BANKA SLOVENIJE

EVROSISTEM

SREP 2023

Results

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Contents

Introduction

This year's supervisory review and evaluation process (SREP) unfolded in a period of uncertainty surrounding the economic outlook and the dynamics on the financial markets.

Despite the uncertain economic situation, the high inflation and the resulting rise in interest rates, the war in Ukraine, the war in the Middle East, and the shocks on the financial markets caused by bank failures in Switzerland and the US, the banking sector in Slovenia remains resilient to the effects of these events. The banks in Slovenia remain in sound capital and liquidity positions, although there is considerable variation between them.

The banks in Slovenia have strengthened and improved their risk management in the last year, which has brought an improvement in the overall SREP score at system level. The improvement is attributable to the progress in risk management in all four elements of the SREP: the risk inherent in the business model, internal governance and risk management, risks to capital and risks to liquidity.

Exogenous shocks resulting from financial, geopolitical and macroeconomic risks have caused supervisors to remain cautious in their banking supervision. Banka Slovenije has imposed several qualitative measures on banks, which mainly addressed deficiencies in the management of risks in connection with internal governance and risk management, and risks to capital and liquidity.

The **SSM SREP methodology** for significant institutions and the **SSM LSI SREP methodology** for less significant institutions can be found on the ECB website.

The results from the 2023 SREP cycle for banks in Slovenia are summarised below.

1 SREP scores

The overall SREP score (ordinary mean of the SREP scores) has been relatively stable over the years, but a trend of improvement has been evident in recent years, in line with the gradual improvement in the scores for individual risks. The overall SREP score improved from 2.4 to 2.3[1] over the last SREP cycle, with the greatest improvements in the SREP score being recorded by internal governance and risk management, and by liquidity risk.

Internal governance and risk management has been one of the supervisory priorities for a number of years now, and supervision has therefore been quite intensive in this area in recent years. A number of recommendations and requirements to rectify the identified deficiencies and irregularities were issued to the banks, which was reflected in an improvement in the aggregate score in the area of internal governance and risk management.

The overall score for liquidity risk improved from 2 to 1.8. Despite this spring's shocks on the financial markets caused by the collapse of certain banks in Switzerland and the US, banks in Slovenia are maintaining a sound liquidity position, thanks in particular to their liabilities structure, where there is only a small share of wholesale funding following their major repayment of the TLTRO.[2] It is household deposits that prevail, and they are diverse and stable.

The overall score for the risk inherent in the business model improved from 2.5 to 2.4 over this year's SREP cycle. The increase in net interest income brought an increase in return on equity: It stood at 14.7% at system level at the end of 2022, and increased further to 16.5% over the first half of 2023. In addition the banks succeeded in raising their cost effectiveness, which drove an additional reduction in profitability risk, and contributed to an improvement in the score for the risk inherent in the business model.

The main improvement in the risks to capital in 2023 was seen in credit risk, as the NPL ratio declined further in 2022 before reaching a record low of 1.5% in the first half of 2023. Market risk and interest rate risk deteriorated slightly, as a result of changes in market prices of debt securities driven by rising interest rates, but our assessment is that the risk of the banks being forced into selling these assets on the market before maturity is low, as the banks have favourable liquidity and capital positions, and their business models focus on taking deposits and lending to businesses and households.

The evolution of the scores for individual risks over time is illustrated in the figure 1.

[1] The SREP scale:

