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THE BANKING SYSTEM DURING THE CORONAVIRUS PANDEMIC

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ABSTRACT

In the difficult situation brought by the coronavirus pandemic, the economies of the euro area and of Slovenia are facing a decline in activity. Monetary policy measures have aimed to calm the financial markets and to provide sufficient liquidity to banks, and hence to businesses and households. In addition, the Banka Slovenije measure to freeze profit distributions at banks for a year has brought an increase in bank capital, and thus in risk resilience. The measure relating to household lending also remains in place. The emergency laws are also affecting banking: the level of moratoria on bank loans to corporates and households in Slovenia is among the highest in the EU. In this situation bank performance is declining: the banking system remains profitable, but next year and, in particular, the following years are expected to see a deterioration in credit portfolio quality and growing pressure on bank profitability.

This year has been marked by the coronavirus pandemic, which alongside a health crisis has unleashed unprecedented and difficult challenges at the global level. One of the consequences was a sharp decline in economic activity in the euro area overall and in Slovenia, particularly in the second quarter of this year, while a slightly smaller decline is also expected in the final quarter as the situation worsens.

The vast majority of sectors in the domestic economy have recovered since the containment measures were lifted in May, but there are considerable differences between them. The situation in services has worsened in particular in recent months. Banka Slovenije's assessment is that in this segment of the economy, which was hit hardest by the epidemic, there is a high probability of a lasting crisis. The services hit hardest by the containment measures accounted for approximately 22% of jobs and 20% of value-added in the domestic economy before the crisis, and 25% and 19% respectively in the euro area overall.

The banks have different levels of exposure to the sectors hit hardest by the crisis. The accommodation and food service activities sector, which was worst hit during the crisis, accounted for 5.4% of the total stock of bank loans to the corporate sector in October, followed by administrative and support services, with 1.3%. The other worst-affected sectors (arts, entertainment and recreation) did not account for more than 1% of the total.

Economic policymakers were quick in responding to the health crisis, and the resulting economic crisis, with coordinated and extensive action. The monetary policy response aimed to calm the financial markets, and to provide sufficient liquidity to banks and businesses to address the liquidity crunch.

Banka Slovenije also used macroprudential measures to help maintain financial stability. The measure to freeze profit distributions until April 2021 has succeeded in increasing the available capital at banks, and with it their risk resilience. The measure relating to household lending also remains in place, and has been tailored to the circumstances to allow banks to ignore a temporary loss of income when calculating creditworthiness.

The moratoria provided for by the emergency laws are making it easier to repay loans, and are mitigating the economic consequences of the health crisis. Borrowers have been able to claim moratoria practically since the outbreak of the crisis. The share of exposure for which a moratorium has been approved is highest at firms in sectors whose operations were most curtailed or even shut down by the containment measures in the first wave of the epidemic. The majority of the total loan stock in the worst-hit sector (accommodation and food service activities) is now covered by a moratorium. The Slovenian banking system ranks among banking systems with high levels of moratorium coverage of corporate and household loans (the share stood at almost 13% in October).

Measures have also partly addressed corporate liquidity: a guarantee scheme for corporate loans has been introduced. The available quota of loan principal is EUR 2 billion, but for various reasons no more than just over EUR 50 million of this sum had been taken up by the beginning of December.

Bank performance in highly adverse circumstances is currently still being alleviated by anti-crisis measures. Given the situation, the banks recorded relatively high profits over the first nine months of the year (EUR 414 million), largely as a result of a one-off effect (the merger of two banks). Bank lending activity declined sharply, while the large inflow of deposits into the banking system was reflected in an increase in the most liquid forms of asset. Banks are facing a decline in income driven by the decline in credit growth and falling returns on assets, while impairment and provisioning costs are increasing at the same time. The NPE ratio continued to decline through September, despite the adverse conditions. It is encouraging that the banking system's liquidity and capital positions have remained good. Banka Slovenije is forecasting profits of more than EUR 300 million in the banking system this year, although the figure would be just a third of that if the one-off effect were ignored.

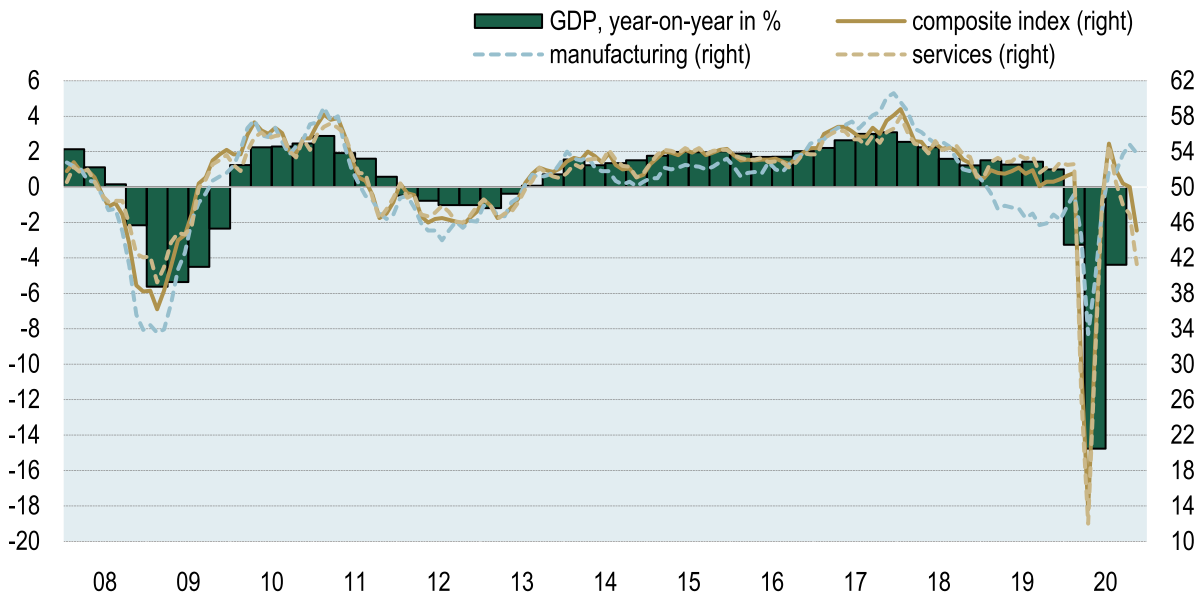
The risks to financial stability have increased sharply. Alongside the high risk coming from the weakened macroeconomic environment, Banka Slovenije is also highlighting the elevated income risk and credit risk at banks, who have suffered a sharp deterioration in their business conditions. In these circumstances the quick, wide-ranging policy action at national and supranational levels was particularly important, calming global financial markets and making a key contribution to the financing conditions in euro area countries remaining favourable.

Next year and in the following years, as the moratoria and other emergency measures expire, Banka Slovenije is forecasting a deterioration in credit portfolio quality and increased pressure on bank profitability. The trend in non-performing exposures has remained favourable this year, but there is an increasing risk that after the measures expire numerous exposures will be downgraded or even classed as non-performing. In light of the effects of Covid-19, our forecast is that there could be a significant increase in the stock of NPEs and the NPE ratio by the end of 2022. It nevertheless appears that the banking sector will remain robust in capital and liquidity terms over the next two years, thanks to a solid starting position and all the measures taken.

1. MACROECONOMIC ENVIRONMENT

This year has been marked by the coronavirus pandemic, which alongside a health crisis has unleashed unprecedented and difficult challenges at the global level. One of the consequences was a sharp decline in economic activity in the euro area overall and in Slovenia. This was particularly acute in the second quarter of this year, followed by intensive recovery during the summer after the lifting of the containment measures. Due to the continuing spread of Covid-19, in the final quarter of the year we are once again facing a decline in activity, which, however, will be lower than that during the first wave of the epidemic. High-frequency indicators for November indicate another decline in activity, as both economic sentiment and the euro area PMI have dropped considerably. The second wave of the crisis will have the worst impact on the services sector (Figure 1). With the highly uncertain global economic and heath situation, the economic growth forecasts are falling, which in turn increases the length of time needed for the GDP to return to its pre-crisis level and for inflation to be brought to its target of close to, but below, 2%.

