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FINANCIAL STABILITY

STABILITY OF THE SLOVENIAN BANKING SYSTEM

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The December 2012 Stability of the Slovenian Banking System is based on figures and information available in mid-November 2012, except where stated otherwise.

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

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CONCLUSIONS

For the majority of this year, Slovenian banks' performance and the development of their financial risks have been defined on one hand by declining economic activity, a contraction in investment spending and a decline in household consumption, and on the other hand by slowing economic growth in the EU and the international financial markets' lack of confidence in Slovenia's long-term sovereign debt and, consequently, in its banks.

The persistence of the economic and financial crisis is increasingly making Slovenian corporates' business conditions worse and reducing their credit demand, in particular demand for investment loans. Non-financial corporations' indebtedness relative to equity remains high at 144%, despite repayments of debt to domestic banks and a reduction in debt financing for the fourth consecutive year. In addition to the crunch in financing at banks, corporates are continuing to face problems with financing via other domestic resources. This is a reflection of the deterioration in the competitiveness of domestic financial intermediaries and the lack of liquidity in the domestic capital market. The latter remains unattractive to both domestic and foreign investors. In contrast to 2011, in 2012 the banks under majority foreign ownership have reduced their cross-border lending to Slovenian corporates by just under 2%, although the corporates seeking financial resources directly in the rest of the world disclose lower financial leverage on average. The reason for excessively slow decline in financial leverage of Slovenian corporates is steady decline in the value of capital and the lack of pace or even negligible level of recapitalisation by corporate owners. The lack of pace in business and financial restructuring of corporates is largely the result of financially weak owners and numerous institutional and legal barriers that prevent the timely resolution of perceived financial difficulties and all too often fail to allow creditors to take coordinated action.

The banking system's total assets declined by more than EUR 2 billion during the first ten months of the year, more than in the whole of 2011. Growth in loans to the non-banking sector stood at -5.7% in October, lower than at the end of last year, as a result of a decline in loans to non-financial corporations and declining growth in housing loans. The supply of loans to the private non-banking sector is also being limited by government borrowing from the domestic banking system. The banks' net claims against the government sector have increased sharply this year as a result of the decline in government deposits, borrowing via loans and issues of treasury bills on the domestic market. At the same time the banks have made net repayments to foreign creditors and net repayments of securities. Both processes have reduced the banks' lending potential to the domestic private sector, by EUR 1.9 billion this year, and by fully EUR 7 billion between May 2010 and October 2012.

The process of restructuring bank funding has continued intensively this year. During the first ten months of the year the banks repaid EUR 3.1 billion of debt to foreign creditors (loans, repos and securities), while the general government sector reduced its deposits by EUR 0.7 billion. The banks have partly compensated for this decline by increasing their 3-year funding at the Eurosystem, which is favourable in price terms, not by means of household deposits, which have declined slightly in recent months. The proportion of total liabilities to the rest of the world accounted for liabilities maturing within 1 year has declined. In the course of one year it declined by 5 percentage points to 26%. Here the banks under majority foreign ownership have more short-term funding than the banks under majority domestic ownership. The repayment of liabilities to foreign creditors and the improving debt structure in terms of residual maturity has slightly reduced refinancing risk, which remains high as a result of the limited access to the international financial markets given the potential downgrading of the long-term sovereign debt.

The change in the banks' funding structure has been reflected in a decline in the pool of eligible collateral at the Eurosystem that is free. This remains satisfactory at the level of the banking system, but liquidity risk has increased at the banks with lowest liquidity. The banking system's liquidity risk as measured by the first-bucket liquidity ratio was slightly lower at the end of November than in 2011, while the ratio of secondary liquidity to total assets remained around 11%. However, liquidity management is being adversely affected by a decline in Slovenian banks' participation in the money market for unsecured loans and the increasing lack of confidence on the part of the international financial markets. In the future, increased credit risk could be another factor in the deterioration in the liquidity of individual banks, resulting in reduced access to financial resources.

The banks' average funding costs increased in the first three quarters of 2012 as a result of an increase in the estimated average cost of capital. At the same time the banks continued to compete for deposits by the non-banking sector, as a result of repayments to the rest of the world and a change in the business model of funding at certain banks under majority foreign ownership. While Slovenian banks' interest rates on long-term household deposits in the first nine months of the year were 1.2 percentage points higher than euro area average, the interest rates on short-term deposits were 0.5 percentage points lower. However, neither the interest rates on short-term household deposits nor those on long-term household deposits have fallen as much as market interest rates since the second half of 2011. Moreover, on the loan supply side the banks are seeing their competitiveness reduced by the persistent limits on foreign funding, and high impairment and provisioning costs. As a result, Slovenian banks' interest rates on corporate loans are higher than the euro area average. The spread on corporate loans of up to EUR 1 million was almost 2 percentage points, although the net interest margin at Slovenian banks is relatively low, and narrowed further during the first ten months of the year, to 1.99%. The uncompetitive supply of loans at Slovenian banks is becoming a key problem, which can at least be partly addressed by greater differentiation in the assessment of clients' credit risk. The banks must offer lower risk premiums to lower-risk clients whose projects have better prospects, and thereby lower interest rates.

The banking system's high credit risk increased slightly in the first nine months of the year, but at a slower pace than in 2011. The proportion of total classified claims accounted for by non-performing claims, those where clients are more than 90 days in arrears, increased to 14.2%, to almost EUR 7 billion. Of this, EUR 5.6 billion was concentrated in the non-financial corporations sector, which accounted for 23.9% of total classified claims against non-financial corporations. But the deterioration in the quality of the credit portfolio has not been uniform across all the bank groups: at the banks under majority foreign ownership the figure has almost completely stabilised at 6.4%. At the large domestic banks the rate of increase diminished during the first three quarters. But as the number of bankruptcy proceedings initiated among non-financial corporations has increased, the proportion accounted for by claims against corporates in bankruptcy has also increased. These claims reached EUR 2.9 billion in November, almost 6% of total classified claims. Resolving these claims depends strongly on the duration of the bankruptcy proceedings, and on their gradual write-down. An additional element in the increase in credit risk was an increase in the proportion of the banks' claims whose collateral value declined as a result of securities, commercial and residential real estate prices decline. This has been reflected in the yearly persistence of high impairment and provisioning costs. Greater coordination in resolving the financial difficulties of corporates with better prospects, supported by greater legal protection for creditors from irresponsible and financially depleted owners, would mitigate the adverse impact of the spread of insolvency to a growing circle of non-financial corporations.

The banking system's income risk remained large as a result of decline in lending and deterioration in the quality of the portfolio, which in the first ten months of the year required impairment and provisioning costs up 19% on the same period of 2011. Interest income declined more quickly than interest expenses, and only favourable net non-interest income prevented an even worse operating result. The banking system's pre-tax loss during the first ten months of the year was almost a quarter larger than in the same period of the previous year. The third consecutive year of losses is reducing the Slovenian banking system's attractiveness to new investors and is preventing the banks from generating their own capital internally.

The banking system's interest rate risk as measured by the difference between the average repricing periods for asset and liability interest rates has increased; the banks have become more exposed to the risk of a rise in interest rates. Currency risk remains low. The net open foreign exchange position was negligible at EUR 0.8 million as at September 2012.

The banking system's overall capital adequacy has fluctuated around 11.5% during the crisis, and this is where it stood in September 2012. The banking system's Tier 1 capital ratio increased to 10.1% during the first nine months of the year. The capital structure has improved as a result of the increase in the proportion of original own funds. Solvency risk is nevertheless increasing, because the banks are meeting capital requirements primarily by reducing turnover and repurchasing subordinated debt. The reduction in capital requirements contributed to an increase of 0.55 percentage points in overall capital adequacy. Operating losses, the prepayment of subordinated debt and other reductions in capital components all acted to reduce capital adequacy. At 11.9%, the overall capital adequacy of Slovenian banks on a consolidated basis is 1.6 percentage points less than the euro area average, which is not helping to overcome the lack of confidence on the part of investors. The differences in capital adequacy between the bank groups have widened. The capital adequacy of the banks under majority foreign ownership had increased to 13% by September, primarily as a result of lower capital requirements, just over 2 percentage points higher than the figure for the domestic banks.

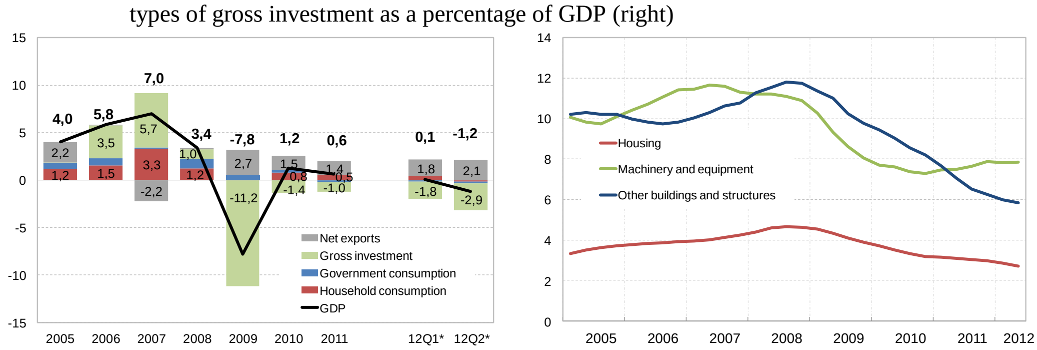
Addressing the problem of access to relatively inexpensive funding has remained the central focus of the banks' attention this year. Meanwhile sufficient capital strength is important to maintaining the confidence of depositors and investors. Owing to the crisis, the limits for sufficient capital adequacy at the banks have been set relatively high, and are a complex product of market expectations, international institutions, and new, updated, yet-to-be-enacted regulations. All of this leaves bank executives facing the need for the most optimal use of bank capital, which as capital becomes increasingly expensive and owners remain inactive, and even uninterested in certain cases, is increasingly being reflected in a contraction in turnover and in a decline in lending to higher-risk sectors, i.e. corporates. The banks' poor performance is the logical consequence of such business decisions. The banks' losses are directly reducing capital, making it even harder for bank executives to meet their capital requirements. Measures that would be likely to encourage capital investment in the Slovenian banking system and would improve the quality structure of the credit portfolio include incentives for the new lending that would come from coordinated bank action in respect of corporates with good prospects, and major write-downs of bad debts against the current owners followed by consolidation in the sector.

1 ECONOMIC TRENDS AND SECTORAL OVERVIEW

GDP fell by 1.2% in the second quarter

GDP declined in the second quarter of 2012, primarily as a result of a major decline in the investment portion of domestic consumption, and also in government and household final consumption. This year the government has further adjusted final consumption to the adverse fiscal situation, while households have responded more strongly to the adverse economic situation, which for them has been reflected in high unemployment and diminished purchasing power. Net exports contributed to GDP growth, partly as a result of a decline in imports. Investment in other buildings and structures, which includes investment in public infrastructure, has already halved during the crisis. Investment in residential real estate has declined by just slightly less as a result of a standstill on the real estate market. Investment in other buildings and structures was significantly larger in terms of its ratio to GDP, at 12%.

Figure 1.1: Annual growth in GDP in percentages and contributions to growth by GDP expenditure components in percentage points (left) and individual types of gross investment as a percentage of GDP (right)

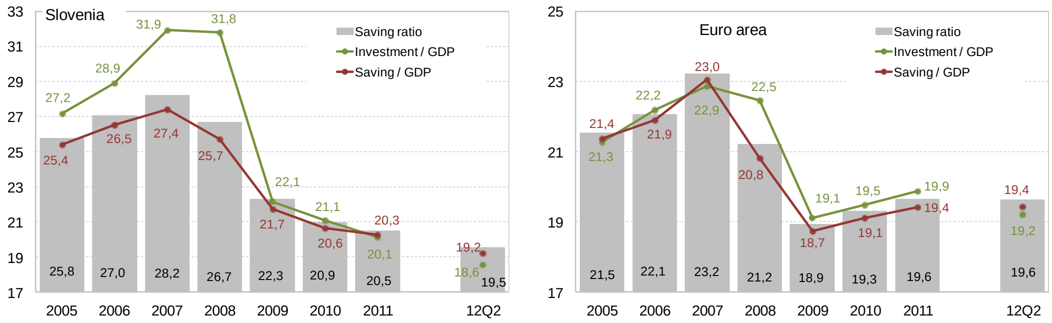


Note: * Annual growth in moving sum of four quarters.
Source: SORS

Construction investment will remain constrained.

Construction investment will remain constrained by fiscal consolidation measures, a lack of liquidity in the real estate market and difficulties with financing.[1] Investment in machinery and equipment is also being adversely affected by the growth forecasts for the principal trading partners and the limited financing possibilities. Given the situation on the labour market and the fiscal consolidation measures in connection with reducing the size of the welfare state, no increase in household consumption can be expected.

Figure 1.2: Saving ratio and ratio of investment and saving to GDP in percentages for Slovenia (left) and the euro area (right)



Sources: SORS, ECB

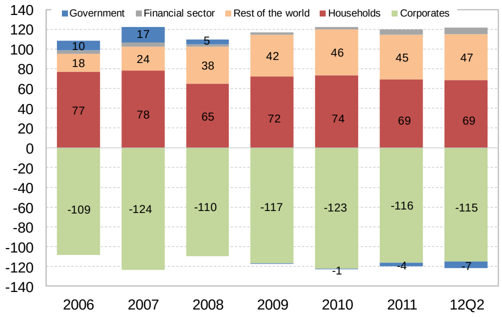
In addition to investment, there has been a decline in savings.

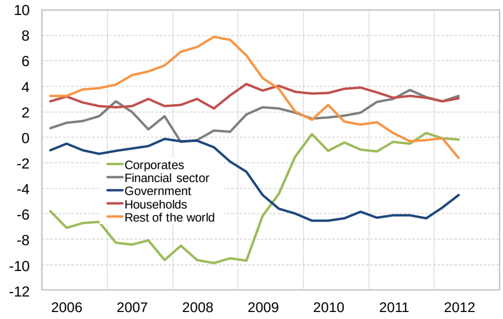
As recently as 2011 Slovenia's national saving ratio and the ratio of investment to GDP were higher than in the euro area overall. The figures closely approached the euro area averages in the second half of 2012, as a result of a decline in national saving and investment in Slovenia. The decline in investment was the result of limited financing and worsening investment opportunities in the current situation. Saving was actually higher than investment in the second quarter, which resulted in a decline in Slovenia's net borrowing from the rest of the world. The decline in saving was the result of limited

[1] Forecasts of macroeconomic variables from the Price Stability Report, October 2012, Bank of Slovenia.

growth in disposable income, and hence a greater proportion of money being used for urgent (final) consumption.

Figure 1.3: Net financial position of institutional sectors as percentage of GDP in terms of stock (left) and annual transactions (right)



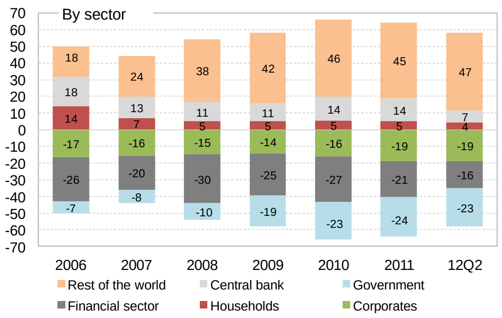


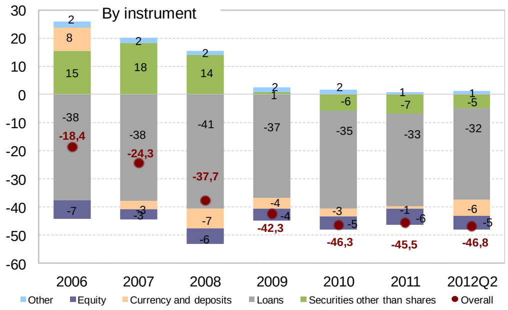
Note: The net financial position of the institutional sectors is calculated on the basis of financial sector accounts. The net financial positions from financial and non-financial accounts differ, given the different methods used to calculate the accounts.
Sources: Bank of Slovenia, SORS

Non-financial corporations have an almost balanced current net position.

The net borrowing/lending position of individual institutional sectors (annual transactions) reveals some significant changes after 2008. By reducing investment non-financial corporations have moved into a neutral net position, thereby closing Slovenia's current net negative position against the rest of the world. As expected, the crisis brought an increase in the government sector's net negative position, which is diminishing, while there was an increase in the net positive position of the financial sector, which coincides with the standstill in the banking sector's lending growth, while the net position of the household sector remained almost unchanged.

Figure 1.4: Institutional sectors' net financial position against the rest of the world as percentage of GDP (left) and net financial position against the rest of the world by instrument as percentage of GDP (right)





Note: Includes the central bank.
Source: Bank of Slovenia

In mid-October the Slovenian government issued a 10-year government bond with a nominal value of USD 2.25 billion on the American market.

Slovenia's negative net financial position against the rest of the world had increased to 46.8% of GDP by the end of June 2012, as a result of the banks' participation in ECB operations. Ignoring the central bank, liabilities to the rest of the world in the form of loans and bonds declined, partly as a result of the difficulties in accessing foreign financing. In mid-October the Slovenian government issued a reference 10-year government bond with a nominal value of USD 2.25 billion on the American market.[2] The issue was a success in terms of the demand demonstrated, and suggests a revival of access to the international capital markets.

Deleveraging process

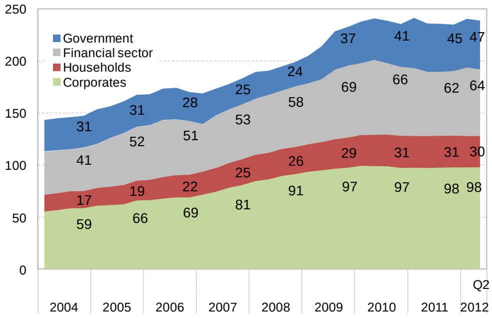
The deleveraging process in Slovenia is still in its initial stage.

In Slovenia the deleveraging process has not yet begun in earnest. It was only after 2011 that the institutional sectors' debt stopped growing. Given the situation, the level of debt is cause for concern, particularly in respect of the non-financial corporations sector and the financial sector, which recorded high growth in debt in the pre-crisis period between 2004 and 2008.[3] The non-financial sector saw its debt increase by 113%, while the financial sector saw its debt increase by 83%. Household debt increased by 116% during

[2] The yield amounted to 5.5% after currency conversion.
[3] The calculation includes debt in the financial accounts in the form of loans and bonds.

the same period, households having previously had relatively low levels of debt. The non-financial corporations sector and the financial sector in particular will have to deleverage. In contrast to other sectors, the government sector did not increase its debt until the crisis years of 2009 and 2010.

Figure 1.5: Debt of individual institutional sectors as percentage of GDP



Note: Debt includes all loans and securities other than shares.
Source: SORS

The challenge in the deleveraging process is finding the right balance between debt reduction and economic recovery.

The vital challenge in the deleveraging process is finding the right balance between debt reduction and economic recovery. According to the McKinsey Global Institute,[4] deleveraging usually proceeds in two phases. In the first phase non-financial corporations, the financial sector and households reduce their debt, with regard to their debt levels and past growth in debt. Economic growth is very low or even negative at this point. Normally during this period the government sector's debt increases as a result of higher social transfers and lower tax inflows. In the second phase there is a reversal in economic growth, and the long process of reducing government debt begins.[5] Given the loss of confidence on the international markets, Slovenia is unable to borrow freely. The deleveraging of the private sector, which adversely reduces gross investment and household consumption, is thus happening simultaneously with the deleveraging of the public sector, which reduces government consumption. Renewed economic growth is therefore directly dependent on exports in particular, alongside other indirect factors. Economic growth can recover after the deleveraging of the private sector, when certain conditions are in place: the financial sector has been stabilised, and lending is growing; structural reforms allow for increased productivity; a credible medium-term plan to reduce public debt has been adopted, and confidence has been renewed; exports are growing; private investment is gradually increasing, the real estate market has stabilised and investment in real estate is recovering.

[4] McKinsey Global Institute (2012). Debt and deleveraging: Uneven progress on the path to growth.
[5] The McKinsey Global Institute has found that the deleveraging process typically begins two to three years after the outbreak of the crisis. Historical data shows that the deleveraging period lasts between six and seven years on average, and reduces the debt-to-GDP ratio by around 25%. GDP usually contracts in the first years, while lending growth falls sharply, before increasing again.

2 BANKS' ASSESSMENTS OF DEMAND FOR LOANS AND CREDIT STANDARDS IN SLOVENIA AND THE EURO AREA[6]

Corporate loans

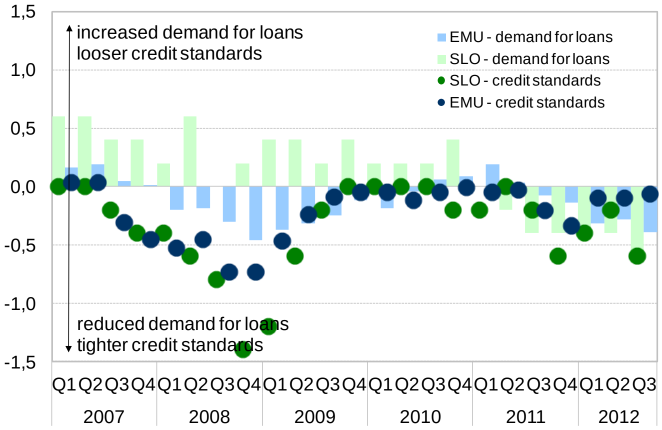
The decline in corporate demand for loans was largest in the third quarter of 2012.

According to a survey based on ECB methodology, corporate demand for loans in Slovenia has declined significantly since the second half of 2011. Slovenian banks attributed the decline in demand to lower investment in capital formation and the use of other financing. Corporate demand for loans also declined in the euro area overall. As in Slovenia, the largest decline came in the third quarter of 2012.

The tightening of credit standards was gradually diminishing, but only until the third quarter of 2012, when the tightening was very sharp.

The tightening of credit standards[7] for corporate loans in Slovenia eased in the first half of 2012. The banks then resumed tightening their credit standards sharply in the third quarter. They cited their liquidity positions, problems with access to market funding and, to a lesser extent, risk perception. Some Slovenian banks therefore raised their interest rate premiums on average and higher-risk loans, while raising collateral requirements in the loan terms and reducing the stock of lending.

Figure 2.1: Demand for corporate loans and credit standards



Sources: ECB, Bank of Slovenia

Loans to households

Demand for housing loans has been declining since the second half of 2011.

There has been a decline in household demand for housing loans since the second half of 2011, and demand remained negative in the third quarter of this year. The decline in demand is primarily the result of anticipated developments on the housing market. Household demand for housing loans has also declined in 2012 in the euro area overall, although there is great variation from country to country, which is typical of the housing markets in the euro area countries. Slovenian banks sharply tightened credit standards for housing loans in the middle of 2012. This was attributed to the perception of risks relating to general economic activity and developments on the housing market. Banks across the euro area have been tightening credit standards for housing loans since the beginning of 2010, but the tightening was smaller in each quarter of 2012.

In the third quarter of 2012 household demand for consumer loans in Slovenia recorded its largest decline since the beginning of 2009, even though it had been stagnating for the previous six months. The decline in demand in 2012 resulted in reduced requirements for funding, household savings and loans from other banks. After stagnating for a year, credit standards for approving consumer loans were also tightened in the second and third quarters of 2012. The banks attributed the tightening to risk perceptions, including the

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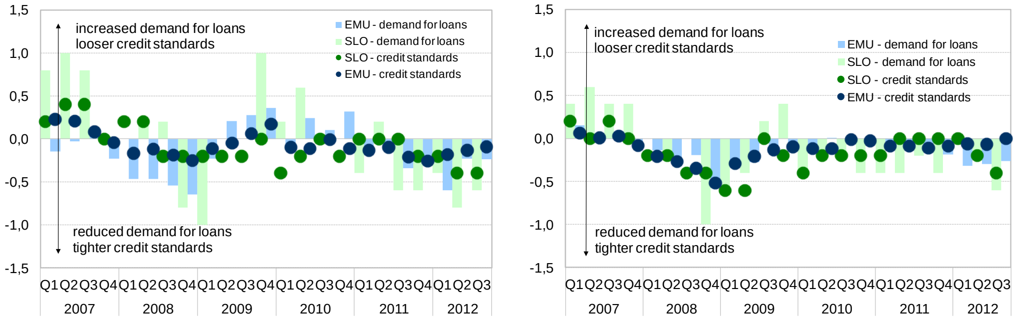
[6] Five Slovenian banks take part in the survey. Methodological limitations mean that the results for Slovenia and for the euro area as a whole are not directly comparable, and the substantive conclusions are less solid than in quantitative analyses.

[7] 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).

expectations for general economic activity, poor consumer creditworthiness and the risks related to collateral requirements.

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



Sources: ECB, Bank of Slovenia

3 CHANGES IN THE BANKING SYSTEM'S BALANCE SHEET STRUCTURE

Given the difficulties in accessing wholesale funding and the contraction in deposits by the non-banking sector, the banks have increased their proportion of funding from the Eurosystem this year. As liabilities mature the banks are investing in more liquid forms, and limiting their lending to the non-banking sector. The decline in creditworthy demand from corporates and households has also been a factor in the decline in lending. The banks are seeing the quality of their credit portfolios deteriorate in the context of relatively high funding costs and below-average capital adequacy relative to the EU. As a result, the banks in Slovenia are increasingly becoming less competitive.

3.1 Factors in the decline in total assets

The contraction in total assets has strengthened in 2012. Year-on-year growth in total assets stood at -5.9% at the end of October. Total assets declined by EUR 2.1 billion during the first ten months of the year. The decline in growth in total assets is continuing to coincide with the banks' debt repayments on the wholesale markets, a decline in government deposits and negative growth in loans.

Table 3.1: Banking system's balance sheet as at 31 October 2012

	Stock				Increase on	Growth on	Annual
	2009	2010	2011	Oct 2012	Dec 2011	Dec 2011	growth
	EUR million				EUR million	rate, %	
Assets							
Cash and balances at central bank	1.454	1.121	1.374	1.215	-159	-11,6	3,3
Loans	39.618	39.265	37.663	36.369	-1.294	-3,4	-7,0
to banks	5.708	4.815	4.652	4.375	-276	-5,9	-15,4
to non-banking sector	33.910	34.450	32.875	31.797	-1.078	-3,3	-5,7
of which:							
... non-financial corporations	20.165	19.766	18.293	17.259	-1.034	-5,7	-9,0
... households	7.886	8.646	8.836	8.669	-168	-1,9	-1,9
... government	735	1.162	1.218	1.728	510	41,8	50,4
... OFIs	2.719	2.584	1.809	1.601	-208	-11,5	-15,7
Financial assets / securities	8.876	8.274	7.865	7.289	-577	-7,3	-4,0
Other	1.665	1.660	1.846	1.781	-65	-3,5	2,6
Liabilities							
Financial liabilities to Eurosystem	2.100	581	1.703	3.941	2.238	131,4	386,6
Liabilities to banks	15.937	15.213	12.917	11.198	-1.718	-13,3	-18,0
of which to foreign banks	13.024	11.721	9.598	8.081	-1.518	-15,8	-22,2
Liabilities to non-banking sector (deposits)	23.570	23.509	24.170	23.202	-967	-4,0	-4,1
of which to non-financial corporations	3.825	4.033	3.857	3.861	4	0,1	2,8
of which to households	13.801	14.292	14.539	14.304	-236	-1,6	-1,1
of which to government	3.990	3.030	3.442	2.709	-733	-21,3	-25,0
of which to OFIs	1.124	1.282	1.459	1.366	-93	-6,4	-9,5
Debt securities	3.435	4.498	3.712	2.214	-1.498	-40,4	-46,3
Subordinated liabilities	1.512	1.546	1.423	965	-458	-32,2	-36,2
Equity	4.291	4.118	3.924	4.254	330	8,4	-0,9
Other	768	853	899	879	-20	-2,2	-11,6
Total assets	51.612	50.319	48.748	46.654	-2.095	-4,3	-5,9

Source: Bank of Slovenia

In 2012 the banks made their largest debt repayments on the wholesale markets, while the government sector was the main factor in the decline in deposits by the non-banking sector.

Debt repayments to banks in the rest of the world during the first ten months of 2012 were comparable to those in the previous year, at EUR 1.6 billion. The banks made further repayments of EUR 1.5 billion via securities during the same period. The banks' total net repayments of debt on the wholesale markets amounted to EUR 3.1 billion during the first ten months of the year, EUR 1.7 billion more than in the same period of the previous year. The banks also recorded a decline of EUR 967 million in deposits by the non-banking sector, the government sector accounting for almost three-quarters of this. Household deposits declined significantly less, and in October stood at their level of the end of 2010 at EUR 14.3 billion.

The increase in capital and the reduction in subordinated debt on the banking system's balance sheet was primarily the result of NLB's transactions in June and July, when it repurchased a portion of its subordinated debt and the government increased its capital in the bank. As a result of the banks' borrowing of EUR 2 billion via 3-year LTROs at the ECB in February, liabilities to the Eurosystem were alone in recording a significant increase in 2012.

The most important form of bank funding in 2012 was an increase in long-term liabilities to the Eurosystem.

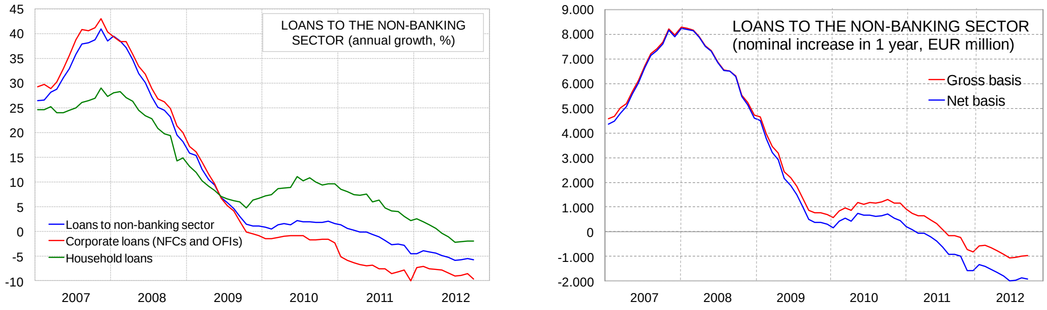
The banks responded in part to the contraction in funding by reducing investments in securities. The stock declined by EUR 577 million during the first ten months of the year, equivalent to just under one-third of the decline in total assets. There was no significant change in the proportion of total assets accounted for by securities.

3.2 A lending crunch and changes in the structure of the banks' investments.

The contraction in loans to the non-banking sector has continued in 2012. Growth was already negative at the end of last year. Loans to the non-banking sector were down 5.7% in year-on-year terms. They declined by EUR 1,078 million during the first ten months of the year, primarily as a result of declines of EUR 1,034 million in loans to non-financial corporations and EUR 208 million in loans to other financial institutions.

Loans to the non-banking sector have continued to contract in 2012.

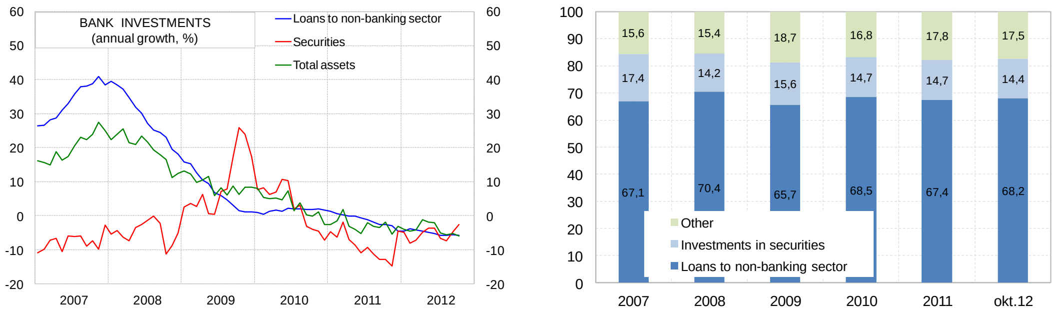
Figure 3.1: Year-on-year growth in loans to the non-banking sector and to individual segments in percentages (left) and gross and net (including impairments) nominal increase in loans to the non-banking sector in EUR millions (right)



Source: Bank of Slovenia

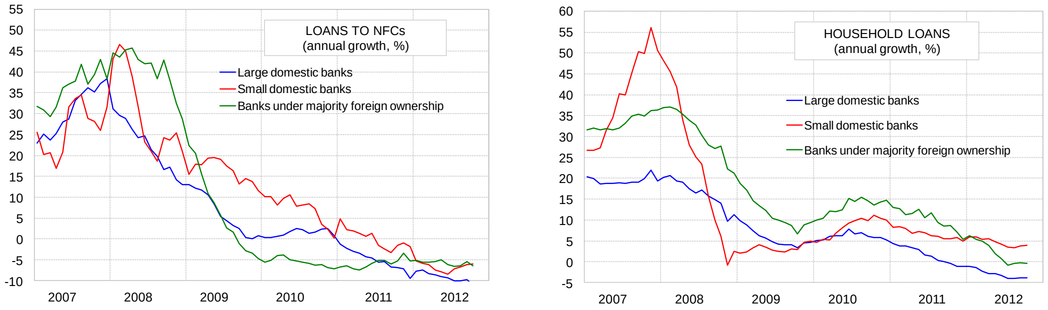
Even in early 2012 the decline in loans was primarily the result of a contraction in short-term loans, but since June long-term loans have been declining faster. In October long-term loans were down 6.1% in year-on-year terms, 1.5 percentage points more than short-term loans.

Figure 3.2: Year-on-year growth in bank investments (left) and ratios to total assets (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

Loans to non-financial corporations have contracted the most. Loans to the government sector are increasing.

Lending to non-financial corporations has declined fastest in 2012. In October loans to non-financial corporations were down 9.0% in year-on-year terms. Growth in loans to households, which has been slowing for a longer period, turned negative in the middle of 2012. The decline in loans to the non-banking sector was mitigated slightly by an increase in loans to the government sector, which in October were up 50% in year-on-year terms. Year-on-year growth in loans to the non-banking sector other than loans to the government then stood at -7.7%, down 1.8 percentage points on December 2011.

The reasons for the decline in lending lie both on the supply side and the demand side for loans.

The decline in loans to the non-banking sector is the result of lower demand for loans, and the less favourable supply of loans. The decline in economic activity has resulted in lower demand for loans both from the corporate sector and from households. At the same time the sharp deterioration in access to funding on the international financial markets has forced the banks to reduce lending. Another factor forcing the banks to restructure investments is the need for optimal capital use as a result of low capital adequacy compared with other banking systems in the EU.

Reasons for lower demand for loans:
- **weak domestic and foreign consumption**
- **situation in the construction sector**

The worsening debt crisis is being reflected in the real economy. Economic growth has been negative since mid-2011 in Slovenia and in the euro area overall. The decline in demand has been reflected in a decline in new orders. Low domestic demand is now being exacerbated by weak foreign demand. In this situation corporates have lower demand for loans and are investing less, which is inhibiting economic growth. The crisis is being felt most in the sectors that had most inflated the previous credit cycle, most notably the construction sector.[8]

- **high corporate indebtedness**
- **payment indiscipline**

Corporates are relatively highly indebted, and their financial leveraging remains high despite deleveraging, which in combination with low economic activity and projected income is reducing their creditworthiness. Corporates are operating in an environment of high insolvency, as a result of which they are losing competitiveness in comparison with the competition from neighbouring better-functioning financial systems.

- **decline in the value of assets used as loan collateral**

The uncertainty on the real estate market is reducing values and liquidity. Together with the reduced liquidity on the capital market and the fall in securities values, this is reducing the value of the assets used by corporates as loan collateral. The banks are tightening their loan collateral standards, and both are having an adverse impact on the ability of corporates to raise new loans.

- **higher funding costs, which pass through into higher loan costs**

The mounting debt crisis in Europe and in Slovenia has raised the required yields on Slovenian bonds, which has led to increases in the cost of foreign funding for Slovenian banks.[9] These costs are being passed through into higher lending rates at Slovenian banks, and are reducing the competitiveness of their services and consequently their lending.

[8] GDP in the third quarter was down 3.3% in year-on-year terms. In September new orders were down 8% in year-on-year terms, while exports were down 5% in year-on-year terms. The amount of construction put in place was down 12.3% in year-on-year terms, the number of building permits was down 2.4% and the corresponding floorspace was down 14%, but transaction volume in used housing was up 3.6%.

[9] The premium on 2-year Slovenian government bonds over the German benchmark fell from 423 basis points at the end of 2011 to 236 basis points at the end of October. The premium on 10-year government bonds fell from 498 basis points at the end of 2011 to 395 basis points at the end of October. The premium peaked on 13 August 2012, when it stood at 604.9 basis points. The required yield on 10-year government bonds was then more than 7%, and peaked at 7.45%. The premiums and the required yields on Slovenian government bonds fell after the successful issue of the US dollar bonds in October.

Creditworthy corporates are therefore turning to foreign financing, which is reducing the demand for loans from Slovenian banks.

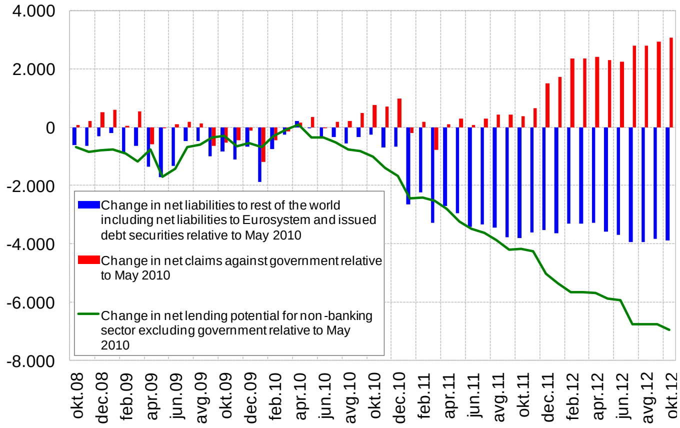
- lower household demand

The adverse macroeconomic situation is affecting the labour market. As a result of unemployment and the decline in the real value of wages, household creditworthiness and credit demand are deteriorating. Households are also being hit by measures to ensure the sustainability of public finances, which is being reflected in lower consumption.

Reasons for the diminished supply of loans:
- **high funding costs**
- **deterioration in the portfolio**
- **maturing liabilities**

Lending growth is also being curbed by the limited supply of loans. Given the problems in accessing foreign funding, wholesale funding has sharply declined in importance. This has primarily been reflected in a decline in liabilities to foreign banks at the banks under majority foreign ownership, and in a decline in the proportion of funding accounted for by securities at the domestic banks. The banks are seeing further deterioration in the credit portfolio, which is having an adverse impact on capital adequacy, as impairments of claims deplete capital via losses. Given the slightly better quality of their credit portfolio, the banks under majority foreign ownership were the only bank group to increase their loans to the non-banking sector during the first ten months of the year, although year-on-year growth remained negative in October. The banks under majority foreign ownership have also increased their market share of total loans to the non-banking sector since 2007, and have become the largest lenders to households.

Figure 3.4: Change in net lending potential for the non-banking sector excluding the government sector relative to May 2010, in EUR millions



Source: Bank of Slovenia

The supply of loans to the non-banking sector excluding the government sector is declining.

The supply of loans to the non-banking sector excluding the government sector is also being curbed by government borrowing from the domestic banking system. Between October 2008 and May 2010 net claims against the government moved in parallel with net wholesale funding and in concert with claims against the Eurosystem. The banks' net claims against the government began increasing sharply in May 2010 as a result of the decline in government deposits, borrowing via loans and issues of treasury bills. The banks have also made net debt repayments in the rest of the world and have repaid securities in 2012. The net lending potential for the private non-banking sector in October 2012 was down EUR 6.95 billion on May 2010 as a result.

The banks have placed the funding obtained by borrowing from the Eurosystem in the most-liquid forms of investment.

