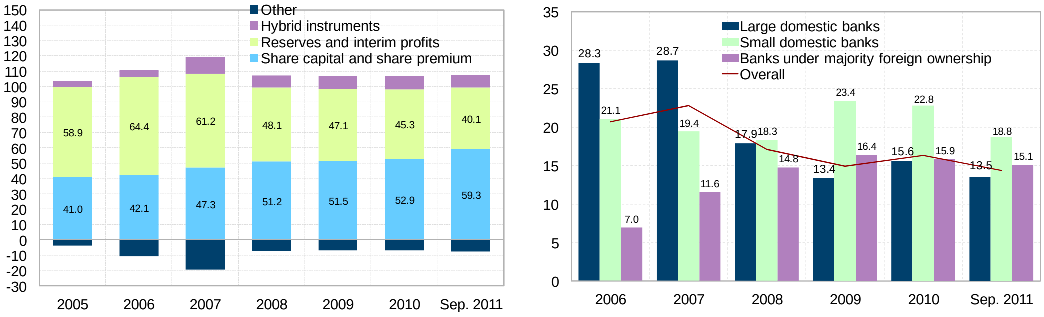
Losses prevent increases in capital on the basis of banks' operations.

The proportion of the banking system's original own funds accounted for by share capital and the share premium account recorded the highest growth over the first nine months of 2011, of 6.4 percentage to stand at 59.3%. In contrast, the pre-tax losses generated by the banking system, which stood at EUR 107 million, reduced the balance of reserves and retained and interim profits by 5.2 percentage points to stand at 40.1% of original own funds. Nine banks generated a pre-tax loss over the first nine months of the year.

The banking system's income risk is increasing in the context of the continuing stagnation in lending to non-banking sectors and the rising proportion of non-performing claims[23]. This diminishes the banks' capacity to generate capital internally. At the same time, the introduction of stricter capital requirements at the EU level is envisaged. These requirements relate to raising the Core Tier 1 ratio to 9% by the end of June 2012 for systemically important banks. Eleven Slovenian banks do not achieve a Core Tier 1 ratio of 9%. According to figures for September 2011, those banks would be forced to increase capital by EUR 438 million on a consolidated basis and by EUR 298 million on an individual basis.

[23] Non-performing claims are D- and E-rated claims.

Figure 10.6: Components of original own funds (left) and the ratio of subordinated debt to original own funds by bank group (right) in percentages

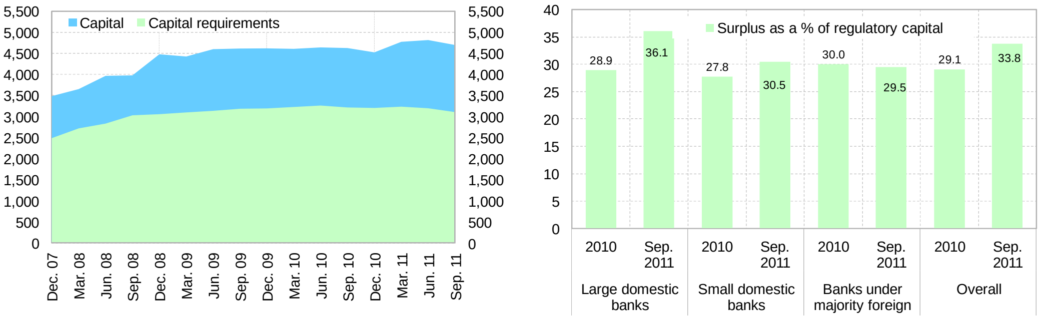


Source: Bank of Slovenia

Regulatory capital stood at EUR 4,696 million in September 2011, an increase of EUR 173 million compared with December 2010. Year-on-year growth in regulatory capital stood at 1.5%, the lowest level of growth recorded in 2011. Capital requirements were down 3.4% in year-on-year terms in September, primarily owing to declining lending growth. The surplus of regulatory capital over capital requirements was up 4.7 percentage points as a result, to stand at 33.8%. The surplus of regulatory capital is highest at the domestic banks. Nevertheless, the willingness to assume risk has diminished at all bank groups owing to a lack of original own funds for capital adequacy needs. The banks are striving to secure sufficient capital and to improve the security of operations.

The surplus of regulatory capital over capital requirements rose to 33.8% owing to the stagnation in lending growth.

Figure 10.7: Regulatory capital and capital requirements in EUR million (left) and surplus of capital over capital requirements as percentage of regulatory capital (right)

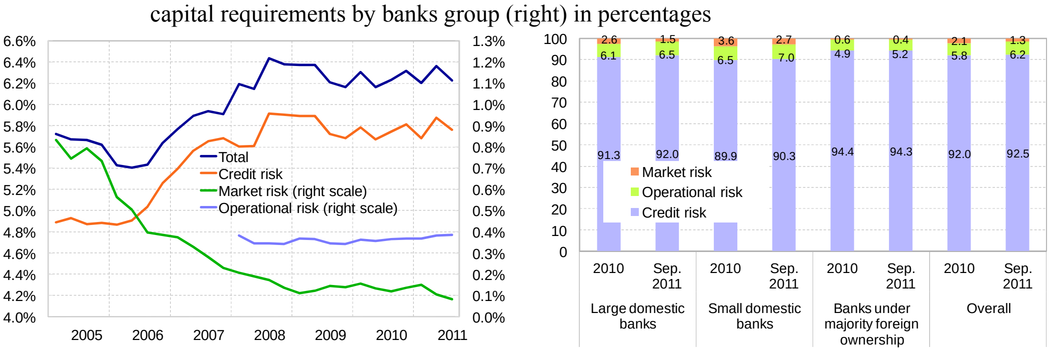


Source: Bank of Slovenia

10.3 Capital requirements

Capital requirements were down EUR 100 million over the first nine months of the year, primarily owing to a decrease in capital requirements for credit risk. The banking system's total assets were also down in the context of debt repayments. Capital requirements as a proportion of total assets were virtually unchanged, having declined by 0.1 percentage points to stand at 6.23% at the end of September.

Figure 10.8: Ratio of capital requirements to total assets (left) and the structure of capital requirements by banks group (right) in percentages



Source: Bank of Slovenia

Capital requirements have declined due to reduced lending activity.

At 92.5%, capital requirements for credit risk account for the majority of capital requirements. The large domestic banks recorded the sharpest decrease in capital requirements for credit risk (of EUR 89 million) owing to reduced lending activity. Capital requirements for operational risk increased at all bank groups, most notably at the banks under majority foreign ownership.

The increase in capital requirements for unsettled past-due liabilities reflects the deterioration in the quality of the banks' investments.

The quality of the credit portfolio deteriorated over the first nine months of 2011, primarily at the domestic banks, which can be seen in a renewed increase in capital requirements for unsettled past-due claims, which were up EUR 59 million or 58% over the first nine months of the year. The main factor was the large domestic banks, which contributed EUR 42.5 million or 72% of the overall increase, while the highest growth was recorded by the small domestic banks, at 110%.

The small domestic banks remain the most vulnerable bank group with respect to the structure of capital requirements for credit risk. The proportion of capital requirements for credit risk accounted for by regulatory high-risk items was up 1 percentage point at the small domestic banks and, at 14.8%, remains highest among all bank groups. The deterioration in the structure of capital requirements for credit risk is particularly evident at the large domestic banks, which recorded the highest growth in regulatory high-risk items this year, at 8.7%.

Table 10.2: Capital requirements for credit risk for the banking system and bank groups in EUR million and breakdown in percentages

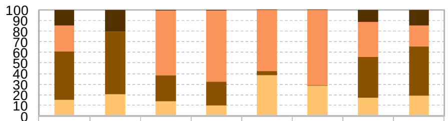
	2010				Sep. 2011				Change			
	Large domestic banks	Small domestic banks	Banks under majority foreign ownership	Overall	Large domestic banks	Small domestic banks	Banks under majority foreign ownership	Overall	Large domestic banks	Small domestic banks	Banks under majority foreign ownership	Overall
Capital requirements for credit risk, EUR million	1,855.7	280.4	815.4	2,951.6	1,766.8	277.0	830.6	2,874.5	-88.9	-3.4	15.2	-77.1
	Breakdown of capital requirements for credit risk, %								Change, percentage points			
Public sector, international organisations	0.8	1.7	1.7	1.1	0.8	1.7	0.6	0.8	0.0	0.0	-1.1	-0.3
Institutions	11.3	6.2	2.4	8.4	11.0	5.8	3.0	8.2	-0.4	-0.4	0.6	-0.2
Corporates	55.5	49.3	51.6	53.8	51.8	44.8	50.6	50.8	-3.7	-4.5	-1.0	-3.1
Retail banking	17.4	13.7	32.5	21.2	17.8	15.3	31.9	21.6	0.5	1.6	-0.6	0.4
Secured by real estate	0.0	7.7	1.1	1.0	0.0	7.5	1.4	1.1	0.0	-0.2	0.4	0.1
Past-due items	3.5	2.4	3.7	3.4	6.1	5.1	4.7	5.6	2.6	2.7	1.0	2.1
Regulatory high-risk items	7.9	13.7	3.9	7.4	9.0	14.8	3.8	8.1	1.1	1.0	-0.1	0.7
Other	3.6	5.3	3.1	3.7	3.5	5.1	3.9	3.8	-0.1	-0.1	0.8	0.2

Source: Bank of Slovenia

Capital requirement for market risks were down at all bank groups.

Capital requirements for market risks were down 40% to stand at EUR 41 million at the end of September 2011 owing to declining bank investments in securities. The major factor in the aforementioned decline was the large domestic banks, which completely reversed capital requirements for settlement risk. The reason for the reversal lies in the maturity of futures contracts in the second quarter, which were rebooked to on-balance-sheet claims and taken into account in capital requirements for credit risk due to non-settlement. The small banks and the banks under majority foreign ownership reduced their capital requirements for equity and debt instruments due to the sell-off and reduction in the value of investments.

Figure 10.9: Breakdown of capital requirement for market risk by bank group in percentages



	Large domestic banks		Small domestic banks		Banks under majority foreign ownership		Overall	
	2010	Sep. 2011	2010	Sep. 2011	2010	Sep. 2011	2010	Sep. 2011
Other	14.4	20.2	0.7	0.7	0.1	0.2	11.0	14.4
Settlement risk	24.5	0.0	61.0	66.6	57.3	71.0	33.1	20.2
Equity financial instruments	45.7	59.6	24.5	22.6	4.1	0.7	38.9	46.5
Debt financial instruments	15.4	20.2	13.8	10.1	38.6	28.3	17.0	18.9

Source: Bank of Slovenia

Capital requirements for operational risk stood at EUR 192 million in September, an increase of 2.6% on the end of the previous year. They were up at all bank groups, most notably at the banks under majority foreign ownership, by 8.4%.

ANNEXES

1. REAL ESTATE MARKET

Real estate prices in Slovenia rose significantly faster than in other euro area countries until 2008, when they reached their peak. Slovenian real estate prices have not fallen drastically since that time (the prices of newly built housing having fallen by 15.5% and the prices of used housing by 6.4%), despite a high inventory of unsold housing.