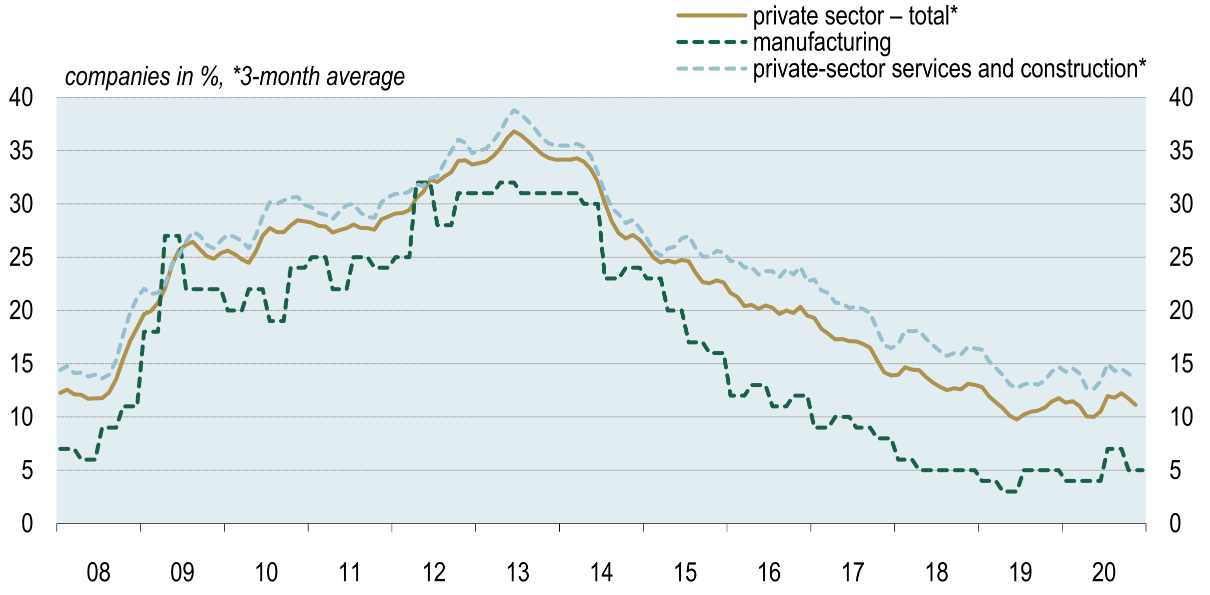
Figure 1: Purchasing Managers' Index (PMI) and GDP growth – euro area



Note: PMI values over 50 indicate increased activity, those below 50 indicate decreased activity.
Sources: IHS Markit, Eurostat, Banka Slovenije calculations.

The Slovenian economy also recovered extremely quickly in the third quarter, but the situation deteriorated significantly in November, though less than in the spring. Quarterly economic growth reached 12.4%, and GDP was just 2.6% lower year-on-year, which is a smaller drop than that in the euro area. The strong recovery occurred in both private consumption and investment, and goods exports also showed a marked rebound. However, similar to the euro area, by November the situation had begun to deteriorate rapidly. This brought a sharp deterioration in economic sentiment, and estimates of current demand and demand forecasts. Pessimism is widespread among consumers, who are expecting to see a significant rise in unemployment and very limited spending. However, the drop in activity is lower than in the spring, and is primarily associated with the most vulnerable sectors in personal services. Companies at least on aggregate are not reporting layoffs or major financial difficulties (Figure 2), while manufacturing industries are even showing fairly optimistic demand forecasts. This is a consequence of domestic and international economic policy measures, increased flexibility of operations in epidemiological conditions and stronger foreign demand in comparison with the first wave. Nevertheless, the renewed intensification of the crisis will also increase the recovery period of the Slovenian economy, thereby extending the period during which domestic deflationary pressures will be present.

Figure 2: Performance limiting factors in the Slovenian economy – financing



Note: The aggregate indicators are weighted by the share of the individual sectors in total value-added. The data includes responses to questions about difficulties obtaining construction loans, difficult access to bank loans for the retail segment, financial obstacles in the services sector and financial difficulties in manufacturing. The data for manufacturing are quarterly.
Sources: SORS survey data, Banka Slovenije calculations.

The great majority of economic sectors recovered quickly after the lifting of the most restrictive containment measures in May, but there are significant differences in losses among the various sectors (Figure 3). Among sectors whose monthly indicators are available, information and communications technology stands out with minimal losses of revenues, which can be expected, as this sector includes computer services. The drop in construction activity was also minor, as second-quarter losses were offset to a great extent by increased residential construction and increased government investment activity during the last part of the year. The drop in revenues among professional, scientific and technical activities amounted to just 3% by September of this year, as revenues from business consulting have increased significantly. The normalisation of the situation in supply chains and increasing foreign demand following the shock in March and April also brought a considerable improvement in manufacturing. Of the major sectors, only the manufacture of basic metals was still facing a deep contraction in September, while just over a third of manufacturing sectors exceeded last year's level of output. Nevertheless, total manufacturing output up to September was down 7% year-on-year. The retail sector faced the same decline, although the situation improved markedly after the lifting of the containment measures in May. Other sectors saw a drop of 10% or more in the first nine months of this year. It was most pronounced in the administrative and support services sector, and in accommodation and food service activities, where it stood between 25% and 30%. We believe that with the new wave of the epidemic, the likelihood of a lasting crisis in the most vulnerable areas of the services sector has increased. Before the crisis, the most vulnerable sectors accounted for approximately 22% of jobs and 20% of value-added in Slovenia, and 25% and 19% respectively in the euro area overall.[1]

[1] The sectors most directly affected by the epidemic and the containment measures are wholesale and retail trade and repair of motor vehicles and motorcycles (G), land, water and air transport (H49-51), accommodation and food service activities (I), publishing activities (J58), travel agencies (N79), and arts, entertainment and recreation (R). The calculations are based on the latest annual national accounts figures available. At the same time, we would like to point out the substantial heterogeneity of the activities within the sectors according to the single-digit classification in the NACE Rev. 2. For example, sector N (administrative and support services), where we find a difference of a full 69 percentage points in the year-on-year losses in revenue between the most and the least affected sectors up to September of this year.

Figure 3: Economic activity by sector in the Slovenian economy

Note: I – accommodation and food service activities, N – administrative and support services, L – real estate activities, D – electricity, gas and steam supply, H – transport and storage, G – vehicle sales, maintenance and repair, C – manufacturing, B – mining, M – professional, scientific and technical activities, F – construction, J – information and communication technology.
The original real indicators of production, construction put in place and sales were used.
The calculations are rounded to the nearest whole number.
Sources: SORS, Banka Slovenije calculations.

The banks have different levels of exposure to the sectors hit hardest by the crisis. The share of loans granted to the accommodation and food services sector among all bank loans to the corporate sector in October amounted to 5.4%, while exposure to the sector that was next most affected by the crisis, i.e. administrative and support services (N), with a 1.3% share of total lending, is significantly lower. Bank loans to the hardest hit sectors are minimal, with loans to the arts, entertainment and recreational activities sector accounting for just 0.7%, and to travel agencies just 0.3% of bank loans to corporates. The sectors with the most significant representation in bank portfolios include transport and storage activities at 14.1% (which includes overland, air and maritime transport at 2.9%) and the retail sector with a 16% share of all loans to corporates. Manufacturing as a whole accounts for 30.8% of all loans to corporates, but there is a great deal of heterogeneity among them with respect to the impact of the crisis. This is also being reflected in moratoriums on loan commitments: the share of exposure for which a moratorium has been approved is highest at firms in sectors whose operations were most curtailed or even shut down by the containment measures in the first wave of the epidemic. The majority of the total loan stock in the worst-hit sector (accommodation and food service activities) is now covered by moratoria.

