



Report of the Bank of Slovenia on the causes of the capital shortfalls of banks and the role of the Bank of Slovenia as the banking regulator in relation thereto, the recovery of banks in 2013 and 2014, the efficiency of the system of corporate governance of banks under state ownership and the manner of resolving the consequences of the capital inadequacy of commercial banks

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1. INTRODUCTION

At its session of 30 January 2015 the National Assembly adopted the Resolution in connection with the activities of the Bank of Slovenia regarding the recovery and resolution of the banking system.

In the Resolution, the National Assembly recommended that within 30 days the Bank of Slovenia draft and send to the National Assembly information on:

- the causes of the capital shortfalls of the banks under review and the role of the Bank of Slovenia as the banking regulator in relation thereto,
- the efficiency of the system of corporate governance of banks under state ownership and
- the manner of resolving the consequences of the capital inadequacy of commercial banks.

The Bank of Slovenia drafted the report and owing to the current debates in the National Assembly supplemented it with information on the recovery and resolution of banks in 2013 – 2014.

Chapter **2. PHASES OF THE FINANCIAL AND ECONOMIC CRISIS AROUND THE WORLD AND IN SLOVENIA AND THE DEVELOPMENT OF RISK IN THE SLOVENIAN BANKING SYSTEM** lists the causes for the capital shortfalls of the banks under review.

Chapter **3. FRAMEWORK FOR MANAGEMENT OF SYSTEMIC RISKS (BANK OF SLOVENIA ACTIONS)** clarifies the role of the Bank of Slovenia as the banking regulator.

Chapter **4. RECOVERY OF BANKS (2013 – 2014)** sets out the procedures for the comprehensive review and recapitalisation of banks.

Chapter **5. ASSESSMENT OF THE CORPORATE GOVERNANCE OF BANKS** gives the Bank of Slovenia's assessment of the efficiency of the system of corporate governance of banks under state ownership.

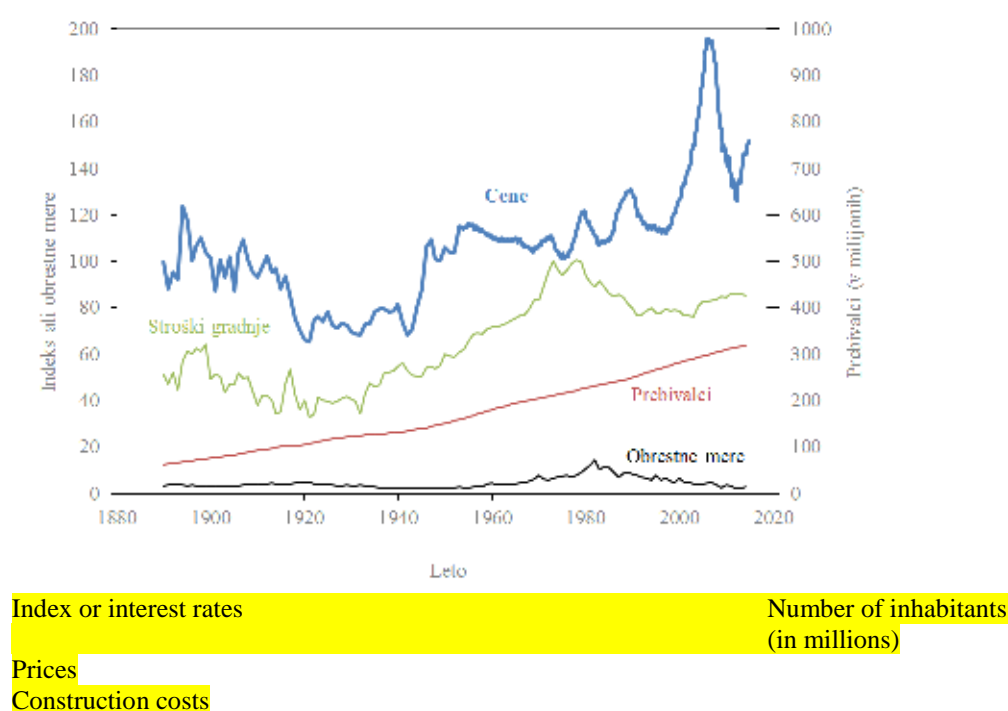
Chapter **6. IMPROVING SUPERVISION TO PREVENT A REPEAT OF THE CRISIS** presents measures for preventing future crises.

2. PHASES OF THE FINANCIAL AND ECONOMIC CRISIS AROUND THE WORLD AND IN SLOVENIA AND THE DEVELOPMENT OF RISK IN THE SLOVENIAN BANKING SYSTEM

The financial and economic crisis erupted in the USA in mid-2007. The origin of the crisis was the bursting of the bubble in real estate prices¹ in the middle of 2006 (Figure 1), followed by a drop in the prices of securities that were tied to real estate prices, of which the most important were mortgage-backed securities. Since they were held by the largest financial institutions in the USA and a significant number of EU countries, the crash in the prices of mortgage-backed securities threatened their existence.

After the American government allowed Lehman Brothers to go bankrupt in September 2008 and be liquidated, it formed TARP (Toxic Asset Relief Program) amounting to over USD 700 billion and prevented the bankruptcy of the other four investment banks in the USA. The majority of these institutions operated with extremely high leverage (the ratio between debt and share capital at Lehman Brothers in 2007 was 31:1, i.e. the percentage of share capital was around 3% of the total risk-weighted assets), which meant that they did not have sufficient capital to be able to absorb the loss of value of their financial holdings.

Figure 1: The bursting of the real estate bubble



¹ The expansion of mortgages reflected the exceptional growth of subprime mortgages, particularly in 2004 and 2005. The reasons for the growth of mortgages include low lending standards, low FED (American central bank) interest rates (the Federal Funds Rate (FFR) went from 6.5% in 2000 to 1% in 2003), government promotion of real estate ownership through the Fannie Mae and Freddie Mac funds, high proportions of loans at real estate values, rewarding employees for approving loans, the moral hazard associated with transferring loans to the owners of mortgage-backed securities, and inappropriate assessment of the quality of mortgage-backed securities by international credit-rating agencies.

Inhabitants
Interest rates

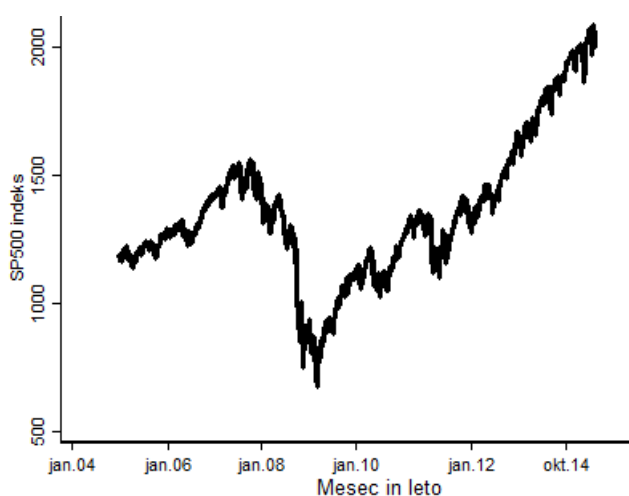
Year

Source: Figure 3.1, R. Shiller, Irrational Exuberance, Princeton University Press, 2015.

Note: The blue line shows real estate prices, and the green line shows construction costs.

Due to increased risk with respect to the quality of the securities, the prices of other securities were also lowered, which further weakened the financial results of financial institutions in the USA and other countries (Figure 2). Owing to uncertainty about the effects of the devaluation of certain investment instruments on bank balance sheets, in Q3 2008 the possibility of financing on wholesale markets essentially disappeared overnight, and not just for banks, as the financing of countries also became temporarily extremely difficult. The reduction of the real property of households in the USA led to the lowering of household consumption and consequently to the reduction of the real GDP² and increased unemployment.

Figure 2: Movement of the S&P 500 Index



S&P 500 Index

Jan.04 Jan.06 Jan.08 Jan.10 Jan.12 Okt.14
Month and year

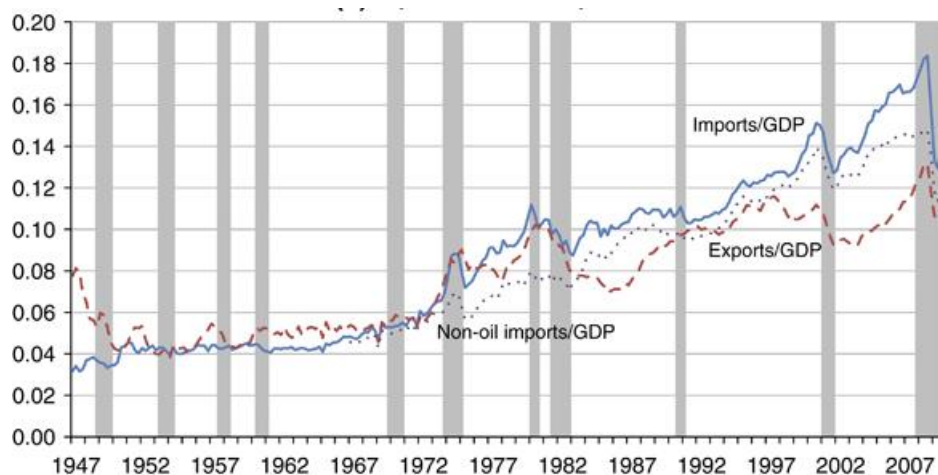
Source: Standard and Poor's, 2015.

The decline of the GDP affected export demand, thus affecting other countries around the world, including the EU countries and consequently also Slovenia.

Alongside the cumulative decline of the US GDP in 2008 and 2009 (from top to bottom) by 3.8%, US imports fell by 21.4%, and exports fell by 18.9% (Figure 3; Levchenko et al, 2010). This included a major decline in import demand for intermediate goods.

Figure 3: Movement of imports and exports in the USA

² The gross domestic product in the USA began to fall in the fourth quarter of 2007, but negative growth was only recorded for one quarter, so that officially it was not a recession. The GDP then fell for several quarters in succession from the third quarter on. The main contributor to the decline was the reduction in final household consumption.



Source: Andrei A Levchenko, Logan T Lewis and Linda L Tesar: The Collapse of International Trade during the 2008–09 Crisis: In Search of the Smoking Gun, IMF Economic Review, 2010, Vol. 58, 214-253.

In 2009, Slovenia recorded a decline in exports of 16%, and a parallel decline in imports of 19%, which indicates the effects of changes in the dynamics of the international market at the global level on dynamics in Slovenia (Figure 4). Slovenia, similarly to the USA, owing to a current account deficit and the consequent increased macroeconomic imbalance, reduced imports more than exports, through which the external imbalance was corrected. The table below shows that the decline in real GDP was also significantly negatively affected by a decline in investment, partly owing to low foreign demand for export goods and services, and partly to low government demand for investment goods (e.g. cessation of construction of the motorway network) and decreased demand for real estate among households.

Figure 4: Real growth rate of GDP components

	2007	2008	2009	2010	2011	2012
Final consumption	4.8	3.2	0.5	1.4	0.2	-3.8
Households	6.2	2.5	-0.1	1.5	1.0	-4.8
Government	0.6	5.9	2.5	1.3	-1.6	-1.3
Gross investment	19.3	3.1	-34.3	-7.3	-2.3	-16.5
Exports of goods and services	13.7	4.0	-16.1	10.2	7.0	0.6
Goods (FOB)	13.9	1.8	-16.6	12.0	8.2	-0.1
Services	13.2	14.3	-14.0	3.5	1.9	3.7
Minus: imports of goods and services	16.7	3.7	-19.2	7.4	5.6	-4.7
Goods (FOB)	16.2	3.0	-20.2	8.3	6.6	-5.1
Services	19.7	8.2	-12.4	2.6	-0.6	-2.2
GDP	7.0	3.4	-7.9	1.3	0.7	-2.5

Source: Table 26.5, Statistical Yearbook, 2013, Ljubljana: SORS.

The correction of international current account imbalances also involved the adjustment of financial flows. While the USA had a major current account deficit before the crisis, it was cut in half from 2006 to 2009. The reduction of the current account deficit also meant a smaller level of net financial inflows. Similar was true in Slovenia, which went from a nominal deficit in foreign trade (the main component of the current account surplus/deficit) of EUR 938 million (2.5% GDP) in 2008 to a surplus in 2012 of EUR 1.7 billion (4.8% GDP). The net inflow of foreign financial sources thus turned into a net payment of foreign debts.

The beginning of the crisis in the Slovenian banking system was also associated with the sudden loss of financing opportunities on international financial markets and the unwillingness or inability of creditors to refinance mature liabilities. When country risk also became a problem for the operation of the international financial markets (after the onset of the crisis in Greece in May of 2010), the

possibility of refinancing mature liabilities with government bonds disappeared. After this episode, Slovenian banks repaid their mature liabilities³ either with recovered mature liabilities from corporations or through supplementary borrowing from the ECB within the framework of monetary policy, which was limited through strict rules on credit ratings, capital adequacy and collateral.

