BANKA SLOVENIJE

BANK OF SLOVENIA

REPORT

ON SUPERVISION OF BANKING OPERATIONS IN THE YEAR 2001 AND THE FIRST HALF OF 2002

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Pursuant to Article 26 of the Bank of Slovenia Act (Official Gazette of the Republic of Slovenia, No. 58/02), we hereby lay before the National Assembly of the Republic of Slovenia the Report on Supervision of Banking Operations in 2001 and the first half of 2002.

The purpose of the Report on Supervision of Banking Operations is to give an overview of prudential supervisions of banks and savings banks, as well as the trends and developments in Slovenia's banking environment throughout 2001 and during the first six months of 2002.

In our efforts to promote general stability of the banking system and encourage transparency of operations conducted by banks and savings banks, the services they provide and the principles to which they subscribe, we hereby release the Report to the professional and general public to promote understanding of issues relating to the banking sector. When disclosing data and information in relation to prudential supervision of banks and savings banks (including savings and loan undertakings), the provisions laid down in the Banking Act (Article 59 of the Banking Act, which elaborates upon the contents of data relevant to proper discharging of tasks and responsibilities conferred upon the Bank of Slovenia and authorities to which the Bank of Slovenia may send data) have to be taken into account.

MISSION STATEMENT

By fostering effective banking supervision, the Banking Supervision Department promotes safety and soundness of banking operations.

OBJECTIVE

The primary responsibility of the Banking Supervision Department is to ensure depositor protection and thereby maintain the stability of the financial system and boost confidence in the financial intermediation system as a whole. Effective banking supervision the Banking Supervision Department subscribes to shall be the underlying objective and its fulfilment lies with all organisational units and people who exercise powers conferred upon the Banking Supervision Department.

PHILOSOPHY

We are committed to promoting the safety and soundness of our credit institutions. The principles we advocate within the framework of market economy assume that banks are managed by professionals chosen by the owners who lay down the guidelines to be adhered to. The Banking Supervision Department must not make decisions instead of the owners and must not interfere with the responsibilities conferred upon management teams of credit institutions. Banking supervisors must be satisfied that effective policies and practices are in place and that management takes necessary remedial actions in response to weaknesses identified by internal and external auditors. Regular open communication between the Banking Supervision Department on the one hand and credit institutions on the other help keep up the standards of safe and sound banking, while appropriate corrective actions taken by the Bank of Slovenia are yet another tool of effective supervision.

ROLE OF MANAGEMENT AND INTERNAL AUDITORS

Management teams that are at the helm of credit institutions have responsibility not only to owners but also to regulators, who strive to encourage sound practices throughout the financial system by being relentless in enhancing supervision of credit institutions and other related undertakings. These efforts have been essential components of a functioning economic environment. As regards ensuring responsibility of bank management for safety of banking operations, it is their duty to introduce clearly defined rules as to management of all kinds of risks banks are exposed to. Banks cope with industry-related risks by setting up a system of internal controls. With regard to supervision of both owners and regulators, banking supervisors must require from bank management to set out in writing rules to be followed and mechanisms deployed for the purpose of risk management. As for benchmarking business results, bank management teams must have in place long-term business strategy, which shall be implemented by means of business policies tailored for each area of banking operations. A step further is the need to have in place a well-developed internal audit department, which is in charge of monitoring and assessing the adequacy and appropriateness of aforementioned functions, and who shall promptly notify bank directors on findings and put forward recommendations. It is essential that bank directors and senior officers recognise the role and importance, as well as the scope of responsibilities conferred upon the internal audit department, and to duly consider its findings and recommendations. To keep this communication channel navigable is in the best interest of both sides.

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REPORT

CONTENTS

MACROECONOMIC ENVIRONMENT

A global economic downturn observed in 2001 and a spate of unexpected and often disruptive events should be overcome in the course of 2002. Interim figures mirror new confidence in economic recovery. Despite a squeeze in foreign demand, foreign trade has remained the driving force of Slovenia's economic activity best described as being resilient rather than buoyant. For a second year in a row, there has been little sign of a pick up in modest domestic demand with faltering gross investments. Slovenia's economic growth in 2001 was 3.0%, in the first quarter of 2002 it decelerated to 2.2% but it is expected to recover in the second half of the year. Rather flat economic activity has also affected employment-related figures. The growth of employment has been losing pace since the second half of 2001 but the unemployment rate has been going down for the third consecutive year.

The current account balance recorded a small deficit in 2001 (0.4% of GDP) and a surplus of 1.1% of GDP estimate in the first five months of 2002 owing to moderate imports and relatively favourable export movements. Exporters managed to make up for the weak demand from Slovenia's traditional trade partners by re-routing exports to the markets of former Yugoslavia and Soviet Union; hence regional export structure slightly changed.

The year 2001 witnessed a sharp increase in financial flows generated largely by the euro cash changeover and foreign direct investment in Slovenia. Net financial inflows in 2001 amounted to as much as 10.3% of GDP. Foreign direct investment continued also in the first half of 2002 and remain the main source of financial inflows - during the first five months FDI inflows accounted for 3.8% of the GDP estimate.

The weakening of economic activity and lower oil prices have resulted in lower inflation abroad. Price pressures from abroad started to moderate in the second half of 2001 dampening the rise of consumer price in Slovenia and posting December annual inflation rate at 7%. Despite higher oil prices in world markets, higher value-added tax rates and excise duties at home, as well as rising prices in some monopoly sectors, inflation during the first half of 2002 remained at the level from the end of 2001. In June, the annual consumer prices growth was 6.8%.

High financial flows have affected the movements in monetary aggregates and have made pressures for the appreciation of the tolar. The growth rate of the broad monetary aggregate in 2001 was 23.9%, while the M1 aggregate increased at the rate of 12.8%, implying faster growth of the components other than the transaction money (tolar time deposits and foreign currency deposits of households), which do not directly affect inflation. As the financial flows from abroad subsided in the first half of 2002, the growth in broad monetary aggregates moderated.

In 2001 the Bank of Slovenia reviewed its framework of monetary policy implementation for the period before entering the EMU. The Bank of Slovenia has adopted a medium-term inflation target: to reduce inflation to the 4% rate by the end of 2003. In line with the new strategy, monetary policy implementation rests on two pillars of monetary policy indicators with money and its components being included in the first pillar. The Bank of Slovenia conducted an active exchange rate policy enabling a gradual reduction in inflation and partial closing of the gap between domestic and foreign interest rates.

I. DEVELOPMENT RELATED TO BANKING SUPERVISION

1. PRUDENTIAL SUPERVISION OF FINANCIAL INSTITUTIONS IN SLOVENIA

The regulatory and supervisory powers are vested in three supervisory authorities responsible for financial institutions

Responsibility for supervision of different segments of Slovenia's financial system is shared by several regulatory and supervisory authorities. In discharging its supervisory functions, the Bank of Slovenia focuses on supervision of banks (including Slovene Export Corporation – banking operations) and savings banks. Savings and loan undertakings were set up on the basis of the Law on Savings and Loan Undertakings promulgated in 1990 and they may continue to operate in line with the provisions of the Banking Act, which also requires that the savings and loan undertakings must converge their operations with the provisions laid down in the Regulation of the Bank of Slovenia. The Bank of Slovenia supervises the process of harmonisation of operations carried out by the savings and loan undertakings with the provisions of the Banking Act and the Decree on the Bringing of the Operation of Savings and Loan Undertakings into Line with the Provisions of the Banking Act. The savings and loan undertakings were granted a five-year transitional period after the Banking Act came into force to fully harmonise their operations and the transitional period is scheduled to expire on 20 February 2004.

The Agency is independent organisation which carries out supervision and other tasks and competencies as laid down in the Securities Market Act, the Investment Funds and Management Companies Act, the Takeovers Act, the Act Regulating First Pension Fund of the Republic of Slovenia and the Conversion of Privatisation Funds, the Pension and Disability Insurance Act, the Foreign Exchange Act, and the Non-Materialised Securities Act and the regulations based on them. The Securities Market Agency was given new powers in 2001 pursuant to the Money Laundering Prevention Act and the amended Companies Act. The Securities Market Agency is responsible for supervision of operations carried out by brokerage firms, management companies, privatisation funds, mutual funds, mutual pension funds, the Ljubljana Stock Exchange and the Central Securities Clearing Corporation.

The Insurance Supervision Agency became operational on 1 June 2000[1] as a self-governed and independent legal person responsible for supervision of insurance undertakings[2], the Slovenian Nuclear Insurance and Reinsurance Pool, the Slovenian Insurance Association – guarantee fund, the Slovene Export Corporation - insurance operations, Kapitalska dru•ba pokojninskega in invalidskega zavarovanja - Pension Fund Management - voluntary pension insurance, insurance agency and intermediation companies, insurance agents and intermediaries, as well as some other entities.

To give a picture of the scope of supervisory oversight, here are the figures to illustrate the size of an individual segment of the financial system.

Aggregate total assets of credit institutions accounted for almost 89% of GDP at end-2001

At the end of 2001, there were 21 operating banks in Slovenia and their total assets added up to 3,962,8 billion tolars and three savings banks with total assets of 15.2 billion tolars. The share of aggregate total assets of these institutions in gross domestic product (hereinafter: GDP) at the end of 2001 was just over 87 per cent, while the combined share of banks and savings banks and 45 savings and loan undertakings was just below 89 per cent of GDP. Supervisory tasks in relation to these institutions were carried out by 45 employees (as at 30 June 2002: a staff of 50) of the Banking Supervision Department, which has operated within the framework of the Bank of Slovenia since 1992.

1 Before 1 June 2000, supervision of the insurance sector was in the hands of the Insurance Supervisory Authority of the Republic of Slovenia operating within the frame work of the Ministry of Finance.

2 The term insurance undertaking (also insurance firm) refers both to an insurance undertaking, which engages in the activities related to direct insurance as well as an insurance undertaking, which provides reinsurance.

At the end of 2001, there were 31 brokerage firms[3], 18 management companies[4] with 37 privatisation funds and 18 mutual funds and 5 mutual pension funds run by five operators. Supervision of the aforementioned institutions at the end of 2001 was conducted by 30 employees.

The first mutual pension funds were established in 2001.

Brokerage firms posted as at 31 December 2001 303.1 billion tolars of own investments (6.6 per cent GDP), 18.2 billion tolars managed investments (0.4 per cent GDP) and 749.9 billion tolars in under brokerage (16.4 per cent of GDP) with the total of 1,071.2 billion tolars in investments (23.5 per cent of GDP). Therefore, in comparison with the 2000 figures, these institutions recorded a 30 per cent increase. Total assets of privatisation funds as at 31 December 2001 amounted to 548.1 billion tolars (12 per cent GDP) and this figure shows that there was a 4.4 per cent decline in comparison with the figures posted as at 31 December 2000. This lacklustre result is partly attributable to the steps taken in the direction of the harmonisation and transformation of privatisation funds in accordance with the provisions of the Investment Funds and Management Companies Act and the Act on the First Pension Fund of the Republic of Slovenia and the Conversion of Privatisation Funds. The aforementioned assets encompassed unused ownership certificates, which accounted for just below one third of aggregate assets. Total assets of mutual funds jumped by 37 per cent to 14.6 billion tolars (0.3 per cent of GDP); hence privatisation funds had a total of 562.7 billion tolars in managed investments. The first mutual pension funds were established in 2001. At the end of 2001, there were five operating funds, of which one was still not fully operational. By the end of 2001, the operating mutual pension funds achieved 1.1 billion tolars in net worth of assets.

At the end of 2001, a breakdown of the count of operating insurance undertakings in Slovenia showed 13 insurance firms (11 insurance firms carrying out insurance business and two insurance firms engaged in reinsurance business) 172 insurance intermediation and agency firms, the Slovene Export Corporation – the insurance operations, the Pension Fund Management - voluntary pension insurance, the Slovenian Nuclear Insurance and Reinsurance Pool and the Slovenian Insurance Association - claims fund. The Insurance Supervision Agency had a staff of 21 at the end of 2001.

Total assets of insurance and reinsurance firms accounted for 8.6% of GDP at year-end.

Total assets of insurance firms (without taking into account the Slovene Export Corporation and the Slovenian Nuclear Insurance and Reinsurance Pool) according to audited data as at 31 December 2001 amounted to 338.4 billion tolars, total assets of re-insurance companies amounted to 54.1 billion tolars, with the grand total amounting

Table 1: The number of financial institutions

Type of financial institution	31 Dec 1997	31 Dec 1998	31 Dec 1999	31 Dec 2000	31 Dec 2001	30 Jun 2002
Banks	28	24	25	25	21	21
Savings banks	6	6	6	3	3	3
Savings and loan undertakings	70	70	68	64	45	37
Investment firms 1)	43	42	42	36	32	29
Management companies	26	23	22	21	20	20
Privatisation funds	60	46	46	43	37	34
Mutual funds	15	15	17	19	18	18
Mutual pension funds					7	7
Insurance undertakings	13	13	13	11	11	11
Reinsurance undertakings	2	3	3	3	2	2

* Including 11 banks authorised for performing investment services in the securities field.
Source Bank of Slovenia, Securities Market Agency, Insurance Supervision Agency

[3] Including 11 banks authorised for performing investment services in the securities field.
[4] Nine management companies runs solely privatisation funds, two engage in solely management of mutual funds, while the remaining nine management companies manage both kinds of funds.

to 392.5 billion tolars (8.6 per cent of GDP). Gross premium charged in 2001 amounted to 222.5 billion tolars (4.9 per cent of GDP), of which 122.1 billion tolars i.e. 54.8 per cent from property, 57.9 billion tolars i.e. 26 per cent from voluntary health insurance, and 42.5 billion tolars i.e. 19.2 per cent from life assurance policies.

Table 2: Exposure of banks and savings banks to financial institutions

in millions of Tolars, in %

	31 Dec 2000		31 Dec 2001	
	Amount	Share in agregate exposure	Amount	Share in agregate exposure
Brokerage firms	7,755	0.20	7,630	0.16
Privatisation funds	13,293	0.35	12,365	0.26
Management companies	8,705	0.23	11,055	0.24
Mutual funds	0.1	0.00	12	0.00
Insurance undertakings	6,067	0.16	7,005	0.15
Slovene Export Corporation	5,040	0.13	5,533	0.12
Pension Fund Management	4,175	0.11	7,928	0.17
Total	**45,035**	**1.18**	**51,529**	**1.10**

Source: Bank of Slovenia

2. INDEPENDENT ASSESSMENTS OF THE FINANCIAL SECTOR IN SLOVENIA

The joint IMF-World Bank mission made the FSAP in Slovenia in November 2000.

The International Monetary Fund (hereinafter: the IMF) conducted the first assessment program called the Financial Sector Assessment Program (hereinafter: the FSAP) in collaboration with the World Bank in Slovenia in November 2000. The members of the IMF Mission during two weeks prepared an assessment of the financial sector in Slovenia and compliance of supervisors of financial institutions with the Core Principles for Effective Banking Supervision (hereinafter: the Core Principles), with the Objectives and Principles of Securities Regulations issued by the International Organization of Securities Commissions (IOSCO), with the Insurance Core Principles of the International Association of Insurance Supervisors (IAIS) and with the Systematically Important Payment Systems issued by the Basel Committee on Payment and Settlement Systems.

The assessment of the banking sector and compliance of the Bank of Slovenia as a banking supervisor with the Basel Core Principles endorsed in September 1997 by the Basel Committee on Banking Supervision, was made on the basis of the self-assessment made by the Bank of Slovenia in August 1999 (after the new the Banking Act came into force in February 1999). This was the second self-assessment made by the Bank of Slovenia with the aim to gauge compliance with the Core Principles (the first self-assessment gauged compliance with the provisions of the 1991 Law on Banks and Savings Banks in June 1998).

The findings made by the members of the IMF Mission suggest that the Slovenian banking system has developed into a sound and safe well-capitalised system that appears robust to a number of external shocks and does not pose a significant macroeconomic risk. According to the mission's findings, a drawback of the Slovenian banking system is the fact that it has evolved in a largely protected environment in which limited competition has inhibited consolidation and is still dominated by the largest banks which are controlled by the state. Despite a strong supervisory framework, there is room for improvement in the areas of lending to connected persons, market risks, as well as in the area of consolidated supervision.

The mission's assessment resulted in the Action Plan

On the basis of the findings of the members of the IMF Mission, the Banking Supervision Department wasted no time and drafted an Action Plan for Improving

Alignment with the Core Principles for Effective Banking Supervision. The Governing Board of the Bank of Slovenia endorsed at its session held on 16 January 2001 the Action Plan to boost compliance with the Core Principles.

The IMF report - the Financial System Stability Assessment (hereinafter: FSSA) was available to general public in April 2001 on the website of the IMF. A summary of the FSSA was the integral part of the report on the 2001 Article IV Consultation with Slovenia.

On the basis of the recommendations of the IMF, the Banking Act was modified and amended in July 2001, while a month before the Act on the Modifications and Amendments to the Companies Act was promulgated. Most recommendations made by the members of the IMF Mission were taken into account and incorporated in the modifications and amendments to the Banking Act and certain provisions laid down in the Banking Act have now been fine-tuned to the EU directives and the overall situation can be regarded as far more satisfactory than before the changes and amendments were adopted. The adoption of the modifications and amendments to the Banking Act called for modifications and amendments of also the related acts of secondary legislation passed by the Bank of Slovenia.

Slovenia was in the focus of the Peer Review in September 2001.

In September 2001, a team of seven experts from the European supervisory authorities in the area of financial services visited Slovenia in order to review the progress made in setting up adequate supervision over the financial sector and in meeting the European requirements. The assessment was commissioned by the European Commission, DG Internal Market, while for the banking environment the assessment was prepared by two experts from two European banking supervisory authorities. The members of the Mission Peer Review as the foundation for their work used the FSSA report of the IMF.

On the basis of the draft report made by the mission - the so-called Peer Review, the Governing Board of the Bank of Slovenia adopted at its session held on 17 January 2002 the new Action Plan for boosting compliance with the Core Principles. In April 2002, the final report was made - the Peer Review of Effective Financial Services Supervision - and it contains information classified as confidential.

Overall, the assessment made by the Peer Review Mission is favourable for the Banking Supervision Department. The members of the mission wrote down that they appreciate the efforts made by the Bank of Slovenia to correct the weaknesses of prudential regulatory framework and that the activities conducted in 2001(modifications and amendments to the Banking Act and secondary legislation) were a step in the right direction. Most identified weaknesses did not come as a surprise and it is only the question of timing as it will take the right blend of external conditions if these issues are to be addressed efficiently. To this end, the Action Plan adopted in January 2002 is already in place and steps are being taken in the right direction. Nevertheless, for the full implementation further touches to the effective Banking Act are still needed.

The Banking Supervision Department monitors the implementation of both Action Plans for enhancing compliance with Core Principles. We have given an account as to the implementation of the first Action Plan three times so far to the IMF and in November this year we are to report for the first time to the European Commission.

Certain findings made by the members of both Missions deal with the highly sensitive area of banking operations such as supervision on a consolidated basis, capital requirements for market risks, connected lending, etc. The implementation of the relevant principles at the grass-root level calls for experience and specific knowledge.

The mission's findings were addressed by promulgating Modifications and Amendments to the Banking Act in July 2001.

At the Bank of Slovenia we took timely steps to transpose the findings i.e. recommendations made by the members of the IMF Mission as early as practicable. To illustrate our vigilance, the changes and amendments to the Banking Act enacted in July 2001 provide a broader definition for a person in a special relationship with the bank. Each exposure a bank incurs to the persons in a special relationship with the bank after July 2001 must be authorised by the supervisory board of the bank in question.

As regards the progress made in relation to consolidated supervision, the banks were first obliged as at 31 March 2001 to send to the Bank of Slovenia in addition to quarterly returns on the composition of the banking groups also the financial statements, statements on changes in equity, large exposures and equity investments in shareholders' equity of non-financial institutions and tangible fixed assets as at 31 December 2000. The momentum of on-site examinations conducted in subsidiaries of banks in Slovenia (autonomously or in co-operation with the Securities Market Agency) continued. Furthermore, the signs of progress were clearly noticeable in relation to supervision of subsidiary banks and branches abroad on a consolidated basis.

As regards changes in capital requirements, the Regulation on Capital Adequacy of Banks and Savings Banks was promulgated in February 2001 and also addressed the area of market risks. On the basis of the requirement put across by the Mission Peer Review for calculating capital requirements on a consolidated basis for the banks, which are obliged to calculate and comply with capital requirements for market risks and due to the need to make some improvements to the regulation in question, a new Regulation on Capital Adequacy of Banks and Savings Banks was promulgated in March 2002.

Driven by the need for a couple of examiners to acquire adequate experience and skills in the market risk area, the Bank of Slovenia has entered into a consultancy contract with a former expert of the American supervisory authority - the Office of the Comptroller of the Currency, who specialises in the area of on-site supervision of banks exposed to market risks. A working group for market risks has been appointed. It includes three examiners, one expert for the accounting area and one regulator. Joint activities started at the beginning of 2001 and have continued in 2002.

On the basis of the recommendations made by the members of the Mission of the IMF the Memoranda of Understanding (hereinafter: the MoUs) were drafted and eventually signed between the Bank of Slovenia and all audit firms appointed by banks and savings banks. The MoUs have been drafted along the guidelines of the paper of the Basel Committee on Banking Supervision, which regulates the relationship between banking supervisors and external auditors of banks while taking into account the possibilities and restrictions in relation to the exchange of information in force under Slovenian legislation.

The members of the Mission Peer Review have proposed further changes to the Banking Act so as to prescribe a prior authorisation for the acquisition of qualifying holding in a bank in accordance with the European directive. To address this weakness, a draft bill proposing changes to the Banking Act has been made and is due to be submitted into the parliamentary procedure in autumn 2002.

3. OWNERSHIP STRUCTURE OF THE BANKING SECTOR AND PRIVATISATION OF BANKS

Most Slovenian banks are in private hands.

The banks in Slovenia are mostly in private hands. This does not apply to the two biggest banks - Nova Ljubljanska banka (hereinafter: NLB) and Nova Kreditna banka Maribor (hereinafter: NKBM), which became state property through the rehabilitation and Slovenska investicijska banka, d.d. (Slovenian Investment Bank) with 11.3 per cent equity holding of the Republic of Slovenia in the equity capital. Poštna banka Slovenije d.d. (Post Office Bank of Slovenia) is indirectly controlled by the government.
Only resident shareholders own savings banks.

More non-resident shareholders in Slovenian banks.

The share of non-residents in equity capital in 2001 rose due to the take over of SKB banka d.d. by Société Générale, Paris (as at 31 December 2000, the equity holding of non-residents in SKB banka d.d. was 59.4 per cent, as at 31 December 2001 the foreign-owned equity holding was 98.4 per cent) and the sale of Banka Koper to SanPaolo IMI (as at 31 December 2001 the Italian bank held 15 per cent of equity capital). In the first half of 2002, the equity holding of SanPaolo IMI in Banka Koper increased, as did the foreign-owned equity holding in Krekova banka. As at 30 June 2002, the share of foreign capital in shareholders' equity of Slovenian banks was a hefty 21.1 per cent.

After the rehabilitation of the two state-owned banks initiated in Ljubljanska banka d.d. initiated with the decision of the Bank of Slovenia in January 1993 and in Kreditna banka Maribor d.d. in March 1993 was successfully completed in July 1997, privatisation of both banks started in 2000 on the basis of the decision of the Government of the Republic of Slovenia passed in July 1999.

Privatisation of NLB and NKBM with a combined market share of 46 per cent in terms of total assets has been a gradual process. In April 2000, 10 per cent of shares owned by the Republic of Slovenia were transferred to Kapitalski sklad pokojninskega in invalidskega zavarovanja (as from 1 January 2000 - Kapitalska dru•ba pokojninskega in invalidskega zavarovanja - Pension Fund Management) and Slovenski odškodninski sklad (transformed into Slovenska odškodninska dru•ba - Slovenian Restitution Corporation) i.e. swapped for shares of other corporations controlled by these two state-owned corporations.

In May 2001, the Government of the Republic of Slovenia adopted the privatisation programme for NLB and NKBM. The Government proclaimed two high-priority goals expected to be achieved through the pending privatisation, *viz.*:

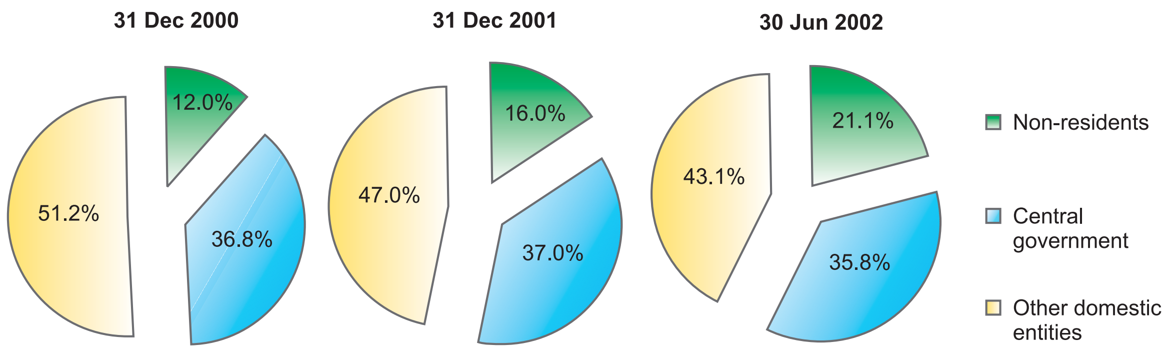
- To boost effectiveness and sharpen the competitive edge of the banks and the banking system and
- To fetch the highest possible price for the Government to reduce the public debt.

The first step of NLB privatisation completed.

The **NLB** privatisation program from May 2001 envisages the sale of a 48 per cent stake of the bank's equity capital, which means that once this phase is completed, the Republic of Slovenia will still own 25 per cent + 1 share. This privatisation phase envisages the sale to the following groups of investors: 34 per cent to key investors and 14 per cent to well-instructed portfolio investors. The Government adopted the amendment to the privatisation programme in December 2001 referring to the segment where the sale of a 14 per cent share is to be offered to well-instructed portfolio investors in a combination with a 15 per cent recapitalisation of NLB, both after the 34 per cent stake will have been sold to a key investor.

The second phase of the privatisation programme was intended for institutional portfolio investors. The idea was to sell simultaneously in addition to a 14 per cent stake of shares packed for portfolio investors a new issue of shares, which NLB will issue to strengthen its capital base. The enlarged portfolio sale has attracted the European Bank for Reconstruction and Development (hereinafter: the EBRD), which ahead of the commencement of the sale of new shares (recapitalisation) had acquired 5 per cent of shares. The EBRD, which will temporarily purchase any shares that have not been sold

Figure 1: The ownership structure of the banking sector as at 31 December 2000 and 31 December 2001 by equity holding[5]



Source: Bank of Slovenia

[5] Equity capital is the sum of subscribed capital and foundation deposits of savings banks, share premium, reserves of the bank, capital revaluation adjustment, net profit or loss brought forward, net profit or loss for the financial year minus subscribed unpaid capital and holdings of own shares.

to institutional investors, will offer those shares over the next few years to other investors with the aim to set up a target ownership structure: one third to remain in the state-hands, one third going to a key investor, and one third spread among portfolio investors.

The second stage of privatisation is mainly expected to produce the following results:

· To inject additional capital in the bank needed for the implementation of the NLB expansion strategy in the home market and abroad for the period 2002-2003
· To come up with a roster of opportunities for the participation of domestic investors in the NLB ownership structure
· To provide an additional safeguard for all present and future small shareholders of NLB by floating NLB shares on the Ljubljana Stock Exchange and
· To reduce uncertainty as to the rules applying to the transactions with the shares of NLB after privatisation and thus create conditions for fetching a higher price through the privatisation process.

Due to privatisation of NLB in the second half of 2002, the ownership structure of NLB looks different (see Appendix 2a).

The sale of 65.9% shares of NKBM halted in April 2002.

The privatisation programme of **NKBM** endorsed in May 2001, the Government was set on disposing of a 65 per cent share to a foreign strategic partner. The Committee appointed for steering and supervision of the procedure for the sale of NKBM made due diligence of three offers and after negotiations with potential investors came to the conclusion that no offer met all the objectives set under the NKBM privatisation programme. The Government confirmed in April 2002 the Committee's decision to suspend the procedure for the sale of 65.94 per cent of shares of NKBM. The Supervisory Board and the Management Board of NKBM are to prepare a programme for the implementation of the strategy for development of NKBM without losing the focus on the delivery of the strategic goals to be achieved by recapitalisation and partial privatisation of the state-owned equity holding.

4. GRANTING AUTHORISATIONS

Banks in Slovenia may provide banking services, other financial services and auxiliary banking services.

The banks operating in Slovenia may provide banking services, other financial services listed in the first paragraph of Article 6 of the Banking Act, and ancillary banking services referred to in the second item of the second paragraph of Article 96 of the Banking Act.