Score	Risk level
1	low risk
2	medium-low risk
3	medium-high risk
4	high risk

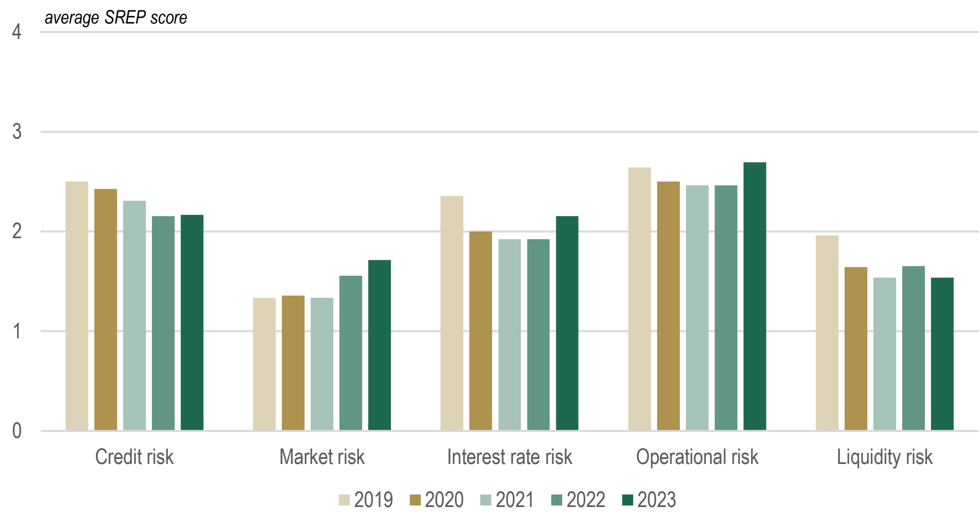
[2] Targeted longer-term refinancing operations.

Figure 1: **Average SREP scores for each element and on aggregate in SREP cycles 2019 to 2023**

Source: Banka Slovenije
Note: The data in the entire document relates to banking institutions in Slovenia on a consolidated basis.

The trend of improvement in the scores in recent years is also evident in the score for the inherent risk and the control environment for significant banking risks. Recent years have seen a discernible trend of improvement in the scores for credit risk, which came to an end in 2023 on account of the deterioration in economic indicators, the uncertainties on the market, and the changes in interest rates. There was a reversal in the trend in the scores for market risk and interest rate risk, driven by the recent rise in interest rates, and in the score for operational risk, where we are highlighting the importance of managing cyber risk.

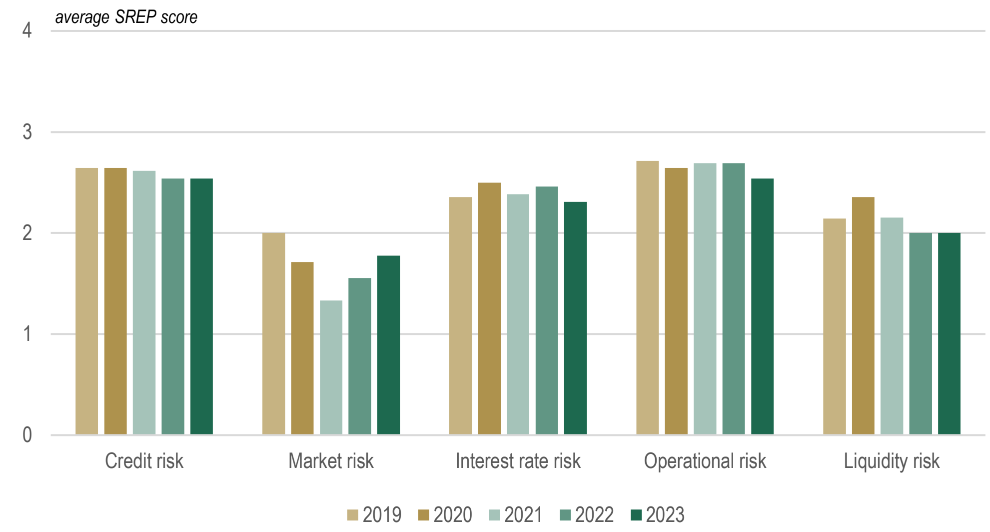
Figure 2: **Average score for inherent risk over SREP cycles 2019 to 2023**



Source: Banka Slovenije

The score for the risk control for individual risks is affected by the findings from ongoing supervision and inspections during the current SREP cycle, and also the banks' success in remedying the previously identified deficiencies and in upgrading the control environment. In general the scores for the risk control for individual risks are stable, with the exception of market risk, where the risk control score has recently deteriorated on account of a growing number of deficiencies identified on the basis of supervisory activities.

