BANKA SLOVENIJE
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<u>Press release</u>

557th Meeting of the Governing Board of the Bank of Slovenia

<u>Ljubljana, 7 June 2016</u>

The Governing Board of the Bank of Slovenia discussed the June 2016 Macroeconomic Forecast for Slovenia* and the June 2016 Financial Stability Review.

1. **Macroeconomic Forecast for Slovenia, June 2016***

The situation and outlook in the international environment are improving. **After slowing temporarily over the last two years, global economic growth is forecast to again approach 4% over the next two years. Growth in foreign demand is accordingly expected to strengthen, bringing solid growth in Slovenian exports.** The strengthening global economic activity is expected to bring increased demand for commodities and a moderate rise in commodity prices.

The Slovenian economy will continue to grow, albeit at a more moderate pace than in the last two years. Growth will stand at **1.9%** this year, as a result of the pronounced impact of the government investment cycle, but is then forecast to increase to **around 2.5%**. In the wake of an improvement in the situation on the labour market, private consumption is forecast to gradually strengthen, and together with the recovery in private-sector investment is expected to become the most important engine of economic growth. At the same time the export sector is expected to remain competitive, with growth in unit labour costs not outpacing the euro area average, and it will thus support the anticipated growth in domestic demand, thereby maintaining the large trade surplus.

The situation on the labour market will improve. In the wake of employment growth of more than 1%, unemployment is expected to fall to **below 8%** by the end of 2018. This will be attributable in part to increased labour market flexibility, alongside the favourable economic cycle. Employment is forecast to rise in private-sector services in particular, while remaining virtually unchanged in the government sector. The diminishing uncertainty on the labour market and the improved financing conditions are also expected to gradually strengthen domestic demand. This will raise corporate earnings, and will allow for wage increases in sectors with rising productivity. As austerity measures are relaxed, wages in the government sector will rise by an average of 4% annually.

After moderate deflation this year, inflation is forecast to average around 1.5% over the next two years. Price developments this year will again be primarily under the influence of falling oil and energy prices, while deflationary pressures will also be seen in prices of non-energy industrial goods and services. Price growth is nevertheless forecast to pick up by next year, as a result of growth in energy prices and the strengthening of domestic inflation factors. Core inflation will thus gradually rise over the projection period, as a result of faster wage growth and the consequent strengthening of private consumption and economic activity.

The risks associated with the economic growth forecasts are judged to be relatively small and balanced at this time, while the risks in connection with inflation are concentrated slightly on the upside. **The largest risks again come from the external environment, with the possibility of the relaxation of EU sanctions against Russia, and the potential slowdown in growth in developing countries, China in particular.** The first would raise export growth, while the second would lower it. Additional uncertainty comes from the **possibility of a freeze in oil production**, which could make growth in oil prices higher than forecast. The risks from the domestic environment are small, but not negligible, and are primarily connected with the **negotiations on wage growth in the public sector, investment activity and the effects of structural reform.**

** The **Macroeconomic Forecast for Slovenia** is a new publication in which the Bank of Slovenia releases its projections of economic developments. It will be released twice a year, in June and December.*

2. Financial Stability Review, June 2016

In 2015 and the first quarter of 2016 the banking system operated in an environment of favourable economic activity and an outlook of moderate growth this year. The most significant risks in the banking system show no change in the trend since the last Financial Stability Review was released in January 2016, with credit risk, income risk and interest rate risk remaining prominent. The risks inherent in the persistent environment of low or negative interest rates have recently come to the fore. As inflation remains low, the slow and uncertain economic recovery in the euro area is increasing the uncertainty over the maintenance of low interest rates, thereby escalating the adverse impact on financial intermediation. To maintain their interest margin and profitability, banks are adjusting their business models to the new environment by changing the structure and maturity of investments and funding, and by switching investments to higher-yielding, higher-risk assets. While the proportion of funding accounted for by sight deposits is increasing rapidly, additional unpredictability is being introduced into operations. The changes in bank behaviour are increasing the likelihood of the realisation of interest rate risk, credit risk and market risk in the future, and are simultaneously requiring adequate secondary liquidity as a safety valve in the event of the realisation of these risks.

The ongoing process of corporate deleveraging and favourable domestic economic growth are having a positive impact on the financial position of firms and their creditworthiness. As leverage declines, the burden on firms with excessive financial debt is also gradually diminishing. Leverage remains above-average at SMEs, although they have deleveraged more than the average since 2008, and have improved performance more than large enterprises. In contrast to other euro area countries, the corporate sector in Slovenia has primarily deleveraged by paying down debt, while its equity has remained practically unchanged over the last seven years.