In the context of a low number of transactions, the structure of demand has had a significant impact on the renewed growth in prices of newly built housing in the last year. Quality housing in selected locations has largely been purchased by wealthier buyers. The bankruptcies of construction companies, which held mid-priced housing, have also led to rising prices. The sale of housing held by construction companies, together with the banks, with the aim of transferring the banking system's exposure from the construction sector to households, will be limited in the future. Creditworthy buyers have already exploited favourable lending offers, such as low interest rates, reduced loan approval costs, a higher LTV ratio and affordable collateral.

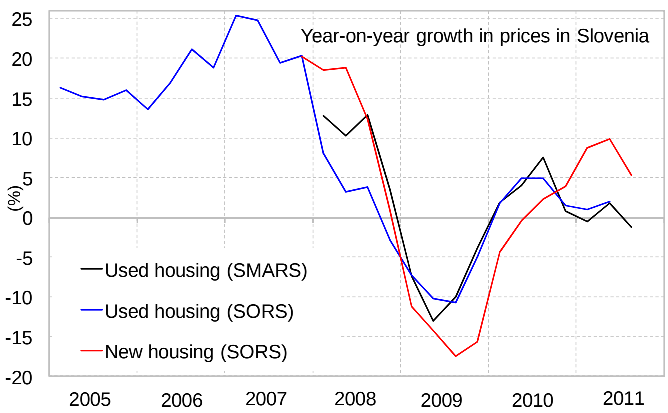
The pressure to reduce real estate prices will be considerable over the next two years, despite the contraction in construction activity. At the current price levels, the supply of real estate continues to outstrip demand. Many unsold housing units are uninteresting due to features or location. The prices of such housing must therefore be adjusted to the expectations of potential buyers. Owing to the bankruptcy of construction companies and the protracted procedures involved, foreclosed housing will represent additional supply on the market the next time an attempt is made to sell that housing. Two years following construction, such housing will lose some of its quality and will be taxed at a lower real estate sales tax, the same as used housing. A significant proportion of construction companies repay their liabilities in arrears, which could result in additional bankruptcies. On the other hand, the disposable income of households is rising at a slower pace than their debt, which could further drive down demand for real estate.

Real estate price developments

The prices of used housing were down 1.2% in the third quarter of 2011. According to survey figures, the prices of new housing were up 5.3%.

According to figures from the Surveying and Mapping Authority (SMARS), the prices of used housing in Slovenia were down 1.2% in year-on-year terms at the end of the third quarter of 2011 and down 8% from their peak in the second quarter of 2008, despite a temporary rise. Prices in Ljubljana were up 5.3% over the same period, but down 9.6% from their peak. Used housing transactions were down 11.5% over the first three quarters of 2011 relative to the same period the previous year, and were down on the four-year average.

Figure 1.1: Year-on-year growth in the prices of used and newly built residential real estate in percentages

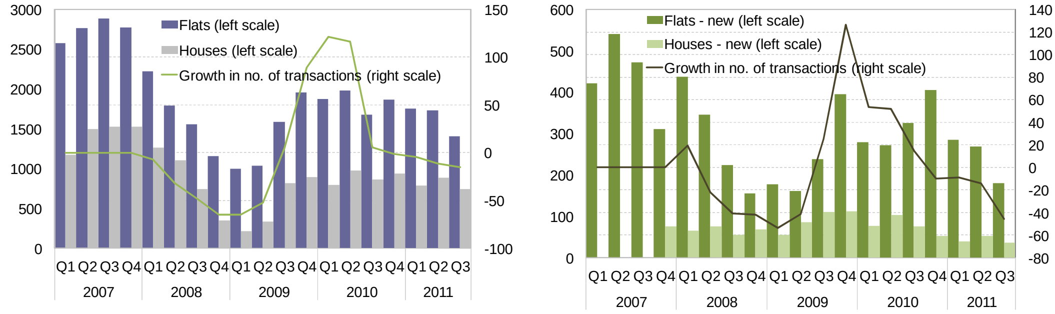


Sources: Bank of Slovenia, TARS, SMARS, SORS

The liquidity of the real estate market fell again.

According to SORS survey figures, the prices of new housing units were up 5.3% in year-on-year terms in the third quarter of 2011. The reasons lie in the drop in the supply of housing at moderate prices on account of bankruptcy proceedings against construction companies, in the sales of more expensive housing at the best locations in specific neighbourhoods and the low number of transactions included. The sale of housing from bankruptcy estates via tenders or auctions is not included. The prices of newly built housing were down 11% from their peak in the third quarter of 2008. The liquidity of the market was lower than in 2010 and below the average of the last four years.

Figure 1.2: Number of recorded transactions and growth in flat and house transactions – used (left) and new (right) in percentages



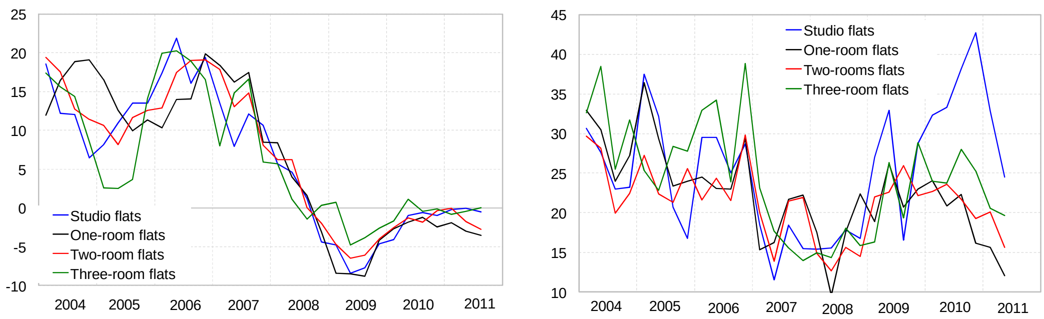
Sources: SMARS, SORS, Bank of Slovenia calculations

Advertised prices of residential real estate

The gap by which advertised prices exceed transaction prices has narrowed, reflecting the lower expectations of sellers and the urgency to sell on the part of certain market participants.

The gap by which advertised prices exceed transaction prices narrowed in 2011, meaning that the sellers of housing have adjusted somewhat to the lower demand. Although some sellers are inactive, the narrowing of the gap means diminishing opportunities for certain sellers to delay their sales until the desired prices are achieved. There is an increasing number of persons on the market who are both sellers and buyers looking to exchange housing units. Advertised prices fell most notably at the end of the third quarter of 2011, when the prices of one- and two-room flats were down 3.5% and 2.7% respectively, while the prices of studio flats and three-room flats were virtually unchanged.

Figure 1.3: Year-on-year growth in advertised housing prices (left) and the gap by which advertised prices exceed transaction prices per square metre (right) in Ljubljana in percentages

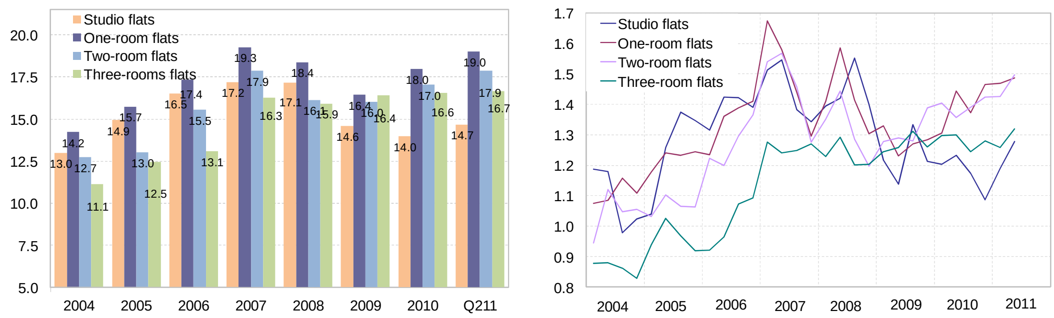


Sources: TARS, SMARS, SLONEP, Bank of Slovenia calculations

The overvaluing of housing with respect to the price to rent ratio was on the rise again in the first half of 2011 owing to rising housing prices.

The price to rent ratio (P/E) in Ljubljana deteriorated slightly during the first half of 2011 owing to a more significant rise in real estate prices than rents. The latter were down slightly for larger dwellings. From an investment point of view, owners received between 5.3% and 6.8% of the market value of real estate via rents. The ratio of actual to fundamental prices was up slightly on the end of 2010, which indicates the renewed overvaluing of housing. One- and two-room flats remain the most overvalued, and account for the majority of transactions completed.

Figure 1.4: Price to rent ratio (P/E; left) and the ratio of actual to fundamental housing prices for Ljubljana calculated on the basis of the P/E ratio (right)



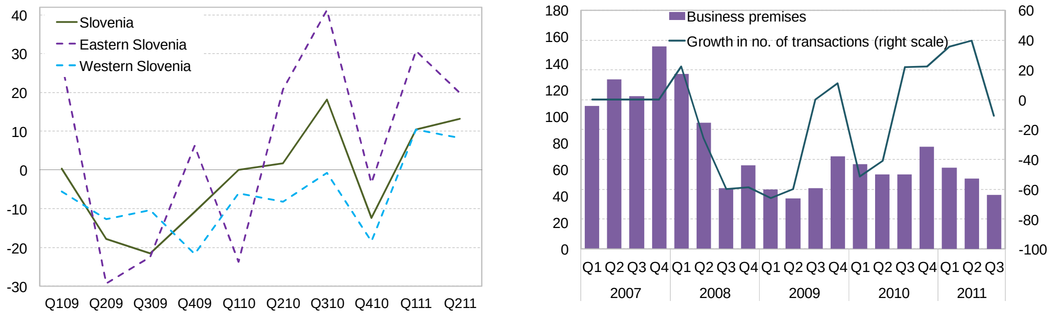
Sources: SLONEP, TARS, SMARS, Bank of Slovenia calculations

Commercial real estate prices

The number of commercial real estate transactions over the first three quarters of this year was just two thirds of the average number of transactions in the last four years. For that reason, the interpretation of the movement in commercial real estate prices is made even more difficult. Transaction prices for office space were up 13% during the first half of 2011, while advertised prices for the Ljubljana area were unchanged. In line with the increased number of corporate bankruptcies, and problems with liquidity and free capacities, no increase in the value of fixed assets and investment property can be expected in the short term.

Commercial real estate prices have risen. The location and specifics of a sale have a significant impact on the movement in average prices owing to the low number of transactions.

