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UNEDITED

FINANCIAL STABILITY

STABILITY OF THE SLOVENIAN BANKING SYSTEM

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The January 2014 Stability of the Slovenian Banking System is based on figures and information available by the first week of January 2014, except where stated otherwise.

NOTE: The demarcation of the banking system into homogeneous groups of banks, namely large domestic banks, small domestic banks and banks under majority foreign ownership, used for analytical purposes in this publication does not derive from the prevailing ownership of the banks. The demarcation is instead based on the features of their operations, in particular their funding structure.

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CONCLUSIONS

The development of systemic risks in the Slovenian banking system in 2013 was influenced by the continuing economic recession and the sharp contraction in financial intermediation. The contraction in lending activity was the result of a decline in capital expenditure and domestic consumption, the constraints on the banks' access to funding, their net repayments of debt on the international wholesale markets, tightened credit standards and the adverse situation on the domestic capital market. The contraction in the banks' balance sheets, which has been ongoing since 2010, brought an increase in credit risk at the banks, and also resulted in changes to the business conditions of relatively highly indebted corporates. The rapid debt repayments on foreign wholesale markets, which exceeded EUR 8.3 billion or 23% of GDP between the outbreak of the crisis and November 2013, have resulted in limited access to financing for corporates, and a lack of pace in the restructuring of financing in favour of an increase in the proportion accounted for by equity. And conversely, the persistence of a high level of corporate debt relative to equity is not improving their creditworthiness, as it forces them into additional divestment or restraint in new investments. The relatively high corporate sensitivity to the financial crisis is the result of the high dependence on debt (loan) financing via banks and the relatively low proportion of equity. The amplitude of the financial cycle is therefore significantly larger than the amplitude of the business cycle, and has stronger adverse consequences for economic activity than is observed in certain comparable economies. Only an increase in the amount of equity at corporates and a reduction in the dependence on the prevailing debt financing at banks will reduce corporate sensitivity to the persistence of the financial crisis. An assessment of corporate indebtedness reveals under-capitalisation and a relatively high concentration of debt in certain sectors, while as the financial crisis has persisted the problem of corporate over-leveraging has also been seen in sectors that are considered less cyclically sensitive. For corporates to reduce their relative indebtedness to the level of the best-performing corporates in their sector, i.e. those with above-average value-added, equity would have to increase by around EUR 5 billion. However, correcting the structure of corporate and bank balance sheets is a mutual process: the faster it takes place in the banking sector via net repayments of debt to the rest of the world, the more slowly it takes place in the corporate sector.

After five years of the financial crisis, the banks remain less exposed to the household sector in terms of causing credit risk. One factor in this was the low level of household indebtedness and the high saving rate before the outbreak of the financial crisis.

The change in the structure of bank funding and the contraction in lending activity brought a deterioration in the quality of the credit portfolio until last December, when the process of restructuring several large banks began under the Government Measures to Strengthen Bank Stability Act, and was also reflected in an increase in income risk and interest rate risk at the banks.

Credit risk declined in December after the asset quality reviews at the banks and the transfer of the two largest banks' non-performing claims to the Bank Asset Management Company (BAMC). The quality of the investments at the government-owned banks improved as a result of a decline of non-performing claims and as a result of an increase in investments in risk-free BAMC bonds and government bonds for the capital increases at the aforementioned banks. Although credit risk remains concentrated in the corporate sector, there nevertheless remains a risk of a renewed deterioration in bank asset quality should there be no significant economic recovery. As the economic crisis persists there is a risk of contagion in the healthy part of the economy, and a deterioration in this portion of the banking system's portfolio. The additional level of capitalisation at the banks provides a good basis for increased lending to corporates that show healthy creditworthiness and have business models with good prospects. The banks themselves can be a major factor in preventing further growth in non-performing claims by means of a proactive approach to their debtors, as can the BAMC, which could reduce the debt burden on corporates whose claims have been transferred to it by converting debt into equity and actively managing or selling it.

Following the capital increases at the banks, solvency risk is low. Further increases in capital adequacy are anticipated after the realisation of all the restructuring measures and capital increases envisaged for the remaining banks. The banking system's overall capital adequacy is expected to have increased by the middle of 2014. Higher capital adequacy in the banking system is also diminishing the arguments for reducing lending activity as a lever to increase capital ratios. The transfers of non-performing claims to the BAMC undertaken in December and in the future at values lower than the book value entails an additional increase in the impairments of insufficiently impaired transferred claims at the banks, and a consequent decline in equity and downward pressure on the capital adequacy ratio.

The increase in income risk was the result of the high proportion of non-performing claims in the banking system's portfolio and the contraction in lending. The increased income risk at the banks has been seen in a sustained decline in net interest income, a decline in net non-interest income and a sharp rise in impairment and provisioning costs. Another main factor in the fall in interest rates on deposits by the non-banking sector in 2013 was the measure taken by the Bank of Slovenia in the spring to restrain the banks in competing for deposits via high deposit rates. The decline in liability interest rates is mitigating downward pressures on the net interest margin, which is among the lowest in the region. After four years of losses in the banking system, 2014 will be important from the point of view of the banks' ability to adapt their business models to ensure profitability and the internal generation of capital. The crisis has confirmed that excessive bank funding via the wholesale financial markets increases their sensitivity to the fast-changing conditions on the international financial markets, and that growth in bank turnover is also conditioned by the ability to increase autonomous funding, thus maintaining a more stable loan-to-deposit ratio.

The banks maintained relatively stable liquidity last year, while measures at the end of the year actually brought significant improvement. Secondary liquidity has reached a stable 12% of the banking system's total assets. The shallow domestic money market and the limited access to international financial markets nevertheless mean that the banks could temporarily face difficulties in effective liquidity management. This is particularly the case for the banks that are more dependent on wholesale funding and have less stable deposits by the non-banking sector.

The sustained financial crisis is forcing the banks to make relatively sharp adjustments to their funding structure. After the stress tests and the immediate measures by the government and the Bank of Slovenia to increase bank stability, refinancing risk on the wholesale markets declined, and the conditions for regaining access to funding in the rest of the world can be expected to ease. In the short term the banks do not face high refinancing risk, as a large proportion of the debt to the rest of the world has already been repaid. An increased need for bank refinancing appears in a time horizon of more than one year. At the end of 2014 and beginning of 2015 the banks face the maturing of EUR 3.3 billion of liabilities from long-term refinancing at the ESCB, which the banks intend to partly prepay in the early part of 2014.

The rapid and pronounced change in the structure of bank funding in recent years has begun to be reflected in increased interest rate risk. This is particularly the case for those banks whose average maturity of funding shortened significantly. The banks under majority domestic ownership have become more sensitive to the risk of a rise in interest rates in the year ahead.

The development of systemic risks in the banking system remains uncertain, despite an effective beginning to bank restructuring in December 2013 under the Government Measures to Strengthen Bank Stability Act. The process of the contraction in the banks' financial intermediation is strongly dependent on economic recovery, and on the success of the restructuring of bank funding, which will continue in 2014. The latter should be reflected in a further decline in dependence on unstable short-term funding on the international financial markets and in a further increase in the proportion of funding accounted for by autonomous and long-term resources. This year of 2014 will be decisive for the banks that have embarked upon the restructuring process in order to adapt their business models to the new business conditions, which will ensure that they return to profitability and have sufficient ability to generate capital internally. Improvements in the banks' efficiency must be reflected in a rise in the net interest margin, which will ensure an adequate return on the capital invested and the proper evaluation of the risks taken up. Because not all of the banks in the relatively saturated banking market will be capable of making these adaptations, further consolidation in the banking system is vital.

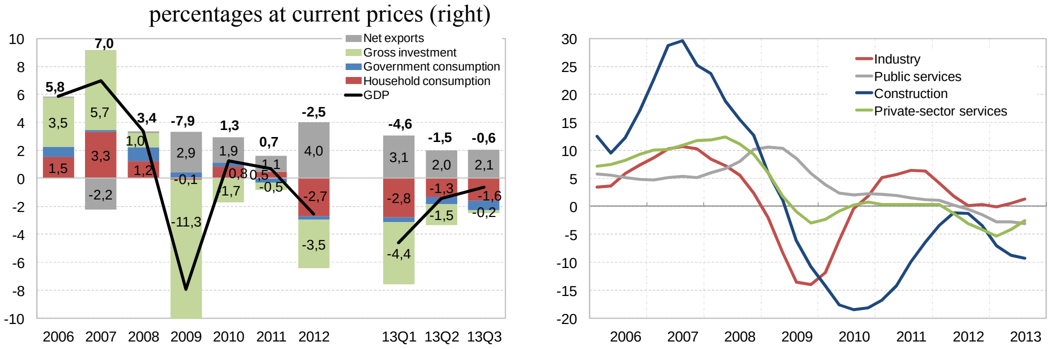
1 ECONOMIC TRENDS AND SECTORAL OVERVIEW

The contraction in economic activity continued in the first three quarters of 2013. The contraction slowed in the second and third quarters.

The contraction in economic activity continued in the first three quarters of 2013. A gradual recovery is forecast to arrive in 2015, while economic activity in 2014 is forecast to be under the influence of weaker growth in foreign demand, constraints on financing, additional fiscal consolidation measures and the associated decline in government spending, a fall in employment and a decline in household consumption, and a decline in investment as a result of the uncertainty in the economy.[1] When the results of the stress tests were released in December 2013, the Bank of Slovenia and the government also outlined measures to stabilise the banking system, which in the future will help reduce the level of uncertainty in the economy. Government measures to deleverage the corporate sector and measures related to effective corporate governance at government-owned firms are continuing and also execution of the planned privatisation processes. GDP in the first three quarters of the year was down 2.2% on the same period of the previous year. The decline slowed in the second quarter, partly as a result of the one-off effect of an increase in demand before July's rise in VAT rates.[2] GDP in the third quarter was almost unchanged from the previous quarter. The decline in economic activity remains under the influence of a decline in investment and consumption. Household consumption has been hit by the decline in consumer purchasing power, high unemployment and the decline in consumer confidence, while the decline in government consumption is a reflection of fiscal consolidation. Investment has been affected by limited domestic and foreign demand, the high indebtedness of the corporate sector and constraints on financing. The export sector has remained the most flexible in the crisis, and is having a positive impact on GDP. Industry is the only corporate sector to have retained positive growth in value-added, which is the partly result of its adaptations and its search for new export markets.

The government and the Bank of Slovenia have instituted measures to stabilise the Slovenian banking system.

Figure 1.1: Year-on-year and quarterly GDP growth in percentages and contributions to GDP growth by components of demand in percentage points at constant prices (left) and year-on-year growth in value-added by sector in percentages at current prices (right)



Note: Year-on-year growth is calculated as four-quarter moving sums
Source: SORS

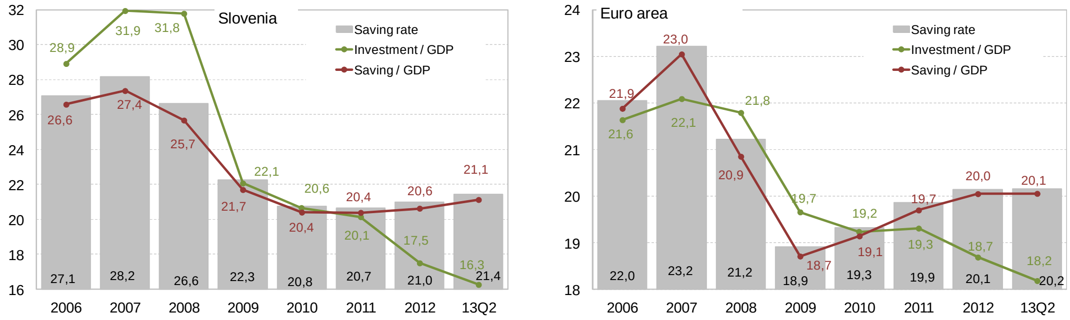
The annual saving rate of the Slovenian economy increased to 21.4% in the second quarter.

Despite the negative developments in disposable income, the saving rate increased to 21.2% in the second quarter as a result of limited final consumption. The saving rate in the national economy, i.e. the ratio of saving to disposable income, thus increased to 21.4% in Slovenia. The ratio of investment to GDP fell to 16.3% and remains below the euro area average, an indication of the problems of the over-leveraged corporate sector, the burden on the financial and banking system, and limited demand. Net national lending, which is the difference between saving and investment, thus increased to 4.5% of GDP in the second quarter.

[1] Forecasts from the Macroeconomic Developments and Projections, October 2013, Bank of Slovenia.

[2] The VAT rates were raised from 20% to 22% and from 8.5% to 9.5%.

Figure 1.2: Saving rate and ratio of investment and saving to GDP in percentages for Slovenia (left) and the euro area (right)

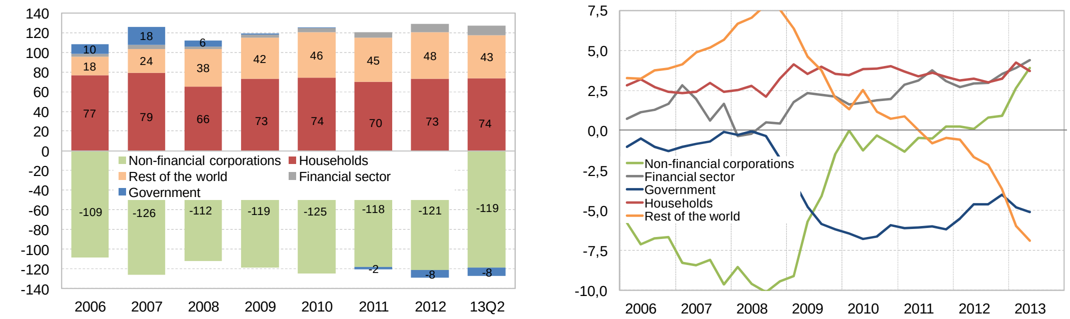


Note: Ratios are calculated as four-quarter moving sums
Sources: Bank of Slovenia, SORS, ECB, Eurostat

Corporates are increasing their current net positive financial position.

The Slovenian economy's net financial liabilities to the rest of the world had declined to 43.3% of GDP by the end of the first half of 2013, as a result of the repayment of financial liabilities to the rest of the world. The corporate sector is continuing to pay down debt, and since 2012 has been increasing its net surplus, which entails net repayments and a decline in liabilities. Households and the financial sector are increasing their net positive financial positions, while the government sector has maintained its net negative financial position.

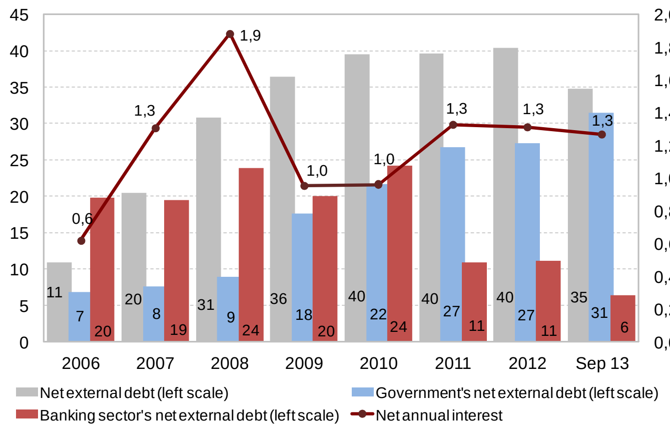
Figure 1.3: Net financial position of economic sectors in terms of stock (left) and annual transactions (right) as a percentage of GDP



Note: Annual transactions are calculated as four-quarter moving sums
Sources: Bank of Slovenia, SORS

Rest of the world

Figure 1.4: Net external debt of Slovenia and net annual interest paid as a percentage of GDP

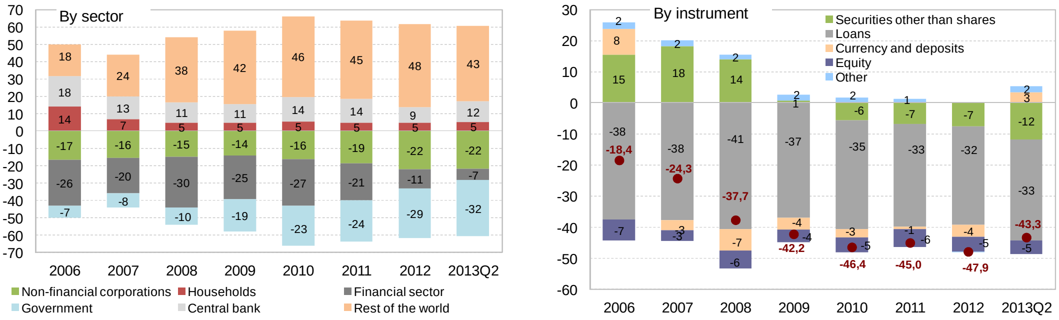


Note: The difference between the net external debt and the net financial position against the rest of the world in the financial accounts is the result of differences in methodology. The external debt does not include equity, for example.
Sources: Bank of Slovenia, SORS

The net external debt declined to 35% of GDP.

The net external debt declined by just over EUR 2 billion during the first nine months of 2013 to 35% of GDP, despite an increase in government liabilities to the rest of the world. The banking system continued to reduce its net liabilities to the rest of the world, by EUR 1.7 billion in the first three quarters of the year. During this period the government sector's net debt to the rest of the world increased by EUR 1.3 billion, most notably in May, when it issued two bonds with a total nominal value of EUR 3.5 billion, namely a 10-year bond with a coupon rate of 5.85% and a 5-year bond with a coupon rate of 4.75%. More than 95% of the purchasers were non-residents.

Figure 1.5: Net financial position against the rest of the world by economic sector (left) and by instrument (right) as a percentage of GDP



Source: Bank of Slovenia

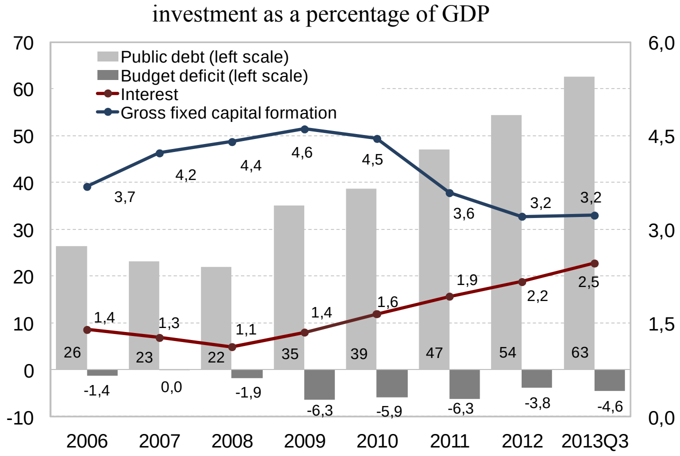
Slovenia's dependence on foreign funding stood at 43% of GDP at the end of the first half of 2013. Net liabilities from equity have remained low, at 5% of GDP. The Slovenian corporate sector is over-leveraged, primarily from the point of view of the ratio of equity to debt capital, for which reason foreign capital, FDI in particular, remains a potential source of fresh capital for corporates. The government sector's net liabilities to the rest of the world have increased, while the corporate sector's net liabilities to the rest of the world have remained at a high level, an indication of the constraints on financing for the corporate sector in Slovenia and the problems of the domestic banking sector.

Government sector

The general government debt rose to 75.6% of GDP at the end of 2013 according to government estimates. The euro area average is more than 90%.

The general government debt rose to 62.6% of GDP in the first three quarters, while the budget deficit amounted to 4.6% of GDP. In addition to the two bond issues on foreign markets, treasury bills in the amount of EUR 1.8 billion were issued in the first three quarters of the year. The majority were sold to domestic investors. In November the government issued a 3-year bond with a nominal value of EUR 1.5 billion and a yield at issue of 4.85%. The cost of servicing the government sector's debt increased to 2.5% of GDP in the first three quarters of 2013, as a result of the rise in the public debt and the high required yield on Slovenian bonds. The introduction of measures aimed at restructuring the banking system raised the government sector's gross debt to 75.6% of GDP at the end of 2013 according to government estimates.

Figure 1.6: Public debt, budget deficit, interest payments and gross government investment as a percentage of GDP



Source: SORS

2 CHANGES IN THE BANKING SYSTEM'S BALANCE SHEET STRUCTURE

2.1 Factors in the decline in total assets

The banking system's total assets declined by EUR 3.4 billion during the first eleven months of last year.

With the economy in recession, the contraction in the banking system's balance sheet accelerated in 2013. Year-on-year growth in total assets stood at -9.5% at the end of November, total assets having declined by EUR 3.4 billion over the first eleven months of the year. On the funding side the decline in growth in the balance sheet total coincided with the banks' debt repayments on wholesale markets in the rest of the world and in a decline in equity as a result of losses during the first eleven months of the year, while the largest decline on the asset side was recorded by loans.

Table 2.1: Banking system's balance sheet as at 30 November 2013

	Stock				Increase to		Year-on-year growth Nov 2013
	2010	2011	2012	Nov 2013	Nov 2013		
	EUR million				EUR million	%	%
Assets							
Cash and balances at central bank	1.136	1.389	1.604	1.965	361	22,5	45,5
Loans	39.534	38.020	35.498	32.470	-3.027	-8,5	-11,5
to banks	4.842	4.684	4.269	4.203	-66	-1,6	-11,0
to non-banking sector	34.692	33.143	30.962	27.997	-2.965	-9,6	-11,7
of which:							
… non-financial corporations	19.789	18.320	16.440	14.287	-2.153	-13,1	-16,0
… households	8.854	9.060	8.847	8.568	-279	-3,2	-3,6
… government	1.162	1.219	1.753	1.657	-96	-5,5	-4,1
… OFIs	2.594	1.824	1.468	1.323	-145	-9,9	-16,2
Financial assets / securities	8.413	8.023	7.300	6.688	-613	-8,4	-10,5
Other	1.676	1.811	1.717	1.623	-94	-5,5	-7,0
Liabilities							
Financial liabilities to Eurosystem	603	1.741	4.013	3.878	-134	-3,3	-2,5
Liabilities to banks	15.219	12.919	10.698	7.844	-2.855	-26,7	-27,3
of which to foreign banks	11.721	9.598	7.621	5.439	-2.182	-28,6	-29,2
Liabilities to non-banking sector (deposits)	23.877	24.580	23.856	24.974	1.118	4,7	2,6
of which to non-financial corporations	4.064	3.890	3.714	4.127	414	11,1	5,8
of which to households	14.573	14.863	14.829	14.370	-459	-3,1	-2,2
of which to government	3.048	3.463	3.023	4.054	1.031	34,1	23,3
of which to OFIs	1.289	1.464	1.270	1.085	-185	-14,6	-24,0
Debt securities	4.504	3.715	2.165	1.686	-480	-22,2	-21,9
Subordinated liabilities	1.557	1.432	866	795	-72	-8,3	-17,6
Equity	4.140	3.950	3.731	2.755	-977	-26,2	-33,8
Other	859	905	789	815	26	3,3	-4,7
Total assets	50.760	49.243	46.119	42.746	-3.373	-7,3	-9,5

Source: Bank of Slovenia

The banks continued to make debt repayments on the wholesale markets during the first eleven months of last year.Losses also reduced the banks' equity.The government sector was the main factor in the increase in deposits by the non-banking sector.

Slovenian banks' repayments to banks in the rest of the world amounted to EUR 2.2 billion during the first eleven months of the year, and accounted for two-thirds of the decline in total liabilities. Total net repayments of debt on the wholesale markets amounted to EUR 2.7 billion during the first eleven months of the year. Deposits by the non-banking sector increased by EUR 1.1 billion during the first eleven months of the year, as a result of an increase in government deposits before capital increases were carried out at five banks in December.[3] The proportion of the banking system's funding accounted for by wholesale funding declined over the first eleven months of the year, while the proportions accounted for by deposits by the non-banking sector and liabilities to the ECB increased.

The largest decline on the asset side was in loans to non-financial corporations.

Loans to the non-banking sector declined by EUR 2,965 million during the first eleven months of the year, primarily as a result of a decline of EUR 2,153 million in loans to non-financial corporations. Impairments of loans accounted for 32% or EUR 692 million of the decline in loans to non-financial corporations. The economic crisis meant that growth in loans to households also remained negative last year. The banks adjusted to the decline in funding in part by reducing investments in securities on the asset side, although the pace of the reduction was similar to the contraction in total assets, for which reason the proportion of total assets that they account for remained stable at 15.6%.

[3] The figures do not yet reflect the decline in government deposits that followed the conversion of these deposits to capital in December 2013.

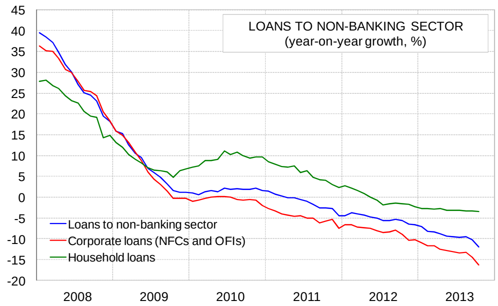
The measures taken by the government to stabilise the banking system in December 2013 will result in changes in the structure of the banking system's assets and liabilities by the end of the year. This will be the result of the following factors: a) capital increases at NLB d.d., NKBM d.d., Abanka Vipa d.d. and two smaller banks, Factor banka d.d. and Probanka d.d., which have been undergoing an orderly wind-down process since September, via the conversion of deposits by the Slovenian Ministry of Finance into equity; b) capital increases in the form of government securities obtained by the banks in their portfolios; c) the write-down of subordinated instruments; and d) the transfer of non-performing claims at NLB d.d. and NKBM d.d.[4] to the Bank Asset Management Company (BAMC). This will result an increase in equity on the liability side, and a decline in government deposits and subordinated debt. On the asset side, the proportion accounted for by securities will increase, as a result of the bonds and treasury bills received in the banks' portfolios. The asset side will also lose the stock of loans transferred to the BAMC, while BAMC securities will increase.

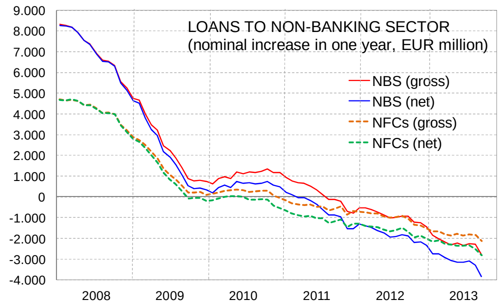
The measures taken by the government to stabilise the banking system in December 2013 will have a profound impact on the structure of the banking system's balance sheet.

2.2 A contraction in loans and changes in the structure of the banking system's investments

The contraction in loans to the non-banking sector continued in the second half of 2013. As a result of the private sector's weak demand for loans and the limited supply of loans, year-on-year growth in loans before and after the creation of impairments (gross and net) was negative for both corporates and households. A credible restructuring of the banking sector will primarily reduce the downward supply-side pressures on lending activity, but launching a new credit and investment cycle will require the institutional environment for healthy demand for loans.

Figure 2.1: Year-on-year growth in loans to the non-banking sector in percentages (left), and gross and net increase in loans to the non-banking sector and to non-financial corporations (before and after impairments) in EUR millions (right)





Source: Bank of Slovenia

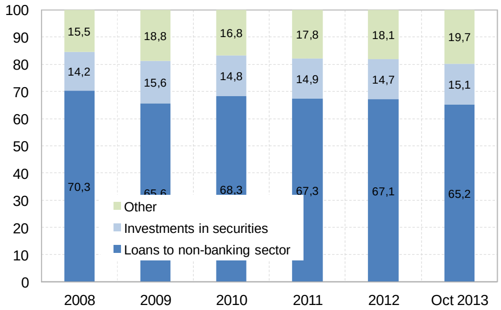
Low demand, the tightening of credit standards and the accelerated creation of impairments and provisions mean that the contraction in loans in Slovenia has been faster than the decline in total assets. The proportion of total assets accounted for by securities increased between December 2012 and October 2013, despite negative growth in investments, while the proportion accounted for by loans declined.

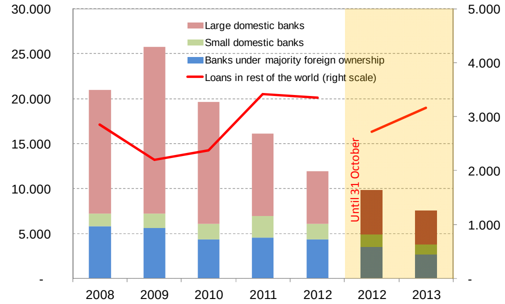
The proportion of total assets accounted for by loans is declining as a result of the low volume of new loans, and the faster creation of impairments and provisions.

New loans in the first three quarters of the year were down on the same period of 2012, and amounted to merely approximately 45% of the new loans recorded in the first three quarters of 2009. New loans at the banks under majority foreign ownership and the small domestic banks, which are subject to lower downward supply-side pressures, were above-average relative to their total assets, as a result of which the large domestic banks are gradually losing their market share of the loan market.