Corporate debt servicing capacity is increasing as a result of the deleveraging process and improved performance. Firms' improved financial positions have been reflected in the banking system's credit portfolio through an increase in client upgradings and a slowdown in client downgradings.

Alongside the favourable impact of economic growth, the ongoing decline in credit risk at the banks was largely attributable to bank activity in the form of forbearance, increased write-offs and collateral realisation. The proportion of claims more than 90 days in arrears had declined to 8.2% by March of this year, while the proportion of non-performing exposures according to the broader European Banking Authority definition had fallen to 10.8%. The backlogs are still in the SMEs segment, where the resolution of non-performing claims is only now intensifying, and has been encouraged by the Guidelines for the management of non-performing exposures to SMEs adopted by the Bank of Slovenia. The proportion of claims with lengthy arrears of several years, where the likelihood of successful forbearance is smaller, also remains relatively high.

The retention on bank balance sheets of non-performing claims that do not yield income represents a major burden in achieving appropriate profitability or, in the case of banks bound by commitments to the European Commission, the required profitability. The banks with better investment quality were able to begin cutting lending rates earlier, and offered them at lower levels than the banks with poorer investment quality. As a result of increased competition and the successful clean-up of portfolios at the latter, the gap narrowed over the last two years, and had almost disappeared by early 2016. Competing on low interest rates without the requisite client risk assessments can underestimate future credit risk. On long-term loans with variable interest rates it is particularly vital to assess credit risk from the perspective of the debtor's creditworthiness in connection with increasing loan maturities.

Despite a growing economy, a sharp fall in lending rates and an increase in corporate creditworthiness, bank lending activity has continued to contract. The banks' tightened credit standards, which have primarily prevented the creation of new non-performing claims against already over-leveraged debtors, are no longer the key factor in the ongoing contraction in loans. The sharply reduced interest rates are more encouraging to new borrowing than in the past. In past years the restricted access to loans at Slovenian banks encouraged firms to seek alternatives, first by borrowing in the rest of the world, which despite a decline in the last year continues to account for a large proportion of loans to non-financial corporations (NFCs), at 28%. With greater access and a fall in the cost of financing on capital markets, the attraction of borrowing via bond and commercial paper issuance grew at large enterprises. Given the lack of development in the capital market in Slovenia, this source of financing remains limited solely to large enterprises, and represents a modest alternative to bank financing. **The main factor in the limited demand for loans was firms' propensity to make use of internal financing**, which will increase further in importance as profitability rises. Firms assess that access to financing is diminishing in importance as a limiting factor in performance.

The resilience of the banking system to potential shocks increased further, primarily through recapitalisations, but also through the earnings generated across the system in the last year. Alongside the relatively high coverage by impairments (among the highest in the euro area), the remaining non-performing claims are sufficiently covered by capital in the system overall. However, the small domestic banks remain prominent as the most capitally vulnerable bank group, even though their exposure to solvency risk diminished slightly last year. Although capital adequacy is favourable across the system, the gaps between banks are widening.

As a result of the favourable trend in credit risk in 2015 and early 2016, income risk is lower than in previous years, but the effect is thought to be more short-term. Reduced impairment and provisioning costs placed less of a burden on bank profitability than during five years of losses. Their ongoing impact on bank income depends strongly on the future success of the resolution of the banks' remaining non-performing portfolio. The effects of the release of impairments on successfully forborne claims could also have further positive effects on bank income in the future. Over the long term income risk is strongly dependent on the duration of the environment of low interest rates, and the banks' success in adjusting their business models to these circumstances.

The falls in lending rates and in returns on securities, and the contraction in loans are reducing the banks' income generation base. Banks across the euro area have partly compensated for the fall in lending rates by increasing lending activity, which is not the case for Slovenian banks in a situation of ongoing contraction in credit activity. As the average maturity of deposits continues to shorten, the banks' net interest expenses have also continued to decline, although the sharply reduced level of interest rates and the increase in the proportion of sight deposits mean that the banks have diminishing room for additional cuts in interest expenses. Despite an improvement in the income performance indicator after five years in negative territory, the maintenance of the low interest rate environment is a factor in the banks' exposure to income risk.

The banks are adjusting to the new structure by changing the structure and maturity of their investments, thereby slightly mitigating the impact of falling interest rates on the interest margin. In corporate lending, the average maturity of approved loans is lengthening, and is now unreasonably longer than in the period of high growth in borrowing. A decline in short-term corporate lending is however a positive development from the perspective of the past improper practice of financing long-term projects via short-term loans. In the household segment the spread between asset and liability interest rates is being maintained or even widened, by means of the lengthening of the average maturities of housing loans, and as a result of a sharp reduction in average maturities and hence in interest expenses on household deposits. Income risk at Slovenian banks would only diminish in the wake of the resumption of stable credit growth, which would partly compensate for the pressure of low interest rates on the net interest margin.

