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**Abbreviations:**

AMC	Association of Management Companies
APLRRS	Agency of the Republic of Slovenia for Public Legal Records and Related Services
BH	Brokerage house
BoS	Bank of Slovenia
CCBM	Correspondent Central Banking Model
CCI	Chamber of Commerce and Industry of Slovenia
CEFTA	Central European Free Trade Agreement
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CSCC	Central Securities Clearing Corporation
ECB	European Central Bank
ECBC	European Covered Bond Council
EFAMA	European Funds and Asset Management Association
EFTA	European Free Trade Association
EMF	European Mortgage Federation
EMU	Economic and Monetary Union
EONIA	Euro OverNight Index Average (weighted average interest rate for overnight credit)
ERM II	Exchange Rate Mechanism 2
ESCB	European System of Central Banks
EU10	EU member-states joining in enlargement of 1 May 2004
EU12	Euro area member-states
EU13	EU member-states not in the euro area
EU25	EU member-states
EU3	EU member-states prior to enlargement of 1 May 2004 not in the euro area
EURIBOR	Interbank interest rate at which representative banks in the euro area offer deposits to one another
Eurostat	Statistical Office of the European Communities
Fed	Board of Governors of the Federal Reserve System
HFRS	Housing Fund of the Republic of Slovenia
IC	Investment company
IF	Investment fund
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
ISA	Insurance Supervision Agency
Leaseurope	European Federation of Leasing Company Associations
LSE	Ljubljana Stock Exchange
LTI	Loan-to-income ratio
LTV	Loan-to-value ratio
MCs	Management companies
MF	Mutual fund
NACE	Nomenclature of economic activities
NHSS	National Housing Saving Scheme
OECD	Organisation for Economic Cooperation and Development
OFOs	Other financial organisations
PDII	Pension and Disability Insurance Institute
PID	Authorized Investment Company

PIX	Investment funds index
RICS	Royal Institution of Chartered Surveyors
RTGS	Real-Time Gross Settlement
S&P	Standard and Poor's
SAS	Slovenian Accounting Standards
SBI20	Leading Slovenian stock market index
SCIS	Standard classification of institutional sectors
SIONIA	Slovenian OverNight Index Average (weighted average interest rate for overnight deposits)
SITIBOR	Slovenian interbank interest rate on tolar time deposits as formed on the domestic interbank money market
SLA	Slovenian Leasing Association
SLONEP	Slovenian real estate portal ( <a href="http://www.slonep.net">www.slonep.net</a> )
SLU	Savings and loan undertaking
SMA	Securities Market Agency
SORS	Statistical Office of the Republic of Slovenia
TARS	Tax Administration of the Republic of Slovenia
TUVL	Secondary trading with government securities
VEP	Mutual fund unit price
Vzajemci.com	Portal of Slovenian mutual funds ( <a href="http://www.vzajemci.com">www.vzajemci.com</a> )

## CONCLUSIONS

Macroeconomic and financial stability have allowed Slovenia to complete the process of European integration by joining the euro area on 1 January 2007. The financial stability report examines how stability has been ensured in Slovenia's financial system, and describes the systemic risks that are arising anew or are merely continuing in a more recognisable form.

With interest rates rising, the high growth in bank loans to households is being reflected in increasing indebtedness and a higher burden on income in this sector. As they compete and aim to maintain their high current growth in household loans, banks are lowering their lending standards and offering new forms of long-term loans tied to investment products, such as housing loans with the principal repaid at maturity, and loans tied to the movement of the Swiss franc's exchange rate against the euro. These forms of loan already accounted for one-fifth of all housing loans at the end of last year, and have thus become a significant potential credit risk for banks in the event of a major appreciation in the Swiss franc against the euro in the long-term future. That the household sector began to face problems last year in making regular loan repayments is confirmed by the first deterioration for several years in insurance companies' claims ratios for consumer and housing loans. Nevertheless, the household sector in Slovenia remains less burdened by debt than the household sector in the euro area overall.

The relatively low interest rates on bank deposits mean that households are increasingly turning to alternative forms of saving, which attract higher returns but also incorporate greater market risks. Among the most attractive alternative forms are units in equity mutual funds, in particular those with an investment strategy focusing on the Balkan financial markets. The proportion of assets held in equity funds in Slovenia far exceeds the proportion held in equity mutual funds in the euro area, which is further evidence of the relatively high tendency for Slovenian investors to assume risks.

The high returns on the capital market last year mean that insurance companies were able to successfully compete to attract new financial assets by offering life insurance tied to mutual fund units, the investment risk thus being transferred to a certain extent to the policyholders.

Other factors in the banking sector's good performance last year were the high growth in corporate loans, and the one-off effects of the changeover to the International Financial Reporting Standards (IFRS). Growth in debt at Slovenian companies was nevertheless moderate, primarily as a result of rapid restructuring towards liabilities to the domestic banks. At the same time there was a rapid increase in borrowing by the institutional sectors that already have a high level of financial gearing, and sectors whose performance depends on the business cycle. The favourable economic climate in the context of fierce competition between financial intermediaries is contributing to the potential underestimation of credit risks, which could be realised to a greater extent should economic conditions deteriorate.

If the aforementioned indirect risks to the Slovenian banking system increased in the past year, then the direct risks diminished. Interest-rate risk diminished at banks, in particular the risk of a change in the exchange rate after the introduction of the euro, while the liquidity of the banking system remained at comparable level to 2005. With Slovenian banks joining the single currency zone of the euro area, the banking system's sensitivity to potential liquidity shocks diminished, but as borrowing in the rest of the world increased in the context of relatively low growth in household deposits, the stability of the sources of financing is deteriorating. Estimating the change in credit risk at banks was made more difficult by the effects of the changeover to the IFRS at the beginning of last year. This institutional change brought the release of specific forms of provisions and, to a lesser extent, an increase in bank capital, which had a beneficial impact on capital adequacy, but also led to banks being less conservative when creating impairments for claims.

In addition to the one-off effects of first-time adoption, the changeover to the IFRS in the banking sector last year and in the insurance sector this year will lead to greater variation in profits in both segments of the financial system in the future.

It is estimated that the financial system remains relatively stable, and that its direct exposure to risks has diminished following the introduction of the euro. However, the indirect exposure to risks originating in growing debt and the introduction of new financial instruments is increasing relatively rapidly. While domestic institutional sectors are integrating more and more closely into the international financial environment, it is becoming harder and harder for financial institutions to estimate the exposure of individual subjects to various risks.

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## EXECUTIVE SUMMARY

Financial stability is defined as a situation in which the components of the financial system (financial markets, financial institutions and the financial infrastructure) function without systemic disruptions, and in which each component of the system provides the greatest possible degree of flexibility in responding to any shocks that occur. This operational definition is followed in the structuring of the Financial Stability Report, which, with the aim of identifying potential systemic risks, examines not only financial relationships inside the financial system, but also the financial system's relationships with the corporate sector, the household sector and the rest of the world. The first section gives a clear illustration of the financial claims and liabilities between all the national institutional sectors on the basis of financial accounts. This is followed by a description of financial changes in the household sector and the corporate sector. This is wider-ranging and more precise than in previous financial stability reports, as a result of the increasing transfer of various forms of financial risk outside the financial system. In addition, in their financial decisions the two sectors have an impact on the financial flows with the rest of the world and between domestic intermediaries, which is reflected in individual segments of the financial markets. The core section of the Financial Stability Report consists of an examination of the operations of Slovenian banks and the development of the financial risks to which banks were exposed in the process of changes in the economic environment as a result of Slovenia's preparations for introducing the euro. The same applies to other non-banking financial intermediaries, such as insurers, voluntary supplementary pension providers, investment funds and leasing companies, and to financial infrastructure.

Alongside the favourable economic climate and the gradual rise in interest rates, the growing competition between banks brought a continuous increase in growth in lending to households throughout the period to the middle of 2006, when growth finally stabilised, before declining to a still-high 24.1% by the end of the year. The pace of household borrowing was also a factor in the stagnation of households' total net financial assets. Among households' total financial liabilities, there was prominent growth in borrowing in the form of bank loans and leasing loans. Household debt at banks was at a historical high at the end of 2006, at more than 7.9 times net monthly wages.

In addition to the rise in household debt, which remains low compared with the euro area average, exposure to interest-rate risk is increasing. The proportion of loans with a variable interest rate rose by 10 percentage points last year to 68% of all loans. More than 90% of newly approved housing loans are with a variable interest rate, which is sharply increasing households' sensitivity to a rise in interest rates.

Despite the introduction of the euro and the nullification of household exposure to exchange-rate risk as a result of changes in the tolar's exchange rate against the euro, last year there was a sharp increase in exposure to exchange-rate risk against the Swiss franc. The reason for household borrowing in Swiss francs or the use of loans tied to the Swiss franc was that the Swiss franc Libor was lower than the EURIBOR. At the end of 2006, 21% of the stock of housing loans were tied to the Swiss franc or were in Swiss francs, while the figure was more than 30% among newly approved loans. The banks under majority foreign ownership were the most active in making these offers. The offer was rapidly extended to consumer loans, but the stock of such loans tied to the Swiss franc was still relatively low at the end of 2006. Exposure to exchange-rate risk as a result of the potential appreciation of the Swiss franc against the euro is even more sensitive for households because they do not have any natural hedge against this type of exchange-rate risk. Banks offer households partial protection with the option of a currency swap in return for an appropriate service fee.

The household sector is increasingly exposed to capital risks. Households are assuming full market risks by making investments in investment funds. Investments in life insurance policies tied to mutual fund units are increasingly popular. In the last year households have been able to take out long-term loans where the principal is repaid as a lump sum at maturity, with some of these loans tied to investments in mutual funds from which the debtor's liabilities are to be settled when the loan matures. Banks generally still secure such long-term loans with a mortgage.

With various forms of risk being transferred from households to different segments of the financial system, it remains unknown to each financial institution how much financial risk has already been assumed by an individual, or whether it has been accurately estimated. In general households lack sufficient ability to manage the constantly increasing financial risks that they have assumed in the relatively good economic climate. At the same time the various segments of the financial sector are not aware of how many forms of risk are concentrated among particularly high-risk population groups such as low-income households.

Despite the stagnation in households' net financial assets, the value of real assets in the form of investments in real estate is growing. The transaction prices for housing in Slovenia were up 14.6% in 2006, but with major regional differences in both growth rates and price levels. The sustained rise in housing prices meant that housing became an attractive alternative to financial investments, particularly in central Slovenia. However, given the ratio of house prices to net wages, the housing accessibility index, and the ratio of actual prices to underlying prices, it is estimated that the overpricing of smaller dwellings in the capital increased further last year, which supports the assumption of a gradual slowdown in housing price growth in the future.

In the context of high economic growth based on rising investment demand, corporate demand for financing also increased in 2006. New loans accounted for two-thirds of all financial flows to corporates last year. Growth in Slovenian banks' loans to corporates was relatively high for the second successive year, but again moved in line with growth in nominal GDP in 2006. As a result of equalisation in the terms of lending at home and abroad, and competition between banks, the switch from foreign to domestic sources of financing by corporates continued last year. The high growth in corporate loans does thus not entail an uncontrolled rise in debt, but rather a restructuring towards domestic financial institutions. While year-on-year growth in corporate debt was steady, there was a sharp shift towards domestic banks, which now account for 60% of the total.

Corporate debt is not growing evenly, and is not equally high in all sectors of the economy. In 2005 companies in the sectors of construction and trade were the most indebted, their financial and operating liabilities standing 2.7 times and 1.7 times in excess of their capital respectively. In previous years there was also a rapid deterioration in financial gearing in the hotels and catering sector and at companies in the real estate sector. Performance, and the related increase or decline in the ability to repay debt, are relatively sensitive to the phase of the economic cycle in the majority of these sectors. During the current period of high economic growth the circumstances are favourable, but in a tougher economic climate the burden of loan repayment will be relatively greater for them.

That banks are aware of the increased debt at certain corporates is confirmed by the increase in the risk premium for long-term and short-term risk-bearing loans, which points to banks being more prudent when evaluating credit risk. Last year Slovenian banks' interest rates on euro loans almost entirely equalised with the euro area average rates, displaying a rising trend.

The rising interest rates will bring an increase in corporate expenditure on debt servicing, with 97% of newly approved loans at Slovenian banks carrying a variable interest rate, an increase even from the final quarter of 2005. The figure is only slightly lower for loans taken in the rest of the world.

In 2004 and 2005 the short-term liabilities of Slovenian corporates grew faster than their short-term claims, which reduced the liquidity ratio of the entire corporate sector during these two years. Companies in the hotels and catering sector are most notable for their relatively low liquidity ratios, and a significant deterioration in the last three years.

Should the trend of rising interest rates continue, the trends described in the corporate sector such as an increase in debt ratios, an increase in the proportion of newly approved loans with variable interest rates, and a deterioration in liquidity will lead indirectly to an increase in credit risk for banks and other domestic lenders.

Together with the favourable economic climate and certain institutional changes, the high growth in loans to non-banking sectors brought continuing growth in the banking system's profitability. One factor in the 50% increase in bank profits was a moderate increase in net interest income that came from a restructuring of bank assets from relatively low-yielding investments in securities towards relatively higher-yielding loans, and from interest-bearing assets being higher than interest-bearing liabilities. The process of a decline in the net interest margin also continued in 2006. A more important source in the increase in banks' gross income was the high growth in net trading income. To a great extent this was the result of the valuation of securities at fair value, which will also bring greater variability to banks' profits in the event of larger fluctuations in stock market prices.

The most important factor in higher profitability was the changeover to the IFRS in the accounting practice of Slovenian banks in 2006. In comparison with 2005, there was a sharp decline in provisioning and impairment costs, their proportion in the disposal of gross income almost halving from the average provisioning and impairments created between 2001 and 2005. As a direct consequence of the changeover to the IFRS, provisions declined by 24% on the balance sheet, while there was a simultaneous, slightly lower, increase in bank capital. In addition to the one-off changes in banks' financial statements and performance indicators, the changeover to the IFRS will also be reflected in greater variability in banks' profits.

Analysis of the reasons for the increase in profitability at banks has established that last year predominantly the rising profit margin and to a much lower extent increased risks assumed by banks were factors, while the decline in risk-weighted income and the decline in financial gearing acted to reduce ROE. This ended the period (2003 to 2005) when the reason for increasing profitability was an unfavourable combination of factors, namely an increase in the risk assumed by banks, a simultaneous decline in income per unit of risk-weighted assets, and an increase in financial gearing.

Despite the high growth in loans, growth in the banking system's total assets was just 15%. The reason for the modest growth in total assets is the redemption of Bank of Slovenia bills and the sharp decline in the stock of securities on bank balance sheets. Banks earmarked the money released in this manner for funding lending growth. However, the modest growth in deposits by non-banking sectors meant that the unfavourable trend of a deterioration in the coverage of loans by deposits by non-banking sectors continued. The liabilities of Slovenian banks to foreign banks increased further from 2005, particularly at those banks under majority foreign ownership. This continued the process of an increase in the

banking system's dependence on foreign sources of financing, which for the domestic banks are a less stable resource and are more sensitive to changes in interest rates on international markets than household deposits.

Credit demand remained strong in the good economic climate, but the increase in exposure to credit risk slowed last year. The banking system's diversity of exposure to different institutional sectors also increased. As exposure to manufacturing and trade declined, there was an increase in exposure to the financial intermediation sector and the real estate and business services sector. The highest rates of growth recorded by banks in 2006 were in rated claims against those credit segments and institutional sectors that in the current favourable economic climate are assessed as less risky. This was reflected in the decline in the overall risk of the portfolio, seen via a decline in the coverage of claims by impairments to 3.9% by the end of 2006.

Assessing the movement of credit risk is made more difficult because of the changeover to the IFRS, whereby prudence as the motive for provisioning has been replaced with the creation of impairments on the basis of actual downgradings. Warning that the development of credit risk is not unambiguously beneficial comes from the increase in the coverage of bad claims by impairments and the increase in the proportion of classified claims classed as non-performing to 2.6%. Last year banks continued to reduce their credit standards when approving new loans. According to surveys, banks have increased the share of unsecured loans in their portfolios. While the large banks are relatively conservative in approving new unsecured loans, the small banks and the banks under majority foreign ownership accounted for more than four-fifths of the unsecured loans approved last year.

In 2006 there was also an increase in the number of large exposures, which reached record levels along with the ratio of the total of large exposures to regulatory capital, the burden falling on the small banks in particular.

The banking system's exposure to interest-rate risk as measured by the gap between the average repricing periods for lending rates and deposit rates at the end of 2006 was less than a year earlier at 10.8 months. The gap narrowed further after the introduction of the euro, as a result of greater matching between interest-sensitive assets and liabilities. In the short-term the banking sector is more exposed to a rise in interest rates, with the small banks being the most exposed, and the banks under majority foreign ownership the least exposed. Mismatching between interest-sensitive assets and interest-sensitive liabilities tied to various reference interest rates is increasing. The proportion of assets tied to a reference interest rate is greater than that of liabilities.

The introduction of the euro brought a sharp decline in exchange-rate risk at banks, both directly from their open foreign exchange positions, and indirectly as a result of less exposure to exchange-rate risk in non-banking sectors. Banks primarily held long open foreign exchange positions in the currencies of the former Yugoslav republics, where they hold significant capital investments. The large banks held the longest open foreign exchange positions.

The liquidity of the banking system remained at the favourable level it had been in 2005. The improvement in the liquidity ratios in the first and second categories at the beginning of this year was the result of the change in the Bank of Slovenia regulation. The vulnerability in bank liquidity can be seen in the gradual deterioration in other liquidity indicators from the point of view of the quality of resources and the way in which credit growth is financed. A major feature of Slovenian banks is that they are more dependent on borrowing at banks in the rest of the world than the EU banking system overall.

As a result of the change in risks at banks, which was reflected in relatively high growth in risk-weighted assets and even higher growth in regulatory capital, capital adequacy rose to 11.1% in 2006. Banks more than compensated for the sharp decline in exposure to exchange-rate risk with an increase in exposure to credit risk. Banks thus took advantage of the improved capital adequacy in 2006 as a result of the changeover to the IFRS and changes in the methodology for calculating currency-risk-weighted assets to assume greater credit risk. If banks wish to maintain the level of capital adequacy that they have attained, while growth in loans to non-banking sectors remains high, they will soon need capital injections. This is particularly the case for the small banks, which have a very low capital adequacy compared with the small banks in the EU banking system overall.

The same factors that were behind the improvement in bank performance were responsible for the improvement in the performance of insurers in 2006. The net profits of insurers were up 37% as a result of an improvement in the profits from non-life insurance, and a decline in the losses from health insurance.

In life insurance, which gained in importance in 2006, the trend of an increase in life insurance investments tied to mutual fund units continued. The proportion of life insurance investments in favour of policyholders that assume the investment risk increased to 17.6% last year. In this way insurance companies are offering their clients financial products that are comparable to competing financial investments in terms of expected returns. In competing for higher earned premiums insurance companies are exposing their clients to ever-greater risks with promises of higher returns on life insurance. In the last two years Slovenian insurance companies have expanded their offer of life insurance that includes hedge funds among its investments. Such forms of life insurance investment are more risky in essence than insurance tied to mutual fund units, in which the risk is more or less entirely transferred to the policyholder.

The claims ratio improved last year for all the major types of insurance with the exception of non-life insurance, where there was a minimal deterioration. The claims ratio for credit protection deteriorated sharply. The main factor in this was the deterioration in the claims ratio for consumer loans, which was partly the result of the rise in interest rates and the increase in the burden placed on household income by loan repayments. The ratio of sum insured for credit insurance for housing loans, consumer loans and loans to sole proprietors to household loans almost halved.

The coverage of mathematical provisions with the assets dedicated for that purpose increased by 10 percentage points, but the coverage of other technical provisions with the assets dedicated for that purpose deteriorated by 11 percentage points. The investment risk in non-life insurance increased slightly.

The investment strategy of Slovenian insurers remains relatively conservative, but the proportion of investments with higher returns and higher risks is increasing. Thus last year the proportion of investments in government securities and equities diminished, while the proportion of investments in equities and mutual fund units increased. Insurers are successfully diversifying their investments in terms of region, the proportion of investments in foreign securities having risen to 23%. Investments in equities are increasing insurers' exposure to the capital markets of the former Yugoslavia.

The solvency of the insurance companies and reinsurance companies improved in 2006, as a result of capital injections and the changeover to the IFRS. The changeover to the IFRS in 2007 means that insurers are obliged to eliminate equalisation provisions for all types of insurance other than credit protection, and to disclose them as part of capital. As in the banking sector, the changeover to the IFRS, which do not set out a single methodology for valuing all assets and liabilities, will lead to greater variability in profits in the insurance sector, with profit depending more on current market conditions.

The result of the encouraging conditions on the domestic capital market and the quest for higher returns in investments offering an alternative to bank deposits was an increase of almost 40% in mutual fund assets. Evidence of Slovenian investors' high tolerance of risk is the 60% of mutual fund assets that are invested in equity funds, one-third higher than the European average. Of the Slovenian mutual funds, only the equity funds recorded net inflows in 2006. One-third of inflows into equity funds were invested in the four funds with an investment strategy focusing on the Balkans, which produce above-average returns. The relative popularity of mutual funds among Slovenian investors is the result of inexperience, and the fact that they have not yet experienced an extended recession in the domestic capital market and other capital markets of the former Yugoslavia.

Foreign shares account for 90% of the continuously increasing proportion of foreign investments by mutual funds. Each year there is increasing regional diversification into different capital markets, while the proportion of investments in euro area capital markets is simultaneously declining, which is leading to an increase in exposure to exchange-rate risk.

It is estimated that the financial system remains relatively stable, but with newer forms of risk increasingly being transferred outside the financial sector, indirect exposure is rising. This is particularly the case as certain financial institutions do not know how much and what type of risks individual subjects have assumed via investments in various financial instruments. As these risks primarily accumulate in the corporate sector and household sector during favourable economic times when the majority of financial risks are understated, during an economic downturn the likelihood of the simultaneous realisation of interest-rate, exchange-rate and capital risk is greater. Here it should be borne in mind that the ever-fiercer competition between segments of the financial sector to offer higher returns is increasing the exposure of individual financial institutions to higher-risk regional markets.

At the same time the banking sector and the insurance sector have been faced with the changeover to the IFRS, which, in addition to the one-off effect of the release of certain forms of provisions in the two sectors, also had a longer-term effect of greater variability in profits, with profits becoming more dependent on current economic conditions.

## 1 INTER-SECTOR FINANCIAL CLAIMS AND LIABILITIES

Inter-sector financial claims and liabilities are the basic indicator of the mutual dependence of the institutional sectors of the Slovenian economy, and their level of integration into the international financial environment. The description given in this section reflects the situation in the middle of 2006.

Table 1.1: Inter-sector financial claims and liabilities of sectors of the Slovenian economy as at mid-2006 as percentage of GDP

(% of GDP)	Claims						Total liabilities
	Domestic sectors					Rest of the world	
	Corporates	Financial sector	Government	Households	Total		
<b>Corporates</b>	<b>76.3</b>	<b>60.2</b>	<b>26.7</b>	<b>31.1</b>	<b>194.8</b>	<b>39.8</b>	<b>234.6</b>
Currency and deposits	0.0	0.0	0.0	0.0	0.0	0.0	
Sec. other than shares	0.5	1.2	0.1	0.1	2.0	0.1	
Loans	7.2	47.4	1.0	2.7	58.3	10.5	
Equity	44.0	10.1	21.6	23.8	99.7	18.6	
Other	24.6	1.5	4.1	4.5	34.8	10.5	
<b>Financial sector</b>	<b>18.5</b>	<b>37.2</b>	<b>11.0</b>	<b>56.8</b>	<b>124.5</b>	<b>51.6</b>	<b>176.1</b>
Currency and deposits	10.5	10.6	5.1	40.2	67.4	10.1	
Sec. other than shares	0.8	15.1	0.5	0.1	16.5	1.2	
Loans	0.3	6.1	0.0	0.1	6.6	35.6	
Equity	4.7	4.2	4.3	7.3	20.6	4.0	
Other	2.1	1.1	1.1	9.1	13.4	0.8	
<b>Government</b>	<b>5.5</b>	<b>18.8</b>	<b>13.9</b>	<b>2.0</b>	<b>40.5</b>	<b>8.1</b>	<b>48.6</b>
Currency and deposits	0.0	0.0	0.0	0.1	0.1	0.0	
Sec. other than shares	0.6	16.2	0.9	1.3	19.2	7.1	
Loans	0.3	2.2	2.0	0.0	4.6	0.9	
Equity	0.0	0.0	6.8	0.0	6.8	0.0	
Other	4.6	0.4	4.1	0.6	9.8	0.1	
<b>Households</b>	<b>4.2</b>	<b>20.8</b>	<b>0.7</b>	<b>0.0</b>	<b>25.6</b>	<b>0.3</b>	<b>25.9</b>
Currency and deposits	0.0	0.0	0.0	0.0	0.0	0.0	
Sec. other than shares	0.0	0.0	0.0	0.0	0.0	0.0	
Loans	1.2	19.9	0.2	0.0	21.3	0.2	
Equity	0.0	0.0	0.0	0.0	0.0	0.0	
Other	3.0	0.9	0.5	0.0	4.3	0.1	
<b>Rest of the world</b>	<b>23.5</b>	<b>45.0</b>	<b>3.7</b>	<b>4.3</b>	<b>76.5</b>		<b>76.5</b>
Currency and deposits	0.2	10.6	0.0	2.3	13.2		
Sec. other than shares	0.1	24.2	0.3	0.1	24.7		
Loans	2.0	4.4	0.0	0.0	6.4		
Equity	6.7	4.7	0.5	1.7	13.5		
Other	14.5	1.2	2.9	0.2	18.7		
<b>Total claims</b>	<b>128.0</b>	<b>182.1</b>	<b>56.0</b>	<b>94.3</b>	<b>462.0</b>	<b>99.8</b>	

Note: The table is based on financial accounts compiled by the Bank of Slovenia. The unconsolidated figures have been aggregated and restructured into the form of a matrix with the aim of illustrating the underlying mutual financial ties between the four major domestic sectors and the rest of the world.

Source: Bank of Slovenia

### Households

At 68% of GDP, the surplus of households' financial claims over liabilities was ten times the size of the surpluses of the government and the financial sector, and was therefore vital in covering the corporate sector's deficit of 106% of GDP. Liabilities to the domestic financial sector account for four-fifths of household liabilities, mainly in the form of long-term loans.

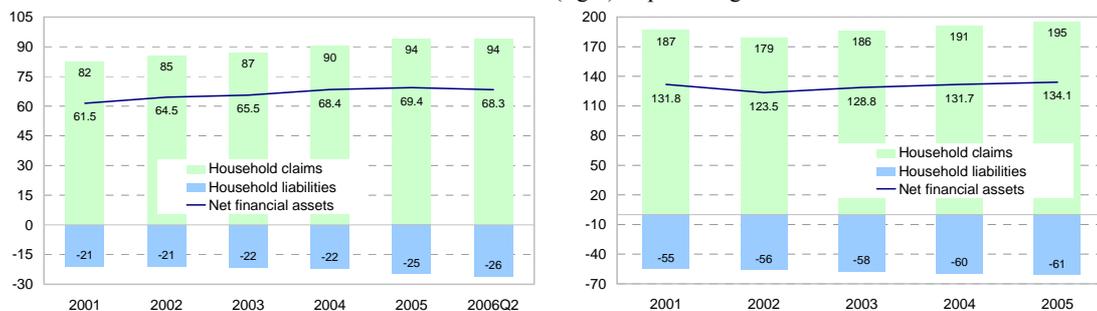
**The household surplus covered two-thirds of the corporate sectors' deficit.**

The household sector is not heavily indebted in comparison with the euro area overall, despite the intensive borrowing during the period of relatively low interest rates. The latter also facilitated a notably high housing ownership rate and a relatively high proportion of real assets. Borrowing in the first half of 2006 meant that households' net



financial assets showed no increase for the first time since 2001. This is in contrast to the household sector in the euro area overall, whose net financial assets have increased since 2002. At the same time the gap between the figures for household financial assets widened, the ratio of household financial assets to GDP in the euro area being double that in Slovenia. Here it should be noted that household real assets increased as a result of rising real estate prices in both Slovenia and the euro area overall.

Figure 1.1: Claims, liabilities and net financial assets of households in Slovenia (left) and the euro area (right) as percentage of GDP



Sources: Bank of Slovenia, Eurostat, SORS

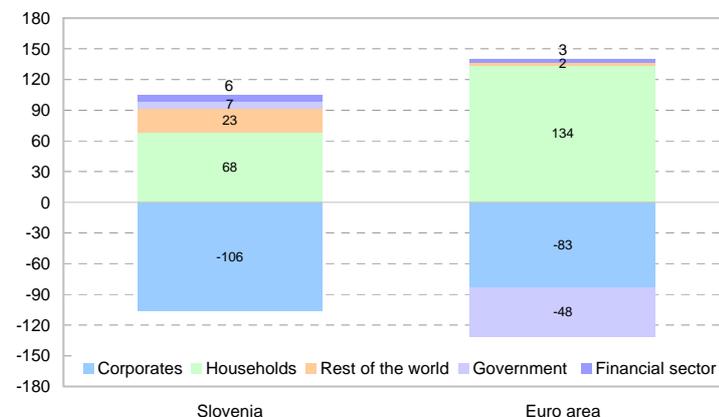
### Corporates

Prevalent among the financial claims of corporates are equity investments within the corporate sector, equivalent to 44% of GDP. At 43%, the proportion of Slovenian corporates' financial assets used on intra-sector equity ties is relatively comparable to the average proportion in the corporate sector in the euro area. The government sector was the most important corporate owner, its total holding in corporates standing at twice the size of that of the financial sector. The two most notable features of corporate debt financing were the domestic financial sector, which accounted for two-thirds of all corporate borrowing, and the negligible importance of debt securities. Equivalent to 40% of GDP, liabilities to the rest of the world were one-half in the form of equity, and one-quarter each in the form of loans, whose importance has gradually diminished, and other forms of financing, which include the financing of merchandise trade.

### Slovenian corporates covered one-fifth of the deficit using foreign resources.

Slovenian corporates covered one-fifth of the deficit using foreign resources. Here they differed from corporates in the euro area, where the financial surpluses of households were sufficient to cover the financial deficit not just of the corporate sector, but also of the government sector.

Figure 1.2: Financial deficit (below the line) and sectoral breakdown of sources to cover the deficit (above the line) in Slovenia (mid-2006) and euro area (2005) as percentage of GDP

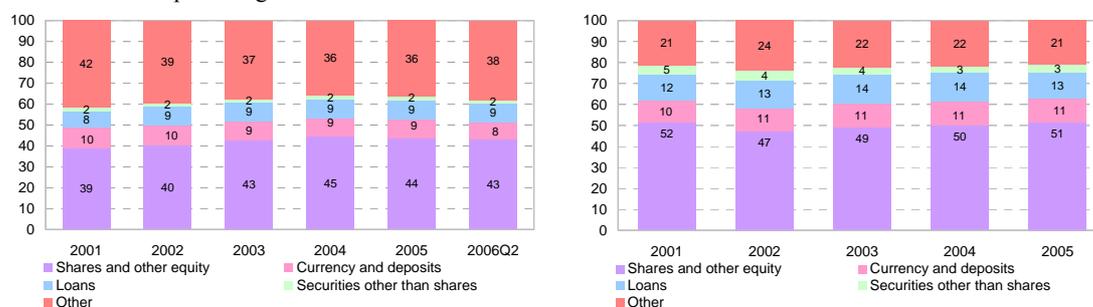


Sources: Bank of Slovenia, Eurostat, SORS

Other claims, which include instruments for financing domestic sales and foreign trade, were prevalent in corporate claims in Slovenia, equivalent to 38% of GDP. This means that Slovenian corporates had to use a larger proportion of their financial assets to

promote sales than did the corporate sector in the euro area overall. In this area the Slovenian financial sector could offer a better variety of financial instruments to replace relatively expensive corporate financial assets.

Figure 1.3: Breakdown of corporate claims in Slovenia (left) and the euro area (right) in percentages



Sources: Bank of Slovenia, Eurostat

### Financial sector

The largest of the financial sector's liabilities were household financial assets, of which the majority, equivalent to 40% of GDP, was in the form of cash and deposits. At the same time household financial assets were an important source of financing for equity in the financial sector, with the financial sector's remaining liabilities in the form of equity being distributed evenly among the government, the rest of the world, and the financial sector itself. The financial sector had the largest liabilities to the rest of the world among all of the domestic sectors. The high and rising proportion of loans among the liabilities is an indication of the decline in direct borrowing in the rest of the world by the Slovenian corporate sector, the domestic financial sector also covering an increasing proportion of its financial needs by borrowing in the rest of the world.

### Government

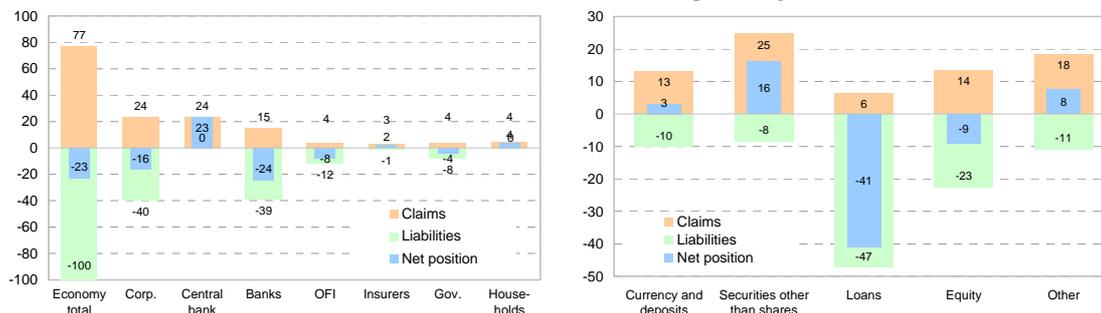
One-half of the domestic liabilities of the government sector, equivalent to 19% of GDP, was in the form of debt securities, mostly long-term, held by domestic financial institutions. Government liabilities to the rest of the world were one-fifth of the sector's domestic liabilities, and were also mostly in the form of long-term debt securities.

### Rest of the world

As in liabilities to the rest of the world, the financial sector was prevalent among the Slovenian economy's claims on the rest of the world, accounting for 60% of the total. The majority of these claims were in the form of long-term debt securities or cash and deposits, as a result of the Bank of Slovenia's foreign exchange reserves and investments by banks and insurers. In its high proportion of claims against the rest of the world in these forms, the financial sector contrasted sharply with the corporate sector, whose prevalent form of claims in the amount of 14% of GDP also consisted of instruments for financing merchandise exports. The majority of the Slovenian economy's net financial deficit consisted of the external debt of commercial banks and leasing companies, with corporate debt standing at one-half of this. The increase in the household sector's claims against the rest of the world partly reflected investments in alternative forms of saving.

**The financial sector's largest claims against the rest of the world were in the form of debt securities, and cash and deposits.**

Figure 1.4: Claims and liabilities vis-à-vis the rest of the world and forms of coverage of the deficit as at mid-2006 as percentage of GDP

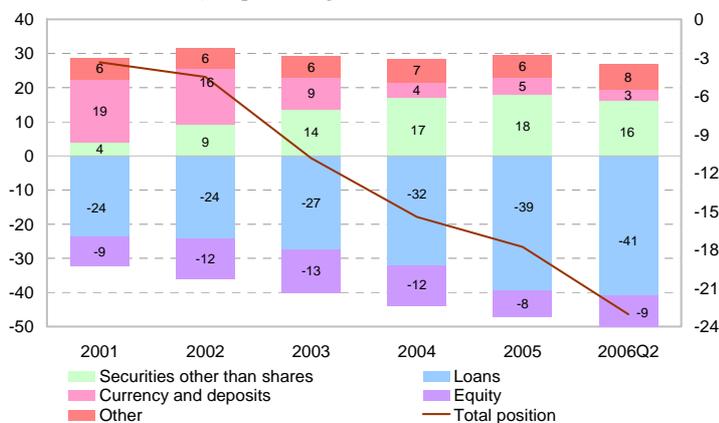


Source: Bank of Slovenia

The household sector is thus borrowing at a fast pace at domestic financial institutions, but transferring part of its financial assets to the rest of the world. In keeping with the sectoral aspects described in the financing of the Slovenian economy's net financial deficit, loans cover the largest proportion, with foreign equity also prominent.

Between 2001 and 2006 the Slovenian economy's net financial deficit against the rest of the world increased by 20 percentage points. The majority of the financial deficit consisted of an ever-increasing stock of loans taken out in the rest of the world, and, after 2003, a decline in net liabilities to the rest of the world in the form of equity. The latter is the result of an increase in equity investments abroad.

Figure 1.5: Netted claims against (below the line) and netted liabilities to (above the line) the rest of the world by financial instrument, and total position (right scale) as percentage of GDP



Source: Bank of Slovenia

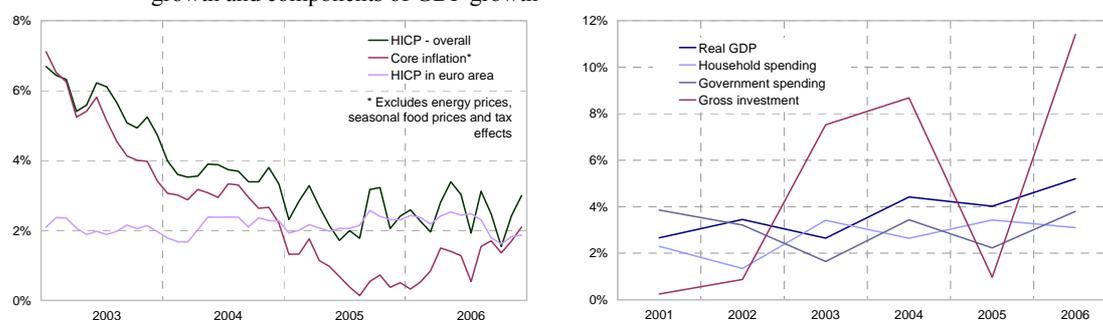
## 2 ECONOMIC TRENDS IN SLOVENIA

### 2.1 Inflation trends and economic growth

Inflation in Slovenia averaged 2.5% in 2006, unchanged from the previous year. Slovenia has constantly met the Maastricht inflation criterion since November 2005. Moderate growth in labour costs and the favourable situation on the labour market were also factors in the low inflation rate. Growth in labour costs remained behind productivity growth in 2006, thus limiting price pressures on the supply side. However, the output gap closed in 2006, having acted to counter inflation in 2005. Although inflation remains settled, there remain medium-term risks owing to the uncertain situation on oil markets and the potential continuation of an increase in surplus aggregate demand. Warning of this comes from the rise in core inflation in the second half of last year and the early part of 2007.

**Average inflation remains low in Slovenia.**

Figure 2.1: Movement of inflation indices in Slovenia and the euro area, and GDP growth and components of GDP growth



Source: Bank of Slovenia

Economic growth in Slovenia rose to 5.2% last year, the highest figure in the last six years. One factor in this was the encouraging performance of other EU economies, which grew faster than had been forecast. The engines of Slovenia's GDP growth in 2006 were export demand in the first half of the year, and domestic demand, investments in particular, in the second half of the year. Growth in final consumption was outstripped by GDP growth. However, there was an increase in the relative contribution made to economic growth by gross investment. There was also high growth in investment in the construction sector, and investment in plant and equipment. The growth was sustainable, helped by the structure of final consumption, with weak household spending and fluid government spending. Slovenia succeeded in maintaining a moderate current account deficit, which stood at 2.6% of GDP in 2006.

**Economic growth in Slovenia increased last year to its highest level since 1999.**

Future economic growth will depend primarily on the climate in Slovenia's most important trade partners, and domestic investment. Further evidence that economic growth can be expected to remain lively comes from the indicator of economic sentiment, which reached a record high in February.

**Economic growth will again depend on the climate in the EU in 2007.**

### 2.2 Country risk

Slovenia's ratings from international agencies have improved for several years in succession. The factors behind the favourable risk assessments are the good economic growth, the fall in inflation to a level meeting the Maastricht criterion, and the moderate size of the current account deficit. Another factor in the favourable ratings is the government's commitment to fiscal prudence, which is reflected in the moderate budget deficit and low government debt.

**Slovenia's country risk rating improved again in 2006.**

Ratings agency S&P upgraded Slovenia again on 16 May 2006, from AA-/A.1+ to AA/A-1+, just over six months before it joined the EMU. Slovenia thus became relatively well-established among the AA countries. In its most recent report, in March 2007, S&P cited

the commitment to fiscal prudence, the good outlook for economic growth and membership of the EMU as the main factors behind Slovenia's good rating. Among the weaknesses it cited were the low wealth level in comparison with the "median AA country", and its sluggishness with regard to economic reforms. The future outlook is stable, and reflects continuing fiscal prudence, solid improvement in competitiveness, and further economic restructuring. However, pressure for a downgrading could arise in the event of a major deterioration in the public finance position. In its long-term rating S&P warns of the challenges related to the ageing of the population and the reform of the pension system.

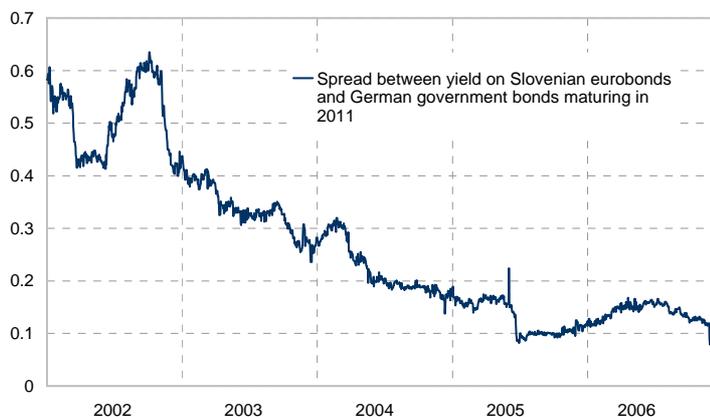
With Slovenia having joined the EMU, and given the level of GDP it has attained, the ratings agency no longer compares it with most of the countries that joined the EU at the same time, but rather with Greece, Portugal, Malta, Cyprus, Spain and Belgium. Slovenia has a lower standard of living compared with these countries, with approximately 60% of the median per capital GDP, but its relative unit labour costs are comparable. Slovenia's fiscal achievements are even better, but are sensitive to factors related to the ageing of the population. Slovenia has a similar or lower rating than the comparable members of the EMU and the small EU countries: Portugal is rated AA/A-1+, Italy A+/A-1+, Greece A/A-1, Belgium AA+/A-1+, and Malta and Cyprus A/A-1+. S&P also emphasises Slovenia's outstanding performance in terms of sustained economic growth and growth in labour productivity. It forecasts economic growth of between 3.5% and 4% in the years ahead.

Similar ratings and conclusions were cited by Moody's, which upgraded Slovenia on 25 July 2006 from Aa3 to Aa2. The agency also awarded positive outlooks, citing management with decades of experience in EU markets, the political consensus over economic decisions, the good results in fiscal policy and the manageability of the debt among the factors improving Slovenia's credit rating. However, the main challenges facing Slovenia were described as cuts in public sector expenditure and social welfare, an improvement in labour market flexibility and labour cost control, and the slow pace of privatisation in the financial sector. Moody's cites the commitment to an incomes policy where growth in real wages remains behind productivity growth and possible measures to reduce the structural government deficit as factors that could lead to a further upgrading. Further declines in the competitiveness of the economy and a deterioration in the fiscal position as a result of demographics and ineffective pension reform could bring a downgrading: without sufficient control of social transfers, the latter would lead to an increase in government debt. Moody's also mentions a possible increase in domestic spending as a result of low interest rates following the introduction of the euro, which could gradually lead to macroeconomic imbalances should economic policy fail to act.

**Slovenia's country risk premium was minimal in 2006.**

A decline in the country risk premium as measured by the spread between yields on Slovenian eurobonds and German government bonds has been present for a long time now. In 2006 the premium fluctuated between 0.10 and 0.15 percentage points.

Figure 2.2: Country risk premium for investments in domestic eurobonds maturing in 2011 (percentage points)



Source: Bank of Slovenia

## 3 HOUSEHOLD SECTOR

### 3.1 Household borrowing

Household consumption slowed in the final quarter of 2006 to take annual growth to 3.3%, down slightly from 2005. The main factor in the decline in household consumption in the final quarter in 2006 was the rise in interest rates on (then foreign currency) loans in euros. Consumption was partly financed by borrowing. Household borrowing has accelerated in the last two years, from average annual growth of 11% between 2002 and 2004, to more than 18% in 2005 and 2006. The ratio of household borrowing to GDP had reached 26.1% by the third quarter of 2006, up 4.3 percentage points from the end of 2004.

**Household financial liabilities reached 26.1% of GDP, primarily as a result of growth in loans taken.**

Households are primarily borrowing by taking loans, mainly at domestic banks. The high growth in loans is being driven by the exceptional demand for housing loans, while growth in consumer loans is relatively moderate. Borrowing at other financial intermediaries is also growing at high rates, particularly in the form of leasing loans.

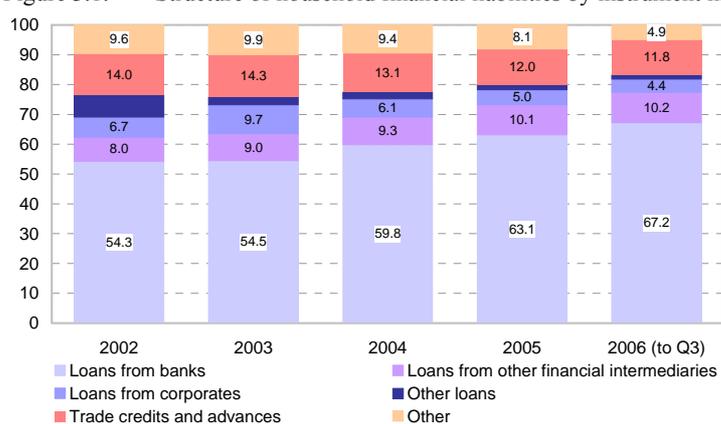
Table 3.1: Stock of household financial liabilities by instrument in EUR million

	2002	2003	2004	2005	2006 <sup>1</sup>
	(EUR million)				
Total	4,680	5,228	5,721	6,776	7,759
Growth rate (%)	11.6	11.7	9.4	18.4	18.2
Loans	3,578	3,964	4,432	5,417	6,459
Corporates	315	509	350	339	342
Banks	2,542	2,849	3,423	4,279	5,216
Other financial intermediaries	376	472	531	684	790
Government	274	64	61	60	55
Rest of the world	71	69	67	54	57
Trade credits and advances	655	746	751	814	918
Other	447	518	537	545	382

Note: <sup>1</sup>Figures for September 2006.

Source: Bank of Slovenia

Figure 3.1: Structure of household financial liabilities by instrument in percentages



Source: Bank of Slovenia

Domestic banks account for 81% of all household loans, up almost 10 percentage points on the figure three years earlier. Borrowing at leasing companies has maintained a stable proportion of 12%, while loans from all other sectors (government, corporate sector, rest of the world) are declining in the breakdown. Corporates have partly relinquished the financing of household purchases via loans and trade credits, transferring it instead to banks, which reduced household debt at the corporate sector by 9 percentage points in the last three years to 16% in 2006.

**Household borrowing at banks**

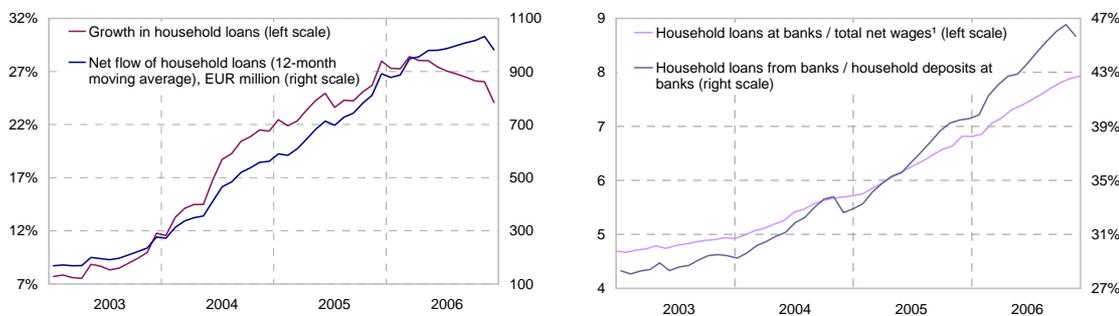
**Growth in household loans stabilised, but household debt is increasing.**

Households borrowed at a growing pace in the first half of 2006, but year-on-year growth stabilised in the second half of the year. Growth in household loans stood at 24.1% at the end of the year. Household debt increased further in 2006, the ratio of household loans at banks to total net wages rising to 7.9, high in excess of the previous value. Housing loans recorded the largest increase, the proportion of total household loans that they account for rising by 2.3 percentage points in 2006 to stand at 37.9% at the end of the year.

**The proportion of loans with a variable interest rate is increasing.**

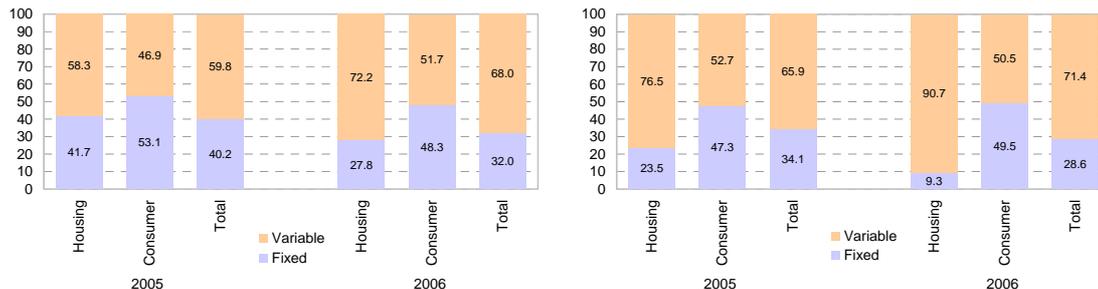
Examining the breakdown of household loans by type of interest rate, the proportion with a variable interest rate is increasing. It stood at 68% of all household loans at the end of 2006, while 71.4% of new loans in the final quarter had a variable interest rate. The vast majority, 90.7%, were new housing loans. This means that households are increasingly exposed to interest-rate risk. Any rise in interest rates will raise their monthly loan instalments, increasing the burden on net wages. This is particularly the case for the low-income households and young families embarking on first-time buying by taking large long-term loans.

Figure 3.2: Net flow of household loans in EUR million, growth in household loans, and household debt at banks



Note: <sup>1</sup>Total net wages are calculated as the 12-month average of the product of the average net wage and the workforce in employment.  
 Source: Bank of Slovenia

Figure 3.3: Structure of household loans by type of interest rate in percentages

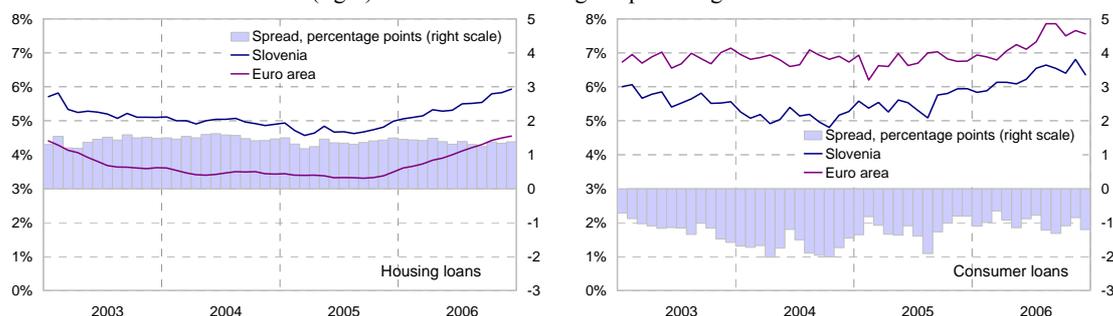


Source: Bank of Slovenia

**The spread between interest rates in Slovenia and the euro area was positive on housing loans, but negative on consumer loans.**

The slow process of nominal convergence in interest rates on household loans continued in 2006. Comparing Slovenian interest rates on household loans with the euro area overall, there were different situations with housing loans and consumer loans. While the average interest rate on housing loans in 2006 was still approximately 1.4 percentage points higher than in the euro area, as in 2005, the interest rate on consumer loans in Slovenia was 1 percentage point lower than the euro area average (compared with 1.2 percentage points in 2005). This trend of convergence in interest rates on household loans was at least partly the result of the relatively low level of integration of bank interest rates in the retail segment in the EU, and could remain in the future.

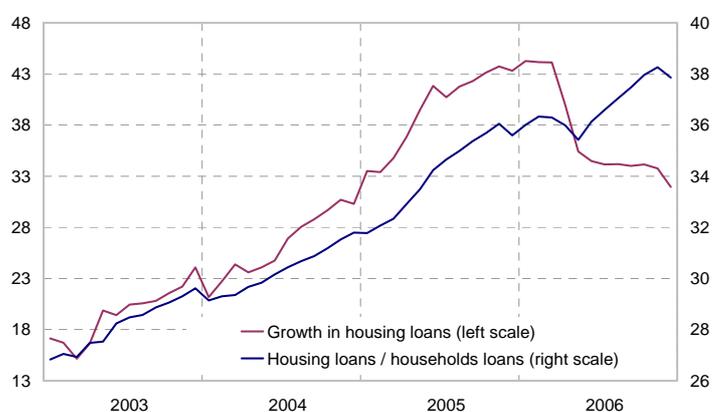
Figure 3.4: Comparison of Slovenian interest rates on housing loans (left) and consumer loans (right) with euro area average in percentages



Note: Includes loans with a contracted interest rate that is variable or fixed for up to 1 year. The figures for Slovenia have been in line with ECB methodology since May 2005, with the previous figures estimated on the basis of reports by eight banks.

Source: Bank of Slovenia

Figure 3.5: Growth in housing loans, and proportion of total household loans accounted for by housing loans in percentages



Source: Bank of Slovenia

As stated previously, there was a significant increase in the stock of housing loans in 2006. At the end of the year 31.9% of the stock of housing loans were tolar loans. The next most common were loans in euros, and loans with a clause tied to the euro. The largest increase, to 20.8%, was recorded by the proportion of housing loans in Swiss francs and with a clause tied to the Swiss franc, this having stood at 12% at the end of 2005. The increase in the proportion tied to the Swiss franc was even more prominent in new housing loans in the final quarter of 2006: 31% of new housing loans were in Swiss francs or with a clause tied to the Swiss franc. The largest proportion of new loans in Swiss francs was recorded by the banks under majority foreign ownership, where 42.5% of new housing loans and 28.8% of all household loans were such. The figures show that the banks under majority foreign ownership are increasingly focusing as well on consumer loans in Swiss francs, their market share for new loans in Swiss francs being higher than that for new housing loans in Swiss francs.

**The proportion of housing loans tied to the Swiss franc is increasing.**

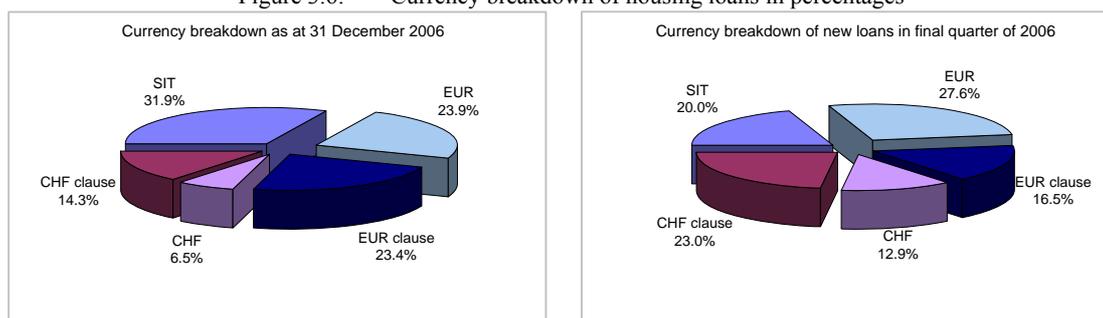
Table 3.2: Proportion of new household loans in Swiss francs as at the end of 2006 in percentages

2006	Proportion of new loans in CHF (%)			
	Housing loans		Household loans	
	Proportion of loans in CHF	Bank group's proportion of total loans	Proportion of loans in CHF	Bank group's proportion of total loans
Large banks	21.9	33.9	6.3	26.2
Small banks	1.1	0.2	0.1	0.1
Banks under majority foreign ownership	42.5	65.9	28.8	73.7
Banking sector	30.9	100.0	13.5	100.0

Source: Bank of Slovenia

The major factor in the higher household demand for Swiss franc loans was the lower interest rates on Swiss franc loans compared with euro loans in recent years, but prudence and risk awareness is still required especially for housing loans and loans with very long maturity. The monetary policy of the Swiss central bank is independent from that of the ECB. In addition, there also needs to be awareness of exchange-rate risk, given that the majority of the borrowers do not have any income in Swiss francs. The movement of the Swiss franc against the euro is less predictable than the movement of the tolar against the euro in recent years. In the event of any global imbalances or shocks on the capital markets, and refuge being sought in safe investments and safe currencies, loans in Swiss francs could become more expensive as a result of appreciation in the Swiss franc.

Figure 3.6: Currency breakdown of housing loans in percentages



Source: Bank of Slovenia

**The average maturity of housing loans is lengthening.**

Banks are bringing greater flexibility to their offers when approving housing loans. They are allowing young borrowers, generally first-time buyers, to take out housing loans over longer terms. Thus more than one-third of the housing loans approved in 2006 had a maturity of more than 20 years. The proportion of housing loans with a maturity of between 5 and 10 years was up 2 percentage points on 2005. These maturities are primarily for those looking to upgrade their housing by purchasing a larger home or by purchasing a home in a more desirable location.

Table 3.3: Maturity breakdown of new housing loans in percentages

(%)	up to 5 years	5 to 10 years	10 to 15 years	15 to 20 years	over 20 years
2003	3.0	19.7	52.8	20.1	4.4
2004	3.2	18.6	46.7	20.8	10.6
2005	2.2	13.0	35.0	24.2	25.6
2006	2.3	15.2	24.6	23.7	34.2

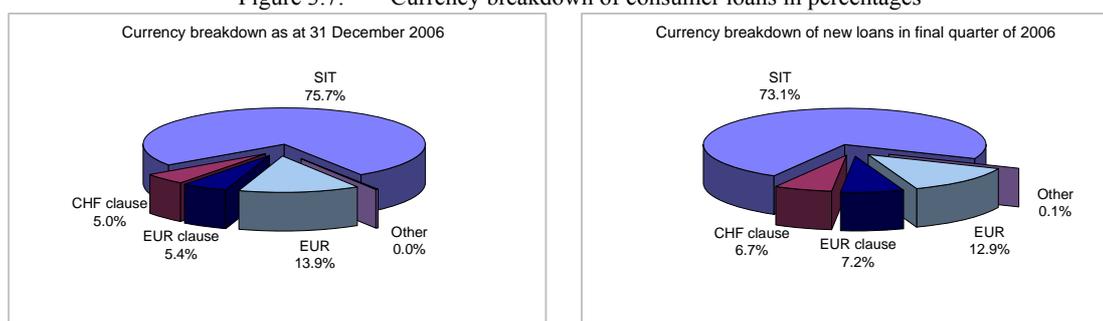
Note: The figures to 2005 relate to loans by the eight largest banks, while the figures for 2006 cover all banks.

Source: Bank of Slovenia

**The majority of consumer loans in 2006 were in tolar.**

Tolar lending prevailed among consumer loans in 2006, accounting for more than 70% of new loans in the final quarter, and more than 70% of the stock at the end of the year. Approximately 20% of consumer loans were in euros or had a clause tied to the euro. In contrast to housing loans, the proportion of consumer loans in Swiss francs or with a clause tied to the Swiss franc was low.

Figure 3.7: Currency breakdown of consumer loans in percentages



Source: Bank of Slovenia

## 3.2 Forms of household financial assets

Household financial assets have grown at more than 10% a year on average in the last four years. The largest proportion of financial assets, albeit declining, consists of household deposits at domestic banks, while a smaller proportion of deposits are held by households in bank accounts abroad. The fastest-growing household holdings are investments in shares and mutual fund units, which have grown by almost 30% on average in each of the last five years. More than one-half of the increase comes from the returns on the funds, the remainder coming from current investments by households. The proportion of household assets held in investment funds has doubled in five years to reach 8.1%.

**The fastest-growing household investments are in shares, in investment funds and insurance.**

Table 3.4: Stock of household financial investments by instrument in EUR million

	2002	2003	2004	2005	2006 <sup>1</sup>
	(EUR million)				
Total	19,104	21,130	23,556	25,755	27,285
Growth rate (%)	15.7	10.6	11.5	9.3	10.8
Cash and deposits <sup>2</sup>	9,485	10,241	11,028	11,918	11,937
Bank deposits	8,454	9,165	9,853	10,415	10,752
Securities other than shares	607	592	741	468	469
Loans	525	619	617	871	831
Shares and other equity	4,990	5,714	6,730	6,860	7,567
Investment fund shares/units	844	905	1,230	1,816	2,220
Life insurance	610	776	1,002	1,069	1,343
Pension insurance	73	106	169	510	605
Other technical reserves	443	546	561	632	660
Other claims	1,527	1,631	1,478	1,610	1,653

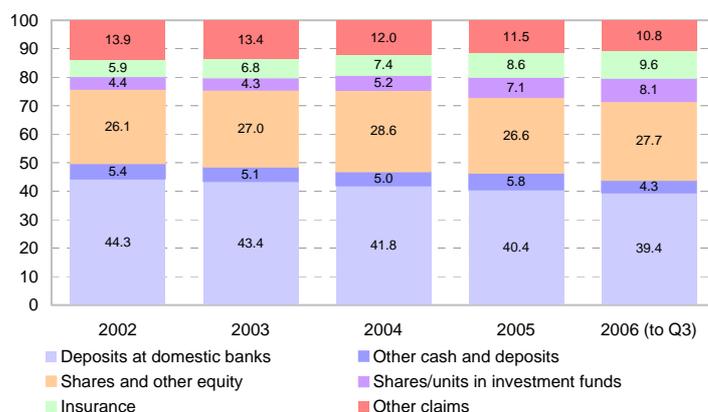
Notes: <sup>1</sup>Figures for September 2006.

<sup>2</sup>Cash and deposits does not include foreign currency holdings that households keep outside the domestic banking system, but does include deposits in accounts in the rest of the world.

Source: Bank of Slovenia

Prime among the other fast-growing forms of household asset are investments in pension insurance and life insurance, the proportion of which increased to just under 10%. Despite rapid growth in the last two years, the proportion of total household investments accounted for by pension and life insurance is still much smaller in Slovenia than in the euro area overall, where at 27% it represents an alternative to bank savings.

Figure 3.8: Structure of household financial investments by instrument in percentages



Source: Bank of Slovenia

Investments in shares and other equity (excluding investment funds) remain stable at approximately 28% of the total. Approximately 80% of increase in this form of asset is the result of valuation changes while the remaining 20% consist of current household investment in corporate shares.

With borrowing increasing faster than investment, net household assets grew more slowly than before 2005, when they recorded double-digit growth. The same trend was also seen in net household assets at domestic banks, where net household investments have also been declining in absolute terms. Until 2003 banks were the main recipients of net household assets, but since then their proportion has been declining rapidly. In the last three years loans from banks have increased at more than three times the pace of bank deposits, and as a result of these movements the stock of net household savings at banks has begun to decline in absolute terms. The ratio of net household investments at banks to GDP declined for the fourth successive year to 19%.

Table 3.5: Stock of net household investments at banks

	2002	2003	2004	2005	2006 <sup>1</sup>
(EUR million)					
Liabilities to banks	2,730	3,032	3,603	4,457	5,249
Growth (%)	10.9	11.0	18.8	23.7	22.5
Investments in banks	8,580	9,270	9,994	10,552	10,899
Growth (%)	13.1	8.0	7.8	5.6	6.0
Net investments	5,850	6,238	6,391	6,095	5,650
As % of GDP	24.7	25.1	24.3	22.1	19.0

Note: <sup>1</sup>Figures for September 2006.

Source: Bank of Slovenia

### Interest rates on household deposits at banks

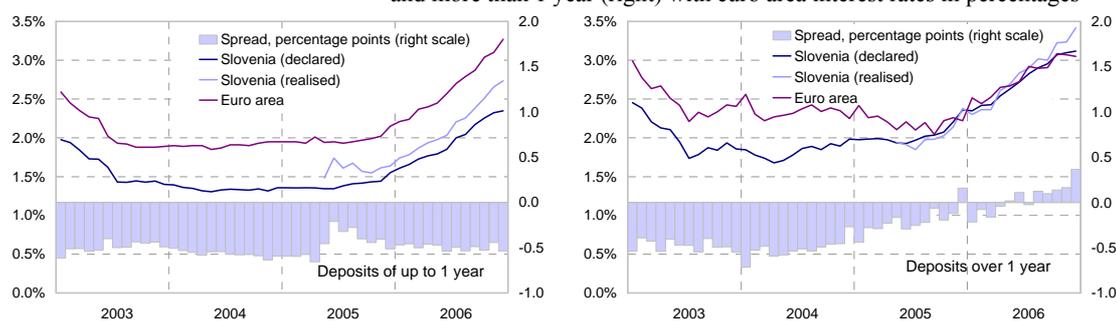
**The spread between interest rates in Slovenia and euro area on short-term deposits remains negative.**

The spread between domestic interest rates and average euro area interest rates on deposits of up to 1 year remained negative in 2006. As in previous years, interest rates in the euro area were higher, finishing 2006 at 3.27%, compared with rates of 2.73% on deposits of up to 1 year in Slovenia.

**Interest rates on long-term deposits in Slovenia surpassed those in the euro area in the second half of 2006.**

There was further convergence in 2006 in interest rates on deposits of more than 1 year. After the spread between domestic interest rates and interest rates in the euro area remained negative, albeit small, in the first half of the year, in the second half of the year interest rates in Slovenia rose above those in the euro area. The positive spread reached its high of 0.37 percentage points in December, when the interest rate on long-term deposits in Slovenia stood at 3.42%. However, despite the rising interest rates being higher than the euro area average, there has been no discernible significant increase in growth in bank deposits. Households are also being encouraged to use alternative forms of saving by the institutional changes already made in pension insurance, and by new alternative forms.