The banks have partly compensated for the decline in wholesale funding with funding obtained in 3-year LTROs. Some of this funding has been earmarked for the repayment of maturing liabilities to the rest of the world, while some has been held in the most-liquid form in a settlement account with minimal remuneration. Repayments of liabilities and an inability to refinance by issuing securities or borrowing from foreign banks have reduced the banking system's total assets, although the investment structure has not changed significantly since December 2011.

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

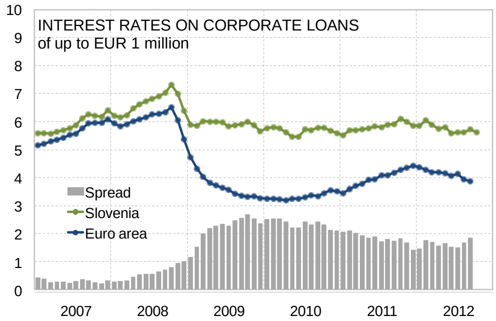
Asset interest rates[10]

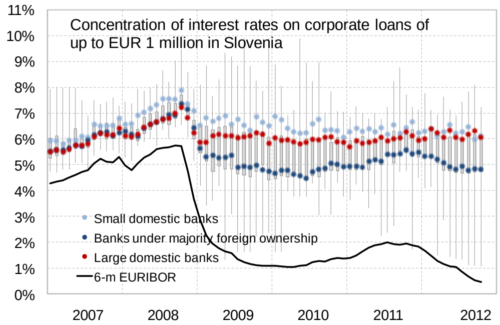
Slovenian banks' interest rates on corporate loans rose again in the first three quarters of 2012 compared with the euro area average.

Slovenian banks' interest rates on corporate loans of up to EUR 1 million have remained just under 6% for the fourth consecutive year. Interest rates on corporate loans in the euro area overall have fallen again in 2012. The spread in interest rates on corporate loans of up to EUR 1 million between Slovenia and the euro area overall narrowed to less than 2 percentage points last year; in the first three quarters of 2012 it averaged 1.6 percentage points. During this period more than three-quarters of loans approved were for more than EUR 1 million, the interest rates on which averaged 4.6%. The spread between the interest rates of Slovenian banks and those of euro area banks on loans of more than EUR 1 million has widened again in 2012, reaching 2.6 percentage points by October.

The dispersion between banks of interest rates on corporate loans of up to EUR 1 million widened significantly. The banks under majority foreign ownership had lower interest rates, and responded more to this year's fall in the EURIBOR than did the banks under majority domestic ownership. The spreads widened from May onwards. Interest rates on loans of up to EUR 1 million at the large domestic banks were 1.2 percentage points higher than at the banks under majority foreign ownership in October, compared with a spread of around 0.7 percentage points last year. The banks under majority foreign ownership also had lower interest rates on average on loans of more than EUR 1 million. The increasing spreads in lending rates are the result not only of differences in funding costs, but also of differences in the quality of the credit portfolio. This is lower on average at the banks under majority domestic ownership.

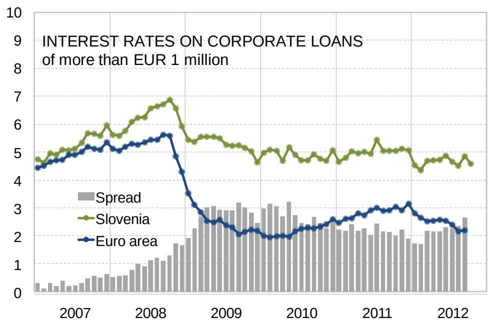
Figure 3.5: Interest rates on corporate loans of up to EUR 1 million in percentages: comparison with the euro area (left) and dispersion at Slovenian banks (right)

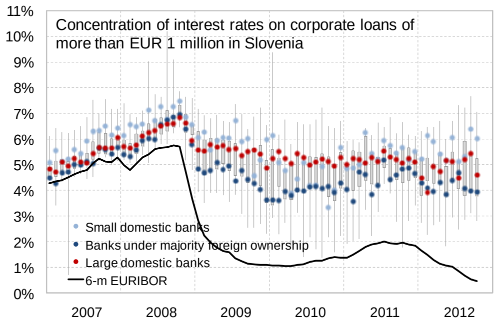




Sources: Bank of Slovenia, ECB

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





Sources: Bank of Slovenia, ECB

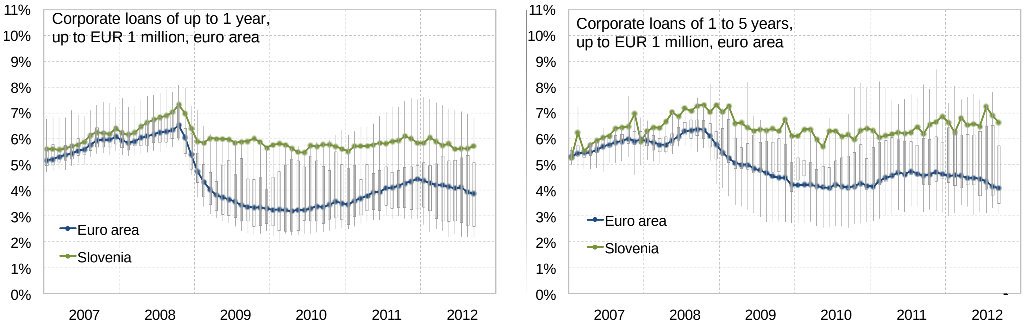
The banks have been averse to taking up risks during the crisis, and have tightened credit standards at the same time because of the increasing proportion of bad debts. They are trying to compensate for the loss of interest income by raising asset interest rates. High

[10] The comparison with the euro area takes account of euro loans on which the contractual interest rate is variable or fixed for up to 1 year.

liability interest rates are also being passed through into higher asset interest rates. The rise in funding costs is making the banks' services uncompetitive. Net interest on average interest-bearing assets is relatively low.

The breakdown of corporate size also has an impact on the level of average lending rates. In Slovenia there are a large number of micro enterprises that are not exchange-listed, and therefore have limited access to alternative forms of financing. For financially weak corporates that do not have sufficient internal capital, this entails more expensive financing via bank loans or a contraction in turnover.

Figure 3.7: 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



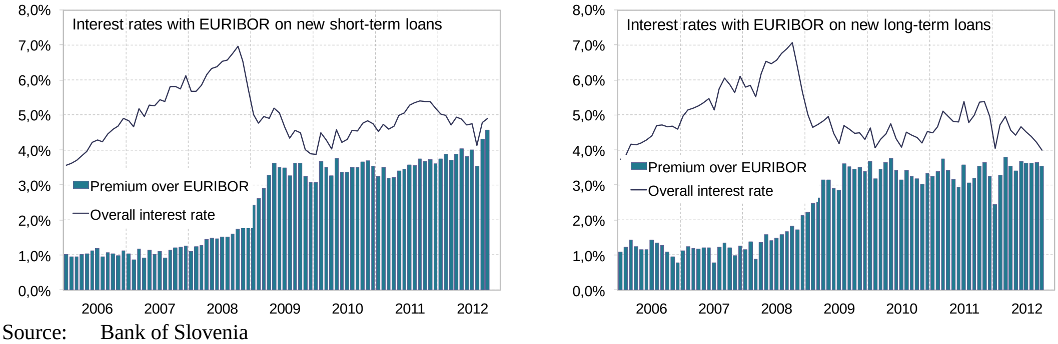
Source: ECB

High long-term interest rates on corporate loans are restricting investment.

In 2012 Slovenian banks' interest rates on corporate loans have remained in the upper quartile in euro area countries, and are currently the third highest. Only Portugal and Greece have higher interest rates, with Spain and Italy closely behind Slovenia. Interest rates in the other countries are significantly lower.

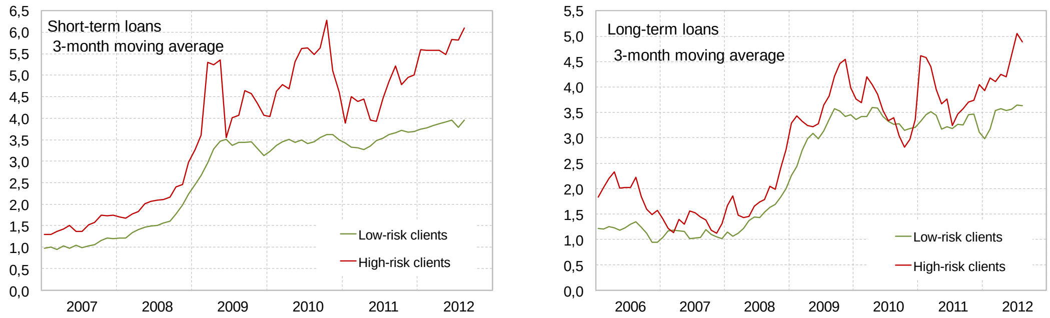
The spread between the highest and lowest interest rates on loans of up to EUR 1 million in different euro area countries averaged 4.9 percentage points during the first three quarters of 2012. Slovenian banks' interest rates averaged 5.8%, 1.5 percentage points less than those in the country with the highest rates and 3.4 percentage points more than the lowest. The average spread during the first three quarters on loans of longer maturities of 1 to 5 years was 4.3 percentage points. Slovenian banks' interest rates averaged 6.7%, 0.8 percentage points less than those in the euro area country with the highest rates and 3.5 percentage points more than the lowest. The higher lending rates will further adversely affect the competitiveness of Slovenian firms' exports of merchandise and services to European markets.

Figure 3.8: 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

Figure 3.9: Premiums over the EURIBOR for new short-term (left) and long-term (right) corporate loans to high-risk and low-risk clients in percentages



Source: Bank of Slovenia

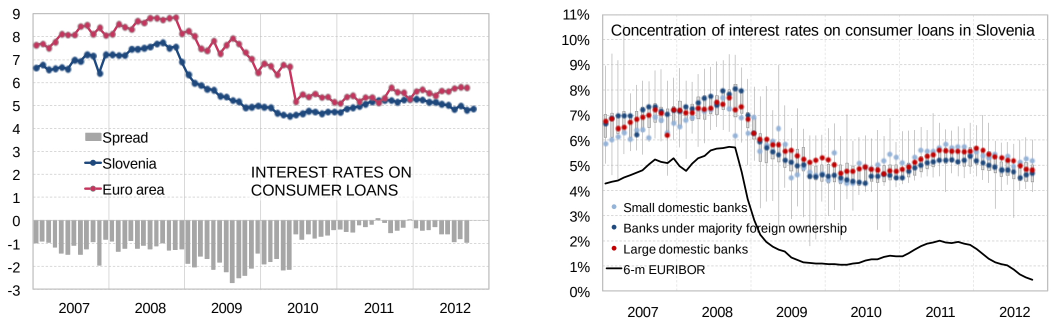
The premium over the variable interest rate on corporate loans rose again in 2012.

If only loans with an interest rate tied to the EURIBOR are taken into account, Slovenian banks' interest rates fell slightly in the first three quarters of 2012, but the premium rose. Average interest rates during the first three quarters of 2012 were down 0.3 percentage points on the 2011 average on short-term corporate loans, and down 0.5 percentage points on the 2011 average on long-term corporate loans. The premium over the EURIBOR increased by an average of 0.5 percentage points on short-term loans and 0.1 percentage points on long-term loans. The above figures giving the premiums for high-risk and low-risk clients show that the banks should adjust their attitude to risk to the new crisis conditions. This should be reflected in widening spreads in the premiums over the EURIBOR on loans between low-risk and high-risk clients.

Interest rates on consumer and housing loans do not differ significantly from the euro area average.

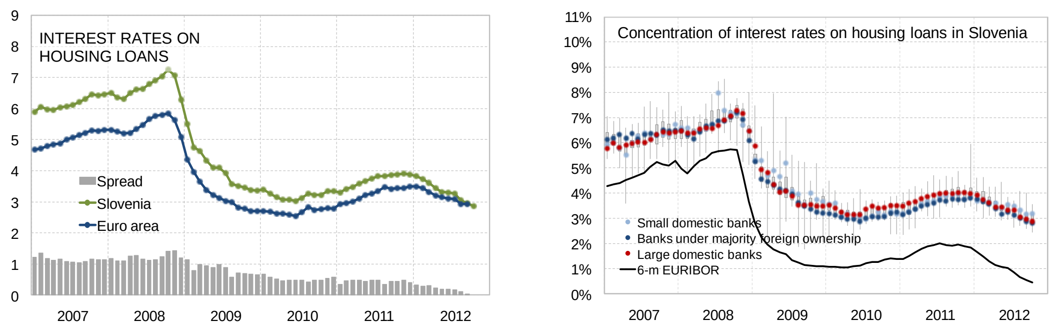
The interest rate spread on household loans between Slovenian banks and euro area banks overall is low. Variable interest rates on Slovenian banks' consumer loans have been lower than the euro area average for several years now. Variable interest rates on housing loans were higher than the euro area average, but the spread had disappeared by the end of the third quarter of 2012.

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



Sources: Bank of Slovenia, ECB

Figure 3.11: Interest rates on housing loans in percentages: comparison with the euro area (left) and dispersion at Slovenian banks (right)



Sources: Bank of Slovenia, ECB

The spreads between Slovenian banks' interest rates on household loans 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 averaged 1.3 percentage points during the first three quarters. There is no significant variation in interest rates between the bank groups. Although interest rates on housing loans began falling in 2012, the already high premium over the EURIBOR rose. It averaged 2.3 percentage points during the first three quarters, up 0.3 percentage points on the 2011 average. The premium rose even more strongly, by 0.5 percentage points, on short-term loans and long-term consumer loans, to average 2.5 percentage points and 4 percentage points respectively.

Liability interest rates

Competition between banks for short-term household deposits is higher than for long-term deposits.

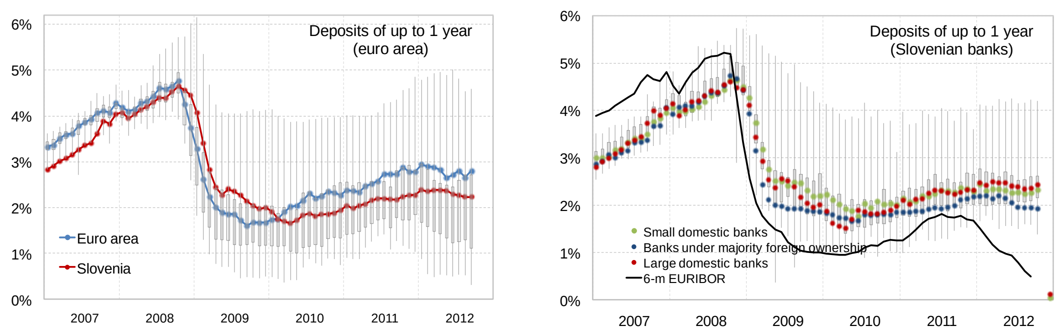
Slovenian banks' interest rates on household deposits of up to 1 year have been lower than the euro area average since mid-2010. They were 0.5 percentage points lower on average during the first three quarters of 2012. Competition via interest rates on short-term deposits remains high between banks in Slovenia. The spread between the bank with the lowest and highest interest rates remains high at 2.6 percentage points, more than double the average in 2007 and 2008.

Slovenian banks' interest rates on long-term deposits during the first three quarters were 1.2 percentage points higher than euro area average. Slovenian banks' interest rates on long-term deposits were among the highest in the euro area, while those on short-term deposits were in the early part of the third quartile. Austria, Finland, Germany, Belgium and Estonia offer the lowest average interest rates on deposits, and Greece, Cyprus and Portugal the highest. The spread between the Slovenian banks with the highest and lowest interest rates averaged 1.7 percentage points during the first three quarters of 2012.

The level of competition between banks for household deposits has been reflected in liability interest rates falling more slowly than the EURIBOR over the last year. The fall has been significantly slower than that seen in the second half of 2008 when the financial crisis deepened.

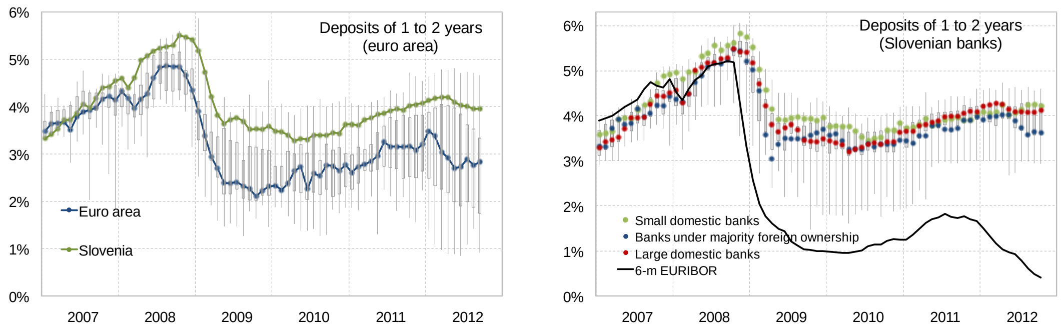
The banks under majority foreign ownership have recorded an increase in household deposits, despite having the lowest interest rates. Lower lending rates have also resulted in an increase in deposits, because approved loans are transferred to the client's account in the majority of cases. Restrictions on lending by certain foreign banks relative to deposits collected did not raise liability rates at this bank group, with the exception of individual banks.

Figure 3.12: Dispersion of interest rates on household deposits of up to 1 year in percentages: comparison with the euro area (left) and at Slovenian banks (right)



Sources: Bank of Slovenia, ECB

Figure 3.13: Dispersion of interest rates on household deposits of 1 to 2 years in percentages: comparison with the euro area (left) and at Slovenian banks (right)



Sources: Bank of Slovenia, ECB

3.4 Bank funding

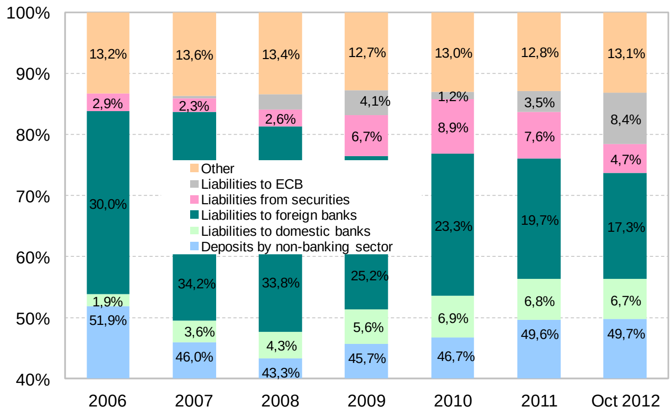
Banks are reducing their dependence on wholesale funding. They have primarily replaced this funding with borrowing at the Eurosystem.

Given the increasingly limited access to funding on the international financial markets, in 2012 the banks have continued to reduce their dependence on wholesale funding. The proportion of funding accounted for by issued debt securities stood at 4.7% in October, down 2.9 percentage points on December 2011. The proportion accounted for by liabilities to foreign banks declined by 2.4 percentage points over the same period to 17.4%. The banks failed to compensate for the loss of funding by increasing deposits by the non-banking sector, the proportion of funding for which they account increasing by just 0.1 percentage points. It was more favourable for the banks to borrow via 3-year LTROs at the Eurosystem. The proportion of funding from the Eurosystem increased by 5 percentage points, to stand at 8.4% in October.

The banks are also seeing a contraction in deposits by the non-banking sector.

Deposits by the non-banking sector have declined in 2012. The year-on-year rate of growth stood at -4.2% in October. There was a particular decline in government deposits, which accounted for 75% of the decline in deposits by the non-banking sector. They were down 25% on October 2011. The proportion of funding accounted for by deposits by the non-banking sector was maintained, primarily as a result of the concurrent contraction in the banking system's turnover. Liabilities to foreign banks have been contracting since the outbreak of the crisis, and were down 22.2% in year-on-year terms in October. The banks under majority foreign ownership accounted for EUR 1,104 million of the decline of EUR 1,517 million in liabilities to foreign banks.

Figure 3.14: Breakdown of bank funding in percentages

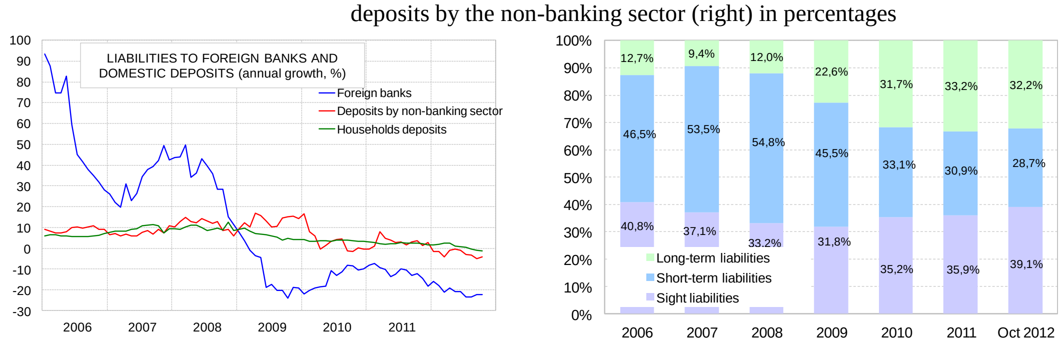


Source: Bank of Slovenia

Deposits by non-banking sectors at the banks under majority foreign ownership increased by 11.5% during the first ten months of the year, primarily as a result of an increase in deposits by households and non-financial corporations. Government deposits at the banks under majority foreign ownership declined by 12.5%, less than at the domestic banks. Deposits by the non-banking sector declined by 10.6% at the small domestic banks and 9.0% at the large domestic banks during the same period.

The proportion of deposits by the non-banking sector accounted for sight deposits increased over the same period, while those accounted for by short-term deposits and long-term deposits declined. The largest change was in the maturity breakdown of government deposits, where the proportion accounted for by sight deposits increased by 6.5 percentage points to 14.7%.

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



Source: Bank of Slovenia

Differences in breakdown of funding between the bank groups

The differences in the breakdown of funding between the bank groups are narrowing. The foreign banks are making the largest debt repayments in the rest of the world.

The banks have adjusted their funding breakdowns to the market situation differently according to their size and ownership structure. In general, the differences in funding breakdowns between the bank groups have narrowed, although they remain large. The banks under majority foreign ownership have recorded the largest decline in the proportion accounted for by liabilities to foreign banks, as a result of changes in policy by their parent banks, which have been reducing the funding of their subsidiary banks in Slovenia over the long term. During the first ten months of the year they compensated for the loss of this funding by means of deposits by the non-banking sector and borrowing at the Eurosystem. The proportions accounted for by deposits and by liabilities to the Eurosystem at the banks under majority foreign ownership nevertheless remain below the averages for the banking system. The opposite is true of domestic banks. Both the small and the large domestic banks have reduced their liabilities to foreign banks, but have also faced a decline in deposits by the non-banking sector. Given their inability to fund themselves by issuing debt securities, the domestic banks were forced to seek funding by borrowing from the Eurosystem. The proportion of total funding accounted for by this form is high at both bank groups, and is increasing as a result of the contraction in total liabilities.

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			
2008	27,7	6,9	52,3	33,8
2009	16,8	3,5	48,9	25,2
2010	15,0	1,7	47,8	23,3
2011	12,2	1,5	40,8	19,7
Oct 2012	11,6	0,9	32,9	17,3
	Deposits by non-banking sector			
2008	47,8	56,8	31,2	43,3
2009	49,6	59,2	33,7	45,7
2010	49,8	60,2	36,0	46,7
2011	52,3	60,4	40,7	49,6
Oct 2012	50,9	57,8	45,2	49,7
	Household deposits			
2008	32,0	30,7	18,6	27,7
2009	30,3	30,3	18,2	26,7
2010	31,4	31,7	20,9	28,4
2011	32,6	34,7	22,6	29,8
Oct 2012	33,2	36,2	24,1	30,7
	Issued debt securities			
2008	3,5	6,5	0,0	2,6
2009	10,0	5,2	0,0	6,7
2010	13,2	7,7	0,0	8,9
2011	11,2	7,4	0,0	7,6
Oct 2012	6,8	7,4	0,0	4,7
	Liabilities to Eurosystem			
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
2011	3,4	5,6	3,1	3,5
Oct 2012	9,4	9,9	6,2	8,4

Source: Bank of Slovenia

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

The coverage of loans by wholesale funding and deposits by the non-banking sector has declined.

The coverage of loans by wholesale funding and deposits by the non-banking sector declined by 8.7 percentage points during the first ten months of the year to 105.3%. During this period the banks maintained the proportion of investments accounted for by loans, while deposits by the non-banking sector accounted for an almost unchanged proportion of funding, as a result of which the coverage of loans by this form of funding remained almost unchanged. The coverage of loans by wholesale funding declined significantly. The coverage of loans by liabilities to foreign banks declined by 3.8 percentage points during the first ten months of the year to 25.4%, while the coverage of loans by issued debt securities declined by 4.3 percentage points to 7.0%.

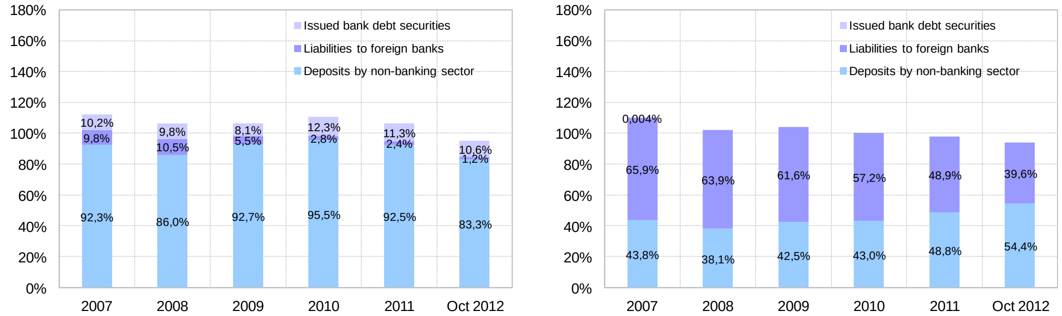
Figure 3.16: Coverage of loans to the non-banking sector by funding in the banking system overall (left) and at the large domestic banks (right) in percentages

Source: Bank of Slovenia

The coverage of loans by wholesale funding and deposits by the non-banking sector remains lowest at the banks under majority foreign ownership. The large domestic banks have the highest coverage.

At the domestic banks the coverage of loans by wholesale funding and deposits by the non-banking sector declined by 11.0 percentage points to 114.7%. At the large domestic banks the largest decline was in the coverage of loans by issued debt securities, while at the small domestic banks coverage by deposits by the non-banking sector declined most. At the banks under majority foreign ownership the coverage of loans by liabilities to foreign banks declined by 9.3 percentage points to 39.6%, while the coverage of loans by deposits by the non-banking sector increased.

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



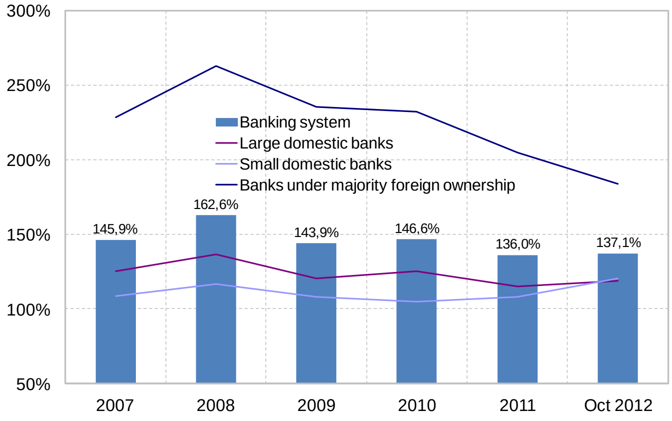
Source: Bank of Slovenia

Loan-to-deposit ratio for the non-banking sector

The decline in the LTD ratio for the non-banking sector ended.

There was an end to the decline in the ratio of loans to the non-banking sector to deposits by the non-banking sector seen in the Slovenian banking system since 2009, and the ratio actually increased by 1.1 percentage points during the first ten months of the year to 137.1%. This was the result of the decline in government deposits in the second half of the year and declining growth in household deposits. The decline in the loan-to-deposit (LTD) ratio ended at a relatively high level, despite the contraction in loans to the non-banking sector. In previous years the banks had already significantly reduced the dependence of their credit activities on foreign financial markets, but a new stable equilibrium has not yet been established. Of the different bank groups, only the banks under majority foreign ownership recorded a decline in the LTD ratio for the non-banking sector during the first ten months of the year, by 21.1 percentage points to 183.7%. The figure confirms that the banks under majority foreign ownership have sharply reduced their dependence on foreign funding during the crisis years. Since peaking at 262.7% in 2008, the LTD ratio for the non-banking sector has declined by 78.9 percentage points, competition between the banks for primary local funding thereby increasing sharply. While the large domestic banks reduced this ratio by 17.5 percentage points during the aforementioned period, at the small domestic banks it actually increased slightly, although the ratio for the banking system as a whole declined by 25.5 percentage points. All of this confirms the experience of foreign banking systems from previous financial crises, where the bank deleveraging process and adjustments to bank funding structure are very slow and lengthy.

Figure 3.18: Breakdown of bank funding in percentages



Source: Bank of Slovenia

Table 3.3: Switching of deposits by the non-banking sector between bank groups in 2011 and first ten months of 2012 in percentages

(%)	Increase in deposits by NBS		Increase in deposits by NFCs		Increase in deposits by OFIs		Increase in government deposits		Increase in household deposits	
	2011	Jan-Oct 2012	2011	Jan-Oct 2012	2011	Jan-Oct 2012	2011	Jan-Oct 2012	2011	Jan-Oct 2012
Large domestic banks	1,1	-9,0	-9,2	-0,8	4,4	-24,8	15,3	-26,7	0,0	-4,6
Small domestic banks	-5,9	-9,3	-21,3	-15,5	-36,9	-21,5	0,6	-25,7	2,8	-1,3
Banks under majority foreign ownership	12,2	11,6	11,2	6,1	99,3	39,4	18,0	9,8	7,1	7,5
Overall	2,8	-4,1	-4,4	0,1	13,8	-6,4	13,6	-21,3	1,7	-1,6

Source: Bank of Slovenia

The refocusing on domestic funding by the banks under majority foreign ownership increased the competition between banks to attract deposits by the non-banking sector. The banks under majority foreign ownership succeeded in capturing some of the outflow of deposits by the non-banking sector from the domestic banks, most notably household deposits. The reason for deposit switching was not solely higher interest rates, but also in the short term the perception of the relative security of the banks under majority foreign ownership compared with the domestic banks. The banks under majority foreign ownership also increased their deposits by other non-financial corporations, primarily thanks to their higher ratings, which have an impact on investments by insurance corporations. Given the favourable average lending rates at the banks under majority foreign ownership, when raising new loans clients also opted to transfer their free liquid assets to this bank group.

The banks under majority foreign ownership have increased their deposits by the non-banking sector, which is increasing the competition for primary domestic funding.

The long-term factors in the slower growth in bank deposits and the decline in deposits in the third quarter include the sustained repayment of debt to the rest of the world and the contraction in lending activity.

3.5 Bank funding costs

The banks' average funding costs rose by 0.65 percentage points during the first three quarters of 2012 to 3.95%, as a result of a rise in average capital costs. The cost of bank debt funding fell over the same period as a result of the fall in interest rates on the international financial markets and an increase in the proportion of funding accounted for by cheaper forms.

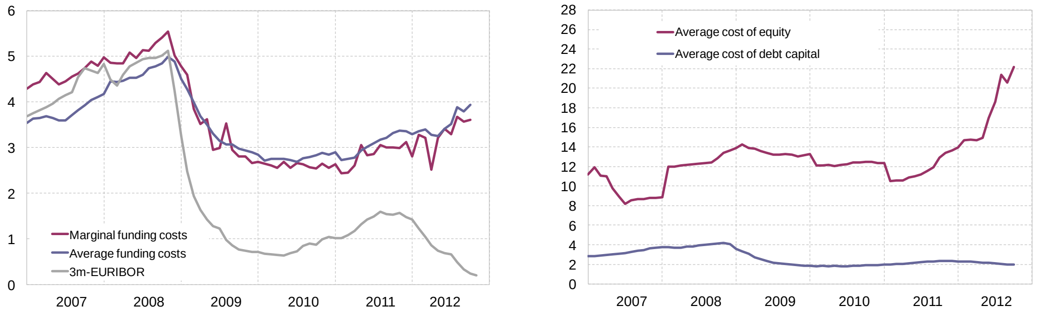
Funding costs have risen in 2012 as a result of higher capital costs.

The 3-month EURIBOR declined sharply during the first ten months of the year. It declined from 1.42% in December 2011 to average 0.21% in October. The fall in the average cost of debt funding only partly tracked the fall in interest rates on the financial markets. The proportion of bank funding accounted for cheaper forms has increased in 2012. The largest decline was in the proportion accounted for by funding on the wholesale financial markets. Issued debt securities, which are the most costly form of debt funding, accounted for half of this decline. The proportion of funding accounted for by cheaper ECB funding increased relatively sharply in March 2012.

The costs of debt funding have fallen in 2012.

The trend of falling interest rates continued after the cuts in the ECB's key interest rate in December 2011 and July 2012, and as a result of high excess liquidity. The fall in interest rates on the international financial markets and the banks' replacement of issued securities with funding at the ECB are therefore having a favourable impact on the average cost of debt funding.

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

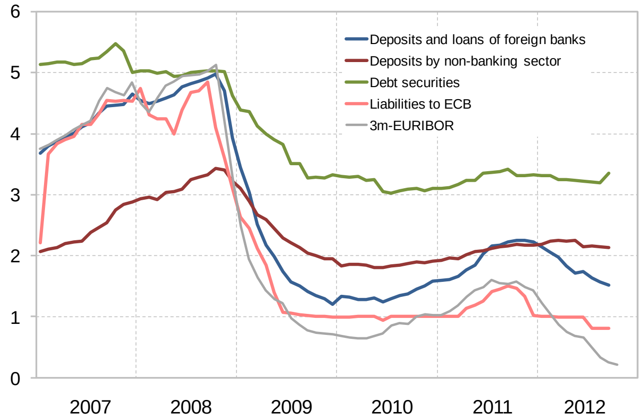


Sources: Bank of Slovenia, LJSE

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

Equity was the most expensive form of funding for the banks. Its price reached 22.2% in September, up 8.3 percentage points on December 2011. The fall in market interest rates was reflected differently in different forms of debt funding. The average costs of deposits by the non-banking sector and issued debt securities issued in September were comparable to last year at 2.1% and 3.4% respectively, therefore having not fallen. The average interest rate on liabilities to foreign banks fell by 0.71 percentage points to 1.5%.

Figure 3.20: Average cost of bank debt funding in percentages

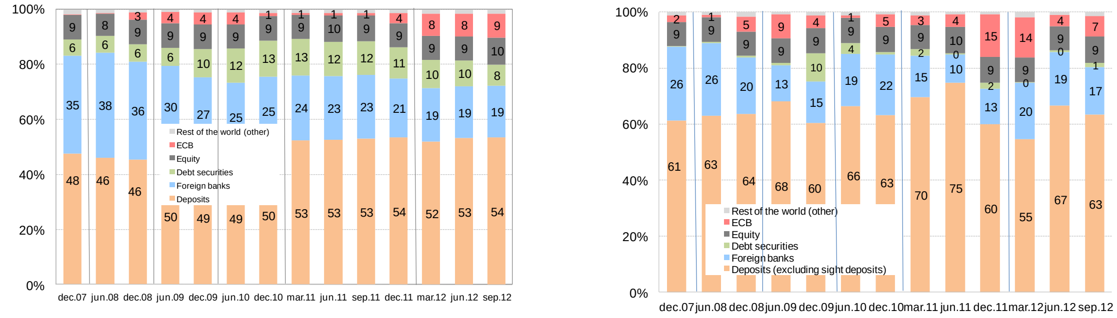


Source: Bank of Slovenia

The banks' average funding costs via debt securities were unchanged over the first nine months of the year, remaining at 3.4%. The banks have made significant repayments of debt via issued debt securities in 2012. After the larger Slovenian banks compensated for the loss of funding at foreign banks by means of issued debt securities in the first two years of the crisis, in 2011 and the first half of 2012 they made prepayments to reduce the stock of securities owing to their higher costs and the costs of the government guarantee.

Growth in household deposits at banks became negative in the middle of 2012. The small domestic banks offer higher-than-average interest rates on deposits by the non-banking sector and household deposits, while those of the banks under majority foreign ownership are lower-than-average. However, interest rates on household deposits have not fallen to the same extent as the EURIBOR this year.

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

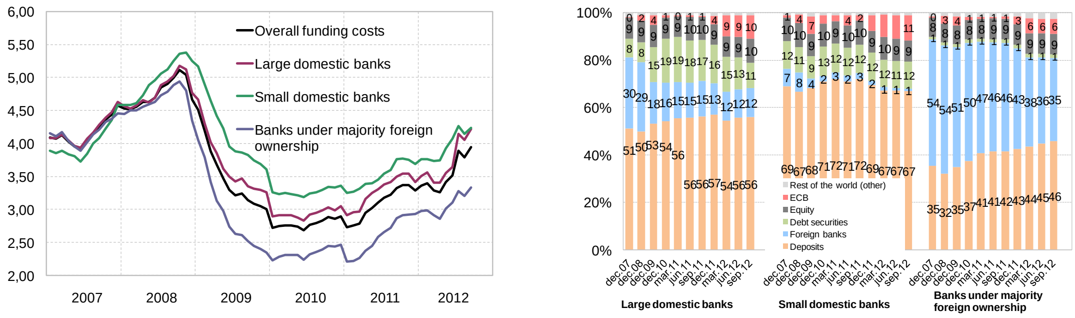
Difference in funding costs between bank groups

The banks under majority foreign ownership have the cheapest funding.

The banks under majority foreign ownership had the lowest average funding costs in September 2012 at 3.3%, followed by the two groups of domestic banks at 4.2%. The difference between the two largest groups widened to 0.9 percentage points. If debt funding, which accounts for the vast majority of bank funding, is taken into account alone, the difference between the two largest bank groups widened by just a tenth of a percentage point to reach 0.7 percentage points in September.

The average cost of debt funding was the lowest at the banks under majority foreign ownership at 1.5%, a reflection of the most favourable funding structure at this bank group, where the liabilities to foreign banks account for the highest proportion of funding. This still stood at 35% in September, despite deleveraging. The average cost of debt funding in September stood at 2.16% at the large domestic banks and 2.49% at the small domestic banks. The largest fall in debt funding costs in 2012 was recorded by the banks under majority foreign ownership at 0.38 percentage points, while the fall at the banks under majority domestic ownership was smaller at 0.27 percentage points. Debt funding costs were unchanged in the first nine months of the year at the small domestic banks.

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 the ECB has increased this year, while the proportion accounted for by wholesale funding has declined.

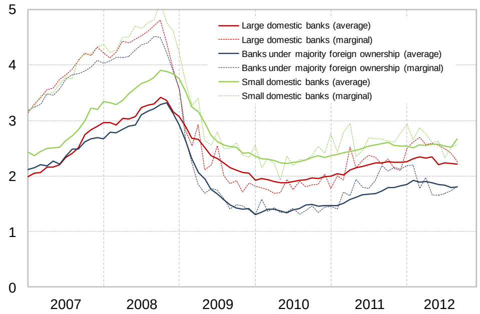
The proportion of funding accounted for by deposits by the non-banking sector is increasing.