Figure 3: **Average score for risk control over SREP cycles 2019 to 2023**

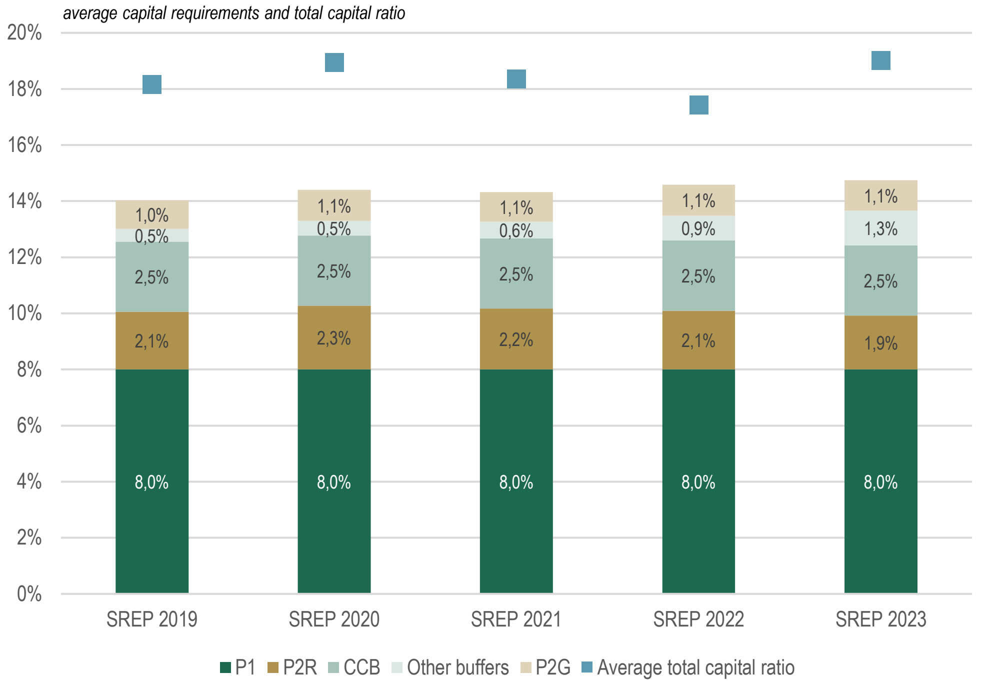


Source: Banka Slovenije

2 Capital requirements and capital surplus

The overall capital requirement that will apply to the banks as of 1 January 2024 has increased slightly as a result of the SREP 2023, and is estimated at 14.8% of risk-weighted assets at aggregate level. The average overall capital level in the banking system stood at 19% at the end of September 2023. A simulation of the capital surplus over the capital requirements for 2024 indicates that all the banks and savings banks in Slovenia will exceed the capital requirements in January of next year. Estimated level of capital surplus in the banking system over overall capital requirement including capital guidance in year 2024 is €1.5 billion.

Figure 4: **Average overall capital requirements and guidance under SREP cycles 2019 to 2023 and total capital ratios**



Source: Banka Slovenije

Note: Average weighted by risk-weighted assets; capital requirements created during the SREP cycle in question and estimate of capital buffers in force in the next year; capital requirement SREP 2023 includes 0.5% countrcyclical capital buffer rate for Slovenia that banks have to comply with from December 31, 2023 onwards; total capital ratio at year end for 2019 to 2022, and at end of third quarter for 2023.

The improvement in the overall SREP scores over the last four years has consequently reduced the additional capital requirements (P2R[3]), which amount to 1.9% of risk-weighted assets. The overall capital requirement (OCR) will rise slightly in the next year, as a result of an increase in **capital buffer** requirements (the CCB,[4] which is set in accordance with the Banking Act, and the macroprudential instruments in the form of the O-SII buffer, the systemic risk buffer and the countercyclical capital buffer) by 0.4 percentage points on aggregate due to introduction of countercyclical capital buffer for Slovenia.