Figure 1.5: Growth in prices (left) and number of transactions (right) in business premises – offices taken into account in the calculation of average price and growth in percentages



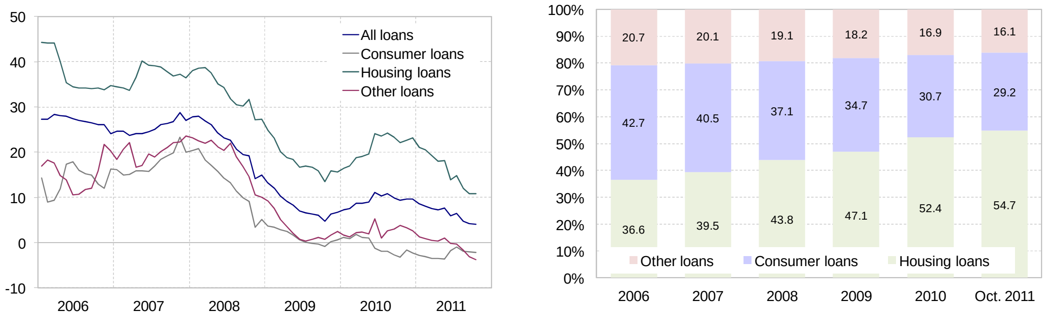
Source: SMARS

Supply and demand factors of real estate prices

Housing loans exceeded half of all loans to households already at the beginning of 2010, and accounted for 55% in October 2011. The value of newly approved housing loans to households amounted to EUR 697 million over the first three quarters of 2011, down one quarter on the same period the previous year and down on the average of the previous four years. Growth in housing loans is slowing primarily due to lower household demand, which derives from uncertainty on the labour market and low growth in disposable income.

Growth in housing loans has slowed to 10%, while primarily wealthier clients have borrowed.

Figure 1.6: Growth in loans to households (left) and structure of loans by type (right) in percentages

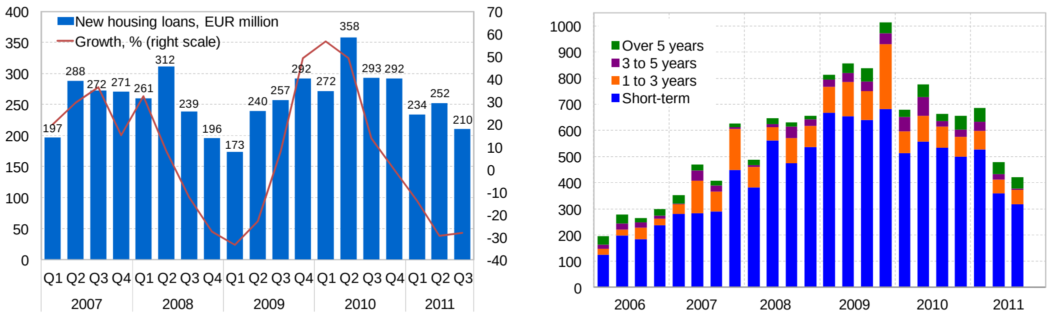


Source: Bank of Slovenia

The average maturity of newly approved loans rose by six months relative to 2010 to stand at 19.3 years. The majority of loans were approved in the domestic currency, while slightly less than 1% were approved in Swiss francs. Loans in Swiss francs accounted for one fifth of existing housing loans in October 2011. Some 95% of new loans were approved with a variable interest rate. Although the banks are aware of the lower demand, they do not compete amongst themselves to a greater extent via interest rates. Interest rates on housing loans remain slightly above the euro area average. The banks under majority foreign ownership had lower interest rates on average than the domestic banks. Growth in housing loans slowed to 10% in October 2011.

According to survey figures, the trend of rising average income of individuals to whom housing loans were approved was positive in 2010. The banks were inclined to approve loans to clients from the highest income bracket, and in that way mitigated credit risk. In contrast, the savings banks approved housing loans to clients with the lowest average net income. On average, individuals from the lowest and middle income brackets raised loans of lower values than borrowers from the highest income bracket. The average LTV ratio (the ratio of the stock of approved housing loans to the average value of all collateral) stood at 48% in October 2011. Four fifths of secured housing loans are secured by a mortgage on residential real estate, while the banks under majority foreign ownership frequently require additional forms of collateral. The value of housing pledged as collateral is 1.7 times higher than the value of existing housing loans. Half of existing housing loans are secured by residential real estate, which has priority according to the expected order of redemption. The value of household real estate is 1.1 times higher than the total value of existing housing loans. The banks are not planning to further tighten lending conditions for the approval of housing loans.

Figure 1.7: Newly approved housing loans to households (left) and newly approved loans to the construction sector (right) in EUR million

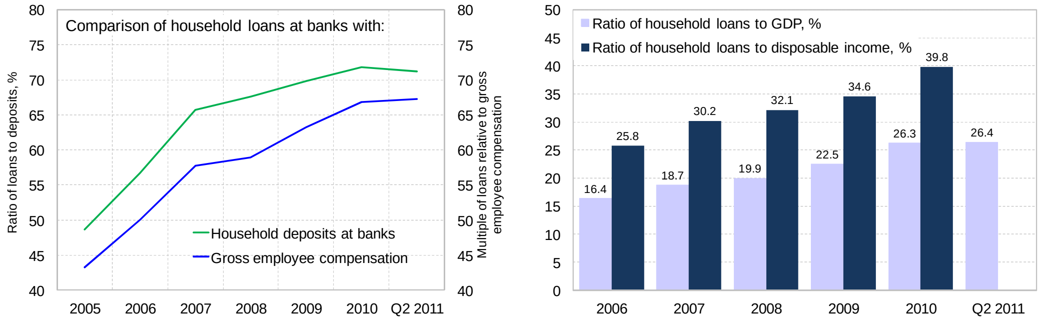


Source: Bank of Slovenia

Indicators of household indebtedness are gradually easing. Slovenian households are considerably less indebted than the euro area counterparts.

The deterioration in household indebtedness indicators continues at a significantly lower rate than in previous years. The loan repayment burden on the gross wages of households was unchanged in the first half of 2011. The proportion of disposable household income accounted for by loans rose by 5 percentage points in 2010 to 39.8%, the largest jump since the outbreak of the crisis. A higher proportion can also be expected in 2011, but more owing to the expected fall in disposable income than due to an increase in lending to households. At 26.4% of GDP, Slovenian households remain considerably less indebted than their counterparts from the euro area, where indebtedness is 65.4% of GDP.

Figure 1.8: Indicators of household indebtedness at banks



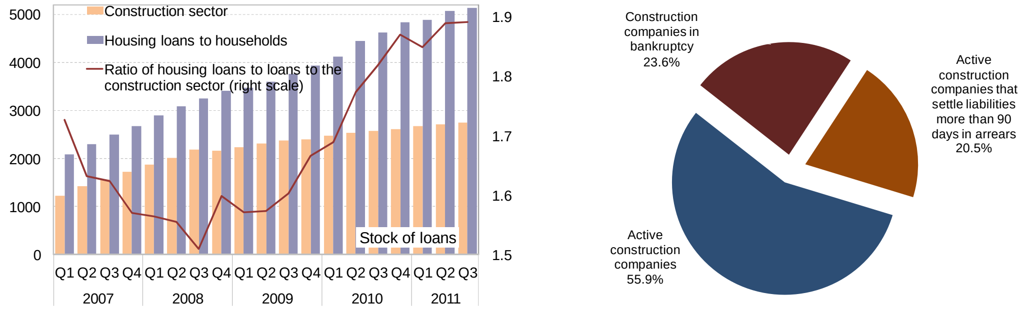
Source: Bank of Slovenia

Newly approved loans to the construction sector were down one quarter over the first three quarters of 2011 compared with the same period last year, both short-term and long-term loans having declined. Year-on-year growth of 6.6% in the stock in September 2011 was the result of the rescheduling of loans.

The liquidity problems of construction companies persist owing to excessively slow restructuring.

The value of the banking system's classified claims against the construction sector stood at EUR 3.7 million in September 2011, accounting for 14% of the banks' total classified claims against non-financial corporations. More than two thirds of those claims were in the balance sheets of the large domestic banks, while the banks under majority foreign ownership accounted for slightly less than one quarter. Classified claims against construction companies in bankruptcy accounted for 23% of all classified claims against this client segment. A further 27% of classified claims against active construction companies are paid more than 90 days in arrears, the large domestic banks accounting for the majority. The gradual restructuring of construction companies' balance sheets is causing liquidity problems, while any deviation from the solution will affect real estate prices.

Figure 1.9: Stock of loans to the construction sector and the stock of housing loans to households in EUR million and the ratio of the two (left), and the banking system's classified claims against the construction sector in percentages (right)



Sources: Bank of Slovenia, AJPES

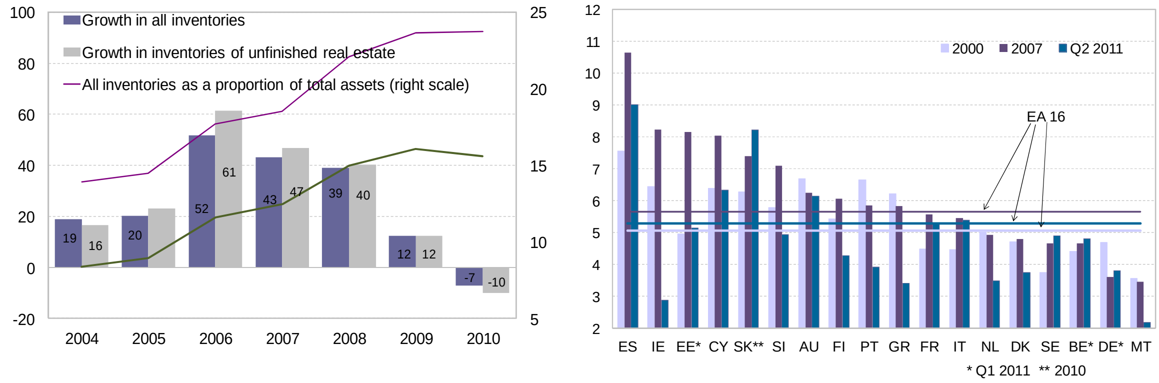
The number of bankruptcies of construction companies has risen over the last two years. According to balance sheet figures for 2009, companies that have entered bankruptcy in 2010 and 2011 accounted for 21% of the construction sector's total assets and 22% of its inventories of finished goods, work in progress and investment property.