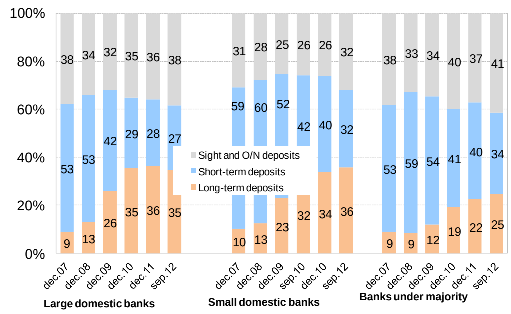
During the financial crisis the proportions of bank funding accounted for by funding at foreign banks and by issued debt securities have declined the most. The proportion accounted for by deposits by the non-banking sector is increasing, despite the decline in their stock. Other forms of funding, with the exception of funding at the ECB, have declined faster. Deposits by the non-banking sector are increasing in importance at the banks under majority foreign ownership in particular. These banks are increasingly focusing on funding on the Slovenian retail market, while rolling over only some of their liabilities to the rest of the world. The proportion of funding accounted for deposits by the non-banking sector at the banks under majority foreign ownership increased by 4 percentage points during the first nine months of the year to 46%, up 14 percentage points on the end of 2008. The corresponding figures for September 2012 at the other two bank groups were comparable to those at the end of the previous year. Deposits by the non-banking sector accounted for 56% of total funding at the large domestic banks, and for 67% at the small domestic banks.

The differences between the different bank groups in relation to deposits by the non-banking sector have remained relatively large in 2012. The small domestic banks had the highest deposit funding costs in September, at an average cost of 2.6%, 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 fall in interest rates on the financial markets was reflected most in the lower cost of funding via liabilities to foreign banks. The fall was nevertheless smaller than the fall in the EURIBOR. These costs fell sharpest at the banks under majority foreign ownership, by 0.8 percentage points to 1.3%, followed by the large domestic banks, where they were down 0.6 percentage points at 1.8%, and the small domestic banks, where they were down 0.3 percentage points at 2.9%.

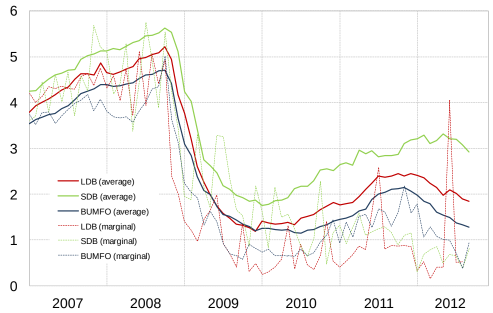
Figure 3.23: Average and marginal funding costs for deposits by the non-banking sector (left) and original maturity breakdown of deposits (right) by bank group in percentages

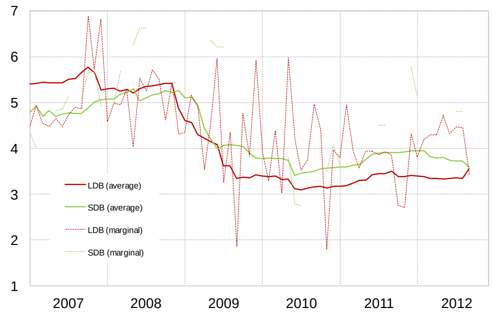




Source: Bank of Slovenia

Figure 3.24: Average and marginal funding costs for liabilities to foreign banks (left) and from issued securities (right) by bank group in percentages





Source: Bank of Slovenia

There was little difference in the cost of issued bank securities at the two groups of banks under majority domestic ownership in September. The cost was up slightly in 2012 at the banks under majority domestic ownership overall, by 0.14 percentage points at 3.5%, as the small domestic banks recorded a decline of 0.35 percentage points to 3.6%.

No significant fall in debt funding costs can be expected in the future.

Bank funding costs fell during the first nine months of 2012 as a result of an increase in ECB funding, a fall in ECB interest rates and a fall in the EURIBORs on the financial markets. The two 3-year LTROs have significantly reduced price pressures on the funding side. However, the costs of new funding on the wholesale markets are not falling, while the fall in funding costs is not compensating for the decline in interest income. In the given circumstances no significant fall in bank funding costs can be expected, as a result of the following factors: interest rates on the international financial markets have fallen to very low levels, new bank funding on foreign banking markets would be more expensive than existing funding and very limited, and an increasing proportion of funding is accounted for deposits by the non-banking sector, whose costs have not fallen.

4 BANKING SYSTEM'S INCOME STATEMENT AND INCOME RISK

The banking system's income risk is high. It is being increased by the adverse macroeconomic situation, the further deterioration in the quality of the credit portfolio, low write-downs of bad debts, and the decline in lending. Impairment and provisioning costs during the first ten months of the year were up 19% on the same period of 2011, despite having been high in recent years. Expressed as a ratio to gross income, impairment and provisioning costs in the first ten months of the year amounted to almost two-thirds, despite the increase in gross income brought by the favourable temporary effect of June's increase in non-interest income as a result of the prepayment of subordinated debt.

The banking system's pre-tax loss during the first ten months of the year amounted to EUR 155 million.

The banking system's pre-tax loss amounted to EUR 155 million during the first ten months of the year, EUR 31 million more than in the same period of 2011. This year will be the banking system's third consecutive loss-making year. This is additionally deterring potential investors in Slovenian banks. The banking system's net interest income during the first ten months of the year was down 11.3% on the same period of the previous year, as a result of interest income declining faster than interest expenses. Without more radical changes, the banks will also make a loss in 2013.

Table 4.1: Income statement for first ten months of 2012

	2010	Breakdown	2011	Breakdown	2012	Breakdown	Annual growth, %
EUR million, % growth	Jan-Dec	%	Jan-Dec	%	Jan-Oct	%	Oct 2011 - Oct 2012
Interest income	2.055		2.184		1.657		-9,8
Interest expenses	1.017		1.178		900		-8,5
Net interest	1.038	70,4	1.007	68,3	757	62,9	-11,3
Non-interest income	437	29,6	423	28,7	535	44,5	53,0
of which net fees and commission	343	23,3	340	23,1	276	23,0	-3,5
of which net gains/losses from financial assets and liabilities held for trading	-49	-3,3	-10	-0,7	10	0,8	-178,4
Gross income	1.474	100,0	1.430	97,0	1.292	107,4	7,4
Operating costs	766	51,9	763	51,7	607	50,5	-2,3
of which labour costs	413	28,0	408	27,7	333	27,7	-1,6
Net impairments and provisioning	810	54,9	1.206	81,8	840	69,8	19,0
of which net impairments of financial assets at amortised cost and provisioning	639	43,3	949	64,4	752	62,5	25,9
Pre-tax profit	-101	-6,9	-539	-36,6	-155	-12,9	24,8
Taxes	3		95		-31		…
Net profit	-98		-444		-187		…

Source: Bank of Slovenia

The banks are strongly exposed to income risk, as a result of the decline in net interest and as a result of credit risk.

The following are factors in the high income risk. Growth in net interest income has declined in 2012. The reason is a decline in interest income, year-on-year growth in which stood at -9.8% at the end of October, having still been positive at the end of the first quarter. The decline in interest income is the result of the decline in lending and the increase in loan impairments, which is reducing the stock of loans and, consequently, the amount of interest income accruing.

The decline in interest expenses has had a beneficial impact on the banking system's (gross) income, but it is short-term. Year-on-year growth in interest expenses was positive at end of the first quarter of 2012 at 5.5%, but had declined to -8.5% by the end of October. This was the result of the decline in the stock of funding, lower interest rates on the international financial markets and a more favourable funding breakdown. The proportion accounted for by more-expensive funding has declined, while the proportion accounted for by relatively cheap ECB funding has increased. The decline in interest income nevertheless exceeded the decline in interest expenses.

The main factors in growth in the banking system's net non-interest income were exceptional developments related to the prepayment of subordinated debt. Net income from fees and commissions declined as a result of the decline in lending activity, while income from trading was very limited because of the situation on the capital and foreign exchange markets. The banking system's gross income during the first ten months of the year was up 7.4% on the same period of the previous year, as a result of an increase in income in June and July from the prepayment of subordinated debt at a discount.

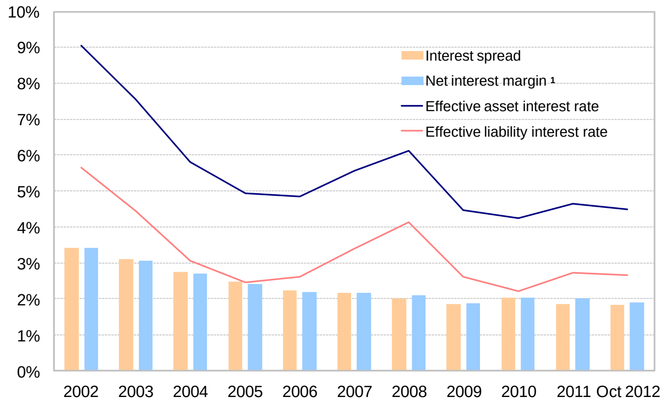
Net interest income and interest margin

Effective asset and liability interest rates have fallen by the same amount in 2012.

Net interest is declining faster than total assets, which has further reduced the net interest margin. The year-on-year decline in interest income during the first ten months of the year was 5.4 percentage points larger than that in total assets. The banking system's interest margin calculated per total assets during the first ten months of the year stood at 1.9%. The decline in net interest is the result of a larger decline in the banks' interest income than in interest expenses.

Average effective asset and liability interest rates in the third quarter of 2012 were down just under 0.5 percentage points on the final quarter of 2011, to 4.2% and 2.3% respectively. The average spread over the preceding year declined by a tenth of a percentage point to 1.8%.

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



Note: [1] The October figure is calculated cumulatively for the period of January to October 2012.
Source: Bank of Slovenia

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

All the bank groups have seen a decline in net interest in 2012.

Growth in net interest in the first ten months of the year was negative at all the bank groups. The banks under majority foreign ownership and the large domestic banks saw interest income decline by around 12%, while the small domestic banks recorded a decline of just over 5%. The latter had previously recorded the largest decline in net interest in 2011. The large domestic banks recorded the largest increase in net non-interest income, for the aforementioned reasons, while the other two bank groups saw no change or a slight increase. The banks under majority domestic ownership, the large domestic banks in particular, have reduced their operating costs in 2012.

The disposal of gross income on impairment and provisioning costs during the first ten months of the year was highest at the small domestic banks.

The largest year-on-year increase in impairment and provision costs during the first ten months of the year was recorded by the small domestic banks, at 84%, while the only decline was recorded by the banks under majority foreign ownership, where impairment and provisioning costs also accounted for the lowest proportion of the disposal of gross income.

The banks under majority domestic ownership recorded negative ROE and ROA as a result of pre-tax losses. The pre-tax return on average equity (ROE) at the domestic banks stood at -1.4% during the first ten months of the year, while the return on average assets stood at -0.6%. The two indicators were positive at the banks under majority foreign ownership, thanks to their profits. Their ROA stood at 0.14%, and their ROE at 1.54%.

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

	Annual 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
	Net interest income							
2011	-3,1	-13,3	0,3	-3	67,5	76,2	74,9	70,4
Oct 2012	-11,8	-5,2	-12	-11,3	52,3	75	70,2	58,6
	Non-interest income							
2011	0,8	-23	-6,9	-3,1	32,5	23,8	25,1	29,6
Oct 2012	78,6	-0,9	4,3	53	47,7	25	29,8	41,4
	Operating costs							
2011	-2,8	-0,8	4,5	-0,4	51,1	59,6	56,4	53,4
Oct 2012	-4,8	-0,9	1,8	-2,4	41,4	59,1	58,2	47
	Impairments and provisioning							
2011	66	38,4	-7,8	48,9	109,5	71,4	35,5	84,4
Oct 2012	21,2	84,2	-10	19	75	82,7	35	65
	Profit							
2011	263,3	-535,2	-11,3	431,4	-60,6	-31	8,1	-37,7
Oct 2012	-12,6	…	-39,5	24,8	-16,3	-41,8	6,8	-12

Source: Bank of Slovenia

The banks under majority domestic ownership had a lower net interest margin than the banks under majority foreign ownership.

The high financial intermediation margin of 3.38% at the domestic banks during the first ten months of the year was the result of June's increase in non-interest income. The margin stood at just 2.6% in May. Before the increase in non-interest income at the large domestic banks, the banks under majority foreign ownership had been operating with a higher financial intermediation margin, which stood at 2.98%. The banks under majority domestic ownership had a lower net interest margin (1.84%) than the banks under majority foreign ownership (1.98%). The nominal decline in costs meant that the ratio of operating costs to total assets at the domestic banks was slightly lower than at the banks under majority foreign ownership. The indicator stood at 1.45% at the domestic banks and at 1.68% at the banks under majority foreign ownership. By contrast the ratio of impairments of financial assets measured at amortised cost to gross assets was a high 9% at the large domestic banks in October, compared with just 4.3% at the banks under majority foreign ownership.

Table 4.3: Bank performance indicators during the first ten months of 2012 in percentages

	End of period				
(%)	2009	2010	2011	Oct 2011	Oct 2012
Profitability					
Financial intermediation margin*	2,87	2,87	2,86	2,89	3,22
ROA	0,32	-0,20	-1,08	-0,30	-0,39
ROE	3,85	-2,36	-12,67	-3,47	-4,56
Interest margin on interest-bearing assets	1,98	2,13	2,13	2,16	1,99
Net non-interest income / operating costs	64,45	57,01	55,45	56,26	88,08
Operating costs					
Labour costs / average assets	0,84	0,80	0,82	0,81	0,83
Other costs / average assets	0,70	0,69	0,71	0,68	0,68
Quality of assets					
Impairments of financial assets measured at amortised cost / gross assets	3,02	4,20	5,90	5,38	7,54

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

5 LIQUIDITY RISK

Liquidity risk as measured by the first-bucket liquidity ratio was moderate during the first eleven months of the year, and down on the previous year. The liquidity of Slovenian banks, particularly the domestic banks, is however more dependent on Eurosystem funding than in the past.

The banking system's net borrowings from the Eurosystem increased during the first eleven months of the year, while the pool of eligible collateral at the ECB that is free halved, although at the level of the banking system it remains satisfactory at 34%. Liquidity risk is concentrated at the banks with the lowest level of free eligible collateral. Secondary liquidity declined by 4%, with the large domestic banks recording the largest decline.

Participation in the money market for Slovenian banks' unsecured loans to the Eurosystem has declined in 2012 as a result of the growing lack of confidence on the European interbank market and a decline in the excess liquid assets placed by Slovenian banks in the rest of the world. The decline in excess liquidity is also reducing the volume of trading on the Slovenian interbank market.

Liquidity ratios

The average first-bucket liquidity ratio in 2012 was higher than in the previous year.

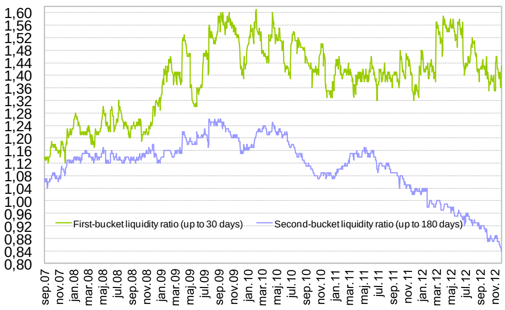
The first-bucket liquidity ratio averaged 1.46 during the first eleven months of 2012, up 0.06 on the average of the previous year. After increasing in the first quarter of 2012 as a result of the funding obtained in February's tender for 3-year LTROs at the ECB, the first-bucket liquidity ratio declined significantly in July and September as a result of the maturity and repayment of liabilities from government-guaranteed debt securities issued at two banks. At the end of November the first-bucket liquidity ratio stood at its level of the previous December.

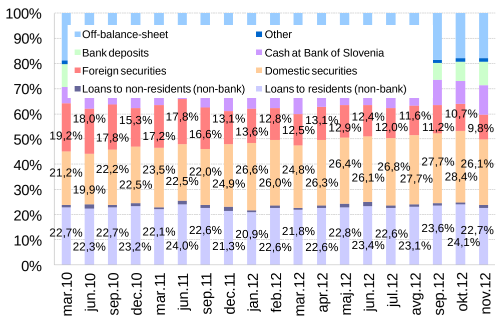
The current satisfactory liquidity at Slovenian banks is the result of the funding obtained from the ECB.

The satisfactory liquidity in the Slovenian banking system is largely due to the funding obtained from the Eurosystem. The primary dependence on a single source of funding is, however, increasing liquidity risk. The small domestic banks are most exposed to liquidity risk. The banks under majority foreign ownership have guaranteed funding from their parent banks, and therefore participate in ECB tenders to a lesser extent.

The second-bucket liquidity ratio averaged 0.95 during the first eleven months of the year, down 0.15 on the 2011 average. The two factors in the decline in the second-bucket liquidity ratio are the repayment of liabilities from maturing issued debt securities and the shortening of average maturities of liabilities to the rest of the world.

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





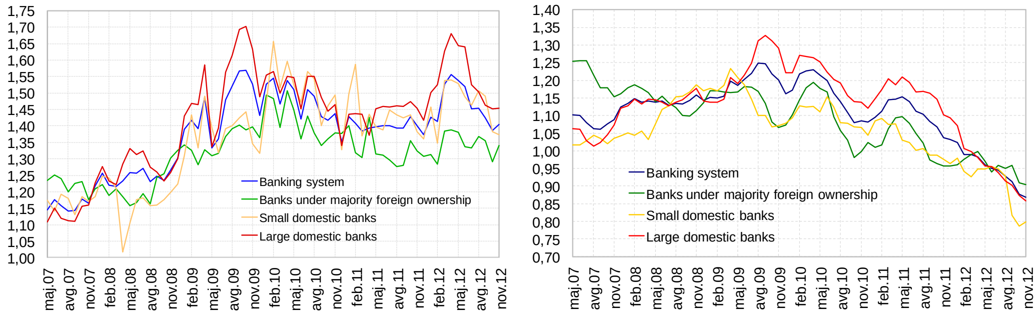
Source: Bank of Slovenia

The large domestic banks recorded the largest increase in the first-bucket liquidity ratio.

The differences in the first-bucket liquidity ratio between the bank groups have widened in 2012. The first-bucket liquidity ratio increased at the domestic banks, the large domestic banks recording the largest increase of 0.1 to 1.55, while the ratio at the banks under majority foreign ownership remained at its average level of 2011. This was the result of the banks' participation in the LTRO tender, where the majority of funding was obtained by the domestic banks.

The second-bucket liquidity ratio has gradually declined throughout 2012 at all the bank groups. The largest decline was recorded by the large domestic banks, by 0.21 to 0.95 on average, primarily as a result of the maturing of issued debt securities and the shortening of the average maturities of liabilities to the rest of the world.

Figure 5.2: First-bucket liquidity ratio (up to 30 days; left) and second-bucket liquidity ratio (up to 180 days; right) by bank group, monthly averages



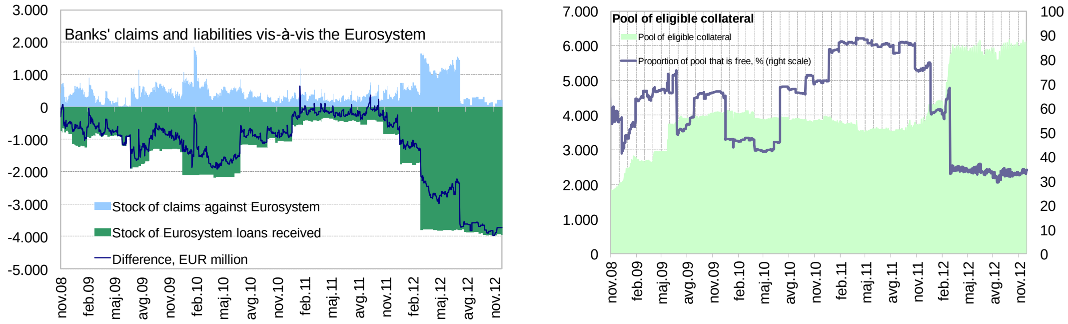
Source: Bank of Slovenia

Net borrowings from the Eurosystem have increased.

Net borrowings from the Eurosystem increased after Slovenian banks' participation in the tender for 3-year LTROs at the end of February. The banks invested the excess liquidity in the deposit facility, which increased claims against the Eurosystem. After the interest rate on the deposit facility was cut to zero in the first half of July, the banks held these funds in their transaction accounts, which increased net borrowings from the Eurosystem. They amounted to EUR 3.9 billion at the end of October, or 8.4% of the banking system's total assets.

The pool of eligible collateral at the Eurosystem amounted to EUR 6.2 billion at the end of November 2012, up EUR 1.8 billion on the end of 2011. The proportion of the banking system's pool of eligible collateral that is free halved after the banks' participation in the tender for the 3-year LTROs at the end of February, and then remained stable at around 34% until the end of November. Liquidity risk is increasing at the banks with the lowest level of free eligible collateral.

Figure 5.3: Commercial banks' claims, liabilities and net position vis-à-vis the Eurosystem in EUR millions (left), and banking system's pool of eligible collateral at the Eurosystem in EUR millions (right)

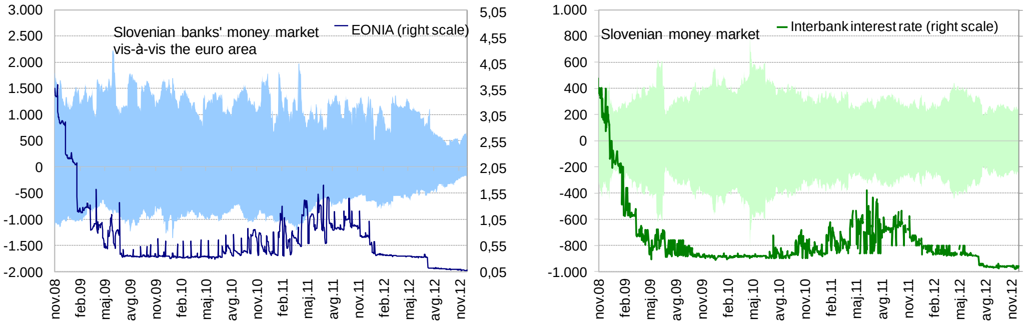


Source: Bank of Slovenia

The lack of confidence on the European interbank market was reflected in a decline in loans received from the rest of the world.

Slovenian banks' participation in the money market for unsecured loans to the Eurosystem declined during the first eleven months of the year. Net claims against foreign banks increased by EUR 559 million to EUR 430 million, as loans granted to the rest of the world increased by EUR 77 million and loans received from the rest of the world declined by EUR 482 million. This was the result of the growing lack of confidence on the European interbank market and a decline in the excess liquid assets placed by Slovenian banks in the rest of the world in the form of loans. The volume of trading on the Slovenian interbank market is down 20% to EUR 236 million this year, a reflection of the decline in excess liquidity.

Figure 5.4: Stock of unsecured deposits of Slovenian banks placed and received on the Eurosystem money market (left) and the Slovenian money market (right) in EUR million, and movement of the EONIA and the interest rate on the Slovenian interbank market in percentages



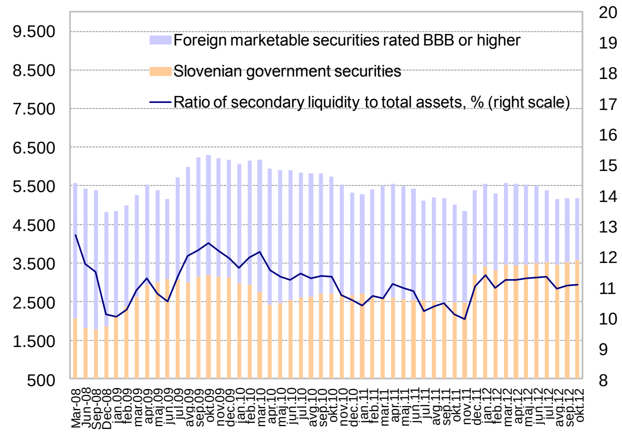
Source: Bank of Slovenia

Secondary liquidity

Secondary liquidity is down 4%, but its ratio to total assets is stable.

Secondary liquidity declined by EUR 210 million during the first ten months of the year to EUR 5.2 billion. While investments in Slovenian government securities increased as a result of subscriptions to treasury bills, the stock of foreign marketable securities rated BBB or higher declined. The proportion of total secondary liquidity accounted for by Slovenian government securities increased from 59.6% at the end of 2011 to 69.4% in October 2012. Among the bank groups it was primarily the domestic banks that reduced their secondary liquidity, as they have reduced their investments in foreign marketable securities as a result of the problems in accessing funding on the international financial markets. The ratio of secondary liquidity to total assets remained at the same level as in 2011 at 11.1%, as a result of the decline in total assets.

Figure 5.5: Changes in secondary liquidity (monthly averages in EUR millions) and ratio of secondary liquidity to total assets in percentages

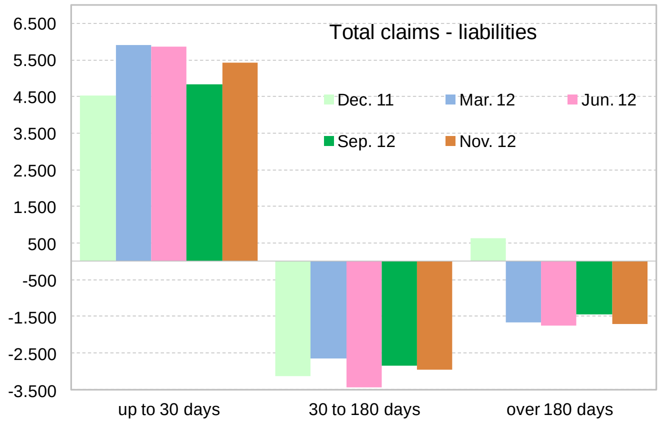


Source: Bank of Slovenia

Liquidity gap

The positive liquidity gap in the bucket with residual maturity of up to 30 days amounted to EUR 5.4 billion in November, EUR 0.9 billion more than at the end of 2011. The banks' participation in the LTRO tender at the end of February widened the liquidity gap in the first quarter of 2012, which then narrowed in the third quarter as a result of repayments of liabilities and the maturing of debt securities issued by banks. Its increase in November was the result of an increase in the stock of balances at the central bank brought by an increase in government sight deposits at banks after the issue of 10-year Slovenian government bonds in US dollars.

Figure 5.6: Liquidity gap as the difference between total assets and total liabilities defined in the liquidity ladder methodology in EUR millions



Source: Bank of Slovenia

6 REFINANCING RISK

Slovenian banks' refinancing risk remains high, despite a decline in the debt servicing burden over shorter time horizons after the repayment of liabilities in the rest of the world in 2012. The high level of uncertainty on the international financial markets, the downgradings of sovereign debt and banks, and the increasing focus of the banks under majority foreign ownership on retail funding were all factors in the continuing repayment of liabilities to the rest of the world in 2012, and thus in the contraction in bank balance sheets. It is likely that this process will continue in 2013, albeit more slowly.

The banks are slightly less exposed to the burden of debt servicing over shorter time horizons. In October 2012 some 26% of the banks' liabilities to the rest of the world[11] were maturing in up to 1 year, compared with 31% in October 2011. A total of EUR 2.3 billion of the banking system's liabilities to the rest of the world will mature over a period of up to 1 year (until October 2013), compared with EUR 4.1 billion a year earlier. At the same time the banks will see EUR 1.6 billion of general government deposits[12] mature in up to 1 year, of the total of EUR 2.7 billion of debt, which is almost comparable with the figure of the previous year.

The banks eased the pressure from maturing funding on the wholesale markets by means of 3-year funding obtained in LTROs at the Eurosystem in December 2011 and February 2012. Liabilities to the Eurosystem had increased to EUR 3.9 billion by the end of October, reducing the banks' refinancing risk in 2013. This funding nevertheless does not represent a definitive solution in the restructuring of bank funding.

Banks and sovereign long-term debt have been downgraded in 2012. Any further downgradings could reduce the value of the pool of eligible collateral for ECB operations. This would reduce the banks' access to Eurosystem funding, and increase refinancing risk. The short-term burden of servicing debt to the rest of the world has diminished in 2012, but the banks have significantly less free eligible collateral for Eurosystem operations than in 2011.

The amount of new loans raised by banks in the rest of the world has been modest in 2012, and the loans are short-term loans with fixed interest rates. The rates have averaged around 2%, similar to the previous year. The breakdown of the maturing debt (including issued debt securities) to the rest of the world is less favourable at the banks under majority foreign ownership that at the banks under majority domestic ownership. The latter will see 20% of their debt to the rest of the world mature within 1 year, while the banks under majority foreign ownership will see 31% mature. The difference is even greater over the period of up to 2 years, when the banks under majority domestic ownership will see 23% of their debt to the rest of the world mature, and the banks under majority foreign ownership 46%.

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

a) General government deposits at banks

The banks will see just over 60% of general government deposits mature between October 2012 and October 2013.

After becoming an important source of funding for banks during the crisis, the government has begun gradually withdrawing deposits from banks in 2012. General government deposits declined by EUR 733 million during the first ten months of the year, and accounted for just under 12% of deposits by the non-banking sector in October. In terms of residual maturity, the banks will see EUR 1.6 billion of general government deposits mature within 1 year and EUR 2.6 billion within 2 years.

The largest and most variable component in general government deposits at banks comprises fixed-term deposits by the Ministry of Finance of the Republic of Slovenia (MoF). They amounted to EUR 1,537 million at the end of October 2012, or 57% of total government deposits. Government deposits at the banks increased in late October and

[11] Liabilities to banks in the rest of the world include debt securities issued in the rest of the world.
[12] The general government sector includes central government, regional government units, local government units and social security funds (S.13).

early November after the MoF deposited part of the proceeds of the sale of 10-year government bonds at banks.

According to the maturity breakdown of the MoF fixed-term deposits, the large domestic banks are most heavily exposed to refinancing risk on their basis in the period of up to 1 year. Of the EUR 2.05 billion of MoF deposits at banks, two-thirds were placed with the large domestic banks as at 20 November 2012.

The small domestic banks have the highest ratio of government deposits to total liabilities, but their maturity breakdown is better than at the other two bank groups.

General government deposits are a relatively important source of funding for the banks under majority domestic ownership. The ratio of liabilities to the government sector to total liabilities is higher at the banks under majority domestic ownership. In October 2012 it stood at 8.6% at the small domestic banks, 6.5% at the large domestic banks and 3.8% at the banks under majority foreign ownership. The ratio of government funding to total liabilities has declined at all the bank groups in 2012 as a result of the withdrawal of government deposits from banks.

Table 6.1: Breakdown of the banks' maturing liabilities from Ministry of Finance deposits at banks in percentages (November 2012)

	Cumulative maturing of government bonds				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	1.390	417	242	2.050				
				Breakdown, %				
Up to 3 months	28,7	76,7	12,4	36,5	28,7	76,7	12,4	36,5
3 to 6 months	33,7	76,7	26,4	41,6	5,0	0,0	14,0	5,1
6 months to 1 year	49,3	81,3	45,8	55,4	15,5	4,6	19,4	13,8
Until 1 April 2014	100,0	100,0	100,0	100,0	50,7	18,7	54,2	44,6
Total					100,0	100,0	100,0	100,0

Source: Bank of Slovenia

b) Issue of bank securities on the financial markets

The largest factor in the decline in issued debt securities in late 2012 was the maturing of government-guaranteed 3-year bonds.

The banks have reduced their stock of funding via debt securities in the last two years, by EUR 786 million in 2011 and by EUR 1.5 billion during the first ten months of 2012. The latter was the result of the prepayment or the final maturity of 3-year bonds of two banks issued with a government guarantee. Most notably the two banks reduced their liabilities by EUR 303 million in March 2012 via partial prepayments of bonds. Then in June the liabilities declined by EUR 768 million as a result of the maturity of one of the bank's 3-year bonds. The other bank's 3-year government-guaranteed bond matured in September, in the residual amount of EUR 281 million. SID banka issued 1-year bonds in September and October with a total nominal value of EUR 210 million. Liabilities from issued debt securities declined to EUR 2.2 billion by the end of October. Because the banks have repaid liabilities that matured in 2012, the average maturity of this debt in terms of residual maturity has lengthened. The majority of October's stock of issued debt securities in the amount of EUR 2.2 billion comprised liabilities at the large domestic banks. The debt servicing burden in the segment of shortest maturities declined after the repayment of bonds. The banks will see only 20% of the debt based on issued bonds mature within the period of 1 year. The largest portion of this debt, just under EUR 1.5 billion, lies in the maturity segment of 2 to 3 years.

c) Bank funding from the Eurosystem

The Slovenian banking system had liabilities to the Eurosystem of EUR 3.9 billion in mid-November 2012.

Liabilities to the Eurosystem increased by EUR 2.2 billion during the first ten months of 2012 to EUR 3.9 billion, equivalent to 8.4% of the banking system's total assets in October. The ratio was between 9% and 10% at the domestic banks, while the banks under majority foreign ownership were less exposed to the Eurosystem with a ratio of 6.2%. The increase was the result of 19 Slovenian banks' participation in February's 3-year LTRO.

The increase in Slovenian banks' funding from the Eurosystem in LTROs has eased refinancing pressures in terms of price and maturity. Because the majority of the liabilities to the Eurosystem only mature in the first quarter of 2015, the banks will be less exposed to refinancing pressures in 2013. However, less of the banks' pool of eligible collateral at the Eurosystem is free. The proportion of the pool that is free stood at 86% a year earlier, but had declined to 34% by November.

The potential downgrading of Slovenia’s long-term sovereign debt, which since August 2012 has been rated Baa2 by Moody's, A- by Fitch and A by S&P, could further reduce the pool of eligible collateral at the Eurosystem that is free in the future. Were Slovenia to be downgraded to BBB-, premiums on government securities and government-guaranteed assets would rise and the assets of public sector entities would be removed from the total pool of eligible collateral for Eurosystem operations, which would reduce the amount of Eurosystem funding the banks are able to obtain. The government’s efforts to achieve fiscal consolidation in order to maintain long-term sovereign credit ratings are thus vital to ensuring that these risks are not realised.

The Eurosystem funding obtained by the banks in 3-year LTRO tenders has only temporarily deferred their mandatory rapid deleveraging. As a result of debt repayments in the rest of the world, the slowdown in growth in deposits by the non-banking sector and eventual contraction in these deposits, and the increase in liabilities to the Eurosystem, the banks have partly restructured their funding in 2012, easing refinancing pressures on the wholesale financial markets.

d) Maturing bank liabilities to the rest of the world

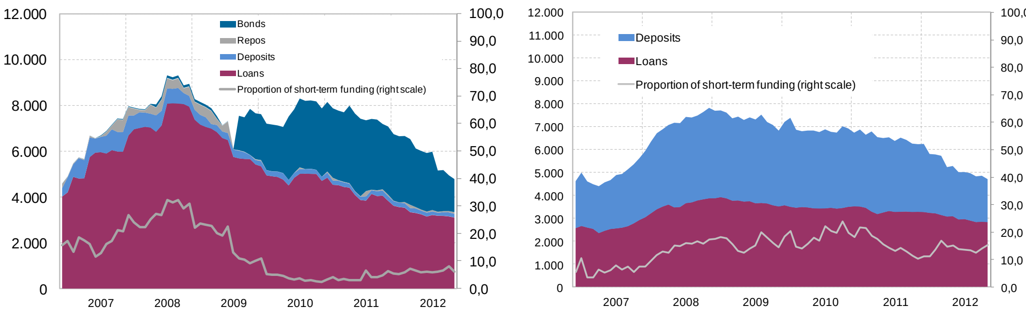
The banks have succeeded in rolling over only some of the maturing liabilities on the wholesale markets in the rest of the world. Between September 2011 and September 2012, according to survey figures the banks under majority foreign ownership rolled over 49% of their maturing liabilities to foreign banks. The figure at the banks under majority domestic ownership was 19%.

The domestic banks and the banks under majority foreign ownership have again reduced their liabilities to foreign banks in 2012.

Slovenian banks reduced their liabilities to foreign banks during the first ten months of the year, the domestic banks by 11% or EUR 421 million, excluding liabilities from issued bonds. Bank bonds issued in the rest of the world were reduced by a half or EUR 1.45 billion, for the aforementioned reasons. Both short-term and long-term debt to the rest of the world were reduced. The proportion of the stock of debt accounted for by short-term debt increased slightly, to average 6.4% in 2012.

The banks under majority foreign ownership reduced their liabilities to foreign banks by 19% or EUR 1.1 billion during the first ten months of the year. The banks under majority foreign ownership primarily rely on short-term funding. The average proportion accounted for by short-term deposits stood at more than 14% in 2012, as in 2011.

Figure 6.1: Stock of funding at foreign banks for the banks under majority domestic ownership (left) and the banks under majority foreign ownership (right) in EUR millions



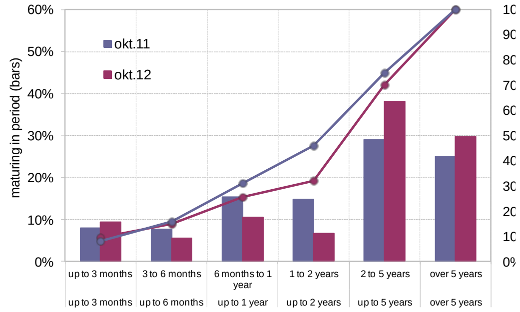
Source: Bank of Slovenia

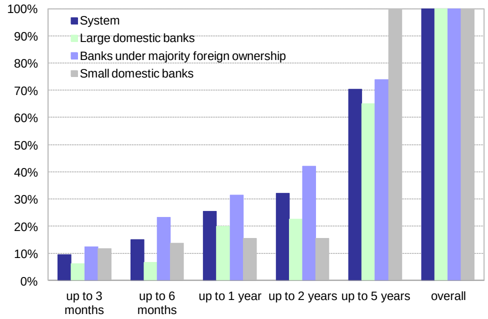
The bond repayments have lengthened the average maturity of debt in 2012, because the banks did not roll over the maturing bonds given the adverse situation on the international financial markets and given the magnitude of the required yields on Slovenian bonds.

The average maturity of debt has lengthened this year.

As a result the maturity breakdown of the debt to the rest of the world in October 2012 was longer than a year earlier. Debt with a maturity of up to 1 year accounted for 26% of total liabilities to foreign banks, compared with 31% in October 2011. Repayments of debt securities issued by the large domestic banks have lengthened the maturity breakdown of their debt. According to the figures for October 2012, the large domestic banks will see just 20% of their debt to the rest of the world or EUR 903 million mature within a period of 1 year, and 23% within two years. By contrast, the debt to the rest of the world at the banks under majority foreign ownership was significantly more short-term in nature. They will see just 31% or EUR 1.4 billion of their debt to the rest of the world mature within a period of 1 year, and 46% within two years.

Figure 6.2: Maturing of liabilities to foreign banks by maturity interval (left) and 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 [13]

	Cumulative maturing of liabilities to foreign banks				Maturity breakdown of liabilities			
	Banking system	Large domestic banks	majority foreign ownership	Small domestic banks	Banking system	Large domestic banks	majority foreign ownership	Small domestic banks
Total, EUR million	9.483	4.556	4.714	213				
				Breakdown, %				
Overnight / sight	1,7	1,7	0,4	0,3	1,7	1,7	0,4	0,3
Up to 1 month	6,0	4,7	2,9	3,9	4,3	3,0	2,5	3,6
1 to 3 months	9,4	6,2	11,7	11,7	3,4	1,5	8,9	7,8
3 to 6 months	14,9	6,5	24,6	13,6	5,5	0,3	12,9	1,9
6 months to 1 year	25,5	19,8	31,0	15,4	10,6	13,3	6,4	1,8
1 to 2 years	32,1	22,6	46,1	15,4	6,6	2,8	15,1	0,0
2 to 3 years	59,7	55,7	54,2	100,0	27,6	33,1	8,1	84,6
3 to 4 years	66,1	62,1	68,1	100,0	6,4	6,4	13,9	
4 to 5 years	70,3	65,2	73,8		4,2	3,1	5,6	
5 to 7 years	78,8	67,3	92,3		8,5	2,1	18,5	
7 to 10 years	87,1	75,0	98,3		8,3	7,7	6,0	
10 to 15 years	92,7	84,9	100,0		5,6	9,9	1,7	
15 to 20 years	100,0	100,0			7,3	15,1		
Over 20 years								
Total					100,0	100,0	100,0	100,0

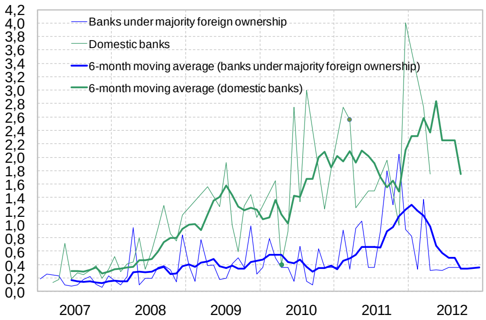
Source: Bank of Slovenia

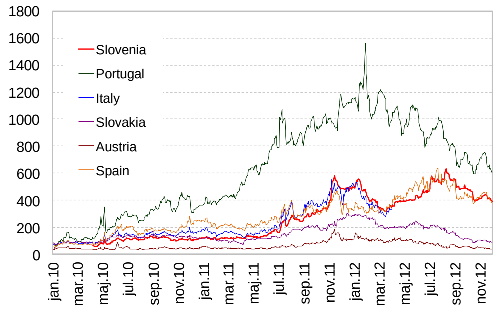
The interest rates on new transactions in 2012 have been comparable to those in the previous year.