The savings banks authorised in Slovenia may carry on banking and other financial services with the exception of managing pension and investment funds. They may conduct transactions in tolars only, save in the case of exchange operations.

The following financial services are regarded as banking services:

· Accepting deposits from individuals and legal entities and granting credits for its own account and
· Services, which in line with law, may be provided only by banks.

Under the Banking Act, other financial services refer to the financial services listed below:

1. Factoring
2. Financial leasing
3. Issuing of guarantees and other commitments
4. Lending operations including consumer credits, mortgages and financing of commercial transactions
5. Trading in foreign means of payment including foreign exchange transactions
6. Trading in financial derivative instruments

7. Compilation, analysis and dissemination of information on credit standing of legal entities
8. Mediation in sales of insurance policies in accordance with the law governing the insurance sector
9. Issuing and administering of payments instruments (e.g. payment and credit cards, travellers' cheques, bank bills of exchange)
10. Safe custody services
11. Mediation in the conclusion of loan and credit transactions
12. Services in connection with securities in accordance with the law governing the securities market
13. Management of pension and investment funds in accordance with the law governing pension and investment funds and
14. Performance of payment transactions.

Under the amended Banking Act, the issuance of electronic money and the provision of trusteeship services are other financial services.

In accordance with modifications and amendments to the Banking Act, issuing of electronic money and provision of trusteeship services have been added to the list of other financial services.

A bank may also provide ancillary banking services connected with real-estate management and management or administration of a data processing system, and it may carry other activity deemed to be ancillary activity in relation with core business of one or more banks.

A bank may be incorporated only as a joint-stock company authorised to provide banking services and other financial services, and it shall have the authorisation issued by the Bank of Slovenia.

The provisions of the Banking Act set out requirements a bank must meet in order to be authorised to provide banking services as well as other financial services. The Bank of Slovenia is responsible for laying down personnel, organisational and technical requirements for carrying on banking and other financial services.

The minimum amount of initial capital for establishing a bank is 1.1 billion tolars (4.9 million euros at the exchange rate ruling at 30 June 2002) regardless of the scope of banking services, and for a savings bank it is 220 million tolars (approximately 1 million euros).

A foreign bank may establish a branch with the Bank of Slovenia's authorisation

Until full-fledged membership of the Republic of Slovenia of the European Union, a foreign bank may provide banking services and other financial services within the territory the Republic of Slovenia only through a branch. A foreign bank may set up a branch within the territory the Republic of Slovenia if it meets regulatory requirements to be authorised by the Bank of Slovenia. Thus the Bank of Slovenia may require from the foreign bank, which has applied to establish a branch within the territory the Republic of Slovenia to deposit endowment capital, to pledge other eligible financial assets, or to provide other collateral as a security that liabilities that may arise from business transactions concluded within the territory the Republic of Slovenia will be duly settled.

Since a branch is a business-organisational unit of a foreign bank and hence does not have attributes of a legal person, the provisions set out in the Banking Act in relation to risk management and control, protection of confidential information and data, books of account and annual report and accounts, internal and independent audit, as well as the provisions related to bank management (branch managers) shall meaningfully apply to a foreign bank branch.

In addition to authorisations to carry on banking services and authorisations to engage in other financial services, credit institutions shall apply to the Bank of Slovenia for authorisation in the following cases:

- Acquisition of a qualifying holding
- Merges and acquisitions
- Establishment of a cross-border branch
- Establishment of a foreign bank branch within the territory of the Republic of Slovenia

- Establishment of a foreign bank representative office and
- Discharging duties and responsibilities of member of the bank's management board.

The decision to grant or reject an authorisation is made by the members of the Governing Board of the Bank of Slovenia on the basis of a proposal prepared by the Banking Supervision Department. The Governing Board also decides on eligibility of nominees for members of banks' management boards on the basis of a proposal prepared by the Committee of the Governing Board of the Bank of Slovenia responsible for the preparation of opinions regarding fitness and properness of a person to sit on a bank's management board

Table 3: Granted and rejected authorisations to banks and savings banks in 2001 and the first half of 2002

	Type of authorisation	2001		First half of 2002	
		Granted	Rejected	Granted	Rejected
1	Authorisation to take up and pursue banking services	0	0	0	0
2	Authorisation to take up and pursue other financial services	10	1	1	2
3	Authorisation to a foreign bank to establish a branch	0	0	0	0
4	Authorisation for merger/acquisition of a bank/savings bank	4	0	0	0
5	Authorisation to a foreign bank to establish a representative office	2	0	0	0
6	Authorisation for the acquisition of a qualifying holding	6	1	2	2
7	Authorisation for the appointment of member of the management board	7	0	14	0
	Total	**29**	**2**	**17**	**4**

Source: Bank of Slovenia

5. CONSOLIDATED FINANCIAL STATEMENTS AND SUPERVISION ON A CONSOLIDATED BASIS

Consolidated financial statements are integral part of auditor's report.

Consolidated financial statements and notes to the accounts where auditors assess risk management and control within a banking group had to be included in the auditor's report for 2000 for the first time. In line with the regulatory requirements regarding supervision on a consolidated basis, ten banks prepared consolidated financial statements for a banking group and drew up reports on risk management policy and practice within the banking group.

The preparation of consolidated financial statements for banks and savings banks is stipulated in the Regulation on Books of Account and Annual Reports of Banks and Savings Banks and the Decree (Regulation) on the Supervision of Banks and Savings Banks on a Consolidated Basis. Consolidated financial statements prepared in line with one or the other decree may differ since they serve a different purpose.

A group of companies as defined in the Slovene Accounting Standards (hereinafter referred to as the SAS) is composed of the parent (controlling) company and its subsidiaries - controlled companies - operating under the guidance of the parent company. This definition excludes affiliated (or associated) companies where the parent undertaking has a dominant influence but no control. Such consolidated financial statements (accounts) have to cast light on all significant links (or interest) between the bank and other entities (financial and non-financial undertakings), as well as the effect of these links on the operating results of the respective bank. Under the SAS, the financial statements prepared by controlled undertakings (subsidiaries) being run by the parent undertaking on a temporary basis only shall be excluded from the consolidated financial statements. The same applies to controlled undertakings operating within the framework of strictly set constraints on the transfer of assets to the parent undertaking.

Consolidated financial statements for the purpose of consolidated supervision are a basis for the drawing up of the return on the banking group risk management.

Consolidated financial statements prepared for the purpose of consolidated supervision serve primarily as a basis for the preparation of reports as to how risks are managed and controlled within the respective banking group. A banking group as defined under the Decree on the Supervision of Banks and savings Banks on a Consolidated Basis includes banks, financial holdings, other financial institutions and companies providing ancillary banking services directly or indirectly controlled by the parent bank (or financial holding) or undertakings where the bank has directly or indirectly a participating interest (more than 20 per cent holding in equity capital or voting rights). The financial statements prepared at the consolidated level for the banking group shall exclude non-financial institutions (with the exception of those that in relation to the bank are of ancillary nature) and insurance companies, which shall be treated differently due to their specific activity, i.e. inherent risks). These consolidated financial statements are prepared as summary statements enclosed to the auditor's report (drawn up in conformity with the provisions set out in the Regulation on the Minimum Scope and Content of Audit and Auditor's Report). The Decree on the Supervision of Banks and Savings Banks on a Consolidated Basis allows to exclude other financial institutions and companies providing ancillary banking services from consolidated supervision in the case that these companies are so small that their influence on the assessment of the financial position of the banking group is negligible, where there are obstacles hindering such a company to pass on information to the parent bank, i.e. when to include such a company in consolidated financial statements would result in misleading results in relation to the objectives of consolidated supervision.

According to the SAS, the banks shall prepare consolidated financial statements for the controlled companies by using the method of full consolidation, while for the statements prepared on a solo basis, financial investments in subsidiaries whose financial statements are part of consolidation, shall be prepared by using the capital method. The banks are to use the investment method when disclosing financial investments in subsidiaries not included in consolidation, as well as for financial investments in affiliated undertakings.

Generally speaking, for the purpose of consolidated supervision all undertakings where the bank has a direct or indirect controlling interest or in any other way exercises dominant influence shall be included in consolidated financial statements by applying the full consolidation method. In the case where the participating interest is equity holding above 20 per cent of capital or the bank has significant influence on other undertakings, the financial statements of such persons are to be included in the consolidated financial statements by applying the capital method.

In accordance with the Regulation on Books of Account and Annual Reports of Banks and Savings Banks, the annual report prepared by the bank shall, among other things, comprise basic information about the banking group and the organisational structure of the banking group verified by the auditor within the framework of audit of consolidated financial statements. This requirement applies to the group for which the bank has prepared consolidated financial statements in accordance with the SAS. In the case that the bank is at the same time a parent undertaking as stipulated under the Decree on the Supervision of Banks and savings Banks on a Consolidated Basis, it is necessary to add a short explanation saying that the bank has also prepared consolidated financial statements adjusted for the purpose of consolidated supervision of the bank within the banking group, and all members of the group shall be listed.

6. REPORTING TO THE BANK OF SLOVENIA

As regards prudential supervision, the banks are obliged to report to the central bank on a daily, monthly, quarterly, semi-annual and annual basis.

Reporting on a solo basis addresses the following issues:

Daily
- Expected tolar liquidity flows.

Monthly
- Balances on book accounts
- Deposits from 30 largest depositors and depositors whose aggregate amount of deposits exceeds 200 million tolars and
- Liquidity ratio of tolar maturity ladder.

Quarterly
- Capital and capital adequacy
- Classification of on-balance sheet assets and off-balance sheet items
- Large exposure and exposure to connected parties
- Equity investments in non-financial institutions and investments in tangible fixed assets and
- Lending and deposit interest rates.

Semi-annually
- Equity investments and
- Guaranteed deposits.

Annually
- Auditor's report.

Reporting on a consolidated basis:

Quarterly
Semi-annually
- Composition of a banking group
- Financial statements
- Capital
- Large exposure and
- Investments in equity of non-financial institutions and tangible fixed assets.

7. SUPERVISORY EXAMINATIONS OF BANKS AND SAVINGS BANKS

Ongoing supervision of banks is ensured through regular on-site examinations.

The ongoing supervision and surveillance of banks and savings banks is conducted by examining the reports compiled by banks and savings banks on a regular basis and sent to analysts who verify the data, as well as by performing on-site examinations. In other words, the supervisory process is conceived upon the so-called four-eye principle where analysts and examiners share responsibility for monitoring operations of the respective bank and savings bank.

The analysts evaluate operating results posted by banks and savings banks once a month, they participate in the preparation of propositions with regard to granting authorisations for operations of banks and savings banks, they also assess proposals of new system solutions and advise in relation to the implementation of rules and standards for safe and sound banking operations. In addition, the analysts monitor compliance with limits for safe and sound business, and they participate in the preparations for on-site examinations in banks and savings banks and for consultations with management of banks and savings banks. Furthermore, they prepare reports, proposals, analyses and other papers for the bodies of the Bank of Slovenia. In the case where findings reveal that a respective bank or a savings bank does not operate in compliance with laws and regulations, the responsible analyst notifies immediately the examiners and the management of the Banking Supervision Department of the irregularity, and a decision is taken whether an on-site examination of that bank or savings bank would be appropriate.

Both the analysts and the examiners in the event of identified irregularities in operations of banks or savings banks take action and monitor the remedial steps taken.

The Department's on-site supervisory process aims at examining each bank and a savings bank at least once a year.

The strategic plan of the Banking Supervision Department for the period 2000 – 2003 sets the number of full-scope examinations of banks and savings banks to be in the range between seven and nine a year, the number of targeted examinations of particular segments of banking operations has been set at around 30 a year. An individual bank or a savings bank may be examined several times a year. Which area of the banking business is to be examined is decided on the basis of information obtained in advance and analyses of operations of individual banks or savings banks, acting upon the initiative given by the management of the Bank of Slovenia or other departments in the Bank of Slovenia or upon the initiative given by external institutions. A particular area of examinations is the assessment of the risk associated with information technology. On-site examinations enable in-depth examinations of those segments of operations where the level of risk is more elevated or where the Bank of Slovenia lacks appropriate or reliable data.

Since credit risk is generally regarded as the most serious risk faced by banks and savings banks, the focus of examinations is on adequate classification of on-balance-sheet assets and off-balance-sheet items. In particular, supervision on a consolidated basis is considered to be of utmost importance when a bank and all persons connected with it are examined. The examiners of the Bank of Slovenia sift through financial statements of connected persons, the bank's business policy (current and future) do connected persons, quality of assets - investments, corporate governance and relationship with the bank and risks stemming from business operations. On this basis, the examiners check among other things whether provisions and value adjustments made for the bank's exposures (credit, capital investments) to connected persons are adequate.

In 2001 and the first half of 2002, the examiners of the Banking Supervision Department focused during on-site examinations of banks and savings banks - alongside standard areas of examination – on supervision on a consolidated basis, market risks, implementation of the Consumer Credits Act, implementation of the Money Laundering Prevention Act, Payment Transactions Act, card operations, etc.

The planned number and scope of on-site examinations of the Banking Supervision Department in 2001 was fully realised with certain changes due to mergers. Full-scope examinations were conducted in seven banks and one savings bank.

In addition to eight full-scope examinations, in 2001 there were 30 target examinations of banks, savings banks, including savings and loan undertakings and other firms, and without taking into account the examinations of the information technology area. As regards the information technology issues, 20 examinations were performed in 2001 within the framework of full-scope examinations of banks or savings banks or targeted examinations.

The planned number of on-site examinations was realised.

Overall, the planned scope of examinations was fulfilled in the first half of 2002. Full-scope examinations were performed in four banks, one savings bank and two savings and loan undertakings. Targeted examinations i.e. examinations of a specific area of operations conducted by the banks and savings banks (including savings and loan undertakings) as well as other firms added up to 15. Only in the information technology area, there were 16 examinations (conducted separately or within the framework of full-scope examinations).

In 2001, the Banking Supervision Department filed a motion to start a bankruptcy procedure for one savings and loan undertaking and issued one decision to instigate forced liquidation.

The most commonly revealed irregularities in the examined banks and savings banks were as follows:

- Inadequate credit risk control (the classification of customers and making value adjustments and provisions)
- Incorrect calculation of capital and capital adequacy
- Substandard control of foreign exchange and market risks
- Incomplete or non-compliant of internal enactments

- Ineffectiveness of internal audit department and internal control systems
- Weaknesses in IT support to banking operations (lack of comprehensive risk analysis accompanied by adequate risk management, no comprehensive security policy has been drawn up and implemented, no schemes for continuous operations for business functions, imcompliete anti-virus protection)
- Organisational deficiencies as to safety and control of operations, etc.

As regards the savings and loan undertakings, the most common irregularities were as follows:

- Inability to comply with capital requirements and the principles of prudent and safe operations
- Inadequate classification of clients, making value adjustments and provisions
- Inadequate accounting coverage of operations
- Inadequate information support to operations from the standpoint of safety, etc.

The sharpest deficiencies i.e. risks in banks and savings banks identified in the area of information technology are described in detail in the section titled *Risks encountered in the automated information systems environment.*

On the basis of the findings of the Bank of Slovenia, in accordance with its legal mandate in the first half of 2002 issued eight decisions for the remedy of irregularities and a series of recommendations to improve operations (the latter does not include the decisions and recommendations related to the IT area). Three decisions were issued in the first six months of 2002 – one decision on conditional withdrawal of authorisation with the possibility to start the liquidation procedure – and two decisions on the recognition of conditions to file for bankruptcy. In the IT area nine decisions were issued in 2001 (seven banks and two savings banks), while in the first half of 2002 two such decisions were passed (one bank and one savings bank).

As regards the activities to combat money laundering, the examiners of the Banking Supervision Department conducted in 2001 a total of 25 one-day examinations in almost all banks and savings banks. The examinations of the business area related to anti-money laundering were in the first half of 2002 a part of all regular and targeted examinations of the Slovenian banks and savings banks.

Working together with the colleagues from other departments of the Bank of Slovenia, the examiners of the Banking Supervision Department also participated in the verification of the criteria for the transfer of payment transactions to the banks.

The Bank of Slovenia has a mandate to undertake on-site reviews of the legal persons related to the bank.

In accordance with the Banking Act, the Bank of Slovenia is also authorised for carrying out supervision of operations of legal persons connected with the bank, should that be necessary for the supervision of the operations carried out by the bank. In 2001, the examiners of the Bank of Slovenia carried out in seven banks targeted examinations of operations of certain firms being in a 100 per cent ownership of those banks (leasing firms).

Supervisory authority of the Bank of Slovenia has also been extended to other entities in the event of a suspicion that they provide banking services without being duly authorised by the Bank of Slovenia. In the year 2001, the examiners of the Bank of Slovenia acted on the basis of announcements made by competent state institutions (namely the Ministry of the Economy, Market Inspectorate of the Republic of Slovenia) and initiatives given by the members of the Governing Board of the Bank of Slovenia, conducted six on-site examinations of the companies suspected of having engaged in an activity for which they have not been duly authorised by the Bank of Slovenia. During the first half of 2002, the examiners of the Bank of Slovenia performed three examinations of the companies for which there was a suspicion that they engaged in an activity for which they have not been duly authorised by the Bank of Slovenia. In one case a decision was issued, the ruling and the motion to start the liquidation procedure was filed.

In accordance with the Basel Core Principles for Effective Banking Supervision, the supervisors of the Bank of Slovenia keep in touch on a regular basis with management of banks and savings banks. In addition to other communication channels, there are regular annual meetings organised upon the completion of a full-scope examination or as the need may be. These meetings serve mainly to assess the results of operations and the position of the banks or savings banks and to learn about its strategy for the future development. Exchange of opinions and information between supervisors and management boards of the banks and savings banks is another prerequisite for timely and appropriate behaviour in the event of possible difficulties in operations of banks or savings banks.

The Bank of Slovenia liaisons with other supervisory authorities at home and abroad.

Besides liaisoning with the Market Inspectorate of the Republic of Slovenia and the Money Laundering Prevention Office, the Banking Supervision Department also co-operates with the other two supervisors responsible for the financial market – the Securities Market Agency and the Insurance Supervision Agency (for more details about the signed MoUs with local supervisory authorities see the section *Co-Operation with domestic supervisory authorities*).

On the basis of the MoUs four reviews of operations of subsidiary banks and firms and the cross-border branches of the largest Slovenian bank were carried out in 2001 (in Germany, the U.S.A., Switzerland and Italy) together with foreign supervisors or autonomously (for further details about the finalised MoUs see the section *Cross-border co-operation*).

Also in the first half of 2002, the examiners of the Bank of Slovenia played a proactive role in examinations of subsidiaries in the banking group parented by the largest Slovenian bank, and namely a financial corporation in Switzerland and two bank subsidiaries of the largest Slovenian bank (in Macedonia and Bosnia and Herzegovina). In the event of identifying irregularities through the examinations of banks in Macedonia and Bosnia and Herzegovina, as well as in other foreign countries, taking further steps falls under the jurisdiction of the supervisory authorities of the relative country.

8. ASSESSING INTERNAL CONTROLS SYSTEMS AND INTERNAL AUDIT DEPARTMENT

An effective internal controls system and proficient internal audit function are two pillars of risk management in banking business.

The effective internal controls system and appropriate functioning of the internal audit department are key elements for assessing a bank's policies and practices for managing and controlling risks associated with banking operations with the ultimate goal to encourage safe and sound banking practices and avert a crisis.

The enactment of the 1999 Banking Act was yet another step towards the direction of equipping the Slovenian banking system with resources and skills required to stand up to full-size market pressures. By identifying the place, role and competence of internal audit department, the implementation of widely accepted principles for effective banking supervision with the underlying significance of adequate effective internal controls system has been facilitated. It is of paramount importance that a bank has in place an adequate internal controls system, which is fully operational, while the motive for the effective performance of the internal controls function is the need to have risks inherent in banking business on short rein. Under the condition that the internal audit department fulfils all statutory requirements, internal auditors for banks function in accordance with internal audit standards and code of conduct that lays down professional ethics for internal auditors, then solid foundations have been laid for banking supervisors to enforce principles required for safe and sound banking operations.

Assessing the adequacy and effectiveness of internal controls system is the centrepiece of on-site examinations. In the light of the importance of internal controls function, this area deserves constant attention. By being compliant with the Principle 14 of Core Principles for Effective Banking Supervision, sound and comprehensive internal controls function is highlighted.

Assessment of adequacy and effectiveness of the internal controls system is regarded as one of the key areas of banking supervision.

The role of banking supervisors is essential in the process, since it is up to banking supervisors to see that all banks, irrespective of their size, have in place effective internal controls systems, which must be commensurate to the type, complexity and scale of risks associated with their on- and off-balance sheet operations, and which will enable them to respond promptly to changes in banking environment and market volatility. In the cases where banking supervisors conclude that internal controls system is not sized to risks the bank faces, they are to take steps asking the bank's management to address the weakness without delay.

Although the bank's management and supervisory board are ultimately responsible for effective functioning of a bank's internal controls system, it is up to banking supervisors to assess the internal controls system of a bank within the framework of their ongoing supervisory function. It is essential to establish whether management of the examined bank pay appropriate and immediate attention to the problems identified through internal audit function. In other words, banking supervisors must be satisfied that the attitude of the bank's management towards reports drawn up by internal auditor is appropriate and that both the response time and the reaction to such a report are adequate for the nature and scale of the particular bank's business. In cases where management failed to react in response to important findings included in the internal auditor's report, banking supervisors still may decide to use such reports. However, this fact would raise doubts as to their value in the process of enhancing effectiveness of controls. It is essential that banking supervisors do not limit their assessment on how effective the entire internal controls system is, but also to evaluate individual controls incorporated primarily in those areas associated with high levels of risk (e.g: areas characterised by particularly high profitability, fast growth, and innovative products). Banking supervisors shall pay particular attention to banking policies and procedures issued in writing.

Additionaly, banking supervisors must always have a means of reviewing findings and recommendations made by external auditors in relation to effectiveness of internal controls. Banking supervisors must also check if the bank's management and supervisory board have taken any corrective actions in accordance with recommendations given by external auditors. The scale and nature of problems identified by auditors associated with control procedures shall be taken into account also when banking supervisors assess effectiveness of internal controls that the bank has in place.

The quality of work and proficiency of staff working in internal audit departments is improving.

Although there is always room for improvement of adequacy and effectiveness of internal audit function, the quality of performance and the qualification structure of personnel working in internal audit departments have been steadily improving; the number of auditors certified by the Slovenian Institute of Auditing has been growing since banks must meet the requirements laid down in the Banking Act. Namely, each bank shall have at least one employee who is a certified i.e. qualified internal auditor to discharge tasks and responsibilities delegated to internal audit function.

There are still rather significant differences in the number of internal auditors and their professional skills from one bank to another but the situation is improving. How many skilled experts in this field will a bank recruit is commensurate to the scale of its operations and resources a particular bank allocates to internal audit function. Due to the ever-increasing role of information technology and risks associated with that area, auditors are stressing the importance of vigilance and sophisticated control tools in monitoring and controling information technology risk.

It is a key factor that bank management acknowledges how important and beneficial internal audit function is. The bottomline is that bank management are responsible for safe, efficient and lucrative banking operations; therefore, they have to recognise in internal audit function a tool for achieving the set targets through monitoring of timely implementation of policies and actions and by taking the necessary steps to avert adverse business situations.

9. CO-OPERATION WITH SUPERVISORY AUTHORITIES

9.1. Co-operation with domestic supervisory authorities

A co-ordinated action of all supervisory authorities is a key to effective supervision.

To ensure effective supervision of financial institutions, all supervisory authorities have to work hand in hand aiming to achieve synergy needed if supervision of the individual segments of the financial system in Slovenia is to live up to expectation. In response to the model where several institutions are responsible for supervision of the financial sector, the Code of Practice was issued in 1999 on the basis of the Banking Act addressing the liaisoning of supervisory authorities.

Before formalising the relationship between Slovenia's supervisory authorities in July 1999, the financial supervisors collaborated along the lines laid down in protocols concluded between the Bank of Slovenia and other supervisory authorities.

The form and substance of the collaboration between supervisory authorities is formalised in the Code of Practice.

The Code of Practice for the collaboration between Slovenian supervisory authorities addresses a number of practicalities such as the nature and scope of collaboration between the Bank of Slovenia, Securities Market Agency and Insurance Supervision Agency (prior to 1 June 2000: Insurance Supervision Authority of the Republic of Slovenia). The key issues dealt with in the Code of Practice refer to collaboration related to the following:

- Strategic issues in relation to development, annual planning of joint actions endorsed by the Steering Committee and monitoring of the implementation of the signed MoUs
- Exchange of data required in the course of conducting supervision of financial institutions
- Sharing information required for the purpose of granting authorisations
- Exchange of data referring to facts and events concerning connected persons when such persons fall within the supervisory jurisdiction of another supervsory authority
- Dissemination of data necessary for decision-making in relation to other individual issues
- Organisation of joint examinations
- Notification of irregularities detected by one supervisory authority while carrying out a supervisory review in case such findings appear to be important for the work of other supervisory authorities and
- Other joint activities, which contribute to the harmonised conducting of supervision, increase efficiency of supervisory authorities and strengthen the effectiveness of the financial market function.

The Steering Committee was appointed on the basis of the said Code of Practice. It is chaired by the Minister of Finance and among its prominent members there is the Governor of the Bank of Slovenia, President of the Council of Experts of the Securities Market Agency and since September 2000 also President of the Council of Experts of the Insurance Supervision Agency.

The Code of Practice provides the guidelines for supervisory authorities to liaison

Since the Code of Practice has opened the door to formalising the relations between supervisory authorities, the MoU was signed between the Bank of Slovenia and the Securities Market Agency and on the co-operation between the Bank of Slovenia and the Ministry of Finance – Insurance Supervision Authority of the Republic of Slovenia in November 1999. Since the Insurance Supervision Authority was transformed into the Insurance Supervision Agency in June 2000, a new MoU was concluded between the Bank of Slovenia and the Insurance Supervision Agency followed in February 2001 by the MoU concluded between the Securities Market Agency and the Insurance Supervision Agency.

The MoUs provide the grounds for the harmonisation of previously signed protocols with the Code of Practice and articulate the details of the nature and the method of collaboration between the signatories of the MoUs, as well as the channels for the dissemination of information. In order to implement these agreements reached by supervisory authorities and facilitate the execution of tasks adopted by the Steering

Committee, there is a Liaison Group that meets at least once every three months. The Liaison Group comprises the Deputy Governor of the Bank of Slovenia, i.e. the director of the Banking Supervision Department of the Bank of Slovenia, the director the Securities Market Agency, and the director of the Insurance Supervision Agency.

In most cases Slovenia's supervisory authorities conducted on-site examinations independently. The co-operation among national supervisory authorities has been going on successfully along the lines laid down in the of the MoUs through regular exchange of information and dissemination of particular information requested by another supervisory authority. As a prerequisite for information sharing as stipulated in the Banking Act, supervisors must protect confidential information and keep professional secrets. Furthermore, supervisory authorities are obliged to notify other supervisory authority of any identified irregularities, which fall within the areas overseen by that supervisory authority. In some cases the supervisory institutions also conduct joint examinations.

The members of the Steering Committee of the supervisory authorities responsible for supervising financial institutions first met in January 2000 to discuss the body's future activities and the scope of work of the Liaison Group. It was agreed that the Liaison Group would monitor the issues in relation to the implementation of financial regulations and will warn the Steering Committee of the supervisory authorities against any problems which may arise primarily with regard to the grey areas where the regulatory framework does not cover all activities of financial intermediaries. In such cases, it is up to the Liaison Group to propose modifications or amendments to the respective pieces of regulations.

The Liaison Group has met eight times so far since its constitutional meeting in February 2000. During the first year, the joint meetings were convened by the Bank of Slovenia; during the second year (from April 2001 to March 2002) those meetings were convened by the Securities Market Agency, and at present the Insurance Supervision Agency chairs the Liaison Group.

Supervisory authorities cooperate by sharing information in the first place.