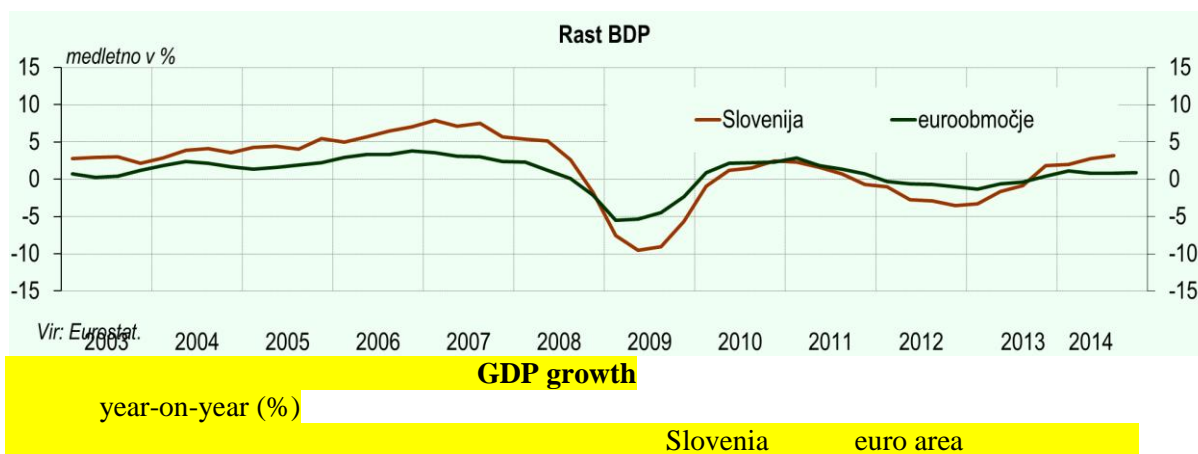
Below we present three key segments which contributed to the development of the banking crisis in Slovenia. These segments are:

1. **Rapid and unbalanced growth before the crisis;**
2. **Excessive debt of non-financial corporations and a privatisation model financed through borrowing and the encumbrance of future monetary flows of acquired companies for the repayment of debts from privatisation;**
3. **Factors leading to the accumulation of non-performing loans during the crisis.**

2.1 Pre-crisis model of economic growth

In the pre-crisis period, Slovenia was characterised by a **very high growth rate of the gross domestic product (GDP)**. The growth of Slovenia's GDP systematically exceeded the growth rate of the European Union and the euro area (Figure 5), and further accelerated starting in 2005.

Figure 5: Economic growth of Slovenia and the euro area (%)



Source: Eurostat.

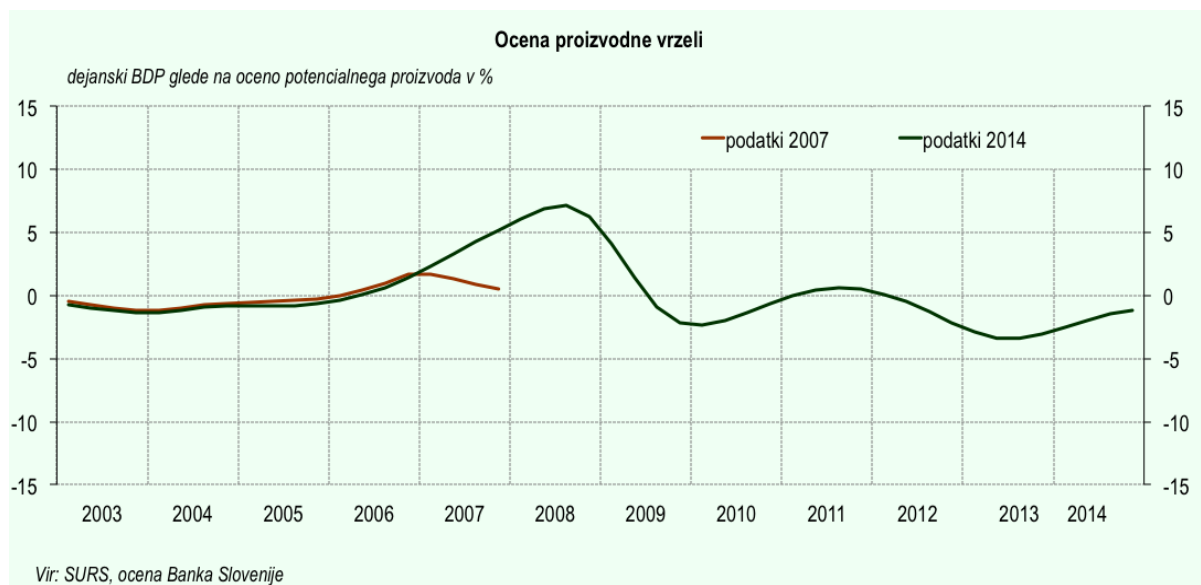
Consequently the economy was overheated, which can be illustrated by **estimates of the output gap**⁴, which are shown in Figure 6. It can be seen that at the peak of economic activity in 2008 the gap between the actual output and the output trend reached 7% of GDP, which is a good indicator of the overheating of the economy, which can be followed by a major economic decline. It is also true that the extent of the overheating of the economy can still be seen to its full extent today. **The assessments**

³ From 2011-2014, domestic banks reduced their exposure to foreign banks from EUR 11.7 billion to EUR 4.5 billion, as can be seen in Figure 13.

⁴ The output gap is defined as the difference between the actual output (GDP) and the potential output. On the basis of calculations of the potential output and the output gap, we can assess the economic situation with respect to the economic cycle and forecast future developments.

that could be made with the data available in 2007, when Slovenia achieved record economic growth, indicate that the extent of the overheating was much harder to identify.

Figure 6: Estimates of the output gap in Slovenia from 2007 and 2014

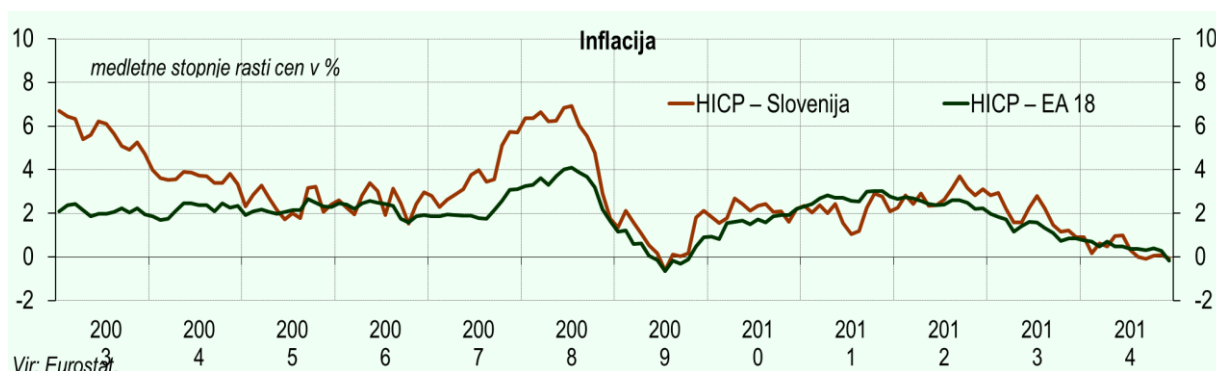


Estimated output gap	
actual GDP with respect to the estimated potential output (%)	
2007	2014

Source: SORS, Bank of Slovenia estimate.

The overheating of the economy was manifested in **high inflation**, which was significantly higher than the euro area average particularly in 2008, as can be seen in Figure 7.

Figure 7: Inflation in Slovenia and the euro area (%)



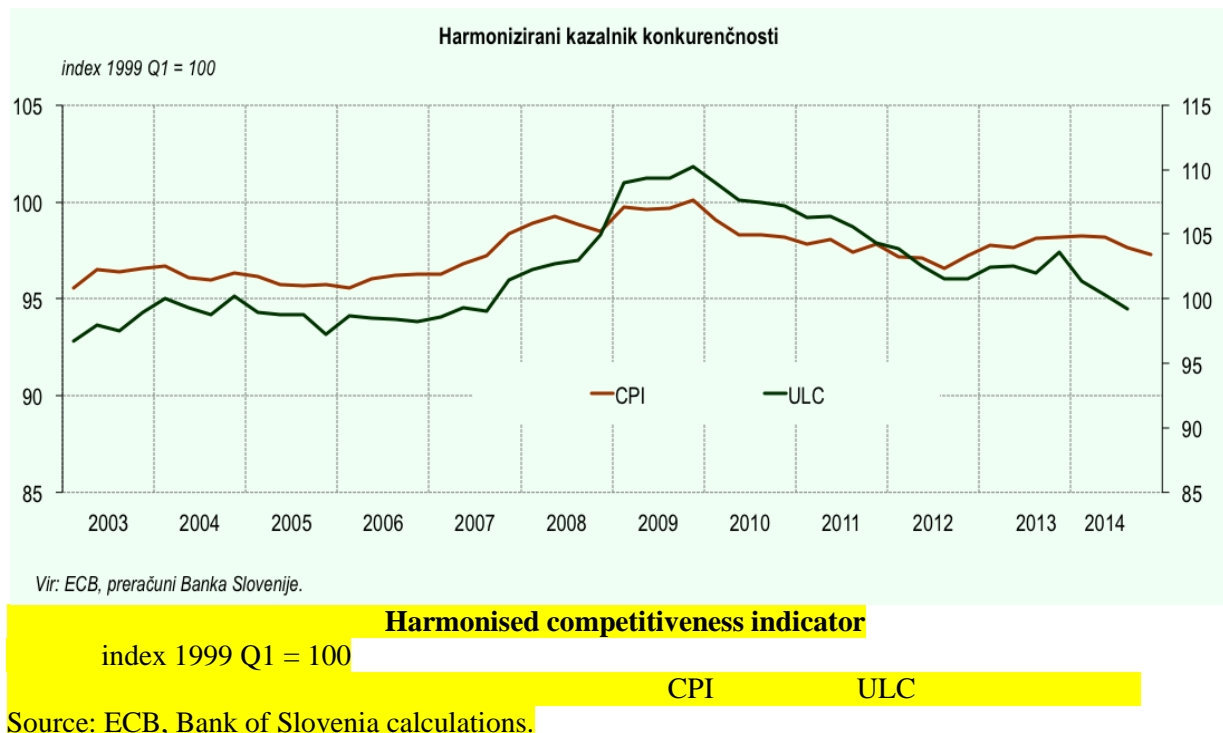
Inflation	
year-on-year growth (%)	
HICP – Slovenia	HICP – EA 18

Source: Eurostat.

High inflation was one of the factors, in addition to rapid economic growth, which led to **fast growth of salaries**, which together with increased salaries in the public sector just before the beginning of the crisis significantly weakened the cost-competitiveness of the economy. This is confirmed by Figure 8, which shows the movement of the real exchange rate.

The **real exchange rate**, adjusted by unit labour costs, grew dramatically (which means a loss of competitiveness) precisely in 2007 and 2008. It was also particularly problematic that this growth continued (additional loss of competitiveness) in 2009, when Slovenia was already in a deep recession. This was connected with increased salaries in the public sector, an increase in the minimum wage and the consequent social transfers and pensions.

Figure 8: Competitiveness index: movement of the real exchange rate



Note: ULC – unit labour costs, CPI – Consumer Price Index

Pushing the economy through unsustainable growth of domestic final consumption and loss of competitiveness was also expressed in a large **current account deficit**, which reached its peak in the middle of 2008, when it neared 6% of GDP.

At the same time, the **gross external debt exceeded EUR 33 billion**, which was a full EUR 19 billion higher than before Slovenia's entry into the EU.

2.1.1 Factors affecting the overheating of the economy

The overheating of the economy was a consequence of several factors. After entering the ERM2 exchange rate mechanism on 28 June 2004, at the same time as providing a stable tolar exchange rate against the euro, a process of lowering domestic interest rates began, and restrictions on movements of equity were lifted. With this, the Bank of Slovenia lost control of the amount of money in circulation, i.e. monetary sovereignty. This is a normal process before adoption of the euro, when other economic policies have to take the central role in providing macroeconomic stability.

Institutional involvement of the Bank of Slovenia in the EU, ESCB, and Eurosystem

Slovenia enters the EU – 1 May 2004: Upon its accession to the EU on **1 May 2004** Slovenia adopted EU regulations (Treaty of Accession to the EU) and transferred part of its sovereignty to EU institutions. Slovenia also became a member of the Economic and Monetary Union (EMU) through

derogation, which means that the rules for the economic union were applied to it, but not yet for the monetary union (these were applied upon the adoption of the euro).

Slovenia adopted EU legislation governing the internal market (including regulations on banking and other financial services), competition (rules applying to state aid) and other regulations. The EU has among other things exclusive competence to establish monetary policy and the competition rules necessary for the functioning of the internal market.

By joining the EU, the Bank of Slovenia became member of the European System of Central Banks (ESCB) consisting of the ECB and the national central banks of the EU member states. The Governor of the Bank of Slovenia became a member of the General Council of the ECB.

Adoption of the euro – 1 January 2007: After the introduction of the euro, Slovenia became a part of the euro area and the Eurosystem (which comprises the ECB and the national central banks of countries with the euro). Upon the adoption of the euro, the competence for the implementation of monetary policy was transferred to the Eurosystem.

In accordance with the Statute of the ESCB and of the ECB, the Bank of Slovenia, as one of the euro area national central banks, carries out the tasks conferred upon it in accordance with the rules established by the ECB's decision-making bodies. The functioning of the Eurosystem is such that decisions are taken by the ECB, i.e., in a centralised manner, and implemented via the national central banks, i.e., in a decentralised manner.