2. BANK OPERATION SCENARIOS PRIOR TO THE ADOPTION OF THE MEASURES

During the first wave of the Covid-19 epidemic, i.e. prior to the wide-ranging implementation of economic policy measures, Banka Slovenije conducted and published[2] a preliminary assessment of systemic risks and resilience of the financial sector using an alternative method. The assessment was conducted, at a time of great uncertainty regarding the economic situation in the coming months, on the basis of two scenarios of GDP developments, and relied on certain assumptions that have to be taken into account in the interpretation of the results. In the scenarios, we forecast the following rates of growth in economic activity, depending on the number of weeks of economic shutdown: the baseline scenario envisages a drop in GDP of 6.2% in 2020, and the severe scenario envisages a 16.1% drop in GDP. In our analysis, we did not take into account the effects of the emergency measures at the national and supranational level, since, due to the fact that their content in some cases had not been completely defined, it was not yet possible to make a satisfactory assessment of their effects during that period.

At the time, we estimated that in the event of the realisation of the baseline scenario, the banking system would be close to breaking even in 2020. We envisaged the continued slowdown in growth in household loans, which began even before March of this year, and in corporate loans we forecast in particular a decline in long-term loans (loans for investment purposes) and an increase in short-term loans (liquidity loans). We forecast a drop in both interest and non-interest income, while the key factor that will impact on bank performance in 2020 will come from the net creation of impairments and provisions. We forecast a deterioration of the credit portfolio only for corporates, which, however, is expected to be mitigated through the emergency measures and the firms' good initial financial positions. There would be a deterioration in the quality of the household portfolio, primarily due to rising unemployment and falling income. We forecast that in the initial months, the Covid-19 crisis would not have a major impact on the

[2] Assessment of systemic risks and the resilience of the financial sector during the Covid-19 epidemic.

liquidity of the banking system, but increased risks in the economy will gradually lead to pressures to decrease the banks' capital adequacy.

On the other hand, we estimated that in the event of the realisation of the severe scenario, the banking system would operate at a major loss in 2020. We envisaged that in the wake of a large contraction in economic activity, credit portfolio quality would deteriorate sharply, and impairment and provisioning costs would increase markedly, eating up almost three-quarters of the banks' income. In the event of a lasting crisis, lower lending activity and loan repayment difficulties, interest income would also begin to decline sharply. Deposits by the non-banking sector would begin to decline (corporate deposits as a result of a lack of cash inflows during temporary shutdown or reduced operations, and household deposits as a result of reduced income), which could bring a deterioration in the banks' liquidity position, particularly at banks with smaller liquidity surpluses. A significant downturn in the economy would severely reduce the banking system's capacity to absorb credit losses through the capital surplus.

The measures to alleviate the consequences of the Covid-19 epidemic taken by governments and central banks have made a significant contribution to maintaining the stability of the financial system. The measures of most concern to banking are those that allowed firms and households to defer loan repayments, measures to promote lending to firms and households to bridge liquidity difficulties, incentives for firms in the hardest-hit sectors and other measures designed to save companies and preserve jobs, and to ensure a flow of household income during the period of the epidemic. In addition to their impact on the real economy, all of these measures have also had a significant impact in maintaining the liquidity position and capital position of the banking system, or minimising their deterioration. Due to all of the measures that economic policymakers have adopted in the areas of monetary and fiscal policy and bank regulation and supervision, and also due to the efforts of the banks themselves, the situation in the banking system in Slovenia, at least in the first nine months, turned out significantly better than the initial indicators suggested, i.e. much better than it would have been had the measures not been adopted.

3. ECONOMIC POLICY MEASURES

Various economic policymakers, both in Slovenia and elsewhere, were quick to respond to the health crisis and the resulting economic crisis, with decisive and coordinated action. In addition to its general aim, monetary policy also aims to calm the financial markets and to provide sufficient liquidity to banks and businesses so that they are able to withstand the liquidity crunch. Regulatory supervisory measures pursue the objective of providing financial stability, in particular to strengthen banking sector initiatives and capacities to support the economy. Fiscal measures are aimed at managing the healthcare situation, preserving jobs and saving businesses, mitigating the social effects of the crisis and providing liquidity. All of the measures have also made it possible that the health and economic crises have not been reflected to a great degree in the banking system, as had been initially forecast. Below we summarise some of the key measures affecting the financial system that were adopted in this context.

3.1 Monetary policy providing sufficient liquidity of the banking system

Due to pursuing an inflation target "close to, but below, 2%", and the weak economic outlook, the ECB's monetary policy was expansionary even prior to the outbreak of the epidemic.[3] As the epidemic spread around Europe, the alarm on financial markets raised the risk of an excessive correction in market valuations of financial instruments. There was an almost complete halt in market-based financing of the corporate sector, and government bond spreads also increased, which could increase borrowing costs for banks and businesses in the euro area. At the same time, in order to bridge the liquidity problems caused by the measures to contain the spread of the virus, corporate demand for liquidity loans in the euro area rose to historical levels.

[3] In September 2019, the Governing Council of the ECB adopted a package of measures that in general include dropping the interest rate on the deposit facility to -0.5%, reactivation of net purchases amounting to EUR 20 billion under the asset purchase programme (APP), easing the terms of the TLTRO III operations, and a two-tier system for reserve remuneration. The details of the decisions are available at: https://www.ecb.europa.eu/press/pr/date/2019/html/ecb.mp190912~08de50b4d2.en.html.

The ECB's monetary policy response aimed to calm the financial markets, and to provide sufficient liquidity to banks and businesses to address the liquidity crunch. Among the measures adopted, two were given a central role: the pandemic emergency purchase programme (PEPP), and easing the terms for targeted longer-term refinancing operations (TLTRO III). Under the former, the key feature was the flexibility in the allocation of the EUR 1,350 billion in planned funds, which ensured that the purchases were directed towards the market segments of the economies in which the terms and conditions of financing were most affected by the outbreak of the epidemic. The programme succeeded in returning premiums to levels that permit expansionary monetary policy in all of the economies in the euro area. On the other hand, the easing of the terms of the TLTRO III programme made it possible for banks to provide financing, without liquidity pressures, to firms that had to weather a loss in cash flow due to the measures to contain the epidemic. The success of the programme is reflected in the drawdown of funds under the programme, which has exceeded expectations.[4] The measures have also helped the Slovenian economy, and also the government, as the premiums on government bonds after an initial growth spurt have more or less returned to their pre-crisis level.

3.2 Macroprudential policies have helped maintain financial stability

In April of this year, Banka Slovenije adopted a resolution on macroprudential restriction on profit distribution by banks, through which we placed a one-year moratorium on the distribution of earnings in cash, the purchase of treasury shares and the payment of the variable part of remuneration to a defined group of employees. The main reason for the implementation of the measure was the high level of uncertainty regarding the economic and financial consequences at the outset of the Covid-19 crisis, and the related difficulties in planning banks' capital requirements in order to provide stable financing of the economy. This uncertainty has not substantially receded during the extended period of the second wave of the Covid-19 epidemic from October 2020 on, and is reflected in expectations of a slower economic recovery than was foreseen in the spring.

[4] Other measures include additional funding under the APP, increased eligible collateral for securing Eurosystem operations, and various regulatory measures that ease pressures on banks' capital adequacy.

We believe that the objectives set upon the introduction of the macroprudential measure have been achieved. The retaining of earnings and the consequent increase in CET1 capital has allowed the banks' resilience to systemic risks, particularly to increased credit risk, to remain on a high level, by nearly 9%. The banking system thus has sufficient capital at its disposal to cover major losses due to credit risk, and a capital surplus that allows coverage of household lending needs. Furthermore, we believe that this has also had a strong demonstration effect, as the majority of banks did not pay out earnings in the form of dividends or variable bonuses during the period of implementation of fiscal and monetary policy measures in order to maintain economic activity.