The most prominent activities pursued by the Liaison Group during the period between April 2001 and March 2002 are listed below:

1. Ongoing sharing of information on novelties from the scope of work of supervisory authorities and particularly in relation to applications received and in relation to authorisations issued for entities pursuant to the pension and Disability Insurance Act
2. Consultation concerning the issues from the province of work of the supervisory authority in question bearing relevance to the activities of any or all supervisory authorities
3. Sharing information with other supervisory authorities on contacts with the Ministry of Finance (including any bodies operating under its auspices) in relation to the drafting of financial regulations or their amendments and modifications (Banking Act, Insurance Act, Investment Funds and Management Companies Act, Act on Tax of Legal Persons, Money Laundering Prevention Act)
4. Ongoing reporting on international activities of individual supervisory authorities (on signing of MoUs with supervisory authorities of other countries and participation in meetings of associations)
5. Harmonised actions of supervisory authorities during visits of delegations of the European Commission when performing the Peer Review, when reviewing drafts of reports of the European Commission and on the occasions of other international contacts
6. Joint preparations of the Regulation on the Guarantee Scheme for the Claims of Investors in Investment Firms (Official Gazette of the Republic of Slovenia, No. 56/01) by the Securities Market Agency and the Bank of Slovenia
7. In response to the motion given by the Liaison Group, the working group for the drafting of the proposal for the new establishment of the system for penal sanctions to be passed by supervisory authorities for financial institutions drafted a report. The Committee endorsed the report and sent it to the Ministry of Finance and the Ministry of Justice

8. Early in 2002, a joint publication of all three supervisory authorities was issued in the English language presenting the most important primary and secondary legislation in relation to the supervision of financial institutions
9. In December 2001, the Insurance Supervision Agency staged a conference of high-profile representatives of the Bank of Slovenia, the Securities Market Agency and its own experts with the topic: The Supervision of Financial Conglomerates – European and Slovenian Experiences, where all three supervisory authorities delievered presentations and exchanged experiences
10. The Bank of Slovenia, the Central Securities Clearing Corporation, the Ljubljana Stock Exchange and the Securities Market Agency made a joint public statement in relation to the procedure for converting bonds from the national currency in the euro area in euro
11. The initiative for the collaboration between the Ministry of Finance, Tax Administration of the Republic of Slovenia - Special Tax Office of the Republic of Slovenia when drafting new tax legislation has been accepted but their response has been modest so far
12. Each supervisory authority examined operations conducted by the financial conglomerate composed of two insurance firms and one bank in 2001. In addition, on-site examinations were conducted to check the banks' investments in shares issued by insurance firms. Certain banks, which own management companies were examined in 2001.
13. The Liaison Group has monitored the problems of the implementation of regulations related to the financial area and initiatives for eventual changes and amendments to the regulations governing the financial area
14. The Liaison Group addressed at meetings the issues in relation to the implementation of the Investment Funds and Management Companies Act and above all the issues arising from the transformation of privatisation funds and problems to be adequately resolved within the framework of modifications and amendments to the Investment Funds and Management Companies Act, in particular in relation to the definition of financial holdings and their supervision and surveillance or at least define the criteria for drawing the line between funds that should be subject of supervision of the Securities Market Agency and funds for which supervision is not required
15. The Liaison Group has addressed on a regular basis the issues related to the implementation of the Pension and Disability Insurance Act. Among other, the issue of the role of supervisory authorities, laying grounds for transparency of information in relation to operations of funds, ensuring guaranteed yield and earmarking of provisions within mutual pension funds, as well as other related issues
16. Harmonised actions of all three supervisory authorities when proposing changes and amendments to the Pension and Disability Insurance Act. The Liaison Group has put forward a proposal asking all three supervisory authorities to explore the similarities and differences between all products marketed by pension funds, mutual pension funds and pension companies. A special working group was appointed from the ranks of the representatives of all three supervisory authorities. The working group has a mandate to draft proposals for improving the efficiency of operations of pension funds or companies and notified the Liaison Group of its findings
17. The representatives of supervisory authorities have identified the need for further activities of supervisory authorities for the implementation of the new Act on the Prevention of Money Laundering
18. The experience gained through high profile takeovers that have been finalised so far has shown that the scope of sanctions presently incorporated in the Takeovers Act is inadequate and that these sanctions fall short of the target.

The findings of the Liasion Group witness that the collaboration between supervisory authorities at the expert level has been satisfactory when dealing with concrete issues where supervisory jurisdiction of another supervisory authority applies.

The members of the Steering Committee focused efforts in 2001 and in the first half of 2002 on the issues set out below:

1. Cross-border investments of insurance undertakings i.e. insurance technical provisions (so-called »investment policy«), as well as assets of other financial institutions abroad

2. The co-operation with the Tax Administration of the Republic of Slovenia - Special Tax Administration Office of the Republic of Slovenia and the Ministry of Finance
3. Proposing pecuniary sanctions for violating the regulations, whose implementation is supervised by supervisory authorities
4. The issue of the implementation of the Pension and Disability Insurance Act
5. Modifications and amendments to the Investment Funds and Management Companies Act
6. The appointment of other two members of the Council of Experts of the Insurance Supervision Agency etc..

9.2. Cross-border co-operation

The Bank of Slovenia is a member of the Group of Banking Supervisors from Central and Eastern Europe and its representatives regularly attend meetings, seminars, workshops and conferences of the Group. In September 1999, the Bank of Slovenia for the first time hosted the Conference of the Group of Banking Supervisors from Central and Eastern Europe and in June 2002 it organised a five-day workshop on E-banking, Customer Due Diligence and Corporate Governance.

The Bank of Slovenia is a member of the Group of Banking Supervisors from Central and Eastern Europe.

The Banking Act has lifted all larger obstacles to the exchange of information between the Bank of Slovenia and foreign supervisory authorities. In practice, its provisions have laid ground for setting up the home-country control scheduled to be fully in place as of full-fledged Slovenia's membership of the EU. Even before the Banking Act came into force, the Bank of Slovenia had a mandate to carry out surveillance of branches and subsidiary banks set up abroad by the Slovenian banks through desk analyses of statutory returns and other documentation.

The MoUs have been concluded with the following institutions:

The Bank of Slovenia has already signed 7 MoUs with foreign supervisory institutions

- In January 2000 with the State of New York Banking Department
- In January 2001 with the Austrian Federal Ministry of Finance (the Bundesministerium für Finanzen, which as of 1 April 2002 was amalgamated with the Austrian Securities Authority – Bundes-Wertpapier-Aufsicht in the Austrian Financial Market Authority - Finanzmarktaufsicht)
- In April 2001 with the Federal Banking Supervisory Office in Germany (the Bundesaufsichtsamt fur das Kreditwesen, which as of 1 May 2002 merged with the Federal Insurance Supervisory Office and the Federal Securities Supervisory Office in the Federal Financial Supervisory Authority - Bundesanstalt für Finanzdienstleistungsauficht)
- In June 2001 with the National Bank of the Republic of Macedonia (Narodna banka Makedonije)
- In November 2001 with the Banking Agency of the Federation of Bosnia and Herzegovina (Agencija za bankarstvo Federacije Bosne i Hercegovine) and the Banking agency of Republika Srpska (Agencija za bankarstvo Republike Srpske) and the Central Bank of Bosnia and Herzegovina (Centralna banka Bosne i Hercegovine)
- In November 2001 with the Bank of Italy (Banco d'Italia)
- Shortly we expect to sign the MoU with the French Banking Commission (Commission Bancaire).

The MoUs signed with the supervisory authorities of the EU Member States and other foreign countries lays grounds for the signatories of the MoU in question to collaborate when conducting on-site examinations of branches and subsidiaries of banks in their jurisdiction abroad. Supervisory authorities make a commitment to safeguard all data obtained on the basis of the exchange of data with the signatories of the MoU as confidential and are allowed to use them only for the purposes for which they have been obtained.

Since Slovenia is the associated member of the European Union, the representatives of the Bank of Slovenia have participated in the meetings of the Sub-Committee on

Internal Market within the framework of the European Commission (former Sub-Committee on Financial Services, Establishment and Capital Movement) and the Sub-Committee on Economic and Monetary Issues, Capital Movement and Statistics. Furthermore, the Banking Supervision Department has taken part in the talks with the IMF and the World Bank within the framework of the FSAP and Article IV Consultation with the Republic of Slovenia.

In September 2001, the team of experts from the European supervisory institutions assessed all three financial supervisory authorities in Slovenia – the Bank of Slovenia, Securities Market Agency and Insurance Supervision Agency from the standpoint of adequacy and ability to assume tasks and responsibilities valid in the EU single market. The details are presented in a special section with the title *Independent Assessments of the Financial Sector in Slovenia.*

Furthermore, the Banking Supervision Department participated in a number of fact-finding visits paid by the representatives of rating agencies, foreign commercial banks and other visitors from abroad.

10. LIAISONING WITH EXTERNAL AUDITORS

Auditors gave no objection to financial statements of all banks and savings banks.

Financial statements prepared by the banks and savings banks were audited as at 31 December 2001 for the preceding year by the following audit firms: PriceWaterhouseCoopers (7 banks), Ernst & Young (6 banks), KPMG (5 banks), Deloitte & Touche (2 banks) and ITEO-Abeceda (1 bank and 3 savings banks). For the first time one savings bank will be audited for the financial year 2002 by the audit company Constantia MT& D. Over the last year, the Bank of Slovenia filed two denunciation with the Slovenian Institute of Auditing on the grounds of revealed irregularities against audit companies. The probes carried out by the Slovenian Institute of Auditing resulted in steps been taken against one of the audit companies in 2002.

The opinion regarding financial statements was for all banks and savings banks positive/without objections, which means that in auditors' opinion, financial statements drawn up by the banks and savings banks give a true and fair picture of financial state, results of operations and movements in financial flows over the reporting period. It is the duty of auditors to express their opinion as to the balance sheet, profit and loss account and changes in financial flows being the responsibility of the management board of the banks and savings banks.

The meetings with auditors are organised in the event of substantial deficiencies or difficulties revealed in a bank or a savings bank and in the event of outstanding professional issues as the case may be.

The Banking Supervision Department participates in the development of the audit profession (both external and internal) through the Slovenian Institute of Auditing and the Committee on Internal Audit under the Bank Association of Slovenia, it supports a pro-active stance also when addressing open accounting issues through the Committee on Accounting within the framework of the Bank Association of Slovenia.

As already mentioned in the section *Independent assessments of the financial sector in Slovenia*, all audit companies appointed to audit the banks and savings banks in Slovenia, with the Bank of Slovenia signed the MoUs providing a frame for the co-operation between the Bank of Slovenia and audit firms. The following audit firms are on this list: KPMG, Iteo Abeceda, Ernst & Young, PricewaterhouseCoopers, Constantia MT&D and Deloitte & Touche. The MoUs regulates the collaboration between supervisors and external auditors with the aim to boost efficiency of supervision and simultaneously reduce the burden on the shoulders of the supervised entities due to overlapping supervisory efforts. In addition, the MoUs deals with the exchange of information and in that case the principle of reciprocity applies to all shared information and confidentiality. Supervision of audit companies is in the hands of the Slovenian Institute of Auditing.

11. THE ROLE OF A BANKING SUPERVISOR IN THE AREA RELATED TO THE PREVENTION OF MONEY LAUNDERING IN SLOVENIA

Slovenia has put in place a comprehensive system to detect and prevent money laundering.

Slovenia has in place the legislative framework governing the area of the prevention of money laundering. The Money Laundering Prevention Act was promulgated in October 2001[6] and amended in July 2002. The rationale for the amendments was to incorporate the requirements set out in Directive 2001/97/EC into Slovenia's legislation, so as to extend the circle of accountable entities by adding to financial institutions attorneys/ solicitors, notaries, traders in works of art, audit firms, chartered accountants and tax advisors. Pursuant to the Penal Code money laundering is defined as a criminal offence (Article 252).

The key features of the Money Laundering Prevention Act are the following:

- Defining accountable entities (in accordance with Directive 2001/97/EC)
- Obligatory identification upon opening of an account or establishing a permanent business relationship
- Obligatory identification when a client requests or makes a transaction whose value exceeds 3 million tolars (equivalent of 13,300 euros at the exchange rate of the Bank of Slovenia as at 30 June 2002)
- Obligatory identification when a client requests or makes a transaction involving a passbook with a password
- Obligatory face to face identification except in special, that is extraordinary cases prescribed by the minister
- Obligatory reporting to the Office for Money Laundering Prevention of cash transactions in excess of 5 million tolars (equivalent of 22,100 euros at the exchange rate of the Bank of Slovenia as at 30 June 2002)
- Mandatory appointment of the compliance officer, professional training, a list of indicators and internal controls
- The Office for Money Laundering Prevention is empowered to suspend a transaction for up to 72 hours and
- Mandatory keeping of statutory records for 10 years.

In addition to penal legislation and legislation that directly governs the money laundering issues, Slovenia has ratified a number of international conventions.

In this way Slovenia has put in place a comprehensive system to detect and prevent money laundering, which has been assessed by the relevant organisations (UN, European Council, European Commission, Financial Action Task Force/FATF) as a modern one and compliant with international standards.

In July 2001, Slovenia was included in the second round of assessment aimed at checking Slovenia's compliance with anti-money laundering activities within the framework of the Select Committee of Experts on the Evaluation of Anti-Money Laundering Measures (PC-R-EV) by the European Council. The main purpose of the mission was to verify efficiency of the system and implementation of the recommendations made by the first assessment mission dating back to April 1998. The findings were that on the whole Slovenia complies with the 25 criteria defining non-cooperative countries or territories (NCCT), of which four criteria have been partially met. These weaknesses refer to certain legislative weaknesses due to the fact that the assessment was made in 2001 before new legislation was adopted. As far as the banking operations are concerned, the procedures followed when authorising exchange offices and transactions related to passbooks with a password or on the bearer seemed problematic.[7]

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6 The first Law was promulgated back in 1994, but it was substantially amended in 2001.

7 Transactions involving passbooks with a password without identification were legal until the year 1994; since then it has been obligatory to make identification of the holder when opening such a passbook. According to certain authorities this practice was not in accordance with the Recommendation Nr. 10 of the Financial Action Task Force; hence the Law was amended in July 2002 by making identification obligatory at each transac tion involving these passbooks. Otherwise, the volume of transactions with these instru ments is very low and accounts for less than 0.5% of deposit-related operations.

Unlike money laundering, financing terrorism has not been defined as a criminal offence in the Penal Code, which lists terrorism, international terrorism, abduction of persons and vehicles, and other acts connected with terrorism, as well as the establishment or collaboration in criminal associations. It is in this context that financing terrorism may be persecuted under the Penal Code as participation in a criminal offence. The Ministry of Justice is preparing amendments to the Penal Code, which should comprise the definition of financing terrorism as a criminal offence.

In Slovenia the principal criminal offences, which generate dirty money are linked to the illicit drug trafficking, as well as illegal trade in arms and immigration. All these criminal offences, as well as money laundering, go on within the framework of organised criminal associations.

The backbone authority involved in anti-money laundering activities is the Office for Money Laundering Prevention, which operates within the framework of the Ministry of Finance. The primary function of the Office for Money Laundering Prevention is to look after the implementation of the provisions laid down in the Money Laundering Prevention Act. Furthermore, the Office for Money Laundering Prevention collects the reports on suspicious transactions sent by accountable institutions, which serve as a basis to instigate criminal procedures with competent authorities (police/law enforcement, court etc.).

The Bank of Slovenia supervises the implementation of the Money Laundering Prevention Act in banks and savings banks.

The Bank of Slovenia supervises the implementation of the provisions set out in the Money Laundering Prevention Act in banks and savings banks. It is one of the responsibilities conferred upon the Bank of Slovenia under the Banking Act (Article 123), which stipulates that the Bank of Slovenia carries out supervision with the aim of verifying if the banks and savings banks comply with the rules on risk management and control and other rules laid down in the Banking Act and other laws applicable to operations conducted by banks and savings banks. Unlike the work of other authorities such as law enforcement/police and public prosecutors, the activities carried out by financial supervisors serves is described as being of a preventive nature.

In its capacity of the supervisor of the banking system, the Bank of Slovenia is aware of the tasks it is to carry out by virtue of effective legislation. At the same time, the Bank of Slovenia is vigilant when it comes to the risks associated with a non-compliance with the provisions of the Money Laundering Prevention Act, above all the reputational risk for a single bank, as well as the risk of smearing reputation of an entire banking system.

The Bank of Slovenia engages in the activities related to anti-money laundering by taking part in the work of the committee for the prevention of money laundering operating under the auspices of the Bank Association of Slovenia and conducting on-site examinations of banks and savings banks.

As regards enforcement, the Bank of Slovenia has not taken any supervisory measures in response to a bank’s failure to comply with anti-money laundering procedures.

At the Bank of Slovenia we are aware of the powers and responsibilities conferred upon us primarily with regard to stability and integrity of the market. Nevertheless, it is essential that banks grasp all potential risks (reputational risk - losing good name, operational risk, legal risk and concentration risk), which may arise from inadequate “know your customer” procedures. The Bank of Slovenia is committed to making the “know your customer” principles the integral part of risk management and control in all banks.

II. RESULTS OF OPERATIONS OF BANKS AND SAVINGS BANKS IN 2001 AND THE FIRST HALF OF 2002[8]

1. STRUCTURE OF THE BANKING SECTOR

As at 31 December 2001, there were 21 banks operating in Slovenia including four subsidiaries parented by foreign banks and one branch set up by a foreign bank. In addition, there were three savings banks and 45 savings and loan undertakings.

On 31 December 2001 there were four banks less year-on-year.

The number of banks has been slowly declining since 1994. Out of 33 operating banks at that time, the number of banks started to fall over the following couple of years. The downward trend culminated in 1998 when three mergers and one liquidation decreased the count. In 1999, another merger took place and for the first time after five years the Bank of Slovenia was in a position to grant authorisation to a new bank to take up the banking business - Hypo Alpe-Adria-bank. Since under the Banking Act foreign banks were allowed to establish branches in the territory of the Republic of Slovenia, the first branch of a foreign bank was established in 1999 - Kaerntner Sparkasse AG, Podru•nica v Sloveniji. So far it has remained the only branch of a foreign bank opened in Slovenia.

The consolidation of the Slovenian banking sector continued in 2001. The peak was reached in the last quarter of 2001 when Nova Ljubljanska banka d.d., Ljubljana took over three banks – Dolenjska banka d.d. Novo mesto, Pomurska banka d.d., Murska Sobota and Banka Velenje d.d., Velenje. In addition, SKB banka d.d. Ljubljana took over Societe Generale Ljubljana d.d..

Thus between the end of 2000 and the end of 2001 the number of banks declined by four as opposed to the number of savings banks, which remained unchanged.

No further consolidation occurred in the banking system during 2002. The number of banks remains at 21 as was the case at year-end 2001. However, one merger between the fifth largest bank Abanka d.d. Ljubljana and a smaller Slovene bank Banka Vipa d.d. that currently has 1.7% market share is proposed to take place January 2003.

In the first half of 2002, the number of savings banks has not changed. However, as of 1 July 2002, Nova Kreditna banka Maribor d.d acquired LLT hranilnica in posojilnica Murska Sobota d.d..

Table 4: The number of business units and employees in banks, total assets of banks and GDP

	31 Dec 1995	31 Dec 1996	31 Dec 1997	31 Dec 1998	31 Dec 1999	31 Dec 2000	31 Dec 2001
Number of business units	558	577	590	557	570	576	643
Number of employees	10,137	10,317	10,410	10,394	10,445	10,929	11,258
Total assets (in millions of Tolars)	1,497,544	1,729,083	2,022,037	2,350,359	2,687,600	3,192,792	3,962,822
Total assets/Number of employees (in millions of Tolars)	147.7	167.6	194.2	226.1	257.3	292.1	352.0
GDP at current prices (in millions of Tolars)	2,221,459	2,555,369	2,907,277	3,253,751	3,648,401	4,035,518	4,566,191
Total assets/GDP (in %)	67.4%	67.7%	69.6%	72.2%	73.7%	79.1%	86.8%

Source: Bank of Slovenia

1 The figures for the first half of 2002 or interim results as at 30 June 2002 are unaudited.

The number of savings and loan undertakings has been declining under the weight of requirements laid down in the Banking Act.

The number of savings and loan undertakings has been declining over the past few years because of the harmonisation requirements set out in the Banking Act. The Bank of Slovenia required the savings and loan undertakings to comply with the requirement to provide at least half of the prescribed initial capital by 31 December 2001, namely 110 million tolars. Since most savings and loan undertakings could not meet this requirement, they signed merger agreements with the Association of Savings and Loan Undertakings and banks or transfered their assets and liabilities to the banks. Besides the already concluded mergers, it is expected that by the end of 2003, most of the remaining savings and loan undertakings will join the Association of Savings and Loan Undertakings or banks. At the end of June 2002, the overall count of savings and loan undertakings was 37, eight less than at the end of 2001.

The market share of savings banks and savings and loan undertakings (in terms of total assets) is very low in comparison with the banks whose slice of the market at the end of December 2001 and at the end of June 2002 was a mere 2 per cent (savings banks 0.4 per cent, savings and loan undertakings 1.6 per cent).

Out of 21 operating banks, seven of them were as at 31 December 2001 controlled by domestic shareholders and five banks were fully owned or controlled by foreign owners. The remaining nine banks were controlled by domestic shareholders, while the share of foreign shareholders in six banks was around 1 per cent only. As at 30 June 2002, the number of banks controlled by foreign shareholders rose by one resulting in erasing one bank from the list of banks controlled by domestic shareholders. All savings banks have domestic owners and are mostly in private ownership.

2. OPERATIONS OF BANKS AND SAVINGS BANKS

2.1. Operations of banks

2.1.1. Operations of banks in 2001

High growth in total assets

According to audited annual figures, **total assets** of all banks in Slovenia amounted to 3,963 billion tolars as at 31 December 2001 (including NLB branch in Italy). Total assets increased in 2001 by 24.1% (16.8% in real terms), thus setting the highest effective real growth of the volume of operations over the past five years. High growth was a reflection of that in household deposits, which was most prominent during the last two months of 2001, due to the changeover to euro notes and coins.

Table 5: Total assets and market shares of the largest banks

Banks	Total Assets		Nominal Growth		Market Share	
	31 Dec 2000	**31 Dec 2001**	**2000/1999**	**2001/2000**	**31 Dec 2000**	**31 Dec 2001**
	in millions of Tolars		in %		in %	
NLB	918,828	1,382,308	22.1	50.4	28.8	34.9
NKBM	368,109	463,093	14.4	25.8	11.5	11.7
SKB banka	323,353	389,061	5.1	20.3	10.1	9.8
Abanka	188,133	255,606	26.0	35.9	5.9	6.5
Banka Koper	198,310	243,961	18.1	23.0	6.2	6.2
Banka Celje	185,182	226,470	18.9	22.3	5.8	5.7
Gorenjska banka	159,137	206,840	22.1	30.0	5.0	5.2
Total - top 7 banks	2,341,054	3,167,338	17.9	35.3	*73.3*	*79.9*
Total - all banks	**3,192,792**	**3,962,822**	**18.8**	**24.1**	**100.0**	**100.0**
NLB Banking Group	1,443,222	1,762,811	38.6	22.1	45.2	44.5
Majority foreign-owned banks	497,246	615,737	285.0	23.8	15.6	15.5

Source: Bank of Slovenia

In 2001, total assets of all banks (20 banks and one branch of a bank incorporated outside Slovenia) increased. In nominal terms, the growth rates ranged between 14.7% and 109.4%.

The market share of the biggest banks grew

The high concentration of banks in the Slovenian banking system increased in 2001, due to the strengthening of the market share held by the largest bank. The market share held by Slovenia's top bank at year-end 2001 totalled 34.9% (2000: 28.8%) and its combined share with three subsidiaries topped 38.8%. The market share of the three largest banks, which between 1994 and 2000 ranged between 50.4% and 53%, rose to 56.4% at the end of 2001. The market share of the seven largest banks that had between 71% and 73.9% of total assets of all banks between 1994 and 2000, rose to 79.9% in 2001. The market share of the top ten banks reached 87.0% at the year-end.

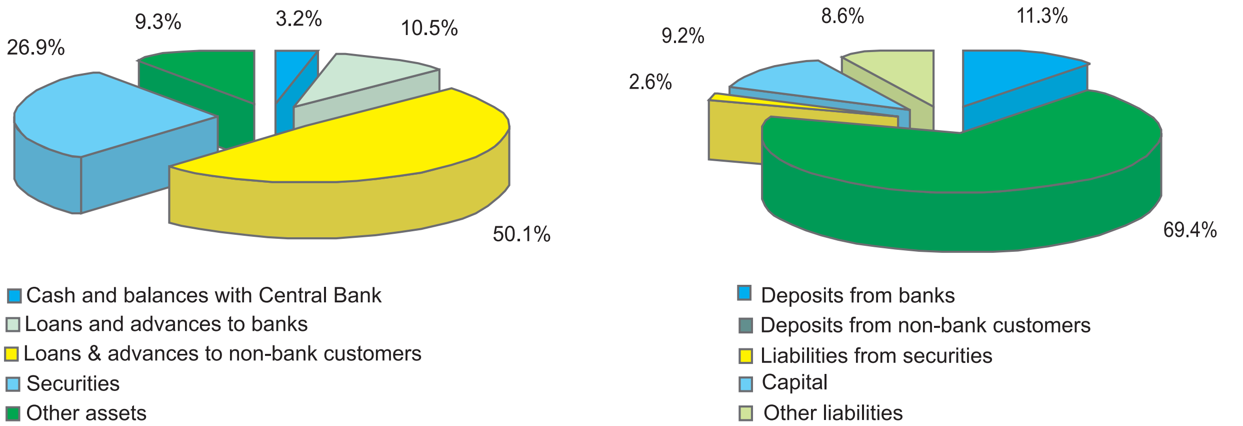
Table 6: Share of top ten banks in the entire banking sector as at 31 December 2000 and 31 December 2001

in %

	Market share (measured by total assets)		Loans and advances to non-bank customers		Deposits from non-bank customers		Capital	
	31 Dec 2000	31 Dec 2001	31 Dec 2000	31 Dec 2001	31 Dec 2000	31 Dec 2001	31 Dec 2000	31 Dec 2001
1 largest bank	28.8	34.9	27.1	33.3	28.0	35.5	24.7	30.8
3 largest banks	50.4	56.4	47.6	52.6	50.2	57.5	43.2	49.7
5 largest banks	62.5	69.0	60.0	66.3	63.1	70.9	54.3	61.5
7 largest banks	73.3	79.9	71.7	78.0	73.4	81.1	68.4	76.8
10 largest banks	81.8	87.0	80.6	85.6	82.4	88.2	78.3	83.2

Source: Bank of Slovenia

Figure 2: Average structure of banks'assets and liabilities as at 31 December 2001



Source: Bank of Slovenia

At the end of 2001, the share of household deposits and issued securities in average total liabilities increased.

As regards the average structure of **liabilities** in 2001, the share of deposits from the non-bank sector remained hardly changed in comparison with 2000. The structural share of deposits from the government declined (down by 1.9 percentage points) and deposits from non-financial institutions lost 0.4 percentage points. On the other hand, the structural share of household deposits strengthened (up by 2 percentage points) due to more vigorous growth in foreign exchange deposits at year-end. The share of issued securities in average liabilities also went up by 0.7 percentage points. The share of deposits from the banking sector in 2001 remained unchanged year-on-year, whereas the share of capital decreased by 0.6 percentage points.

Liabilities of banks to the non-bank sector (customers) increased greatly in 2001 (up by 28% as opposed to 16.1% in 2000). The real growth rate of deposits placed by the non-bank sector (19.6%) was well above the growth rates achieved during the period 1998–2000 when the figures ranged between 3.2% and 10.9%. Such a high growth rate came as a consequence of the strong growth in foreign exchange household deposits during the last quarter of 2001. During the year 2001, the share of deposits from the non-bank sector in average total liabilities was 68.4% (2000: 68.6%).

More vigorous growth in deposits from non-financial institutions …

The growth in deposits from non-financial institutions (17.2%) was up compared to 2000 (11.8%) and was more pronounced in the tolar-denominated segment than in the foreign exchange one. In 2001, demand and time deposits with agreed maturity between 91 days and 1 year enjoyed the best growth. In spite of higher figures, the share of deposits from non-financial institutions in average total liabilities decreased to 13.5%.

... and household deposits ...

After vigorous growth of household deposits in 2000, the year 2001 showed even higher figures. The achieved real growth rate (26.9%) was well ahead of the growth rates between 1998 and 2000 (5.8% to 14.9%). The rise in household deposits was in comparison with previous years particularly strong in the tolar-denominated segment (time deposits of over 91 days to 1 year) and in the foreign exchange segment (deposits repayable on demand). Their share in average total liabilities increased to 41.7% (2000: 39.7%).

… and a downswing in deposits placed by the government.

Since deposits placed by the government fell by 11.5% primarily due to lower obligations under the New Finance Agreement, the share of this item in average total liabilities in 2001 decreased to 5%. The movement in deposits from other financial institutions was in contrast with the movements in the government deposits. This item went up in 2001 by 40.4% (2000: 8.6%); hence their share in average total liabilities rose to 5.5%.

Liabilities to banks increased in 2001 by 13.9% - less than in past years. The whole increase arises from higher liabilities to cross-border banks, but it still remained below the figures in 1999 and 2000 (despite the fact that in 2001 foreign banks invested heavily in equity capital of Slovenian banks). Liabilities to cross-border banks, which accounted at year-end for 72.6% of aggregate liabilities to banks (2000: 67.7%), continued to be the most important sub-item of liabilities to banks. The share of these liabilities in average total liabilities practically stayed the same in 2001 (11.3% compared to 11.1% in 2000).