[4] The transfer of non-performing claims to the BAMC has only been undertaken at the aforementioned two banks to date, and not at Abanka Vipa.

Figure 2.2: Structure of the banking system's investments in percentages (left) and new loans to Slovenian corporates by bank group in EUR millions (right)





Source: Bank of Slovenia

Low investment activity and weak final consumption are leading to low demand for loans.

In 2013 the banks faced limited access to wholesale funding, which restricted the funds available for investments in the Slovenian economy. The further deterioration in the credit portfolio in the second half of the year and the accumulated losses have continued to put pressure on capital adequacy, which is forcing the banks to further reduce lending activity with the aim of reducing capital requirements. It is for this reason that beginning the process of transferring non-performing claims to the BAMC in December 2013 is a prerequisite for the normalisation of the banking system's credit operations.

The banks' limited access to funding and accumulated losses have constrained the supply of loans.

Demand for loans is also declining. Gross fixed capital formation by Slovenian corporates during the first three quarters of 2013 was down a further 6% on the same period of the previous year. Another factor in the reduced demand for loans was a further fall in real estate prices, which is reducing the value of assets used as loan collateral. A decline in final consumption, which over the first three quarters of last year was down 4.1% in year-on-year terms (consumption of durables was down 8.1%), and a decline in disposable income have contributed to a decline in demand for household loans.

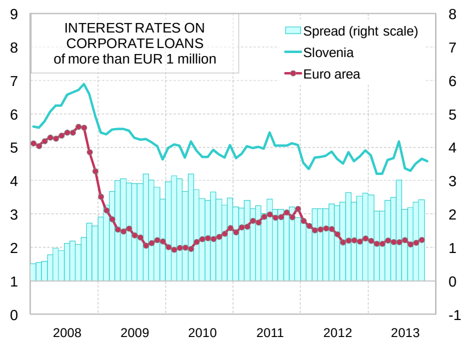
Without the proper institutional environment for investment, demand for loans will remain weak.

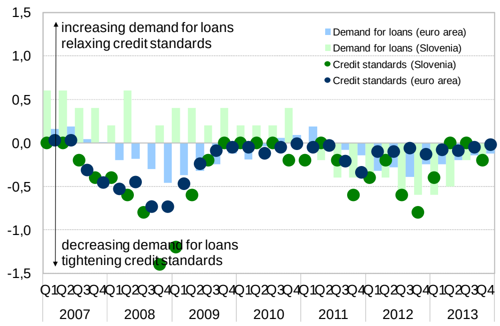
With the expected stabilisation of consumption and investment, the decline in the private sector's demand for loans will slow in the future. For a faster economic recovery it is necessary to provide corporates with an institutional environment that will encourage new investment, and thus healthy demand for loans.

The credible restructuring of the banking sector will reduce the downward supply-side pressures on lending activity.

Following the transfer of non-performing claims to the BAMC and the capital increases carried out at three largest banks in December 2013, the downward pressure on the supply of loans can be expected to have eased. The transfer of non-performing claims to the BAMC will reduce the average weight for the calculation of capital requirements, and the stock of loans included in the calculation of capital requirements will also decline. In addition to the direct impact on equity and the reduced downward pressure on lending activity, credible restructuring of the banking sector will facilitate access to wholesale funding at affordable prices, first for the government, and then for the banks. This will provide more stable funding for the banks for launching a renewed lending cycle.

Figure 2.3: Interest rates on corporate loans of more than EUR 1 million in Slovenia and the euro area in percentages (left) and corporate demand for loans and credit standards (right)





Sources: ECB, Bank of Slovenia

Further evidence of the current developments and expectations for demand and supply of loans to corporates and households comes from by the banks' reporting for the needs of the survey on demand for loans and credit standards in Slovenia and in the euro area overall.[5]

2.3 Change in breakdown of bank funding and refinancing risk

2.3.1 Bank funding

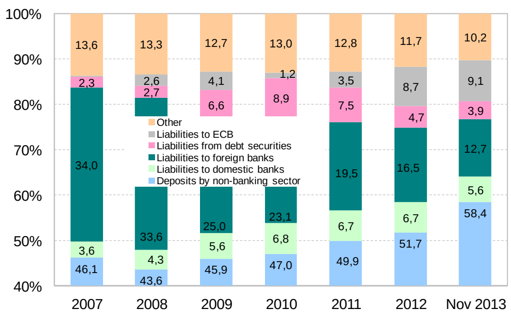
The banks again reduced their dependence on wholesale funding last year.

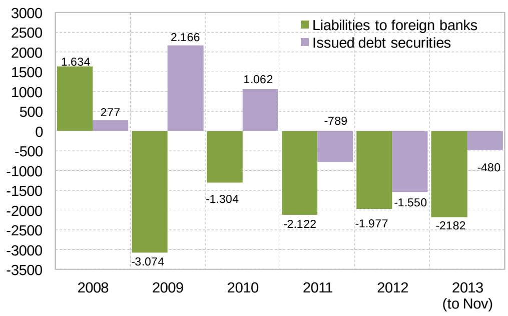
The process of restructuring funding, which began at the outbreak of the financial crisis, continued intensively in 2013. The banks continued to reduce their dependence on wholesale funding, as their access to funding on foreign markets was made more difficult by the uncertain situation on the international financial markets, and owing to the downgrading of Slovenia's sovereign debt and banks in 2012. In 2009 and 2010, the first two years of the crisis, the banks compensated for their debt repayments to banks in the rest of the world by issuing debt securities. However, the increasingly uncertain economic, political and financial situation in Slovenia has hindered further borrowing of this kind. The proportion accounted for by wholesale funding, which at the outbreak of the crisis was more than one-third of total bank funding in Slovenia, had halved to 17% by November 2013.

Deposits by the non-banking sector increased over the first eleven months of last year as a result of growth in government deposits.

Deposits by the non-banking sector at the end of November 2013 were up 2.7% in year-on-year terms. The main factor in the growth in deposits by the non-banking sector was an increase in government deposits, as a result of the issue of US dollar bonds by the Slovenian government in May. The positive growth in deposits by the non-banking sector and the moderate decline in household deposits compared with the decline in total assets contributed to an increase in the proportion of total liabilities accounted for by deposits by the non-banking sector and household deposits. Deposits by the non-banking sector accounted for 58.4% of the stock of bank funding at the end of November 2013, and household deposits for 33.6%. Compared with the outbreak of the crisis, the first figure was up almost 15 percentage points and the second was up 5.6 percentage points.

Figure 2.4: Percentage breakdown of bank funding (left) and the banks' net debt repayments on the wholesale markets in EUR millions (right)





Source: Bank of Slovenia

Last year's largest increase in deposits by the non-banking sector was recorded by the banks under majority foreign ownership, which in November were up 12.2% in year-on-year terms, primarily as a result of an increase in household deposits and deposits by non-financial corporations, government deposits having declined. Deposits by the non-banking sector were down 0.6% in year-on-year terms in November at the large domestic banks, and down 3.7% at the small domestic banks. The proportion of deposits by the non-banking sector accounted for by short-term deposits increased last year.

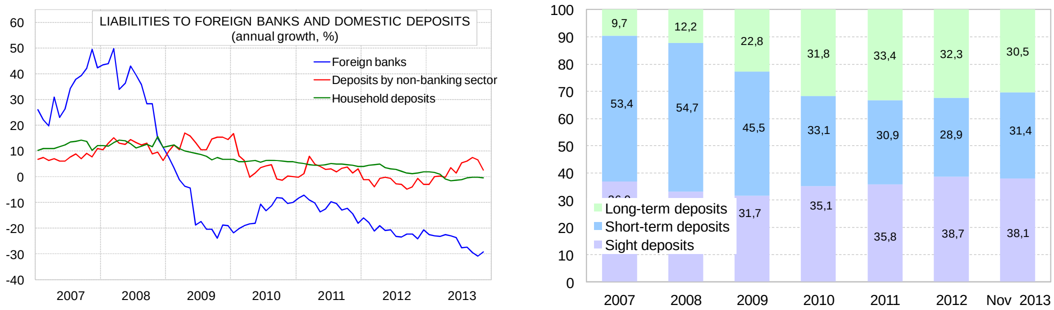
[5] In the banks' reporting for the needs of the survey on demand for loans and credit standards in Slovenia and in the euro area, the banks reported a decline in demand for corporate loans and the tightening of credit standards in all three quarters. The third quarter saw the tenth consecutive quarterly report of a decline in demand for corporate loans. After seven consecutive reports of a decline in demand for housing loans, the banks reported unchanged demand for housing loans in the second and third quarters, and on unchanged credit standards for housing loans. The banks are not reporting any positive expectations of demand for loans or of easing credit standards alleviation for any type of loan.

Table 2.2: Increases and growth in household deposits in EUR millions and percentages

Bank group	Increase in household deposits, EUR million			Year-on-year growth in household deposits, %		
	2012	2013 (to Nov)	2013 (to Nov)	2012	2013 (to Nov)	2013 (to Nov)
Large domestic banks	-402,4	-724,9	-40,2	-4,1	-7,6	-0,5
Small domestic banks	11,9	-65,9	-18,2	0,9	-4,7	-1,4
Savings banks	46,7	97,8	9,7	14,4	26,4	2,1
Banks under majority foreign ownership	310,1	234,1	40,4	9,6	6,6	1,1
Overall	-33,7	-458,9	-8,3	-0,2	-3,1	-0,1

Source: Bank of Slovenia

Figure 2.5: Year-on-year growth in bank funding (left) and maturity breakdown of deposits by the non-banking sector (right) in percentages



Source: Bank of Slovenia

Differences in the breakdown of funding at individual bank groups

The differences in the breakdown of funding between the bank groups narrowed last year, but remain large.

The banks have been relatively fast in adjusting the breakdown of their funding to the market situation in recent years. All the bank groups reduced their debt on the wholesale markets in the rest of the world; the banks under majority foreign ownership have actually been the most intensive in so doing. The differences in the funding breakdown between the different bank groups nevertheless remain relatively large.

Table 2.3: Ratios of individual forms of funding to total liabilities by bank group

(%)	Large domestic banks	Small domestic banks	Banks under majority foreign ownership	System overall
	Liabilities to foreign banks			
2009	16,8	3,2	48,9	25,0
2012	11,1	0,4	31,8	16,5
Nov 2013	8,4	0,1	24,0	12,7
	Deposits by non-banking sector			
2009	49,6	61,1	33,7	45,9
2012	52,9	62,2	46,4	51,7
Nov 2013	57,5	73,9	56,2	58,4
	Household deposits			
2009	30,3	33,1	18,2	27,0
2012	34,6	41,1	24,8	32,2
Nov 2013	34,5	51,5	27,5	33,6
	Government deposits			
2009	8,7	10,4	4,7	7,7
2012	7,2	8,8	4,7	6,6
Nov 2013	11,5	12,1	5,2	9,5
	Issued debt securities			
2009	10,0	4,9	0,0	6,6
2012	6,9	6,1	0,0	4,7
Nov 2013	5,9	4,8	0,2	3,9
	Liabilities to Eurosystem			
2009	3,9	6,3	3,7	4,1
2012	9,6	11,0	6,2	8,7
Nov 2013	10,1	17,1	5,1	9,1

Source: Bank of Slovenia

The large domestic banks made debt repayments in the rest of the world, while they also recorded a decline in deposits by the non-banking sector, most notably household deposits. They compensated by raising government deposits. The proportion of total funding accounted for by deposits by the non-banking sector at the large domestic banks thus increased. Household deposits are the most important source of funding for the domestic banks. They accounted for more than a third of total liabilities at the large domestic banks in November, and for more than half at the small domestic banks and savings banks. Both bank groups are more exposed via liabilities to the Eurosystem than are the banks under majority foreign ownership.The banks under majority foreign ownership continued to make debt repayments in the rest of the world. The parent banks began reducing their financing of subsidiary banks in Slovenia three years ago, the latter then focusing on obtaining funding on the local market. The proportion of branches' funding accounted for by parent banks in the rest of the world declined by more than half to stand at just a quarter at the end of November. The development of the financial crisis to date has revealed that excessive dependence on funding on the wholesale markets does not guarantee banks a business model that is stable in the long term. Excessive dependence on wholesale funding also forced some banks into a rapid contraction in total assets during the crisis.

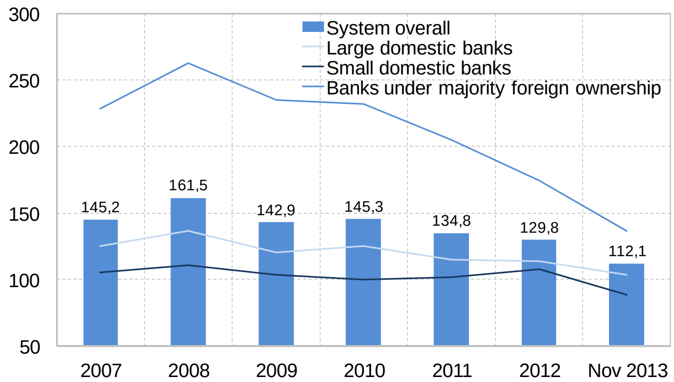
During the crisis years the banks under majority foreign ownership have made the largest repayments of debt in the rest of the world in relative terms, and are increasingly focusing on attracting funding on the Slovenian market.

Loan-to-deposit ratio

The increasing constraints on funding on the financial markets led to an increase in the importance of the funding that the banks succeed in obtaining via deposits on the domestic market. The indicator of the sustainability of bank funding, as measured by the loan-to-deposit ratio for the non-banking sector, has declined since the outbreak of the crisis. It declined by around 50 percentage points between the end of 2008 and November 2013 to stand at 112% The largest decline in the aforementioned indicator during this period was recorded by the banks under majority foreign ownership, where it is still above-average at 137%. As lending has declined, the main factor in this was the aggressive acquisition of deposits on the local market. While unable to obtain to funding on foreign markets, the domestic banks also faced a withdrawal of deposits, which was the result of their downgrading and a loss of public confidence. The loan-to-deposit ratio for the non-banking sector has improved in recent years, although it should be noted that it is likely to have risen slightly again in December 2013 in the context of the sharp decline in government deposits brought by conversion into equity in the largest banks and the transfer of non-performing loans to the BAMC.

The LTD ratio for the non-banking sector declined over the first eleven months of the year.The banks are less dependent on funding in the rest of the world than before the outbreak of the crisis.

Figure 2.6: LTD ratio for the non-banking sector by bank group in percentages



Source: Bank of Slovenia

Last year saw an increase in the switching of deposits between the bank groups within the banking system. As household deposits contracted across the banking system (albeit by far less than the contraction in total assets), the banks under majority foreign ownership succeeded in capturing some of deposits by the non-banking sector from the domestic banks, primarily deposits by non-financial corporations, deposits by other financial institutions and household deposits.

The banks under majority foreign ownership were the only group to record an increase in deposits by the non-banking sector over the first eleven months of the year.

Table 2.4: Migration of deposits by the non-banking sector between bank groups in 2012 and the first eleven months of 2013, year-on-year growth in percentages

(%)	Deposits by NBS			Deposits by NFCs			Deposits by OFIs			Government deposits			Household deposits		
	2011	2012	Nov 2013	2011	2012	Nov 2013	2011	2012	Nov 2013	2011	2012	Nov 2013	2011	2012	Nov 2013
Large domestic banks	1,1	-7,3	-0,6	-9,2	-1,8	-8,8	4,4	-26,3	-45,7	15,3	-15,8	38,3	0,0	-4,6	-7,1
Small domestic banks	-3,7	-4,8	-3,7	-19,8	-15,2	-32,3	-36,5	-22,6	-60,0	1,2	-17,8	12,3	5,0	2,1	3,1
Banks under majority foreign ownership	12,2	18,0	12,2	11,2	8,2	34,5	99,3	56,8	4,3	18,0	61,0	-11,3	7,1	7,7	8,5
System overall	3,0	-1,0	2,7	-4,3	-4,1	5,8	13,6	-2,6	-24,0	13,6	-5,0	23,3	2,0	-1,1	-2,2

Source: Bank of Slovenia

The main factor in the increase in deposits by other financial institutions and non-financial corporations at the banks under majority foreign ownership was the higher credit ratings that this bank group enjoys relative to the domestic banks, while the main factors in the increase in household deposits were the active policy of attracting these deposits, and the fact that households perceive the banks under majority foreign ownership as more stable, given the poor performance of the large domestic banks and the initiation of the orderly wind-down process at two smaller banks. The banks under majority foreign ownership have lower interest rates on household deposits than the domestic banks, although the spread narrowed in 2013.

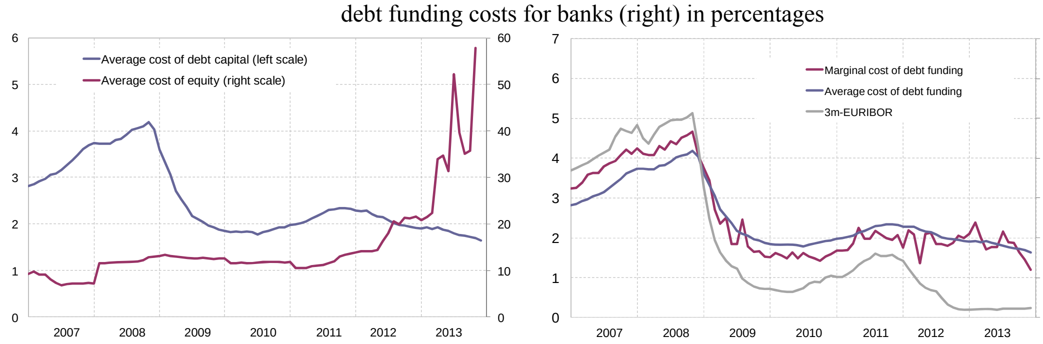
2.3.2 Bank funding costs

The decline in the average cost of the banks' debt funding in 2013 was primarily the result of a fall in interest rates on deposits by the non-banking sector, which was most evidently reflected in a decline in funding costs at the large domestic banks. Debt repayments to foreign banks at the banks under majority foreign ownership were the main factor in their smaller decline in funding costs, as liabilities to banks in the rest of the world are a relatively favourable source of bank funding in cost terms. With the exception of SID banka, there were no new issues of bank debt securities in 2013, and neither did the banks obtain new loans at the ECB in a significant amount. There was a sharp rise in the cost of the banks' equity in 2013, as a result of a sharp fall in their share prices.

The cost of debt funding declined in 2013, while the cost of equity increased sharply.

The average cost of debt capital declined by 0.25 percentage points over the first eleven months of the year to 1.64%, while the cost of equity increased sharply.[6] The decline in the cost of debt capital in 2013 was primarily the result of a decline in the banks' liability interest rates on deposits by the non-banking sector, which fell by 0.4 percentage points during the first eleven months of the year to 1.72%, and the increase in the proportion of bank funding accounted for by ECB funding.

Figure 2.7: Average costs of equity and debt capital (left) and average and marginal debt funding costs for banks (right) in percentages



Source: Bank of Slovenia

Slovenian banks cut their liability interest rates in 2013.

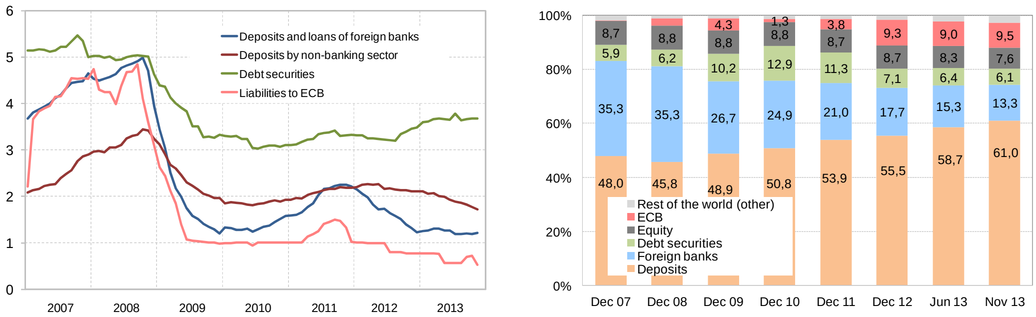
The proportion of the banks' debt funding accounted for by deposits by the non-banking sector had increased to 61% by November 2013.[7] With an average interest rate of 1.7%, deposits by the non-banking sector are the third most expensive source of funding.

[6] The limited number of bank shares listed on the Ljubljana Stock Exchange means that estimated cost of equity is the same for all bank groups. The differences in bank funding costs are solely due to differences in the cost of debt capital and the proportions of funding accounted for by equity at each bank group.

[7] In size terms, the funding used to calculate funding costs is slightly smaller than total liabilities, as only equity and interest-bearing items are included, as a result of which the proportions of individual forms of funding are slightly higher than their ratios to total liabilities.

Slovenian banks sharply cut their interest rates in 2013 in an attempt to improve their cost competitiveness and relieve the pressure on their relatively low interest margins. Another major factor in the decline in the average cost of debt funding in 2013 was the further decline in bank funding via issues of debt securities, which are the most expensive source of debt funding in relative terms. The proportion of bank funding accounted for by borrowing at the ECB increased slightly. The costs of this funding declined by 0.25 percentage points over the first eleven months of the year, the ECB having cut its key interest rate to 0.25% in November. The reference interest rates did not change significantly over the year.

Figure 2.8: Average cost of bank debt funding (left) and breakdown of funding (right) in percentages



Source: Bank of Slovenia

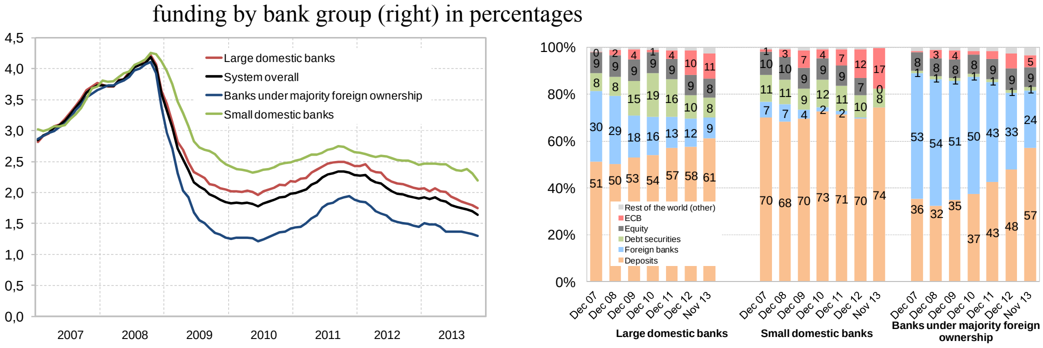
The large domestic banks recorded the largest decline in debt funding costs in 2013.

The lowest average cost of debt funding at the end of November 2013 was recorded by the banks under majority foreign ownership at 1.3%, followed by the large domestic banks at 1.7% and the small domestic banks at 2.2%. The largest fall in funding costs over the first eleven months of the year was recorded by the large domestic banks, at 0.32 percentage points, followed by the small domestic banks with 0.25 percentage points, and the banks under majority foreign ownership with 0.15 percentage points.

All the bank groups have continued to increase the proportion accounted for by relatively more expensive deposits by the non-banking sector.

The differences in the funding costs at each bank group are a reflection of the differences in the breakdown of their funding and the costs of individual forms of funding. All the bank groups have continued to reduce the proportion of funding accounted for by banks in the rest of the world and to increase the proportion accounted for by relatively more expensive deposits by the non-banking sector, the cost of which fell last year. The main form of funding at the banks under majority foreign ownership is no longer cheaper liabilities to foreign banks, but is instead deposits by the non-banking sector, as at the other two bank groups.

Figure 2.9: Average cost of debt funding by bank group (left) and breakdown of funding by bank group (right) in percentages



Source: Bank of Slovenia

2.3.3 Refinancing risk

By November 2013 the banks were slightly less exposed to the burden of repayment in shorter maturity buckets on the wholesale markets than at the end of 2012. As a result of the banks' intensive debt repayments on the international wholesale markets since the end of 2009, and a significant decline in the stock of these liabilities, the short-term pressure on refinancing declined significantly last year. Towards the end of last year the banks were exposed to the maturing of government deposits, which were partly converted into equity in the early part of the restructuring process at certain large domestic banks in December 2013. The banks will be most exposed to refinancing risk in the period between

November 2014 and December 2015. The banks will see EUR 1.9 billion in liabilities to the rest of the world mature between December 2014 and the end of November 2015, and in the first quarter of 2015 will have to repay the remaining EUR 3.3 billion in long-term liabilities to the Eurosystem.

a) Government deposits at banks

On 18 December 2013 the government converted EUR 2,140 million of deposits into equity.

During the crisis the government became an important source of funding for the banks. The proportion of general government deposits to total assets in November of last year compared with the outbreak of the crisis, more than doubled reaching EUR 4.054 million or 9.5% of total assets, which stood at 16% of the deposits by non-banking sectors.

The majority of the government deposits were fixed-term deposits by the Ministry of Finance, the stock of which stood at EUR 2,928 million at the end of November 2013. The fixed-term deposits at banks by the Ministry of Finance declined sharply on 18 December 2013, by EUR 2,140 million. The government converted them into equity at certain banks.[8] Total government deposits at banks were thus halved.

At the large domestic banks government deposits accounted for just over a tenth of total liabilities at the end of last November, but the figure declined sharply in December and will only slightly exceed the pre-crisis level.

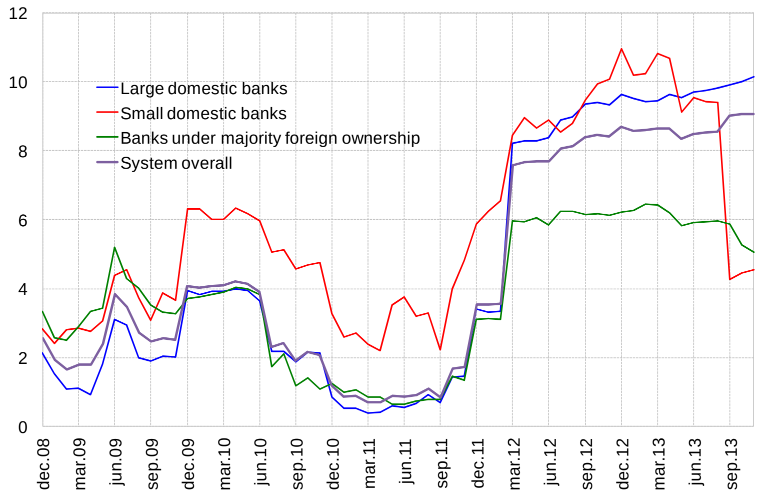
Before December's measures the banks under majority domestic ownership had a higher ratio of liabilities to the government sector to total assets than the banks under majority foreign ownership. In November it stood at 12.1% at the small domestic banks, 11.5% at the large domestic banks, and 5.2% at the banks under majority foreign ownership. According to figures for the end of 2013, there will have been a sharp decline in the proportion of total liabilities accounted for by government funding, and the figure across the banking system is expected to have declined to a level comparable to the pre-crisis level.

b) Bank funding from the Eurosystem

The banking system had EUR 3.9 billion of liabilities to the Eurosystem at the end of November 2013.

The stock of liabilities to Eurosystem instruments declined by EUR 134 million over the first eleven months of the year to EUR 3.9 billion. The contraction in total assets meant that the relative importance of this form of funding increased slightly last year, the proportion of the banking system's total liabilities that it accounts for increasing by 0.4 percentage points to 9.1%. The majority (EUR 3.3 billion) of the aforementioned liabilities are from LTROs concluded in the first quarter of 2012. The stock of 3-year LTROs declined from EUR 3.7 billion to EUR 3.3 billion last year, as a result of the prepayment of 3-year LTROs by certain banks and the withdrawal of access to ordinary ECB instruments at two smaller banks undergoing ordinary liquidation proceedings.

Figure 2.10: Liabilities to Eurosystem instruments as a proportion of the banking system's total liabilities



Source: Bank of Slovenia

The approach of the first quarter of 2015 is increasing the banks' refinancing risk at the ECB.

The gradual approach of the first quarter of 2015, when the banks will have to repay or refinance liabilities from the 3-year LTROs at the Eurosystem, is increasing refinancing risk for this funding. The majority of the debt from the 3-year LTROs is concentrated at

[8] On 18 December the Ministry of Finance carried out capital increases at Abanka, Factor banka, NKBM, NLB and Probanka. Part of the capital increase at these banks was undertaken via the conversion of fixed-term deposits by the Ministry of Finance into equity in the banks.

the large domestic banks, which account for just under EUR 2.6 billion of the total EUR 3.3 billion. Should the ECB not offer the banks new LTROs, the banks would be been forced to weaken the maturity breakdown of this funding, i.e. to switch to 3-month LTROs or main refinancing operations. In structuring their investments the banks are already actively preparing for the repayment of the liabilities from the 3-year LTROs and for gradual prepayments in 2014.

c) Maturing bank liabilities to the rest of the world

The domestic banks and the banks under majority foreign ownership reduced their debt to foreign banks last year.