The banks' funding conditions at banks in the rest of the world remain tight. Premiums over the EURIBOR have varied significantly from month to month and from transaction to transaction. The premium on loans to domestic banks has ranged between 1.75 percentage points and 2.75 percentage points in 2012. The banks under majority foreign ownership have borrowed with premiums of between 0.31 percentage points and 1.37 percentage points in 2012. However, the banks' funding in the rest of the world was primarily of a short-term nature, with fixed interest rates. The average interest rates on these transactions in 2012 have been comparable to those in the previous year. They have averaged 2% at the banks under majority foreign ownership, and 2.2% at the banks under majority domestic ownership.

[13] Liabilities to banks in the rest of the world include issued debt securities. These figures are reported by the banks in accordance with the Guidelines for implementing the regulation on reporting by monetary financial institutions, where the reporting of residual maturity takes account of the date of the final repayment of the loan.

Figure 6.3: Premiums over the EURIBOR on loans raised in the rest of the world with respect to majority ownership, monthly average and 6-month moving average in percentage points (left), and movement in premiums on 10-year Slovenian government bonds over the German benchmark 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 premiums on Slovenian government bonds over German bonds fell in the final quarter of 2012.

There were a number of factors in 2012 in Slovenia's sovereign downgrading, which resulted in significantly tighter funding conditions for Slovenian banks. The sovereign downgrading by the three main rating agencies in September 2011 has been followed by further downgradings, the latest in August 2012. The major factors cited by the agencies were political risk in relation to the (non-)implementation of the required reforms, and the deterioration in the banks' portfolio, which also resulted in bank downgradings. The required yields on 10-year government bonds rose at the same time. The required yields and premiums fell for Slovenia and the periphery countries after the ECB action taken in the summer of 2012. The premiums on Slovenian bonds fell further after the successful issue of US dollar 10-year bonds in October. The risk premium on government bonds nevertheless remained relatively high. In early December the premium fell slightly to below 400 basis points above the yield on 10-year German government bonds.

7 CREDIT RISK

The low economic activity and the decline in investment demand have been reflected in a decline in demand for corporate loans, while the banks' maintenance of tight credit standards has reduced the supply of loans. The slowdown in corporate lending has been reflected in a further decline in the quality of bank investments and an increase in credit risk, albeit at a slower pace than in the previous year. The proportion of the portfolio caught in bankruptcy proceedings increased further during the first ten months of the year, which is increasing the risk of future losses of income and capital at banks.

The lengthening of the economic crisis will result in the transmission of the adverse consequences of the crisis along production and supply chains from the directly afflicted firms in cyclical sectors and major firms in bankruptcy to firms that have performed well to date. The ineffective approach to the financial problems of firms that have economic potential and open projects is widening the pool of the affected entities as a result of lost business and increased insolvency, which is feeding back into a deterioration in the quality of the banks' portfolio. This could later affect banks that currently have a higher level of portfolio quality. Through a more active and coordinated approach to supporting promising projects and firms, the banks would themselves contribute to a faster economic recovery and a reduction in the feedback into increasing credit risk.

7.1 Quality of the credit portfolio

The banks' non-performing claims reached 14.2% of the total portfolio, non-financial corporations and OFIs recording the largest proportions.

The deterioration in the quality of the banks' credit portfolio continued in the first three quarters of 2012. After last year's deterioration, non-performing claims have continued to increase, albeit at a slower pace. The proportion of classified claims accounted for by non-performing claims, i.e. those more than 90 days in arrears, had increased to 14.2% by September. Most non-performing claims, EUR 5.6 billion of a total of EUR 7 billion, are concentrated at non-financial corporations, the proportion of total claims against non-financial corporations accounted for by non-performing claims increasing by 5.4 percentage points during the first nine months of the year to 23.9%. The portfolio of claims against non-residents has deteriorated more rapidly than in the previous year, and 13.4% of these claims are now more than 90 days in arrears. Increased arrears at financial holding companies meant that non-performing claims accounted for 22% of claims against non-monetary financial institutions in September, the rate of growth having slowed compared with the previous year.

Table 7.1 : Breakdown of classified claims by client segment in terms of number of days in arrears in the settlement of liabilities to banks in EUR million and percentages

	Classified claims			Classified claims in arrears in client segment					
				Total arrears			which: arrears of more than 90 day		
	Dec. 10	Dec. 11	Sep. 12	Dec. 10	Dec. 11	Sep. 12	Dec. 10	Dec. 11	Sep. 12
Total, EUR million	49.766	49.466	49.012	6.822	9.462	9.863	3.688	5.547	6.968
				Proportion of total, %					
Corporates	49,8	49,1	48,3	21,3	28,8	31,8	12,3	18,5	23,9
OFIs	4,8	4,4	4,2	19,2	25,3	29,8	6,9	18,9	22,2
Household sector[1]	20,3	20,7	20,6	9,8	10,2	-	4,0	4,5	-
sole proprietors	2,0	2,1	2,0	21,1	21,7	23,0	12,8	14,1	14,8
households[1]	18,3	18,6	18,6	8,6	8,9	-	3,1	3,5	-
Non-residents	12,8	11,4	10,7	12,6	15,5	25,7	5,2	8,7	13,4
Government	4,0	5,7	6,9	1,4	28,6	4,3	0,1	0,8	0,5
Banks and savings bank	7,6	7,5	7,2	1,4	0,2	0,2	0,2	0,1	0,0
Central bank	0,6	0,8	1,9	0,0	0,0	0,0	0,0	0,0	0,0
Other	0,1	0,4	0,3	0,0	0,0	0,0	0,0	0,0	0,0
Total	100,0	100,0	100,0	13,6	19,1	20,1	7,4	11,2	14,2

Note: [1] The figures for 2010 and 2011 for households are estimated on the basis of figures from the bank survey. The estimate is also taken into account in the household sector aggregate.
Sources: Bank of Slovenia, bank survey

The deterioration in the quality of the credit portfolio has not been uniform across all the bank groups: at the banks under majority foreign ownership it has almost ceased. The quality of the credit portfolio is least favourable at the large domestic banks, where 17.9% of claims are more than 90 days in arrears. The deterioration at these banks was largely

There has been a sharp increase in non-performing claims against non-financial corporations at the banks under majority domestic ownership.

the result of an increase in non-performing claims against non-financial corporations, which had reached 30.7% of classified claims against this client segment by September, having more than doubled since the end of 2010. Another factor was the contraction in loans to non-financial corporations, which is being reflected in lower approvals of new loans, which are relatively better, and in repayments of loans by good clients.

The deterioration in the portfolio has accelerated this year at the small domestic banks, where the proportion of non-performing claims reached 15.2%. In addition to non-financial corporations, this bank group has seen a particularly rapid increase in non-performing claims against non-residents and non-monetary financial institutions.

The banks under majority foreign ownership have maintained the highest credit portfolio quality.

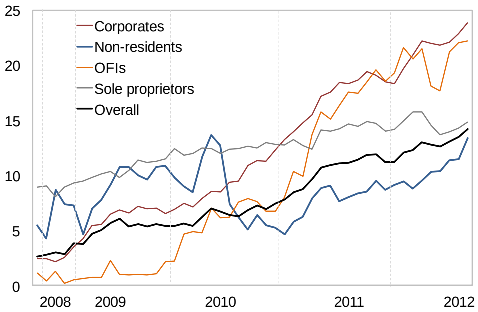
The quality of the portfolio and the pace of deterioration are significantly more favourable at the banks under majority foreign ownership, where the proportion of claims more than 90 days in arrears was down a half on the system average at 6.4% in September. The level of and changes in non-performing claims against non-financial corporations reveal the more active approach to the problem of bad debts at these banks. This bank group has best adjusted the structure of its credit portfolio to the new crisis situation, by increasing the proportion of loans to lower-risk sectors.

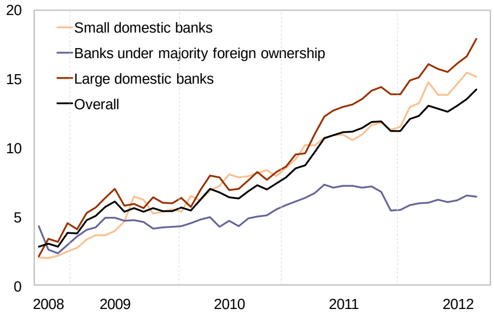
The banks under majority foreign ownership have the highest quality of credit portfolio of all the bank groups in all customer segments other than claims against sole proprietors. Non-performing claims accounted for 17.3% of classified claims against sole proprietors at these banks in September, more than double the ratio at the small domestic banks and 2.3 percentage points more than the ratio at the large domestic banks.

The sole proprietors portfolio has the most stable quality.

The quality of the banks' claims against sole proprietors in the system overall continue to rank them among the more stable segments. Although this sector of the economy is more responsive to the economic climate and is strongly dependent on liquidity in the economy, the quality of the sole proprietors portfolio has deteriorated significantly more slowly than the remainder of the corporate sector. The banks have succeeded in maintaining the quality of this segment of the portfolio by acting faster to address the non-performing claims, which is easier given the lower individual exposures.

Figure 7.1: Arrears of more than 90 days as a proportion of the banks' classified claims by client segment (left) and bank group (right) in percentages





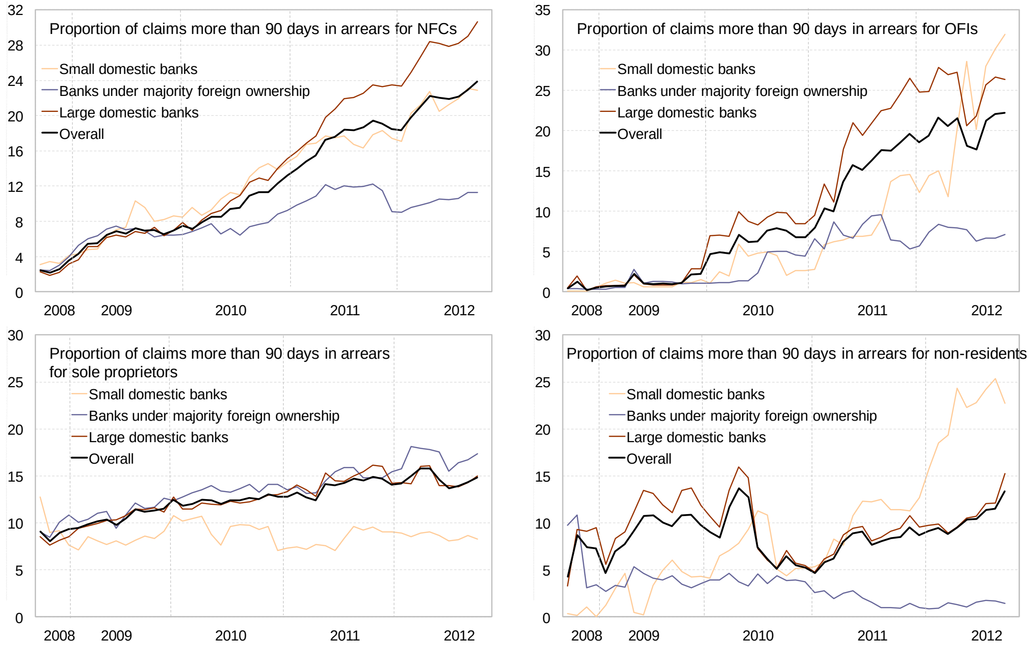
Source: Bank of Slovenia

The non-residents and OFIs portfolios have deteriorated sharply this year at the small domestic banks.

Non-performing claims against non-monetary financial institutions increased sharply at the large domestic banks in the previous year, but the proportion has remained at 26.4% this year. There has been a sharp deterioration in this segment of the portfolio at the small domestic banks this year, the proportion of non-performing claims increasing to 32%. There was also a sharp deterioration in the quality of claims against non-residents during the first nine months of the year at the small domestic banks, claims more than 90 days in arrears accounting for 22.7% of classified claims in this segment in September. The large domestic banks have also seen a deterioration in the non-residents portfolio in recent months, as a result of the uncertain economic situation in the former Yugoslav republics.

The quality of claims against households remains stable. According to the latest survey data for the end of 2011, the proportion of non-performing claims against households stood at 3.5%. A parallel source of data on loans in arrears reveals there to have been no increase in their level in the household segment this year. However, given the actual and expected fall in employment and household income, the proportion of bad debts can also be expected to increase in this segment of the banks' credit portfolio, particularly if the financial crisis persists for much longer.

Figure 7.2: Arrears of more than 90 days as a proportion of the banks' classified claims by bank group and individual client segment in percentages

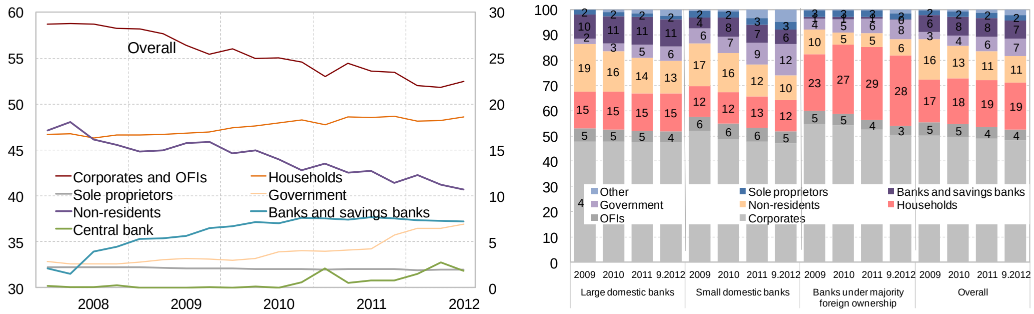


Source: Bank of Slovenia

The large domestic banks have maintained the same proportion of non-financial corporations in their portfolio as three years earlier, at 47%. The proportion has remained unchanged as claims against bad payers have been retained and the inflow of new clients has been limited. The other two bank groups have reduced their exposure to non-financial corporations by 5 percentage points relative to the end of 2009. At the small domestic banks credit risk from non-financial corporations is increasing, despite a decline in exposure to this client segment, an indication that exposure is not declining on account of bad clients but rather through the repayment of debts by firms able to repay maturing debts.

The proportion of classified claims accounted for by non-financial corporations has fallen by 5 percentage points since 2009 at the small domestic banks and the banks under majority foreign ownership.

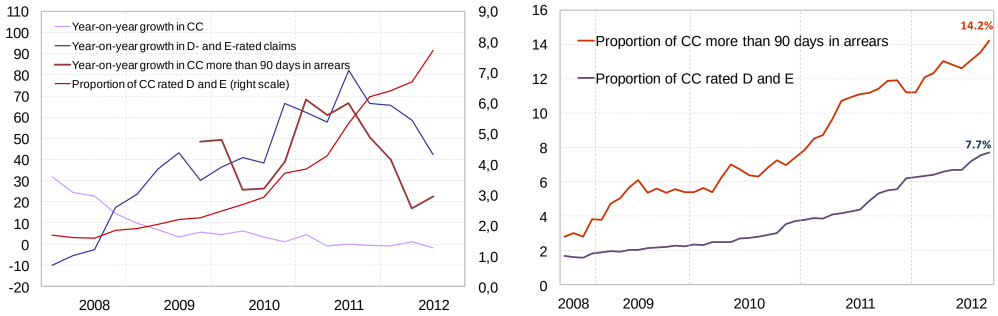
Figure 7.3: Breakdown of classified claims by sector, total (left) and by bank group (right) in percentages



Source: Bank of Slovenia

At the small domestic banks last year and this year have seen major restructuring of the portfolio to reduce the proportion of higher-risk client segments on their balance sheets. The proportion of claims accounted for by non-residents declined by 7 percentage points or just over a third between the end of 2010 and September 2012, while the proportion accounted for by claims against non-financial corporations declined by 5 percentage points. Over the same period these banks have increased their exposure to safer forms of investment, in particular the government sector, by 5 percentage points. To a lesser extent, the large domestic banks have also restructured the portfolio away from non-residents and towards the government sector.

Figure 7.4: Growth in classified claims (CC) and D- and E-rated claims (left), and comparison of the proportion of claims more than 90 days in arrears with the proportion of D- and E-rated claims (right) in percentages



Source: Bank of Slovenia

The banks have continued to downgrade claims and to create additional impairments.

The banks' total classified claims have remained at just under EUR 50 billion since mid-2010. Growth in non-performing investments, which accelerated during the reversal of the credit cycle in 2008, has slowed in the last year. Year-on-year growth in claims more than 90 days in arrears declined to 22% in September. As the proportion of the portfolio being settled in arrears has increased, the banks have continued to downgrade claims to lower ratings and to create additional impairments. The proportion of claims with the highest ratings (A and B) declined by 2.3 percentage points during the first nine months of the year to 86.4%. D- and E-rated claims accounted for 6.2% of classified claims at the end of 2011, and for 7.7% in September 2012. Despite this increase in their proportion of classified claims, growth in D- and E-rated claims has declined, although it remained high at 42% in year-on-year terms in September.

Table 7.2: Ratings breakdown of classified claims and coverage of claims by impairments and provisions, in EUR millions and percentages

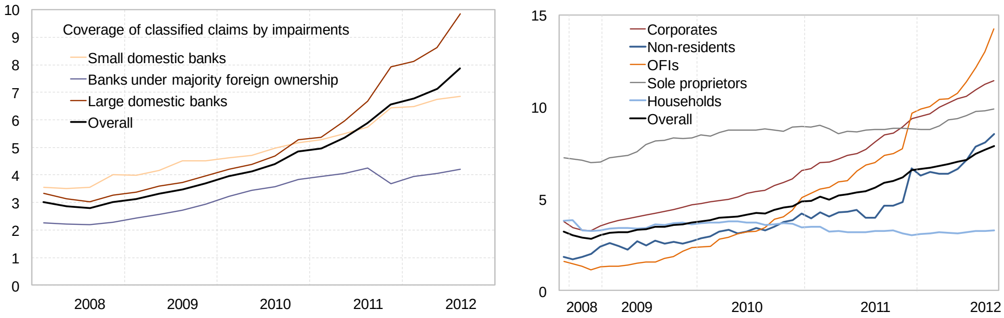
	31 Dec 2010			31 Dec 2011			30 Sep 2012		
	Classified claims	Impairments	Coverage of claims by impairments, %	Classified claims	Impairments	Coverage of claims by impairments, %	Classified claims	Impairments	Coverage of claims by impairments, %
Total, EUR million	49.766	2.420	4,86	49.466	3.249	6,57	49.011	3.861	7,88
	Breakdown, %			Breakdown, %			Breakdown, %		
A	70,60	5,7	0,4	66,02	3,3	0,3	56,92	1,9	0,3
B	21,35	19,8	4,5	22,65	14,6	4,2	29,47	13,4	3,6
C	4,35	22,4	25,0	5,13	20,9	26,8	5,90	20,3	27,2
D	2,91	35,8	60,0	5,50	50,6	60,4	6,78	52,5	61,0
E	0,79	16,3	100,1	0,70	10,6	100,0	0,93	11,9	100,0

Source: Bank of Slovenia

The downgrading of claims is proceeding faster at the domestic banks.

The differences in credit portfolio structure between the bank groups have widened. The downgrading of claims has been most intensive at the small and large domestic banks, and much more subdued at the banks under majority foreign ownership. The proportion of claims accounted for by D- and E-rated claims stood at 9.9% at the large domestic banks and 6.7% at the small domestic banks in September, but had remained stable at 3.8% at the banks under majority foreign ownership.

Figure 7.5: Coverage of classified claims by impairments by bank group (left) and by client segment (right) in percentages



Source: Bank of Slovenia

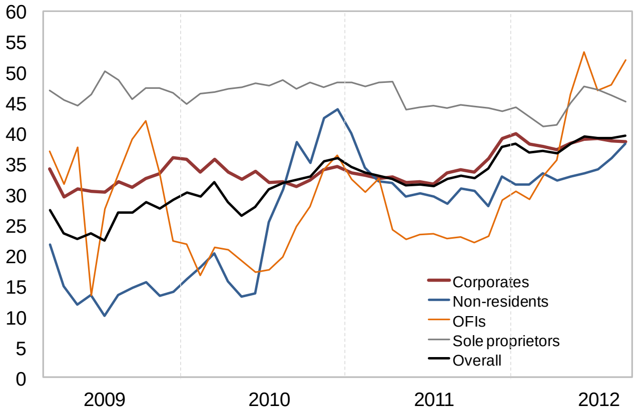
The creation of impairments for claims against non-monetary financial institutions is increasing rapidly.

Impairments and provisions had reached EUR 3.9 billion by the end of September 2012, equivalent to 7.9% of the banks' classified claims. As the non-monetary financial institutions portfolio (primarily financial holding companies) has deteriorated, the banks have intensified the creation of impairments for this client segment. As a result of the devaluation of collateral in the form of shares and other equity, the unsecured portion of non-performing claims against OFIs has increased. The coverage of the OFIs portfolio by impairments increased by 4.7 percentage points to 14.3%, higher than all other segments, including non-financial corporations. Coverage by impairments has increased in other client segments, particularly in those undergoing a faster deterioration in the portfolio this year: for non-financial corporations coverage is up 2 percentage points at 11.4%, while for non-residents it is up 1.9 percentage points at 8.5%.

The coverage of non-performing claims excluding collateral has increased to 39.6%.

The coverage of claims more than 90 days in arrears by impairments increased to 39.6% in September. The largest increase was in the coverage of non-performing claims against OFIs, which rose from 29% at the end of the 2011 to 52.1% in September 2012. The coverage of non-performing claims against non-financial corporations and sole proprietors by impairments this year has remained close to the levels seen at the end of 2011, namely 39% for non-financial corporations and 45% for sole proprietors.

Figure 7.6: Coverage of claims more than 90 days in arrears by impairments by client segment in percentages



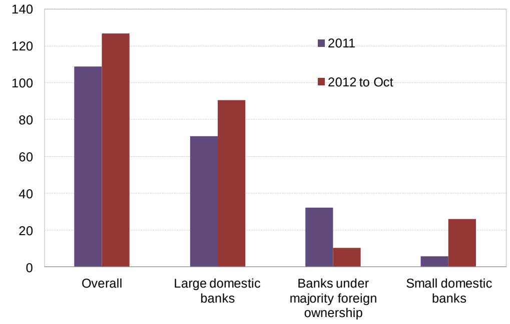
Source: Bank of Slovenia

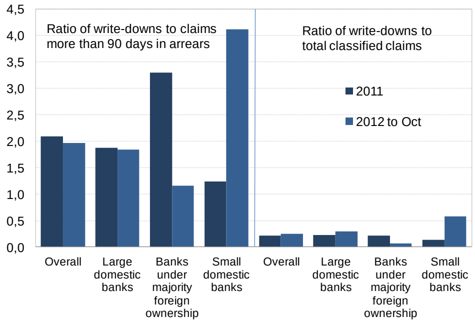
The coverage of D- and E-rated claims, including collateral, stands at 65.7%.

The indicator of the coverage of claims more than 90 days in arrears by impairments does not take account of collateral pledged by the debtor. D- and E-rated claims have higher coverage by impairments on average, because collateral is taken into account in this indicator. The coverage of D- and E-rated claims by impairments stands at 65.7% for the overall portfolio, and at around 75% for claims against non-residents and sole proprietors.

The persistence of the economic crisis is increasing the possibility of a further decline in the value of borrowers' assets as a result of falls in the value of real estate, securities, etc. This could require the banks to create additional impairments in the coming year. An increase in the banks' impairments will not necessarily be a reflection of a continuing deterioration in the quality of the credit portfolio, but rather a consequence of adverse developments on the real estate market and financial market, independent of the quality of claims.

Figure 7.7: Write-downs of financial assets at the banks in EUR million (left) and ratio of write-downs to claims more than 90 days in arrears and to total classified claims in percentages (right)





Source: Bank of Slovenia

Just over EUR 800 million in non-performing claims, 11.5% of the total, was more than 3 years in arrears in September. The majority of these claims comprise claims in bankruptcy proceedings or other claims with minimal likelihood of repayment. This year the banks have opted to write down these claims slightly more than in the previous year (EUR 127 million during the first ten months of the year, compared with EUR 109 million in 2011). This was equivalent to 4.1% of total claims more than 90 days in arrears over the two years, the small domestic banks recording the largest figure of 5.4%, the banks under majority foreign ownership 4.1% and the large domestic banks 3.7%. The retention of the remaining claims with the longest arrears in the banks' portfolios means that there remains a threat to capital from future losses, which is no incentive for potential capital investors.

Table 7.3: Coverage of classified claims more than 90 days in arrears and D- and E-rated claims by impairments by client segment, excluding collateral, in percentages

	Coverage of total classified claims by impairments, %			Coverage of claims more than 90 days in arrears by impairments, %			Coverage of D- and E-rated claims by impairments, %		
	Dec. 10	Dec. 11	Sep. 12	Dec. 10	Dec. 11	Sep. 12	Dec. 10	Dec. 11	Sep. 12
Corporates	6,5	9,4	11,4	34,5	39,2	38,7	66,4	65,0	64,5
OFIs	5,1	9,6	14,3	36,4	29,0	52,1	48,6	58,4	65,2
Household sector	4,0	3,6	3,9	-	-	-	79,9	66,6	67,0
sole proprietors	8,9	8,8	9,9	48,4	43,7	45,2	74,7	74,7	77,0
households	3,4	3,0	3,3	-	-	-	81,6	64,4	64,4
Non-residents	4,2	6,6	8,5	44,0	32,9	38,3	73,0	66,8	74,2
Government	0,1	0,1	0,2	11,8	3,3	5,8	58,7	87,4	90,2
Banks and savings banks	0,2	0,5	0,6	42,1	12,1	12,8	100,0	97,3	90,2
Total coverage	4,9	6,6	7,9	36,0	37,8	39,6	68,5	64,9	65,7
	Classified claims			Claims more than 90 days in arrears			D- and E-rated claims		
Total, EUR million	49.766	49.466	49.011	3.688	5.547	6.968	1.840	3.065	3.782
Ratio to GDP, %	139,8	136,7	136,0	10,4	15,3	19,3	5,2	8,5	10,5

Source: Bank of Slovenia

7.2 Non-financial corporations

Low economic activity that is failing to provide for creditworthy demand for loans is having an adverse impact on growth in the banking system's credit risk from non-financial corporations. The negative economic growth forecast in 2013, primarily driven by slowing domestic demand, will hit corporates in the non-tradable sector hardest. In addition to the crunch in financing at banks, corporates are continuing to face problems with financing via other domestic resources, a reflection of the deterioration in the competitiveness of domestic financial intermediaries and the inadequacy of the domestic capital market.

Financing of non-financial corporations in Slovenia remains at low levels.

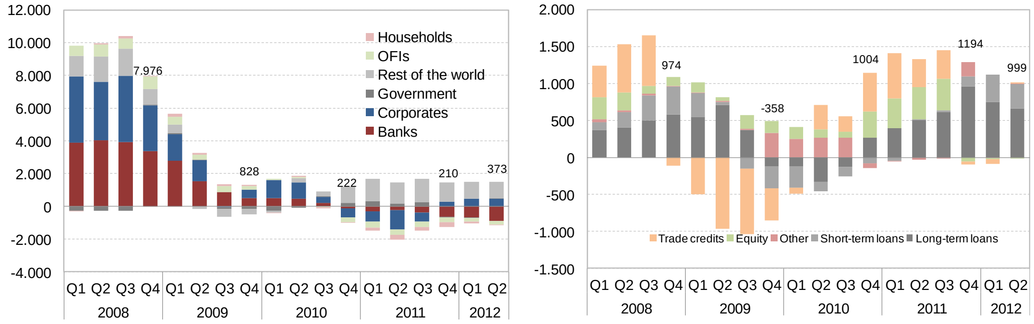
The annual flow of corporate financing had strengthened slightly by the summer of 2012, but was still at the diminished levels seen since the middle of 2009. The repayment of corporate debt to banks and non-monetary institutions and the stabilisation of the flow of new financing from the rest of the world have continued. Loans in business-to-business financing increased slightly at the end of the previous year, while equity flows also increased in the first half of this year, but the stock of this financing has remained at low levels and in no way does it represent an adequate form of alternative corporate financing. Having accounted for up to 10% of corporate financing during the economic boom years, non-monetary financial institutions have been repaid corporate debt in the last two years. The stock of corporate borrowings via loans from this sector in June 2012 was down just over a quarter on the end of 2009.

Banks have primarily extended existing loans.

Low corporate liquidity and high indebtedness at banks are increasing the demand for loans for restructuring, while demand for loans for investment and for working capital is declining.[14] The extension of loans to bad clients as a result of corporate inability to service debts also entails the maintenance of a high level of default risk on their balance sheet.

[14] Source: Survey of the demand for corporate loans at banks in 2012.

Figure 7.8: Corporate borrowing by sector (left) and corporate financing flows in the rest of the world by instrument (right), annual moving total of flows in EUR millions



Source: Bank of Slovenia

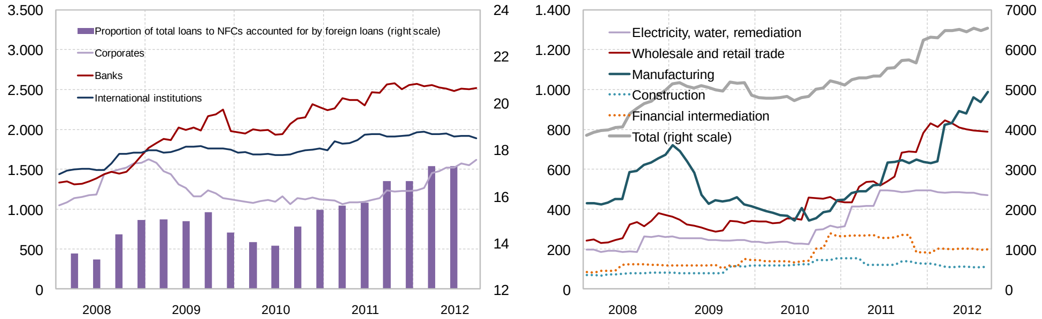
Despite the decline in demand for loans, a large proportion of the demand for corporate loans at the banks is being refused. The rate of excess demand for bank loans has fluctuated between 28% and 31% for the last two and a half years. The main reasons that loan transactions are not being concluded are the banks' credit standards, which are more strictly assessing corporate ability to service debts, and the rejection of the banks' terms by corporates. Part of this refused demand is being realised in the rest of the world, particularly in the case of corporates in better-performing sectors.

Financing from the rest of the world is slowing.

Financing in the rest of the world increased more slowly during the first two quarters of this year than in the previous year, but has now almost reached the levels seen in the pre-crisis period. Year-on-year growth in certain creditor sectors has already turned negative in recent months. Having increased by 12% and 9% respectively in the previous year, corporate borrowings via loans from banks in the rest of the world and from international institutions recorded year-on-year growth of -1.7% and 1.3% in September. Financing at corporates in the rest of the world is still increasing, the rate of growth reaching 31% in September, and is resulting in positive growth in aggregate financing via loans in the rest of the world. The proportion of total corporate debt (loans and issued securities) accounted for by the rest of the world has increased from 18.3% to 18.8% in 2012. Financing from the rest of the world is nevertheless unable to compensate for the loss of financing at the domestic banks.

Only corporates in the manufacturing sector recorded positive growth in financing from the rest of the world during the first nine months of 2012; in other sectors the inflow of foreign loans slowed or stopped. In the manufacturing sector financing from parent companies in the rest of the world has increased in particular: in September it accounted for 62% of the sector's stock of loans from the rest of the world (compared with a significantly lower figure of 32% for non-financial corporations overall). Financing at foreign banks has displayed a slowing trend in all sectors this year, the level of debt having remained at previous levels, without any major changes.

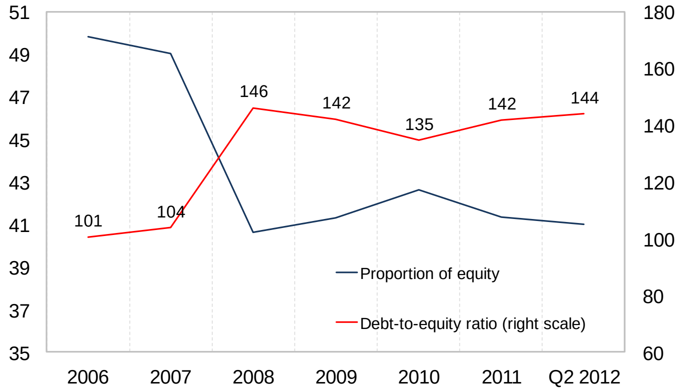
Figure 7.9: Stock of corporate loans from the rest of the world by foreign creditor sector (left), and for selected activities (right) in EUR millions



Source: Bank of Slovenia

Slower growth in merchandise trade has been reflected in a decline in financing via trade credits from the rest of the world and in net repayments of trade credits. The repayments were limited to trade credits from the EU, while trade credits from non-EU countries are increasing. Growth in trade credits from non-EU countries has coincided with the partial refocusing of merchandise trade to these countries and an increase in the proportion of Slovenian imports and exports that they account for.

Figure 7.10: Corporate debt-to-equity ratio in percentages



Source: Bank of Slovenia

Corporate financial leverage remains high.

The renewed economic slowdown has left corporates with similar levels of indebtedness to the outbreak of the economic crisis. With a debt-to-equity ratio of 144%, corporates remain over-leveraged. However, the high financial leverage is not a reflection merely of high indebtedness but also of corporate capital devaluation as a result of the general adverse economic situation and developments on the financial markets, which have affected the value of otherwise soundly performing firms. Corporate debt capital is declining for the fourth consecutive year, although this has not been reflected significantly in the debt-to-equity ratio.

During a time when economic growth is forecast to be negative or very low, no major changes can be expected in corporates' financial position, particularly if the banks maintain their strict standards and are unwilling to take up risks, by which they themselves could contribute to the realisation of projects with good prospects, and consequently to a faster recovery in the corporate sector.

The proportion of new loans at the banks entailing restructuring is increasing.

There has been an increase during the first nine months of the year in the proportion of new loans in which the banks were restructuring previous loans that the clients were unable to repay under the existing terms. In the sectors of construction and real estate activities two-thirds of new loans this year have entailed an extension of the maturity of previous loans, while the proportion is even higher for new short-term loans. In all sectors other than manufacturing the proportion of new long-term loans accounted for by loans that merely entail the restructuring of existing loans has increased this year. The increase in extensions for periods of more than 1 year suggests that the banks are aware that a faster recovery cannot be expected for these clients. In addition to construction and real estate activities, the financial intermediation sector is also notable for long-term extensions.

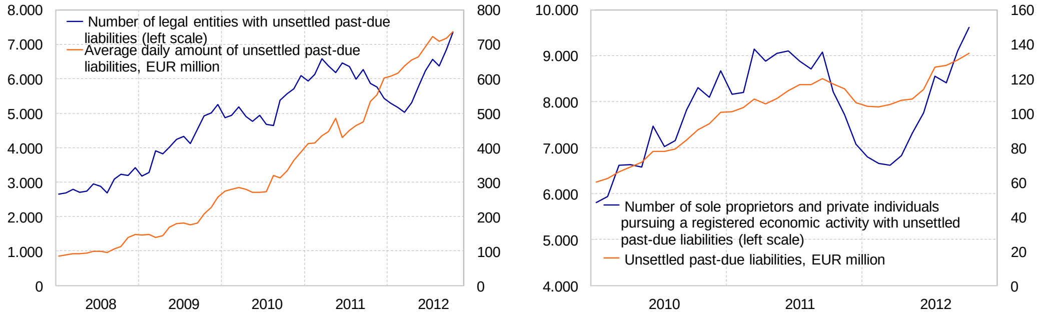
Table 7.4 : Proportion of new corporate loans at banks accounted for by loans with extended repayment maturities in percentages

Loan maturity[1]		Manufacturing	Construction	Wholesale and retail trade	Transportation and storage	Accommodation and food service activities	Financial intermediation	Real estate activities	Professional, scientific and technical activities	Non-financial corporations (overall)
Long-term	2011	40,4	30,8	33,3	39,2	15,7	23,1	50,8	24,4	35,1
	2012	27,1	53,1	34,3	44,6	41,2	66,3	63,3	33,7	38,2
	change	*-13,3*	*22,4*	*1,0*	*5,4*	*25,4*	*43,2*	*12,5*	*9,3*	*3,1*
Short-term	2011	45,0	65,5	23,3	45,9	78,3	69,3	73,0	60,3	46,6
	2012	55,8	70,8	25,9	31,1	78,8	61,6	70,0	58,8	47,7
	change	*10,8*	*5,3*	*2,6*	*-14,8*	*0,5*	*-7,7*	*-3,0*	*-1,5*	*1,1*
Overall	2011	43,0	58,6	26,1	41,3	47,9	62,6	64,5	50,7	42,7
	2012	45,9	67,3	27,2	43,2	59,4	63,3	67,6	53,6	44,8
	change	*2,9*	*8,7*	*1,2*	*1,8*	*11,5*	*0,7*	*3,0*	*3,0*	*2,2*

Note: Loan maturity refers to the period of extension, and not to the original maturity of the loan.

Source: Bank of Slovenia

Figure 7.11: Number of legal entities (left) and sole proprietors and private individuals pursuing a registered economic activity (right) with unsettled past-due liabilities from court enforcement orders and tax debt and their average daily amount of unsettled past-due liabilities in EUR millions

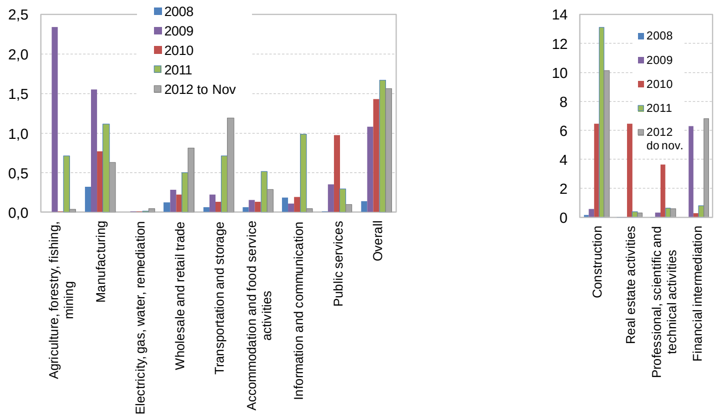


Source: AJPES

After falling for a year, the number of corporates with unsettled past-due financial liabilities from court enforcement orders and tax debt has increased since March and has already passed its peak of March 2011. There is similar movement in the number of sole proprietors and other private individuals with unsettled past-due liabilities from court enforcement orders and tax debt. The average daily amount of these liabilities has been rising continuously for legal entities, and also for sole proprietors after a short-lived improvement in the first half of the year.

After a temporary improvement, the number of corporates with unsettled financial liabilities is rising again.