During the year 2001, the banks showed a preference for the issuance of cheaper securities with shorter maturity that have no characteristics of a subordinated debt rather than for the issuance of instruments, which have the characteristics of a subordinated debt. **Liabilities arising from issued securities** increased in 2001 by 59.9%. The banks generally opted for the issuance of short-term and long-term securities. The share of liabilities arising from issued securities in the average structure of liabilities went up from 1.9% to 2.6% in 2001. Given the growth in **capital** compared to the growth in total assets in the year 2001 there was a decline in the share of capital in average total liabilities from 9.8% to 9.2%.

Investments in securities gained momentum in 2001 ...

As regards the structure of **assets,** the share of investments in securities increased (up by 1.2 percentage points) and loans and advances to the banking sector (up by 0.3 percentage points) in 2001 due to a fall in the share of loans and advances to the non-bank sector (down by 1 percentage point). The downward trend was mainly caused

Table 7: Maturity structure of deposits from and lending to the non-bank sector

in millions of Tolars, in %

	31 Dec 2000		31 Dec 2001		2001/2000	
	Amount	Share	Amount	Share	Nominal growth	Real growth
Short-term loans and advances	947,305	57.9	1,096,151	57.2	15.7	8.1
Long-term loans and advances	689,253	42.1	819,597	42.8	18.9	11.1
Total loans and advances	**1,636,558**	**100.0**	**1,915,748**	**100.0**	**17.1**	**9.4**
Demand deposits	723,962	33.6	946,722	34.3	30.8	22.2
Short-term deposits	1,243,653	57.6	1,602,178	58.0	28.8	20.4
Long-term deposits	189,894	8.8	212,751	7.7	12.0	4.7
Total deposits	**2,157,509**	**100.0**	**2,761,651**	**100.0**	**28.0**	**19.6**

Source: Bank of Slovenia

by a fall in lending to households (down by 1.4 percentage points), while the share of loans and advances to non-financial institutions increased (by 0.8 percentage points).

… the banking sector borrowed more and the non-banking sector borrowed less …

A steady rate of growth in lending to non-financial institutions throughout the year 2001 reached 24.4%, being above the 2000 rate of growth of 20.9%. The achieved real growth rate in lending to non-financial institutions after 1999 (7.1%) reflected an ever-increasing orientation of banks towards crediting this sector in 2000 (11%) and 2001 (16.3%). Borrowing by households increased in 2001 by 7.7% (2000: 12.5%). The effective real growth rate in loans and advances to households after the record high 1999 (34.5%), due to the introduction of value added tax fell in 2000 and 2001 to 3.3% and 0.7%, respectively. While loans and advances to individuals stayed at the 1999 level in real terms, loans and advances to sole traders fell in real terms. The rates of growth in lending to other financial institutions in 2001 went down to 16.5%, this figure being considerably below 91.8% in 1999 and 30% recorded in 2000. Loans and advances granted to the government in 2001 showed in a 5.4% growth - a drop in comparison with the previous year (21%), since the government substituted borrowing from banks and tapped into fresh funds by issuing securities (Treasury bills and bonds). This trend was consistent with lending to non-residents that declined by 10.9% and to non-profit institutions serving households that fell by 30.9%.

… the share of long-term lending also up

The composition of loans and advances to customers other than banks by maturity has been gradually changing over the past five years in favour of long-term lending. Therefore, the ratio between short-term and long-term loans at year-end 1995 was 59:41 compared to 2001 when it was 57:43. During the year 2001, short-term lending increased by 15.7%, while long-term lending went up by 18.9%. The real growth rates indicate a steady decline in the growth of short-term loans and advances, whilst growth in long-term lending recovered in 2001 after flagging in 1999 and 2000. The growth of loans and advances denominated in foreign currency with a 25.7% rise achieved in 2001 was below the figures for 2000 and 1999 (31.4% and 34.4% respectively). The share of investments in securities in average total assets was up in 2001 after a drop in 1999 (4.9 percentage points) and 2000 (2.8 percentage points) owing to underwriting of bills issued by the Bank of Slovenia (up 1.2 percentage points to 26.9%). The composition of securities held by banks at year-end showed the largest portion of securities of the Bank of Slovenia (52.7%), followed by government-issued securities whose share in 2001 decreased to 34.8% in spite of a new issues of Treasury bills, and other securities with 12.5%.

Table 8: Principal balance sheet items carried by banks

	Amount		Nominal growth		Real growth
	31 Dec 2000	**31 Dec 2001**	**2000/1999**	**2001/2000**	**2001/2000**
	in millions of Tolars		in %		in %
Cash and balances with Central Bank	98,631	206,225	11.1	109.1	95.4
Loans and advances to banks	364,388	396,245	44.2	8.7	1.6
Loans and advances to non-bank customers	1,636,557	1,915,748	17.9	17.1	9.4
- corporate sector	939,660	1,168,900	20.9	24.4	16.3
- households	483,789	521,135	12.5	7.7	0.7
- government	150,921	159,075	21.0	5.4	-1.5
Securities	793,180	1,109,316	11.9	39.9	30.7
Other assets	300,036	335,287	20.4	11.7	4.4
Total assets	**3,192,792**	**3,962,822**	**18.8**	**24.1**	**16.0**
Deposits from banks	399,712	455,102	29.4	13.9	6.4
Deposits from non-bank customers	2,157,509	2,761,651	16.1	28.0	19.6
- corporate sector	441,787	517,744	11.8	17.2	9.5
- households	1,293,711	1,756,177	25.2	35.7	26.9
- government	171,202	151,533	-18.0	-11.5	-17.3
Liabilities from securities	69,405	110,996	55.1	59.9	49.5
Other liabilities	250,556	295,382	28.1	17.9	10.2
Capital	315,611	339,690	13.0	7.6	0.6
Total liabilities	**3,192,792**	**3,962,822**	**18.8**	**24.1**	**16.0**

Source: Bank of Slovenia

Bank of Slovenia bills headed the list of investments in securities.

Investments in securities in 2001 increased by 39.9%, with investments in the Bank of Slovenia bills rising most (up 59.9%), both in foreign currency due to the higher foreign exchange minimum and tolar-denominated – the strengthening of these items was most prominent in the second half of the year 2001 and reflects the policy pursued by the Bank of Slovenia to withdraw excess liquidity by deploying tolar-denominated instruments. Investments in government securities increased by 18.8% in 2001 most with investments in short-term securities (Treasury bills) leading. Investments in other securities (shares/stocks, bonds, securities of non-resident issuers, governments, etc.) increased by 35.2% especially with shares (stocks) and securities of non-resident issuers.

In 2001, investments in the banking sector rose by 8.7%, particularly when denominated in foreign currency. A break down of the average assets showed that the share of investments channelled into the banking sector grew from 10.2% in 2000 to 10.5% in 2001. The composition of investments in banks hardly changed during the year 2001; hence at year-end tolar-denominated investments accounted for 16.5%, and investments denominated in foreign currency accounted for 83.5% of the item in question (2000: 16.5% and 83.5%, respectively).

At year-end, the share of cash and balances at central bank accounted for a rather high share in aggregate total assets with 5.2% (overnight deposits).

Average total liabilities in foreign currency dropped.

Excess supply of foreign exchange in the foreign currency markets was the source of a continuous pressure on the tolar exchange rate to appreciate. The lagging behind of the growth rate of the base interest rate (TOM), was more pronounced than in 2000, was translated into the falling **share of average foreign exchange liabilities in the aggregate average liabilities** carried by banks**.** This figure remained within the average for the year 2001 (33.9%), however it was by 1.2 percentage points above the figure for 2000. The average share of foreign exchange assets in banks' average assets was with 33.1% in 2001 up by 1.5 percentage points year-on-year. The banks had on average in 2001 by 2.4% more foreign-exchange liabilities than assets.

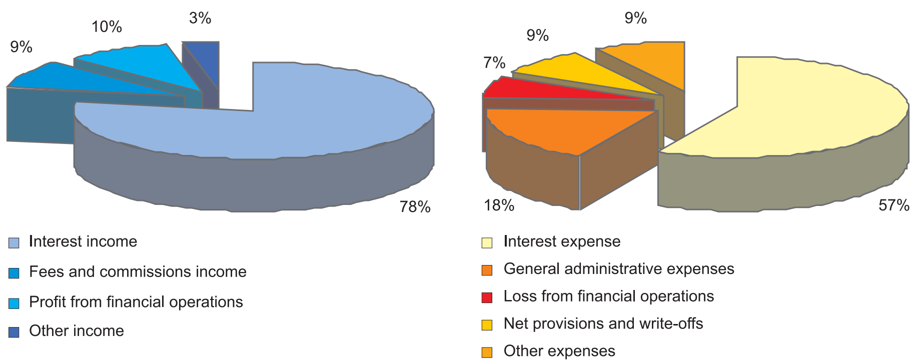
Banks' posted thinner profit due to a major bank's loss

Banks earned in 2001 15.4 billion tolars in **profit before tax** including the gain from revaluation of 30.2 billion tolars. In comparison with the year 2000, the generated profit was lower by 17.1 billion tolars, that is by 52.6%. It was the lowest over the past six years as the consequence of a high loss of one major bank (setting aside additional funds to accommodate the requirements related to the classification of the parent bank). By excluding the high loss incurred by the bank in question, profit before tax earned by the banking system in 2001 was 34.9 billion tolars. Profit after tax for 2001 totalled 1.9 billion tolars (2000: 19.9 billion tolars).

A breakdown of gross income shows that the share of net interest declined and the share of net fees and net financial operations rose.

Net interest earned in 2001 was 117.2 billion tolars. After a strong rise in net interest recorded in 2000 (by 30.1%, in real terms by 19.5%), net interest earned in 2001 declined by 6.1 billion tolars (by 5.0%, in real terms by 11.2%) due to falling revaluation interests. **Net fees and commissions** amounted to 41.5 billion tolars in 2001. In

Figure 3: The composition of banks' income and expense in 2001



Source: Bank of Slovenia

comparison with 2000, this item increased by 9.7% (by 2.5% in real terms) driven mainly by fees and commissions earned by providing payment operations in the country and on intermediary and agency deals. The year 2001 was highly favourable for banks in the segment of **net financial transactions**, since they earned 19.1 billion tolars - this figure being by 5.7 billion tolars, by 43% more than the figure in 2000, primarily due to valuation of investment securities and securities held for dealing purposes as quotations for securities went up. The item referred to as net other (other income from operations, extraordinary income and expenses, and revaluation of capital) in 2001 amounted to -6.2 billion tolars. In comparison with 2000 this item rose by 33.9% due to the increase in extraordinary expenses (payments of taxes and loss incurred by selling fixed assets).

Gross income (income before tax) earned by the banks in 2001 totalled 171.5 billion tolars and due to a fall in net interests year-on-year it rose only by 1.0% (in real terms it decreased by 5.6%). As regards the composition of this item, the share of net interest dropped (from 72.6% to 68.3%) in comparison with 2000, and the share of net fees and commissions grew (from 22.3% to 24.2%) followed by net financial operations (from 7.9% to 11.1%).

Table 9: Principal items carried by banks in adjusted profit and loss account in 2000 and 2001

	Amount		Share in gross income		Nominal growth	
	2000	2001	2000	2001	2000/1999	2001/2000
	in millions of Tolars			in %		in %
Net interest income	123,298	117,167	72.6	68.3	30.1	-5.0
Net fees and commissions	37,858	41,523	22.3	24.2	12.3	9.7
Net financial operations	13,355	19,096	7.9	11.1	40.0	43.0
Net other	-4,666	-6,248	-2.7	-3.6	11.5	33.9
Gross income	**169,845**	**171,539**	**100.0**	**100.0**	**26.9**	**1.0**
Operating expenses	100,041	111,309	58.9	64.9	14.6	11.3
- labour costs	49,085	53,510	28.9	31.2	12.3	9.0
Net income	**69,804**	**60,230**	**41.1**	**35.1**	**50.0**	**-13.7**
Net provisions and write-offs	-37,233	-44,783	-21.9	-26.1	41.0	20.3
Profit before taxation	**32,571**	**15,447**	**19.2**	**9.0**	**61.8**	**-52.6**

Source: Bank of Slovenia

Operating costs in 2001 were 111.3 billion tolars. In comparison with 2000 it rose by 11.3%, meaning in real terms up by 4.0%. The real growth rate of operating costs indicated that in 2001 banks managed to control expenses more effectively than during the period 1998–2000 when the real growth rates ranged between 4.9% and 6.6%. The proportion of operating costs in gross income increased in 2001, due to sluggish growth of gross income and went from 58.9% to 64.9% and the proportion of staff costs from 28.9 to 31.2%. A faster growth in the volume of operations than the growth in operating costs resulted to a fall in operating costs (from 3.4% to 3.1%), as well as in staff costs (from 1.7% to 1.5%) on average assets.

Given the stagnant gross income, the growth in operating costs was reflected on **net income** earned (60.2 billion tolars), which was by 13.7% below the 2000 figure when the growth rate was a record high. The fall in real net income is a continuation of reduced earnings in 1998 and 1999 interrupted by the recovery in 2000 when income figures went up in real terms due to a sharp rise in net interest.
The banks set aside 44.8 billion tolars in **net provisions** in 2001 or 7.6 billion tolars (20.3%) more than in 2000. The share of provisions in the composition of allocation of gross income in 2001 was 26.1% (2000: 21.9%).

Net revaluation gain in the amount of 30.2 billion tolars was in 2001 by 8.4 billion tolars (21.8%) below the 2000 figure and reflects the reduction in »inflation profit« earned by banks in 2001.

Due to a major bank's loss, return on assets and return on equity in 2001 were considerably below the 2002 level.

Return on average assets earned by banks in 2001 totalled 0.4% - the lowest over the past seven years. During the period between 1995 and 2000, profit ranged between 0.8% and 1.2% of average assets. By disregarding the loss made by one bank in 2001, the banks' return on average assets in 2001 was 1.1%. **Return on average equity** was 4.8% in 2001 or 11.9% when disregarding the bank with a high loss.

Table 10: Banks' key performance ratios

in %

	1999	2000	2001
Return on average assets	0.8	1.1	0.4 (1.1)
Return on average equity	7.8	11.3	4.8 (11.9)
Net interest margin	4.0	4.5	3.6 (3.7)
Labour costs/Average total assets	1.7	1.7	1.5 (1.5)
Other expenses/Average total assets	1.7	1.7	1.6 (1.6)

Note: Values in the brackets exclude the bank with a high loss.
Source: Bank of Slovenia

2.1.2. Operations of banks in the first half of 2002

The introduction of Slovenian Accounting Standards brought some changes.

The introduction of the new Slovenian Accounting Standards as of 1 January 2002 brought along a number of changes to the balance sheet and profit and loss account of banks and savings banks, described in the section *Overview of modifications and amendments to regulations concerning supervision of banking operations in 2001 and the first half of 2002*. In accordance with the new Regulation on Books of Account and Annual Reports of Banks and Savings Banks (Official Gazette of the Republic of Slovenia, No. 24/02 and 52/02) and the Chart of Accounts as its integral part, the banks were obliged to report in conformity with the new requirements on their balances as at 31 May 2002. As the preparation of financial statements under the new Slovenian Accounting Standards became obligatory, the data for the previous reporting periods (31 December 2001 and 30 June 2001) had to be prepared on the basis of data conversion made by the Bank of Slovenia. However, due to the limitations that had to be observed when converting data from four-digit analytical accounts whose data cannot be divided on individual analytical accounts to which the balance refers, these data are not entirely accurate.

Total assets of all Slovenian banks stood at 4,130 billion tolars as at 30 June 2002 and showed a 6.5 per cent increase in nominal terms in comparison with the end of 2001 meaning a rise by 253.5 billion tolars. By taking into account consumer price index as a measure of the rise in prices over the first six months of 2002 in the amount of 4.7 per cent, then total assets increased in real terms by 1.7 per cent. This result is significantly lower in comparison with the same period a year earlier (4 per cent in real terms).

According to interim figures, total assets of most banks (17 banks and one foreign bank branch) have increased in nominal terms – nominal growth rates in these banks range between 0.8 per cent and 34.9 per cent, while the fall in the volume of operations in real terms has been posted by seven banks, between them there are also three largest banks.

The aggregate **market share** of the three largest banks measured by total assets declined by 2.7 percentage points to 53.8 per cent as the result of a fall in total assets in all three banks in real terms and this also effected the decline in the market share of the largest seven banks by 1.3 percentage point to 78.4 per cent.

The increase in the structural share of **liabilities** of the non-bank sector by 1.5 percentage points posted for the first six months of 2002 at 71.6 per cent of average total liabilities, has been mainly generated by a rise in the share of household deposits (up by 2.5 percentage point). According to interim figures, household deposits accounted for a hefty 45.2 per cent of average liabilities and act as a buffer against a decline in deposits from government (down by 1.1 percentage point). In particular, the structural share of deposits from other financial institutions in average total liabilities increased by 0.5 percentage point and followed by issued securities that also grew (up by 0.3

percentage point). The structural share of capital declined (by 0.9 percentage point less in comparison with the end of 2001) and a downward trend was also witnessed in the share of deposits from the banking sector (down by 0.3 percentage point to 11.2 per cent) and deposits placed by non-financial institutions fell by 0.2 percentage point.

The growth in household deposits was back to normal in the first half of 2002.

The fact that there was an increase in the volume of operations over the first six months of 2002 had most to do with buoyant **household deposits** (denominated in local currency with maturity of over 91 days). Nevertheless, after growing at fast pace throughout 2001, the growth rate of household deposits began to moderate during the first six months of 2002 (5.6 per cent) resulting in less vigorous growth in total liabilities during the first half of 2002 in comparison with last year's interim figures. The cumulative figure for **deposits from non-financial institutions** has risen by 7.3 per cent over the half-year period, of which short-term deposits denominated in foreign currency increased most vigorously. There has also been an outstanding growth in **deposits from other financial institutions** (12.7 per cent), which trail behind growth posted during the first six months a year earlier (19.4 per cent). **Liabilities to banks** judged on the basis of interim figures went up by 8.6 per cent and mostly due to the swelling cross-border borrowing, which was considerably above the figure as at 30 June 2002.

The structural share of investments in securities in the structure of **assets** strengthened in the first half of 2002 (by 4.3 percentage points). The largest share of total assets are loans and advances to the non-bank sector (49.1 per cent), whose share in the first half of 2002 declined by 2.2 percentage points largely driven by structural decline in lending to households (down 1.4 percentage points) and to non-financial institutions (by 0.9 percentage point), whereas the structural share of lending granted to government rose (by 0.2 percentage point). The structural share of loans and advances to banks also dropped (by 1.6 percentage points).

Loans to non-financial institutions were rising at a slower pace.

During the first six months of 2002, the increase in **loans and advances to non-financial institutions** as opposed to a year earlier lost momentum. With 3.2 per cent the realised growth rate was modest (negative in real terms: -1.4 per cent). The growth in **lending to households** hardly fared better (3.5 per cent). As opposed to the interim figures for 2001, within the framework of the non-bank sector the item referring to **lending to government** enjoyed a strong growth (up by 19.7 per cent), and loans and advances extended to **other financial institutions** jumped (up by 21 per cent). Unlike a year earlier, this year's main feature is a buoyant growth in loans denominated in

Table 11: Principal balance sheet items of banks as at 31 December 2001 (after data conversion) and as at 30 June 2002

in millions of Tolars, in %

	31 Dec 2001		30 Jun 2002		Jun 2002 / 2001	
	Amount	Share	Amount	Share	Nominal growth	Real growth
Cash and balances with Central Bank	206,225	5.3	145,473	3.5	-29.5	-32.7
Loans and advances to banks	396,245	10.2	339,567	8.2	-14.3	-18.1
Loans and advances to non-bank customers	1,913,914	49.4	2,013,897	48.8	5.2	0.5
- corporate sector	1,167,066	30.1	1,204,182	29.2	3.2	-1.4
- households	521,135	13.4	539,558	13.1	3.5	-1.1
- government	159,075	4.1	190,344	4.6	19.7	14.3
Securities	1,109,316	28.6	1,333,603	32.3	20.2	14.8
Other assets	251,067	6.5	297,798	7.2	18.6	13.3
Total assets	**3,876,768**	**100.0**	**4,130,337**	**100.0**	**6.5**	**1.7**
Deposits from banks	455,102	11.7	494,003	12.0	8.5	3.6
Deposits from non-bank customers	2,761,651	71.2	2,918,653	70.7	5.7	1.0
- corporate sector	517,744	13.4	555,660	13.5	7.3	2.5
- households	1,756,177	45.3	1,853,813	44.9	5.6	0.9
- government	151,533	3.9	151,019	3.7	-0.3	-4.8
Capital and subordinated liabilities	375,914	9.7	382,309	9.3	1.7	-2.9
Other liabilities	284,101	7.3	335,373	8.1	18.0	12.7
Total liabilities	**3,876,768**	**100.0**	**4,130,337**	**100.0**	**6.5**	**1.7**

Source: Bank of Slovenia

foreign currency. On the other hand, the banks have channelled the bulk of gathered funds into **investments in securities** (20.2 per cent) during the first half of 2002. These securities have mostly been bills issued by the Bank of Slovenia and government securities. In comparison with the year-end 2001, the amount of **loans and advances to banks** (largely in foreign exchange) decreased and the amount of **cash and balances at central bank** was also down after a high growth posted at the end of 2001.

The structure of deposits from the non-bank sector by maturity experienced a favourable turn

The structure of the non-bank sector **by maturity** has experienced a favourable trend during the first six months of 2002 when long-term funding prevailed being up by 10.5 per cent in real terms (the largest portion of the increase has come from a rise in deposits placed by other financial institutions and household deposits). Also in the portion of short-term deposits, there has been a positive shift, and the strongest rise has been posted by deposits with maturity between 91 days and 1 year, practically entirely arising from a rise in household deposits.

More long-term loans to government, non-financial institutions and partly to households as well has resulted in the share of long-term lending to the non-bank sector during the first half of 2002 being up by 1.8 percentage point to 44.6 per cent.

Table 12: Maturity structure of deposits and loans of the non-bank sector as at 31 December 2001 (after data conversion) and 30 June 2002

in millions of Tolars, in %

	31 Dec 2001		30 Jun 2002		Jun 2002 / Dec 2001	
	Amount	Share	Amount	Share	Nominal growth	Real growth
Short-term loans and advances	1,094,317	57.2	1,115,710	55.4	2.0	-2.6
Long-term loans and advances	819,597	42.8	898,186	44.6	9.6	4.7
Total loans and advances	**1,913,914**	**100.0**	**2,013,897**	**100.0**	**5.2**	**0.5**
Demand deposits	946,722	34.3	969,824	33.2	2.4	-2.2
Short-term deposits	1,602,181	58.0	1,702,633	58.3	6.3	1.5
Long-term deposits	212,748	7.7	246,196	8.4	15.7	10.5
Total deposits	**2,761,651**	**100.0**	**2,918,653**	**100.0**	**5.7**	**0.9**

Source: Bank of Slovenia

Assets denominated in local currency have been increasing faster than assets denominated in foreign currency (up by 8.1 per cent and 3.6 per cent, respectively). This trend can be explained by strengthening of investments in government securities and securities of the Bank of Slovenia, which led to a rise in the share of total assets denominated in local currency over the first six months of 2002 by 0.9 percentage point to 66.5 per cent.

Between January and June 2002, liabilities denominated in local currency were growing faster than liabilities denominated in foreign currency (up by 8.3 per cent and 3.4 per cent, respectively). Deposits from household and other financial institutions contributed most to favourable results. Consequently, the share of total liabilities in local currency rose by 1.1 percentage points to 65.7 per cent.

Faced with rather flat lending operations, the banks stepped up investments in short-term securities issued by the Bank of Slovenia and the Republic of Slovenia. Henceforth, the volume of **secondary liquidity** increased over the first six months of 2002 by 170 billion tolars, resulting in the share of secondary liquidity in total assets increasing from 18.1 per cent at the end of 2001 to 21.1 per cent at the end of June 2002. Consequently, secondary liquidity amounted to 871.8 billion tolars at the end of June 2002, of which the securities issued by the Bank of Slovenia accounted for over 80 per cent and the rest being composed of short-term securities issued by the government.

Banks' profit in the first half of 2002 totalled SIT 29.7 bn.

Aggregate **profit** of all banks (profit before tax) during the first six months of 2002 has climbed to 29.7 billion tolars. With the exception of two banks, during the year 2001 all the banks realised positive operating results. The result posted by banks in comparison with the same period a year earlier was up by 10.5 billion tolars i.e. by 54.4 per cent, largely driven by the change to Slovenian Accounting Standards at the beginning of 2002 (positive net effect of the abolition of revaluation of capital, fixed assets and capital investments), albeit a rise in all categories posting earnings in the profit and loss account. Interim figures for **net interest** added up to 69.6 billion tolars and accounted for 67 per cent of gross income realised by the banks. The interest margin earned in 2002 is by 0.4 percentage point lower than in the same period a year earlier and totalled 3.7 per cent. Interim earnings arising from **net fees and commissions** for 2002 amounted to 23.9 billion tolars and increased in comparison with the first six months of 2001 by 2.6 billion tolars due to higher income from carrying out payment transactions within the country. The banks' earnings from **net financial operations** (8.3 billion tolars) remained at half-year 2002 at approximately the same level as a year earlier.

Operational expenses increased by 15.4 per cent in comparison with the first six months 2001 and their share in average total assets dropped from 3.3 per cent to 3.2 per cent in comparison with the year-end 2001.

The interim figures showed that the banks set aside 11.5 billion tolars in **net provisions**, and remained in the same bracket as at half-year a year earlier.

Table 13: Principal items of adjusted profit and loss account of banks for the first half of 2001 (after data conversion) and the first half of 2002

in millions of Tolars, in %

	Jan-Jun/2001		Jan-Jun/2002		Growth	
	Amount	% in gross income	Amount	% in gross income	Nominal	Real
Net interest income	62,028	114.2	69,587	111.0	12.2	7.2
Net fees and commissions	21,213	39.0	23,856	38.1	12.5	7.4
Net financial operations	8,002	14.7	8,291	13.2	3.6	-1.0
Net other	-6,012	-11.1	2,173	3.5	136.2	125.6
Gross income	**85,231**	**156.9**	**103,908**	**165.8**	**21.9**	**16.4**
Operating expenses	54,335	100.0	62,688	100.0	15.4	10.2
- labour costs	26,532	48.8	30,737	49.0	15.9	10.7
Net income	**30,896**	**56.9**	**41,220**	**65.8**	**33.4**	**27.4**
Net provisions and write-offs	-11,634	-21.4	-11,485	-18.3	-1.3	-5.7
Profit before taxation	**19,262**	**35.4**	**29,735**	**47.4**	**54.4**	**47.4**

Source: Bank of Slovenia

Return on assets and return on equity in the first half of 2002 were up year-on-year.

Return on average assets posted by the banks for the first six months of 2002 stands at 1.5 per cent, which was by 0.3 percentage point more than in the same period a year earlier, and **return on average equity** followed suit by rising to 18.4 per cent (as opposed to 12.5 per cent a year earlier).

Table 14: Banks' key performance ratios (after data conversion)

in %

	1999	2000	2001	Jan - Jun 2002
Return on average assets	0.8	1.1	0.5	1.5
Return on average equity	7.8	11.3	4.8	18.4
Net interest margin	4.1	4.7	3.6	3.7
Labour costs/Average total assets	1.8	1.7	1.5	1.6
Other expenses/Average total assets	1.8	1.8	1.8	1.6

Source: Bank of Slovenia

2.2. Operations of savings banks

2.2.1. Operations of savings banks in 2001

There were three savings banks in Slovenia in 2001. The aggregate assets of the three savings banks at year-end amounted to 15.2 billion tolars and this figure was by 23.5% higher year-on-year. Therefore, the share of savings banks in the Slovenian banking sector remained modest (0.4%). Nevertheless, there were major differences in the size and composition of their balance sheet items.

Household deposits accounted for the largest portion of liabilities of savings banks ...

Deposits of households have remained the most significant source of funding in the composition **of liabilities** carried by the savings banks. In 2001, this item increased by 35.7%, and their share in average total liabilities of the savings banks also rose (to 29.6%). Deposits placed by non-financial institutions declined at the end of 2001 by 23.2% year-on-year and this fall was reflected in the share of these deposits going down (to 16.7%), even though they remained the second most important source in total liabilities of the savings banks. Deposits from the banking sector strongly increased in 2001 (up by 131.7%) due to the deposit from the non-bank sector placed with a savings bank that fell due. In spite of high rate growth the share of deposits from the banking sector on average total liabilities decreased to 8.3%. The proportion of capital to average total liabilities declined to 9.2% in 2001.