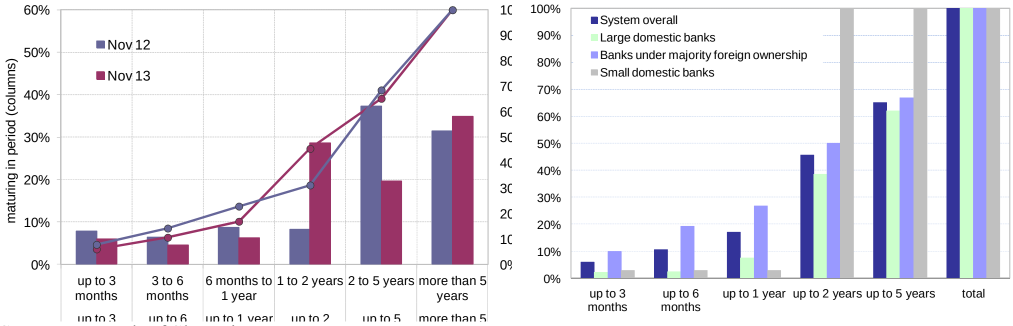
In raising funding on the wholesale markets in the rest of the world, the banks had very little success in rolling over maturing liabilities last year.[9] The banks under majority foreign ownership reduced their debts to foreign banks by EUR 1.2 billion or 27% over the first eleven months of the year, while the large domestic banks reduced their debts by EUR 0.9 billion or 30%.

The proportion of debt to the rest of the world maturing within 1 year was lower last November than a year earlier.

The maturity breakdown of maturing liabilities to foreign banks in the maturity bucket of up to 1 year was more favourable last November than a year earlier, while the breakdown of the maturity bucket of 1 to 2 years was less favourable.

The banks will see EUR 1.125 billion or EUR 16.9% of the total debt mature in the year to November 2015, while a year earlier the figure stood at 22.8%, equivalent to EUR 2.1 billion of debt to foreign banks.

Figure 2.11: Maturing of liabilities to foreign banks by maturity interval (left) and by bank group (right) at the end of November 2013 in percentages



Source: Bank of Slovenia

The banks under majority foreign ownership are more exposed to refinancing risk at shorter maturities.

The banks under majority foreign ownership are more exposed to refinancing risk at shorter maturities, having previously had access to this funding at their parent banks in the rest of the world. The banks under majority foreign ownership will see EUR 880 million or a of their total debt mature within the period of 1 year, compared with just 7.5% or EUR 242 million of debt at the large domestic banks. The small domestic banks will see their entire debt of EUR 142 million mature within the period of 2 years. The banks under majority domestic ownership have made the most intensive debt repayments during the financial crisis, as a result of which they are less exposed to refinancing risk at shorter maturities than the banks under majority foreign ownership.

Low lending activity, the adverse situation on the interbank market, and the change in parent banks' policy towards subsidiary banks brought a sharp reduction in the funding of the banks under majority foreign ownership, while the banks under majority domestic ownership undertook no new borrowing in the rest of the world last year. The stock of new loans raised at banks in the rest of the world at the banks under majority foreign ownership during the first eleven months of the year amounted to EUR 657 million, close to 60% of the figure for the whole of the previous year, and 84% of the new loans were short-term.

d) Bank funding via issued debt securities

The banks reduced their stock of issued debt securities over the first eleven months of last year.

The banks reduced their stock of funding via issued debt securities in the three years to November 2013. The banks' cumulative debt repayments via debt securities in 2011, 2012 and the first eleven months of 2013 amounted to EUR 2.8 billion.

[9] According to bank survey figures, which at that time of writing were available until the third quarter of 2013, between September 2012 and September 2013 only the banks under majority foreign ownership succeeded in rolling over their liabilities to banks in the rest of the world, in the very limited extent of less than 9%, while the domestic banks failed to roll over funding in the rest of the world.

There was no significant increase in borrowing via this form of funding during the first eleven months of the year. The exceptions were the issue of SID banka government-guaranteed 3-year bonds in March with a nominal value of EUR 200 million, and the issue of SID banka 1-year bonds in September with a nominal value of EUR 100 million.

The short-term burden of refinancing in the bucket of shortest maturities has diminished in the last year and a half. The banks will see just 11% of the total debt of EUR 1,686 billion of issued debt securities mature within one year.

3 INCOME STATEMENT AND INCOME RISK

Income risk is increasing at the banks.The banking system's pre-tax loss during the first eleven months of last year amounted to EUR 1,069 million.

The banks are increasingly exposed to high income risk. The deterioration in the quality of the credit portfolio and the decline in lending were the main factors in the decline in the banks' interest income and the increase in impairment and provisioning costs. The decline in net interest income is closely linked to the contraction in the financial and insurance activities sector and the process of restructuring funding. Because there was no repeat of the favourable effects seen in the previous year, the banking system's net non-interest income declined by 42% last year. The banking system's losses increased sharply in the autumn months.The banking system recorded a pre-tax loss of EUR 1,069 million during the first eleven months of 2013.

Increased impairment and provisioning costs were the main factor in the loss recorded by the banking system. Costs amounted to EUR 1,441.5 million over the first eleven months of the year, up 42% on the same period of 2012. The largest contribution of EUR 602 million, 42% of total impairment and provisioning costs in the first eleven months of the year, came from Probanka d.d. and Factor banka d.d., which have been undergoing an orderly wind-down process since September.

Table 3.1: Income statement, January to November 2013

	2011	Breakdown	2012	Breakdown	2011	Breakdown	2013	Breakdown	Year-on-year growth
EUR million, % growth	Jan-Dec	%	Jan-Dec	%	Jan-Oct	%	Jan-Nov	%	Nov 2013
Interest income	2.207		1.944		1.856		1.421		-21,9
Interest expenses	-1.190		-1.058		-994		-738		-25,1
Net interest	1.018	70,3	886	61,3	863	70,8	684	56,2	-18,2
Non-interest income	429	29,7	679	47,0	355	29,2	337	27,6	-42,4
of which net fees and commission	346	23,9	339	23,5	292	23,9	311	25,6	0,5
of which net gains/losses from financial assets and liabilities held for trading	-10	-0,7	-2	-0,2	-12	-1,0	1	0,1	-86,6
Gross income	1.447	100,0	1.566	108,2	1.218	100,0	1.021	83,8	-28,2
Operating costs	-777	-53,7	-743	-51,3	-633	-52,0	-648	-53,2	-4,3
of which labour costs	-416	-28,8	-400	-27,6	-345	-28,3	-350	-28,8	-4,9
Net impairments and provisioning	1.207	83,4	1.599	110,5	707	58,1	1.441	118,4	42,2
of which net impairments of financial assets at amortised cost and provisioning	950	65,6	1.201	83,0	598	49,1	1.200	98,6	45,0
Pre-tax profit	-537	-37,1	-776	-53,7	-122	-10,0	-1.069	-87,8	-295,4
Taxes	95		22		20		-2		…
Net profit	-442		-754		-102		-1.071		…

Source: Bank of Slovenia

The realisation of income risk last year was the result of the decline in net interest income, the decline in net non-interest income relative to the previous year, and the banks' high impairment and provisioning costs.

There were several factors last year in the persistence and realisation of high income risk. Net interest income was down a fifth on average on the previous year. The main factor in this was the negative growth in interest income, which during the first eleven months of the year was down 21.9%. The decline was the result of the decline in lending and high loan impairment costs, which brought a further decline in interest income. The fall in the average level of reference interest rates on the international financial markets was another factor in the decline in interest income and expenses.[10] The decline in interest expenses had a beneficial impact on the banking system's income, but could not compensate for the decline in interest income.

Net interest margin

Effective asset interest rates fell more than liability interest rates in 2013.

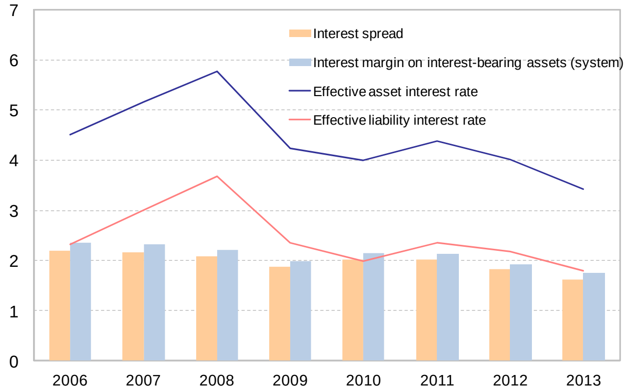
As a result of the decline in net interest outpacing the contraction in total assets, the net interest margin continued to decline last year, reaching 1.75% in November, one of the lowest figures in the region.

Average effective asset and liability interest rates fell over the first eleven months of last year: the average asset interest rate was down 0.6 percentage points on the end of 2012 at 3.4%, while average liability interest rate was down 0.4 percentage points at 1.8%. The

[10]The average of the 3-month EURIBOR over the first eleven months of last year was down 0.36 percentage points on the average figure in 2012, while the 6-month EURIBOR was down 0.49 percentage points.

average spread over the preceding year declined to 1.6 percentage points. Despite the sharper fall in interest rates on deposits by the non-banking sector since the second quarter of last year, the banks are still facing a trend of decline in the net interest margin, major factors in which have been the contraction in loans and the high proportion of non-performing claims in the portfolio.

Figure 3.1: Movement in average asset and liability interest rates, interest spread and interest margin on interest-bearing assets



Note: The figure for October is calculated cumulatively for the period of January to October 2013

Source: Bank of Slovenia

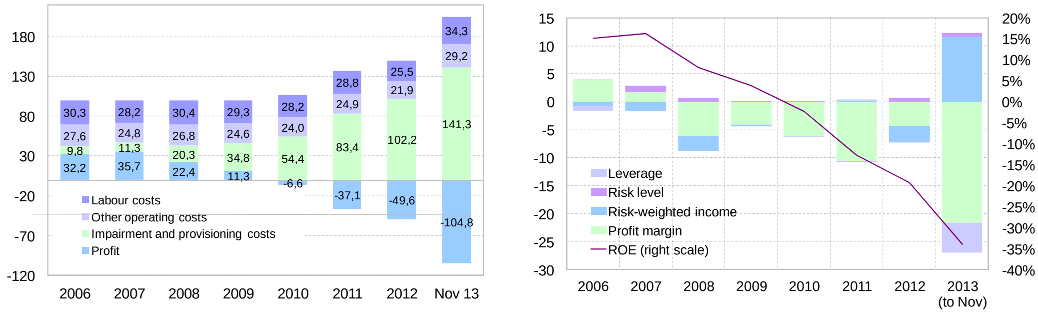
Impairment and provisioning costs

Impairment and provisioning costs during the first eleven months of last year increased sharply as a result of impairments at the two smaller banks at which an orderly wind-down process was initiated.

Only the large domestic banks recorded a year-on-year decline in impairment and provisioning costs during the first eleven months of the year, at 27.7%. They nevertheless accounted for 96% of the disposal of their gross income. The manifold increase in impairment and provisioning costs at the small domestic banks was the result of impairments at two smaller banks. Last year there was a sharp increase of 74.4% in impairment and provisioning costs at the banks under majority foreign ownership. The proportion of the disposal of gross income that they account for at this bank group has doubled over the last two years to 71%.

The proportion of the disposal of gross income accounted for by impairment and provisioning costs can be expected to begin falling after the completion of the transfer of non-performing claims to the BAMC and after the contraction in loans has been halted. This will also contribute to the stabilisation of income risk at the banks.

Figure 3.2: Breakdown of the disposal of the Slovenian banking system's gross income in percentages (left), and ROE in terms of four factors (right)



Source: Bank of Slovenia

The banks under majority domestic ownership had slightly lower margins than the banks under majority foreign ownership last year.

The banks under majority domestic ownership had a slightly lower interest margin on interest-bearing assets (1.69%) than the banks under majority foreign ownership (1.86%).

Table 3.2: Bank performance indicators during the first eleven months of 2013 in percentages

	End of period					
(%)	2009	2010	2011	2012	Nov 2012	Nov 2013
Profitability						
Financial intermediation margin*	2,88	2,88	2,87	3,23	3,20	2,48
ROA	0,32	-0,19	-1,06	-1,60	-0,61	-2,59
ROE	3,87	-2,30	-12,54	-19,04	-7,17	-33,61
Interest margin on interest-bearing assets	1,98	2,14	2,13	1,93	1,98	1,75
Net non-interest income / operating costs	-64,42	-56,99	-55,28	-91,48	-86,30	-51,93
Operating costs						
Labour costs / average assets	0,84	0,81	0,83	0,82	0,83	0,85
Other costs / average assets	0,71	0,69	0,71	0,71	0,69	0,72
Quality of assets						
Impairments of financial assets measured at amortised cost / gross assets	3,00	4,18	5,88	8,05	7,65	10,42

Note: *Gross income / average assets
Source: Bank of Slovenia

4 CREDIT RISK

4.1 Quality of the credit portfolios of banks and savings banks

The quality of the credit portfolio continued to deteriorate until last December, when the government and the Bank of Slovenia actively embarked on the restructuring process at the largest banks. The classified claims of banks and savings banks have been declining since the middle of 2012, and by November 2013 had fallen to the level recorded in 2008. The banks are downgrading claims, as a result of which impairments are increasing. September brought a sharp increase in impairments, primarily at the small domestic banks, as a result of the orderly wind-down process at Factor banka and Probanka.

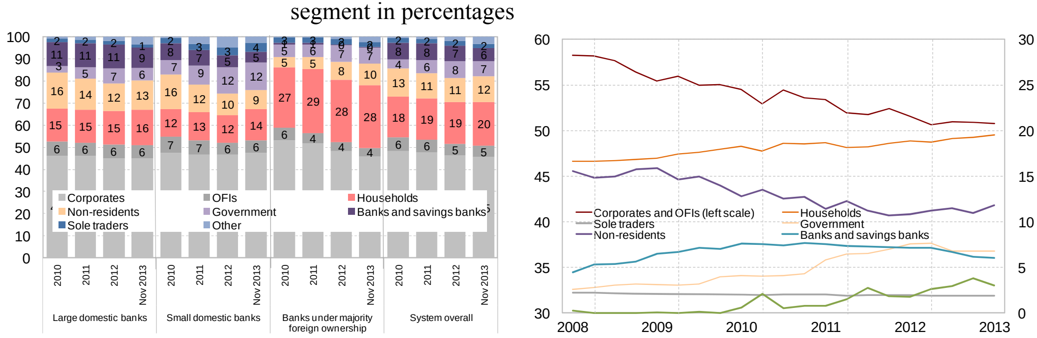
Non-performing claims, defined as those more than 90 days in arrears, accounted for 17.3% of the banks' total classified claims in November. The transfer of some non-performing claims to the Bank Asset Management Company (BAMC) will result in a significant decline in the proportion of non-performing claims across the banking system, but the further development of credit risk will depend on the banks' activities aimed at addressing the remaining non-performing investments by means of more effective recovery, write-downs and, where justified, the conversion of debts into equity, and on the recovery of lending growth. Lending growth will be the main factor in reducing the proportion of non-performing claims in the banks' portfolio. The amendments to the Financial Operations, Insolvency Proceedings and Compulsory Dissolution Act (the ZFPPIPP; Official Gazette of the Republic of Slovenia, No. 100/13) allow banks to address non-performing claims more effectively and comprehensively, which in 2014 should contribute to a more pronounced reduction in the proportion of non-performing claims in the banks' portfolio. The largest deterioration in the portfolio last year was recorded by corporates and OFIs.[11] Some 73% of total impairments have been earmarked for covering non-performing claims, and coverage of non-performing claims thus stood at 47.6% at the end of November. Claims against bankrupt clients accounted for 42% of non-performing claims in November, up on the figure in 2012. The large domestic banks recorded the lowest write-downs of non-performing claims last year.

4.1.1 Total classified claims and coverage of claims by impairments

Across the system of banks and savings banks classified claims fell to the level recorded in 2008.

The classified claims of banks and savings banks have been declining since the middle of 2012, as a result of the decline in the banks' lending activity and the resolution of non-performing investments. According to the latest figures for November, the banks' classified claims amounted to EUR 44.9 billion. They peaked at EUR 50 billion between 2010 and 2012.

Figure 4.1: Breakdown of the banks' classified claims by bank group and by client segment in percentages



Source: Bank of Slovenia

[11] The new ESA 2010 methodology was introduced on 1 January 2014, and applies a new sectoral classification for holding companies and head offices. In addition, the ECB, Eurostat and the OECD established a working group on holding companies and head offices, which defined the criteria for classification as a holding company. The SORS accordingly reclassified holding companies to new sectors when the new sector classification was introduced, as a result of which a number of firms classed under activities of holding companies (64.200) have been reclassified from non-financial corporations (S.11, under financial and insurance activities) to OFIs (S.127, captive financial institutions).

The stagnation in lending is most evident in the corporate and non-resident sectors.

Banks are downgrading their clients.

The main decline relative to 2010 was in corporate lending, which was down EUR 3.6 billion. The proportion of classified claims accounted for by corporates declined by 3 percentage points. However, portfolios are continuing to deteriorate in terms of ratings, and the proportion of clients classified in lower-risk ratings (A and B) is declining. The A and B ratings accounted for 85.5% of the banking system's classified claims at the end of 2012, and 80.1% in November 2013. Another factor in the decline in this proportion was the banks' low lending activity, as new loans are generally classified in the lower-risk ratings. The proportion of total classified claims accounted for by the higher-risk ratings (D and E) reached 11.4%.

Table 4.1: Ratings breakdown of classified claims and coverage of claims by impairments and provisions in EUR millions and in percentages

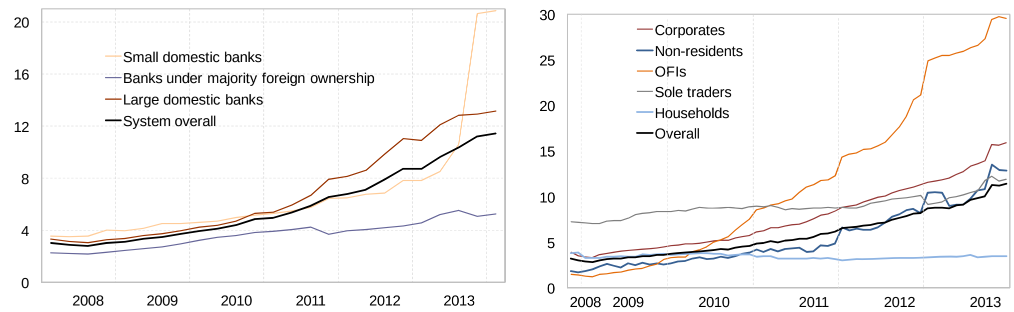
	31. 12. 2011			31. 12. 2012			30.11.2013		
	Classified claims	Impairments	Coverage of claims by impairments, %	Classified claims	Impairments	Coverage of claims by impairments, %	Classified claims	Impairments	Coverage of claims by impairments, %
Total, EUR million	49.466	3.249	6,57	47.876	4.169	8,71	44.879	5.129	11,43
	Breakdown, %			Breakdown, %			Breakdown, %		
A	66,02	3,3	0,3	57,34	2,0	0,3	55,53	1,4	0,3
B	22,65	14,6	4,2	28,13	12,5	3,9	25,26	9,6	4,3
C	5,13	20,9	26,8	5,59	17,2	26,8	7,80	19,0	27,8
D	5,50	50,6	60,4	8,20	59,9	63,6	10,17	59,3	66,6
E	0,70	10,6	100,0	0,74	8,5	100,0	1,24	10,9	100,0

Source: Bank of Slovenia

A record level of impairments and provisions was achieved this year.

In contrast to classified claims, impairments and provisions have been rising consistently since the end of 2008, reaching a peak of EUR 5.1 billion in November. As a result, the coverage of total classified claims by impairments had risen by 2.7 percentage points by November to 11.4%.

Figure 4.2: Coverage of classified claims by impairments by bank group (left) and by client segment (right) in percentages



Source: Bank of Slovenia

The small domestic banks have the largest coverage of claims by impairments.

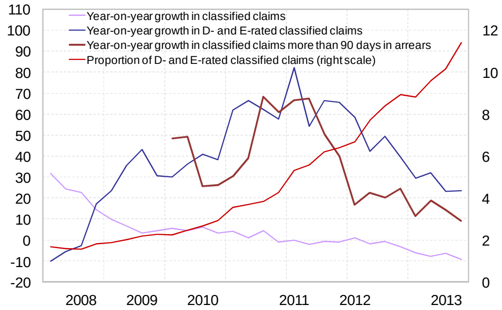
All sectors saw an increase in impairments in 2013, most notably the sectors of OFIs and non-financial corporations, where coverage increased by 4.6 percentage points and 4.4 percentage points respectively. This is a reflection of the above-average risk of these two sectors. In September there was a sharp increase in impairments at the small domestic banks, as a result of an orderly wind-down process at two small banks, Factor banka and Probanka, coverage of claims reaching the above-average level of 21%. Coverage of classified claims by impairments increased throughout the year, as a result of the deterioration in the quality of the banks' credit portfolio.

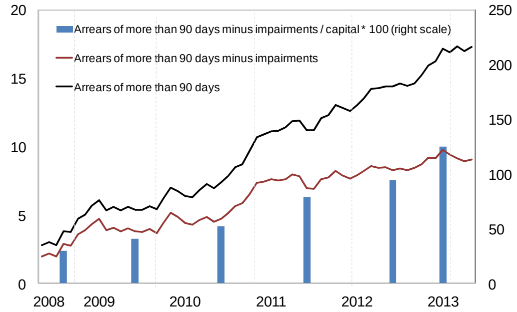
4.1.2 Classified claims more than 90 days in arrears (non-performing claims)

Non-performing claims are defined as classified claims including on-balance-sheet claims measured at amortised cost and high-risk off-balance-sheet claims where the debtor is more than 90 days in arrears in the payment of materially significant liabilities. When a client has several claims at a particular bank, all the claims are included in the calculation of the indicator, even if only certain claims are in arrears. The principle applied is the client based approach.[12]

[12] The definition of non-performing claims varies from country to country, for which reason there is limited comparability in portfolio quality at individual banks and international comparability between banks. The need thus arose for a standard definition, for which reason the European Banking Authority (EBA) approved a document that will form the basis for the regular reporting

Figure 4.3: Growth in classified claims and D-and E-rated claims (left), and proportion of classified claims more than 90 days in arrears with and without impairments (right) in percentages





Source: Bank of Slovenia

Non-performing claims accounted for 17.3% of total classified claims.

Classified claims more than 90 days in arrears reached EUR 7.8 billion in November, equivalent to 17.3% of the banks' total classified claims. The highest credit risks for the banks are the sectors of OFIs, where 36% of claims are non-performing, and non-financial corporations, where 28% of claims are non-performing. The largest non-performing claims in absolute terms were recorded by non-financial corporations, in the amount of EUR 5.7 billion, an indication that this portion of the banks' portfolio accounts for the prevailing credit risk.

Table 4.2: Breakdown of classified claims by client segment in terms of number of days in arrears in the settlement of liabilities to banks in EUR millions and percentages

	Classified claims			Proportion of classified claims in arrears in client segment					
				Total arrears			Of which: arrears of more than 90 days		
	Dec 11	Dec 12	Nov 13	Dec 11	Dec 12	Nov 13	Dec 11	Dec 12	Nov 13
Total, EUR million	49.466	47.876	44.879	9.462	9.180	9.865	5.547	6.904	7.762
				Proportion of total, %					
Corporates	48,1	46,6	45,4	27,8	30,6	36,3	17,4	22,8	28,0
OFIs	5,4	5,1	5,3	35,4	39,9	40,9	28,6	34,7	36,0
Household sector[1]	20,7	20,8	21,4	10,3	9,9	-	4,5	4,9	-
sole traders	2,1	2,0	1,9	22,9	23,8	27,5	14,1	14,9	19,9
households[1]	18,7	18,9	19,5	8,9	8,5	-	3,5	3,8	-
Non-residents	11,4	10,8	11,8	15,5	20,0	22,5	8,7	15,8	18,7
Government	5,7	7,5	6,8	28,6	2,3	1,4	0,8	0,5	0,9
Banks and savings bank	7,5	7,1	6,0	0,2	0,7	0,2	0,1	0,0	0,1
Central bank	0,8	1,7	3,0	0,0	0,0	0,0	0,0	0,0	0,0
Other	0,4	0,3	0,2	0,0	0,0	0,0	0,0	0,0	0,0
Total	100,0	100,0	100,0	19,1	19,2	22,0	11,2	14,4	17,3

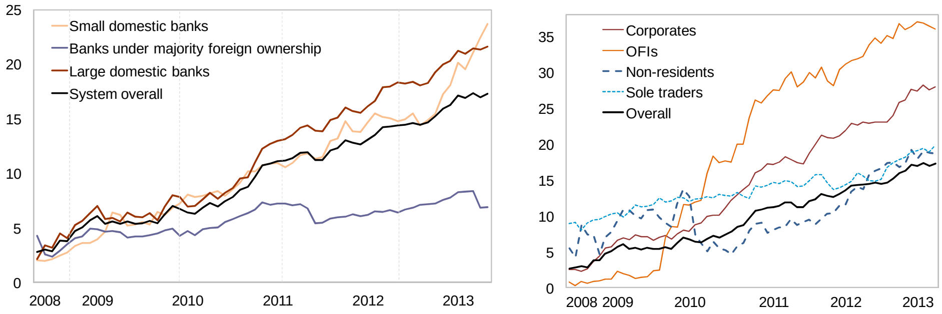
Note: [1] The 2011 and 2012 figures for households are estimated on the basis of figures from the bank survey. The estimate is also taken into account in the aggregate figure for households.

Sources: Bank of Slovenia, bank survey

Non-performing claims rose sharply last year at the small domestic banks to peak at 23.7%, thereby overtaking the proportion of non-performing claims at the large domestic banks (21.6%). The quality of the portfolio of the banks under majority foreign ownership in November was similar to that at the end of 2012.

by banks to the EBA on the amount of non-performing claims as of 2015. The approval of the definition does not exclude other definitions at individual national supervisors. Whether the new definition is adopted in reporting to international institutions (EMF, ECB) will only be evident in 2015.

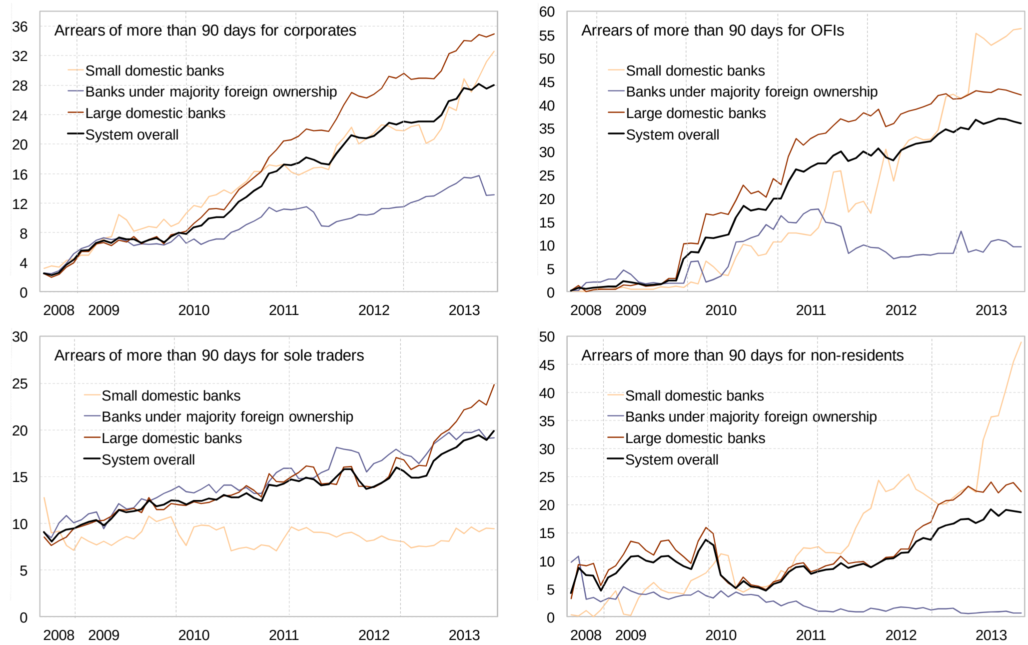
Figure 4.4: Arrears of more than 90 days as a proportion of the banks' classified claims by bank group (left) and client segment (right) in percentages



Source: Bank of Slovenia

Analysis of arrears of more than 90 days by client segment reveals that the main deteriorations relative to the end of 2012 were recorded by the segments of the banks' portfolio exposed to the corporate sector (by 5.1 percentage points to 28%) and to sole traders (by 5 percentage points to 19.9%), and, to a slightly lesser extent, to non-residents (by 2.9 percentage points to 18.7%) and OFIs (by 2.3 percentage points to 36%).