Table 1.1 Balance sheets of construction companies and selected data regarding companies in bankruptcy

Construction sector	2007	2008	2009	2010	2007	2008	2009	2010
Total assets, EUR million	6,498	7,565	7,918	7,312				
Investment property, EUR million	227	320	432	478				
Inventories, EUR million	1,168	1,605	1,790	1,663				
inventories of finished and unfinished real estate as proportion of total inventories, %	85	84	88	89				
Equity, EUR million	1,229	1,381	1,493	1,319				
Leverage excluding companies in bankruptcy, %	405	423	381	405				
ROE, %	20.8	16.2	3.3	-15.0				
	Construction companies in bankruptcy							
No. of bankruptcies in last year (t+1)	3	18	45	125				
					Proportion of bankruptcies in sector, %			
Total assets, EUR million	10	41	501	832	0.2	0.5	6.3	11.4
Investment property, EUR million	-	1	10	55	-	0.2	2.4	11.6
Inventories, EUR million	0	5	151	208	0.0	0.3	8.4	12.5
inventories of finished and unfinished real estate as proportion of total inventories, %	95	73	98	80				

Sources: Bank of Slovenia, court records

Figure 1.10: Inventories in the balance sheets of construction companies (left) and value-added in the construction sector as a proportion of GDP (right) in percentages



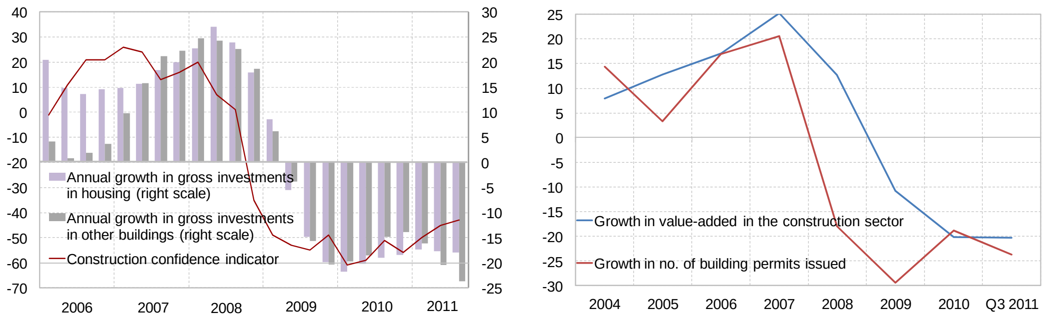
Sources: Bank of Slovenia, SORS

Construction activity contracted by more than one quarter over the first three quarters of 2011. Low supply of new housing will result in a rise in the prices of new dwellings in a few years.

Value-added in the construction sector fell to 4.9% of GDP in the first half of 2011, below the euro area average. In terms of the value of construction work performed, the volume of construction was down 27% over the first three quarters of this year compared with the same period in 2010, and down 32% in terms of house building work. According to short-term indicators, the trend of negative conditions will persist. The construction confidence indicator remains at its lowest level. The value of new contracts was down 32% over the first nine months of the year, and down 60% in house building. In the survey of business trends, half of construction companies continued to state a high level of competition and low demand as factors limiting operations, followed by high labour costs and difficulties raising loans.

A total of 2,925 building permits were issued over the first nine months of 2011, a decrease of 24% on the same period last year, which will be reflected negatively in the lower supply of new housing over the medium term.

Figure 1.11: Construction confidence indicator and annual growth in gross investment in buildings (left), and annual growth in value-added in the construction sector and the number of building permits issued (right) in percentages



Sources: SORS, Bank of Slovenia calculations

2. CAPITAL MARKETS AND COLLECTIVE INVESTMENT UNDERTAKINGS

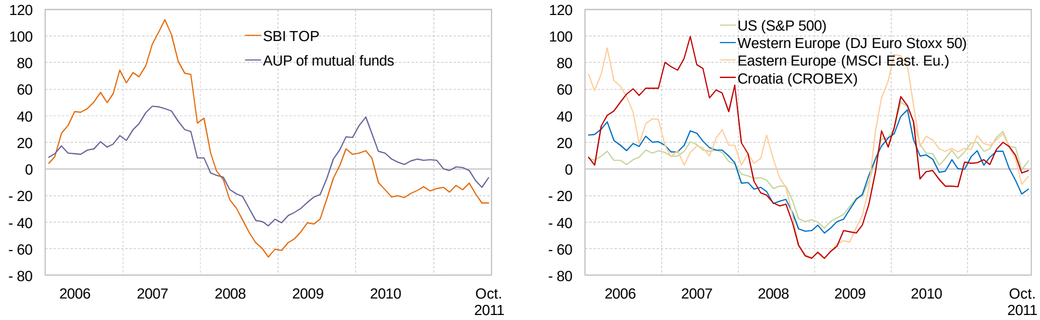
All global stock indices fell owing to the European debt crisis and the weak economic recovery.

The European debt crisis and the slow pace of economic recovery resulted in a renewed drop in global stock indices in early 2011. The European capital markets came under growing pressure this year from the excessive debt of certain European countries, in particular Greece, Portugal and Ireland, which were joined by Italy during the second half of the year as the second most indebted euro area country. Eastern and Western European indices ended October with negative year-on-year growth. Stock indices from the Balkan region continued to record the highest growth until the middle of the year. With the exception of a fall in March in the wake of the earthquake, tsunami and nuclear disaster, the Japanese Nikkei index also persisted at a relatively high level, and began to rise after the first half of the year. Nearly all major stock indices yielded in September under pressure from the unsuccessful resolution of the European debt crisis and the constant activities of ratings agencies. The pessimistic mood linked to the difficulties of periphery countries of the EMU also passed through to the US. Year-on-year growth in the US S&P 500 was zero in September 2011. The lack of confidence and uncertainty regarding the effectiveness of future measures to prevent the spread of the European debt crisis will be present on the market for some time to come.

The Slovenian SBI TOP index also declined. It reached its lowest value ever in autumn 2011.

In Slovenia, relatively good half-yearly corporate operating results have failed to bolster investors' confidence. The downgrading of Slovenia by the three largest international ratings agencies followed. The domestic stock index reached its lowest value ever in autumn 2011. The value of the Slovenian SBI TOP index stood at 643 points at the end of October, down 25.7% in year-on-year terms.

Figure 2.1: Annual growth in domestic (left) and foreign (right) stock indices in percentages



Source: LJSE, Bloomberg

In just over three quarters in 2011, a total of EUR 418 million in transactions were concluded on the Ljubljana Stock Exchange, down three quarters on the same period in 2007.

A decline in the number of securities issued on the Ljubljana Stock Exchange had a negative impact on its liquidity. The number of securities issues fell from 165 to 145 between October 2010 and October 2011. The number of issues on the bond market, in particular, was down, with nine fewer bonds issued over the first ten months of 2011 compared with a year earlier. Also down was the number of shares of investment companies owing to their legally prescribed transformation to mutual funds. The transformation of investments funds was completed already in August 2011, prior to the prescribed deadline. The last investment company to be transformed was NFD 1.

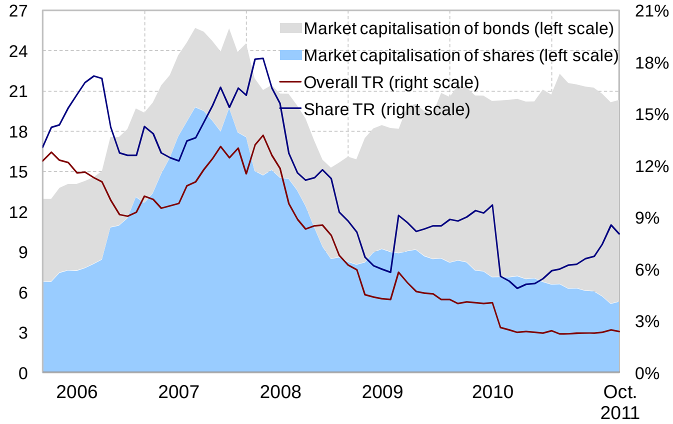
The market capitalisation of shares on the Ljubljana Stock Exchange declined over the first ten months of 2011, while the volume of trading was up 22%.

The market capitalisation of shares on the Ljubljana Stock Exchange declined gradually in 2011, to stand at EUR 5,277 million in October. Corporate shares account for 89% of market capitalisation, followed by the shares of insurance corporations at 6% and banks shares at 5%. In contrast to market capitalisation, which declined on account of the falling value of shares, the volume of trading in shares was up relative to the same period last year. The volume of trading totalled EUR 350.8 million over the first ten months of 2011, up 22% on the same period a year earlier. Investors were considerably more inclined to trading in prime market shares, while trading in standard market shares was down by one half compared with the same period in 2010. Because market capitalisation declined gradually in 2011 and the volume of trading in shares was up, the turnover ratio (TR) rose until autumn. Four shares were delisted between October 2010 and October 2011, while only one share was delisted from the regulated market owing to bankruptcy. At the same time, two new shares were listed for trading, those of Alta Group and Unior.

The market capitalisation of bonds was up, while the volume of trading was down by one half.

The market capitalisation of bonds rose to EUR 15,048 million over the first ten months of the year, an increase of 14% on the same period a year earlier, in part due to nine new bond issues. Two of the newly issued bonds were government bonds, two were bank bonds, while four were bonds of non-financial corporations. Only one bond was delisted from trading on the Ljubljana Stock Exchange, owing to the bankruptcy of the issuing company. Government bonds still account for the majority of market capitalisation at 92%. The volume of trading in bonds was down, despite the significant number of new bond issues. The volume of trading totalled EUR 50.9 million over the first ten months of 2011, down one half on the same period in 2010.

Figure 2.2: Market capitalisation on the Ljubljana Stock Exchange in EUR billion and annual turnover ratios (TR)



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

Investments in gold have risen.

During periods of rapid and sharp falls in share prices, investments in safer forms such as gold have risen. The value of gold reached a record high in the middle of 2011. As a result, there was a sharp increase in investments in "gold ETFs", which further drove up the price of gold. Gold is typically quoted in US dollars on global markets, and is primarily purchased by investors outside the US. Because investors perceive gold as a safe investment, the price of gold will likely be up at the end of 2011. This would be the eleventh consecutive year that the price of gold has risen and the longest bull run since the 1920s.

Table 2.1 Overview of Slovenia's regulated market

	2006	2007	2008	2009	2010	Oct. 2011
			Shares			
Market capitalisation						
amount, EUR billion	11.5	19.7	8.5	8.5	7.0	5.3
as % of GDP	38.7	58.7	22.8	24.2	19.5	14.7
annual growth, %	72.0	71.5	-57.1	-0.1	-16.9	-26.6
non-residents' proportion, %	4.8	5.9	7.1	7.2	10.0	12.6
Volume						
amount, EUR million	1,451.3	3,034.8	952.6	719.8	360.8	350.8
as % of GDP	4.9	9.0	2.6	2.1	1.0	1.0
annual growth, %	54.3	109.1	-68.6	-24.4	-49.9	22.3
Annual change in SBI TOP, %	56.6	71.0	-66.1	15.0	-13.5	-25.7
Dividend yield (prime market), %	1.2	1.0	3.9	2.1	2.1	3.2
			Bonds			
Market capitalisation						
amount EUR, billion	6.6	5.9	6.8	10.8	13.2	15.0
as % of GDP	22.3	17.6	18.3	30.9	36.8	42.0
annual growth, %	9.6	-10.5	14.5	59.2	21.9	13.8
Volume						
amount, EUR million	188.1	165.9	257.0	156.3	108.9	50.9
as % of GDP	0.6	0.5	0.7	0.4	0.3	0.1
annual growth, %	-74.9	-11.8	54.9	-39.2	-30.3	-50.3

Note: Excludes listed investment companies and mutual funds.
Source: LJSE, SORS

Investment links with the rest of the world

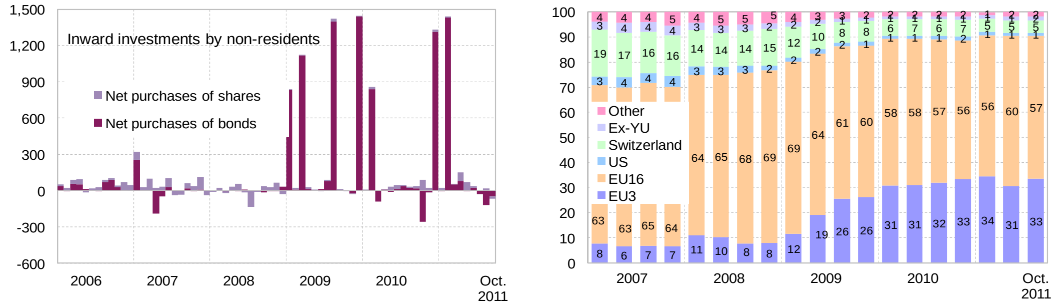
Over the first ten months of the year, non-residents made net purchases of EUR 2,700 million in Slovenian debt securities. Despite a net outflow in the third quarter, non-residents' net purchases of Slovenian bonds were up 18% on the same period last year. The majority of those purchases were of RS69 and RS70 government bonds in January and March 2011 respectively. Nearly all net purchases were made by residents of the UK and Luxembourg.