The maturity of deposits from the non-bank sector placed with the savings banks was slightly longer in 2001. At year-end the maturity composition of deposits showed the following: demand deposits 5%, short-term 70.3% and long-term 24.7%.

… and mainly serve to lend to households …

Funds collected by the savings banks are generally passed on as lending to households, and grew by 19.6% totalling at year-end 2001 81.3% of savings banks' **average assets**. The share of investments in the banking sector increased by the end of 2001 to 5.7%, in non-financial institutions it decreased to 3.1% assets. The share of investments in securities of savings banks in 2001 totalled only 1.9% of average assets.

The proportion of short-term and long-term loans and advances to the non-bank sector which stood at 36 : 64 at the end of 2000 improved to 43 : 57 in 2001 following a shift in long-term lending to residual maturity in one of Slovenia's savings banks.

In 2001, all savings banks operated at a profit. Their aggregate profit totalled 220.7 million tolars - by 63.8 million tolars or 40.7% more than in 2000. In comparison with 2000, gross income went up by 226.7 million tolars, that is by 33% in 2001, largely due to higher net interest (up 126.8 million tolars) and fees and commissions (up 79.7 million tolars). Operating expenses increased by 131.9 million tolars (up 28.3%) in 2001. As operating expenses grew faster than total assets, their share in average assets in 2001 grew from 3.8% to 4.3%. Savings banks in 2001 earmarked provisions in the amount of 94.3 million tolars or 48.8% more than in 2000.

All savings banks made profit.

In 2001, the savings banks achieved a high return on average assets of 1.6% and on equity of 17.2%. Unlike the banks, the interest margin of the savings banks in 2001 increased by 0.5 percentage point to 4.1% and was better than the banks. During the last quarter of 2001, the nominal interest spread of the savings banks was 4.5 percentage points (2000: 4.7 percentage points) and real interest spread was 3.3 percentage points (2000: 3.1 percentage points).

2.2.2. Operations of savings banks in the first half of 2002

Bound by the same regulatory requirements as the banks, the savings banks reported for the first time in accordance with the new Slovenian Accounting Standards on their balances as at 31 May 2002. For this reason this section presents comparative data for the previous periods (31 December 2001 or 30 June 2000) drawn up in line with the new Slovenian Accounting Standards prepared on the basis of the data conversion made in the Bank of Slovenia. Due to the restrictions appearing in connection with the conversion of data from four-digit analytical accounts where data cannot be divided among individual analytical accounts to which the balances relate, these are not entirely accurate.

The growth of savings banks' total assets in the first half of 2002 outpaced the rise in banks' total assets.

Total assets of all three savings banks posted as at 30 June 2002 amounted to 17.5 billion tolars, which in comparison with the year-end 2001 reveals a 17.8 per cent nominal growth (a 12.5 per cent growth in real terms) that is a rise by 2.6 billion tolars. During the year 2001 the savings banks achieved a more vigorous real growth in total assets than the banks (12.5 per cent i.e. 1.7 per cent), largely due to more pronounced growth in total assets realised by two savings banks, while total assets of the smallest savings bank declined. The market share of all three savings banks in the overall banking sector remained modest (0.4 per cent), the savings banks have also preserved all differences and specific aspects in the balance sheet structure.

Deposits from the non-bank sector placed with the savings banks over the first six months of 2002 were rising at fast pace resulting in a rise in those assets in the **average liabilities structure** to 77.5 per cent (up by 1.6 percentage point). The most significant source of funding is household deposits, which accounted for 32.1 per cent of average total liabilities. The share of non-financial institutions in the liabilities structure for the first six months of 2002 declined by 3.2 percentage point to 13.9 per cent as the result of the shrinking volume of operations. Nevertheless, non-financial institutions remain the second most important source of funds for Slovenia's savings banks. Another important and permanent source of funds for the savings banks is also deposits from non-profit institutions serving households and the government.

The growth in lending to households did not match the growth in total assets.

The savings banks have channelled the bulk of gathered assets during the first half of 2002 into lending to households, albeit the growth in this item has lagged behind the growth in total assets; hence the share of lending to households in the **average structure of assets** has declined by 7.5 percentage points (75.4 per cent of average total assets). During 2001, the share of loans and advances to banks increased by 3.6 percentage points, which accounted for 9.4 per cent of average total assets compared to the share of investments in non-financial institutions, which remained unchanged with 3.2 per cent. Since January 2002, the share of investments in securities enjoyed a growth of 3.2 percentage points and stood at 5.1 per cent.

The maturity structure of liabilities has changed in favour of demand deposits and short-term deposits with maturity of over 91 days (non-profit institutions serving households), while long-term deposits declined by 2.3 percentage points in the liabilities structure. Due to mostly long-term lending to households, the share of long-term loans and advances increased from 57.3 per cent to 58.8 per cent.

As investments in securities of the Bank of Slovenia rose, secondary liquidity of savings banks was up by SIT 700 mn.

The **secondary liquidity** figure posted by the savings banks at the end of June 2002 was 920.3 million tolars i.e. 5.3 per cent of total assets and in comparison with the year-end 2001 rose by 700 million tolars, due to a rise in investments in securities issued by the Bank of Slovenia.

During the first half of 2002, all savings banks operated with profit and earned in total 213.5 million tolars in profit, which is 109 million tolars or 104 per cent more year-on-year (the effect of the abolished revaluation of capital, fixed assets and capital investments). The savings banks earned most on **net interest** and namely 346.2 million tolars or 95.3 million tolars more than during the same period a year earlier due to higher income arising from long-term loans). Earnings from **net fees and commissions** after the first six months of 2002 was 224.1 million tolars or 38.3 per cent of gross income. The savings banks posted a better result than a year earlier in the segment called **net financial activities** and primarily from selling shares. Since January 2002, the savings banks earmarked 49.5 million tolars to **net provisions** or 6.4 million tolars more than a year earlier. The share of operating expenses and staff costs in average total assets dropped in comparison with the same period in 2001 as a result of fast growth in total assets and have been converging with the level achieved by banks (3.9 per cent and 1.8 per cent; banks 3.2 per cent and 1.6 per cent).

Interest margin earned by the savings banks stands at 4.4 per cent and in comparison with the figures posted for the first half of 2001 was higher by 0.3 percentage point. With the return on average assets of 2.6 per cent and the return on average equity of 31.4 per cent, interim profitability ratios are favourable.

3. SUPERVISION OF RISK MANAGEMENT

3.1. Credit risk

The banks and savings banks operating in Slovenia are most exposed to credit risk, which is generally defined as risk of incurring a loss due to a borrower's failure to meet liabilities to the bank. When assessing credit risk, credit concentration has to be taken into account (measured by large exposures), the volume of lending (the absolute value of exposures) and the quality of loans and advances (the classification of assets in groups ranging from A to E).

Banks assess credit risk in line with the criteria set by the Bank of Slovenia.

The banks measure credit risk on the basis of the criteria for the classification of assets (claims) in categories from A (the best group or the highest grade) to E (the worst category or the lowest grade). Since the end of 1992 when the criteria for classification of assets took into account merely default tightened in 1993 and remained in force with no further changes until the end of 1996. As from 1997, the criteria for classification of assets became even more demanding. The methodology used until 1996 took into account the assessment of the borrower's creditworthiness, even though it was allowed under certain conditions to classify the loan secured by pledging movable or immovable property as collateral to be classified in the A group and not according to the creditworthiness assessed for the debtor in question. Since January 1997, the assets secured by pledging property may be classified only one group higher that they would have been on the basis of the assessment of the borrower's creditworthiness.

After the Banking Act came into force, the Decree on the Classification of On-Balance Sheet Assets and Off-Balance Sheet Items of Banks and Savings Banks was promulgated (Official Gazette of the Republic of Slovenia, Nos. 32/99 and 103/01), which superseded the Decree issued in December 1996 (amended in July 1998) and by its content did not differ significantly from the Decree adopted in 1996.

The new Slovenian Accounting Standards, which became effective on 1 January 2002, indirectly affected the principles followed when classifying items in the banking book, setting aside funds for provisions and the suspension of income. Therefore, the Bank of Slovenia passed a new regulation and namely the Regulation on the Classification of On-Balance Sheet Assets and Off-Balance Sheet Items of Banks and Savings Banks and the Regulation on Establishing Specific Provisions of Banks and Savings Banks, which entered into force on 1 May 2002.

Investments in securities and capital are to be value according to their fair value.

In accordance with the **Regulation on the Classification of On-Balance Sheet Assets and Off-Balance Sheet Items of Banks and Savings Banks** (Official Gazette of the Republic of Slovenia, No. 24/02) a bank or a savings bank is obliged to classify all loans by individual borrowers in groups A, B, C, D and E (and for these loans possible losses are calculated and provisions for credit risk are earmarked). As regards investments in securities and investments in equity capital according to Slovenian Accounting Standards different valuation rules apply. Under the new Slovenian Accounting Standards, the said investments shall be valued according to their fair value. Despite it, where no other avenues are available, for the purpose of assessing impairment of securities the same criteria as for loans and advances may apply. A new definition has been added specifying that exposures arising from derivative financial instruments traded in the free (over-the-counter) market, are the subject of classification in the amount of credit replacement value.

Another novelty is that no possible losses are calculated for receivables (claims) arising from interest and fees and commissions. Accrued income on assets classified in the C, D and E groups is not included in the profit and loss account as long as the payment has not been received (suspension of income); hence when accrued, this income is to be entered on the assets side as a receivable (claim) and simultaneously also under assets as a 100 per cent adjustment (under the old standards it was carried on the liabilities side on a special account for suspended income). Income - accrued on performing items (A and B categories) is eligible for inclusion under income items when accrued**.** Unlike the effective treatment of accrued interest and fees and commissions in the B category no provisions will be required. The new Regulation on the Classification of On-Balance Sheet Assets and Off-Balance Sheet Items of Banks and Savings Banks requires that allowances for country risk have to be separated from traditional credit risk.

The **Regulation on Establishing Specific Provisions of Banks and Savings Banks** (Official Gazette of the Republic of Slovenia, No. 24/02) introduces a new terminology due to the changes to Slovenian Accounting Standards as well as descriptions of book entries for provisions and adjustments. In order to distinguish between provisions for general banking risks and specific provisions for other risks, the specific provisions for other known risks have been renamed. Provisions for country risk are to be made separately and recorded on the new account for provisions made for country risk on the liabilities side of the balance sheet.

The aforementioned regulations are mandatory and oblige the banks and savings banks to set up framework criteria for the scoring of creditworthiness of borrowers and require the earmarking of provisions in minimum percentages eligible under tax law as expenditure. Nevertheless, individual banks use the system valuation and grading in line with their own internal models, which are even tighter that the prescribed ones.

Risks associated with concentration of credit exposure are in the focus of attention.

As regards credit risk management, the banks are to pay particular attention to risks associated with concentration of exposures to credit risk to single borrowers and groups of connected entities. Just as it was the case in the superseded Decree from May 1999, the **Regulation on Large Exposures of Banks and Savings Banks** (Official Gazette of the Republic of Slovenia, No. 24/02) provides definitions of large exposure and limits on such exposures. Precisely as it was defined in the Decree promulgated in 1999, large exposure shall mean an exposure incurred by a bank or a savings banks to an individual (single) borrower being equal to or in excess of 10 per cent of the bank's own funds. The sum of all large exposures shall not exceed 800 per cent of the bank's own funds. The maximum exposure to an individual borrower shall not exceed 25 per cent of the bank's own funds. The bank's exposure to an individual borrower which the bank directly or indirectly controls, i.e. to counterparties, which are directly or indirectly controlled by the same person as the bank, shall not exceed 20 per cent of the bank's own funds.

In 2001, the modifications and amendments to the Banking Act introduced in addition to 25 per cent and 20 per cent limits on exposures, another 10 per cent limit on exposures to the counterparties in a special relationship with the bank as defined in Article 83 of the Banking Act. The counterparties who fit the description of a person in a special relationship with the bank are defined as the holders of shares or voting rights (holdings in excess of 5 per cent), members of the bank's bodies and any persons related to them.

No bank reported the sum of large exposures above the prescribed limit.

The sum of large exposures across the banking system as at 31 December 2001 reached 203.0 per cent of capital (as at 31 December 2000 the sum of large exposures achieved on average 185.1 per cent of capital of banks, as at 31 December 1999 it was 182.7 per cent). Exposure to persons in a special relationship with the bank was exceeded by 13 banks as at 3 August 2001. The deadline for compliance (applicable to the banks and savings banks which as of the day of the effectiveness of the Act on the Modifications and amendments to the Banking Act carried exposure above exceeded the afore mentioned exposure), will expire on 3 August 2004.

Table 15: Classification of on-balance sheet assets and off-balance-sheet items of banks

in %

Category	31 Dec 1997	31 Dec 1998	31 Dec 1999	31 Dec 2000	31 Dec 2001
A	90.1 (85.7)	89.6 (85.7)	88.5 (84.9)	87.4 (83.9)	86.6 (82.3)
B	4.4 (6.3)	5.0 (6.9)	6.3 (8.3)	7.4 (9.5)	8.0 (10.6)
C	2.3 (3.3)	2.1 (2.8)	2.0 (2.7)	2.1 (2.6)	2.1 (2.7)
D	1.8 (2.5)	1.8 (2.5)	1.5 (2.0)	1.6 (2.0)	1.5 (1.9)
E	1.4 (2.1)	1.5 (2.1)	1.7 (2.2)	1.6 (2.0)	1.9 (2.4)

Note: The classification in brackets does not take into account claims on the Bank of Slovenia and Republic of Slovenia.
Source: Bank of Slovenia

The banks in Slovenia carried as at 31 December 2001 aggregate exposure to credit risk in the amount of 4,516.9 billion tolars (of which 3,696.8 billion tolars refers to on-balance sheet and 820.1 billion tolars to off-balance sheet items).

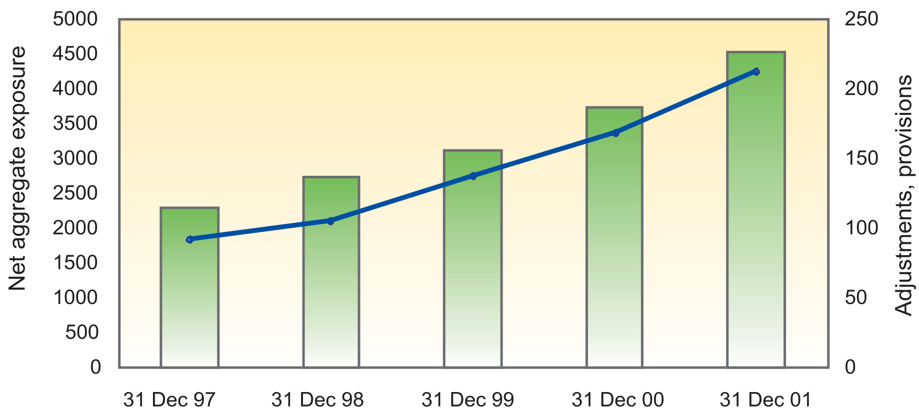
In comparison with the year-end 2000, average exposure to an individual (single) borrower increased by 14 per cent to 137.4 million tolars.

The share of performing assets is approximately 95%.

The quality of the loan portfolio has not changed substantially. The share of performing assets (assets in the A and B categories) has ranged between 93 and 95 per cent (the portion of non-performing assets between 5 and 6 per cent), the portion of bad assets (assets in the D and E categories) between 3 and 4 per cent.

If clients' creditworthiness were to be taken into account without considering different collateral, the share of performing would be somewhat lower. As at 31 December 2001 this figure was 92.9 per cent (92.2 per cent a year earlier), which means 2.4 percentage points less than by taking collateral into account.

Figure 4: Net aggregate exposure and adjustments and provisions made (in billions of tolars)



Source: Bank of Slovenia

The share of bad and doubtful assets in gross assets as at 31 December 2001 with respect to a year earlier increased from 13.1 per cent to 13.4 per cent. The share of value adjustments in gross assets of banks increased over the same period - from from 6.5 per cent to 6.6 per cent. In 2001, the volume of bad and doubtful assets (28.3 per cent) was increasing faster than the total assets (24.1 per cent).

The structure of banks' investments by sector has hardly changed.

The structure of investments made by Slovenian banks by sectors at the end of 2001 as opposed to the year-end 2000 did not change much. 75 per cent exposures of banks was to corporate clients and sole proprietorships, 14.9 per cent to individuals, while the rest is composed of exposures to non-residents (10.1 per cent). As regards exposures to corporate clients and sole traders, exposures to financial intermediation remains in the top bracket where also the claims on the Bank of Slovenia are included (this economic activity posted at the end of 2001 a 19.5 per cent share in aggregate exposures the banks in Slovenia carried to the corporate sector and sole proprietors). The manufacturing sector was on the second place with the share of approximately 14 per cent (with metal-processing and machine industry at the forefront), followed by public administration, defence and social protection on the third place with close to 12 per cent (investments in government securities accounted for just over 8 per cent at the end of 2001).

As regards Slovenian **savings banks,** their exposure to credit risk as at 31 December 2001 amounted to 14.4 billion tolars. The quality of the loan portfolio of the savings banks slightly deteriorated in comparison with the year-end 2000. The share of bad and doubtful assets in gross assets stood at 4.5 per cent (at the end of 2000: 4.5 per cent). Savings banks did not overshoot the limits on large exposures.

3.2. Country risk

Banks set aside funds for country risk in line with the Bank of Slovenia regulation.

As from the end of 1997, the banks are obliged to estimate country risk and set aside provisions for country risk on claims to non-residents. Country risk is defined as the risk of incurring losses associated with the country where the borrower has residency. To make provisions for potential losses arising from country risk, he banks earmark provisions at least in the amount prescribed by the Bank of Slovenia on the basis of assessment of risk inherent in a certain country.

The banks do not make provisions for possible losses arising from country risk for the following:

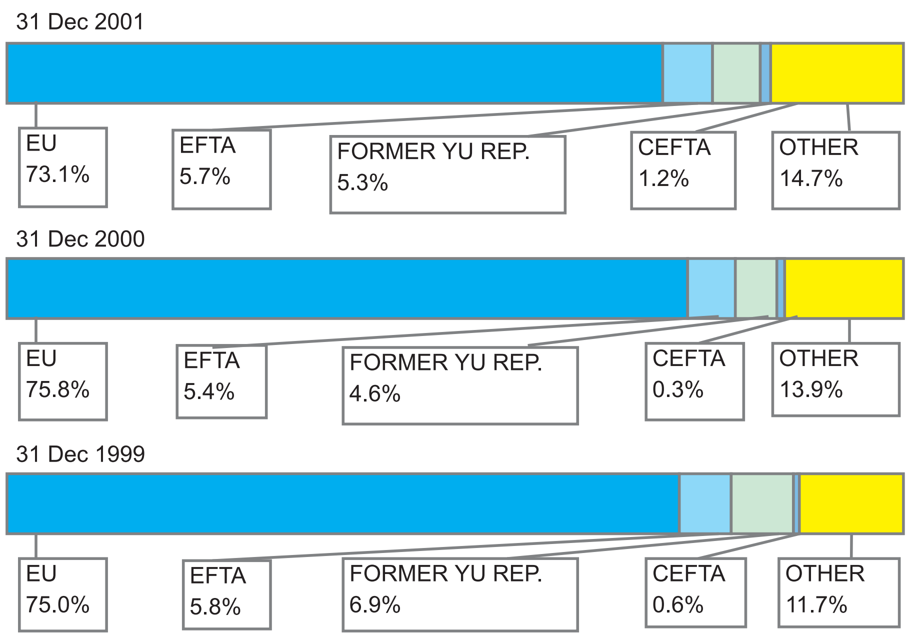
1. Claims on non-residents with contractual maturity of up to 6 months,
2. Claims on branches of investment grade cross-border banks,
3. Claims secured by first-class collateral[1] and
4. Claims secured by a joint and several guarantee of a blue-chip borrower (who meets the criteria for the classification in the A category) from a risk-free country.

Banks were most exposed to counterparties from the EU.

Gross exposure (on- and off-balance sheet items) of banks to non-residents has increased since 1997 and as at 31 December 2001 amounted to 463.5 billion tolars. During that period, the share of exposures to non-residents ranged between 10 and 12 per cent of the aggregate exposure. Gross exposures to non-residents at the end of 2001 in comparison with a year earlier went up by just over 10 per cent.

The banks incorporated in Slovenia carry exposure to counterparties from 56 countries with investments in counterparties from the European Union and the EFTA countries prevailing. These investments largely consist of investments in banks.

Figure 5: Banks' exposures to non-residents



Source: Bank of Slovenia

[1] First-class collateral comprises: bank deposits readily available to settle a claim, securities issued by the Republic of Slovenia, the Bank of Slovenia, governments and central banks of EEA countries and comparable OECD countries, irrevocable guarantees payable on first demand issued by the banks authorised by the Bank of Slovenia and investment-grade foreign banks, gilt-edged debt securities of banks tradable in the financial markets (excluding subordinated and negotiable securities) and irrevocable guarantees issued by the Slovene Export Corporation and the Republic of Slovenia.

Exposure to counterparties from the European Union at the end of 2001 accounted for 73.1 per cent of aggregate exposures to non-residents. The share of exposures to counterparties from the EU declined with respect to 31 December 2000 and banks were most exposed to counterparties from Germany, Austria, Italy and Great Britain. If we extend the group of counterparties from the EU counterparties to counterparties from the EFTA countries with Switzerland being the most important business partner, then aggregate exposure to counterparties with residency in these countries was close to 80 per cent.

Exposures to counterparties from the republics of former Yugoslavia, the share of this type of risk as at 31 December 2001 was 5.3 per cent (as opposed to 4.6 per cent a year earlier) of aggregate exposures to non-residents. Banks in Slovenia were most exposed to counterparties from Croatia, followed by the Federal Republic of Yugoslavia and Macedonia, with exposures to counterparties from Bosnia and Herzegovina tailing behind.

After a fall in the share of exposures to counterparties from CEFTA countries in 2000, exposures to this part of Europe increased in 2001. At the end of 2001, the share of exposure to this group of counterparties was 1.2 per cent of aggregate exposures (as opposed to a mere 0.3 per cent at the end of 2000).

As regards other countries, the banks carried as at 31 December 2001 the highest exposure to counterparties from the U.S.A.

Savings banks do not provide either cross-border payment services or lending operations; hence they are not exposed to country risk.

3.3. Solvency risk

In March 2002, the amended Regulation on Capital Adequacy of Banks and Savings Banks was promulgated.

The modified Regulation on Capital Adequacy of Banks and Savings Banks (Official Gazette of the Republic of Slovenia, No. 24/02) was promulgated in March 2002. The provisions laid down in the “old” Decree on Capital Adequacy of Banks and Savings Banks (Official Gazette of the Republic of Slovenia, No. 16/01, 82/01 and 103/01) from March 2001 had to be updated for a number of reasons. Below are some of them:

1. The wording of the Regulation has been aligned to the provisions laid down in the new Slovenian Accounting Standards and the amended Companies Act particularly concerning provisions in relation to the calculation of capital;
2. Due to the harmonisation with Directive CAD II (98/31/EEC) in the new Regulation on Capital Adequacy of Banks and Savings Banks a new section has been added referring to the use of internal models for the calculation of capital requirements for foreign exchange and market risks. The possibility to use internal models to calculate capital requirements is subject to a prior approval of the Bank of Slovenia and for the time being, the banks may only opt for it in the area of foreign exchange risk. Besides the manner for the calculation of capital requirements for market risks on the basis of models, the Regulation on Capital Adequacy of Banks and Savings Banks prescribes a number of criteria to be fulfilled if the supervisory authority is to grant a formal approval to the bank to use the internal model in question;
3. A new definition is in place as regards two possible ways to calculate capital requirements related to options whose application depends on the manner, kind and volume of option-related operations the bank handles;
4. The modified Regulation on Capital Adequacy of Banks and Savings Banks specifies the method of calculating capital requirements for credit, foreign exchange and market risks on a consolidated basis.

The moratorium for the implementation of the section of the Regulation on Capital Adequacy of Banks and Savings Banks that refers to market risks is scheduled to expire on 31 December 2002. Nevertheless, the banks are to report to the Bank of Slovenia by sending trial returns showing the volume of their trading operations i.e. on the calculated capital requirements for market risks as at the end of September 2002.

After 1995, capital adequacy ratio of Slovenian banks declined...

The capital adequacy ratio achieved by the banks in Slovenia was growing until 1995 spurred by the requirements of the Bank of Slovenia forcing the banks to maintain more capital in order to qualify for authorisations whose scope was pegged to the amount of capital. After 1995, when the capital adequacy ratio of **banks** hit its record with 21.5 per cent, the trend was reversed. The downward trend continued even after the promulgation of the Decree on the Calculation of Capital, Capital Requirements and Capital Adequacy Ratio of Banks and Savings Banks in May 1999, which introduced some changes to the calculation of capital. Supplementary capital did not include provisions made for claims classified in the A category, profit for the current financial year (up to the amount of 50 per cent after the deduction of taxes and other levies) was included in the base capital only if a certified auditor confirmed the amount of profit, and the entire item - intangible long-term assets - was deducted from capital. There were some changes also to risk-adjusted assets and they mostly tightened the conditions for weighting of exposures to other banks, the inclusion of derivative financial instruments, and stricter weighting of assets secured by pledged assets (lower weighting only for real property pledged as collateral).

In accordance with the Banking Act and the Decree on the Calculation of Capital, Capital Requirements and Capital Adequacy Ratio of Banks and Savings Banks adopted in May 1999, which introduced into the calculation of capital adequacy ratio other risk-adjusted items, the banks and savings banks were obliged to report for the first time as at 30 June 2000 on items adjusted to foreign exchange risk.

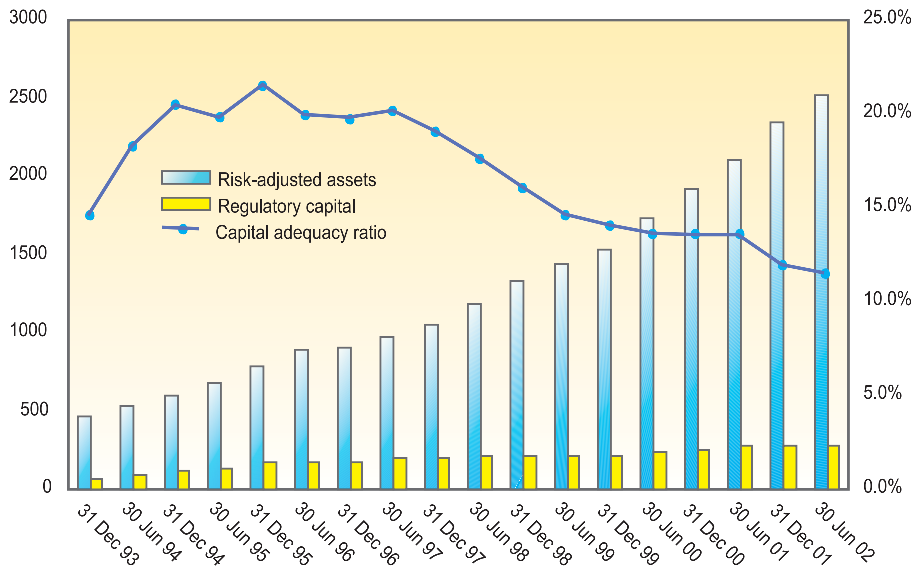
... and landed at 11.4% as of 30 June 2002.

As at 31 December 2000 the banks averaged capital adequacy ratio of 13.5 per cent, as at 31 December 2001 this figure declined to 11.9 per cent, and as at 30 June 2002 it landed at 11.4 per cent.

Capital reduced by certain deductible items and exceeded balances in capital of non-financial institutions as at 31 December 2001 rose by 7.7 per cent in nominal terms with respect to 31 December 2000, risk-adjusted assets and assets adjusted to foreign exchange risk for the reporting period increased by 21.6 per cent.

Capital, reduced by certain deductible items and exceeded balances in capital of non-financial institutions as at 31 December 2001 was 279.7 billion tolars, risk-adjusted assets and assets adjusted for foreign exchange risk pencilled in 2,342 billion tolars.