The Pillar 2 guidance (P2G[5]), which institutions are required to meet using common equity Tier 1 capital (CET1) above the OCR remains stable over the recent period at 1.1%.

[3] Pillar 2 requirement

[4] Capital conservation buffer

[5] Pillar 2 guidance

The banking system remains resilient and in a strong capital position, despite the uncertain economic, macroeconomic and geopolitical conditions.

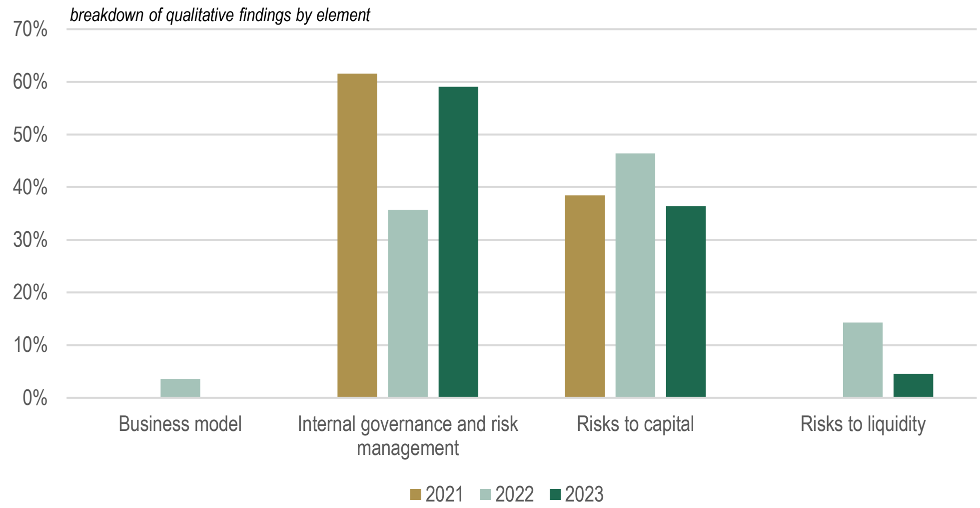
4 Qualitative findings

Qualitative requirements and recommendations addressing the supervisory findings were issued to the majority of Slovenian banks in the 2023 SREP cycle.

More than half of the SREP requirements and recommendations address deficiencies in the area of internal governance and risk management (59%), followed by risks to capital (36%) and risks to liquidity (5%).

- Qualitative requirements and recommendations in the area of internal governance and risk management were issued to more than half of the banks in Slovenia. The findings in the assessment of internal governance mainly encompass deficiencies in the working of the compliance and internal audit functions, the working framework and the composition of the supervisory board, the coordination of governance at the level of the banking group, and the governance of internal acts. Assessing the working of the management board and the supervisory board is a continual supervisory priority.
- The share of qualitative requirements and recommendations accounted for by risks to capital was down relative to the 2022 SREP cycle. The findings with regard to risks to capital relate primarily to capital planning and the preparation of strategy, and to interest rate risk in the banking book (assumptions for measurement, consideration of hidden losses on debt securities measured at amortised cost).
- No requirements or recommendations were issued during the SREP cycle for the business model element, while the requirements and recommendations in the risks to liquidity element addressed deficiencies in the area of the ILAAP.[6]

Figure 5: **Breakdown of qualitative findings by SREP elements in SREP cycles 2021 to 2023**



Source: Banka Slovenije

[6] Internal liquidity adequacy assessment process

Summary

The results of the 2023 SREP cycle reflect the resilience of the Slovenian banking system. The challenges to the banks mainly relate to the macroeconomic environment, digitalisation, which gives banks a competitive advantage but at the same time further exposes them to operational risk and IT risk, the necessity of stabilising profitability over the long term, and, not least, climate risks.