Net purchases of Slovenian bonds were up 18% in October 2011 relative to October 2010, while purchases of Slovenian shares were up one half.

Net purchases of Slovenian equities were also up on last October. Net purchases totalled EUR 218 million over the first ten months of 2011, an increase of more than one half on the same period a year earlier. The majority of net purchases were made by residents of Croatia, Poland and Austria, who primarily purchased shares in Krka and NKBM in the amount of EUR 108 million. The majority of trading in June 2011 (EUR 50 million) was carried out by Austrian investors, owing to the increase in the share capital of Unicredit bank.

The proportion of market capitalisation of shares on the Ljubljana Stock Exchange accounted for by non-residents has risen steadily since the end of 2010, to stand at 12.6% in October of this year.

Figure 2.3: Non-residents' monthly net investments in Slovenia in EUR million (left) and regional breakdown in percentages (right)

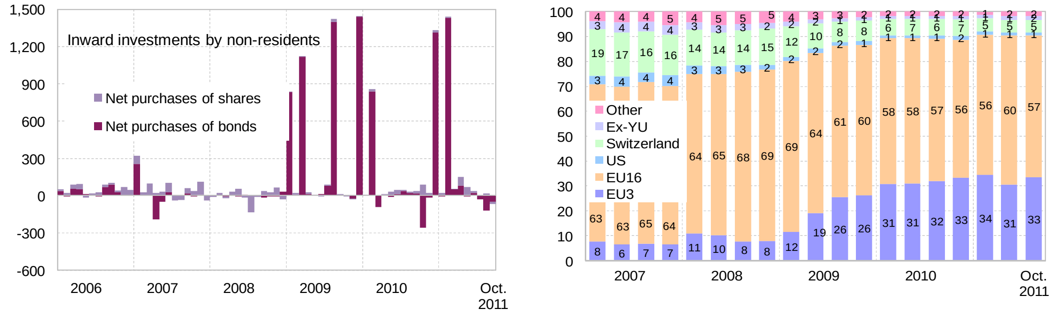


Note: The RS63 government bond issued on the MTS Slovenia system is not included among net purchases made by non-residents in 2008.
Includes investments in listed shares and bonds, and in those not listed on the exchange.
EU3: UK, Denmark and Sweden; EU16: euro area; Ex-YU: former Yugoslav republics.
Sources: CSCC, Bank of Slovenia, own calculations

Residents made net purchases of foreign shares and bonds in the first quarter of 2011, but primarily made requests for net repayments in the second and third quarters. Residents made net sales of EUR 62.2 million in foreign bonds and net purchases of EUR 59.3 million in foreign shares over the first ten months of the year. The sector of insurance corporations and pension funds made the largest net purchases of foreign shares, primarily in euro area shares in the amount of EUR 131.8 million. Insurance corporations also made the largest net purchases of debt securities, in the amount of EUR 176.5 million. The largest net sales of foreign equities were made by the sector of other financial intermediaries excluding insurance corporations and pension funds, in the amount of EUR 40.6 million. The banks primarily sold debt securities from the euro area and North America. Their net sales of debt securities totalled EUR 228.4 million over the first ten months of 2011.

Residents made net sales of EUR 62.2 million in foreign bonds and net purchases of EUR 59.3 million in foreign shares over the first ten months of 2011.

Figure 2.4: Residents' monthly net investments in the rest of the world in EUR million (left) and the regional breakdown of investments by residents in foreign securities, separately for bonds and shares in percentages (right)



Note: EU3: UK, Denmark and Sweden; EU16: euro area; BRIC: Brazil, Russia, India and China; Ex-YU: former Yugoslav republics.
Source: Bank of Slovenia

The stock of residents' investments in foreign securities stood at EUR 8,184 million in October, down 5.7% on October 2010. Debt securities still account for the highest proportion of the total at 62%, while demand for debt securities is highest in the banking sector and in the sector of insurance corporations and pension funds.

The regional breakdown of Slovenian residents' investments in euro area shares and bonds has changed slightly. Residents are gradually reducing their investments in euro area bonds, while increasing their investments in euro area shares. The confidence of Slovenian residents in US shares was bolstered in 2011.

Collective investment undertakings

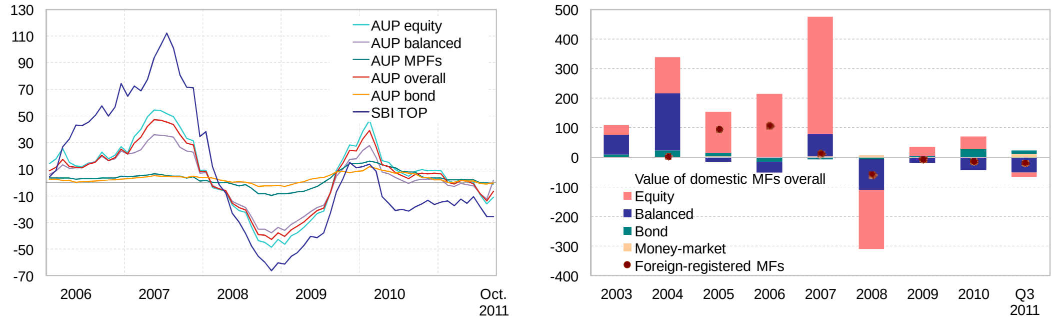
Mutual fund assets were down 5.1% in October 2011 relative to the same period a year earlier.

Mutual fund assets were up at the beginning of 2011 owing to net inflows and a higher average unit price, but have declined since May on account of relatively high outflows. Mutual fund assets totalled EUR 1,879 million at the end of October, down 5.1% on the same period last year.

Mutual fund investors have begun to move towards safer investments. Investors demanded net payments of EUR 60 million and EUR 20 million from balanced and equity funds respectively over the first ten months of 2011, and made net payments of EUR 17 million and EUR 11 million to bond and money-market funds respectively.

Increased optimism was present in mutual funds over the first four months of this year, as investors' net inflows exceeded their net outflows. The opposite was true in the months that followed, when investors' net outflows totalled EUR 72 million from May until the end of October. The reason for such high outflows lies in investors' lack of confidence in the stock market and constantly falling stock indices. Thus, the majority investors' outflows after April 2011 were from equity funds. Because the majority of mutual funds lean heavily towards investments in foreign securities, the return on such funds is dependent on foreign stock markets. The trend of inflows and outflows therefore follows the returns achieved on foreign stock indices. Investors have begun to move towards more stable and safer investments. An increasing number of payments are being made from equity and balanced funds, while investors have begun to invest in bond and money-market funds. Investors demanded net payment of EUR 60 million from balanced funds over the first ten months of 2011 and EUR 20 million from equity funds. Net payments of EUR 17 million and EUR 11 million were made into bond and money-market funds respectively over the same period. Increased aversion to risk was quite obvious in August, when investors invested EUR 6 million in money-market funds, or more than half of all inflows into money-market funds over the first ten months of 2011. This mass migration of investors to safer and more liquid investments was the result of the downgrading of the US and the escalation of the European debt crisis.

Figure 2.5: Annual change in the average unit price of mutual funds and the SBI TOP in percentages (left) and net cash flows into mutual funds in EUR million (right)



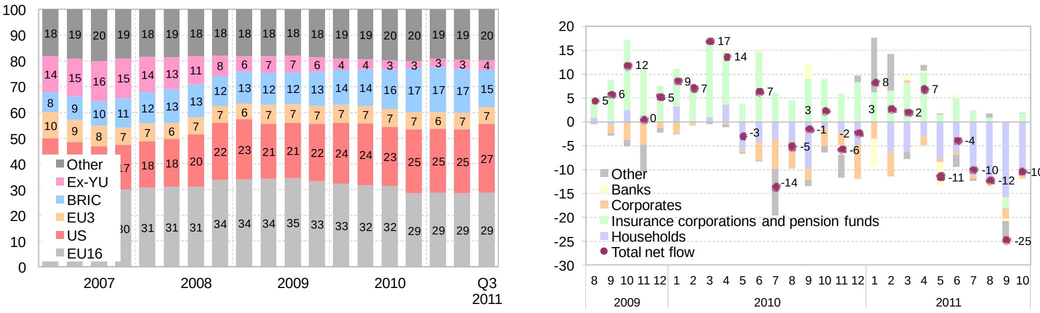
Sources: SMA, LJSE, Bank of Slovenia

The average unit price of mutual funds rose gradually throughout the year, and ended October 2011 up 2% in year-on-year terms.

A similar trend was seen in the annual growth in the average unit price. Year-on-year growth in the average unit price of balanced and equity funds has turned increasingly negative since spring 2011. The opposite is true of the average unit price of mutual funds, which has risen throughout the year and was up more than 2% at the end of October 2011 compared with last October. The average unit price of bond funds began 2011 with positive year-on-year growth, but ended October down 0.2% in year-on-year terms. Unit values also indicate a shift from higher-risk to lower-risk investments, in particular to safer investments in money-market funds. The annual change in the average unit price of mutual funds stood at -6.5% at the end of October 2011.

Despite net outflows from domestic equity and balanced funds in summer and autumn 2011, more than half of the net payments over the first three quarters of this year were from mutual funds created with the transformation of investment companies.

Figure 2.6: Regional breakdown of investments in mutual funds in percentages (left) and net cash flows into mutual funds in EUR million (right)



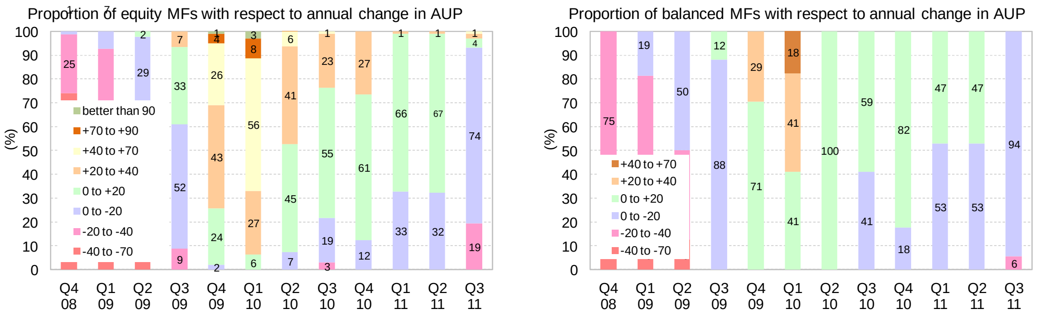
Note: BRIC: Brazil, Russia, India and China.
EU3: UK, Denmark and Sweden
EU16: euro area; Ex-YU: former Yugoslav republics

Sources: SMA, Bank of Slovenia

Net payments demanded by households were nearly four times higher over the first ten months of 2011 compared with the same period in 2010, while the sector of insurance corporations and pension funds halved its net inflows.