During the recent assessment of the grounds for the measure, we concluded that the measure should remain in place until the beginning of April 2021. We could rescind the measure early if the risks decline significantly, or extend the measure in the event of increasing risks. Our decision will also be based on the solutions that we adopt within the framework of European institutions.

During the time of difficult health and economic conditions, the binding macroprudential measure relating to household lending also remained in place, but during the period of the epidemic we allowed banks to ignore temporary losses of income when calculating creditworthiness. Upon the introduction of this instrument in November of last year, the purpose of the measure, in addition to establishing minimum credit standards, was to mitigate the excessive credit growth that appeared among consumer loans. Our most recent analysis indicates that this objective has been met, although due to the pandemic it is currently impossible to separate the effects of the measure from the effects of the current crisis on developments in consumer lending. According to the survey on loan demand, Banka Slovenije's macroprudential measures are less important, as they were in last place among the reasons for refusals of loan applications.

Despite the limitations to the analysis due to the current conditions, we can also conclude the following: i) despite increased lending by non-bank lenders, following the introduction of the measure they had compensated for only around 5% of the reduced amount of consumer lending; ii) the banks are mostly adhering to the restrictions on household lending, and iii) loans that exceed Banka Slovenije's macroprudential limits are riskier, which is reflected in a higher percentage of deferrals, i.e. non-performing loans.

3.3 The emergency laws are making it easier to defer repayment of loans and are mitigating the economic consequences of the health crisis

A significant part of the emergency measures relates to the management of the healthcare situation. All of the measures adopted also have a significant impact on the banking system and the preservation of financial intermediation. We shall look at some of these measures and their impacts below.

The decisions on deferral of payments of borrowers' liabilities have had substantial impacts. Soon after the onset of the crisis, legal and natural persons were able to request one-year moratoria on the payment of non-past-due liabilities arising from loan contracts. In certain cases, partial government guarantees have been provided for the deferred liabilities. Under normal conditions, the banks would be required to recognise such deferrals through major redistributions of their claims into portfolios of poorer quality, and to create additional impairments of the loan portfolio, but regulatory solutions adopted at nearly the same time at the EU and Slovenia levels have allowed banks to forego making these redistributions taking account of the emergency and temporary nature of the circumstances. This borrower and bank relief package is temporary, as the current decisions of EU institutions and our own national solutions already indicate the discontinuation of these allowances in the coming year.

The Slovenian banking system ranks among banking systems with high levels of moratorium coverage of corporate and household loans. The share of loans for which moratoria were approved among all corporate and household loans at the level of the banking system stood at a full 12.9% at the end of September. The share of exposure for which a moratorium has been approved is highest at firms in sectors whose operations were most curtailed or even shut down by the containment measures due to the epidemic. Since the drop in activities is also the highest in these sectors, there is an increased likelihood that these forms will be classed as defaulters in the future.

Measures have also partly addressed corporate liquidity: a guarantee scheme for corporate loans has been introduced. The available quota of loan principal is EUR 2 billion, but for various reasons no more than just over EUR 50 million of this sum had been taken up by the beginning of December. There are several reasons for the modest taking up of these loans, including the considerable complexity of the system for approval of such loans. Soon after the promulgation of the law that allowed these types of loans, the banks reported that the mere implementation of the procedure was quite complicated, and providing the required documentation constituted a major burden for both bank operations and customers. On the other hand there is the fact that the new government-backed liquidity loans are just one of the forms of state assistance to the economy, with a wide range of financing options available from SID banka, and other liquidity loans from banks.

4. BANK PERFORMANCE IN THE CURRENT YEAR

Bank performance in highly adverse circumstances is currently still being alleviated by anti-crisis measures, but we can expect that the effects of the consequences of the crisis, which are currently being felt particularly in the real sector, will be delayed in the banking sector. Given the situation, the banking system recorded relatively high profits over the first nine months of the year, largely as a result of a one-off effect. Bank lending activity declined sharply, while the large inflow of deposits into the banking system was reflected in an increase in the most liquid forms of asset. Banks are facing a decline in income driven by the decline in credit growth and falling returns on assets, while impairment and provisioning costs are increasing. The NPE ratio continued to decline through September, despite the adverse conditions. It is encouraging that the banking system's liquidity and capital positions have remained good.

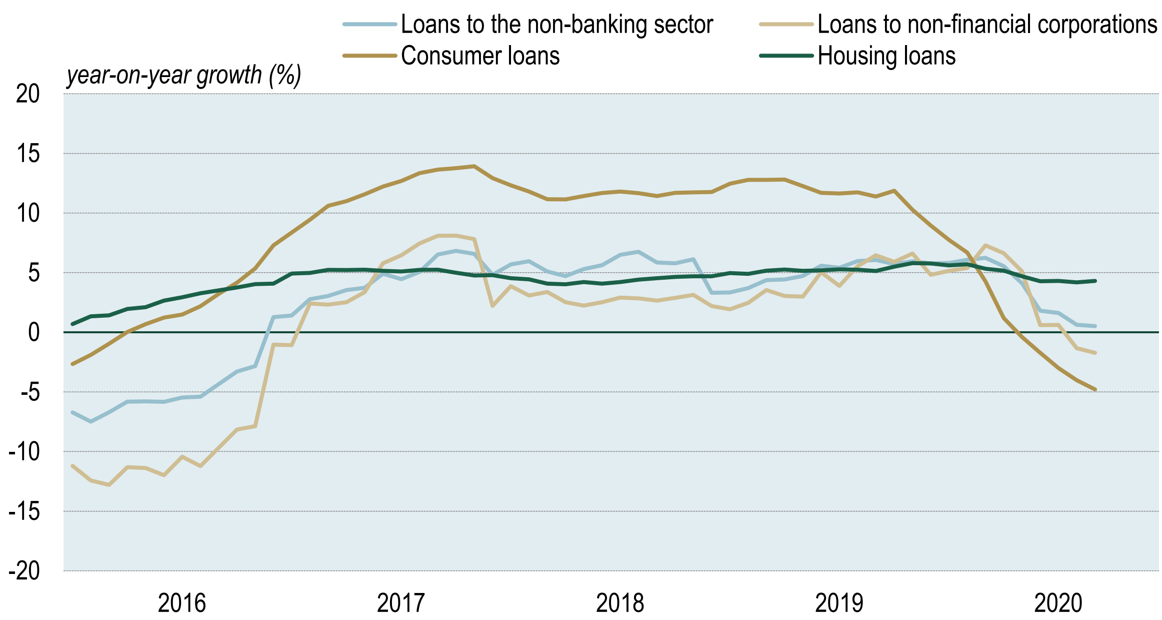
Growth in the balance sheet total increased this year and reached 7.5% year-on-year in September. It increased by EUR 2.3 billion during the first nine months of the year to EUR 43.5 billion. Along with a significant increase in deposits from the non-banking sector and reduced lending, banks increased the most liquid forms of investments, particularly in the form of claims against the central bank. The proportion of bank investments accounted for by securities remained high, and accounted for one fifth of the balance sheet total at the level of the banking system. On the liabilities side, deposits from the non-banking sector increased markedly.

Due to the Covid-19 pandemic and its adverse consequences for economic activity, the banks' lending activity was down sharply this year, but the differences between the individual types of loans are substantial. Loans to the non-banking sector increased by just EUR 35 million by the end of September, which is the lowest increase since 2016 taking account of the first nine months of the individual years. Year-on-year growth in loans to the non-banking sector remained positive, despite dropping by more than five percentage points this year, and stood at 0.5% in September.

The severe slowdown in the growth of household lending was primarily the result of a decline in consumer loans, while housing loans continued to grow. As can be seen in Figure 4, year-on-year growth in household loans had declined to 1.4% by September of this year. The decline in their volume was particularly acute during the first half of this year, as opportunities for consumption of goods and services were considerably diminished during the first wave of the epidemic. Consumer loans declined steadily this year, and in September they were down 4.8% year-on-year, which can be attributed to the increased level of general uncertainty, lower household revenues and the effect of the macroprudential restrictions on household lending. On the other hand, we note that growth in housing loans has slowed this year (to 4.3%), but has not deviated significantly from the average year-on-year growth in the last five years. This can also be attributed to relatively favourable developments on the real estate market, as despite the crisis the majority of indicators on the real estate market have remained relatively stable.