Figure 7.12: Proportion of total assets in sector accounted for by assets of corporates in bankruptcy by year of initiation of bankruptcy proceedings* in percentages



Note: * Ratio of total assets of corporates against which bankruptcy proceedings have been initiated to total assets in the sector. The figures refer to the year prior to the initiation of bankruptcy proceedings when the corporates were still filing financial statements.
Sources: Bank of Slovenia, Supreme Court, AJPES

This year to mid-November there were a total of 527 new bankruptcy proceedings initiated, 457 of which related to non-financial corporations. The non-financial corporations at which bankruptcy proceedings have been initiated this year accounted for 1.6% of the total assets of non-financial corporations, similar to the figure in 2011 (1.7%). The collapse of construction firms has continued: the proportion of total assets in the sector accounted for corporates at which bankruptcy proceedings were initiated stood at 13.1% last year, and a further 10.1% during the first eleven months of the year.

The burden on the banking system's credit portfolio exerted by claims against corporates in bankruptcy is large and growing. The banks' claims against corporates in bankruptcy increased from EUR 1.7 billion at the end of 2011 to EUR 2.9 billion in mid-November this year. An increasing number of the banks' claims against the construction sector are trapped in bankruptcy proceedings, the figure reaching 45% in November. The banks' exposure to non-financial holding companies in bankruptcy, in which just over a fifth of all claims against the aforementioned sector are located, is also increasing extremely rapidly. There is also a heavy bankruptcy burden on the banks' claims against corporates in the professional, scientific and technical activities sector (11.3%).

The banks' claims against corporates in bankruptcy have increased to EUR 2.9 billion.

Table 7.5: Banking system's' classified claims (CC) against non-financial corporations in bankruptcy in EUR millions, and proportion of total claims against non-financial corporations accounted for by these claims in percentages by sector

	Dec 2008		Dec 2011		Sep 2012[1]	
	CC against corporates in bankruptcy, EUR million	Proportion of total CC in sector, %	CC against corporates in bankruptcy, EUR million	Proportion of total CC in sector, %	CC against corporates in bankruptcy, EUR million	Proportion of total CC in sector, %
Agriculture, mining	2	0,8	15	4,5	14	4,4
Manufacturing	38	0,6	360	5,9	400	6,6
Electricity, gas, water	2	0,2	0	0,0	4	0,3
Construction	10	0,3	900	25,5	1.555	45,0
Wholesale and retail trade	20	0,4	83	1,9	167	4,0
Transportation and storage	2	0,1	27	1,1	151	7,2
Accommodation and food service activities	1	0,1	4	0,6	12	1,8
Information and communication	3	0,4	24	4,1	22	3,6
Financial intermediation[2]	0	0,0	12	0,8	303	22,4
Real estate activities	2	0,1	40	3,7	46	4,2
Professional, scientific and technical activities	9	0,4	225	11,2	231	11,3
Public services	0	0,0	0	0,1	3	0,7
Total	89	0,4	1.690	7,0	2.907	12,3
No. of proceedings initiated in year: - NFCs	64		587		457	
- total	86		681		527	

Notes: [1] Includes the banks' classified claims as at September 2012 (the most recent data available when the report was being drawn up) against corporates against which bankruptcy proceedings had been initiated by mid-November 2012. [2] Corporates in the financial intermediation sector in bankruptcy proceedings are mostly non-financial holding companies. The banks have an additional EUR 269 million of exposure against financial holding companies against which bankruptcy proceedings have been initiated (which are included among OFIs).

Source: Bank of Slovenia

Despite increasing defaults and a rise in the number of bankruptcies, construction is one of the few sectors where the stock of debt at banks is increasing. The retention of claims against the construction sector on bank balance sheets is primarily the result of a high level of restructuring of existing loans and, to a lesser extent, of new loans to this sector. The proportion of claims against non-financial corporations accounted for by construction has increased by 3.5 percentage points during the economic crisis to 12.8%. The only other significant increase in the proportion of claims against non-financial corporations accounted for by a particular sector was recorded by the low-risk sector of electricity, gas, water and environmental remediation, the figure increasing by 1.8 percentage points to 4.5%.

Table 7.6: Increases in loans to non-financial corporations and breakdown of stock by sector in EUR millions and percentages

	Manufacturing	Construction	Wholesale and retail trade	Transportation and storage	Accommodation and food service activities	Financial intermediation	Real estate activities	Professional, scientific and technical activities	Non-financial corporations (overall)
2007	723,0	618,7	704,4	361,6	79,1	746,6	291,8	553,2	4.517,7
2008	963,7	406,2	719,6	329,1	128,5	250,0	251,6	146,1	3.438,6
2009	68,6	214,9	-177,5	187,2	81,2	-465,1	20,3	111,5	216,2
2010	36,9	234,5	-5,0	75,3	32,3	-241,8	-17,6	-48,3	138,6
2011	-290,9	100,0	-208,3	-21,1	-5,5	-25,6	-6,4	-147,4	-598,4
Sep 12	-85,3	29,4	-249,4	-73,3	-12,8	-25,6	-3,2	-109,7	-327,5
	Breakdown of stock of loans to non-financial corporations by sector, %								
Dec 07	26,8	9,3	19,8	8,4	2,5	10,6	5,1	9,7	100,0
Sep 12	26,5	12,8	17,3	9,7	3,2	6,6	5,6	8,1	100,0

Note: Loans are in gross amounts, excluding impairments.

Source: Bank of Slovenia

Three-quarters of non-performing claims against the construction sector are against corporates in bankruptcy.

Claims against non-financial corporations more than 90 days in arrears amounted to 23.9% of classified claims in September. The most notable figure was recorded by corporates in the construction sector, 62.2% of claims against which are non-performing, up 12.3 percentage points on the end of 2011. Almost three-quarters of these claims are against corporates in bankruptcy, compared with around a half at the end of the previous year. The worst quality of claims against the construction sector was recorded by the large domestic banks, 70% of whose claims are non-performing, but the figure is also high at the small domestic banks at 61%, while the banks under majority foreign ownership have the least unfavourable portfolio in this sector, with 38% of claims classed as non-performing.

Table 7.7: Arrears of non-financial corporations by sector

	No. of corporates with arrears, Sep 12	Proportion of bank clients in sector with arrears, %			Average no. of days in arrears	Proportion of portfolio accounted for by classified claims in arrears, %			
		total	of which more than 90 days in arrears			total	of which more than 90 days in arrears		
		Sep 12	Dec 11	Sep 12		Sep 12	Dec 10	Dec 11	Sep 12
Agriculture, forestry, fishing, mining	61	27,2	13,5	17,0	305	29,7	5,8	9,4	15,4
Manufacturing	988	23,9	13,5	14,9	442	26,1	9,2	11,4	15,7
Electricity, gas, water, environmental remediation	58	13,7	5,8	8,0	155	8,8	1,5	2,2	3,8
Construction	1172	39,0	27,0	31,7	528	69,5	19,5	49,9	62,2
Wholesale and retail trade	1537	22,8	15,2	16,5	559	20,0	13,6	11,8	14,2
Transportation and storage	412	28,5	18,1	20,1	402	19,0	6,5	11,3	13,7
Accommodation and food service activities	353	32,6	20,2	21,3	307	34,7	6,6	14,5	23,3
Information and communication	213	14,4	8,6	8,9	651	36,1	23,2	25,5	29,5
Financial intermediation	49	28,3	18,8	21,4	520	47,0	18,3	20,7	39,3
Real estate activities	202	29,6	17,7	22,0	479	30,9	10,3	17,3	24,0
Professional, scientific and technical activities	856	16,3	9,5	10,9	544	29,5	17,7	20,3	19,9
Public services	199	14,6	7,6	8,9	262	18,7	2,7	5,0	8,3
Total	6.102	23,4	14,7	16,5	491	31,9	12,4	18,5	23,9

Source: Bank of Slovenia

A large increase in non-performing claims in financial intermediation, and a high proportion of non-performing claims.

There was a sharp deterioration during the first nine months of the year in the quality of the banks' claims against the financial intermediation sector, which was already low. The proportion of non-performing claims in this sector increased to 39.3% in September. More than half of these claims are against corporates in bankruptcy. The large domestic banks were notable for the low quality of their financial intermediation sector portfolio, where 53% of claims are more than 90 days in arrears. The banks under majority foreign ownership are significantly less exposed to credit risk in this sector: just under 8% of their claims are classed as non-performing. This bank group is also the least exposed to credit risk from all other sectors.

The proportion of non-performing claims in the professional, scientific and technical activities sector has stabilised at 20%.

Non-performing claims have also continued to increase rapidly this year in the real estate activities sector and the accommodation and food service activities sector, where the proportion of claims more than 90 days in arrears has approached a quarter. Corporates in the information and communication sector are notable for 30% of their claims being classed as non-performing, most prominently at the large domestic banks, where the figure is 42%. The quality of the portfolio in the professional, scientific and technical activities sector has stabilised somewhat this year and the previous year, as the proportion of non-performing claims has remained around 20% for a year.

The large domestic banks have an above-average proportion of non-performing claims in most sectors. They account for 77% of all non-performing claims against non-financial corporations, or EUR 4.3 billion, while their market share is 60%.

Table 7.8: Breakdown of the 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 2012 in percentages

	Breakdown of claims against NFCs, %				Proportion of claims more than 90 days in arrears, %			
	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, mining	1,3	1,2	2,0	1,4	15,4	20,3	9,0	10,3
Manufacturing	25,8	27,4	22,7	23,6	15,7	19,6	14,3	7,4
Electricity, gas, water	5,6	4,8	3,8	7,8	3,8	6,5	1,6	1,0
Construction	14,6	16,6	16,1	10,3	62,2	70,4	60,5	37,9
Wholesale and retail trade	17,5	15,5	20,4	20,5	14,2	19,1	10,7	8,0
Transportation and storage	8,9	9,4	2,0	10,0	13,7	16,3	34,8	7,9
Accommodation and food service activities	2,8	3,0	2,3	2,6	23,2	28,5	32,8	9,4
Information and communication	2,6	2,7	1,5	2,6	29,5	42,2	25,3	5,0
Financial intermediation	5,7	6,3	8,2	4,0	39,3	52,9	22,9	7,9
Real estate activities	4,7	3,9	6,3	5,6	24,0	30,8	21,3	15,8
Professional, scientific and technical activities	8,6	7,4	13,2	9,6	19,9	25,0	17,1	13,4
Public services	1,9	1,9	1,5	2,1	8,3	9,5	7,9	6,2
Total	100,0	100,0	100,0	100,0	23,9	30,7	22,8	11,3
Total, EUR million	23.665	14.115	2.121	7.429	5.651	4.328	485	838

Source: Bank of Slovenia

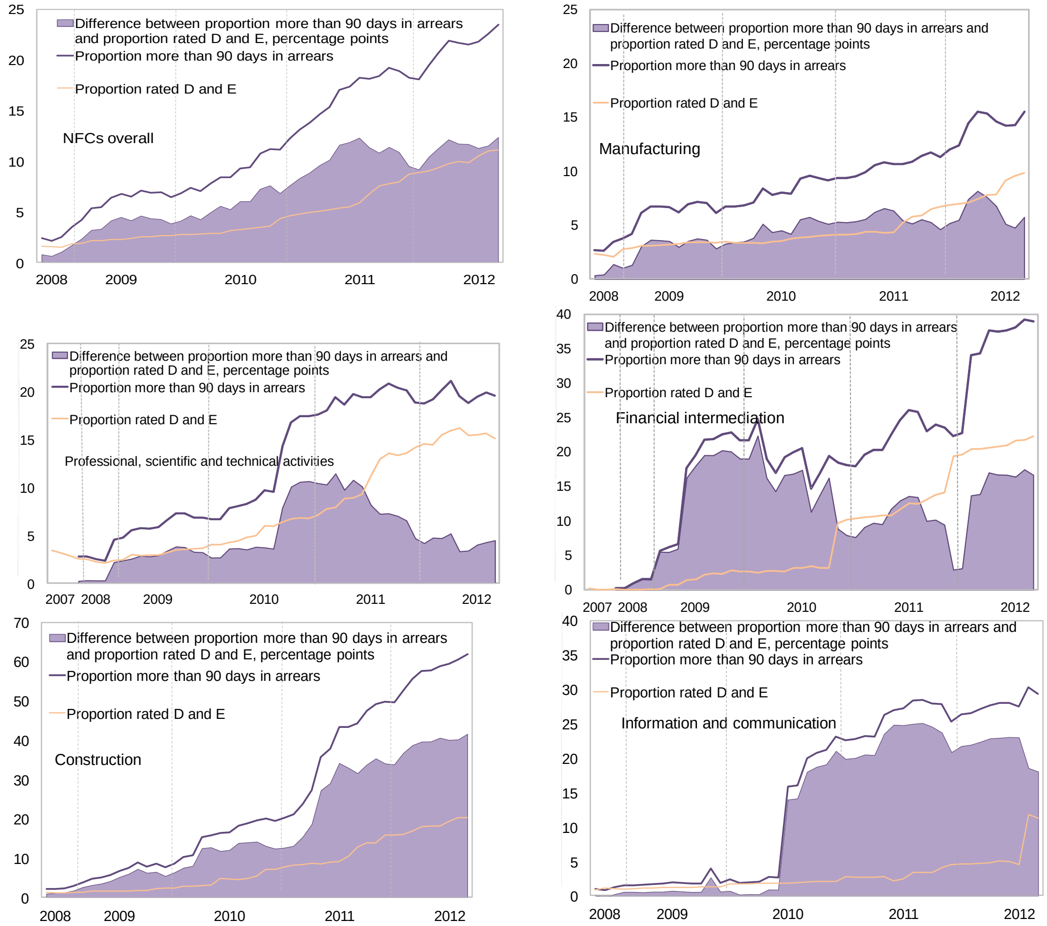
Table 7.9: Coverage of classified claims by impairments, and D- and E-rated claims against non-financial corporations by sector

	Impairments of classified claims, EUR million		Coverage of classified claims by impairments, %		Classified claims rated D and E: Amount, EUR million	Classified claims rated D and E: as proportion of total classified claims, %	
	2011	Sep 2012	2011	Sep 2012		2011	Sep 2012
Agriculture, mining	21	23	6,9	7,4	15	4,9	4,9
Manufacturing	456	574	7,2	9,4	603	6,8	9,9
Electricity, gas, water	17	25	1,6	1,8	18	0,8	1,3
Construction	613	739	17,4	21,4	706	15,7	20,4
Wholesale and retail trade	329	366	7,4	8,8	286	5,3	6,9
Transportation and storage	139	154	6,2	7,3	193	7,6	9,2
Accommodation and food service activities	45	61	6,5	9,1	47	5,7	7,0
Information and communication	71	91	11,9	15,0	68	4,5	11,3
Financial intermediation	211	251	13,7	18,5	305	18,0	22,5
Real estate activities	90	122	8,2	11,0	114	7,4	10,4
Professional, scientific and technical activities	264	276	13,2	13,6	306	15,1	15,0
Public services	17	22	3,7	4,8	12	1,6	2,6
Total	2.271	2.704	9,4	11,4	2.673	8,8	11,3

Source: Bank of Slovenia

Of the EUR 5.6 billion in non-performing claims against non-financial corporations, just under a half or EUR 2.7 billion have the lowest ratings of D and E, EUR 0.5 billion more than at the end of 2011. The difference between these two indicators is the result of collateral being taken into account when claims are rated, while collateral value is not taken into account when arrears are being determined. The proportion of claims in the information and communication sector rated D and E more than doubled during the first nine months of the year to 11.3%. The financial intermediation and construction sectors are notable for high increases in D- and E-rated claims and for the proportion of claims that such claims account for being more than 20%.

Figure 7.13: Difference between the proportion of claims against non-financial corporations more than 90 days in arrears and the proportion of non-performing claims by bank group in percentages



Note: Monthly figures from March 2009, quarterly figures before.
Source: Bank of Slovenia

The creation of additional impairments can be expected in some sectors.

Despite faster downgrading, there remains a large gap in these sectors between the proportion of claims more than 90 days in arrears and the proportion of claims given the lowest ratings. In the information and communication sector it is only in recent months that downgradings and the increased creation of impairments have begun, two years after a sharp increase in arrears of more than 90 days. Downgradings in the financial intermediation sector have also failed to tack the rapid growth in non-performing claims, particularly given that the continuation of the crisis means that the quality of the collateral will not suffice to cover the gap between created impairments and the quality of claims. This sector and the construction sector can be expected to undergo further adjustments to the value of the portfolio, with an impact on the earnings and capital of the banks.

Box 7.1 Analysis of the credit portfolio of non-financial corporations on the basis of client credit ratings and arrears in loan repayments

Borrower credit ratings and their arrears in loan repayments are used in this box for the analysis of the quality of the credit portfolio. The analysis covers non-financial corporations that have borrowings from at least one bank in Slovenia, whose liability to the bank is greater than EUR 1,000 and for which information about the credit rating is available.

The credit rating structure is one of the indicators of the quality of the credit portfolio. Borrower credit ratings are used, which are to a great extent independent of collateral. The proportion of A- and B-rated clients declined by 11.1 percentage points between 2008 and September 2012, while the proportion of D- and E-rated clients rose by 8.3 percentage points. The classified claims of bad clients accounted for 21.5% of all classified claims against non-financial corporations in September 2012.

Table 7.10: Credit rating structure of non-financial corporations between 2008 and September 2012 in percentages

	2008	2009	2010	2011	Sep 2012
A	54,76	50,35	47,71	42,63	39,47
B	30,19	31,10	31,66	33,62	34,39
C	5,97	7,30	7,28	7,86	8,64
D	4,42	6,08	5,42	5,37	5,40
E	4,66	5,16	7,93	10,52	12,11
Total number of bank-borrower relationships	32.448	33.567	34.998	36.311	36.798

Source: Bank of Slovenia

Like credit ratings, the arrears in loan repayments also reflect a deterioration in the credit portfolio. The proportion of clients more than 90 days in arrears amounted to 16.4% in September 2012, up 8 percentage points on 2008. The classified claims of these clients accounted for 24.2% of all classified claims against non-financial corporations in September 2012.

Table 7.11 Breakdown of arrears in loan repayments between 2008 and September 2012 in percentages

	2008	2009	2010	2011	Sep 2012
No arrears	86,65	84,64	82,53	79,81	76,86
1 to 90 days	4,91	4,86	5,17	5,75	6,73
More than 90 days	8,44	10,50	12,31	14,44	16,41
Total number of bank-borrower relationships	31.118	32.365	33.869	35.166	35.496

Source: Bank of Slovenia

There were several reasons for the deterioration in the quality of the credit portfolio: (1) The adverse economic situation is hindering corporate performance. After a modest recovery in 2010 and 2011, this year and next year are again expected to see negative GDP growth, which will add to clients' loan repayment difficulties. (2) The number of bankruptcies has risen significantly in recent years. There were 675 bankruptcy proceedings initiated in 2011, twice as many as in 2009, when GDP declined by 7.8%. A large number of bankruptcy proceedings have also been initiated in 2012: the figure had reached 469 by September. (3) The strong business links and cross-ownership between firms are causing rapid transmission of problems from one firm to another. This is being exacerbated by insolvency, and a business environment that allows it. (4) There is no increase in new loans that would improve the quality of the credit portfolio. This is partly the result of the adverse economic situation and low client creditworthiness, and partly the result of the banks' aversion to taking up additional risks and their limits on funding and costs. (5) In the favourable economic climate the banks financed higher-risk projects and clients, whose performance has deteriorated during the crisis and who are no longer able to repay their debts. (6) Relatively few write-offs are made because of protracted recovery proceedings against insolvent debtors. The Regulation on the assessment of credit risk losses of banks and savings banks was updated in April 2012, which should help to bring about faster write-offs of claims.

Table 7.12: Credit rating structure for the same non-financial corporations at an individual bank in percentages

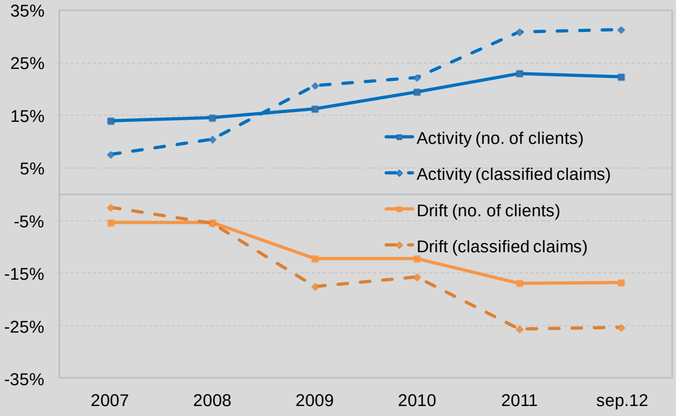
	2008	2009	2010	2011	Sep 2012
A	58,37	52,25	48,30	40,83	36,31
B	30,09	30,60	30,06	32,05	32,34
C	4,98	7,14	7,51	8,27	9,31
D	3,56	5,83	5,53	5,84	6,06
E	3,00	4,19	8,59	13,00	15,98
Total number	21.590	21.590	21.590	21.590	21.590

Source: Bank of Slovenia

The credit rating structure of clients that had a lending arrangement with the same bank between 2008 and September 2012 deteriorated significantly during this period. The proportion of A- and B-rated corporates declined by 19.8 percentage points, while the proportion of D- and E-rated clients rose by 15.5 percentage points to 22%. The deterioration in the credit ratings of the same clients is to be expected, as several factors that affect risk can arise over the long term. The observation

period is also a factor in the sharp deteriorations, as it begins in the year before the crisis when corporates were rated excessively optimistically.
Since 2007 both the activity[1] and drift[2] have gradually increased. This means that banks have regraded an increasing number of clients, while a larger proportion of corporates have been downgraded. When transitions are weighted for classified claims, the deterioration is even more pronounced, which means clients to which banks hold above-average exposures are being downgraded.

Figure 7.14: Activity and drift in percentages



Note: Activity and drift were calculated for a 1-year period in September 2012.
Sources: Bank of Slovenia, own calculations

The probabilities of transitions to lower ratings have increased significantly during the crisis. It is evident from the transition matrices that the deterioration in the quality of the credit portfolio was most pronounced in 2011, but has continued to September 2012. The proportion of downgradings in September 2012 was 7.7 percentage points higher than the average between 2005 and 2011. The largest difference is in the D rating, where the proportion of downgradings was 18.1 percentage points higher.

Table 7.13: Probability of transitions of non-financial corporations between credit ratings in percentages

Average transition matrix 2005 - 2011

		current year				
		A	B	C	D	E
previous year	A	87,00	9,78	1,66	0,86	0,70
	B	6,87	81,10	7,03	4,10	0,90
	C	2,38	10,27	65,28	14,60	7,47
	D	1,70	2,29	3,65	65,57	26,80
	E	0,68	0,18	0,34	0,68	98,12

Transition matrix 2010

		2010				
		A	B	C	D	E
2009	A	86,59	9,26	2,11	1,10	0,94
	B	7,05	79,31	7,27	5,24	1,13
	C	1,47	12,82	58,80	16,79	10,12
	D	0,35	1,63	3,91	45,48	48,63
	E	0,21	0,14	0,21	0,99	98,44

Transition matrix 2011

		2011				
		A	B	C	D	E
2010	A	78,60	17,10	2,27	1,26	0,76
	B	6,57	77,48	8,51	5,27	2,17
	C	1,08	6,82	60,36	16,79	14,94
	D	0,13	1,16	4,24	48,55	45,92
	E	0,08	0,17	0,55	0,42	98,78

Transition matrix Sep 2012

		Sep 2012				
		A	B	C	D	E
Sep 2011	A	78,42	17,18	2,71	1,11	0,58
	B	5,68	78,02	9,91	4,62	1,77
	C	0,89	7,32	61,89	15,88	14,02
	D	0,24	0,96	3,77	50,12	44,92
	E	0,07	0,07	0,76	0,59	98,51

Sources: Bank of Slovenia, own calculations

The default rate on the basis of credit ratings in September 2012 was down slightly on 2011, while the default rate on the basis of arrears increased by 0.4 percentage points. This indicates that banks have failed to track the increase in the proportion of clients more than 90 days in arrears by downgrading these clients to D and E ratings.

Table 7.14: Default rates on the basis of credit ratings and corporate arrears in loan repayments in percentages

	2008	2009	2010	2011	Sep 2012[1]
Based on credit ratings[2]	2,76	4,90	5,52	6,41	5,81
Based on arrears[3]	3,61	5,30	5,48	5,84	6,24

Notes: [1] The default rate was calculated for a one-year period in September 2012.
[2] Proportion of clients downgraded from A, B or C ratings to D or E ratings in one year.
[3] Proportion of clients with arrears of less than 90 days in the previous year and arrears of more than 90 days in the current year.
Sources: Bank of Slovenia, own calculations

1 Activity shows the proportion of corporates whose credit rating has been regraded.
2 Drift is calculated as the number of clients that were upgraded minus the number of clients that were downgraded, relative to the number of clients that have a lending arrangement with the same bank in the current year and the previous year.

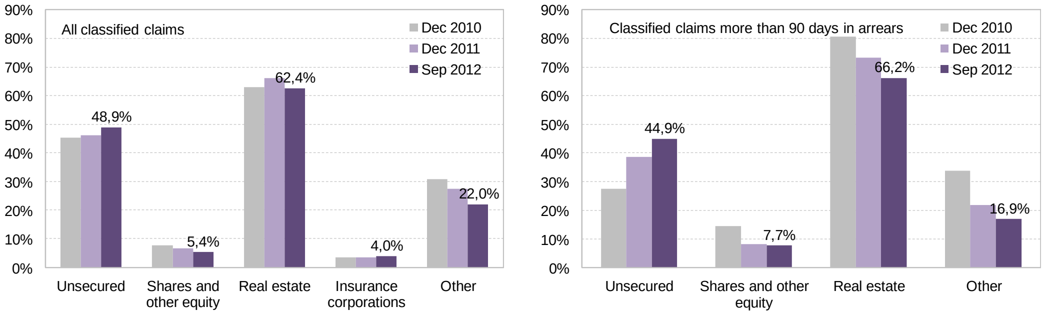
7.3 Loan collateral

7.3.1 Coverage of the credit portfolio by collateral

The proportion of unsecured claims has increased by 2.1 percentage points in 2012 to 48.9%.

The proportion of classified claims accounted for by unsecured claims has continued to increase in 2012.[15] Between the end of 2011 and September 2012 it increased by 2.1 percentage points to 48.9%. At the same time the total value of all forms of collateral fell to below the total value of classified claims. Coverage stood at 93.9% in September 2012. One factor was a decline in the market value of collateral, in particular real estate and securities, while another was the continuing increase in the proportion of classified claims against lower-risk sectors, which are almost entirely unsecured. In 2012 this increase has primarily been in the form of claims against the central bank, as the banks deposited the funding obtained in the 3-year LTROs in the deposit facility and settlement accounts, and in the form of claims against the government. Given the adverse conditions of borrowing on the international financial markets, the government sector largely borrowed by issuing treasury bills, which were primarily purchased by Slovenian banks.

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



Source: Bank of Slovenia

Coverage of classified claims by collateral in the form of real estate declined, although the proportion of collateral in the form of real estate increased.

The coverage of classified claims by collateral declined for all forms of collateral. The proportion of classified claims secured by real estate collateral declined by 3.5 percentage points. Real estate nevertheless remains the most important form of collateral, accounting for 62.4% of classified claims. Further evidence of this is that the proportion of total collateral value accounted for by real estate increased by 2.5 percentage points in 2012 to 66.5%. A significant portion of collateral thus remains exposed to the risk of a fall in real estate values. The situation on the real estate market remains uncertain, while growth in household income and corporate earnings remains weak as a result of the ongoing crisis.

The proportion of claims more than 90 days in arrears that is unsecured increased by 6.4 percentage points to 44.9%.

The proportion of classified claims more than 90 days in arrears that is unsecured was up 6.4 percentage points in September 2012 at 44.9%. Of the claims reclassed as being more than 90 days in arrears in 2012, 70% were unsecured. The proportion of such claims accounted for by corporates from higher-risk sectors is also high. Although the banks' exposure to the construction sector increased, there was also a significant increase in the proportion of unsecured claims accounted for by the construction sector, by 6.1 percentage points to 43.4%.

[15] The figure includes unsecured claims and claims secured with forms of collateral that are not taken into account in the bank's calculation of impairments and provisions (e.g. collateral in the form of bills of exchange). Certain types of claims against lower-risk clients (sectors), e.g. the government sector, and those backed by guarantees from investment-grade clients are not necessarily secured by collateral from the borrower.

Table 7.15: Collateral for classified claims by client segment at the end of September 2012 in percentages

	Classified claims, EUR million	Ratio of collateral[2] to classified claims, %							
		Unsecured[1]	Secured						Total collateral value[3]
			Shares, other equity and mutual fund units	Commercial property[3]	Residential property[3]	Insurance corporation	Other form of collateral		
Corporates	24.035,2	39,8	9,1	66,8	7,1	0,0	30,9		114,0
OFIs	2.076,6	59,2	15,9	12,1	2,1	0,0	25,9		55,9
Households	10.269,8	26,8	0,4	16,0	92,1	19,2	10,8		138,4
Non-residents	5.300,9	65,3	2,8	30,7	3,5	0,0	21,5		58,5
Government	3.442,7	81,5	0,0	2,0	0,1	0,0	18,6		20,8
Banks and savings banks	3.542,9	96,6	0,0	0,3	0,0	0,0	3,1		3,4
Total	49.742,3	48,9	5,4	39,5	22,9	4,0	22,0		93,9

Notes: [1] The figure includes unsecured claims and claims secured with forms of collateral that are not taken into account in the bank's 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 bank claims with seniority 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

Only classified claims against corporates and households have a higher collateral value than claim value, primarily in the form of real estate collateral.

Claims against corporates and households account for the largest proportion of classified claims. The aforementioned sectors are the only sectors where the total value of collateral exceeds the value of the claims, primarily thanks to real estate collateral in both cases. Although the coverage of classified claims against corporates and households by collateral in the form of real estate declined relative to December 2011, the proportion of total collateral value accounted for by real estate increased. The risk of a loss of collateral value as a result of a fall in real estate prices is greatest in claims against corporates and households. In contrast to claims against corporates, where the proportion of unsecured claims increased by 4.6 percentage points during the first nine months of the year to 39.8%, the proportion of unsecured claims against households declined by 3.4 percentage points in 2012 to stand at 26.8% in September. Households were the only debtor category whose proportion of unsecured claims declined in 2012. The largest increase in the proportion of unsecured claims was recorded by other financial institutions, at 7.0 percentage points. This sector has the highest proportion of claims secured by collateral in the form of shares and other equity.

Table 7.16: Collateral for classified claims by bank group at the end of September 2012 in percentages

	Classified claims, EUR million	Ratio of collateral[2] to classified claims, %						
		Unsecured[1]	Shares, other equity and mutual fund units	Commercial property[3]	Residential property[3]	Insurance corporation	Other form of collateral	Total collateral value[3]
Small domestic banks	4.511,3	47,1	7,8	51,8	21,8	3,3	20,8	105,5
Banks under majority foreign ownership	15.458,4	37,6	2,3	37,8	39,5	4,0	30,3	114,0
Large domestic banks	29.772,6	55,0	6,7	38,6	14,5	4,1	17,9	81,7
Banking system	49.742,3	48,9	5,4	39,5	22,9	4,0	22,0	93,9

Notes: [1, 2, 3] See previous table.

Source: Bank of Slovenia

The proportion of claims more than 90 days in arrears that are unsecured is highest at the large domestic banks.

The banks under majority foreign ownership are the bank group with the lowest proportion of unsecured claims, at 37.0%. Part of the reason for this is the structure of their portfolio. The banks under majority foreign ownership have a lower proportion than the other bank groups of claims against sectors whose loans are lower-risk and have less or no collateral, such as the government, banks and the central bank. The banks under majority foreign ownership nevertheless have only 6.4% of their claims more than 90 days in arrears. Of these claims, 34.0% are unsecured, which places them second in terms of this indicator to the small domestic banks, where 30.6% of such claims are unsecured. At these two bank groups the total value of collateral for claims more than 90 days in arrears exceeds the value of the claims. This is not the case of the large domestic banks, where the coverage of claims more than 90 days in arrears by collateral of all types stands at 78.2%. The coverage was down 11.4 percentage points on December 2011. The proportion of claims more than 90 days in arrears that are unsecured is also highest at the large domestic banks, at 48.8%.

Table 7.17: Collateral for classified claims more than 90 days in arrears by bank group at the end of September 2012 in percentages

	Classified claims, EUR million	Ratio of collateral[2] to classified claims, %						
		Unsecured[1]	Shares, other equity and mutual fund units	Commercial property[3]	Residential property[3]	Insurance corporation	Other form of collateral	Total collateral value[3]
Small domestic banks	683,6	30,6	13,4	77,4	25,9	0,0	26,0	142,7
Banks under majority foreign ownership	996,6	34,0	3,0	63,5	23,7	0,0	33,1	123,3
Large domestic banks	5.334,7	48,8	7,8	52,5	5,0	0,0	12,7	78,2
Banking system	7.014,9	44,9	7,7	56,5	9,7	0,0	16,9	90,9

Notes: [1, 2, 3] See previous table.
Source: Bank of Slovenia

8 INTEREST RATE RISK

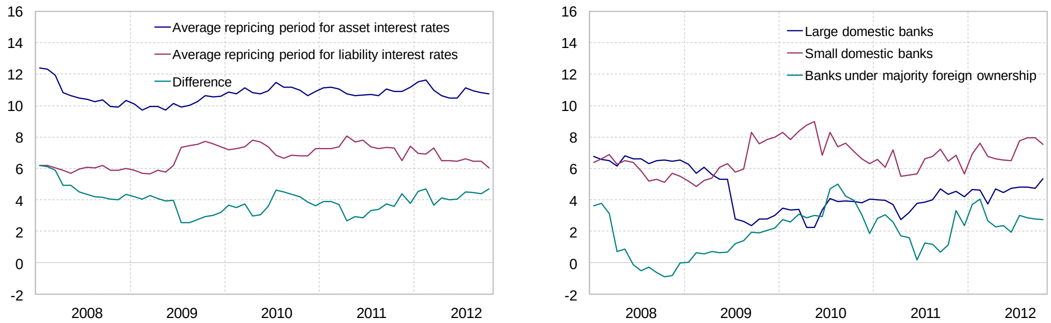
Interest rate risk as measured by the difference between the average repricing periods for asset and liability interest rates has increased in 2012. The difference between the average repricing periods for asset and liability interest rates has increased by 1 month and 4 days over the course of one year to 4 months and 21 days. Consequently, the banks have become more exposed to the risk of a rise in interest rates. The gap has increased as a result of the shortening of the average repricing period for liability interest rates by 1 month to 6 months. The shortening was the result of the maturing of bank debt securities, and the decline in the stock of loans and deposits received and the shortening of the average maturity. This shortening of the average repricing period for liability interest rates is likely to continue in 2013, unless long-term funding becomes more accessible to the banks. The banks under majority foreign ownership recorded the largest increase in interest rate risk between October 2011 and October 2012, primarily as a result of the shortening of the average repricing period for interest rates on loans received. Despite the difference widening, interest rate risk remains lowest at the banks under majority foreign ownership and highest at the small domestic banks.

The cumulative interest-rate gap in the interval of up to 1 year between interest-sensitive assets and liabilities declined by EUR 782 million between September 2011 and September 2012 to EUR 206 million. The banks under majority foreign ownership had a positive gap, while the domestic banks had a negative gap. The domestic banks were thus exposed to the risk of a rise in interest rates over the upcoming period of 1 year. The currency breakdown of on-balance-sheet interest-sensitive items remains unchanged. The majority of on-balance sheet interest-sensitive items are in domestic currency, while the proportion of items in Swiss francs is declining.

8.1 Average repricing period for interest rates

The interest rate risk indicator as measured by the difference between the average repricing periods for asset and liability interest rates has widened over the last 12 months, which entails an increase in interest rate risk. At the end of October 2012 the average repricing period for asset interest rates was almost 11 months, while the average repricing period for liability interest rates was 6 months. The difference between the average repricing periods for asset and liability interest rates has increased by 1 month and 4 days between October 2011 and October 2012. The reason for the increase in the gap lay on the liability side: the average repricing period for asset interest rates has not changed significantly over the last 12 months (it shortened by 4 days). The key factors in the shortening of the average repricing period for liability interest rates were the maturing of debt securities, and the decline in the stock of loans and deposits received and the shortening of the average maturity. This shortening of the average repricing period for liability interest rates is likely to continue in 2013, if the banks' access to long-term funding is hindered.

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



Source: Bank of Slovenia

There are differences between the bank groups in the changes in the average repricing period for asset and liability interest rates. The largest change in the average repricing periods for asset interest rates between October 2011 and October 2012 was recorded by the small domestic banks, where it lengthened by 1 month. The key factor in this was the lengthening of the average repricing period for interest rates on investments in debt securities by almost 3 months. Debt securities are one of the most important investments for the small domestic banks. The largest change in the average repricing periods for liability interest rates between October 2011 and October 2012 was recorded by the banks under majority foreign ownership, where it shortened by 2 months.

An increase in interest rate risk at the banks under majority foreign ownership.

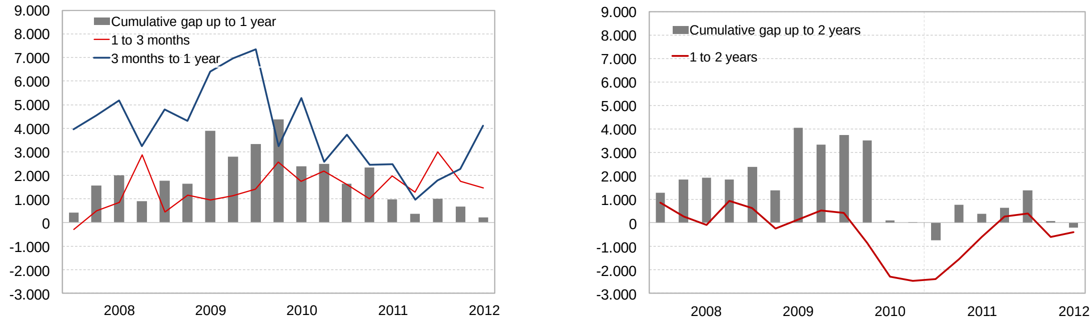
The largest increase in the gap between the average repricing periods for asset and liability interest rates was recorded by the banks under majority foreign ownership, where it lengthened by 1 month and 18 days. A major factor in the shortening of the average repricing period for liability interest rates at the banks under majority foreign ownership was the shortening of the average repricing period for interest rates on loans received by almost 6 months. This reflects a change in business strategy between subsidiary banks and their parent banks in the rest of the world. The change in funding conditions has brought a gradual increase in interest rate risk at the subsidiary banks. Their exposure to a rise in interest rates has increased, as they are increasing their longer-term investments, the funding for which is of shorter maturities. Despite the increase, the gap between the average repricing periods for asset and liability interest rates remains lowest at the banks under majority foreign ownership. The small domestic banks and savings banks, where the gap is 7.5 months, are the most exposed to a rise in interest rates.

8.2 Interest-rate gap

The banks under majority foreign ownership are exposed to a fall in interest rates, while the domestic banks are exposed to a rise.

At the end of the third quarter of 2012 the cumulative interest-rate gap in the interval of up to 1 year between interest-sensitive assets and liabilities stood at EUR 206 million, down EUR 782 million on a year earlier. The banks under majority foreign ownership had a positive gap of EUR 621 million, while the domestic banks had negative gaps of EUR 104 million at the large banks and EUR 310 million at the small banks. One of the reasons for the differences between the bank groups is the proportion of assets tied to variable asset interest rates. The banks under majority foreign ownership have 84% of their assets tied to a variable rate or with an initial rate fixed for up to 1 year. The figure is 64% at the large domestic banks, and just 40% at the small domestic banks.

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



Source: Bank of Slovenia

A decline in the cumulative gap.