The corporate sector's demand for payments from mutual funds over the first ten months of 2011 was down slightly on the same period last year. The household sector's response to the uncertain conditions and falling values was significantly more evident: at EUR 80 million, their demand for net payments was nearly four times higher than in the same period in 2010. A lack of confidence was also demonstrated by the sector of insurance corporations and pension funds, which reduced the net inflows into mutual funds by nearly one half. Insurance corporations and pension funds demanded net payments in September 2011, the first time in three years that this has happened. Having received payments of EUR 10 million from mutual funds over the first ten months of 2011, the banks also demanded significant net payments.

Figure 2.7: Relative distribution of domestic equity funds (left) and domestic balanced funds (right) in terms of annual change in average unit price



Sources: SMA, own calculations

Table 2.2: Proportion of total assets accounted for by the liquid assets of mutual funds in percentages

(%)	Bond	Balanced	Equity	Money-market	Overall
Sep. 09	37.1	16.6	8.1	99.4	12.4
Dec. 09	36.2	15.3	7.4	99.3	11.4
Mar. 10	30.5	14.0	7.0	99.4	10.6
Jun. 10	27.6	12.8	6.4	99.1	9.9
Sep. 10	29.1	13.8	6.9	99.1	10.7
Dec. 10	27.3	11.8	5.6	99.0	8.9
Mar. 11	25.8	10.9	4.6	99.6	8.1
Jun. 11	23.5	13.0	5.5	99.5	9.4
Sep. 11	20.3	12.8	5.5	99.5	9.5

Source: SMA, own calculations

3. RESULTS OF THE SURVEY ON DEMAND FOR LOANS BY NON-FINANCIAL CORPORATIONS

SUMMARY

Demand for loans from non-financial corporations was down significantly in 2010, but that decrease was outpaced by the even bigger decline in the number of newly approved loans. Excess demand from non-financial corporations at the banks was up sharply in 2010 and amounted to 29% of all requested loans. That trend continued to a somewhat lesser extent during the first half of 2011.

A positive shift has been seen in the structure of loan demand, with rising demand for loans for investments and falling demand for loans to finance current operations. There has been a sharp increase in demand for loans for restructuring, which is a reflection of the problems of corporates with a high level of debt and significant arrears in the settlement of liabilities to the banks.

The highest rates of excess demand are seen in the sectors that contribute relatively little to the structure of value-added: electricity, gas and water supply sector, and remediation and public services[24]. In contrast is the manufacturing sector, which achieved the highest economic growth in 2010 and 2011 in the context of the lowest rate of excess demand, while reducing overall demand and the number of newly approved loans in absolute terms.

Among the factors affecting the high rate of excess demand for bank loans are the high standards of banks which, with the tightening of conditions since 2009, refuse to lend to non-financial corporations due to their low credit ratings, unpromising projects or inappropriate collateral. On the other hand, there are factors deriving from corporates, which reject the banks' counter offers as too demanding. The proportion of such factors is relatively high in this year's survey. This is a warning sign indicating that good clients can choose and channel demand for loans elsewhere. According to figures regarding financing from the rest of the world, the latter has already reached the pre-crisis level.

All findings and comparisons with previous years in this report are based on this year's survey on demand for loans, which should ensure the comparability of data at the individual bank level. Here it should be noted that the data regarding demand for loans is slightly overestimated whenever a company turns to several banks for a loan, as the loan is only approved by one bank, or not at all. The duplication of data is possible in all years captured in the survey. However, demand for loans and thus the rejection of loans is higher during a period of tightened credit standards than in normal conditions.

Excess demand

The banks responded to survey questions regarding the volume of demand for loans and newly approved loans to non-financial corporations by individual economic sector[25]. The aim of the survey was to determine the extent of excess demand in this client segment, and to get a clearer picture on the causes for the stagnation in corporate lending on the basis of the banks' responses regarding the reasons for the rejection of loan requests.

Banks reported demand for loans for restructuring separately in this year's survey. However, these data are of a lesser quality and the associated conclusions are therefore less sound.

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[24] The survey only captures that (minor) portion of public services provided by non-financial corporations.

[25] The results of this year's survey on excess demand are deemed to be of higher quality than the results from last year's survey. Certain banks have submitted higher-quality data for 2009, while five banks reported that they did not establish records on loan demand until 2010. The analysis includes 22 banks and savings banks. Aggregates that include all 22 banks and savings banks are given in comparisons of 2010 and 2011, while comparisons with 2009 relate to a smaller sample of 17 banks (excluding the five banks that did not report excess demand for 2009).

The rate of excess demand [26] fluctuated across a wide range in 2010 by individual bank, from 0.4% to 79%. The figure was below 5% at three banks and two savings banks, ranged from 10% to 20% at eight banks, and from 30% to 80% at nine banks. The rate of excess demand rose at the majority of banks (12 of 17) in 2010, while the banking system average rose by 10 percentage points to 28.8%, and slightly higher to 29.1%, taking into account the full sample of banks with the appropriate reporting in 2010. The rise in the rate of excess demand continued at a slower pace during the first half of 2011, to 33.6%. The number of banks at which the rate of excess demand rose in 2011 increased to 18 (out of 22).

Non-financial corporations' total demand for loans and newly approved loans

Total demand for loans reached EUR 18.4 billion in 2010. The banks for which demand may be compared with 2009 reported demand of EUR 16 billion, a decrease of 11% compared with 2009.

Table 3.1 Non-financial corporations' demand, excess demand, and rate of excess demand for loans

	2009	2010	Jan-Jun 2011	2010	Jan-Jun 2011
	Excluding five banks			All banks	
Demand for loans, EUR million	18,071	16,026	6,390	18,342	7,425
Excess demand, EUR million	3,403	4,616	2,144	5,332	2,496
Rate of excess demand, %	18.8	28.8	33.6	29.1	33.6

Source: Bank of Slovenia survey

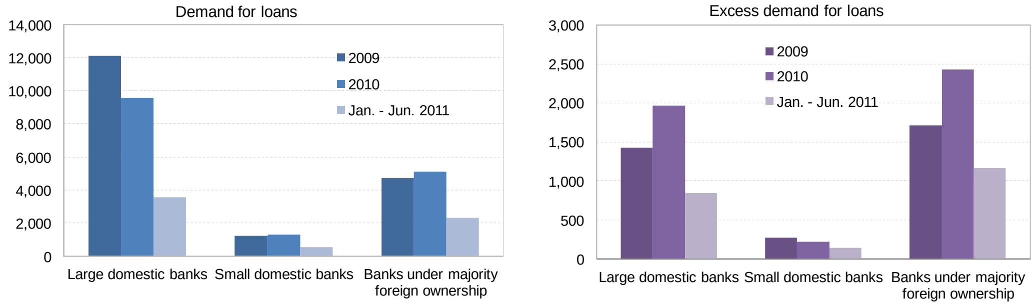
The volume of newly approved loans fell more sharply (by 22%) than demand for loans in 2010. As a result, the volume of excess demand rose by 36% or EUR 1,213 million.

Demand and loan approval by bank group

Non-financial corporations' demand for loans declined in 2010 at the large domestic banks only. The decline was so extensive, however, that it was reflected in the aggregate of the entire banking system. Demand for loans was down 21% at the large domestic banks compared with 2009, to stand at EUR 9.6 billion.

The volume of excess demand rose to slightly less than EUR 2 billion, while the rate of excess demand rose to 22.6%, despite the sharply lower demand for loans at the large domestic banks owing to a more significant drop (of 28.8%) in newly approved loans.

Figure 3.1: Demand and excess demand for loans by bank group in EUR million



Source: Bank of Slovenia survey

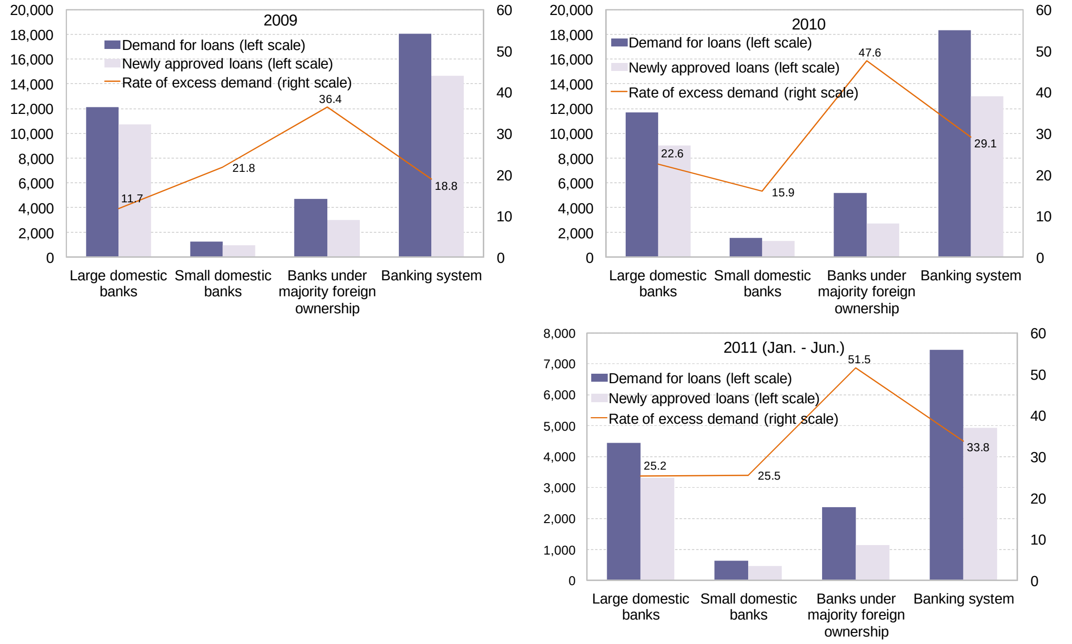
Corporates channelled a portion of their demand for loans to the small domestic banks and the banks under majority foreign ownership. The small domestic banks reported growth in demand for loans of 6.1% relative to the previous year, to which they responded with higher growth (of 12.8%) in newly approved loans. The rate of excess demand thus fell to 16.8% in 2010 at the small domestic banks, and to 15.9% for the banks overall. The rate of excess demand rose again during the first half of 2011 at this bank group, which recorded the largest increase of all bank groups.

Non-financial corporations' demand for loans was up 9% on the previous year in 2010 at the banks under majority foreign ownership. Despite the most significant increase in

[26] Excess demand is defined as the difference between the volume of demand and the volume of newly approved loans. The rate of excess demand = (the volume of demand – the volume of newly approved loans) / the volume of demand * 100.

demand in relative terms, these banks reduced their volume of newly approved loans by 10%, and thus increased their rate of excess demand to 47.6%.