Figure 4.5: Arrears of more than 90 days as a proportion of the banks' classified claims by bank group and individual client segment in percentages



Source: Bank of Slovenia

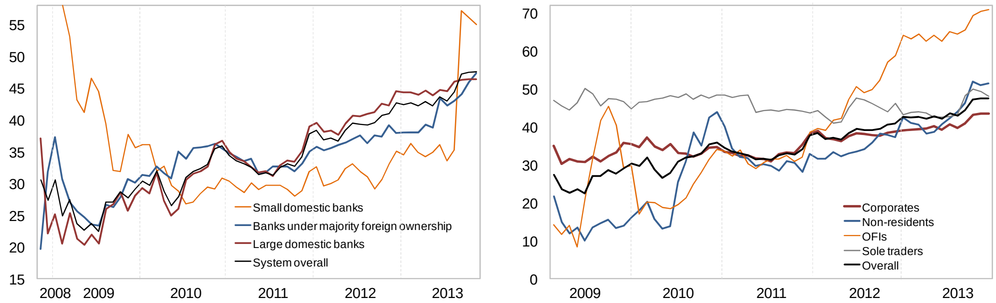
The main deteriorations in the portfolio were seen in the sectors of non-financial corporations, non-residents and OFIs.

The highest proportion of non-performing claims and growth in non-performing claims was recorded by the small domestic banks in the corporate and non-resident sectors. The proportion of non-performing claims against corporates was up almost 10.2 percentage points on 2012 at 32.6%, while the proportion of non-performing claims against non-residents rose extremely sharply by 28.8 percentage points to 48.9%. Non-performing claims against OFIs are smaller in absolute magnitude, but increased to an extremely high proportion of 56.3%. This was primarily the result of the deterioration in the portfolio of two small banks, Factor banka and Probanka

Like the small domestic banks, the large domestic banks have the highest proportions of non-performing claims against non-financial corporations, at 35% or EUR 4.2 billion in absolute terms, and OFIs, at 42.2% or EUR 682 million in absolute terms. The figures for the portfolio of sole traders and non-financial corporations deteriorated by 9.1 percentage points and 6.2 percentage points respectively relative to 2012.

The quality of the banking system's portfolio of sole traders was relatively stable until the end of 2012. The proportion of non-performing claims against sole traders began increasing last year at all the bank groups. The largest increase was at the large domestic banks, where the figure rose by 9.1 percentage points to 24.8%. The sustained financial crisis is slowly expanding to segments of lending that had previously not entailed significant credit risk for the banks.

Figure 4.6: Coverage of classified claims more than 90 days in arrears by impairments by bank group (left) and by client segment (right) in percentages



Source: Bank of Slovenia

73% of total impairments are earmarked for covering non-performing claims.

Of the banks' total impairments in the amount of EUR 5.1 billion, EUR 3.7 billion is earmarked for covering non-performing claims more than 90 days in arrears. The indicator of the coverage of claims more than 90 days in arrears by impairments does not take account of credit protection in the form of collateral pledged by the debtor. The coverage of claims more than 90 days in arrears by impairments increased throughout the year, reaching 47.6% in November.

Impairments at Factor banka and Probanka increased sharply in September, which brought a pronounced increase in the coverage of non-performing claims by impairments at the small domestic banks to 57%, compared with 35% at the end of 2012. The other two bank groups recorded similar levels of coverage of non-performing claims, at 46%. The coverage of non-performing claims increased by 1.8 percentage points at the large domestic banks and by 9.5 percentage points at the banks under majority foreign ownership over the same period.

Table 4.3: Coverage of total classified claims and non-performing claims more than 90 days in arrears in percentages

	Coverage of total classified claims by impairments, %				Coverage of claims more than 90 days in arrears by impairments, %			
	Dec 10	Dec 11	Dec 12	Nov 13	Dec 10	Dec 11	Dec 12	Nov 13
Corporates	6,1	8,8	11,5	15,9	34,7	38,2	39,2	43,6
OFIs	8,5	14,4	24,9	29,5	34,1	38,7	64,1	71,0
Household sector	4,0	3,6	3,9	4,2	-	-	-	-
sole traders	8,9	8,8	9,1	11,9	48,4	43,7	43,3	48,1
households	3,4	3,0	3,3	3,5	-	-	-	-
Non-residents	4,2	6,6	10,4	12,9	44,0	32,9	42,6	51,5
Government	0,2	0,1	0,2	0,3	11,8	3,3	5,3	14,0
Banks and savings banks	0,2	0,5	1,2	2,4	42,2	12,1	12,2	0,5
Total coverage	4,9	6,6	8,7	11,4	36,0	37,8	42,7	47,6
	Total classified claims				Total claims more than 90 days in arrears			
Total, EUR million	49.766	49.466	47.876	44.879	3.688	5.547	6.904	7.762
Ratio to GDP, %	139,8	136,8	135,0	128,2	10,4	15,3	19,5	22,2

Source: Bank of Slovenia

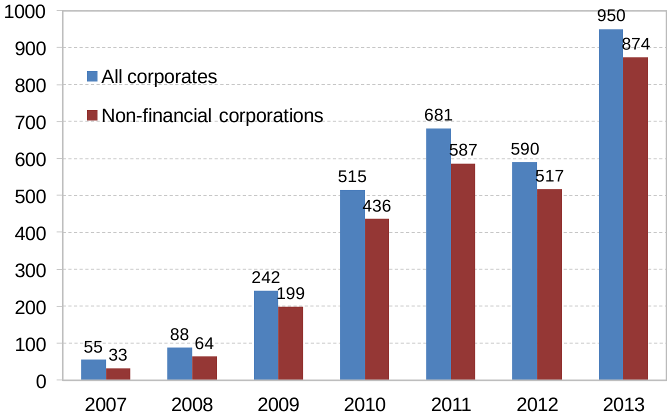
The coverage of classified non-performing claims for individual segments of the portfolio indicates which client group has a higher level of risk after allowing for collateral quality. The coverage of non-performing claims against OFIs reached 71% in November.

Classified claims against bankrupt clients and write-downs

The number of bankruptcies in the corporate sector increased further last year compared with 2011 and 2012. The banks' exposure to firms in bankruptcy constitutes the largest risk of claims being lost or only partially repaid. The analysis covers firms in the sectors of non-financial corporations, OFIs and sole traders, but does not cover non-resident firms.[13]

[13] It includes all firms established in the Republic of Slovenia to which banks were exposed as at 30 November 2013 that were undergoing personal bankruptcy proceedings or corporate bankruptcy proceedings.

Figure 4.7: Number of bankruptcy proceedings initiated at year end



Source: Bank of Slovenia

Table 4.4: Classified claims against Slovenian firms in bankruptcy and total classified claims, November 2013, in EUR millions

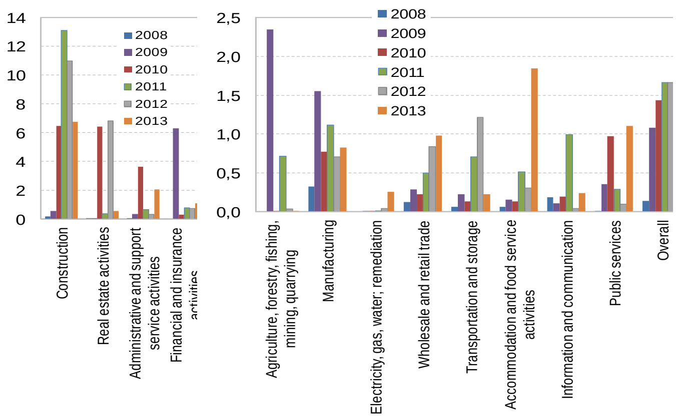
	Corporates	OFIs	Sole traders	Overall
Agriculture, mining	12			12
Manufacturing	502		8	510
Electricity, gas, water	9			9
Construction	1.255		1	1.256
Wholesale and retail trade	276		3	279
Transportation and storage	141		4	145
Accommodation and food service activities	37		2	40
Information and communication	12			12
Financial and insurance activities	65	621		686
Real estate activities	76		0,1	76
Professional, scientific and technical activities	142	104	0,2	246
Public services	2		0,1	2
Total classified claims against bankrupt entities	2.530	725	18	3.272
Total classified claims	20.392	2.400	850	23.642
Proportion of classified claims against bankrupt entities, %	12	30	2	14

Source: Bank of Slovenia

Of the total non-performing claims of EUR 7.8 billion in November, 42% consisted of claims against firms in bankruptcy proceedings. OFIs and sole traders account for 22% and 0.6% of bankrupt claims respectively.

Claims against firms in bankruptcy account for 42% of non-performing claims.

Figure 4.8: Percentage of total assets in sector accounted for by firms in bankruptcy by year of initiation of bankruptcy proceedings* in percentages



Note: *Ratio of total assets of firms against which bankruptcy proceedings have been initiated to total assets in the sector. The figures refer to the year prior to the initiation of bankruptcy proceedings when the firms were still filing financial statements.

Sources: Bank of Slovenia, Supreme Court, AJPES

Non-financial corporations against which bankruptcy proceedings were initiated in 2013 accounted for 1.1% of the total assets of non-financial corporations or EUR 1 billion, down from 1.7% or EUR 1.5 billion in 2012. In terms of sector, the largest proportion of total assets accounted for by firms in bankruptcy was recorded by the construction sector, where the figure was 6.8% in 2013, equivalent to EUR 362 million. This sector also recorded the highest figures in 2011 and 2012, at 13.1% and 11% respectively.

Classified claims against clients in bankruptcy increased by EUR 360 million relative to the end of 2012. The largest increases in classified claims against firms in bankruptcy during the first eleven months of 2013 were recorded by the sectors of manufacturing (EUR 134 million) and wholesale and retail trade (EUR 123 million). These changes were minimal in all other sectors.

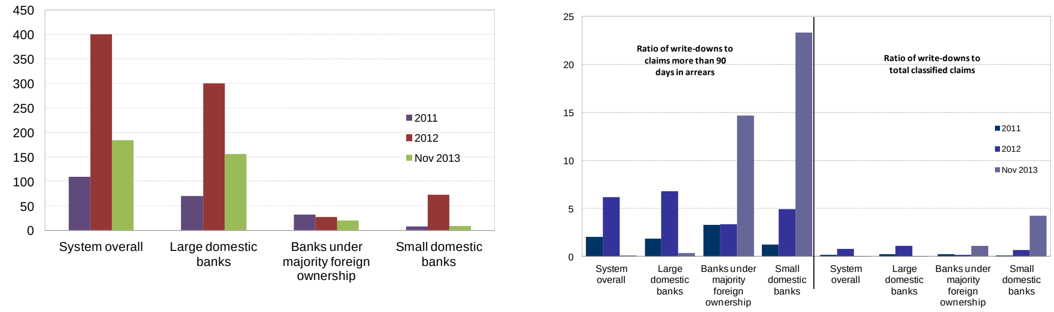
Table 4.5: Banks' classified claims against non-financial corporations in bankruptcy in EUR millions and as a proportion of total claims against non-financial corporations in percentages by sector

	Classified claims against firms in bankruptcy, EUR million				Proportion of total claims against sector, %			
	Dec 08	Dec 11	Dec 12	Nov 13	Dec 08	Dec 11	Dec 12	Nov 13
Agriculture, mining	2	15	12	12	0,9	5,1	3,9	4,3
Manufacturing	38	360	368	502	0,6	5,7	6,3	9,4
Electricity, gas, water	2	0	3	9	0,2	0,0	0,2	0,8
Construction	10	850	1.254	1.255	0,3	24,6	38,4	42,3
Wholesale and retail trade	20	83	153	276	0,4	1,9	3,9	7,6
Transportation and storage	2	27	136	141	0,1	1,2	6,9	7,1
Accommodation and food service activities	1	4	12	37	0,1	0,6	1,8	5,8
Information and communication	3	24	16	12	0,4	4,0	2,5	2,1
Financial and insurance activities	2	11	65	65	0,1	1,2	8,0	10,1
Real estate activities	2	38	40	76	0,1	3,5	3,8	7,8
Professional, scientific and technical activities	9	112	108	142	0,5	5,5	5,8	8,3
Public services	0	0	3	2	0,0	0,1	0,7	0,7
Overall	90	1.526	2.170	2.530	0,4	6,5	9,8	12,4
No. of proceedings initiated in year: NFCs	64	587	516	874				
- total	86	681	589	950				

Source: Bank of Slovenia

Despite the high growth in claims against firms in bankruptcy proceedings, it is only to a lesser extent that the banks are opting to write off such claims or to apply one of the other approaches to addressing such claims that were defined more clearly in the amended Financial Operations, Insolvency Proceedings and Compulsory Dissolution Act (the ZFPPIPP-F; Official Gazette of the Republic of Slovenia, No. 100/13). Claims against firms in bankruptcy have mostly been impaired in nearly their full amounts prior to being written off, meaning that the write-offs had relatively little impact on the banks' operating results. Write-offs in 2012 were mostly prompted by the possibility of writing off such claims more expediently when the banks assessed during recovery proceedings that they will not be repaid.[14] The banks' total write-offs thus amounted to EUR 403 million in 2012, and to EUR 184 million during the first eleven months of last year. Given that the large domestic banks have the highest proportion of non-performing claims, the amount of write-offs of the aforementioned claims was also highest at that bank group, at EUR 156 million.

Figure 4.9: Write-offs of financial assets at the banks in EUR millions (left) and ratio of write-offs to claims more than 90 days in arrears and to total classified claims in percentages (right)



Sources: Bank of Slovenia

The small domestic banks recorded the highest proportion of write-offs of non-performing claims, as a result of the orderly wind-down process at Factor banka and Probanka.

The ratio of write-offs of claims to total claims more than 90 days in arrears was highest at the small domestic banks, at 23.3% The corresponding figure at the banks under

[14] The Bank of Slovenia regulation on the assessment of credit risk losses from April 2012 allows for the more expedient write-off of claims, even if no court decision on the completion of bankruptcy proceedings has been issued, provided that the banks assess during recovery proceedings that the claims will not be repaid. The banks were thus able to write off unsecured claims against debtors that are more than three years in arrears or in bankruptcy proceedings for more than one year, and claims secured by real estate collateral more than five years in arrears or for which the bank in question did not receive any payment from the redemption of collateral over the same period.

majority foreign ownership was 14.7%, while the large domestic banks recorded the lowest figure of 0.3%.

4.2 Non-financial corporations and their impact on the credit risk at the banks

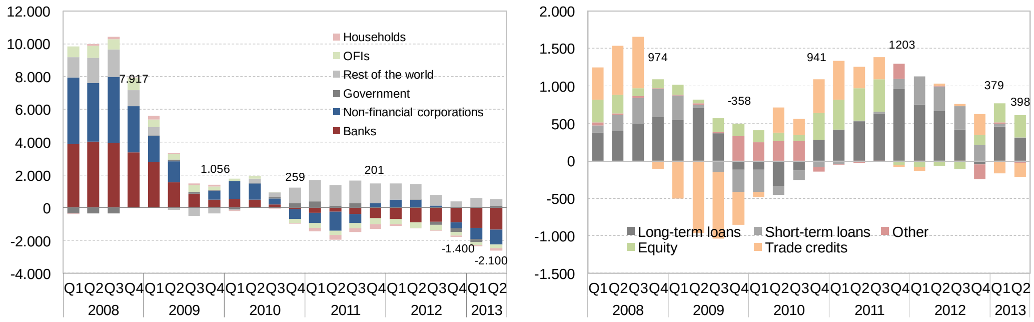
The banks' exposure to non-financial corporations is the highest-risk segment of the credit portfolio, for which reason changing the structure and method of corporate financing is vital to the future development of credit risk at the banks.

The flow of financing to non-financial corporations in Slovenia was again negative in 2013.

The flow of financing to Slovenian corporates was again negative last year, as a result of the tightened financing conditions. The annual flow of financing in the second quarter of 2013 was negative in the amount of EUR 2.1 billion. A decline in financing was seen in all sectors, most notably in financing at banks and business-to-business financing in Slovenia. After a brief recovery in 2011, business-to-business financing has again declined over the last two years, in the forms of both business-to-business loans and financing via trade credits. Only corporate financing in the rest of the world has remained at almost the same level. The origin in the inflow of foreign equity has changed: since the third quarter of 2012 it has primarily come from countries outside the EU, while in previous years EU Member States were prevalent.

A survey on non-financial corporations' demand for loans in 2012 and the first half of 2013 reveals that demand for loans at banks and savings banks in Slovenia contracted. There has been a sharp increase in demand for loans for restructuring at the large domestic banks, which is a reflection of the problems of corporates with a high level of debt and significant arrears in the settlement of liabilities to the banks, while demand for loans for working capital and for investment has declined. Despite the decline in non-financial corporations' demand for loans, the level of surplus demand has risen in the last three and a half years, from 28% in 2010, to 33% in 2012 to 41% in the first half of last year. The main reasons cited by banks and savings banks when rejecting loans are the client's poor credit rating, and the client's refusal to accept the bank's terms.

Figure 4.10: Financing flows of non-financial corporations by sector (left) and financing of non-financial corporations in the rest of the world by instrument (right), annual moving total of flows in EUR millions



Source: Bank of Slovenia

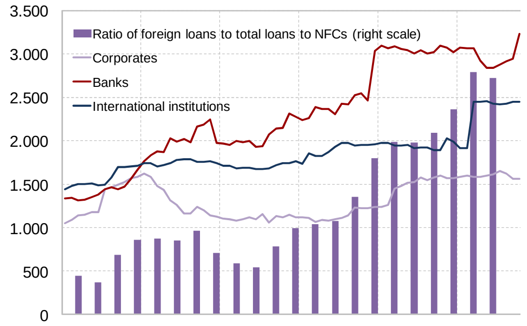
The inflow of equity from the rest of the world strengthened in the first half of 2013.

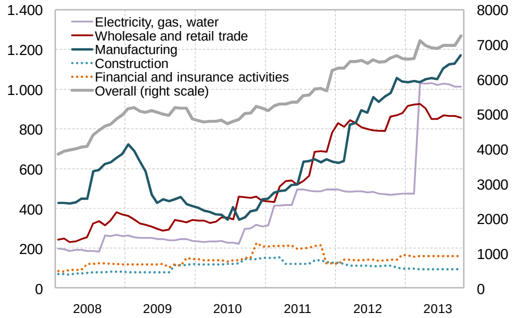
The main increases in the financing of non-financial corporations in the rest of the world in the first half of last year were in long-term loans and equity, which slightly compensated for the loss of domestic funding. The inflow of equity, which since its peak of EUR 470 million in 2007 has mostly remained low, strengthened slightly in the first half of 2013 to EUR 170 million. It nevertheless remains modest given the need for a more pronounced change in the breakdown of corporate financing in favour of equity.

Loans from the rest of the world accounted for an increasing proportion of total corporate financing via loans. Loans to corporates from the rest of the world accounted for 21% of all corporate loans in the second quarter of 2013, up 3 percentage points on the same period of the previous year. The proportion of loans from the rest of the world reached the level recorded in 2004, when it stood at more than 20% but then declined sharply in the following years as a result of the rapid growth in loans at the domestic banks during the pre-crisis period.

Positive year-on-year growth in financing in the rest of the world during the first ten months of last year was recorded by corporates in the sectors of manufacturing, electricity and water supply, wholesale and retail trade, and financial and insurance activities. Despite its major impact on growth in economic activity as a result of its export orientation, manufacturing recorded an above-average decline in financing at the domestic banks. The increase in financing in the rest of the world is an indication of the possibility of choosing between financing at the domestic banks or banks from affiliates in the rest of the world.

Figure 4.11: Stock of corporate loans from the rest of the world by foreign creditor's sector (left) and for selected sectors (right) in EUR millions



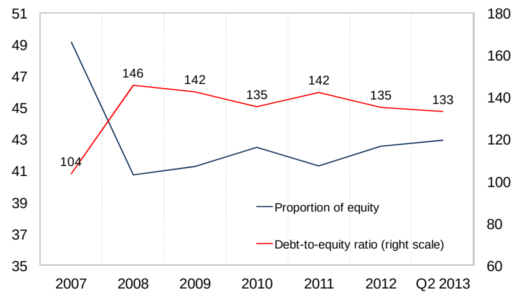


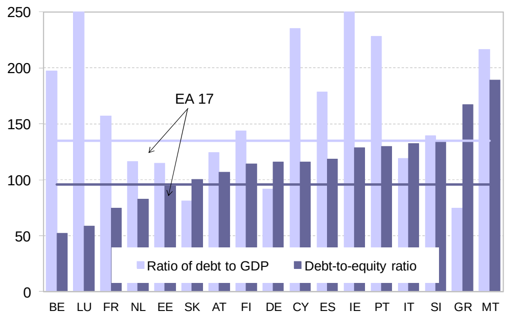
Sources: AJPES, Bank of Slovenia calculations

Leverage remains high, primarily as a result of a lack of equity.

High corporate indebtedness remains one of the main reasons for low financing at the domestic banks. Given the debt repayments at the domestic banks, the average debt-to-equity ratio has been declining, but remains among the highest in the euro area. By contrast, in terms of the ratio of corporate debt to GDP, Slovenian corporates are among the least-indebted, an indication that the reason for the high leverage is primarily a lack of equity, and only to a lesser extent the amount of debt.

Figure 4.12: Corporate debt-to-equity ratio in percentages (left) and comparison of corporate indebtedness in Slovenia with the euro area (right)

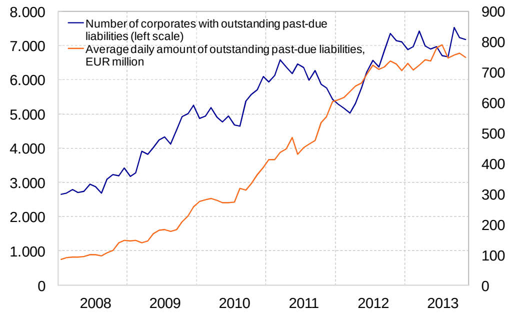


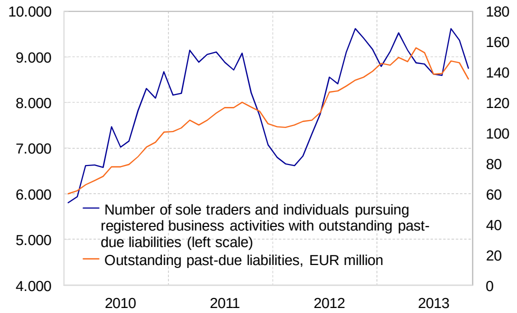


Sources: AJPES, Eurostat, Bank of Slovenia calculations

The number of corporates with outstanding past-due financial liabilities from court enforcement orders and tax debt increased slightly in 2013, having already passed its peak of March 2011 in March 2012. There is similar movement in the number of sole traders and other private individuals with outstanding past-due liabilities from court enforcement orders and tax debt. The average daily amount of these liabilities is increasing at legal entities, while for sole traders the average daily amount of these liabilities remained at almost the same level in 2013.

Figure 4.13: Number of legal entities (left) and sole traders and individuals pursuing registered business activities (right) with outstanding past-due liabilities from court enforcement orders and tax debt and their average daily amount of outstanding past-due liabilities in EUR millions

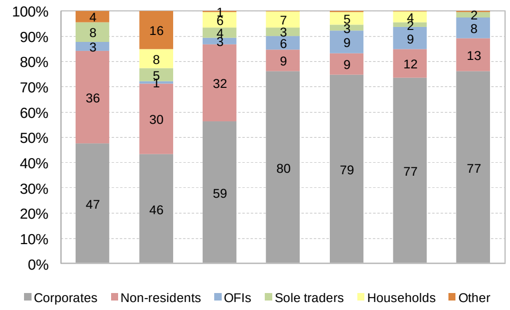


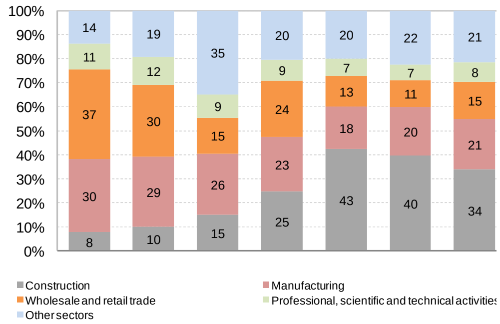


Source: Bank of Slovenia

In terms of client segment, corporates account for the largest proportion of classified claims in the banks' portfolios. This segment accounted for 45.4% of total classified claims in November 2013, equivalent to a total exposure of EUR 20.4 billion. Non-financial corporations account for 76.6% of non-performing claims. The banks' exposure to non-financial corporations amounted to EUR 5.7 billion.

Figure 4.14: Breakdown of the banks' non-performing claims by client segment (left), and within the corporate sector by sector (right) in percentages





Source: Bank of Slovenia

The largest classified claims more than 90 days in arrears are recorded by corporates in the sectors of construction, manufacturing, and wholesale and retail trade.

The largest proportion of classified claims against non-financial corporations more than 90 days in arrears is accounted for by the construction sector, at 34%. The construction sector reached the top of this ranking in 2011, but the figure has begun to decline as the corporate portfolio in other sectors deteriorates. Next comes the manufacturing sector, whose figure has increased over the years like that of construction, albeit at a slower pace: it now accounts for 21% of claims more than 90 days in arrears. A similar trend was also seen in the wholesale and retail trade sector, which accounted for 15% of total non-performing claims in November 2013.

Table 4.6: Breakdown of banks' classified claims and the proportion of liabilities to banks settled more than 90 days in arrears by bank group and by sector, November 2013, in percentages

	Breakdown of classified claims against corporates, %				Proportion of arrears of more than 90 days in sector, %			
	System overall	Large domestic banks	Small domestic banks	Banks under majority foreign ownership	System overall	Large domestic banks	Small domestic banks	Banks under majority foreign ownership
Agriculture, mining	1,3	1,2	2,1	1,3	15,6	22,5	16,2	2,6
Manufacturing	26,3	28,6	22,3	22,9	22,3	25,7	30,9	11,5
Electricity, gas, water	6,1	5,0	3,9	9,0	5,6	10,2	4,4	0,8
Construction	14,6	17,0	17,4	9,1	65,2	74,9	61,5	32,5
Wholesale and retail trade	17,7	15,4	20,9	21,1	24,4	32,9	18,3	14,4
Transportation and storage	9,8	10,0	2,1	11,5	11,0	13,1	33,1	6,2
Accommodation and food service activities	3,2	3,3	2,8	3,1	39,3	47,4	38,9	22,4
Information and communication	2,9	2,9	2,0	3,3	30,8	45,8	33,2	4,8
Financial and insurance activities	3,2	3,3	5,9	2,0	22,7	24,5	25,2	14,4
Real estate activities	4,8	4,4	6,9	4,9	26,8	33,8	29,7	13,4
Professional, scientific and technical activities	8,3	6,9	12,6	9,8	27,9	33,5	35,2	17,5
Public services	1,9	1,9	1,1	2,1	12,6	13,0	21,1	10,5
Overall	100	100	100	100	28,0	35,0	32,6	13,2
Total, EUR million	20.392	12.153	1.938	6.301	5.710	4.249	632	829

Source: Bank of Slovenia

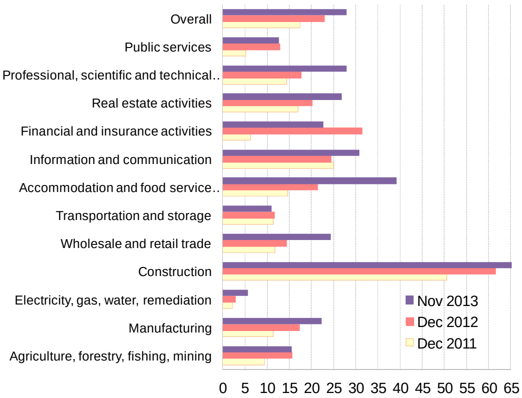
Exposure to classified claims more than 90 days in arrears by bank group

The proportion of claims against corporates more than 90 days in arrears stood at 28% in November 2013. The quality of the banks' credit portfolio of non-financial corporations deteriorated by an additional 4.6 percentage points from the end of the previous year. The figure is highest at the large domestic banks at 35%, followed by the small domestic banks, whose figure of 32.6% is primarily the result of additional losses disclosed in the audit of the two banks undergoing the orderly wind-down process. The banks under majority foreign ownership have the lowest proportion of claims more than 90 days in arrears, at 13.2%. The largest proportion of defaulters more than 90 days in arrears is in the construction sector, where claims more than 90 days in arrears amount to EUR 2 billion, or 65.2% of total classified claims against the sector. Next come manufacturing, with claims of EUR 1.2 billion equivalent to 22.3% of total classified claims against the sector, and wholesale and retail trade, with claims of EUR 880 million equivalent to 24.4% of classified claims against the sector.

The proportion of classified claims in arrears increased last year in the sectors of accommodation and food service activities and wholesale and retail trade.

There has been a deterioration in corporate solvency in the majority of sectors relative to the end of 2011 and 2012 across the system. The largest increases in arrears of more than 90 days relative to 2012 were recorded by the accommodation and food service activities sector and the wholesale and retail trade sector, at 17.9 percentage points and 10 percentage points respectively.