Figure 3.9: Comparison of Slovenian interest rates on deposits of up to 1 year (left) and more than 1 year (right) with euro area interest rates in percentages



Note: The figures for realised interest rates on deposits in Slovenia are from May 2005 only. The spread with the euro area before this date is calculated from declared interest rates.

Source: Bank of Slovenia

## 3.3 Real estate market

**Growth in real estate prices increased in 2006.**

In both 2005 and 2006, the Slovenian real estate market recorded differing dynamics in the residential segment and the commercial segment. Residential real estate prices and the associated bank lending activity grew strongly, as in the majority of European countries. Price growth in the commercial real estate market was slower.

Growth in prices of residential and commercial real estate<sup>1</sup> in Slovenia increased in 2006. Like last year, this year's prices of residential and commercial real estate in the Ljubljana urban region have grown faster than in the rest of Slovenia.

**Measurement of growth in real estate prices in Slovenia using the Fischer index for analytical purposes.**

Table 3.6: Fischer real estate price index, growth rates in percentages

(%)	2005	2006	2006 I	2006 II	2006 III	2006 IV
Slovenia	4.1	8.6	13.6	13.1	16.8	8.6
Ljubljana urban region (SKTE 2)	8.0	12.5	9.0	12.1	14.8	12.5
Rest of Slovenia (SKTE 2)	2.1	7.1	16.5	13.6	17.6	7.1

Sources: TARS, own calculations

There were no signs of a slowdown in prices on the Slovenian housing market in 2006, with growth actually increasing. A similar development could be seen in most European real estate markets, which did not slow after the rise in ECB interest rates. There was still double-digit growth in housing prices in many countries in 2006. There was a slight decline in some countries of euro area that had high growth in 2005, while the majority of the new EU member-states<sup>2</sup> are still recording very high growth in housing prices.<sup>3</sup>

Transactions prices for residential real estate in Slovenia increased by 14.6% on average in 2006. Prices of residential real estate grew fastest in the rest of Slovenia, where prices are lower, and slightly slower in the Ljubljana urban region.<sup>4</sup> Growth in the capital city increased further, despite the high prices, and there was a similar development in its surroundings.

Table 3.7: Year-on-year growth in transaction prices of flats and houses in percentages<sup>5</sup>

(%)	Slovenia	Ljubljana urban region	Ljubljana city	Ljubljana surroundings	Rest of Slovenia	Euro area <sup>1</sup>
2005	10.8	9.7	10.9	6.5	11.5	7.8
2006	14.6	13.1	13.8	11.2	15.4	7.0

Note: <sup>1</sup> Figures for 2006 are second quarter.

Sources: TARS, Bank of Slovenia, ECB

Table 3.8: Regional differences in housing prices<sup>6</sup>

	Slovenia	Ljubljana urban region	Ljubljana city	Ljubljana surroundings	Rest of Slovenia
2004	100.0	141.5	150.4	104.4	75.2
2005	100.0	146.0	155.4	108.5	74.8
2006	100.0	143.0	152.2	107.5	74.8

Sources: TARS, Bank of Slovenia

The regional differences in housing price levels declined slightly in 2006, but remain large. The average housing price in Ljubljana exceeded the average price in Slovenia by 52%, while the average price in the rest of Slovenia was just 75% of the national average.

**The regional differences in housing price levels declined slightly, but remain large.**

<sup>1</sup> Real estate price index: in 2005 the Bank of Slovenia began calculating an index of real estate prices for analytical purposes based on figures for real estate transactions. The index includes transactions on the secondary market in flats, houses, holiday homes, office premises and parking garages. The index is calculated in the form of a Fischer ideal index, which takes symmetrical consideration of prices and quantities in the two periods, viz. the period being compared and the comparison period. The figures are reviewed before the index is calculated, with illogical records being deleted using data investigation methods. For a detailed calculation, see Kompnej, Jeran: Real estate price index, 15<sup>th</sup> Days of Statistics, Collection, SORS, 2005.

<sup>2</sup> Poland, Bulgaria, Estonia, Lithuania, Romania, Malta.

<sup>3</sup> European Housing Review 2007, RICS Research, 2007.

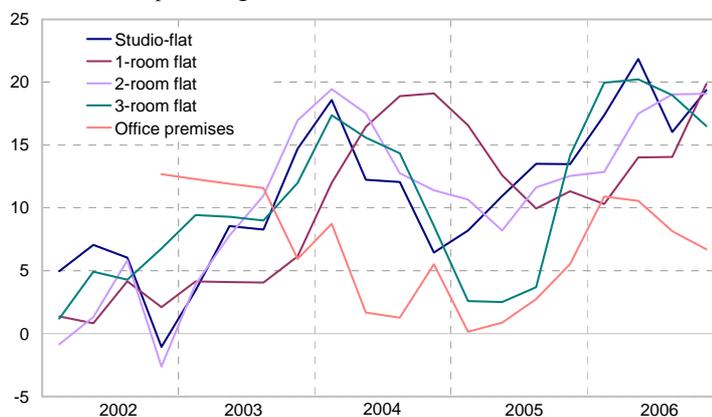
<sup>4</sup> Growth in prices in the overall real estate market as measured by the Fischer index was highest in the Ljubljana urban region, as a result of prices of office premises in the region growing faster than in the rest of Slovenia.

<sup>5</sup> The geographical breakdown of transaction prices of housing was made in line with level 2 statistical regions (SKTE 2), where the Ljubljana urban region is the same as the Central Slovenia level 3 region, and the rest of Slovenia comprises the 11 other level 3 regions. The Ljubljana urban region is then further divided into the city of Ljubljana, and the surroundings.

<sup>6</sup> The regional differences in price levels are calculated from the weighted average transaction prices in each quarter.

Growth in advertised housing prices in Ljubljana approached 20%, with the exception of 3-room flats. Growth in prices of office premises did not increase significantly. The difference between advertised housing prices and transaction prices in Ljubljana increased slightly in 2006.

Figure 3.10: Year-on-year growth in advertised real estate prices<sup>7</sup> in Ljubljana in percentages

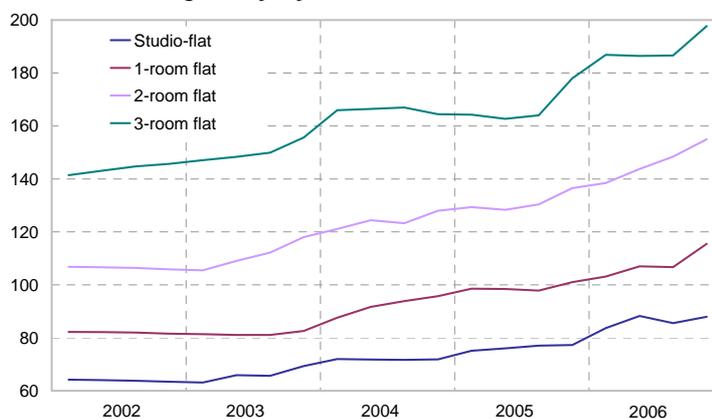


Sources: SLONEP, own calculations

### Price sustainability

The sustainability of housing prices depends on the ratio of actual prices to fundamental prices, i.e. the prices justified on economic and institutional grounds. Three indicators of the sustainability of prices in the real estate market in Ljubljana<sup>8</sup> are illustrated, the ratio of housing prices to the moving average of net monthly wages, the housing affordability index, and the ratio of housing prices to rents, based on which the fundamental housing price has been calculated.

Figure 3.11: Ratio of housing prices in Ljubljana to 12-month moving average of net wages in Ljubljana<sup>9</sup>



Sources: SLONEP, SORS, own calculations

### Housing affordability as the ratio of prices to net wages.

Housing affordability calculated as the ratio of housing prices in Ljubljana to the annual moving average of net monthly wages declined further in 2006. At the end of 2006 purchasing a studio-flat required 11.2 more average net monthly wages than a year earlier,

<sup>7</sup> Office prices in Ljubljana were used to calculate the growth rate.

<sup>8</sup> Due to limited data availability the calculations have been made solely for Ljubljana. Based on these indicators alone, there can be no talk of a price bubble in the real estate market. In interpreting these indicators, there should also be an awareness of the limitations related to the quality of the figures for advertised prices and housing rents.

<sup>9</sup> In calculating the ratio of housing prices to average monthly wages, advertised housing prices were reduced by 10%. Those involved in the real estate market estimate that advertised prices are 10% to 15% higher than actual prices. The gap varies from month to month, for which reason the calculated affordability can also differ from the actual affordability.

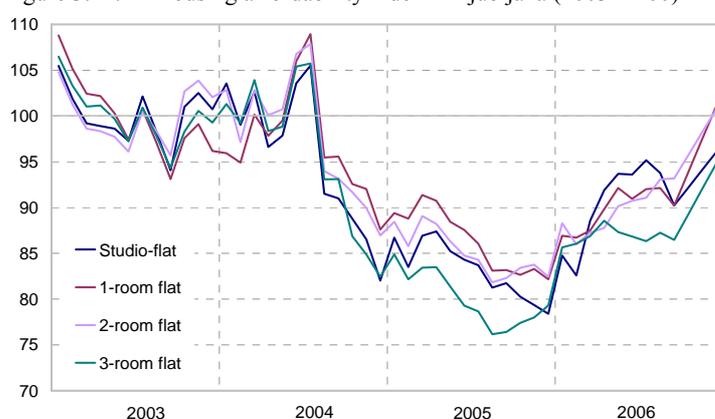
a 1-room flat 15.1 more, a 2-room flat 19.4 more, and a 3-room flat 20.9 more. In relative terms, the largest declines in affordability were recorded by 1-room flat and studio-flats.

**Box 3.1: Housing affordability index**

In addition to household income, the terms of financing the purchase of real estate also have an impact on housing affordability. The housing affordability index as an indicator of current affordability of housing also takes the movement of interest rates and the average term of new loans into consideration alongside household income. It is assumed in the calculation that the full value of the real estate is financed via a housing loan from a bank.<sup>1</sup> In the calculation of the index, the monthly annuity for a loan in the amount of housing value is first computed on the basis of the interest rates and weighted average maturity of new housing loans. The next step is to calculate the ratio of the monthly annuity to the 12-month moving average of net monthly wages in Ljubljana, from which the basic index is then calculated. A rise in the index indicates a decline in housing affordability.

<sup>1</sup> The LTV ratio at Slovenian banks was below 100% in 2006, which requires buyers to invest their own money when purchasing real estate.

Figure 3.12: Housing affordability index in Ljubljana (2003 = 100)



Sources: SLONEP, Bank of Slovenia, SORS, own calculations

However, the actual decline in housing affordability in Ljubljana in the last four years was not as drastic as indicated by the ratio of housing prices to net wages, particularly if the conditions on the housing loan market are taken into consideration alongside real estate prices and net monthly wages when affordability is measured. Housing affordability as measured by the housing affordability index was increasing until the end of 2005 as a result of declining interest rates and, above all, the lengthening of the average maturity of new housing loans. Housing affordability in Ljubljana began to decline in 2006 as a result of rising interest rates. The higher growth in prices was no longer compensated for by the rapid lengthening of the average maturity of new housing loans, which showed no significant change in 2006.

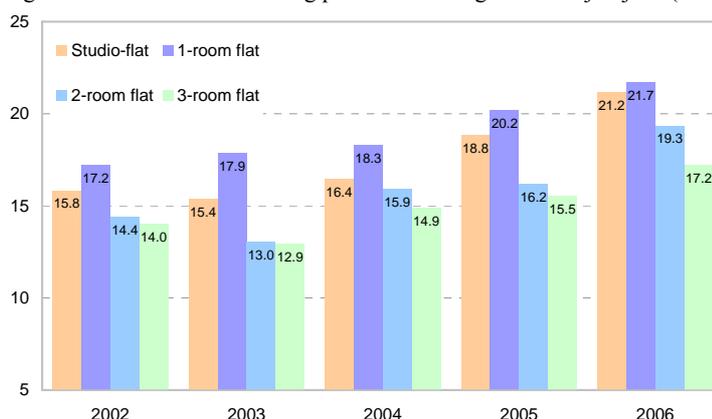
The ratio of the monthly housing loan annuity to the average net monthly wage, which is included in the calculation of the housing affordability index, increased by between 19.5% and 23%, depending on the size of the flat. However, it remains lower than at the beginning of 2003 for all sizes of flats.

Growth in housing rents in Ljubljana was outstripped by growth in housing prices last year, as well as in the previous years. The ratio of housing prices to housing rents in Ljubljana increased.

**Housing affordability index.**

**Ratio of prices to rents.**

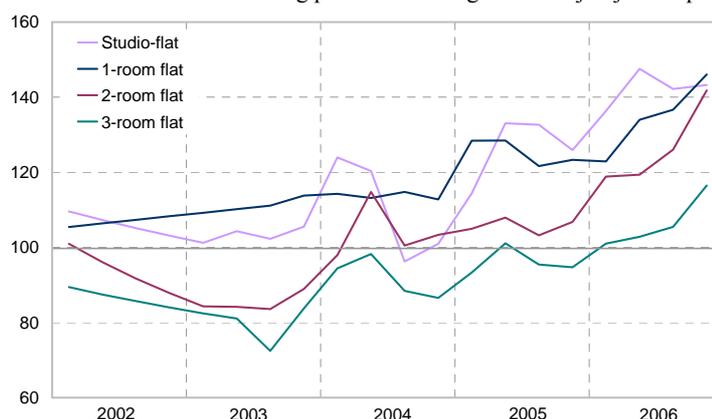
Figure 3.13: Ratio of housing prices to housing rents in Ljubljana (P/E)<sup>10</sup>



Sources: SLONEP, own calculations

The actual prices of smaller flats have exceeded the fundamental prices for several years now. The gap widened in 2006, particularly for 2-room flats. The actual prices of larger flats were slightly in excess of the fundamental price in the second half of 2006.<sup>11</sup>

Figure 3.14: Ratio of actual prices to fundamental prices calculated on the basis of the ratio of housing prices to housing rents in Ljubljana in percentages



Sources: SLONEP, own calculations

**The P/E ratio indicates that studio-flats, 1-room and 2-room flats in Ljubljana are overpriced.**

On the basis of the ratio of housing prices to net wages, the housing affordability index and the ratio of actual prices to fundamental prices, it is estimated that the studio-flats and 1-room flats in Ljubljana became more overpriced in 2006. 2-room flats were also overpriced in 2006 according to the P/E ratio.

#### Factors in real estate prices

Imbalances between supply and demand on the real estate market continued in 2006. It is the supply of housing, which is delayed in adjusting to demand in the housing market, that is the main factor in the high growth of housing in recent years. Despite the response in supply to rising real estate prices, the number of new dwellings is insufficient to meet the excessive demand.

<sup>10</sup> The calculation of fundamental housing prices on the basis of the ratio of housing prices to housing rents (P/E) takes into consideration the average P/E value between 1995 and 2003, with fundamental prices for 2002 to 2006 being calculated from figures for rents.

<sup>11</sup> A more accurate calculation of the fundamental price would require the calculation of the average P/E ratio over a longer, more stable period of at least 10 or 15 years. The short time in which the Slovenian housing market has functioned normally makes this impossible. These limitations must be borne in mind when interpreting the results, although over a longer timeframe a lower average P/E ratio would be anticipated, and housing would appear to be even more overpriced according to this indicator.

### Supply-side factors

In recent years supply has begun to respond to higher housing prices. This is clear from the higher growth in gross investment in residential buildings, which reached 17.2% in 2006, the increase of 6.1% in the value of construction put in place on residential buildings, and the increase of 18.3% in the number of building permits issued for housing in 2006. According to a bank survey, there was an increase in demand for loans to finance construction of residential buildings in 2006.

**Response in supply to higher housing prices.**

Growth in the construction costs, excluding land costs, outstripped inflation in recent years, but was significantly lower than growth in housing prices. The construction costs contributed to growth in housing prices, but were a less important factor in price movements. The main factors in housing prices, alongside demand, were land costs, utilities costs, and the costs of financing projects until construction begins, as the procedures for obtaining building permits can be very lengthy.<sup>12</sup> Shortening the administrative procedures and increasing the availability of land with building permissions are the keys to expanding housebuilding and slowing housing price growth.

**Growth in construction costs of new housing.**

Table 3.9: Completed dwellings, building permits issued and gross investment in housing

	2001	2002	2003	2004	2005	2006
Estimate of housing stock						
Number of dwellings <sup>1</sup>	722,924	730,064	736,420	743,133	750,355	
Number of dwellings per 1,000 inhabitants	363	366	369	372	375	
Completions including extensions and change of purpose						
Number of new dwellings	6,715	7,265	6,567	7,004	7,516	
Number of new dwellings per 1,000 inhabitants	3.37	3.64	3.29	3.51	3.80	
Floor area (m <sup>2</sup> )	778,817	824,608	746,517	761,430	807,607	
Building permits issued						
Number of dwellings	5,168	5,080	6,122	7,002	7,235	8,558
Floor area (m <sup>2</sup> )	606,262	597,366	711,385	793,200	880,751	1,027,152
Growth rate (%)						
Gross investment in residential buildings	7.0	8.5	-8.0	15.7	20.5	17.2
Value of construction put in place on residential buildings	17.7	-8.9	-7.5	67.4	23.7	6.1
Growth rate (%)						
Construction costs - new housing <sup>2</sup>	6.0	4.5	6.6	11.7	3.0	4.6
Material costs				14.7	1.0	5.5
Labour costs				4.4	8.4	2.5

Notes: <sup>1</sup>The housing stock includes occupied and temporarily unoccupied dwellings for permanent use.

<sup>2</sup>Costs of construction, fittings and installation work on new dwellings, excluding land costs.

Sources: SORS, own calculations

The size of the existing housing stock is another important factor in the supply of housing. There were 375 dwellings per 1,000 inhabitants in Slovenia at the end of 2005, well below the average figure in the EU15 in 2002 of 490.<sup>13</sup> The number of new dwellings per 1,000 inhabitants increased in 2004 and 2005, but is still significantly below the level in the majority of the EU15. In addition to a lack of housing, Slovenia also faces a structural imbalance. According to the 2002 Census, more than 40% of households were living in housing of the wrong size.<sup>14</sup>

The Housing Fund of the Republic of Slovenia (HFRS) is trying to influence the supply of housing. It sells housing at prices below the market price, thus trying to create a price anchor, but the number of such dwellings is too small for it to have a discernible effect on market prices.

<sup>12</sup> According to the constructors and investors, in the worst case they can take as long as five years.

<sup>13</sup> Housing Statistics in the European Union 2004, 2005, and own calculations.

<sup>14</sup> Sendi, Richard, Critical Housing Shortage Under Circumstances of a Surplus Existing Dwelling Stock, ENHR Conference, University of Cambridge, 2004.

### Demand-side factors

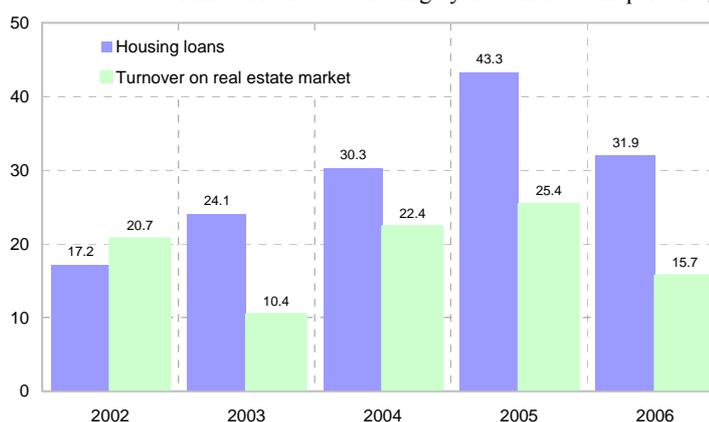
The real growth in net wages continued to have a beneficial impact on the demand for housing and housing loans.

#### Increase in interest rates on housing loans.

Interest rates on housing loans began to rise in 2006, but the average maturity of new housing loans remained at 15.3 years.<sup>15</sup> This was reflected in reduced affordability of housing loans, which should reduce the demand for housing if all other factors remain unchanged.

The rise in the ECB's interest rates was not fully reflected in an increase in interest rates on housing loans, owing to which their impact on the housing market was limited. While the ECB was raising its interest rates by 150 basis points, interest rates on foreign currency housing loans in Slovenia tied to the Euribor rose by just 93 basis points. There was a similar trend on the European mortgage loan markets, where interest rates on mortgage loans rose by significantly less than the ECB's rates. The main reasons for this development in Europe are the increased competition on mortgage loan markets, which has expanded the range of products available and has forced lenders into greater efficiency,<sup>16</sup> and the delay in the pass-through of changes in central bank interest rates into lending rates. The spread between Slovenian interest rates on housing loans and interest rates in the euro area remains, and averaged 1.4 percentage points in 2006.

Figure 3.15: Year-on-year growth in the stock of housing loans, and growth in the volume of real estate trading by households<sup>17</sup> in percentages



Sources: Bank of Slovenia, TARS, own calculations

#### Growth in housing loans remains high.

Lending on the housing loan market remains lively. The high growth in the stock of housing loans in recent years, which given the low stock of housing loans (just 3% of GDP at the end of 2003) was also the result of convergence, declined in 2006 to a still-high 31.9%. The stock of housing loans remains relatively low at the equivalent of 6.4% of GDP, particularly in comparison with the EU15, where the stock of mortgage loans stood at 48.9% of GDP at the end of 2005.<sup>18</sup>

The mortgage loan markets in the euro area remained very lively in 2006. In eight countries growth in mortgage loans exceeded 10%. The highest growth in mortgage loans was recorded by Greece, Ireland and Spain.<sup>19</sup> In Greece, where the stock of mortgage loans is still relatively low (equivalent to 25.1% of GDP at the end of 2005), year-on-year growth in mortgage loans stood at 30% at the end of the third quarter of 2006. Growth in mortgage loans in some of the new member-states at the end of the third quarter of 2006

<sup>15</sup> There was no significant lengthening of the average maturity of newly approved housing loans in Slovenia between the end of 2005 and the end of 2006, although the average term of all new loans in 2006 was approximately 1.3 years longer than that in 2005.

<sup>16</sup> Mercer, Oliver Wyman, European mortgage markets - 2006 adjusted price analysis, 2007.

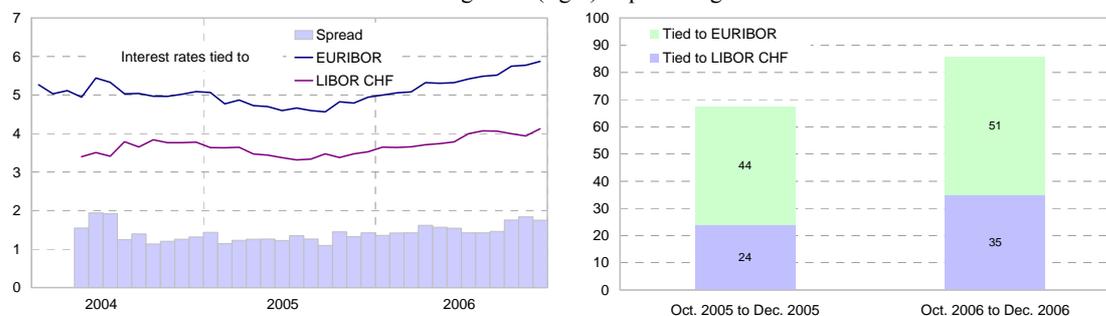
<sup>17</sup> Turnover on real estate market is estimated on the basis of data on the 2% real estate sales tax payments when the taxpayer is an individual. It is the seller of the real estate that usually pays the tax. Sales of new real estate are not included. Henceforth the trading volume in real estate refers to the volume generated by households.

<sup>18</sup> European Mortgage Federation.

<sup>19</sup> European housing review 2007, Executive summary, RICS Research, 2007.

was significantly higher than in Slovenia, even though the ratio of housing loans to GDP was higher than in Slovenia at the end of 2005.<sup>20</sup> On European housing markets there has recently been an extension in the average maturity of new housing loans, which has allowed borrowers access to loans with lower monthly repayments.<sup>21</sup>

Figure 3.16: Interest rates on foreign currency housing loans (left) and prevailing forms of remuneration on new housing loans (right) in percentages



Source: Bank of Slovenia

The amount of newly approved housing loans increased by 22% last year.<sup>22</sup> The Slovenian banking system approved EUR 818.8 million of housing loans in 2006, equivalent to 52.5% of the estimated trading volume recorded by households on the secondary real estate market. Growth in newly approved housing loans was also related to household expectations of further growth in housing prices, with households aiming to resolve their housing problems before the anticipated rise in VAT on new housing.

**Increase of 22% in newly approved housing loans.**

The proportion of newly approved housing loans tied to the LIBOR CHF is rising, as a result of lower interest rates. In loans in Swiss francs households are exposed to exchange-rate risk in addition to interest-rate risk, as they do not have income in Swiss francs.

**Increase in the proportion of housing loans tied to the Swiss franc.**

Rented housing is usually the alternative to owner-occupation. In Slovenia the rental market is so small that renting is not a genuine alternative to buying in resolving the housing problem. According to the most recent figures from the 2005 Housing Survey, Slovenia has one of the lowest rental rates in Europe, with just 9% of housing rented.

Demand from non-residents is another factor in real estate prices. The number of purchases by non-residents is increasing, the majority of these being recorded by the tax offices in Koper, Murska Sobota, Kranj and Nova Gorica, with relatively few at the Ljubljana tax office. According to real estate agents and dealers, non-residents primarily purchase older houses, land and apartments in tourist areas. They have a negligible impact on the housing market in Ljubljana and the other major towns.

**The proportion of non-resident real estate purchasers is increasing.**

Table 3.10: Proportion of real estate purchases by non-residents recorded by tax offices in percentages<sup>23</sup>

(%)	Celje	Koper	Kranj	Ljubljana	Maribor	Murska Sobota	Nova Gorica	Other	Total
Jul. - Dec. 2004	3.4	9.5	4.6	0.7	1.3	19.3	6.4	2.5	3.7
2005	2.3	6.5	6.0	0.8	1.6	15.3	15.0	3.6	3.9
2006	3.3	9.9	4.1	0.7	1.0	16.4	19.1	4.0	4.2

Source: TARS

<sup>20</sup> Over 50% in Poland (6% of GDP), over 65% in Estonia (24.8% of GDP), over 70% in Lithuania (11% of GDP) and over 75% in Latvia (19.6% of GDP). Source: European Mortgage Federation.

<sup>21</sup> European Mortgage Federation Mortgage Info, January 2007.

<sup>22</sup> The availability of figures for the entire banking system means that only housing loans approved between May and December have been included in the calculation of growth.

<sup>23</sup> All purchases by non-residents have been included in the numerator, irrespective of the type of real estate, while the denominator includes all purchases of flats, houses and holiday homes recorded by the individual tax offices in the relevant period.

**Institutional factors in real estate prices****The anticipated rise in VAT is unlikely to apply to the majority of new dwellings.**

A major factor in the rise in prices was the anticipated rise in the VAT rate on new housing from 8.5% to 20% in 2008,<sup>24</sup> which will probably not happen. Households were already partly anticipating an increase in prices of new housing in 2005 and 2006, which was also reflected in growth in prices of old housing. The Slovenian government needs to obtain the approval of all 27 member-states and the European Commission in order to extend the transition period of reduced VAT on new housing not deemed part of social policy. Should the government fail to do so, it has announced that new apartments in blocks with floorspace of no more than 120 m<sup>2</sup> and single apartments and houses with floorspace of no more than 250 m<sup>2</sup> will be defined as part of social policy, and will continue to be taxed at the reduced VAT rate.<sup>25</sup> Defining housing that is part of social policy is in the power of the individual member-states.

The Slovenian tax system became less encouraging to housing ownership in 2007. New tax legislation abolished the tax relief on the purchase of housing,<sup>26</sup> and equalised the taxation of capital gains from the disposal of housing in which the owner was not permanently resident with the taxation of other capital gains.<sup>27</sup> Capital gains from the disposal of housing remain exempt from tax, if the owner has registered the housing as his or her permanent residence for three years.

In 2006 there was considerable public attention given to the anticipated introduction of a real estate tax, which at the appropriate tax rate should help to reduce the structural imbalances in the real estate market, narrowing the gap between supply and demand. The introduction of a real estate tax, and its beneficial effect in eliminating imbalances on the real estate market, has been postponed. According to the Ministry of Finance, no bill is expected to be drafted in the next two years.

February 2006 saw the entry into force of the Mortgage Bond and Municipal Bond Act, with secondary legislation also being passed, but for the moment no bank has asked for Bank of Slovenia approval for issuing mortgage bonds or municipal bonds.

The period when changes in the general terms of housing loans, declining interest rates and lengthening average maturity had a key impact on the movement of housing prices has come to an end, as was evidenced in 2006. The range of products on the housing loan market, with the exception of mortgage banking, has become comparable to that in the euro area overall. Rising interest rates will affect price dynamics, but a moderate rise in interest rates could still be compensated for by lengthening the maturity of housing loans. It is above all supply on the housing market that will be the key determinant of price movements. The current rate of growth in housing prices is not sustainable in the long term, although we estimate that there is no danger of a sudden fall in prices. In the event of VAT on new housing remaining at the low rate, as seems very likely, there could be a temporary halt in price growth, as expectations of a rise in VAT to 20% have already been included in the current pricing of old housing. In the long term a slowdown in growth depends primarily on shorter administrative procedures and wider availability of land with planning permission, which will increase construction of residential buildings.

**Purchase of housing as an alternative to financial investments****Return on investment in housing.**

Higher growth in housing prices last year meant that the capital gains made from the purchase of housing increased significantly. Purchasing housing, particularly in central

<sup>24</sup> VAT Act (Official Gazette of the Republic of Slovenia, No. 117/2006); Council Directive 2006/112/EC.

<sup>25</sup> Ministry of Finance: press release ([http://www.gov.si/mf/slov/mediji/2007/2007-04-23\\_2.htm](http://www.gov.si/mf/slov/mediji/2007/2007-04-23_2.htm)), 23 April 2007.

<sup>26</sup> Until the end of 2006 any purchaser of housing had 15 years from the time of purchase to claim tax relief on the amounts paid with the aim of resolving housing problems. The amounts included the purchaser's own funds, and the principal and interest of a housing loan. The maximum relief was 4% of the taxpayer's annual taxable base. In addition, the owner of a flat or house was given a further reduction of up to 2% in the taxable base as part of general tax relief for payments related to housing maintenance.

<sup>27</sup> Under the new tax legislation, the tax rate on capital gains is 20% for real estate disposed of within five years, 15% for real estate disposed of after five years, 10% for real estate disposed of after 10 years, 5% for real estate disposed of after 15 years, and 0% for real estate disposed of after 20 years.

Slovenia, remains a very attractive alternative to financial investments, despite the extension of the period after which sales of real estate are exempted from capital gains tax from 10 years to 20 years. After a long period of rising housing prices, households regard the purchase of housing as a very secure form of long-term “saving”, with good returns.

Table 3.11: Return<sup>28</sup> on investments in housing in Ljubljana after loan repayment, and comparison of return on investments in housing with other forms of financial investment<sup>29</sup> in percentages

(%)	Purchase of housing with loan tied to the euro	Investing own funds			
		Housing	Capital market indices		Deposit rate <sup>1</sup>
			SBI20	VEP MF	
2003	19.3	30.1	17.7	17.1	7.8
2004	11.9	19.6	24.7	17.8	4.5
2005	14.0	18.9	-5.6	7.2	3.3
2006	19.2	24.7	37.9	18.8	2.8
Average annual return					
2003 - 2006	10.1	21.5	17.6	15.2	4.6

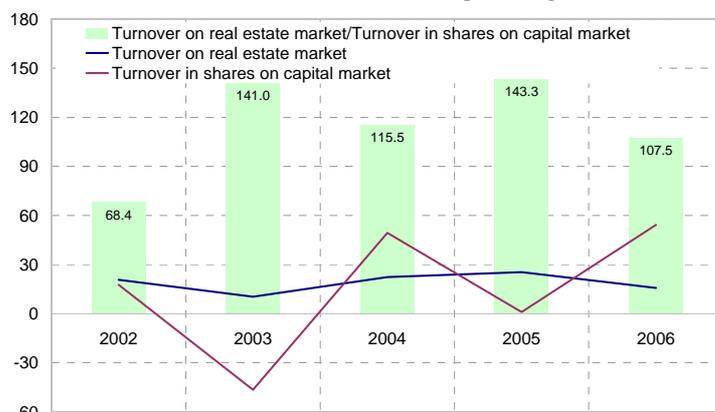
Note: <sup>1</sup> Average annual interest rate for deposits of more than 1 year.

Sources: SLONEP, Bank of Slovenia, SORS, LJSE, Vzajemci.com, own calculations

Turnover on the real estate market has grown continuously in recent years. Growth in turnover on the real estate market fell from 25.4% in 2005 to 15.7% in 2006. High returns meant that the turnover of shares on the Slovenian capital market increased by 54.3% to EUR 1,451 million. As a result, after an increase in 2005, the ratio of turnover on the real estate market to turnover on the capital market declined last year.

**Decline in the ratio of turnover on the real estate market to turnover on the capital market.**

Figure 3.17: Year-on-year growth in turnover on the capital market and real estate market, and ratio of turnover in percentages



Sources: TARS, LJSE, own calculations

Growth in turnover on the real estate market was slightly lower than growth in newly approved housing loans. A large proportion of real estate purchases were undoubtedly financed by loans taken at banks. This is confirmed by figures from the 2005 Housing Survey, in which households intending to become owner-occupiers were asked about the resources for purchasing, building or converting their housing. Prevalent among the resources was the use of their own money (including the revenue from selling previous housing), which was seen in the majority of purchases. Prime among the external resources that households intend to use are loans, which appear in 80% of the planned financial constructions for obtaining owner-occupied housing.<sup>30</sup> A smaller proportion of the purchasers’ own resources come from selling capital investments and from household

<sup>28</sup> All returns are before tax.

<sup>29</sup> Calculations are for a 60m<sup>2</sup> flat in Ljubljana. The calculation of return uses the price of the flat at the beginning of the year in question. For the purchase of the apartment the LTV ratio is assumed to be 100%, while the return is calculated under the assumption that the loan is repaid early when the flat is sold at the end of the year in question. Rents have been included alongside capital gains as income. The return on the investment of the buyer’s own funds in a flat includes the increase in the value of the flat and rental income.

<sup>30</sup> Andreja Cirman: Economic aspects of housing, 2005 Housing Survey, HFRS.

deposits. There are no figures on buy-to-lets, but based on the high returns on the capital market and on mutual funds it is estimated that the desire on the part of households to invest their savings in housing was slightly lower in 2006 than in 2005.

Table 3.12: Time deposits and alternative financial investments of households, volume on the real estate market, and changes in the stock of housing loans

	2002	2003	2004	2005	2006
	(EUR million)				
Change in the stock of household time deposits excluding sight deposits	637.9	257.5	538.2	-424.3	163.1
Change in the stock of household financial assets <sup>1</sup>	2,557	1,923	2,411	2,128	5,315
Turnover in shares on the capital market	1,163.6	623.1	931.0	940.8	1,451.3
Turnover on the real estate market	795.6	878.6	1,075.0	1,347.9	1,559.4
Change in the stock of housing loans	91.9	150.9	235.5	438.7	463.8
	Growth rate (%)				
Household time deposits excluding sight deposits	14.0	5.0	9.9	-7.1	2.9
Household financial assets <sup>2</sup>	15.9	10.3	11.7	9.3	22.1
Turnover in shares on the capital market	17.7	-46.4	49.4	1.0	54.3
Turnover on the real estate market	20.7	10.4	22.4	25.4	15.7

Notes: <sup>1</sup>The figures for household financial assets from financial accounts comprise household deposits, securities and other equity, loans, technical provisions from life insurance and pension insurance, and other claims. The change for 2006 has been calculated from the values at the end of the third quarters in 2005 and 2006.

<sup>2</sup>Year-on-year growth for 2006 relates to the end of the third quarter.

Sources: Bank of Slovenia, TARS, LJSE, own calculations

### Box 3.2: Mortgage banking

In 2006 the Mortgage Bond and Municipal Bond Act (Official Gazette of the Republic of Slovenia, No. 17/2006) and the corresponding secondary legislation established the legal basis in Slovenia for the issue of covered bonds that have coverage in mortgage loans and loans to public sector entities. This area is already regulated in the majority of EU member-states. The basic elements of the new law that provide high security for mortgage and municipal bonds are the separation of the cover assets from the issuer's other assets, the management of the cover assets in the cover register, the special oversight of the cover assets by a custodian who is independent of the issuer, the preferential position of bond holders in the event of the issuer's bankruptcy, and the bankruptcy remoteness of the cover assets.

The high quality of the cover assets is guaranteed by legally defined conditions on their composition: loans secured by a mortgage or land debt on residential or commercial real estate are eligible.<sup>1</sup> The proportion of mortgage loans collateralized by residential real estate under construction is limited to 5%, while the proportion of mortgage loans with commercial real estate collateral is limited to 20%. The risk of negative movements on the real estate market making the value of the real estate collateral less than the residual amount of the loan is significantly higher for real estate under construction and for commercial real estate. Mortgage loans collateralized by real estate outside Slovenia may account for no more than 50% of the cover assets.<sup>2</sup> The maximum value of a loan included in the cover assets is 60% of the mortgage value of the real estate. In the valuation of real estate the law introduces the mortgage credit value, with the cyclical and speculative influences excluded from the market value, and sets out the basic valuation procedure.

According to a bank survey, 52.6% of housing loans (worth EUR 1,060 million in total) were secured with a mortgage on real estate at the end of 2006. There were EUR 531 million of housing loans and EUR 74 million of consumer loans secured with a mortgage on real estate approved in 2006. The stock of housing loans secured with a mortgage on real estate that could be included in cover assets should mortgage bonds be issued is slightly lower than the stock of housing loans secured with a mortgage on real estate. A certain proportion of housing loans secured with a mortgage on real estate, in particular those approved in recent years, have an LTV ratio of more than 60%, and are not therefore eligible as cover assets. In addition to housing loans, a minority of consumer loans are also secured with a mortgage on residential real estate. Applying the legal criterion for the composition of the cover assets, the Slovenian banking system would probably be able to issue approximately the same amount of mortgage bonds each year as Poland or Austria did in 2005.

Table 3.13: Stock of mortgage bonds and issued bonds in selected countries in 2005 in EUR million

	Hungary	Czech Republic	Poland	Lithuania	Austria
Stock at end of 2005	5,072	3,863	558	14	3,560
Issued in 2005	809	2,898	224	14	214

Source: ECBC

Alongside the existing legal basis and a sufficient stock of mortgage loans, giving impetus to mortgage financing for housing loans urgently requires demand from credit institutions for this type of financing on the capital markets and a readiness on the part of investors to invest in mortgage securities.

At the moment banks are not showing any interest in issuing mortgage bonds. The favourable terms of financing available to banks when borrowing from banks abroad, which is a longer-term resource than deposits, is reducing the incentive to issue mortgage bonds. The high liquidity in the banking system and the prevailing proportion of housing loans with a variable interest rate<sup>3</sup> are also providing no encouragement for banks to issue mortgage bonds. Another factor is the unclear interest on the part of potential investors.

Given the growth in housing loans, the low growth in deposits and the need for better maturity matching between investments (housing loans) and sources of assets, the incentive to refinance loans secured with a mortgage on real estate should increase. Furthermore, the integration of the European mortgage financing markets is opening up the possibility of links with credit institutions in other countries, granting easier access to capital markets and cheaper refinancing for housing loans.

<sup>1</sup> The law sets out in terms of the type of real estate which types of collateral are required for the loan to be eligible for inclusion in the cover assets.

<sup>2</sup> EEA or Switzerland.

<sup>3</sup> The proportion of housing loans with a variable interest rate stood at 72.2% at the end of 2006.

### Box 3.3: The National Housing Fund and the national saving scheme<sup>1</sup>

As part of the National Housing Saving Scheme (NHSS), the Housing Fund of the Republic of Slovenia (HFRS) held six successful tenders and one failed tender between 1999 and 2006 for 5- to 10-year housing saving at banks. The HFRS published its sixth successful tender in September 2006, with a premium one-half lower than in previous tenders. The tender involved seven banks and almost 6,000 savers, of whom more than 95% opted for the minimum 5-year saving period, which can be extended to 10 years. An amendment to the National Housing Saving Scheme Act in 2006 allowed the HFRS to issue a call in October 2006 for subsidies for young families for first-time buying. The response was small, with only half of the 321 applications received meeting the conditions set.

The HFRS concluded 99,407 contracts within the NHSS. By the end of 2006, savers had withdrawn from 16% of the contracts, saving had been completed in 44% of the contracts, and 39% of the contracts were still active.

Table 3.14: Stock of savings by scheme as at 31 December 2006 in EUR million

Scheme	No. of active contracts	No. of savers	Stock of savings (EUR million)			
			Inflows	Premiums	Interest	Total
1.	1,784	1,720	17.93	1.7	5.1	24.7
2.	1,281	1,224	9.09	0.9	2.1	12.1
3.	1,228	1,172	7.55	0.6	1.5	9.7
4.	13,693	13,144	75.58	5.3	9.4	90.3
5.	14,482	13,456	62.89	4.2	5.7	72.8
6.	6,400	5,992	1.99	0.0	0.0	2.0
<b>Total</b>	<b>38,868</b>	<b>36,708</b>	<b>175.04</b>	<b>12.7</b>	<b>23.8</b>	<b>211.5</b>

Source: Bank of Slovenia

The NHSS has had a significantly smaller impact than it might have had as an instrument of supplementary financing for purchasing housing on the market. By the end of 2006, on the basis of the 43,817 matured contracts banks had approved just 5,183 loans totalling EUR 73 million, just 10% of the potential value of loans based on the NHSS. At the same time, at the end of saving the average saver had a sum of EUR 22,533 at his/her disposal, not enough even to purchase new housing with floor space of 20m<sup>2</sup>. The largest response to saving offers in the NHSS was in two of the wealthier regions, where prices of real estate are significantly higher than in the rest of the country. Inhabitants of central Slovenia were twice as likely to participate in the NHSS as the average inhabitant of Slovenia, with inhabitants of the coastal/karst region the next most likely. In May 2006 the HFRS offered 268 dwellings on the market, and a further 116 in December. Given the surplus demand, particularly in the capital city, this had no notable impact on housing prices. Instruments to encourage the supply of land covered by planning permission would be more effective in reducing the gap between supply and demand on the housing market.

<sup>1</sup> Source: Bank of Slovenia, HFRS

## 4 CORPORATE SECTOR

### 4.1 Corporate financing at domestic banks and net corporate debt

#### Corporate financing flows

In the context of favourable economic growth of 5.2%, which in 2006 was based on high final demand, in particular investment, the demand for corporate financing increased further, by 65% in the first nine months of the year.

#### A growing role for banks in corporate financing.

With comparable terms of financing at home and abroad, the switch from foreign sources to domestic sources continued in 2006. While the proportion of total corporate financing accounted for by foreign sources declined to 14% in the first nine months of the year,<sup>31</sup> the proportion accounted for by the domestic banks increased to more than 50%. Inter-corporate financing accounted for almost one-quarter of the total in 2006, but is showing a declining trend. Other sectors, primarily non-monetary financial institutions and households continue to account for less than 10% of corporate financing.

Table 4.1: Flow of corporate financial liabilities by sector in EUR million

	2002	2003	2004	2005	2006 <sup>1</sup>
	(EUR million)				
Total	2,555	2,597	2,756	3,887	3,581
Growth in financial flows (%)		1.7	6.1	41.1	65.2
Slovenia	1,156	1,958	2,227	3,301	3,092
Growth in financial flows (%)		69.4	13.7	48.2	72.8
Corporates	1,303	1,044	-89	1,149	888
Banks	747	1,067	1,355	1,847	1,852
Non-monetary financial institutions	-172	-8	128	144	186
Government	-785	-341	677	-255	-85
Households	62	196	155	415	251
Rest of the world	1,399	639	529	586	488
Growth in financial flows (%)		-54.3	-17.3	10.8	29.0
	(%)				
Structure of borrowing	100.0	100.0	100.0	100.0	100.0
Slovenia	45.2	75.4	80.8	84.9	86.4
Corporates	51.0	40.2	-3.2	29.6	24.8
Banks	29.3	41.1	49.2	47.5	51.7
Non-monetary financial institutions	-6.7	-0.3	4.7	3.7	5.2
Government	-30.7	-13.1	24.6	-6.6	-2.4
Households	2.4	7.6	5.6	10.7	7.0
Rest of the world	54.8	24.6	19.2	15.1	13.6

Note: <sup>1</sup> First nine months

Source: Bank of Slovenia

**Corporates are mostly financing themselves via loans, and only exceptionally via debt securities.**

Corporates mostly covered the need for new financing by taking loans. Despite high growth of 36%, loans declined slightly as a proportion of corporate financing, as during this period there was again an increase in trade credits after the net repayments in 2004, mostly between domestic corporates, and partly also from foreign suppliers. Corporates very rarely use debt security issues for financing.

<sup>31</sup> The high proportion accounted for by the rest of the world in 2002 was primarily the result of several major corporate takeovers by non-residents in that year.

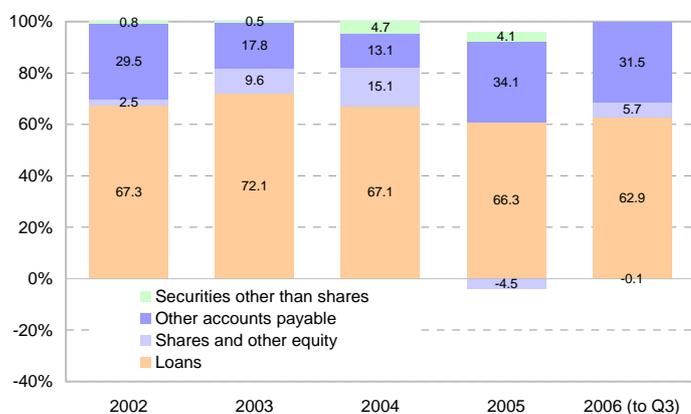
Table 4.2: Flow of corporate financial liabilities by instrument in EUR million

	2002	2003	2004	2005	2006 <sup>1</sup>
(EUR million)					
Total	2,554.9	2,597.4	2,755.8	3,887.3	3,580.7
Shares and other equity	63.4	250.5	416.8	-174.4	204.9
Loans	1,719.0	1,872.6	1,849.0	2,577.1	2,251.5
Securities other than shares	20.0	11.7	128.5	160.4	-2.2
Other accounts payable	752.5	462.6	361.6	1,324.2	1,126.5
Growth rate (%)					
Total		1.7	6.1	41.1	65.2
Shares and other equity		295.2	66.4	-141.8	-126.9
Loans		8.9	-1.3	39.4	35.5
Securities other than shares		-41.5	995.1	24.9	-102.8
Other accounts payable		-38.5	-21.8	266.2	-5.2

Note: <sup>1</sup> First nine months

Source: Bank of Slovenia

Figure 4.1: Breakdown of corporate financing by instrument in percentages



Source: Bank of Slovenia

The domestic banks account for the largest, still-growing proportion of corporate financing via loans. They approved 80% of the loans taken by corporates in the first nine months of 2006, up 12 percentage points and 10 percentage points on the two preceding years respectively. Since 2003 there has also been a rapid increase in loans taken from non-monetary financial institutions, particularly in the form of leasing loans. These institutions recorded a notable increase in their proportion of corporate financing to 16% in 2004, and recorded the same figure in the first nine months of 2006, following a temporary decline in 2005.

**Corporates have borrowed intensively at domestic monetary and non-monetary financial institutions in recent years.**

Table 4.3: Corporate financing flows via loans in EUR million

	2002	2003	2004	2005	2006 <sup>1</sup>
(EUR million)					
Total	1,719.0	1,872.6	1,849.0	2,577.1	2,251.5
Growth in financial flows (%)		8.9	-1.3	39.4	35.5
(%)					
Structure of loans	100.0	100.0	100.0	100.0	100.0
Slovenia	81.2	77.2	97.1	103.7	97.4
Corporates	17.4	1.2	12.2	12.5	3.0
Banks	47.1	65.2	69.9	67.7	80.2
Non-monetary financial institution	10.5	7.4	15.9	12.9	15.8
Households	5.2	4.5	-1.1	9.7	-1.3
Rest of the world	18.8	22.8	2.9	-3.7	2.6

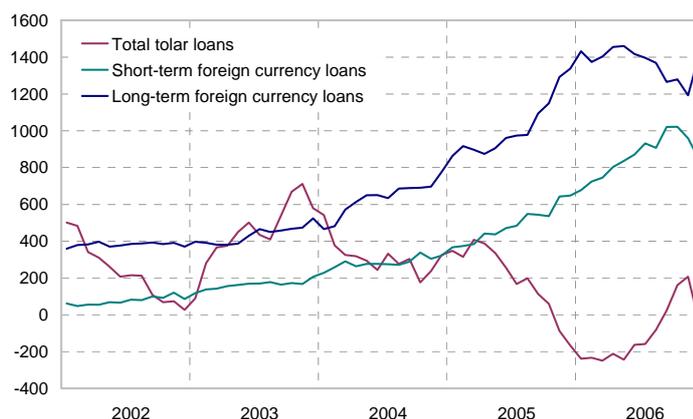
Note: <sup>1</sup> First nine months

Sources: APLRRS, own calculations

The switch in corporate borrowing from abroad to domestic monetary and non-monetary institutions was reflected in the sharp decline in the proportion of foreign loans after 2003

to just 3%, while in 2005 repayments actually exceeded the new loans taken. To secure the resources for their business activities, corporates are turning to both Slovenian banks and Slovenian non-monetary institutions instead of foreign institutions, as a result of the equalisation of the terms of corporate financing in Slovenia and abroad, and increasing competition between banks in attracting new customers or in lending to established customers. The increase in the role of Slovenian banks in corporate financing is a reflection of the more effective competition to direct corporate borrowing abroad, particularly in the last two years. Bank loans remain the most important source of corporate financing, although non-monetary financial institutions such as leasing companies are increasingly prominent as domestic lenders.

Figure 4.2: Corporate borrowing at domestic banks (12-month moving total) in EUR million



Source: Bank of Slovenia

**Growth in loans from banks remains rapid, particularly short-term loans in 2006.**

The net disbursement of corporate loans at domestic banks increased by 22.5% in 2006. The growth came entirely from growth in foreign currency loans, primarily euros, while corporates made repayments of tolar loans. At the end of 2006 tolar loans accounted for 36% of corporate loans, down 8 percentage points. In contrast to 2005, when long-term and short-term foreign currency loans recorded similar growth, in 2006 growth in long-term loans slowed, while growth in short-term loans continued at a similar pace.

**Sources of corporate finance**

The rapid growth in borrowing in 2006 meant that total corporate financial liabilities increased by 13.7% in the first nine months of the year. In the context of high growth in bank loans, the proportion of corporate financial liabilities accounted for by the Slovenian banking sector increased sharply. The changes in the proportions accounted for by other sectors were less pronounced.

Table 4.4: Stock of corporate financial liabilities by sector

	2001	2002	2003	2004	2005	2006 <sup>1</sup>
(EUR million)						
Total	43.643	48.612	52.631	57.210	62.597	68.393
Growth rate (%)		11,4	8,3	8,7	9,4	13,7
(%)						
Structure of liabilities	100,0	100,0	100,0	100,0	100,0	100,0
Slovenia	83,8	83,0	82,4	83,1	82,8	83,3
Corporates	33,7	34,4	34,5	32,7	32,6	32,0
Banks	14,5	14,4	15,2	16,3	18,0	19,4
Bank loans	13,0	12,9	14,0	15,1	16,7	18,0
Non-monetary financial institutions	7,1	7,1	7,0	7,3	6,6	6,7
Government	14,7	13,1	11,9	12,9	11,9	11,6
Households	13,8	13,9	13,9	13,9	13,7	13,5
Rest of the world	16,2	17,0	17,6	16,9	17,2	16,7
Loans at foreign banks	3,0	2,9	2,6	2,3	1,7	1,6

Note: <sup>1</sup> September 2006

Source: Bank of Slovenia

The proportion of corporate liabilities accounted for by the rest of the world in 2006 was the lowest in the last five years, but is only changing slowly. Given the low growth in financing via foreign loans in recent years, a larger decline in the proportion of corporate liabilities accounted for by the rest of the world was prevented by growth in other forms of financing and borrowing in the rest of the world: trade credits, and non-residents' equity in Slovenian corporates.

Table 4.5: Stock of corporate financial liabilities by instrument

	2001	2002	2003	2004	2005	2006 <sup>1</sup>
(EUR million)						
Total	43,643	48,612	52,631	57,210	62,597	68,393
Growth rate (%)		11.4	8.3	8.7	9.4	13.7
Debt <sup>2</sup>	10,970	12,321	13,987	15,903	18,649	20,873
Growth rate (%)		12.3	13.5	13.7	17.3	11.9
As % of GDP	49.6	52.0	56.2	60.6	67.5	70.2
(%)						
Structure of liabilities	100.0	100.0	100.0	100.0	100.0	100.0
Securities other than shares	0.5	0.4	0.4	0.6	0.8	0.7
Loans	24.7	25.0	26.2	27.2	29.0	29.8
Short-term	9.7	9.0	9.0	8.6	9.5	10.4
Long-term	15.0	16.0	17.2	18.6	19.5	19.4
Shares and other equity	52.6	53.7	53.6	54.1	51.0	50.0
Other accounts payable	22.3	20.9	19.8	18.1	19.2	19.5
Trade credits and advances	16.8	16.0	14.9	13.6	14.1	14.0
Other	5.5	4.9	4.9	4.5	5.1	5.5

Notes: <sup>1</sup> September 2006

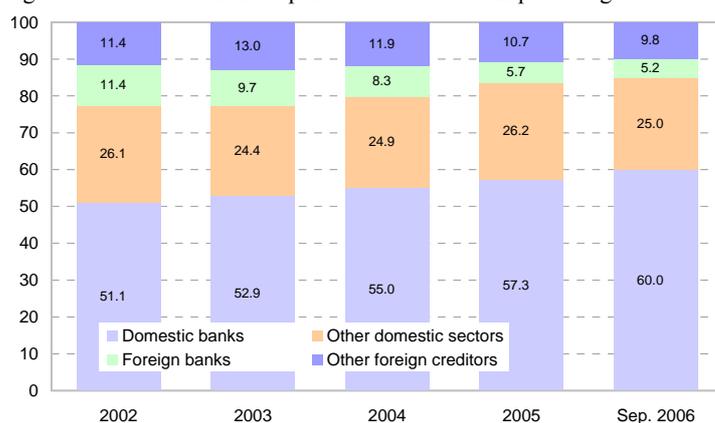
<sup>2</sup> Debt includes loans, debt securities (excluding derivatives) and insurance technical reserves, and in the Slovenian corporate sector practically consists solely of loans.

Source: Bank of Slovenia

Equity prevails in corporate financial liabilities, accounting for 50%. The role of equity is rather small in current corporate financing, and the proportion of the stock that it accounts for is thus declining. The increase in the proportion of current financing accounted for by loans meant that the proportion of corporate liabilities accounted for by loans rose to almost 30%. A further 20% consist of other forms of financing, primarily short-term trade credits. Trade credits are an important source of direct financing for sales, exports in particular, as the trade credits granted by corporates exceed those received.

**The proportion of corporate financial liabilities accounted for by loans is increasing.**

Figure 4.3: Slovenian corporate debt structure in percentages



Source: Bank of Slovenia

The breakdown of the financial liabilities of Slovenian corporates differs little from that of corporates in the euro area. Equity also prevails in liabilities at euro area corporates, accounting for 54%. At 33%, the proportion of financial liabilities accounted for by loans does not differ significantly from the Slovenian corporate sector. The similarity in the breakdown of corporate financing in Slovenia to that of corporate financing in the euro area entails a similar response to changes in the terms of financing as a result of the exercise of a common monetary policy. The only significant difference is the proportion

accounted for by other instruments (primarily trade credits), which is almost 20% in the Slovenian corporate sector, but just 12% in the euro area overall. The high proportion of financing within the corporate sector, which accounts for almost one-third of the total, is an indication of the strong financial ties between Slovenian corporates, and also of the further possible entry of financial intermediaries such as banks and other financial institutions.

**Corporate debt is similar to debt in the euro area.**

The ratio of Slovenian corporate debt to GDP has increased by 20 percentage points in recent years to just over 70%. This corporate debt ratio in Slovenia is slightly lower than in the euro area, where it stood at 78% of GDP in 2005. The differences in the ratios of corporate debt to GDP in Slovenia, Portugal and Greece are larger, these countries being comparable in terms of wealth. At Portuguese corporates it was 107%, more than in Slovenia, while in Greece the ratio is lower at 55% of GDP.

**The most indebted companies are in the sectors of construction and trade.**

According to the debt ratio which shows what proportion of total assets is financed by financial and operating liabilities, approximately 50% of corporate assets were financed by external resources. According to the figures by the sector of activity, which are only available up to 2005, the largest increases in debt ratio were recorded by the sectors of agriculture, forestry, fishing and mining. Despite the rapid growth, companies in these branches remain among the least indebted. The largest debt ratios were recorded by companies in the sectors of construction (69%) and trade (62%).

Construction was also prominent in 2006 in terms of a number of other indicators. High demand means that the potential for development in this sector is great, but the rising debt ratio is a risk to companies in the sector, particularly under the conditions of rising interest rates.

Table 4.6: Debt ratios by sector in percentages

	2000	2001	2002	2003	2004	2005
	Debt ratio - financial and operating liabilities/total assets (%)					
Agriculture, forestry, fishing and mining	22.7	28.2	30.7	34.5	37.8	42.0
Manufacturing	40.0	40.1	40.2	41.2	44.0	45.3
Electricity, gas and water	25.1	31.5	31.6	28.7	28.3	28.5
Construction	63.4	63.3	65.7	67.9	68.2	69.1
Trade	59.7	59.7	60.3	59.8	62.0	62.1
Hotels and catering	33.1	34.9	38.0	39.0	44.2	43.3
Transport and communications	48.9	50.6	52.8	44.2	45.8	44.9
Financial and business services, real estate	46.6	38.9	39.8	39.8	42.9	45.5
Public services <sup>1</sup>	84.5	87.0	87.2	87.3	86.7	85.7
Total	46.9	48.5	49.2	48.6	50.9	51.8

Notes: Based on book values

<sup>1</sup>Public services include public administration, defence, social security, education, health, social work and other public, communal and personal services.

Sources: APLRRS, own calculations

**A deterioration in the overall net financial position alongside an improvement in the financial position against the rest of the world.**

The net corporate financial position (financial assets netted of financial liabilities) has deteriorated in recent years. At the end of September 2006, net financial liabilities stood at 105% of GDP. The comparable figure for the euro area is significantly lower at 83%, but given the similar debt ratio the difference lies mainly in financial assets, which at euro area corporates stands at 147% of GDP, 24 percentage points more than in the Slovenian corporate sector.

Table 4.7: Net corporate financial liabilities at year end in EUR million

	2001	2002	2003	2004	2005	2006 <sup>1</sup>
	(EUR million)					
Total	19,309	21,116	22,831	26,224	27,916	31,295
Growth rate (%)		9.4	8.1	14.9	6.4	16.9
As % of GDP	87.4	89.2	91.8	99.9	101.0	105.2
	(%)					
Structure of net liabilities	100.0	100.0	100.0	100.0	100.0	100.0
Slovenia	81.5	80.1	79.6	82.2	84.2	85.0
Banks	15.9	17.5	20.5	22.2	26.4	29.7
Non-monetary financial institutions	12.4	12.0	10.9	11.1	10.5	10.1
Government	27.2	23.6	22.4	22.9	21.3	20.0
Households	26.2	27.3	26.0	26.1	26.2	25.4
Rest of the world	18.5	19.9	20.4	17.8	15.8	15.0

Note: <sup>1</sup>September 2006

Source: Bank of Slovenia

The breakdown of the net financial position also reflects the switch in corporate financing from foreign to domestic sources. The corporate position against the rest of the world declined significantly. In addition to smaller borrowing, another major factor in the more favourable corporate position against the rest of the world was the increase in outward investments, in both equity and debt forms, via more intensive financing of the rest of the world via loans and trade credits.

With corporate borrowing at domestic banks growing fast, and deposits growing very slowly, the net corporate borrowing at banks has increased exceptionally in recent years. The stock of corporate loans at banks increased at an average annual rate of 22.7% between 2003 and 2006, while the stock of deposits at banks increased at just 7.3% each year. The net corporate borrowing at banks was more than 2.5 times its level four years earlier, approaching 30% of GDP.

**Net corporate debt at banks approached 30%.**

Table 4.8: Stock of corporate loans and deposits at banks at the end of the years

	Corporate borrowing at banks		Corporate deposits	Net corporate borrowing at banks		
	Corporate loans				Ratio	
	(EUR million)	(as % of GDP)	(EUR million)	(EUR million)	(as % of GDP)	
	(1)	(2)=(1)/GDP	(3)	(4)=(1-3)	(5)=(1/3)	(6)=(4)/GDP
2000	3,915.6	18.7	1,843.5	2,072.1	2.1	9.9
2001	4,870.1	22.0	2,160.5	2,709.6	2.3	12.3
2002	5,353.2	22.6	2,524.4	2,828.8	2.1	11.9
2003	6,663.6	26.8	2,585.5	4,078.1	2.6	16.4
2004	8,087.0	30.8	2,654.6	5,432.4	3.1	20.7
2005	9,907.0	35.9	3,128.1	6,778.9	3.2	24.5
2006	12,126.4	40.8	3,328.3	8,798.1	3.6	29.6

Source: Bank of Slovenia

## 4.2 Interest rates and interest-rate risk for corporates

### Convergence of lending rates for corporates

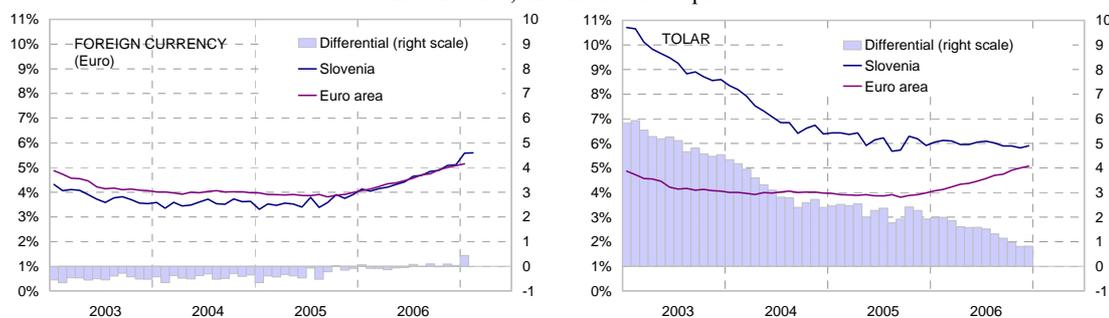
After Slovenia joined the ERM II, the decline in tolar interest rates on corporate loans slowed, almost ending in 2006. Convergence in the segment of interest rates nevertheless continued, as a result of the rise in euro area interest rates. Before the euro was introduced at the beginning of 2007, the spread between the foreign euro interest rates and domestic tolar interest rates stalled at 0.8 percentage points.

Interest rates on smaller foreign currency loans at Slovenian banks were actually lower than those in the euro area by the end of 2005. Since then interest rates at Slovenian banks have entirely tracked the level and the current rate of growth of euro area interest rates. Interest rates have equalised on loans of up to EUR 1 million, which is the most common

**Convergence in interest rates on smaller foreign currency loans was achieved at the end of 2005.**

type of corporate loan at Slovenian banks.<sup>32</sup> Full convergence in this segment of the loan market is the result of the growing competition between the domestic banks, and the wide open environment for competition from foreign banks.

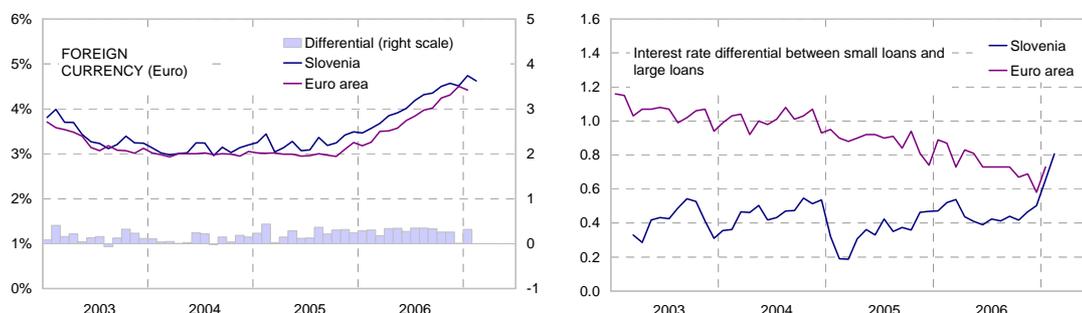
Figure 4.4: Interest rates on loans of up to EUR 1 million at banks in Slovenia and in the euro area, and interest rate spread



Sources: Bank of Slovenia, ECB

Interest rates on larger loans at Slovenian banks are still approximately 0.3 percentage points higher than those at banks in the euro area. The reason for this is that there is less differentiation in interest rates with regard to the size of the loan at Slovenian banks than at banks in the euro area. In the last four years the spread between interest rates on smaller and larger loans in Slovenia has fluctuated within a stable range of 0.3 to 0.5 percentage points. The spread at banks in the euro area declined during this period, but was nevertheless still 0.6 percentage points at the end of 2006. The result of these movements was convergence in nominal interest rates in the market segment of larger loans, but in the context of a passive role by Slovenian banks.

Figure 4.5: Interest rates on loans of more than EUR 1 million at banks in Slovenia and in the euro area, and comparison of the interest rate spread in Slovenia and the euro area



Sources: Bank of Slovenia, ECB

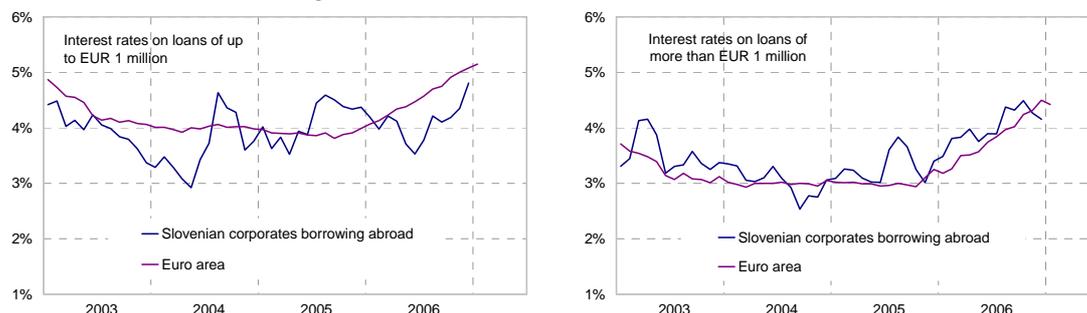
Entering 2007 there was a rise of 0.5 percentage points in average lending rates. The rise resulted from the terms on previous tolar loans being transformed into those on new loans in euros when the euro became the domestic currency.