Figure 3.2: Newly approved loans and demand for loans in EUR million and rate of excess demand in percentages by bank group



Source: Bank of Slovenia survey

Demand for loans and loan approval by sector

The non-financial corporations from eight sectors reduced their demand for loans by a total of EUR 2,881 million in 2010, while non-financial corporations from four sectors increased their demand for loans by a total of EUR 836 million. The total demand of non-financial corporations was down 11.3% in year-on-year terms in 2010, while demand for loans contracted most in the following sectors (in relative terms):

- real estate activities (- 41%),
- information and communication activities (- 35.9%),
- accommodation and food service activities (- 31.6%), and
- manufacturing (- 27.6%).

The aforementioned sectors also stand out in terms of the decline in newly approved loans (in similar percentages to demand). For this reason, the rate of excess demand is virtually unchanged in these sectors.

At 15.7%, the rate of excess demand in the manufacturing sector was one of the lowest in 2010. We can therefore assume that the banks' support of corporates from this sector via loans was relatively better. Worrisome, however, in this regard is that both demand and newly approved loans to the manufacturing sector were down sharply in 2010, as higher demand for loans from these corporates should be expected given the relatively higher growth in economic activity (of 7.4%) in this sector.

In contrast to the manufacturing sector, demand for loans was up sharply in the following sectors, where positive economic growth was recorded in 2010:

- public services (+ 51.8%; 2.2% growth in value-added),
- electricity, gas and water supply, and remediation (+ 35.8%; 2.7% growth in value-added),
- financial intermediation (+ 23.7%; 5% growth in value-added), and
- professional, scientific and technical activities (+ 1.7%; 4.9% growth in value-added).

Figure 3.3: Demand for loans, newly approved loans and excess demand for loans by sector in 2010 in EUR million

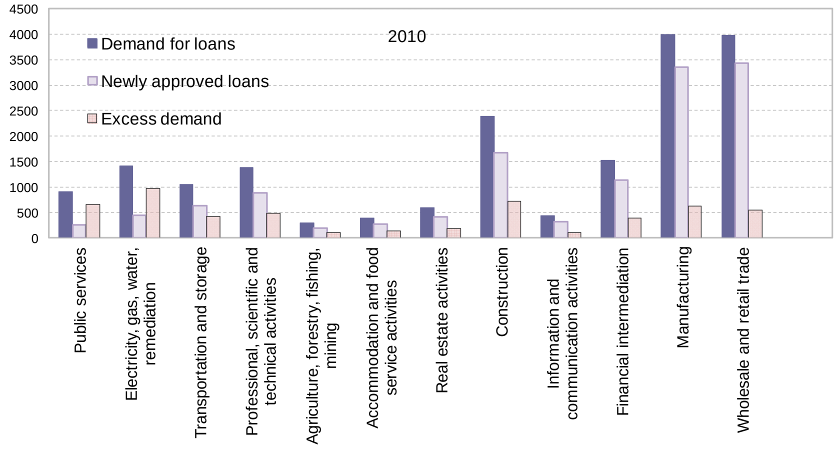
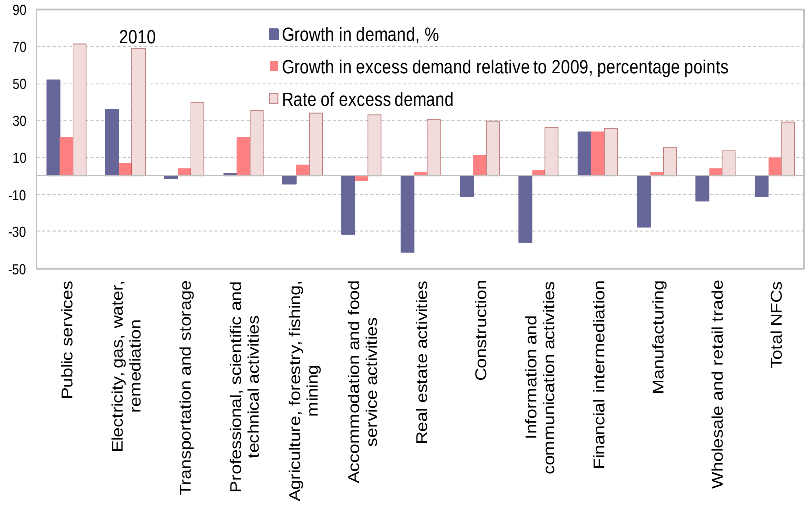


Figure 3.4: Growth in demand, excess demand and the rate of excess demand in 2010 in percentages



Rate of excess demand by sector, %	
Public services	71.5
Electricity, gas, w ater, remediation	68.8
Transportation and storage	39.8
Professional, scientific and technical activities	35.6
Agriculture, forestry, fishing, mining	34.1
Accommodation and food service activities	33.1
Real estate activities	30.6
Construction	29.8
Information and communication activities	26.2
Financial intermediation	25.7
Manufacturing	15.7
Wholesale and retail trade	13.6
Total non-financial corporations	29.1

Note: For both figures on this page, sectors are classified by rate of excess demand, from highest to the lowest.
Source: For both figures on this page, Bank of Slovenia survey

The banks did not respond to such high demand, which caused the rate of excess demand in these sectors to rise sharply, with growth exceeding 20 percentage points by individual sector. The first two sectors deviate significantly from the average rate of excess demand of non-financial corporations: the rate of excess demand in the sector of public services is 71.5%, while that of the sector of electricity, gas and water supply, and remediation is 68.8%. A higher rate of excess demand was also seen in the sectors of transportation and storage (39.8%), while the lowest rates were recorded in the sector of wholesale and retail trade (13.6%) and, as previously mentioned, in the manufacturing sector (15.7%).

The construction sector did not deviate significantly from the average of non-financial corporations in 2010, both in terms of the year-on-year decline in demand for loans and the decline in newly approved loans. At 29.8%, the rate of excess demand in the construction sector was likewise slightly above the average of non-financial corporations[27].

The trend of a rising rate of excess demand continued in the **first half of 2011**, but at a slower pace than in 2010. The rate of excess demand has risen to 33.6%. The largest increases in the rate of excess demand were recorded in the sector of real estate activities (by 16.5 percentage points to 47%) and the manufacturing sector (by 11.2 percentage points to 26.9%), which stood out in 2010 with the lowest levels of excess demand, and the construction sector. Problematic is the higher rate of excess demand in the manufacturing sector, which is enjoying continued economic growth in 2011.

[27] At EUR 643 million, the construction sector ranked second behind the sector of electricity, gas and water supply, and remediation in 2010 in terms of the absolute volume of excess demand.

The rate of excess demand reached 40.8% in the construction sector during the first half of 2011. The rejection of loans requests from corporates from the sectors of construction and real estate activities is to be expected, given the high credit risk and the deteriorating economic situation in these sectors. In the sectors where economic recovery can be seen, in particular the manufacturing sector, the reasons for high excess demand lie with the banks, which persist with their strict credit standards, and with corporates, which reject the banks' high standards.

Demand for loans by loan type [28]

The decline in non-financial corporations' demand for loans varied by loan type in 2010. Primarily demand for loans to finance current operations was down, by 26.3%, while demand for loans for investments was up 29.6%. The higher demand for loans for investments coincides with the economic recovery in 2010, while lower corporate demand for loans to finance current operations can be explained by the efforts of corporates to streamline operations and lower their excessively high leverage, which becomes a major obstacle to raising bank loans during a period of financial contraction. In line with expectations, demand for loans for restructuring increased sharply, by 78.3%. This relates primarily to the segment of corporates with increasing difficulties in servicing their debt and an increase in longer arrears at the banks.

Table 3.2 Growth in demand by loan type in 2010 in percentages

	Banking system	Large domestic banks	Small domestic banks	Banks under majority foreign ownership
Total demand:	-11.3	-21.0	6.1	9.0
- for restructuring	78.3	95.5	16.0	66.9
- for investments	29.6	40.7	111.2	15.0
- for current operations	-26.3	-33.8	2.5	-7.9
- other	-6.8	-40.4	-48.4	68.4

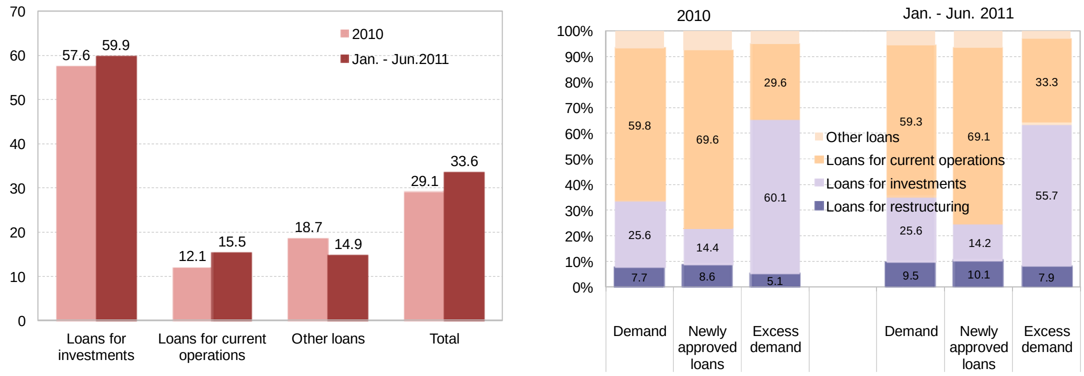
Source: Bank of Slovenia survey

Despite this shift, loans for financing current operations represent the highest proportion, at nearly 60% of total corporate demand for loans. The high proportion of such loans is the result of their typically short-term maturities, meaning that corporate demand for such loans is more frequent than for other types of loans (particularly in comparison with loans for investments), and that demand from the same corporates may be expressed at the banks several times over the course of one year.

The proportion of long-term loans for investments is relatively low at 26% in the breakdown of non-financial corporations' demand, while long-term loans are predominant in the structure of excess demand owing to the high rate of rejection of such loans. Loans for investments account for more than 60% of all rejected loans. The rate of excess demand for loans for investments stood at 57.5% in 2010, significantly higher than the rate for loans to finance current operations (12.1%) and for other loans (18.7%) .

[28] The rate of excess demand by loan type is assessed on the basis of responses regarding rejected loans. Those responses do not explain the reasons for the rejection of all loans. Thus, the aggregates calculated as such are not fully in line with overall aggregates.