Interest-sensitive assets with interest rates set for less than 1 year declined by EUR 3.4 billion over the course of one year, while corresponding liabilities were down EUR 2.6 billion. The cumulative gap for the interval of up to 1 year has declined by EUR 207 million in the last 12 months, and is now almost closed. The largest factors were a decline in the stock of deposits and issued securities on the liability side, and a decline in the stock of loans on the asset side. The cumulative gap for the interval of up to 2 years has declined over the last 12 months, and is almost closed.

On 5 July 2012 the Governing Council of the ECB passed a resolution cutting the interest rate on the Eurosystem's main refinancing operations by 25 basis points to 0.75%. The EURIBOR reference interest rates also responded, and have declined since the end of 2011.

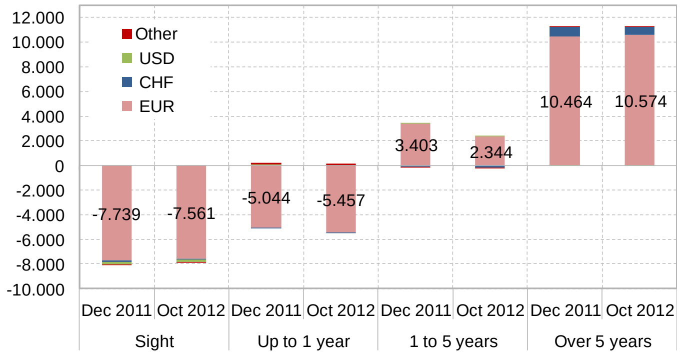
8.3 Basis risk

Interest-rate gaps by currency

The currency breakdown of interest-sensitive balance sheet items has remained almost unchanged.

The currency breakdown of interest-sensitive asset and liability items has not changed significantly compared with the end of 2011: 95% of interest-sensitive asset items and 96% of liability items are in domestic currency. The proportion accounted for by Swiss francs[16] declined, reaching 3.5% on the asset side and 2.6% on the liability side by the end of October. The same is true of US dollars,[17] which accounted for 0.6% of interest-sensitive assets and 1.1% of interest-sensitive liabilities at the end of October. Other currencies account for 0.6% of interest-sensitive assets and 0.2% of interest-sensitive liabilities.

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



Source: Bank of Slovenia

Gaps by type of reference interest rate

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

Interest-sensitive asset items tied to reference interest rates declined by 2.6% between December 2011 and the end of October 2012 to EUR 27.2 billion, while liability items were virtually unchanged at EUR 13.1 billion. The proportion of interest-sensitive items tied to reference interest rates increased by 3.4 percentage points on the asset side of the balance sheet to 66.6%, and by 1.5 percentage points on the liability side to 32.4%. The gap between the proportions of interest-sensitive assets and liabilities tied to reference interest rates stood at 34.2 percentage points.

[16] In September 2011 the Swiss central bank undertook to hold the exchange rate against the euro at a floor of CHF 1.20, and there have therefore been no major fluctuations this year. 31 Oct 2012: EUR/CHF=1.2154. 30 Dec 2011: EUR/CHF=1.2076. (Source: ECB reference exchange rates).

[17] The euro / US dollar exchange rate has fluctuated since the beginning of the year, but ended October at a similar level to December 2011. 31 Oct 2012: EUR/USD = 1.2993; 30 Dec 2011: EUR/USD = 1.2939. (Source: ECB reference exchange rates).

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

	Interest-sensitive assets					Interest-sensitive liabilities				
	Dec 08	Dec 09	Dec 10	Dec 11	Oct 12	Dec 08	Dec 09	Dec 10	Dec 11	Oct 12
Stock, EUR million	44.724	48.591	46.140	44.077	40.794	40.747	45.028	43.643	42.538	40.582
Proportion with reference rate, %	67,0	54,7	62,7	63,2	66,6	37,6	31,4	34,1	30,9	32,4
	Proportion of items tied to a reference rate accounted for by individual reference rate, %									
EURIBOR										
1-month	17,2	8,0	6,1	6,7	6,7	19,7	11,0	5,9	2,5	0,8
3-month	24,0	29,5	29,3	30,6	31,3	25,0	28,4	33,5	35,1	26,3
6-month	47,1	51,8	55,4	54,7	54,7	42,6	48,5	51,6	51,3	48,2
1-year	1,9	2,1	1,8	1,5	1,4	1,6	0,4	0,4	0,4	0,3
Swiss franc LIBOR										
1-month	0,7	0,5	0,4	0,3	0,2	0,5	0,3	0,1	0,0	0,0
3-month	2,2	1,8	1,5	1,1	0,9	3,2	3,6	4,2	3,7	3,7
6-month	3,2	3,2	2,9	2,6	2,4	3,4	2,6	1,6	1,3	0,6
1-year	1,6	1,6	1,5	1,4	1,3	1,7	1,3	1,0	1,1	1,2
Central bank interest rate	0,0	0,0	0,1	0,1	0,2	0,0	2,8	0,0	2,4	17,0
Other	2,1	1,5	1,0	0,9	1,1	2,3	1,1	1,8	2,3	1,9

Source: Bank of Slovenia

The most commonly used reference interest rates on the asset side of the balance sheet are the 6-month and 3-month EURIBORs. Together they account for 86.9% of assets tied to reference interest rates. In addition to the 6-month and 3-month EURIBORs, the central bank interest rate is also significant on the liability side of the balance sheet. As a result of the decline in balance-sheet items denominated in Swiss francs, the proportion accounted for by the LIBOR has declined on the asset and liability sides of the balance sheet.

The banks have lengthened their long position in all EURIBOR reference interest rates in 2012. The largest increase was in the overall net position in the 3-month EURIBOR, by 3.5 percentage points or EUR 1.1 billion. Other than the 6-month LIBOR, the banks have reduced their long position in all LIBOR reference interest rates in 2012.

Table 8.2: Interest-rate gap in interest-sensitive assets in terms of residual maturity by reference interest rate in percentages

(%)	Overall net position					Net position by bucket, Oct 2012			
	Dec 2008	Dec 2009	Dec 2010	Dec 2011	Oct 2012	Sight	Up to 1 year	1 to 5 years	Over 5 years
EURIBOR									
1-month	4,7	1,2	1,9	3,5	4,2	0,0	2,1	1,0	1,2
3-month	7,5	7,8	7,6	8,9	12,4	0,0	0,9	4,1	7,3
6-month	16,9	14,1	18,2	19,3	20,9	-1,3	2,2	7,9	12,2
1-year	0,7	1,0	1,0	0,8	0,8	0,0	0,0	0,2	0,6
LIBOR									
1-month	0,3	0,2	0,2	0,2	0,1	0,0	0,0	0,0	0,0
3-month	0,4	0,0	-0,4	-0,4	-0,6	0,0	0,1	-0,3	-0,4
6-month	1,0	1,0	1,3	1,3	1,4	0,0	0,0	0,1	1,3
1-year	0,5	0,5	0,6	0,6	0,5	0,0	0,0	-0,3	0,8

Source: Bank of Slovenia

9 CURRENCY RISK

Currency risk has remained low in 2012.

The Slovenian banking system's currency risk has remained low in 2012. The net open foreign exchange position amounted to EUR 0.8 million. Despite an almost closed overall foreign exchange position, the open foreign exchange positions in the majority of individual currencies increased slightly, most notably in the currencies of the European Economic Area. The small domestic banks were most exposed to currency risk as at September 2012, with a net open foreign exchange position of EUR 7 million or 1.8% of regulatory capital.

9.1 Currency breakdown and open foreign exchange position

Foreign currency on-balance-sheet and off-balance-sheet asset and liability items were down around 14% in year-on-year terms in September 2012 at just under EUR 3 billion. The banks held 4.8% of their on-balance-sheet assets in foreign currency in September 2012, and 3.7% of their on-balance-sheet liabilities. In the foreign currency breakdown the proportion accounted for by Swiss francs has continued to decline as a result of the decline in the stock of loans in Swiss francs or with a foreign currency clause tied to the Swiss franc, while the proportions accounted for by US dollars and the currencies of the European Economic Area have increased.

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

	2010		2011		Sep 2012	
	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
Total foreign currency other than euros, EUR milli	3.637	3.572	3.308	3.291	2.922	2.921
year-on-year growth, %	7,5	6,9	-9,1	-7,9	-13,9	-13,5
Breakdown of foreign currency other than euros			(%)			
global currencies	92,3	94,5	90,1	90,9	90,4	90,9
Swiss franc	60,6	62,0	55,1	55,8	53,8	54,6
pound sterling	1,4	1,4	1,9	1,9	1,8	1,8
US dollar	28,3	29,0	31,0	31,0	32,6	32,4
Canadian dollar	0,5	0,5	0,7	0,7	0,7	0,7
Japanese yen	1,0	1,1	0,8	0,8	0,5	0,5
Australian dollar	0,5	0,5	0,8	0,8	1,0	1,0
EEA currencies	2,7	2,2	4,9	5,5	5,3	6,3
Other currencies	3,5	3,3	4,0	3,5	3,5	2,8
CIU	1,5	0,0	0,9	0,0	0,8	0,0

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

The net open foreign exchange position amounted to EUR 0.8 million as at September 2012.

The banking system's overall net open foreign exchange position amounted to EUR 0.8 million as at September 2012. Although the overall proportion of asset and liability items in foreign currencies is almost balanced, the net open foreign exchange positions in individual currencies increased compared with 2011, with the exception of collective investment undertaking units in foreign currencies. The largest increase was in the open foreign exchange position in the currencies of the European Economic Area, which was short in the amount of EUR 30 million in September 2012.

Table 9.2: Net open foreign exchange positions by currency in EUR millions

	Non-banking sector	Non-financial corporations	OFIs	Government	Households: All loans	Households: Housing loans
			Stock of loans, EUR million			
2010	1.868,1	429,5	134,4	6,0	1.298,2	1.128,4
2011	1.685,9	339,1	138,8	5,7	1.202,3	1.060,9
Sep 2012	1.400,2	235,1	106,4	5,0	1.053,7	948,8
			Growth, %			
2010	-1,2	-7,6	-22,5	-6,4	4,1	9,0
2011	-15,0	-32,8	-2,9	-9,2	-10,4	-8,6
Sep 2012	-16,9	-30,7	-23,4	-11,9	-12,4	-10,6

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

The small domestic banks were most exposed to currency risk in September 2012, with a net open foreign exchange position of EUR 7 million or 1.8% of regulatory capital. They held a long net foreign exchange position in all currencies, as a result of which they are exposed to a fall in currency values. The large domestic banks and the banks under majority foreign ownership had a short net foreign exchange position in the amount of 0.2% of regulatory capital.

Loans in Swiss francs accounted for 3.6% of all loans to the non-banking sector in September 2012.

The stock of loans to the non-banking sector in Swiss francs or with a Swiss franc currency clause was down 17% in year-on-year terms in September 2012. The main reason for the fall was the stabilisation of the euro / Swiss franc exchange rate. Loans in Swiss francs or with a Swiss franc currency clause accounted for 3.6% of total loans to the non-banking sector in September 2012. The banks under majority foreign ownership held the largest proportion of such loans on their balance sheets, at 7.5%.

Table 9.3: Stock and year-on-year growth of loans in Swiss francs or with a Swiss franc currency

	Non-banking sector	Non-financial corporations	OFIs	Government	Households: All loans	Households: Housing loans
	Stock of loans, EUR million					
2010	1.868,1	429,5	134,4	6,0	1.298,2	1.128,4
2011	1.685,9	339,1	138,8	5,7	1.202,3	1.060,9
Sep 2012	1.400,2	235,1	106,4	5,0	1.053,7	948,8
	Growth, %					
2010	-1,2	-7,6	-22,5	-6,4	4,1	9,0
2011	-15,0	-32,8	-2,9	-9,2	-10,4	-8,6
Sep 2012	-16,9	-30,7	-23,4	-11,9	-12,4	-10,6

Source: Bank of Slovenia

Table 9.4: 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, %	
	2011	Sep 2012	2011	Sep 2012	2011	Sep 2012
Large domestic banks	-10,0	-14,6	32,5	32,4	2,2	2,0
Small domestic banks	-32,6	-13,7	0,8	0,9	0,4	0,4
Banks under majority foreign ownership	-13,9	-15,7	66,7	66,7	8,6	7,5
Overall	-15,0	-16,9	100,0	100,0	4,1	3,6

Source: Bank of Slovenia

10 BANK SOLVENCY

Solvency risk is increasing, because the banks are increasingly meeting their capital requirements by reducing turnover. This translates into fewer financial resources for the non-banking sector, and even more problems in economic recovery. The banking system's overall capital adequacy stood at 11.5% in September 2012, down 0.1 percentage points on the end of 2011. A decline in capital requirements during the first nine months of the year acted to raise capital adequacy by 0.55 percentage points, but operating losses, the prepayment of subordinated debt and a fall in other capital components resulted in the decline of 0.1 percentage points in capital adequacy. The banks' activities in the area of solvency are focused on an increase in the core Tier 1 capital ratio. The differences between the banks are more evident in the distribution. The breakdown of overall capital adequacy reveals the positive impact of capital increases, an increase in hybrid instruments of original own funds and the decline in capital requirements. But other than at the banks under majority foreign ownership these measures do not suffice to cover operating losses and the decline in the stock of subordinated instruments of additional own funds. The overall capital adequacy of the banking system and the domestic banks has declined. In terms of capital adequacy indicators, Slovenian banks, in particular the small banks, remain well behind the average for EU banks of comparable size, what foreign investors see as higher-risk. The reason for the below-average capital adequacy lies more in the level of capital requirements than on the side of capital.

Capital adequacy limits are set high, and the core Tier 1 capital ratio is expected to reach at least 9%, even under the stress scenario. Lending growth is the key to strengthening the banks' income and easing impairment costs. This could allow the banks to operate profitably, thereby generating capital internally. At the same time owners need to decide whether to provide banks with capital support or to withdraw, while privatisation with capital increases and consolidation in the sector are vital measures.

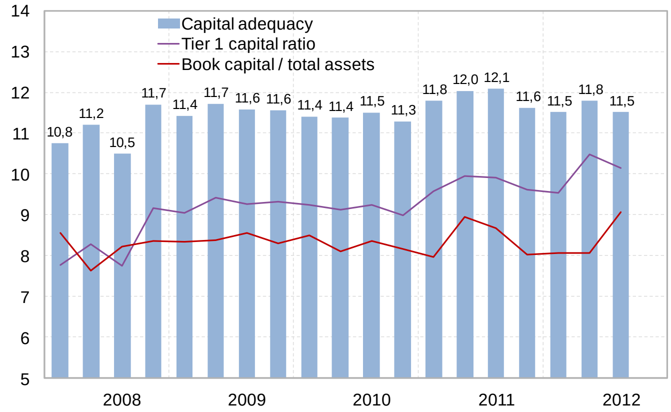
10.1.1 Capital adequacy

The banking system's capital adequacy stood at 11.5% in September 2012, while the Tier 1 capital ratio stood at 10.1%.

The banking system's overall capital adequacy has remained around 11.5% throughout the financial crisis. Deviations were only noteworthy for brief periods after major capital increases, while there has been no significant shift in the level of capital adequacy. The same is true of 2012. Capital adequacy rose slightly during the middle of the year, but by September had fallen to 11.5%, lower than at the end of 2011.

Given the requirements at EU level for a core Tier 1 capital ratio of 9% and the Bank of Slovenia requirements for 80% of the internal assessment of the capital requirements to be met by original own funds, the Tier 1 capital ratio has risen over the last two years. It stood at 10.1% in September 2012, up 0.5 percentage points on the end of 2011. The ratio of the book value of capital to total assets rose sharply in the third quarter of 2012 to 9.1%, as a result of capital increases and a sharp decline in total assets.

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



Source: Bank of Slovenia

The banks are focusing on raising the CT1 CR. It has increased by 0.9 percentage points in 2012 to 9.8%.

The core Tier 1 capital ratio (CT1 CR) rose by 0.9 percentage points during the first nine months of the year to 9.8%, up 1.5 percentage points on 2010.

The banks are facing difficulties in carrying out capital increases. The adverse economic situation is preventing owners from generating surpluses. The banks are thus unable to meet capital adequacy criteria by means of capital increases from their current owners, who are often too passive. Operating losses also mean that the banks' ability to generate capital by means of retained earnings is very limited. Capital adequacy is primarily being strengthened by the decline in capital requirements as turnover is reduced. However, there are time limits on such a contraction, since it is associated with a reduction in exposure to good clients and an increasing negative impact on income. The banks are also reducing the stock of subordinated instruments. In so doing the banks are generating positive income effects and a higher Tier 1 capital ratio by making prepayments at discounts. The prepayments of subordinated instruments are however reducing overall capital adequacy.

Prepayments are weakening capital adequacy. The difference between capital adequacy and the CT1 CR has declined to 1.7 percentage points in 2012.

Having stood at around 3 percentage points in the previous years, the difference between overall capital adequacy and the CT1 CR has declined to 1.7 percentage points in 2012. Returning to the ratios of the past while attaining a CT1 CR of 9% would require an overall capital adequacy of 12%. Prepayments of subordinated instruments with discounts imposed on the investors are reducing their demand for investing in such instruments in the future. The banks are thus losing flexibility in the implementation of future capital increases, as a result of which they will be more dependent on capital increases via share capital.

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

	2008	2009	2010	2011	Sep 2012
Capital adequacy (CA)	11,7	11,6	11,3	11,6	11,5
Tier 1 capital ratio	9,2	9,3	9,0	9,6	10,1
Core Tier 1 capital ratio (CT1 CR)	8,6	8,7	8,3	8,9	9,8
Book capital / total assets	8,4	8,3	8,2	8,0	9,1
	Differences between capital adequacy indicators, percentage points				
Difference between CA and Tier 1 capital ratio	2,5	2,2	2,3	2,0	1,4
Difference between CA and CT1 CR	3,1	2,9	3,0	2,7	1,7
Difference between CA and book capital / total assets	3,3	3,3	3,1	3,6	2,5

Source: Bank of Slovenia

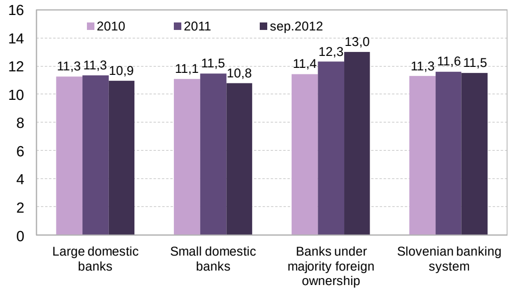
The differences between the banks are increasing.

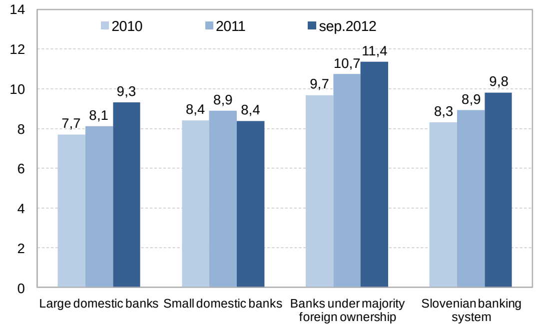
The differences in capital adequacy between the bank groups have widened significantly. The banks with sufficient potential capital have increased it, while those having difficulties in securing capital are focusing all their attention on increasing the core Tier 1 capital ratio.

The banks under majority foreign ownership are increasing all capital adequacy ratios, while the large domestic banks are increasing the CT1 CR, and the small domestic banks are having greatest difficulties.

Even in 2010 all the bank groups had a capital adequacy at the level of the banking system, namely 11.3%. By September 2012 the capital adequacy of the banks under majority foreign ownership had risen to 13%, while at the domestic banks it had fallen to just under 11%. The pressure being exerted on the banks from the market and from international institutions for attaining a core Tier 1 capital ratio (CT1 CR) of at least 9% is primarily being reflected at the large domestic banks, where the CT1 CR has increased by 1.2 percentage points in 2012 to 9.3%. The banks under majority foreign ownership have the highest CT1 CR, at 11.4% at the end of September. By contrast, by September 2012 the CT1 CR at the small domestic banks had declined to its level of 2010 at 8.4%.

Figure 10.2: Capital adequacy (left) and core Tier 1 capital ratio (right) by bank group in percentages



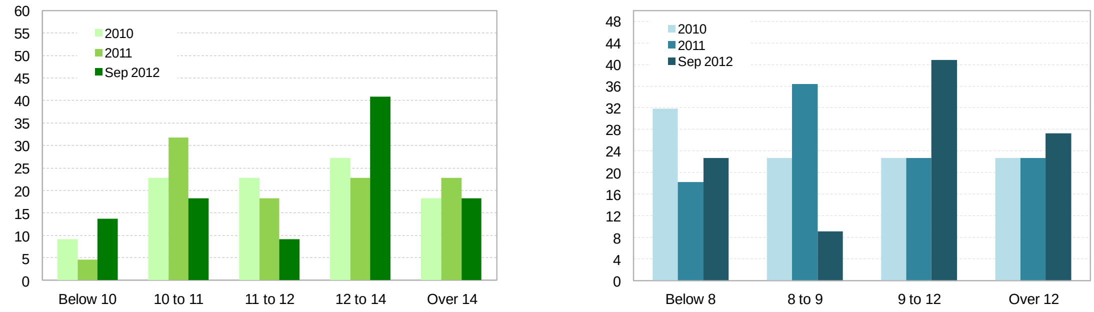


Source: Bank of Slovenia

The distribution of the banks' capital adequacy indicators is shifting towards higher values. Here there has been a rapid decline in the middle bracket, as the differences between the banks have widened. The number of banks whose capital adequacy indicators lie in the lowest distribution bracket increased slightly relative to 2011. The proportion of banks attaining capital adequacy in terms of the criteria of the financial markets increased significantly. This has been reflected in the bank distribution in a large increase in the proportion of banks with a CT1 CR of more than 9% and in the proportion of banks with a capital adequacy of more than 12%.

The distinctions between the banks are also notable in the distribution of the banks in terms of capital adequacy.

Figure 10.3: Distribution of capital adequacy (left) and core Tier 1 capital ratio (right) in percentages



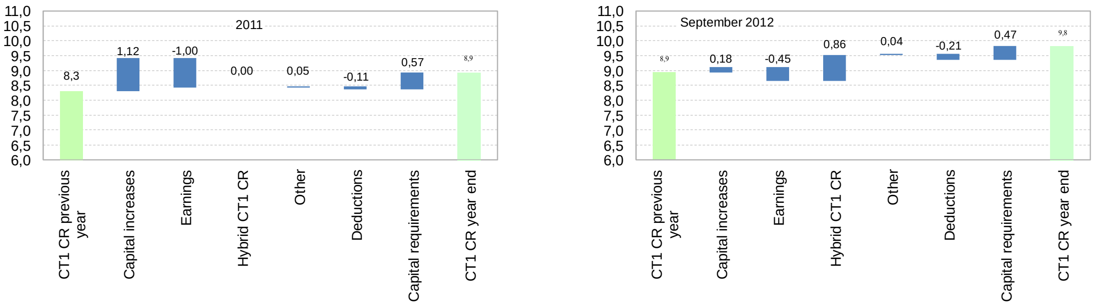
Source: Bank of Slovenia

10.1.2 Decomposition of capital adequacy

The decomposition of the banking system's capital adequacy shows that the CT1 CR improved in 2012 primarily as a result of an increase in the stock of hybrid instruments, which accounted for 0.86 percentage points of the increase in the CT1 CR. There was also a positive effect from lower capital requirements, which accounted for 0.47 percentage points of the increase in the CT1 CR, although this effect was cancelled out by earnings-related items.

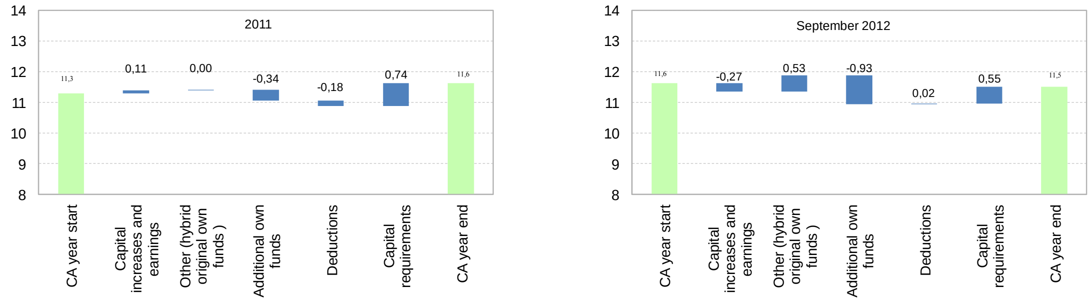
An increase in the CT1 CR as a result of a larger stock of hybrid instruments and a decline in capital requirements.

Figure 10.4: Decomposition of the core Tier 1 capital ratio in 2011 (left) and the first nine months of 2012 (right) for the banking system in percentage points, CT1 CR in percentages



Note: CT1 CR: core Tier 1 capital ratio
Source: Bank of Slovenia

Figure 10.5: Decomposition of capital adequacy in 2011 (left) and the first nine months of 2012 (right) for the banking system in percentage points, capital adequacy in percentages



Note: CA: capital adequacy
Source: Bank of Slovenia

Losses and the decline in subordinated instruments had a negative impact on the banks' capital adequacy.

Operating losses have continued to reduce the banks' capital adequacy. In contrast to 2011, the net effect in the first nine months of the year was negative, taking into account losses and capital increases, at -0.27 percentage points. The most negative impact on the banking system's capital adequacy came from the decline in additional own funds, as a result of prepayments of subordinated and hybrid instruments. The net effect of the decline in additional own funds and the increase in hybrid instruments of original own funds on the banking system's overall capital adequacy stood at -0.4 percentage points in 2012. The main factor in overall capital adequacy in September being down only 0.1 percentage points on the end of 2011 was the decline in capital requirements, which made a positive contribution of 0.55 percentage points.

A negative impact from losses at the small domestic banks, and a negative impact from the decline in additional own funds at the large domestic banks.

Only at the banks under majority foreign ownership was capital adequacy higher in September 2012 than at the end of 2011, primarily as a result of a decline in capital requirements. The contribution made by earnings-related items and by deductions was also positive at this bank group. The largest decline in capital adequacy during the first nine months of the year was recorded by the small domestic banks, primarily as a result of operating losses and the decline in additional own funds. Were solely earnings-related items and the decline in additional own funds as a result of prepayments of subordinated instruments to be taken into account, capital adequacy at the large domestic banks would have declined by 2.1 percentage points during the first nine months of the year. That the capital adequacy at the large domestic banks declined by only 0.4 percentage points was primarily the result of an increase in hybrid instruments in original own funds, the decline in capital requirements, and capital increases.

Table 10.2: Decomposition of capital adequacy for 2011 and the first nine months of 2012 for the banking system and bank groups in percentage points, capital adequacy in percentages

	Banking system		Large domestic banks		Small domestic banks		Banks under majority foreign ownership	
	2011	Jan-Sep 2012	2011	Jan-Sep 2012	2011	Jan-Sep 2012	2011	Jan-Sep 2012
CA year start	11,28	11,61	11,25	11,32	11,07	11,47	11,43	12,30
Capital increases	1,12	0,18	1,39	0,27	0,34	0,07	0,75	0,03
Earnings	-1,00	-0,45	-1,60	-0,65	-0,33	-0,88	0,17	0,13
Other (hybrid original own funds)	0,00	0,53	-0,03	0,84	0,05	0,09	0,07	0,02
Additional own funds	-0,34	-0,93	-0,44	-1,45	-0,36	-0,23	-0,07	-0,03
Deductions	-0,18	0,02	-0,19	-0,03	0,07	-0,04	-0,26	0,12
Capital requirements	0,74	0,55	0,95	0,63	0,63	0,29	0,24	0,43
Overall	0,33	-0,10	0,07	-0,39	0,40	-0,70	0,88	0,69
CA year end	11,61	11,51	11,32	10,94	11,47	10,77	12,30	13,00

Note: CA: capital adequacy
Source: Bank of Slovenia

10.1.3 Capital structure

The increase in the proportion accounted for by original own funds is a reflection of the improvement in capital structure, but the surplus of regulatory capital over capital requirements is simultaneously declining.

Regulatory capital declined by 5.6% as a result of the decline in additional own funds.

The banking system's regulatory capital stood at EUR 4,115 million at the end of September 2012, down EUR 246 million or 5.6% on the end of 2011. Original own funds increased and deductions remained unchanged, while prepayments of subordinated instruments brought a sharp decline in additional own funds.

Table 10.3: Stock of and growth in components of regulatory capital in EUR millions and percentages

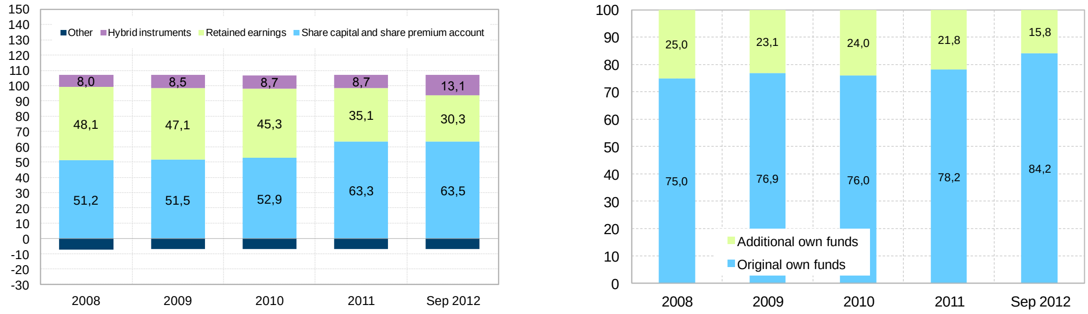
	Stock			2011			Sep 2012		
(EUR million unless stated)	2008	2009	2010	Stock	Change	Growth	Stock	Change	Growth
Regulatory capital	4.475	4.616	4.523	4.361	-162	-3,6%	4.115	-246	-5,6%
Original own funds	3.835	4.116	4.001	4.047	46	1,1%	4.145	98	2,4%
Additional own funds	1.277	1.239	1.265	1.130	-135	-10,7%	780	-350	-31,0%
Deductions	-636	-739	-742	-816	-74	9,9%	-810	6	-0,7%
Original own funds for CA	3.501	3.722	3.605	3.606	1	0,0%	3.627	21	0,6%
Core Tier 1 capital for CA	3.283	3.453	3.332	3.352	20	0,6%	3.509	157	4,7%
Capital requirements	3.059	3.194	3.207	3.004	-203	-6,3%	2.860	-144	-4,8%

Source: Bank of Slovenia

The capital structure has seen an increase in the proportion accounted for by original own funds, while the proportion of hybrid instruments in the latter has also increased.

Original own funds[18] at the level of the banking system increased by EUR 98 million during the first nine months of the year to EUR 4,145 million. The increase was primarily the result of increases of EUR 193 million in hybrid instruments and EUR 69 million in items related to share capital. However, the positive effect of these items was offset by operating losses. Earnings-related items declined by EUR 171 million. The proportion of original own funds before deductions accounted for by earnings-related items was down almost 5 percentage points on the end of 2011 at 30.3%. While the proportion accounted for by items related to share capital and share premium accounts was maintained at a level of just over 63%, the proportion of original own funds accounted for by hybrid instruments increased sharply to 13.1%. The proportion of own funds before deductions accounted for by original own funds increased by 6 percentage points during the first nine months of the year to 84.2%.

Figure 10.6: Structure of original own funds (left) and structure of own funds before deductions (right) in percentages

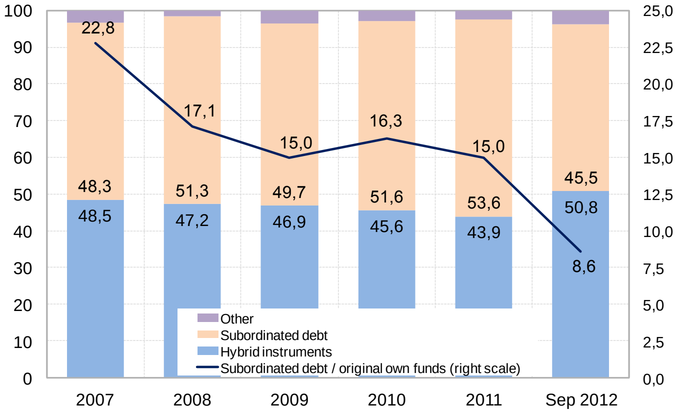


Source: Bank of Slovenia

The ratio of subordinated debt to original own funds declined by 6.4 percentage points to 8.6%.

The banking system's additional own funds declined by EUR 350 million during the first nine months of the year as a result of prepayments of subordinated instruments. Of this, EUR 250 million comprised a decline in subordinated debt, while EUR 106 million comprised a decline in the stock of hybrid instruments of additional own funds. The sharper decline in subordinated debt meant that the proportion of additional own funds accounted for by hybrid instruments increased by almost 7 percentage points to 50.8%. The ratio of subordinated debt to original own funds declined from 15% at the end of 2011 to 8.6% in September 2012.

Figure 10.7: Structure of additional own funds and ratio of subordinated debt to original own funds in percentages



Source: Bank of Slovenia

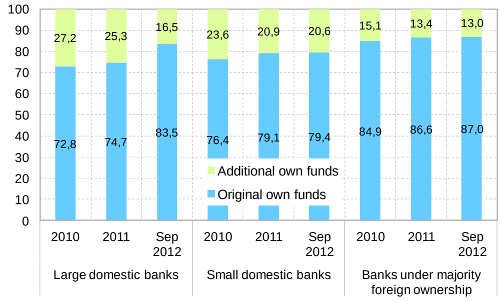
Additional own funds declined at all the bank groups, while original own funds declined at the small domestic banks.

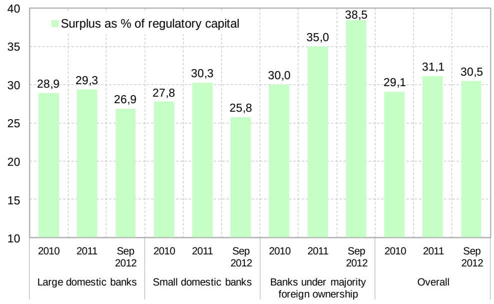
The large domestic banks and the banks under majority foreign ownership recorded an increase in original own funds during the first nine months of 2012, while the original own funds of the small domestic banks declined by 7.8%. Additional own funds declined at all the bank groups, most notably at the large domestic banks, by almost 40%. The stock of subordinated debt declined at eight banks. The proportion of own funds before deductions accounted for by original own funds is highest at the banks under majority

[18] Original own funds before deductions. The calculation of the Tier 1 capital ratio uses original own funds minus deductions, illustrated as "Original own funds for CA" in the table.

foreign ownership, at 87%. This bank group also has the highest surplus in regulatory capital over the capital requirements, which stood at 38.5% of regulatory capital in September 2012. The small domestic banks had the lowest surplus of 25.8%, compared with an overall surplus of 30.5% in the banking system.

Figure 10.8: Structure of own funds before deductions (left) and regulatory capital surplus over capital requirements (right) by bank groups in percentages





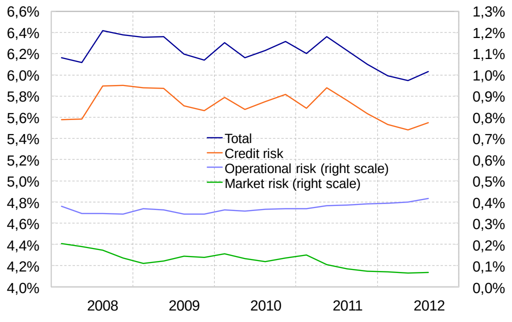
Source: Bank of Slovenia

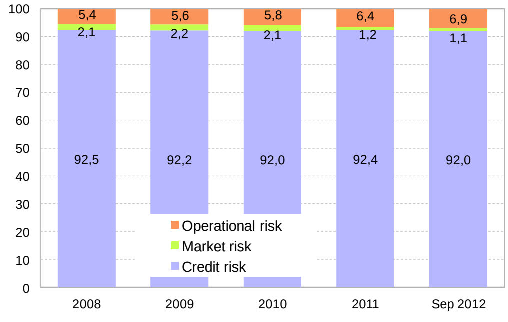
10.1.4 Capital requirements

The ratio of capital requirements to total assets declined to 6%.

Capital requirements amounted to EUR 2,860 million at the end of September 2012, of which 92% comprised capital requirements for credit risk. The ratio of capital requirements to total assets fluctuated around 6.2% until the end of 2011. It then declined to 6% in 2012, a reflection of the decline in capital requirements for credit risk. The banks are reducing their business with the highest risk clients in particular, as a result of which capital requirements are declining faster than total assets. As a result of mark-to-market valuations, where market values are falling, and given the banks' focus on basic banking services, the importance of the trading book is diminishing. Capital requirements for market risks are thus continuing to decline. In September 2012 they accounted for 1.1% of total capital requirements, and were equivalent to less than 0.1% of the banking system's total assets. As a result of the use of basic indicator approaches and standardised approaches, and given the higher level of gross income in the past, the banks are continuing to see an increase in capital requirements for operational risk. They account for 6.9% of total capital requirements, equivalent to 0.4% of the banking system's total assets.

Figure 10.9: Ratio of capital requirements to total assets (left) and breakdown of capital requirements (right) in percentages





Source: Bank of Slovenia

The largest decline was recorded by capital requirements for exposures to corporates.

Capital requirements for credit risk declined by EUR 145 million during the first nine months of the year, having declined by EUR 176 million during the whole of 2011. The largest decline of EUR 153 million was recorded by capital requirements for exposures to corporates, which accounted for 50.4% of capital requirements for credit risk at the end of 2011 and for 47.4% in September 2012.

Table 10.4: Breakdown of capital requirements for credit risk in percentages

	2010				2011				Sep 2012			
	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	1855,7	280,4	815,4	2951,6	1707,2	270,5	797,8	2775,5	1598,7	261,7	769,9	2630,2
	Breakdown of capital requirements for credit risk, %											
Public sector, international organisations	0,8	1,7	1,7	1,1	0,7	1,5	0,4	0,7	0,5	1,2	0,8	0,6
Institutions	11,3	6,2	2,4	8,4	11,7	5,4	2,7	8,5	11,7	3,2	2,9	8,3
Corporates	55,5	49,3	51,6	53,8	50,9	45,3	51,0	50,4	47,1	39,5	50,5	47,4
Retail	17,4	13,7	32,5	21,2	17,6	15,8	33,1	21,9	17,9	16,9	31,5	21,8
Secured by real estate	0,0	7,7	1,1	1,0	0,3	7,3	1,7	1,4	0,4	7,9	3,0	1,9
Past-due items	3,5	2,4	3,7	3,4	5,6	5,3	4,2	5,1	6,8	7,4	3,6	6,0
Regulatory high-risk items	7,9	13,7	3,9	7,4	9,4	14,5	2,8	8,0	12,1	18,3	4,1	10,4
Other	3,6	5,3	3,1	3,7	3,8	4,9	4,0	4,0	3,5	5,6	3,6	3,7

Source: Bank of Slovenia

Capital requirements for past-due and regulatory high-risk items have reached 16.3% of total capital requirements.

There was a sharp increase in capital requirements for regulatory high-risk items during the first nine months of 2012. The total proportion accounted for by past-due and regulatory high-risk items increased by 3.2 percentage points to 16.3%. The most difficult position is at the small domestic banks, where capital requirements for past-due and regulatory high-risk items now account for a quarter of total capital requirements.

The banks are also reducing capital requirements by restructuring the portfolio and redeeming collateral.

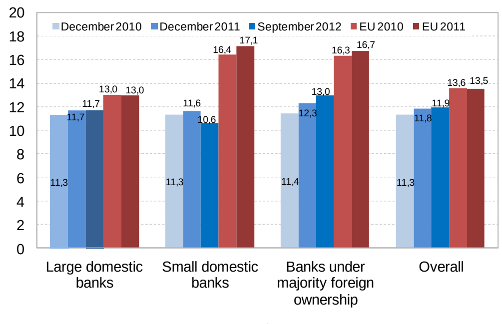
The banks are trying to mitigate the adverse impact on capital adequacy from the deterioration in the quality of the portfolio and operating losses by reducing turnover, by altering the portfolio by reducing exposures with the highest risk weights, and by applying lower weights because of collateral. Some banks have significantly increased their capital requirements for exposures secured by real estate, whose weights are half lower than exposures of the same type when collateral is not taken into account.