After the huge drop in economic activity following the declaration of the pandemic, growth in corporate loans slowed sharply, and turned negative for the first time since January 2017. Corporate loans were down 1.7% year-on-year in September. In line with expectations, the loan breakdown changed substantially, whereby demand for loans for investment purposes was down, while demand for loans for current operations and liquidity was up. Future lending activity in this segment will depend to a great extent on the economic recovery.

Figure 4: Growth in loans by sector



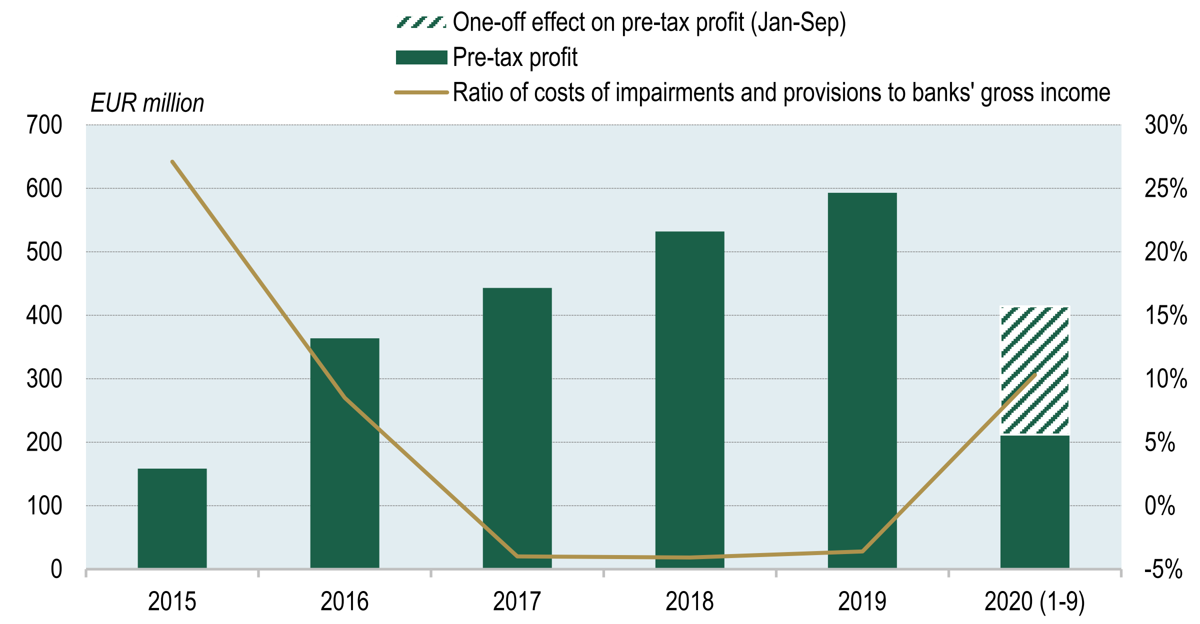
Source: Banka Slovenije.

Despite the sharp decline in economic activity, bank non-performing exposures continued to decrease for several months after the start of the crisis. At the level of the entire portfolio, the NPE ratio declined by 0.4 percentage points from the start of the epidemic to September, to stand at 1.8%. During this period, banks lowered their NPE ratios the fastest in the corporate portfolio, so that by the end of September the NPE ratio in this segment had fallen to 3.7%. Even in sectors that suffered above-average impacts from the initial crisis and whose revenues and liquidity were significantly affected had not shown growth in NPEs by the end of September. During the initial months of the crisis, NPEs increased among consumer loans, but the growth plateaued in June, and the percentage stabilised at 2.7%. For housing loans, the falling trend for NPEs continued in the months following the onset of the crisis, and from June onwards has stabilised at around 1.7%. These developments are contrary to what was initially foreseen, and at the same time we can conclude that amid adverse operating conditions and the consequent deterioration of the financial position of households and corporates, the adopted economic policy measures played a crucial role in maintaining favourable trends.

Despite the adverse conditions, non-banking sector deposits increased this year and thus remain a dependable source of financing for the banks. In August they were up 9.7% year-on-year, primarily as a result of increases in household deposits (9.5%) and corporate deposits (12.2%). They increased markedly in the second quarter of this year, which can be mainly attributed to decreased consumption and the simultaneous allocation of state aid to mitigate the consequences of the pandemic on the labour market. This mainly drove a rise in sight deposits, which allow savers instant access to their savings in the event of need. In September, sight deposits accounted for 77% of total non-banking sector deposits, and 59% of the balance sheet total of the banking system. The banking system’s dependence on other sources of financing remained low.

The profitability of the banking system has decreased in the current conditions this year. Pre-tax profit at the level of the banking system amounted to EUR 414 million to September 2020, down a fifth on the same period last year. It should be emphasised that the relatively minor shortfall is the result of the one-off effect of the merger of two banks, which is reflected in higher non-interest income. Without this effect, the figure for the first nine months of this year would have been significantly lower, i.e. half (5.7%) of the realised amount (11.3%). While the release of impairments and provisions in past years contributed significantly to the high profits of the banking system (which in fact hit their record high last year), the adverse conditions this year have already begun to be reflected in a turnaround in this segment as well. Banks have already recorded costs of impairments and provisions this year, but their share as a percentage of gross income is still relatively low, which can also be attributed to the various regulatory relief measures extended to banks in order to maintain their ability and willingness to support the real economy. However, there is still pressure on bank profitability owing to the banks' difficulties in generating net interest and non-interest income due to the decline in lending and the adverse economic conditions (i.e. in part also due to lower credit demand).

Figure 5: Pre-tax profit and ratio of net impairment and provisioning costs to gross income



Source: Banka Slovenije.

We currently estimate, and our assessment is fairly consistent with the banks' own assessments, that the banking system will generate pre-tax profits of over EUR 300 million this year.[5,6] As noted above, this at first glance relatively encouraging figure is to a great extent the result of a one-off effect, otherwise the estimate would be just a third of that amount. There has been a noticeable decrease in nearly all elements of bank income, particularly net interest and non-interest income. On the other hand, interest expenses will increase slightly this year, due to an increase in issued debt securities, which in principle represent a more expensive source of funding for banks, but which will be maintained at low levels. Operating costs will increase over last year, partly on account of accounting changes in reporting, i.e. the transfer of certain items from other operating expenses to operating costs.