### Lending rates for corporates in Slovenia and abroad

There has been a sharp decline in the volume of loans taken abroad by corporates since 2004, as a result of the favourable and competitive foreign currency loans available at Slovenian banks. The role of foreign commercial banks has rapidly diminished in corporate financing in recent years, being replaced to a certain extent by financing at international financial institutions, although the latter involve a small number of loans of extremely high value.

<sup>32</sup> According to the most recent figures available for 2005 at the eight largest banks, smaller loans of up to EUR 1 million taken at the domestic banks accounted for 95% of all loan agreements in that year, and for approximately 38% of the total value covered by these agreements.

Figure 4.6: Comparison of interest rates on loans for Slovenian corporates from abroad with average euro area interest rates



Note: The rates compared are those on variable-rate euro loans, irrespective of maturity.

Source: Bank of Slovenia

As further evidence of the relatively low level of credit risk at Slovenian corporates, the average interest rates that they achieve on smaller loans taken abroad<sup>33</sup> are more favourable than the euro area average. They also achieved more favourable terms than at domestic banks, which was also the case when Slovenian banks offered lower interest rates on foreign currency loans than banks in the euro area.<sup>34</sup>

**The Slovenian corporate sector achieves terms in the rest of the world better than or similar to the euro area average.**

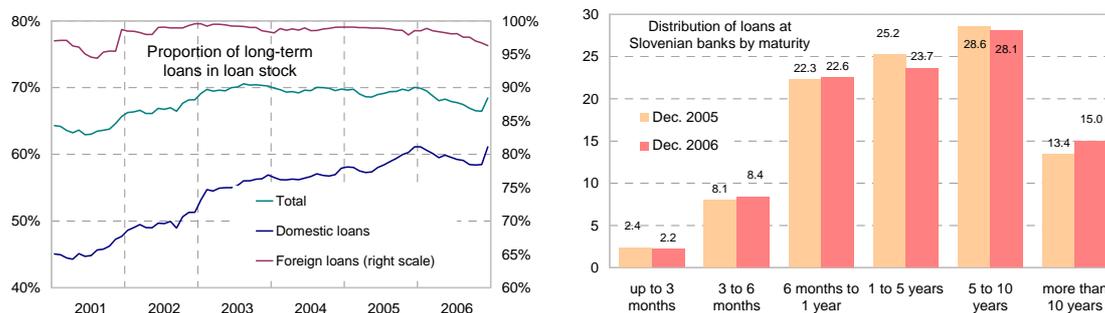
By contrast, Slovenian corporates recorded slightly higher interest rates on larger loans from abroad than the euro area average, which at the same time did not differ much from the interest rates on such loans at Slovenian banks. These loans are mostly for larger Slovenian corporates, which do not take foreign loans because of more favourable terms, but rather because of the large debt that they have already recorded with domestic banks, and because of limits on exposure to an individual client at Slovenian banks.

The loans taken at foreign banks in the last five years have been almost entirely long-term loans. The proportion of short-term loans increased slightly in 2006, but was still less than 4% at the end of the year. The proportion of short-term loans at the domestic banks was almost 40% at the end of the year, with the average term of the loans having continuously lengthened in recent years. This trend came to an end in 2006, when there was temporary shortening in the average loan term during the year.

**Loans from abroad are almost entirely long-term, while the average maturity term at domestic banks is lengthening each year.**

A more detailed breakdown of the maturities of loans at the domestic banks reveals a slight lengthening in the average term. Of particular note are loans with the longest terms, the proportion of which increased to 15%, at the expense of loans with a term of up to 10 years.

Figure 4.7: Maturity breakdown of foreign and domestic loans



Source: Bank of Slovenia

<sup>33</sup> Smaller loans of up to EUR 1 million taken at foreign banks accounted for more than 60% of the total number of loans concluded in 2006, but for approximately 4% of the total value covered by the loan agreements.

<sup>34</sup> The movement of interest rates shows high variability as a result of the relatively low number of loans, owing to which individual larger loans have a strong impact on the average.

### Interest-rate risk for corporates (proportions of fixed and variable interest rates)

**Corporate exposure to interest-rate risk is highest on domestic loans.**

The majority of loans taken at the domestic banks by Slovenian corporates have a variable interest rate,<sup>35</sup> with fixed-rate loans rarely appearing. Fixed-rate loans are more common in the euro area, having accounted for 13% of loans in the last three years. Fixed-rate loans at Slovenian banks are significantly more expensive than in the euro area, which to a certain extent explains their low importance in corporate financing. The supply-side factors can be found in the lesser willingness for domestic banks to assume the risk that fixed interest rates bring in a period when further rises in interest rates are expected.

Under the terms that Slovenian corporates have achieved in previous years when taking foreign loans, particularly in the segment of smaller loans, exposure to interest-rate risk is still slightly lower than the euro area average. Slovenian corporates agreed a fixed interest rate on approximately 10% of their new foreign loans, the proportion of loans of up to EUR 1 million with a fixed interest rate approaching 40% in 2006.

Table 4.9: Proportion of loans with a variable interest rate<sup>1</sup>

	2003	2004	2005 <sup>2</sup>	2006
			(%)	
Euro area	83.8	86.6	88.0	87.0
Under EUR 1 million	84.2	87.8	87.5	85.8
Over EUR 1 million	83.6	86.1	88.1	87.5
Loans to Slovenian corporates				
From the rest of the world	93.4	91.0	88.0	90.6
Under EUR 1 million	69.4	66.4	63.6	61.8
Over EUR 1 million	94.5	93.2	90.0	92.7
At domestic banks			95.2	97.1
Under EUR 1 million			96.0	97.2
Over EUR 1 million			94.8	97.1

Notes: <sup>1</sup>In accordance with ECB methodology, variable-rate loans includes also those loans where a fixed interest rate is agreed for a period of less than 1 year.

<sup>2</sup>The figure for the domestic banks in 2005 relates to the final quarter.

Source: Bank of Slovenia

The repricing period of variable-rate loans taken in 2006 is shorter than 3 months in two-thirds of the cases, and shorter than 6 months in almost 90% of the cases. Given the high proportion of long-term loans, the repricing period is an additional factor of interest-rate risk for corporates, particularly those with a high level of debt. The risk is slightly lower on smaller loans from abroad, but the proportion of total interest-rate risk that they account for is much lower as a result of the switch to the domestic banks in financing.

### Risk premiums for euro loans at domestic banks with regard to the debtor's credit rating

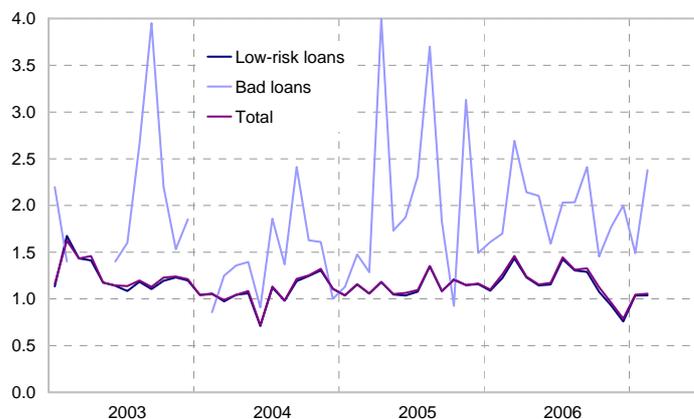
**An increase in the risk premium for high-risk long-term loans.**

The risk premium on corporate loans at the domestic banks has been stable in recent years. The premium over the EURIBOR on long-term loans in euros averaged 1.1 percentage points in 2006, similar to the three preceding years. There was even a slight decline noticeable in the second half of the year. The premium on good or low-risk loans<sup>36</sup> is practically equal to the average premium, banks rating the majority of corporate loans as such.

<sup>35</sup> Fixed-rate loans on which the repricing period is less than one year are also included among variable-rate loans.

<sup>36</sup> Low-risk loans are those rated A or B by banks according to the previous regulation on the classification of claims into credit rating categories.

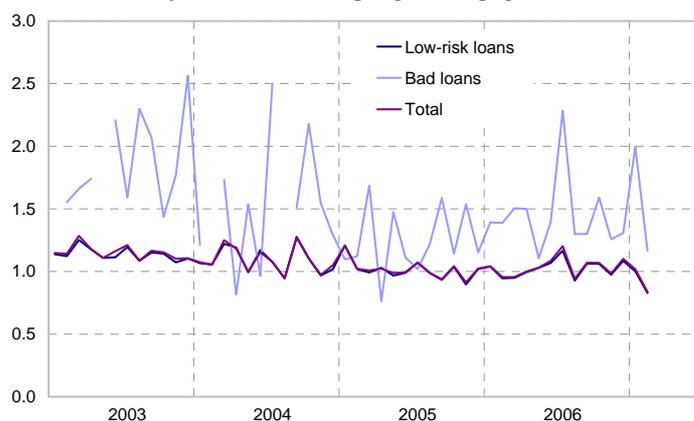
Figure 4.8: Risk premiums over the EURIBOR for long-term corporate loans in euros by client credit rating in percentage points



Source: Bank of Slovenia

The risk premium on bad long-term loans was significantly higher, with a rising trend, and reached 1.8 percentage points in 2006. This was up 0.2 percentage points on 2005 and 0.5 percentage points on two years earlier. There are few clients so rated, the average premium varying from month to month in a wide range of 1 to 4 percentage points.<sup>37</sup>

Figure 4.9: Risk premiums over the EURIBOR for short-term corporate loans in euros by client credit rating in percentage points



Source: Bank of Slovenia

As with long-term loans, the risk premium on short-term corporate loans in euros has been stable in the last two years. It averaged 1 percentage point in 2005 and 2006, 0.1 percentage points less the average for long-term loans. There has been a gentle declining trend in the average risk premium on short-term loans over the longer term.

The premium over the EURIBOR on bad short-term loans averaged 1.4 percentage points in 2006, 0.3 to 0.4 percentage points lower than that of bad long-term loans, and 0.1 percentage points higher than in 2005. The risk premium on bad short-term loans is slightly less variable than that of long-term loans, and fluctuates between 0.7 and 2.5 percentage points.

**A slightly smaller increase in the risk premium for bad short-term loans.**

#### Risk premium over the EURIBOR for corporate financing abroad

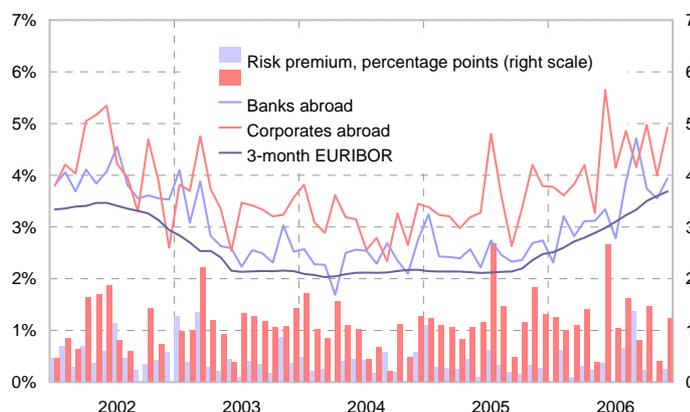
To a great extent, Slovenian banks financed their domestic corporate lending in the last three years by borrowing abroad. Here Slovenian banks achieved significantly more favourable terms than corporates, primarily as a result of favourable risk assessments by foreign creditors. The average interest rate on foreign loans to banks tied to the

**The risk premium for bank loans taken abroad is stable.**

<sup>37</sup> The figures relate solely to the eight largest banks for the majority of the period examined, but include all Slovenian banks from the final quarter of 2005 forth. Full inclusion meant that there was a significant decline in the variability of the series in 2006.

EURIBOR was 3.4% in 2006, compared with 4.3% for corporate loans, but both were almost 1 percentage point higher than the average in 2005 as a result of increase in the EURIBOR.

Figure 4.10: Interest rates on long-term bank loans and corporate loans taken abroad, and risk premium over the 3-month EURIBOR



Source: Bank of Slovenia

The risk premium on Slovenian banks' loans in taken abroad averaged 0.3 percentage points in 2006, similar to 2004 and 2005, and down 0.2 percentage points from 2002 and 2003. Excluding the figures for the outlying months makes the decline over the five-year period even more evident, and more even over the years.

**The risk premium for corporate loans from abroad is higher than at banks, but is not changing significantly.**

Corporates paid an average premium 0.9 percentage points higher on foreign loans than Slovenian banks, but there were no major deviations in comparison with previous years. The premium over the 3-month EURIBOR mostly fluctuated within a wide range of 0.5 and 1.5 percentage points from month to month.

#### Corporate loan repayment burden

Despite the increase in corporate borrowing via financial loans, the interest repayment burden on corporates did not increase in the last years. Interest rate convergence meant interest paid, in both gross and net amounts, actually declined in absolute terms in 2004 and 2005. The ratios of interest paid to total income and to net profit also declined. The ratio of net interest paid to total income ranges from 0.2% to 1.2%, while among the general declining trend there were slightly increases in the sectors of hotels and catering, financial and business services, and real estate. Slightly worse are the indicators of the burden placed on net profit by net interest, which reached 41.6% in the construction sector, and 16.4% in financial and business services, while in the hotels and catering sector, which has recorded a net loss in recent years, net interest paid was four times the net loss recorded in 2005. In other sectors this indicator was below 20%, the average falling to 15.9% in 2005.

Table 4.10: Indicators of the corporate interest repayment burden in percentages

(%)	2001	2002	2003	2004	2005
Ratio of interest paid to income	1.1	1.1	1.1	0.9	0.8
Ratio of net interest paid to income	0.7	0.6	0.6	0.5	0.5
Agriculture, forestry, fishing and mining	0.4	0.3	0.6	0.9	0.8
Manufacturing	0.6	0.5	0.6	0.5	0.4
Electricity, gas and water	0.8	0.7	0.5	0.3	0.2
Construction	0.8	0.7	0.8	0.7	0.7
Trade	0.4	0.5	0.4	0.3	0.3
Hotels and catering	0.9	1.6	1.4	1.1	1.2
Transport and communications	0.9	1.1	1.5	1.0	0.7
Financial and business services, real estate	1.8	0.9	1.0	0.8	1.0
Public services	0.2	0.1	0.2	0.4	0.4
Ratio of net interest paid to net profit	-22.6	32.8	24.0	18.8	15.9

Sources: APLRRS, own calculations

With corporate borrowing continuing to grow rapidly in 2006, and interest rates rising from the end of 2005, this indicator can be expected to deteriorate in the coming period.

### 4.3 Structure of corporate assets and liabilities

Table 4.11: Structure and year-on-year growth of corporate assets

	2002	2003	2004	2005	Growth rate (%)			
					2002	2003	2004	2005
Assets (EUR million)	52,927.1	57,611.3	62,721.8	67,462.6	9.1	8.9	8.9	7.6
	Structure (%)							
Fixed assets	64.7	64.3	63.8	63.1	8.0	8.1	8.1	6.4
Intangible assets	2.2	2.2	3.4	3.2	11.1	8.8	69.6	-1.2
Tangible assets	73.9	70.0	69.1	68.6	4.0	2.5	6.6	5.7
Long-term financial investments	24.0	27.8	27.5	28.2	22.6	25.3	7.0	9.0
Current assets	34.9	35.3	35.8	36.4	11.2	10.1	10.4	9.6
Inventories	24.4	23.9	24.5	24.4	8.4	8.0	13.2	9.1
Operating receivables	51.1	50.2	49.6	49.4	9.5	8.2	9.1	9.2
Short-term financial investments	18.6	19.5	20.3	20.4	18.8	15.7	15.0	9.8
Bank balances, cheques, cash	5.9	6.4	5.5	5.8	15.6	17.7	-4.1	14.3
Deferred expenses and accrued revenues	0.4	0.5	0.5	0.5	6.9	15.7	8.4	13.1

Sources: APLRRS, own calculations

The total assets of the Slovenian corporate sector increased by 5% in real terms in 2005, similar to 2004. The structure of corporate assets changed in favour of shorter-term assets. Current assets account for 36.4% of total corporate assets, while the proportion of financial receivables is increasing at the expense of operating receivables. Among fixed, long-term financial investments, in particular those in affiliates, are increasing the most, but significantly more slowly than in the period before 2003, when they recorded double digit growth.

**Asset structure is shifting towards short-term assets.**

Financial and operating liabilities have been the fastest-growing liability items in the last two years. Within this category, there have been above-average increases in liabilities to banks, and liabilities, primarily long-term, to affiliated companies. Trade payables are increasing slightly more slowly, but faster than in previous years.

**Financial and operating liabilities are the fastest-growing liability items.**

Table 4.12: Year-on-year growth in individual liability categories in percentages

(%)	2001	2002	2003	2004	2005
Capital	8.1	8.3	10.3	4.5	5.4
Provisions	4.3	-4.1	1.4	-0.4	8.8
Financial and operating liabilities	15.3	10.8	7.4	14.0	9.6
Accrued expenses and deferred revenues	22.3	-1.9	21.7	-6.9	2.0

Sources: APLRRS, own calculations

The largest and also the fastest-growing financial and operating liabilities are recorded by companies in the sectors of manufacturing, trade and real estate. These three sectors account for 68% of total corporate financial and operating liabilities, and 83% of short-term corporate financial and operating liabilities. As in previous years, the largest increase in 2005 was recorded by the financial and operating liabilities of companies in the real estate sector.

Table 4.13: Corporate financial and operating liabilities by sector in percentages

	2002	2003	2004	2005	Growth rate (%)			
					2002	2003	2004	2005
Corporate financial and operating liabilities (EUR million)	26,050.9	27,982.8	31,904.8	34,974.2	10.8	7.4	14.0	9.6
	Structure (%)							
Agriculture, forestry, fishing and mining	1.2	1.3	1.4	1.4	8.9	15.6	20.3	15.4
Manufacturing	24.0	26.0	25.1	27.4	10.3	16.2	10.0	9.3
Electricity, gas and water	5.9	5.1	4.5	4.8	3.5	-7.0	0.1	6.8
Construction	6.0	6.5	6.6	7.4	13.4	16.2	14.9	11.7
Trade	22.4	22.1	22.5	24.8	9.2	6.1	15.9	10.3
Hotels and catering	1.6	1.6	1.9	1.9	20.5	9.3	31.2	-1.5
Transport and communications	10.8	7.6	7.8	8.0	8.2	-23.8	17.2	1.5
Financial and business services, real estate	12.9	14.0	15.1	16.0	19.6	16.3	22.8	16.7
Public services	15.1	15.6	15.2	14.8	10.3	11.3	10.4	7.0

Sources: APLRRS, own calculations

**Corporate liquidity deteriorated slightly in 2004 and 2005.**

Short-term receivables and liabilities account for almost 60% of financial and operating receivables and liabilities. In 2004 and 2005 short-term liabilities grew faster than short-term receivables, reducing the liquidity ratio of the entire corporate sector by 1.3 percentage points over these two years.

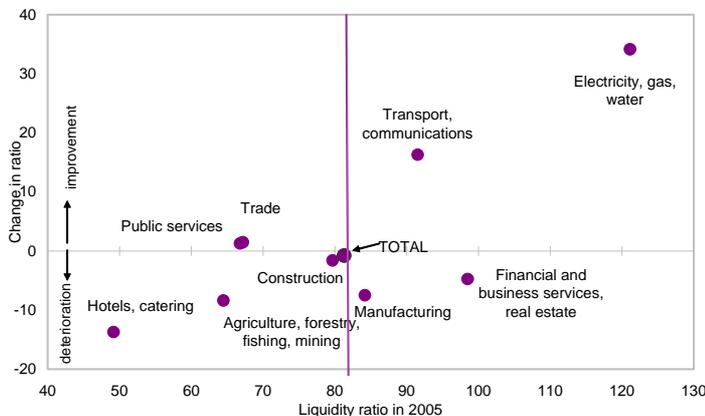
Table 4.14: Maturity breakdown of financial and operating receivables and liabilities in percentages

(%)	2001	2002	2003	2004	2005
Financial and operating receivables					
Long-term	38.3	40.3	43.0	42.3	42.5
Short-term	61.7	59.7	57.0	57.7	57.5
Financial and operating liabilities					
Long-term	39.9	41.1	39.7	41.2	41.0
Short-term	60.1	58.9	60.3	58.8	59.0
Financial and operating receivables / liabilities					
Long-term	77.4	80.9	87.4	83.7	83.4
Short-term	74.2	79.2	94.7	85.8	86.3
Short-term	79.6	82.1	82.6	82.1	81.3

Sources: APLRRS, own calculations

There was an exceptional improvement in liquidity at companies in the electricity, gas and water supply sector, whose previously good short-term liquidity increased sharply in 2005 to reach 121%. There was a significant improvement in the transport, storage and communications sector, where short-term receivables almost fully cover short-term liabilities. Companies in the hotels and catering sector are notable for their low liquidity ratio (49%), and a significant deterioration of 10 percentage points in the last two years. The manufacturing sector's liquidity ratio of 84% differs little from the average for the corporate sector overall.

Figure 4.11: Liquidity ratios by sector, and change between 2002 and 2005

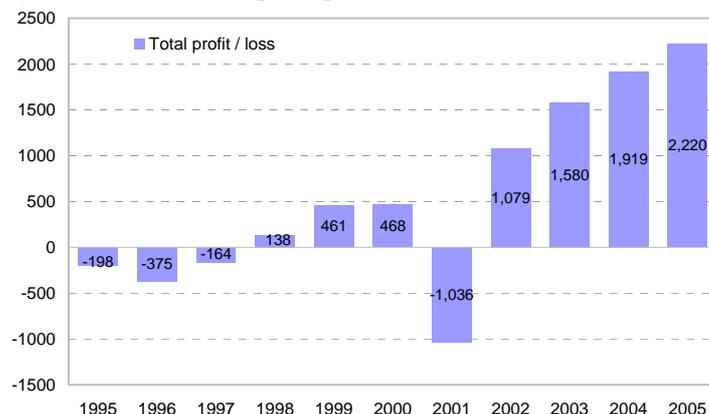


Sources: APLRRS, own calculations

The corporate sector finished 2005 with net profit of EUR 2.2 billion. The current rate of growth in profit was slightly slower than in previous years. The profitability indicators, in terms of both sales and equity, have continued to improve. Growth in aggregate profit in the corporate sector is partly the result of increases in profits at companies operating in the black, and partly the result of smaller losses at those operating in the red. The good corporate performance in 2005 is expected to have continued in 2006, given the increase in economic growth, and is allowing for further corporate financing via debt instruments.

**Good corporate performance in 2005.**

Figure 4.12: Overall corporate profit/loss in EUR million



Sources: APLRRS, own calculations

#### 4.4 Corporate financial gearing

Financial gearing in the corporate sector deteriorated in 2004 and 2005, as a result of corporate debt financing growing faster than equity financing. Companies in the sectors of construction and trade were notable for their level of financial gearing in 2005, their financial and operating liabilities standing at 2.7 times and 1.7 times their capital respectively. Rapid growth in financial gearing was also seen in the manufacturing sector, where coverage of liabilities by capital, having remained stable between 2000 and 2002, gradually deteriorated for three successive years. The real estate sector also recorded similar dynamics in this indicator. The deterioration ended in 2005 in the hotels and catering sector, where financial gearing had increased most rapidly in the preceding years, alongside the construction sector. In addition, performance in these sectors is very sensitive to the phase of the economic cycle. During the current period of high economic growth the circumstances are favourable for these sectors, but in a tougher economic climate the burden of loan repayment will be relatively greater for them.

**A deterioration in corporate financial gearing.**

Companies in the construction sector borrow abroad to a small extent, with most of their financial and operating liabilities being recorded against domestic creditors. By contrast, the trade sector, with the second-highest level of debt, recorded just over 50% of its liabilities against the rest of the world, although its economic strength means it is also one of the largest domestic debtors, immediately behind manufacturing. Companies in the sectors with the highest indebtedness are more exposed to various risks. Their creditors, in sectors mentioned above primarily in domestic environment, are also indirectly exposed to those risks.

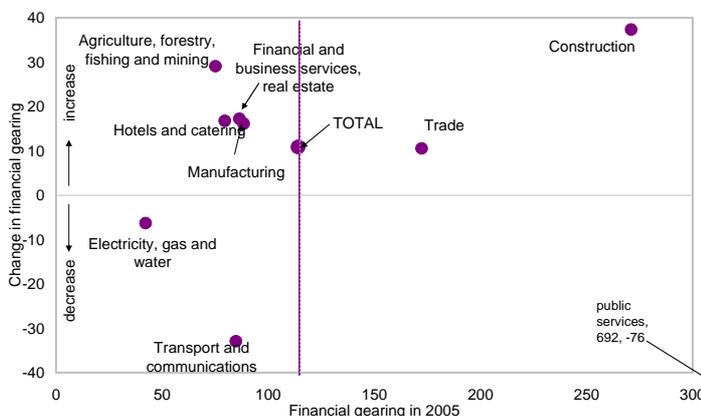
Table 4.15: Financial gearing by sector in percentages

	2000	2001	2002	2003	2004	2005
Financial gearing: financial and operating liabilities/capital (%)						
Agriculture, forestry, fishing and mining	30.7	41.4	46.0	54.9	63.0	75.1
Manufacturing	71.9	72.4	72.3	75.0	84.1	88.4
Electricity, gas and water	35.5	49.7	48.5	42.3	41.5	42.2
Construction	205.7	201.5	233.6	253.0	268.2	271.0
Trade	160.6	159.2	161.7	157.0	171.8	172.3
Hotels and catering	50.8	55.2	62.8	65.1	80.9	79.6
Transport and communications	99.8	106.9	117.7	82.7	88.0	84.8
Financial and business services, real estate	92.8	67.0	69.2	70.6	77.7	86.4
Public services	611.3	751.8	768.5	761.5	720.5	692.3
Total	94.5	100.9	103.2	100.5	109.7	114.1

Sources: APLRRS, own calculations

The best ratios of financial and operating liabilities to capital, with a trend of further improvement, were recorded by the electricity, gas and water supply sector, and the transport, storage and communications sector.

Figure 4.13: Financial gearing by sector, and change between 2002 and 2005



Sources: APLRRS, own calculations

## 4.5 Corporate position against the rest of the world

After slowing temporarily in 2004, growth in liabilities and claims vis-à-vis the rest of the world increased again in 2005.

**Foreign investment is increasing among long-term sources of corporate financing, while debt financing is diminishing.**

Non-residents' equity was prevalent among corporate liabilities to the rest of the world. They recorded the highest growth in 2005, at 21%. By contrast, financing from abroad via long-term debt instruments declined in the last two years. Short-term operating liabilities, primarily trade credits received, continue to account for a relatively high but stable proportion of liabilities to the rest of the world.

Table 4.16: Structure and year-on-year growth of liabilities to the rest of the world

	2002	2003	2004	2005	Growth rate (%)			
					2002	2003	2004	2005
Liabilities to the rest of the world (EUR million)	6,964.7	8,445.5	8,945.2	9,953.1	16.4	21.3	5.9	11.3
Structure (%)								
Non-residents' equity	26.2	33.2	33.9	37.0	20.8	53.6	8.2	21.3
Long-term liabilities	32.6	29.1	27.4	23.3	17.5	8.2	-0.2	-5.4
Short-term operating liabilities	35.2	31.5	32.4	32.8	13.0	8.4	8.9	12.8
Short-term financial liabilities	5.6	5.8	5.9	6.4	12.3	26.1	7.7	20.8
Accrued expenses and deferred revenues	0.4	0.4	0.4	0.5	20.9	38.3	9.0	36.5

Sources: APLRRS, own calculations

The stock of loans and financial leasing taken abroad grew at the low rates of 0.7% and 1.4% in 2004 and 2005, as a result of the switch in corporate borrowing from abroad to Slovenian banks. In the context of net repayment of long-term foreign loans, the proportion of external debt accounted for by short-term debt increased. The largest increase among short-term debt in 2005 was recorded by liabilities to affiliates abroad, but the majority of the debt, both long-term and short-term, was nevertheless recorded against non-affiliates.

Corporate claims against the rest of the world grew at a similar rate to 2004, just over one-half of the rate recorded in 2001 to 2003. The structure of the claims against the rest of the world is changing profoundly, the proportion accounted for by financial investments increasing at the expense of operating receivables.

Table 4.17: Structure and year-on-year growth of claims against the rest of the world

	2002	2003	2004	2005	Growth rate (%)			
					2002	2003	2004	2005
Claims against the rest of the world (EUR million)	3,675.2	4,571.3	5,084.0	5,738.8	22.2	24.4	11.2	12.9
	Structure (%)							
Real estate	2.8	3.1	2.5	2.2	24.0	34.6	-8.3	-0.4
Financial investments	25.3	32.1	32.4	36.1	54.4	58.1	12.0	25.8
Operating receivables	69.8	63.4	63.2	59.8	12.2	12.9	10.8	6.8
Other assets	2.0	1.4	1.9	1.9	114.5	-15.8	55.3	13.7

Sources: APLRRS, own calculations

Outward corporate financial investments in 2005 were almost five times higher than those in 2000, with financing via both debt and equity instruments increasing. Within financing via loans, financing for companies without capital ties has been increasing in recent years. The role of providing loans to the rest of the world has to a great extent been assumed by Slovenian banks in recent years, but direct corporate financing has retained a significant proportion of the total, with companies supporting their own exports. With loans to non-affiliates growing rapidly, the proportion accounted for by loans to subsidiaries is declining, but these loans nevertheless remain an important segment of outward corporate investment.

**The high increase in outward corporate financial investments comes from both equity and debt investments.**

Table 4.18: Structure and year-on-year growth of outward financial investments

	2002	2003	2004	2005	Growth rate (%)			
					2002	2003	2004	2005
Financial investments (EUR million)	929.5	1,469.5	1,645.7	2,070.1	54.4	58.1	12.0	25.8
	Structure (%)							
Loans	28.0	33.5	23.7	28.9	91.0	89.0	-20.7	53.5
Subsidiaries	60.2	41.6	40.2	28.6	62.3	30.4	-23.3	9.3
Parent companies	28.2	16.9	35.1	33.5	208.6	13.3	64.5	46.5
Non-affiliates	11.5	41.5	24.7	37.9	89.5	580.0	-52.8	135.3
Shares	69.9	63.9	71.0	68.7	49.8	44.5	24.5	21.8
Other	2.1	2.6	5.3	2.3	-39.2	98.9	124.8	-44.5

Sources: APLRRS, own calculations

Corporate investments in foreign shares account for almost 70% of all outward financial investments. The flow of outward direct investment in the last four years has been three times in excess that of inward investments in the Slovenian corporate sector, which is increasingly exposing Slovenia not just as a recipient of capital, but also as an exporter.

**The majority of transactions with the rest of the world are in euros.**

With integration into international flows high and rising, the Slovenian corporate sector has always been exposed to high exchange-rate risk. This risk declined sharply with the introduction of the euro as the domestic currency in 2007, the majority of Slovenia's transactions with the rest of the world being denominated in euros. In 2006 some 90% of foreign trade was conducted in euros, while the link between real and financial transactions means that the majority of financial claims and liabilities are denominated in this currency too.

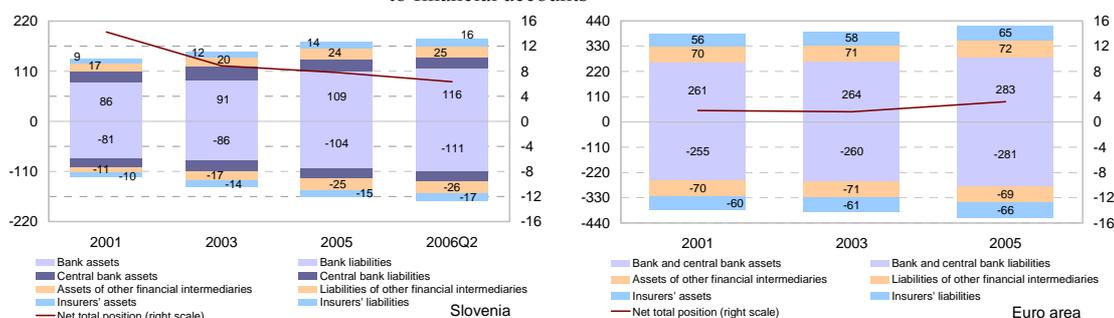
## 5 THE SLOVENIAN FINANCIAL SYSTEM

### 5.1 Structure of the Slovenian financial system

**The depth of the euro area financial system is almost 2.5 times that of Slovenia.**

The Slovenian financial system is in a process of catching up with the financial system of the euro area. With financial assets equivalent to 180% of GDP,<sup>38</sup> its depth is significantly less than that of the financial system in the euro area, where financial assets are almost two and a half times higher. In addition to a lower level of wealth in terms of per capita GDP, the other reasons are that the Slovenian capital market has existed for barely 15 years, and the aggressive development of institutional investors in the Slovenian financial market has only arrived recently. An increase in financial assets can be expected primarily as a result of increasing awareness among the households, which is the most important sector in surplus, of the importance of saving in order to maintain a certain standard of living after retirement.

Figure 5.1: Financial assets, liabilities and net position of the financial sector in Slovenia (left) and the euro area (right) as a percentage of GDP according to financial accounts



Sources: Bank of Slovenia, Eurostat, SORS

**The importance of institutional investors in Slovenia is still relatively small, but is expected to increase.**

The banking sector prevails among the financial institutions in Slovenia, accounting for approximately 73% of financial assets, as it does in the euro area, where its proportion is approximately 6 percentage points lower. Given Europe's growing demographic issues, insurers and pension funds are gaining in importance, but they still only account for approximately 10% of the assets of the Slovenian financial sector. In the euro area the figure is over 15%, and is showing a rising trend. Life insurance and pension insurance can be expected to gain in importance in Slovenia, owing to the deepening of financial intermediation and increased saving for old age, and also to a certain extent because of the reallocation of financial assets. The proportion of the Slovenian financial sector accounted for by other financial intermediaries (primarily investment funds and leasing companies) is just over 16%, and is only 1 percentage point less than the figure in the euro area.

**The operations of the different financial sectors vary considerably.**

The aforementioned three financial sectors differ considerably in their operations, and their balance assets totals or financial assets are not necessarily the best indicator of comparability. The financial assets of insurers and pension funds, and of a portion of the sector of other financial intermediaries, which includes investment funds, are primarily long-term investments in the form of debt and equity securities and other financial instruments, which mostly represent a liability to household savings. By contrast, the financial assets of banks primarily consist of loans granted, and, to a lesser extent, investments in financial instruments, a significant proportion of which are acquired via deposits, or increasingly via loans from foreign banks and issued debt securities. The operation of leasing companies is also different, and in Slovenia they constitute a significant proportion of the sector of other financial intermediaries. These place the majority of their funds, in the form of leasing loans, with the household sector, having obtained them via loans from the rest of the world, primarily banks and affiliates. Given the considerable variation in the resources and liabilities of individual financial

<sup>38</sup> Includes the central bank.

institutions, comparing total assets alone could disguise the importance of non-monetary financial institutions to the economy as a whole and to its stability.

Table 5.1: Overview of the Slovenian financial sector in terms of total assets

	Assets (EUR million)		Structure (%)		% of GDP		No. of inst.	
	2005	2006	2005	2006	2005	2006	2005	2006
Monetary financial inst. <sup>1</sup>	29,435	33,928	71.8	72.2	106.5	114.1	25	25
Non-monetary fin. inst.	11,552	13,035	28.2	27.8	41.8	43.8		
Insurers <sup>2</sup>	3,260	3,895	8.0	8.3	11.8	13.1	16	15
Pension funds	670	893	1.6	1.9	2.4	3.0	11	11
Investment funds	2,220	2,845	5.4	6.1	8.0	9.6	59	107
Leasing companies <sup>3,4</sup>	3,185	3,185	7.8	6.8	11.5	10.7	19	20
BHs, MCs, others <sup>4</sup>	2,218	2,218	5.4	4.7	8.0	7.5	-	-
<b>Total</b>	<b>40,987</b>	<b>46,963</b>	<b>100.0</b>	<b>100.0</b>	<b>148.4</b>	<b>157.9</b>		

Notes: <sup>1</sup> Monetary financial institutions do not include the central bank.  
<sup>2</sup> The 2006 figures for reinsurance companies relate to the end of the third quarter.  
<sup>3</sup> The number of leasing companies is taken to be the number of active members of the SLA.  
<sup>4</sup> Figures for the end of 2005 only.

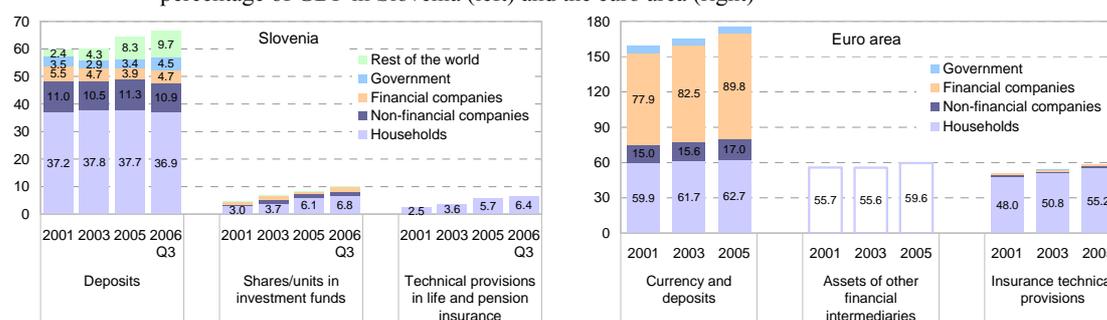
Sources: Bank of Slovenia, ISA, SMA, AMC, SLA, APLRRS

### Comparison of financial institutions in terms of intermediation of savings

A comparison of financial institutions can be made from the point of view of the management of savings in the economy with regard to the financial instruments of intermediation, typically deposits for banks, units or shares for investment funds, and technical provisions for pension funds and insurers. Domestic bank deposits are very important among the aforementioned instruments, accounting for 80% of the total (20 percentage points more than in the euro area), but there is a clear declining trend. Technical provisions from life insurance and pension insurance are exclusively household assets, as are the majority of investment fund assets. Households only account for three-quarters of deposits, and the declining trend is more pronounced. Ignoring transferable deposits, households account for just under 60% of the total, the figure having stood at more than 80% at the end of 2001.

**Non-transferable bank deposits now account for just 60% of household assets invested in the instruments of financial intermediaries.**

Figure 5.2: Value of certain financial instruments of domestic financial institutions as percentage of GDP in Slovenia (left) and the euro area (right)



Note: Because of the limited availability the figures for Slovenia and the euro area are not entirely comparable. For the euro area, currency is included alongside deposits, while the technical provisions include other types of insurance alongside life insurance and pension insurance. The lack of availability for the F.52 instrument means that the total financial assets of other financial intermediaries other than loans are included in shares and investment fund units for the euro area.

Sources: Bank of Slovenia, Eurostat, SORS

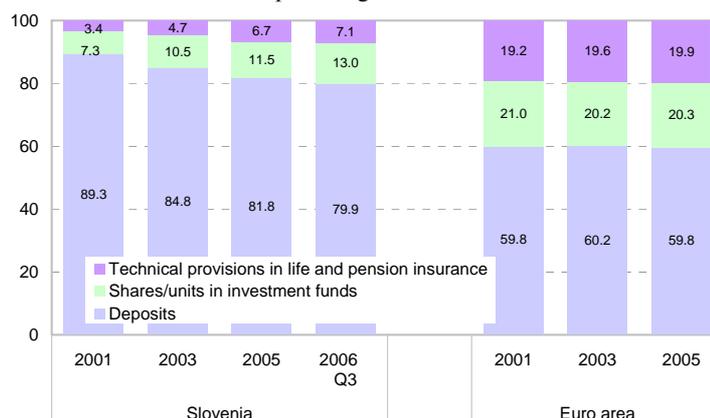
The increasing role of non-monetary financial institutions in transferring savings in the national economy, primarily those of households as the sector with the largest surplus of assets, means that they are becoming more and more important to the successful functioning of the economy. Given the current development, this is also increasing household exposure to risk. (1) In the case of investments in investment funds, households are assuming the risk in full. (2) Investments in life insurance linked to mutual fund units, where the risk is transferred from insurers to households, are growing in importance. These account for just over 17% of total investments in life insurance, a relatively low proportion, but it is rising rapidly. (3) As elsewhere in the world, demographic issues

**Households are assuming more and more risk.**



means that recently in Slovenia there has been more talk of defined-contribution pension plans to replace defined-benefit plans, which would again entail risk being transferred to households. (4) Households are also increasingly assuming risk on the liability side. The majority of loans approved now carry a variable interest rate, while recently so-called bullet loans have started to appear. The different segments of the financial sector are thus offering households an expanding palette of different financial instruments, via which various markets risks are being transferred to households, from capital risk to exchange-rate risk to interest-rate risk. The question is raised of whether households are sufficiently qualified investors in recognising and managing risks, and whether the different financial sectors are aware of how much risk is concentrated with any individual.

Figure 5.3: Breakdown of financial assets from intermediation in Slovenia and the euro area in percentages



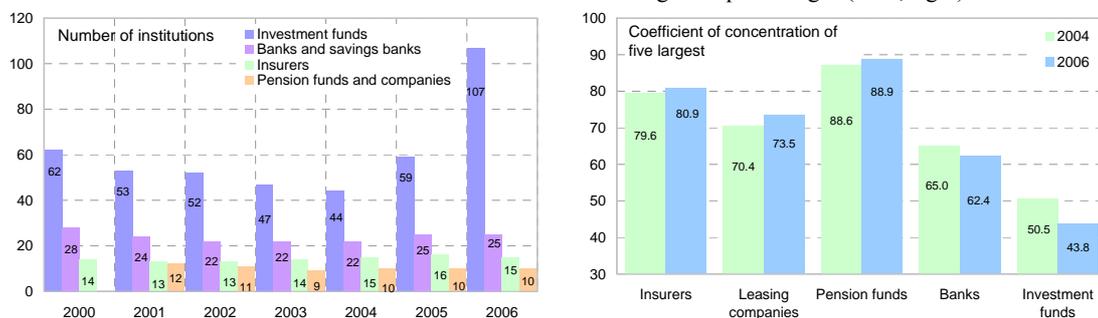
Note: See previous figure.  
 Sources: Bank of Slovenia, Eurostat

**Banks are increasingly active in non-banking financial services.**

Demographic changes, the development of financial markets, and the fiscal saving incentives related in particular to the reform of the pension system, mean that bank intermediation is losing importance. This is reducing the proportion of the banking system's gross income accounted for by net interest income. Banks are having to increasingly focus on non-banking financial products, both by diversifying the services that they provide, and by owning non-banking financial intermediaries. In addition, the largest banks are expanding their branches in the transition countries, where demographic trends are more favourable.<sup>39</sup>

**Selected financial indicators**

Figure 5.4: Number of financial institutions of different type (left), and market concentration of the five largest in percentages (CC5; right)



Note: The CC5 index is calculated in terms of total assets, with the exception of leasing companies, for which it is calculated in terms of volume of transactions concluded. Insurers include reinsurance companies, whose total assets relate to the end of the third quarter of 2006. Pension funds do not include the First Pension Fund, as this is a closed fund that does not envisage any more contributions.  
 Sources: Bank of Slovenia, ISA, SMA, AMC, SLA, APLRRS

<sup>39</sup> For more, see Mejra Festič: The relevance of an ageing population to banks, *Bančni vestnik* 04/2007, Ljubljana, 2007.

The competition existing within sectors of financial institutions and between them is expected to continue in the future. Growing competition from the rest of the world will also have an impact on this. Competition is fiercest in the segments of investment funds and banking, while the five largest insurers and pension funds are still succeeding in retaining their market shares.

**Competition is highest in the investment funds sector.**

The business practices of the different types of financial institution differ greatly, and are not directly comparable. Comparing their basic profitability indicators primarily exposes the specific features of their business. While ROA since 2003 at insurers has been constantly higher than at banks, the opposite is the case for ROE, primarily as a result of the use of financial leverage at banks. The effect of financial leverage on the large discrepancy between ROA (1.6%) and ROE (23%) is particularly prominent at leasing companies. Extremely high ROA is being recorded by management companies, which do not need many assets for their business.

**Financial indicators are not comparable between the different types of financial institution.**

Table 5.2: Financial indicators for types of financial institution

	2003	2004	2005	2006
Pre-tax profit (EUR million)				
Banks	199.3	234.2	261.0	393.4
Insurers	40.9	32.2	59.2	76.1
Leasing companies	40.7	46.1	49.1	-
Management companies	-	16.6	18.1	-
ROA (%)				
Banks	1.00	1.05	1.00	1.25
Insurers	1.67	1.13	1.81	2.16
Leasing companies	2.23	1.96	1.67	-
Management companies	-	12.69	12.94	-
ROE (%)				
Banks	12.47	13.34	13.51	15.07
Insurers	10.04	6.43	10.84	12.91
Leasing companies	29.28	26.66	23.18	-
Management companies	-	18.19	18.10	-

Note: The 2006 figures for banks are in line with the IFRS. The figures for 2006 include insurance companies only, not reinsurance companies.

Sources: Bank of Slovenia, ISA, APLRRS

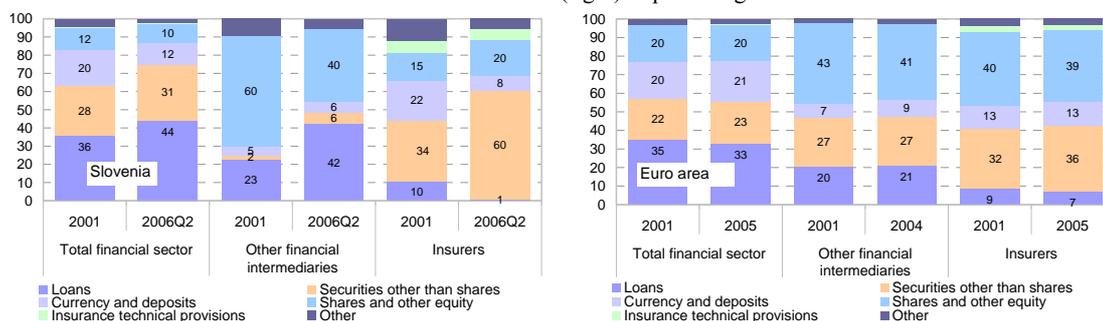
#### **Comparison of the structure of the financial sector's financial assets and liabilities with the euro area**

The differences in the business of individual financial sectors are also expressed in the structure of their assets and liabilities, which in the last four years have seen considerable shifts. While the banking sector's assets are increasingly dominated by loans, bonds and shares are gaining in importance at insurers and pension funds. There has been a notable increase in the proportion of the assets of other financial intermediaries accounted for by loans, as a result of leasing companies growing more rapidly than investment funds. In the euro area, investment funds are much more powerful in the sector of other financial intermediaries, which is seen in the larger proportion of the assets of other financial intermediaries accounted for by bonds and shares. In particular, at 27%, the proportion accounted for by bonds in the euro area is much higher than Slovenia's figure of 6%, which is also the result of the larger role of bond funds in the euro area. Bond funds account for very little of the mutual funds' total assets in Slovenia, and recently most interest has been in higher-risk equity mutual funds. The insurance sector in the euro area has a significantly larger proportion of equity in its assets than Slovenia's, which is also the result of the higher proportion accounted for by life insurance and pension insurance, and the historically more developed capital market.

**The structure of financial assets and liabilities varies greatly from financial sector to financial sector.**



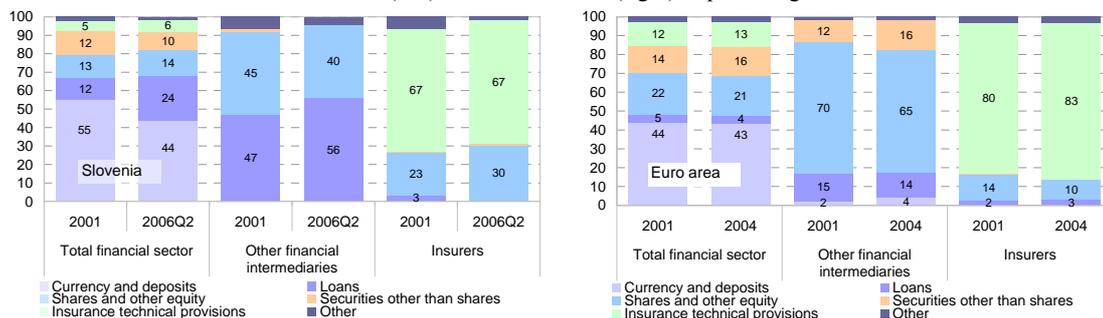
Figure 5.5: Breakdown of the financial assets of the financial sector in Slovenia (left) and the euro area (right) in percentages



Sources: Bank of Slovenia, Eurostat

Financial institutions have also seen considerable change on the liability side in recent years. The proportion of the banking system's liabilities accounted for by deposits declined by 12 percentage points to 62%, primarily at the expense of an increase in borrowing in the rest of the world. There was also an increase in the proportion of other financial intermediaries' sources of financing accounted for by loans taken, although the figure is significantly higher in Slovenia than in the euro area, as a result of the aforementioned greater role of leasing companies. Units and shares issued in investment funds account for a greater proportion in the sector of other financial intermediaries in the euro area than in Slovenia. The proportion of the Slovenian insurance sector's liabilities accounted for by technical provisions remains unchanged.

Figure 5.6: Breakdown of the financial liabilities of the financial sector in Slovenia (left) and the euro area (right) in percentages



Sources: Bank of Slovenia, Eurostat

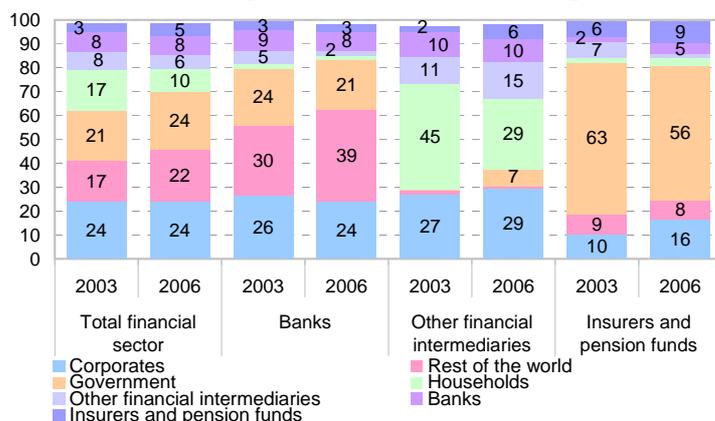
### Capital links in the financial sector

#### Cross-ownership between financial institutions remains low.

There is relatively little cross-ownership between domestic financial institutions. Financial institutions merely hold just under 20% of the issued equity in the sector.<sup>40</sup> This figure has not changed significantly during the last three years. Given the increasing importance of non-monetary financial institutions, banks can also be expected to strengthen their equity holdings in this segment in Slovenia. It is in the sector of other financial intermediaries in particular that a larger equity holding by financial institutions can be seen, as a result of the expansion of investment funds and leasing companies, and the greater interest in these. There is considerable variation in the ownership structures of each financial sector, with banks dominated by non-residents (39%), insurers by the government sector (56%), and other financial intermediaries by the household sector and the corporate sector (30% each). Alongside the currently strong contractual cooperation between banks, insurers and management companies, greater consolidation of ownership within the financial sector can be expected in the future.

<sup>40</sup> Out of that banks account for just over 50%, insurers and pension funds for 20%, and other financial intermediaries for the remainder.

Figure 5.7: Ownership structure of financial sectors in percentages



Note: Includes direct ownership only.  
Sources: CSCC, own calculations

Owing to the need for the regulation of several financial sector groups, particularly in the sense of risk management, more effective supervision, and greater transparency and security in the functioning of the financial system, a financial conglomerates act was passed in Slovenia in 2006, transposing the European directive of 2002 into domestic legislation. Financial conglomerates are corporate groups that consist of at least one company from the insurance sector and at least one from the banking sector or securities market sector. Here the banking sector and the securities market sector are together treated as a single sector. A financial conglomerate is thus a corporate group that primarily provides financial services, which means that financial companies account for at least 40% of the conglomerate's total assets. Each of the sectors, i.e. insurance on one side and banking and securities trading on the other, must account for a significant proportion of the group. This means more than 10% in terms of total assets and in terms of capital requirements. The first such conglomerate, between Zavarovalnica Triglav and Abanka, was recognised at the end of 2006, with the Insurance Supervision Agency coordinating supervision. More financial conglomerates are expected to be recognised in the future.

**The first financial conglomerate was recognised in 2006.**

### Risk in the financial system

With institutional investors playing a larger and larger role in the financial systems of both Slovenia and the euro area, their importance in the latter being much greater than in Slovenia, they are of increasing importance to financial stability, alongside the banks. Compared with banks, institutional investors do not have an important role in the payment system, their liabilities are usually less liquid, and they should be less exposed to the contagion risk. Different types of institutional investor with different investment strategies generally lead to more integrated and stable financial markets. However the increasing importance of institutional investors leads to stronger links between the financial sectors, increasing the complexity of financial systems. This can make the actual location of a risk much harder to evaluate, increasing the contagion risk spreading between financial sectors. A potential destabilisation in the financial system can have a destabilising effect on the real sector.<sup>41</sup>

**The complexity of financial systems is making it difficult to assess risk within them.**

Banks and institutional investors assume different risks. While credit risk, interest-rate risk and liquidity risk prevail in the banking sector, institutional investors mostly face insurance risk, longevity risk and market risk. Some of these risks can be transferred from one part of the financial sector to another, depending on the absorption capacity. The transfer of risk between sectors is becoming more pronounced as derivatives and structured instruments grow. However, no such transfers of risk within the financial sector can be seen yet in Slovenia, at least not to any significant extent.

**Different types of financial institution assume different risks.**

Links are formed between banks and institutional investors in several ways. In addition to the indirect links via the marketing of insurance policies and mutual funds, which primarily expose banks to reputation risk in the event of major losses on these financial

**Banks' investment exposure to other financial sectors is relatively low.**

<sup>41</sup> For more on links between institutional investors and banks, see Pim Lescauwat: Links between institutional investors and banks (Background paper for the Institutional Investors, Global Savings and Asset Allocation Working Group, BIS), National Bank of Belgium, December 2006.

products, investment links are also important. Bank loans to other financial sectors do not represent any large exposure, accounting for just 4.7% of total loans. Banks also hold few investments in debt securities issued by other financial sectors, also as a consequence of the small number of such issues. The banking system's exposure to other financial sectors via equity is slightly larger, at almost 20% of its total capital investments, which is to be expected given their increasing importance. The risk associated with the banking system's exposure to institutional investors and vice-versa is to a great extent dependent on the dispersion of the exposure between banks or institutional investors. Given the declining importance of their traditional activities of accepting deposits and approving loans, banks are becoming more and more active in trading on the financial markets, and thus more directly vulnerable to potential instability in these markets.

Other financial sectors' investment exposure to domestic banks is slightly larger than the reverse exposure. Investments in bank deposits, bonds and shares account for almost 9% of the total financial assets of other financial intermediaries, and just over 18% of the assets of the insurance sector. The insurance sector in particular is reducing its exposure to domestic banks, via both deposits and securities, as a result of its increase in outward investments.

Table 5.3: Investments links between Slovenian financial institutions

	2001	2003	2005	2006Q3	2001	2003	2005	2006Q3
	Domestic banks' exposure to <sup>1</sup>							
	other fin.intermediaries (S.123)				insurers, pens.funds (S.125)			
Value (EUR million)	224	535	869	1,188	34	80	57	78
Bank invest. in debt securities	4	19	3	2	3	28	14	15
Bank loans granted	123	283	685	950	15	20	0	17
Bank capital investments	97	233	180	235	16	32	42	46
As % of:								
Total financial assets	1.3	2.4	2.9	3.5	0.2	0.4	0.2	0.2
Bank invest. in debt securities	0.1	0.3	0.0	0.0	0.1	0.4	0.2	0.2
Bank loans granted	1.4	2.4	4.0	4.6	0.2	0.2	0.0	0.1
Bank capital investments	13.3	24.9	15.5	16.1	2.2	3.4	3.6	3.1
	Exposure to domestic banks of <sup>2</sup>							
	other fin.intermediaries (S.123)				insurers, pens.funds (S.125)			
Value (EUR million)	226	478	537	695	538	687	806	848
Investments in bank deposits	164	227	355	504	384	438	375	377
Investments in bank debt sec.	42	196	132	136	115	202	359	389
Investments in bank capital	19	56	51	54	40	47	72	83
As % of:								
Total fin.assets of S.123 or S.125	6.5	10.0	8.1	8.7	30.5	22.7	21.1	18.5
Investments in deposits	99.9	99.9	93.0	98.4	99.2	99.9	99.4	96.5
Investments in debt securities	51.1	60.1	28.5	30.4	19.2	14.0	15.1	14.2
Capital investments	0.9	2.1	1.9	1.7	14.8	11.0	10.8	8.3

Notes: The table shows the investment links between the banking sector, and both the sector of other financial intermediaries (including investment funds and leasing companies) and the sector of insurers and pension funds.

<sup>1</sup>Investments by domestic banks in the other two sectors, via equity and debt securities, and loans granted. The proportion of total bank financial assets accounted for by the aforementioned investments, and the ratio of exposure to the two aforementioned sectors via a particular instrument to the total value of the instrument are illustrated.

<sup>2</sup>Investments by other financial intermediaries and insurers in bank equity, debt securities and deposits. The proportion of the total assets of these two sectors accounted for by these investments and the relatively exposure to banks via a particular instrument are also given.

Sources: Bank of Slovenia, SORS

**The financial system's dependence on the financial markets is expected to increase.**

Bearing the comparison with the euro area in mind, the expectation is that the proportion of the financial system's assets accounted for by investments in securities will increase, and thus its dependence on the financial markets. In the event of a sudden reallocation of assets by institutional investors, this could lead to high price volatility on the market. Slovenian institutional investors are increasingly investing in foreign mostly more developed capital markets, which allows them to diversify risk further. However, increasing exposure to less advanced, less liquid capital markets is also being seen, particularly at investment funds and in direct investments by households in foreign

markets. The main danger is a potential simultaneous sell-off of financial instruments by institutional investors, which could lead to a collapse of liquidity on the financial markets. The loss of household savings could result in a loss of confidence in the financial system.

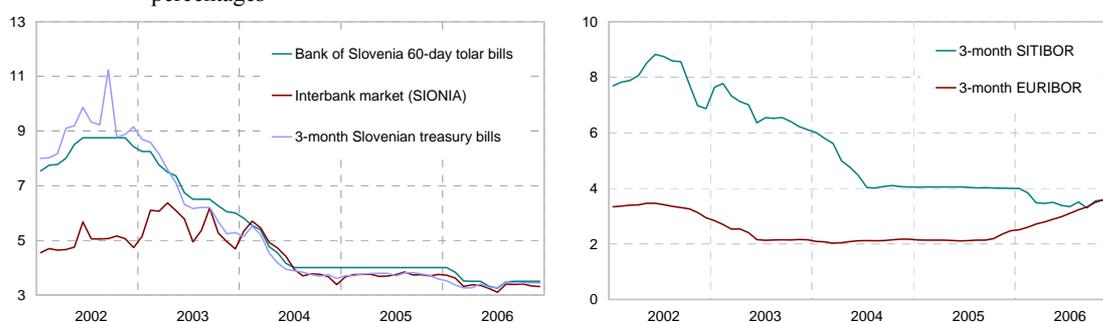
## 5.2 Domestic financial markets

### 5.2.1 Money market

There was no major change in interest rates on the money market in 2006. The money market rate had declined from 3.7% at the beginning of the year to 3.1% by the end of the second quarter, then after rising in August it fluctuated around 3.4%, close to the EONIA. Other than December's divergence between the SIONIA and the EONIA, money market rates had equalised with those in the euro area by the end of the year.

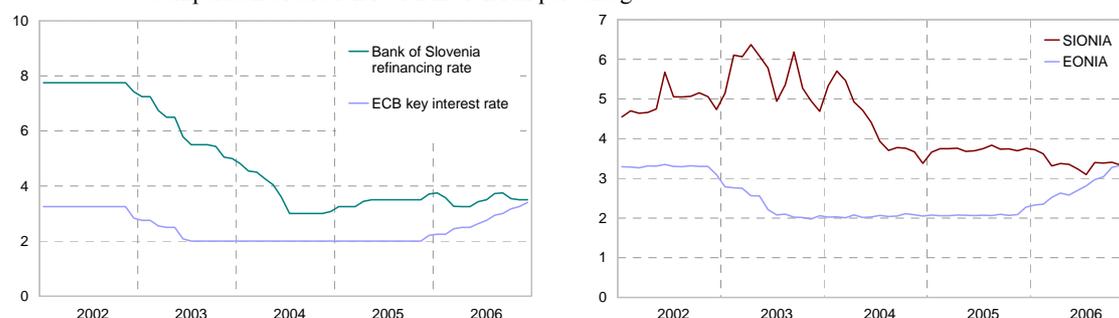
**Interest rates on the money market equalised with interest rates in the euro area before the euro was introduced.**

Figure 5.8: Interest rates on selected Bank of Slovenia instruments, money market rates, and comparison of 3-month SITIBOR with 3-month EURIBOR in percentages



Source: Bank of Slovenia

Figure 5.9: Bank of Slovenia refinancing rate and ECB key interest rate (left), and comparison of SIONIA with EONIA in percentages



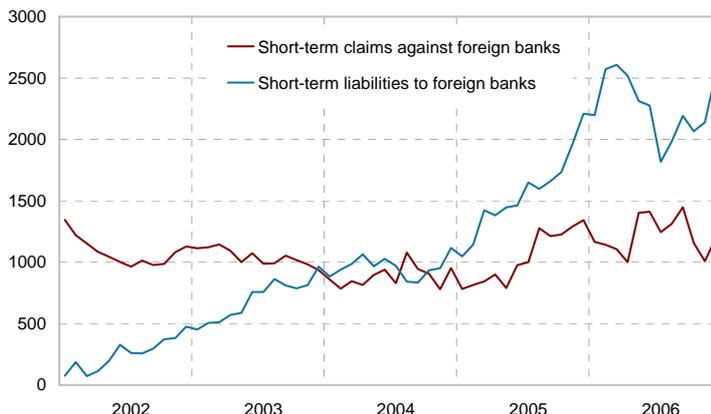
Sources: Bank of Slovenia, ECB

There was an impact on the movement of interest rates on the money market in 2006, depending on maturity, from the final convergence of the Bank of Slovenia's key interest rates with those of the ECB, and the anticipated rise in interest rates on international financial markets. These factors meant that interest rates on the short-term segments of the Slovenian money market rose, while those on long-term instruments declined.

**Last year's movement of interest rates on the money market tracked full convergence on shorter maturities, but on longer maturities was influenced by the expected rise in interest rates.**

The money market rate stood at 3.3% in December 2006, down 0.5 percentage points from a year earlier. Short-term interest rates, the SITIBOR rates and the interest rates on treasury bills tracked the Bank of Slovenia's interest rates. The Bank of Slovenia set its interest rates by gradually reducing the spread between its own interest rates and the ECB's key interest rate until equalisation. A comparison of the movement of the Bank of Slovenia's interest rates with those of the ECB and the rates on the interbank market with a maturity of up to 3 months reveals that the final interest rate convergence before Slovenia joined the euro area proceeded smoothly and evenly.

Figure 5.10: Short-term claims and liabilities vis-à-vis foreign banks in EUR million



Source: Bank of Slovenia

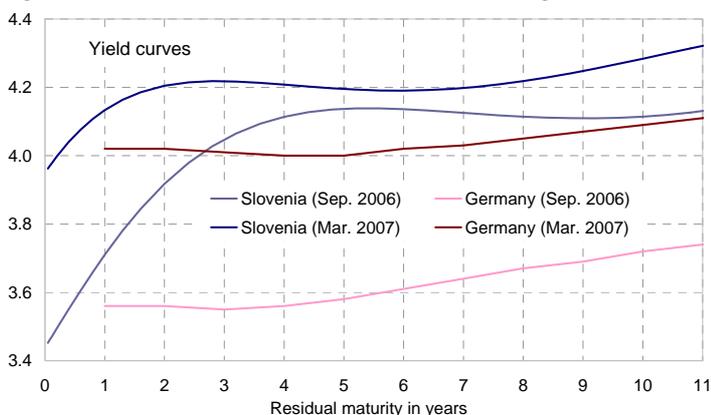
There was an intensive increase in Slovenian banks' short-term borrowing at banks abroad in 2005, but it began to decline in March 2006, before increasing again in the second half of the year. With growth in short-term liabilities (52% year-on-year) outstripping growth in short-term claims (22%) vis-à-vis foreign banks, the surplus of liabilities over claims increased by just under EUR 0.5 billion in 2006. With short-term liabilities to foreign banks increasing faster than short-term claims, in recent years banks have become more dependent on conditions on foreign markets, particularly the banks under majority foreign ownership.

### 5.2.2 Capital market

#### The spread between the Slovenian and German yield curves narrowed.

Slovenia's expectation of joining the euro area in 2007 brought further convergence in Slovenian interest rates in 2006. This was reflected in a narrowing spread between the yield curves on Slovenian and German government securities, which remained at up to 10 basis points at the end of March 2007. The spread is primarily the result of the low liquidity of the Slovenian bond market, and a higher country risk premium in Slovenia than in Germany. The rise in interest rates brought an increase in yields on both Slovenian and German government securities along the entire yield curve. However, the rise in the Slovenian yield curve in the six months to March 2007 was significantly lower. The smaller response in the domestic yield curve to changes in the ECB's interest rates, and to the favourable conditions on stock markets is the result of the aforementioned low liquidity and the retreat of domestic investors towards foreign currency securities, in addition to the convergence effects.