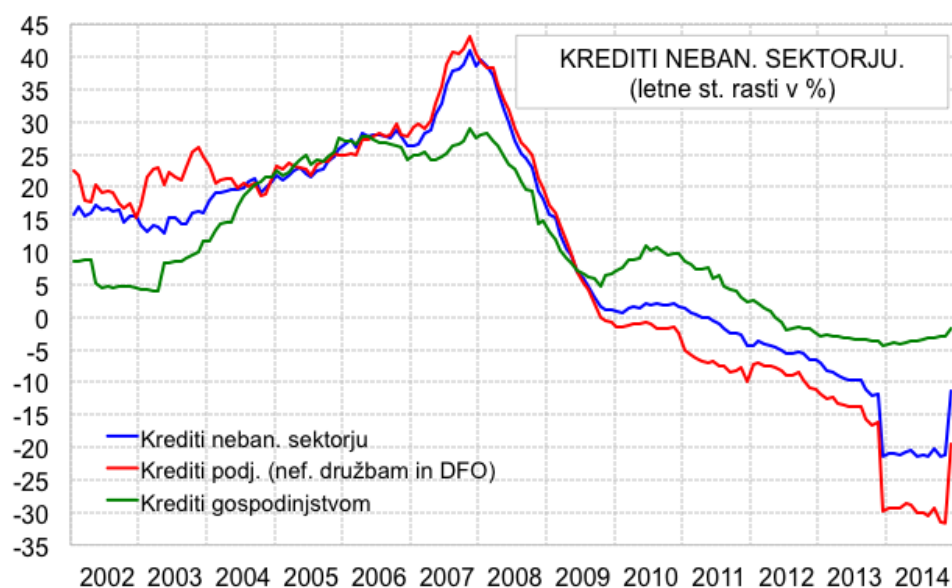
The national central banks perform nearly all of the Eurosystem's operational tasks, in accordance with ECB guidelines and instructions. The Bank of Slovenia thus implements Eurosystem monetary policy, manages foreign reserves, manages and supervises payment systems, issues euro bank notes in cooperation with the ECB, collects statistics for the ECB, assists the ECB with the translation and preparation of publications and assists in economic analyses and research.

The Bank of Slovenia participates in the Eurosystem decision-making process. The Governor of the Bank of Slovenia is a member of the ECB's main decision-making body, the Governing Council, which defines monetary policy for the euro area, and is thus actively involved in the monetary policy decision-making process. The Governor is also a member of the ECB's General Council.

Access and lower interbank or wholesale interest rates from international financial sources encouraged domestic banks to make **increased loans to the private sector**.

The average annual growth in loans to the non-banking sector in the period from 2006-2008 was **30%** (see Figure 9). In absolute terms, short-term corporate loans from banks saw the biggest rise, increasing by EUR 11.2 billion between the end of 2006 and the end of 2009, while long-term loans increased by just EUR 4.3 billion. The pre-crisis period saw a dramatic rise in the **risk of discrepancies between the maturities of the sources and investments** of banks and corporations.

Figure 9: Annual growth in loans to the non-banking sector (%)



LOANS TO NONBANK. SECTOR (regular growth rate (%))

Loans to nonbank. sector

Loans to corporates (non-financial corporations and OFIs)

Loans to households

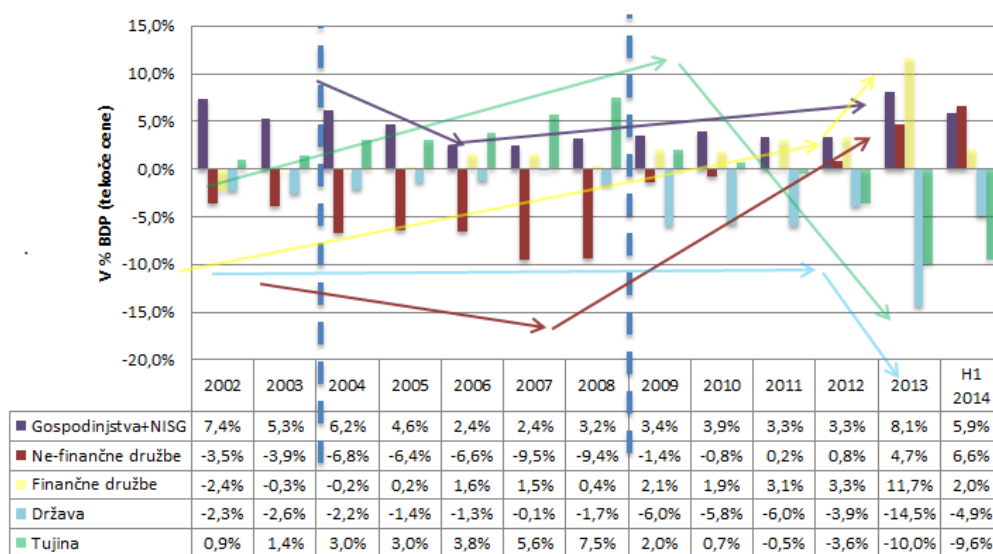
Owing to the high interest margins, arising from the differences between the interest rates of financial sources and the interest rates on loans, the competition among banks to maintain or increase their market shares became increasingly intense, which was reflected in both the **lowering of effective interest rates** and the **lowering of loan standards for corporate loans**, e.g. by reducing the required amounts of collateral.

The growth of loans and management debt purchases led to a bubble in the prices of real and financial holdings, to which the state made a significant contribution, among other things through accelerated construction of the motorway network, with a more than 17-percent average annual growth rate of investments from 2006-2008. This was achieved despite the signing of an agreement in November 2003 on harmonised or countercyclical implementation of economic policies between the Bank of Slovenia and the Government of the Republic of Slovenia in the period before and after the adoption of the euro.

Pro-cyclical effects were also brought about by the tax reforms, which in the period from 2005-2009 gradually lowered labour costs through the gradual elimination of payroll taxes, lowered the effective income tax and lowered the effective corporate taxation, owing to which according to the European Commission's most recent estimates (November 2014), Slovenia's structural budget deficit in the boom years of 2007 and 2008 grew by a total of 2% of GDP.

Overview of growth of macroeconomic difficulties after 2002

Figure 10: Net sectoral surpluses or deficits of financial assets



Vir: Finančni računi, Banka Slovenije.

Prikazana je postavka B.9f po ESA95 – neto posojanje/izposojanje posameznega sektorja slovenske ekonomije

As % GDP (current prices)

15.0%
10.0%
5.0%
0.0%
-5.0%
-10.0%
-15.0%
-20.0%

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	H1 2014
Households + NISH	7.4%	5.3%	6.2%	4.6%	2.4%	2.4%	3.2%	3.4%	3.9%	3.3%	3.3%	8.1%	5.9%
Non-financial corporations	3.5%	3.9%	6.8%	6.4%	6.6%	9.5%	9.4%	1.4%	0.8%	0.2%	0.8%	4.7%	6.6%
Financial corporations	-2.4%	-0.3%	-0.2%	0.2%	1.6%	1.5%	0.4%	2.1%	1.9%	3.1%	3.3%	11.7%	2.0%
Government	-2.3%	-2.6%	-2.2%	-1.4%	-1.3%	-0.1%	-1.7%	-6.0%	-5.8%	-6.0%	-3.9%	-14.5%	-4.9%
Rest of the world	0.9%	1.4%	3.0%	3.0%	3.8%	5.6%	7.5%	2.0%	0.7%	-0.5%	-3.6%	-10.0%	-9.6%

Source: Bank of Slovenia financial calculations.

The above is item 8.9f of ESA95 – net lending/borrowing of an individual sector of the Slovenian economy

Figure 10 shows the trend lines of annual sectoral financial surpluses or deficits which indicate increasing macroeconomic difficulties – imbalances in the Slovenia before the onset of the financial and economic crisis.

The trend lines in different colours (sectors) illustrate the **movement of the net financial surplus/deficit of an individual sector in the period in question**. Since financial accounts are a system of zero-sum sectoral surpluses or deficits, their interrelationships (sectoral financial surpluses or deficits) are therefore very important in order to determine, for example, the functioning or non-functioning of financial intermediation, and for the latter the impairment of the effects of the ECB's monetary policy on the Slovenian economy.

We shall focus on the the last two distinct time periods (2004-2008 and 2008-Q2 2014). Already in the preceding year of 2003, Slovenia abandoned the external equilibrium, and trend line of the Rest of the World sector (*green line*) began to see strong growth of financial surplus (a deficit of domestic sectors of the economy with respect to the rest of the world) which continued into 2008 (7.6% of GDP). On the other hand, the trend line for the financial deficit of the non-financial sector (*red*) deepened into 2007, during which it reached a full 9.7% of GDP, or EUR 3.3 billion. Companies in Slovenia borrowed relatively more than the EMU average for companies in the pre-crisis period. During or after 2007, the lines (yellow and green) changed direction and in the most recent period shown (2009-2012) shrank to a point: just below 0% of GDP around the middle of 2011.

The net sectoral surplus/deficit of the financial sector in Slovenia (*yellow trend line*, expressed as % of GDP) show a nearly linear growth trend during the study period, from a moderate financial deficit in the first period to a distinct financial surplus in the third period.

In the most recent period (2009-2012), financial intermediaries reduced their loan volume. While year-on-year growth rates of newly approved loans to the non-banking sector (corporates and households) in the second study period (2004-2008) exceeded 40% at the end of 2007 (Financial Stability Review, Bank of Slovenia, May 2012, p. 53), this was followed by a drastic drop in lending activity in the most recent period shown. Year-on-year growth rates of net loans⁵ to the non-banking sector at the end of 2009 already showed zero growth, and negative growth at the end of 2012 for, e.g., non-financial corporations amounting to -10.3% (Financial Stability Review, Bank of Slovenia, May 2013, p. 44).

2.2 The causes of high growth in lending

As shown in the preceding section, during the years before the crisis, a process of rapid economic growth was accompanied by a process of rapid expansion in lending. The latter is very important to understanding the causes of the crisis and the situation in the banking system, as the Slovenian crisis primarily manifested as a banking crisis. At the same time, the need for bank recovery arose due to the accumulation of non-performing loans during the period of rapid growth of lending and a major fall in economic activity, which was the consequence of an accumulation of domestic structural imbalances as well as a drop in demand due to the global economic crisis.

The high growth in lending was influenced by several factors on the supply side and demand for loans, which were closely connected with the successful completion of the process of accession to the EU and the introduction of the common currency (euro) in January 2007.

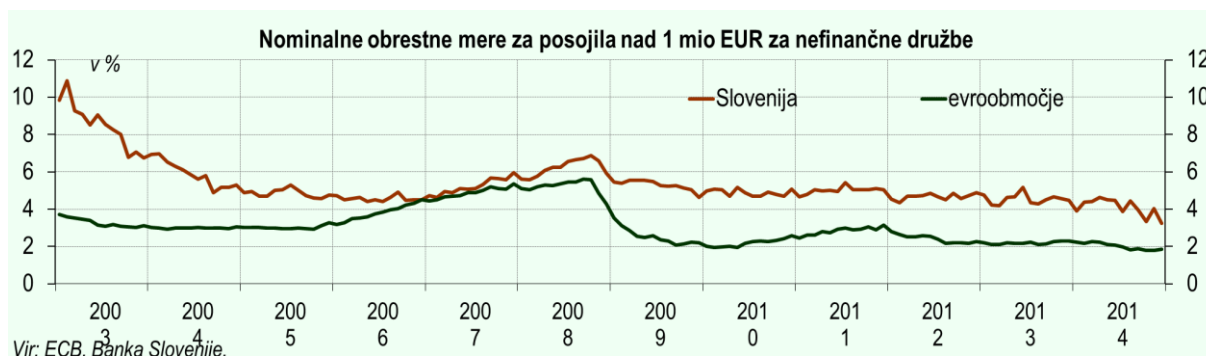
2.2.1 Factors on the supply side

1. Interest rates on loans to corporates from the beginning of the pre-accession period to the EU to mid-2005 fell quickly and reached their lowest value of between 3.5% and 3.9% for loans up to EUR 1 million and over EUR 1 million, respectively. The lower interest rates increased expectations for profitability, and at the same time had the effect of increasing demand for real estate, which

⁵ Loans, less impairments

consequently led to growth in real estate prices. The convergence of interest rates to the level of the interest rate average for the euro area was faster than the lowering of the inflation rate.

Figure 11: Interest rates on corporate loans in Slovenia and in the euro area (%)



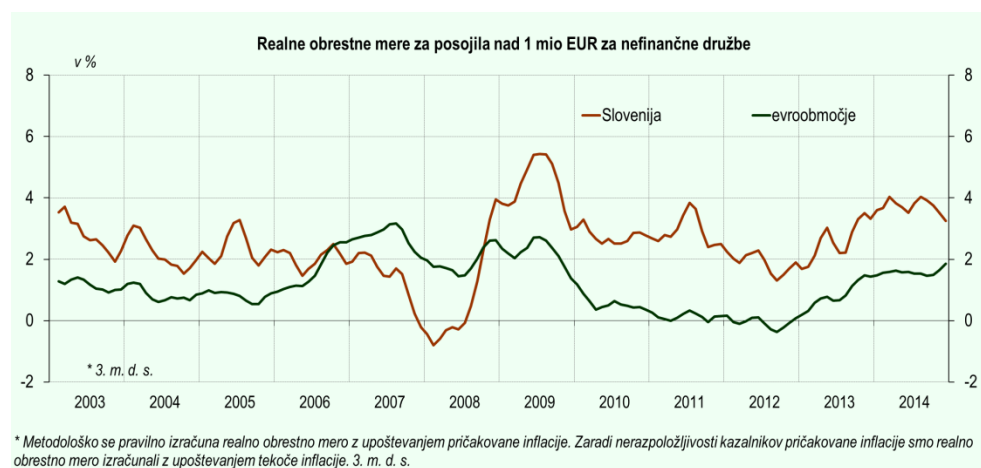
Nominal interest rates on loans of more than EUR 1 million for non-financial corporations (%)

	Slovenia	euro area
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Source: ECB, Bank of Slovenia.