Figure 6: Movements in risk-adjusted assets and capital (in billions of tolars) and capital adequacy ratios (in %)



Source: Bank of Slovenia

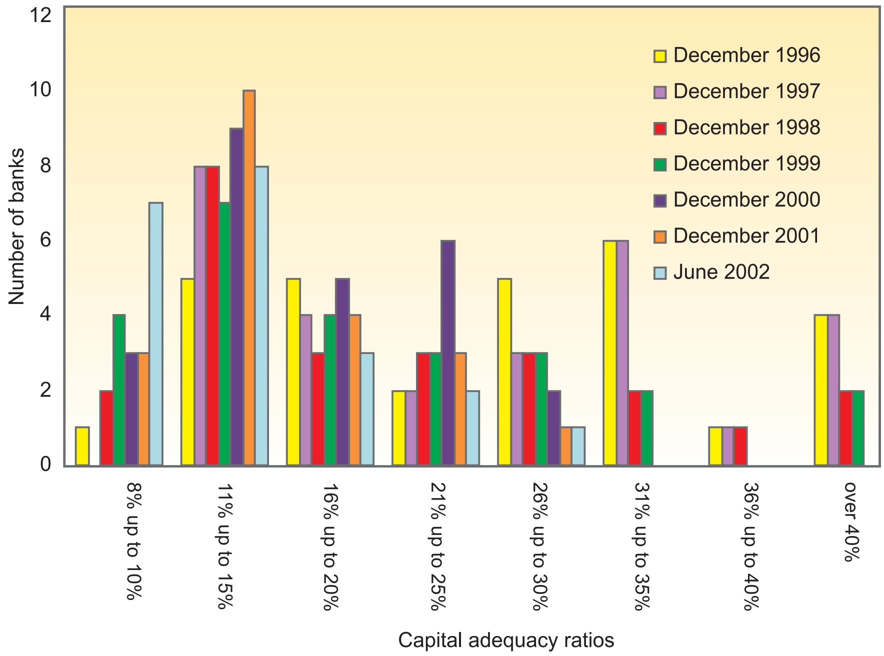
The capital adequacy ratio differs considerably from one bank to another. At the end of June 2002, the highest capital adequacy ratio posted by a bank was 26.8 per cent, and the lowest one was 8.4 per cent.

Most banks maintain capital adequacy ratio below 15%.

By dividing banks in groups according to their capital adequacy ratio since 1996 one can observe the trend of rising number of banks in two groups where the capital adequacy ratio was the lowest. At the end of 2001 three banks had the capital adequacy ratio below 10 per cent, at the end of June 2002 there were 7 banks in this bracket.

Savings banks posted on average even lower capital adequacy ratios than the banks. As at 31 December 2001, the capital adequacy ratio on average was 11.1 per cent, which is by 0.2 percentage point less than at the end of 2000.

Figure 7: Classification of banks by capital adequacy ratio[10]



Source: Bank of Slovenia

3.4. Liquidity risk

Since liquidity is seen as a vital factor for banks, banks and have to ensure and maintain adequate liquidity and focus on management of assets and liabilities.

In accordance with Article 84 of the Banking Act, each bank is responsible for safeguarding its liquidity and manage its assets and liabilities so as to be able at any and all times to meet its liabilities at maturity. The Bank of Slovenia monitors liquidity of banks on the basis of statutory returns concerning liquidity ratios, planned tolar liquidity flows for the current and the next day, and concentration of depositors.

Planning and reporting of banks and savings banks concerning exposures to liquidity risk

By the end of June 2001, the banks and savings banks in accordance with the Decree on the Required Adjustments of the Maturity Structure between Assets and Liabilities (Official Gazette of the Republic of Slovenia, No. 40/99), which prescribed the ratio

10 When cmparing the number of banks in individual groups over the last few years, one should keep in mind that the total number of banks has been fluctuating. As at 31 December 2001, 21 banks were included.

Source: Bank of Slovenia

between assets and liabilities the banks have in bands[11], and were supposed to have as much assets as they had liabilities in the particular band.

As from 1 July 2001, the banks have to abide by the new regulation - the Decree on the Tolar Maturity Ladder (Official Gazette of the Republic of Slovenia, No. 54/01) where some changes in relation to liquidity ratios were introduced. The modifications to the Decree (Regulation) are listed below:

In July 2001, the Decree on the Tolar Maturity Ladder came into force.

- The Decree specified two instead of three bands with residual maturity of up 30 and up to 180 days
- All claims denominated in foreign currency except for the Bank of Slovenia bills denominated in foreign currency were removed from assets
- As regards reporting requirement, the banks had to report on their average liquidity ratios on a monthly basis
- Liabilities to the Bank of Slovenia were added to the item carrying deposits from banks and savings banks, whereas on the assets side the bank could post the uncommitted (lien-free) amount of claims on the Bank of Slovenia
- The banks could not include in its assets the funds committed under a legally binding obligation that in the case of liquidity problems may be pledged to borrow funds within the framework of its banking group.

At the end of September 2000, the Decree on Foreign Exchange Maturity Ladder was promulgated (and amended in June 2001) (Official Gazette of the Republic of Slovenia, Nos. 87/00 and 54/01). The Decree elaborated upon reporting requirements in place for banks concerning matching assets in foreign currency with liabilities in foreign currency on the basis of residual maturity. The banks were asked to report on foreign exchange liquidity in two bands based on residual maturity (first band: between 0 and 30 days and the second band: between 0 and 180 days). Irrespective of residual maturity, the first band contains uncommitted amount of investments in foreign debt securities with high rating, in Eurobonds of the Republic of Slovenia and in the Bank of Slovenia bills denominated in foreign currency. Out of the off-balance sheet items, only futures contracts, future portion of SWAP agreements[12], agreements to lend - credit lines, and the undrawn portion of agreements to lend and under contingent liabilities open uncovered letters of credit are deemed eligible. The banks were obliged to report to the Bank of Slovenia on a monthly basis on their foreign exchange liquidity. The prescribed foreign exchange liquidity ratio (the coverage of foreign exchange liabilities with foreign exchange assets), and it had to be at least 1 in both bands. Therefore, the banks had to be compliant with the first band as from 1 July 2001. The banks were granted a transitional period until 1 January 2002 to be compliant with with the second band, even though they were not allowed to reduce the ratio during the transitional period.

As from 1 January 2002, the banks are obliged to comply with the provisions of two new regulations that address liquidity: the Decree on the Narrowest Liquidity Range Which the Bank Shall Have to Ensure (Official Gazette of the Republic of Slovenia, Nos. 82/01 and 108/01) and the Decree on Daily Planning of Tolar Liquidity and Monitoring of Depositors Concentration (Official Gazette of the Republic of Slovenia, No. 82/01). The Decree on the Narrowest Liquidity Range Which the Bank Shall Have to Ensure superseded the Decree on Foreign Exchange Maturity Ladder and the Decree on Tolar Maturity Ladder.

As of 1 January 2002, two new regulations governing liquidity became effective.

The Decree on the Narrowest Liquidity Range Which the Bank Shall Have to Ensure provides a framework for uniform balancing of tolar and foreign exchange liquidity. As they did in the past, the banks must enter in their returns on liquidity ratios the assets and liabilities[13] by observing the criterion of residual maturity. The banks calculate

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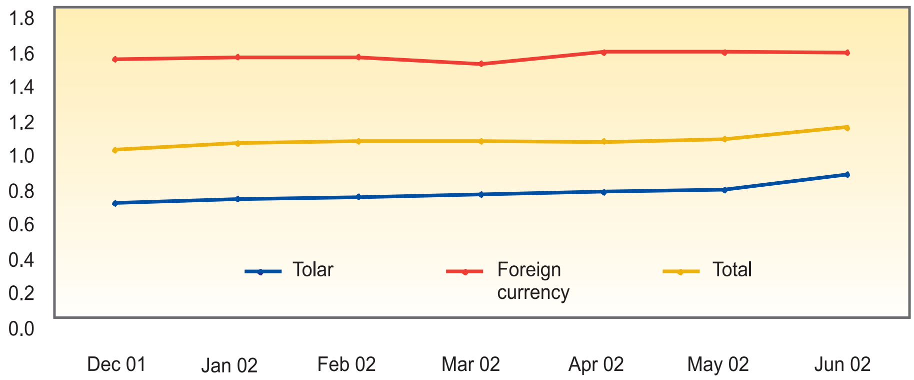
11 The Decree introduced the first, the second and the third band of assets and liabilities classified in relation to maturity.

12 SWAP- outright purchase (or sale) of a given currency and its simultaneous future sale (or purchase). In a SWAP transaction, foreign exchange is transferred from the seller’s account to the account of the buyer.

13 The banks monitor their on-balance sheet assets and liabilities in a certain percentage depending on the nature of exposure also their off-balance sheet items in terms of their residual maturity.

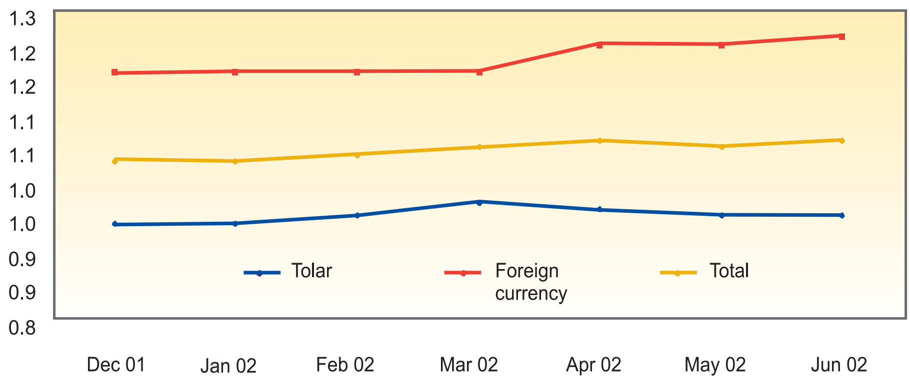
liquidity ratios in two bands (the first band from 0 to 30 days and other bands from 0 to 180 days), separately for the portion denominated in foreign currency and the tolar-denominated portion. The liquidity ratio for a particular band separately for the portion denominated in foreign currency and the tolar portion shall be at least 1[14] and the banks must meet this requirement no later than as at 1 July 2002. During the transitional period from 1 January 2002 to 1 July 2002, the banks had to submit statutory returns only for the last calendar day of the reporting month. As of 1 July 2002, the banks must calculate on a daily basis liquidity ratios and reported to the Bank of Slovenia for the preceding working day. If the bank as at 31 December 2001 failed to reach the liquidity ratio for the relative band, it has to comply gradually no later than on 30 June 2002. By that date it is not to impair the liquidity ratio achieved up to then[15].

Figure 8: Liquidity ratios in the first band during the transitional period between 31 December 2001 and 30 June 2002



Source: Bank of Slovenia

Figure 9: Liquidity ratios in the second band during the transitional period between 31 December 2001 and 30 June 2002



Source: Bank of Slovenia

14 Regardless of the provision, the Bank of Slovenia may pursuant to the Agreement on the Participation of Banks and the Bank of Slovenia, for the purpose of interventions in the foreign exchange market, enter into a binding agreement with the contracting banks to maintain liquidity ratios for the combined tolar portion and the portion in foreign currency within the same band.

15 The banks signatories of the Agreement with the Bank of Slovenia, which allows them to post the combined ratio for the tolar-denominated portion and the foreign exchange portion, this obligation refers to the combined ratio and not to individual ratios for the foreign exchange and the tolar portion. The Agreement has been signed by 20 banks.

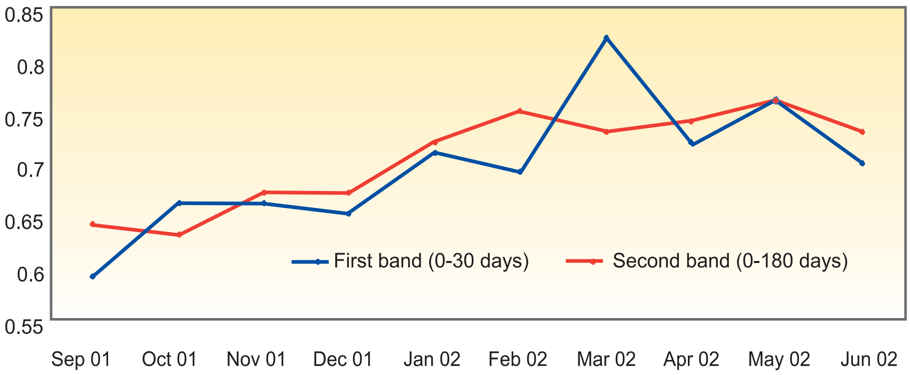
Defined as the ratio between assets and liabilities, liquidity ratio is to be maintained by complying with the requirements specified in the Regulation, *viz.*:

- The banks may carry on the assets side only the claims classified in group A and group B
- Most liquid assets[16] may be classified in both bands of the maturity ladder irrespective of their residual maturity
- The banks in the second band in the tolar-denominated section (and consequently also in the common ratio for the second band) may include assets classified in the group A, irrespective of their maturity but only up to the amount of subscribed bills issued by the Bank of Slovenia and denominated in foreign currency
- The banks are obliged to maintain 80 per cent of foreign exchange assets with maturity of up to 180 days in the form of most liquid assets, of which they are to keep at least 45 per cent in bills issued by the Bank of Slovenia in foreign currency (it prescribes the volume of liquid assets in foreign currency – former foreign exchange minimum).

Savings banks comply with the provisions of the Decree on the Tolar Maturity Ladder for Savings Banks.

As of 1 September 2001, the new Decree on Tolar Maturity Ladder of Savings Banks is in force. The Decree on Tolar Maturity Ladder of Savings Banks (Official Gazette of the Republic of Slovenia, No. 62/01), which superseded the Decree on the Required Adjustments of the Maturity Structure between Assets and Liabilities prescribes two bands of assets and liabilities[17] with defined maturities[18]. The liquidity ratio for an individual band shall be at least 0.7, the savings banks are obliged to calculate them on a daily basis and report on a monthly basis to the Bank of Slovenia on average monthly liquidity ratios[19]. The savings banks, which as at the day the Decree on Tolar Maturity Ladder of Savings Banks came into force did not comply with the prescribed ratio for an individual band must comply no later than 31 December 2002. During this time, it may not deteriorate the ratio already achieved for an individual band as at 30 September 2001.

Figure 10: Liquidity ratios posted by savings banks



Source: Bank of Slovenia

16 Foreign debt and equity securities of appropriate rating, debt securities of Republic of Slovenia and the Bank of Slovenia, as well as other eligible securities the banks may pledge with the Bank of Slovenia when they need liquid assets.

17 Assets as defined under the Regulation are assets denominated in tolars and cash on hand in foreign currency; liabilities are deemed to refer to liabilities denominated in tolars.

18 Until 30 June 2002, the savings banks applied residual maturity estimated in accordance with the Instructions for Drawing Up the Report on Tolar Liquidity Ratios of Tolar Maturity Ladder.

19 Until June 2002, the savings banks calculated and reported to the Bank of Slovenia their liquidity ratios as at the last day of the reporting month.

Since September 2001, savings banks have to plan inflows and outflows in tolars on a daily basis and report on major depositors.

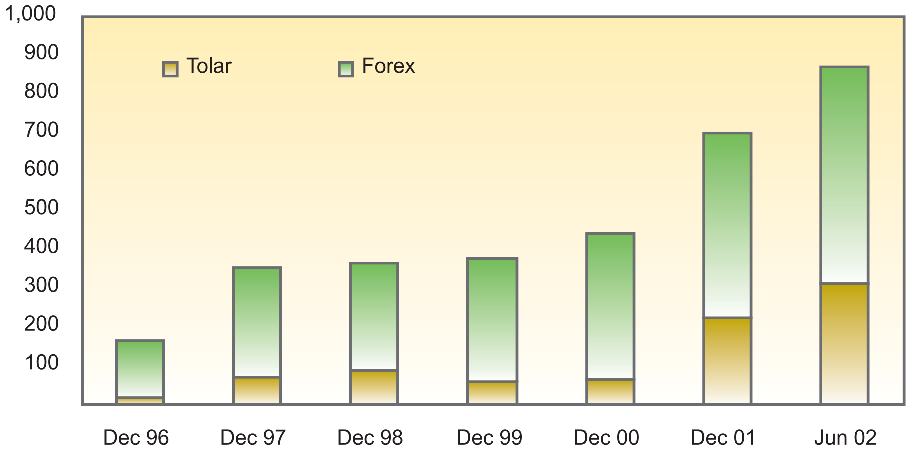
In accordance with the Decree on Tolar Maturity Ladder of Savings Banks, the savings banks are obliged as from September 2001 to plan their tolar inflows and outflows on a daily basis. The planning refers both to known and as well as to potential and expected flows, which may affect the capability of the savings bank to meet currently its contractual liabilities to customers as well as other liabilities, inseparably connected with the operations carried out by savings banks. When planning tolar flows, the savings banks shall subscribe to the principle of prudential behaviour, which means that it may include under its inflows, only those receivables most likely to be received upon maturity. Likewise, it is to include under its outflows all liabilities that fall due on a certain date.

Furthermore, from September 2001 onward, the savings banks are to report on their largest depositors as at the last day of the reporting month, since dispersion of tolar-denominated deposits by source and maturity is an important factor of liquidity risk management.

Secondary liquidity

By definition, secondary liquidity is composed of investments in short-term securities issued by the Bank of Slovenia and the Republic of Slovenia denominated in local and foreign currency; hence they constitute a bank's liquidity reserve. These investments are used as collateral for loans of the Bank of Slovenia in case there is a need to bridge liquidity problems.

Figure 11: Secondary liquidity in banks (in billions of tolars)



Source: Bank of Slovenia

Secondary liquidity is increasing.

Secondary liquidity in the banks has been increasing and as at 30 June 2002 by posting 871.8 billion tolars secondary liquidity reached a record high level. In comparison with 31 December 2001 secondary liquidity rose by 40.7 per cent in nominal terms. The above Figure shows that the banks had the lowest secondary liquidity at the end of 1996 (163.8 billion tolars). The situation improved in 1997 when secondary liquidity started to grow and at the end of December 1999 it was hardly changed. Starting with 2000 growth resumed. Investments in foreign exchange securities prevail. In 2001 and the first six months of 2002 investments in securities denominated in tolars bounced back.

The Slovenian savings banks, which in accordance with the Banking Act may take up and pursue banking and other financial business only in tolars, maintain their secondary liquidity in the forms of Treasury bills and the bills issued by the Bank of Slovenia denominated in tolars. Secondary liquidity of savings banks posted as at 30 June 2002 amounted to 920.3 million tolars.

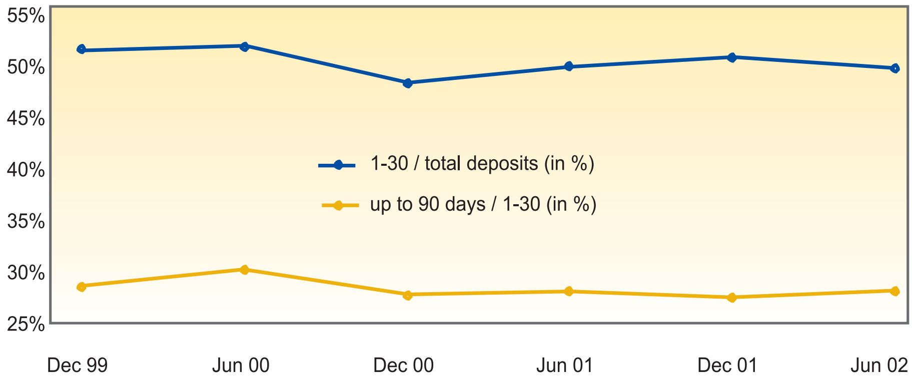
Concentration of depositors

A significant element of liquidity management is to ensure dispersions of deposits placed with the respective bank by individual depositors, types of deposits, markets, maturity dates, etc. The Bank of Slovenia monitors on the basis of monthly statutory returns of banks and savings banks movements in wholesale deposits from thirty largest depositors and their share in overall deposits of the banks i.e. savings banks, interest rates paid and structure of residual maturity of those deposits.

Banks still depend rather heavily on a handful of large depositors.

The concentration of deposits by individual depositors differs considerably between banks and in the case of smaller banks is as a rule higher than in large banks. The share of the largest thirty depositors in overall deposits[20] of the entire banking system (excluding individuals) was 50 per cent as at 30 June 2002 and was by 1 percentage point lower than at the end of 2001 when this figure was 51 per cent i.e. it was by 1.5 percentage points higher than at the end of 2000. The banks are still rather dependent on large depositors and a high degree of dependence on them increases liquidity risk. Since deposits with maturity between 91 days and one year and long-term deposits placed by the non-bank sector were rising vigorously, the share of deposits with residual maturity of up to 90 days in the structure of deposits from the thirty largest depositors declined in 2001, and it remained at approximately the same level also in the first half of 2002.

Figure 12: The share of deposits from 30 largest depositors in aggregate deposits with residual maturity of up to 90 days in deposits largest 30 depositors (in %)



Source: Bank of Slovenia

As from July 2001 onward, the banks are obliged to report in addition to thirty largest depositors about all other depositors whose cumulative deposits exceed 200 million tolars.

The concentration of thirty largest depositors of the savings banks is relatively high and at the end of June 2002 pencilled in 78.2 per cent. The percentage of deposits from thirty largest depositors with maturity of up to 90 days rose and notched 41.1 per cent.

Meeting mandatory reserves and foreign exchange minimum

Mandatory reserve

In the first half of 2002, all banks and savings banks complied with the mandatory reserve requirement.

In the course of 2001, four banks failed to meet the mandatory reserve requirement (January: two banks, February: one bank, March: one bank). During the same period all savings banks complied with the mandatory reserve requirement with the exception of six savings and loan undertakings (January: three, February: two, November: one).

20 Deposit shall mean deposit as defined in the Instructions for Reporting on Largest Depositors.

During the first six months of 2002, all banks and savings banks, including savings and loan undertakings met the mandatory reserve requirement.

The percentages referring to compliance with the mandatory reserve requirement were as follows:

in %

Credit institution:	**2001**	**1 January – 30 June 2002**
Banks	102.4	101.4
Savings banks	109.1	119.2
Savings and loan undertakings	118.6	114.6

Excessive reserves carried in 2001 for banks and savings banks, including savings and loan undertakings stood at 2.8 per cent, in the first half 2002 this percentage was down to 1.8 per cent.

Foreign exchange minimum

Throughout 2001, the foreign exchange minimum was growing and as at 31 December 2001 amounted to 697.9 billion tolars. Overshooting the limits in 2001 fluctuated and as at 31 December 2001 notched 182 billion tolars i.e. 26.1 per cent. The last return on compliance with foreign exchange minimum submitted by the banks for the January 2002 and the first half of February 2002 (until 14 February 2002)[21] was 739.4 billion tolars, excesses (amounts above the limits) as at 14 February 2002 totalled 142.8 billion tolars i.e. 19.3 per cent.

As at 30 June 2002, on-balance sheet liabilities denominated in foreign currency in the second band (0-180 days) prescribed under point 9 of the Decree on the Narrowest Liquidity Range Which the Bank Shall Have to Ensure and replaced foreign exchange minimum totalled 1,034.4 billion tolars. The banks are required under the Decree on the Narrowest Liquidity Range Which the Bank Shall Have to Ensure maintain on a daily basis the prescribed high-quality liquid investments in foreign currency in the second band in the amount of at least 80 per cent of on-balance sheet liabilities in foreign currency in the second band. As at 30 June 2002, on-balance sheet liabilities denominated in foreign currency in the second band amounted to 81.8 billion tolars.

The Decree on the Mismatch between Assets and Liabilities of Banks in Foreign Currency became null and void as of 30 June 2002.

The Decree on the Mismatch between Assets and Liabilities of Banks in Foreign Currency (Open Foreign Currency Position) (Official Gazette of the Republic of Slovenia, No. 37/99) stipulated that a long or a short foreign exchange position on a daily basis shall not exceed 20 per cent of the bank's own funds. Furthermore, the Decree prescribed that the average monthly open foreign exchange position shall not exceed 10 per cent of the bank's own funds. The Decree on the Mismatch between Assets and Liabilities of Banks in Foreign Currency became null and void as of 30 June 2002.

Tolar interest rates on loans to and deposits from the non-bank sector

There is a close relationship between the movements in accrued[22] interest rates for the non-bank sector and the movements in base interest rate. After the base interest rates

[21] The Decree on Meeting the Minimum Foreign Exchange Amount became null and void when the provision laid down in point 9 of the Decree on the Narrowest Liquidity Range Which the Bank Shall Have to Ensure (Official Gazette of the Republic of Slovenia, Nos. 82/01, 108/01 and 28/02) came into force and namely as of 15 February 2002. Accordingly, the banks had to be compliant with the prescribed foreign exchange minimum for the last time as at 14 February 2002.

[22] Interest rates are computed from interest and revaluation income/expense and average balance of assets/liabilities for the non-bank sector on a quarterly basis (hereinafter: accrued interest rate).

for the last quarter of 2001 plunged[23] , there was a period when the base interest rate during the first and the second quarter 2002 increased. Despite strengthening, accrued interest rates on loans and deposits in 2002 have remained below the figures achieved a year earlier.

From 1 July 2002 onward, base interest rate is not applicable on assets and liabilities denominated in domestic currency with maturity of up to 1 year. In other words, assets and liabilities are not revalued. It is worth noting that until that date, a large portion of deposits from the non-bank sector was revalued (42.5 per cent of deposits placed for more than 30 days to 1 year and 23.2 per cent of long-term deposits, that is 65.7 per cent of deposits from the non-bank sector[4]) compared to the revalued portion of loans to the non-bank sector that was considerably higher (short-term loans 39.1 per cent, long-term loans 50.9 per cent - in total 90 per cent[5]). After abolishing revaluation for assets and liabilities with maturity of up to 1 year, loans to the non-bank sector have become more sensitive to changes in the base interest rate, since the bulk of loans still revalued (estimated 50.9 per cent) is still higher than the share of deposits from the non-bank sector (estimated 23.2 per cent).

Table 16: Tolar interest rates for the non-bank sector on loans and deposits

	I/00	II/00	III/00	IV/00	I/01	II/01	III/01	IV/01	I/02	II/02
Interest rates on loans and advances	**14.6**	**14.8**	**14.8**	**14.6**	**14.6**	**14.6**	**14.3**	**12.7**	**13.3**	**13.1**
1.1. Short-term loans and advances	13.8	14.0	13.9	14.0	13.9	14.0	13.8	12.2	12.7	12.6
1.2. Long-term loans and advances	15.2	15.3	15.3	15.0	15.1	15.0	14.6	13.1	13.7	13.4
Interest rate on deposits	**7.9**	**8.1**	**8.1**	**8.2**	**8.4**	**8.7**	**8.9**	**7.8**	**8.3**	**7.9**
2.1. Demand deposits	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.1
2.2. Short-term deposits until 30 days	4.1	4.0	4.0	4.3	4.9	5.2	5.4	5.3	4.8	4.5
2.3. Short-term deposits over 30 days	10.8	11.1	11.1	11.2	11.2	11.7	11.9	10.2	10.7	10.2
2.4. Long-term deposits	13.8	14.3	14.1	13.6	13.4	13.6	13.6	11.8	12.5	12.0
Interest rate spread	**6.7**	**6.7**	**6.7**	**6.4**	**6.2**	**5.9**	**5.4**	**4.9**	**5.0**	**5.2**

Source: Bank of Slovenia

In 2001, interest rates on deposits were rising and interest rates on loans were falling.

During 2001, the interest rates the banks in Slovenia paid on deposits enjoyed a general upward trend compared lending interest rates, which decreased. One of the features of the first half of 2002 is a fall in the declared interest rates on loans and deposits, although interest rates paid on deposits have been falling faster than lending interest rates. The impact of these movements has spilled over to the accrued interest rates.

Consequently, during the first three-quarters of 2001, the effect of the declared deposit interest rates was seen in higher accrued deposit interest rates posted by the banks for January – September 2001. Accrued deposit interest rates rose in the short-term segment (accrued interest rates on deposits repayable within 30 days and slightly less in the case of deposits repayable after 30 days), while accrued interest rates on long-term deposits during the same period did not experience major changes. During the fourth quarter of 2002, average accrued deposit interest rates declined affected by a considerable fall in the base interest rate and despite more vigorous growth in household deposits with shorter agreed maturities.

23 As an illustration of the base interest rate movements for 1st quarter 2001 8.8 per cent, 2nd quarter 9.1 per cent, 3rd quarter 9 per cent, 4th quarter 7.3 per cent, 1st quarter 2002 7.9 per cent, 2nd quarter 7.8 per cent.

24 Interest on the remaining part consists of the nominal interest rate (31.7 per cent); the smaller part refers to foreign currency clause (2.6 per cent).

25 The remaining portion of loans to the non-bank sector denominated in tolars shall be valued by applying the foreign currency clause (7.3 per cent); nominal interest rates are seldom applied (2.7 per cent).

At the end of the first six months of 2002, the interest rate paid on deposit do not diverge significantly from the interest rates paid at the end of 2001 with the exception of a fall in interest rates paid on short-term deposits placed for up to 30 days and a slight increase in interest rates paid on long-term deposits. During the first six months of 2002, the banks have improved their maturity structure of deposits and namely diminished the share of deposits of up to 30 days and boosted the share of deposits with maturity between 90 days and 1 year, which led to higher accrued/calculated interest rates on long-term deposits and lower accrued/computed interest rates on short-term deposits.