Figure 5.11: Yield curves on Slovenian and German government bonds in percentages



Note: The yield curves are calculated using the Svensson methodology.  
 Sources: LJSE (TUVL), Bundesbank website, own calculations

In March 2007, with the syndicated issue of 11-year bonds with a fixed annual yield of 4% in the amount of EUR 1 billion,<sup>42</sup> which is the minimum amount for achieving the appropriate liquidity, Slovenia issued its first reference bond as a member of the euro area on EuroMTS, the single market.<sup>43</sup> Slovenia had previously concluded an agreement with EuroMTS for establishing the MTS Slovenija market for Slovenian government securities.<sup>44</sup> The target is to achieve yields on government securities that are comparable to Slovenia's credit rating. For this, the following conditions need to be met: (1) expanding the investor base, which with Slovenian investors making up barely 5% of those in the aforementioned issue was satisfied; more than half of the investors were asset managers, one-third were banks, while others included insurers, pension funds and central banks. (2) Ensuring the efficient and transparent formation of the actual market price, and (3) providing an appropriate settlement system, which is a condition for increasing liquidity. There was a great deal of interest in the Slovenian bonds during the issue. For liquidity it is vital that investors are ready to trade in the bonds. The issue was also important from the point of view of reaffirming Slovenia's standing in the rest of the world as a reliable issuer, which will have a beneficial impact on borrowing by other economic entities. The organization of the government securities market is an important element in the integration of the domestic financial sector into the more efficient European financial market.

**Slovenia issued its first reference bond for the single European market in March 2007.**

Table 5.4: Overview of the Slovenian regulated capital market

	2002	2003	2004	2005	2006	Feb. 2007
<b>Shares</b>						
Number	139	136	142	118	102	100
Market capitalisation						
(EUR billion)	5.1	5.6	7.1	6.7	11.5	12.7
As % of GDP	23.0	23.0	27.2	24.2	38.7	42.0
Annual growth (%)	45.1	8.6	27.3	-5.9	72.0	86.9
Held by non-residents (%)	19.7	5.9	4.5	3.3	4.8	5.2
Turnover						
(EUR billion)	1.16	0.62	0.93	0.94	1.45	0.49
As % of GDP	5.2	2.6	3.6	3.4	4.9	-
Annual growth (%)	17.7	-46.4	49.4	1.0	54.3	-
Annual growth in SBI20	55.2	17.7	24.7	-5.6	37.9	55.6
P/E	16.3	17.4	24.9	18.7	23.5	25.3
Dividend return	2.0	1.8	1.7	1.6	1.4	1.3
<b>Bonds</b>						
Number	92	92	101	99	93	93
Market capitalisation						
(EUR billion)	2.9	3.7	4.6	6.0	6.6	6.7
As % of GDP	12.9	15.1	17.6	21.9	22.3	22.3
Annual growth (%)	91.4	26.7	26.4	31.0	9.6	9.1
Turnover						
(EUR billion)	0.46	0.54	0.47	0.75	0.19	0.03
As % of GDP	2.1	2.2	1.8	2.7	0.6	-
Annual growth (%)	114.2	17.3	-12.4	58.1	-74.9	-
Annual growth in BIO	1.6	5.7	4.1	0.9	-3.0	-3.3
Turnover on TUVL						
(EUR billion)				0.90	1.77	0.09
As % of GDP				3.3	6.0	-

Note: The figures exclude listed investment companies and mutual funds. Block trades are included. The secondary trading with government securities (the TUVL) began operations on September 2005. The figures for 2007 are for the first two months of the year only.

Sources: LJSE, SORS

<sup>42</sup> The Ministry of Finance will use the money obtained in the issue partly to finance the state budget, and partly to finance the buyback of existing debt. The purpose of the latter is to consolidate the debt into a smaller number of larger issues, allowing for an improvement in liquidity and a long-term reduction in the cost of borrowing, as the relatively low level of public debt means that the volume of the issues is rather limited.

<sup>43</sup> The ECB uses the market yields on the EuroMTS market as reference for determining whether the Maastricht criterion for long-term interest rates is met.

<sup>44</sup> See <http://www.mtsslovenia.com/>

The basic purpose of the establishment of the secondary trading with government securities (the TUVL) at the Ljubljana Stock Exchange, which has been in operation since September 2005, was met. This helped to promote secondary trading in government securities and to increase their liquidity, which is allowing for the formation of more transparent prices. The turnover on this market in the final four months of 2005 exceeded the entire year's value of bond trading on the official market, and that of previous years. The development of the TUVL market has led to a sharp decline in bond trading on the official market. The turnover of government securities on the TUVL market in 2006 was actually higher than the total turnover on the exchange, although it began to decline in the final months of the year, the decline continuing in 2007. Among the reasons for this were the practical completion of the nominal convergence of interest rates with those in the euro area, and the need for greater diversification of investments by domestic investors. At EUR 1.38 billion, net purchases of foreign bonds by residents in 2006 almost reached the turnover on the domestic regulated bond market. The turnover in the first two months of 2007 actually exceeded the net purchases in the whole of 2006, at EUR 1.56 billion. Prominent among the net purchasers of foreign bonds were banks, primarily via investments in euro area government securities as a result of the release of funds from Bank of Slovenia bills.

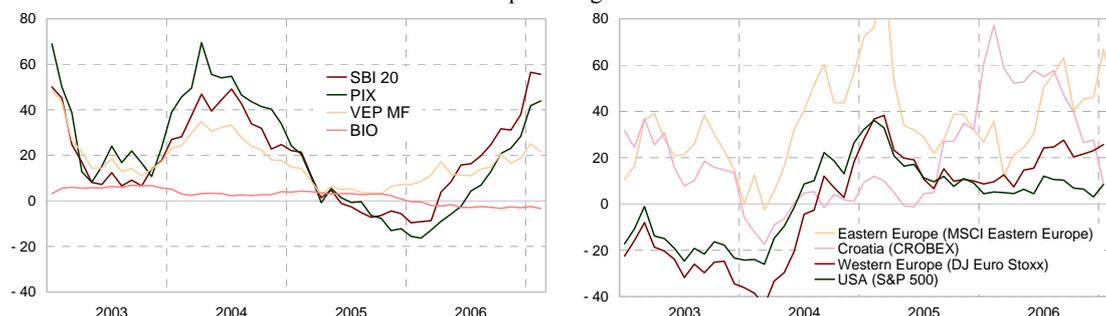
**The market capitalisation of bonds on the Ljubljana Stock Exchange is increasing.**

The BIO, Slovenia's bond index, lost 3% in 2006. Alongside low liquidity, another factor in the decline in prices of domestic bonds was low demand. Recently there has been a sharp increase in demand for foreign bonds, while the increase in non-residents' demand for domestic bonds, primarily government bonds, is not compensating for the outflow of money into foreign bonds. Despite bond prices declining, 14 bonds maturing, and some of bonds being delisted, the market capitalisation of bonds increased to 22.3% of GDP in 2006. The increase was primarily the result of the listing of bonds, mainly bank bonds, previously issued via private placements, which continued in 2007, and of the expansion in the listings of government securities. The rise in the number of listings is an indication of corporate desire for greater transparency in forming the price of debt capital, and a higher profile. Bank bonds account for almost 14% of the total market capitalisation of bonds listed on the Ljubljana Stock Exchange. There have been some private placements of bank bonds, particularly in the recent period, which is an indication of the banking system's desire for alternative financing as growth in bank deposits declines and rising European interest rates make financing via foreign banks more expensive.

**The primary market in Slovenia remains relatively under-developed.**

The most recent bond IPO in which the issuer was not the government was in 2003, while the last share IPO was in 2000. The Slovenian corporate sector still primarily finances itself via bank loans, mutually via trade credits and via internal financing with retained earnings, and only rarely via private capital injections and securities issues.

Figure 5.12: Annual growth in domestic (left) and foreign (right) stock exchange indices in percentages

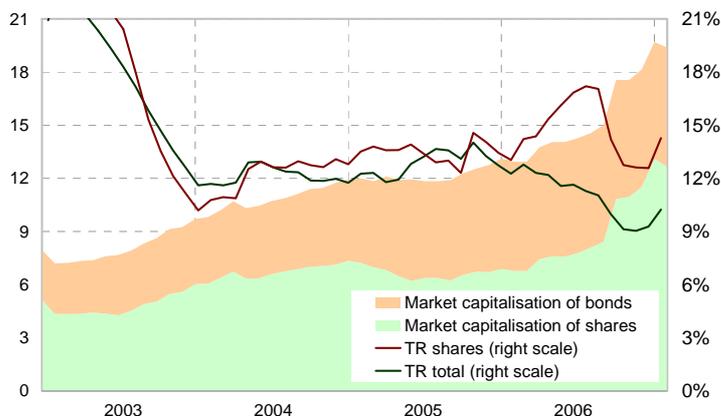


Sources: LJSE, Reuters, Vzajemci.com, own calculations

**The market capitalisation of shares increased by 72% in 2006.**

The market capitalisation of shares increased by 72% in 2006 to EUR 11.5 billion, despite a considerable number of delistings from the semi-official market at Ljubljana Stock Exchange. The increase was the result of the annual growth of almost 40% in the SBI20, October's listing of Telekom Slovenije shares in the amount of almost EUR 2 billion (Telekom's share price had risen by almost 30% by the end of March 2007), and listings and capital injections at certain other share companies. The market capitalisation of shares continued to increase in 2007, with growth of 16% in the first quarter, as a result of the quarterly growth of 20% in the SBI20.

Figure 5.13: Market capitalisation on the stock exchange in EUR billion, and turnover ratio (TR) in percentages



Note: The figures exclude listed investment companies and mutual funds. The turnover ratio (TR) is the ratio of annual turnover to market capitalisation at the end of the year. Block trades are included.

Source: LJSE

At just over EUR 1.4 billion, the total value of share trading (including block trades) in 2006 was more than 50% higher than in the previous year. This was reflected in an increase in the turnover ratio until October, when the listing of Telekom meant that it declined again. The turnover ratio for shares on the Ljubljana Stock Exchange averaged around 15% in 2006, significantly lower than that of more established exchanges (e.g. 116% at Euronext). This is an indication of the exchange's still-quite-low liquidity, which could be a factor in non-transparent share price formation. Ljubljana Stock Exchange carried out several projects in 2006 with the aim of increasing liquidity, most prominently promotional campaigns for issuers outside Slovenia aimed at raising the profile of major Slovenian shares, the creation of the prime market in the first half of the year,<sup>45</sup> and the beginning of trading via market-makers. The prime market accounted for almost 70% of the total value of share trading in 2006.

**Low share liquidity on the Ljubljana Stock Exchange.**

The annual growth of 72% in the SBI20 at the end of the first quarter of 2007 was the result of several different factors that had an important impact also on share liquidity. (1) There has been increased liquidity discernible in the euro area for some time now, which in addition to bringing a rise in stock market indices in Western Europe has also had an impact on the Slovenian capital market via foreign investors. Annual growth in M3 in the euro area had reached 10% by the end of February 2007. (2) Another factor was the introduction of the euro, with the quotation of share prices in euros bringing changes in the psychological limits on prices. (3) The beginning of the second wave of privatisation and the announcement of the government's withdrawal from the corporate sector also had an important impact. (4) Another factor was the issue of certificates by at least three European banks linked to shares in better-performing Slovenian companies and a basket of Slovenian shares, thus increasing foreign demand, and also raising the profile of Slovenian shares. Domestic investors are also major purchasers of certificates, and under current legislation are exempt from paying personal income tax on investments in derivatives. (5) The announcement of relatively good corporate results for 2006 and good profit forecasts coinciding with good macroeconomic indicators for the Slovenian economy encouraged gains. However, the results announced do not justify such high growths by many shares. The average price to earnings ratio for those shares included in the SBI20 had reached almost 27 by the end of March 2007, compared with the 2006 figure of 20, and the 2005 figure of 15 on the Euronext Paris exchange. Given the sharp acceleration in share price growth in recent months, there is a danger of exaggerated increases in share prices, particularly those of companies who have announced moderate results.

**The certificates issued for Slovenian shares were a major factor in the annual growth of 72.5% in the SBI20 in the first quarter of 2007.**

<sup>45</sup> The prime market is a specially created market segment for the top Slovenian companies. The Ljubljana Stock Exchange also calculates a blue-chip index for this segment, the SBI TOP.

### Investment links with the rest of the world

#### Demand from non-residents for Slovenian shares is increasing.

Non-residents made net purchases of EUR 260 million of Slovenian shares in 2006, both listed and unlisted, significantly more than in previous years, and accounted for almost 18% of the total value of share trading on the Ljubljana Stock Exchange. The high proportion accounted for by non-residents was partly the result of the aforementioned campaigns by the Ljubljana Stock Exchange to promote domestic issuers in the rest of the world, and the issue of certificates linked to Slovenian shares, and has continued in the early months of this year. The increased demand from non-residents was expressed in an increase in their holding of total market capitalisation to 5.3% by the end of March 2007. Greater involvement by non-residents means that the domestic regulated capital market is becoming more responsive to developments on foreign markets, which was reflected in February's monthly fall of 2.5% in the SBI20, when world exchanges underwent a brief correction. The greater involvement by non-residents and more rapid responsiveness, which is even more pronounced on a low-liquidity market, will probably lead to large sudden movements in securities prices being more frequent than before, including price falls.

Table 5.5: Overview of investment links with the rest of the world

	2003	2004	2005	2006	Feb. 2007
<b>Residents' investments abroad</b>					
<b>Shares</b>					
Stock (EUR billion)	0.2	0.5	1.5	2.6	3.0
As % of GDP	1.0	2.2	6.3	11.0	12.5
Annual growth (%)	-	114.6	192.8	73.7	68.9
In total stock of issued Sloven. equities (%)	1.4	2.7	8.0	10.7	11.5
Net purchases (EUR billion)	-	0.23	0.76	0.83	0.22
<b>Bonds</b>					
Stock (EUR billion)	0.4	0.8	1.5	2.9	4.4
As % of GDP	1.5	3.4	6.4	12.1	18.6
Annual growth (%)	-	122.8	89.2	89.7	159.0
In total stock of issued Sloven.debt sec. (%)	7.2	13.0	20.6	37.5	56.5
Net purchases (EUR billion)	-	0.43	0.88	1.38	1.56
<b>Non-residents' investments in Slovenia</b>					
<b>Shares</b>					
Stock (EUR billion)	1.4	2.2	2.5	3.2	3.4
As % of GDP	4.6	7.4	8.3	10.7	11.4
Annual growth (%)	-29.6	60.1	13.0	28.5	31.7
In total stock of issued Sloven. equities (%)	8.3	11.8	13.5	13.3	13.3
Net purchases (EUR billion)	0.05	0.09	0.16	0.26	0.09
<b>Bonds</b>					
Stock (EUR billion)	0.2	0.2	0.5	0.9	1.1
As % of GDP	0.6	0.6	1.6	3.0	3.7
Annual growth (%)	63.5	5.5	172.8	85.2	91.0
In total stock of issued Sloven.debt sec. (%)	3.4	2.9	6.7	11.8	14.2
Net purchases (EUR billion)	0.18	0.05	0.36	0.55	0.22

Note: The 2007 figures are for net purchases in the first two months of the year only.

Sources: CSCC, Bank of Slovenia, SORS, own calculations

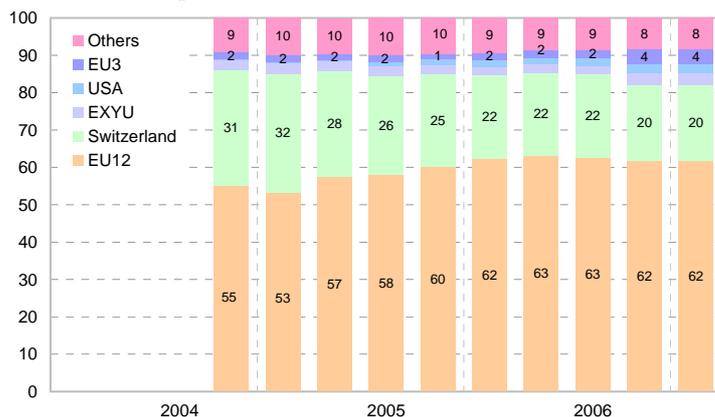
#### At 163%, equity in Slovenia is significantly lower in relation to GDP than in the euro area.

Shares and other equity<sup>46</sup> were equivalent to approximately 163% of GDP in Slovenia at the end of the second quarter of 2006, while the figure for the euro area was significantly higher at almost 230% of GDP. The reasons are that financial intermediation in the Slovenian economy lacks sufficient depth, and that the accelerated development of institutional investors (life insurance companies, pension funds, investment funds) began only recently. A comparison with the euro area reveals that financial companies account for a significantly lower proportion of both issuers and holders of equity in Slovenia. In Slovenia they accounted for 11% as holders and 14% as issuers at the end of the second quarter of 2006, mainly as a result of the much higher proportions accounted for by the

<sup>46</sup> The figures are taken from financial accounts. Item F.5 in financial accounts (shares and other equity) includes all shares (listed and unlisted), shares and units in investment funds, and other equity such as other forms of economic ownership (limited liability companies, unlimited liability companies, etc.).

government sector, while in the euro area the figures were 37% as holders and 42% as issuers in 2004. This lack of development in the domestic capital market is primarily because the market only began to develop just over 15 years ago. As seen previously, the proportion accounted for by non-residents, mainly those from the euro area and the UK, has recently been increasing, which is an indication of the continuing integration of the Slovenia economy into the rest of the world. In February 2007 non-residents accounted for 13% of the stock of issued Slovenian equities, while the increase in their holdings was even more notable for bonds, of which they account for 14%, which is partly related to decline in the country risk premium when Slovenia joined the euro area.

Figure 5.14: Regional breakdown of non-residents' investments in Slovenian securities in percentages



Note: Includes investments in listed shares and bonds, and in those not listed on the exchange. The 2007 figures relate to February.

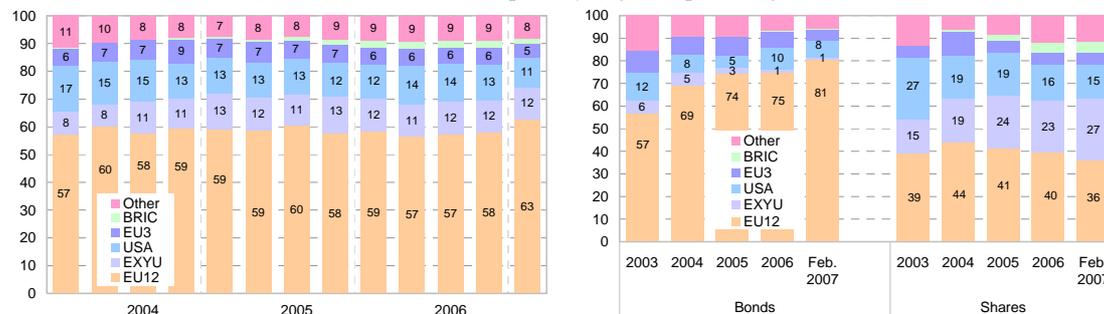
EU3: UK, Denmark, Sweden; Ex-YU: former Yugoslav republics.

Sources: CSCC, own calculations

The trend of increasing investments by Slovenian investors in foreign securities has continued. In addition to (1) the low depth and low liquidity of the Slovenian capital market, (2) domestic investors' desire for higher returns and (3) greater regional diversification were factors in the increase in outward investments. (4) The introduction of the euro means that there is no longer any currency risk on investments in the euro area. (5) Purchases of euro area government bonds by banks have increased in particular in recent months as a result of the release of funds from Bank of Slovenia bills. The increase in investments in emerging markets, in particular the former Yugoslavia, China and Russia, is increasing risk, despite the diversification. Greater integration of the Slovenian capital market into the rest of the world nevertheless also means that the domestic economy is potentially more vulnerable to the situation in the rest of the world.

**The trend of increasing outward investments by Slovenian investors is continuing.**

Figure 5.15: Regional breakdown of investments by residents in foreign securities overall (left), and bonds and shares separately (right) in percentages



Notes: The 2007 figures relate to February. EU3: UK, Denmark, Sweden; BRIC: Brazil, Russia, India, China; EXYU: former Yugoslav republics.

Source: Bank of Slovenia

Bonds accounted for almost 60% of the EUR 7.4 billion of investments in foreign securities. More than 80% of this was euro area bonds, which from 2007 have no longer

**Euro area bonds and shares on emerging markets are increasing among outward investments.**

incorporated currency risk. Banks hold more than three-quarters of the bonds, while insurers account for 20%. Residents' investments in foreign bonds are equivalent to more than 55% of the value of all issued Slovenian debt securities, an indication of the shallowness of the Slovenian debt market in relation to demand from investors. Investors in foreign shares, among whom are prevalent other financial intermediaries (investment funds) with more than 40% and households directly with almost 25%, are increasingly opting to invest in emerging markets, particularly the former Yugoslavia, which has recently recorded extremely high growth.

November 2007 is the final deadline for transposing the Markets in Financial Instruments Directive (MiFID) into Slovenian law.<sup>47</sup> Given the comprehensive changes being introduced by the aforementioned directive together with several others, instead of an amendment to the existing Securities Market Act (the ZTVP-1), legislators have decided to draft a new Market in Financial Instruments Act (the ZTFI). The aim of the new act is to create the conditions for the stable functioning of the market in financial instruments, which is a prerequisite for a stable financial system.<sup>48</sup>

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<sup>47</sup> Markets in Financial Instruments Directive (MiFID); 2004/39/EC.

<sup>48</sup> Ministry of Finance: Market in Financial Instruments Act (ZTFI), bill for first reading, November 2006.

## 6 BANKING SECTOR

### 6.1 Composition of the banking sector

Banks remain the economy's key financial intermediary and the ratio of their total assets to GDP further increased. The proportion of the banking system owned by non-residents again increased in 2006. The banking sector's market concentration fell once more, which reflected the intensification of competitive pressures.

#### Banks and other financial intermediaries

Banks remain by far the most important financial intermediaries, while the proportion of savings banks is negligible. The ratio of bank assets to GDP increased in 2006 by 7.4 percentage points.

Table 6.1: Structure of financial sector by total assets and ratio to GDP

	Ratio to GDP (%)					Proportion of financial sector (%)				
	2002	2003	2004	2005	2006	2002	2003	2004	2005	2006
Central bank	29.9	28.9	25.8	25.6	25.9	20.2	19.3	16.7	14.7	14.1
Monetary financial institutions	86.3	88.1	91.0	106.5	114.1	58.2	58.8	58.9	61.2	62.1
Banks	85.1	87.0	90.5	106.0	113.4	57.4	58.0	58.5	60.9	61.7
Savings banks and SLUs	1.2	1.1	0.5	0.6	0.7	0.8	0.7	0.3	0.3	0.4
Non-monetary financial institutions	32.0	32.9	37.8	41.8	43.8	21.6	21.9	24.4	24.0	23.8
Total	148.3	149.8	154.7	174.0	183.8	100.0	100.0	100.0	100.0	100.0

Note: The 2005 figures are used for some non-monetary institutions: leasing companies, brokerage houses, management companies and others.

Source: ISA, SMA, AMC, SLA, APLRRS, Bank of Slovenia

Banks have managed to increase the scope of business also by expanding the range of products and services to include those of non-monetary financial institutions, i.e. those of insurers and investment companies. This has strengthened links between banks and non-monetary financial intermediaries. These links are going beyond business cooperation and increasingly involve equity ties.

#### Banking sector size and changes of status

The total assets of banks in 2006 reached EUR 33.7 billion, which is over 113% of GDP. Their growth was twice the rate of growth in GDP. This indicates that the ratio between the two growth rates again approached the long-term average in 2006, after growth in total bank assets was four times higher than GDP growth in 2005.

**Total bank assets reached 113% of GDP in 2006.**

At the end of 2006 there were 22 banks operating in Slovenia, two of which were branches of foreign banks. The Kaerntner Sparkasse branch was converted into a subsidiary in 2006 and Banka Koper became a bank under majority foreign ownership. At the beginning of 2007, another bank and another subsidiary started operations: SID and RCI Banque Societe Anonyme. There were also three savings banks operating in 2006.

**At the end of 2006 there were 22 banks operating in Slovenia, including 2 subsidiaries, and 3 savings banks.**

Table 6.2: Total assets of monetary financial institutions compared to GDP

	2002	2003	2004	2005	2006
Total assets (EUR million)	19,009	21,098	23,691	29,276	33,718
GDP - current prices (EUR million)	22,348	24,259	26,172	27,625	29,736
Total assets (as % GDP)	85.1	87.0	90.5	106.0	113.4
Ratio of growth in total assets to GDP growth	1.5	1.3	1.6	4.2	2.0
No. of bank employees	11,543	11,397	11,534	11,632	

Source: Bank of Slovenia

In 2006 one bank registered its provision of services in Slovenia via a subsidiary, while 29 banks registered the direct pursuit of business activities. By the end of March 2007, 142 European banks had registered the direct pursuit of their business activities in Slovenia with the Bank of Slovenia since the country joined the European Union. The largest

**To date 142 European banks have registered to provide services, the most being from Austria and the UK.**

numbers are from Austria and the UK, followed by banks from Germany and France. The majority are authorised to provide some or most of their banking services. Among the banks with more specialist services are banks involved in lending and issuing guarantees, and banks offering asset and securities management and securities issues.

### Bank ownership

**In 2006 the proportion of non-residents in the ownership structure continued to increase.**

A major increase in the proportion of non-residents occurred in 2005 at the expense of the government and residents, after a long period without changes in the ownership structure. This process continued in 2006. The proportion under foreign ownership increased by 2.8 percentage points, with an increase of 8.3 percentage points in the proportion of non-residents controlling over 50% of a bank, while the proportion of non-residents without a majority holding fell by 5.5 percentage points. The proportion of non-residents increased at the expense of “other residents”, and only very slightly at the expense of the government’s holdings. The changes in the ownership structure are due to the establishment of new banks and recapitalisations, and particularly transfers of ownership from residents to non-residents.

Table 6.3: Ownership composition of banking sector (in terms of equity)

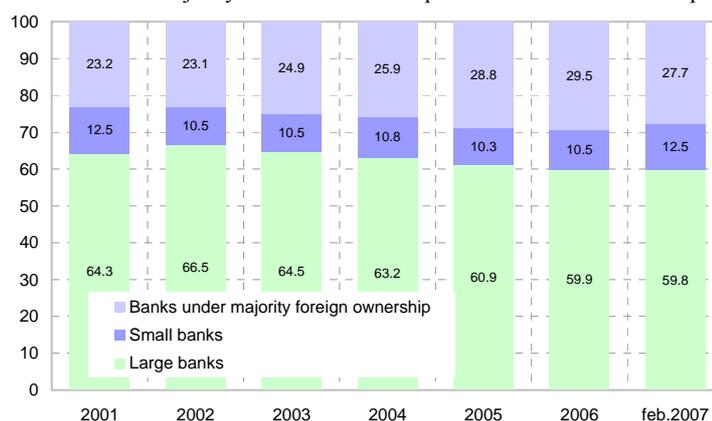
(%)	2002	2003	2004	2005	2006
Central government	20.3	19.4	19.1	18.2	17.9
Other domestic entities	47.2	48.2	48.6	46.9	44.4
Non-residents	32.5	32.4	32.4	34.9	37.7
Non-residents (over 50% control)	15.7	16.6	16.5	19.4	27.7
Non-residents (under 50% control)	16.8	15.8	15.9	15.5	10.0

Note: Relative proportions of ownership.

Source: Bank of Slovenia

In the analysis below, banks are divided into three groups: large banks, small banks and banks under majority foreign ownership. There is no overlap between the groups, so each bank is classified into one group only. The size of the bank is determined by its total assets. In both cases, whether nominal or relative differences are considered, it is reasonable to class the top eight banks as large banks, and the others as small banks. All banks under majority foreign ownership are placed in the same category, regardless of size, due to differences in their behaviour and operational methods.

Figure 6.1: Market share of banks under majority foreign ownership and under majority domestic ownership in terms of total assets in percentages



Source: Bank of Slovenia

### Concentration in banking sector

**In 2006 concentration fell in all sectors, which reflects the increase in competition.**

The concentration of the Slovenian banking sector decreased in 2006, due to the heightened competition between banks trying to increase their market share. In 2006 concentration decreased most in the area of liabilities to banks, primarily to foreign banks. Slovenia’s level of concentration is significantly higher than the euro area average. If, however, one takes into account the unweighted EMU average, where member-states with smaller banking systems have greater weight, Slovenia’s concentration does not differ a great deal from the EMU average.

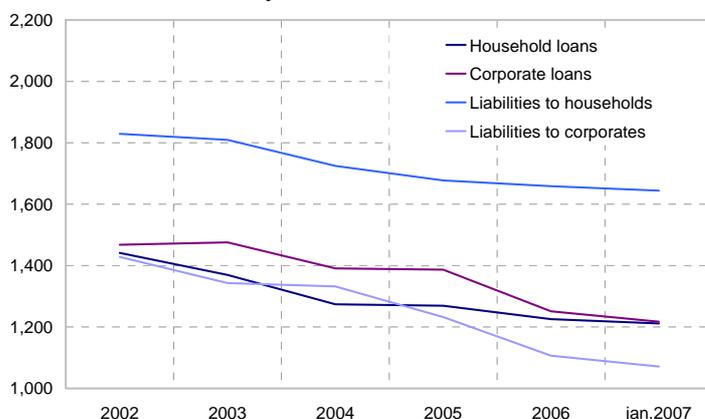
Table 6.4: Market concentration of Slovenian banking market as measured by the Herfindahl-Hirschman index and market share of the top three/five banks

	2002	2003	2004	2005	2006	Jan. 2007	Change 2006-2005
<b>Herfindahl-Hirschman index</b>							
Total assets	1,665	1,553	1,472	1,396	1,321	1,328	-75
Total assets (euro area)	552	580	600	641			
Unweighted	903	946	966	1,000			
Loans to non-banking sectors	1,470	1,393	1,310	1,307	1,213	1,191	-94
Liabilities to non-banking sectors	1,689	1,607	1,570	1,462	1,431	1,464	-31
Liabilities to banks	1,728	1,379	1,278	1,339	1,194	1,174	-145
<b>Market share of top 3 banks (%)</b>							
Total assets	55.4	53.3	52.0	50.3	49.7	49.8	-0.6
Loans to non-banking sectors	52.9	52.5	50.5	49.2	47.9	47.3	-1.3
Liabilities to non-banking sectors	56.8	55.7	55.3	54.1	54.0	54.1	-0.1
Liabilities to banks	56.6	51.7	49.0	49.7	47.2	44.2	-2.4
<b>Market share of top 5 banks (%)</b>							
Total assets	69.5	67.4	65.1	63.3	62.4	61.2	-1.0
Total assets (euro area)	39.3	40.5	41.6	43.0			
Unweighted	52.7	53.1	53.3	54.4			
Loans to non-banking sectors	67.3	66.7	64.2	62.6	61.4	60.7	-1.3
Liabilities to non-banking sectors	71.3	70.6	68.9	67.3	66.7	66.7	-0.6
Liabilities to banks	71.0	64.9	62.0	62.9	60.9	57.2	-2.0

Source: Bank of Slovenia, ECB: Report on EU Banking Structure

In banking activities with non-banking sectors, concentration decreased more in the loans segment than the liabilities segment. What is more surprising, given the increased focus banks have recently placed on households, is that in 2006 concentration fell primarily in the corporate banking sector, both for loans and liabilities.

Figure 6.2: Market concentration in bank operations with non-banking sectors as measured by the Herfindahl-Hirschman index



Source: Bank of Slovenia.

## 6.2 Changes in balance sheet structure

Last year banks maintained a relatively high level of growth in lending to non-banking sectors – at 26.7% on average. At the same time, bank holdings of securities decreased. As a consequence loans to non-banking sectors increased as a proportion of total assets, reaching around 60% at the end of 2006. Despite the low year-on-year growth in deposits by non-banking sectors, which averaged just over 9%, the need for financing from banks abroad fell throughout the year. In 2005 banks financed almost two-thirds of the increase in their total assets from sources abroad, but in 2006 that proportion fell to just one-third.

**Alongside high credit growth, the fall in total asset growth coincided with the reduction of investments in securities and reduction in borrowing abroad.**

Table 6.5: Market shares and growth in total assets and loans to non-banking sectors by individual groups of banks in percentages

(%)	Market shares			Growth		
	2004	2005	2006	2004	2005	2006
<b>Total assets</b>						
Large banks	63.2	60.9	59.9	10.0	19.1	13.3
Foreign banks	25.9	28.8	29.5	16.8	37.1	18.2
Small banks	10.8	10.3	10.5	15.5	17.5	17.7
Total	100	100	100	12.3	23.6	15.2
<b>Loans to non-banking sectors</b>						
Large banks	60.9	58.7	56.5	16.7	21.4	19.7
Foreign banks	29.6	31.9	33.9	30.8	36.2	32.0
Small banks	9.5	9.4	9.7	20.5	24.7	27.9
Total	100.0	100.0	100.0	21.0	26.1	24.4

Source: Bank of Slovenia

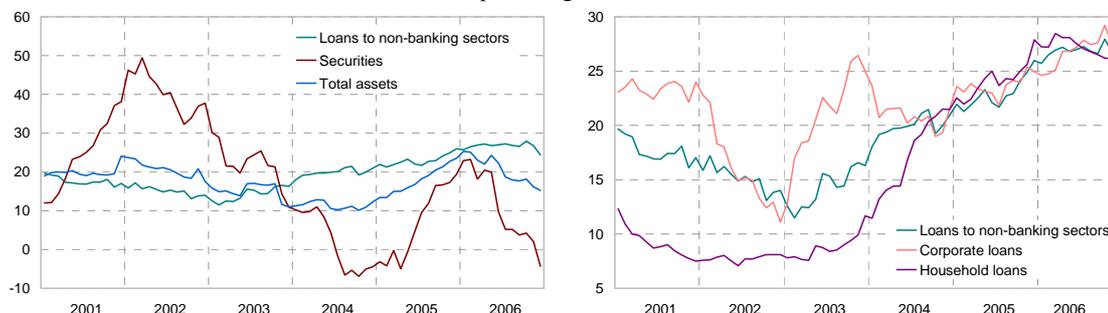
**Scope of banking activities increased most for foreign-owned banks.**

The banking system's total assets increased by 15.2% in 2006. As measured by total assets, the market share of large banks under majority domestic ownership fell, while the market share of banks under majority foreign ownership increased, facilitated by access to cheaper sources of financing from the rest of the world. The increase in the stock of loans to non-banking sectors by banks under foreign majority ownership was therefore significantly above average, which increased their market share of loans by 2 percentage points.

**Structure of assets**

Growth in lending to non-banking sectors further increased last year, reaching its highest value of just over 27% in the middle of the year. The level of growth in loans stabilised in the second half of the year.

Figure 6.3: Year-on-year growth in bank investments and loans to non-banking sectors in percentages



Source: Bank of Slovenia

Despite the increase in banks' foreign currency interest rates, which mirrored the gradual increase in ECB interest rates and on international financial markets, domestic demand for loans did not decrease. This was due to the relatively high economic growth and fierce competition between banks to increase their market share. The growth in short-term and long-term loans was equalised, at 26.7% on average, which kept the proportion of long-term lending at two-thirds.<sup>49</sup> At the end of 2006, the proportion of the cash balance sheet item as the most liquid bank asset increased, due to preparations for the adoption of the euro.

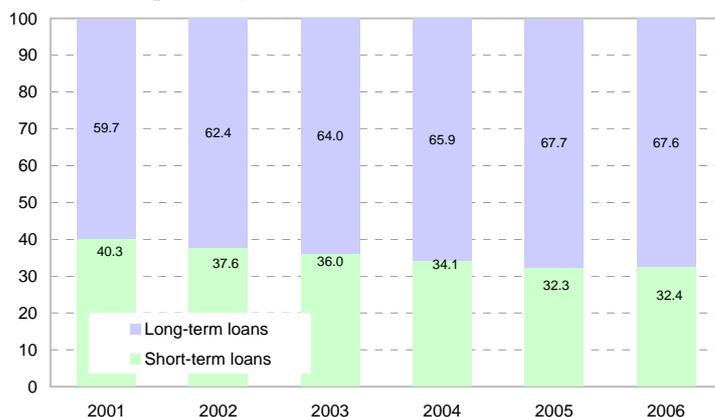
<sup>49</sup> It should be pointed out that following the changeover to the IFRS, the maturity of loans is classified according to original maturity and no longer according to the residual maturity. The same applies to deposits and other balance sheet categories.

Table 6.6: Structure and growth in balance sheet items in banking sector at year-end in percentages

	2003	2004	2005	2006	Growth (%)		
					2004	2005	2006
Total assets (EUR million)	21,098	23,691	29,276	33,718	12.3	23.6	15.2
Assets	Structure (%)						
Cash	2.8	2.5	2.0	3.1	-0.3	1.9	76.3
Loans to banks	6.8	8.9	9.8	9.1	47.0	35.6	6.5
Loans to non-banking sectors	50.2	54.1	55.2	59.6	21.0	26.1	24.4
Corporate loans	31.6	34.1	33.8	36.0	21.4	22.5	22.5
Household loans	12.4	13.5	13.9	15.0	21.4	28.0	24.1
Loans to government	2.8	2.5	2.3	1.7	0.7	11.6	-13.8
Loans to others	3.4	4.0	5.1	6.9	32.4	59.4	54.9
Securities	34.2	29.1	28.2	23.4	-4.4	19.4	-4.2
Bank of Slovenia	20.3	13.5	12.0	5.3	-25.4	9.5	-48.9
Government and other	13.9	15.6	16.2	18.1	26.1	28.0	28.8
Capital investments	1.4	1.3	1.2	1.3	8.3	8.8	22.8
Other assets	4.5	4.0	3.6	3.5	-0.6	11.9	11.7
Liabilities							
Liabilities to banks	16.5	19.7	28.7	31.6	33.7	80.0	26.8
To foreign banks	14.0	17.9	27.0	29.5	43.6	86.4	26.2
Liabilities to non-banking sectors	65.2	62.1	54.7	51.9	7.0	8.8	9.2
To corporates	17.4	16.4	14.8	14.2	5.8	11.6	10.0
To households	43.1	42.0	36.0	33.6	9.5	6.0	7.4
To government	3.1	2.4	3.0	3.3	-14.3	53.4	28.5
To others	1.6	1.3	0.9	0.8	-3.8	-15.6	6.9
Liabilities from securities	4.3	4.0	3.4	2.9	4.0	5.7	-1.6
Other liabilities	6.1	5.5	5.1	4.6	0.1	16.0	3.8
Provisions	2.0	2.1	0.6	0.5	18.8	-64.1	1.9
Subordinated liabilities	1.9	2.5	2.4	2.9	49.7	18.4	40.1
Capital	8.3	8.1	8.4	8.4	9.7	28.9	14.9

Source: Bank of Slovenia

Figure 6.4: Proportions of long-term and short-term loans to non-banking sectors in percentages

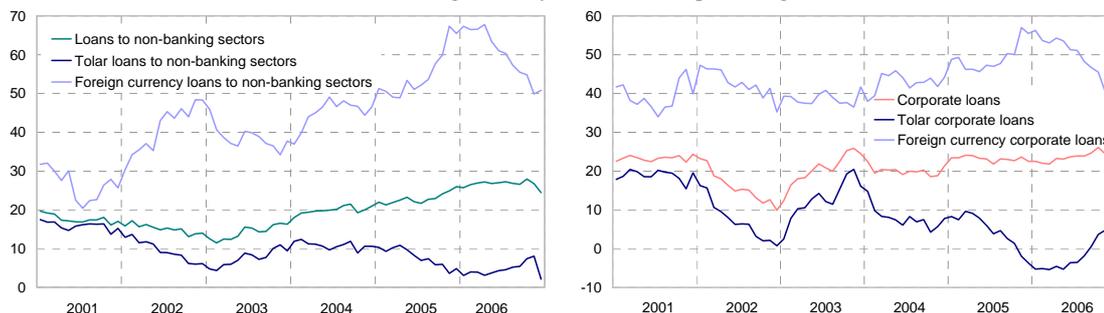


Source: Bank of Slovenia

The introduction of the euro led to foreign currency lending to non-banking sectors further exceeding tolar lending, with growth in foreign currency lending reaching 50.6% by the end of 2006. This led to its proportion – then still of foreign currency lending – in the banking system’s lending structure to non-banking sectors reaching 55.5%, 64.5% of lending to non-financial companies, and 23.2% of lending to households, which represents a relatively high percentage of spontaneous conversion to euro loans.

**The anticipated euro changeover ensured most non-banking sector borrowing was in euros.**

Figure 6.5: Year-on-year growth in loans to non-banking sectors and corporate loans, including currency breakdown in percentages

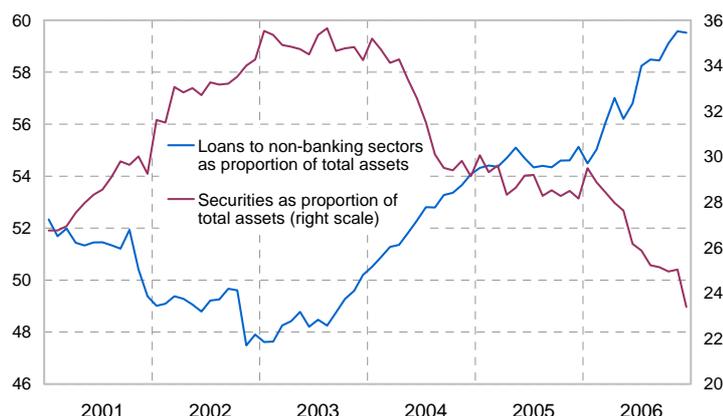


Source: Bank of Slovenia

**The redemption of Bank of Slovenia bills made the structure of Slovenian bank investments more comparable with the average of investments by EU banks.**

In 2006 major changes in the asset structure also occurred due to the decline in the proportion of securities caused by the redemption of Bank of Slovenia bills. The stock of bills fell by EUR 1.7 billion in 2006. A portion of these investments in Bank of Slovenia bills moved to other forms of liquid investment, while a portion was used for lending to non-banking sectors. Despite the pace, the changes in asset structure were smooth and without shocks.

Figure 6.6: Percentage of total assets accounted for by loans to non-banking sectors and securities



Source: Bank of Slovenia

### Assets structure of Slovenian banks and EU banks

Table 6.7: Proportion of balance sheet totals accounted for by selected assets items for Slovenian banks and EU banks, under the IFRS

(%)	2005		2006
	Medium-size EU banks <sup>1</sup>	Small EU banks <sup>1</sup>	Slovenia
Cash	2.0	3.0	3.1
Loans to banks	8.2	16.4	9.1
Loans to non-banking sectors	68.1	60.0	59.6
Financial assets / securities	14.6	14.9	23.4

Note: <sup>1</sup>Domestic banks from EU member-states under the IFRS.

Source: Bank of Slovenia, ECB: EU Banking Sector Stability, November 2006

Comparing the structure of assets by Slovenian banks with the assets structure of medium-size EU banks indicates that the proportion of securities in the total assets of Slovenian banks is comparable to but still higher than the EU average. This is a result of previous years in which the Bank of Slovenia was forced to implement an active policy of sterilising excess liquidity on the market. At the same time the proportion of lending to non-banking sectors is lower than that of comparable banks in EU member-states.

### Sources of financing for banks

Growth in deposits by non-banking sectors remained behind growth in total assets in 2006, but the gap between the two growth rates decreased. The relatively low growth in deposits and fall in the proportion of investments in securities meant that banks were able to gradually reduce the trend of borrowing from banks abroad.

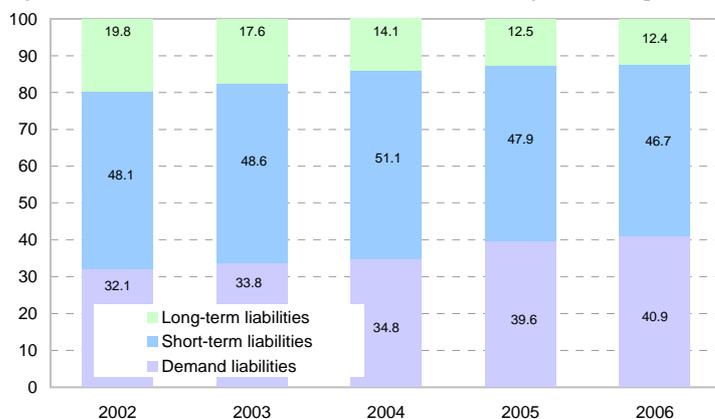
**The growth of non-banking sector deposits remained low.**

Growth in deposits by non-banking sectors reached 9.2% last year. The maturity structure of deposits by non-banking sectors remained fairly stable. However, the long-term trend of a reduction in the proportion of long-term non-banking sector deposits continued, despite the fact that interest rates realised on short-term deposits at Slovenian banks remained behind those in the EMU, while interest rates on long-term deposits were equal. In recent years the relative importance of non-banking sector deposits has fallen, because from the end of 2001 to the end of 2006 the proportion of these deposits in total assets fell by approximately 20 percentage points, and went below half of total assets in the first months of 2007.

**Financing via non-banking sector deposits is extremely short-term.**

While in 2005 banks were still financing two-thirds of growth in total assets from banks in the rest of the world, this was no longer necessary last year. The differences in total assets between individual bank types are relatively large. In December 2006 the large banks under majority domestic ownership disclosed 24% liabilities to banks abroad, while the small domestic banks disclosed just 5%, and the banks under majority foreign ownership half of total assets. Three-quarters of these bank sources are long-term. However, for the banks under majority domestic ownership liabilities to banks in the rest of the world are a less stable and more expensive source of financing than household deposits, so household deposits are important to the long-term stability of bank operations. Last year banks did not use their interest rate policy to stimulate an increase in this form of financing. Even in the first months of 2007, at around 3% the interest rate on short-term deposits remained 1 percentage point behind the 3-month EURIBOR, which is more than the banking average for the euro area.

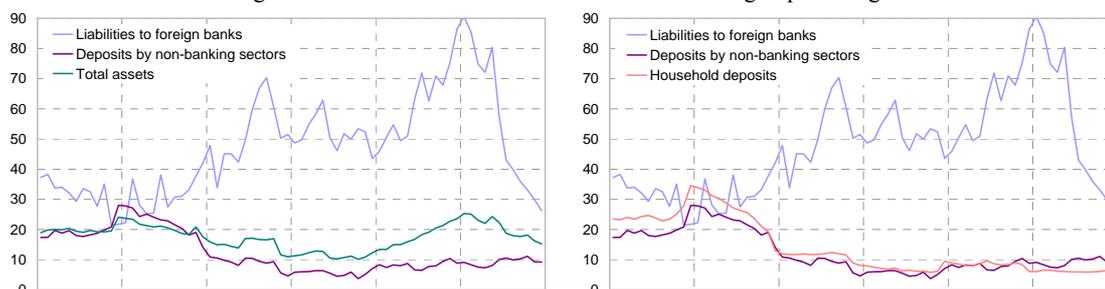
Figure 6.7: Breakdown of liabilities to non-banking sectors in percentages



Source: Bank of Slovenia

Growth in other sources, with the exception of subordinated bank debt, was outstripped by growth in total assets. Growth in subordinated debt, which is important for banks as it can be included in the capital adequacy calculation, increased last year by 21.7 percentage points to 40.1%. Growth in capital almost outpaced growth in total assets last year.

Figure 6.8: Growth in banks' sources of financing in percentages

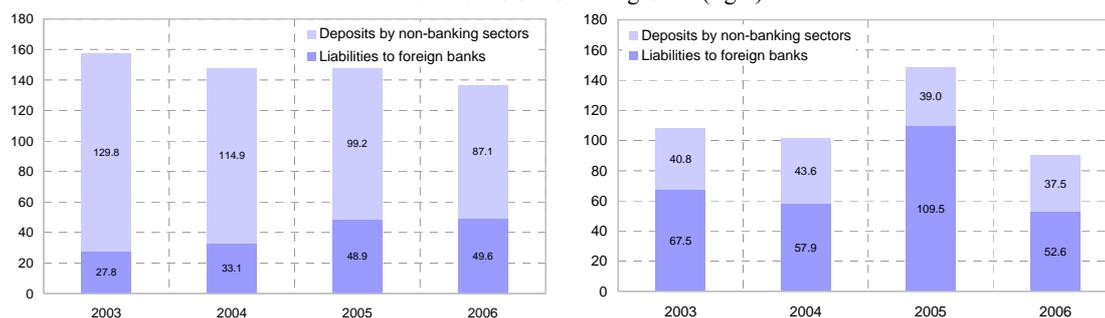


Source: Bank of Slovenia

**Coverage of loans by deposits by non-banking sectors and liabilities to foreign banks**

At the end of 2006 the ratio of non-banking sector deposits to loans was 87%, compared to three years ago when it was almost 130%. This reflects the relatively rapid deterioration in quality of financing sources, as banks finance a lower proportion of lending with their own funds collected on the retail market. Since in recent years banks have economically balanced their balance sheet on the liabilities side, the redemption of securities in 2006 led to the reduction of potential sources in the form of liabilities to foreign banks.

Figure 6.9: Percentage coverage of loans to non-banking sectors by liabilities to foreign banks and by deposits by non-banking sectors in stock terms (left) and in terms of nominal growth (right)



Source: Bank of Slovenia

**Liability structure of Slovenian banks and EU banks**

The proportion of non-banking sector deposits in the Slovenian banking system is similar to that at medium-sized EU banks; it is lower than the proportion at smaller EU banks. The ratio of financing on the interbank market to deposits by non-banking sectors is significantly higher in the Slovenian banking system, owing to borrowing from foreign banks. The proportion of subordinated debt in total assets is also higher at Slovenian banks. The proportion of financing via securities issues is significantly lower for Slovenian banks, particularly compared to medium-size EU banks.

Table 6.8: Proportion of balance sheet totals accounted for by selected liability items at Slovenian banks and average proportion for EU banks, disclosed under the IFRS in percentages

(%)	2005		2006
	Medium-size EU banks <sup>1</sup>	Small EU banks <sup>1</sup>	Slovenia
Liabilities to banks	11.3	10.2	31.6
Liabilities to non-banking sectors	48.6	69.3	51.9
Liabilities from securities	22.5	3.5	2.9
Provisions	0.7	0.4	0.5
Subordinated liabilities	1.8	0.8	2.9
Capital	6.9	12.0	8.4

Note: <sup>1</sup>Domestic banks from EU member-states using the IFRS.

Source: Bank of Slovenia

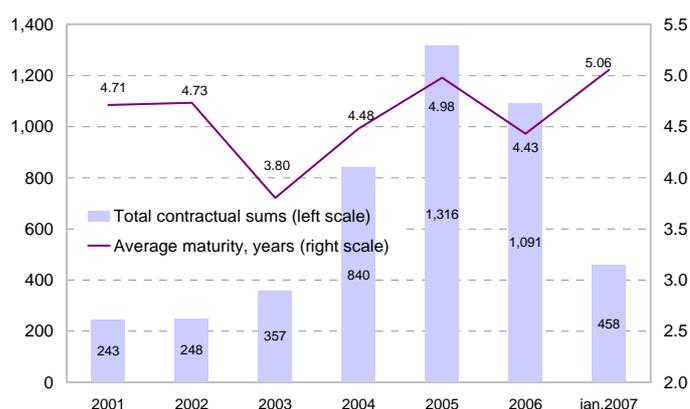
## Syndicated loans

Despite the low volume of syndicated loans, they nevertheless remain an important source of financing, particularly for domestically-owned banks. Banks under majority foreign ownership generally borrow directly from parent banks. The volume of new syndicated loans in 2006 exceeded EUR 1 billion for the second year in succession.

**New syndicated loans in 2006 exceeded EUR 1 billion.**

The average maturity of new syndicated loans remains similar to before 2003, at around 4.6 years, but in recent years volatility has significantly increased. The average maturity of new syndicated loans was 6 months shorter in 2006 than a year earlier.

Figure 6.10: Total contractual sums of new syndicated loans in EUR million and their average maturity

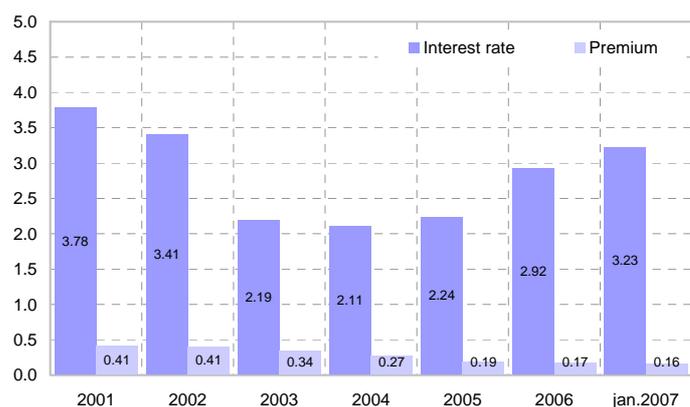


Source: Bank of Slovenia

Most syndicated loans are linked to the 6-month EURIBOR. The premium over the reference interest rate is continuing to fall, a reflection of the competition on the syndicated loans market and the reduction in the risk rating of Slovenian banks. However, the rise in interest rates on international markets is reflected in the total interest rate, which had increased by 1 percentage point by the start of 2007 compared to 2005.

**The premium over the reference interest rate is falling.**

Figure 6.11: Interest rate and premium over reference interest rate for new syndicated loans in percentage and percentage points



Source: Bank of Slovenia

Banks use syndicated loans to finance non-banking sectors, also in the form of syndicated loans. This form of loan is of particular interest to telecommunications and retail companies, and other financial institutions. The total volume of syndicated loans that banks approved to companies and other financial institutions in 2006 was EUR 1.36 billion, or 40% of the volume of syndicated loans taken out with banks in the rest of the world<sup>50</sup>. In 2007 banks anticipate that they will raise a similar volume of new syndicated loans as in 2006.

<sup>50</sup> The source of data is a bank survey carried out in March 2007.

### Off-balance-sheet items and fiduciary operations

Growth in off-balance-sheet items last year outpaced growth in total assets. Most of the increase came from items such as received sureties, guarantees and assets pledged as collateral, depository and other securities records. The ratio of off-balance-sheet items to total assets of 146.2% for last December exceeded the December 2005 figure by over 10 percentage points. The faster growth of off-balance-sheet items compared to total assets was more pronounced in the second half of 2006. There were no major changes in the structure of off-balance-sheet items. The proportion of guarantees and assets pledged, and financial instruments both grew.

Table 6.9: Structure of and growth in off-balance-sheet items in banking sector at year-end in percentages

	2004	2005	2006	Growth (%)		
				2004	2005	2006
Off-balance-sheet items (EUR million)	31,494	39,779	49,288	9.4	26.3	23.9
	Structure (%)					
Letters of credit	0.4	0.5	0.3	-55.4	52.5	-14.6
Guarantees and assets pledged as collateral	6.7	6.2	7.9	-36.5	16.3	59.5
Assumed financial liabilities	9.8	9.4	8.1	-22.4	21.7	6.5
Derivatives <sup>1</sup>	11.3	12.2	13.3	-49.7	36.8	34.9
Depo and other securities records	12.9	13.4	13.5	63.3	30.7	24.7
Records of written-off claims	0.4	0.3	0.2	-58.0	-15.0	1.2
Other off-balance-sheet items	58.5	58.1	56.6	61.8	25.3	20.9
Warranties received	38.3	36.3	37.0	23.4	19.6	26.2
Guarantees and gov. sureties received	3.0	2.9	2.3	19.0	22.5	-3.3
Other	17.2	18.8	17.4	569.1	38.6	14.3

Note: <sup>1</sup>Includes swaps with the Bank of Slovenia.

Source: Bank of Slovenia.

#### Box 6.1: Impact of the introduction of the International Financial Reporting Standards (IFRS) on the volatility of banks' operating results

In June 2002 the European Parliament and Council adopted Regulation EC/1606/2002, which inter alia requires EU banks to apply the IFRS to their consolidated financial statements for accounting periods beginning on or after 1 January 2005. Slovenian banks were required to apply the IFRS when compiling financial statements for the previous financial year in January 2006 for the first time.

The concept of accounting in accordance with the IFRS requires banks to value some accounting items at fair value, instead of historic cost, the predominant method in the past. At the same time, due to changes in the concept for valuing balance-sheet items, the new accounting standards have also had an impact on assessing the amount of losses from credit risk and on the creation of provisions and impairments of financial assets. Provisioning and impairment on an ongoing basis is the direct consequence of a business event, which is incontrovertible proof of the quality of a claim against an individual debtor deteriorating. This ensures that the value of claims is changed according to the information currently available to a bank and their fair value, and only to a lesser extent in accordance with the statistically determined probability of losses occurring over an extended period.

Provisions on balance sheets decreased by 24% as a direct consequence of the changeover to the IFRS in the accounting practice of Slovenian banks, while bank capital increased by 15% at the same time, if only the most significant balance-sheet changes are taken into account. This improved the capital adequacy of banks by a relatively high 1.6 percentage points based on methodological changes to accounting standards alone, without reducing bank exposure to credit or other risk. In addition to the changes in the total assets of Slovenian banks, the favourable economic climate in 2006 led to a reduction in the need for ongoing provisioning, in line with the new criteria. Compared to gross income, over the past year banks have created provisions worth only half as much as those formed in the years preceding the changeover to the IFRS. This has significantly contributed to improvements in bank performance indicators, due to the changes in accounting standards, and not just more effective management. In addition to the one-off changes in banks' financial statements and performance indicators, the changeover to the IFRS will also be reflected in changes in banks' conduct. Banks' credit activities are by nature cyclical, and depend on the phase of the economic cycle. Introducing the fair value concept to valuing balance-sheet items will further increase pro-cyclical bank behaviour. In circumstances of high economic growth, when banks generally overestimate their customers' creditworthiness, the fair value of loans and other assets will also increase with their optimistic risk assessments. The returns, realised or only calculated, from higher asset prices and the improved loan quality will directly affect the relative increase in banks' operating results, which will

encourage banks to further extend their lending. A reverse process will follow in periods of economic downturn. This kind of fluctuation will be relatively greater in banking systems that follow relatively less efficient financial markets with greater price fluctuations in financial product prices, so the operating results of such banks will also be more variable and less predictable. By their very nature, greater fluctuation in financial categories such as returns, prices, profits, and balance-sheet categories of financial actors represent a greater risk to maintaining long-term financial stability.

### 6.3 Profitability and performance indicators

In 2006 the banking system generated a pre-tax profit of EUR 393.4 million, up 50% compared with the previous year. The high growth was fuelled by 8.5% growth in net interest income, and growth of over 25% in non-interest income. Income from securities trading was the main factor in the growth of the latter. By contrast, growth in income distribution categories was weak. Operating costs grew by just 7.8%, despite all the institutional changes. Impairment and provisioning costs were behind the 2005 figures despite the continuing high levels of lending, owing to the changeover to the IFRS.

**Banks recorded profits of EUR 393.4 million in 2006.**

Table 6.10: Banking sector income statement

	Amount (EUR million)			Growth (%)			Proportion of gross income (%)		
	2004	2005	2006	2004	2005	2006	2004	2005	2006
Net interest	599.2	631.5	685.1	-1.4	5.4	8.5	61.0	60.2	56.6
Non-interest income	382.6	417.2	526.0	17.3	9.0	26.3	39.0	39.8	43.4
Of which fees and commissions	258.2	281.7	307.8	12.7	9.1	9.2	26.3	26.9	25.4
Of which net gain/loss on financial assets and liabilities held for trading	84.0	70.8	99.2	25.9	-15.7	40.1	8.6	6.8	8.2
Gross income	981.7	1,048.6	1,211.0	5.2	6.8	15.5	100.0	100.0	100.0
Operating costs	611.9	647.4	697.8	3.6	5.8	7.8	62.3	61.7	57.6
Labour costs	326.1	342.5	364.2	7.4	5.0	6.3	33.2	32.7	30.1
Net income	369.9	401.2	514.3	7.9	8.5	28.2	37.7	38.3	42.4
Net provisioning and impairments	135.7	140.1	120.9	-5.4	3.2	-13.7	13.8	13.4	10.0
Pre-tax profit	234.2	261.2	393.4	17.5	11.5	50.6	23.9	24.9	32.4
Taxes	80.8	51.8	90.6	17.9	-35.9	75.0	8.2	4.9	7.5
Net profit	153.4	209.4	302.8	17.3	36.5	44.6	15.6	20.0	24.9

Source: Bank of Slovenia

#### Net interest income and interest margin

The proportion of gross income accounted for by net interest fell by 3.6 percentage points in 2006. Despite the increasing rate of growth in net interest, it still trailed growth in non-interest income. Interest income only increased last year by 17.9%, and interest expenses by a rather high 28.4%, but the fact that the interest earned on assets was 4.6% higher than interest on liabilities led to an increase in net interest.

**The proportion of non-interest income in total bank income increased.**

The higher growth in net interest was also expressed in changes in the structure of bank assets, i.e. a higher proportion of loans and a decline in the proportion of less-remunerated securities. Lending rates also responded to the rise in interest rates on international financial markets since 2006. The increase in interest expenses was affected primarily by the increase in the proportion of total assets accounted for by liabilities to banks in the rest of the world and the rising interest rates on international financial markets. The link to the EURIBOR means that interest rates on liabilities to banks in the rest of the world rapidly adjust to changing financing conditions, and thus have a rapid impact on banks' interest expenses.

Table 6.11: Average assets and liabilities interest rates calculated from interest income and expenses, interest spread and interest margin in percentages

(%)	2002	2003	2004	2005	2006
Average assets interest rate	9.14	7.62	5.85	4.92	4.79
Average liabilities interest rate	5.62	4.44	3.04	2.44	2.58
Effective interest rate spread	3.52	3.18	2.81	2.49	2.21
Interest margin on interest-bearing assets	3.76	3.35	2.87	2.62	2.35

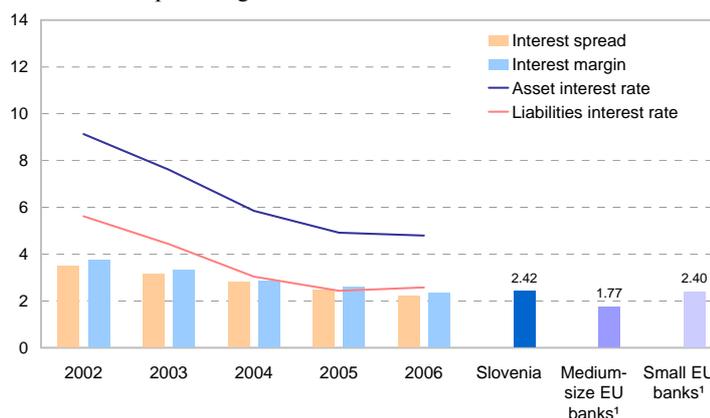
Source: Bank of Slovenia

**The interest rate spread fell last year.**

Cuts in effective<sup>51</sup> assets interest rates slowed last year, while effective liabilities interest rates rose compared with 2005. The interest spread fell by 0.28 percentage points, a similar decline to that in 2005.

The stabilisation of tolar interest rates realised on corporate and household loans led to a slowdown in the decline in effective assets interest rates, at the same time as interest rates on foreign currency lending were gradually rising. Interest rates on foreign currency deposits increased, while realised tolar interest rates remained unchanged throughout the year.

Figure 6.12: Average effective assets and liabilities interest rates calculated from interest income and expenses, interest spread and interest margin in percentages

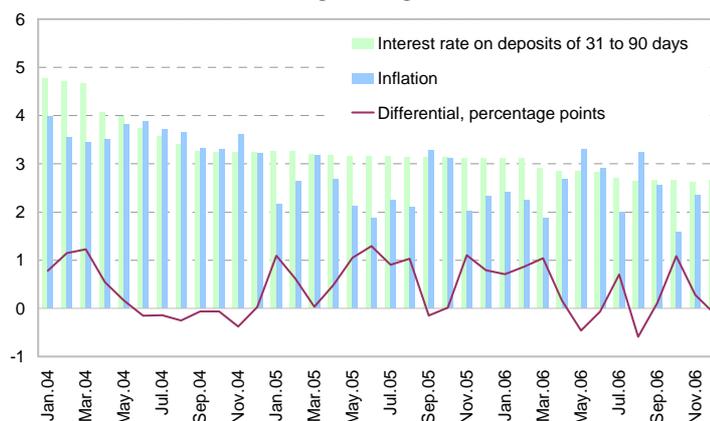


Note: <sup>1</sup>The separate figures for the interest margin in Slovenia and EU member-states using international accounting standards were calculated for 2005 as the ratio of net interest income to total assets. The interest margin for EU banks was taken as the net interest margin for medium-size banks and small banks.

Source: ECB, EU Banking Sector Stability, November 2006

The declared interest rates on short-term tolar deposits by non-banking sectors were ex-post negative in particular months last year. The negative real interest rates for this form of saving were due to the inactive interest rate policy of banks, and the relatively large fluctuation in inflation over 2006.

Figure 6.13: Declared interest rates on tolar deposits of 31 to 90 days, and year-on-year inflation rates in percentages



Source: Bank of Slovenia

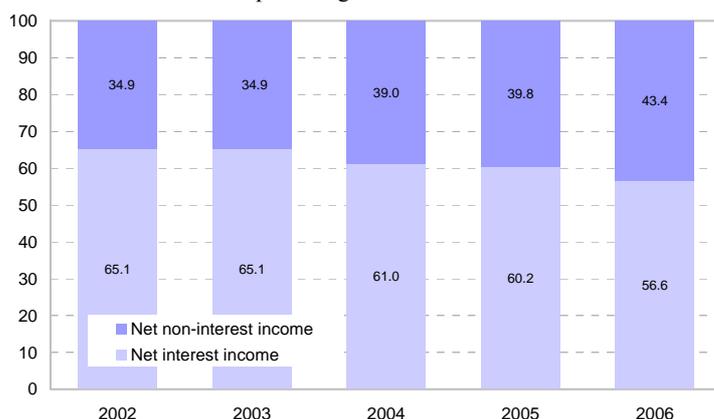
<sup>51</sup> Effective assets interest rates are calculated as the ratio of interest income to interest-bearing assets, while effective liabilities interest rates are calculated as the ratio of interest expenses to interest-bearing liabilities.

### Net non-interest income

In recent years the relative importance of non-interest income in total gross income has increased. The growth in net non-interest income last year came largely from the growth in net trading income. The relatively good growth in such income was the result, to a great extent, of the valuation of securities at fair value, which will also bring greater variability to banks' profits in the event of larger fluctuations in stock market prices. Growth in net fees and commission was just over 9% last year, similar to the previous year.