From the autumn of 2005 until the onset of the financial crisis the interest rates of Slovenian banks also gradually increased proportionately to the increases in the reference interest rates on international financial markets, but the difference between the domestic inflation rate and the inflation rate of the euro area caused a situation in which the ECB's single monetary policy was at the time expansive in local conditions. As shown in Figure 12, the **real interest rates were therefore lower in Slovenia than in other euro area countries, which stimulated demand for loans.**

Figure 12: Real interest rates in Slovenia and in the euro area (%)



Source: Bank of Slovenia, ECB.

Real interest rates on loans of more than EUR 1 million for non-financial corporations

(%)

Slovenia euro area

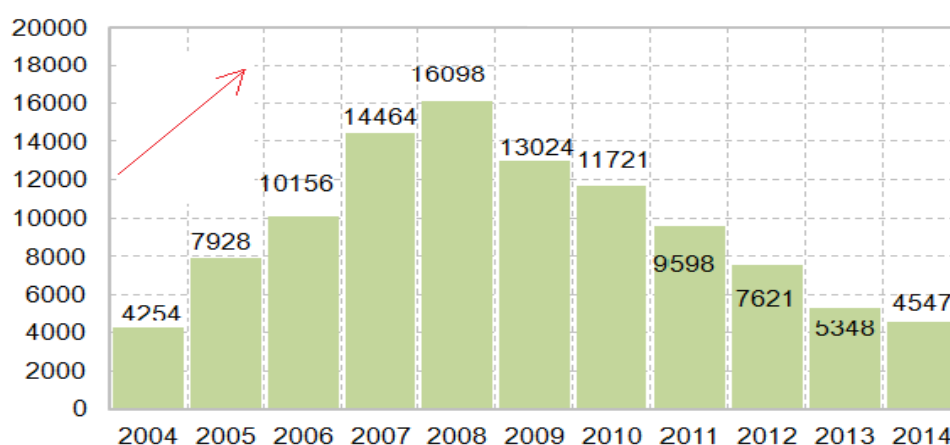
* 3. m. d. s.

* With respect to methodology, real interest rates are usually calculated taking the expected inflation rate into account. Due to a lack of indicators of the expected inflation rate, we calculated the real interest rate using the current inflation rate. 3. m. d. s.

2. In the circumstances at that time, probably the most important factor that allowed high growth in lending was the large supply of assets on the international financial markets, which reflected the dynamics of the economic cycle.

Figure 13 shows the dynamics of borrowing by Slovenian banks on international wholesale markets, which increased steadily until the onset of the crisis. **In the period from 2004-2008, domestic banks increased their exposure to foreign banks from less than EUR 4 billion to more than EUR 16 billion.** An additional difficulty is the fact that as the crisis loomed, foreign borrowing by domestic banks became increasingly short-term.

Figure 13: Liabilities of Slovenian banks to foreign banks (financing on the wholesale market)

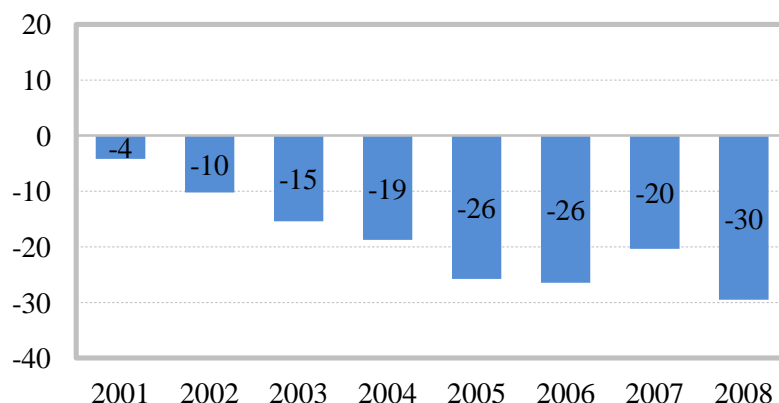


Source: Bank of Slovenia

Consequently, the **net debt of the entire Slovenian economy vis-à-vis the rest of the world** increased. The movements of the net financial position of Slovenian economic sectors vis-à-vis the

rest of the world indicate that from 2001 on the net financing of banks and other segments of the financial sector in the rest of the world grew steadily. **Up to 2005 the proportion of the net financial liabilities of the financial sector to the rest of the world as a percentage of GDP increased more than fivefold, to 26% of GDP, and from then until the year of the onset of the international financial crisis it reached its highest level, at 30% of GDP⁶** (Figure 14).

Figure 14: Net financial liabilities of the financial sector vis-à-vis the rest of the world (as a % of GDP)



Source: Bank of Slovenia

The result of the fast growth of lending based on foreign borrowing by domestic banks and thus the increasing of the net debt of the Slovenian economy was increased vulnerability to financial shocks in the rest of the world, which materialised after the fall of Lehman Brothers in 2008.

The banks steadily increased their level of borrowing from foreign banks, at that time a relatively affordable means of financing on the foreign wholesale market. At the same time they **increasingly neglected to encourage domestic household savings**, which resulted in negative consequences for banks upon the onset of the financial crisis. In the period after 2003 this led to a widening of the gap between domestic deposits and loans to the non-banking sector.

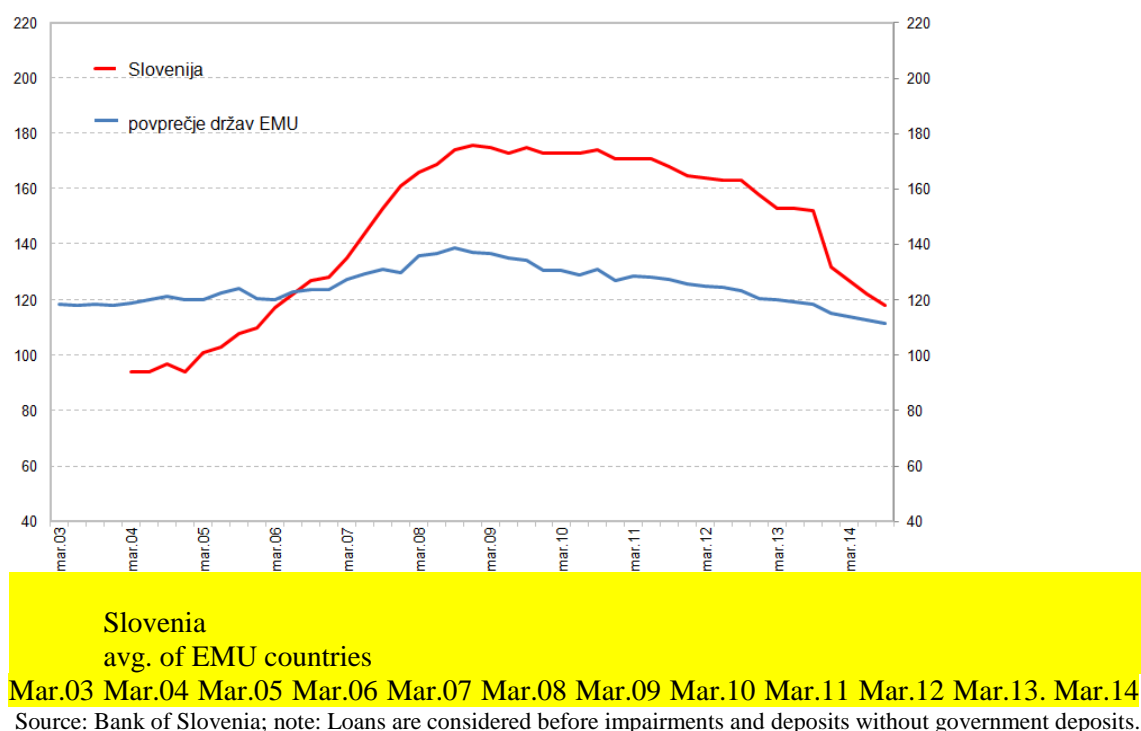
From 2003 on, loans to corporates grew at an annual rate of around 20%, while non-banking sector deposits grew by less than 10% annually.

The loan-to-deposit ratio for the non-banking sector grew steadily right up to the onset of the financial crisis, when it reached 163%. This ratio did not increase only in banks with majority foreign ownership, which had a relatively stable source of financing due to their solid ownership relations with their foreign parent banks (while on the other hand because of the market access model⁷ also the only source), but also in banks which were majority state-owned, which often raised syndicated loans abroad, primarily in the lending market, which became particularly illiquid or inactive in the initial period of the financial crisis. **The average value of the loan-to-deposit ratio in the non-banking sector for EU banks in the period before the onset of the financial crisis was 122%, which indicates the relatively high sensitivity of Slovenian banks to the success/failure of refinancing mature liabilities to foreign creditors, which were themselves experiencing negative shocks due to bad investments.**

⁶ Slovenian banks were therefore faced with **funding liquidity risk** on international markets. Due to the sovereign downgrading which followed, the (state) banks were forced to repay funds borrowed on international financial markets quickly. At the end of 2011 and the beginning of 2012 they were greatly assisted by the ECB through non-standard long-term refinancing instruments (ca. EUR 4 billion).

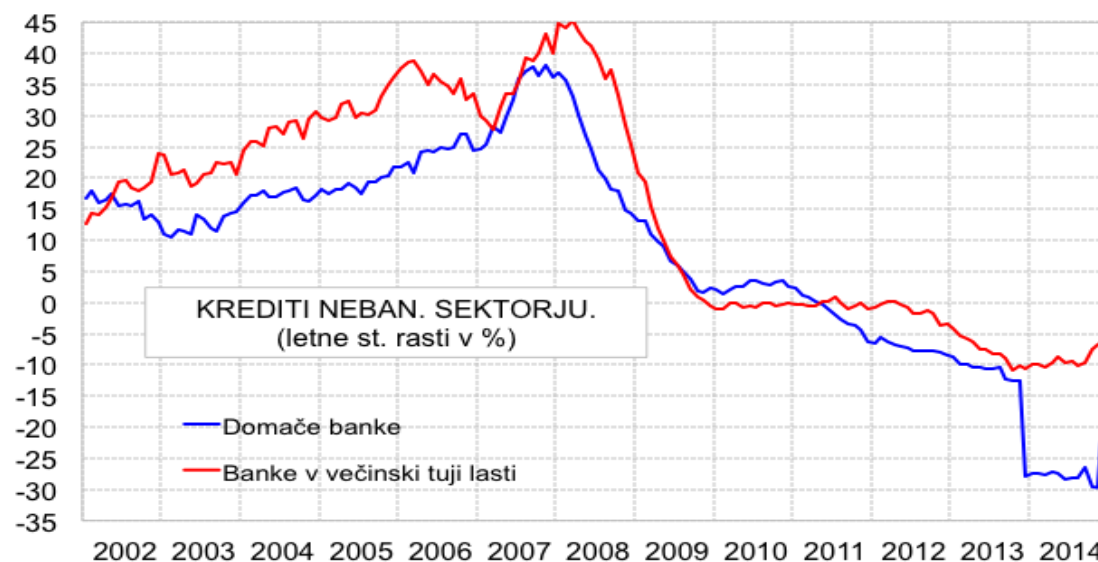
⁷ Foreign banks operated on the Slovenian market primarily using the model of “establishing a new bank”, while sales of existing banks with deposit bases were rare.

Figure 15: LTD ratio in the non-banking sector for banks in Slovenia and the EMU



The fact is that the process of rapid growth of loans was led by banks with majority foreign ownership, which is confirmed by Figure 16.