Figure 4.15: Proportion of the banks' classified claims against non-financial corporations more than 90 days in arrears in percentages



Source: Bank of Slovenia

The transfer of some non-performing claims from NLB and NKBM to the BAMC in December 2013 will significantly reduce the proportion of non-performing claims in the banking system. The rough estimate is that the proportion of claims more than 90 days in arrears across the banking system will decline by approximately 5 percentage points. The estimate does not take account of any write-offs of claims, which could potentially increase at the end of the year, but for the moment are unknown. Because the majority of the claims transferred from the two banks are in the client segments of non-financial corporations and OFIs, the impact on these segments across the banking system will be largest: each of the two client segments will see its proportion of claims more than 90 days in arrears decline by approximately a third.

Box 4.1: Changes in the context of the stress tests and asset quality review

The objective of the comprehensive review of the banking system conducted in the second half of 2013 was to assess the ability of the Slovenian banking system to withstand a sharp deterioration in macroeconomic and market conditions as projected for the future three-year period (2013 to 2015 inclusive) under the adverse scenario. The comprehensive review identified a deficit in the highest-quality form of capital in the amount of EUR 4.8 billion, which in the event of the realisation of a very conservative but very unlikely scenario could potentially be disclosed by eight of the banks covered by the review. Three banks (NLB, NKBM and Abanka) account for 78% of the capital deficit, equivalent to EUR 3.7 billion. In light of the results of the adverse scenario of the stress tests, the transfer of bad claims to the BAMC has reduced the requisite capital increase by EUR 262 million, while the bail-in of subordinated instruments has reduced it by EUR 441 million. The requisite capital increase at three banks amounted to EUR 3.01 billion instead of EUR 3.7 billion. The deficit in the highest-quality capital at the remaining five banks (Banka Celje, Gorenjska banka, UniCredit Banka Slovenije, Hypo Alpe-Adria-Bank and Raiffeisen Bank) totalled EUR 1.06 billion on the basis of the unfavourable scenario.

An immediate measure taken by the Bank of Slovenia after the comprehensive review was to set out approaches to restructuring and covering the capital deficit, and to divide the banks into four categories with regard to the results of the comprehensive review.

- The banks that had unresolved Bank of Slovenia measures requiring a capital increase even before the beginning of the comprehensive review and are in the process of having state aid approved
- The banks that will potentially have a capital deficit by the end of 2015
- The banks that were not involved in the comprehensive review
- The banks that are subject to Bank of Slovenia extraordinary measures for the purpose of an orderly wind-down

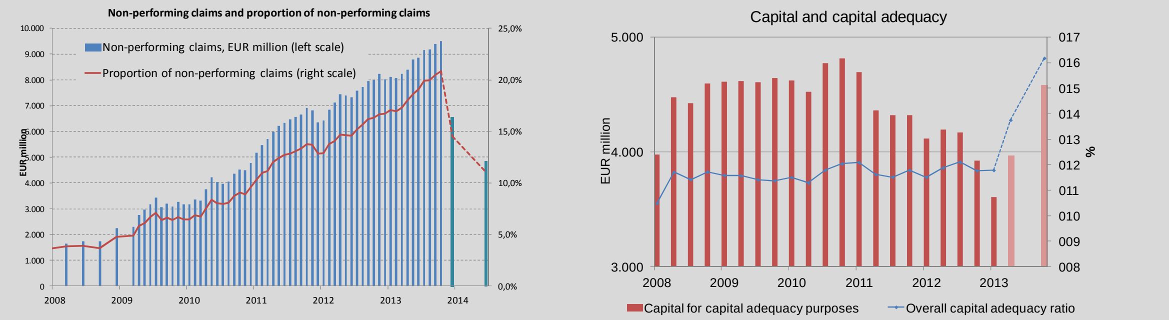
The banks in the first category (NLB, NKBM), which had already drawn up their restructuring plans, received capital increases in the amount of EUR 2.4 billion from the government: two-thirds in cash and one-third in marketable government securities. The capital increases amounted to EUR 1,551 million at NLB and EUR 870 million at NKBM. The capital increase was carried out after the suspension of qualified liabilities (to shareholders and holders of hybrid and subordinated capital instruments) and the transfer of the majority of their non-performing claims to the BAMC. The net value of the non-performing claims transferred from NLB and NKBM to the BAMC was EUR 1.13 billion. The government carried out a capital increase at Abanka in cash in the amount of EUR 348 million. The government will carry out the remainder of the requisite capital increase in the amount of EUR 591 million via marketable government securities after the final approval of state aid by the European Commission, when the transfer of non-performing claims to the BAMC will be made.

The Bank of Slovenia will give the banks in the second category a deadline of 30 days (by the end of January 2014) to draw up a capital strengthening plan that will demonstrate long-term viability, and to draw up measures to cover the capital deficit. Should their actions (primarily an influx of capital from existing owners, a search for new investors, the sale of claims and other assets, and other measures to strengthen capital adequacy) prove futile by the end of June 2014, they will be able to request state aid in accordance with European Commission rules.

As part of its ordinary supervisory activities, the Bank of Slovenia will provide an assessment of capital risk at the banks in the third category using the same approach as at the banks included in the comprehensive review.

The government carried out a capital increase in the amount of EUR 445 million at the banks in the fourth category undergoing the orderly wind-down process. The capital increase was carried out at the same time as the capital increases at three banks, and simultaneous with the suspension of the banks' qualified liabilities.

Figure 4.16: Estimated level of non-performing claims and the banking system's capital adequacy in light of the measures taken



Source: Bank of Slovenia

Other measures approved by the Bank of Slovenia and to be carried out in the future include the strengthening of banking supervision, improvement of the legislative framework and the establishment of macro-prudential supervision. The Bank of Slovenia also believes that, given the current circumstances and expectations, the consolidation of the banking sector is a natural process that will also be supported within the regulator's powers. The Bank of Slovenia's aim in applying a conservative assessment of the banks' capital deficit was to ensure the stability of the banks and a sufficient level of capital at the banks as a prerequisite for the revival of lending to the non-banking sector.

The revival of lending growth is contingent on the establishment of a stable funding structure, which is a key task for the banks in the context of ensuring sufficient capital. The LTD ratio for the non-banking sector is diminishing rapidly. This entails a decline in the liquidity of the non-banking sector, which can only be yet another brake on economic growth. In entirely new circumstances and very turbulent conditions the banks are facing the fact that they must clearly define their strategies to put in place a business model with long-term viability for each bank, without the pro-cyclical behaviour of banks as a group increasing systemic risk with adverse consequences for the non-banking sector, corporates in particular. The genuine restructuring of the corporate sector will be the next major step in the revival of economic growth, where the banks can also play an active role.

4.3 Loan collateral

Collateral value declined to 92% of the value of classified claims.

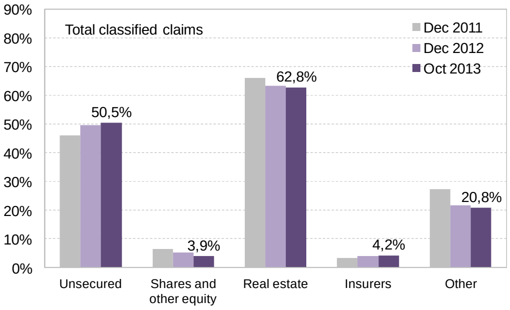
As the economic crisis has persisted, collateral values have, as expected, declined. This was confirmed by the asset quality review, the results of which were announced in December 2013. Accordingly, collateral in the form of real estate was devalued by 27% overall. The largest revision was in land, which was valued at just 52% of the amount disclosed by the banks in their portfolios.

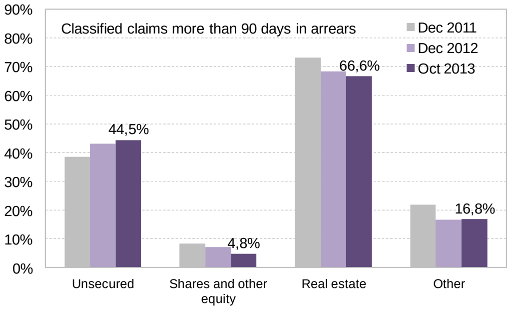
According to figures from the credit register at the Bank of Slovenia's disposal, total collateral value amounted to 91.8% of the total value of the banks' classified claims in October 2013, down 2.5 percentage in the end of 2012. There was also a slight increase in the proportion of unsecured claims.[15] Real estate remains the prevailing form of collateral. The coverage of classified claims by collateral in the form of commercial and residential real estate stood at 62.8% in October 2013. Under the Regulation on credit

[15] The figure includes unsecured claims and claims secured with forms of collateral that are not taken into account in the bank's calculation of impairments and provisioning (e.g. collateral in the form of bills of exchange). Certain types of claims against lower-risk clients (sectors), e.g. the government sector, and those backed by guarantees from investment-grade clients, are not necessarily secured by collateral from the borrower.

protection, banks must obtain valuations from an independent appraiser for real estate included in collateral. Commercial real estate valuations should be updated at least once a year, and residential real estate valuations once every three years. The general market value as published by the Surveying and Mapping Authority of the Republic of Slovenia can be used as the valuation for residential real estate valued at no more than EUR 500,000. From this point of view, assuming that the SMARS valuation model is reasonable, the valuations of the majority of residential real estate at the banks are correct. This was determined in the comprehensive review of the banking system, which revealed that the problem is primarily the value of commercial real estate and land.

Figure 4.17: Coverage of the banks' total classified claims (left) and coverage of the banks' classified claims more than 90 days in arrears (right) by collateral in percentages





Source: Bank of Slovenia

The coverage of claims by collateral is highest in the household sector, whose claims are primarily secured by residential real estate. There is also a high coverage of classified claims, 113% in the corporate sector, which is considered among the highest-risk segments. Real estate is also the prevailing form collateral in this segment. From the point of view of collateral values, the banks are most exposed to the risk of a fall in real estate prices, which in the event of realisation would lead to potential additional losses from credit risk.

Table 4.7: Collateral on the banks' classified claims by client segment in October 2013 in percentages

	Classified claims, EUR million	Ratio of collateral[2] to classified claims, %						
			Secured					
		Unsecured[1]	Shares, other equity and mutual fund units	Commercial property[3]	Residential property[3]	Insurance corporation	Other form of collateral	Total collateral value[3]
Corporates	21.493,5	39,7	7,1	67,3	7,2	0,0	31,4	113,0
OFIs	1.891,5	68,7	10,3	8,2	0,8	0,0	22,0	41,4
Households	9.899,8	28,0	0,3	14,9	99,0	19,8	10,2	144,2
Non-residents	5.472,7	71,9	1,7	26,3	2,1	0,0	13,1	43,2
Government	3.212,6	79,3	0,0	3,3	0,1	0,0	20,2	23,6
Banks and savings banks	2.793,6	95,9	0,0	0,4	0,1	0,0	3,7	4,3
Total	46.419,1	50,5	3,9	38,0	24,8	4,2	20,8	91,8

Notes: [1] The figure includes unsecured claims and claims secured with forms of collateral that are not taken into account in the banks' calculation of impairments and provisions (e.g. collateral in the form of bills of exchange).
[2] Collateral is stated at fair value.
[3] With regard to collateral in the form of real estate, several banks may register a mortgage on the same real estate. In such cases the value of the mortgage at each successive bank is reduced by the value of the claims of banks with seniority in the possible redemption of the collateral. The collateral value is thus multiplied, both for these forms of collateral and as an aggregate.

Source: Bank of Slovenia

The large domestic banks had the highest proportion of unsecured claims, at 54% in October 2013. The same bank group also had the lowest coverage of classified claims by collateral, at 82% in October 2013. This was partly a consequence of the structure of their portfolio, where they have an above-average proportion of claims against lower-risk sectors such as banks and savings banks, and the government sector. It is also an indication of the different business model at these banks, which are predominantly government-owned, and have approved more loans with little or no collateral. This is particularly problematic, given that these banks have a significant proportion of non-performing loans.

Table 4.8: Collateral on classified claims by bank group in October 2013 in percentages

	Classified claims, EUR million	Ratio of collateral[2] to classified claims, %						
		Unsecured[1]	Shares, other equity and mutual fund units	Commercial property[3]	Residential property[3]	Insurance corporation	Other form of collateral	Total collateral value[3]
Small domestic banks	4.138,3	47,9	5,3	54,5	23,2	3,5	22,9	109,4
Foreign banks	14.872,3	44,1	1,7	32,3	37,9	3,8	29,4	105,2
Large domestic banks	27.408,4	54,3	5,0	38,6	17,9	4,6	15,8	81,8
System overall	46.419,1	50,5	3,9	38,0	24,8	4,2	20,8	91,8

Notes: [1,2,3] As in previous table
Source: Bank of Slovenia

There is an even more pronounced difference in coverage by collateral between the bank groups with regard to classified claims more than 90 days in arrears. The coverage at the large domestic banks is 41 percentage points lower than that at the banks under majority foreign ownership, and the former can therefore expect significantly lower repayment of these claims. Although the claims more than 90 days in arrears are mostly claims against corporates, which is the highest-risk sector, the coverage of these claims by collateral at the large domestic banks is lower than their overall coverage of claims, which includes lower-risk claims against households, banks and the government sector and also performing claims.

Table 4.9: Coverage of classified claims more than 90 days in arrears by collateral by bank group in October 2013 in percentages

	Classified claims, EUR million	Ratio of collateral[2] to classified claims, %						
		Unsecured[1]	Shares, other equity and mutual fund units	Commercial property[3]	Residential property[3]	Insurance corporation	Other form of collateral	Total collateral value[3]
Small domestic banks	928,7	41,5	11,4	64,3	17,7	0,0	18,0	111,4
Foreign banks	1.005,4	38,5	3,6	64,9	20,0	0,0	31,3	119,8
Large domestic banks	5.850,5	46,0	4,0	56,1	5,0	0,0	14,2	79,2
System overall	7.784,6	44,5	4,8	58,2	8,4	0,0	16,8	88,3

Notes: [1,2,3] As in previous table
Source: Bank of Slovenia

5 LIQUIDITY RISK

Liquidity risk as measured by the first-bucket liquidity ratio deteriorated slightly overall in 2013. The first-bucket liquidity ratio improved significantly after the government carried out capital increases at banks in late December. The issue of three Slovenian government bonds, treasury bill issues, the government's capital increases at banks and the transfer of non-performing claims to the BAMC at the end of the year had a positive impact on the banking system's liquidity in various segments. These developments brought an increase in secondary liquidity in the banking system, a reduction in net debt to the Eurosystem, and an increase in the pool of eligible collateral at the Eurosystem and thus in the proportion of the pool that is free, which was up 10 percentage points overall by the end of December to stand at 44%.

The positive impact on the banking system's liquidity was partly nullified by the introduction of an orderly wind-down process at two banks in the middle of September. Slovenian banks also strengthened their net creditor position on the market for unsecured euro area loans, as their claims increased by a third and their liabilities halved. This remains a reflection of counterparties' lack of confidence and the change in the policy of the banks under majority foreign ownership being funded by their parent banks. This is continuing to suppress the Slovenian interbank market.

Given the lack of depth in the Slovenian interbank market, and the limited possibility of funding on foreign financial markets, banks are seeing their opportunities for effective liquidity management diminish, which in light of the protracted financial crisis and increased credit risk is increasing the liquidity risk of the Slovenian banking system.

5.1.1 Liquidity ratios

The banks' liquidity improved after the government issued bonds and carried out capital increases.

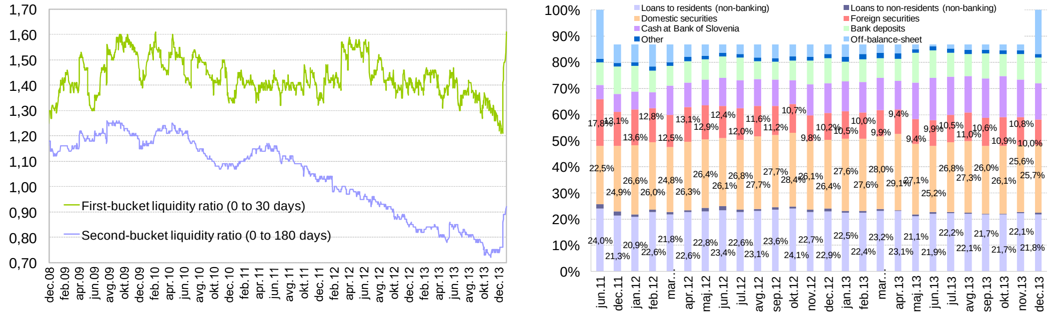
The first-bucket liquidity ratio averaged 1.37 in 2013, down 0.09 on the previous year. The first decline in early April of last year was the result of the final entry into force of a change in the methodology for calculating the first-bucket liquidity ratio,[16] which brought a reduction in the ratio at the banks under majority foreign ownership in particular. The first-bucket liquidity ratio rose to 1.42 after two Slovenian government bonds were issued in May. The gradual decline in the aforementioned ratio in the second half of the year was the result of the approaching maturity of government deposits, the repayment of issued debt securities and the introduction of an orderly wind-down process at two banks in the first half of September. The pronounced increase in the last ten days of December was the result of the government's capital increases at certain banks, which significantly reduced the stock of government deposits and increased the stock of Slovenian government securities. The first-bucket liquidity ratio stood at 1.61 at the end of December.

The second-bucket liquidity ratio deteriorated as a result of the exclusion of ineligible loans.

There was also a decline in the second-bucket liquidity ratio, movement in which was similar to the first-bucket liquidity ratio. The second-bucket liquidity ratio averaged 0.80 in 2013, down 0.13 less on the previous year. Another factor in the decline alongside the aforementioned factors was the exclusion of loans to the non-banking sector from the liquidity ladder because of a failure to meet eligibility criteria.

[16] The change in the methodology for calculating the first-bucket liquidity ratio entered into force on 1 October 2012 with the Regulation amending the regulation on the minimum requirements for ensuring an adequate liquidity position at banks and savings banks (Official Gazette of the Republic of Slovenia, No. 26/12). Under the aforementioned regulation, the liquidity ladder began to take account of 75% of the value of contractually raised credit lines and the undrawn portion of raised loans instead of the previous 100% during a transition period, and then 50% as of the final entry into force of the regulation on 1 April 2013.

Figure 5.1: Daily first-bucket and second-bucket liquidity ratios (left) and breakdown of the method of meeting the first-bucket liquidity ratio by instrument (right) in percentages

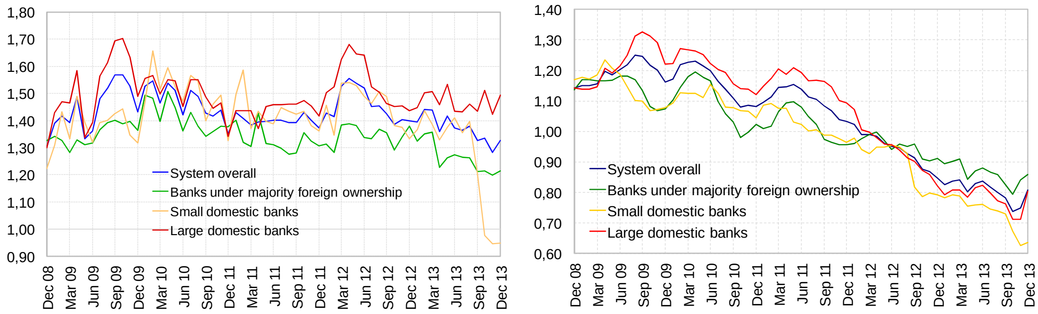


Source: Bank of Slovenia

The largest decline in the first-bucket liquidity ratio was at the small domestic banks, as a result of the initiation of an orderly wind-down process at two banks.

All the bank groups recorded a decline in the first-bucket liquidity ratio in 2013, the average at the small domestic banks and savings banks declining the most, by 0.19 to 1.26, primarily as a result of the initiation of an orderly wind-down process at two banks, and the consequent decline in the ratio below 1 by in mid-September. The final entry into force of the change in the methodology for calculating the first-bucket liquidity ratio was the main factor in the decline in the ratio at the banks under majority foreign ownership, where the average figure was down 0.08 at 1.26 in 2013. Despite a decline by 0.07 to 1.47, the average first-bucket liquidity ratio at the large domestic banks remained above the average for the banking system.

Figure 5.2: Liquidity ratios for the first bucket (0 to 30 days; left) and the second bucket (0 to 180 days; right) of the liquidity ladder by individual bank group, monthly averages



Source: Bank of Slovenia

Slovenian banks reduced their debt to the Eurosystem as a result of prepayments of 3-year LTROs.

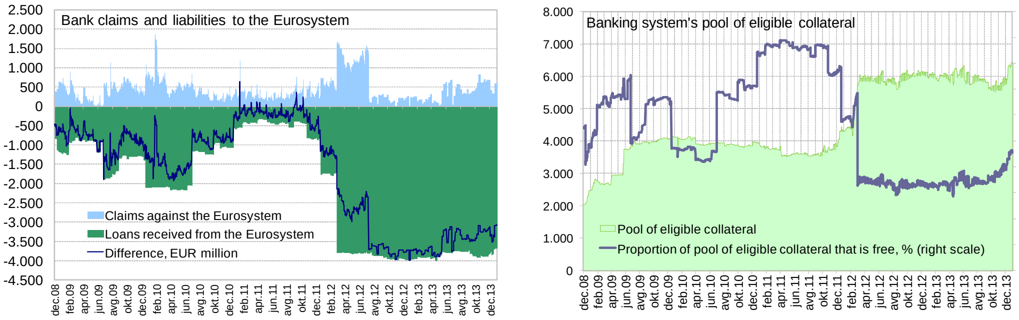
The net debt of Slovenian banks to the Eurosystem declined in 2013, as a result of a decline in liabilities to and an increase in claims against the Eurosystem. The net debt averaged EUR 3,269 million in December 2013, EUR 513 million less than in December 2012. Liabilities to the Eurosystem declined by EUR 226 million over one year to EUR 3,747 million, as a result of a decline in Slovenian banks' participation in ECB operations and prepayments on the two 3-year LTROs. In 2013 Slovenian banks prepaid EUR 419 million or 11.3% of the liabilities from the two 3-year LTROs.[17] The increase in surplus liquidity during the increase in government deposits after the government bond issues in May and November 2013 brought an increase of EUR 287 million in the stock of fixed-term deposits at the Eurosystem.

The average proportion of the pool of eligible collateral that is free increased by 10 percentage points to 44%.

The increase in the pool of eligible collateral at the Eurosystem was partly the result of the banking system's partial investments in securities after the government bond issues, the purchase of Slovenian treasury bills by the banks, and the related increase in the 1-week fixed term deposit facility at the ECB in the second half of December. The positive impact of these factors in increasing the pool of eligible collateral at the Eurosystem was partly nullified by a decline in funds after the initiation of an orderly wind-down process at two banks. The proportion the banking system's pool of eligible collateral that is free fluctuated around 34% in the first three quarters of the year, before increasing in the final quarter as a result of the aforementioned developments. It averaged 44% in December 2013.

[17] Three banks repaid the funding in full, two of which did so because of the loss of eligible counterparty status after the initiation of an orderly wind-down process.

Figure 5.3: Commercial banks' claims, liabilities and net position vis-à-vis the Eurosystem (left), and pool of eligible collateral at the Eurosystem (right) in EUR millions



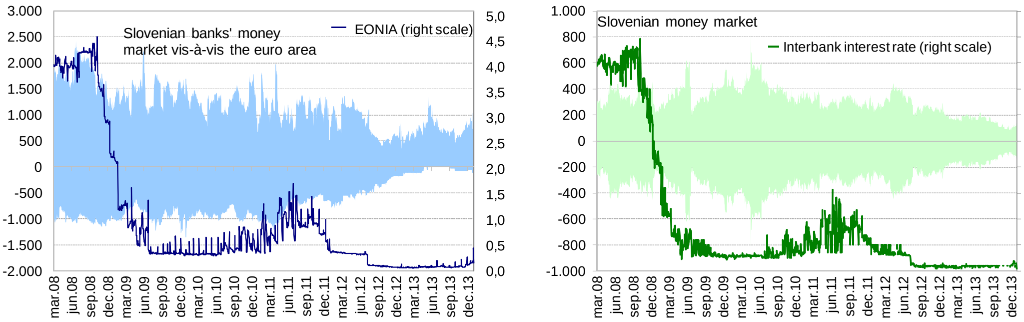
Source: Bank of Slovenia

Slovenian banks' net creditor position on the money market for unsecured euro area loans strengthened further in 2013. Net claims averaged EUR 766 million in December, up EUR 316 million on the average in December 2012. The increase was the result both of higher claims and of lower liabilities. This was a reflection of counterparties' lack of confidence in the period before the asset quality review and stress tests, and the change in the policy of the banks under majority foreign ownership being funded by their parent banks.

Slovenian banks' net claims on the market for unsecured euro area loans increased.

The decline in volume on the Slovenian interbank market continued in 2013. The stock of deposits placed and received averaged EUR 109 million in December 2013, down just over a half on December 2012.

Figure 5.4: Stock of unsecured loans of Slovenian banks placed and received on the euro area money market (left) and the Slovenian money market (right) in EUR millions, and movement in the EONIA and the interbank interest rate on the Slovenian money market



Source: Bank of Slovenia

5.1.2 Marketable secondary liquidity

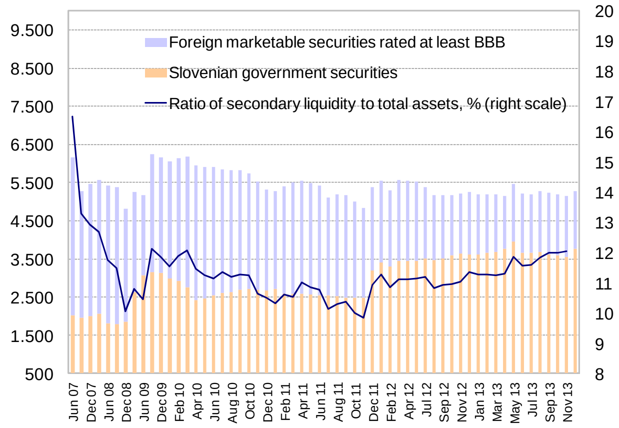
The average stock of marketable secondary liquidity[18] increased minimally by EUR 22 million in 2013 to EUR 5,268 million. EUR 130 million of this increase comprised an increase in Slovenian government securities, while there was a decline of EUR 108 million in foreign marketable securities rated BBB or higher. According to figures available in November, the ratio of marketable secondary liquidity to total assets stood at 12%.

An increase in the stock of Slovenian government securities in secondary liquidity.

The breakdown of secondary liquidity shifted towards Slovenian government securities in 2013, increasing their majority in the breakdown. They accounted for 71.3% of secondary liquidity in December 2013, up just over 2 percentage points on December 2012. It is very important for the banks to maintain the widest possible regional diversification in marketable secondary liquidity, as this makes it easier to obtain primary liquidity in the event of increased need.

[18] Marketable secondary liquidity is calculated from liquidity ladder data as the sum of the monthly average of Slovenian government securities and foreign marketable securities rated BBB or higher.

Figure 5.5: Changes in the stock of marketable secondary liquidity (monthly averages in EUR millions) and ratio of marketable secondary liquidity to total assets in percentages



Note: Secondary liquidity is calculated from liquidity ladder data as the sum of the monthly average of Slovenian government securities and foreign marketable securities rated BBB or higher.

Source: Bank of Slovenia

6 OTHER RISKS

6.1 Interest rate risk

The banks saw their interest rate risk increase over the first ten months of 2013. The difference between the average repricing periods for asset and liability interest rates stood at 5 months and 15 days in October 2013, having widened by 1 month and 19 days since December 2012. A gradual increase in the difference between the average repricing periods for asset and liability interest rates has been evident since April 2011. The banks are becoming more exposed to the risk of a rise in interest rates. The reason for the widening gap is the more significant shortening of the average repricing period for liability interest rates than the average repricing period for asset interest rates. The shortening of the average repricing period for liability interest rates was the result of a decline in the stock of deposits and borrowings and the shorter maturities thereof, and the maturing and prepayment of bank debt securities. In recent years the difference has been widest at the small domestic banks, which are most exposed to the risk of a rise in interest rates.