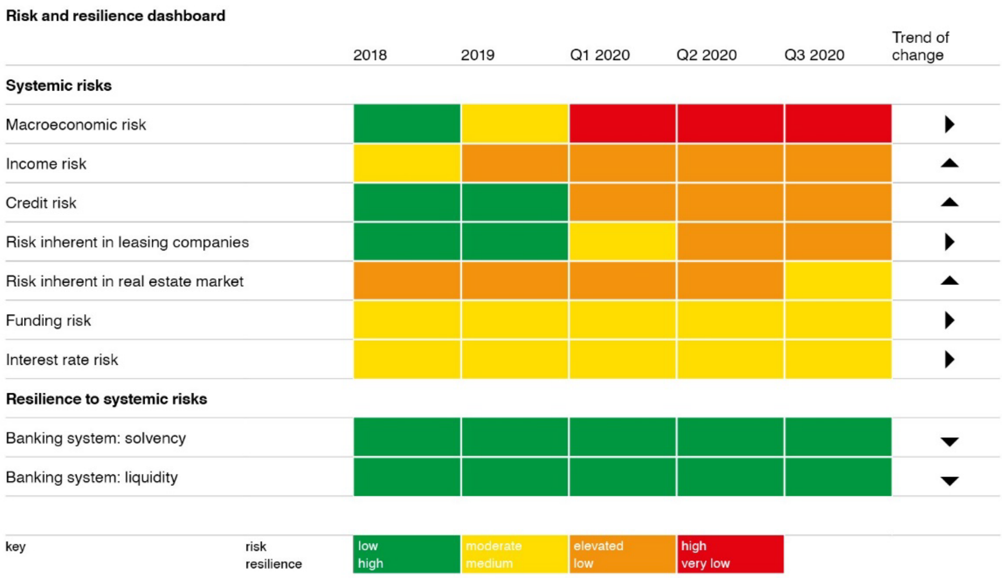
[5] The assessments are based on three alternative approaches, e.g. proportional projections of past developments taking account of historical seasonal developments, the seasonal time series model, and balance sheet forecasts based on satellite models for individual types of banking risk, which are combined using accounting equations. The latter approach is based on the core projections published in *Macroeconomic Projections for Slovenia, June 2020*. The baseline scenario of the macroeconomic forecast is based on the assumption of the containment of Covid-19 and a manageable second wave without the reintroduction of stringent containment measures, meaning that the second implementation of stringent containment measures in 2020 has not been taken into account in the assessments, nor has the new (sixth) legislative package in connection with the Covid-19 epidemic. Each approach has its advantages and disadvantages, and is based on limitations and assumptions that are set out in detail in internal materials.

[6] The banks drew up their profit and loss projections on a consolidated basis, while the Banka Slovenije assessments are made on an individual basis.

5. RISKS IN THE BANKING SYSTEM

The initial financial position of corporates and households at the outset of the current crisis was good, which, due to the reserves created, helped them weather their liquidity problems before the adoption of all of the economic policy measures. Nevertheless, at the onset of the crisis, key risks were identified as significantly increased and with a growth trend, primarily due to uncertainty regarding the duration and seriousness of the crisis, and the circumstances that bank customers would find themselves in after the end of the crisis and when the mitigation measures are no longer in place. The risks and resilience in the banking system are shown in Table 1.

Table 1: Overview of risks and resilience in the Slovenian banking system



Note: The colour code in the risk and resilience dashboard relates to the assessment for up to one quarter in advance. The arrow illustrates the expected change in risk or resilience in the scale (up or down) over a slightly longer horizon of around one year. For risks, an up arrow means an increase in risk, and vice-versa, while for resilience it means strengthening, and vice-versa. The risk and resilience dashboard is based on analysis of key risks and resilience in the Slovenian banking system, and is defined as the set of quantitative and qualitative indicators for defining and measuring systemic risks and resilience.
Source: Banka Slovenije.

In addition to macroeconomic risk, which has increased significantly due to the current conditions and is assessed as high (red), income risk is also increased. During the Covid-19 pandemic, the banks are facing adverse operating conditions that significantly impact the conditions for generating profits. Already based on the macroeconomic forecasts at the end of last year, in which we predicted a slowdown in economic growth in the current year, we also forecast a turnaround in the trend in impairments and provisions this year, i.e. the end of their releases after three years. The unexpected onset of the crisis and the growth of credit risk resulted in immediate impairment costs at all of the banks, in both the non-performing and performing parts of their portfolios. What had been one of the banks' main factors of their high profits in past years thus became a key factor in their decline in this and probably in the coming year. Due to the uncertainty regarding future economic trends, the developments in credit risk and future creation of impairments are also unclear, which is keeping income risk at a high level and with a growth trend.

In addition to the aforementioned costs of impairments and provisions, the drop in lending is also a factor in the increased income risk. Lending is decreasing this year due to lower demand for loans and the banks' tightened lending standards in response to the adverse conditions in the macro environment. The results of our survey on demand for corporate loans indicate that such demand is limited to loans for financing current operations and liquidity loans. The former in particular are usually approved for short periods, and their maturity (when not deferred) reduces the existing loan stock more quickly, and due to the restrictions on operations, renewal is at a lower level than in normal economic conditions. Due to the uncertainty, corporate investment plans have been postponed, as has demand for such loans. The currently negative year-on-year growth of corporate loans and consumer loans could last for an extended period of time and could have an adverse effect on bank incomes.

We have already mentioned the turnaround in the trend in impairments and provisions, which we can also expand on from the perspective of the IFRS 9 accounting standard. In contrast to the previous standard, when impairments were created only when performing exposures were reclassified as non-performing, in accordance with the new standard the largest amount of impairments are to be created at the beginning of a recession, since, according to the standard, a forward-looking approach has to be used when creating impairments. Consequently, banks are expected to immediately create model-based impairments for the currently still-performing exposures on the basis of the declining macroeconomic outlook. In addition, the reclassification of performing financial assets from Stage 1 to Stage 2 is expected, where the banks, instead of one year impairments, form higher lifetime allowances due to credit risk. In the event of a sudden deterioration, for these reasons we could expect to see a cyclical increase in impairments, which is currently partially being reflected in bank performance results. Despite recording the costs of impairments and provisions this year, we can conclude that the effect would be even larger if not for the adoption of the regulatory measures and guidance for banks regarding a less pro-cyclical interpretation of the accounting standard.

At the onset of the epidemic, credit risk in the banking system was immediately assessed as increased due to the sudden deterioration in economic conditions. Regardless of the otherwise still-favourable indicators regarding non-performing exposures, in this assessment we are bearing in mind that the individual segments of the economy and households will not be able to continue operations, i.e. repay their debts. The survey figures show that the fifth of all households with the lowest net assets have debt and debt servicing costs that exceed the euro area average. These are the debtor segments in which non-performing exposures are likely to increase first. Future reclassifications to defaulter or NPE status depend on the duration of the crisis and the mitigation measures to curb the spread of the epidemic. Reclassification as NPEs could occur in the most-affected businesses and sectors even before the end of the period of approved moratoria.

On the other hand, funding risk remains moderate, as the banking system is not highly dependent on foreign funding, while the inflow of non-banking sector deposits continues. Thanks to its low dependence on wholesale funding, the banking system is less exposed to adverse effects on financing from the international financial markets. The percentage of bank liabilities to the Eurosystem also remains low, at 3.2% of the balance sheet total. Non-banking sector deposits thus remain the primary and most stable source of funding for the banks. The banks recorded an above-average inflow of deposits this year relative to previous years. Similarly to household deposits, there was a significant increase in the stock of corporate deposits in the first months of the Covid-19 pandemic, while the inflow slowed in the third quarter. We believe that the stock of household deposits will initially increase in the last few months of this year, due to the repeated stoppage of various economic sectors and public life, and thus diminished opportunities for consumption. With the downturn on the labour market, growth in household deposits is expected to slow in the future, as will growth in corporate deposits, as firms will need the money to bridge liquidity gaps and other difficulties.

Along with the decline in bank lending this year and the significant inflow of deposits into the banking system, the difference between the growth in non-banking sector deposits and growth in lending to the non-banking sector is increasing. Consequently, after a few stable years, the loan-to-deposit (LTD) ratio for the non-banking sector has also fallen, and stood at 71.8% at half year, indicating that the banks are (or could be) directing the increased deposits into increasingly less profitable investments. One possible source of instability in bank funding derives from mismatches in the maturities of investments and liabilities. In the context of a sound liquidity position, however, the ability to absorb the negative effects of the potential realisation of funding risk is relatively good.

The risk to the banking system from the real estate market remains moderate. Despite the Covid-19 crisis, the dynamics of the majority of indicators on the real estate market remain stable, with moderate growth. The growth in residential real estate prices slowed, and we believe that these prices are still close to their long-term fundamentals. Bank exposure to the construction and real estate sectors is much smaller than during the previous crisis, and growth in housing loans has been restrained in recent years. The Covid-19 pandemic has not severely affected growth in housing loans, which remains stable and only slightly lower than in past years. The final impact of the crisis on the residential and commercial real estate market will depend on its duration and on the pace of the economic recovery. However, the impact of the second wave of the pandemic in Europe will be decisive. As a consequence, we have maintained a trend of increased risk in the future.