**The importance of net non-interest income in overall bank income increased.**

Figure 6.14: Net interest income and net non-interest income as a proportion of gross income in percentages



Source: Bank of Slovenia

### Gross income structure of Slovenian banks and EU banks

Slovenian banks' gross income structure is very similar to the average gross income structure of EU banks. Non-interest income accounted for 40% of the Slovenian banking system's gross income in 2005, which was the same as for medium-size EU banks.

Table 6.12: Gross income structure of Slovenian banks and EU banks

	Income as proportion of gross income (%)		
	Medium-size EU banks	Small EU banks	Slovenia 2006
Net interest	59.8	57.4	56.6
Non-interest income	40.2	42.6	43.4

Source: Bank of Slovenia, ECB: EU Banking Sector Stability, November 2006

### Banks' operating costs

The growth in bank operating costs, at 7.8%, last year remained behind the growth in total assets, and they fell below 58% of gross income. Labour costs grew at a relatively moderate pace, though the numerous institutional changes did cause additional costs: i.e., preparations for the introduction of the euro, the changeover to the IFRS, and preparations for implementing the CAD directive. Among operating costs, labour costs grew by just 6.3% last year, while depreciation/amortisation costs grew by only 1.4%. General administrative costs increased the most, by 12.2%, with preparations for the euro changeover foremost amongst the causes.

**Banks' operating costs remained low.**

Based on survey responses from banks, the costs of the changeover to the euro came to EUR 44 million, EUR 9 million of which was incurred in 2005. Banks assess that the total costs of the changeover to the euro amounted to 3.7% of gross income, or 11.3% of the banking sector's 2006 pre-tax profit.

The introduction of the euro will also affect 2007 operating results, primarily the amount of net non-interest income. According to survey results, banks expect the introduction of the euro to reduce net non-interest income in 2007 by EUR 23 million. Banks assess that 48% of that sum will be accounted for by the fall in net payments income and 39% by the decline in foreign exchange operations. The remaining 13% will be roughly evenly divided between the loss of net non-interest income from derivatives, and the category "other".

Table 6.13: Year-on-year growth in operating costs by groups of banks in percentages

(%)	Total	Large banks	Foreign banks	Small banks
2004	3.6	2.1	7.6	2.6
2005	5.8	1.8	12.7	11.3
2006	7.8	8.3	6.3	8.6

Source: Bank of Slovenia

The coverage of operating costs by net non-interest income improved significantly last year due to the high growth in such income, reaching 75.7%. However, this improvement is probably not permanent due to the anticipated fluctuations in non-interest income.

#### Operating cost structure of Slovenian banks and EU banks

The relatively sound management of operating costs by Slovenian banks meant that they fell by 0.26 percentage points to 2.22% of average total assets in 2006. This figure is above the average ratio of operating costs to total assets at medium-size EU banks (1.69%), but is significantly lower than at small EU banks (2.92%). Comparing the operating cost structure indicates that the ratio of labour costs to total assets is lower for banks in Slovenia. In 2005 banks in Slovenia lagged behind comparable bank groups in the EU in terms of coverage of operating costs by net non-interest income. In 2006 Slovenian banks reduced this gap.

Table 6.14: Costs as proportion of operating costs, cost-to-income ratio (CIR) and coverage of operating costs by net non-interest income in Slovenia and the EU in percentages

(%)	Costs as proportion of total operating costs, and CIR		
	2005		2006
	Medium-size EU banks	Small EU banks	Slovenia
Labour costs	67.9	57.2	52.2
Administrative costs	25.1	35.0	36.3
Other costs	7.0	7.8	11.5
Total	100.0	100.0	100.0
CIR (operating costs/gross income)	57.0	62.3	57.6
Non-interest income/operating costs	70.4	68.5	75.4

Source: Bank of Slovenia, ECB: EU Banking Sector Stability, November 2006

#### Impairment and provisioning costs

#### The changeover to the IFRS had an impact on lower impairment and provisioning costs.

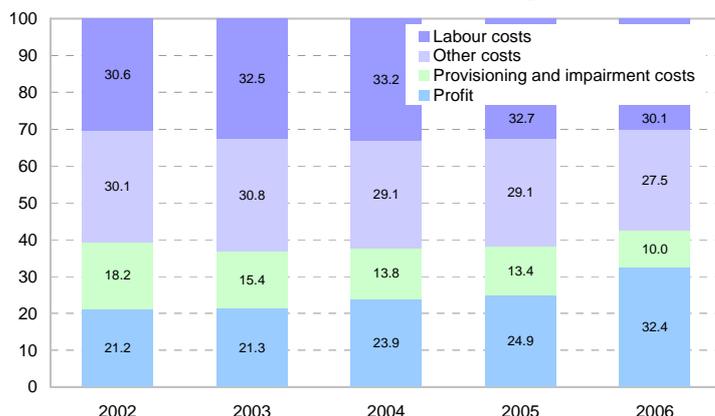
There was a sharp decline in banks' impairment and provisioning costs last year compared to 2005, despite lending levels remaining high. The main reason for the reduced impairment and provisioning costs was the changeover to the IFRS. These figures will change in the next few years, and in future banks could be exposed to pressure to increase the proportion of income dedicated to impairments and provisioning as a consequence of high levels of lending in the past.

Table 6.15: Loans, and impairment and provisioning costs in percentages

(%)	Large banks	Small banks	Foreign banks
Growth in loans to non-banking sectors in 2006	19.7	27.9	32.0
Growth in provisions and impairments in 2006	-5.3	-84.4	10.6
Provisioning and impairments/gross income in 2006	12.5	2.1	7.1
Provisioning and impairments/gross income in 2005	15.0	15.0	7.9

Source: Bank of Slovenia

Figure 6.15: Breakdown of banks' gross income in percentages



Source: Bank of Slovenia

The banking system's ROE rose last year by 2.3 percentage points, to exceed 15%. A number of factors contributed to the increase in ROE: positive growth in net interest income, a large increase in non-interest income owing to favourable movements on stock markets, moderate growth in operating costs, and a decline in impairment and provisioning costs, mainly as a result of the changeover to the IFRS. The interest margin continued its declining trend. The interest margin fell by 0.24 percentage points to 2.18% on total assets, which did not however cover the 0.7 percentage-point increase in the non-interest margin.

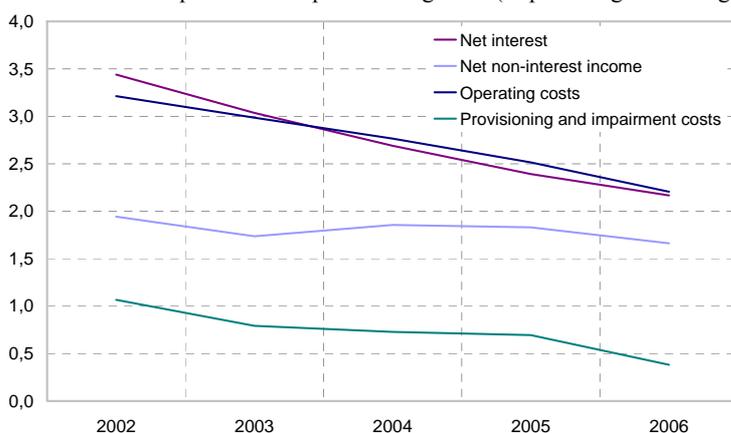
**Bank returns increased last year.**

Table 6.16: Bank performance indicators in percentages

(%)	2002	2003	2004	2005	2006
ROA	1.11	1.00	1.03	1.00	1.25
ROE	12.55	11.89	12.51	12.73	15.03
Costs/gross income	60.61	63.28	62.32	61.74	57.61
Interest margin on interest-bearing assets	3.76	3.35	2.87	2.62	2.35
Interest margin on total assets	3.41	3.05	2.64	2.42	2.18
Non-interest margin	1.84	1.63	1.69	1.60	1.67
Gross income/average assets	5.25	4.68	4.33	4.02	3.85

Source: Bank of Slovenia

Figure 6.16: Net interest income, net non-interest income, operating costs and banks' impairment and provisioning costs (as percentage of average assets)

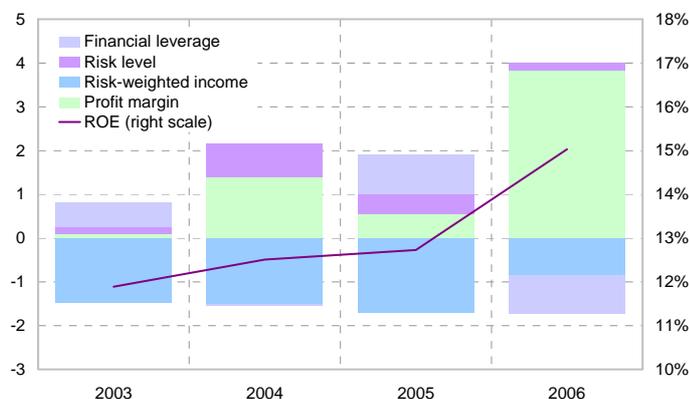


Source: Bank of Slovenia

### Decomposition of ROE<sup>52</sup>

In order to analyse the reasons for banks' increased profitability, ROE (return-on-equity) can be broken down into four components: profit margin, risk-weighted income, risk level and financial leverage.

Figure 6.17: Changes in ROE and impact of four factors on changes in banks' ROE



Source: Bank of Slovenia

### The profit margin affected the increase in banks' profitability in 2006.

Analysis of the reasons for the increase in profitability at banks has established that last year predominantly the rising profit margin and to a much lower extent increased risks assumed by banks were factors, while the decline in risk-weighted income and financial leverage acted to reduce ROE. Over the past three years the profit margin was also a factor in increased profitability, but together with the increasing financial leverage and assumption of greater risk by banks. At the same time the decline in banks' risk-weighted income over the past four years has reduced their profitability. With the exception of the past year, when the profit margin was the main source of increased bank profitability, from 2003 to 2005 the source of increased profitability was an unfavourable combination of factors: an increase in the risk assumed by banks, a simultaneous decline in income per unit of risk-weighted assets, and an increase in financial leverage.

Table 6.17: Breakdown of ROE into four factors

	Profit margin pre-tax profit gross income	Risk-weighted income gross income risk-weighted assets	Risk level risk-weighted assets total assets	Financial leverage total assets capital	Profitability = ROE
2005	0.25	0.05	0.73	12.82	0.13
2006	0.32	0.05	0.74	12.12	0.15

Source: Bank of Slovenia

### Profitability of Slovenian banks and EU banks

Table 6.18: Bank performance indicators in percentages

(%)	2005		2006
	Medium-size EU banks	Small EU banks	Slovenia
Net interest / total assets	1.77	2.69	2.18
Non-interest income / total assets	1.19	2.00	1.67
Gross income / total assets	2.96	4.69	3.85
Operating costs / total assets	1.69	2.92	2.22
operating profit / total assets	1.27	1.77	1.63
Provisioning and impairment costs (and other)	0.27	0.23	0.38
Pre-tax profit	1.00	1.54	1.25
ROE <sup>1</sup>	11.89	12.51	15.03

Note: <sup>1</sup>ROE calculation for EU banks based on Tier 1 capital (EU Banking Sector Stability, November 2006), and consolidated data.

Source: Bank of Slovenia, ECB: EU Banking Sector Stability, November 2006.

<sup>52</sup> An example of an ROE breakdown can be found in Financial Stability Report 2006:2, Sveriges Riksbank, p. 36, and Bank of England: Financial Stability Review, December 2003.

As a proportion of the Slovenian banking system's total assets, the interest margin ranged between the average values for medium-size and small EU banks at the end of 2005. The same applied to the non-interest margin and operating costs, so there is no great difference in profitability between Slovenian banks and both groups of EU banks. The ROE for the Slovenian banking system in 2005 was comparable to that for both EU bank types, and in 2006 it increased further.<sup>53</sup>

## 6.4 Risks in the banking sector

### Survey of major risks

Analysing the results of a survey carried out in 2007<sup>54</sup> indicates that banks are clearly more concerned than in previous years by movements on financial markets, particularly the rise in interest rates and their increased volatility. Another concern is the possibility of large corrections on stock markets. Banks reported concerns due to higher interest rates, which will worsen borrowers' capabilities to service debts and reduce demand for loans. They also pointed out the greater exposure to the risk of housing prices falling, given the high growth in housing loans.

The second risk group that banks identified as increasing in 2007 was risks arising from the banking sector. The increasing pressure from competitors, which reduces interest margins, has a significant impact on banks' product and service ranges and pricing policies. Competition increases with the entry of new participants on the market, not just banks but also other financial intermediaries (mutual funds, insurance companies). The consolidation of existing financial institutions is also a factor since it increases the size of individual participants.

Banks assessed that when viewed globally, the risks in the remaining three categories – the macroeconomic environment, bank strategy and operations, and the regulatory environment – are lower than in previous surveys. Nevertheless, banks mentioned a number of risks falling under these categories that they consider as being very important. The main factors relating to the macroeconomic climate are the overheating of the domestic economy and movements in oil prices.

The main bank strategy and operation-related risks for banks are the need for greater efficiency and increased scope of business. Banks also mentioned as a risk the insufficient volume of domestic financing and hence the greater dependence on borrowing in the rest of the world, risks relating to new markets and operational risk.

As banks enter new markets, either geographically or by introducing new products and services, they are exposed to the risk of losses due to insufficient knowledge and understanding of the markets, greater political and economic risks, unreliable returns and competition. Banks that do not diversify geographically or in terms of products face the risk of focusing too narrowly on their core activities and a market of insufficient size.

According to bank statements, operational risk is mainly related to information technology. The introduction of the IFRS in 2006, the adoption of the euro in 2007 and preparations for Basel II are all projects requiring major adjustments to banks' information technology and applications, and they consequently increase operational risk. At the same time, the high priority of these projects and the lack of staff mean that other development projects demanding IT support become sidelined.

Banks assess that the introduction of the IFRS and the adoption of euro have reduced the relevance of risks linked to the regulatory environment in 2007, though it does remain a

**The greatest risk arises from financial markets and market risk.**

**Banks assess that risks arising from the banking sector, particularly more competition, are greater than a year before.**

**Banks considered that the overheating of the domestic economy and movements in oil prices were a major macro-economic risk.**

**Major risks tied to strategy and operations include increasing efficiency, entering new markets and operational risk.**

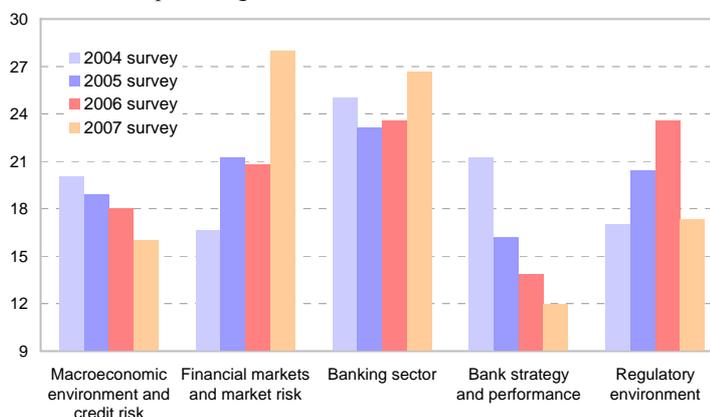
**Despite reduced importance compared to the past, regulatory risk remains an important risk, particularly relating to the introduction of Basel 2.**

<sup>53</sup> It should be taken into account for both groups of EU banks harmonised with the IFRS that the figures refer to consolidated data, and the profitability calculation to "Tier 1" capital. The figures for Slovenia include the profit of the entire unconsolidated banking system and all capital.

<sup>54</sup> The major risk survey has been carried out annually since 2004. The group of banks covered by the survey initially changed but has been consistent for 2006 and 2007. It includes five banks from different categories, so the conclusions based on the survey provide a reliable picture of the banking sector. In the survey, the banks define the key risks for the coming year (from March onward).

major risk group. By far the most important risk for banks is that relating to Basel 2, because of the complexity of the project, and the fact that it is the third major project in the past three years. Banks also mentioned differences in regulatory environments between different countries, due to elements left to national discretion. Other factors mentioned include the reporting burden, and insufficiently developed tax legislation.

Figure 6.18: Results of 2004 to 2007 surveys on main origins of risk for coming year in percentages



Source: Annual bank surveys

**Box 6.2: Z-score index (Maechler, Mitra, Worrell 2005)<sup>1</sup>**

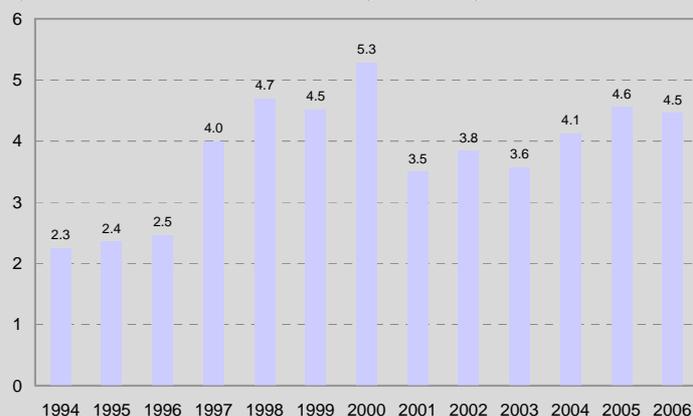
The Z-score index is effectively the Distance to Default (DtoD) indicator, with the difference being that it is calculated from banks' balance-sheet data and is therefore a more conservative measurement than the DtoD. Its advantage lies in the fact that it is still not difficult to calculate for countries with a poorly developed capital market, where banks are not generally listed on the stock market. The weakness of the indicator is that it is based on historic data. Expectations are only reported to a small extent in the return volatility, but not in the market value of capital or assets, as is the case with DtoD.

It is defined as  $z = (\mu + k)/\sigma$ , where  $\mu$  is the average return on assets,  $k$  is the capital to total assets and  $\sigma$  is the standard deviation of return on assets.

As with the DtoD, the higher the Z-score the better is the quality of the bank and the lower is the probability that the bank will fail or that its assets will be less than its liabilities.

Looking at the same period addressed by the original paper (Maechler, Mitra, Worrell 2005), i.e. 1997 to 2004, the results for Slovenia indicate that the quality of the Slovenian banking system is at the level of three EMU member states – Spain, Portugal and Greece – and better than the average for the other new EU member states. The indicator reached the lowest value for Slovenia in 1994 to 1996 period, then again from 2001 to 2003, and since then it has been on the increase once more.

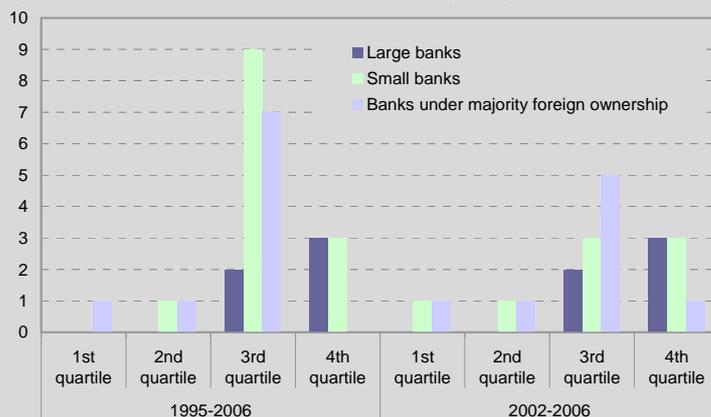
Figure 6.19: Z-score for the banking sector; log(z)



Source: Bank of Slovenia

The lowest Z-score by bank group is for the banks under majority foreign ownership, while the highest (best) score is for the large domestic banks. However, one cannot state that ownership and size alone are the key factors in defining bank risk, as there are significant differences within the individual groups of banks. For the entire period from 1995 to 2006 and for the last five years, the large domestic banks have been classified in the top 50% of banks, while the small domestic banks and banks under majority foreign ownership have appeared in all four quartiles within the past five years. The Z-score is interesting because it indicates that some banks that do not have problems in meeting capital adequacy requirements and that to date have not been considered as a particular risk, are indeed more exposed to risk. On the other hand, among the banks under foreign ownership, which are usually seen as banks prepared to assume greater risk, it separates the less risky banks with Z-scores placing them in the upper quartile of the banking system.

Figure 6.20: Distribution of banks according to log(z), number of banks per quartile



Note: Banks with the lowest Z-score – i.e. riskiest – are in the 1st quartile, and the least risky in the 4th quartile. Banks with scores for one year only are excluded.

Source: Bank of Slovenia

<sup>1</sup> Andrea Maechler, Srobona Mitra, DeLisle Worell: Exploring Financial Risks and Vulnerabilities in New and Potential EU Member States, ECFIN Research Conference: Financial Stability and the Convergence Process in Europe, 2005

### Box 6.3: Macro stress tests for the Slovenian banking system

The purpose of this section is to present an assessment of the banking system's sensitivity to simulated shocks in selected risk factors, and is a summary of a lengthier Bank of Slovenia report from autumn 2006. The macro stress test method is based on a top-down approach.

#### Methodological changes in the macro stress test model and definition of risk factor shocks

The changeover to the IFRS at banks means that the balance sheet items were adjusted in a manner that takes into account the instrument principle, and not merely the item valuation principle. In order to ensure the greatest possible responsiveness of the stress test model to the selected risk factor shocks, the equations for growth in the demand for corporate loans and household loans and the equations for growth in deposits by the two sectors were reassessed this year. To ensure a more credible assessment of interest-rate risk, the effects of changes in reference interest rates on banks' effective interest rates – which make it possible to directly calculate net interest income – were assessed by the ARIMA model. The variables of import-export prices by institutional sector were reasonably replaced with inflation variables in the credit risk assessment model.

The level of simulated risk-factor shocks was limited to less probable, but still possible shocks. As in previous years, the size of the simulated shocks was limited to the largest historical changes, which occurred with a statistical probability of 5% in the period from the beginning of 1995 to the second quarter of 2006. As the stability of economic categories increased during the second half of that period, the size of the risk-factor shocks is diminishing.

Table 6.19: Shocks relative to the baseline scenario

Risk factors	Shock: change from baseline scenario	Duration of shock (quarters)	Post-shock
Real GDP	Growth down 2.2 percentage points	IV/06-III/07	returns to pre-shock level
Interest rates	Interest rates up 2.4 percentage points	IV/06-III/07	returns to pre-shock level
Net interest margin	Net interest margin down 0.5 percentage points	IV/06-III/07	returns to pre-shock level

Source: Bank of Slovenia

### Results of the macro stress tests under the integrated approach

In contrast to 2005, the appreciation and depreciation of the euro/tolar exchange rate were not included among the simulated shocks because previously foreign currency items in euros are not exposed to exchange-rate risk after the euro introduction. In simulating a decline of 0.5 percentage points in the interest margin, it was assumed that the most probable factor for it was a rise in interest rates on liabilities to foreign banks. The other two tested risk-factor shocks are a decline in growth in GDP components by 2.2 percentage points, and a rise in reference interest rates by 2.4 percentage points.

We observed the effects of temporary, one-year shocks in terms of the response of banks' pre-tax profit, the response of return on equity, capital adequacy, growth in loans to and deposits by non-banking sectors, and the change in their proportions of total assets.

The strongest response was that of banks' pre-tax profit to the shock of a decline in interest rates and a decline in the interest margin. The cumulative decline in profit in the first case would be EUR 172.8 million, and in the second case EUR 162.8 million, which is approximately half of the banking sector's annual profit. The lowest drop is the fall in profit in the case of the decline in GDP growth.

Loan growth responds comparatively strongly and quickly to the simulated shocks, notably to the rise in interest rates, when in 2007 it is 4 percentage points lower than in the baseline scenario. The impact of lower GDP component growth on lower loan growth is longer-term, and highest in 2008 at 3.6 percentage points decrease in lending growth rate. Rigidity is greater with non-banking sector deposits, and the response to the shocks therefore smaller. The response of deposit growth to the rise in interest rates is lower than to the rise in the growth of GDP components. In the latter case, wage growth and growth in disposable income allocated for saving purposes slows, which is the reason growth in deposits by non-banking sectors is 2.1 percentage points lower in 2008. In the case of a larger interest rate shock, growth in deposits falls by 0.3 percentage points in 2007 and 2008.

Due to the lower shocks, the response of capital adequacy is smaller than in the results of the macro stress tests presented in 2005. Capital adequacy drops as early as 2007 in the case of the interest margin shock by 0.18 percentage points due to the drop in profit as an important source of banks' regulatory capital. In the other two cases, the fall in the growth of GDP and the rise in interest rates, the effect of the shocks on the drop in loan growth is higher than the effect on the drop in banks' profit, which, in terms of results, means a rise in capital adequacy of 0.39 percentage points in 2008 in the first case, and in the second case, a rise in capital adequacy of 0.17 percentage points in 2007.

Table 6.20: Impact of the individual shocks on changes in certain categories of banks' balance sheets, changes relative to the baseline scenario by years, in percentage points

2006									
Shock	Profit (EUR million)	ROE	Capital adequacy	Growth in loans to non-banking sectors	Loans/ TA	Growth in deposits by non-banking sectors	Deposits/ TA	Growth in TA	
Shock 1 - GDP	2.9	0.1	0.01	-0.1	0.0	-0.1	0.0	0.0	
Shock 2 - change in interest rates	-28.0	-1.1	0.02	-0.4	-0.1	0.0	0.1	-0.2	
Shock 3 - fall in interest margin	-38.0	-1.5	-0.02	-	-	-	-	-	
2007									
Shock	Profit (EUR million)	ROE	Capital adequacy	Growth in loans to non-banking sectors	Loans/ TA	Growth in deposits by non-banking sectors	Deposits/ TA	Growth in TA	
Shock 1 - GDP	-2.1	-0.1	0.12	-1.4	-0.3	-1.0	-0.1	-0.9	
Shock 2 - change in interest rates	-148.1	-5.1	0.17	-4.0	-0.9	0.3	1.3	-2.3	
Shock 3 - fall in interest margin	-124.8	-4.3	-0.18	-	-	-	-	-	
2008									
Shock	Profit (EUR million)	ROE	Capital adequacy	Growth in loans to non-banking sectors	Loans/ TA	Growth in deposits by non-banking sectors	Deposits/ TA	Growth in TA	
Shock 1 - GDP	-5.0	-0.2	0.39	-3.6	-0.9	-2.1	-0.1	-2.3	
Shock 2 - change in interest rates	3.3	0.1	-0.13	3.6	-0.2	0.3	0.5	2.0	
Shock 3 - fall in interest margin	0.0	0.0	-0.18	-	-	-	-	-	

Source: Bank of Slovenia

The stress test findings are similar to those for 2005. The banks' response to the simulated shocks is essentially not changed. Banks are mainly exposed to the risk of a decline in the interest margin due to the higher cost of borrowing at banks abroad and the risk of a rise in interest rates. Banks are considerably less sensitive to the shock of a decline in growth in GDP components. However, none of the simulated shocks, due to their short duration, puts the solvency of banks at risk.

### Assessing credit risk by a model

Implementing stress tests using a piecewise approach indicated changes in the credit risk assessed by a model. In addition to a comparison of the estimates of the proportion of non-performing loans in the credit portfolio to the actual situation in 2005, the response of the proportion of non-performing loans to individual shocks was also assessed.

A comparison of the actual structure of the credit portfolio with the model estimates shows that, similarly to the previous year, the *2004 Model* predicts for 2005 a higher proportion of non-performing loans in the credit portfolio (6.97%) than banks themselves estimated (5.93%). Consequently, in line with the results for the model, in 2005 there was a continued lowering of the criteria for assessing credit risk in banks subject to maintaining or increasing market share in the lending market. The high share (60.44%) of clients with an A-rating in the entire portfolio in 2005 is the consequence of the classification of clients into higher credit rating categories at the conclusion of new transactions. Given the changing structure of the credit portfolio over a four-year period, it was established that the same bank clients migrate to lower credit rating categories as early as in the first year. The transfer of clients from the A and B ratings to lower ratings further intensifies in the subsequent years.

It follows from the stress tests conducted that a higher short-term indebtedness by businesses has less impact on the banking sector than does the impairment of their liquidity. These results indicate that, in contrast to the past, banks, in classifying businesses into credit ratings, place comparatively more emphasis on the liquidity of businesses and less emphasis on their short-term indebtedness.

### Liquidity shocks

Due to banks' increased borrowing from banks in the rest of the world and their dependence on foreign sources of financing, the liquidity shocks were tested in the form of the outflow of foreign sources of financing from the total assets of individual banks. The sudden outflow of foreign funds could have a negative impact on banks' profitability and capitalisation due to a reduction in lending growth.

To estimate the sensitivity of individual banks to foreign sources of financing, the liquidity ratio was calculated first.<sup>1</sup> The liquidity ratio was calculated as the ratio of liquid assets to liabilities to banks and short-term liabilities to non-banking sectors. Due to considerable diversity in banks' total asset structure, banks were assigned to three relatively homogenous groups: the large domestic banks, the small domestic banks and the banks under majority foreign ownership. The liquidity ratio for the following three scenarios was calculated for each group:

- baseline scenario
- 100% withdrawal of foreign sources of financing
- 20% withdrawal of foreign sources of financing.

The ratios were calculated using banks' balance-sheet figures for September 2006.

The small banks have the highest liquidity ratio, followed by the large domestic banks. Both groups had a liquidity ratio higher than 1. Since one of the main roles for banks under majority foreign ownership is transferring funds from the parent bank into long-term lending to non-banking sectors, in September 2006 this group of banks had a liquidity ratio of 0.5837. Banks under majority foreign ownership not only had the lowest liquidity ratio, but would also experience the largest loss of liquidity if liabilities to foreign banks were removed from the balance sheet. In the case of a 100% withdrawal of foreign sources of financing, the liquidity ratio for banks under majority foreign ownership would fall for 32 percentage points to 0.2603. However, the liquidity ratios of domestic banks would not be harmed. The ratios would rise for large and small domestically-owned banks. It should be mentioned that the liquidity ratio for the entire banking system is higher than the baseline scenario after the shock. The reason for this is that liquid assets of individual banks did not cover their liabilities to the rest of the world, and they had to reduce their stock of loans. It therefore applies to the entire banking system that a lower amount was subtracted from liquid assets than from short-term liabilities. The effect on liquidity ratios is lower, in the case of 20% withdrawal of foreign sources of financing.

Table 6.21: Liquidity ratios calculated from September 2006 data

Group	Baseline scenario	100% withdrawal of foreign sources of financing	20% withdrawal of foreign sources of financing
Large domestic banks	1.0260	1.0468	1.0286
Small domestic banks	1.3658	1.4132	1.3744
Foreign banks	0.5837	0.2603	0.5126
Overall	0.9212	0.9819	0.9129

Source: Bank of Slovenia

There is a clear difference between domestic and majority foreign-owned banks. The banks under foreign ownership have a lower liquidity ratio and are more dependent on foreign sources of financing. This means they are significantly more sensitive to an outflow of foreign sources of financing, though that the probability of an outflow of that kind is very low due to the close ties with the parent banks.

<sup>1</sup> The major significance of liabilities to banks in the rest of the world for some banks led to the entire stock of liabilities to banks and their impact on changes in the stock of liabilities to banks of the rest of the world being taken into account within the liquidity ratio defined in that manner.

## 6.5 Credit Risk

The decline in the coverage of claims by impairments continued in 2006, but this does not necessarily indicate a reduction in credit risks at banks, particularly because the coverage of non-performing claims by impairments increased at the same time. Assessing credit risk is made more difficult because of the institutional factors, primarily the changeover to the IFRS, whereby prudence as the motive for provisioning has been replaced with the creation of impairments on the basis of actual downgradings.

Related to the scope of business, the exposure to credit risk slowed down in 2006. Banks are increasing the share of claims against lower risk sectors, with exposure to service sectors growing more quickly than exposure to industrial sectors. The concentration of exposures between sectors and branches further decreased and reduced bank exposure to credit risk due to portfolio concentration.

Factors that did contribute to increasing banks' exposure to credit risk in 2006 were: reduction in credit standards, especially for housing loans, high growth in exposure to the rest of the world, a higher assessment of the risk of exposure to the countries of former Yugoslav republics than in 2005 and a growing number of large exposures, despite the high growth in regulatory capital.

### 6.5.1 Credit growth

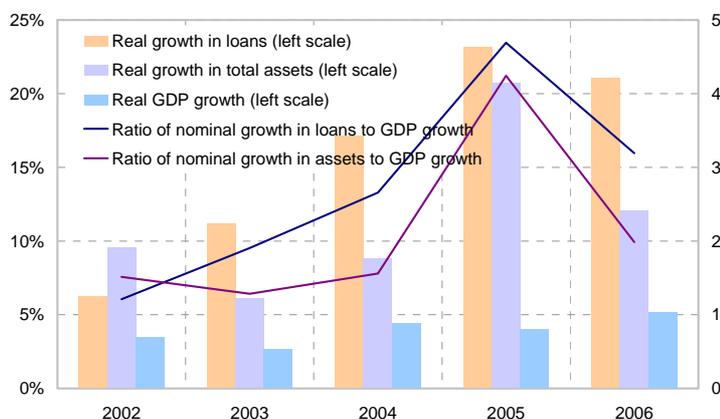
**The growth in loans to non-banking sectors in 2006 was again more in line with GDP growth.**

**Bank exposure to credit risk due to the growth in business activities fell in 2006.**

Credit growth in 2006 was again in line with growth in GDP. The ratio of nominal growth in loans to nominal GDP growth fell from 4.7 to 3.2 in 2006. The deepening of the banking market consequently slowed down.

The slowdown in growth in loans and indeepening of the credit market reduced bank exposure to credit risk. This may also indicate banks' increased awareness of the credit risks assumed from past high-growth years that was not only due to increased economic activity, but also significantly influenced by banks themselves, via less strict credit standards.

Figure 6.21: Real growth in loans to non-banking sectors, total assets and GDP and ratio of nominal growth in loans to GDP and nominal growth in assets to GDP



Source: Bank of Slovenia

In 2006 banks under majority foreign ownership again achieved the highest growth in loans to non-banking sectors, however the differences between groups of banks decreased. Only the small banks managed to achieve higher growth of loans and maintain their growth in total assets at the level from the previous year. As there was a very strong impact of institutional factors in 2006, the introduction of the IFRS and adjustments to Bank of Slovenia instruments due to the introduction of the euro, the conclusion, that the small banks exposed themselves more to credit risk than other bank groups, would be precipitate.

Table 6.22: Year-on-year growth in loans to non-banking sectors by bank groups in percentages

(%)	2002	2003	2004	2005	2006
Loans to non-banking sectors					
Large banks	15.1	15.6	16.7	21.4	19.7
Small banks	-6.7	9.2	20.5	24.7	27.9
Banks under majority foreign ownership	21.6	20.8	30.8	36.2	32.0
Total	14.0	16.3	21.0	26.1	24.4
Total assets					
Large banks	21.6	7.8	10.0	19.1	13.3
Small banks	-1.6	11.8	15.5	17.5	17.7
Banks under majority foreign ownership	16.7	19.9	16.8	37.1	18.2
Total	17.5	11.0	12.3	23.6	15.2

Source: Bank of Slovenia

## 6.5.2 Credit standards

In 2006 banks continued to reduce their credit standards when approving new loans, primarily in relation to housing loans.

### Loan-to-income (LTI) ratio

Based on survey responses regarding banks' business policy, the maximum permitted LTI ratio fell in 2006. However, the actual proportion of newly approved loans with high LTI ratios is still increasing, particularly in the case of housing loans. The proportion of borrowers taking out new housing loans in 2006 where the loan instalment exceeded one-third of their income was 2 percentage points higher in 2006 than in the previous year, at 60.4%.

The growing proportion of loans with high LTI ratios is even more risky due to the rising interest rates. The rise in reference interest rates increases loan instalments, increasing the burden on borrower income. This is further intensified by the fact that the proportion of loans with a high LTI ratio is found particularly in the case of housing loans, which are very long-term in nature, and offer the borrower little opportunity of withdrawal in case of unfavourable movements in interest rates.

Table 6.23: Loan-to-income (LTI) ratio

	Maximum LTI under bank's business policy	Actual proportion of newly approved housing loans with		Actual proportion of newly approved consumer loans with	
		LTI >= 33%	LTI >= 50%	LTI >= 33%	LTI >= 50%
2005	52.7	58.4	11.6	48.0	8.3
2006	50.8	60.4	12.8	47.0	8.8

Note: LTI is the ratio between the loan instalment and the borrower's income.

Source: Bank survey

### Maturity

Credit standards regarding maturity were also reduced in 2006. Banks adjusted the new loans they offered, particularly in the housing loan segment. There was an increase in the proportion of new housing loans with a maturity of over 20 years primarily in the second half of 2006, at the expense of reducing the proportion of loans with a maturity between 15 and 20 years. The proportion of new housing loans with a maturity of 15 years or less remained relatively stable.

**The proportion of loans with a high LTI ratio grew for housing loans in particular.**

**There was a significant increase in the proportion of new loans with a maturity of over 20 years in the housing loan segment.**

### Repayment method

#### Banks introduced bullet loans as a new product for households.

The repayment method falls also under the credit standards. Most loans are paid in instalments according to an amortisation schedule, but banks also offer bullet loans where the principal is repaid as a lump sum at maturity. Loans of this kind are usually offered to corporates, but have started to be offered to households. Corporate and household bullet loans accounted for approximately 6% of all loans to non-banking sectors in 2006, according to the bank survey. Around 2.6% of these loans are to households.

Banks have also started to provide bullet loans that are linked to investment products. These are tied to investments in mutual funds or insurance policies from which the loan principal is settled on maturity. Given the risk of such loans for banks as well as borrowers, the bank survey indicated that interest in them was relatively low.

### Loan-to-value (LTV) ratio

#### The LTV ratio increased for new loans to households.

The loan to value ratio, for newly approved households housing loans secured by real estate collateral, increased in 2006, but decreased for corporate loans.

The loan-to-value ratio for loans where securities are used as collateral is higher than with a lien on real estate, primarily because it is very unusual for securities to be the only form of collateral for an individual loan. Usually securities are used in conjunction with other forms of collateral.

Table 6.24: Loan-to-value (LTV) ratio

	Real estate LTV	Securities LTV	Real estate LTV > 100% <sup>1</sup>	Securities LTV > 100% <sup>2</sup>
2005				
Corporate loans	70.7	91.8	33.9	44.0
Household loans	50.0	69.7	21.3	18.9
Housing loans	53.6	54.5	6.3	40.6
2006				
Corporate loans	68.7	97.3	32.8	47.0
Household loans	56.6	67.9	18.7	24.6
Housing loans	57.0	219.5	12.8	41.1

Note: LTV – ratio of loan to value of collateral used as security.

<sup>1</sup> The proportion of loans secured by real estate collateral where the LTV is over 100%.

<sup>2</sup> The proportion of loans with securities or mutual fund points as collateral where the LTV is over 100%.

Source: Bank survey

### New loans collateral

The actual form of collateral is important to banks, as well as the loan-to-value ratio. The bank's exposure to credit risk depends on the proportion of unsecured loans, and the liquidity of the assets used as collateral.

#### In 2006 banks increased the proportion of unsecured loans in the total balance of household and corporate loans.

According to surveys, in 2006 banks increased the proportion of unsecured loans in their portfolios. The proportion of unsecured loans increased for housing loans more than for corporate loans. However the proportion of unsecured housing loans is relatively low, at just 3.1% in 2006. There are more unsecured loans made to corporates, particularly among new loans. In 2006, 41% of newly approved corporate loans were unsecured<sup>55</sup>.

<sup>55</sup> In this report a new source of data was used that does not provide full comparability with the data in past reports. In 2006 a new methodology was used to report on loans structure by type of collateral. In the past when several forms of collateral were used for an individual loan, the relative proportions were taken into account. This year types of collateral have been prioritised. If a loan has no form of collateral or the only form is a bill of exchange, it is deemed as unsecured. If in addition to other forms of collateral, a loan is also secured with real estate as collateral, it is deemed as secured by real estate. If a loan is not secured by real estate collateral and is secured via an insurance company it is classified as insured at an insurer. Loans secured with securities as collateral cover all loans not insured at an insurer or with real estate collateral, and include securities or mutual fund points used as collateral to secure a loan. All other loans are classified as "other".

Table 6.25: Structure of outstanding and new corporate loans by type of collateral in percentages

Type	Corporate loans		
	Stock		New
	2005	2006	2006
Secured loans:	71.4	70.1	59.0
Real estate collateral	28.0	28.3	24.1
Insured at insurer	0.1	0.8	0.0
Securities or mutual fund points as collateral	7.2	7.5	11.1
Other forms of collateral	36.1	33.5	23.8
Unsecured loans	28.6	29.9	41.0

Source: Bank survey, Bank of Slovenia

Table 6.26: Structure of outstanding and new housing loans by type of collateral in percentages

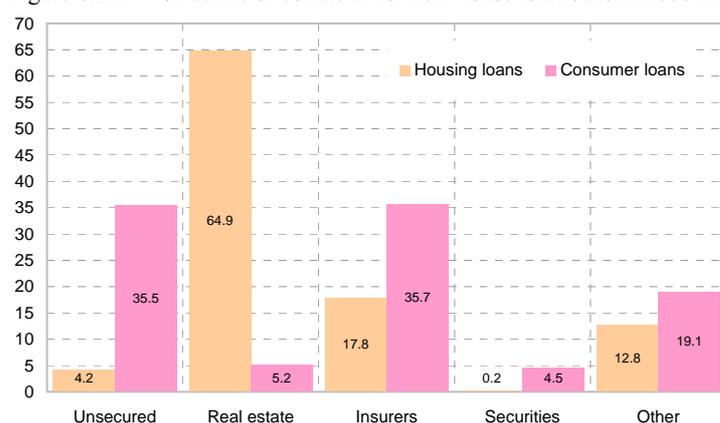
Type	Housing loans		
	Stock		New
	2005	2006	2006
Secured loans:	99.7	96.9	95.8
Real estate collateral	35.3	51.0	64.9
Insured at insurer	35.1	27.5	17.8
Securities or mutual fund points as collateral	0.2	1.1	0.2
Other forms of collateral	29.1	17.3	12.8
Unsecured loans	0.3	3.1	4.2

Source: Bank survey, Bank of Slovenia

Most newly approved consumer loans are either unsecured or insured at insurers, while most new housing loans are secured by real estate collateral, with a smaller proportion insured at insurers.

**New consumer loans were generally insured at insurers or unsecured, with housing loans secured by real estate.**

Figure 6.22: Structure of collateral for new household loans in 2006 in percentages



Source: Bank of Slovenia

The proportion of unsecured loans is higher in the structure of all new loans to banks and non-banking sectors. In 2006 it was on average 77%, however this proportion is very changeable. Banks approve more unsecured loans in the summer months, particularly August, and in the first two months of the year. The most stable is the proportion of new loans insured at insurers, which remain a little over 1%. The proportion of loans secured by securities as collateral or mutual fund points is growing.

**The proportion of unsecured loans in total new loans was 77% on average in 2006.**

Table 6.27: Structure of new loans collateral by bank group in 2006 in percentages

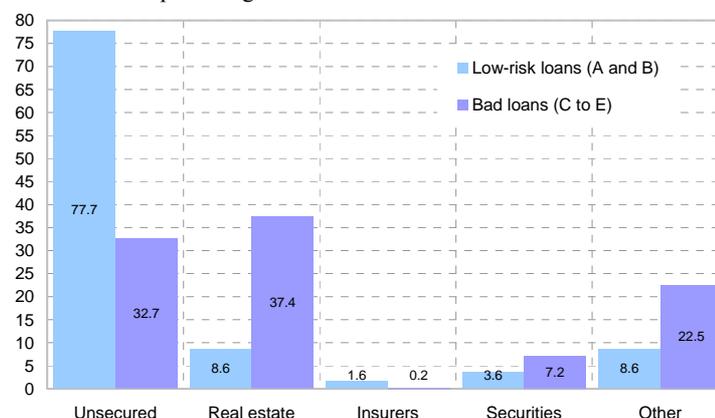
(%)	Large banks	Small banks	Banks under majority foreign ownership	Banking sector
Unsecured	69.9	81.3	83.5	77.0
Real estate	12.7	5.7	6.2	9.1
Insurers	1.7	1.6	1.4	1.5
Securities	5.9	3.3	1.1	3.6
Other	9.8	8.1	7.8	8.8
New loans (EUR million)	20,520	6,899	17,497	44,916

Source: Bank of Slovenia

**Large banks have the fewest unsecured loans.**

The large banks are the most conservative in the approval of new loans, as they have the lowest share of unsecured loans. There are no major differences between the small banks and the banks under majority foreign ownership. The latter have the higher proportion of unsecured loans, while the small banks have a higher proportion of loans secured by securities and mutual fund points as collateral.

Figure 6.23: Structure of new loans by credit rating and type of collateral in percentages



Source: Bank of Slovenia

**Of new loans, nearly one third of bad loans are not secured.**

Most new low-risk loans, i.e. loans for which the banks create an impairment of up to 15% of loan value<sup>56</sup>, are not secured. Only 22.3% of such loans are secured, usually with real estate collateral or other forms of protection. In accordance with expectations, the proportion of unsecured loans among bad newly approved loans<sup>57</sup> is significantly lower; in 2006 it was 32.7%. Most bad newly-approved loans are secured with real estate collateral.

**6.5.3 Portfolio quality**

**Portfolio quality is still improving, in part due to institutional factors.**

Portfolio quality continues to improve, but the current picture is obscured by institutional factors, the introduction of the IFRS, and amendments to the regulation on the assessment of credit risk losses.

**First signs of the turn in credit cycle. High growth in non-performing claims in 2006.**

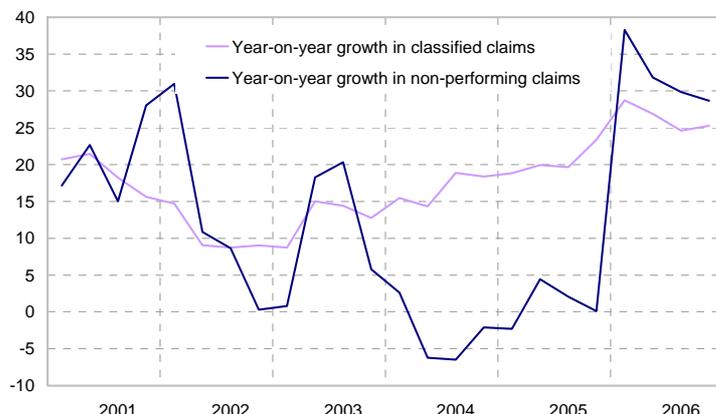
There are some signs of more tense conditions on the credit market. The main sign was the high growth in non-performing claims in 2006, i.e. claims for which banks create impairments of over 40%<sup>58</sup>. After two years of lagging significantly behind the growth in overall classified claims, in 2006 non-performing claims growth rate exceeded the growth in classified claims by 5 percentage points, reaching 28.7% at the end of the year.

<sup>56</sup> Loans rated A or B according to the previous regulation.

<sup>57</sup> According to the previous regulation, loans rated C to E.

<sup>58</sup> Loans rated D and E under the previous regulation.

Figure 6.24: Year-on-year growth in classified and non-performing claims in percentages



Source: Bank of Slovenia

The slowdown in credit growth, despite very high growth in economic activity, higher interest rates and high growth rate of non-performing claims are the first three signs indicating a turnaround in the credit cycle. Because of banks procyclical behaviour and optimistic assessments of customers quality in 2004 and 2005, when the growth of non-performing claims did not match the growth in classified claims, a turnaround in the trend of non-performing claim growth was very much to be expected. Relatively high growth and the rising proportion of non-performing claims can be expected also in 2007.

Table 6.28: Structure of classified claims and coverage of claims by impairments and provisions

	31. December 2005			31. December 2006		
	Classified claims	Impairments	Coverage of claims by impairments (%)	Classified claims	Impairments	Coverage of claims by impairments (%)
Total (EUR million)	25,209	1,169	4.6	31,581	1,234	3.9
	Structure (%)			Structure (%)		
A	83.3	17.5	1.0	77.1	7.1	0.4
B	11.8	26.2	10.3	18.8	28.6	6.0
C	2.4	13.5	26.4	1.6	9.6	24.0
D	1.1	13.7	57.1	1.2	20.1	66.4
E	1.3	29.1	100.0	1.4	34.6	100.0

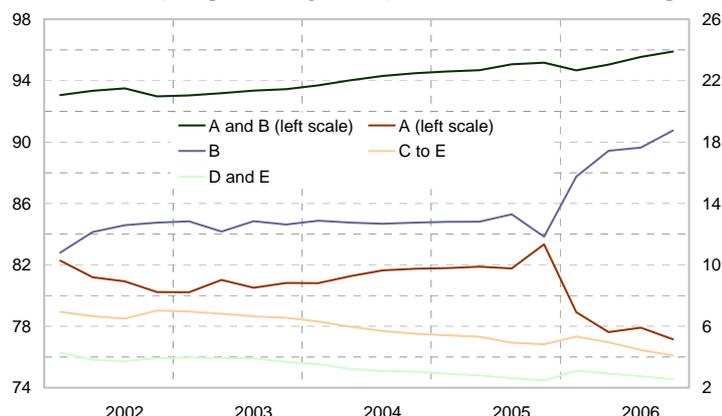
Note: Bank branches not included in table.

Source: Bank of Slovenia

The total stock of classified claims increased in 2006 by 25.3%, to EUR 31.6 billion. If percentages of impairments created are used to define credit rating groups comparable to those reported by banks before 2006, when individual impairment was introduced, in 2006 the proportion of claims rated A declined, while the proportion rated B increased. Total claims rated A and B were 0.7 percentage points higher in 2006, at the expense of C-classified claims. The proportion of non-performing claims (D and E) increased to 2.6%.

**Volume of classified claims up 25.3% in 2006.**

Figure 6.25: Proportion of claims rated A and B, C to E (bad claims) and D and E (non-performing claims) to total classified claims in percentages



Source: Bank of Slovenia

**Coverage of claims by impairment down to 3.9% in 2006.**

The coverage of claims by impairments in 2006 decreased further, reaching 3.9% at the end of the year. The reduced coverage does not necessarily reflect a reduction in credit risk, because of the major impact of introducing the IFRS and the amended regulation on assessment of credit risk losses, which introduced individual impairment.

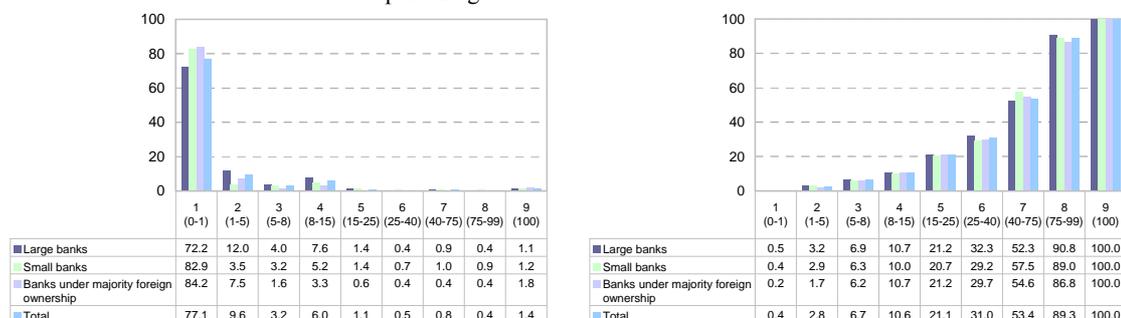
**Coverage of bad claims by impairment up by 7.3 percentage points to 61.3% in 2006.**

The quality of bad claims is deteriorating, which may indicate that credit risk is increasing or otherwise greater prudence by banks in assessing claim quality. The coverage of bad claims (C to E) by impairment increased in 2006 by 7.3 percentage points to 61.3%. The possibility of creating individual impairments, however, significantly reduced the coverage of A and B-classified claims by impairment.

**Large banks have lowest proportion of top quality claims, small banks have highest proportion of non-performing claims.**

By groups, the large banks are the most conservative. While the small banks and the banks under majority foreign ownership create at most 1% impairments for over 80% of claims, the proportion of such claims at large banks was 72.2% at the end of 2006. The small banks have largest proportion of non-performing claims. The proportion of claims for which banks create impairments of over 40% was 3.1% at the small banks, while for the large banks and the banks under majority foreign ownership it was 2.5%. This may indicate that the small banks are less efficient in monitoring customers and risk management processes. Given their greater sensitivity to the business cycle compared to larger banks, and the fact that they have a higher proportion of non-performing claims in favourable phases of the business cycle exposes the small banks group to the possibility of increasing credit risk during periods of less favourable economic conditions than other bank groups.

Figure 6.26: Structure of classified claims (left) and average coverage of classified claims by impairments by bank group for the end of 2006 (right) in percentages



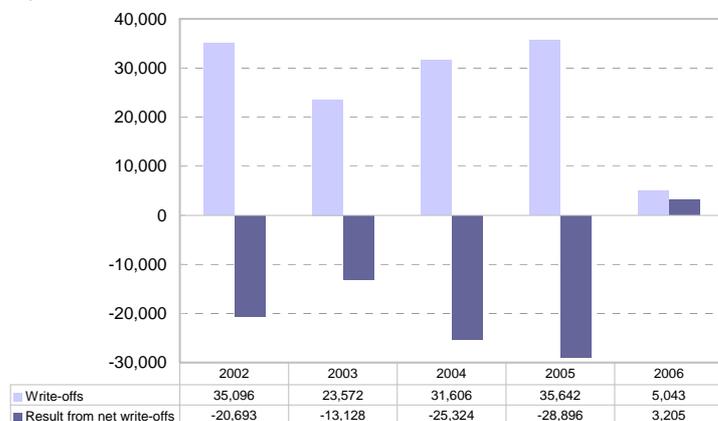
Source: Bank of Slovenia

**Volume of claim write-offs in 2006 down on previous year.**

Write-offs of loans and other claims is a further credit risk indicator. The volume of write-offs in 2006 was much smaller than for the previous year, primarily on account of the banks under foreign majority ownership. Furthermore, compared to 2005, the banks under foreign majority ownership and the small banks also had more revenues from written-off

claims. The net result for the banking sector from written-off claims was positive for the first time. However, due to the impact of introducing the IFRS and changes in the tax regime for written-off claims, these movements cannot be defined as indicating a reduction in banks' credit risk.

Figure 6.27: Write-offs and results from net write-offs in EUR thousand



Note: Results from net write-offs are losses from write-offs minus profits from written-off claims.

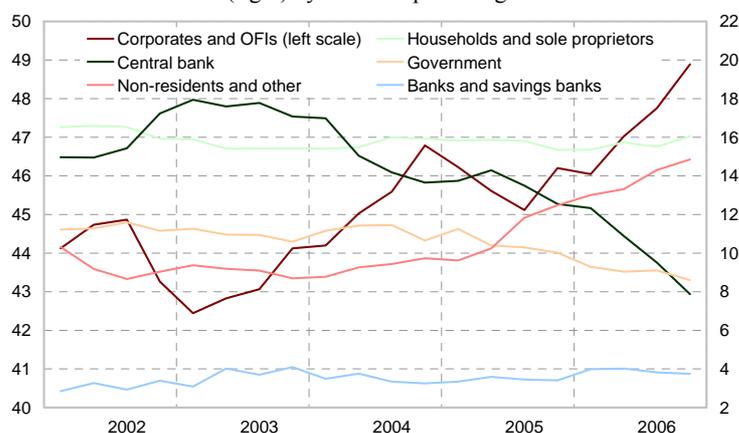
Source: Bank of Slovenia

#### 6.5.4 Portfolio diversification

The reduction in banks' investments in Bank of Slovenia instruments in 2006 continued the process of reducing the proportion of total banking sector exposure accounted for by exposure to the central bank<sup>59</sup>. The proportion of exposure to companies and other financial institutions and to the rest of the world increased.

**The process of increasing exposure to corporates and non-residents at the expense of the central bank continued.**

Figure 6.28: Percentage breakdown of bank exposure in Slovenia (left) and classified claims (right) by sector in percentages



Source: Bank of Slovenia

Banks are most exposed to the manufacturing sector, although the proportion of exposure to this sector has fallen over the past three years. As exposure to manufacturing and trade declined, there was an increase in exposure to the financial intermediation sector and the real estate and business services sector.

**Banks are most exposed to the manufacturing sector. Exposure to the financial intermediation sector was up.**

<sup>59</sup> The proportion of classified claims accounted for by classified claims against the central bank increased in 2006 due to the frontloading of euro cash.

Table 6.29: Structure of classified claims by sector in percentages

	Proportion of classified claims (%)				
	2002	2003	2004	2005	2006
Agriculture	0.5	0.6	0.6	0.6	0.6
Mining	0.2	0.3	0.3	0.3	0.2
Manufacturing	16.9	18.2	17.9	17.4	15.7
Electricity, gas and water supply	2.6	1.8	1.4	1.2	1.1
Construction	4.7	4.9	5.2	5.1	5.0
Trade	14.0	14.0	14.1	13.4	12.0
Hotels and catering	1.7	1.6	1.5	1.6	1.6
Transport, storage and communications	7.7	7.1	6.4	5.6	5.6
Financial intermediation	6.6	7.2	9.2	9.9	13.1
Real estate and business services	8.2	9.6	10.2	11.3	12.3
Public administration and defence	3.6	3.2	2.3	2.5	3.0
Education	0.1	0.1	0.2	0.1	0.1
Health and social work	0.3	0.3	0.3	0.3	0.3
Other public services	1.0	1.0	1.1	0.8	0.8
Households	19.7	18.9	18.5	17.7	16.8
Sole proprietors	0.2	0.2	0.2	0.2	0.2
Non-residents	2.3	3.0	3.7	4.1	5.3
Foreign financial institutions	9.1	7.6	6.8	7.7	6.2
Other	0.5	0.4	0.3	0.0	0.0
Total (EUR million)	15,307	17,352	20,734	25,734	31,692
Herfindahl - Hirschman index	1,177	1,188	1,187	1,168	1,135

Source: Bank of Slovenia

**Dispersion of exposure across sectors is still increasing.**

The dispersion of banks' exposure to individual sectors is increasing, which is reducing bank exposure to credit risk caused by concentration of the credit portfolio.

**Increasing spread at the expense of greater exposure to more cyclical sectors may later lead to a reduction in quality of classified claims.**

In the long term, the current trend towards greater diversity could expose banks to additional credit risk and a deterioration in the quality of classified claims due to a redirection from non-cyclical to cyclical sectors. What seems most problematic is the trend towards an increase in exposure to the real estate and business services sector, which is currently the third most important sector in the credit portfolio. Given the rapid growth in real estate prices, bank assessments of the quality of subjects in this sector may be very positive at present, due to real estate collateral, which currently has a high price, or due to project financing and control over customer cash flows. In the case of major price corrections to the real estate markets, the value of such collateral and the quality of customers in the real estate sector could rapidly deteriorate, and also affect the quality of the entire portfolio due to its increasing proportion in the credit portfolio.

**Growth in claims to industry, is down, growth in claims to service sector up.**

In 2006 year-on-year growth in classified claims was at a similar level to the previous year, while the relations between the sectors changed significantly. Growth in claims against industry slowed down, while claims against the service sector increased.

**Growth is higher for sectors assessed by banks as lower risk.**

In 2006 banks, with the exception of claims against non-residents, achieved highest growth in classified claims to the sectors and branches that they assess as lower risk (financial intermediation, public administration), which also positively influenced the reduction in overall portfolio risk. The sectors that banks assess as the lowest risk are financial intermediation, non-resident financial institutions, public administration and defence. The banks under foreign majority ownership also include the electricity, gas and water sectors among the lowest risk.

Table 6.30: Year-on-year growth in classified claims by sector in percentages

	Year-on-year growth in classified claims (%)				
	2002	2003	2004	2005	2006
Agriculture	27.8	20.0	22.3	38.9	13.5
Mining	7.5	35.6	18.0	27.4	4.0
Manufacturing	14.2	21.6	18.1	20.3	11.6
Electricity, gas and water supply	-5.3	-18.5	-9.6	11.2	7.2
Construction	20.7	17.1	26.2	23.0	20.6
Trade	14.7	13.8	19.9	18.1	10.2
Hotels and catering	17.0	7.1	12.7	27.5	25.7
Transport, storage and communications	-0.6	4.4	7.4	8.7	23.0
Financial intermediation	-2.8	23.3	51.4	34.2	62.5
Real estate and business services	15.2	33.3	26.4	37.9	33.6
Public administration and defence	19.3	-1.6	-14.0	34.4	52.1
Education	24.1	-24.0	255.3	0.9	10.7
Health and social work	17.4	18.4	31.5	26.5	7.1
Other public services	8.5	16.8	35.8	-7.5	17.1
Households	7.9	8.6	16.8	19.2	17.0
Sole proprietors	48.0	5.4	4.1	46.9	10.3
Non-residents	42.1	49.4	45.5	40.1	58.2
Foreign financial institutions	3.0	-5.0	6.3	40.4	-1.0
Other	19.7	1.3	-10.2	-97.9	-31.2
<b>Total</b>	<b>10.0</b>	<b>13.4</b>	<b>19.5</b>	<b>24.1</b>	<b>23.2</b>

Source: Bank of Slovenia

For domestically-owned banks the highest risk sectors and branches, i.e. those for which the highest percentage of impairments are created, are the sole proprietors and agriculture sector, while the banks under majority foreign ownership have the highest coverage of claims by impairments for exposures to non-residents.

**Banks assess sole proprietors as one of riskiest sectors.**

Table 6.31: Breakdown of average risk of classified claims in 2006 by bank groups in percentages

	Banking sector	Large banks	Small banks	Banks under majority foreign ownership
Other	48.5	68.4	5.6	78.4
Sole proprietors	18.2	25.8	15.1	5.5
Agriculture	8.4	8.6	20.0	2.8
Manufacturing	6.7	7.8	8.0	3.8
Non-residents	6.4	5.0	2.3	18.0
Hotels and catering	5.5	6.2	13.3	3.4
Trade	5.2	5.3	9.0	4.0
Construction	4.7	4.7	4.8	4.8
Other public services	4.6	5.9	4.9	2.6
Households	4.5	4.2	3.4	5.1
Real estate and business services	3.4	3.7	4.5	2.4
Education	2.7	3.3	3.9	2.1
Health and social work	2.1	2.7	1.1	1.6
Transport, storage and communications	2.0	2.1	1.8	1.8
Mining	1.9	2.3	1.6	1.5
Electricity, gas and water supply	1.2	1.1	7.9	0.5
Financial intermediation	0.8	1.0	0.4	0.7
Foreign financial institutions	0.4	0.3	2.8	0.2
Public administration and defence	0.4	0.2	1.4	0.3
<b>Total</b>	<b>3.9</b>	<b>4.2</b>	<b>4.3</b>	<b>3.2</b>

Note: Bank branches not included in table.

Source: Bank of Slovenia

### Exposure to the rest of the world

**Exposure of Slovenian banks to the rest of world grew by 37.8% in 2006.**

In the past two years the exposure of Slovenian banks to the rest of the world has increased rapidly, by 37.8% in 2006. Exposure to subsidiary banks in the western Balkan region is increasing, and banks are following the expansion of corporate activities in that region. The impact of changing banks' securities portfolio structure is also important, with foreign securities representing an increasing proportion of the portfolio.

**Banks' exposure to the western Balkan region is increasing above all.**

Exposure to other EU member-states still represents most of the exposure to the rest of the world, but since 2004 this has been falling, down to 59.1% at the end of 2006, 10.2 percentage points less than at the end of 2004. The biggest increase over the period was for exposures to the former Yugoslav republics and Bulgaria, and to other higher risk economies (Russia, East Asia).

Table 6.32: Total banking sector exposure to country groups

	Proportion (%)		
	2004	2005	2006
EU15/25 <sup>1</sup>	69.3	63.5	59.1
EFTA	4.3	5.5	4.8
Former Yugoslav republics	15.4	19.2	22.6
CEFTA <sup>2</sup>	0.7	1.1	1.4
Others	10.3	10.7	12.1
Total (EUR million)	2,701	4,264	5,877

Notes: <sup>1</sup>From 2004 onward the data relates to the EU25.

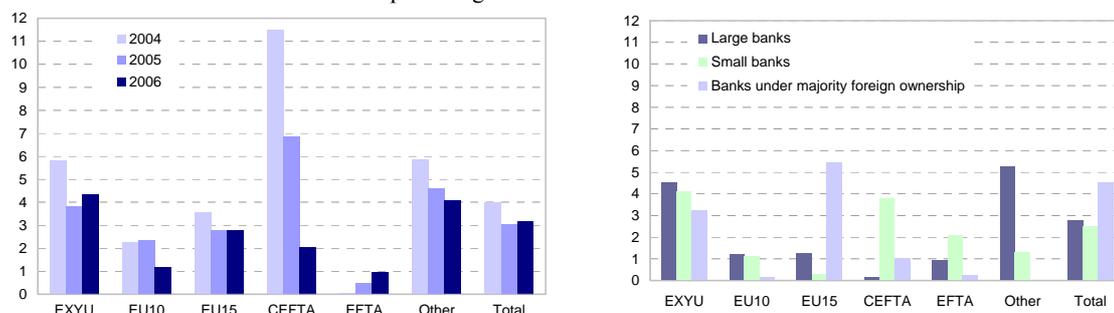
<sup>2</sup>From 2004 onward includes Bulgaria and Romania only.

Source: Bank of Slovenia

**Banks assess their exposure to the rest of the world as lower risk than exposure to domestic subjects.**

Banks assess exposure to the rest of the world, which includes financial and non-financial companies, as lower risk than claims against domestic subjects. For the past two years the most notable trend has been the rapid reduction in the risk assessment of claims against CEFTA countries, particularly Bulgaria.

Figure 6.29: Coverage of classified claims by impairments for banking sector (left) and for bank groups at the end of 2006 (right) by country groups in percentages



Source: Bank of Slovenia

**Large banks have the highest percentage of impairments for claims against countries of the former Yugoslavia.**

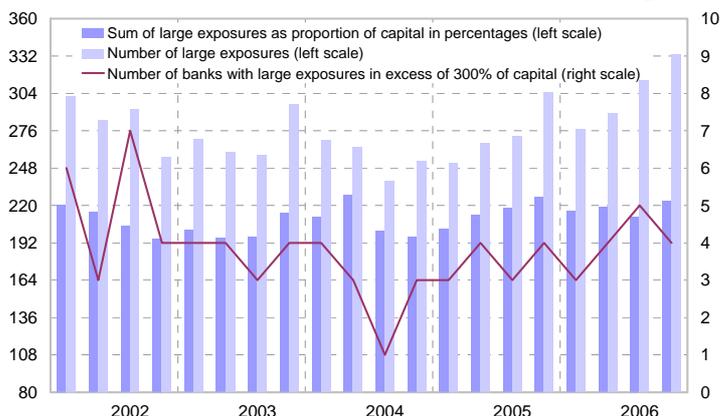
Banks assess that the risk of claims against the region of former Yugoslavia has increased in comparison with 2005. The percentage of impairments for claims against countries in the region increased primarily at the small banks. The highest percentage of impairments created for this region is by the large banks, the lowest by the banks under majority foreign ownership. Despite this, compared to the large and small banks, the banks under majority foreign ownership assess claims against Serbia, Montenegro and Macedonia, as significantly more risky and the claims against Croatia as significantly less risky.

