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ADDRESS BY THE GOVERNOR OF THE BANK OF SLOVENIA

Slovenian Bankers' Day, 6 November 2017

Mr Miro Cerar, prime minister, Ms Stanislava Zadravec Caprirolo, president of the Bank Association of Slovenia, and Mr Yves Mersch, member of the Executive Board of the ECB, a warm welcome and a thank you to the association for the invitation and opportunity to speak at this traditional annual gathering of bankers, economic policymakers and representatives of academia.

This year's theme of *Banking in the Age of Digitalisation* does not raise the question of digitalisation as a yes or no, but rather of how the Slovenian banking sector is to face it. It is also not a question of when. I believe the answer is right now. The question of precisely how we should face the challenge of digitalisation I will find it difficult to answer, as I am not an expert in this field. Although I have often been surprised by the incredible capacities attributed to me by some: from being responsible for the huge banking hole – in the opinion of alleged experts and according to calculations that no-one has ever seen – to obtaining too much advantage for taxpayers in the case of the recovery of NLB, to deciding on the reprogramming of debt at major firms, appointing my own banking supervisors and inviting foreign tycoons to Slovenia. I will repeat it here, once again, for the n^{th} time: the size of the capital shortfall was calculated by foreign advisors in line with the rules applying across the European Union, and not by the Bank of

Slovenia, the data was submitted by the banks themselves, and, let us recognise for once, the crisis in the Slovenian banking sector was very large, albeit a few years after the global crisis. By way of comparison, I will only say that before recapitalisation the banking sector found itself in a situation where GDP was 8.5% lower than in 2008. The crisis could not have been avoided, but the consequences would have been significantly smaller had the government acceded to the Bank of Slovenia's requests and recapitalised the banks promptly, as done elsewhere in Europe. Here it is worth remembering the expression that an opportunity missed is an opportunity lost. At moments of crisis, it is always necessary to make a decision, as the response to the crisis is the key, and decisions require courage. Courage is something that the key decision-makers in Slovenia might have had in greater quantities at that moment.

I will again emphasise something for all the armchair experts who now claim that Slovenian banks were recapitalised too much after recovery. If this were really the case, it would have been established in the stress tests conducted by the ECB in 2014 under the same methodology as in 2013. But it was not. In fact, the opposite is the case.

First, regarding the compliance of the asset quality review (or AQR) with the International Financial Reporting Standards (IFRS). As part of its establishment of the Single Supervisory Mechanism, the ECB published a manual for the AQR. Careful reading of the manual will show that the procedures of the AQR comply fully and wholly with the IFRS. Furthermore, compliance with the IFRS has specifically been confirmed on multiple occasions by the ECB: for example, in October 2013, i.e. at the time of the AQR, and most recently in October 2017, when it issued an opinion on judicial relief granted to holders of qualified bank credit. It should also not be forgotten that the balance sheets of Slovenian banks as at 31 December 2013, which contained the findings of the AQR (and thus the revisions to capital values), were also audited. During the audit the auditors confirmed the balance sheets' compliance with the IFRS, which is merely extra proof that all claims of the non-compliance of the AQR with the IFRS are baseless, erroneous and malicious.

I will continue with a brief summary of the errors made by the armchair experts in connection with regulatory procedures and the determination of the capital shortfall. Their statements fail to distinguish between procedures for the regulatory assessment of capital adequacy and procedures of financial reporting and auditing. To put it another way, they fail to take into account that any capital shortfall (for a bank as a going concern) is determined in a regulatory procedure, and thus the question of how much the determination of the regulatory procedure is reflected in the financial statements becomes of secondary importance. Accordance between one and the other is both expected and desirable, but the second is not automatically a consequence of the first. In any case regulatory procedures for the assessment of capital adequacy are never the result of financial reporting.

Bank recovery measures relieved the Slovenian banking sector of non-performing loans totalling EUR 5.5 billion. The transfer of non-performing loans to the Bank Asset Management Company (BAMC) and the Bank of Slovenia's extraordinary measures that provided for bank recapitalisation via state aid, and thus adequate capital stability at key banks, were the most important factor in the retention of the supply-side capacities of these banks, and thus of the banking system as a whole. The constitutional court confirmed that the measures to maintain the stability of the financial system and the economy, such as the extinction of subordinated instruments and share capital as a means of attaining bank capital adequacy, were constitutional. While on the subject of the constitution of Slovenia, allow me to remind us that it speaks of the independence of the Bank of Slovenia, which all too often some simply forget.

In the context of bank recovery measures, I would like to highlight two other findings by the Bank of Slovenia from analysis of business cycle factors in the crisis, which are further evidence of the missed opportunity in the response to the crisis. Analysis has revealed that the slow pace of bank resolution had an adverse impact on the economic recovery. Had bank balance sheets been more promptly relieved of the burden of non-performing loans, GDP would have been approximately EUR 1 billion higher by the end of 2015. Furthermore, the bank recovery was a significant positive factor in the economic recovery in 2014 and 2015. The historical decomposition of the business cycle shows that two factors that correlate with business confidence, namely consumer confidence and firms' appetite for investment, returned to positive territory with the bank recovery.

Let me return to last year's address, which I concluded with the following words: "Just as central banks adapted to the modified situation and took entirely new, non-standard measures to restore the functioning of the monetary policy transmission mechanism, so too must the banking sector adapt to the modified circumstances. This is certain to require a good deal of work: more openness, and more self-confidence and courage, including coming out of the comfort zone."