The resilience of the banking system to the adverse effects upon the potential realisation of risks remains high due to the banks' good capital and liquidity positions, although there are differences among the individual banks. The Slovenian banking system's total capital ratio on a consolidated basis improved by nearly 20% over the first half of 2020, while Tier 1 capital ratio fell by a minimal amount. As a result, the Slovenian banking system's capital adequacy remains above the euro area average, bearing in mind that the differences between the individual banks are substantial. Equity increased both through subordinated debt instruments and through retained earnings from the previous year. In accordance with Banka Slovenije's macroprudential measures, the banks retained their earnings from the previous year in full, thus contributing to the robustness of the banking system. Regardless of the current assessment, the capital resilience of the banking system is expected to decline in the future, as a result of the deterioration in the quality of the credit portfolio and the decline in bank profitability. The banks with lower capital surpluses and the banks with large exposure to the sectors hit hardest in the crisis will find it harder to deal with the consequences of the economic shock. The liquidity indicators are also stable and favourable, i.e. substantially higher than the regulatory required levels, and also higher than the EU average (LCR). The robustness of the banking system is also indicated by our regular liquidity stress tests, on the basis of which we conclude that despite low liquidity surpluses at certain banks, their survival period in an emergency will be relatively long, which will allow them to adapt to the situation. Amid the worsening of the epidemiological and consequently the economic conditions, the banking system's currently favourable liquidity position could deteriorate in the future, but in the current conditions and with the current expansionary monetary policy measures we do not foresee increased risk on this account.

6. OUTLOOK FOR THE FUTURE

Next year and particularly in the following years, as the moratoria and other emergency measures expire, Banka Slovenije is forecasting a deterioration in credit portfolio quality and increased pressure on bank profitability, but it should be emphasised that the future developments are highly uncertain. The future dynamics of economic activity will depend on the development of the epidemiological conditions and the economic policy measures. However, even after the abatement of the health crisis, at least in the banking sector we cannot expect a significant reduction in uncertainty, particularly after the expiry of the emergency measures. This uncertainty is related to how many credit exposures will actually be viable after that period, and how many exposures will be downgraded or even classed as non-performing. An important role will also be played by the new IFRS 9, under which impairments are based on model estimates, where the standard permits a certain amount of flexibility. There is e.g. flexibility in the choice of approaches used when determining the criteria for reclassification from Stage 1 to Stage 2, when determining weights and the severity of the scenarios when calculating expected credit losses, and during modelling and the taking of expert decisions. In addition, the application of models is associated with modelling risk. Forecasting is therefore extremely difficult and uncertain.

Even based on the historical series that include the last financial crisis in 2009, when the drop in GDP in the first year was lower than in the present crisis, we can conclude that there is significant credit risk in the medium term. Very fast increases in default rates among Slovenian companies has occurred on two occasions in the past. The first was between 2009 and 2011, when GDP growth was profoundly negative or near zero, and even more so one year after the period of contracting GDP, and second in 2013 and 2014, again one year after negative GDP growth had been recorded. History therefore teaches that large increases in default rates tend appear after a delay, particularly in years following negative GDP growth. The rapid increase in default rates in these periods can be explained by the increased correlation between non-financial corporations' probability of default and the drawdown of internal reserves, which can lead to payment indiscipline and a domino effect.

Assessments of credit risk according to IFRS 9 are based to a large extent on historical data and links between variables, but the Covid-19 recession could have different transmission channels, severity and dynamics, since the shock is quite different from the previous shock in terms of its origin. The previous recession was a double-dip (W-shaped), and default rates therefore increased for several years. But it is worth noting that the breakdown of bank portfolios, i.e. the banking system’s total loans, is significantly different today to what it was at the beginning of the financial crisis in 2009. This time there is less corporate exposure, as firms were more indebted on average prior to the great financial crisis than they are today, and there is less exposure to traditionally risky sectors (construction, financial holding companies), while there is more exposure to households, where there has been a significant structural change in the share of consumer loans. Due to the higher levels of capital adequacy for banks and lower dependence on wholesale sources of funding of banks, there will be less pressure to reduce lending from these channels than there was in the previous crisis. One positive note is that the current corporate default rates are at a record low level. In addition, it has to be taken into account that the risks are mitigated by the fact that both corporates and banks entered this crisis in a significantly better position than in the last financial crisis. A large number of emergency measures have also been adopted to mitigate the consequences of the crisis, which relate not only to corporate financing, but also to other factors that directly impact the ability of bank customers to service their debts (e.g. measures to preserve jobs).

However, another significant unknown is the question of whether the emergency measures will succeed in mitigating the consequences of the epidemiological crisis in the long term, and whether the adverse effects of the crisis are in fact merely temporary (the measures in this case would resolve liquidity problems, and solvency risks would not increase significantly). Significantly more damage to the national economy and adverse effects on the banking system could be incurred if certain sectors suffer severe losses, which would be followed by a domino effect on the other companies (partly as a result of unfavourable sentiment). Therefore, developments in banks’ credit portfolios will be subject to the greatest amount of discussion in the upcoming period. The deterioration of the situation in the last few months in Slovenia and among its trade partners has brought additional uncertainty among banks and in the economy in general.

Although the banks have managed to reduce non-performing exposures in past years, and this year as well, the review of the banks' plans regarding the NPE dynamics and strategy indicated that the current crisis resulted in the appearance of new NPEs as early as the first half of this year. Nevertheless, the banks believe that they are to a large extent adequately prepared for the impacts of the pandemic. The banks themselves have been significantly more cautious than in past crisis conditions with regard to NPE dynamics, and they believe that major adverse effects will be felt only in 2021 and 2022 (after the expiry of the moratoria). Taking into account the impacts of Covid-19, the banks are forecasting an increase in non-performing exposures of nearly EUR 300 million, or 25%, by the end of 2022. Furthermore, it is not immaterial that the bank's reports were submitted during a period of improvement in the epidemiological situation (during a time of slightly increased optimism) and that the plans and dynamics were drawn up on the basis of the half-year results, in which the impacts of Covid-19 were not yet so pronounced.

Our estimates regarding the future situation in the banking system are more conservative than those of the banks. This is shown in the results of our top-down macro stress tests, which we conducted recently, and which are based on our June forecasts and the banks' initial reporting data with the cut-off date of 31 December 2019,[7] but we also bore in mind our estimation of increased credit risk, which we described in more depth in the October Financial Stability Review. In the case of the baseline scenario, the banks' assessments and our internal prognoses are aligned only in 2020, while for the following two years the banks' planned levels of NPEs are significantly lower than our estimates (in 2021 and 2022 lower by 44% and 70% respectively). With

[7] The macroeconomic projections were published in *Macroeconomic Projections for Slovenia, June 2020*. The baseline scenario of the macroeconomic forecast is based on the assumption of the containment of Covid-19 and a manageable second wave without the reintroduction of stringent containment measures, meaning that the second implementation of stringent containment measures in 2020 has not been taken into account in the baseline scenario, nor has the new package of emergency measures under the sixth anti-coronavirus law, which among other things extends the moratoria, been taken into account in any scenario. Taking this additional information into account, on one hand we can expect NPEs to continue to grow, but on the other we can also expect the growth of NPEs to be delayed until the coming years, and fewer effects in 2021 due to the extension of the emergency measures and the forecast start-up of government infrastructure projects. The forecasts also do not take account of the positive effect on reducing NPEs due to the recent merger of large banks.