Figure 16: Growth rate of loans to the non-banking sector with respect to bank ownership: domestic/foreign



LOANS TO NONBANK. SECTOR

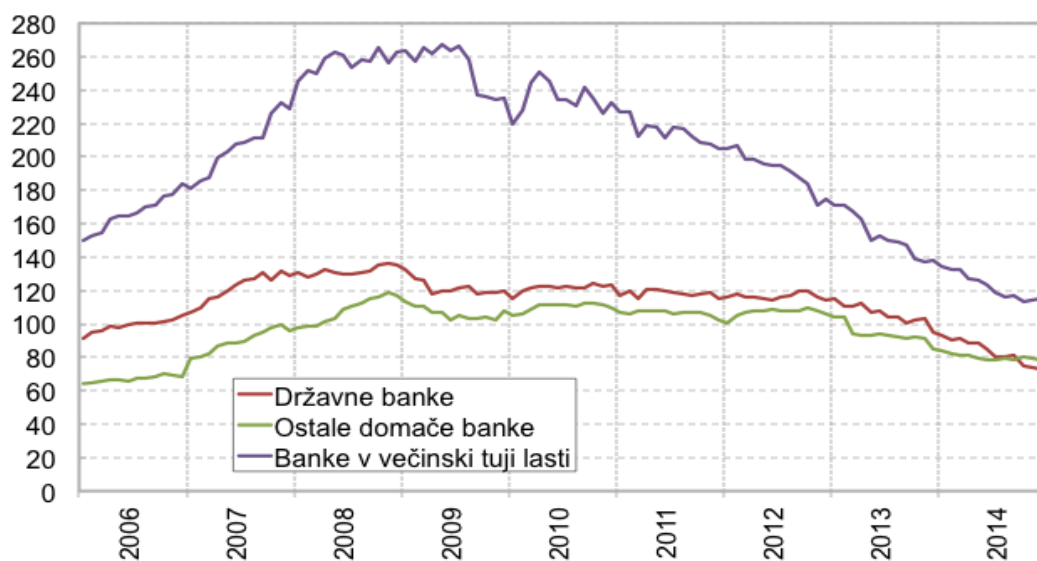
(annual gr. rate in %)

Domestic banks

Majority foreign owned banks

From 2003 on, the growth rate of loans from foreign banks exceeded the growth rate of loans by domestic banks, which reflects an intensive process of fighting for market share, which was led by the foreign banks owing to their opportunities for obtaining cheaper sources of funds. Recently, as part of international bank groups they have enjoyed the benefits of so-called internal capital markets (obtaining of funds from parent banks). This is confirmed by Figure 17, which shows the LTD ratio at majority Slovenian-owned and majority foreign-owned banks.

Figure 17: LTD ratio at majority Slovenian-owned and majority foreign-owned banks



State-owned banks

Other domestic banks

Majority foreign-owned banks

The figure shows that foreign banks obtained financing on international financial markets or from their parent banks at a disproportionately higher level. These sources of funds were disproportionately cheaper than local deposits and enabled the expansion of the loan portfolio at lower interest rates.

Access to cheaper sources of financing for majority foreign-owned banks, in addition to allowing the rapid expansion of lending before the crisis, gave these banks' lending activities a higher degree of stability during the crisis itself. **As Figure 16 indicates, with the exception of 2010, the growth rate of lending by foreign banks exceeded the growth rate of lending by domestic banks right up to the present, i.e. the entire period in question from 2002-2014.**

3. One significant factor in encouraging banks toward high growth of lending in the pre-crisis period was the **process of restructuring investments** in Bank of Slovenia securities, which originated in the exchange rate policy before the introduction of the euro. The intensiveness of the implementation of the policy of sterilisation of foreign currency inflows before Slovenia's accession to the EU (1 May 2004) and during the period of the ERM2 exchange rate mechanism (from 28 June 2004) influenced the high percentage of bank investments in Bank of Slovenia bills. As at 31 December 2003, banks had SIT 1.027 billion (EUR 4.3 billion) in Bank of Slovenia bills, which at the time constituted 19.5% of the total assets of Slovenian banks.

Upon the elimination of the restrictions on the so-called foreign exchange minimum in 2002, a period of intensive adjustment of the banks' investment structure began: reducing investments in Bank of Slovenia securities and increasing the proportion of loans in the banks' portfolios. Owing to the higher interest rates on loans than the interest rates on Bank of Slovenia bills, the banks' operating results improved. **In the year of the onset of the international financial crisis, the banks reduced their share of investments in securities to less than 16% and increased their share of loans to the non-banking sector to more than 70% of total assets.** In the last two years before the crisis alone, the banks reduced their investments in Bank of Slovenia securities and the reserve requirement by more than EUR 4.5 billion, which corresponded to the entire flow of corporate financing in 2006.

After the adoption of the euro, an additional increase of the banks' liquid assets was influenced by a decision of the Slovenian Ministry of Finance on the early purchase of long-term bonds from domestic

financial institutions⁸ and on the issue of new long-term bonds with a relatively low interest rate on international financial markets.

4. The banks also obtained a part of the capital needed for the intensive growth of lending indirectly with the introduction of the International Financial Reporting Standards (IFRS) at the beginning of 2005, which meant a significant reduction in the scope of required impairments.

As a direct result of the introduction of the IFRS, provisions fell by 24%, while the capital of banks at the same time grew by 15%. The capital adequacy of banks improved by 1.6 percentage points based on methodological changes to accounting standards alone. The favourable economic climate in 2006 led to a reduction in the need for current provisioning in accordance with the new criteria; the banks created only half the provisions with respect to gross income in comparison with the years before the introduction of the IFRS.

5. Lack of use of appropriate models for assessing risk and/or the adopted expansive strategies of the owners (expansion of operations in the region). The existence of additional available funds from commercial banks still did not mean that increased lending was economically rational for the owners of the commercial banks.

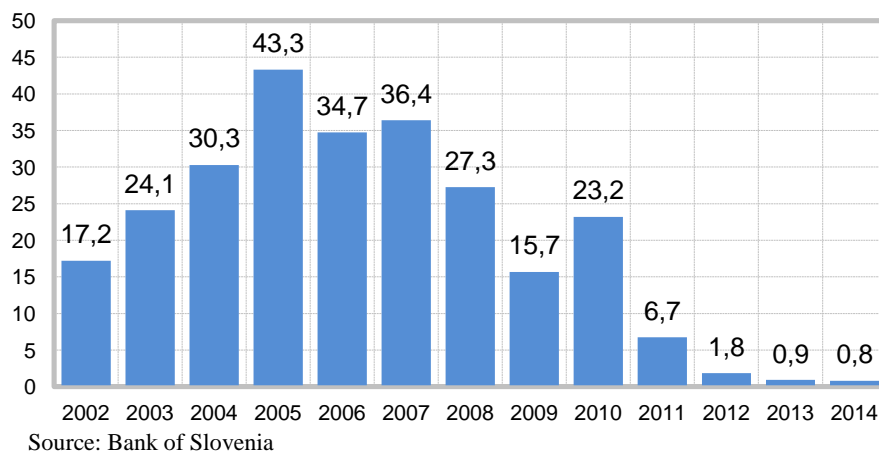
Loan approval was reasonable only in the case that their expected return was higher than the total costs of sources of financing and other operating costs. The banks had to approve loans on the basis of adequately assessed probabilities of default on loans and the incurring of losses upon default, taking account of pledged assets. According to the Basel II rules, banks had to develop their own models for forecasting the probability of default and assess the rationale of loans on the basis of such econometric models. The models had to take account of both individual characteristics and aggregate characteristics such as the presence of economic cycles (e.g. GDP growth, unemployment rate, etc.). On the basis of such models and strategies, before the beginning of the crisis the banks had to predict the expected aggregate losses, and the owners had to provide adequate capital strengthening while taking on increased risk owing to the rapid expansion of operations.

2.2.2 Factors on the demand side

1. Demand for housing loans Demand for housing loans in Slovenia in the years before the crisis grew because of the increasing real household income, expectations of future increases in housing prices and because of the lowering of real interest rates. The growth rate of real estate transactions from 2004 through 2007 was in excess of 20 percent on average, and was also associated with rapid growth of housing loans, as can be seen in Figure 18.

Figure 18: Growth of housing loans (annual, in %)

⁸ In 2007 the total amount of early bond repayments and purchases reached a record EUR 1,098,286,434.72. Source: Report on Debt Management in Slovenia for 2007.

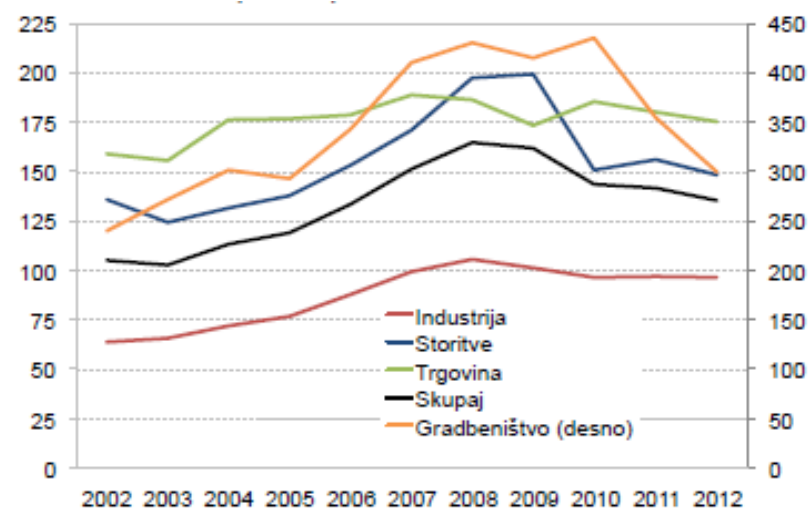


2. Demand for corporate loans The rapid growth of demand for corporate loans was only partially encouraged by the rapid growth of demand on the domestic and foreign markets.

The rise in real estate prices caused a gap to appear between retail prices and construction costs (including costs of purchasing land, use fees, engineering, construction and financing), which meant increased profits for real estate sellers. Demand for loans for highly profitable construction projects from contractors (legal and natural persons) was therefore initially based on the real growth of their cash flows.

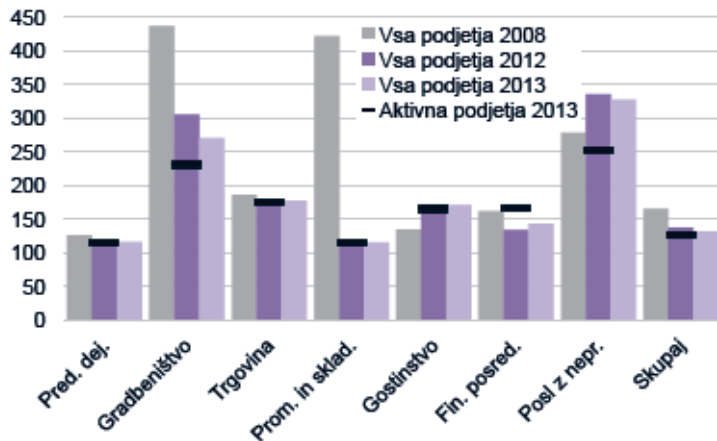
At the same time, the banks did not limit the scope of lending for such projects, as they allowed an exceptionally high proportion of loans tied to the value of pledged real estate, through which they exposed themselves to excessive risks (Figure 19 shows the rise of leverage in construction). In view of the constantly present moral hazard that companies would not use the loans for the intended purpose, in the past banks had to apply more restrictive conditions on loans.

Figures 19a and 19b: Leverage by sector



Industry
Services
Wholesale and retail trade
Total
Construction (right)

Note: Leverage is calculated as the percentage debt-to-equity ratio; Source: Bank of Slovenia



All corporates 2008

All corporates 2012

All corporates 2013

Active corporates 2013

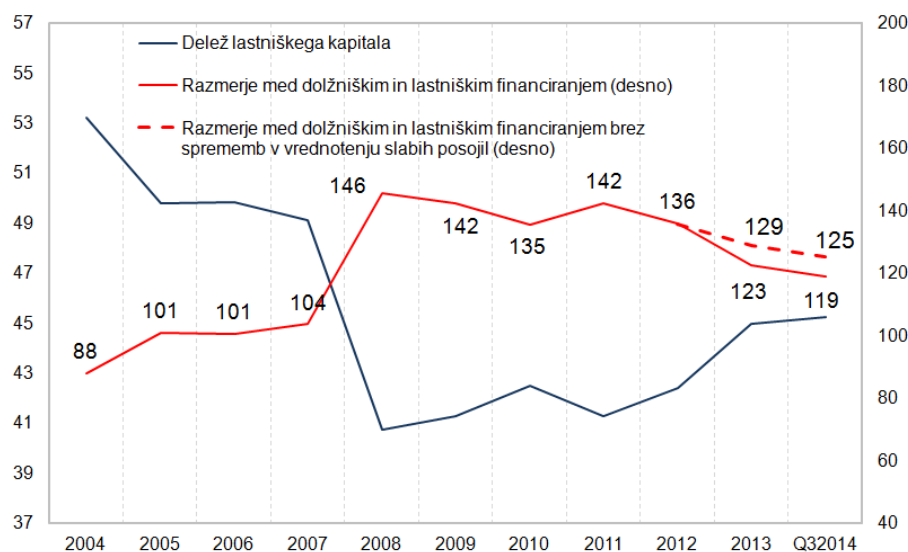
Mfg. Construction Trade Trans. and stor. Food service Fin. int. Real est. Total

Source: Bank of Slovenia

Similar errors in banks' decision-making were characteristic of companies carrying out leveraged buy-outs (LBOs), which caused major losses to the banking system through small investments of their own funds.

3. The companies that increased their debt the fastest were precisely those in expressly cyclical economic sectors such as construction and real estate, for which economic prosperity and also government investment projects allowed above-average growth, and financial holding companies. Through capital investments in various, often unrelated undertakings, they attempted to obtain ownership influence over as much of the economy as possible, through excessive debt, without a real vision for the development of the companies, and with inefficient corporate governance.⁹ At the same time, demand increased for lending for purposes that would usually have been financed by investment banks and not commercial banks (e.g. MBOs).

Figure 20: Debt-equity ratio of Slovenian companies



⁹ In July 2008, the Bank of Slovenia submitted information to the National Assembly on the role of the banks in the takeover of majority interests in the companies Pivovarna Laško, Merkur and Istrabenz.