This we are still missing: openness, self-confidence and courage. Not only in dialogue, but above all in making strategic decisions. Slovenia is so small, that practically any bad decision by an individual or group has an impact on the whole country, whether a CEO, a supervisory board, a ministry or the government. It will be no surprise when I say that I agree with those who firmly believe that Slovenia has great opportunities, but the question is solely whether we will know when to take advantage of them (those that we haven't missed), not only for our individual benefit, but also to our benefit as citizens.

Last month I was in Washington, at the IMF annual meeting, presenting the position of the Slovenian banking sector. Today I will also present it to you.

The macroeconomic situation in 2017 and the forecast of economic developments in 2018 and 2019 are favourable. This is agreed on by everyone: politicians, economists, researchers and institutions, foreign and domestic alike.

After seven years of contraction, credit growth is increasing again, as a result of more favourable terms on the supply side, and the improved quality of credit demand owing to the deleveraging of the corporate sector and the low indebtedness of Slovenian households.

Growth in the Slovenian economy stood at 3.1% in 2016, and 4.4% in the second quarter of 2017. This put it among the highest in Europe.

The main factor supporting the economic cycle is growth in private consumption and private-sector investment, which continued in the wake of an improvement in the situation on the labour market – the unemployment rate fell, and average gross wages rose – and in the corporate sector.

Credit growth is gradually reviving. After seven years of decline, corporate loans began recording positive growth in 2017. Alongside improved profitability and

low corporate indebtedness, the low interest rates and improved situation in the banking sector began to be reflected in higher growth in corporate loans in early 2017. Growth in housing loans remained stable throughout the period of the crisis, while growth in consumer loans has picked up in 2017. The growth in both has been attributable to the low indebtedness of households, and the improved situation on the labour market and real estate market.
Growth in loans to non-financial corporations is forecast to merely be gradual in the future, owing to the increasing proportion of financing from the rest of the world (which is an important alternative source) and from retained earnings.

Firms repaired their balance sheets during the crisis.
The corporate sector has been deleveraging for the last eight years. It reduced the debt-to-equity ratio by 40 percentage points from 146% in 2008 to 106% in 2016, a figure comparable to the euro area median. The decline in the debt-to-equity ratio has been based on a reduction in liabilities, and not on an increase in equity. The ratio of corporate debt to GDP in Slovenia stood at 103% in the first quarter of 2017, lower than the euro area median.
The corporate investment rate is increasing, and further growth can be anticipated while the economic situation remains favourable.

The quality of the credit portfolio is also improving.
Since the recovery of the Slovenian banking system in 2013, credit risk as measured by the proportion of classified claims more than 90 days in arrears and the NPE ratio has been continually declining: the proportion of classified claims more than 90 days in arrears declined from 18% in 2013 to 5% in 2017. Since 2013 Slovenian banks have been more active in resolving non-performing claims, have increased sales of non-performing loans, have transferred claims to the

BAMC, have written off claims, have liquidated collateral and have accelerated action to address non-performing loans in the SMEs segment.

The low interest rate environment is altering funding structure. Since the end of the crisis, the proportion accounted for by deposits by the non-banking sector has increased, while the proportion accounted for by wholesale funding has declined. Rollover risk remains low, although the stability of deposits by the non-banking sector could be conditional, given the increasing ratio of sight deposits to total liabilities.

The increase in the ratio of sight deposits to total liabilities and the approval of loans of longer maturities are increasing the maturity mismatch between assets and liabilities. The average maturity of corporate loans is increasing. The intensive approval of housing loans means that the average maturity of household loans is also increasing.

The new circumstances are increasing the stock of liquid assets on bank balance sheets.

The total capital ratio on a consolidated basis increased by 0.5 percentage points during 2016 to end the year at 19.1%, while the common equity Tier 1 capital ratio increased by 0.5 percentage points to 18.5%.
Despite this increase, the small domestic banks’ total capital ratio is still lower than the euro area average.

Slovenian banks have improved their profitability over the last two years, primarily by reducing impairment and provisioning costs, and partly by taking successful measures to improve the quality of the credit portfolio.

Renewed credit growth can be expected to have a positive impact on interest income, although it cannot be overlooked that the net interest margin remains under pressure in the low interest rate environment, which in the long term could increase income risk while the banks' operating costs remain elevated. As a result, the banks' retained earnings could be insufficient to maintain capital adequacy at an appropriate level. The banks should therefore continue adapting their business models.

In Slovenia the process of consolidation and concentration in the banking system has been underway since the nineties: the number of commercial banks has fallen from 36 in 1994, to 24 in 2008, and 15 in 2016. And what are the challenges facing Slovenian banks in the future?

Renewed credit growth should have a positive impact on the quality of the credit portfolio and on interest income.With the improvement in the financial position of non-financial corporations, low indebtedness, a better income position for households and favourable economic forecasts, the conditions are being put in place for a new credit cycle.

Despite the optimism in economic progress, and in the development of the banking sector, there remain challenges.

The banks’ earnings in the coming years will depend primarily on turnover, developments in interest rates, sustainable credit growth, and credit risk parameters. The banks will have to focus more on additional sources of non-interest income, and the further introduction of advanced technology and digitalisation.

The banks’ ability to adapt their business models with the aim of seeking better returns and optimising risk take-up is certain to be one of the key factors in their successful performance.

To reiterate: the new economic and regulatory situation requires significant adaptations by all actors. And as I said at the beginning: just as central banks adapted to the modified situation and took entirely new, non-standard monetary policy measures, so too must the banking sector adapt to the modified circumstances. We must therefore be more open, more self-confident and courageous, and must finally emerge from the comfort zone.