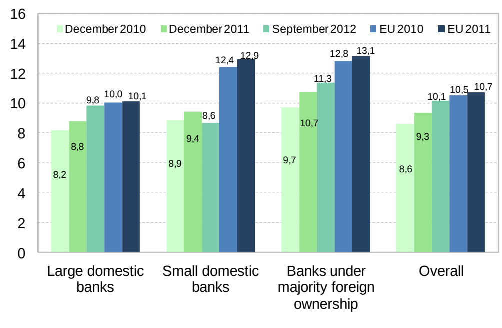
10.1.5 Comparison of capital adequacy with the EU: consolidated figures

The banks have reduced the gap by which their Tier 1 capital ratio trails the EU average.

Lower deductions mean that the banking system has slightly higher capital adequacy on a consolidated basis than on an individual basis. It stood at 11.9% in September 2012. The Slovenian banking system thus has one of the lowest overall capital adequacy ratios in the EU, 1.6 percentage points less than the EU average. Slovenian banks' focus on improving their core Tier 1 capital ratio is also being reflected in the comparison with the EU, where the banking system has largely succeeded in making up the gap by which its Tier 1 capital ratio trails the EU average.

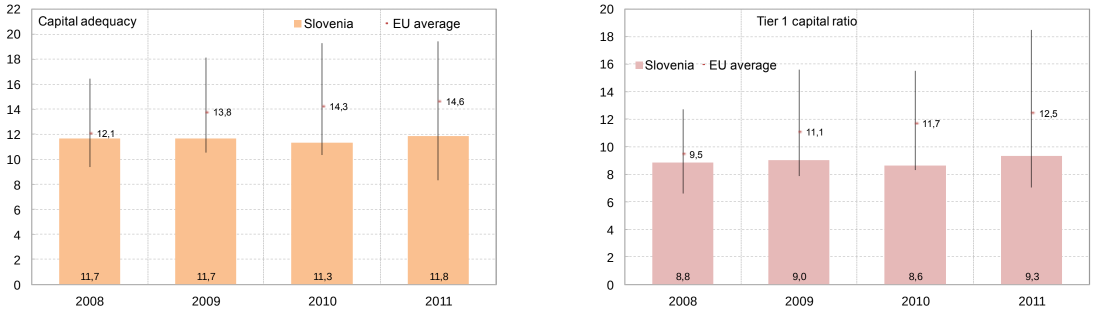
Figure 10.10: Capital adequacy (left) and Tier 1 capital ratio (right) compared with the EU, figures on a consolidated basis in percentages





Sources: ECB (SDW), Bank of Slovenia

Figure 10.11: Distribution of capital adequacy (left) and Tier 1 capital ratio (right) of EU Member States, figures on a consolidated basis in percentages

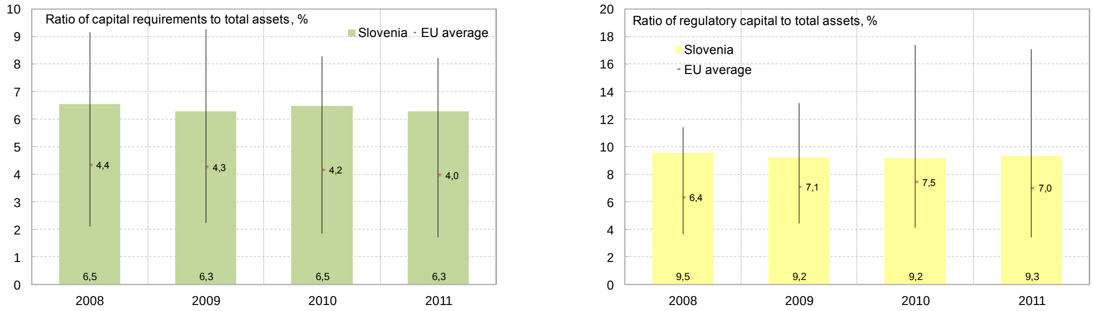


Note: EU average capital adequacy is calculated as a simple average of Member States.
Sources: ECB (SDW), Bank of Slovenia

High capital requirements are the key factor in Slovenia's low capital adequacy compared with other EU Member States.

The key reason that Slovenian banks have lower capital adequacy than the EU average is a very high ratio of capital requirements to total assets. However, the ratio of regulatory capital to total assets is above the EU average.

Figure 10.12: Distribution of ratio of capital requirements to total assets (left) and ratio of regulatory capital to total assets (right) of EU Member States, figures on a consolidated basis in percentages



Sources: ECB (SDW), Bank of Slovenia

The high capital requirements are largely the result of the use of high risk weights.

The ratio of capital requirements to total assets at Slovenian banks stood at 6.3%[19] at the end of 2011, compared with an EU average of 4%. The ratio increased at Slovenian banks during the economic upcycle, peaking in September 2008, and has been declining since the middle of 2011. The main reasons that the ratio of capital requirements to total assets at Slovenian banks is much higher than the EU average are as follows:

1) Most of the banks use the standardised approach for calculating capital requirements for credit risk.
2) Off-balance sheet exposures are also taken into account.
3) A large part of the portfolio is tied to corporates and households, and to a lesser degree to interbank exposure.
4) The banks' counterparties usually do not have credit ratings from recognised agencies.
5) All these factors are reflected in high risk weights. The average risk weight declined by 6.5 percentage points over four years, but was still high in September 2012 at 68.5%.[20] The average risk weight stood at 96.4% for exposures to corporates, 74.2% for retail exposures and 46.6% for exposures to institutions. The average risk weight for past-due and regulatory high-risk items was 128%. This year some banks have increased their capital requirements for exposures secured by real estate, to which a lower risk weight is applied, but these exposures still account for a very small proportion of total exposure (2.4%).

[19] It stood at 6% on an individual basis at the end of September 2012.
[20] Calculated from data on an individual basis.

ANNEXES

1 HOUSEHOLD SECTOR

Households began to deleverage in 2011.

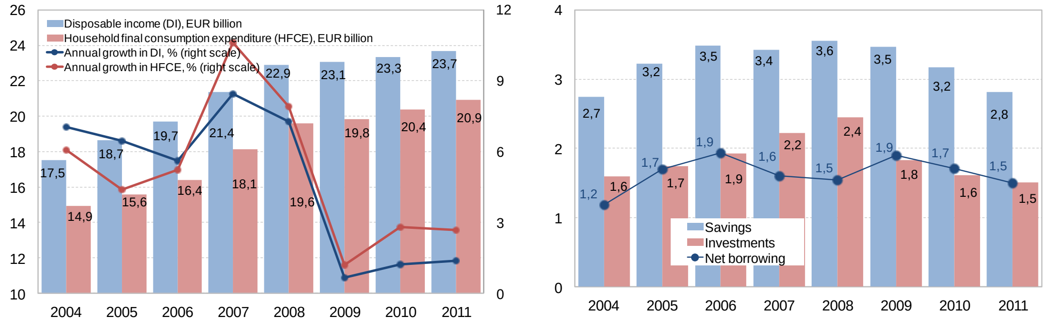
Households continued to increase their financial liabilities after 2008, when economic growth had already declined. The repayment of debt by households began in 2011, with the process continuing during the first half of 2012. The deleveraging process by households is seen in a decline of newly approved bank loans, a trend that is also evident with euro area households. The aggregate debt of Slovenian households is relatively low. The ratio of Slovenian households' financial liabilities to their disposable income stood at 53% in 2011 (an increase of 12 percentage points in the last five years), compared with 108% for euro area households (an increase of 7 percentage points). The deleveraging process is not likely to be as pronounced in the households sector, and will depend on the situation on the real estate market, which is reflected in the trend in household loans, and on developments in unemployment and household income.

Macroeconomic background for households

The savings of households have been declining since the economic situation began to deteriorate, as reflected in stagnating growth in their disposable income.

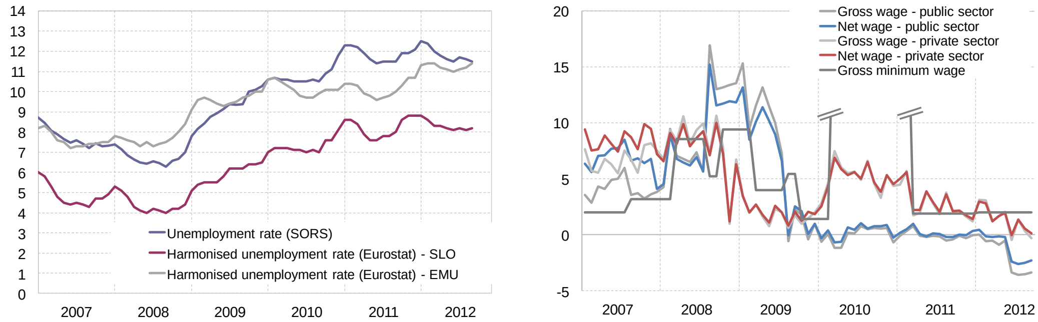
At around 1.3%, disposable household income has achieved very low growth since 2008, when economic growth fell sharply. As a result, growth in household final consumption expenditure is declining at an otherwise slower pace, but with a clear effect on economic growth. A sharper decline in disposable income relative to final consumption and the resulting increase in the proportion of disposable income accounted for by household final consumption is reflected in lower household savings, which were down 11% in 2011. The savings of households, as the most important domestic sector in terms of disposable funds for net lending to other sectors, are of particular importance in the current economic situation. Net borrowing by the household sector is declining in line with the decline in household savings. Given the stagnation on the real estate market and the discouraging macroeconomic situation, the decline in household investment is expected and has had a positive impact on the net position of households.

Figure 1.1: Disposable income and household final consumption expenditure in EUR billion and percentages (left), and savings, investments and net borrowing of households in EUR billion (right)



Note: Disposable income less consumption represents savings.
Source: SORS

Figure 1.2: Unemployment rate in percentages (left) and annual growth in net and gross wages in the private and public sectors (right)

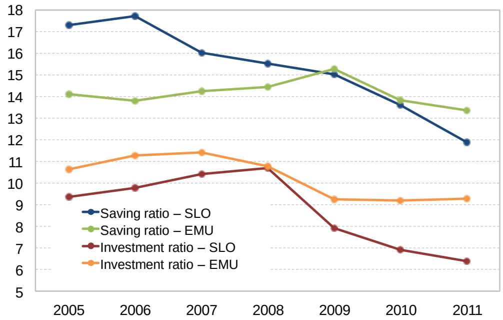


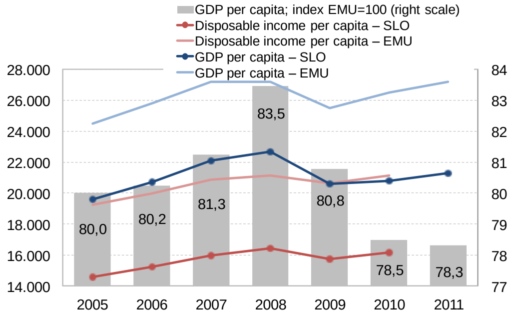
Sources: SORS, ECB

Given the economic growth forecasts for 2012 and 2013, a reversal in the trend of household disposable income and thus savings is unlikely.[21] The lowering of public sector wages in the middle of the year and a reduction in social assistance linked to public finance consolidation measures had a significant impact on the decline in household disposable income in 2012. Also contributing to the decline will be persistently high unemployment, which is significantly lower than the euro area rate, but nevertheless reflected in households' pessimism with regard to consumption.

The lowering of public sector wages and high unemployment affect the movement of disposable income.

Figure 1.3: Saving ratio and investment ratio in percentages (left), and disposable income and GDP per capita with respect to purchasing power parity in EUR (right)





Note: The saving ratio and investment rate are calculated as saving and investment as a proportion of disposable income.
Sources: SORS, ECB

The saving ratio of Slovenian households fell below the euro area rate in 2009. The gap is increasing from year to year. The main factor in 2009 and 2010 was lower growth in the final consumption of euro area households, and higher growth in the latter's disposable income in 2011. The proportion of disposable income accounted for by household final consumption expenditure has been higher in Slovenia than in the euro area since 2009. Growth in investment by euro area households is a reflection of the recovery, while growth in investment by Slovenian households remains negative. In terms of purchasing power parity, Slovenia achieves slightly more than 78% of the GDP per capita of the euro area. The same is true for disposable household income. Thus, the same proportion of disposable income accounted for by the savings of Slovenian and euro area households would not result in the same nominal value of funds saved.

The saving ratio of Slovenian households declined to 11.9%.

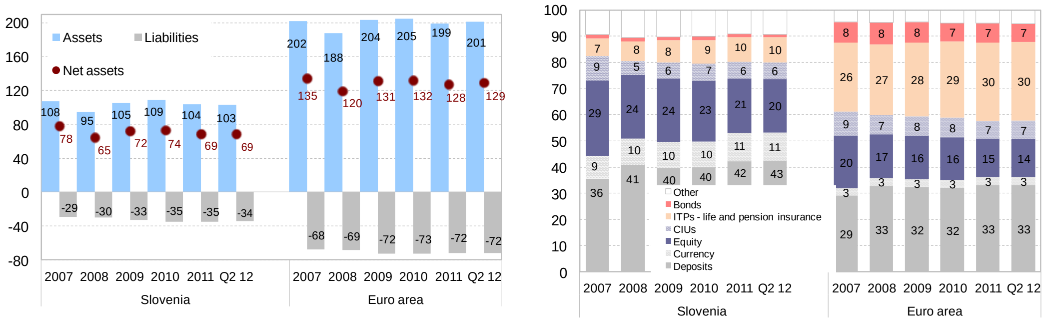
Households' financial assets

Slovenian households' financial assets were down 1.7% during the first half of 2012, primarily owing to value changes and, to a lesser degree, transactions. Value changes, as the result of developments on the capital markets, have reduced households' assets since 2008, inclusive, with the exception of 2009. Also contributing for the first time to the decline in assets in 2011 were transactions, primarily as a result of the withdrawal of assets from the capital markets and collective investment undertakings, a smaller increase in bank deposits and the withdrawal of assets from pension insurance schemes during the first half of 2012. In contrast, interest in life insurance was up slightly during the first half of 2012. The proportion of Slovenian households' assets accounted for by life and pension insurance remains merely a third of the proportion of euro area households.

Alongside value changes, transactions have also contributed to the decline in households' financial assets since 2011.

[21] Forecasts of macroeconomic variables from the Price Stability Report, October 2012, Bank of Slovenia.

Figure 1.4: Net financial position as percentages of GDP (left), and the breakdown of Slovenian and euro area households' financial assets in percentages (right)



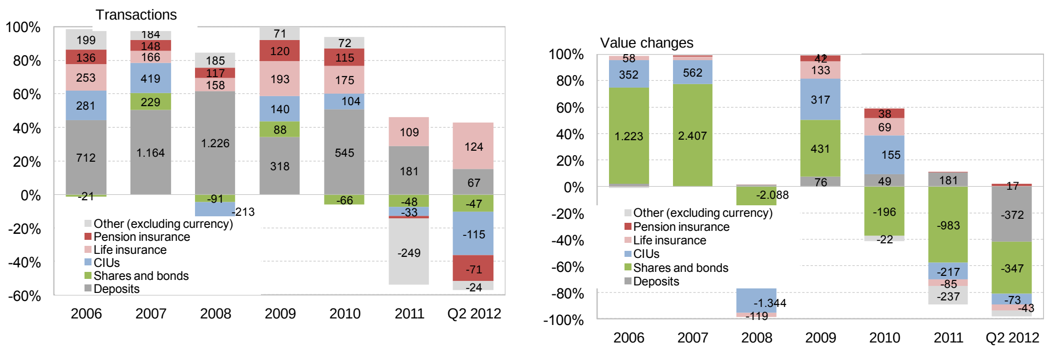
Sources: Bank of Slovenia, SORS, ECB

Table 1.2: Households' financial investments by instrument

	2006	2007	2008	2009	2010	2011	Q2 2012
Total in EUR million	31.979	37.198	35.352	37.476	38.284	37.521	37.183
annual growth, %	13,1	16,3	-5,0	6,0	2,2	-2,0	-2,5
annual change in stock, EUR million	3.707	5.219	-1.846	2.123	808	-763	-961
as % GDP	103,0	107,5	94,9	105,4	107,5	103,7	103,1
	Annual growth, %						Half-yearly growth, %
Cash	17,3	-6,0	8,8	5,3	2,5	8,1	-1,7
Deposits	6,6	9,6	9,5	2,7	2,7	3,6	-0,5
Bonds	-1,2	-0,4	-1,8	0,7	5,9	-8,4	-16,6
Equity	17,7	32,8	-20,3	5,8	-2,6	-11,8	-2,7
Collective investment undertakings	34,6	39,9	-45,3	24,2	7,1	-6,3	0,6
Life insurance	27,3	17,4	2,3	18,8	8,6	4,1	3,6
Pension insurance	26,1	26,7	14,4	17,4	10,3	2,8	-5,3
Other	5,3	5,8	6,2	2,7	1,4	-12,7	2,0

Sources: Bank of Slovenia, SORS

Figure 1.5: Breakdown of transactions (left) and value changes (right) in individual forms of households' financial assets in EUR million and percentages



Note: Deposit transactions also include accrued interest, value changes account for the remainder.

Source: Bank of Slovenia

Household deposits at banks are declining.

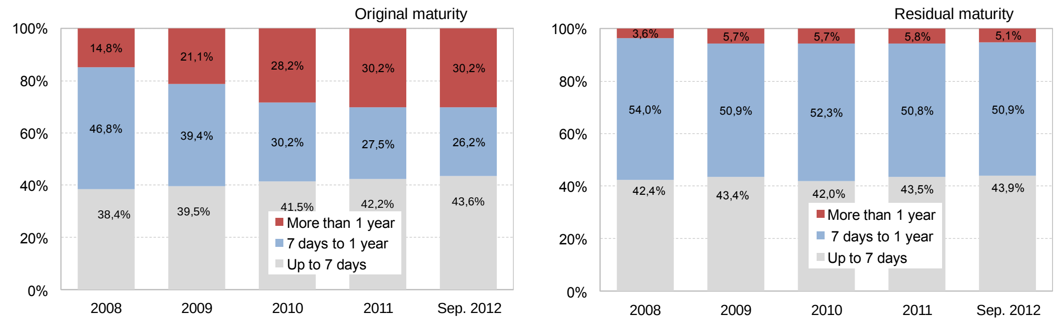
Household deposits at banks were down 0.8% over the first three quarters of 2012. They were down 3.7% at the large domestic banks and up at the other two bank groups, by 1.5% at the small domestic banks and by 7% at the banks under majority foreign ownership. The decline in deposits at the large domestic banks was, to a certain extent, the result of a shift in deposits between bank groups that is not linked to changes in interest rates. During the first nine months of the year, average interest rates on deposits of more than one year, which represent more than 30% of all deposits in terms of original maturity and around 5.5% in terms of residual maturity, were 0.3 percentage points lower at the banks under majority foreign ownership than the large domestic banks. The banks under majority foreign ownership actually reduced deposit interest rates by 0.3 percentage points during the observation period.

Table 1.3: Slovenian household deposits at banks

	2006	2007	2008	2009	2010	2011	Sept. 2012
Deposits, EUR million	10.852	11.909	13.688	14.312	14.832	15.084	14.968
Annual growth, %	8,3	9,7	14,9	4,6	3,6	1,7	-0,7
Annual growth, EUR million	836	1.057	1.779	623	520	253	-109
Large domestic banks	502	629	1.325	432	132	-11	-443
Small domestic banks	123	188	232	182	154	63	39
Banks under majority foreign ownership	210	240	222	9	235	206	296
Loans/deposits, %	50,5	58,1	57,7	59,3	62,6	62,7	62,4

Source: Bank of Slovenia

Figure 1.6: Proportions of household deposits accounted for by deposits of up to 7 days, deposits of 7 days to 1 year, and deposits of more than 1 year with respect to original (left) and residual maturity (right) in percentages



Source: Bank of Slovenia

One major reason for the decline in household deposits is the decline in their savings as a result of the adverse economic situation, which results in a stagnation or decline in disposable household income. Final consumption expenditure also declines as a consequence, but to a lesser extent. There was no significant shift between forms of household savings. To some degree, the decline in deposits is also a reflection of households' response to sustained negative media coverage of the banking system and certain domestic banks, and to government measures linked to social transfers. Savings at banks reduce the scope of social transfers and eligibility to receive them.

One of the major reasons for the decline in deposits by households is the decline in their savings.

Household borrowing

In line with the decline in financial assets, the financial liabilities of households have also been declining since 2011, albeit at a slower pace. For that reason, households' net financial assets are declining, and stood at 68.7% of GDP at the end of June 2012. In contrast, loans are declining faster than household deposits. This has the positive effect of reducing the ratio of loans to household deposits at banks. Macroeconomic data do not indicate that Slovenian households are over-indebted. At 72% of GDP, the financial liabilities of euro area households are more than double the financial liabilities of Slovenian households, at 34% of GDP. Interest on banks loans accounted for 1.9% of disposable household income in Slovenia in 2011.[22] Higher real estate prices, low interest rates, looser credit standards and an optimistic atmosphere in the economy resulted in high growth in loans and household debt prior to the crisis. Given the still moderate level of household debt, major impairments and write-offs by banks in the household sector are less likely. The proportion of banks' classified claims against households settled more than 90 days in arrears was 3.5% in September 2012. At 2.5% at the banks under majority foreign ownership, that proportion was 1.5 percentage points lower than at the domestic banks. The lower proportion of claims in arrears could point to a higher-quality portfolio. It is also in part a result of higher growth in housing loans at this bank group in recent years. As of yet there has been no indication of potential difficulties in the repayment of the aforementioned loans. Given the economic situation as it relates to high unemployment, uncertain developments in wages, deteriorating consumer confidence and the uncertain situation on the real estate market, significant growth in loans to households is not likely over the next two years.

Households' financial liabilities have begun to decline.

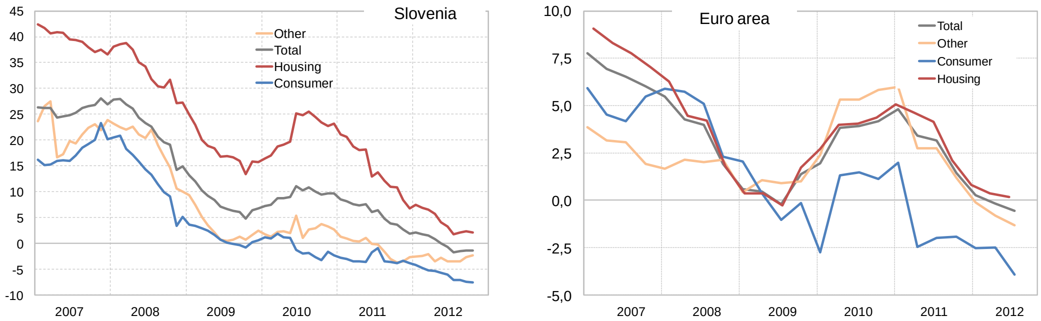
[22] The ratio of bank's interest income from loans to households to disposable household income.

Table 1.4: Household financial liabilities by instrument and disposable income

	2006	2007	2008	2009	2010	2011	Q2 2012
Financial liabilities, EUR million	8.093	10.054	11.204	11.779	12.521	12.507	12.407
growth, %	17,6	24,2	11,4	5,1	6,3	-0,1	-1,3
change in stock, EUR million	1.210,0	1.960,9	1.149,5	575,0	742,4	-13,9	-162,4
as % of GDP	26,1	29,1	30,1	33,1	35,2	34,6	34,4
	Breakdown, %						
Loans	83,7	85,7	86,6	87,5	88,0	88,3	87,6
corporates	4,2	3,8	3,1	3,4	3,2	2,9	2,6
banks	67,8	68,9	70,6	72,0	74,3	75,9	75,8
other financial intermediaries	9,8	11,9	11,4	10,6	9,3	8,5	8,1
Other	16,3	14,3	13,4	12,5	12,0	11,7	12,4
Disposable income, EUR million	19.697	21.360	22.911	23.060	23.340	23.663	
change in stock, EUR million	1.047	1.663	1.551	149	280	323	
growth, %	5,6	8,4	7,3	0,7	1,2	1,4	
as % of GDP	63,4	61,7	61,5	64,9	65,5	65,4	
Debt as % of disposable income	41,1	47,1	48,9	51,1	53,6	52,9	

Sources: Bank of Slovenia, SORS

Figure 1.7: Annual growth in individual types of household loans in Slovenia (left) and the euro area overall (right) in percentages



Sources: Bank of Slovenia, ECB

Growth in housing loans was 2.3% in September 2012.

Housing loans account for 22% of disposable household income or more than 55% of Slovenian households' total liabilities to the banking sector. The rise in the proportion of housing loans is a result of the decline in consumer loans to households since 2010 and growth in housing loans, which stood at just 2.3% at the end of the third quarter of 2012. The decline in consumer loans is in line with the decline in household final consumption expenditure and movement in the consumer confidence indicator, which has been very low again since the end of 2011. The maturity of housing loans began to shorten again in 2012, in part as the result of a decline in the stock of approved housing loans and lower demand for housing loans from customers with less favourable financial structures. The vulnerability of around 14% of households with mortgage debt whose housing costs, including principle and interest on a housing loan, account for more than 40% of their disposable income, depends on the economic situation, in particular the situation on the labour market.[23] That proportion is higher primarily at households with lower disposable income and at households with unemployed head of the household. Slovenia lacks a national strategy to address financial education and the over-indebtedness of households.

At 13%, the small domestic banks recorded the highest growth in housing loans over the first three quarters of the year, while growth at the large domestic banks and banks under majority foreign ownership did not exceed 2%. The difference in average interest rates on housing loans between bank groups is very small, at 10 basis points. Interest rates on housing loans fell by slightly less than 1 percentage point during the first nine months of this year. The average differences in interest rates on consumer loans between bank groups were higher at around 40 basis points over the first nine months of the year. The banks under majority foreign ownership had the lowest interest rates. Consumer loans were down at all banks groups over the first nine months of 2012, most notably at the large domestic banks.

[23] The ratio is calculated for the period from 2006 to 2009. The source is SORS (EU-SILC survey).

Table 1.5: Growth in loans to Slovenian households by bank group

	2006	2007	2008	2009	2010	2011	Sept. 2012
	Housing loans						
Annual growth, EUR million	589	717	734	532	898	326	119
Large domestic banks	270	328	279	292	353	60	21
Small domestic banks	5	15	19	11	30	36	30
Banks under majority foreign ownership	314	374	436	228	515	231	67
	Consumer loans						
Annual growth, EUR million	318	460	140	18	-71	-110	-206
Large domestic banks	146	190	36	-87	-114	-105	-129
Small domestic banks	49	101	-8	4	15	-11	-13
Banks under majority foreign ownership	123	169	112	101	28	5	-63

Source: Bank of Slovenia

Table 1.6: Household financial liabilities by instrument and disposable income

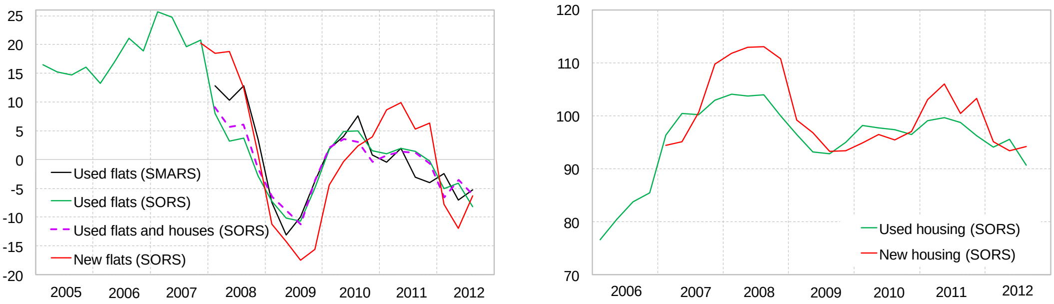
	2006	2007	2008	2009	2010	2011	Sept. 2012
Loans, EUR million	5.385	6.847	7.874	8.436	9.282	9.453	9.338
Housing	1.958	2.674	3.408	3.939	4.837	5.164	5.250
Consumer	2.286	2.746	2.886	2.904	2.833	2.722	2.554
Other	1.141	1.426	1.580	1.593	1.612	1.568	1.534
Loans as % of GDP	17,3	19,8	21,1	23,7	26,1	26,1	25,9
Housing	6,3	7,7	9,1	11,1	13,6	14,3	14,6
Consumer	7,4	7,9	7,7	8,2	8,0	7,5	7,1
Other	3,7	4,1	4,2	4,5	4,5	4,3	4,3
Annual growth, EUR million	1.177	1.462	1.027	563	846	171	-130
Housing	591	717	734	532	898	326	119
Consumer	321	460	140	18	-71	-110	-206
Other	265	286	154	13	19	-45	-43
Annual growth, %	28,0	27,1	15,0	7,1	10,0	1,8	-1,4
Housing	43,2	36,6	27,4	15,6	22,8	6,7	2,3
Consumer	16,3	20,1	5,1	0,6	-2,4	-3,9	-7,5
Other	30,3	25,0	10,8	0,8	1,2	-2,8	-2,7
Newly approved loans, EUR million	2.721	3.516	3.264	3.015	3.057	2.363	2.033
Housing	822	1.028	1.007	963	1.211	905	744
Consumer	1.502	1.909	1.718	1.517	1.284	1.064	940
Long-term	186	407	378	294	199	179	184
Short-term	1.316	1.502	1.341	1.223	1.085	885	756
Other	398	579	539	536	563	393	349

Sources: Bank of Slovenia, SORS

2 REAL ESTATE MARKET

Negative trends continue on the real estate market due to declining construction activity, the deteriorating economic position of the households and a decline in housing loans. The collapse of numerous construction companies resulted in the withdrawal of a significant portion of new housing from the market, while inventories of new housing remain, as public auctions and other sales from bankruptcy estates were mostly unsuccessful. In the context of a decline in housing loans and a gradual fall in real estate prices, only on the used housing market has trading been in part maintained. The number of used housing transactions was down 6% on the average of the previous five years over the first three quarters of 2012.

Figure 2.1: Year-on-year growth in prices of used and new-build housing in Slovenia (left), and the basic housing price index (2007 = 100) (right) in percentages



Sources: Surveying and Mapping Authority, SORS

Used housing prices are falling gradually in the context of moderate turnover.

According to figures from the Surveying and Mapping Authority of the Republic of Slovenia (SMARS), the trend of a gradual fall in used housing prices has continued for five consecutive quarters. Housing prices had fallen to 2007 levels by the end of the third quarter of 2012. According to SMARS figures, average housing prices in Slovenia were down 5.3% at the end of the third quarter of 2012, at 1,646 EUR/m^2, and down 14.7% from the peak in the second quarter of 2008. Average prices of used housing in Ljubljana were down 7.9%, at 2,321 EUR/m^2, and down 17.7% on their peak.

Table 2.2: Transactions on the real estate market

	Used residential real estate			New residential real estate				Proportion of
Year	Flats	Houses	Total	Flats	Houses	Total	Total residential real estate	transactions in new real estate, %
				Number of transactions				
2007	6.310	1.889	8.199	1.745	75	1.820	10.019	18,2
2008	4.297	1.271	5.568	1.163	263	1.426	6.994	20,4
2009	3.522	848	4.370	971	364	1.335	5.705	23,4
2010	4.910	1.424	6.334	1.282	307	1.589	7.923	20,1
2011	4.441	1.330	5.771	927	184	1.111	6.882	16,1
Q3 2011	3.095	907	4.002	734	129	863	4.865	17,7
Q3 2012	3.105	1.002	4.107	519	117	636	4.743	13,4
				Growth, %				
2008	-31,9	-32,7	-32,1	-33,4	-	-21,6	-30,2	
2009	-18,0	-33,3	-21,5	-16,5	38,4	-6,4	-18,4	
2010	39,4	67,9	44,9	32,0	-15,7	19,0	38,9	
2011	-9,6	-6,6	-8,9	-27,7	-40,1	-30,1	-13,1	
Q3 2012	0,3	10,5	2,6	-29,3	-9,3	-26,3	-2,5	

Note: The figures for transactions in new-build housing are survey figures.
Sources: SORS, Bank of Slovenia calculations

According to SORS figures, the prices of used housing in Slovenia were down 8.2% at the end of the third quarter of 2012, and down 12.9% on their peak in the first quarter of 2008.

The index of the Statistical Office of the Republic of Slovenia (SORS) indicates a fall in used housing prices of 6.2% at the end of the third quarter of 2012. Prices of used housing in Slovenia were down 8.2%, and down 12.9% on their peak in the first quarter of 2008. Given that the prices of used housing rose by 95% in the five years prior to the peak resulting in an unsuitable ratio to purchasing power, the downward adjustment of prices during the crisis is more than likely to continue. Transactions in used houses were up slightly on the average of the previous five years over the first three quarters of 2012, while transactions in used flats were down 8.6%.

According to SORS survey figures, the prices of new housing units were down 6.4% at the end of the third quarter of 2012. The decrease was the same for prices of new flats and prices of new houses. The prices of new-build housing were down 16.7% from their peak in the third quarter of 2008. At 13.4%, the proportion of all real estate transactions accounted for by new-build housing reached its lowest level in the last six years during the first three quarters of 2012. Transactions in new-build housing were down 42% on the average of the previous five years, as a result of the unsuccessful sale of housing units from bankruptcy estates.

Table 2.3: Selected indicators that affect the movement of residential real estate prices

	2006	2007	2008	2009	2010	2011	Q3 2012
Growth in nominal gross wage bill, %	6,4	10,3	10,4	-2,2	0,9	0,0	-2,9
Growth in final household consumption, %	6,4	12,5	10,1	-9,0	-1,6	-6,6	-6,7
Growth in stock of housing loans, %	34,7	36,4	27,3	15,7	23,2	6,7	2,3
Number of used residential real estate transactions	6.868	8.199	5.568	4.370	6.334	5.771	2.862
Number of new residential real estate transactions - survey data		1.820	1.426	1.335	1.589	1.111	439
Growth in used residential real estate prices, %	18,8	20,7	-2,9	-4,9	1,5	-0,2	-4,1
Growth in new residential real estate prices, %		20,2	0,9	-15,7	3,9	6,4	-11,9
Value of residential real estate pledged as collateral for construction loans, EUR million				512	597	604	546
Assessed number of unoccupied housing units - SORS						9.500	
Assessed number of unoccupied housing units - SMARS							3.300-3.500

Sources: Bank of Slovenia, SORS, SMARS

A sharp decline in household income will result in a drop in demand for residential real estate. Pressure on declining prices will increase.

The decline in household income accelerated sharply in the third quarter of 2012. The intensity of the deterioration is similar to that seen at the outbreak of the crisis. A sharp decline in long-term household consumption can therefore be expected. In addition to the nominal gross wage bill, the average nominal gross wage also declined sharply for the first time. This means that receipts were also down in the highest income brackets, which will result in increased prudence in purchases. This has been seen already to some extent, as activity on the used housing market was maintained by significantly fewer loans over the first three quarters of 2012. Buyers are primarily those with more savings and those making purchases according to the principle of intergenerational solidarity.

Given limited borrowing, the over-valuation of housing on the market and the notable trend of declining household purchasing power in the context of sufficient inventories of housing units, forecasts of declining economic activity and employment, and higher consumer prices point to a continuing fall in real estate prices. The fall in prices will most likely be slow, as economic agents are not actively addressing their market position by lowering offered prices because they are incurring higher impairments of investments at the expense of already deficient capital. Bridging their current position on the market by waiting for the situation to improve further limits investment in the economy. Problems pass through to the household sector, which could lead to a significant long-term decline in demand for real estate.

According to SORS figures, the number of unoccupied, newly built housing units was estimated at 9,500 at the end of 2011, and at between 3,300 and 3,500 according to SMARS figures at the end of June 2012. According to estimates, inventories of new housing units are sufficient for at least the next three years in the context of an average number of transactions from the previous five years. With average prices that are nearly a third higher, new housing units are even less affordable than used housing. Due to the protracted sales process, new units are also losing in terms of quality and becoming increasingly less attractive to potential buyers. Due to lower entry costs and optimal planning, housing units that will only later be placed on the market are more likely to be sold.

The National Housing Fund issued a public call for the purchase of housing units in the amount of EUR 40 million. The base prices was set at between EUR 900/m2 in smaller cities and towns and a maximum of EUR 1,700/m2 in major centres. The real estate price index will not include these possible transactions, as the end customer is not a natural person. Possible successful transactions by the National Housing Fund could prevent a fall in offered prices to a level that is line with the purchasing power of potential buyers. In any case, such transactions will be built into the expectations of buyers. Otherwise the establishment of the rental market leads to the more balanced functioning of the real estate market.

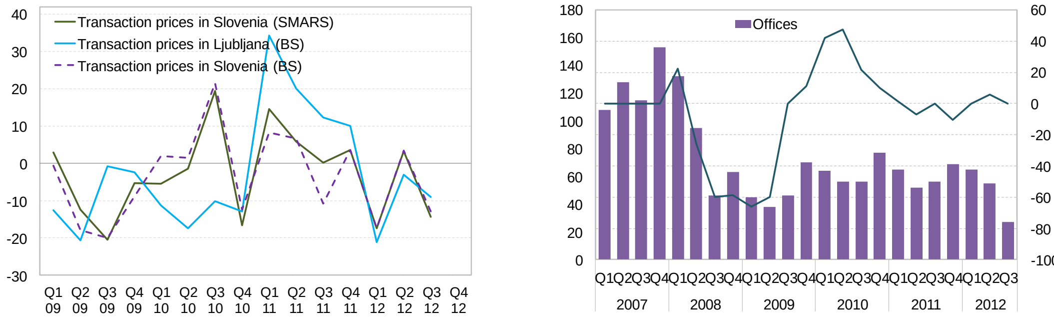
The possible introduction of a higher tax rate on unoccupied housing units would have the positive effect of reviving the real estate market. According to findings of the European Commission, the rental market, which is underdeveloped and disorganised in Slovenia, is the key factor in structural differences between countries that leads to imbalance and real estate cycles. A rise in the rate of ownership leads to the increased volatility of residential real estate prices.

Commercial real estate prices

The commercial real estate market is illiquid.

Demand for commercial real estate was down again in 2012. This was particularly evident in the third quarter. Market illiquidity, which hinders the real valuation of property, remains the main factor limiting the interpretation of the movement of prices. According to SORS figures, prices for office space were down 14.3% at the end of the third quarter of 2012, and down 18.5% on their peak in the third quarter of 2008. In line with macroeconomic forecasts and corporate expectations, no significant demand can be expected in the short term. Thus, prices are more likely to fall than stagnate. In the context of a low number of transactions, the commercial real estate price index will continue to fluctuate due to the effect of the location of sales.

Figure 2.2: Growth in commercial real estate (office) prices (left) and number of transactions included in the calculation of average price and growth therein (right) in percentages

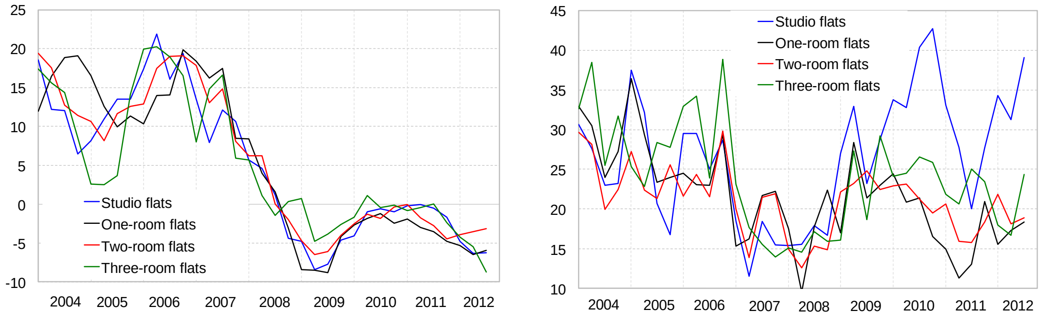


Sources: SMARS, Bank of Slovenia calculations

Advertised housing prices in Ljubljana

Advertised housing prices in Ljubljana have fallen since the outbreak of the crisis. In 2012 the fall in prices accelerated to the pace seen at the onset of the crisis. The gap by which advertised prices of studio flats exceed transaction prices remains somewhat higher, indicating a continued fall in advertised prices.