Equity

Debt-equity ratio (right)

Debt-equity ratio w/o

changes in assessment of non-performing loans (right)

Lenders were insufficiently critical of this business optimism, and in the desire to increase their market share and improve operating results occasionally even encouraged it, particularly in an environment in which the economic policymakers did so based on growth, which was not favourable to direct foreign investment. The result was a problematic structure of financing among Slovenian companies. Figure 19b shows the development of financial leverage in various sectors of the Slovenian economy. It is clear that it increased rapidly in general, but particularly in cyclical sectors, which were subsequently the most affected in the crisis.

A similar situation is shown in Figure 20, which shows that **in the structure of financing of Slovenian companies before the crisis, the proportion of equity fell drastically, and the proportion of debt financing increased. This again means increased vulnerability of the economy in the event of a financial crisis.** When the banks found themselves under pressure to repay the loans that they had taken out on the international wholesale market, they applied pressure on the companies to repay their loans. The excessively indebted companies were not able to neutralise this pressure in the short term, leading to increased inability to repay their liabilities to the banks, and thus the accumulation of non-performing loans.

4. Optimism on the capital markets Similarly to corporate loans, the major impairments in the banks were a consequence of the dynamics on secondary financial markets. This situation also occurred on the domestic capital market, as the growth rate on the SBI TOP stock index exceeded 80% in the middle of 2007, and net payments to mutual funds reached nearly EUR 500 million annually with high growth of the unit value (UV) of assets, which exceeded 40% for a brief period.

The most prominent form of highly leveraged financial derivatives, which at the time attracted numerous private investors and which caused additional growth of share prices on the domestic capital market (and with this also the value of eligible collateral for taking out loans), were investment certificates from foreign banks on shares in Slovenian companies. Investment certificates had a much greater impact on the volatility of share prices of Slovenian companies and on short-term speculation on the movement of those share prices with minimal cash contributions than they did on the development of the Slovenian capital market.

This flourishing of the financial markets was also occurring on other markets in SE Europe, which encouraged numerous domestic investors to invest in equity instruments in the territory of the former Yugoslavia, along with the simultaneous increase in debt financing of Slovenia on foreign markets. Therefore the market risk of the Slovenian economy increased, reaching its peak just before the onset of the international financial crisis in the autumn of 2008. From this perspective, Slovenian investors also assumed country risk.

2.3 The impact of the crisis on the development of risk in the Slovenian banking system

2.3.1 Refinancing risk

The fall of the American investment bank Lehman Brothers in September 2008, which signified the onset of the international financial crisis, and the consequent difficulties of several US investment and commercial banks, did not directly affect the Slovenian banking system owing to its relatively low direct exposure in terms of both the volume of foreign trade and the size of the financial flows.

The financial crisis was reflected in increased loss of trust – on one hand among bank depositors, and on the other hand lack of trust on the market led to a suspension of interbank financing. This suspension, due to the high proportion of foreign loans in the sources of financing of the Slovenian banking system, led to an exceptional increase in liquidity risk for the Slovenian banking system, which in the first wave of the effects of the global financial crisis on the Slovenian system (in 2008) was neutralised by the government through the issuance of unlimited guarantees on all deposits and the issuance of government guarantees for refinancing banks on international financial markets. Furthermore, decreased import demand in the USA led to decreased economic activity in the EU and consequently to decreased demand for Slovenian goods and services, which was reflected in decreased added value in manufacturing and transport.

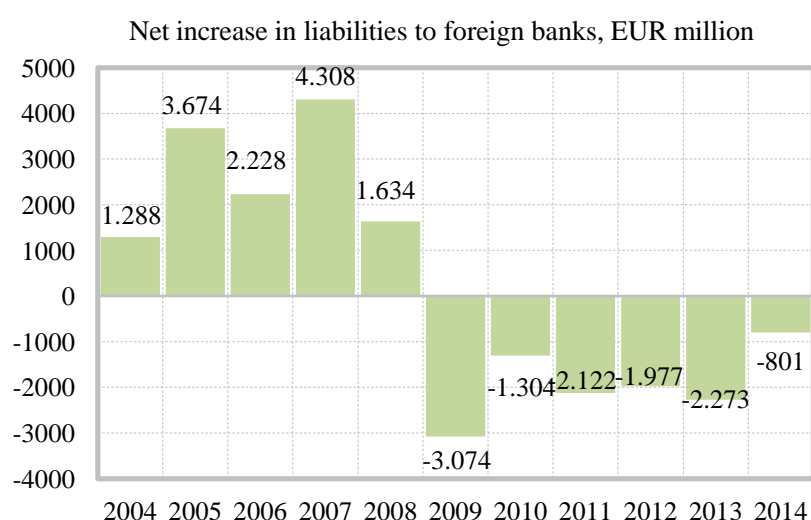
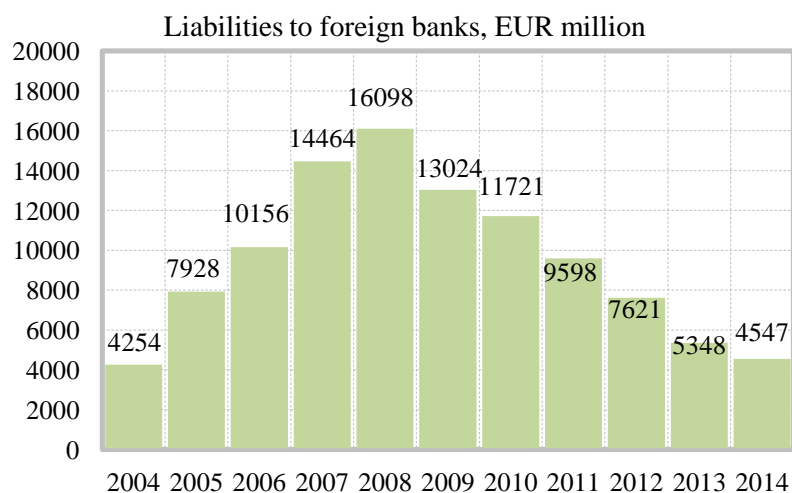
The fall of (several) American banks, as mentioned, did not cause significant losses at Slovenian banks, since they were mostly not exposed to the institutions and instruments that were the first to be affected by the crisis. In contrast to banks from the developed Western European financial markets, domestic banks were not invested in so-called structured finance instruments or derivatives based on subprime mortgage-backed securities from American investment banks. At the end of 2007, Slovenian banks held just EUR 253 million in various structured finance instruments or 0.6% of total assets at that time, and less than EUR 5 million in structured finance instruments from securitisation, which caused losses of EUR 14.8 billion in the first year of the financial crisis.

In addition, investments in foreign debt securities accounted for less than 10% of the total assets of Slovenian banks, and thereby limited exposure to market risks. In August 2008, Slovenian banks disclosed investments of just EUR 193 million (or 0.4% of total assets) in the securities of US issuers and EUR 118 million in investments in the securities of nine US investment and commercial banks.

The financial crisis caused a lack of trust on the financial markets, owing to which the money and capital markets completely dried up; bank borrowing was not possible, which deeply affected the Slovenian banking system, since the banks had financed themselves to a great extent through favourable foreign loans during the rapid economic growth of the pre-crisis period. Furthermore, the foreign banks, which had incurred losses associated with the American securities market, decreased their foreign investment in order to improve their own liquidity.

For these reasons, from the middle of 2008 on Slovenian banks deleveraged and reduced their debt load by EUR 12 billion, or 75%, as can be seen in Figure 21a. Lines of credit were not re-extended, there were no new sources of financing, the liquidity of the banking system was substantially replaced by government deposits and increased government debt abroad, and by refinancing mature liabilities through borrowing against government guarantees.

Figure 21a and 21b: Movement of liabilities of Slovenian banks to foreign banks (financing on the wholesale market)



Source: Bank of Slovenia

The financial crisis, which soon expanded to the real sector in the USA and the EU, via export demand for Slovenian goods, developed into a very severe general economic crisis.

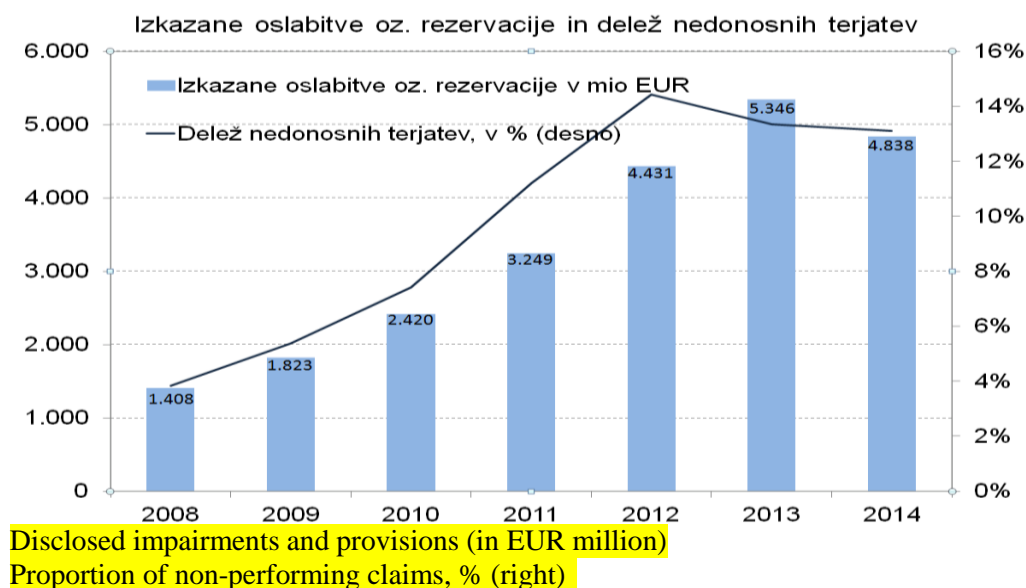
2.3.2 Deep and lasting recession

As presented in the introduction to this section, Slovenia's GDP fell by 7.9% in 2009, one of the largest drops in the EU. Due to the drastic fall in economic activity, the increased government debt, budget shortfalls, and difficulties in the banking system, Slovenia's sovereign credit rating began to slide. As early as 2009, the European Commission placed Slovenia into a procedure designed to eliminate the excessive deficit and imposed comprehensive measures for short and medium-term fiscal consolidation. The banks' credit ratings also began to slide in 2009, which meant significantly higher financing costs.

The growth rates of individual components of the GDP shown in Figure 4 indicate that from the perspective of the fall in GDP the key drop was imports of goods and services (a nominal decrease of 16.6%), which manifested in the activities of manufacturers (industry). In that same year Slovenia recorded a fall in construction, transport and storage, trade, and vehicle maintenance and repair.

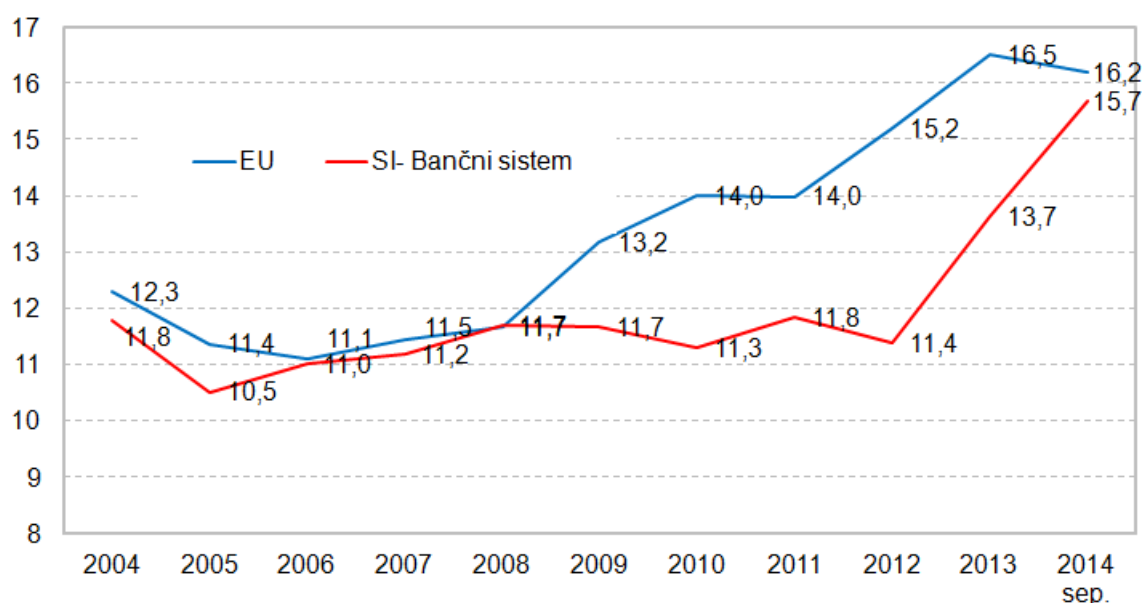
Due to difficulties in corporate operations the quality of bank portfolios diminished rapidly, and these impairments caused the banks to incur operating losses, which led to a reduction of capital.