The opening of maturity gaps between investments and funding is increasing interest rate risk at the banks. The recent lengthening of the average repricing period on loans was particularly attributable to the increase in new housing loans with a fixed interest rate. The widening gap between the average repricing periods for asset and liability interest rates is increasing interest rate risk, which in the event of a rise in interest rates would be reflected in faster growth in expenses from short-term funding than in income from long-term investments.

Deposits by the non-banking sector strengthened their position as the banks' most important source of funding, although the increase in sight deposits means that there is no guarantee of their stability. Stable growth in household deposits is strengthening the stability of funding structure, in which dependence on the financial markets is declining permanently. The increase in new deposits, particularly in the household sector, is almost exclusively in the sight deposits segment, while the inflow of sight deposits is being fuelled by maturing fixed-term deposits, on account of discouraging interest rates. The proportion of household deposits accounted for by sight deposits reached almost 60%. The virtual equalisation of deposit rates between banks is not encouraging savers to switch between them. In the event of a rise in market interest rates there is a risk of renewed competition between banks to retain their primary source of funding.

Slovenian investors' reticence towards alternative forms of investment is not a sufficient guarantee that certain savers will not diversify their portfolios and make withdrawals from banks. **For this reason controlling liquidity risk at banks and maintaining an adequate level of secondary liquidity are gaining in importance.** It is also important to control liquidity risk at the level of the individual bank while maintaining the stability of deposits across the banking system, as triggers for switching may arise within the banking system, in the wake of an increase in the vulnerability of an individual bank.

Bank liquidity indicators remain high and stable. The banks' excess liquidity and the availability of additional funding from the Eurosystem represent a challenge to the effective management of excess liquidity and the quest for appropriate returns in a situation of high liquidity across the Eurosystem. Marketable secondary liquidity has reached a stable 18% of the banking system's total assets, primarily in Slovenian government bonds. This concentration has been diminishing over the last six months, as investments increase in foreign securities rated BBB or higher, which are still eligible collateral for the Eurosystem. The banks' predictions of a reduction in the concentration of secondary liquidity are thus being realised, and also reflect the quest for higher-yielding investments.

The risk of the strengthening of shadow banking in Slovenia remains at low levels. The environment of low interest rates and ever-stricter regulation of the banking sector are increasing the risk of the strengthening of shadow banking within the euro area. The risk of strengthening entails the transfer of activities from the more-regulated banking sector to other less-regulated sectors such as investment funds, other financial intermediaries and financial auxiliaries. The risk of the strengthening of shadow banking in Slovenia nevertheless remains below the euro area average, as alternative sources of financing for the economy are less developed in Slovenia.

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Illustration of risks in the Slovenian banking system

Systemic risk	Risk assessment Q4 2015	Q1 2016	Trend in risk	
Macroeconomic risk			→	Favourable forecasts of ongoing economic growth. Exports remain the key factor, while household consumption is also increasing, under the influence of positive trends on the labour market.
Credit risk			↓	Further improvement in the quality of the credit portfolio under the influence of the improvement in the financial position of firms, economic growth, and bank activity in forbearance, write-offs and collateral realisation. Coverage by impairments and capital is increasing.
Real estate market			→	Stabilisation of real estate prices, and increased volume in used housing on the real estate market.
Refinancing risk			↓	Further stabilisation of funding structure with reliance on domestic funding. High excess liquidity, a high proportion of unencumbered collateral and thereby a potential source of liquidity at the ECB. Stabilisation of the LTD ratio. Potential instability of funding as a result of the shortening of average funding maturity.
Interest rate risk			↑	Opening of the gap between the average repricing periods for asset and liability interest rates, as a result of the widening of maturity gaps between investments and liabilities. The increased focus on loans with a fixed interest rate is widening the gap between assets and liabilities.
Solvency risk			→	Further growth in capital adequacy, as a result of growth in capital (bank profitability) and a renewed decline in capital requirements as lending activity continues to contract. The small domestic banks remain the most vulnerable in capital terms, with a total capital ratio below the euro area average.
Income risk			→	The risk remains relatively high owing to the persistence of the environment of low interest rates and the ongoing contraction in bank turnover. A favourable effect of reduced credit risk via a decline in impairments and provisions.

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