During 2001, there was a downward trend in declared lending interest rates reflected in a fall in average interest rates charged on loans and advances, the downward trend has continued in 2002. Slightly higher accrued/calculated lending interest rate during the first and the second quarter of 2002 are the result of higher revaluation income, as opposed to the growth in loans and advances to the non-bank sector over the period in question that lost momentum.

Interest spread expressed as the difference between lending interest rate and deposit interest rate narrowed in 2001 due to a rise in deposit interest rates and falling lending interest rates. Thinner spread affected the short-term segment more severely than the long-term segment, mostly due to considerable reduction in lending interest rates in comparison with the reduction in deposit interest rates. In 2002, interest spread has slightly risen due to a faster decline in interest rates paid on deposits.

Interest margin was down in 2001 and interest spread was getting thinner.

Net interest margin expressed as a ratio between net interest and average gross interest-bearing assets has been decreasing since 1997 (excluding the year 2000), and in 2001 declined by 1 percentage point to 3.6 per cent. If the figures posted by the bank, which in 2001 operated with a high loss, are carved out, net interest margin of the banking system in 2001 was 3.7 per cent. Individual banks posted net interest margins in a vast span in 2001 ranging between 1.1 per cent and 6.9 per cent.

3.5. Operational risk

Operational risk has come to the forefront lately.

Among the efforts focused on encouraging safe and sound banking practices, the treatment of operational risk has been one of the top priorities for regulators and supervisors over the past few years, as well as for credit institutions. Operational risk is generally regarded as one of the most significant banking risks. The standard industry definition describes operational risks as the risk of loss resulting from fraud, ATMs breakdown, natural disasters, human errors, inadequate or failed information systems, etc. It is generally associated with flawed functioning of internal controls and disturbances in corporate governance. A key role in addressing operational risk management is to be played by the bank's directors and senior officers and its internal controls system. Operational risk often goes hand in hand with other risks such as market and credit risk. Most banks have started setting aside capital for operational risk not long ago and there are no formal risk management systems in place. Since there are no methodologies for calculating operational risk, we can talk about simple experimental methods. The factors determining operational risk are of internal nature (quality of internal audit department, scope of operations, number of transactions, error rate, etc.), where the correlation between the factors and degree of exposure to risk remains largely unknown. Consequently, measurement of risks is hampered. There is little doubt as to the value of an effective internal controls system and internal audit department as the primary contol system, although there are other forms such as system constraints on the basis of risk factors, collateral, earmarking provisions, etc. The Banking Act addresses the area of operational risk management in Article 26, which defines the duties of the members of management board. Supervisory authorities have still not developed more sensitive methodologies to measure risk since quantitative definition remains an open issue. Changes are expected shortly in this area since the Basel Committee on Banking Supervision has been working on defining the operational risk charge under new Capital Accord. Banking Supervision Department is committed to paying due attention to this kind of risk both through on-site examinations and by drawing up relative regulations.

3.6. Risks encountered in the automated information systems environment

Risks associated with the use and development of information technology

The Banking Supervision Department has been fully engaged in the activities aimed at ascertaining whether the banks are capable of managing operational risk and other connected reputational risks, the risk of losing a market share and other traditional banking risks.

In relation to operational risks associated with the use of information technology, credit institutions have been exposed mostly to the following:

- the risk threatening security and integrity of data
- the risk of ensuring the adequate degree of availability (24/7, response time)
- the risk of reengineering of information systems (late delivery, quality)
- the risk arising from information infrastructure (lack of new knowledge)
- the risk arising from outsourcing (engaging outcontracted experts – development of software applications, Internet suppliers, SWIFT operations, outsourcing the entire implementation of particular support functions)
- the risk arising from a failure to audit and control new areas (new area, operating frequency)
- the risk inherent in inadequate quality management (inadequate testing)
- the risk arising from inadequate change control (planning, monitoring, acting)

The consequences of inadequate risk management and inadequate internal controls in place have reflected on individual cases where information systems were misused. There have been delays in the implementation of more appropriate solutions, data processing has been inaccurate and late, there have been occasional interruptions and continuity of business processes has been difficult to ensure, pipelines for commun cating events has been clogged and the degree of information systems security has been impaired.

Alongside the benefits associated with new market channels (electronic operations) clearly visible in faster and more efficient transactions concluded between customers and banks. The fact that banks operate in a more open environment increases the transparency of the banking information system. Customers become aware of even a minor case of instability in the information system sooner. According to the findings made so far, the fact that the Slovenian banks operate in an open environment has not increased the degree of bank vulnerability by invading the information systems and abuse by unauthorised customers.

Identification, monitoring and analysing of risks

Banks must abide by the Slovenian standard PSIST BS 7799.

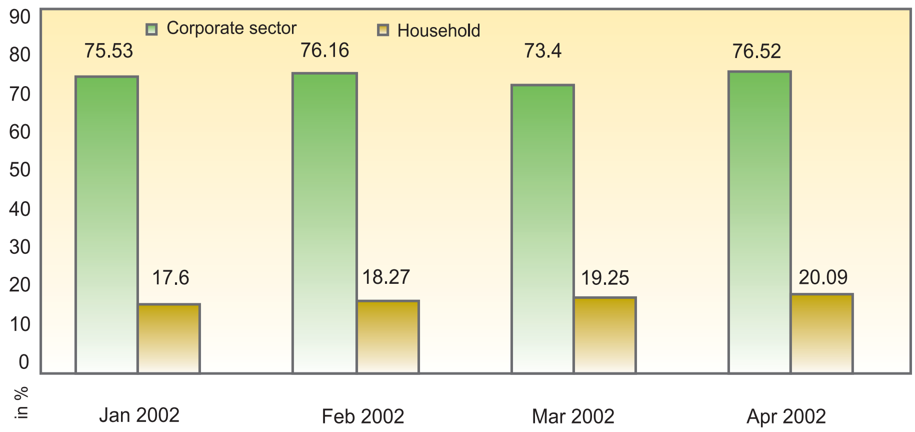
The supervisory function including compilation, analyses, monitoring of data and ongoing on-site examinations has been extended by adding random supervisory visits with a focus on the segments judged by the Bank of Slovenia to be of vital supervisory concern (payment transactions, new reporting requirements of the Bank of Slovenia, the status of the projects renewal of information systems). The regular on-site examinations were planned and focused primarily on verifying whether the Decree issued by the Bank of Slovenia with regard to the security of the information system is observed by the banks and whether the mandatory standard PSIST BS7799 (ISO17799/ BS7799) is duly observed.

In order to ensure a more appropriate support for monitoring and analysing the development of the IT support to banking services and their impact on a potential need to tighten supervision and surveillance of banks, an analysis of operations of the Slovenian banks using new electronic channels was made in May 2002 with the aim to lay the foundations for more sophisticated monitoring of the IT area (Internet and Other Electronic Connections).

E-banking is becoming highly important in payment services for legal persons.

The results of the analysis indicate that there have been some changes in the structure of market channels by using the e-market tools in use (e-operations) with the most prominent changes being made in the relation to payment transactions in the Corporate Sector. In April 2002, the percentage of electronic data transmission in the Corporate Sector was already over 76 per cent, while the percentage of the tools available through electronic banking to individual users was considerably lower (20 per cent). It is reasonable to expect that by setting up a single collection centre, the pace of introducing changes in this segment will gain momentum.

Figure 13: The share of electronic operations in the first quarter of 2002

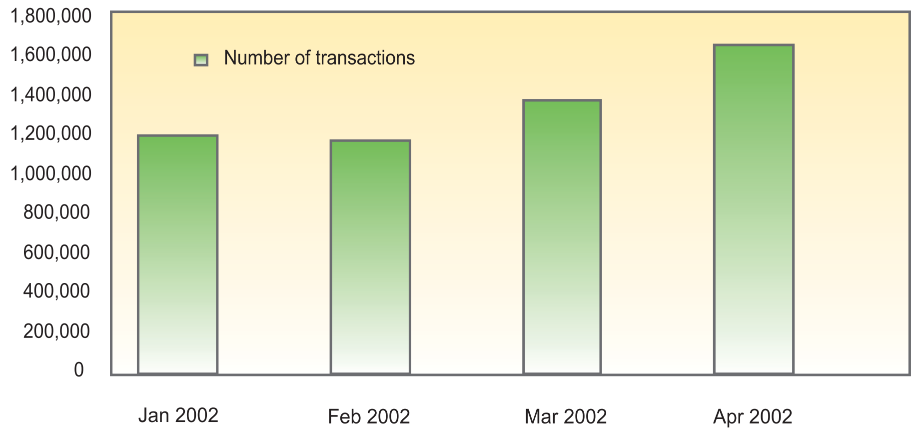


Source: Bank of Slovenia

The volume of transactions effected through E-banking is rising.

The volume of electronic transactions executed in the Corporate Sector in Slovenia has risen in the first quarter by 38 per cent as the result of livelier migration of accounts to commercial banks in the month of April 2002. The trend continued until the completion of the payment transaction reform in July 2002.

Figure 14: Upward trend in electronic operations in the first quarter of 2002



Source: Bank of Slovenia

Having carried out more random reviews, we came to the conclusion that most directors and senior officers of the Slovenian banks are aware of risks, although it appears that the support for the adoption and implementation of adequate security policy has to be strengthened. Overall, findings show that the banks relied heavily on the same supplier/provider of the solution (development of software, Internet supplier).

Most commercial banks still fail to meet the criteria for on-going (continuing) business operations (testing stand-by facilities).

The readiness of banks to realise reporting requirements and provide support in a situation where the volume of operations increases has been assessed as a rather low risk. However, the findings concerning the renewal of information systems where in addition to stretching the statutory time frame, the fact that inadequate risk management and control in connection with such projects have been identified, is a cause for serious supervisory concerns.

Education, consulting, cooperation and exchange of professional opinions

The results of the analyses and examinations focused on electronic operations were presented at the workshop of the Basel Financial Stability Institute with the title »E-Banking, Customer Due Diligence and Corporate Governance« organised by the Bank of Slovenia in Ljubljana in June 2002.

The participants could share the Slovenian experience and learned about the legal basis for the implementation of electronic operations, as well as how methodology and standards are used for the implementation of supervision.
Payment transactions performed within the country were a show case to examine the reasons for the implementation of supervision, risks identified in the Slovenian banking industry and the recommendations made by supervisors as to how the present situation could be improved (the banks, supervisors).

Assessment of future situation and plans for the future

Internet crime makes banks increasingly vulnerable.

At the Bank of Slovenia we believe that banks will be always more vulnerable as sophisticated tools become more early available and know-how required to commit Internet crime is relatively easy to acquire. As the process of modernisation unfolds, information systems installed in banks will gain in complexity and sophistication. Further risks are likely to come from new requirements posed on banking environment (organising shared interbank connections, mass migration of data, implementation of additional control mechanisms for the prevention of money laundering, statistical monitoring, etc.)

Over the forthcoming period, efforts should focus on monitoring the process of acceptance and implementation of a security policy as well as the process of performing strategies of information systems with a special emphasis on development of e-banking and the success of reengineering of information systems.

In the supervision process of internal audit related to information systems, further attention will be paid to validating whether control procedures and practice have been duly adjusted to the new conditions of data processing (STP[26], integrated, distributed systems).

If we wolud like to reduce operational risks, we should pay more attention to the requirements demanding a higher degree of reliability and security of information systems throughout the Slovenian banking environment.

Not only banks but also other companies will be subject of scrutiny arising from interbank connections for more efficient management of payment transactions.

[26] STP-Straight Through Processing refers to the automated processing of transactions for different financial instruments from the initial request to its completion.

BANKA SLOVENIJE
BANK OF SLOVENIA

III. DEVELOPMENTS RELATED TO BANKING LEGISLATION, PAYMENT SYSTEMS REFORM AND ORGANISATION OF BANKING SUPERVISION

1. OVERVIEW OF MODIFICATIONS AND AMENDMENTS TO REGULATIONS CONCERNING SUPERVISION OF BANKING OPERATIONS IN 2001 AND THE FIRST HALF OF 2002

In 2001, the Banking Supervision Department modified and amended several regulations relating to the banks and savings banks in efforts to incorporate changed to the Banking Act promulgated on 3 August 2001. The modifications and amendments to the Banking Act were described in detail in the Report on Supervision of Banking Operations in 2000 and the First Half of 2001.

In order to address the modifications to the Companies Act promulgated in 2001 and new Slovenian Accounting Standards (2001) whose implementation is mandatory as from 1 January 2002, the Bank of Slovenia drafted in the first half of 2002 new regulations for banks and savings banks.

In the first half of 2002, the Bank of Slovenia issued several new regulations.

Innovation introduced under the amended Banking Act and new Slovenian Accounting Standards influenced the changes to

- the Regulation on Books of Account and Annual Reports of Banks and Savings Banks
- the Regulation on the Classification of On-Balance Sheet Assets and Off-Balance Sheet Items of Banks and Savings Banks
- the Regulation on Establishing Specific Provisions of Banks and Savings Banks and
- the Regulation on the Minimum Scope and Content and Audit and of Auditor’s Report.

To provide for practical guidance, the Banking Supervision Department amended the instructions where the content, form, and format of reporting by banks and savings banks are thoroughly described.

New Slovenian Accounting Standards, which are based on the Companies Act, were adopted by the Expert Council of the Slovenian Institute of Auditing. Slovenian Accounting Standards have been modified along the lines of a Slovenian accounting theory and international requirements, mainly International Accounting Standards and EU Directives.

New, modern accounting standards are based on certain premises, which differ considerably from those we used to know in the past. The modern valuation method encourages and recommends and stresses mainly true and fair presentation of assets and liabilities as well as profit and loss account and cash-flow statement of a company or a bank.

An important change introduced under Slovenian Accounting Standards is the abolition of revaluation.

Modifications to financial statements

The layout of balance sheet and profit and loss account (also referred to as income statement) have broadly remained unchanged, since these two statements were aligned in1999 with the layout of the balance sheet and profit and loss statement laid down in 8^{th} EU Directive when the first Decree on Books of Account and Annual Reports was promulgated. Nevertheless, the need to make some changes to the structure and substance has been recognised and acted upon.

Balance sheet

Suspended income shall not be carried on the liabilities side of the balance sheet.

Suspended income previously carried on the liabilities side of the balance sheet have to shown now on the accounts for value adjustments of bad and doubtful assets or claims due to impairment on the assets side of the balance sheet. Consequently, the figure for banks' total assets is lower.

Investments in securities are carried according to different criteria for valuation and the purpose for which investments have been made, as investments in securities held for trading purposes or investments held to maturity, or a new additional item - investments in securities available for sale.

Whereas for loans and advances the amount of provisions made still depends on the classification in categories in accordance with the regulations of the Bank of Slovenia the investments in securities, investments in capital, investments in own shares and discounted bills of exchange are to be valued in accordance with the definitions laid down in Slovenian Accounting Standards. In other words, no provisions have to be made for these items since they are to be carried at fair or repayment value.

Among the elements of capital, capital revaluation adjustment has been replaced by general capital revaluation adjustment. There is a new item special capital revaluation adjustment for posting revaluation adjustment of receivables and payables to show their fair value in accordance with the definitions set out in Slovenian Accounting Standards.

Profit and loss account

New Slovenian Accounting Standards do not prescribe revaluation adjustment for the purpose of preserving the value of loans, receivables and payables. Under the new standards, revaluation income/expense from interest shall be posted on the accounts for interest income/expense. Foreign exchange differences are added to income/ expense from financial operations. Revaluation income from investments in capital is summed up with income from investments in capital.

The layout of profit and loss account has been modified only in the section where write-offs and specific provisions are carried, since these items are posted under the item losses arising from granted loans and claims reduced by repaid amounts. Under one item, the net amount of provisions for general banking risks is carried.

Specific provisions for investments in capital and securities are not to be made under the new Slovenian Accounting Standards, since these investments are valued in accordance with new Slovenian Accounting Standards. Expense from revaluation of this kind of investments due to their impaired value shall be carried as revaluation financial expense, which is to be included under the item expense from financial operations.

Only income accrued on non-performing assets may be suspended.

In order to enable a high degree of comparability with new Slovenian Accounting Standards, both the methodology and the criteria for the suspension of income. The profit and loss account shall post accrued and still not received income from claims classified in the A and B group, provided that the claim has not been classified in the group B on the basis of collateral provided by pledging real property. Consequently, only income accrued on non-performing claims classified in the C, D and E category is suspended.

The layout of profit and loss account differs from the layout laid down in Slovenian Accounting Standard 31 Accounting solutions in banks and namely in items, which refer to the posting of tax on profit. Standard 31 prescribes the layout of profit and loss account that has been reconciled with the layout of the profit and loss account prescribed under the Companies Act and under the EU directives. The latter requires separate carrying of tax on profit earned from regular (ordinary) operations and tax on profit earned from extraordinary operations. Since under the effective Slovenian legislation corporate tax is levied on profit earned on both kinds of operations, it would be reasonable to keep in place the layout drawn up on the basis of effective legislation.

Cash flow statement and statement of changes in equity capital

Cash flow statement has replaced the statement of movements in financial positions and the statement of monetary flows.

The statement of cash flow is new in Slovenia. It has replaced the statement of movements in financial positions and the statement of monetary flow. Cash flow statement is a base financial statement, where true and fair presentation of changes in balances of monetary funds and their equivalent is made. The banks in Slovenia prepare the cash flow statement by applying the indirect method because a large portion of monetary funds is carried as money equivalents, although reporting accuracy of a direct method would be higher.

The statement of application of profit and coverage of loss has been replaced by a new statement of changes in equity capital, which ensures a detailed overview of individual components of capital.

Table 17: Overview of modifications and amendments to regulations issued by the Banking Supervision Department in 2001 and first half of 2002

Decree on Modifications to the Decree on the Conditions to be Met by Credit Intermediary	**February 2001**
Decree on Capital Adequacy of Banks and Savings Banks Decree on Annual Supervisory Fee, Lump Sum Supervisory Charges and Authorisation Duties	**March 2001**
Decree on Modification to the Decree on Special Liquidity Loans Granted with Participation of Banks	**May 2001**
Decree on Tolar Maturity Ladder	**June 2001**
Act on Modifications and Amendments to the Banking Act Decree on Guarantee Scheme for the Claims of Investors in Investment Firms Instructions for Reporting on Largest Depositors Instructions for Completing the Report on Tolar Liquidity Flows in Banks Instructions for Drawing Up the Report on Liquidity Ratios of Tolar Maturity Ladder Decree on Tolar Maturity Ladder of Savings Banks Decree on Modification to the Decree on the Bringing of the Operation of Savings and Loan Undertakings into Line with the Provisions of the Banking Act	**July 2001**
Decree on Modifications and Amendments to the Decree on the Bringing of the Operation of Savings and Loan Undertakings into Line with the Provisions of the Banking Act Decree on Modifications and Amendments to the Decree on Annual Supervisory Fee, Lump Sum Supervisory Charges and Authorisation Duties Decree on Modifications and Amendments to the Decree on Large Exposure of Banks and Savings Banks Decree on Modifications and Amendments to the Decree on the Implementation of Article 127 of the Banking Act Decree on Modification to the Decree on the Detailed Method for the Calculation of Liabilities, Claims and Holdings for the Purpose of Determining Net Indebtedness	**September 2001**
Decree on the Detailed Contents of the Documentation to be Submitted with the Application for an Authorisation to Perform the Function of a Member of a Bank's Management Board or Liquidator in a Bank or a Savings Bank Decree on Amendment to the Decree on Minimum Scope of Documents to be Submitted by a Foreign Bank with Application to Establish a Branch Decree on Amendment to the Decree on Minimum Requirements for Obtaining Authorisation for the Provision of Banking and Other Financial Services and Documents to be Attached to Application Decree on Daily Planning of Tolar Liquidity and Monitoring of Depositors Decree on Modification to the Decree on Capital Adequacy of Banks and Savings Banks Decree on the Narrowest Liquidity Range which the Bank Shall Have to Ensure	**October 2001**
Instructions for the Implementation of the Decree on the Narrowest Liquidity Range which the Bank Shall Have to Ensure	**November 2001**

November 2001	Decree on Modifications and Amendments to the Decree on the Bringing of the Operation of Savings and Loan Undertakings into Line with the Provisions of the Banking Act Decree on Modifications to the Decree on Tolar Maturity Ladder of Savings Banks Instructions for Drawing Up the Report on Liquidity Ratios of Tolar Maturity Ladder
December 2001	Instructions for Completing the Report on Tolar Liquidity Flows in Banks Decree on Modification to the Decree on the Classification of the On-Balance Sheet Assets and Off-Balance Sheet Items of Banks and Savings Banks Decree on Modifications and Amendments to the Decree on the Capital Adequacy of Banks and Savings Banks Decree on Modification to the Decree on the Narrowest Liquidity Range which the Bank Shall Have to Ensure
March 2002	Regulation on Books of Account and Annual Reports of Banks and Savings Banks Regulation on the Classification of On-Balance Sheet Assets and Off-Balance Sheet Items of Banks and Savings Banks Regulation on Large Exposure of Banks and Savings Banks Regulation on Establishing Specific Provisions of Banks and Savings Banks Regulation on the Minimum Scope and Content of Audit and Auditor's Report Regulation on Capital Adequacy of Banks and Savings Banks
April 2002	Instructions for Implementation of the Regulation on Books of Account and Annual Reports of Banks and Savings Banks (methodology for the preparation of financial statements) Instructions for the Implementation of the Regulation on the Classification of On-Balance Sheet Assets and Off-Balance Sheet Items and the Regulation on Establishing Specific Provisions of Banks and Savings Banks Decree on Modification of the Decree on Deposit-Guarantee Scheme Instructions for Completing the Report on Guaranteed Deposits Instructions for Calculation of Some Common Interest Rates on Deposits from Non-Bank Sector and Loans to Non-Bank Sector Instructions for Reporting on Largest Depositors
June 2002	Decree on Modification of the Regulation on Books of Account and Annual Reports of Banks and Savings Banks Modifications of the Instructions for Implementation of the Regulation on Books of Account and Annual Reports of Banks and Savings Banks (methodology for the preparation of financial statements) Instructions for Implementation of the Regulation on Books of Account and Annual Reports of Banks and Savings Banks – methodology for the calculation of ratios

2. PREPARATIONS FOR BASEL II IN SLOVENIA

Banks will have to prepare for the three pillars comprising the New Basel Capital Accord.

The New Basel Capital Accord and EU capital directives are scheduled to be in place by 2006 and are knocking on the doors of the Slovenian banks and the Bank of Slovenia as their regulatory and supervisory authority. Preparations for a three pillars Capital Accord have to start as soon as practicable and in coping with changes, banks will have to be particularly agile if they are to benefit from more favourable approaches to measurement of risks in terms of capital and a more sensitive approach offered under The New Capital Accord. Implementation of new capital rules will go hand in hand with a host of new requirements and banks will have to become familiar with these innovations in order to be able to react timely and adequately to new challenges. An important function of the Bank of Slovenia is to draft modifications to the Banking Act, related secondary legislation and practical guidelines in response to the new capital requirements. Feet dragging would mean losing competitive edge and placing the local banking industry in a position inferior to the position of other banks in the EU single market where Slovenia is expected to be a full participant by the time The New Basel Capital Accord is in place.

Banks in Slovenia are relatively well informed of the forthcoming changes.

First steps have already been taken in Slovenia to brace for »capital changes« mainly by briefing management and senior officers of local banks with the requirements to be posed under The New Basel Capital Accord. The Bank of Slovenia has polled the local banks earlier this year to find out how much is known about the pending changes to regulatory and supervisory functions in relation to capital adequacy. The poll prepared in collaboration with the Bank Association of Slovenia has given indications as to how to approach the revised capital rules and what avenues should the banks explore to be ready for their implementation. As expected, the poll shows that the Slovenian banks are reasonably well informed on regulatory developments.

Prime concerns for the local banks with regard to The New Capital Accord are to have in place adequate IT infrastructure. As opportunities expected from the new capital rules, the banks see the use of internal methods for risk management and the convergence between regulatory capital and the actual exposure of risk incurred by a particular bank. Internal rating systems in most banks still lack sophistication required if they were to be used for the calculation of capital requirements. The most common weakness identified so far is the lack of fine-tuning when it comes to sensitivity to credit risk (the number of risk categories or “risk buckets” is too small and the concentration in the top category is too high) and the time sets of data on borrowers default are too short (if any). Few banks in Slovenia use models to assess economic capital, the criteria used to measure efficiency and allocation of capital are in general broad (e.g.: Return on Equity). The results of the poll also show that the local banks are unanimous when it comes to defining a time frame for the preparations - activities aimed at adapting to the forthcoming changes should start immediately and not once The New Capital Accord is in place.

Since the poll has highlighted the need to keep the banks’ top decision-making levels informed, a presentation was organised in March 2002 for management board members and senior officers by the Bank Association of Slovenia and the Bank of Slovenia to discuss the content and importance of The New Basel Capital Accord. Backing and understanding of banks’ management are seen as key elements to a pro-active participation of banks in the project for the preparation for The New Capital Accord. How successful this implementation will be, is most likely to be one of decisive factors in the future that will determine a bank’s place in the market and even its ability to compete with foreign banks in the local market that is becoming ever more global.

3. SAVINGS AND LOAN UNDERTAKINGS

Savings and loan undertakings were established under a special law.

In accordance with Article 79 of the Law on Banks and Savings Banks (Official Gazette of the Republic of Slovenia, Nos. 1/91, 38/92 and 46/93) - the only article still in force after the Banking Act became effective, a savings and loan undertaking is a savings bank established in the manner and under the terms and conditions stipulated in a separate law. So far, savings and loan undertakings were established in the territory of the Republic of Slovenia in accordance with a special Law on Savings and Loan Undertakings first promulgated back in 1969 and superseded in 1990 by the law currently in force. No initial capital was required for the establishment of a savings and loan undertaking; conditions for operations carried out by a savings and loan undertaking were ensured by its founders. The Law on Savings and Loan Undertakings stipulates that founders are jointly and severally liable for savings deposits and all liabilities of the savings and loan undertaking in question. Only in the case where a savings and loan undertaking obtains a bank guarantee, the Republic of Slovenia guarantees on a subsidiary basis for the savings deposits covered by that guarantee.

Most savings and loan undertakings were founded within the framework of agricultural and forestry co-operatives and are members of the Association of Savings and Loan Undertakings - in terms of legal status also a savings and loan undertaking. Savings and loan undertakings - members of the Association of Savings and Loan Undertakings - are obliged to maintain a liquidity reserve with the Association in the amount of at least 5 per cent of deposits repayable on demand with the aim to ensure funds to bridge any liquidity problems on a mutual basis.
The operations of savings and loan undertakings revolve around their core function - to gather savings deposits from individuals (primarily farmers) and to reinvest funds in the sector by granting loans to their founders - co-operatives and individuals.

At the end of June 2002, there were 37 operating savings and loan undertakings in Slovenia.

At the end of June 2002, the number of operating savings and loan undertakings in Slovenia stood at 37 in line with the downward trend present since the Banking Act came into force. Statistical data show that at the end of 1999 there were 68 savings and loan undertakings in Slovenia, at the end of 2000 their count dropped to 64, at the end of 2001 it decreased to 45. The reasons for such a fall are explained in short in the section *Structure of the banking sector*. It is worth repeating the fact that the market share of this type of a credit institution is very modest and stood at a mere 1.3 per cent (in terms of total assets) as at 30 June 2002.

Interim figures (as at 30 June 2002) put aggregate total assets of the savings and loan undertakings in Slovenia at 55.8 billion tolars roughly corresponding to the size of a bank ranked among the bottom third of all banks in Slovenia.

Savings and loan undertakings have to meet the requirements under the Banking Act by 20 February 2004.

The Banking Act takes into account the specific situation concerning savings and loan undertakings, and recognises the fact that these institutions are by content of their activities credit institutions; hence they are bound to meet in the near future the requirements laid down in European directives applicable to credit institutions. In accordance with the Second Banking Directive, the Banking Act demands savings banks (therefore also savings and loan undertakings) to have minimum capital in the amount of 220 million tolars (1 million euros). During the transitional period of five years after the Banking Act entered into force (by 20 February 2004), the savings and loan undertakings must comply with the minimum capital requirement and other provisions laid down in the Banking Act, which refer to risk management and control and safe and sound operations.

Even before the Banking Act entered into force, the Bank of Slovenia monitored savings and loan undertakings for statistical and monetary policy purposes. Under the provisions of the Law on Banks and Savings Banks, these institutions were required to keep books of account in accordance with standards valid for the banking industry and comply with the mandatory reserve requirement. Since 1992, the savings and loan undertakings have been sending to the Bank of Slovenia monthly returns on accounts balances carried in their books, annual financial statements and returns referring to mandatory reserve compliance. As from the third quarter of 1994, the savings and loan undertakings report on average interest rates.