### 6.5.5 Large exposures

**The number of large exposures increased to 333 in 2006.**

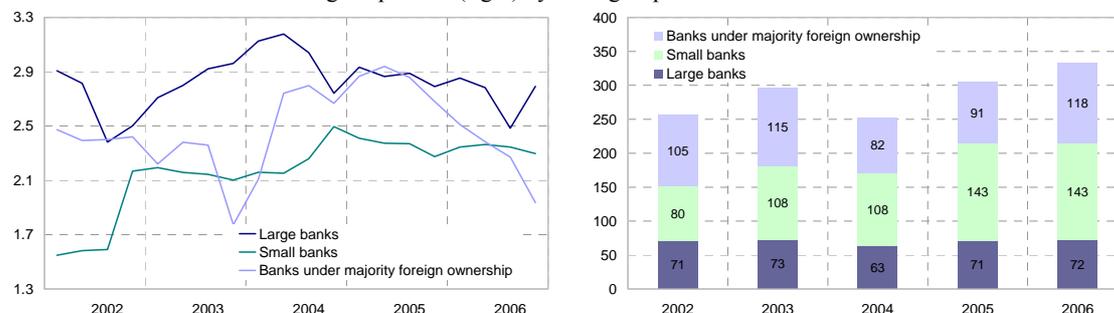
The number of large exposure increased in 2006 by 28 to 333, however mainly due to two banks undergoing a significant increase. Despite the higher number of large exposures, their total sum as a proportion of capital remained stable throughout 2006. The number of large exposures and their sum as a proportion of regulatory capital is at historically high levels.

Figure 6.30: Total sum and number of banking sector's large exposures



Source: Bank of Slovenia

Figure 6.31: Average size of large exposures as proportion of regulatory capital (left) and number of large exposures (right) by bank groups



Source: Bank of Slovenia

Given the high growth in regulatory capital (28%), the number of large exposures would be expected to fall, but this did not happen. It even increased at the banks under majority foreign ownership.

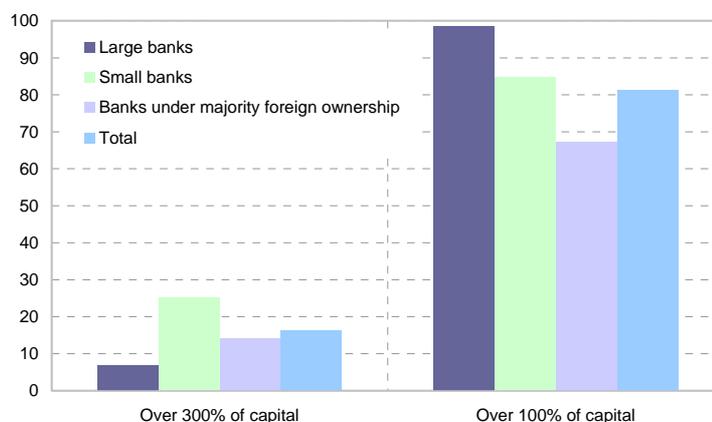
**Despite high growth in regulatory capital the number of large exposures did not decrease.**

The fact that number of large exposures increases and average value of large exposures as a percentage of regulatory capital is maintaining the same level given the high growth of the capital reflects the increase in exposure to large clients and greater assumption of credit risk. The sum of all large exposures was 30% higher in 2006 at the large banks, 24% higher at the banks under foreign majority ownership, and 17% higher at the small banks, compared with 2005.

The large exposure problem is the biggest burden on small banks that have a small volume of capital and therefore large numbers of large exposures. The small banks also have the most unfavourable ratio of large exposures to regulatory capital, as the percentage exceeding 100% of regulatory capital is significantly less than at the large banks, but the percentage exceeding 300% of regulatory capital is much larger than at the large banks. The small banks are the most sensitive to an economic downturn, which would also lead to a downturn in business activities of banks' large customers.

**Small banks most affected by large exposures.**

Figure 6.32: Proportions of observations with sum of large exposures over 300% and over 100% of regulatory capital between the final quarter of 1999 and the end of 2006



Note: A pair quarter-bank represents one observation. There are 20 banks and 29 quarters included. The case of one bank in one quarter represents 1 out of 580 observations, or 0.17%.

Source: Bank of Slovenia

## 6.6 Interest-Rate Risk

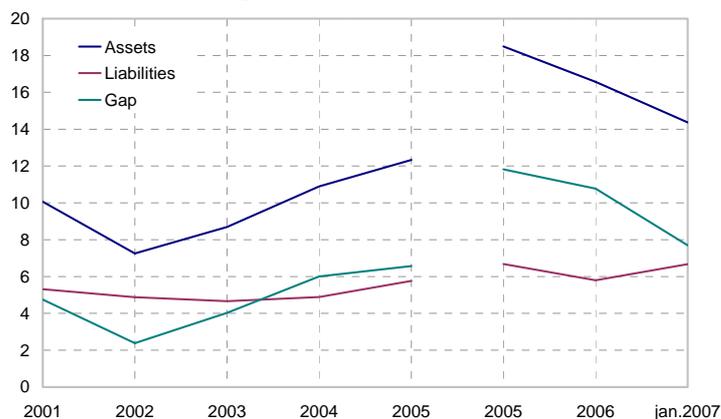
The banking system's exposure to interest-rate risk, as measured by the gap between average period of change in assets and liabilities interest rates at the end of 2006, was less than in 2005 and even lower at the start of 2007. The introduction of the euro contributed to the continued reduction in interest-rate risk in 2007 due to greater currency matching between interest-sensitive assets and liabilities. The banking sector's vulnerability is seen in the increase in mismatching between interest-sensitive assets and interest-sensitive liabilities tied to various reference interest rates. The proportion of assets tied to a reference interest rate is significantly greater than that of liabilities.

### 6.6.1 Average period of change in interest rates

**The reduction in the gap between the average period of change in assets and liabilities interest rates reflects lower interest-rate risk.**

The trend of increasing interest-rate risk due to mismatching of the average period of change in assets and liabilities interest rates reversed in 2006. The reduction in the gap between the average period of change in assets and liabilities interest rates to 10.8 months in 2006, and to 7.7 months in January 2007, indicates a reduction in interest-rate risk at banks. The average period of change in assets interest rates reduced significantly, and that trend strengthened at the start of 2007. This was largely due to the reduction in interest-sensitive assets with maturities of more than one year. In 2006 the volume of interest-sensitive liabilities with maturities of more than one year also fell, however the proportion of these items in the total interest-sensitive liabilities was just under 8%, while the proportion of items with maturities of more than 1 year in interest-sensitive assets being almost 20%.

Figure 6.33: Average period of change in assets and liabilities interest rates in months<sup>60</sup>



Note: The data for 2005 are given according to old and new methodology  
Source: Bank of Slovenia

In terms of currency and the proportion that individual currencies represent in the structure of interest-sensitive assets and liabilities, the greatest interest-rate risk is from items tied to the TOM indexation clause and the Swiss franc. In 2006 the difference between the average period of change in assets and liabilities interest rates was highest for tolar items, at 20 months. However, the much smaller difference for euro-denominated items meant that the merging of items after the introduction of the euro led to a reduction in the domestic currency gap to 8.3 months. For TOM-indexed items the gap between the average period of change in assets and liabilities interest rates remained at around 12 months. Banks are therefore exposed to a loss of net interest income on items in the domestic currency in the case of a rise in interest rates. The opposite applies to items tied to the Swiss franc, where the difference between the average period of change in assets and liabilities interest rates is negative, at -14.1 months at the end of 2006.

**The highest level of interest-rate risk is from items tied to TOM and to the Swiss franc.**

<sup>60</sup> When assessing interest-rate risk, a new source of bank interest-rate reporting has been used, with a slightly different methodology. In contrast to the previous source, the new data:

- Includes all banks, not just the eight largest.
- In addition to residual maturity it includes data on the repricing period for variable interest rates and the original maturity.
- There are also more maturities buckets reported. In particular the maturity bucket of over 5 years is further divided, which contributes to a significant increase in the average period of change in assets interest rates, less so for liabilities interest rates, which have a shorter average maturity.

According to the new methodology, the calculation of the average period of change in interest rates takes into account a shorter of the two periods the residual maturity and the repricing period. For new transactions the original maturity is taken into account if no other data is available.

Table 6.33: Average period of change in assets and liabilities interest rates (months)

	Dec. 05	Dec.06	Jan. 07
Interest-sensitive assets			
Tolars	24.8	24.9	
Of which indexed to TOM base rate	27.2	26.3	
Euros	12.7	10.5	14.8
Of which with foreign currency clause	30.0	20.8	
Of which indexed to TOM base rate			24.4
Swiss francs	6.6	5.4	5.7
Of which with foreign currency clause	8.9	7.7	6.8
Dollars	5.2	7.5	7.3
Others	0.8	15.9	18.3
Total	18.5	16.6	14.4
Interest-sensitive liabilities			
Tolars	5.5	4.9	
Of which indexed to TOM base rate	13.5	14.0	
Euros	8.0	6.1	6.4
Of which with foreign currency clause	19.2	21.6	
Of which indexed to TOM base rate			12.4
Swiss francs	8.4	19.6	19.3
Of which with foreign currency clause	13.0	25.9	22.8
Dollars	2.0	2.0	2.2
Others	1.3	1.3	1.5
Total	6.7	5.8	6.7
Gap			
Tolars	19.3	20.0	
Of which indexed to TOM base rate	13.7	12.3	
Euros	4.8	4.5	8.3
Of which with foreign currency clause	10.8	-0.9	
Of which indexed to TOM base rate			12.0
Swiss francs	-1.8	-14.1	-13.6
Of which with foreign currency clause	-4.1	-18.2	-16.0
Dollars	3.2	5.5	5.2
Others	-0.5	14.6	16.7
Total	11.8	10.8	7.7

Source: Bank of Slovenia

Taking into account the average period of change in assets and liabilities interest rates, in the short term the banking sector is more exposed to a rise in interest rates. Most exposed to a rise in interest rates are the small banks, while the banks under majority foreign ownership are the least exposed.

For the banks under foreign majority ownership, mismatching between the average period of change in assets and liabilities interest rates is greatest for items tied to the Swiss franc. While for the large and the small banks, mismatching is greatest for items tied to a TOM clause or other currencies, with those currencies where banks hold significant capital investments being of particular significance.

### 6.6.2 Structure of interest-sensitive items by currency

Average interest-sensitive assets at the end of 2006 stood at EUR 31.8 billion, while average interest-sensitive liabilities stood at EUR 30.2 billion. Their year-on-year growth of 7.1% and 9.8% remained behind growth in total assets.

In addition to the gap between interest-sensitive assets and liabilities, differences in their structure present another source of interest-rate risk. Since instruments in different currencies are only rarely tied to movements in the same interest rates<sup>61</sup>, the differences in the currency structure of interest-sensitive assets and liabilities indicate banks' exposure to interest-rate risk. According to bank data, interest-rate risk from currency mismatched items is falling.

<sup>61</sup> Loans in tolar and euros tied to the EURIBOR were such an example.

In 2006 the approach of the changeover to the euro brought in important changes in the structure of interest-sensitive items. The increase in the proportion of euro items at the expense of tolar items continued throughout 2006, however, primarily for assets and particularly at the large banks. The proportion of items indexed to TOM almost halved. At the end of 2006 the banking sector held 43.4% of interest-sensitive items in tolar, with the lowest level held by the banks under majority foreign ownership. In relation to interest-sensitive liabilities, the restructuring between tolar and euro items was much lower, except for the banks under majority foreign ownership. In 2006 the proportion of tolar-denominated interest-sensitive liabilities declined by 7.4 percentage points to 26.3% overall, while that proportion at the small banks was 66.7% at the end of 2006.

**Currency mismatching of interest-sensitive items decreased.**

Table 6.34: Currency structure of interest-sensitive assets and liabilities

(%)	Dec. 05	Dec. 06	Jan. 07
<b>Interest-sensitive assets</b>			
Tolars	50.1	43.4	
Euros	45.7	51.4	94.7
Swiss francs	1.7	3.1	3.0
Dollars	2.3	1.9	2.0
Others	0.2	0.3	0.3
Total (EUR million)	29,686	31,781	32,748
<b>Interest-sensitive liabilities</b>			
Tolars	46.6	43.0	
Euros	49.4	52.4	95.3
Swiss francs	1.3	2.5	2.5
Dollars	2.4	1.9	2.0
Others	0.3	0.2	0.2
Total (EUR million)	27,530	30,223	30,802
<b>Gap</b>			
Tolars	3.5	0.4	
Euros	-3.7	-1.0	-0.6
Swiss francs	0.4	0.6	0.5
Dollars	-0.1	0.0	0.0
Others	-0.1	0.0	0.1
Total (EUR million)	2,156	1,558	1,946

Source: Bank of Slovenia

Items tied to the dollar were the largest item among other currencies held by domestic banks as interest-sensitive assets and liabilities, while for the banks under majority foreign ownership the largest items were tied to the Swiss franc.

In January 2007 approximately 95% of all the banking sector's interest-sensitive items were denominated in euros. The proportion was even higher at the small banks (98%), while the proportion at the banks under majority foreign ownership was lower, at 91%, due to the importance of items denominated in Swiss francs.

A significant finding for interest-rate risk assessments is that in 2006, and even more in 2007, currency mismatching of interest-sensitive items fell significantly. This occurred because the proportion of euro-denominated items on the assets side, which lagged well behind the proportion on the liabilities side in 2005, increased at the expense of tolar items much faster in the assets than liabilities side of the balance sheet. In 2007, when tolar and euro items were combined in a single category, the currency mismatch was reduced further, and in January was down to -0.6 percentage points.

The greatest mismatch remained between TOM-indexed assets and liabilities, where January 2007 data indicates that the proportion of interest-sensitive assets tied to the TOM totalled 4.2%, while the figure for liabilities was 1.9%. The mismatch in TOM-indexed items represents additional risk. Since the proportion of TOM-indexed items is greater on the asset side, the interest expenses for these sources of financing are partly tied to changes in inflation, and partly to changes in interest rates. The large banks have the largest proportion of TOM-indexed items and the highest mismatch between TOM-indexed assets and liabilities. In January 2007 the gap was 3.3 percentage points compared to 2.3 percentage points for the total banking sector.

**The highest level of mismatch is for TOM-indexed items which are tied to inflation.**

### 6.6.3 Structure of interest-sensitive items by reference interest rate

**The mismatch between interest-sensitive assets and liabilities linked to a reference interest rate is increasing.**

An additional source of interest-rate risk was the mismatch in the structure of interest-sensitive assets and liabilities, in relation to the reference interest rate. While the currency mismatch of interest-sensitive assets and liabilities items fell up until 2007, the mismatch by reference interest rate increased significantly. The proportion of interest-sensitive assets tied to a reference interest rate is significantly greater than that of liabilities, and is also increasing more quickly. At the end of 2005 this proportion of assets was 35.5%, while at the end of 2006 it reached 44.8% and continued to increase. At 31.8%, the proportion of liabilities tied to reference interest rates was 13 percentage points lower than assets at the end of 2006. A lower concentration of reference interest rates is noticed for interest-sensitive assets, as the proportion of other interest rates that do not fall within the seven most commonly used is higher for assets than for liabilities, and the number of reference interest rates actually used is also higher.

Table 6.35: Structure of interest-sensitive assets and liabilities by reference interest rate in percentages

(%)	Interest-sensitive assets			Interest-sensitive liabilities		
	Dec. 05	Dec. 06	Jan. 07	Dec. 05	Dec. 06	Jan. 07
Proportion tied to reference rate	35.5	44.8	48.2	25.7	31.8	31.3
Proportion of tied items accounted for by individual reference rate						
EURIBOR						
1 month	14.2	17.5	17.3	2.2	7.6	6.4
3 month	20.3	21.0	22.7	35.3	46.3	42.0
6 month	43.1	41.8	43.9	55.5	36.1	43.2
1 year	2.5	2.4	2.9	1.3	1.4	1.0
Swiss franc LIBOR						
6 month	1.8	2.7	2.5	0.4	1.5	1.5
1 year	1.0	1.6	1.5	0.7	2.0	1.8
Bank of Slovenia 60-day tolar bill rate						
	7.6	4.8	1.9	0.0	0.0	0.0
Other	9.5	8.2	7.3	4.7	5.1	4.0

Source: Bank of Slovenia

The most frequently-used reference interest rates are those tied to the EURIBOR, primarily the 3-month and 6-month EURIBOR. The increase in loans tied to the Swiss franc has led to an increase in importance of the Swiss franc LIBOR as a reference interest rate. As the euro changeover date approached, the importance of the 60-day Bank of Slovenia tolar bill interest rate as a reference interest rate decreased, replaced by the ECB's refinancing rate, although the proportion of the latter is still rather low. The structure was similar for new transactions, but the LIBOR on the dollar remained one of the more frequently used reference interest rates for assets, while for liabilities it was the LIBOR on the euro.

Table 6.36: Structure of new transactions in interest-sensitive assets and liabilities by reference interest rate in percentages

(%)	Interest-sensitive assets		Interest-sensitive liabilities	
	Dec. 06	Jan. 07	Dec. 06	Jan. 07
Proportion tied to reference rate	19.3	55.1	4.8	3.6
Proportion of tied items accounted for by individual reference rate				
EURIBOR				
1 month	22.0	7.5	9.2	10.7
3 month	16.8	79.1	34.4	7.4
6 month	40.7	12.2	39.0	72.4
1 year	1.5	0.2	0.9	2.1
Swiss franc LIBOR				
3 month	1.1	0.1	4.5	0.0
6 month	2.3	0.4	3.3	0.0
1 year	1.3	0.2	3.3	0.1
Bank of Slovenia 60-day tolar bill rate				
	10.5	0.0	0.0	0.0
Other	3.8	0.3	5.5	7.3

Source: Bank of Slovenia

## 6.7 Exchange-Rate Risk

The introduction of the euro brought a sharp decline in exchange-rate risk at banks, both directly from their positions, and indirectly as a result of less exposure to exchange-rate risk in non-banking sectors. After the introduction of the euro, foreign currency sub-balances represent around 5% of total assets, and the proportion of foreign currency assets is greater than the proportion of foreign currency liabilities for the first time.

Despite the reduced exchange-rate risk following the euro adoption, banks' exposure to exchange-rate risk on individual segments increased. Banks have long open foreign exchange positions in the currencies of countries where they hold significant capital investments. These are primarily the currencies of the western Balkan states. Indirect exposure of banks to exchange-rate risk against the Swiss franc also increased via the housing loan segment, where almost one-third of all new loans were tied to the Swiss franc.

### 6.7.1 Foreign currency balance sheet of banks before and after the euro adoption

Increasing in the proportion of foreign currency loans accelerated at the end of 2006, with the proportion of loans to non-banking sectors denominated in foreign currencies reaching 55.5% by December 2006. On the deposit side, the unfavourable interest spreads for foreign currency deposits led to the foreign currency structure of deposits remaining unchanged until the euro adoption. The proportion of foreign currency deposits was even lower on average in 2006 than a year before. After the introduction of the euro, the proportion of foreign currency loans remained higher than the proportion of foreign currency deposits on account of loans in Swiss francs, although the two proportions were almost equal. The proportion of foreign currency loans in February 2007 was 4.4%, while the proportion of foreign currency deposits was 3.5%.

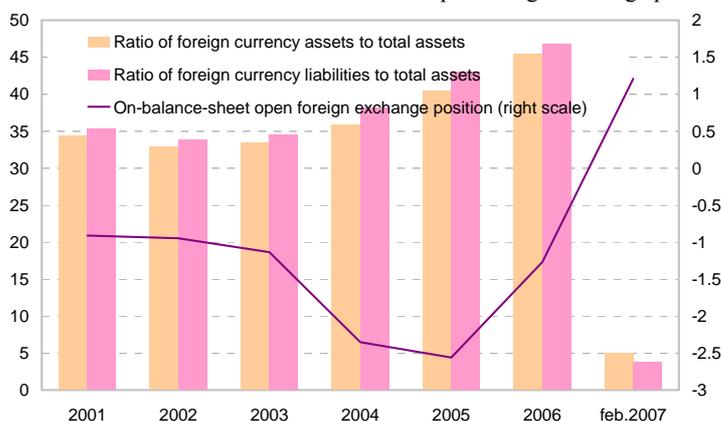
Because slow growth in bank deposits meant that the high growth in loans was mainly financed by borrowing from banks in the rest of world, in contrast to non-banking sectors, the proportion of foreign currency liabilities increased faster than the proportion of foreign currency assets, taking into account total assets. At the end of 2006 the proportion of foreign currency liabilities in total assets was 46.8%, while the proportion of foreign currency assets was 45.5%.

After the foreign-exchange position had been short for the entire period from 1994 onward, the introduction of the euro reversed the situation for the first time. The increase in banks' exposure to the western Balkan region in the form of capital investments and credit exposure, and the increasing importance of loans in Swiss francs led to the proportion of foreign currency assets in total assets exceeding the proportion of foreign currency liabilities after the introduction of the euro. In February 2007 the proportion of foreign currency assets was 5% and the proportion of foreign currency liabilities was 3.7%.

**The currency structure of deposits remained unchanged until the euro adoption due to differences in yield. The proportion of foreign currency loans grew throughout 2006.**

**The proportion of foreign currency liabilities remained higher than the proportion of foreign currency assets until the euro adoption, when the situation reversed.**

Figure 6.34: Ratio of foreign currency liabilities and foreign currency assets to total assets and on-balance-sheet open foreign exchange position in percentages



Source: Bank of Slovenia

**The most common other currencies are the dollar, Swiss franc and the currencies of the former Yugoslavia.**

The approach of the euro adoption not only led to an increase in the proportion of euro items in bank balances at the expense of tolar items, but also the proportion of other currencies increased. At the end of 2006, other currencies (i.e. other than euro) represented 11.4% of foreign currency assets and 9.9% of foreign currency liabilities. In recent years there has been a noticeable increase in the proportion of items in Swiss francs, primarily assets until the end of 2005, and in 2006 also on the liabilities side. The proportion of Swiss francs increased primarily at the expense of the US dollar. The currencies of other former Yugoslav countries also acquired importance on the assets side, and rapid growth in items in Bulgarian lev was also recorded<sup>62</sup>. In recent years there had been an increasing number of currencies represented in banks balance sheets, increasing from 23 in 2004, to 30 currencies in 2006.

Table 6.37: Currency breakdown of assets and liabilities

	December 2004		December 2005		December 2006	
	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
Total (EUR million)	11,157	11,493	15,926	16,257	21,164	20,437
Euros (EUR million)	10,072	10,482	14,201	14,823	18,751	18,416
Other currencies (EUR million)	1,085	1,011	1,725	1,435	2,413	2,021
Structure (%)						
Euros	90.3	91.2	89.2	91.2	88.6	90.1
Other currencies	9.7	8.8	10.8	8.8	11.4	9.9
Structure of currencies other than euros (%)						
Global currencies	90.0	93.5	85.3	93.2	87.3	94.3
US dollar	63.4	68.1	50.5	60.2	39.5	45.6
Swiss franc	22.7	20.0	30.6	26.6	41.5	40.8
Pound sterling	2.2	2.9	2.4	3.3	2.7	3.4
Canadian dollar	0.8	1.3	0.9	1.6	1.8	2.4
Australian dollar	0.6	0.9	0.3	0.8	0.4	0.8
Yen	0.3	0.2	0.7	0.8	1.3	1.1
New EU member-states	3.4	1.1	1.0	0.2	1.9	0.4
Scandinavia	1.0	0.6	0.5	0.5	0.5	0.5
Former Yugoslav republics	5.6	4.9	12.6	6.1	10.3	4.8
Russia, Africa, Middle East, Asia	0.0	0.0	0.6	0.0	0.1	0.0

Source: Bank of Slovenia

## 6.7.2 Open foreign exchange position

**The open foreign exchange position closed significantly with the introduction of the euro as domestic currency, though remaining long.**

In the second half of 2006, after final confirmation of the tolar-to-euro conversion rate, banks were still reporting items in euros, however, these were not taken into account as items exposed to exchange-rate risk. The open foreign exchange position remained long in 2006, though closing strongly towards the end of the year. In December 2005 it was EUR 439.9 million, but by the end of 2006 it was down to just EUR 118.1 million. If euro items were deemed as items exposed to exchange-rate risk until the euro adoption, the open foreign exchange position would increase significantly, due to the much faster migration from tolar to euro positions on the assets side than liabilities side.

**The open foreign exchange position closed in 2006 due to the closing of positions in Swiss francs.**

In 2006 the position in Swiss francs was almost closed. Given the increasing importance of borrowing in Swiss francs to non-banking sectors, banks are paying increasing attention to sources of financing in Swiss francs. This reduced their direct exposure to changes in the Swiss franc exchange rate, while they remain indirectly exposed via the non-banking sectors.

<sup>62</sup> Bulgaria is included in the group of new EU member-states, although it only actually joined on 1st January 2007.

Table 6.38: Open foreign exchange positions in EUR million

	December 2004	December 2005	December 2006
Total (EUR million)	430.0	439.9	650.9
Euros (EUR million)	443.4	274.5	532.7
Other currencies (EUR million)	-13.5	165.4	118.1
Global currencies	-23.5	28.7	-29.9
US dollar	-21.2	-24.1	-23.7
Swiss franc	-4.4	50.9	-7.0
Others (GBP, CAD, AUD, JPY)	2.0	1.9	0.9
New EU member-states	0.4	2.7	15.1
Scandinavia	1.5	2.0	-1.8
Former Yugoslav republics	13.7	127.8	133.7
Russia, Africa, Middle East, Asia	-5.5	4.2	1.0

Source: Bank of Slovenia

Banks hold long open foreign exchange positions in the currencies of countries where they hold significant capital investments. Banks' exposure to exchange-rate risk is therefore highest for items in the currencies of the western Balkan region, particularly items in the convertible mark, Serbian dinar and Bulgarian lev. The open foreign exchange position lengthened most for items in these currencies in 2006.

**Banks' most open positions, all long, are in the currencies of countries in which they hold significant capital investments.**

Viewed by bank groups and excluding items in euros, the large banks have a long position, while the foreign exchange position of the small banks and the banks under foreign majority ownership is practically closed, representing just 1% of regulatory capital. The position is long at the small banks and short at the banks under foreign majority ownership.

Table 6.39: Open foreign exchange position by bank groups

	Open foreign exchange position (EUR million)			As proportion of capital (%)		
	Dec. 04	Dec. 05	Dec. 06	Dec. 04	Dec. 05	Dec. 06
Large banks	-9.4	170.7	121.0	-0.8	12.7	7.2
Small banks	-2.8	-2.1	3.8	-1.3	-0.9	1.4
Banks under majority foreign ownership	-1.2	-3.3	-6.8	-0.3	-0.8	-1.4
Overall	-13.5	165.4	118.1	-0.7	8.2	4.8

Note: The proportion of capital for December 2006 relates to capital as at September 2006. Branches are excluded from the calculation.

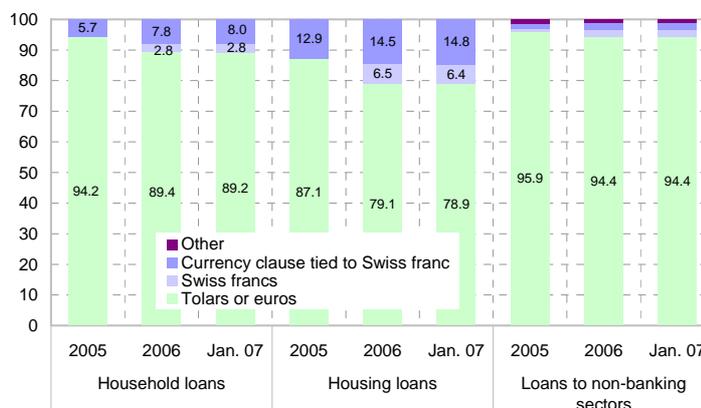
Source: Bank of Slovenia

### 6.7.3 Borrowing in Swiss francs

The indirect exposure of banks to exchange-rate risk via non-banking sectors remains significant – primarily exposure to the Swiss franc exchange rate in the segment of housing loans. The proportion of loans to non-banking sectors tied to the Swiss franc was 4.6% in 2006. The banks under majority foreign ownership stand out most, Swiss francs accounting for almost 30% of their stock of housing loans in January 2007.

**Banks' main indirect exposure to exchange-rate risk is from housing loans in Swiss francs.**

Figure 6.35: Currency breakdown of household loans, housing loans and loans to non-banking sectors

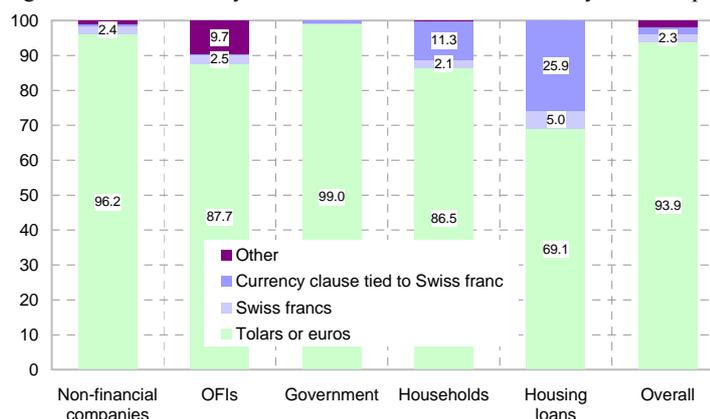


Source: Bank of Slovenia

**In 2006, 30.9% of new housing loans were tied to the Swiss franc.**

The increasing importance of loans denominated in Swiss francs is expressed even more clearly in the breakdown of new loans. The proportion of newly approved housing loans tied to the Swiss franc in 2006 reached 30.9%, while it was just 4.3% in the breakdown of all new loans to non-banking sector.

Figure 6.36: Currency breakdown of new loans in 2006 by sector in percentages



Source: Bank of Slovenia

The increase in borrowing in Swiss francs is due to lower reference interest rates for the Swiss franc than for the euro loans. In this way borrowers are also assuming exchange-rate risk, which would lead to increased credit risk for banks should the Swiss franc appreciate against the euro.

## 6.8 Liquidity risk

The liquidity of the banking sector showed no significant change in 2006 relative to the previous year. At the end of 2006 and in January 2007 there was a marked rise in the ratio for up to 30 days, which by the end of March 2007 had already returned to the level attained at the end of 2006. The increase in the ratio was chiefly a response to the amended regulation that abolished the possibility of including long-term foreign currency loans and reduced the weights for household and corporate sight deposits in the calculation of liquidity ratios. Owing to the large proportion of deposits by non-banking sectors in total assets, after the amendment of the regulation the ratio changed most for the small banks.

The vulnerability of banks has been seen in the deterioration of other coefficients indicating bank liquidity, but more from the aspect of sources of funds and financing lending growth. The rapid growth in loans to non-banking sectors financed by borrowing

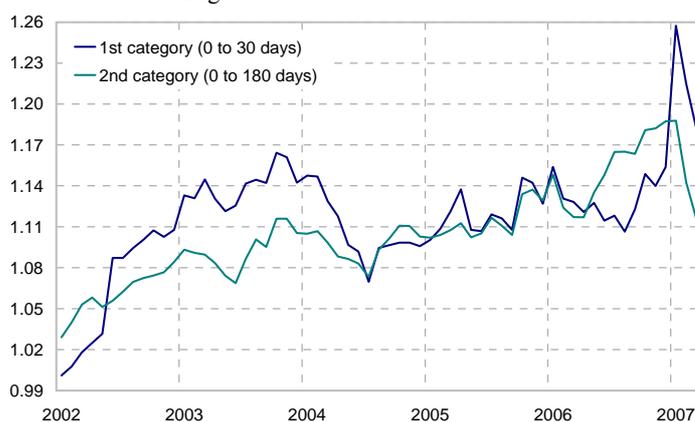
from banks in the rest of the world has been reflected in a reduction in the ratio of deposits to loans vis-à-vis non-banking sectors. The coverage of loans by liabilities to foreign banks also started to decline, which may be a sign that the conditions on the credit market are tightening up. The maturity of Bank of Slovenia bills meant that there was a considerable reduction in the proportion of debt securities in banks' total assets.

### 6.8.1 Liquidity coefficients

Following a relatively stable trend in 2006, the Category 1 liquidity coefficient (the assets to liabilities ratio with a residual maturity of up to 30 days) increased by 0.11 to 1.26 in January 2007 alone. This increase was a consequence of the amendment to the regulation, whereby the weights for sight deposits were reduced, even though at the same time it was no longer possible for the calculation of the liquidity coefficient to take into account foreign currency loans with a residual maturity of more than 180 days. Following the increase in the liquidity ratio, banks started rapidly optimising their positions and reducing surplus liquidity and thereby the liquidity coefficient. By the end of March the ratio had already come right back to the level from the end of 2006. Following the new regulation, the liquidity coefficient for Category 2, with residual maturity of up to 180 days, has been merely of an informative nature, so immediately after the regulation entered into force banks started rapidly lowering this coefficient too, and in March 2007 it reached a level comparable with the lowest level of 2006.

**After the amendment to the regulation Category 1 liquidity coefficient improved but the Category 2 liquidity coefficient rapidly decreased.**

Figure 6.37: Liquidity coefficients for Categories 1 and 2 of liquidity ladder, monthly averages



Source: Bank of Slovenia

The highest liquidity coefficients are achieved by the banks under majority foreign ownership. In December 2006 the average coefficient for this bank group was 0.13 higher than the coefficient for the banking sector overall. At the small banks the coefficient was at the level of the banking sector, while the large banks were 0.05 below that level.

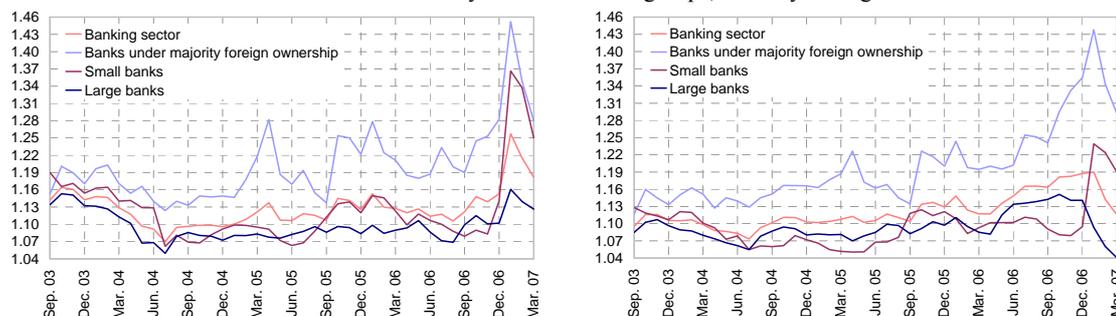
**The highest liquidity coefficient were achieved by banks under majority foreign ownership, and the largest increase owing to the amended regulation was achieved by small domestic banks**

First to change over to the new regulation were banks for which foregoing the possibility of taking into account foreign currency loans with a longer residual maturity did not signify a deterioration in the liquidity coefficient, or rather the deterioration was less than the benefits brought by lower weighting percentages for households and corporate sight deposits. The very rapid changeover to the new regulation was made primarily by the small banks, with 70% of the small banks starting to apply the new regulation before the beginning of 2007. These banks are by nature regional banks, and are closely tied to deposits by non-banking sectors. Following the amendment of the regulation, the liquidity coefficient showed the largest increase precisely in the small banks, and in January 2007 it was 0.23 higher than in December of the previous year. The liquidity coefficient for Category 1 of the liquidity ladder also increased for the large banks, but much less than the average for the entire banking sector. The largest delay in changing over to the new regulation was observed at the banks under majority foreign ownership. Before the beginning of 2007, only 10% of the banks under majority foreign ownership had changed over to the new regulation, despite the fact that following the changeover the liquidity coefficient improved considerably for the majority of them.

**Large banks started to speed up their lowering of the Category 2 ratio, which is now merely informational and so it is no longer essential for it to exceed the value of 1.**

The change in the importance of the Category 2 coefficient, which is merely informative and is therefore no longer subject to the requirement that it must exceed the value of 1, elicited the most rapid response from the large banks, where the coefficient dropped sharply in January 2007, and by March it had reached the lowest level in the last four years.

Figure 6.38: Liquidity coefficients for Categories 1 (left) and 2 (right) of liquidity ladder by individual bank groups, monthly averages



Source: Bank of Slovenia.

**Box 6.4: Regulatory changes in the area of liquidity**

Owing to the introduction of the euro and the transition to the Eurosystem instruments of monetary policy, in 2006 the Bank of Slovenia continued to align the regulation on the minimum liquidity level.

- The requirement that in Category 2 of the foreign currency part of liquidity ladder banks must ensure the sum of foreign exchange claims against the Bank of Slovenia, the Republic of Slovenia, foreign and domestic banks, investments in foreign securities and foreign cash in an amount that is equal to at least 70% of the monthly average liabilities (the foreign currency minimum), was reduced in April 2006 to 50%, in July to 30% and in October it was entirely abolished.

In October 2006 a new regulation was adopted, but up until the end of 2006 banks could still use the previous one. The new regulation is harmonised with IFRS terminology, as appropriate financial investments irrespective of residual maturity the investments that meet the criteria for eligibility as collateral for Eurosystem claims are added, and in addition to this the regulation introduced four other important new features:

- The liquidity coefficient for Category 2 is merely informative in nature.
- It is no longer possible for banks with a long foreign currency position, in the calculation of liquidity coefficients in Category 1 and 2 of the foreign currency part of liquidity ladder, to take into account the foreign currency loans with a residual maturity of over 180 days.
- The regulation gives banks the possibility of using their own methodology for calculating the proportion of core deposits. On the basis of an authorisation from the Bank of Slovenia, banks may use their own methodology, if they satisfy the minimum requirements for the use of an internal methodology, including an adequate database, which must contain data for at least a five-year period, and there is also a requirement for testing with scenarios of extreme situations and the preparation of crisis plans and retroactive testing, which checks the quality of the forecast with the actual situation.
- The percentage for taking into account sight deposits by households and non-financial companies (non-core deposits) in Category 1 of the liquidity ladder has been lowered from 85% to 50% and in Category 2 from 60% to 45%. Where banks use their own methodology, these percentages of sight deposits taken into account can be lower than those prescribed in the regulation, but no lower than 20%. In the event that liquidity management at a bank is not sufficiently reliable, the Bank of Slovenia may also prescribe higher percentages of weights for sight deposits than are prescribed in the regulation.

**6.8.2 Other liquidity indicators**

**A further deterioration in other liquidity indicators which reflect the structure of sources of funds and the financing of credit growth.**

While liquidity measured by the liquidity coefficients in 2006 was favourable, there was however a continuing deterioration in other liquidity indicators which reflect the structure of sources of finance and the financing of lending growth. The rapid growth in loans to non-banking sectors financed through borrowing from banks in the rest of the world was reflected in the reduction in the coverage of loans by deposits by non-banking sectors from 99.2% in 2005 to 87.1% in 2006. Coverage fell most at the banks under majority foreign ownership, where the deposits by non-banking sectors to loans ratio was a little

under 55% in 2006. In 2007 this trend is continuing, with the difference that coverage is falling especially at the small banks, which remain the sole bank group with a larger stock of deposits than loans to non-banking sectors.

Table 6.40: Selected ratios in balance sheet items that define bank liquidity over a longer timeframe in percentages

(%)		Large banks	Small banks	Banks under majority foreign ownership	Total
Ratio of deposits by non-banking sectors to loans to non-banking sectors	2003	137.2	152.3	104.8	129.8
	2004	124.9	147.8	83.7	114.9
	2005	109.7	135.9	69.1	99.2
	2006	100.1	124.3	54.9	87.1
	Feb. 2007	95.5	105.9	53.9	82.5
Ratio of short-term deposits to short-term loans to non-banking sectors	2003	178.4	139.3	188.0	175.1
	2004	187.7	144.1	147.8	172.1
	2005	154.1	132.2	138.4	146.9
	2006	127.5	118.3	124.1	125.3
	Feb. 2007	127.2	110.1	122.5	123.5
Ratio of liabilities to foreign banks to loans to non-banking sectors	2003	22.1	7.5	48.3	27.8
	2004	25.8	9.0	55.8	33.1
	2005	40.3	9.5	76.1	48.9
	2006	41.9	9.3	73.8	49.6
	Feb. 2007	41.3	7.6	63.7	45.4
Ratio of debt securities to total assets	2003	34.5	32.2	27.8	32.6
	2004	29.8	29.2	21.2	27.5
	2005	28.6	30.8	19.2	26.2
	2006	24.7	20.3	13.1	20.8
	Feb. 2007	25.7	15.0	9.3	19.8
ECB liquidity indicator (ratio of cash and claims against banks to liabilities to banks)	2003	65.0	113.3	41.7	58.2
	2004	70.4	136.9	35.5	58.0
	2005	48.0	86.5	30.3	41.3
	2006	44.9	116.3	25.1	38.6
	Feb. 2007	38.6	92.0	22.5	38.1
Proportion of total deposits by non-banking sectors accounted for by 30 largest depositors*	2003	17.1	32.0	24.9	20.7
	2004	16.1	29.5	24.8	19.9
	2005	19.4	31.4	20.7	21.2
	2006	20.3	32.7	19.9	21.9
	Jan. 2007	18.2	27.4	21.3	20.1

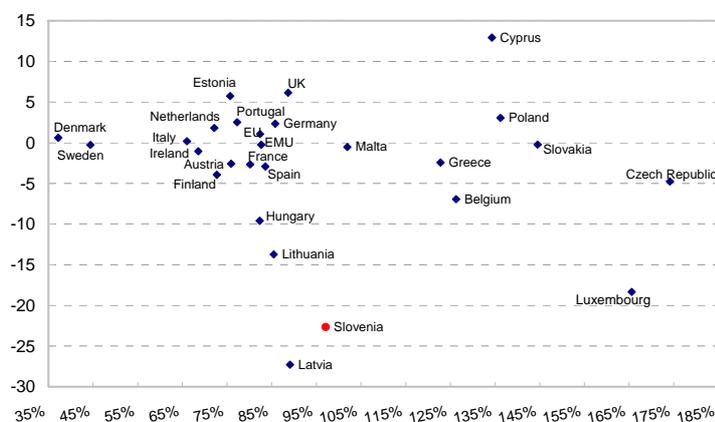
Note: For 2003 and 2004 the 30 largest depositors included deposits by banks, so for those two years the 30 largest depositors to deposits by banks and non-banking sectors ratio is calculated.

Source: Bank of Slovenia

On the European scale, Slovenia stands out less in its low level of coverage of loans by deposits by non-banking sectors and more by its rapid reduction in coverage. The ratio of non-banking sector deposits to loans in Slovenia in 2005 was well above the EU average, and even among the new EU member-states four had lower ratios. While on the EU and EMU average, coverage of loans to non-banking sectors by deposits remains on a similar level, in the majority of new EU member-states the growth in deposits has not kept pace with the growth in loans to non-banking sectors, and for this reason coverage of loans by deposits has fallen, in 2005 it was only in Latvia that coverage fell more than in Slovenia.

**On the European scale Slovenia stands out for its very rapid reduction in the coverage of loans by deposits from the non-banking sector, and this has only been faster in Latvia.**

Figure 6.39: Coverage of loans to non-banking sectors by deposits by non-banking sectors in 2005, and the change relative to 2004 by individual European Union countries



Note: x-axis: coverage of loans by deposits in percentages  
y-axis: change in coverage in 2005 relative to 2004 in percentage points. Loans to non-banking sectors and deposits by non-banking sectors have been taken into account. For Slovakia figures from the Slovakian Central Bank have been used, and for other countries figures from the ECB.

Source: EU Banking Structure, Slovakian Central Bank

Banks in Slovenia and especially the banks under majority foreign ownership are concentrating primarily on long-term loans, which ensure for them a long-term relationship with clients. For this reason the short term coverage of loans by deposits by non-banking sectors remains high, and at all groups of banks the stock of short-term deposits is greater than the stock of short-term loans to non-banking sectors. At the large banks coverage declined sharply in 2006, although it is still higher than at other bank groups.

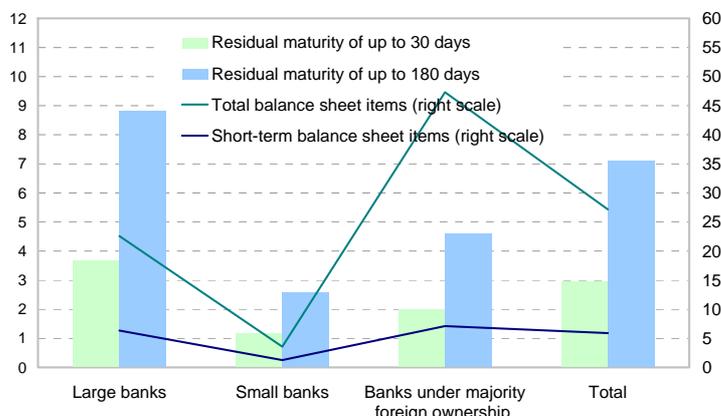
**The reduction in coverage of loans by borrowing from foreign banks may point to a tightening of the conditions for lending to the non-banking sector.**

In the financing of lending growth, borrowing from banks in the rest of the world continues to play an important part, and this is especially true of the banks under majority foreign ownership, where liabilities to banks in the rest of the world represent more than 70% of the stock of loans to non-banking sectors, or almost half of total assets. However the banks under majority foreign ownership show primarily long-term liabilities to parent banks in the rest of the world. The coverage of loans to non-banking sectors by liabilities to banks in the rest of the world did increase in 2006 in the banking sector, but mainly on account of the large banks, where liabilities to banks in the rest of the world already represent a high 42% of loans to non-banking sectors, or around a fifth of the total assets. At the small banks and even more at the banks under majority foreign ownership, coverage of loans to non-banking sectors by liabilities to banks in the rest of the world fell in 2006, and the drop has been even more pronounced in the first few months of 2007, with coverage also falling at the large banks. These might be the first signs of a tightening in lending to non-banking sectors, since there has been a reduction in both the coverage of loans by borrowing from banks in the rest of the world and by deposits by non-banking sectors. The growth in interest rates is tightening up access to sources of finance in the European financial market, while in deposits by non-banking sectors considering the favourable conditions in the capital markets banks have strong competition in mutual funds.

**In the short term, large domestic banks are more sensitive to the trends in liabilities to foreign banks than banks under majority foreign ownership.**

In the short term, the sensitivity of banks to the fluctuations of liabilities to banks in the rest of the world is greater at the large banks under domestic ownership than at the banks under majority foreign ownership. While at the banks under majority foreign ownership, liabilities to banks in the rest of the world with residual maturity of up to 30 days in January 2007 represented 2% of total liabilities in this category of the liquidity ladder, at the large banks this proportion stands at 3.7%. In the category with residual maturity of up to 180 days, the differences are greater. At the large banks, the proportion of liabilities to banks in the rest of the world in the entire stock of liabilities with residual maturity of up to 180 days amounts to 8.8%, while at the banks under majority foreign ownership it is 4.6%.

Figure 6.40: Liabilities to banks in the rest of the world as a proportion of total liabilities with residual maturity of up to 30 days or up to 180 days and in the short-term (relative to original maturity) and total balance sheets of banks



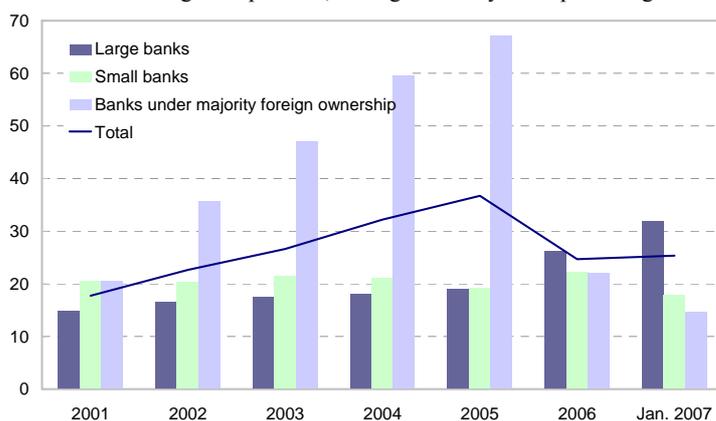
Source: Bank of Slovenia

Contrary to what might have first been expected, taking into account the items regarding residual maturity up to 30 days or up to 180 days and the trend of liabilities to banks in the rest of the world, the liquidity of the large banks is most sensitive, and more so than that of the banks under majority foreign ownership to movements in liabilities to foreign banks. The banks under majority foreign ownership are sensitive to movements in liabilities to banks in the rest of the world over a very long-term period, and they or their lending activity would be affected primarily by a withdrawal of the parent bank, which is less probable, however.

With the withdrawal of banks from Bank of Slovenia bills, there was also a reduction in the proportion of debt securities in total assets. In 2006 the proportion fell by 5.4 percentage points and by a further percentage point in the first two months of 2007. The proportion of debt securities in total assets fell most at the small banks.

**Reducing Bank of Slovenia securities has reduced the proportion of debt securities in banks total assets.**

Figure 6.41: Proportion of deposits by the largest depositor in the deposits of the 30 largest depositors, average for the year in percentages



Note: For 2003 and 2004 the 30 largest depositors included deposits by banks, so for those two years the 30 largest depositors to deposits by banks and non-banking sectors is calculated.

Source: Bank of Slovenia

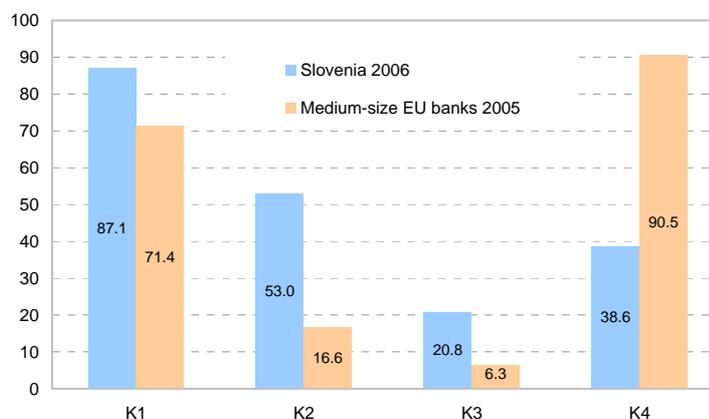
The concentration of the 30 largest depositors increased in 2006, except at the banks under majority foreign ownership, and the same is true of the concentration of the largest depositor, but the data for previous years are not entirely comparable<sup>63</sup>. Since deposits by banks are no longer included in reporting, the proportion of deposits by the largest

**The concentration of depositors is increasing further.**

<sup>63</sup> With the new reporting scheme bank deposits are excluded. There is also a difference in the reporting method, which is now done on a solo basis, while previously associated persons were also taken into account.

depositor is smallest at the banks under majority foreign ownership, where it is also most rapidly diminishing.

Figure 6.42: Comparison of indicators for the Slovenian banking sector and medium-size banks in the EU



Note: K1 – Ratio of deposits by non-banking sectors to loans to non-banking sectors  
 K2 – Ratio of liabilities to banks to loans to non-banking sectors  
 K3 – Proportion of debt securities in total assets  
 K4 – Ratio of the sum of cash and claims against banks to liabilities to banks

Source: Bank of Slovenia, ECB (EU Banking Sector Stability)

**Liquidity indicators deriving from the structure of the balance sheet are more favourable than in medium-sized EU banks, despite the reduction.**

In comparison with the EU, despite the drop, the proportion of debt securities in balance sheets and coverage of loans to non-banking sectors by deposits by non-banking sectors are still well above the average for medium-size banks in the EU, which are comparable in size to the large banks in Slovenia. Slovenian banks are characterised by a much greater dependence on borrowing from banks in the rest of the world. Coverage of loans to non-banking sectors by liabilities to banks is thus more than three times higher in Slovenia than the EU average. Consequently, it is much worse compared to the EU average the ratio regarded by the ECB as the liquidity ratio (EU Banking Sector Stability), that is, money and claims against banks relative to liabilities to banks.

## 6.9 Bank solvency

Institutional factors had a particular impact on capital adequacy movements in 2006: the introduction of the IFRS, the change in the methodology of calculating the exchange rate risk adjusted items, and since July, the exclusion of items in euros as items exposed to exchange rate risk.

The introduction of the IFRS had a major impact on the level and structure of regulatory capital. The effects of the IFRS were reflected in the increase in core capital and the reduction in both supplementary capital and deductions from capital investments. Owing to the increase in core capital, regulatory capital grew additionally, since in contrast to previous years, all banks could take into account total supplementary capital in their calculation of capital adequacy.

Owing to the changed methodology, there was a stark reduction in exchange rate risk adjusted items, although despite this, overall risk-adjusted assets recorded high growth. There was an increase especially in the risk-adjusted balance sheet assets of banks owing to the increased exposure of banks to credit risk, also due to the shift of banks from low-risk Bank of Slovenia securities to higher-risk investments.

Last year's Financial Stability Report pointed out that the anticipated improvement in capital adequacy in 2006 would not be a consequence of less risky behaviour by banks, but the effect of institutional factors. These have stimulated changes in bank behaviour towards greater willingness to assume additional or greater risk. The effect of the sharp reduction in exposure to exchange-rate risk was more than made up for by banks through increased exposure to credit risk. At the end of 2006 capital adequacy stabilized at a level of 11%. If banks wish to maintain that level of capital adequacy in the future, with the

continued high growth of loans to non-banking sectors they will soon require an additional increase in capital.

Most vulnerable here are the small banks, which have the smallest amount of capital. Since they mainly provide basic banking services only, they are more tied to the business cycle. A comparison with the average for small banks in the EU also points to the insufficient capital adequacy of small banks in Slovenia.

### 6.9.1 Capital adequacy

The capital adequacy of the banking sector amounted to 11.1% in 2006. The expectations of the favourable impact of institutional factors on capital adequacy in 2006 were fulfilled, with the capital adequacy of the banking sector growing to 11.4% up to the third quarter of 2006, settling at the end of the year at 11%, this being the level around which it hovered for most of 2004.

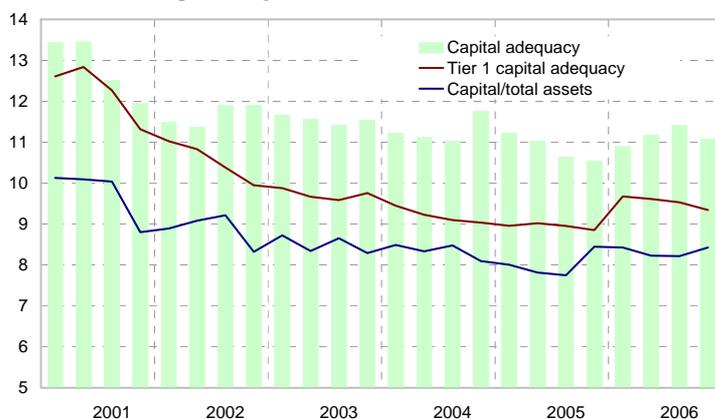
Tier 1 capital adequacy absorbed the effect of the IFRS introduction sooner than overall capital adequacy. In the first quarter of 2006 it grew by 0.8 percentage points relative to the end of 2005, reaching 9.7%, and then started to decline, ending the year at 9.3%.

Events of recent years, that is the trend of falling capital adequacy since the middle of 2001, a return of capital adequacy by the end of 2006 to the level of 11% after a major reduction in the second half of 2005 and almost constant Tier 1 capital adequacy throughout 2005, indicate that the banking sector has formulated a policy of the optimal level of capital adequacy around the level of 11% and Tier 1 capital adequacy around 9%. This is also confirmed by individual banks, which have published plans for the coming period indicating that they wish to maintain capital adequacy above the 10% level.

**Capital adequacy of the banking sector amounted to 11.1% in 2006, and Tier 1 capital adequacy to 9.3%.**

**Data indicate that banks assess balanced capital adequacy to be around 11%.**

Figure 6.43: Capital adequacy, Tier 1 capital adequacy and capital to total assets ratio in percentages



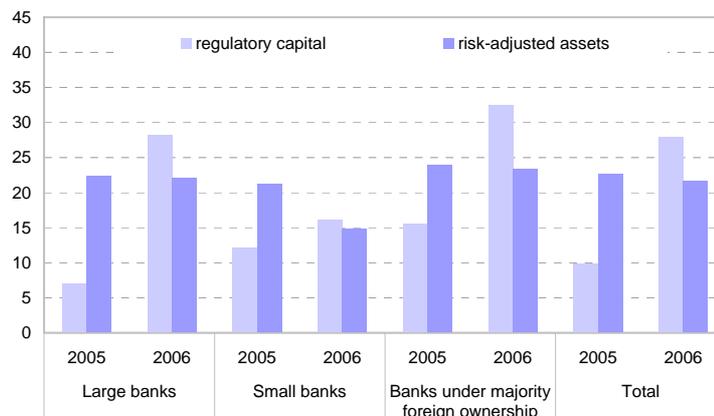
Source: Bank of Slovenia

In contrast to 2005, when high growth was recorded above all by risk-adjusted items, in 2006 capital adequacy grew on account of the high 28% growth in regulatory capital. Alongside capital injections, the extent of which was a quarter higher than in 2005, the reason for the high growth in capital lies mainly in the effects of introducing the IFRS. Those forms of provisions that are no longer created pursuant to the IFRS were transferred via retained earnings into core capital. The changeover to the IFRS also abolished the revaluation of fixed assets and capital investments, which were therefore transferred from other items within supplementary capital to the capital reserves. Owing to the abolition of the equity method, after the changeover to the IFRS there was also a drop in deduction items for capital investments in banks and other financial organisations.

**In 2006 capital adequacy was higher mainly on account of the high growth in capital, which increased owing to the adoption of the IFRS.**

Primarily the banks under majority foreign ownership recorded much higher growth in capital than risk-adjusted items, while the growth of both components of capital adequacy at the small banks was equal and very low relative to other bank groups.

Figure 6.44: Year-on-year growth rates of regulatory capital and risk-adjusted items in percentages



Source: Bank of Slovenia

**In 2006 small banks had the lowest capital adequacy.**

Consequently, the capital adequacy of the small banks remained at the level of the previous year and was lowest among all bank groups. In 2006 there was an increase primarily in the capital adequacy of the banks under majority foreign ownership, and the capital adequacy of the large banks was also half a percentage point higher. That banks approached the optimal level of capital adequacy is also indicated by the very small differences in the level of capital adequacy between the bank groups. The variation from the average for the banking sector at all bank groups is less than 0.2 percentage points.

Table 6.41: Capital adequacy of banks in percentages

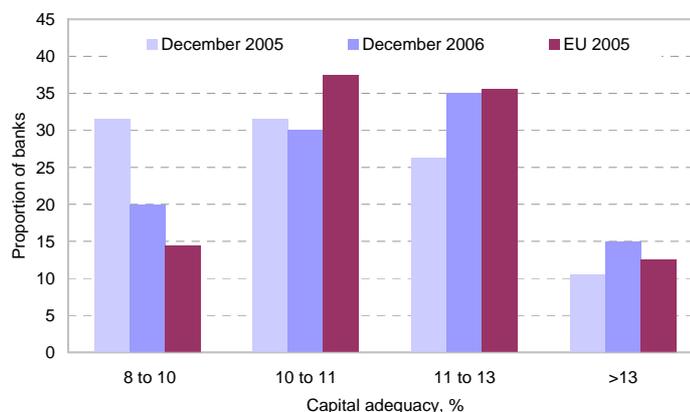
(%)	2002	2003	2004	2005	2006
Large banks	11.9	11.2	12.0	10.5	11.0
Small banks	13.5	13.2	11.7	10.8	10.9
Banks under majority foreign ownership	11.3	11.6	11.3	10.5	11.3
Banking sector	11.9	11.5	11.8	10.5	11.1

Source: Bank of Slovenia

**Compared to the EU, Slovenia has a lower proportion of banks with capital adequacy above 10%.**

There are bigger differences in the level of capital adequacy between individual banks. In 2006 there was an increase especially in the proportion of banks with capital adequacy between 11% and 13%, which is identical to that in the EU. In comparison with the EU, Slovenia has more banks with capital adequacy between 8% and 10%, although the proportion of these banks is falling.

Figure 6.45: Distribution of capital adequacy indicators for Slovenian banks and comparison with the EU in percentages



Note: Proportion relative to the number of banks, for the EU weighted with risk-adjusted assets.

Source: Bank of Slovenia, EU Banking Sector Stability

After a rise in 2006, the capital adequacy of the banking sector reached a level comparable to the 2005 EU average. Tier 1 capital adequacy was for the first time much higher, and is one percentage point above the EU average.

Table 6.42: Comparison of capital adequacy and Tier 1 capital adequacy in Slovenia and the EU for the entire banking sector and individual bank groups in percentages

(%)	Capital adequacy			Tier 1 capital adequacy		
	2005		2006	2005		2006
	EU25	Slovenia	Slovenia	EU25	Slovenia	Slovenia
Large banks	11,1			7,8		
Medium-size banks	12,0	10,5	11,0	8,7	8,5	8,6
Small banks	16,5	10,8	10,9	15,4	9,0	9,8
Banks under majority foreign ownership	13,0	10,5	11,3	11,1	9,6	10,7
Banking sector	11,4	10,5	11,1	8,2	8,9	9,3

Note: According to the ECB criteria, a large bank is a bank with a balance sheet that exceeds 0.05% of the consolidated total assets of the EU banking sector. According to these criteria, Slovenia has no large banks.

Source: Bank of Slovenia, ECB: EU Banking Sector Stability, November 2006

The most prominent place is taken by the small banks, which in comparison with similar-sized banks in the EU have much lower capital adequacy. A comparison with the EU, taking into account the way how small banks conduct their business, which is small in scope and focused primarily on basic banking services, and in this way is more tied to the business cycle than the larger banks, points to the insufficient capital adequacy of small banks in Slovenia.

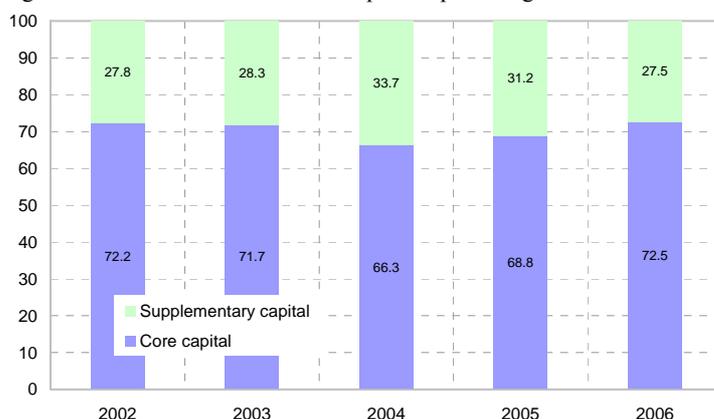
**A comparison with the EU average points to insufficient capital adequacy in small banks in Slovenia.**

## 6.9.2 Capital

At the end of 2006 the banking sector had EUR 2.58 billion in regulatory capital. Owing to the effects of the IFRS, the increase in supplementary capital was outstripped by that of core capital, which spurred a change in the structure of capital prior to deductions in favour of core capital. Deductions stemming from capital investments were less than in 2005.

**The proportion of core capital in the structure of regulatory capital prior to deductions increased to 72.5% in 2006.**

Figure 6.46: Structure of banks' capital in percentages



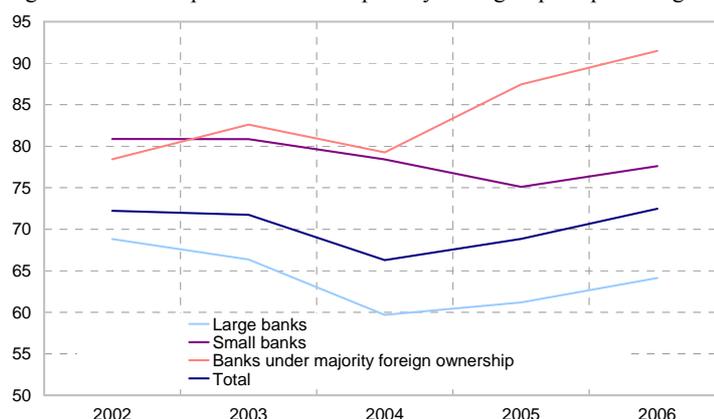
Source: Bank of Slovenia

In comparison with other bank groups, the banks under majority foreign ownership have a much higher proportion of core capital (91.5% at the end of 2006). The intensely concentrated structure of owners, who have a very active role and influence in operations, affords subsidiary banks easier access to capital. At the same time, several banks under majority foreign ownership are relatively small, in an intensive period of growth, for which they require more frequent capital injections.

**A high proportion of core capital is held especially by banks under majority foreign ownership.**

Up until 2004 the small banks followed the banks under majority foreign ownership, then the proportion of core capital in the structure of capital prior to deductions from capital investments started to decline. The lowest proportion of core capital is recorded by the large banks.

Figure 6.47: Proportion of core capital by bank groups in percentages



Source: Bank of Slovenia

### Core capital

**In 2006 alone core capital grew by 28.4%, chiefly on account of the introduction of the IFRS.**

At the end of 2006 the core capital of the banking sector amounted to EUR 2.18 billion. Relative to the previous year, this was EUR 481 million or 28.4% higher. Core capital increased mainly owing to the IFRS adoption, when banks transferred released provisions to capital. Retained earnings were thus 63 times greater in 2006 than in 2005. High growth was also recorded by the net profit for the current year, with year-on-year growth standing at 148%.