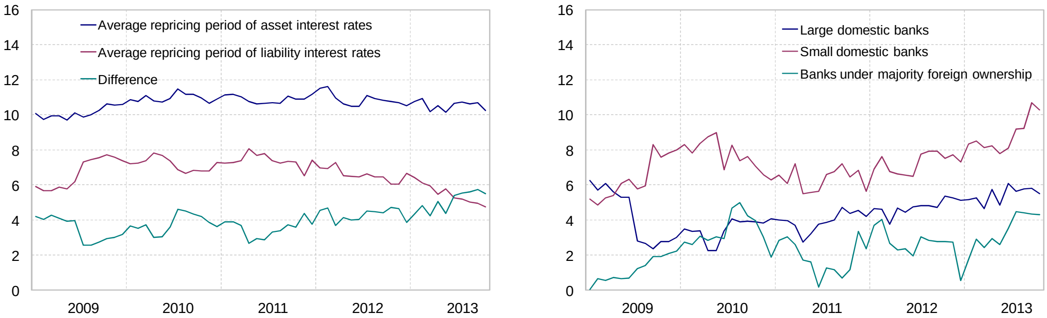
Between December 2012 and September 2013 the cumulative interest-rate gap of up to 1 year between interest-sensitive assets and liabilities narrowed by EUR 2.6 billion to a negative gap of EUR 3.3 billion. The domestic banks recorded a negative gap, while the banks under majority foreign ownership recorded a positive gap. This means that the domestic banks are exposed to the risk of a rise in interest rates and the banks under majority foreign ownership are exposed to the risk of a fall in interest rates over the next one-year period.

6.1.1 Average repricing period for interest rates

The difference between the average repricing periods for asset and liability interest rates widened.

Interest-rate risk as measured by the difference between the average repricing periods of asset and liability interest rates stood at 5 months and 15 days in October 2013. The average repricing period for asset interest rates was 10 months, while the average repricing period for liability interest rates was nearly 5 months. The difference between the average repricing periods for asset and liability interest rates lengthened by 1.6 months between December 2012 and October 2013. The reason for the widening of the difference during the aforementioned period lies on the liability side: the shortening of the average repricing period for liability interest rates (almost 2 months) outstripped the shortening of the average repricing period for asset interest rates (8 days). The main reasons for the shortening of the average repricing period for liability interest rates were a decline in the stock of deposits received, the shortening of the average repricing period for interest rates on loans raised, and the maturing and prepayment of debt securities. The shortening of the average maturity of liability interest rates is expected to continue as long as the banks face limited access to long-term funding. The likelihood is that the risk of a rise in interest rates will increase further.

Figure 6.1: Average repricing period for interest rates in months (left) and difference between the average repricing period for interest rates by bank group in months (right)



Source: Bank of Slovenia

The average repricing periods of asset and liability interest rates vary between the bank groups. The largest change in the average repricing period for asset interest rates between December 2012 and October 2013 was recorded by the banks under majority foreign ownership. The largest change in the average repricing period for liability interest rates over the same period was recorded by the small domestic banks.

The small domestic banks remain the most exposed to interest rate risk.

The difference between the average repricing periods of asset and liability interest rates is largest at the small domestic banks, at 10.3 months. The small domestic banks are thus most exposed to the risk of a rise in interest rates. Interest rate risk at this bank group increased during the observation period. The difference between the average repricing periods for asset and liability interest rates lengthened by 3 months between December 2012 and October 2013. The reason for the lengthening of the difference at the small domestic banks lies on the liability side. The average repricing period for liability interest rates shortened by almost 3 months, while the average repricing period for asset interest rates did not change significantly. The shortening of maturities on loans raised and deposits was the largest factor in the shortening of the average repricing period of liability interest rates. These two factors also acted to shorten the average repricing period for liability interest rates at the other two bank groups.

The largest increase of 3.7 months in the difference between the average repricing periods for asset and liability interest rates during the observation period was recorded by the banks under majority foreign ownership. The difference between the average repricing periods of asset and liability interest rates at the banks under majority foreign ownership gradually increased by 0.6 months between December 2012 and October 2013 to stand at 4.3 months. Despite the increase, the difference remains lowest at this bank group. The increase in the difference was the result of the lengthening of the average repricing period for asset interest rate and the shortening of the average repricing period for liability interest rates. The main reasons for the lengthening of the average repricing period for asset interest at this bank group were the lengthening of the average repricing period for interest rates on investments in debt securities and on loans granted.

6.1.2 Interest rate gap

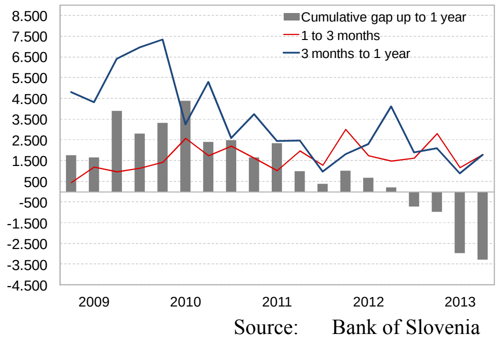
The banks under majority foreign ownership are exposed to a fall in interest rates, while the domestic banks are exposed to a rise.

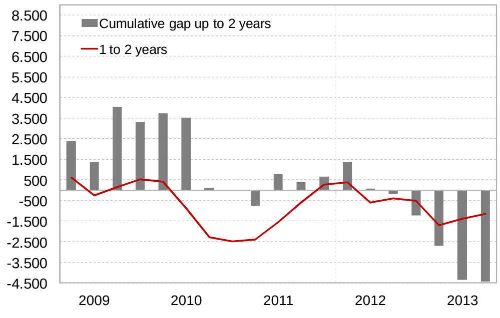
The cumulative interest rate gap of up to 1 year between interest-sensitive assets and liabilities was negative in the amount of EUR 3.3 billion at the end of the third quarter of 2013, having narrowed by EUR 2.6 billion since December 2012. Interest-sensitive assets with an interest rate repricing period of less than 1 year declined by EUR 2.7 billion between December 2012 and September 2013, while liabilities declined by EUR 102 million. The large domestic banks had the largest negative interest rate gap in the amount of EUR 2.7 billion, and also recorded the most notable narrowing since December 2012, by EUR 1.6 billion. The banks under majority foreign ownership had a positive gap of EUR 362 million (the gap having narrowed by EUR 388 million since December 2012).

One of the reasons for the differences between the bank groups is the proportion of assets tied to variable asset interest rates. At the banks under majority foreign ownership 88% of total assets have an original maturity of up to 1 year or have a longer maturity but are tied to a variable interest rate or to a fixed initial interest rate of up to 1 year. The equivalent figure is 77% at the large domestic banks and 59% at the small domestic banks.

The cumulative gap of up to 2 years narrowed from EUR 1.2 million in December 2012 to a negative gap of EUR 4.4 billion in September 2013. All the bank groups recorded a negative gap, which entails an increase in the risk faced by the banks of a rise in interest rates over the next two-year period.

Figure 6.2: Gap between interest-sensitive assets and interest-sensitive liabilities by individual bucket in EUR millions





Source: Bank of Slovenia

6.2 Currency risk

Currency risk declined in the first nine months of last year, and does not represent a major threat to the banks' performance. The net open foreign exchange position amounted to EUR 21.7 million in September, or 0.6% of regulatory capital. With a net open foreign exchange position in the amount of EUR 24.1 million or 1.1% of regulatory capital, the large domestic banks were most exposed to currency risk. With the exception of the Swiss franc, the net open foreign exchange positions were predominantly long. The banks were thus exposed to the risk of a fall in these currencies against the euro.

Table 6.1: Net open foreign exchange positions by currency in EUR millions

EUR million unless stated	2011	2012	Sep 2013 System overall	Sep 2013 Large domestic banks	Sep 2013 Small domestic banks	Sep 2013 Banks under majority foreign ownership
Global currencies	-9,6	15,7	1,4	5,5	0,5	-4,6
US dollar	4,4	5,9	6,2	6,2	0,1	-0,1
Swiss franc	-13,4	6,8	-6,6	-2,2	-0,1	-4,4
other (GBP, CAD, AUD, JPY)	-0,6	3,1	1,8	1,4	0,5	-0,1
EEA currencies	-18,0	-14,2	9,3	8,6	0,2	0,5
Other currencies	15,3	25,3	9,0	8,0	0,6	0,5
CIU	29,6	2,4	1,9	1,9	0,0	0,0
Total	17,2	29,3	21,7	24,1	1,2	-3,6
As % of regulatory capital	0,4	0,7	0,6	1,1	0,8	-0,3

Note: EEA: European Economic Area, i.e. EU, Iceland and Norway; CIU: foreign exchange position in collective investment undertaking units

Source: Bank of Slovenia

The stock of loans to the non-banking sector in Swiss francs or with a Swiss franc currency clause in October 2013 was down 14.8% in year-on-year terms at EUR 1,176 million. Loans in Swiss francs or with a Swiss franc currency clause accounted for 3.4% of total loans to the non-banking sector. The volatility in the Swiss franc / euro exchange rate has recently increased slightly, while its overall movement has been in the direction reducing the credit burden faced by borrowers.

7 SOLVENCY RISK[19]

As the financial crisis persists, solvency risk in the banking system is increasing. This was confirmed by the recent asset quality review and stress tests. There was no significant change in capital adequacy during the first nine months of the year, while capital increases were carried out at five[20] banks in December after the asset quality review and stress tests, which improved their capital adequacy. Solvency risk has been reduced at banks with a sufficient capital surplus, most notably the banks under majority foreign ownership. The core Tier 1 capital ratio remains a significant measure of bank stability. This ratio is higher than 9% at two-thirds of the banks.

The capital adequacy of the Slovenian banking system, which in September 2013 was still below the European average, will have closed the gap with the European average by the end of the year as a result of capital increases at certain banks and the transfer of non-performing claims to the Bank Asset Management Company (BAMC). However, this is not sufficient to maintain long-term capital adequacy. The banks must increase their internal generation of capital by means of profitable operation. The optimisation of the use of capital via a contraction in turnover and a switch to lower-risk investments is merely a temporary means of reducing capital requirements. The renewal of economic growth remains a key factor in stable capital adequacy for Slovenian banks, as it will allow them to increase their income and thus to generate capital internally.

7.1.1 Capital adequacy

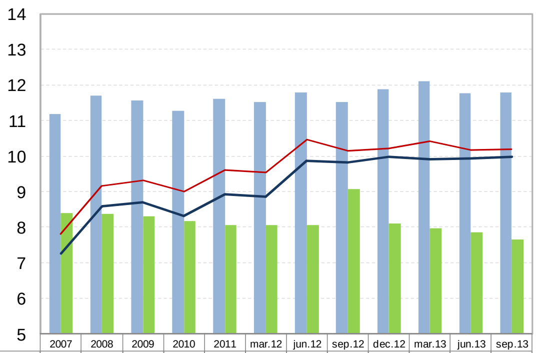
The capital adequacy ratios remained unchanged.

Slovenian banks saw no significant change in their overall capital adequacy[21] during the first nine months of the year. The banking system's overall capital adequacy ratio declined by 0.1 percentage points during this period to end September at 11.8%. The core Tier 1 capital ratio, which has become a key indicator of bank stability, was maintained at 10% during the first nine months of last year. The difference between the Tier 1 capital ratio and core Tier 1 capital ratio remained at 0.2 percentage points, an indication that the quality of capital structure was maintained.

The ratio of book capital to total assets is lower, as a result of operating losses.

In contrast to the capital adequacy ratios, which remained almost unchanged over the first nine months of the year, the ratio of book capital to total assets declined by 0.5 percentage points to 7.6%. The main factor in this was the relatively large decline in capital compared with total assets, which was the result of operating losses. This widened the gap between overall capital adequacy and the ratio of book capital to total assets to 4.2 percentage points.

Figure 7.1: Banking system's basic capital adequacy ratios in percentages



	2007	2008	2009	2010	2011	mar.12	jun.12	sep.12	dec.12	mar.13	jun.13	sep.13
Overall capital adequacy	11,2	11,7	11,6	11,3	11,6	11,5	11,8	11,5	11,9	12,1	11,8	11,8
Book capital / total assets	8,4	8,4	8,3	8,2	8,0	8,0	8,1	9,1	8,1	8,0	7,8	7,6
Tier 1 capital ratio	7,8	9,2	9,3	9,0	9,6	9,5	10,5	10,1	10,2	10,4	10,2	10,2
Core Tier 1 capital ratio	7,3	8,6	8,7	8,3	8,9	8,9	9,9	9,8	10,0	9,9	9,9	10,0

Source: Bank of Slovenia

The large domestic banks saw a deterioration in capital adequacy ratios.

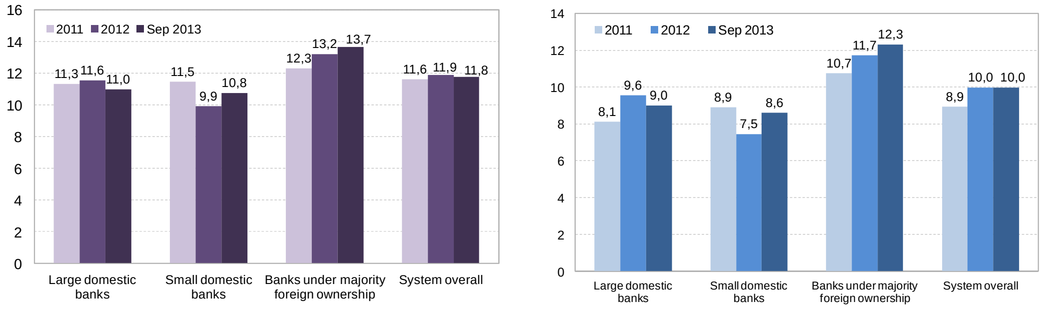
While there was no change in the capital adequacy ratios at the level of the banking system, analysis of the figures reveals differences between the bank groups. The large domestic banks saw a deterioration in capital adequacy ratios, primarily as a result of

[19] In the solvency analysis, the figures for September 2013 do not include the two banks undergoing an orderly wind-down process, which is one of the reasons for the larger changes in growth rates and increases in individual indicators.
[20] Capital increases were carried out at three large domestic banks (NLB, NKBM and Abanka) and two small domestic banks undergoing the orderly wind-down process (Factor banka and Probanka).
[21] All figures are on an individual basis unless stated otherwise.

their operating losses, which reduced capital by more than the reduction in capital requirements brought by the contraction in turnover. Overall capital adequacy at the large domestic banks declined by 0.6 percentage points during the first nine months of the year to 11%, while the core Tier 1 capital ratio declined by 0.6 percentage points to 9%, as more than half of the large domestic banks ended September with a core Tier 1 capital ratio of less than 9%. The capital increases at three large domestic banks in the amount of EUR 3,012 million at the end of the year is projected to have improved the overall capital adequacy in this bank group to the EU average, which according to the latest figures for the end of 2012 stood at 14.4% on a consolidated basis.

The capital adequacy ratios of the banks under majority foreign ownership improved again. All the banks in this group have a core Tier 1 capital ratio of more than 9%. The majority of these banks do not face a major lack of capital, and their use of existing capital is better while their investment portfolios are lower risk. The small domestic banks continue to record the lowest capital adequacy. Overall capital adequacy had declined to 9.7% by the end of the first half of the year, while the core Tier 1 capital ratio had declined to 7.2%. This was primarily the result of the poor performance of the two banks at which an orderly wind-down process was initiated in early September. The two banks underwent capital increases at the end of 2013.

Figure 7.2: Overall capital adequacy (left) and core Tier 1 capital ratio (right) by bank group in percentages

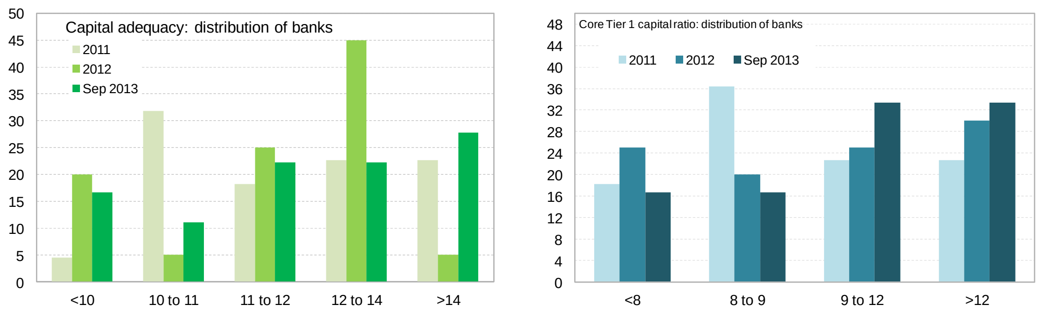


Source: Bank of Slovenia

The number of banks with an overall capital adequacy in excess of 14% more than doubled.Two-thirds of the banks have a core Tier 1 capital ratio in excess of 9%.

The mere monitoring of average capital adequacy ratios across the banking system does not reveal the significant improvement in capital ratios at a large number of banks in the first nine months of 2013. Just over half of the banks recorded an increase in overall capital adequacy in the first three quarters of the year, primarily banks that have a sufficient capital surplus. Almost three-quarters of the banks have an overall capital adequacy in excess of 11%, while the number of banks with an overall capital adequacy in excess of 14% more than doubled. The distribution of core Tier 1 capital ratios also improved: this ratio is more than 9% at two-thirds of the banks, compared with just over a half at the end of 2012. This is an indication of a change in the trend of recent years, and a reversal of developments in capital adequacy ratios at a large number of banks.

Figure 7.3: Distribution of overall capital adequacy (left) and core Tier 1 capital ratio (right) in percentages



Source: Bank of Slovenia

Initial assessments are that the capital increases at five Slovenian banks undertaken by the government at the end of December 2013 and the transfer of non-performing claims to the BAMC will have improved the Slovenian banking system’s capital adequacy ratios. According to estimates including the two banks undergoing the orderly wind-down process, overall capital adequacy will rise to 13.8% while the core Tier 1 capital ratio will rise to 13%. This is projected to involve increases of EUR 845 million in

The capital increases and the transfer of non-performing claims to the BAMC will have raised capital adequacy to an estimated 13.8% and the core Tier 1 capital ratio to 13%.

regulatory capital and EUR 1,170 million in original own funds. The capital requirements will have been reduced by an estimated EUR 220 million at the same time. The actual effects of the aforementioned activities on the capital categories of the banking system will be evident after all the banks have reported their figures for the end of 2013.

7.1.2 Capital structure

A decline in regulatory capital as a result of operating losses, and a decline in subordinated debt.

The banking system's regulatory capital stood at EUR 3,605 million at the end of September 2013, down EUR 591 million on the end of 2012. Original own funds were down EUR 494 million or 13.4%, primarily as a result of operating losses. The decline in the stock of subordinated debt also brought a decline of 16.6% in the banks' additional own funds. Slovenian banks nevertheless maintained their capital structure prior to deductions, an indication of their ability to meet capital requirements by means of the highest quality forms of capital. Original own funds accounted for fully 85.6% of the capital structure at the end of September 2013.

Table 7.1: Stock of and growth in components of regulatory capital in EUR millions and percentages

	Stock				2012			Sep 2013		
	2008	2009	2010	2011	Stock	Change	Growth	Stock	Change	Growth
Regulatory capital	4.475	4.616	4.523	4.361	4.196	-164	-3,8%	3.605	-591	-14,1%
Original own funds	3.835	4.116	4.001	4.047	3.678	-369	-9,1%	3.184	-494	-13,4%
Additional own funds	1.277	1.239	1.265	1.130	645	-485	-42,9%	537	-107	-16,6%
Deductions	-636	-739	-742	-816	-126	690	-84,5%	-116	10	-7,9%
Original own funds for CA	3.501	3.722	3.605	3.606	3.604	-2	-0,1%	3.119	-485	-13,5%
Core Tier 1 capital for CA	3.283	3.453	3.332	3.352	3.104	-248	-7,4%	3.055	-49	-1,6%
Capital requirements	3.059	3.194	3.207	3.004	2.827	-177	-5,9%	2.447	-380	-13,4%

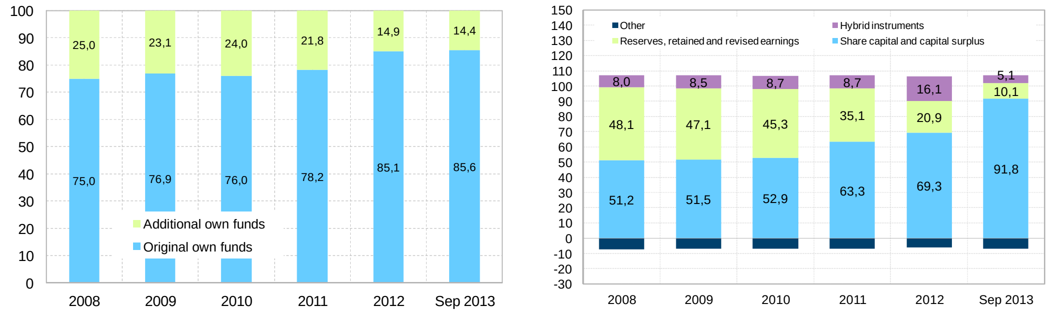
Source: Bank of Slovenia

Share capital and the capital surplus account for almost 92% of original own funds.

The structure of original own funds changed over the first three quarters of 2013. Share capital and capital surplus account for nearly 92% of original own funds, up 22 percentage points during the observation period. There were two main factors in this. The first, the conversion of (CoCo) bonds into share capital, reduced the proportion accounted for by hybrid instruments by 11 percentage points to 5.1%. The second was the banking system's operating loss, which reduced the proportion of earnings-related items to 10%. The largest contribution to this change came from the large domestic banks, while original own funds at the banks under majority foreign ownership maintained a similar structure as at the end of 2012.

Following the capital increases at certain banks at the end of 2013, the process of the improvement in capital structure in favour of original own funds continued. The proportion of own funds accounted for by original own funds will increase as a result of growth in share capital and write-downs of subordinated instruments in the amount of EUR 441 million, as a result of which the proportion accounted for by additional own funds will decline.

Figure 7.4: Structure of own funds prior to deductions across the banking system (left) and structure of original own funds (right) in percentages



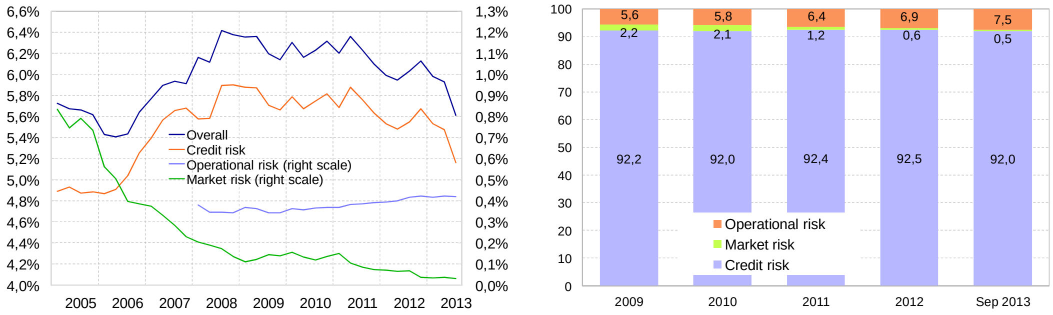
Source: Bank of Slovenia

7.1.3 Capital requirements

Capital requirements declined by EUR 380 million over the first three quarters of 2013 to EUR 2,447 million. The larger decline in capital requirements relative to the contraction in total assets is a reflection of the ongoing contraction in turnover, the shift to lower-risk exposures and the banks' risk-aversion.

As lending activity contracted, the proportion of capital requirements accounted for by capital requirements for credit risk declined to 92%. Capital requirements for market risk account for just 0.5% of total capital requirements, the banks having reduced their portfolio of securities as they increasingly turn to primary banking. In the context of a gradual decline in gross income in previous years, capital requirements for operational risk also declined, to EUR 182 million, but the proportion of total capital requirements that they account for increased to 7.5% as a result of the larger relative declines in the other two categories.

Figure 7.5: Ratio of capital requirements to total assets in percentages



Source: Bank of Slovenia

The decline in capital requirements for corporates has continued.

Capital requirements for credit risk amounted to EUR 2,252 million at the end of September 2013, down 13.9% on December 2012, partly as a result of the exclusion in the third quarter of the two banks undergoing the orderly wind-down process. Capital requirements for exposures to corporates declined by EUR 264 million or 22% over the first three quarters of the year, the highest figure in recent years. The stock was down just over a half in the third quarter. This also reduced the proportion of capital requirements for credit risk that they account for to just under 41%.

A smaller increase in capital requirements for past-due and regulatory high-risk items in the first half of 2013.

There were also positive developments in the breakdown of capital requirements. The total stock of past-due and regulatory high-risk items increased by just EUR 17.4 million in the first half of the year, just over a third of the increase in the same period of 2012. Past-due and regulatory high-risk items declined by EUR 24 million in the third quarter, which was partly the result of the initiation of liquidation proceedings at two small banks.

The banks continued to optimise the use of capital in the first half of the year, which was reflected in an increase of EUR 11 million in capital requirements for exposures secured by real estate. This increase was neutralised by a decline in the third quarter.

Table 7.2: Breakdown of capital requirements for credit risk in percentages

	2011				2012				Sep 2013			
	Large domestic banks	Small domestic banks	Banks under majority foreign ownership	System overall	Large domestic banks	Small domestic banks	Banks under majority foreign ownership	System overall	Large domestic banks	Small domestic banks	Banks under majority foreign ownership	System overall
Capital requirements for credit risk, EUR million	1.707	271	798	2.775	1.608	251	758	2.617	1.457	100	695	2.252
	Breakdown of capital requirements for credit risk, %											
Public sector, international organisations	0,7	1,5	0,4	0,7	0,5	1,1	0,9	0,7	0,4	2,5	1,0	0,7
Institutions	11,7	5,4	2,7	8,5	15,6	2,9	2,9	10,7	9,9	3,4	2,7	7,4
Corporates	50,9	45,3	51,0	50,4	43,6	40,7	49,8	45,1	39,4	25,6	45,5	40,6
Retail	17,6	15,8	33,1	21,9	16,7	16,8	31,2	20,9	16,5	36,5	31,7	22,1
Secured by real estate	0,3	7,3	1,7	1,4	1,3	7,7	3,3	2,5	2,0	7,4	4,3	2,9
Past-due items	5,6	5,3	4,2	5,1	6,9	5,9	3,7	5,9	8,8	11,0	5,0	7,7
Regulatory high-risk items	9,4	14,5	2,8	8,0	10,8	19,2	3,7	9,6	12,4	8,9	4,9	9,9
Other	3,8	4,9	4,0	4,0	4,6	5,6	4,5	4,7	10,6	4,7	5,0	8,6
Past-due and regulatory high-risk items	14,9	19,7	7,0	13,1	17,8	25,1	7,4	15,5	21,2	19,8	9,9	17,7

Source: Bank of Slovenia

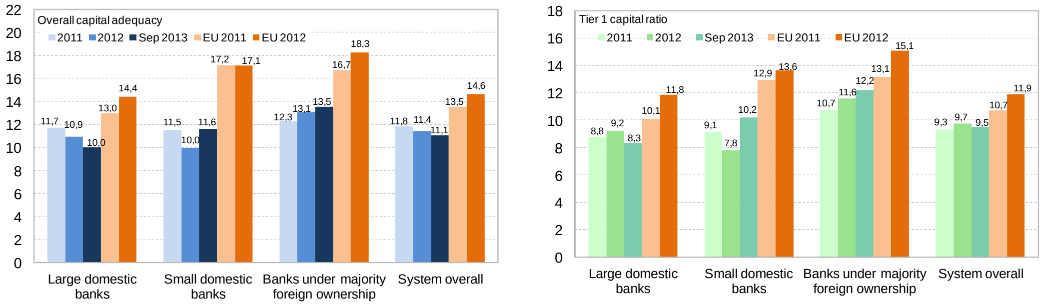
7.1.4 Comparison of capital adequacy with EU (consolidated figures)

The capital adequacy of Slovenian banks on a consolidated basis stood at 11.1% in September 2013, 3.5 percentage points less than the EU average according to available figures. In terms of overall capital adequacy and the Tier 1 capital ratio, only two EU Member States were behind Slovenia at the end of 2012.

High capital requirements mean that capital adequacy trails the European average.

The reasons for Slovenia's shortfall on the EU average lie both in the amount of capital and in the high level of capital requirements. In light of the government-funded capital increases at certain Slovenian banks and given the potential response by the owners of other banks to the call to increase capital, the capital adequacy of the Slovenian banking system is projected to approach the European average. The banks must now focus more on reducing capital requirements, and thus on optimising the use of capital, and on improving performance with the aim of generating capital internally.

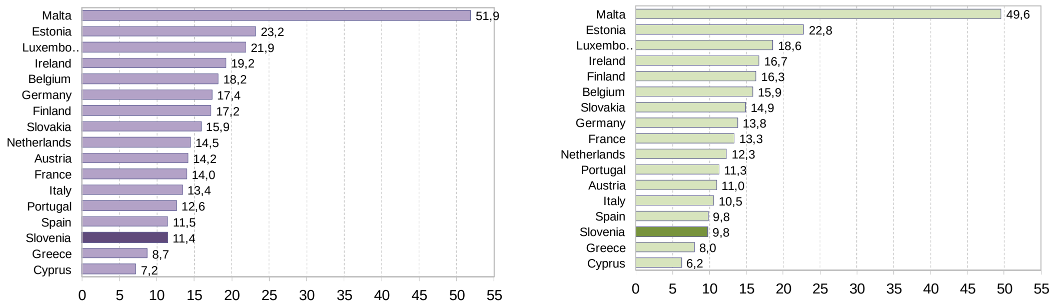
Figure 7.6: Capital adequacy (left) and Tier 1 capital ratio (right) compared with the EU, figures by bank group on a consolidated basis in percentages



Note: Figures for EU banking sector overall only available to June 2012, and figures for EU bank groups available to December 2012.