Under the Banking Act, the Bank of Slovenia is responsible for supervision of the alignment of savings and loan undertakings with the provisions laid down in the said Act. To this end, the Bank of Slovenia passed in December 1999 the Decree on the Bringing of the Operation of Savings and Loan Undertakings into Line with the Provision of the Banking Act demanding the savings and loan undertakings to harmonise gradually with the requirements applicable to credit institutions, so as to be fully compliant at the end of the five-year transitional period in 2004. Consequently, the savings and loan undertakings had to meet the requirements of the Banking Act by reaching at least a half of the prescribed minimum capital by 31 December 2001, and since then they are to strengthen it so as to dispose from 31 December 2003 onward with regulatory minimum initial capital (220 million tolars). As from that date, the savings and loan undertakings must also comply with the regulatory capital and remain within the limits of exposures to a single borrower or a group of connected persons, and observe the limits set on the sum of large exposures. The Decree also stipulates mandatory classifications of assets (claims), setting aside capital for provisions against credit and other risks, and reporting requirements.

The first requirement prescribed at the end of 1999 by the Bank of Slovenia read that the savings and loan undertakings had a period one year to decide about their future. By 29 January 2001, no savings and loan undertaking filed for liquidation. Most savings and loan undertakings decided (as already mentioned in the section elaborating upon the banking sector structure) to join the Association of Savings and Loan Undertakings or to transfer its assets and liabilities to one of the banks. The remaining savings and loan undertakings must fulfil the requirements stipulated in the Banking Act in the manner and in line with the time frame determined under the Decree on the Bringing of the Operation of Savings and Loan Undertakings into Line with the Provision of the Banking Act. The same applies to those savings and loan undertakings that may eventually opt for amalgamation with another institutions. The alignment process must continue until the institution is entered in the court register.

In contrast with the explicit mandate given to the Bank of Slovenia to take steps against delinquent savings and loan undertakings, there have been cases where a savings and loan undertaking misinterpreted the wording of the Banking Act and was under the impression that the Bank of Slovenia would take supervisory measures after the expiration of the transitional period, i.e. after February 2004. One savings and loan undertaking filed a suit in August 2001 against the Bank of Slovenia and the Supreme Court at the end of May 2002 ruled that the Bank of Slovenia is obliged to take steps against a savings and loan undertaking failing to meet the prescribed prudential requirements already in the course of the five-year transitional period.

The Bank of Slovenia has started to monitor more closely the progress savings and loan undertakings are making in efforts to become fully compliant.

In accordance with the aforementioned Decree, the savings and loan undertakings sent their first prudential returns in March 2001 as at the last day of 2000 reporting on the classification of on- and off-balance-sheet items. Other landmark events in compliance with regulatory requirements was at the end of 2000 and then in 2001 when the Bank of Slovenia performed an in-depth supervision of alignment of savings and loan undertakings with a focus on those institutions where on the basis of available data it assessed the financial position to be problematic and found it hard to believe that the savings and loan undertaking in question was capable of raising 110 million tolars in initial capital.

As at the end of 2001, eight savings and loan undertakings reached the prescribed initial capital in the amount of 110 million tolars. Nevertheless, there are no guarantees that these institutions will continue to raise capital to the benchmark of 220 million tolars by the end of 2003.

Forced liquidation of HKS GZP commenced on 27 July 2001 and it was successfully completed on 10 July 2002.

A case of a savings and loan undertaking placed under bankruptcy procedure in June 2002 is presented hereunder. The first bankruptcy procedure instigated for a savings and loan undertaking was on 13 November 2001 forcing HKS Trbovje p.o. to be wound up following the bankruptcy of its founder - a co-operative.

3.1. Bankruptcy procedure in HKS Slovenska hranilnica in posojilnica Kranj, p.o., Kranj

HKS Slovenska hranilnica in posojilnica Kranj, p. o., Kranj (hereinafter: HKS SHP) acquired the attributes of a legal person by entry into the court register on 18 January 1991 and namely on the basis of the Law on Savings and Loan Undertakings (Official Gazette of the Republic of Slovenia Nos. 14/90, 30/90). The abbreviated company name was entered into the court register as »Slovenska hranilnica in posojilnica Kranj, p.o.«. The said savings and loan undertaking was registered prior to the promulgation of the Law on Banks and Savings Banks in June 1991 prohibiting the use of the name "bank or savings bank and any derivatives from these words if the legal person has not been registered in accordance with the said law. The Companies Act also defines the use of the name of Slovenia and its derivatives in the names of corporate entities only subject to approval by the Government of the Republic of Slovenia adopted in July 1993. Therefore, the Bank of Slovenia had no legal grounds to ask the entity in question to change its registered name (firm).

The Law on Savings and Loan Undertakings did not prescribe the amount of foundation capital. HKS SHP was founded with a minimum foundation capital of 8,000 tolars as stipulated under the Companies Act adopted in 1988. The sole condition prescribed under the Law on Savings and Loan Undertakings was to have among the founders an agricultural or crafts co-operative - the condition met by HKS SHP.
The first Slovenian Law on Banks and Savings Banks from June 1991 did not enact any new requirements with regard either to status or operations of savings and loan undertakings. Henceforth, the Bank of Slovenia became responsible for supervision of banks and savings banks but not savings and loan undertakings (savings and loan undertakings had to maintain minimum liquidity reserve and submit statistical data).

In accordance with the Law on Banks and Savings Banks from June 1991, only companies authorised by the Bank of Slovenia beforehand could provide banking services. This requirement did not apply to savings and loan undertakings since they could take up the provision of banking services directly on the basis of the Law on Savings and Loan Undertakings. It was not before the promulgation of the Banking Act in February 1999 and particularly its modifications and amendments enacted in August 2001, that savings and loan undertakings were required to abide by almost the same conditions when engaging in banking and other financial services already in place for banks and savings banks. The Bank of Slovenia has adopted a stance that savings and loan undertakings must start to operate along the lines of minimum standards of safe and sound operations; hence it proposed only one year to achieve compliance and force the savings and loan undertakings to meet all regulatory requirements (by February 2000). However, in the process of the promulgation of the Banking Act, the National Assembly extended the transitional period to 5 years - until 20 February 2004.

With deposits with savings and loan undertakings being a cause of supervisory concerns, the Bank of Slovenia insisted on a mandate to take steps against a savings and loan undertaking if it does not meet during the transitional period the key prudential requirements laid down in a special regulation (tested also through the aforementioned court trial). At the end of the transitional period (early in 2004), there will be no differences between the prudential regulatory framework for savings and loan undertakings and the framework applicable to banks and savings banks for some years already.

HKS SHP failed to meet regulatory requirements regarding capital.

HKS SHP is one of the savings and loan undertakings deemed by the Bank of Slovenia to be hardly capable of meeting capital requirements. The founders of HKS SHP also became aware of this possibility and decided in January 2001 to abandon its independent status of a credit institution and team up with other financial institution. Management and founders of HKS SHP who are jointly and severally responsible for liabilities HKS SHP with all their property tried in vain to find a bank willing to take over the ailing savings and loan undertaking failed.

The Bank of Slovenia conducted an on-site examination of operations of HKS SHP and identified the grounds to file for bankruptcy under Article 162, Para 2 of the Banking Act.

Consequently, the statutory duty for the Bank of Slovenia to file a motion for the winding up of HKS SHP with the competent court of law was triggered.

Bankruptcy of a savings and loan undertaking starts by making an entry into the court register. The District Court at Kranj registered the commencement of bankruptcy on 21 June 2002.

As regards the repayment of deposits of the depositors, the Banking Act introduced a new guarantee scheme to ensure that savings can be repaid to depositors in the event that a credit institution authorised to provide banking services goes bust. All banks and savings banks must be authorised by the Bank of Slovenia for banking services, as opposed to savings and loan undertakings that will be obliged to apply for such an authorisation after the transitional period has expired in February 2004. Deposits in banks and savings banks guaranteed jointly and severally up to the amount of 4.2 million tolars (equivalent of 18,969 euros at the middle exchange rate of the Bank of Slovenia as at 31 December 2001) placed with a bank or a savings bank (a deposit is the sum of all deposits in local and foreign currency less liabilities of the depositor in question to a bank or a savings bank). The payment of deposits in the event of bankruptcy of a bank or a savings bank is organised by the Bank of Slovenia.

The funds placed by depositors with savings and loan undertakings are not covered by the aforementioned deposit guarantee scheme since no savings and loan undertaking has met the conditions prescribed for authorisation of the Bank of Slovenia to provide banking services. Nevertheless, under the Banking Act these credit institutions still have time until February 2004 to become compliant. In accordance with the Law on Savings and Loan Undertakings, a savings and loan undertaking guarantees for its liabilities by its assets. If assets do not suffice, the founders are jointly and severally liable with all their property. Most savings and loan undertakings have safeguarded deposits of its depositors along the lines of their operating policies also by arranging a bank guarantee. HKS SHP did not have such a guarantee.

The Bank of Slovenia has repeatedly disseminated information concerning the deposit guarantee scheme to the media.

The Bank of Slovenia has notified the media of the guarantee scheme in place on more than one occasion. This campaign was particularly intense at the promulgation of the Banking Act, and the last time was in 2001 when a liquidation procedure was instituted in one financial institution that was taking deposits without being authorised by the Bank of Slovenia for taking up and the pursuit of banking business. Aware of inherent risks, the Bank of Slovenia asked all savings and loan undertakings back in August 1997 to display conspicuously in their premises a notice explaining how they guarantee for gathered funds.

Therefore, deposits placed by depositors of HKS SHP will be repaid from the bankruptcy proceeds. The competent court has appointed a receiver who will do his best in accordance with his mandate to increase the bankruptcy proceeds and thus provide more funds for repayment of deposits of depositors who entrusted their savings to HKS SHP.

In accordance with the ruling of the District Court at Kranj as of 21 June 2002, the depositors, i.e. creditors shall register their claims to the panel of receivers no later than within two months after the announcement to institute the bankruptcy procedure was published in the Official Gazette of the Republic of Slovenia (by 28 August 2002). The first hearing has been set for 18 October 2002 for claims probation. Debtors of HKS SHP must duly settle their liabilities upon maturity; hence bankruptcy proceeds will increase and hence the possibility for depositors to get back as much of their deposited funds as possible.

4. DEPOSIT GUARANTEE SCHEME IN SLOVENIA

As from 1 January 2001, a deposit guarantee scheme is in place in the Republic of Slovenia for deposits held with banks and savings banks. The deposit guarantee scheme is aligned with European Directive 94/19/EC and includes all banks and savings banks authorised by the Bank of Slovenia for taking up and pursuit of banking business, as well as the branch of a foreign bank (hereinafter: the banks). Savings and loan undertakings will be members of the deposit guarantee scheme subject to being compliant i.e. having obtained authorisation by the Bank of Slovenia.

Banks and savings banks report to the Bank of Slovenia on a semi-annual basis on balances of guaranteed deposits and on compliance with the obligation to provide for investments in securities considered to be highly liquid assets required for the payment of guaranteed deposits.

Only 5% of depositors are not fully covered.

The received returns show that aggregate retail and corporate deposits (excluding deposits from other banks and government) placed with banks and savings banks amounted to 2.664,2 billion tolars, of which 47.8 per cent or 1,275.0 billion tolars was in guaranteed deposits. All holders of guaranteed deposits (individuals and small corporate clients) placed with banks and savings banks numbered 2,086,198, the average guaranteed deposit stood at 611 thousand tolars as at 30 June 2002. Among these holders of deposits only 5.2 per cent or 108,665 did not have fully guaranteed deposits. The portion that is not guaranteed or excess deposits above the guaranteed amount of these depositors stood at the aggregate amount of 817.7 billion tolars. As a consequence, the core purpose or rather the mission of the guaranteed deposit scheme to provide cover to a myriad of small depositors (in terms of their number) whose complete deposits have a safety net in the event the bank goes bust.

It is worth mentioning that 457.5 billion tolars in deposits are excluded from the Scheme by virtue of law (medium and large legal persons, persons connected to the bank and some other foreseen ineligible depositors allowed under European directive). In addition, by comparing the present and previous figures, the share of deposits placed by natural persons on the basis of agreements concluded prior to the entry into force of the Banking Act has been declining. In other words, the deposits placed before 20 February 1999 and guaranteed by the state under the terms and conditions of the old deposit guarantee system are being phased out. The value of these deposits is only 3.1 billion tolars and this amount is negligible in the face of the volume of aggregate deposits from natural persons.

Data on guaranteed deposits are the basis for the calculation of liabilities of banks and savings banks for meeting mandatory investments the banks are to make in securities (on the basis of the Decree on Deposit Guarantee Schem it has been calculated in the amount of 2.5 per cent of guaranteed deposits), and for the calculation of the ceiling amount of permissible annual debit on the banks in the amount of 3.2 per cent of guaranteed deposits.

5. REFORM OF PAYMENT SYSTEMS AND CASH TRANSACTIONS

5.1. Payment systems

Payment systems reform

In 2001 and the first half of 2002 the final leg of the payment systems reform took place.

The reform of the Slovenian payment systems continued throughout 2001 and the first half of 2002. Those eighteen months were the final phase of the reform launched on 11 September 2000. Under the payment systems reform, the accounts of legal persons were transferred from the Agency for Payments into the banking environment. As the completion of the final phase of the reform was drawing closer, the Payment Transactions Act promulgated in March 2002 stipulated that as of 30 June 2002 when the Agency for Payments was to close its door for payment transactions of legal persons, the payment systems reform will be completed. In addition to the migration of accounts of legal persons, other activities were going on in relation to payments systems with the purpose to improve the structure and the functioning of payments systems, but also with the aim to boost their safety and efficiency.

Payment Transactions Act

The promulgation of the Payment Transactions Act by the National Assembly on 20 March 2002 was a long stride towards full compliance with legislation and recommendations of the European Union related to payment operations.

By elaborating upon the definitions of services provided within the framework of payment operations and the criteria required when providing payment services, the Payment Transactions Act has amended the substance of the Banking Act in the section, which addresses other financial services, which may be taken up and pursued also by banks and savings banks, provided that they have been duly authorised by the Bank of Slovenia.

The first section of the Payment Transactions Act deals with institutional, substantial and operational issues in relation to the provision of payment services. The relationship between the providers of payment services is defined, the minimum substantial requirement referring to relations between the providers and users of payment services and it also specifies minimum criteria for the provision of payment services (deadlines for the execution of a payment order, irrevocable nature of a payment order - finality, damage liability of the provider of payment services, etc.).

Furthermore, the Payment Transactions Act also regulates the area of settlement of monetary liabilities between providers within the payment system. Besides, drawing the line between large-value and small value payments is also important. On the basis of the promulgated Act, the Bank of Slovenia is responsible for management of the payment system that handles large value payments effected in real time. The Payment Transactions Act stipulates that an authorisation issued by the Bank of Slovenia is required in order to perform settlements and for the management of small value payments systems. Therefore, two new services related to the payment operations have been introduced. In addition to the issuance of authorisations to provide payment services, arrange settlements and manage the payments systems, the Payment Transactions Act also empowers the Bank of Slovenia to oversee the regularity and lawfulness with regard to the provision of these services and activities. An important area addressed by the new Act is the issuance of electronic money.

The second part of the Act addresses the dismantling of the Agency for Payments and the establishment of the Public Payments Administration within the framework of the Ministry of Finance and the Agency of the Republic of Slovenia for Public Records and Services, established by the Government of the Republic of Slovenia.

In July 2002, the Agency for Public Records and Services became operational.

The migration of legal persons' accounts

The Agency for Payments *ex officio* discontinued giro accounts of legal persons at the end of June 2002.

Commitment to transfer gradually legal persons' accounts from the Agency for Payments to the banks called for drawing up seven lists (operational plans) designed to facilitate the account migration by dividing the legal persons. In the year 2001, the 2nd, 3rd, 4th and 5th operational plan were implemented, and as from 1 January 2002 onward, all legal persons could transfer their accounts to commercial banks. This did not apply to direct and indirect budgetary recipients and those legal persons whose overdue and unsettled liabilities were registered. The number of accounts opened in the banking environment by April 2002 was below expectations, while later on the average daily number of accounts transferred into banks increased sharply. The rising number of accounts transferred over the last days of April was a direct consequence of the entry into force of the Payment Transactions Act, i.e. the publication of the deadline set for legal persons to transfer their account to the banking environment, and the implementation of the programme designed to boost migration. By the end of March 2002, just below 24,500 accounts of legal persons migrated to the banking environment (i.e. the estimates of the Bank of Slovenia show that this number corresponds to just over 48 per cent of accounts of entities obliged to transfer their accounts), while by the end of June 2002 this number rose to approximately 42,660. The giro accounts of legal persons who failed to transfer their account and the giro accounts of legal persons who were obliged to settle their outstanding liabilities first (the overall number is in the range of 7500) were closed down by the Agency for

Payments *ex officio* as of 29 June. Furthermore, the Agency for Payments also closed down over 16,000 giro accounts of budgetary recipients and giro accounts for payments made in favour of the budget revenue. On the same day the Bank of Slovenia opened sub-accounts for the budget recipients and for payments into the government budget within the framework of a single treasury account.

The settlement of the cash leg of securities transactions

Throughout 2001 and the first half of 2002, there was an inter-institutional project for the setting up of the cash leg settlement of securities transactions in central bank money through accounts with the Bank of Slovenia. The project designed to replace securities transactions settlement within the framework of the Agency for Payments was led by the Bank of Slovenia and Central Securities Clearing Corporation (hereinafter: KDD).

The activities within the framework of the project were carried out on two tracks: to set up infrastructure for the cash leg of settlement for transactions concluded on the Ljubljana Stock Exchange, through the RTGS system, and to set up infrastructure for the cash leg of settlement arising from transactions concluded outside the organised market (over-the-counter - OTC transactions) operations in central bank money under the principle Delivery versus Payment.

The first part of the project was directly linked with the migration and involved the transfer of certain monetary accounts of the members of the KDD (Central Securities Clearing Corporation) (12 banks and 19 brokerage firms), from the Agency for Payments to the Bank of Slovenia. On the one hand the procedures conducted under clearing of those transactions and the logic of cash settlements remained unchanged, the cash leg of settlement of securities transactions through the clients' funds and clearing accounts with the Bank of Slovenia was implemented as from 20 June onward.

The second part of the project, which was successfully completed as early as in July 2001 when the clearing settlement account of the KDD (Central Securities Clearing Corporation) was opened in the RTGS system, is a giant step towards higher quality in the settlement of over-the-counters deals. So far, the participants who were buying and selling on the OTC market were exposed to counterparty and settlement risk. Having completed the project, the RTGS settlement runs at full steam and the mechanism of Delivery versus Payment, which enables simultaneous settlement of counterparties' liabilities also for that segment of securities transactions. With the RTGS system in place, the KDD acting in its capacity of an agent for the execution of the transaction, provides for a simultaneous settlement of both parties in a very short period of time (no later than on the same working day). It is not obligatory to make use of this mechanism when OTC deals are concluded and the application has been developed primarily as a supporting pillar to the growth of the short-term money market.

The assessment of the Slovenian payment and settlement systems made by the European Central Bank

In June 2002, the European Central Bank made assessment of payment and settlement systems in Slovenia.

The European Central Bank made in June 2002 an assessment of the Slovenian payment and settlement systems on the basis of authorisation of the European Commission. The assessment focused largely on the RTGS and the Giro Clearing systems, and on the KDD, as well as the role of the Bank of Slovenia in the payment systems. The assessment was completed in autumn 2002 within the framework of the Final Report on the Progress of Slovenia towards the Accession towards the EU addressed under the negotiations with the candidate countries on the eve of the EU's next round of enlargement.

The purpose of the European Central Bank was in the first place to assess:

- whether payment and settlement infrastructure in the candidate countries is sufficiently robust to prevent in the event of problems would contain a spread of systemic risk and a crisis spill-over to other EU Member States;
- whether the infrastructure in question is sufficiently effective to enable the participants of the local market to compete with the participants in the single market on equal footing;

- whether the implementation of oversight over the functioning of the payment and settlement systems by the central bank is efficient enough to ensure the realisation of the two aforementioned objectives.

The assessment of the European Commission will serve to the European Council as a confirmation that in the candidate countries there are no critical deficiencies in the payment systems area likely to hinder the accession process.

Reviews of banks by the Expert Committee

On the basis of the decrees of the Governing Board of the Bank of Slovenia, the Expert Committee of the Bank of Slovenia continued in 2001 with its work on the verification of the degree of harmonisation between the documentation for carrying out domestic payment transactions on behalf of legal persons and the actual state of affairs in the banks.

Appointed in April 2000, the Expert Committee started with the review of the documentation received from the banks with the aim to substantiate their compliance with the criteria to provide payment transactions for legal persons within the national borders, and to prepare opinions for granting authorisations to provide domestic payment transactions to legal persons. The mandate of the Expert Committee was extended in May 2000 to carry out examinations of banks in the segment related to the implementation of payment transactions and related functions.

Banks were well prepared to take over legal persons' accounts.

The examinations conducted by the Expert Committee included screening of payment transactions, cash-related transactions, information technology and internal audit. The Expert Committee completed the examinations in all banks authorised by the Bank of Slovenia to provide domestic payment transactions for legal persons by the end of June 2001. Overall, the Expert Committee believes that banks are well prepared to take over accounts of legal persons. Examination of payment transactions, information technology deployment and internal audit function fall within the scope of regular examinations of banks and savings banks by examiners of the Banking Supervision Department, while systematic oversight of payment operations within the territory of the Republic of Slovenia is performed by the Payment Systems Department of the Bank of Slovenia.

Integrated small value payment system

The concept for setting up an integrated small value payments system (ISVPS) was first approved by the Governing Board of the Bank of Slovenia and presented to all banks in January 2001 when the banks unanimously backed the motion for interbank co-operation in that area.

Designed as a support for the realisation of the described concept, a two-tier architecture of the banking environment is seen as the set-up for adopting strategic decisions in the Committee for Payment Services and operating implementation of tasks at the level of working groups.

A draft agreement on the co-operation related to the carrying out of small value payments was prepared along the aforementioned guidelines. The draft proposal elaborated upon the area and the way in which the signatories (banks, savings banks and the Bank Association of Slovenia) work side by side to set up the small value payments systems. The Agreement was signed in May 2002.

The Agreement envisages the collaboration in the area of the development of new and standardised existing payment instruments, the preparation of common standards for automated payments processing, the establishment of the payment systems guarantee scheme, the integration of the existing clearing and settlement systems and the definition and channelling activities of the clearing house. It is the area where effects of synergy produced by interbank co-operation are due to be soon felt, while the relationship between a bank and a customer belongs to the competitive environment.

Transaction accounts of natural persons

The next step is to open transaction accounts to individuals.

Following the completion of migration of accounts of legal persons, the banks, savings banks and savings and loan undertakings will start with the opening of transaction accounts also for natural persons (individuals). The date by which all individuals who already have an account with the bank will have to get a transaction account is 30. June 2003, and it has been stipulated in the Payment Transactions Act.

After that date, all customers of banks, savings banks and savings and loan undertakings will have transaction accounts regardless of their legal status. This is a way to achieve another objective of the reform - to place all customers on an equal footing and to erase the line between payment transactions carried out within the country and cross-border transactions.

5.2. Cash transactions

Supply with cash in tolars is organised in line with the concept of smooth migration of cash payment transactions to the banking environment using depots for banknotes of the Bank of Slovenia (hereinafter: the depots), coin vault and until 30 June 2002 the network of the Agency for Payments.

In 2001 and first half of 2002, there were eight depots for banknotes of the Bank of Slovenia operating within the framework of five commercial banks -depositories. The depots could also obtain cash from the local unit of the Agency for Payments as long as such a unit operated in the region.

Bank of Slovenia depots for banknotes get cash mainly from regular cash operations of banks and savings banks.

The depots of banknotes of the Bank of Slovenia satisfy most of their needs for cash from regular cash operations of banks and savings banks conducted with legal and natural persons - users of their services. Direct users of a depot sign an agreement with the depository to get access to its services. Under these agreements, the transactions are carried out in standard qualities of 1,000 banknotes (bundles) for withdrawals from and payment into the depot. Indirect users of depot services conduct transactions in the retail market for banknotes by buying cash from and selling it to depositories.

The bottom line of the step-by-step migration of accounts of legal persons to banks and the removal of the cash leg of payment transactions from the Agency for Payments to banks is to authorise banks to take cash from and pay out cash to legal persons. The banks obtain cash from clients and in the retail cash market. The supply with cash from the central bank's distribution outlets (depots of banknotes of the Bank of Slovenia) serves to level out surplus and shortage of cash from operations - the ultimate goal of the cash distribution concept. The function will come to the forefront in the second half of 2002 when the Agency for Payments closes down.

6. ORGANISATIONAL STRUCTURE AND TASKS OF THE BANKING SUPERVISION DEPARTMENT

The Banking Supervision Department is celebrating the 10th anniversary of operations.

Set up in the Bank of Slovenia on 1 July 1992, the Banking Supervision Department discharges its functions through three units:

- Issuance of authorisation
- Off-site supervision of banking operations
- On-site supervision of banking operations

The pace of growth of the Banking Supervision Department is well illustrated by the fact that from 17 employees the headcount ten years later climbed to 50. A breakdown of this figures shows that there were 8 people in the executive section, 18 employees were working in the off-site supervision section, 21 people were engaged in on-site supervision (including one clerical officer) and three employees were responsible for licensing as at 30 June 2002.

Within the off-site supervision there are 6 analysts who monitor the operations of banks and savings banks, 2 specialists for accounting issues, a 5-strong staff (economists and lawyers) responsible for drafting secondary legislation, keeping abreast with EU directives and Basel standards, etc. In addition, one lawyer handles general legal matters, there are three officers and head of the unit.

On-site supervisory tasks are handled by 20 examiners and head of the unit. Of the total number of 20 examiners, three have specialised in the area of information technology.

Changes in the legislative field mean a challenge and increase workload on the Banking Supervision Department.

After the Banking Act came into force, new responsibilities were conferred upon the Banking Supervision Department: supervision on a consolidated basis, supervision of legal and natural persons in the event of a reasonable doubt that they engage in the provision of banking services without being duly authorised by the Bank of Slovenia, supervision of savings and loan undertakings, etc. The list of new responsibilities delegated to the Banking Supervision Department includes tasks under the Consumer Credits Act, Money Laundering Prevention Act and the Payment Transactions Act.

The Banking Supervision Department subscribes to a pro-active human resource policy. In addition to the careful selection of new recruits from the ranks of dedicated professionals, it pays a lot of attention to vocational and on-the-job training of staff. High standards have been achieved through a combination of hands-on experience and up-to-minute theoretical knowledge acquired either at post-graduate studies, or at tailored courses. Seminars, workshops, and working visits to high-profile foreign supervisory authorities were the most common forms of professional training during the period under review.

There are three segments of responsibilities within the Banking Supervision Department located in three units.

Core tasks carried out by individual units of the Department:

Granting authorisations (Licensing)

- Preparation of secondary legislation that governs licensing requirements and/or rules,
- Advising on the implementation of secondary legislation that governs licensing requirements and/or rules,
- Processing applications and the preparation of reports on authorisations granted,
- Drafting decisions and explaining grounds for the decisions taken,
- Monitoring of the enforcement of the decisions issued.

Off-site supervision of banking operations

- Drawing up the legal framework for the carrying out supervision and surveillance of banks and savings banks,
- Monitoring international recommendations in the field of supervision,
- Counselling in the implementation of financial legislation,
- Preparation of instructions with regard to implementation of accounting standards and accounting counselling,
- Controlling operations carried out by banks and savings banks on the basis of prudential reports and statutory returns,
- Corrective actions launched with the aim of resolving non-compliance identified in operating activities of banks and savings banks, and monitoring of implementation of such corrective actions,
- Analysis of results of operations of banks and savings banks,
- Co-operation with domestic and international institutions,
- Participation in the preparation for on-site examinations in banks and savings banks,
- Legal counselling,
- Electronic data processing and other related services.

On-site supervision of banking operations

- Preparatory activities leading to on-site examination on the basis of prudential reports of banks and savings banks and other statutory returns,
- On-site examinations of business operations of banks and savings banks, elaboration of reports and proposals for corrective measures,
- Implementation of corrective measures designed to mitigate deficiencies that have been detected in operations of banks and savings banks,
- Monitoring of the enforcement of corrective measures taken against banks and savings banks,
- Advising within on-site supervising function on the way to improve banking operations of banks and savings banks,
- Monitoring banks and savings banks,
- Preparation of measures aimed at preventing deterioration in the financial position of banks and savings banks,
- Co-operation in assessing conditions for instituting special administration in banks and savings banks,
- Co-operation in assessing conditions for liquidation of banks and savings banks,
- Co-operation in assessing conditions for bankruptcy of banks and savings banks,
- Governing and managing banks and savings banks in special cases,
- Co-operation with local and foreign supervisory authorities,
- Co-operation with foreign chartered accountants/certified auditors, etc.

The Report was prepared by: Banking Supervision Department and Payment Systems and Banknote Department (Reform of Payment Systems and Cash Operations)

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