Figure 22: Impairments and provisions in the banking system (in EUR million)



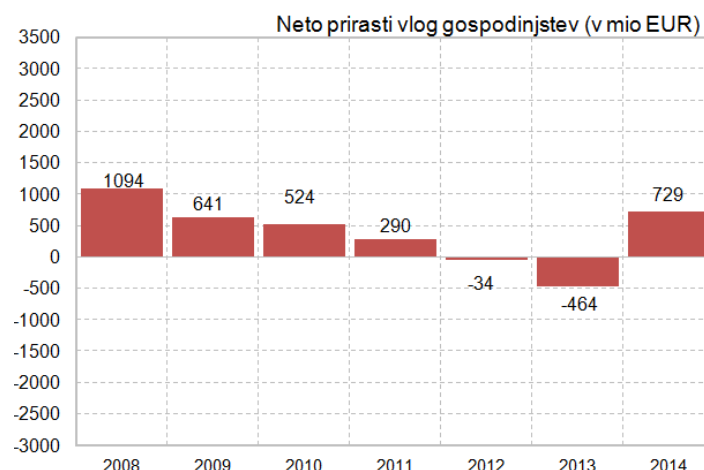
The **solvency risk** of the Slovenian banking system as measured by capital ratios (capital adequacy ratio in the graph below) increased and contrasted with the EU average, where the capital adequacy of banks began to improve. At the same time the increased credit risk increased capital requirements. Despite requirements from the Bank of Slovenia for increased capital, the capital adequacy of Slovenian banks did not increase after the onset of the crisis – in 2010 and 2012 it actually fell below its 2008 level, an indication of inadequate action and an inability to recapitalise, particularly on the part of domestic owners (the government) (*for more detail see Chapter 3.3, Requirements for recapitalisation*).

Figure 23: Movement of capital adequacy of banks in Slovenia and in the EU (average, in %)



Despite the crash of stock indexes on capital markets, household savings essentially did not return to relatively safe bank deposits; after the onset of the crisis they increased substantially less than they had before the onset of the crisis.

Figure 24: Net growth of household deposits (EUR million)



Net growth of household deposits (EUR million)

In 2011 and 2012, due to the high level of net repayment of liabilities by Slovenian banks to foreign institutions, competition between banks for deposits from the non-banking sector increased, particularly for long-term household deposits. The competition among banks was reflected in a wider range of deposit interest rates among the banks and relatively high exceeding of the average interest rates in the Eurosystem for deposits of the same type.¹⁰

This competition among banks by way of higher interest rates was also a consequence of changes in the business policies of majority foreign-owned banks, which had financed themselves through collecting deposits on local markets to a greater extent than before the crisis, and their financing structure became similar to that of the financing structure of large majority state-owned banks.¹¹

The competition among banks for non-banking sector deposits thus merely resulted in an increase in the average costs of financing banks (from the middle of 2010 to the beginning of 2012) and thereby increased income risk, but not in increasing the volume of deposits, e.g. from households. Despite the relatively marked decrease in the reference market interest rates in the first three quarters of 2012, no significant decreases in deposit interest rates occurred until 2013 and 2014.¹²

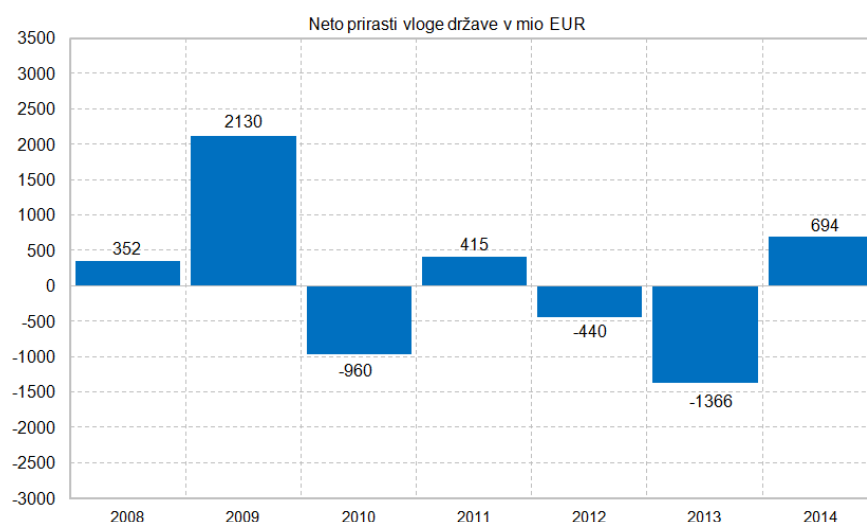
¹⁰ In the middle of 2012 the average interest rate at banks in Slovenia for new household deposits with a fixed term of over 1 year was 4.1 percent, while for banks in the euro area it was 2.7 percent.

¹¹ The Bank of Slovenia contributed to the successful reduction of the relatively high level of competition among banks for deposits on the local market through the adoption of a macro-prudential measure limiting the upward adjustment of liability interest rates, i.e. taking account of the increased income risk in the calculation of the economic capital required for banks whose deposit interest rates exceeded a certain value in the first half of 2012.

¹² This had the favourable effect of decreasing the average costs of debt financing of banks, but this was not reflected to its full extent in the adjustment of interest rates on loans. Only when the net interest margin for banks rose above 2% in 2014 could we begin to expect that conditions would be established for the gradual decreasing of loan interest rates for creditworthy borrowers.

Bank liquidity was relatively well-managed throughout the period of financial crisis owing to appropriate adjustments to investment policy of excess liquidity of the state and the policy and need for the pre-financing of the state budget.

Figure 25: Net increase in government deposits in banks (EUR million)



Net growth of government deposits in banks (EUR million)

In an environment of a relatively rapidly and radically changing financing structure, with respect to liquidity adjustments to the new conditions, banks were also assisted by relatively high secondary liquidity in bank balance sheets and the preservation of the credit rating instrument in the liquidity ladder, which required banks to match the maturities of investments with the maturities of liabilities with maturities from one to 30 days and from one to 180 days. The Bank of Slovenia also kept the instrument in question in force with certain adjustments upon accession to the EU and upon the introduction of the euro in 2007. Thus for most of the period of the financial crisis, liquidity risk did not cause any additional unforeseen systemic consequences for the banking system. Despite this, liquidity risk requires continued monitoring and evaluation, since bank liquidity is crucial to the maintaining of trust in the banking system.

2.3.3 Tightening of lending conditions

The banks also reacted to the decreased sources of funding due to the repayment of loans to foreign banks and the decreased quality of portfolios by tightening lending conditions. Since the banks had not carried out capital strengthening in time (more on this to follow), this was a logical move on their part.

The tight lending conditions¹³ can be illustrated empirically. The Bank of Slovenia has surveyed commercial banks on demand for loans since 2009.¹⁴ The survey does not allow the measurement of actual demand, since a single company could inquire about loans at several banks, so care must be taken in interpreting the results. In 2009 the demand for loans was EUR 17.6 billion, of which EUR 15.3 billion in loans was approved, and excess demand was EUR 2.3 billion. A closer look at bank ownership indicates that excess demand was higher at foreign banks, which indicates that during the time before the crisis they had been more careful when approving loans.

¹³ Corporate borrowing in Slovenia before and during the crisis was analysed by Arjana Brezigar Masten and Urška Lušina in an article in the October 2011 issue of *Bančni vestnik*.

¹⁴ The results of the survey on demand for loans by non-financial corporations are available on the Bank of Slovenia's website, on the Financial Stability page (Finančna stabilnost, <http://www.bsi.si/financna-stabilnost.asp?MapaId=1598>).

From 2010 to the first half of 2014, demand for loans fell from EUR 18.2 billion to EUR 4.6 billion.

The excess demand also decreased, from EUR 5.3 billion in 2010 to EUR 1.6 billion in 2014, while loans decreased from EUR 20.3 billion to EUR 11.1 billion. The data therefore show (Figure 27) that there was a significant decrease in demand for loans in the non-banking sector, which is a consequence of the worsening of conditions on the goods and services market and a consequent reduction in expected profitability of entrepreneurial projects and higher uncertainty regarding profits.

The dynamics of excess demand, which are supposed to be a measure of financial constraints, indicate that the situation improved after 2010 and that the excess in demand over supply decreased, and amounted to less in 2014 (EUR 1.65 billion) than in 2009 (EUR 2.38 billion).

The higher level of excess demand at foreign-owned banks can be interpreted as a tightening of lending conditions, although such tightening can be justified by increased lending risk, since in the period from 2009-2014 the proportion of non-performing loans increased from approximately 4% to approximately 14% (Figure 31).

Figure 26: Demand for loans, newly approved loans and excess demand in Slovenia, 2009

	povpraševanje po posojilih	novoodobrena posojila	presežno povpraševanje	stopnja presežnega povpraševanja
	1	2	3: 1-2	4: (1-2)/1*100
Velike domače banke	10.047	9.650	396	3,9
Male domače banke	1.451	1.388	62	4,3
Banke v večinski tuji lasti	6.146	4.226	1.920	31,2
Skupaj	17.643	15.264	2.379	13,5

	demand for loans	newly approved loans	excess demand	level of excess demand
	1	2	3: 1-2	4: (1-2)/1*100
Large domestic banks	10,047	9,650	396	3.9
Small domestic banks	1,451	1,388	62	4.3
Banks under majority foreign ownership	6,146	4,226	1,920	31.2
Total	17,643	15,264	2,379	13.5

Source: Bank of Slovenia survey on demand for loans by non-financial corporations, September 2010.

Figure 27: Demand for loans and excess demand in Slovenia, 2010-2014

	2010	2011	2012	2013	I pol 2014
Povpraševanje po posojilih (mio EUR)	18.246	13.257	11.329	8.926	4.590
- v deležu BDP v %	50,4	36,0	31,5	24,7	12,7
Presežno povpraševanje (mio EUR)	5.342	3.735	3.650	3.084	1.646
Stopnja presežnega povpraševanja (%)	29,3	28,2	32,2	34,6	35,9
Stanje posojil pri bankah (povpr. leta., mio EUR)	20.276	19.269	17.726	15.136	11.133
- v deležu BDP v %	56,0	52,3	49,2	41,9	30,8

	2010	2011	2012	2013	2014
Demand for loans (EUR million)	18,246	13,257	11,329	8,926	4,590
– as a percentage of GDP	50.4	36.0	31.5	24.7	12.7
Excess demand (EUR million)	5,342	3,735	3,650	3,084	1,646
Level of excess demand (%)	29.3	28.2	32.2	34.6	35.9
Stock of loans at banks (annual avg., EUR million)	20,276	19,269	17,726	15,136	11,133
– as a percentage of GDP	56.0	52.3	49.2	41.9	30.8

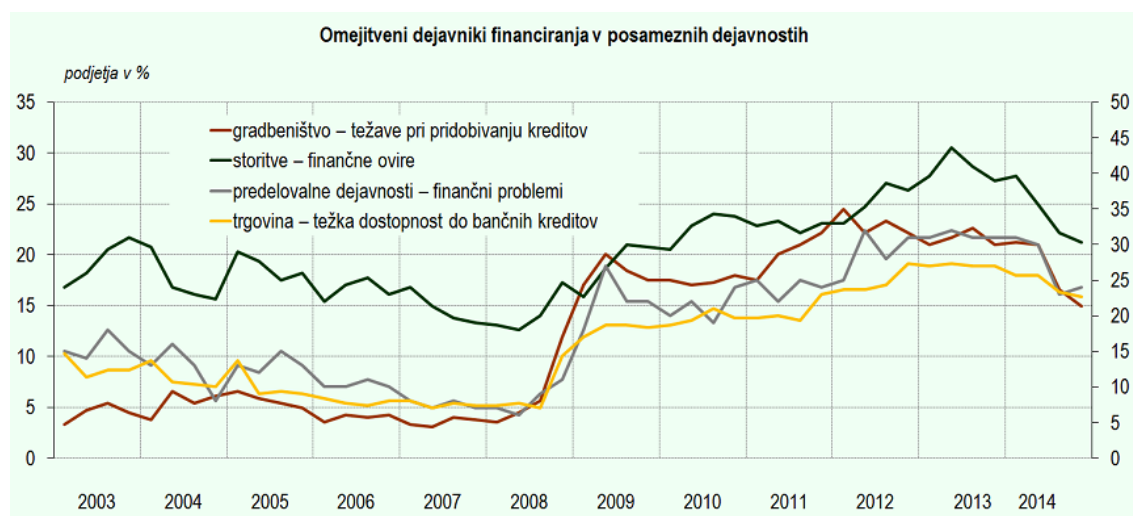
Source: Bank of Slovenia survey on demand for loans by non-financial corporations, November 2014.

The tightening of lending conditions before the beginning of the Bank of Slovenia surveys is indicated in a survey from the Statistical Office of the Republic of Slovenia, which surveyed a sample of relatively large companies on the significance of financial obstacles to operations.

The survey shows the percentage of companies which report that the tightening of the conditions for financing caused a reduction in the volume of loans. The figure shows that the services sector reports larger financial constraints than the other sectors, which indicates the conditioning of financing with the possibility of insurance, which is lower in these sectors.

The figure also shows a more severe tightening of conditions at the beginning of the crisis in 2008 and 2009, and further tightening up to the middle of 2013. The percentage of non-service corporations which reported financial obstacles increased from 5% to 20%, and the percentage of service firms increased from 20% to more than 40%. As can be seen in Figure 27, after 2013, when financing conditions improved in numerous countries due to a decrease in uncertainty, the financial constraints also eased in Slovenia.