Sources: ECB (SDW), Bank of Slovenia

Figure 7.7: Capital adequacy (left) and Tier 1 capital ratio (right) for EU Member States, figures on a consolidated basis for December 2012 in percentages



Sources: ECB (SDW), Bank of Slovenia

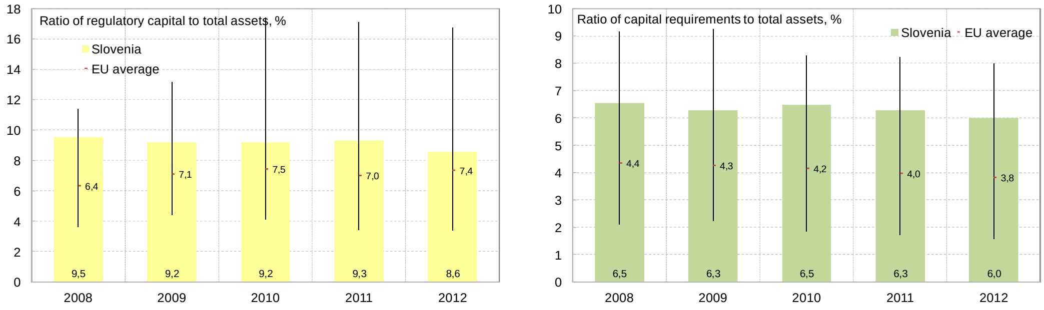
The ratio of capital requirements to total assets is above the average of EU Member States.

The ratio of capital requirements to total assets stood at 5.8% in September 2013, higher than the EU average of 3.8% (figures available to the end of 2012). Only one Slovenian bank uses an IRB approach, while the majority of Slovenian corporates do not have credit ratings from recognised agencies that would give the banks greater possibility of applying lower weights to exposures to corporates with low probability of default. Capital requirements for exposures to corporates and retail exposures account for almost two-thirds of the capital requirements for credit risk.

The banks could reduce their capital requirements by using lower risk weights.

The banks nevertheless have the possibility of reducing capital requirements for exposures secured by real estate, which accounted for just 2.9% of total capital requirements in September 2013. Collateral arrangements could allow the banks to meet the strict criteria for the use of lower risk weights, namely a weight of 50% for exposures to corporates secured by commercial real estate and a weight of 35% for exposures secured by residential real estate. The average risk weight for exposures to corporates stood at 91.8% in September 2013, while the average weight for retail exposures stood at 73.4%.

Figure 7.8: Distribution of the ratio of regulatory capital to total assets (left) and the ratio of capital requirements to total assets (right) for EU Member States, figures on a consolidated basis in percentages



Sources: ECB (SDW), Bank of Slovenia

APPENDICES

1 HOUSEHOLD SECTOR

The household sector is a relatively low-risk client category for the banks. Household indebtedness is just half of household indebtedness in the euro area overall. The rational behaviour by households, which even during the period of highest growth in lending did not indulge in excessive borrowing, is reflected in the low proportion of non-performing claims in this segment of the banks' investments.

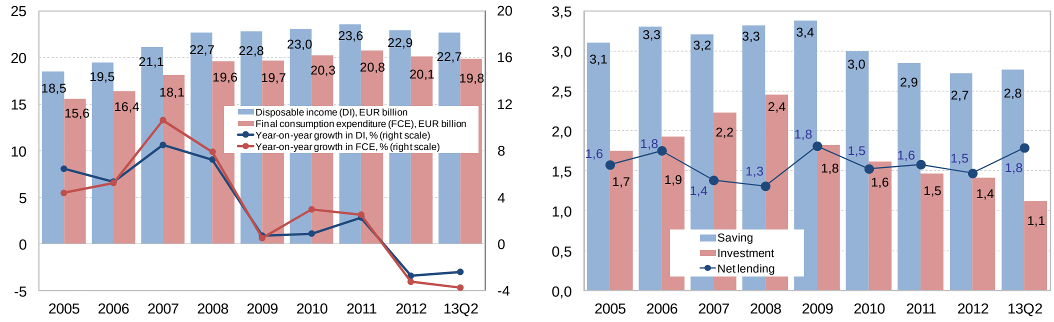
Uncertainty has continued in the household sector.

The aggregate figures and analysis of the micro data for the period between 2006 and 2011 suggest that Slovenian households are not over-leveraged. The adverse situation in the economy has resulted in high unemployment and a decline in consumer purchasing power, which has led to an increase in the at-risk-of-poverty or social exclusion rate among Slovenian households. High unemployment and the decline in disposable income are also reducing household consumption and limiting saving by households. In 2013 Slovenian banks began the process of cutting liability interest rates and raising asset interest rates for the household segment, which is vital to improving their competitiveness

Consumer purchasing power declined again in 2013.

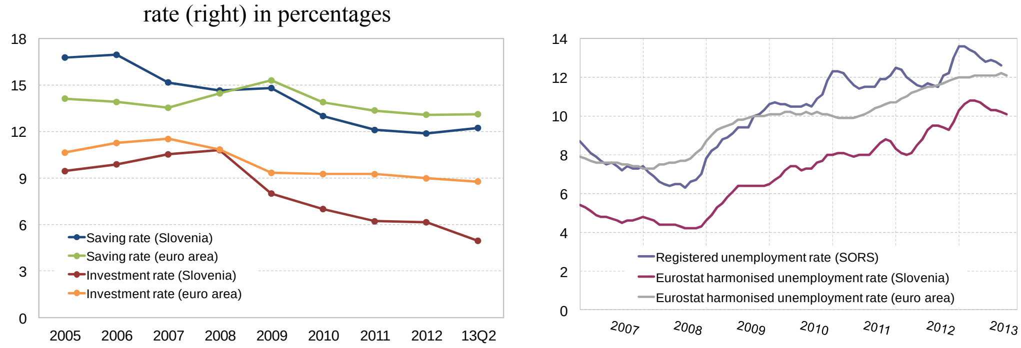
Disposable household income continued to decline in 2013, and was down 2.4% in year-on-year terms during the first half of the year. The decline in disposable income, which is related to high unemployment and uncertainty, is resulting in a decline in consumption. Consumption during the first half of the year was down 3.7% in year-on-year terms, more than the decline in income, which indirectly means more money for saving. Saving during the first half of the year increased to EUR 2.8 billion. Household investment continued to fall during the first half of the year, as a result of limited available funds, the uncertainty surrounding future developments in the economy, and the situation on the real estate market, where there are expectations of further falls in real estate prices. The movement of prices on the real estate market will also depend significantly on the manner in which, the pace at which and the final prices at which the BAMC sells its transferred real estate collateral. The decline in investment is increasing the net household assets that are available to other institutional sectors. The investment rate of Slovenian households has been significantly below the overall euro area figure for some time now, while the figures for the saving rate approached each other in the first half of the year.

Figure 1.1: Disposable income and household final consumption expenditure in EUR billion and percentages (left), and saving, investment and net lending of households in EUR billion (right)



Sources: SORS, Eurostat

Figure 1.2: Household saving rate and investment rate (left) and unemployment rate (right) in percentages

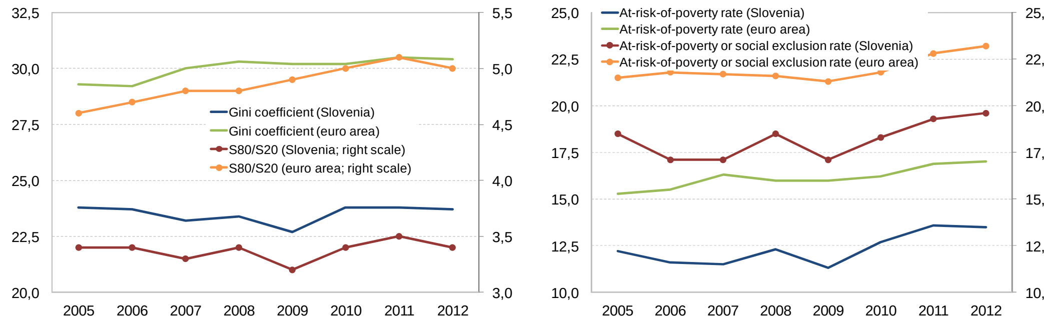


Sources: SORS, Eurostat, ECB

The survey unemployment rate in Slovenia was 2 percentage points below the euro area average.

The survey unemployment rate fell slightly in 2013, but remained high at 10.3% at the end of the first half of the year, albeit 2 percentage points less than the euro area average. The ratio of the workforce in employment to the total population declined from almost 50% at the end of 2008 to 44% at the end of the second quarter of 2013. The inactive population, which accounts for around 37% of the total population, consists primarily of pensioners (67% of the total), followed by university students and high-school students (18%). High unemployment and the high proportion of the population that is inactive are bringing increased risk of poverty, and diminishing ability to repay debt. Comparing the inequality of the distribution of income in Slovenia with the euro area, the Gini coefficient and the ratio of the disposable income of the highest quintile to that of the lowest quintile (income quintile share ratio), which measure income distribution, are significantly lower for Slovenian households than for euro area households overall. This explains why the credit risk of the household sector is still relatively low at present. In terms of the at-risk-of-poverty rate, and in particular the at-risk-of-poverty or social exclusion rate, Slovenian households are gradually but relatively clearly approaching the euro area average.

Figure 1.3: Comparison of Gini coefficients (in percentages) and S80/S20 income quintile share ratio (left), and at-risk-of-poverty rate and at-risk-of-poverty or social exclusion rate (right) between Slovenia and the euro area



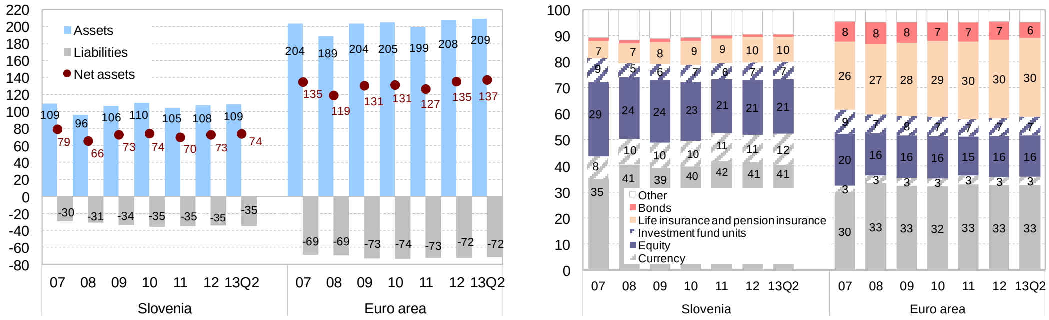
Note: The Gini coefficient and the S80/S20 ratio show the inequality of income distribution. The higher they are, the greater is the inequality in the distribution of household income. The **Gini coefficient** is a measure of income concentration, ranging from zero to 100%. The **S80/S20 income quintile share ratio** is the ratio of the sums of equivalised disposable income in the highest income quintile (the 20% of households with the highest equivalised income) and the lowest quintile (the 20% of households with the lowest equivalised income).
The **at-risk-of-poverty rate** is the proportion of people living in households with an equivalised disposable income below the at-risk-of-poverty threshold. The at-risk-of-poverty threshold is 60% of the median equivalised disposable income (including social transfers). Equivalised income is calculated the sum of the income of all members of a household divided by the number of household members according to the equivalised scale as follows: 1.0 for the first adult, 0.5 for each household member aged 14 or over, and 0.3 for each household member younger than 14.
The **at-risk-of-poverty or social exclusion rate** is the proportion of people living in households that are below the at-risk-of-poverty threshold or are suffering serious material deprivation (their living conditions are strongly constrained by limited financial resources; they meet at least four of the nine material deprivation criteria), or living in households with low work intensity (adults in the household have worked for less than 20% of the total potential working hours in the year before the survey). Individuals are counted only once, even if covered by two or three of the indicators.
Sources: SORS, Eurostat

Household financial assets and liabilities

Household debt in Slovenia is just half of that in the euro area overall.

In the first half of 2013 the net financial assets of Slovenian households rose to 74% of GDP, as a result of a small increase in financial assets and a decline in financial liabilities. The financial liabilities of Slovenian households amounted to 35% of GDP and 54% of disposable household income, just under half of the figures for euro area households (72% of GDP and 110% of disposable income). In terms of aggregate indebtedness, Slovenian households are not problematic. However, at 109% of GDP, the financial assets of Slovenian households are lower by half than the figure for households in the euro area, an indication of their lower financial security reserve. A comparison of the breakdown of assets between the two groups of households also reveals that Slovenian households rely too heavily on the compulsory state pension system. Households also hold their security reserves in real assets. According to SORS figures, in 2011 Slovenian households held twice as many assets in residential real estate than in financial assets, while the figures were equal for euro area households overall. Among euro area countries, Slovenian households have a high level of real estate ownership, and a low proportion of households with mortgage debts. According to certain survey figures, around 80% of households in Slovenia own the real estate in which they reside.

Figure 1.4: Financial assets, liabilities and net financial position of households as a percentage of GDP (left) and breakdown of household financial assets in percentages (right) in Slovenia and the euro area

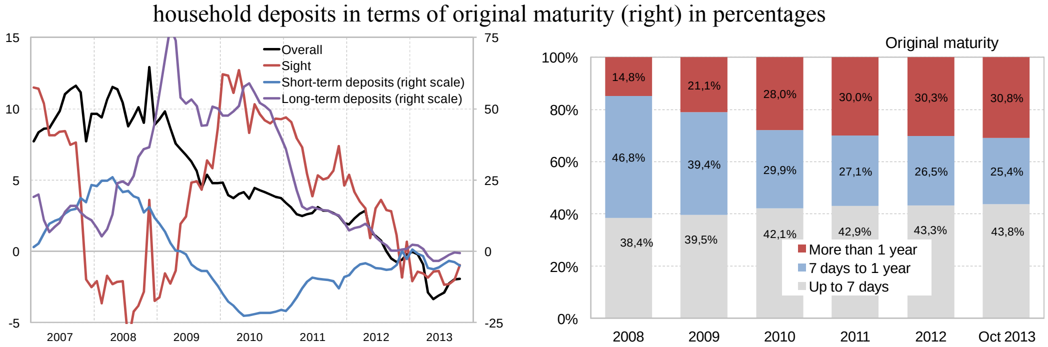


Sources: Bank of Slovenia, SORS, ECB

Household deposits at Slovenian banks declined by EUR 465 million during the first ten months of the year.

Deposits remain the most important form of household asset in Slovenia, accounting for 41% of the total, despite having declined in the first half of 2013. Household deposits at banks in Slovenia declined by almost EUR 465 million during the first ten months of the year. The decline in deposits was the result of a deterioration in the income position of households and of rising unemployment. There was a net outflow of household deposits at the large domestic banks, while the banks under majority foreign ownership and the small domestic banks recorded net inflows of household deposits. The largest outflow of deposits was recorded between March and May, under the influence of developments in Cyprus and the resulting uncertainty for savers in Slovenia. There was also an increase in outflows of household deposits between August and October.

Figure 1.5: Annual growth in household deposits (left), and breakdown of household deposits in terms of original maturity (right) in percentages

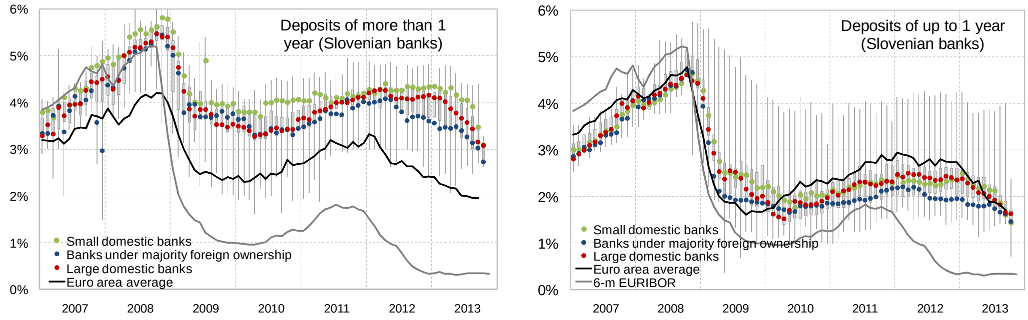


Source: Bank of Slovenia

Interest rates on deposits of more than 1 year remain high in Slovenia, despite falling.

Interest rates on household deposits fell in 2013, despite relatively stable, albeit low, reference interest rates. Interest rates on deposits of up to 1 year equalised with average interest rates in the euro area in 2013, while the spread in interest rates on deposits of more than 1 year over euro area interest rates had increased to 1.6 percentage points by the end of October 2013 from 1.3 percentage points at the end of 2012. The reason was that average interest rates in the euro area were falling faster. Despite falling, interest rates on deposits of more than 1 year in Slovenia have remained high, which has resulted in the maintenance of a high proportion of deposits with an original maturity of more than 1 year. The high interest rates on deposits are also reducing the banks' interest margin, and thus their international competitiveness. The largest falls in interest rates on deposits of more than 1 year during the first ten months of the year were recorded by the banks under majority domestic ownership, both large and small. The fall was the result of low reference interest rates, the burden on the domestic banking sector in 2013, and the fact that the higher interest rates in 2012 did not reduce the outflow of deposits at domestic banks.

Figure 1.6: Interest rates on household deposits of up to 1 year (left) and more than 1 year (right) in percentages and dispersion at Slovenian banks

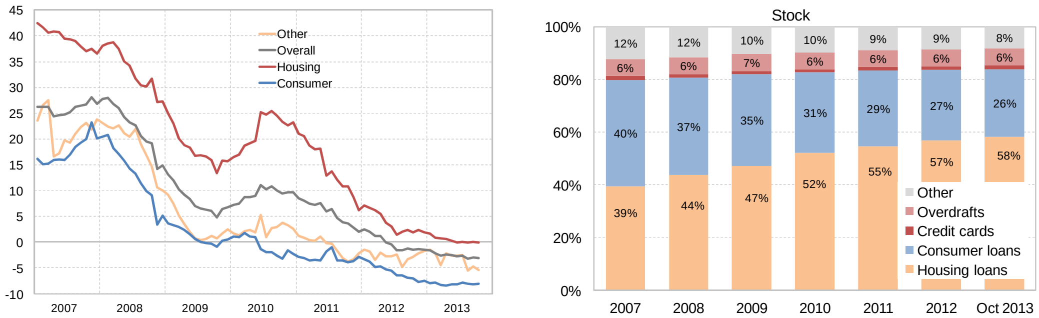


Sources: Bank of Slovenia, ECB

Consumer loans are declining, while housing loans are stagnating.

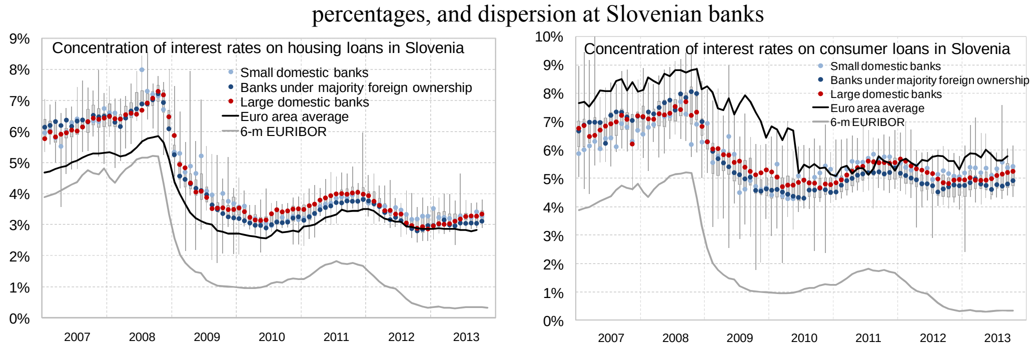
Bank loans account for three-quarters of the total financial liabilities of Slovenian households. The decline in consumer loans has been present since mid-2010, and is proceeding in line with the decline in final consumption expenditure and the movement in the consumer confidence indicator. Housing loans are stagnating, partly as a result of the situation on the real estate market. The larger decline in household loans than in deposits had a positive impact on the LTD ratio for households, which fell to approximately 62%. Given the economic situation as it relates to high unemployment, uncertain developments in wages, lower consumer confidence and the uncertain situation on the real estate market, there can be no expectation of any significant growth in loans to households and thus in household debt in the next two years.

Figure 1.7: Annual growth (left) and breakdown of stock of bank loans to households by type (right) in percentages



Source: Bank of Slovenia

Figure 1.8: Interest rates on housing loans (left) and consumer loans (right) in percentages, and dispersion at Slovenian banks



Source: Bank of Slovenia

Interest rates on housing loans at Slovenian banks were 0.3 percentage points higher than interest rates on deposits of more than 1 year at the end of October.

Interest rates on housing loans at Slovenian banks rose by an average of 0.3 percentage points between December 2012 and October 2013 to 3.2%. Interest rates across the euro area fell slightly, as a result of which the spread between interest rates on housing loans at Slovenian banks and euro area banks overall widened to 0.3 percentage points. Interest rates on consumer loans are higher in the euro area overall than at Slovenian banks, having risen more in 2013 than at Slovenian banks, which further widened the negative spread to 0.7 percentage points. The largest rise in interest rates on housing and consumer loans was recorded by the large domestic banks, which still had the largest spread between deposit and lending rates for households at the end of 2012. This rise significantly improved their net interest income. In October 2013 interest rates on deposits of more than 1 year at Slovenian banks were 0.3 percentage points lower than interest rates on housing loans (compared with a spread of 0.9 percentage points in the euro area overall), while at the end of 2012 interest rates on housing loans had been 1.2 percentage points lower than interest rates on deposits of more than 1 year (compared with 0.5 percentage points higher in the euro area overall). The premiums on housing loans at Slovenian banks increased by 0.3 percentage points during the first ten months of the year, while those on consumer loans increased by 0.2 percentage points. The process of falling liability interest rates in 2013, whereby only certain Slovenian banks have interest rates on deposits of up to 1 year that are below the euro area average, and rising asset interest rates is a significant factor in improving the competitiveness of Slovenian banks.

The micro data indicates that the most vulnerable households are less-wealthy households with an annual disposable income of less than EUR 20,000 and households whose head is low-skilled, unemployed or retired.

Household debt servicing capacity has deteriorated slightly, and the proportion of the banks' classified claims against households more than 90 days in arrears stood at 4.7% at the end of October. Analysis of the micro data on Slovenian households' mortgage indebtedness for the 2006 to 2011 period from the survey of living conditions (EU-SILC) conducted by the SORS reveals that mortgage debt is rising at wealthier households whose heads are younger (below 45), working and better-qualified. Two main debt servicing measures are given in the literature for identifying when households become more vulnerable: a ratio of 30% between the total loan instalment and disposable income, and a ratio of 40%. For households with mortgage debt, the mortgage repayment constitutes a major portion of housing costs. Housing costs accounted for more than 40% of disposable income at 13.4% of households with mortgage debt between 2009 and 2011, compared with 6.8% of all households. The largest debt servicing burden falls on households with mortgage debt that are low-income households, households whose annual disposable income is less than EUR 20,000 and households whose head is young or middle-aged (younger than 45), unemployed or low-skilled.

Table 1.1: Breakdown of all Slovenian households and households with mortgage debt, proportion of all households and households with mortgage debt where housing costs are more than 40% of income, and breakdown of households with mortgage debt where housing costs are more than 40%, 2006 to 2008 and 2009 to 2011, in percentages

	Breakdown				Proportion of households where housing costs are more than 40% of income					
	all households		households with mortgage debt		all households		households with mortgage debt		Breakdown of households with mortgage debt	
	2006-08(%)	2009-11(%)	2006-08(%)	2009-11(%)	2006-08(%)	2009-11(%)	2006-08(%)	2009-11(%)	2006-08(%)	2009-11(%)
Overall	**100,0**	**100,0**	**100,0**	**100,0**	**6,6**	**6,8**	**17,8**	**13,4**	**100,0**	**100,0**
Income brackets, EUR										
up to 10,000	23,0	20,5	9,0	7,6	21,2	24,2	63,2	65,3	31,9	37,0
10,000 to 20,000	34,7	30,7	33,3	24,2	3,8	4,7	20,2	25,0	37,8	45,2
20,000 to 30,000	25,7	25,1	33,2	33,3	1,3	1,4	10,7	5,5	20,0	13,6
over 30,000	16,6	23,7	24,5	35,0	0,5	0,2	7,5	1,6	10,3	4,3
Age group										
under 35	11,2	12,5	25,6	27,3	7,4	9,0	17,0	13,4	24,4	27,4
35 to 44	17,5	17,0	27,1	31,1	5,1	5,7	18,7	14,2	28,4	33,0
45 to 54	23,1	22,2	27,1	21,5	5,1	4,5	17,0	9,3	25,9	14,9
55 to 64	19,0	20,3	13,1	14,6	7,3	7,4	23,4	15,8	17,1	17,3
over 65	29,2	28,0	7,1	5,6	7,9	7,9	10,4	17,7	4,2	7,4
Economic status										
Employed	49,6	49,3	78,1	79,4	4,1	4,3	17,5	11,2	76,9	66,4
Unemployed	6,0	7,0	6,3	5,9	17,4	16,0	27,7	33,3	9,8	14,8
Retired	41,9	41,0	14,0	14,1	7,4	7,8	15,4	17,4	12,1	18,3
Qualifications										
Primary/secondary	81,3	79,1	71,8	68,2	7,4	7,8	20,4	17,0	82,1	86,5
Tertiary	18,5	20,5	28,2	31,8	2,8	2,8	11,3	5,7	17,9	13,5

Source: SORS (EU-SILC)

2 ANALYSIS OF CORPORATE INDEBTEDNESS IN SLOVENIA ON THE BASIS OF MICRO DATA

As the crisis has endured, the problem of high corporate indebtedness in Slovenia has spread to other sectors, and is no longer confined to sectors that are more cyclically sensitive. The concentration of corporate indebtedness is high, although the problem of high indebtedness can also be seen at other firms. The main reason that indebtedness remains high is a lack of equity. The proportion of corporate financing accounted for by equity has diminished as the crisis has continued, but the need for equity varies according to the nature of the firm and the sector and the possibility of finding alternative financing. Recapitalisation is merely one approach to corporate financial restructuring, and other measures at the level of the corporate sector and measures to stimulate economic growth can also play a part in reducing corporate indebtedness.

The aim of this analysis of Slovenian corporate indebtedness on the basis of micro data for 2012 is to determine the extent of indebtedness of Slovenian firms, to estimate the level of indebtedness at Slovenian firms with above-average value-added per employee and to estimate the requisite additional capital or revaluation of capital that would ensure proper financial restructuring at firms.

The analysis is based on individual figures from the balance sheets and income statements of firms in Slovenia for 2012, as collected by the Agency of the Republic of Slovenia for Public Legal Records and Related Services (AJPES). The analysis covered 28,337 firms from all sectors with at least one employee that did not have any missing data under assets or a negative or missing figure for equity. Firms undergoing bankruptcy proceedings were excluded. In the calculation of indebtedness indicators (leverage, ratio of financial debt and debt to EBITDA, equity ratio), the median of indicators at the level of the firm[22] was taken into account.

Corporate indebtedness in Slovenia

In the majority of sectors micro and small enterprises were the most indebted in 2012, and large enterprises the least indebted.

The indebtedness of Slovenian firms[23] is high. According to figures from the financial accounts, leverage stood at 146% in 2008, but had declined to 135% by the end of 2012. Leverage is high compared with other EU Member States: it stands at 107% in Austria, 116% in Germany, 118% in Spain, 129% in Ireland and 82% in the Netherlands (source: Eurostat). According to the analysis of the micro data at the level of the firm, leverage stood at 145% in 2012. Indebtedness was highest in the sectors of real estate activities, accommodation and food service activities, and transportation and storage. In the majority of sectors micro and small enterprises are the most indebted, and large enterprises are the least indebted. The financial debt to EBITDA ratio stands at 1.2, while the debt to EBITDA ratio, which includes financial and operating liabilities, is significantly higher at 5.8. Estimated cash flows are not sufficient to service existing debt at 16% of firms.

[22] The analysis covered half of Slovenian firms, with 87% of total assets. 43% of Slovenian firms did not have an employee or had missing data; they accounted for just 10% of total corporate assets. Furthermore, 16% of firms had negative equity. The use of the median reduces the impact of the most indebted firms (outliers) on the level of the indicators.