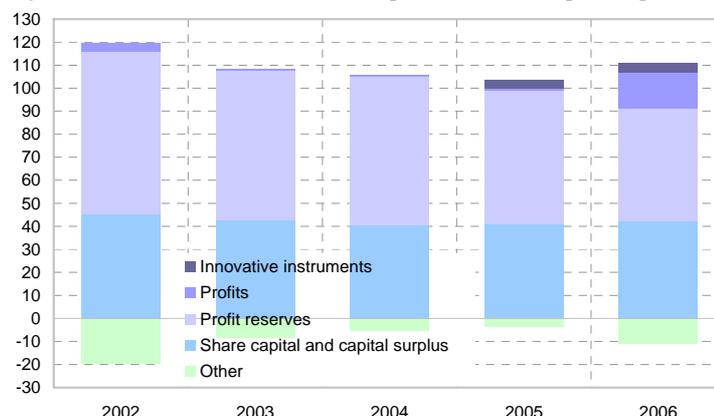
**The sum of deduction items from impairment grew by the end of 2006 to 21.2% of core capital.**

The negative contribution to core capital from the category “other” was greater in 2006 than in the previous year, primarily because under the IFRS banks could no longer create provisions for general banking risk. Moreover, under the regulation on the assessment of losses from credit risk, banks must take into account the difference between declared impairments and the amount of identified impairments calculated on the basis of percentages from the regulation for group impairments as a deduction item in calculating core capital. Up until the end of 2006 the amount of deduction items stemming from this reached EUR 461.9 million, or 21.2% of core capital.

**Recapitalisation was carried out by seven banks in a total amount of EUR 41 million.**

In 2006 capital injections in a total amount of EUR 41 million were carried out by seven banks: five under majority foreign ownership and two small banks. In 2005 banks could for the first time increase their capital by including innovative instruments in core capital, up to a level of 15% of the core capital. In 2006 the proportion of innovative instruments in core capital increased by 0.4 percentage points to 4.3%. At the large banks the proportion stands at 7.2%, while at the small banks it accounts for 2% of core capital. The banks under majority foreign ownership do not have innovative instruments as part of their core capital.

Figure 6.48: Contribution of the components of core capital in percentages



Note: The item “profit” includes retained earnings and net profit for the current year, while the item “other” includes provisions for general banking risk, deductions in core capital and other items.

Source: Bank of Slovenia

### Supplementary capital

At the end of 2006, supplementary capital taken into account in the calculation of capital adequacy reached EUR 827 million. Year-on-year growth in supplementary capital amounted to 7.7% and was at the same level as in 2005. There were greater differences among individual banks, and in particular there were more banks in 2006 with very low or very high year-on-year growth rates of supplementary capital compared to 2005. In 2006 the banks under majority foreign ownership again recorded negative growth in supplementary capital of -11%, having recorded growth of -28.3% the previous year. At the small banks the growth in supplementary capital in 2006 amounted to 9% and at the large banks to 9.8%.

Owing to the effects of the IFRS introduction, the proportion of "other" items in the structure of supplementary capital at the banks under majority foreign ownership fell from 51.6% down to 15.8%. In 2006 other bank groups also recorded lower growth rates, especially on account of the "other" item category. On the level of the entire banking sector the extent of these items fell in 2006 by 84.3%, and most of all at the large banks, by 88.6%. The reason for this lies in the abolition of the revaluation of capital investments and non-current assets. Assets from these items were transferred to share capital and the capital reserves.

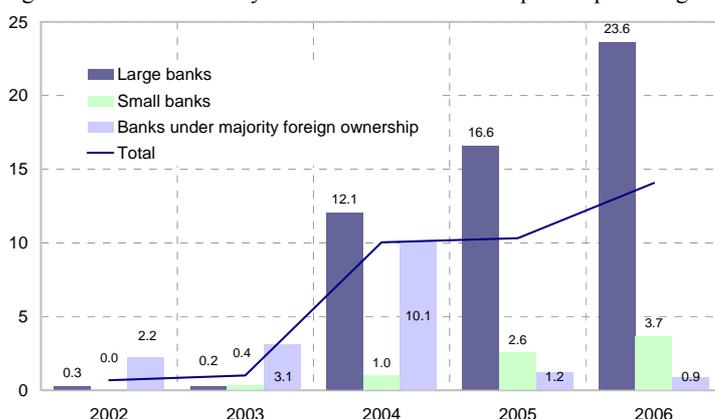
In 2006 supplementary capital increased primarily on account of hybrid instruments. At the end of the year these amounted to EUR 306 million, increasing by 75% relative to 2005. In the structure of supplementary capital used to calculate capital adequacy, at the end of 2006 hybrid instruments accounted for 37%, with their highest level of 42% at the large banks. In comparison with core capital, at the end of 2006 at the large banks hybrid instruments had thus already attained 23.6% of core capital. The banks under majority foreign ownership did not change their stock of hybrid instruments in 2006.

**At 7.7%, growth of additional capital remained on the 2005 level.**

**The IFRS introduction also had a major impact on the level of supplementary capital in 2006.**

**The volume of hybrid instruments increased by 75%, with the majority of the growth at large banks.**

Figure 6.49: Ratio of hybrid instruments to core capital in percentages



Source: Bank of Slovenia

While banks under domestic ownership heavily increased their stock of hybrid instruments in 2006, the banks under majority foreign ownership concentrated more on increasing their stock of subordinated debt. At the end of 2006 the subordinated debt of the banking sector amounted to EUR 451 million, and the year-on-year growth rate stood at 17.3%. All bank groups showed an increase, but most prominently banks under majority foreign ownership, by 43.3%. The entire banking sector has achieved a ratio of subordinated debt to core capital of 20.7%.

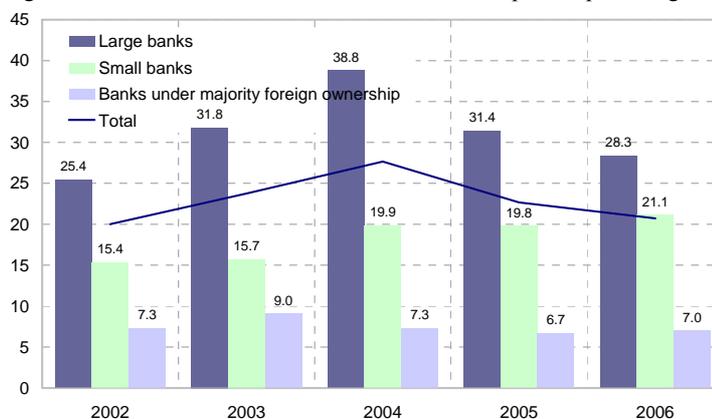
The high growth in core capital in itself raises capital adequacy, while at the same it allows banks in their calculation of capital adequacy to take into account a greater portion of supplementary capital. Owing to the considerable lower growth of subordinated debt compared to the growth in core capital, in 2006 all banks could take into account the entire extent of their subordinated debt in the calculation of capital adequacy, since at no bank did subordinated debt exceed the limit of 50% of core capital. At one bank it came very close to that limit, and at two others the ratio of subordinated debt to core capital exceeded 40% at the end of 2006. Even in respect of other items of supplementary capital

**The ratio of subordinated debt to core capital in the banking sector is falling.**

**Owing to the high growth in core capital, all banks could take into account their entirety of subordinated debt and their total supplementary capital.**

or of total supplementary capital, banks did not exceed the limits, so all banks could take into account all of their supplementary capital in its entirety.

Figure 6.50: Ratio of subordinated debt to core capital in percentages



Source: Bank of Slovenia

### Deductions in regulatory capital

**The IFRS introduction also had an impact in terms of the deduction stemming from capital investments.**

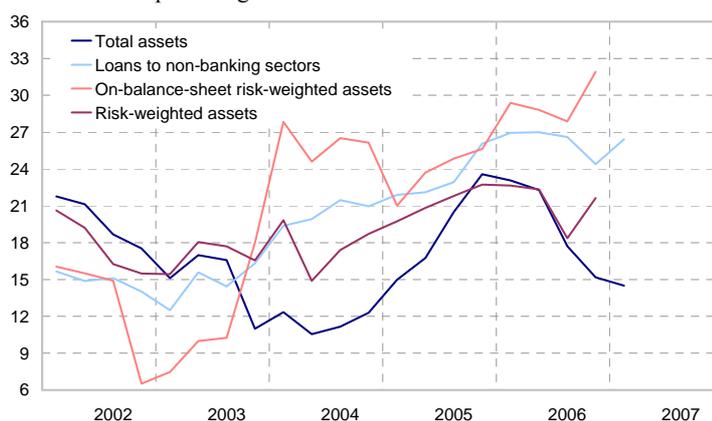
In 2006 the deductions stemming from capital investments, which lower the amount of core and supplementary capital in the calculation of capital adequacy, were 5% lower than in the previous year. The reason for this lies in the abolition of the equity method with the introduction of the IFRS, so the effect is reflected primarily at the large banks.

### 6.9.3 Risk-adjusted assets

**In 2006 banks increased the risks of their operations.**

With year-on-year growth in total assets, loans to non-banking sectors, and on-balance-sheet and total risk-adjusted assets having almost equalised at the end of 2005, differences between the year-on-year growth rates in these categories increased again in 2006, especially in the second half of the year. At the end of 2006 year-on-year growth in on-balance-sheet risk-adjusted assets thus amounted to 31.9%, while growth in total assets amounted to just 15.2%.

Figure 6.51: Year-on-year growth of total risk-adjusted assets, on-balance-sheet risk-adjusted assets, total assets and loans to non-banking sectors in percentages

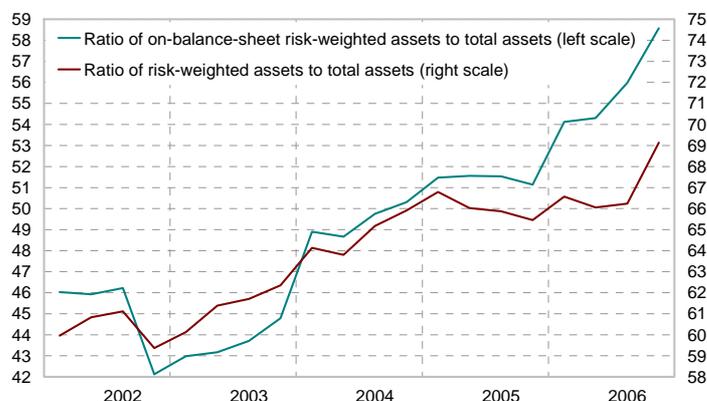


Note: Total risk-adjusted assets include items adjusted for exchange rate risk and market risk.  
 Source: Bank of Slovenia

In 2006 banks redirected their funds from the lowest-risk Bank of Slovenia securities to other securities, and in part they used freed-up money to finance credit growth. Owing to institutional factors, in 2006 banks therefore significantly changed their commercial policy and attitude to risk. The ratio of on-balance-sheet risk-adjusted assets to total assets increased by 7.4 percentage points to 58.6%. The ratio of total risk-adjusted assets

including exchange rate risk and market risk adjusted items to total assets increased by 3 percentage points in the second half of 2006 alone to 69.1% in December 2006.

Figure 6.52: Ratio of on-balance-sheet risk-adjusted assets and risk-adjusted assets to total assets in percentages



Note: Total risk-adjusted assets include items adjusted for foreign exchange risk and market risk.

Source: Bank of Slovenia

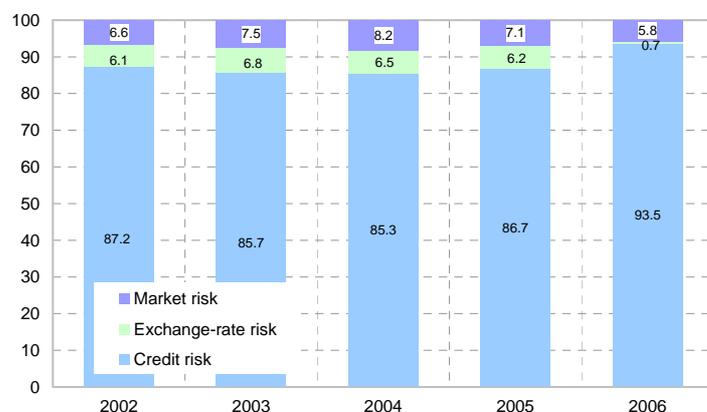
The greater willingness of banks to assume additional risk is even more obvious given the fact that in 2006, owing to methodological changes, there was a marked reduction in foreign exchange risk adjusted items. The new methodology no longer distinguishes between items in foreign currency and in the currency clause, and furthermore as a common position, it no longer takes into account the sum of absolute values of the amount of all short and all long positions, but just the bigger of the two amounts. There was a further reduction in foreign exchange risk adjusted items in the second half of 2006, when following the final confirmation of the tolar to euro conversion rate banks still reported items in euros, but were no longer required to take them into account as items exposed to exchange-rate risk.

**Owing to methodological changes, the extent of items adjusted for foreign exchange risk fell steeply.**

Despite the fact that at the end of 2006 items adjusted for foreign exchange risk were less than 15% of their levels in 2005, total risk-adjusted assets including items adjusted for foreign exchange and market risk recorded 21.6% year-on-year growth in 2006. The high growth was achieved primarily on account of the assuming of greater credit risk. In the structure of risk-adjusted assets, the proportion of items adjusted for foreign exchange and market risk in 2006 was halved, and amounted to just 6.5% at the end of the year.

**Banks more than made up for their lower exposure to foreign exchange risk through greater exposure to credit risk.**

Figure 6.53: Structure of total risk-adjusted assets including other risk-adjusted items in percentages



Source: Bank of Slovenia

The greatest changes in the structure of risk-adjusted assets were observed at the banks under majority foreign ownership, where the proportion of items tied to credit risk in the structure of total risk-adjusted assets increased by 10.7 percentage points. In the past, the

**Banks under majority foreign ownership recorded the largest increases in the proportion of items tied to credit risk. The proportion of items tied to market risk fell for all bank groups.**

banks under majority foreign ownership had the greatest proportion of foreign exchange risk adjusted items. Owing to the closing of the position in Swiss francs and the exclusion of items in euros, the proportion of items adjusted for foreign exchange risk in the structure of total risk-adjusted assets in 2006 at that bank group was almost wiped out. In 2006 it was therefore the large banks group that had the highest proportion of foreign exchange risk adjusted items, at 1.1% of total risk-adjusted assets. The proportion of items adjusted for market risk fell in all bank groups.

Table 6.43: Structure of total risk-adjusted assets, including other risk-adjusted items by individual bank group for December 2005 and December 2006

	December 2005 (%)			December 2006 (%)			Change (percentage points)		
	Credit risk	Exchange rate risk	Market risk	Credit risk	Exchange rate risk	Market risk	Credit risk	Exchange rate risk	Market risk
Large banks	87.6	5.0	7.4	92.4	1.1	6.5	4.8	-3.9	-0.9
Small banks	83.4	4.7	12.0	91.1	0.2	8.7	7.7	-4.4	-3.3
Banks under majority foreign ownership	86.3	9.6	4.1	97.0	0.2	2.8	10.7	-9.4	-1.2
Total	86.7	6.2	7.1	93.5	0.7	5.8	6.8	-5.5	-1.3

Source: Bank of Slovenia

## 7 NON-BANKING FINANCIAL INSTITUTIONS

### 7.1 Insurers

#### 7.1.1 Features of insurers' business and comparison with the EU

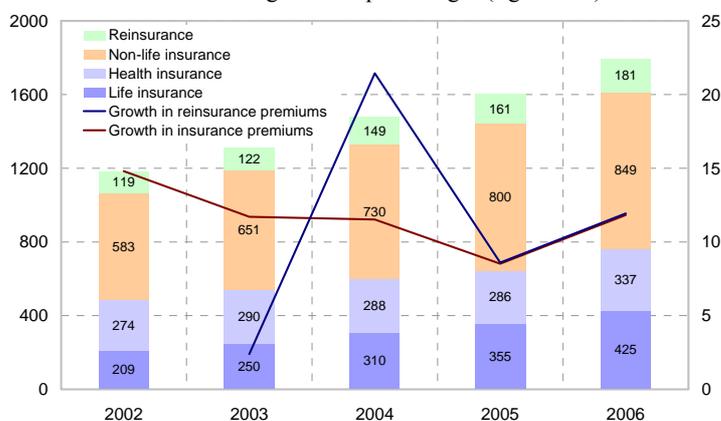
At the end of 2006 there were 13 insurance companies,<sup>64</sup> two reinsurance companies and two branches of foreign insurers operating in Slovenia. Concentration in the insurance sector declined slightly during the year. The market share of the largest insurance company in terms of collected premium declined by 1.8 percentage points to 41%, while that of the largest reinsurance company increased to 57.5%. The largest non-life insurance company covers 38.5% of the market in non-life insurance, the largest life insurance company has 48% of the life insurance market, and the largest health insurance company has 65% of the health insurance market. The markets for particular types of insurance remain highly concentrated, and are only slowly opening.

**The largest decline in concentration was in the health insurance market.**

Insurers performed even better in 2006 than in 2005. The gross collected premium of the insurance companies and the reinsurance companies increased by 12%. The insurance companies collected premiums of EUR 1,612 million from life insurance, non-life insurance and health insurance, and the reinsurance companies premiums of EUR 181 million. The net technical provisions increased by 10%, while their coverage by the assets covering technical provisions increased to 123.4%. The insurance companies' profitability improved further in 2006. ROE<sup>65</sup> amounted to 8.7%. There was also an improvement in the profitability of the reinsurance companies in the first nine months of 2006, with ROE amounting to 10.2%.

**Good performance by insurers in 2006.**

Figure 7.1: Gross collected premium by type of insurance in EUR million (left scale), and annual growth in percentages (right scale)



Source: ISA

The insurance companies recorded a sharp increase in gross collected premium in 2006, primarily as a result of growth of 20% in collected premium from life insurance and 18% in collected premium from health insurance. Growth in non-life insurance premiums declined for the second successive year in 2006, to 6%. As a result, the proportion of total collected premium accounted for by life insurance increased to 26%, and the proportion accounted for by health insurance increased to 21% after several years of decline, while the proportion accounted for by non-life insurance declined by 2 percentage points to 53%.

**An increase in the proportion of collected premium accounted for by life insurance.**

<sup>64</sup> Of the 13 insurance companies, eight were providing non-life insurance and life insurance (of which two were also providing health insurance), two were providing non-life insurance alone, one life insurance alone, and two health insurance alone.

<sup>65</sup> For insurers the ROE is calculated from profits after tax.

The insurance sector in Slovenia is less developed compared with the majority of older EU member-states, but the gaps are diminishing. The total collected premium of insurers reached 5.4% of GDP in 2006, or EUR 805 per capita, which is significantly below the EU25 average of 8.4% of GDP and EUR 1,978 per capita in 2005.<sup>66</sup> The collected premium from life insurance in Slovenia reached 1.4% of GDP in 2006, or EUR 213 per capita. The proportion of total collected premium that it accounts for is constantly increasing, and reached 26.4% in 2006. The gap between the relative sizes of the Slovenian and the EU insurance markets is particularly wide in life insurance, which is significantly more important in the EU25, and there is great potential for growth with regard to its proportion of total collected premium at Slovenian insurers.

Table 7.1: Total gross collected premium and gross collected premium from life insurance expressed in various categories for Slovenia in 2006 and for selected countries in 2005

	Slovenia	EU15	EU25	Greece	Portugal	Germany	UK
Total premium (EUR billion)	1.61	946.28	965.01	3.88	13.42	158.62	241.44
Per capita (EUR)	805	2,315	1,978	359	1,309	1,858	3,698
As % of GDP	5.4	8.6	8.4	2.2	9.1	6.8	12.5
Life insurance premiums (EUR billion)	0.43	583.18	590.61	1.85	9.21	72.55	160.52
Per capita (EUR)	213	1,442	1,222	171	896	838	2,643
As % of total premium	26.4	61.6	61.2	47.7	68.6	45.7	66.5
As % of GDP	1.4	5.4	5.2	1.0	6.2	3.1	8.9

Sources: ISA, Swiss Re, own calculations

#### Life insurance and contractual integration of insurers with banks

#### Rapid growth in life insurance tied to mutual fund units.

Life insurance continued to increase in importance in 2006. The total assets of life insurance accounted for 48.6% of the total assets of insurers at the end of 2006. In the life insurance sector, the pronounced trend of an increase in life insurance investments tied to mutual fund units has continued. The collected premium from this segment more than doubled in 2006, to account for almost 41% of the total collected premium from life insurance. The proportion of life insurance investments in favour of policyholders assuming the investment risk increased by 7.3 percentage points in 2006 to 17.6%, compared with a figure of 22% at the end of 2005 in the euro area.<sup>67</sup>

Table 7.2: Collected premium and number of policyholders for life insurance and pension insurance provided by insurers

	2003	2004	2005	2006	2003	2004	2005	2006
Life insurance total					Growth rates (%)			
Premium (EUR million)	250	310	355	425	13.1	24.0	14.7	19.7
Number of policyholders	739,003	852,955	926,306	986,803	13.5	15.4	8.6	6.5
Life insurance tied to mutual fund units					Proportion of life insurance (%)			
Premium (EUR million)	20	57	80	173	8.0	18.3	22.5	40.8
Number of policyholders	40,264	96,313	154,886	216,122	5.4	11.3	16.7	21.9
Voluntary supplementary pension insurance								
Premium (EUR million)	15	15	15	18	5.9	4.8	4.3	4.3
Number of policyholders	45,801	37,455	39,623	42,413	6.2	4.4	4.3	4.3

Source: ISA

#### An increased transfer of risks to policyholders.

The rapid increase in life insurance tied to mutual fund units is insurers' response to the high returns on capital markets and the low level of interest rates, which have made traditional life insurance less attractive. Via life insurance tied to mutual fund units, insurers are offering products that are comparable to competing financial investments in terms of expected returns. Slovenian insurers do not offer life insurance with guaranteed returns, as commonly seen elsewhere in the EU, but only products with a guaranteed principal, or a warranty on the principal and the return already achieved. Life insurance tied to mutual fund units is a higher-risk product in which the insurer transfers risk to the policyholder. The expansion of this form also entails greater concentration of risk at households, which are less qualified in managing risks than insurers. There was also increased transfer of risk to households in the euro area in 2005. The proportion of

<sup>66</sup> Swiss Re.

<sup>67</sup> Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS).

guaranteed products declined, while the proportion of products tied to mutual fund units increased.<sup>68</sup> The changes in the valuation of assets and liabilities under the IFRS and the new methods for valuing technical provisions and risk-weighted capital requirements to be introduced by the proposed Solvency II<sup>69</sup> have probably influenced the transfer of risk, and will continue to do so to a certain extent.

In the last two years Slovenian insurance companies have expanded their offer of investment-based life insurance policies that include hedge funds among its investments. The higher risks entailed by hedge funds means that these products carry even more risk than life insurance tied to mutual fund units. There were four<sup>70</sup> Slovenian insurance companies offering a total of six such products by the end of the first quarter of 2007. The insurance companies' investment strategies for these products vary, with the proportion of hedge funds ranging from 5% to 100%, or even in excess of 100% if financial leverage is used. At two insurance companies investors can stipulate themselves what proportion of their funds is to be invested in hedge funds according to their willingness to accept risk, while at two insurance companies investors are guaranteed the principal and the returns already achieved at the end of endowment period.<sup>71</sup>

**Increasing availability of investment life insurance incorporating hedge funds.**

As insurance, life insurance in particular, grows in importance, so do the banking system's ties with insurers in the sale of insurance policies. In April 2007 there were 14 banks and two branches of foreign banks that held an authorisation to broker the sale of insurance policies, with surveys indicating that 14 banks were engaging in such transactions. The value of the transactions concluded in 2006 more than doubled to EUR 62 million. The proportion of the banking system's fees and commissions accounted for by the earned commissions from these transactions increased slightly, but remains negligible at 0.59%.

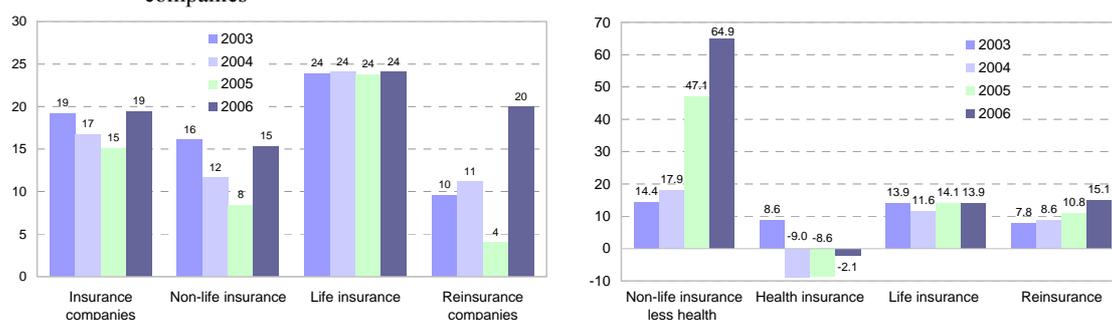
**An increase in ties between banks and insurers in the marketing of insurance policies.**

#### Financial statements and capital adequacy

The total assets of the insurance companies increased by 19% in 2006 to EUR 3,519 million. Growth in the total assets of life insurance remained unchanged compared with the three preceding years, while growth in the total assets of non-life insurance increased. The total assets of the reinsurance companies increased by one-fifth in the first nine months of last year to EUR 376 million.

**Insurers' total assets increased by 19%.**

Figure 7.2: Growth in total assets in percentages (left), and result from ordinary activities in EUR million (right) of insurance companies and reinsurance companies<sup>72</sup>



Source: ISA

Net profit increased by 37% in 2006 to EUR 51.5 million. This was primarily the consequence of improved result in non-life insurance and smaller losses in health insurance. Rising interest rates meant that insurance companies recorded a further increase in interest income in 2006.

<sup>68</sup> ECB Financial Stability Review, December 2006.

<sup>69</sup> BIS, ECB.

<sup>70</sup> Zavarovalnica Tilia, Zavarovalnica Maribor, Slovenica Življenje and Zavarovalnica Merkur.

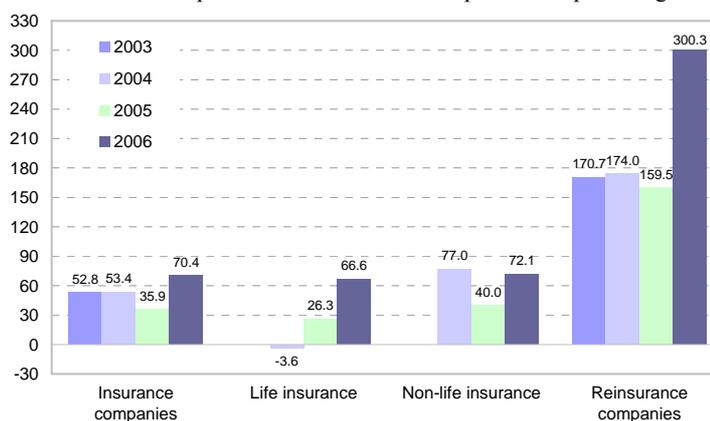
<sup>71</sup> One insurance company guarantees the premiums paid for two products at the end of endowment period, the other guarantees 80% of the principal and the returns already generated as at a specific day in each individual year.

<sup>72</sup> The 2006 figures for the reinsurance companies relate to September.

**Insurers' solvency improved.**

The solvency of the insurance companies and reinsurance companies improved in 2006, partly as a result of the elimination of equalisation provisions<sup>73</sup> and their inclusion in capital, and partly from capital injections. The surplus of disposable capital over the required minimum capital increased by 115%, to stand at 70% of the required minimum capital. The surplus of disposable capital over the required minimum capital at reinsurance companies had increased to fully 300% by the end of the third quarter of 2006.

Figure 7.3: Surplus of disposable capital over required minimum capital at insurance companies and reinsurance companies<sup>74</sup> in percentages



Source: ISA

**Institutional changes at insurers.**

As of 1 January 2007, insurers have been obliged to begin applying the IFRS. Prior to this date they had to eliminate their equalisation provisions for all insurance other than credit insurance, disclosing them as part of capital. Compiling financial statements under the IFRS will present a major challenge to insurers in the future, as they do not set out a uniform methodology for valuing assets and liabilities, which could be reflected in greater volatility in insurers' profits. An additional challenge faced by insurers will be the introduction of and adaptation to Solvency II, which with its new methods for valuing technical provisions and risk-weighted capital requirements will lead to insurers' investment policies and risk management strategies becoming more closely tied to the structure of their liabilities.<sup>75</sup> The introduction of new solvency standards will in all likelihood also bring about consolidation in the insurance sector, as the new arrangements will have benefits in the release of capital for larger, more diversified insurers in particular.<sup>76</sup>

**7.1.2 Stability of the insurance sector**

**Underwriting risk**

**Improvement in insurers' claims ratios.**

The claims ratio at the insurance companies as measured by the ratio of gross claims paid to gross collected premium improved to 0.57 in 2006, the best figure in the last six years. Life insurance and health insurance contributed to the improvement in the claims ratio. The improvements in the claims ratios for life insurance and health insurance were the result of collected premium growing faster than claims paid. The deterioration in the claims ratio for non-life insurance came from deteriorations in the claims ratios for land motor vehicle insurance, credit insurance and other non-life insurance. The level of retained risk at the insurance companies remained slightly above 82%.

The risk that the insurance companies are exposed to from damages derives primarily from the possibility of the occurrence of a natural disaster or pandemics, while the risk of man-made catastrophes (terrorism) is less pronounced than in other euro area countries.

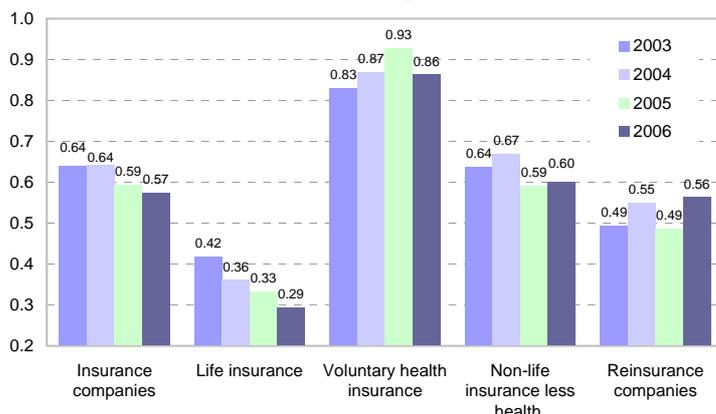
<sup>73</sup> Insurers still disclosed EUR 80.7 million of equalisation provisions as at 31 December. As of 1 January 2007, all equalisation provisions not created for credit protection must be transferred to capital (after payment of tax), which will further improve solvency.

<sup>74</sup> The 2006 figures for the reinsurance companies relate to September.

<sup>75</sup> BIS.

<sup>76</sup> ECB.

Figure 7.4: Claims ratios for major types of insurance



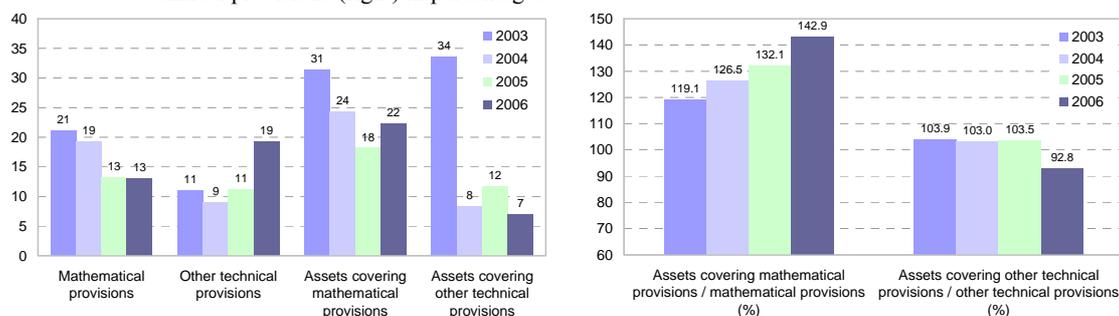
Source: ISA

### Investment risk

Insurers' assets covering technical provisions increased by 15% in 2006 to EUR 2,856 million, or 9.6% of GDP. Last year growth in life insurance investments again outstripped growth in non-life insurance investments, which was reflected in the proportion of the assets covering technical provisions accounted for by assets covering mathematical provisions increasing by 3 percentage points to 58%. The coverage of the insurers' net technical provisions by the assets covering technical provisions increased by just under 6 percentage points in 2006 to 123.4%. This was the result of an improvement of 11 percentage points in the coverage of mathematical provisions by the assets covering mathematical provisions. The investment risk in life insurance declined in 2006 according to this indicator. The coverage of other technical provisions by the assets covering other technical provisions deteriorated by just under 11 percentage points. The investment risk in non-life insurance increased slightly according to this indicator.

**The coverage of technical provisions by the assets covering technical provisions improved.**

Figure 7.5: Growth in net provisions and assets for life insurance and non-life insurance (left), and coverage of technical provisions by assets covering technical provisions (right) in percentages



Sources: ISA, own calculations

The investment policy of Slovenian insurers remains more conservative than in the euro area overall, but in recent years there have been shifts towards slightly better returns and higher risk in the investment structure. This is evident from the decline of 3 percentage points in the proportion accounted for by government securities, debt securities and deposits to 73%, and increases of 1 percentage point in the proportion accounted for by equities to 10%, and 4 percentage points in the proportion accounted for by mutual fund units to 11%. In the euro area<sup>77</sup> the proportion of insurers' investments accounted for by debt securities and deposits stood at 55.7% at the end of 2005, while the proportion accounted for by equities and mutual fund units, including mutual fund units in favour of policyholders assuming the investment risk, stood at 36.4%.<sup>78</sup>

**A shift towards investments with better returns and higher risks, primarily as a result of life insurance.**

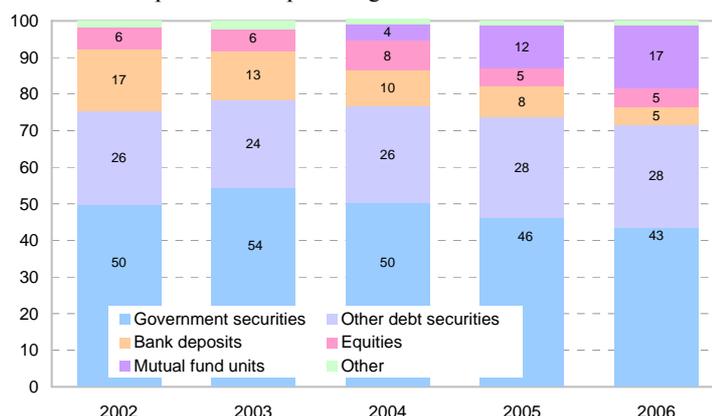
<sup>77</sup> Excluding Greece.

<sup>78</sup> Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS).

**The proportion of life insurance investments in mutual fund units increased to 17%.**

The move towards forms of investment with better returns and higher risk is particularly pronounced in life insurance, in the assets covering mathematical provisions. The proportion of the assets invested in the safest forms (deposits, government securities and other debt securities) declined by 5.7 percentage points in 2006 to 76%. It remains high compared with the euro area, where the figure was 51.6% at the end of 2005. There was no significant change in the proportion invested in equities in 2006, while the proportion invested in mutual fund units increased by 5 percentage points.

Figure 7.6: Structure of insurance companies' assets covering mathematical provisions in percentages

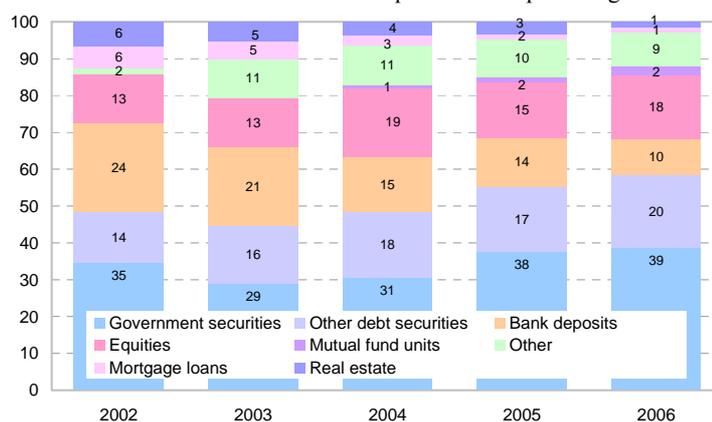


Source: ISA

**The investment structure of assets covering technical provisions remains relatively conservative.**

The proportion of the assets covering technical provisions accounted for by government securities and other debt instruments increased in 2006, at the expense of the proportion accounted for by bank deposits. The proportion accounted for by equities increased by 3 percentage points to 18%. The insurance companies' investment strategies for assets covering technical provisions other than mathematical provisions remains more conservative than in the euro area.

Figure 7.7: Structure of insurance companies' assets covering technical provisions other than mathematical provisions in percentages

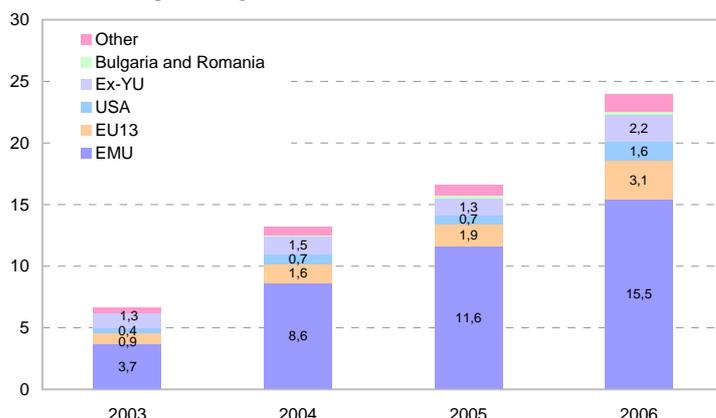


Source: ISA

**An increase in the proportion of insurers' investments in foreign securities.**

Insurers are increasing the regional diversification of their investments. The proportion of insurers' assets invested in foreign securities increased by 6 percentage points in 2006 to 23%. The proportion of assets covering mathematical provisions (in life insurance) accounted for by foreign securities increased by 7 percentage points to 31%, while the proportion of assets covering technical provisions other than mathematical provisions accounted for by foreign securities increased by 4 percentage points to 11%. The entire insurance sector, which includes pension funds alongside insurance companies and reinsurance companies, recorded a significant increase in its investments in foreign securities from EUR 579 million at the end of 2005 to EUR 1,017 million at the end of 2006, 24% of the sector's total investments.

Figure 7.8: Share of the insurance sector's investments in the rest of the world in percentages



Sources: Bank of Slovenia, ISA, SMA

EU25 securities still constitute the majority of the foreign debt securities. The decline in the proportion of foreign debt securities accounted for by the EU25 and the former Yugoslavia was compensated for by an increase of 3.6 percentage points in the proportion accounted for by American debt securities. The proportion of investments accounted for by equities rose to 26% in 2006. Issuers from the EU25 remain prevalent among the foreign equities with 65%, although this proportion was down 8.3 percentage points. The increase in exposure to the capital markets of the former Yugoslavia continues. The proportion accounted for by shares in Croatian, Bosnian, Serbian, Montenegrin and Macedonian issuers increased by 8.6 percentage points in 2006 to almost 30%, while the proportion accounted for by Bulgarian and Romanian issuers increased by 0.7 percentage points to 2.3%.

**The proportion of investments in equities of issuers from the former Yugoslav republics is increasing.**

In 2006 the Slovenian insurance sector expanded its operations into the markets of south-eastern Europe, the former Yugoslav republics in particular. Expansion in these countries, and in Bulgaria and Romania, is planned also in the future. The insurance markets of south-eastern Europe have great potential for development, particularly in life insurance and pension insurance. The current and projected increase in the exposure of Slovenian insurers to the insurance markets of south-eastern Europe entails great growth potential for them, but is also exposing them to greater risk.

**Great potential in the insurance markets of south-eastern Europe, but also greater risk.**

Table 7.3: Development of insurance markets in south-eastern Europe in 2005

	Slovenia	Bulgaria	Romania	Croatia	Serbia and Montenegro
Total premium (EUR billion)	1.44	0.55	1.21	1.01	0.42
Per capita (EUR)	720	79	56	221	39
As % of GDP	5.27	2.55	1.53	3.25	2.23
Life insurance premiums (EUR billion)	0.36	0.07	0.26	0.26	0.04
Per capita (EUR)	178	9	12	57	3
As % of total premium	24.7	12.7	21.1	25.8	8.6
As % of GDP	1.30	0.32	0.32	0.84	0.19

Sources: ISA, Swiss Re

Owing to the introduction of the euro, and the resulting elimination of exchange-rate risk and convergence in interest rates, the proportion of investments accounted for by foreign securities can be expected to increase, at the expense of the proportion accounted for by Slovenian government securities and deposits. The introduction of the euro has significantly increased the choice of instruments available to Slovenian insurers that are of a comparable credit quality, with similar returns and greater liquidity than Slovenian government bonds.<sup>79</sup>

**The introduction of the euro increased the choice of securities with better liquidity than Slovenian government bonds.**

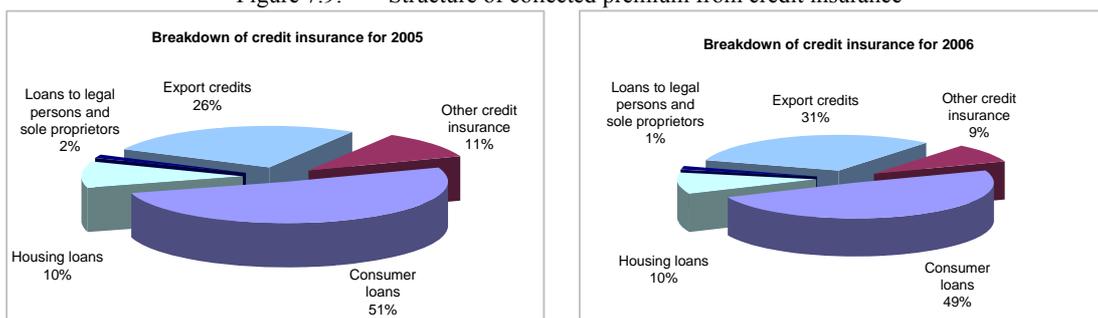
<sup>79</sup> Kelemen, Kirn, Pivk: Insurers' investment strategies after the introduction of the euro, Bančni vestnik 10/2006.

### 7.1.3 Influence of insurers on the stability of the banking sector through credit insurance

#### A decline in the importance of credit insurance.

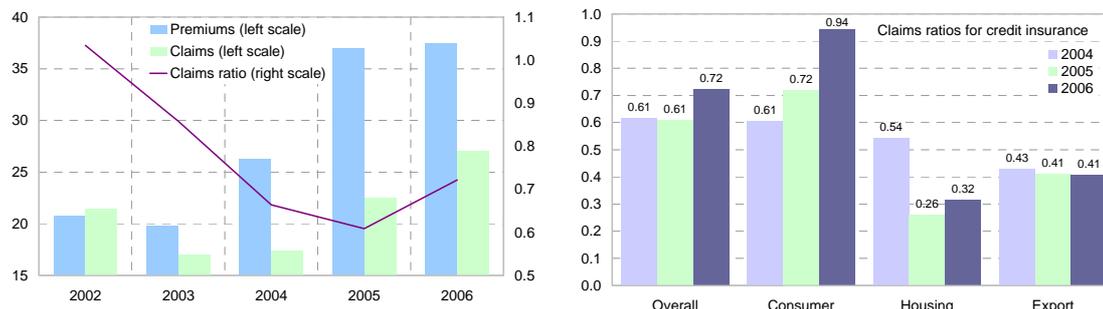
Credit insurance at insurance companies for bank loans slightly diminished in importance in 2006. Collected premium from credit insurance increased by 1.3%, the proportion of insurance companies' total collected premium that it accounted for declining to 2.3%. The ratio of the sum insured for credit insurance at Slovenian insurance companies to loans to non-banking sectors declined from 27.3% at the end of 2005 to 26.6% a year later, while the ratio of the total credit insurance for housing loans, consumer loans and loans to sole proprietors to total household loans declined from 20.4% to 12.7%. There were no major changes in the breakdown of the collected premium from credit insurance in 2006.

Figure 7.9: Structure of collected premium from credit insurance



Source: ISA

Figure 7.10: Collected premium and paid claims in EUR million, and claims ratios for credit insurance



Source: ISA

#### A deterioration in the claims ratio for credit insurance, primarily as a result of consumer loans.

In 2006 there was a deterioration in the claims ratio for credit insurance to 0.72, with consumer loans the largest factor in this. There was a continuation of the trend of a decline in the claims ratio for consumer loans, which rose from 0.72 to 0.94 in 2006. There was no change in the claims ratio for export credits, while the claims ratio for housing loans increased slightly. Based on the trends in the claims ratios, it is estimated that the danger of the realisation of systemic risk from bank loan credit insurance at insurance companies increased slightly, particularly on consumer loans, but, given the diminishing importance of credit insurance at insurance companies for loans, the risk remains limited.

The rise in interest rates has to a certain extent already been reflected in a deterioration in the claims ratio for credit insurance for consumer loans and housing loans. Given that the rise in the ECB's main interest rate was only partly reflected in a rise in interest rates on consumer and housing loans, the claims ratio could be expected to deteriorate in the future, particularly for housing loans, which have a relatively low claims ratio.

## 7.2 Voluntary Supplementary Pension Insurance

The number of policyholders covered by voluntary supplementary pension insurance increased by 7.5% in 2006 to almost 460,000. Collected premium was up 12% on 2005 at EUR 204 million, while assets were up 32% at EUR 783 million.

**Assets from voluntary supplementary pension insurance increased to EUR 783 million.**

Table 7.4: Voluntary supplementary pension insurance providers: number of policyholders, collected premium and assets

	2002	2003	2004	2005	2006
Number of policyholders	173,089	212,060	404,885	427,645	459,764
Structure (%)					
Mutual pension funds	18.2	16.8	50.7	49.3	48.0
Insurers	21.8	21.6	9.5	9.3	9.2
Pension companies	60.0	61.6	39.8	41.4	42.8
Earned premium (EUR million)	52	94	179	182	204
Structure (%)					
Mutual pension funds	0.0	24.1	51.6	46.3	44.1
Insurers	24.0	15.8	8.3	8.3	9.0
Pension companies	76.0	60.1	40.1	45.3	46.9
Assets (EUR million)	99	204	398	592	783
Structure (%)					
Mutual pension funds	24.8	25.0	38.0	40.6	43.0
Insurers	20.0	18.2	13.1	11.5	10.9
Pension companies	55.2	56.8	48.9	47.8	46.1

Sources: ISA, SMA

The increase in employment and the high economic growth mean that the pressure on the compulsory pension and disability insurance treasury temporarily eased a fraction, but in the longer term this pressure will increase. The ratio of the workforce in employment to the number of pensioners increased to 1.60 in 2006, while the ratio of the average pension to the average wage remained unchanged. There was an increase of 0.1 years to 58.9 in the average age of new pension claimants.

Given the demographic trends, individuals who wish to avoid a substantial fall in their standard of living after retirement must rely on extra savings in addition to their premiums for compulsory pension and disability insurance. Tax legislation also encourages the second pillar of pension saving by providing tax relief.

In July 2006 the Act Amending the Pension and Disability Insurance Act (the ZPIZ-G; Official Gazette of the Republic of Slovenia, No. 69/2006) established the legal basis for the provision of pension plans of collective voluntary supplementary pension insurance by foreign pension plan providers established under the regulations of an EU member-state. By the beginning of April 2007, the Ministry of Labour, Family and Social Affairs was yet to receive an application from the relevant authority in another member-state for the pursuit of these activities.

### Investment structure of voluntary supplementary pension insurance providers

Voluntary supplementary pension insurance is gradually growing in importance in Slovenia. This is confirmed by the rise in the ratio of assets to GDP, which increased by 0.4 percentage points in 2006 to 2.6%, and the rise in the ratio of collected premium to the PDII's tax revenues, which stood at 7.5% in 2006. The level of development of the second pension pillar in Slovenia as measured by the ratio of assets to GDP is still well behind that of the euro area, where the figure was 15.3% at the end of 2005. There are also large differences between Slovenia and the euro area in the structure of pension funds' investments. The investment strategy of Slovenian voluntary supplementary pension insurance providers is significantly more conservative. At the end of 2006, deposits and debt securities accounted for 87% of their investments, and shares for just 6%. In the euro area cash, deposits and debt securities accounted for 46% at the end of 2005, and shares for 38%.

**Conservative investment strategy of voluntary supplementary pension insurance providers.**

Table 7.5: Pension fund assets and structure in selected European countries at the end of 2005/2006 in percentages

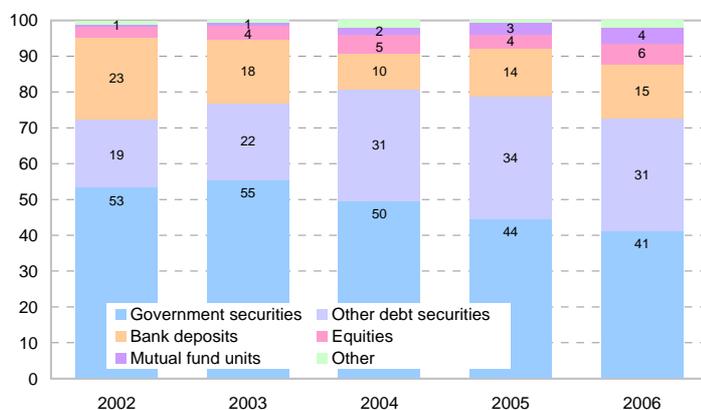
	Slovenia <sup>1</sup>	EMU <sup>2</sup>	Portugal	Germany	UK
Pension fund investments (EUR billion)	1	1,226	20	91	1,302
As % of GDP	2.6	15.3	12.9	3.9	70.1
Structure (%)					
Cash and deposits	15	3	10	3	2
Debt securities	73	43	41	31	20
Shares	6	38	21	35	40
Mutual fund units	4	5	22	-	18
Loans	0	5	-	27	1
Other	2	7	6	4	19

Notes: <sup>1</sup> The figures for Slovenia are for 2006; other figures are for 2005.

<sup>2</sup> Excludes Greece and Ireland.

Sources: ISA, SMA, OECD Pension Markets in Focus, October 2006, Issue 3.

Figure 7.11: Structure of voluntary supplementary pension insurance providers' investments in percentages



Sources: ISA, SMA

The conservativeness of the investment strategy of Slovenian voluntary supplementary pension insurance providers, which originates in the legally prescribed minimum guaranteed return, diminished slightly in 2005 and 2006. In 2006 the proportion accounted for by equities increased by 2 percentage points, and the proportion accounted for by mutual fund units by 1 percentage point. The proportion accounted for by foreign securities had increased to 20.9% by the end of 2006, or EUR 74.6 million, from 15% a year earlier. The pension companies had 23% of their assets from voluntary supplementary pension insurance in foreign securities, the mutual pension funds 20% and the insurance companies 14%.

**The legally prescribed minimum guaranteed return increased to 1.44% in 2006.**

The legally prescribed minimum return, which is 40% of the average annual yield on government securities with a maturity of more than 1 year, increased by 0.3 percentage points in 2006 to 1.44%. The return on money invested in the second pillar of pension insurance remains very low. Annual growth in the unit price of the mutual pension funds actually declined to 3.3%, having stood at 3.8% in 2005. The returns on assets from voluntary supplementary pension insurance at individual pension companies and insurance companies improved in 2006, and ranged between 3.1% and 7.4%, having ranged between 0.05% and 4.8% in 2005.

The public's awareness of the importance of additional saving for old age will increase further in the future. What proportion voluntary supplementary pension insurance providers succeed in attracting depends above all on their competitiveness with alternative financial investments (the third pillar). One obstacle to the faster development of voluntary supplementary pension insurance is the low return on the assets invested, particularly in comparison with investments in mutual funds and life insurance. Given the demographic trends and the low ratio of voluntary supplementary pension insurance assets to GDP, there is great potential for development in this segment in Slovenia. To

develop faster, providers should also offer higher-risk and better-return products without a guaranteed return, which would attract investors with a greater appetite for risk. They should also allow policyholders to switch between pension plans with investment strategies with varying levels of risk, with regard to age and the years of work remaining until retirement.

### 7.3 Investment funds

Slovenian investment funds had a very encouraging year in 2006. They reached an asset value of EUR 2.8 billion, equivalent to more than one-quarter of household bank deposits. Almost 30% of the annual growth in assets came from the encouraging conditions on domestic and foreign capital markets and the continuing search for high returns in alternative investments to bank deposits, despite the rise in interest rates in 2006. The result of the first was an annual return of almost 20% on mutual fund unit prices, while the second produced a net annual inflow of EUR 163 million into mutual funds. Mutual funds account for close to 70% of the assets on all investment funds. Investment companies also had a good year in 2006. The PIX, the stock exchange index of investment funds, recorded an annual growth of 28%, and turnover was relatively high. The increased demand for investment funds shares was partly the result of the favourable conditions on the domestic capital market, on which they still hold the majority of their investments, and partly the result of discounted listing and the anticipated conversion into mutual funds.

**Investment fund assets exceeded one-quarter of household bank deposits.**

Table 7.6: Overview of investment funds

	2001	2002	2003	2004	2005	2006
Assets (EUR million)						
Investment funds	2,349	2,163	1,833	2,086	2,220	2,845
Mutual funds	61	233	389	877	1,385	1,929
Net annual inflows	6	120	108	339	138	163
Investment companies	-	578	894	1,209	835	916
Authorised invest.comp. (PIDs)	2,287	1,352	550	-	-	-
Annual turnover	221	358	254	250	149	166
Structure (%)						
Mutual funds	3	11	21	42	62	68
Investment companies	-	27	49	58	38	32
Authorised invest.comp. (PIDs)	97	63	30	-	-	-
Growth rate (%)						
Investment funds	-3.7	-7.9	-15.3	13.8	6.4	28.1
Mutual funds	37.6	278.9	66.9	125.7	57.9	39.3
Investment companies			54.7	35.3	-30.9	9.7
VEP	23.1	54.3	17.1	17.8	7.2	18.8
PIX	4.4	71.9	23.5	33.8	-12.2	28.3

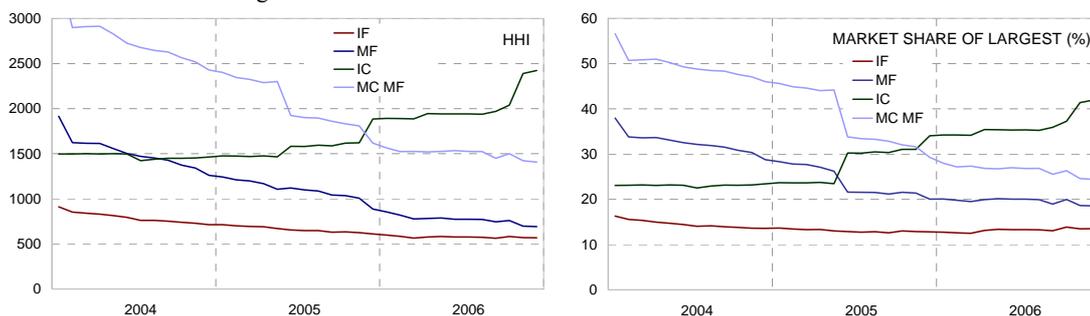
Sources: AMC, Vzajemci.com, LJSE, own calculations

There was no significant change in the market concentration of investment funds in 2006. The largest share of between 13% and 16% is held by one of the investment companies, with the conversion of other companies increasing its dominant position in this segment of the investment funds market. There was only one such conversion in 2006.<sup>80</sup> By contrast, the converted investment companies are adding to the enhanced competition between mutual funds brought by the establishment of new funds and the aggressive marketing of foreign funds. There were 49 new mutual funds established in 2006 (bringing the total to 99) under the operation of domestic managers. The marketing of foreign funds also proceeded at pace, and they have already strongly outnumbered the domestic funds. By the end of 2006 there were a total of approximately 230 funds and sub-funds being marketed in Slovenia.

**Competition between mutual funds is growing constantly.**

<sup>80</sup> Before its conversion into a mutual fund, the converted investment company accounted for just over 4% of the total assets of investment funds.

Figure 7.12: Market concentration of investment funds



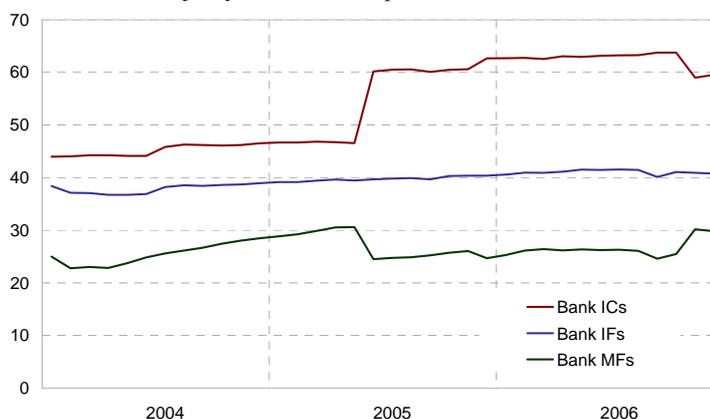
Note: MC MF: Market concentration of management companies in terms of mutual fund assets under management.  
 Sources: AMC, own calculations

**Interaction of investment funds and the banking sector**

**Banks indirectly manage 40% of investment fund assets.**

The proportion of investment fund assets managed by management companies under majority bank ownership has not deviated far from 40% for a long time now. They record a significantly higher proportion among investment companies than among mutual funds, as the concentration of the former is much higher. Mutual fund units are competing products for bank deposits, although the two products satisfy different investor preferences. During a period of low interest rates and favourable conditions on capital markets, investors prefer investments with better returns, despite the higher risks. Via their ownership of management companies, banks do not dispose of the invested assets as in the case of deposits received, but they do share in profit distributions and a portion of the commissions from marketing the funds. In 2005 management companies recorded total assets of EUR 140 million, profits of EUR 18 million, and an ROE of 18.1%. These figures are higher than in 2004, despite a minor lull in returns and net inflows in 2005.

Figure 7.13: Percentage assets of investment funds, and separately for investment companies and mutual funds managed by management companies under majority bank ownership



Source: AMC

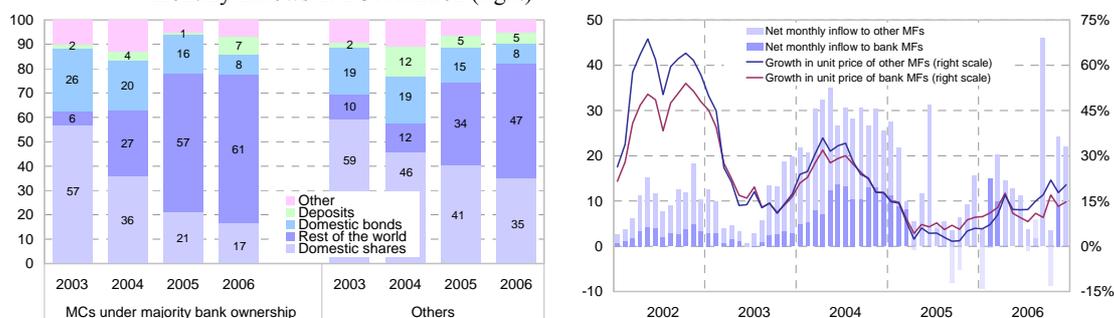
**Banks are the most important distribution channel for mutual funds in Europe.**

Given the anticipated continuation of the trend of a shift from bank deposits to alternative investments, banks are active in marketing not only their own mutual funds, but also others. Additional income is generated from the commissions thus obtained. The value of the transactions with mutual funds concluded via banks has been growing from year to year, and recorded growth of 50% in 2006. This is increasing the volume of commissions earned, which accounted for 0.66% of the banking system's gross income in 2006. In addition to their own points of sale, management companies also make considerable use of internet sales, and sales via banks and insurance companies in the form of unit-linked life insurance.<sup>81</sup> According to some international observers, banks are and will remain the most important distribution channel for mutual funds, although their share has been

<sup>81</sup> An SMA authorisation is required for the direct marketing of foreign mutual funds, but not for the marketing of foreign mutual funds via unit-linked life insurance.

declining in recent years. Insurance companies, special institutional distributors and financial advisors are growing in importance.<sup>82</sup>

Figure 7.14: Comparison of mutual funds managed by management companies under majority bank ownership and others: breakdown of investments in percentages (left), and annual growth in unit prices in percentages and net monthly inflows in EUR million (right)



Sources: AMC, Vzajemci.com, own calculations

The 37 mutual funds managed by management companies under majority bank ownership have a significantly higher proportion of their investments abroad than other mutual funds. This is because the management companies under majority bank ownership established some important funds after the 2002 relaxation of the legal limit of 10% on investments abroad.<sup>83</sup> They thereby avoided problems in connection with portfolio restructuring. As the investment structure has a direct impact on mutual funds' returns, the favourable conditions on the domestic capital market in 2006 helped other mutual funds to record better returns. This was a complete contrast to 2005, when the domestic capital market actually recorded negative returns, which meant that the funds of the management companies under bank ownership performed better. As a result of the strong correlation between past performance and net inflows, in 2006 inflows were higher at mutual funds not under majority bank ownership.

Among the potential transfers of risk from investment funds to banks, it is difficult to evaluate the transfer of the risk of a loss of confidence in mutual fund units to banking or insurance products. With the aim of avoiding reputation risks, back in May 2004 the Bank of Slovenia warned banks to clearly define who was assuming the risk in the marketing of these products. In 2006 the Securities Market Agency also issued instructions for compiling the Investor Profile form, based on which it attempts to make investors aware that they are assuming the risk, and to aid them in making the right choice of fund for their level of risk.<sup>84</sup> Compared with foreign investors, investors in Slovenia have a greater appetite for higher-risk equity funds, which is partly a consequence of their inexperience, and the fact that they have not yet experienced an extended recession in the domestic capital market.

Recently banks have more often marketed bullet loans in conjunction with management companies, where the borrower repays the principal when the loan matures, but pays only interest in the interim. These are loans of more than 10 years, where the banks require the borrower to have at least one-third of the money, which is invested in mutual funds stipulated in advance. This product exposes the bank to higher credit risk, if the return on the mutual funds is not as expected and the borrower is not able to raise the money from other sources to repay the principal at the end of the term. The bank thus compels all its clients that opt for these loans to invest in a small number of mutual funds with a single management company. Should the pessimistic scenario come to pass, this could undermine confidence in bank products.

**It is very important that mutual fund investors are aware that they themselves are assuming the risk.**

**Bullet loans with an investment in mutual funds are appearing.**

<sup>82</sup> Current Trends in the European Asset Management Industry, Report Lot 1, Zentrum für Europäische Wirtschaftsforschung GmbH – ZEW/OEE, Mannheim, 2006.

<sup>83</sup> The Investment Funds and Management Companies Act (the ZISDU-1; Official Gazette of the Republic of Slovenia, No. 110/2002) of 2002 removed the 10% legal limit on investments funds' investments abroad. The deadline for complying was two years later, at the end of 2004. Until compliance, investment funds were obliged to carry the designation "special".

<sup>84</sup> Decision on the Method and Conditions of Marketing and Advertising of Investment Funds (Official Gazette of the Republic of Slovenia, No. 23/2006).

**The danger of the direct transfer of risks between management companies and banks is limited.**

The danger of the direct transfer of risks between management companies and banks is very limited. At EUR 73 million in 2006, which is 0.4% of bank lending to non-banking sectors, management companies' borrowing from domestic banks was low, and often short-term, related to the liquidity needs of investment funds. Mutual funds' investments in domestic bank deposits, which depend primarily on current inflows, are also limited. Regular periodic inflows make liquidity planning easier for mutual fund managers.

**7.3.2 Mutual funds**

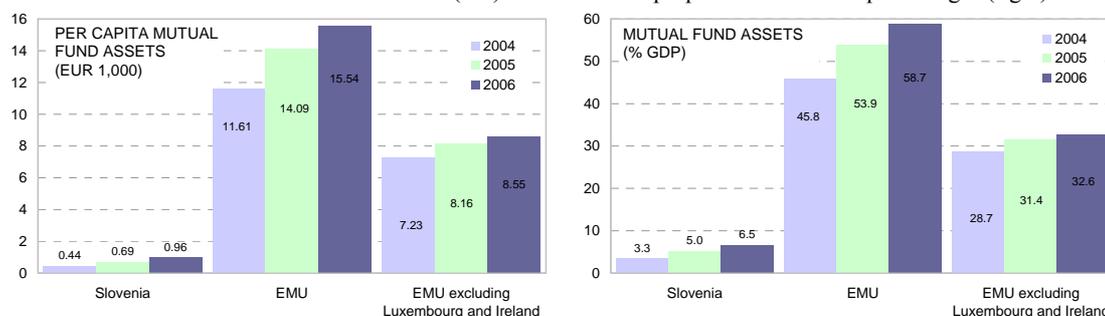
**The assets of Slovenian mutual funds reached EUR 1,000 per capita.**

The assets of Slovenian mutual funds have reached almost EUR 1,000 per capita, equivalent to 6.5% of GDP, which is still significantly less than the euro area average. The main reasons for the low figure lie in the lack of depth of financial intermediation in the Slovenian economy. Another reason is evident from a comparison of the structure of household financial assets in Slovenia and the euro area. While in the former households hold over 10% of their financial assets in investment funds, the figure in Slovenia is lower at 7%, primarily as a result of the higher proportion held in bank deposits.<sup>85</sup> The increase in the ratio of mutual fund assets to GDP is expected to be more a result of the deepening of financial intermediation than a result of restructuring in the existing portfolio of household financial assets.

**An increase of 40% in the assets of Slovenian mutual funds.**

The assets of Slovenian mutual funds increased by almost 40% in 2006, to just under EUR 2 billion. Other factors alongside the conversion of one of the investment companies were the annual growth of 20% in unit prices, and net inflows of EUR 163 million, equivalent to 8.6% of the assets at the end of 2006. The encouraging conditions on global capital markets brought annual growth of 15% in the assets of European mutual funds. These recorded net inflows of EUR 357 billion, equivalent to 4.7% of their assets at the end of the year. Some estimates put the proportion of cross-border inflows (including those from outside Europe) at up to 72%, the Luxembourg and Irish funds in particular.<sup>86</sup> Competition from foreign, officially registered funds is also very strong in Slovenia. In 2006 the net inflows of foreign funds were 74% of those of domestic funds, while the assets of domestic investors invested in foreign-registered funds increased to 16% of the assets of domestic funds.