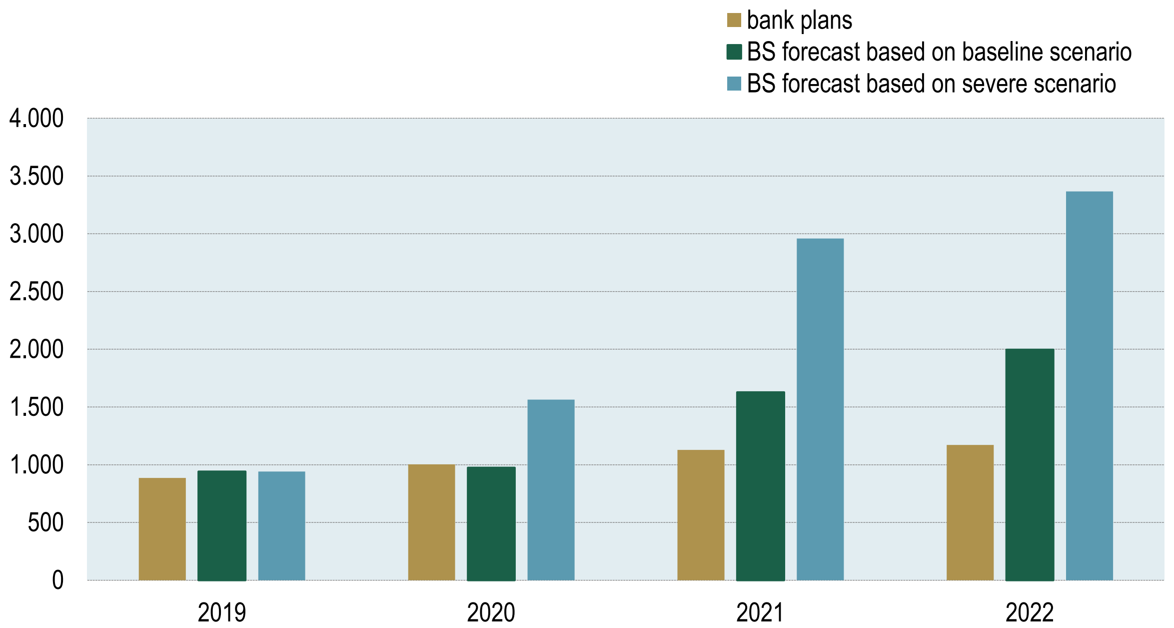
a further deterioration in the epidemiological picture, the likelihood of the realisation of our severe scenario would increase, which would further increase this gap over the next two years. According to our estimates, under the baseline scenario the NPE ratio could increase over the next two years from the current just under 2% (September) to around 5% by 2022, and as high as almost 10% under the severe scenario. In the historical context, this estimate is still substantially lower than the record high NPE ratios from 2012-2014, but the potential relative change is very similar to that from the time of the financial crisis. These estimates are shown in more detail in Figure 6.

As we noted in Section 2, when reviewing these assessments as well, one has to be aware of the assumptions and limitations of the analyses and the built-in implicit conservativeness. It is nearly impossible to give precise estimates, as we are still facing major uncertainty regarding the further course of events and the duration of the crisis, and furthermore we have no comparable case study in modern history on which we could base them. We have already discussed uncertainties at the beginning of this section, but here we should also mention the main limitation of modelling, which is that we are limited to the characteristics of empirical models[8] based on the identification of patterns and sensitivities between variables in historical

[8] Certain assumptions and simplifications are also necessary due to the lack of availability of sufficiently long time series of detailed information for certain portfolios, and from the perspective of the assessment of the mitigation measures introduced by banks to reduce non-performing exposures (sale of assets, liquidation of collateral, cash repayments, etc.). The effects of the emergency fiscal measures have been introduced into the assessments via macroeconomic variables. The assessment also includes an assessment of the effects of the moratoria pursuant to the first Emergency Deferral of Borrowers' Liabilities Act. The assessment is simplified and based on the assumption that deferred exposures have the same probability of default as calculated for the whole portfolios. Assumptions also need to be made with regard to the impact of the moratoria in the first year and in the following years. In the first year, we assume no deferred exposures will be classified as default, while in the following years we assume that a certain proportion could be classified as default, with a probability of default that applies to the entire portfolio. Due to the uncertainty, the potential growth of the correlations and the non-linearity of the time series models, we use a more conservative 75th percentile of the distribution of forecasts. The models for corporates are segmented into portfolios of exposures secured by real estate and unsecured exposures. Segmentation by sector is not currently employed. The assessments do not show the change in the methodology for calculating interest on NPEs and with respect to the exclusion of exposures to central banks, which could lead to additional increase of the NPE ratio.

time series, which do not include the specifics of this shock and the emergency measures. We should also mention the potential limitations of bank's models upon the application of the new IFRS 9 accounting standard, as they have not been tested on the types of structural breaks and non-linearities that this could cause. The emergency measures could continue to obscure the current level of economic risks. There are also certain limitations to the analyses, which are completely objective and which cannot be avoided at the moment, such as uncertainty regarding the use of the vaccine and in particular the attitude towards vaccination, and on the other hand the emergency measures are gradually being extended and infrastructure projects are being anticipated.

Figure 6: NPE values by year in EUR million; bank plans and baseline and severe scenarios in Banka Slovenije projections



Note: The data for 2019 from the bank plans are as at 30 June 2020. The Banka Slovenije projections take account of the off-balance-sheet exposure, multiplied by conversion factors.

In the sections on the economic policy measures, we have already discussed certain regulatory relief measures for banks, which were adopted in order to maintain the banks' activities and financial intermediation. As a result, there have not been any major increases in reclassification between the individual stages of exposure. **In other words, nearly 70% of all exposures for which moratoria were approved are still classified as non-default, but despite this, we can already detect the first formal recognition of increased credit risk, as a full 12% of the moratoria have already been reclassified from non-default status to status of exposures with increased credit risk.** Of course, the main focus is on exposures after the expiry of all of the emergency measures. We estimated this using a sensitivity analysis, i.e. via simulations of the reclassification of individual "Covid-19" exposures to default (or increased risk) status. Consequently we developed three scenarios: i) under the milder scenario, we forecast that only those exposures that already have increased credit risk will be reclassified to default; ii) under the more severe scenario, in addition to the aforementioned under the milder scenario, there will also be increased risk for exposures classified as non-default (reclassification as exposures with increased credit risk); and iii) under the extreme scenario we forecast the reclassification of the entire portfolio to default. The results of this analysis are shown in Table 1.

Based on this analysis, we conclude that the NPE ratio at the level of the banking system in the event of the realisation of the milder or more severe scenario would increase to 3.2%, and to 7.0% in the event of the extreme scenario.[9] The banks would consequently have to create additional impairments and provisions in excess of the current (year-on-year) profits, which would result in a reduction of the capital adequacy of the system by one-fifth of a percentage point (more severe scenario) or 3.6 percentage points (extreme scenario). The system's capital adequacy would remain sufficient even in the event of the extreme scenario, but the differences between the individual banks are very large, from the perspective of both their capital ratio and their exposure to the Covid-19 portfolio.

[9] For comparison, the values are in fact lower than those recorded in the previous financial crisis, but the calculation does not take account of the effects of the second wave and the effects of the reclassification of other customers (outside the Covid-19 portfolio) among defaulters.

Another important factor is the dynamics of the expiry of the moratoria, which could have a major impact on the time scale for the creation of impairments and provisions in the coming months. According to the data as at 30 September 2020, approximately 25% of the deferrals have already fallen due, while more than 30% of them will mature within the next 6 to 12 months. Therefore, the largest increase in the NPE ratio (and drop in the capital ratio) could most likely occur between the end of March and the end of September 2021.

Table 2: Simulation of the impacts of the deterioration of the quality of the Covid-19 portfolio on the basis of the milder, more severe and extreme scenarios.

	Milder scenario	More severe scenario	Extreme scenario
Change in impairments and provisions	€295 million	€430 million	€1,112 million
Profit/loss of the banking system	€91 million	€-44 million	€-726 million
Change in the capital ratio	0 p.p.	-0.2 p.p.	-3.6 p.p.
NPE ratio	3.2%	3.2%	7.0%
Profit/loss of the banking system taking account of reclassifications with deferrals for unaffected sectors*	€57 million	€-163 million	€-1,373 million

**Taking into account also the part of the exposure for which deferrals were not approved.*