[23] Leverage is measured as the ratio of non-current and current liabilities to equity, the financial debt to EBITDA ratio is the ratio of non-current and current financial liabilities to cash flows from operating activities (operating profit or loss plus write-downs and depreciation/amortisation), and the debt to EBITDA ratio takes account of non-current and current financial and operating liabilities. The indicator shows a firm's capacity to regularly service debt (interest and principal), and shows how many years of cash flow the firm needs to repay debt; the lower the ratio, the lower the risk in the repayment of the firm's liabilities. Only firms with positive EBITDA are included in the calculation.

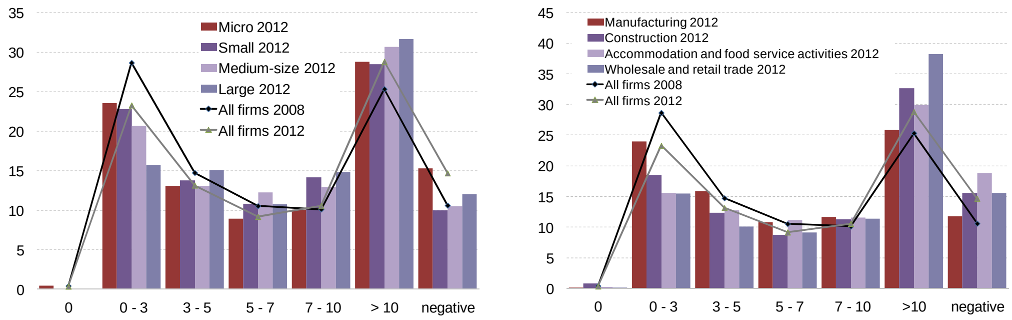
Table 2.1: Leverage and financial debt to EBITDA ratio in 2012 by sector

	No. of firms observed	Leverage					Financial debt / EBITDA				
		Corporate size					Corporate size				
		Micro	Small	Medium	Large	Overall	Micro	Small	Medium	Large	Overall
Agriculture, forestry, fishing, mining, quarrying	234	158	59	75	68	130	1,8	1,7	4,2	2,6	2,0
Manufacturing	4.685	148	149	135	128	146	1,4	2,4	2,9	4,5	1,8
Electricity, gas, water	337	236	97	110	103	155	2,0	1,0	1,2	2,8	1,8
Construction	3.523	171	159	194	171	171	0,8	2,1	3,5	3,9	0,9
Wholesale and retail trade	6.770	178	168	205	151	178	2,0	3,4	3,9	3,5	2,1
Transportation and storage	1.542	210	181	205	124	205	1,2	1,6	2,3	3,0	1,3
Accommodation and food service activities	1.103	222	214	55	82	215	2,3	6,6	2,8	7,8	2,7
Information and communication	1.630	103	76	88	172	100	0,2	0,8	0,6	2,8	0,4
Financial and insurance activities	170	123	773	-	82	98	0,4	1,9		17,2	1,0
Real estate activities	553	219	259	24	283	220	3,5	6,3	0,4	18,2	3,8
Professional, scientific and technical activities	6.416	100	139	205	79	102	0,4	1,9	1,6	3,6	0,5
Public services	1.374	100	114	250	149	100	0,5	3,0	6,3	7,2	0,6
Total	28.337	145	150	159	124	145	1,0	2,4	2,9	3,9	1,2

Sources: AJPES, Bank of Slovenia calculations

Large enterprises' repayments of liabilities were higher-risk in 2012 than those of micro and small enterprises, while the repayments of firms in the wholesale and retail trade sector were higher-risk than those of manufacturing firms. The proportion of firms with higher debt servicing capacity in 2012 was down on 2008, while there was also an increase in the proportion of firms where the indicator is greater than 10, an indication of firms with the lowest debt servicing capacity.

Figure 2.1: Distribution of debt to EBITDA ratio by corporate size (left) and for selected sectors (right), 2008 and 2012



Sources: AJPES, Bank of Slovenia calculations

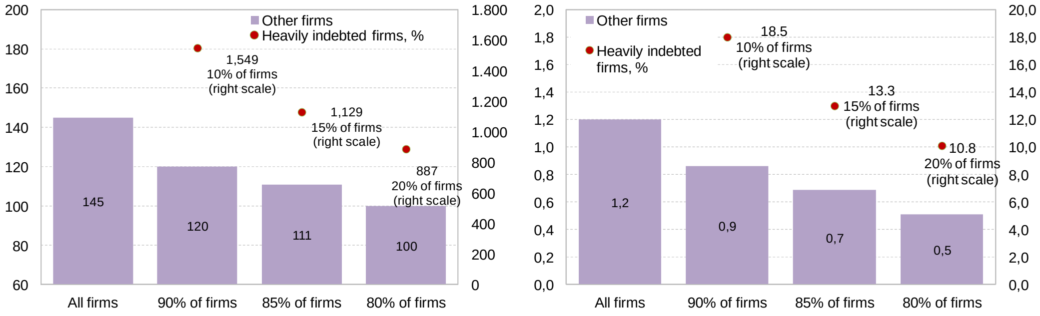
While EBITDA at Slovenian firms increased in 2010 and 2011, in 2012 it declined by 3%, the wholesale and retail trade sector recording the most notable decline of 12%. Improvements in corporate profitability are primarily being constrained by low demand and low consumer purchasing power, while the number of firms in bankruptcy and the number of firms with outstanding past-due liabilities are increasing. Domestic consumption is declining, and is a major factor in the decline in value-added in service sectors in particular. Export growth is having a favourable impact at manufacturing firms in particular, but investment has continued to decline, primarily as a result of the aforementioned constraints on financing and low demand.

High concentration of corporate indebtedness

Leverage at Slovenian firms is high, but just 10% or 15% are classed as heavily indebted.

Analysis on the basis of micro data gives an insight into the scope of corporate indebtedness. The dispersion of indicators among firms is large, but only 10% or 15% of firms are heavily indebted, while the leverage of the remaining firms is 120% or 111% A similar picture is presented by the financial debt to EBITDA ratio, which stands at 1.2 for firms overall, while 90% of firms have a low ratio of 0.9 or below.

Figure 2.2: Leverage (left) and financial debt to EBITDA ratio (right) for heavily indebted firms and other firms at the end of 2012 in percentages

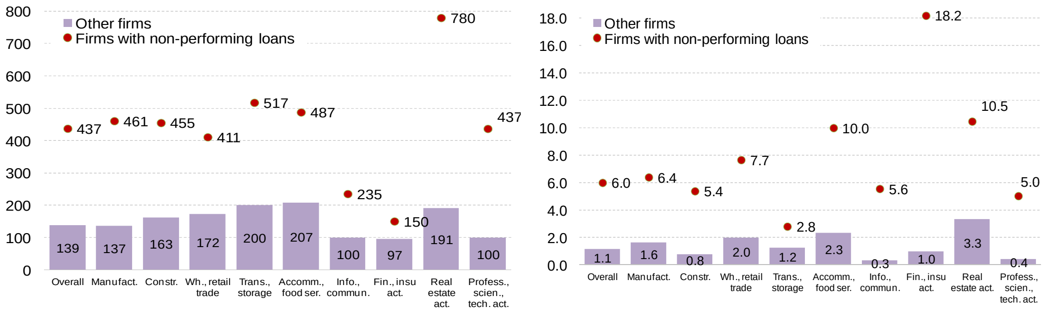


Sources: AJPES, Bank of Slovenia calculations

The six most heavily indebted large firms account for almost half of the total debt in the construction sector.

In the construction sector, where corporate indebtedness is highest at the aggregate level, there is a high concentration of indebtedness. At 36 large construction firms with a total of EUR 791 million of debt, the aggregate debt exceeded equity by 2.5 times (including three firms with negative equity) or 1.9 times (excluding these three firms) in 2012. Leverage at large construction firms stood at 171%, although the six most heavily indebted firms accounted for almost half of the total debt. Leverage is more than 300% at a third of large construction firms.

Figure 2.3: Leverage (left) and financial debt to EBITDA ratio (right) for firms with non-performing loans (more than 90 days in arrears) and other firms



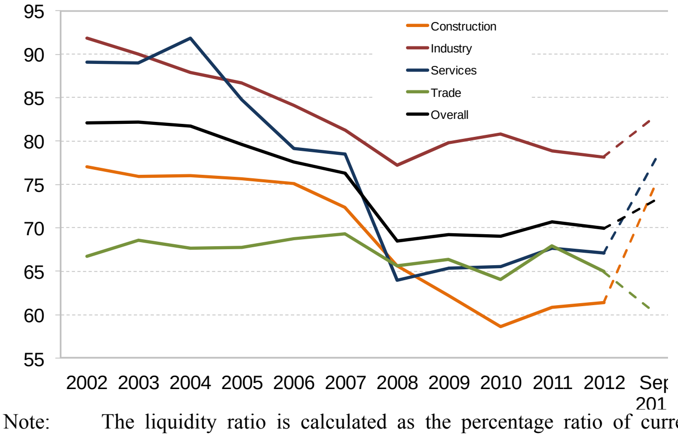
Sources: AJPES, Bank of Slovenia, Bank of Slovenia calculations

Just 3.8% of firms in the sample have non-performing loans.

If wound-up firms and firms undergoing bankruptcy and liquidation proceedings that are no longer submitting annual reports to AJPES are taken into account, 16% of firms had non-performing loans or loans more than 90 days in arrears among their liabilities to the Slovenian banking system at the end of 2012.[24] If only firms that reported closing accounts for 2012 and are not undergoing bankruptcy proceedings, and that also have at least one employee and did not have any missing data under asset items or a negative or missing figure for equity are taken into account, just 3.8% of firms have non-performing loans. As expected, firms with non-performing loans more than 90 days in arrears have significantly higher indebtedness indicators: their leverage is 437%, while their financial debt to EBITDA ratio is 6.0.

[24] Performance of the banks in the current year, developments on the capital market, and interest rates, October 2013.

Figure 2.4: Liquidity ratio for selected sectors in percentages



Note: The liquidity ratio is calculated as the percentage ratio of current receivables to current liabilities

Sources: AJPES, Bank of Slovenia

Corporate liquidity ratios improved in 2012 compared with 2008 and 2009, when the financial crisis hit the corporate sector hardest, and according to initial estimates improved again in 2013.

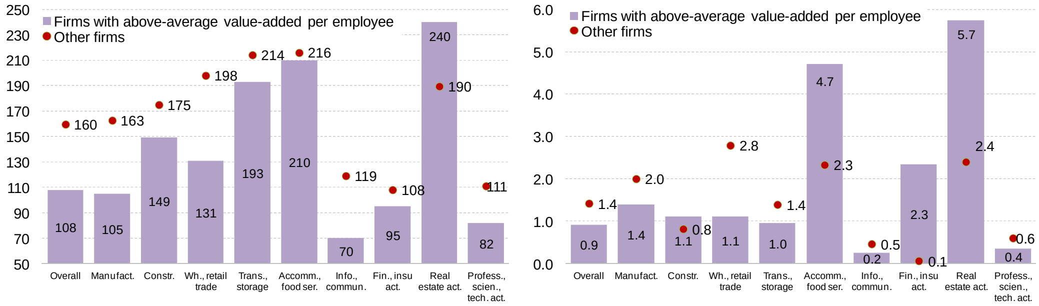
Slovenian firms' need for additional capital

The recommended values for corporate indebtedness indicators are rarely stated in the literature, as they vary significantly with regard to corporate size, the region and the economic cycle. More appropriate values for corporate indebtedness indicators in Slovenia can be estimated, and indebtedness indicators for firms with above-average value-added per employee can be calculated. Net value-added per employee stood at EUR 38,006 in 2012.[25]

Leverage at firms with above-average value-added per employee stood at 108%, while the financial debt to EBITDA ratio stood at 0.9.

As expected, firms with above-average value-added per employee (14,086 in total) had lower indebtedness indicators than other firms in 2012 (except in the real estate activities sector), with leverage of 108%, a financial debt to EBITDA ratio of 0.9, and a debt to EBITDA ratio of 3.4. Leverage at other firms stood at 160%, the financial debt to EBITDA ratio at 1.4 and the debt to EBITDA ratio at 6.9.

Figure 2.5: Leverage (left) and financial debt to EBITDA ratio (right) at firms with above-average value-added per employee and other firms



Sources: AJPES, Bank of Slovenia calculations

Corporate recapitalisation and other measures in the amount of EUR 4.9 billion could reduce leverage from a high 135% to 119%.

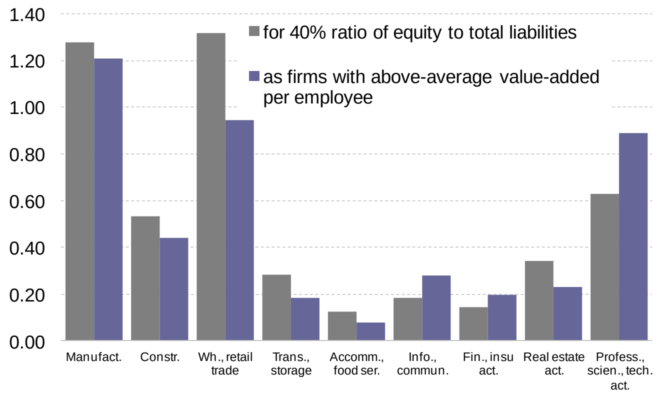
For the recapitalisation of selected firms that in 2012 did not have negative equity and had recorded positive EBITDA in at least one of the five preceding years, attaining a ratio of equity to total liabilities of at least 40% (the overall ratio of equity to total liabilities stood at 39.6% in 2012) would require EUR 5.3 billion (14,165 firms). Should the firms aim to attain the ratio of equity to total liabilities recorded by the firms in their sector with above-average value-added per employee, EUR 4.9 billion would be required (14,086 firms). Recapitalisation is merely one approach to corporate financial restructuring. Improvements in corporate indebtedness indicators can also be achieved through other measures.

[25] Source: AJPES (Information on corporate performance in 2012, May 2013). Value-added is calculated as gross operating profit excluding costs of goods, materials and services and other operating expenses.

Firms with non-performing loans would require a quarter of the estimated additional capital.

Corporate recapitalisation and other measures in the amount of EUR 4.9 billion could reduce aggregate leverage across all firms to 119%, while EUR 5.3 billion would reduce it to 118%. Firms with non-performing loans and loans more than 90 days in arrears would require a quarter of the estimated additional capital.

Figure 2.6: Corporate demand for capital by sector in EUR billion at the end of 2012



Sources: AJPES, Bank of Slovenia calculations

To attain a better structure of financing, 80% of the additional capital would be required by just 7% of firms.

The concentration of corporate indebtedness in Slovenia is high. Attaining a better structure of financing for the majority of firms would not require significant additional capital. Should firms aim to attain the structure of financing recorded by the firms with above-average value-added per employee, each firm would require EUR 40 thousand, an increase of 18% in total liabilities. Thus i.e. 80% of the additional capital would be required by just 7% of the firms or500 firms would require EUR 3.2 billion to reduce their leverage to 124%.

In addition to financial restructuring, Slovenian firms need ownership and corporate restructuring.

It is not only corporate recapitalisations that will facilitate a reduction in corporate indebtedness and an improvement in leverage and the financial debt to EBITDA ratio. It might also be facilitated by easier debt-to-equity conversions under the amendments to the Financial Operations, Insolvency Proceedings and Compulsory Dissolution Act (ZFPPIP-F)[26] and by corporate debt repayments. In addition to financial restructuring, there is a need for responsible ownership restructuring in the corporate sector and corporate restructuring by means of suitable business models that will contribute to increased value-added at Slovenian corporates.

[26] The new Financial Operations, Insolvency Proceedings and Compulsory Dissolution Act (ZFPPIP-F) has further provided for simplified composition proceedings, which will facilitate financial restructuring at insolvent firms.

3 PERFORMANCE OF LEASING COMPANIES

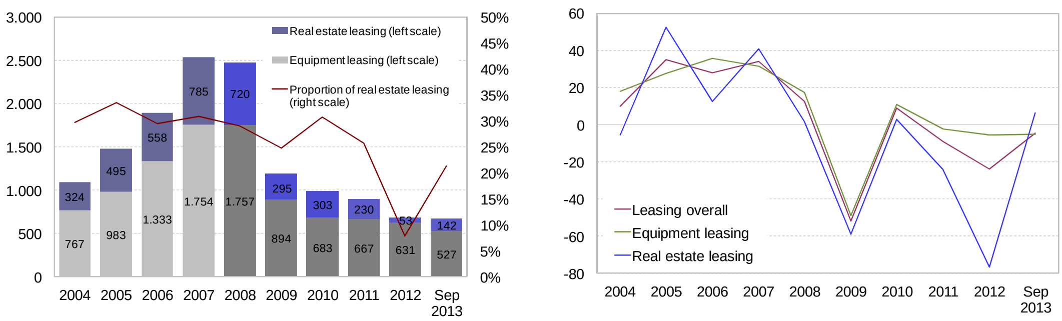
Leasing companies were faced with a loss for the fifth consecutive year, the financial crisis having hit this sector hard. Leasing companies are reducing the proportion of their portfolios accounted for by real estate business. The proportion of claims that are more than 90 days in arrears increased from 6.2% at the end of 2012 to 7.5% in the third quarter of 2013, an indication of the deterioration in the quality of their investments.

The stock of leasing business declined to EUR 3.5 billion at the end of the third quarter of 2013.The main decline was in the proportion accounted for by real estate business.

According to the figures from the leasing companies' new reporting to the Bank of Slovenia,[27] the stock of leasing business amounted to EUR 4 billion at the end of 2012, but had declined to EUR 3.5 billion by the end of the third quarter of 2013. The main decline was in real estate leasing, from EUR 2.2 billion to EUR 1.7 billion, while the stock of equipment leasing remained at the level of EUR 1.8 billion. The top six companies in terms of the stock of business account for two-thirds of the leasing market, and more than half of real estate business.

New leasing business amounted to EUR 669 million during the first three quarters of 2013. The leasing companies focused primarily on equipment leasing, which accounted for 88% of new business in 2012, but 79% during the first three quarters of 2013. Finance leasing accounts for more than three-quarters of equipment leasing business. After two years of decline, new real estate business increased slightly in 2013, along a very low number of new lease agreements, primarily as a result of new loans to non-financial corporations. More than half of the contractual value of non-financial corporations' new business in real estate was concluded as loans. Given that the leasing sector is withdrawing from the real estate market, three leasing companies accounted for 93% of the new business, which was earmarked for the completion of old projects.

Figure 3.1: New leasing business[28] in EUR millions and the proportion accounted for by real estate leasing in percentages (left), and annual growth in new business in percentages (right)



Sources: SLA, BAS, Bank of Slovenia

According to the figures of the leasing committee, new real estate leasing business was up 6% in year-on-year terms in September 2013 after declining by almost 80% in 2012, while new equipment leasing business was down 5%. Monitoring leasing companies is important from the point of view of financial stability and monetary policy, as they have business links with the banking system. The restructuring of the banking sector means that Slovenian banks' ownership of the leasing sector will decline further in the future.

Three-quarters of new real estate leasing business was in the form of loans.

The LTV ratio as measured by the ratio of the approved amount of financing to the value of the subject of the agreement
remained high in 2013, at 82% for equipment leasing and 97% for real estate leasing. There was no significant change in the average maturity of new equipment leasing business. Maturities of 5 to 10 years accounted for 57% of new finance leasing business in the first three quarters of the year, while 68% of operating leasing business

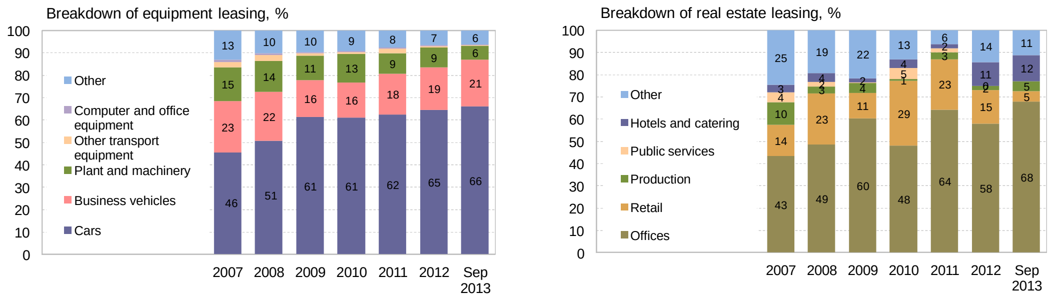
[27] On 31 Dec 2012 the Bank of Slovenia introduced mandatory reporting by companies involved in leasing business. Institutions are selected for mandatory reporting on the basis of the materiality of their business, and must provide quarterly figures; the first reports were submitted for the final quarter of 2012. The analysis of leasing companies has been undertaken on the basis of the data from the new reporting, except where stated that it relates to the figures of the BAS's leasing committee to ensure year-on-year comparability.

[28] Leasing business is disclosed at original cost until 2008 due to the availability of figures (or lack thereof), and thenceforth at financed value, excluding the financing of inventories since 2010.

was concluded with a maturity of up to 1 year. Maturities of up to 1 year accounted for three-quarters of new real estate leasing business, primarily in the form of loans.

Despite the decline in investment in recent years, the breakdown of equipment financing has not changed significantly. As in previous years, cars accounted for the largest proportion of business; the figure of 66% was more than 23 percentage points higher than the euro area average in 2012.There was no significant change from the previous year in the stock of leasing business with households. It amounted to EUR 820 million in the third quarter of 2013, or 23% of all leasing business. Private individuals accounted for 42% of new equipment leasing business, compared with 3% of real estate leasing business. Only 5.4% of the stock was more than 90 days in arrears. The relatively high proportion of leasing business accounted for by private individuals is a reflection of the relatively low credit risk in this segment, and also provides a more stable source of income for leasing companies in crisis conditions. Low corporate investment activity and insolvency have also been reflected in the leasing companies' performance, namely in the volume of new leasing business, profitability, etc.

Figure 3.2: Percentage breakdown of new business in equipment leasing (left) and real estate leasing (right)



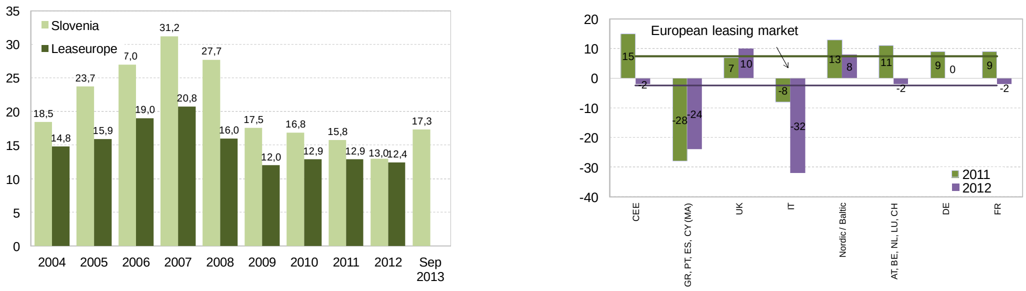
Sources: SLA, BAS, Bank of Slovenia

Some 9% of non-financial corporations' liabilities are more than 90 days in arrears: 5% in real estate leasing and 16% in equipment leasing.

Non-financial corporations accounted for almost two-thirds of the stock of leasing business in the third quarter of 2013 at EUR 2.2 billion, down 3% on the end of the previous year. The sectors of wholesale and retail trade, real estate activities, manufacturing and construction account for two-thirds of all leasing business. Some 9% of non-financial corporations' liabilities are more than 90 days in arrears, 5% in real estate leasing and 16% in equipment leasing. More than 15% of liabilities are in arrears in the sectors of construction, accommodation and food service activities, administrative and support service activities, and agriculture. As for households, at non-financial corporations loans are prevalent in terms of the proportion in arrears. The stock amounted to EUR 144 million in the third quarter, a third of which was more than 90 days in arrears.

The market value of leasing assets repossessed for non-performance of contractual obligations amounted to EUR 173 million in the third quarter of 2013, up 2.5% on the end of 2012. Real estate accounted for the majority (89%).

Figure 3.3: Ratio of leasing business to gross fixed capital formation (left) and growth in new leasing business in selected European countries (right) in percentages



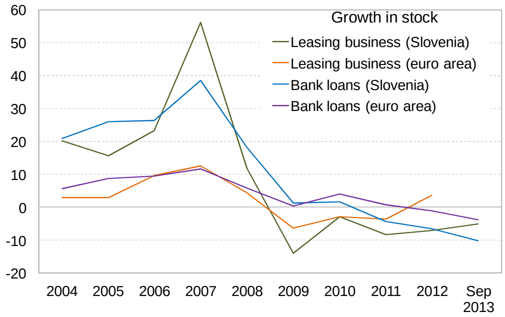
Note: The figures for new leasing business in 2013 used in the ratio of leasing business to gross fixed capital formation are taken from reporting to the Bank of Slovenia (previously the BAS), and includes non-members of the leasing committee, as a result of which the ratio is higher than in previous years. In 2012 Morocco replaced Cyprus in the group alongside Greece, Portugal and Spain.

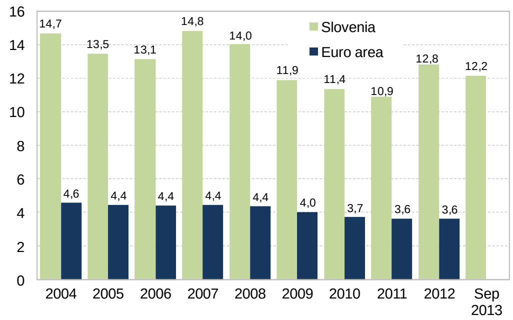
Sources: SLA, BAS, Bank of Slovenia, SORS, Leaseurope

The volume of new business on the European leasing market was down 2.4% in 2012.The largest declines in leasing business were recorded by Italy and the group of Greece, Portugal, Spain and Morocco, but there was a significant decline in real estate leasing in particular in almost all countries.

The ratio of leasing business to gross fixed capital formation declined by almost 3 percentage points in 2012, thereby approaching the European average. According to the leasing companies' reporting for 2013, the ratio of leasing business to gross investment stood at 17.3%. The proportion of financing accounted for by cars in the Slovenian leasing sector was larger than the European average, an indication of the low support for investment in the economy. The ratio of leasing business to bank loans declined by 0.6 percentage points between the end of 2012 and September 2013 to 12.2%, and is estimated to be double that in the euro area overall.

Figure 3.4: Growth in the stock of leasing business and bank loans to the non-banking sector (left)and ratio of leasing business to bank loans to the non-banking sector (right) in percentages





Note: For Slovenia, the figures used in the ratio of leasing business to bank loans for 2012 and 2013 are taken from reporting to the Bank of Slovenia (previously the BAS), and include non-members of the leasing committee, as a result of which the ratio is higher than in the previous year. Data availability (or the lack thereof) means that the figures do not include Ireland, Malta and, in part, Luxembourg.

Sources: SLA, BAS, Bank of Slovenia, ECB

Leasing companies recorded a loss for the fifth consecutive year.

Slovenian leasing companies recorded a loss for the fifth consecutive year (first three quarters of 2013). Several foreign leasing companies and certain leasing companies owned by Slovenian banks, which are significantly tied to the real estate market, ended 2012 with insufficient capital. The proportion of assets accounted for by investment property had increased to 27% by September 2013. The leasing companies' performance indicators in 2013 suggest a slight improvement in the situation in the leasing sector compared with 2012. The leasing companies' equity increased by EUR 126 million during the first nine months of 2013, and there were slight improvements in ROA and ROE, although they remained negative.

Table 3.2: Performance of leasing companies and sources of funding

									Growth, %					
	2006	2007	2008	2009	2010	2011	2012	Sep 2013	2007	2008	2009	2010	2011	2012
Total assets, EUR million	3.555	4.748	5.620	5.663	5.427	5.088	4.842	4.101	33,5	18,4	0,8	-4,2	-6,2	-4,8
Equity, EUR million	205	234	267	200	205	204	114	126	14,2	14,2	-25,2	2,4	-0,3	-43,9
Pre-tax profit/loss, EUR million	43	47	29	-33	-30	-19	-121	-47	8,8	-38,5	-215,3	10,9	34,8	-527,3
ROA, %	2,4	1,1	0,6	-0,6	-0,5	-0,4	-2,4	-1,1						
ROE, %	42,1	21,4	11,5	-14,2	-14,6	-9,4	-76,0	-36,9						
Financial and operating liabilities, EUR million	3.330	4.486	5.314	5.427	5.179	4.843	4.681		34,7	18,5	2,1	-4,6	-6,5	-3,3
liabilities to banks and undertakings in group / total assets, %	94	94	95	96	95	95	97							
Investment property	397	538	560	580	836	929	1.118	1.122	35,4	4,1	3,6	44,0	11,2	20,3
investment property / assets, %	11	11	10	10	15	18	23	27						
Finance expenses from impairments and write-downs of financial assets, EUR million	3	2	10	120	167	127	157							

Note: The figures from financial statements cover leasing companies included in reporting to the Bank of Slovenia (Bank of Slovenia figures for 2013, previously AJPES figures)

Sources: AJPES, Bank of Slovenia