Figure 7.15: Comparison between Slovenia and the euro area in per capita mutual fund assets (left) and assets as a proportion of GDP in percentages (right)



Sources: EFAMA, AMC, Eurostat, own calculations

**Demand for equity funds is increasing.**

The appetite for risk of Slovenian investors in mutual funds is evident in comparisons of fund structure between Slovenia and Europe overall. The proportion of assets held by equity funds is significantly higher in Slovenia at 60%. At the same time bond funds hold barely 2%, and the proportion held by money-market funds is negligible. The reason for the extremely high proportion of assets held by equity funds is the conversion of three investment companies into equity funds, which at the end of 2006 held 23% of the total assets of mutual funds.<sup>87</sup> The management companies' decisions to convert into equity funds were also the result of investors' demand for funds that record the highest returns.

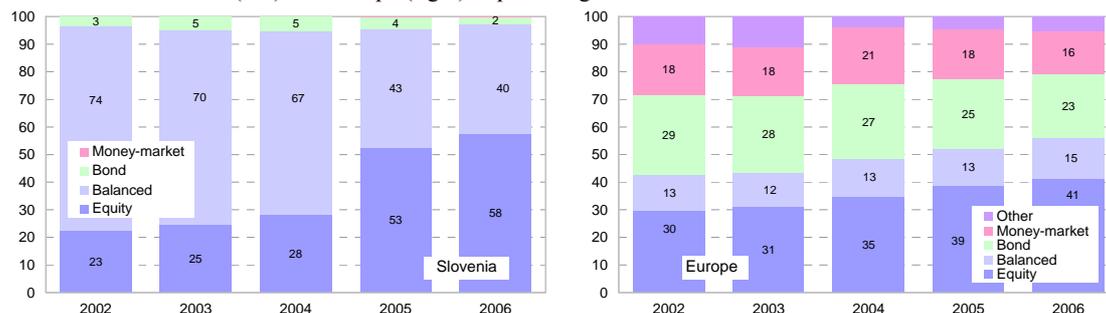
<sup>85</sup> BIS CGFS Papers, Institutional Investors, Global Savings and Asset Allocation, Basel, 2007.

<sup>86</sup> EFAMA, Trends in the European Investment Fund Industry in the Fourth Quarter of 2006 and Results for the Full-Year 2006, Brussels, 2007.

<sup>87</sup> The conversion of the authorised investment companies (the so-called PIDs) created the 11 investment companies in Slovenia. One of the PIDs converted directly into a balanced mutual fund. By March 2007, four of the 11 investment companies had converted into mutual funds: three equity funds and one balanced fund. The aforementioned five mutual funds held almost one-third of the total assets of mutual funds at the end of 2006.

The favourable conditions on the domestic and global capital markets mean that in recent years these have been equity funds. The high returns of equity funds and the corresponding demand for them has also guided managers in the creation of new funds. Of the 49 funds newly created in 2006, 46 were equity funds. Although in Europe the assets are more evenly distributed among the different types of fund – at 40% the proportion held by money-market funds and bond funds is roughly equal to that of equity funds – in recent years there has been a discernible increase in demand for equity funds at the expense of money-market funds and bond funds in the context of relatively favourable trends on global capital markets and low interest rates.

Figure 7.16: Comparison of the breakdown of mutual fund assets by type of fund in Slovenia (left) and Europe (right) in percentages



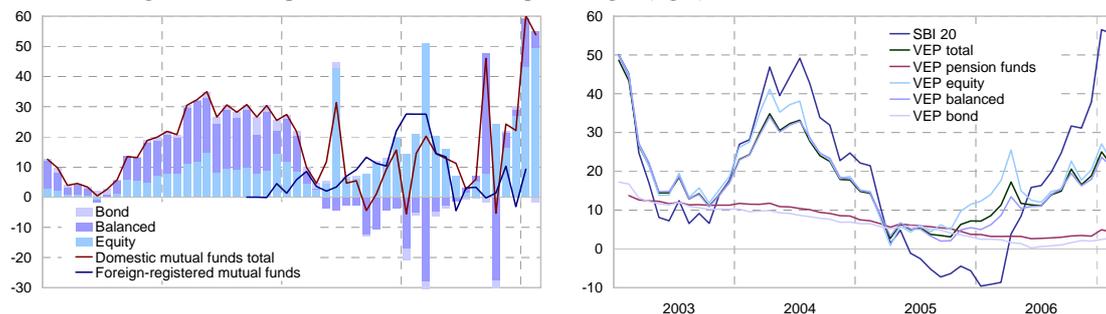
Note: The figures for Europe include all EU member-states other than Slovenia, Cyprus, Malta, Estonia, Lithuania and Latvia, alongside Norway, Switzerland and Liechtenstein.

Sources: EFAMA, AMC, own calculations

Of the Slovenian mutual funds, only the equity funds recorded net inflows in 2006, if the extremely low figure for money-market funds is ignored. Given the net outflows of more than EUR 50 million from the bond and balanced funds, despite the relatively high returns on the latter, the equity funds recorded more than EUR 210 million of net inflows. It seems that investors are also opting to switch money between mutual funds. One-third of the inflows into equity funds in 2006 went into four funds created that year whose investment strategy focuses on the Balkan markets. This further supports the supposition about domestic mutual fund investors' high appetite for risk, and the chasing of past returns irrespective of the fund's performance over the longer term. Three "Balkan" funds created in February 2006 – their annual returns in February 2007 are available – recorded annual returns of 43% to 73%, while the weighted average annual return for all funds was 22%.

**More than 45% of net inflows in 2006 were invested in equity funds with an investment strategy focusing on the Balkans.**

Figure 7.17: Net monthly inflows by type of fund in EUR million (left) and annual growth in unit prices and the SBI 20 in percentages (right)



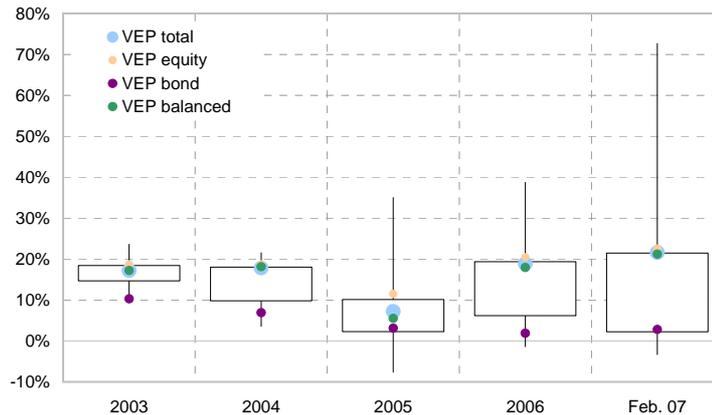
Sources: Vzajemci.com, LJSE, Bank of Slovenia, own calculations

The increasing specialisation of mutual funds in terms of region and sector is resulting in much greater variation in the returns of individual funds. At the end of 2004, when mutual funds had only 16% of their assets invested in the rest of the world, their returns ranged from 3% to 22% (the mutual funds in the second and third quartiles recorded returns of 9% to 18%). The situation was rather different in February 2007, when there were minor uncertainties on global capital markets and the domestic capital market, with domestic mutual funds holding one-half of their assets in foreign markets. Their annual returns ranged from -3% to 73% (the mutual funds in the second and third quartiles recorded

**There is growing specialisation among mutual funds, which is bringing greater variation in returns.**

returns of 2% to 21%). The high annual returns were recorded primarily by funds with an investment strategy focused on the markets of the former Yugoslavia, which did not respond to the developments on global capital markets. The large number of mutual funds of various types is giving investors in funds a greater choice and allowing them to meet their different preferences, but the process of choosing is also much harder. The quality of investment advice is expected to become more and more important, and should warn investors that past returns are no guarantee of future performance, and that short-term saving in mutual funds is not optimal.

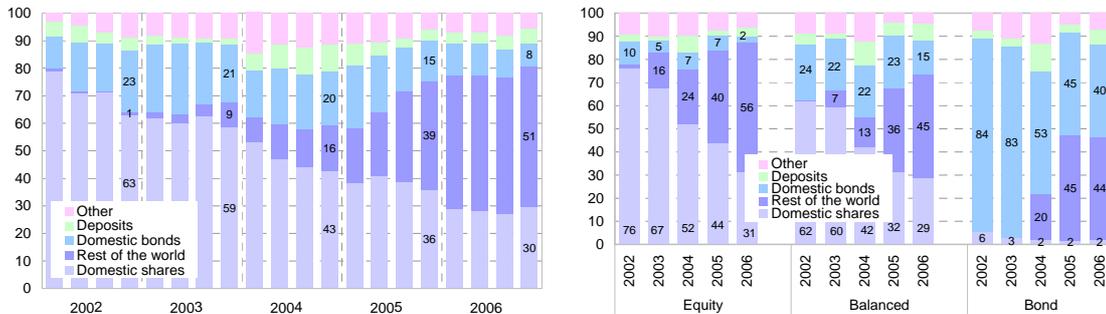
Figure 7.18: Classification of mutual funds in terms of annual return at year end in percentages



Note: As the funds have been classified according to annual return at the end of the year, only those funds in existence for at least one year are included. The figure shows the variation in annual returns between funds, and the relative standing of particular types of fund compared with mutual funds overall. The rectangles represent the 50% of mutual funds whose annual returns are higher than bottom quartile of the funds, and lower than top quartile.

Sources: Vzajemci.com, own calculations

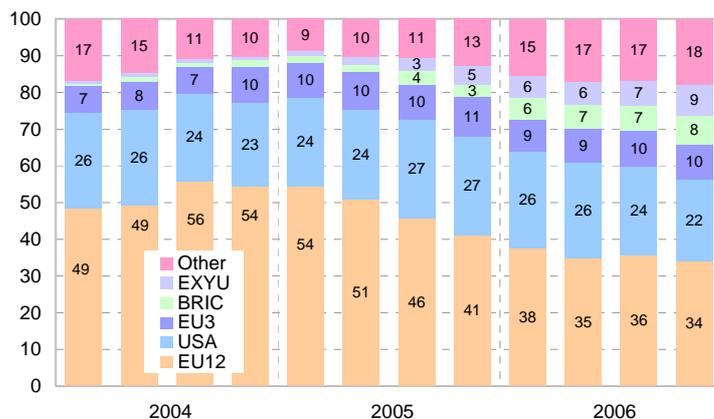
Figure 7.19: Breakdown of mutual fund investments: total (left) and by type of fund (right) in percentages



Source: AMC

Shares are predominant among mutual funds' foreign investments, accounting for more than 90%. Diversification among different global capital markets is growing each year. This means greater risk diversification, but also an increase in risk as the proportion of investments in emerging capital markets also increases. The proportion invested in euro area capital markets has fallen by 15 percentage points in the last three years to one-third, thus increasing currency risk. In particular, there has been an increase in investments in the former Yugoslavia, where proximity and greater familiarity give Slovenian asset managers an advantage of foreign investors. Investments in emerging markets such as Brazil, Russia, India and China are also increasing, as are those in the Japanese and Canadian capital markets.

Figure 7.20: Regional breakdown of investments in foreign shares by the other financial intermediaries sector in percentages



Notes: EU3: UK, Denmark, Sweden; BRIC: Brazil, Russia, India, China; EXYU: former Yugoslav republics.

Source: Bank of Slovenia

In order to optimise the functioning of the single European market for mutual funds, at the end of 2006 the European Commission released a white paper on enhancing the single market framework for investment funds,<sup>88</sup> based on the findings of the green paper of 2005.<sup>89</sup> The main purpose of the white paper was to propose legislative changes, which should be submitted for parliamentary debate in the autumn of 2007. Among the more important proposed measures are the exploitation of economies of scale via (cross-border) mergers of funds and assets, the simplification of the abbreviated prospectus, the maintenance of high levels of protection for investors via the distribution channels, and the exploitation of new investment opportunities.

**Changes in European investment funds legislation.**

There are also to be changes in Slovenian investment funds legislation. At the end of 2006 the Ministry of Finance published the draft act amending the investment funds and management companies act (the ZISDU-1B).<sup>90</sup> Unfortunately the bill does not yet introduce real estate investment funds, which could have also an impact on the development of the Slovenian real estate market. Notable new features are: (1) the equalisation in the terms of business for Slovenian management companies with those from other member-states, primarily in the sense of simplifying the marketing of mutual funds outside Slovenia. To date no Slovenian fund has exploited this possibility. (2) The possibility of creating umbrella funds, establishing some "linkages" between funds that have been separate to date: this will make it easier and advantageous in tax terms for investors to switch between mutual funds with different investment strategies. (3) The possibility of merging an entire mutual fund with another mutual fund: the average size of Slovenian mutual funds is significantly smaller than foreign funds, including those officially marketed in Slovenia. Economies of scale would lower costs, which could also have an impact on the cost to investors. (4) Management companies may issue coupons of different classes for the same mutual fund. The rights in each class can differ in terms of the subscription and redemption fees, the distribution or retention of profits, the transferability of the investment coupons, and so forth. There are currently three mutual funds with transferable coupons in Slovenia, and these are listed on the stock exchange. However, under the current legislation their coupons are fully transferable. The listing of mutual funds on the stock exchange allows management companies to conduct additional marketing, and above all to optimise the allocation of the portfolio with regard to minor fluctuations in direct inflows and outflows.

**Changes to the existing Slovenian legislative framework for investment funds are proposed.**

<sup>88</sup> European Commission, White Paper on Enhancing the Single Market Framework for Investment Funds, Brussels, 2006.

<sup>89</sup> European Commission, Green paper on the Enhancement of the EU Framework for Investment Funds, Brussels, 2005.

See: [http://ec.europa.eu/internal\\_market/securities/ucits/index\\_en.htm](http://ec.europa.eu/internal_market/securities/ucits/index_en.htm)

<sup>90</sup> Ministry of Finance, Draft act amending the investment funds and management companies act (bill for reading), Ljubljana, 2006 (corrected 2007).

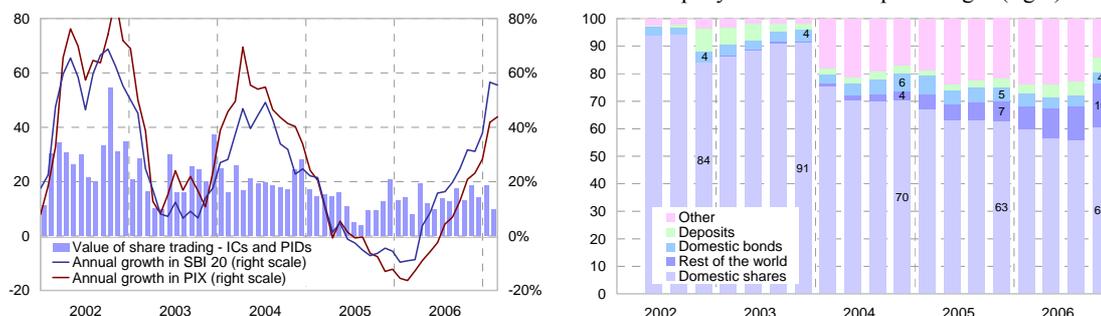
### 7.3.3 Investment companies

Significant demand for investment companies in 2006 helped the PIX to record an annual growth of 28%, and it continued to grow in the first months of this year. However, the proportion of the total value in securities trading, including block trades, accounted for by the seven investment companies on the stock exchange (or eight until October<sup>91</sup>) declined to just over 11%. The decline of just over 4 percentage points from 2005 was primarily the result of increased demand for domestic corporate shares.

**The market values of investment companies are still lower than the book values.**

At almost EUR 700 million, or 6% of the market capitalisation of shares, the market capitalisation of investment companies was equivalent to just 76% of the assets of investment companies at the end of 2006. This shows that their market values are significantly lower than their book values, the former ranging between 73% and 85% of the book value. However the discounts on investment companies are diminishing, as a result of increased demand from investors as the legal deadline for conversion (2011) approaches. This is encouraging an increase in the proportion of investments accounted for by marketable assets. Only the right investment structure will allow the converted investment companies to compete with existing mutual funds.

Figure 7.21: Monthly value of investment companies' share trading in EUR million, and annual growth in the PIX and SBI 20 in percentages (left), and breakdown of investment company investments in percentages (right)



Sources: AMC, LJSE

Investment companies can avoid conversion into mutual fund status if the shareholders so decide at a general meeting with votes representing three-quarters of the capital, which given the fractured ownership will be difficult to achieve. The law also stipulates that mutual funds can charge withdrawing investors a penalty charge of 20% in the first year after conversion and 10% in the second year, at least in the amount of the proportion of non-marketable assets. Prices on the exchange in the period before conversion are expected to approach the book value, at least up to the percentage of the penalty charge.

### 7.4 Leasing companies

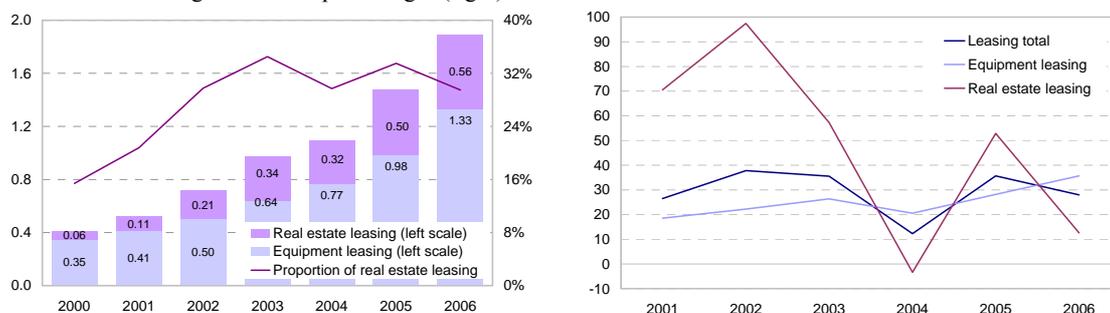
**An increase of 28% in the volume of leasing business in 2006.**

The volume of approved leasing business increased by 28% in 2006 to almost EUR 1.9 billion. Like last year, at EUR 2.7 billion, the stock of leasing loans at the end of the year was equivalent to 13.5% of the stock of bank loans, or one-half of the market share of the largest bank in lending to non-banking sectors. The proportion of leasing business accounted for by real estate leasing slid to around 30%, partly as a result of fierce competition from the banking sector. However, leasing companies recognise the potential for development in loans for real estate, which is partly the result of changes in tax legislation that have equalised leasing with bank loans. Competition both within the leasing sector and with other sources of finance did not significantly diminish the market share of the leading leasing company, which accounted for almost 40% of the business of members of the association in 2006.

<sup>91</sup> A fourth investment company converted into a mutual fund in October. Prior to this it had accounted for 12% of the total market capitalisation of investment companies. The management company opted for the immediate listing of the coupons in the new mutual fund on the exchange.

Leasing of road transport vehicles and motorcars has been predominant in equipment leasing for a number of years, accounting for 60% last year, while leasing of retail facilities and office buildings accounts for the same proportion of real estate leasing. Increasing demand for leasing is also coming from consumers, who accounted for almost 30% of total equipment leasing business.

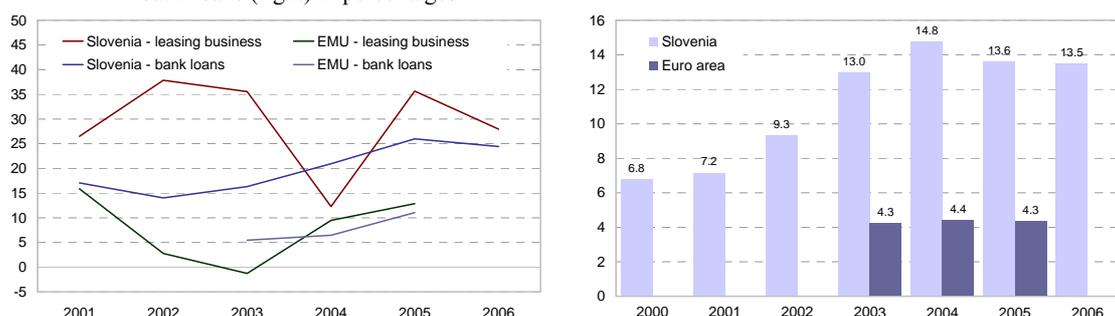
Figure 7.22: Approved leasing business in EUR billion and the proportion accounted for by real estate leasing in percentages (left), and annual growth in leasing business in percentages (right)



Source: SLA

The European leasing market had an encouraging year in 2005.<sup>92</sup> Leasing business increased by almost 14%. High growth was recorded above all by the countries of Central and Eastern Europe, where the low level of economic development means that there is greater opportunity for growth than in more developed economies. Annual growth in leasing business in certain Scandinavian countries was also surprisingly high at close to 40%. The importance of real estate leasing is increasing on the European leasing market, having accounted for 17.8% of total leasing business in 2005 and recorded annual growth of 25%, significantly less than in Slovenia. In both Slovenia and the rest of Europe the acquisition of assets via leasing companies is growing in importance, their links with the banking sector growing strong as a result of financing.

Figure 7.23: Annual growth in the volume of leasing business concluded and bank loans granted to non-banking sectors (left) and ratio of leasing loans to bank loans (right) in percentages



Note: The figures for the volume of leasing business in the euro area do not include Luxembourg or Ireland.

Sources: SLA, Bank of Slovenia, Leaseurope, ECB

Growth in the volume of leasing business and in bank loans approved to non-banking sectors is faster in Slovenia than in the euro area as a result of the nominal convergence in interest rates and the process of catching up economically. The ratio of leasing loans to bank loans is also higher in Slovenia. The ratio has recently declined in both economies, as a result of very high growth in bank loans, with low interest rates making bank loans more accessible.<sup>93</sup>

**Annual growth in the volume of business concluded in Slovenia was higher than the EU average.**

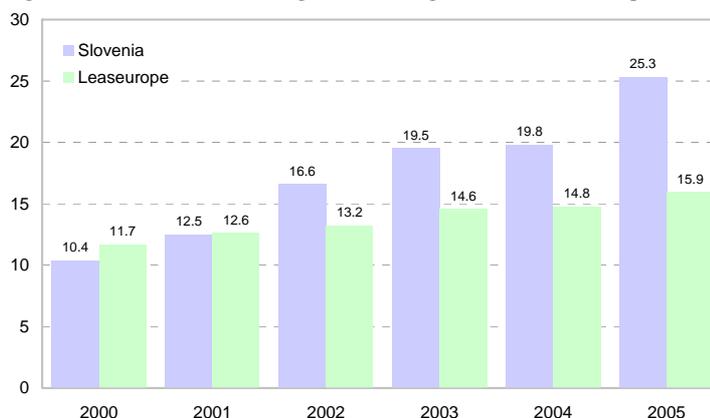
<sup>92</sup> The figures for Leaseurope include all EU member-states other than Luxembourg, Ireland, Cyprus, Malta, Lithuania and Latvia, alongside Norway, Switzerland, Romania and Morocco.

<sup>93</sup> The change in the annual stock of leasing loans granted is significantly smaller than the volume of leasing business concluded. The change in the stock of leasing loans in Slovenia was EUR 508

**Complementarity of leasing loans and bank loans to a certain extent.**

The relatively similar movements in the annual rates of growth in bank loans to non-banking sectors and the volume of leasing business indicated the complementarity of bank loans and leasing activities. Leasing are primarily aimed at allowing businesses and private individuals to finance themselves in an alternative way, which is also seen in the strong role that banks have in leasing activities. Slovenian banks already hold stakes in ten leasing companies, and are the sole owners in eight instances. Of these, seven are members of the Slovenian Leasing Association, and they accounted for more than one-third of the total business of the association in 2006. Almost 47% of leasing loans were made by leasing companies owned by foreign banks, although these banks have subsidiaries in Slovenia. In contrast to 2005, leasing companies owned by the domestic banks are becoming more important, these having accounted for just one-quarter of the volume in the previous year, while the companies under the ownership of foreign banks accounted for almost 52%.

Figure 7.24: Ratio of leasing business to gross investments in percentages



Note: The figures for Leaseurope include all EU member-states other than Luxembourg, Ireland, Cyprus, Malta, Lithuania and Latvia, alongside Norway, Switzerland, Romania and Morocco. Gross investments includes capital expenditure but excludes investments in housing for reason of comparability with the Leaseurope figures.

Sources: SLA, SORS, Leaseurope

**A change in tax legislation facilitated greater competition in leasing business.**

The advantage that leasing loans have over banking loans, and thus their complementarity with them, is evident in more-adaptable and less-demanding loan approval conditions. In financial leasing, the title to the subject of the leasing remains with the lessor until the final instalment is received from the lessee. Leasing loans do not therefore need additional collateral, which allows them to be more competitive in pricing, and this is improving further under new tax arrangements. The new VAT Act,<sup>94</sup> which entered into force in November 2006, offered leasing companies the choice in the method of accounting VAT on the costs of financing, i.e. on interest. It can be accounted as before, by including the value of the subject of the leasing and the costs of financing (interest) in the taxable base, or by not including the latter in the taxable base, thus lowering it. In this case the leasing companies must disclose the costs of financing separately from the value of the merchandise. Competition in particular means that it is assumed that leasing companies will opt for the second possibility, which is more favourable for clients.

**The ratio of leasing business to investments exceeded 25% in 2006.**

Given that economic development is conditioned by investment, which needs financial resources, the ratio of leasing business to investments (the leasing penetration rate) is an indicator of the importance of leasing in the economy. This increased to more than 25% in Slovenia in 2005, and was significantly higher than the EU average; only Estonia, Poland and Hungary recorded higher figures in 2005. Securing the appropriate financial resources is one of the obstacles to better and faster development of SMEs, which generally find access to external sources of financing more difficult. Although Slovenian leasing companies have an important role here, their core activity is not focused on the financing of SMEs.

million in 2006, while the volume of leasing business concluded was EUR 1.9 billion (a ratio of 3.7). The change in stock in the euro area in 2005 was EUR 29.5 billion, while the volume of business concluded was EUR 165.6 billion (a ratio of 5.6). The principal reason is short-term contracts.

<sup>94</sup> The Value Added Tax Act (ZDDV-1; Official Gazette of the Republic of Slovenia, No. 117/06).

### Performance of Slovenian leasing companies

Despite the large increase in leasing business in 2005, the leasing companies' profits increased by just 6.5%. The reason lies in the fierce competition both within the sector and from banks, and the consequent greater flexibility in loan approval, which can also be attributed to lower lending rates. Growth in the total assets of the leasing companies in 2005 was not as high as in the previous year, but they remained in a ratio of 11% to bank assets. Just under 80% of the leasing companies' financing came from foreign sources (liabilities to the rest of the world account for 72% of the leasing companies liabilities, this proportion having fallen slightly in the last two years). In line with the decline in the leasing companies' liabilities to the rest of the world, their short on-balance-sheet foreign exchange position is also closing in terms of total assets, the introduction of the euro in 2007 bringing further significant closure from the 72% figure at the end of 2005.

**Leasing companies receive 80% of their financing from abroad.**

Table 7.7: Performance of leasing companies and sources of financing

	2001	2002	2003	2004	2005	Growth rate (%)				
						2001	2002	2003	2004	2005
Total assets (EUR million)	1,317	1,616	2,022	2,695	3,185	30.8	22.7	25.1	33.3	18.2
Capital (EUR million)	112	129	149	197	227	27.8	15.0	16.0	32.1	15.1
Total profit/loss (EUR million)	20	22	41	46	49	28.5	6.3	88.0	13.5	6.5
ROA (%)	1.75	1.47	2.23	1.96	1.67					
ROE (%)	20.43	18.00	29.28	26.66	23.18					
Financial and operating liabilities (EUR million)	1,086	1,454	1,849	2,476	2,942	35.6	33.8	27.2	33.9	18.8
Liabilities to banks (%)	27	26	27	27	34		26.7	30.6	33.8	51.9
Liabilities to the rest of the world (%)	76	76	81	79	78	47.0	35.3	35.0	30.7	17.3
Open foreign exchange position/assets (%)	-62.3	-68.7	-74.1	-72.7	-72.1					

Note: The figures from financial statements include all companies included under J65.21 (Financial leasing) under the NACE. Members of the Slovenian Leasing Association classed under J65.21 accounted for 91% of the total assets of the companies in this category as at the end of 2005. Three companies, accounting for 5.6% of the total assets of the association, were members of the association, but were not included in category J65.21.

Liabilities to banks do not include liabilities to affiliated banks.

Source: APLRRS

The leasing companies' liabilities to banks again recorded a sharp increase in 2005, of 52%, to almost reach EUR 1 billion, equivalent to 34% of their total liabilities. Liabilities to domestic banks accounted for 47% of this, down 3 percentage points from the end of 2004. Credit risk is the most significant risk for the leasing companies. This they try to mitigate by obtaining or formulating credit ratings of potential lessees, monitoring the payment of leasing instalments, and stipulating appropriate credit protection. The possibility of the transfer of credit risk from the leasing companies to the banking sector is limited, thanks to the good performance of the leasing companies and the low proportion of loans to leasing companies in the total bank loans to non-banking sectors (3%). Interest rate rises also represent a specific risk to leasing companies, with more costly financing for leasing companies leading to a decline in growth in leasing activities.

**Credit risk is the most important risk for leasing companies.**

## 8 FINANCIAL INFRASTRUCTURE

The financial infrastructure, which includes payment systems, and the securities clearing and settlement system, is a key connecting element in economic systems at the national and global levels. Growing technological complexity is making operational and systemic risk the most prominent risks in its functioning, while the increasing pace of transactions demands extra attention in the management of liquidity risk. The integration processes are dictating the speed of adaptation of the financial infrastructure, with the risks increasing in the period in which the changes are being introduced, thereby requiring additional measures to limit the risks. In addition, the period before the introduction of changes requires appropriate management of legal risk, which is particularly complex owing to the interaction of a number of different institutions. A typical example of the management of the aforementioned types of risk during a period of the introduction of deep substantive changes in the financial system was the introduction of the euro in Slovenia.

### 8.1 Payment systems prior to the introduction of the euro in Slovenia

**An increase in the number and value of transactions in the RTGS and Giro Clearing tolar payment systems.**

The principal systems for tolar payments were real-time gross settlement (RTGS) for payments of more than SIT 2 million and urgent low-value payments, and Giro Clearing for payments of up to SIT 2 million, both operated by the Bank of Slovenia. They were linked via the Giro Clearing settlement system, which was executed in the accounts of RTGS system participants.

Table 8.1: Value and number of transactions in RTGS and Giro Clearing

	2003	2004	2005	2006	Year-on-year growth (%)		
					2004	2005	2006
<b>RTGS</b>							
Value (EUR billion)	185.67	204.35	261.62	317.64	12.4	28.0	21.4
No. of transactions (million)	1.26	1.37	1.40	1.57	8.5	2.4	11.6
<b>Giro Clearing</b>							
Value (EUR billion)	19.28	20.30	20.98	22.93	7.5	3.8	9.3
No. of transactions (million)	46.61	48.60	49.42	52.11	4.3	1.7	5.4

Source: Bank of Slovenia

The value of the payments in the two payment systems was also increasing relative to GDP. In an economy whose growth was relatively rapid in recent years, this increase in the volume of payments is no surprise.

Figure 8.1: Ratio of total value of transactions in the RTGS and Giro Clearing systems to GDP, and total number of transactions in the two systems



Sources: Bank of Slovenia, SORS

In addition to the RTGS and Giro Clearing systems operated by the Bank of Slovenia, there were six systems run by other operators: Activa, NLB Clearing (which operated

only until the middle of the year), the Bankart card and ATM systems, and the Visa and Mastercard clearing systems. Their transactions were smaller in size compared with the RTGS and Giro Clearing systems, but relatively high in number.

Table 8.2: Number and value of transactions of systems for tolar payments in 2006

Payment system	No. of transactions (million)	Proportion (%)	Value (EUR billion)	Proportion (%)
RTGS	1.567	1.2	317.643	92.4
Giro Clearing	52.109	38.3	22.927	6.7
Activa	39.883	29.3	1.194	0.4
NLB clearing	0.501	0.4	0.304	0.1
Card settlement	18.156	13.3	0.561	0.2
ATM settlement	23.911	17.6	1.329	0.4
<b>Total</b>	<b>136.128</b>	<b>100.0</b>	<b>343.958</b>	<b>100.0</b>

Note: Does not include data from payment systems whose clearing agent is outside Slovenia (Mastercard and Visa).

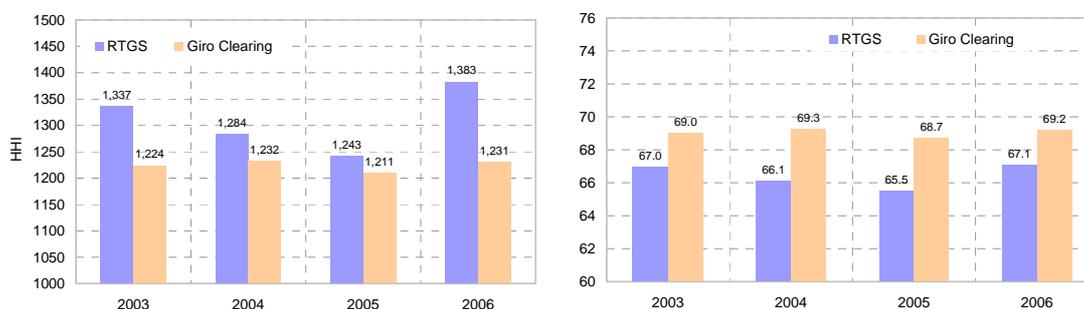
Source: Bank of Slovenia

Liquidity risk in the RTGS system was managed by providing access for banks to Bank of Slovenia liquidity loans, with banks also able to first secure the liquidity required for mutual settlement from three sources: the balances in settlement accounts, inflows into settlement accounts, and loans taken from other commercial banks. Credit risk in RTGS systems is mitigated by current interbank settlement for each individual payment. The management of liquidity and credit risk in the settlement of transactions in the Giro Clearing system is organised so that participants take a liquidity loan from another system participant as required, including the Bank of Slovenia. Should the participant fail to do so, the Bank of Slovenia would trigger the settlement guarantee scheme, which was not required in 2006.

**While risk management was efficient, the concentration in the number of transactions in the RTGS system increased slightly.**

Evidence of the management of operational risk comes from the system availability figures for 2006: Giro Clearing was 100% available, and RTGS was 99.97% available. The increase in the Herfindahl-Hirschman Index in 2006 is an indication that while the number of payment transactions in the RTGS system was increasing, the transactions between banks were being concentrated to the highest level in the last four years. The main factors in the increase in concentration were the banks conducting most transactions, and the fact that three NLB subsidiary banks began conducting their transactions via the parent bank in June. There was a very slight increase in the concentration of transactions in the Giro Clearing system in 2006, this having changed little in previous years.

Figure 8.2: Concentration in the number of transactions in the RTGS and Giro Clearing systems - Herfindahl-Hirschman Index (HHI; left) - and proportion of total number of transactions accounted for by the five largest banks (excluding the Bank of Slovenia; right) in percentages



Source: Bank of Slovenia

The average monthly inflows and outflows in the RTGS system were almost equal, but they fluctuated from bank to bank each month with a standard deviation of 2.12. The comparable variability was lower in the Giro Clearing system.

Slovenian banks made cross-border payments in two pan-European payment systems. Between July 2005 and 31 December 2006, 16 banks and one savings bank conducted payments via remote participation in the German Bundesbank's RTGS<sup>plus</sup> system within the TARGET system. Remote participation entails participation in the national RTGS

**Cross-border payments were made in the TARGET system by remote participation, and in the STEP2 system.**

system of another country (the host country) linked to the TARGET system. Slovenian banks used the STEP2 system for payments of up to EUR 50,000, with 11 of them acting via the Bank of Slovenia as joint entry point.

## **8.2 Payment systems and the introduction of the euro in Slovenia**

**RTGS payments were transferred to the TARGET system, with testing used to mitigate operational risk.**

When the euro became the domestic currency on 1 January 2007, as a tolar payment system the RTGS system was abolished, with the payments previously conducted in the RTGS system now being conducted in the TARGET system. The remote participation in the TARGET system prior to the introduction of the euro did not entail Slovenia's inclusion in the TARGET system in either substantive or formal terms, and did not satisfy the ECB's conditions for joining the euro. The legal basis for the TARGET system was thus upgraded in the period before 1 January 2007, with the Bank of Slovenia ensuring the execution of certain additional procedures to satisfy the ECB's requirements for any central bank introducing the euro.

After the development of the Bank of Slovenia's support system for providing liquidity for Slovenian participants in the RTGS<sup>plus</sup> system, the operational risk in the changeover and operations in the euro environment was mitigated by testing the relationship between the Bank of Slovenia and the Bundesbank in April, the actions of banks and savings banks in a specially created test environment between April and June, and carrying out integrated testing in September, in which a number of state institutions alongside the Bank of Slovenia (the Tax Administration, the Customs Administration, the APLRRS, etc.) tested the operation of their own systems in the euro-adapted payment infrastructure. Preparations for operational inclusion in the TARGET/RTGS<sup>plus</sup> system had been conducted in parallel in the period to the end of May for four institutions that did not express an interest in joining the system prior to the introduction of the euro. Finally, the operational plans for carrying out the actual changeover to the new environment (conversion of account balances, etc.) were drawn up and tested separately.

**The Giro Clearings' settlement was transferred from RTGS to accounts at the Bank of Slovenia.**

With the abolition of the RTGS system, settlement between participants in Giro Clearing was transferred to participants' accounts at the Bank of Slovenia. The threshold for Giro Clearing was increased to EUR 50,000 in line with the threshold in the STEP2 system, with the joint contribution made by participants to the settlement guarantee scheme being correspondingly increased. With the aim of mitigating the operational risk of the changeover from the Giro Clearing system to the euro system, a special test infrastructure was developed, and testing was carried out on the functioning of the card transactions processing centres in the euro environment, with a new methodology for reviewing their operations being developed. At the end of 2006 the Bank of Slovenia upgraded its management of operational risks by adopting a comprehensive risk management methodology based on the ECB methodology for risk management in the TARGET2 system, which is aimed at measuring risks in complex information systems.

**The mitigation of liquidity risk is based on automatic verification of available collateral, and intraday credit.**

In the Bank of Slovenia's automated claim insurance system introduced in July 2006, clients can use assets from the pool of eligible collateral at the Bank of Slovenia to secure monetary policy instruments and intraday credits. In the new system for managing financial assets liquidity risk is mitigated by automatically checking the value of the bank's collateral available to secure a loan before the request to disburse the loan is approved. On 1 January 2007 the Bank of Slovenia also established the intraday credit as an instrument aimed at ensuring that payment systems function without disruptions in the event of insufficient liquidity in the settlement accounts. In this event the Bank of Slovenia approves an interest-free loan for the participant, which it has to repay on the same day by the time that the TARGET system closes. If the loan is not repaid it is converted into an overnight loan. On the next TARGET business day the interest from the overnight loan are added and the sum is converted back into an intraday credit.

**The securities clearing and settlement system at the CSCC was harmonised with ECB standards in 2006.**

In addition to the general importance of the perfect functioning of the securities clearing and settlement systems, in the ECB system all credit operations must be secured with eligible collateral. In order to make it possible to use assets in the Slovenian securities settlement system, an assessment was begun in 2005 of the compliance of the functioning of the securities settlement system at the Central Securities Clearing Corporation with the

ECB's Standards for the use of EU Securities Settlement Systems in ESCB Credit Operations. The ECB's Governing Council approved the final report on the assessment in October 2006, and all the recommendations made on its basis were carried out by the end of the year. When the euro was introduced, eligible securities registered at the CSCC could begin to be used to secure liabilities in the ECB system.

The establishment of the correspondent central banking model (the CCBM) in Slovenia and the Bank of Slovenia's preparations for inclusion in it was an important element in the upgrading of the payment infrastructure as a result of integration into the ESCB system. The CCBM allows credit institutions within the ESCB to use cross-border assets as collateral.

**The correspondent central banking model was established in 2006.**



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## 1. Financial system

Table 1.1: Structure of the financial system

	Total assets (EUR million)		Structure (%)		As % of GDP		No. of institutions	
	2005	2006	2005	2006	2005	2006	2005	2006
Monetary financial institutions <sup>1</sup>	29,435	33,929	71.8	72.2	106.5	114.1	25	25
Banks	29,276	33,718	71.4	71.8	106.0	113.4	22	22
Banks under private ownership	22,787	26,211	55.6	55.8	82.5	88.1	-	-
Domestic	11,172	12,604	27.3	26.8	40.4	42.4	-	-
Foreign	11,616	13,607	28.3	29.0	42.0	45.8	-	-
Banks under gov. ownership	6,489	7,507	15.8	16.0	23.5	25.2	-	-
Savings banks	158	211	0.4	0.4	0.6	0.7	3	3
Non-monetary financial inst.	11,552	13,035	28.2	27.8	41.8	43.8		
Insurers <sup>2</sup>	3,260	3,895	8.0	8.3	11.8	13.1	16	15
Pension funds	670	893	1.6	1.9	2.4	3.0	11	11
Investment funds	2,220	2,845	5.4	6.1	8.0	9.6	59	107
Leasing companies <sup>3,4</sup>	3,185	3,185	7.8	6.8	11.5	10.7	19	20
BHs, MCs and others <sup>4</sup>	2,218	2,218	5.4	4.7	8.0	7.5	-	-
<b>Total</b>	<b>40,987</b>	<b>46,963</b>	<b>100.0</b>	<b>100.0</b>	<b>148.4</b>	<b>157.9</b>		

Notes: <sup>1</sup> Monetary financial institutions do not include the central bank.

<sup>2</sup> The figure of total assets of reinsurance companies is for the end of the third quarter of 2006.

<sup>3</sup> The number of active members of the Slovenian Leasing Association is taken as the number of leasing companies.

<sup>4</sup> Total assets according to date for the end of 2005.

Sources: Bank of Slovenia, ISA, SMA, AMC, SLA, APLRRS

Table 1.2: Market concentration of individual types of financial institution

		Banks		Insurers		Pension funds		Investment funds		Leasing companies	
		2005	2006	2005	2006	2005	2006	2005	2006	2005	2006
HHI	All companies	1,389	1,321	2,650	2,599	1,677	1,712	612	569	1,992	1,923
	Five largest	1,214	1,152	2,599	2,550	1,632	1,663	481	458	1,852	1,797
Share (%)	All companies	100	100	100	100	100	100	100	100	100	100
	Five largest	63	62	81	81	89	89	46	44	74	74

Note: The Herfindahl-Hirschman Index (HHI) is calculated in terms of total assets, with the exception of leasing companies, for which it is calculated in terms of volume of transactions concluded. The term Pension funds does not include the First Pension Fund, which is a closed pension fund that does not envisage further inflows.

Sources: Bank of Slovenia, ISA, SMA, AMC, SLA, APLRRS

Table 1.3: Banking sector's capital investments in other financial and non-financial institutions as at end of 2006

	Banks' capital investments (EUR million)	Proportion of banks' capital investments (%)	No. of institutions with bank capital of				Total	Total no. of institutions
			up to 5%	5% to 25%	25% to 75%	75% to 100%		
Domestic banks and savings banks	99.6	14.6	4	-	5	-	9	25
Insurers	20.7	3.0	5	-	2	-	7	15
Pension companies	5.8	0.9	1	1	2	-	4	4
Management companies	22.2	3.2	-	-	2	3	5	15
Leasing companies	47.0	6.9	-	2	-	8	10	20
Others	488.4	71.4						
<b>Total</b>	<b>683.7</b>	<b>100.0</b>						

Note: The number of leasing companies is the number of active members of the Slovenian Leasing Association.

Source: Bank of Slovenia

Table 1.4: Direct ownership structure of the Slovenian financial system (shares valued at market price or book value) in percentages

ISSUERS	Ownership structure (%)				Total
	Banks	Other financial intermediaries	Insurers and pension funds	Non-financial companies	
HOLDERS					
	2003				
Non-financial companies	26	27	10	30	29
Banks	9	10	2	2	4
Other financial intermediaries	6	11	7	21	18
Insurers and pension funds	3	2	6	2	2
Government	23	0	64	18	19
Households	2	45	2	18	18
Non-residents	30	2	9	6	8
Others	1	3	0	3	3
Total	100	100	100	100	100
	2004				
Non-financial companies	25	23	12	26	25
Banks	10	7	7	2	4
Other financial intermediaries	5	12	16	20	17
Insurers and pension funds	3	7	10	2	3
Government	23	0	44	17	17
Households	2	43	1	18	18
Non-residents	30	3	8	10	12
Others	1	4	1	5	5
Total	100	100	100	100	100
	2005				
Non-financial companies	24	30	14	31	29
Banks	8	8	7	3	4
Other financial intermediaries	2	9	1	11	10
Insurers and pension funds	3	8	10	1	2
Government	23	8	54	23	23
Households	2	34	1	17	16
Non-residents	36	2	10	11	13
Others	2	2	0	3	2
Total	100	100	100	100	100
	2006				
Non-financial companies	24	29	16	29	28
Banks	8	10	5	3	4
Other financial intermediaries	2	15	1	9	8
Insurers and pension funds	3	6	9	2	3
Government	21	7	56	25	25
Households	2	29	3	18	16
Non-residents	39	1	8	11	13
Others	2	2	1	3	2
Total	100	100	100	100	100

Note: The figures for the proportion of issued shares held by the government for 2004 and 2005 are not comparable, as in October 2005 Kapitalna družba was reclassified from the sector of other financial intermediaries (S.123) to the government sector (S.13).

Sources: CSCC, own calculations

## 2. Banking Sector

Table 2.1: Banking sector's balance sheet: amounts in EUR million and growth rates in percentages

	(EUR million)					Growth rate (%)				
	2002	2003	2004	2005	2006	2002	2003	2004	2005	2006
<b>ASSETS</b>	19,009	21,098	23,691	29,276	33,718	17.5	11.0	12.3	23.6	15.2
1) Cash	598	590	589	599	1,057	-30.5	-1.3	-0.3	1.9	76.3
2) Loan to banks (including BoS)	1,591	1,440	2,118	2,872	3,058	-3.8	-9.5	47.0	35.6	6.5
3) Loans to non-banking sectors	9,106	10,591	12,810	16,149	20,088	14.0	16.3	21.0	26.1	24.4
3.1 Currency breakdown										
Tolar	6,895	7,546	8,349	8,757	8,954	6.1	9.4	10.6	4.9	2.2
Foreign currency	2,211	3,045	4,461	7,392	11,135	48.3	37.7	46.5	65.7	50.6
3.2 Maturity breakdown										
Short-term	3,425	3,816	4,369	5,219	6,518	6.4	11.4	14.5	19.5	24.9
Long-term	5,681	6,776	8,441	10,931	13,570	19.1	19.3	24.6	29.5	24.1
3.3 Sector breakdown										
Corporate	5,353	6,664	8,087	9,908	12,134	9.9	24.5	21.4	22.5	22.5
Household	2,349	2,625	3,186	4,078	5,060	8.0	11.8	21.4	28.0	24.1
Government	901	592	596	665	574	35.8	-34.3	0.7	11.6	-13.8
Others	503	710	940	1,498	2,321	80.8	41.2	32.4	59.4	54.9
4) Securities	6,514	7,224	6,904	8,243	7,898	37.7	10.9	-4.4	19.4	-4.2
4.1 Currency breakdown										
Tolar debt securities	3,513	4,195	3,964	5,406	5,015	66.9	19.4	-5.5	36.4	-7.2
Foreign curr. debt securities	2,630	2,680	2,545	2,254	2,006	15.6	1.9	-5.0	-11.5	-11.0
4.2 Maturity breakdown										
Short-term debt securities	4,024	4,396	3,336	3,595	2,101	54.3	9.2	-24.1	7.8	-41.6
Long-term debt securities	2,119	2,479	3,173	4,064	4,920	19.5	17.0	28.0	28.1	21.1
4.3 Sector breakdown										
Government	1,929	2,061	2,508	2,706	2,718	19.7	6.8	21.7	7.9	0.5
Bank of Slovenia	3,839	4,286	3,198	3,501	1,789	57.5	11.7	-25.4	9.5	-48.9
Others	746	877	1,198	2,037	3,391	9.7	17.6	36.6	70.0	66.5
5) Capital investments	236	294	319	347	427	24.2	24.5	8.3	8.8	23.0
6) Other	964	957	952	1,065	1,190	28.1	-0.7	-0.6	11.9	11.7
<b>LIABILITIES</b>	19,009	21,098	23,691	29,276	33,718	17.5	11.0	12.3	23.6	15.2
1) Liabilities to banks (including BoS)	2,440	3,487	4,664	8,397	10,647	29.1	42.9	33.7	80.0	26.8
Foreign banks	1,947	2,949	4,235	7,892	9,962	42.1	51.5	43.6	86.4	26.2
2) Deposits by non-banking sectors	13,142	13,748	14,716	16,018	17,495	14.0	4.6	7.0	8.8	9.2
2.1 Currency breakdown										
Tolar	8,722	9,173	9,623	10,716	11,653	18.3	5.2	4.9	11.4	8.7
Foreign currency	4,420	4,574	5,092	5,300	5,841	6.4	3.5	11.3	4.1	10.2
2.2 Maturity breakdown										
Short-term	10,547	11,335	12,644	14,017	15,329	13.4	7.5	11.6	10.9	9.4
Long-term	2,596	2,413	2,071	1,999	2,165	16.6	-7.0	-14.2	-3.5	8.3
2.3 Sector breakdown										
Corporate	3,555	3,675	3,888	4,340	4,775	15.1	3.4	5.8	11.6	10.0
Household	8,404	9,086	9,946	10,545	11,322	12.9	8.1	9.5	6.0	7.4
Government	866	659	565	867	1,114	37.0	-23.9	-14.3	53.4	28.5
Others	317	328	316	266	285	-11.4	3.7	-3.8	-15.6	6.9
3) Securities	736	903	939	992	976	59.0	22.6	4.0	5.7	-1.6
3.1 Currency breakdown										
Tolar	717	882	923	973	969	83.7	23.1	4.6	5.5	-0.4
Foreign currency	20	21	16	19	7	-73.0	4.2	-22.8	17.6	-63.9
3.2 Maturity breakdown										
Short-term	87	86	77	21	8	-19.7	-1.1	-10.7	-73.3	-63.0
Long-term	649	816	861	971	968	83.2	25.8	5.5	12.8	-0.3
4) Provisions	382	423	502	180	184	20.4	10.6	18.8	-64.1	1.9
5) Subordinated debt	285	400	599	709	994	88.8	40.2	49.7	18.4	40.1
6) Capital	1,582	1,749	1,918	2,473	2,841	11.1	10.6	9.7	28.9	14.9
7) Others	1,177	1,292	1,293	1,500	1,557	35.6	9.7	0.1	16.0	3.8

Notes: Converted to euros at the conversion rate.

The 2006 figures are those reported under the IFRS, while those for previous years are based on estimated values in accordance with the IFRS.

Source: Bank of Slovenia

Table 2.2: Banking sector's balance sheet: as proportion of total assets, and as proportion of GDP in percentages

	Proportion of total assets (%)					As % of GDP				
	2002	2003	2004	2005	2006	2002	2003	2004	2005	2006
ASSETS	100.0	100.0	100.0	100.0	100.0	85.1	87.0	90.5	106.0	113.4
1) Cash	3.1	2.8	2.5	2.0	3.1	2.7	2.4	2.2	2.2	3.6
2) Loan to banks (including BoS)	8.4	6.8	8.9	9.8	9.1	7.1	5.9	8.1	10.4	10.3
3) Loans to non-banking sectors	47.9	50.2	54.1	55.2	59.6	40.7	43.7	48.9	58.5	67.6
3.1 Currency breakdown										
Tolar	36.3	35.8	35.2	29.9	26.6	30.9	31.1	31.9	31.7	30.1
Foreign currency	11.6	14.4	18.8	25.2	33.0	9.9	12.6	17.0	26.8	37.4
3.2 Maturity breakdown										
Short-term	18.0	18.1	18.4	17.8	19.3	15.3	15.7	16.7	18.9	21.9
Long-term	29.9	32.1	35.6	37.3	40.2	25.4	27.9	32.3	39.6	45.6
3.3 Sector breakdown										
Corporate	28.2	31.6	34.1	33.8	36.0	24.0	27.5	30.9	35.9	40.8
Household	12.4	12.4	13.5	13.9	15.0	10.5	10.8	12.2	14.8	17.0
Government	4.7	2.8	2.5	2.3	1.7	4.0	2.4	2.3	2.4	1.9
Others	2.6	3.4	4.0	5.1	6.9	2.2	2.9	3.6	5.4	7.8
4) Securities	34.3	34.2	29.1	28.2	23.4	29.2	29.8	26.4	29.8	26.6
4.1 Currency breakdown										
Of which tolar debt securities	18.5	19.9	16.7	18.5	14.9	15.7	17.3	15.1	19.6	16.9
Of which foreign currency debt securities	13.8	12.7	10.7	7.7	6.0	11.8	11.0	9.7	8.2	6.7
4.2 Maturity breakdown										
Of which short-term debt securities	21.2	20.8	14.1	12.3	6.2	18.0	18.1	12.7	13.0	7.1
Of which long-term debt securities	11.1	11.7	13.4	13.9	14.6	9.5	10.2	12.1	14.7	16.5
4.3 Sector breakdown										
Government	10.1	9.8	10.6	9.2	8.1	8.6	8.5	9.6	9.8	9.1
Bank of Slovenia	20.2	20.3	13.5	12.0	5.3	17.2	17.7	12.2	12.7	6.0
Others	3.9	4.2	5.1	7.0	10.1	3.3	3.6	4.6	7.4	11.4
5) Capital investments	1.2	1.4	1.3	1.2	1.3	1.1	1.2	1.2	1.3	1.4
6) Others	5.1	4.5	4.0	3.6	3.5	4.3	3.9	3.6	3.9	4.0
LIABILITIES	100.0	100.0	100.0	100.0	100.0	85.1	87.0	90.5	106.0	113.4
1) Liabilities to banks (including BoS)	12.8	16.5	19.7	28.7	31.6	10.9	14.4	17.8	30.4	35.8
Foreign banks	10.2	14.0	17.9	27.0	29.5	8.7	12.2	16.2	28.6	33.5
2) Deposits by non-banking sectors	69.1	65.2	62.1	54.7	51.9	58.8	56.7	56.2	58.0	58.8
2.1 Currency breakdown										
Tolar	45.9	43.5	40.6	36.6	34.6	39.0	37.8	36.8	38.8	39.2
Foreign currency	23.3	21.7	21.5	18.1	17.3	19.8	18.9	19.5	19.2	19.6
2.2 Maturity breakdown										
Short-term	55.5	53.7	53.4	47.9	45.5	47.2	46.7	48.3	50.7	51.5
Long-term	13.7	11.4	8.7	6.8	6.4	11.6	9.9	7.9	7.2	7.3
2.3 Sector breakdown										
Corporate	18.7	17.4	16.4	14.8	14.2	15.9	15.1	14.9	15.7	16.1
Household	44.2	43.1	42.0	36.0	33.6	37.6	37.5	38.0	38.2	38.1
Government	4.6	3.1	2.4	3.0	3.3	3.9	2.7	2.2	3.1	3.7
Others	1.7	1.6	1.3	0.9	0.8	1.4	1.4	1.2	1.0	1.0
3) Securities	3.9	4.3	4.0	3.4	2.9	3.3	3.7	3.6	3.6	3.3
3.1 Currency breakdown										
Tolar	3.8	4.2	3.9	3.3	2.9	3.2	3.6	3.5	3.5	3.3
Foreign currency	0.1	0.1	0.1	0.1	0.0	0.1	0.1	0.1	0.1	0.0
3.2 Maturity breakdown										
Short-term	0.5	0.4	0.3	0.1	0.0	0.4	0.4	0.3	0.1	0.0
Long-term	3.4	3.9	3.6	3.3	2.9	2.9	3.4	3.3	3.5	3.3
4) Provisions	2.0	2.0	2.1	0.6	0.5	1.7	1.7	1.9	0.7	0.6
5) Subordinated debt	1.5	1.9	2.5	2.4	2.9	1.3	1.6	2.3	2.6	3.3
6) Capital	8.3	8.3	8.1	8.4	8.4	7.1	7.2	7.3	9.0	9.6
7) Others	6.2	6.1	5.5	5.1	4.6	5.3	5.3	4.9	5.4	5.2

Source: Bank of Slovenia

Table 2.3: Banking sector's income statement: amounts in EUR million and growth rates in percentages

	(EUR million)					Growth rate (%)				
	2002	2003	2004	2005	2006	2002	2003	2004	2005	2006
1. Net interest income	591	608	599	631	685	22.2	2.9	-1.4	5.4	8.5
1.1 Interest income	1,436	1,382	1,194	1,198	1,413	15.4	-3.8	-13.6	0.3	17.9
1.2 Interest expenses	846	774	595	567	728	11.1	-8.4	-23.1	-4.8	28.4
2. Net non-interest income	317	326	383	417	527	50.9	2.9	17.3	9.0	26.3
2.1 Net fees and commissions	225	229	258	282	308	30.0	1.8	12.7	9.1	9.2
2.2 Net financial transactions	71	67	84	71	99	51.6	-5.9	25.9	-15.7	40.1
2.3 Net other	21	30	40	65	120	-305.3	45.7	33.5	60.0	85.5
3. Gross income (1+2)	907	934	982	1,049	1,212	30.9	2.9	5.2	6.8	15.6
4. Operating costs	550	591	612	647	698	19.1	7.4	3.6	5.8	7.8
labour costs	277	304	326	342	364	24.9	9.5	7.4	5.0	6.3
5. Net income (3-4)	357	343	370	401	514	54.4	-4.1	7.9	8.5	28.2
6. Net provisions	165	143	136	140	121	-1.0	-13.3	-5.4	3.2	-13.7
7. Total costs (4+6)	715	734	748	787	819	13.8	2.7	1.8	5.3	4.0
8. Pre-tax profit (3-7)	192	199	234	261	393	197.9	3.8	17.5	11.5	50.6
9. Taxes	69	69	81	52	91	22.2	-0.6	17.9	-35.9	75.0
10. Net profit (8-9)	123	131	153	209	303	1,432.1	6.2	17.3	36.5	44.6

Notes: Converted to euros at the conversion rate.

The 2006 figures are those reported under the IFRS, while those for previous years are based on estimated values in accordance with the IFRS.

Source: Bank of Slovenia

Table 2.4: Banking sector's income statement: as proportion of gross income and as proportion of total assets in percentages

	Proportion of gross income (%)					Ratio to total assets (%)				
	2002	2003	2004	2005	2006	2002	2003	2004	2005	2006
1. Net interest income	65	65	61	60	57	3.0	3.1	2.9	2.5	2.2
1.1 Interest income	158	148	122	114	117	7.7	7.6	6.5	5.0	4.1
1.2 Interest expenses	93	83	61	54	60	4.7	4.4	3.7	2.5	1.9
2. Net non-interest income	35	35	39	40	43	1.3	1.7	1.5	1.6	1.4
2.1 Net fees and commissions	25	25	26	27	25	1.1	1.2	1.1	1.1	1.0
2.2 Net financial transactions	8	7	9	7	8	0.3	0.4	0.3	0.4	0.2
2.3 Net other	2	3	4	6	10	-0.1	0.1	0.1	0.2	0.2
3. Gross income (1+2)	100	100	100	100	100	4.3	4.8	4.4	4.1	3.6
4. Operating costs	61	63	62	62	58	2.9	2.9	2.8	2.6	2.2
Labour costs	31	33	33	33	30	1.4	1.5	1.4	1.4	1.2
5. Net income (3-4)	39	37	38	38	42	1.4	1.9	1.6	1.6	1.4
6. Net provisions	18	15	14	13	10	1.0	0.9	0.7	0.6	0.5
7. Total costs (4+6)	79	79	76	75	68	3.9	3.8	3.5	3.2	2.7
8. Pre-tax profit (3-7)	21	21	24	25	32	0.4	1.0	0.9	1.0	0.9
9. Taxes										
10. Net profit (8-9)										

Source: Bank of Slovenia

Table 2.5: Selected performance indicators for the banking sector

	2002	2003	2004	2005	2006
<b>1) Profitability and margins (%)</b>					
ROA	1.1	1.0	1.0	1.0	1.3
ROE	12.6	11.9	12.5	12.7	15.1
CIR	60.6	63.3	62.3	61.7	57.6
Financial intermediation margin	5.3	4.7	4.3	4.0	3.9
Interest margin (per total assets)	3.4	3.1	2.6	2.4	2.2
Non-interest margin (per total assets)	1.8	1.6	1.7	1.6	1.7
Net interest margin (per interest-bearing assets)	3.8	3.4	2.9	2.6	2.4
Interest spread <sup>1</sup>	5.1	4.5	4.3	3.8	3.8
<b>2) Structure of assets and liabilities (%)</b>					
<b>2.1 Maturity breakdown of loans to non-banking sectors</b>					
Short-term loans	37.6	36.0	34.1	32.3	32.4
Long-term loans	62.4	64.0	65.9	67.7	67.6
<b>2.2 Maturity breakdown of deposits by non-banking sectors</b>					
Short-term deposits	80.2	82.4	85.9	87.5	87.6
Long-term deposits	19.8	17.6	14.1	12.5	12.4
<b>2.3 Regional breakdown of loans</b>					
Residents	97.4	96.7	96.1	95.4	94.8
Non-residents	2.6	3.3	3.9	4.6	5.2
<b>2.4 Foreign currency sub-balance</b>					
Foreign currency assets/total assets		33.4	35.9	40.5	45.5
Foreign currency liabilities/total assets		34.5	38.1	42.9	46.5
Difference		-1.1	-2.3	-2.4	-1.0
Foreign currency loans/loans	32.6	35.1	38.6	48.7	55.9
Foreign currency deposits/deposits	39.8	40.9	44.5	48.8	53.0
Foreign currency loans/loans (non-banking sectors)	24.3	28.8	34.8	45.8	55.4
Foreign currency deposits/deposits (non-banking sectors)	33.6	33.3	34.6	33.1	33.4
<b>2.5 Securities</b>					
Securities/loans to non-banking sectors	72.4	68.0	53.3	50.6	38.3
<b>2.6 Breakdown by sector</b>					
Corporate					
corporate loans/loans to non-banking sectors	61.6	66.2	66.5	65.9	66.6
Foreign currency corporate loans/corporate loans	32.7	37.3	44.3	56.2	64.5
Household					
Household loans/loans to non-banking sectors	25.9	24.9	25.0	25.4	25.3
Foreign currency household loans/household loans	0.7	1.0	3.0	11.8	23.2
Government					
Loans to government/loans to non-banking sectors	9.9	5.6	4.7	4.1	2.9
Non-residents					
Liabilities to foreign banks/total assets	10.2	14.0	17.9	27.0	29.5
<b>3. Asset quality</b>					
Impairments (EUR million)	949.1	1,015.2	1,064.5	1,168.7	1,233.8
Classified claims (EUR million)	15,167.2	17,150.7	20,428.1	25,209.1	31,581.0
Impairments/classified claims (%)	6.3	5.9	5.2	4.6	3.9
Non-performing claims/classified claims (%)	3.9	3.7	3.0	2.5	2.5
Impairments for non-performing claims/non-performing claims (%)	80.5	81.0	80.1	80.6	84.3
Non-performing claims/regulatory capital (%)	44.0	41.4	33.8	30.8	31.0
Non-performing claims minus impairments/capital (%)	8.6	7.9	6.7	6.0	4.9
Sum of large exposures/capital (%)	195.3	214.1	196.2	226.2	222.9
<b>4) Interest-rate risk</b>					
Diff. between proportions of interest-bearing assets and liabilities (percentage points)	3.2	3.5	3.7	3.7	3.7
Interest-bearing assets/assets (%)	87.7	90.3	90.1	90.2	91.3
Interest-bearing liabilities/liabilities (%)	84.4	86.8	86.4	86.5	87.6
<b>5) Exchange-rate risk (%)</b>					
Foreign exchange-risk-weighted assets/regulatory capital	51.6	58.6	55.1	58.8	6.8
Open foreign exchange position/regulatory capital	142.5	122.5	23.4	21.7	25.8
<b>6) Liquidity</b>					
Average liquid assets/average short-term deposits by non-banking sectors (%)	12.1	8.9	9.7	9.5	9.7
Average liquid assets/average total assets (%)	6.9	4.9	5.3	4.8	4.5
Category 1 liquidity ratio	1.06	1.14	1.11	1.12	1.13
Category 2 liquidity ratio	1.06	1.09	1.10	1.11	1.15
Proportion of debt securities in total assets (%)	32.3	32.6	27.5	26.2	20.8
<b>7) Solvency and capital structure (%)</b>					
Capital adequacy	11.9	11.5	11.8	10.5	11.1
Core capital adequacy	9.9	9.8	9.0	8.9	9.3
Supplementary capital/core capital	38.5	39.4	50.9	45.3	38.0

Notes: <sup>1</sup>Spread between the average effective total interest rate on loans and deposits by non-banking sectors in the final quarter.

<sup>2</sup>The 2006 figures are those reported under the IFRS, while those for previous years are based on estimated values in accordance with the IFRS.

Source: Bank of Slovenia

Table 2.6: Financial stability indicators

(%)	2005	2006
<b>Capital adequacy</b>		
Regulatory capital / risk-weighted assets	10.56	11.80
Regulatory core capital / risk-weighted assets	8.88	9.35
Non-performing (D- and E-rated) loans net of provisions / regulatory capital	5.09	4.86
<b>Asset quality</b>		
Non-performing (D- and E-rated) loans net of provisions / total gross loans	2.90	2.52
<b>Sectoral breakdown of loans</b>		
Loans to banks/loans	2.37	2.80
Loans to central bank/loans	4.28	5.87
Loans to other financial institutions/loans	3.32	4.00
Loans to government/loans	3.69	5.11
Loans to non-financial companies/loans	53.13	49.93
Loans to others (domestic sector)/loans	21.12	20.80
Loans to non-residents/loans	12.09	11.49
<b>Profitability</b>		
ROA (before extraordinary items and taxes)	1.01	1.25
ROE (before extraordinary items and taxes)	13.78	15.07
Net interest income/gross income	52.84	52.82
Non-interest income/gross income	62.40	60.74
<b>Liquidity</b>		
Liquid assets/total assets	4.84	4.53
Liquid assets/short-term deposits by non-banking sectors	8.79	9.72
<b>Sensitivity to market risks</b>		
Net open foreign exchange position/regulatory capital	21.71	25.79

Notes: The table gives the basic financial stability indicators in line with IMF methodology. The indicators for 2005 are calculated on the basis of the SAS, while those for 2006 are based on the IFRS. The euro is classed as foreign currency in the 2006 figure for net open foreign exchange position / capital.

Source: Bank of Slovenia