Figure 2.3: Year-on-year growth in advertised housing prices (left) and the gap by which advertised prices exceed transaction prices per square metre (right) in percentages



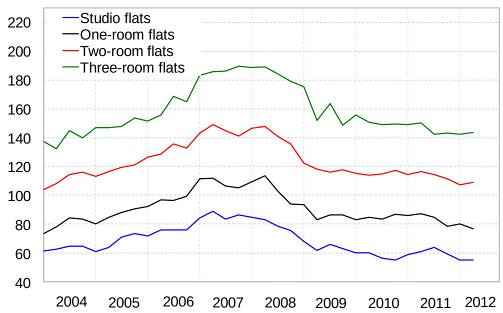
Sources: TARS, SMARS, Slonep, Bank of Slovenia calculations

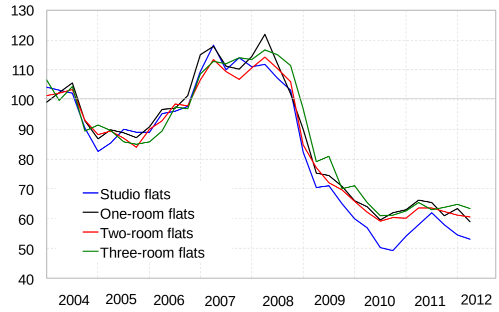
Housing affordability in Ljubljana

Housing affordability in Ljubljana, which is expressed as the ratio of used housing prices to the annual moving average of net monthly wages, improved slightly over the first half of 2012 relative to the situation at the end of 2011. The net average wage, which was up 0.3% in terms of the annual 12-month moving average, and the falls of 7.1% and 1.8% in the prices of used studio flats and used one- and two-room flats respectively, had a favourable impact on the indicator. During the first half of 2012, the amount required for the purchase of a studio flat was down by more than four monthly wages relative to the end of 2011, while that savings was two wages for one- and two-room flats. The indicator did not point to any significant changes in the affordability of larger flats.

When interpreting the data, consideration must be given to the fact that affordability did not necessarily improve in all income brackets, because the increase in the average net wage was in part due to an increase in the lay off of workers in labour intensive sectors with lower income. With the average net wage beginning to fall in June 2012, a slight deterioration in the indicator can be expected during the second half of 2012 in the context of a gradual fall in real estate prices.

Figure 2.4: Ratio of housing prices to annual moving average of net monthly wages for Ljubljana in percentages (left) and housing affordability index (2004 = 100) (right)





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

Once the lending conditions have been taken into account, the affordability of used housing in Ljubljana improved slightly during the first half of 2012, particularly with respect to studio flats. Contributing to the aforementioned improvement were somewhat lower interest rates on housing loans, in the context of little change in the average maturity of newly approved housing loans, which stood at 18.1 years over the first three quarters of this year. Most loans were approved with a variable interest rate tied to the EURIBOR, which in June 2012 was down 0.6 percentage points on December 2011. More expensive sources of bank funding led to an increase in the average premium to 2.4 percentage points, which decreases the long-term affordability of loans. The banks tightened credit standards in the second and third quarters of 2012, meaning that loans are primarily accessible by households in higher income brackets. There was no significant change in the ratio of housing loan annuities to the average net wage in June 2012 relative to the end of 2011; it stood at 34% for studio flats, 47% for one-room flats, 67% for two-room flats and 94% for three-room flats.

Housing loans and loans to the construction sector

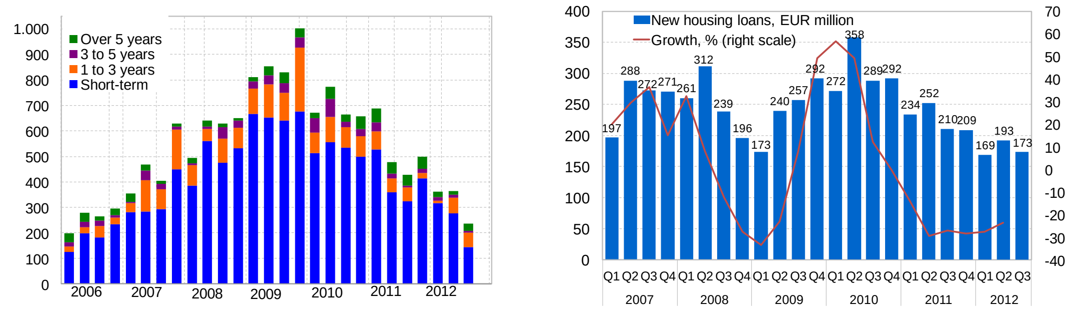
The demand for real estate is driven down further by the slowdown in lending.

Newly approved housing loans to households totalled EUR 535 million over the first three quarters of 2012, down 23.2% on the same period last year. The figure is the lowest volume of newly approved housing loans recorded in the period following the outbreak of the crisis which, in the context of a significant drop in demand, points to a continuing fall in real estate prices.

The LTV (loan-to-value) ratio on new housing loans has risen notably in the last year, particularly at the banks under majority foreign ownership. It averaged 71.9% during the first three quarters, up 13.2 percentage points on the 2011 average. With an LTV ratio of 54.6%, the small domestic banks are the most conservative in terms of collateral requirements, followed by the large domestic banks with an LTV ratio of 69.8% and the banks under majority foreign ownership at 75.6%. In addition to the real estate that is the subject of a given purchase, the banks require a mortgage on other real estate.

With 18% of housing loans in Swiss francs, movement in the euro-Swiss franc exchange rate remains a significant element of risk. Movement in variable interest rates, to which 93% of loans are tied, represents even greater risk for households. Following several years of double-digit growth, growth in housing loans slowed to 6.7% at the end of 2011, and fell to 2.3% in September 2012.

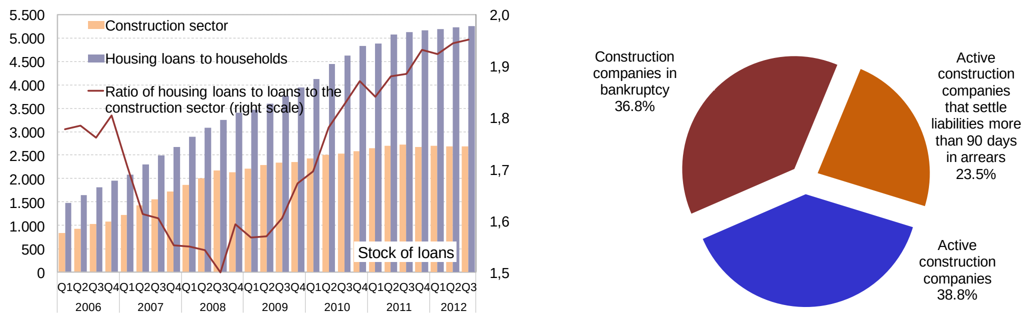
Figure 2.5: New loans to the construction sector in EUR million (left), and new housing loans to households in EUR million and growth in percentages (right)



Source: Bank of Slovenia

Construction activity continues to contract in all segments due to low demand, liquidity problems, a lack of private equity and the absence of major infrastructure projects. The banks approved loans to construction companies totalling EUR 961 million over the first ninth months of this year, down 40% on the same period last year. The stock of loans fell by just 1.2%. This is primarily due to exposure to companies in protracted bankruptcy proceedings and revolving loans; there are numerous unfinished projects in which completion will bring more benefits than abandonment.

Figure 2.6: Stock of loans to the construction sector and stock of housing loans to households in EUR million and the ratio between them (left), and quality of bank claims against the construction sector in percentages (right)



Sources: Bank of Slovenia, AJPES

A lack of private equity and erroneous investment decisions in the past hinder the restructuring of construction companies' balance sheets.

The value of the banking system's classified claims against the construction sector stood at EUR 3.5 billion in September 2012, accounting for 12% of the banks' total classified claims against non-financial corporations. At 14%, that proportion is highest at the large domestic banks and lowest at the banks under majority foreign ownership, at 8%. Fully 61% of classified claims were against construction companies in bankruptcy proceedings or against those that settle their liabilities more than 90 days in arrears, the large domestic banks accounting for the majority. Completed housing units pledged as collateral for those claims will come under the increasing pressure of falling prices. The same is true for housing units in incomplete projects. Attempts to complete such projects are typically made by attracting a new private investor. Official receivers oversee the sale of pledged real estate from a bankruptcy estate. According to the law, however, banks give their consent to the conditions and price of a sale as segregated creditors, and thus have an indirect impact on the success or failure of the sale.

Table 2.4: Impact of the construction sector on banking operations and the real estate market

Sep. 2012	Classified claims, EUR million	Impairments, EUR million	Coverage of classified claims by impairments, %	Unsecured classified claims: EUR million	Unsecured classified claims: as % of classified claims	Secured classified claims, EUR million: Real estate	Secured classified claims, EUR million: Government guarantees	Secured classified claims, EUR million: Other	Secured classified claims, EUR million: Total	Amount by which collateral exceeds value of classified claims, EUR million
	(1)	(2)	(3)=(2)/(1)	(4)	(5)=(4)/(1)	(5)	(6)	(7)	(8)	(10)=(8)/(1)
Total construction sector	3.584	754	21,1	1.555	43,4	2.636	29	799	3.463	1,0
Construction sector excluding bankruptcies; liabilities settled regularly	1.390	51	3,7	597	43,0	1.156	6	452	1.615	1,2
Construction sector excluding bankruptcies; liabilities settled more than 90 days in arrears	841	216	25,7	265	31,5	729	3	227	959	1,1
Construction sector - bankruptcies	1.353	487	36,0	693	51,2	751	19	120	890	0,7

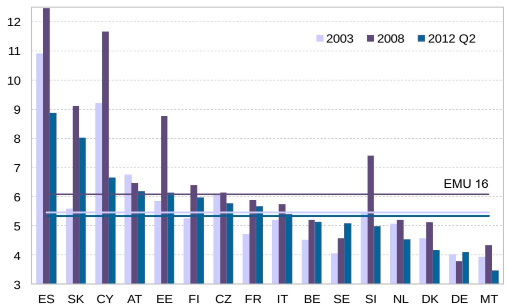
Sources: Bank of Slovenia, AJPES

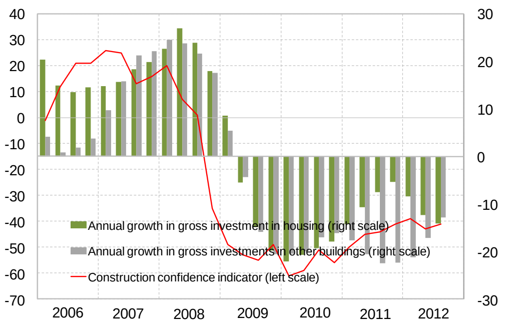
Failure to resolve problems has paralysed the entire construction sector, which continues to pass through to other activities and the household sector owing to financial and business links. Value-added in construction has continued to decline since reaching its peak in 2008. Value-added as a proportion of GDP fell below the euro area average last year. At 5% of GDP at the end of the second quarter of 2012, value-added in construction was 0.3 percentage points below the euro area average.

The situation in the construction sector will continue to deteriorate according to short-term indicators.

According to indicators, the contraction in construction activity will continue in the future. Taking into account the value of construction put in place, construction contracted most notably in the residential construction segment over the first three quarters of 2012, by more than one fifth. In line with a decline in the number of issued building permits, which at 2,228 were down a further 25%, the value of new residential construction contracts more than halved. Insufficient demand and liquidity problems remain the predominant limiting factors, while deterioration in the operations of construction companies will continue in the short term owing to erroneous investment decisions in the past and financing primarily via debt sources.

Figure 2.7: Value-added in the construction sector as a proportion of GDP (left) and construction confidence indicator and annual growth in gross investment in construction (right) in percentages





Sources: Eurostat, SORS, Bank of Slovenia calculations

3 CAPITAL MARKET AND MUTUAL FUNDS

The Slovenian capital market was characterised over the first ten months of 2012 by falling returns, low liquidity and demand from non-residents limited to specific investments.

Difficulties on the Slovenian capital market continued over the first ten months of 2012. The falling share prices of listed companies reached record low values in August, while extremely low liquidity was present throughout the year. A further Slovenia's downgrade has discouraged non-residents, particularly from purchasing Slovenian bonds. However, foreign investors remain interest in the Slovenian capital market to specific equity investments and takeover targets. Slovenian investors are gradually shifting their focus from the domestic capital market to foreign capital markets where better returns are achieved accompanied with high liquidity. Moreover, interest in domestic mutual funds is declining, due to high management commissions, low returns and poor allocation of funds compared to global ETFs[24]. The shift of Slovenian corporates away from financing via bank loans, the search for new funding sources on the capital market and acquiring capital from the rest of the world will be crucial for finding a way out of the economic crisis.

Developments on the capital market

Global stock indices recorded growth owing to announced stimulus measures by central banks, while uncertainty persists due to the unravelling of the crisis in Greece and other periphery countries in Europe.

The adoption of austerity measures in certain European countries, agreements between European politicians regarding fiscal consolidation in the EU and the strengthening of the permanent mechanism to assist euro area countries in distress were the most significant factors for growth in major global stock indices at the beginning of this year. The breakdown of talks between the Greek government and the representatives of Troika (the EC, ECB and IMF) regarding new austerity measures brought uncertainty back to the capital markets in September. The uncertainty continued in October due to the publication of US and European corporate results in the third quarter, which were mostly worse than expected.

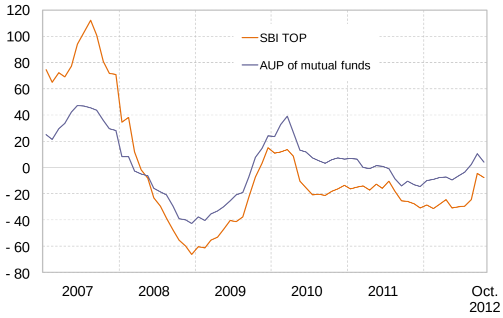
Despite a decline, annual growth in key global stock indices was still high at the end of October 2012. Annual growth in the German DAX stood at 18.2%, the US S&P at 12.7% and the Hong Kong Hang Seng at 8.9%. Annual growth in the Western Europe DJ Euro Stoxx 50 was also relatively high at 6.6%. Growth in the aforementioned stock indices indicates that investors are prepared to accept higher risk and uncertain returns on certain capital markets, despite the return of a high level of volatility in share prices the last two years. The Eastern Europe had experienced the opposite movement of capital market indices. The MSCI Eastern Europe index was down 3.6%, while the falls on the less-liquid Balkan markets were more pronounced: Croatia’s CROBEX was down 4.8% in annual terms, Bosnia’s BIRS was down 11.8%, Serbia’s BELEX 15 was down 17.7%, and Macedonia’s MBI-10 was down 19%.

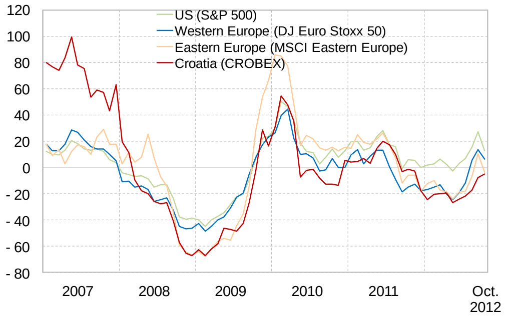
In August 2012 the Slovenian stock index reached its lowest level since at least the beginning of 2004, but recorded one of its highest growth rates of recent years in September.

The SBI TOP index continued to decline over the first eight months of 2012, primarily owing to the poor operating results of the corporate and financial sectors and the decline in domestic consumption. Also having an indirect impact on the Slovenian capital market was the further Slovenia's downgrade by the three largest international ratings agencies, which maintained their negative outlooks. Moody’s made the largest downgrade, by three notches from A2 to Baa2, due to the deteriorating situation in the Slovenian banking system. At the end of August the SBI TOP reached its lowest month-end value since at least the beginning of 2004, at 505 points. A turnaround followed on the domestic capital market in September, the 17% monthly rise was one of the largest recorded in recent years. The reasons for the large rise were the low base and the announcement of the sale of government holdings in certain companies. The value of the SBI TOP index stood at 593 points at the end of October, which, despite September’s growth, still meant a year-on-year fall of 7.7%. The comparable Central European CEESEG index, calculated by the Vienna Stock Exchange, was up 6.6% during the same period.

[24] ETF – Exchange-Traded Fund.

Figure 3.1: Year-on-year growth in domestic (left) and foreign (right) stock exchange indices in percentages





Sources: LJSE, Bloomberg

Slovenian corporates remain highly valued according to the P/E ratio.

The P/E ratio[25] of the SBI TOP index has been higher in recent years than that of selected major share indices. The reason for the higher value of the domestic index lies in the high market prices of securities in the years prior to the economic crisis. The decline in the net profits of corporates included in the SBI TOP index has outstripped the fall in their market prices in the years since the outbreak of the crisis. Thus, at the end of October 2012, corporates included in the SBI TOP index were still valued higher and being more expensive relative to their operating results compared with foreign corporates included in selected major share indices. Consequently, they were less attractive to foreign investors.

Table 3.2: P/E ratios for the SBI TOP and selected major indices

	SBI TOP	DJ EURO STOXX 50	S&P 500	DAX	MSCI EM EAST. EUROPE
Dec. 07	22,5	12,8	17,4	13,7	14,2
Dec. 08	22,9	11,5	15,0	10,7	5,4
Dec. 09	24,5	15,4	18,1	62,6	10,8
Dec. 10	18,3	11,3	15,0	14,3	8,3
Dec. 11	77,5	10,4	13,7	9,9	5,3
Oct. 12	31,2	22,3	14,2	13,5	6,2

Sources: LJSE, Bloomberg

The P/B ratio for the SBI TOP [26]declined from 3.0 at the end of 2007 to 0.7 at the end of October 2012. The market value of corporates included in the SBI TOP index has been lower on average than their book value for the last two years. Given that corporates included in the SBI TOP are overvalued according to the P/E ratio and undervalued according to the P/B ratio, it can be concluded that their return on assets (ROA) is low or that they are too big in terms of assets with respect to actual profits, and are thus less attractive for new capital investments.

The dividend yield of corporates included in the SBI TOP index rose from 0.8% at the end of 2007 to 4.6% at the end of October 2012. Dividend yields increase the attractiveness of equity investments, which is, in the context of mostly ineffective operations, one of the ways companies listed on the SBI TOP index hold on to shareholders.

The number of securities issues on the Ljubljana Stock Exchange fell from 145 to 127 between October 2011 and October 2012, which further decreased liquidity. The number of securities issues on the Ljubljana Stock Exchange has been declining for several years, an indication that the Slovenian capital market is not an appropriate source for funding. The decline is primarily the result of a fall in the number of issues on the bond market, with 11 fewer bonds issued over the first ten months of 2012 compared with a year earlier. There were three fewer issues on the standard market. The shares of Zavarovalnica Triglav and Pozavarovalnica Sava were listed on the prime market, while the new foreign owner of Etol d.d. opted to delist the company's shares. Six shares were delisted from the entry market.

Slovenian corporates very rarely opt to funding on the capital market through the issue of bonds. There is a notable shift from issues of long-term bonds to the issue of less-expensive, short-term commercial paper, which is considered a substitute for bank loans raised by non-financial corporations. The value of commercial paper issued over the first

[25]The P/E ratio reflects the ratio of the market price of a share to earnings per share.
[26]The P/B ratio reflects the ratio of the market price of a share to its book value.

ten months of 2012 totalled EUR 129.7 million, compared with just EUR 9 million in all of 2011. In 2012 SID banka, d.d., issued a bond on the international capital market in a closed offer for specific investors, in the total amount of EUR 210 million. In October 2012 the Slovenian government issued a reference 10-year government bond with a nominal value of USD 2.25 billion and a coupon rate of 5.3% on the US market. The conditions for issuing bonds tightened further over the first ten months of 2012 owing to the additional Slovenia's downgrade. Increased country risk means a higher yield to maturity which, in the context of higher issue and custodial costs, makes the issue of corporate bonds even less attractive. Other reasons for infrequent initial offerings lie in existing over-indebtedness, inappropriately large issues, lack of knowledge of Slovenian companies in the rest of the world, the limited investment policies of domestic institutional investors and the more favourable tax treatment of deposits than debt instruments. The development of the debt instrument market could represent exit from the crisis, as corporates would no longer be dependent solely on banks loans as a source of financing, but on the capital market as well. There were no new primary issues of shares for listing on the Ljubljana Stock Exchange over the first ten months of 2012.

Table 3.3: Overview of the number of new bond issues by residents in Slovenia and in the rest of the world, and total nominal value

	Issued in Slovenia				Value, EUR million	
	Bank	Financial	Government	Non-financial corporations	Total	of which non-financial corporations
2006	8	2	2	1	1.161	6
2007	7	0	0	3	178	7
2008	6	2	1	3	1.891	50
2009	6	2	3	2	4.209	77
2010	5	1	2	0	2.696	0
2011	2	2	2	5	4.028	63
Oct. 2012	1	1	0	0	8	0
	Issued in the rest of the world					
2006	1	0	0	0	50	0
2007	1	0	1	0	1.100	0
2008	0	0	0	0	0	0
2009	2	0	0	1	2.300	300
2010	4	0	0	0	1.350	0
2011	2	0	0	0	500	0
Oct. 2012	1	0	1	0	1.925	0

Sources: CSCC, Bank of Slovenia

Total transactions concluded on the Ljubljana Stock Exchange over the first ten months of 2012 amounted to less than EUR 300 million, down 28.3% on the same period in 2011 and lowest value recorded in the stock exchange’s history. The number of members was down by three over the first ten months of 2012 owing to the decline in transactions on the Ljubljana Stock Exchange. Brokerage firms accounted for 52% of total transactions over the first ten months of 2012, up 8.7 percentage points on the same period in 2011. The market share of members with remote access, who accounted for 16% of total transactions, was also up. Some 32% of transactions on the Ljubljana Stock Exchange were executed via banks, a decrease of 14.7 percentage points on 2011.

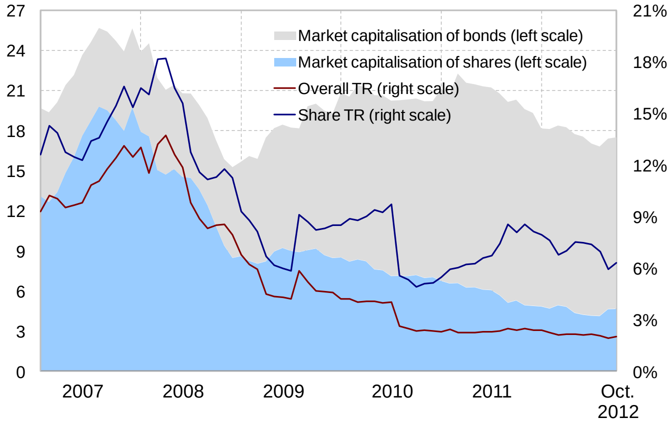
The market capitalisation of shares on the Ljubljana Stock Exchange is less than a third of what it had been prior to the crisis.

The decline in the market capitalisation of shares on the Ljubljana Stock Exchange continued in 2012, to stand at EUR 4,647 million at the end of October, down 12% on the previous year and representing just 30.4% of the market capitalisation of shares in October 2007. At 89%, corporate shares accounted for the highest proportion of the market capitalisation of shares at the end of October 2012, followed by insurance corporations at 9%, while bank shares accounted for less than 2% of total market capitalisation. The volume of trading in shares totalled EUR 248.1 million over the first ten months of 2012, down 29.3% on the same period of the previous year and representing just 15.7% of the volume of trading over the first ten months of 2007. Trading in prime market shares was slightly up on the previous year, primarily due to the listing of two new securities on the prime market. In addition to waning interest from investors, trading in standard market shares and entry market shares was also down due to a fall in the number of securities issues. The turnover ratio (TR) of shares was down by slightly less than 2 percentage points over the last year. At 6.3% in October 2012, the TR reached one of its lowest values since the beginning of 2001, reflecting the exceptionally low liquidity of shares on the Ljubljana Stock Exchange.

The market capitalisation of bonds stood at EUR 12,856 million at the end of October 2012, down 14.6% on October 2011. In October 2012 the Slovenian government issued a reference 10-year government bond with a nominal value of USD 2.25 billion and a coupon rate of 5.3% on the US market. At 92.3%, government bonds account for the majority of market capitalisation. The volume of trading in bonds totalled EUR 49.5 million over the first ten months of 2012, down 2.7% on the same period in 2011.

The market capitalisation and volume of trading in shares on the Ljubljana Stock Exchange were down, while government bonds, denominated in US dollars, were successfully issued on the US market.

Figure 3.2: 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. Block trades are included.
Source: LJSE

The price of gold has demonstrated a distinct growth trend in recent years. Investing in gold is appropriate because it is perceived as a safe investment that holds its value and as a universal means for mitigating the risk associated with an investment portfolio. Interest in investing in gold has risen further during the recent crisis, including among Slovenian residents, owing to the instability of the market prices of securities. The purchase of gold by Asian and South American central banks has also contributed to the rise in the price of gold in recent years. The price of gold stabilised in the short term over the first ten months of 2012, and fluctuated between USD 1,539 and USD 1,790 per ounce.

Growth in the price of gold has slowed; nevertheless, gold remains more expensive than platinum.

Table 3.4: Overview of Slovenia's regulated capital market

	2007	2008	2009	2010	2011	Oct. 2012
			Shares			
Market capitalisation						
amount, EUR billion	19,7	8,5	8,5	7,0	4,9	4,6
as % of GDP	57,1	22,7	23,8	19,6	13,5	12,9
annual growth, %	71,5	-57,1	-0,1	-17,3	-30,3	-12,0
non-residents' proportion, %	5,9	7,1	7,2	10,0	12,3	13,1
Volume						
amount, EUR million	3.034,8	952,6	719,8	360,8	394,5	248,1
as % of GDP	8,8	2,6	2,0	1,0	1,1	0,7
annual growth, %	109,1	-68,6	-24,4	-49,9	9,3	-29,3
Annual change in SBI TOP, %	71,0	-66,1	15,0	-13,5	-30,7	-7,8
Dividend yield (prime market), %	1,0	3,9	2,1	2,1	3,2	4,2
			Bonds			
Market capitalisation						
amount, EUR billion	5,9	6,8	10,8	13,2	14,5	12,9
as % of GDP	17,2	18,2	30,4	37,1	40,0	35,7
annual growth, %	-10,5	14,4	59,2	21,9	9,6	-14,6
Volume						
amount, EUR million	165,9	257,0	156,3	108,9	59,6	49,5
as % of GDP	0,5	0,7	0,4	0,3	0,2	0,1
annual growth, %	-11,8	54,9	-39,2	-30,3	-45,3	-2,7

Note: Excludes listed investment companies, mutual funds and banker's drafts.
Sources: LJSE, SORS

Investment links with the rest of the world

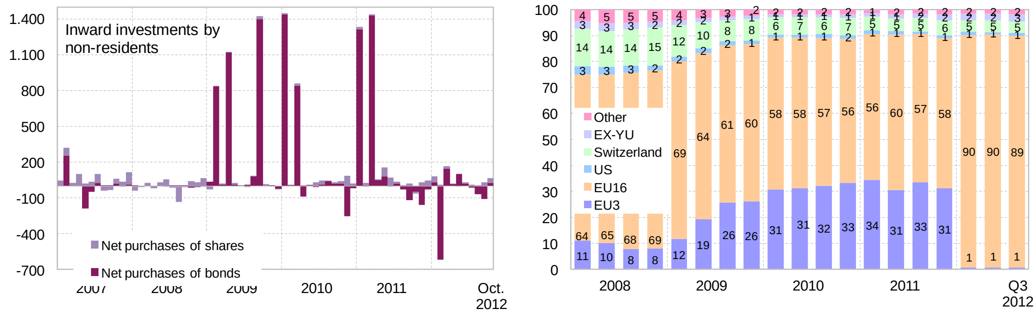
Shift of non-residents from Slovenian bonds and modest purchases of Slovenian shares.

Non-residents made net sales of Slovenian debt securities in the amount of EUR 468 million in 2012. Residents of the UK accounted for the majority of net sales of bonds over the first ten months of 2012 in the amount of EUR 4,216 million. For this reason, the proportion of bonds held by residents of the EU3 was down sharply. Residents of Belgium made the most net purchases of Slovenian bonds in the amount of EUR 3,726 million. Nearly all of the net sales and net purchases made by residents of the UK and Belgium respectively were of government bonds. The reason for the low level of interest shown by non-residents in Slovenian corporate bonds lies primarily in the over-indebtedness of Slovenian companies, which would find it difficult to incur additional debt through the issue of bonds.

Having made net purchases of Slovenian shares in the amount of EUR 179 million over the first ten months of 2012, non-residents have shown that their interest is reserved for specific investments. The largest net purchases were made by residents of Croatia, Austria and Switzerland, who primarily purchased shares of Krka and Mercator totalling EUR 58 million. Residents of Austria increased Volksbank’s capital in the amount of EUR 48 million over the first ten months of 2012, while a Swiss company acquired Etol for EUR 35 million.

The proportion of market capitalisation of shares listed on the Ljubljana Stock Exchange accounted for by non-residents has risen steadily since the end of 2010, and stood at 13.1% in October 2012, up a half of a percentage point on a year earlier.

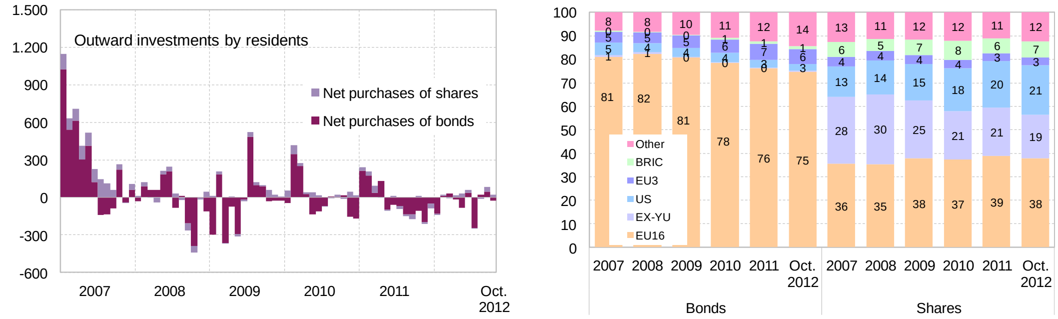
Figure 3.3: Non-residents' monthly net investments in Slovenia in EUR million (left) and regional breakdown of investments in percentages (right)



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 sales of foreign bonds totalling EUR 361.4 million and net purchases of foreign shares in the amount of EUR 99.2 million over the first ten months of 2012. Insurance corporations and pension funds were the largest net purchasers of foreign shares (EUR 82.7 million) and the largest net purchasers of foreign bonds (EUR 246.6 million). Net purchases of both shares and bonds were made primarily in the euro area, while net sales were made primarily in the US. Requests for the largest net payments of foreign bonds were made by banks, in the amount of EUR 592.4 million, 2.6 times more than in the same period in 2011. The majority of net sales comprised bonds from the euro area. At EUR 38.1 million, households were the largest net sellers of foreign shares owing to their loss of confidence in the capital markets and a drop in purchasing power as a result of the deteriorating economic situation.

Figure 3.4: 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 7,620 million at the end of October, down 6.9% on October 2011. The majority of investments, or 60.4%, are accounted for by debt securities. That proportion was down nearly 4 percentage points over a two-year period primarily due to sales of bonds by banks, and by 1.5 percentage points over the last year.

A decrease in investments in securities from the euro area and former Yugoslav republics and an increase in investments in securities from the US and emerging

The geographical breakdown of Slovenian residents' investments in foreign securities is gradually changing. The majority, or 60.1%, is accounted for by investments in bonds and shares from the euro area. That proportion is falling from year to year owing primarily to net sales of bonds by banks. The proportion of predominantly equity investments from the illiquid capital markets of the former Yugoslav republics is also declining. Investments are increasing in the US and emerging markets, where residents are purchasing primarily shares and fewer bonds, due to high returns and better perspectives for economic growth. The proportions of Slovenian residents' investments in foreign securities accounted for by investments in the US and emerging markets were 10% and 3.6% respectively at the end of October 2012.

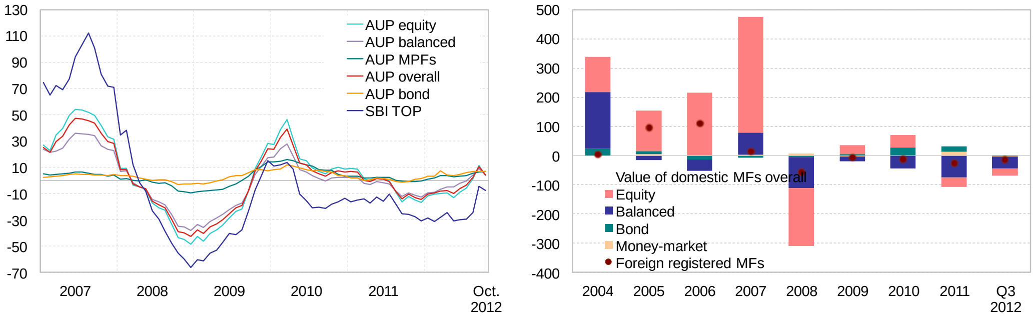
Mutual funds

Mutual fund assets were down 1.8% in October 2012 relative to October 2011.

Mutual fund assets stood at EUR 1,845 million at the end of October 2012, down 1.8% on October 2011.

Having demanded net payments totalling EUR 69.8 million since the beginning of the year, an increase of EUR 17.9 million on the same period last year, pessimism was prevalent among investors in mutual funds. Primarily reasons for investors' lack of confidence in mutual funds were weak returns of mutual funds, the falling share prices of domestic corporates and uncertainty on foreign capital markets. Secondary reasons for declining investor interest included high management commissions and the ineffective allocation of mutual fund assets. By investing in so-called global ETFs with lower costs, investors can improve the diversification of their assets and mitigate risks. Net outflows were predominant in all types of mutual funds, except for bond funds, due to uncertainty on the domestic and foreign capital markets. Investors demanded net payments of EUR 47 million from balanced funds over the first ten months of 2012, EUR 18 million from equity funds, EUR 5 million from money-market funds and a smaller amount from other mutual funds. Net payment totalling EUR 479 thousand were made into bond funds over the first ten months of the 2012. There was no significant change to the structure of mutual fund assets, despite high outflows. Equity funds held 68% of mutual funds' total assets under management at the end of October 2012, while balanced funds held 26%. The proportion of assets under management held by bond funds stood at 5%, while money-market funds held just over 1%. The proportion held by other funds was negligible.

Figure 3.5: 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)



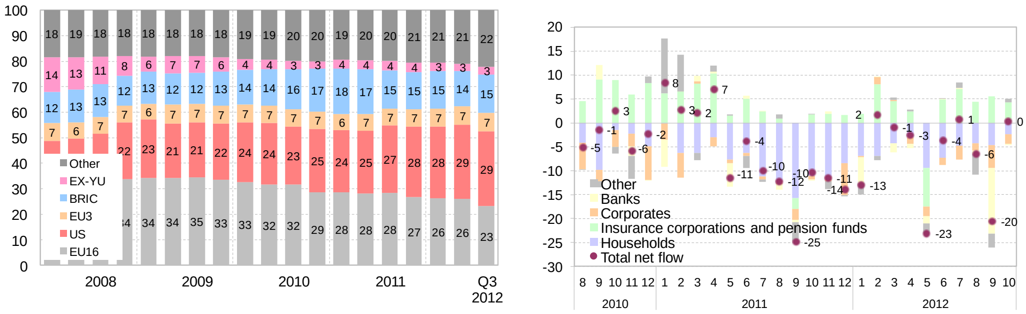
Sources: SMA, LJSE, the Bank of Slovenia

At 6.7%, bond funds recorded the highest year-on-year growth in average unit price in October 2012.

Year-on-year growth in the average unit price of equity and balanced funds was negative until July 2012. Strong growth was recorded in August and September due to growth in global stock indices, but slowed again in October. Year-on-year growth in the average unit price of equity funds and balanced funds was 3.7% and 4.1% respectively at the end of October. The average unit price of bond and money-market funds recorded positive year-on-year growth in each of the first ten months of 2012. Year-on-year growth in the average unit price of bond and money-market funds was 6.7% and 2.2% respectively at the end of October 2012. The annual change in the average unit price of mutual funds stood at 3.9% at the end of October 2012. That growth was significantly higher than the growth recorded by the SBI TOP (a difference of 11.6 percentage points), but lower than the growth recorded by major global indices (the yield was 14.3 percentage points lower than the DAX), which is the main reason for the high net outflows from mutual funds.

Net purchases of foreign shares and net payments from mutual funds by residents in the last two years indicate that residents are increasingly opting to make independent investments in shares in the rest of the world instead of investing in mutual funds.

Figure 3.6: Regional breakdown of investments in mutual funds in percentages (left) and net cash flows into mutual funds by sector in EUR million (right)



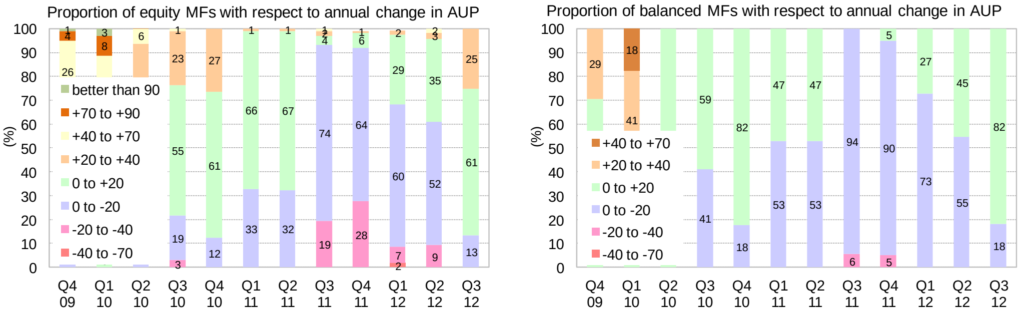
Note: BRIC: Brazil, Russia, India and China;
EU3: UK, Denmark and Sweden;
EU16: euro area; Ex-YU: former Yugoslav republics

Sources: SMA, Bank of Slovenia

Households demanded the majority of net payments from mutual funds, while only insurance corporations and pension funds made net payments into mutual funds.

At EUR 56 million, the household sector accounted for the majority of net payments over the first ten months of 2012 owing to uncertainty on the capital markets and in the economy overall. At nearly EUR 25 million, banks doubled their demands for net payments, while the corporate sector's demands for net payment from mutual funds of EUR 15 million were similar to the same period last year. Insurance corporations and pension funds made net payments into mutual funds of EUR 35 million over the first ten months of 2012, down 13.4% on last year.

Figure 3.7: Relative distribution of domestic equity funds (left) and domestic balanced funds (right) in terms of annual change in average unit price in percentages



Sources: SMA, own calculations

Table 3.5: Proportion of total assets accounted for by the liquid assets of mutual funds in percentages

(%)	Bond	Balanced	Equity	Money-market	Total
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
Dec.11	24,7	16,5	6,6	99,4	11,6
Mar.12	26,2	17,2	7,0	99,0	11,7
Jun.12	29,5	16,6	5,9	98,9	11,1
Sep.12	30,0	17,8	6,1	99,1	11,5

Sources: SMA, own calculations