Figure 3.5: Rate of excess demand by loan type in percentages

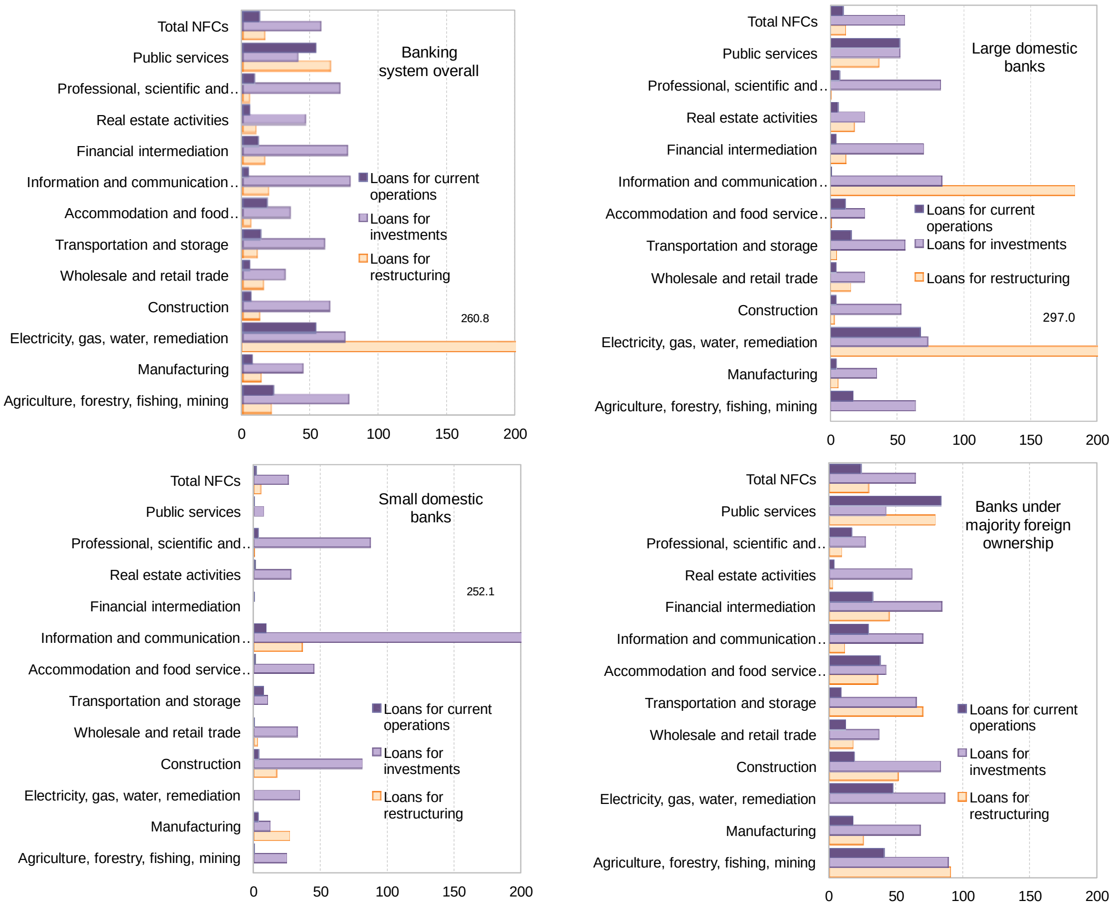


Source: Bank of Slovenia survey

The rate of excess demand for loans for investments fluctuates between 60% and 80% in the majority of sectors. The rate is lower in the manufacturing sector (44%), but corporate demand from this sector for loans for investments rose by just 2%. This leads to the conclusion that these corporates have sought support to stimulate economic activity elsewhere.

The construction sector is faced with a high rate of rejected loan requests for investments (64.4% on average) and a low rate of loan rejection for loans to finance current operations (6%). By supporting the construction sector via short-term loans, the banks continue to finance this sector, which is not the ultimate solution. The large domestic banks, in particular, stand out because they reject fewer loans to construction companies: the rate of excess demand for loans for investments is significantly lower for such corporates (at 53%) than at the other bank groups where it exceeds 80%. The rate of excess demand for loans for investments is lower than the average rate of excess demand at the large domestic banks for non-financial corporations overall.

Figure 3.6: Structure of demand, newly approved loans and excess demand*



* Demand and excess demand are underestimated for loans for restructuring.
Source: Bank of Slovenia survey

The rates of excess demand are, with minor exceptions, highest at the banks under majority foreign ownership, both with respect to a company's sector and type of loan.

Reasons given by the banks for the rejection of loans

The most frequently stated reason by the banks for the rejection of loans was the client's disagreement with loan terms (40.8%), followed a client's low credit rating (26.8%). Among the bank groups, the latter was the most frequent reason for rejection at the small domestic banks (45.8%) and at the banks under majority foreign ownership (49.2%), while client disagreement with loan terms was the most frequent reason at the large domestic banks (42.8%).

The most frequent reason at the banking system level for the rejection of loans for investments was client disagreement with loan terms (34%), although other reasons prevailed by individual group: the banks under majority domestic ownership rejected loans for investments most frequently owing to the unpromising nature of projects, while the banks under majority foreign ownership rejected loans most frequently owing to clients' low credit ratings. Client disagreement with loan terms was also the most frequent reason for the rejection of loans to finance current operations at the banks under majority foreign ownership and the large domestic banks, while low client credit ratings were the decisive factor at the small domestic banks. The latter was also the most frequent reason for the rejection of loans for restructuring and other loans at the banking system level.

Table 3.3 Breakdown of reasons for loan rejection by loan type and bank group in 2010 in percentages

	Loans for restructuring	Loans for investments	Loans for current operations	Other loans	Total loans
LARGE DOMESTIC BANKS					
insufficient collateral	13.3	12.3	5.7	20.6	10.3
unpromising project	2.0	31.6	1.8	6.2	20.3
low client credit rating	4.7	3.1	8.1	19.3	5.0
excessive exposure to client	4.8	2.5	11.6	12.4	5.6
client disagreement with terms	68.5	30.0	64.9	0.3	42.8
other	6.7	20.5	7.8	41.3	16.0
TOTAL	100.0	100.0	100.0	100.0	100.0
SMALL DOMESTIC BANKS					
insufficient collateral	0.0	8.0	13.2	7.4	8.8
unpromising project	0.0	48.2	7.9	17.8	33.4
low client credit rating	92.1	30.1	62.8	63.4	44.2
excessive exposure to client	0.0	8.0	2.1	11.4	6.5
client disagreement with terms	7.9	0.1	9.4	0.0	2.7
other	0.0	5.6	4.6	0.0	4.5
TOTAL	100.0	100.0	100.0	100.0	100.0
BANKS UNDER MAJORITY FOREIGN OWNERSHIP					
insufficient collateral	7.1	1.0	1.4	1.1	1.5
unpromising project	2.6	3.8	2.8	2.5	3.4
low client credit rating	71.4	47.8	38.1	76.3	49.2
excessive exposure to client	3.0	2.1	3.4	0.0	2.3
client disagreement with terms	15.9	40.1	53.4	18.8	40.3
other	0.0	5.2	1.0	1.2	3.4
TOTAL	100.0	100.0	100.0	100.0	100.0
TOTAL BANKS AND SAVINGS BANKS					
insufficient collateral	9.8	7.0	4.0	3.4	6.1
unpromising project	2.3	19.2	2.3	3.5	12.5
low client credit rating	40.8	24.2	21.9	69.8	26.8
excessive exposure to client	3.8	2.4	7.9	1.7	4.1
client disagreement with terms	40.2	34.0	59.1	16.1	40.8
other	3.1	13.1	4.8	5.4	9.8
TOTAL	100.0	100.0	100.0	100.0	100.0

Source: Bank of Slovenia survey

There are considerable differences in the reasons for loan rejection among the sectors observed. The most frequent reason in 2010 for non-financial corporations overall was client disagreement with loan terms (40%), which was particularly evident for smaller sectors: agriculture, forestry, fishing and mining, electricity, gas and water supply, and remediation, transportation and storage, financial intermediation and public services. On the other hand, a low client credit rating was the most frequent reason given in the manufacturing sector at 34.4% (second most frequent reason at the aggregate level), in the construction sector (32.6%), in the sector of information and communication activities (40.2%) and in the sector of real estate activities (46.4%). The two aforementioned factors are equal (at around 40%) in the sector of wholesale and retail trade. Only in one sector (professional, scientific and technical activities) was the most frequent reason (the unpromising nature of a project) different than the above stated reasons.

A change occurred in the breakdown of reasons for rejection in the first half of 2011, with a decrease in the proportion of client disagreement with loan terms (to 29.1%) in favour of a low client credit rating (increase to 33.6%) and other reasons. Excluding other reasons, which can vary significantly, the shift from client disagreement with loan terms to a low client credit rating was particularly notable in the sectors of construction, accommodation and food service activities, financial intermediation and real estate activities.

At the large domestic banks, the reasons given by companies from the majority of sectors for failure to conclude a loan agreement was client disagreement with loan terms, which accounts for more than 70% of rejected loans in certain sectors. The same reason was given in the construction sector for only 10% of rejected loans, as the low quality of these clients prevents them from dictating terms. The main reasons for the rejection of the majority of loans requests from construction companies were inappropriate collateral and the unpromising nature of projects. The latter is also the most frequently given reason in the sector of real estate activities. In the year-on-year comparison, a low client credit rating as a reason for loan rejection, the proportion of which rose in three quarters of all sectors, recorded the sharpest increase at the large domestic banks. The proportion of reasons for loan rejection accounted for by excessive exposure to a client was up sharply in the sector of real estate activities (by 47 percentage points).

Table 3.4: Breakdown of reasons for loan rejection by non-financial corporations' sector in 2010 in percentages

	Insufficient collateral	Unpromising project	Low client credit rating	Excessive exposure to client	Client disagreement with terms	Other	TOTAL
Agriculture, forestry, fishing, mining	3.0	0.1	31.9	0.0	53.7	11.3	100.0
Manufacturing	7.3	4.9	34.4	8.2	31.1	14.2	100.0
Electricity, gas, water, remediation	2.0	10.4	17.8	4.1	60.6	5.1	100.0
Construction	15.9	17.7	32.6	0.6	15.1	18.1	100.0
Wholesale and retail trade	4.2	2.9	39.7	3.0	40.3	10.0	100.0
Transportation and storage	0.5	0.1	10.1	0.0	82.9	6.4	100.0
Accommodation and food service activities	1.0	16.0	26.4	15.5	28.1	12.9	100.0
Information and communication activities	6.6	5.4	40.2	0.0	38.2	9.6	100.0
Financial intermediation	4.0	2.1	34.3	2.8	56.1	0.6	100.0
Real estate activities	4.3	10.5	46.4	4.3	9.8	24.7	100.0
Professional, scientific and technical activities	7.6	52.9	12.6	0.7	10.8	15.4	100.0
Public services	4.7	2.8	17.8	12.0	44.8	17.9	100.0
Total non-financial corporations	6.0	12.3	26.2	4.0	40.0	11.6	100.0

Source: Bank of Slovenia survey

The most frequent reason for loan rejection at the banks under majority foreign ownership in the majority of sectors was a low client credit rating (49.2%). The proportion accounted for by this reason rose further during the first half of 2011. The rejection of loans by clients owing to unfavourable loan terms is also important in this bank group. We assume, however, that the reasons relate more to other repayment terms than to the interest rate. The banks under majority foreign ownership have more favourable interest rates on corporate loans compared to the domestic banks, which has in part resulted in the redirection of demand from the latter.