Figure 28: Financial constraints by sector, 2003-2014



Limiting factors to financing by sector

companies (%)

construction – difficulties in obtaining loans

services – financial obstacles

manufacturing – financial problems

trade – limited access to bank loans

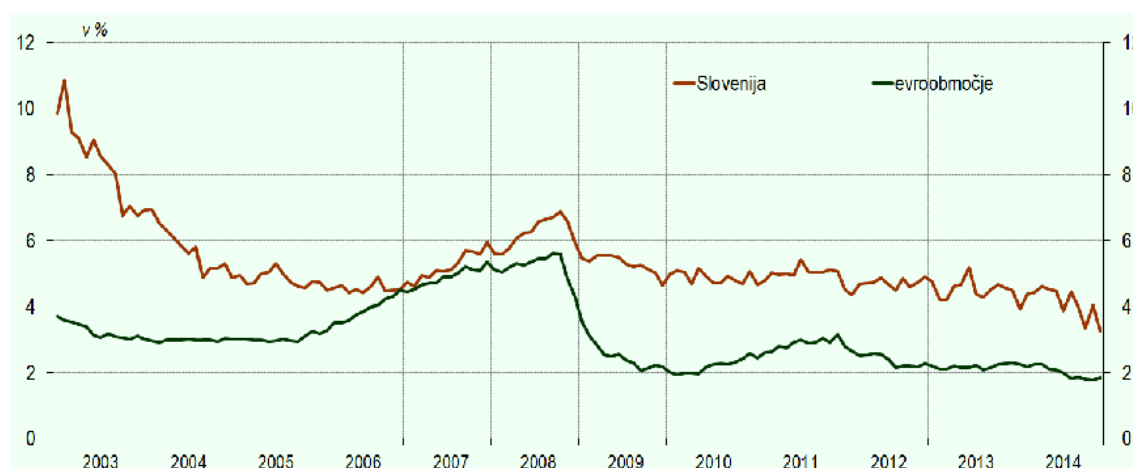
Source: SORS.

Notes: The left-hand scale applies to construction, manufacturing and trade, and the right-hand scale applies to services.

The narrowing of the range of bank loans could be reflected in changes in the nominal and real interest rates.

Figure 29 shows that the **nominal interest rates** in Slovenia for loans above EUR 1 million decreased from 10% to 4.5% at the end of 2006 and thus reached the level of interest rates in the euro area, after which they increased until the beginning of the financial crisis (November 2008). After the beginning of the crisis interest rates decreased from nearly 7% to 5%, while in the euro area they decreased to 2%. This discrepancy is the consequence of increased risk premiums in Slovenia, since the uncertainty connected with the banking sector, public debt and economic recovery is higher.

Figure 29: Nominal interest rates in Slovenia and the euro area on loans of more than EUR 1 million to non-financial corporations, 2003-2014



(%)

Slovenia euro area

Source: Bank of Slovenia

The real interest rates indicate that during the period of high inflation in Slovenia in 2007 and 2008, these rates were much lower than in the EU. From the negative interest rates in 2008 they increased to over 5%, and then fell to 2% until 2012, and later rose again to 4%. Business conditions in Slovenia were tighter in comparison with other euro area countries, which is confirmed by the above described survey results.

Figure 30: Real interest rates in Slovenia and the euro area on loans of more than EUR 1 million to non-financial corporations, 2003-2014



(%)

Slovenia euro area

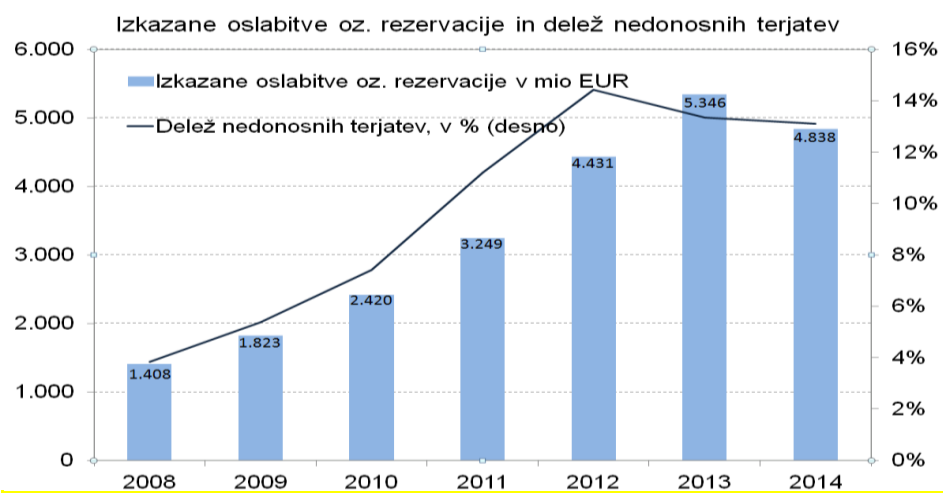
* 3. m. d. s.

Source: Bank of Slovenia.

Notes: With respect to methodology, real interest rates are usually calculated taking the expected inflation rate into account. Due to a lack of indicators of the expected inflation rate, we calculated the real interest rate using the current inflation rate. 3. m. d. s.

The decrease of the range of loans, i.e. tightening of the lending conditions, was economically justified from the perspective of the stability of the banking system. Non-performing claims rose from 4% in 2008 to more than 14% in 2012 and later slightly decreased (Figure 31). The latter is a consequence of the transfer of non-performing claims of NLB and NKBM to the BAMC, which means that the total volume of non-performing loans in the economy did not actually decrease, only that there are fewer non-performing loans in the banking system itself. At the same time, the volume of disclosed impairments or provisions rose from EUR 1.4 billion in 2008 to EUR 5.3 billion in 2013. The poor state of the economy is also confirmed by the increased number of bankruptcies from less than 100 to nearly 1,300 in (the still not completed) 2014 (Figure 32).

Figure 31: Proportion of non-performing loans in Slovenian banks, 2008-2014



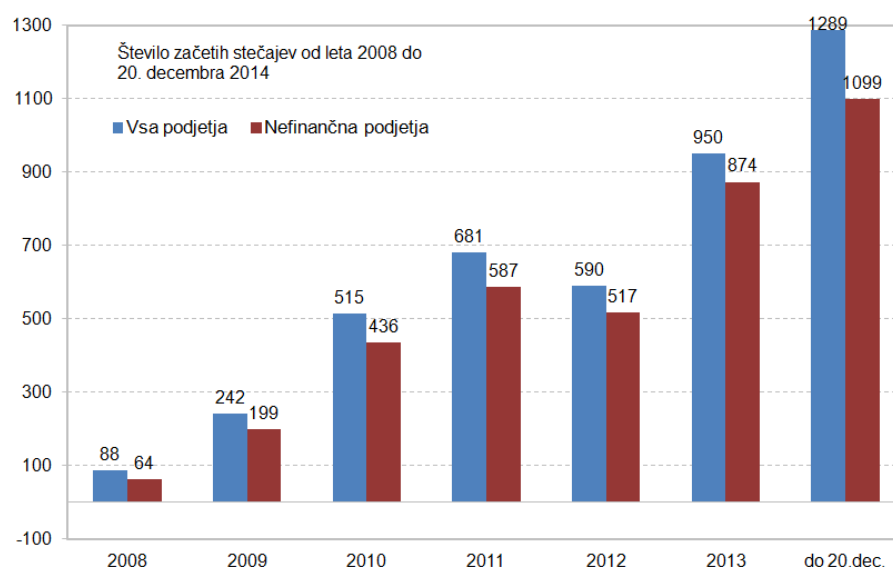
Disclosed impairments and provisions and percentage of non-performing claims

Disclosed impairments and provisions (in EUR million)

Disclosed impairments of non-performing claims, % (right)

Source: Bank of Slovenia

Figure 32: Number of bankruptcies in Slovenia, 2008-2014



Number of bankruptcies initiated from 2008 to 20 December 2014

All corporations Non-financial corporations

up to 20 December

Source: AJPES.

2.3.4 Late implementation of measures for stabilising the banking sector

Slovenia adopted fundamental changes in order to stabilise conditions in the banking system only at the end of 2013. The dynamics of taking such measures were significantly slower than in western countries.

RESPONSE OF EUROPEAN POLICY TO THE FINANCIAL CRISIS SHORTLY AFTER THE FALL OF LEHMAN BROTHERS

At the Summit of the Euro Area Countries (Paris, 12 October 2008), the “**Declaration on a Concerted European Action Plan of the Euro Area countries**” was adopted.

This declaration established a coordinated approach by the EU and the national governments, central banks and supervisors in the following areas (a temporary government guarantee on all deposits in banks had already been agreed beforehand):

- ensuring appropriate liquidity conditions for financial institutions (ECB monetary policy – interest rates, long-term refinancing operations),
- facilitating the funding of banks, which (was) currently constrained (government guarantees and collateral for instruments up to 5 years, under certain standardised criteria),
- providing financial institutions with additional capital resources so as to continue to ensure the proper financing of the economy,
- allowing for an efficient recapitalisation of distressed banks,

- ensuring sufficient flexibility in the implementation of accounting rules given current exceptional market circumstances (*note: this measure was not actually applied, on the contrary, the prudential rules gradually became stricter under pressure from the market*).

Already during the week leading up to 12 October 2008 several Eurosystem countries published comprehensive programmes of aid to the financial sector and adopted corresponding regulations shortly thereafter. In Slovenia the National Assembly adopted a new version of the Public Finance Act (ZJF-D) in November 2008, which foresaw measures for maintaining the stability of the financial system (EUR 12 billion in guarantees to banks, loans, factoring, and capital investments), of which all are unrealised with the exception of the guarantees. In March 2009 the National Assembly adopted two further acts providing guarantees for legal and natural persons.

In accordance with the Treaty on the EU, in the half year after the adoption of the Declaration, the Commission adopted several reports through which it determined the rules and conditions for the harmonisation of state aid under the condition that it not distort competition on the internal market, i.e. that it was possible to obtain the required permit from the EU Council. The Commission expanded and amended these reports (e.g. due to the introduction of the ESFS, ESM, and also supervisory procedures /EDP and Six Pack/) and made them stricter (burden sharing).

The measures taken up to the end of 2010 were important because all of the measures implemented by the states up to 31 December 2010 were exempted from the rules on state aid.

Figure 33 shows an overview of state aid to the financial sector in the EU countries, as reported by the European Commission. It follows from the table that the reactions of the Slovenian government were too little and too late. In the period from 2008-2011, when the measures were most necessary and the majority of European countries had taken the majority of the necessary measures, the measures taken by the Slovenian government were significantly below average. **While during that period the EU average for the amount of all financial funds mobilised for the stabilisation of banks was 12.76% of GDP, Slovenia allocated 6.73% of GDP, which is approximately half of the average.**

If we analyse the structure of the measures implemented, we can state that they were inadequate with respect to the difficulties of Slovenian banks, which were disproportionately affected due to the accumulation of credit risk and the need for restructuring their own claims. The latter means that the basic problem of Slovenian banks was a lack of Tier 1 capital. **It follows from the data that in Slovenia recapitalisation instruments were used for just 0.7% of GDP, while the EU average was 2.55%.** Similarly, Slovenia did not apply any measures for reducing the burden of non-performing investments (establishment of a bad bank). **The emphasis of Slovenia's measures was on the use of guarantee schemes, which had proved to be ineffective for the restructuring of over-indebted companies.**

Late and insufficient action led to a greater increase in the volume of non-performing loans than there otherwise would have been. Banks can restructure their claims only if they have sufficient capital. The restructuring of claims requires a combination of measures for conversion of claims into corporate equity and extending the maturity of loans (and in certain cases also increasing the size of loans), all of which requires additional capital. The insufficient amount of capital in banks made it impossible to carry out an effective restructuring process. Too many companies were thus faced with a demand for deleveraging and therefore shut down their operations instead of being preserved. The banking system and the entire economy thus found themselves in a vicious circle. On one hand the banks were encumbered by faster and stronger growth of non-performing loans and were forced to further tighten their financing conditions. On the other hand, the deleveraging process had strong negative effects on the investment activities of corporations and household consumption, and thereby on economic growth (see UMAR, Ekonomski izzivi 2014).

Figure 33: Overview of state aid to the financial sector in the EU

2008 - 2011										
Member State	Recapitalisation measures		Guarantees (1)		Asset relief interventions		Liquidity measures other than guarantees (2)		2008 - 2011	
	In € billion	As a % of 2011 GDP	In € billion	As a % of 2011 GDP	In € billion	As a % of 2011 GDP	In € billion	As a % of 2011 GDP	In € billion	As a % of 2011 GDP
Belgium	20,40	5,54	44,23	12,01	7,73	2,10	0	0,00	72,36	19,65
Bulgaria	0	0,00	0	0,00	0	0,00	0	0,00	0	0
Czech Republic	0	0,00	0	0,00	0	0,00	0	0,00	0	0
Denmark	10,77	4,50	145,00	60,61	0	0,00	1,97	0,82	157,75	65,94
Germany	63,24	2,46	135,03	5,25	56,17	2,19	4,75	0,18	259,19	10,08
Estonia	0	0,00	0	0,00	0	0,00	0	0,00	0	0
Ireland	62,78	40,13	284,25	181,70	2,60	1,66	0,08	0,05	349,71	223,54
Greece	6,30	2,93	56,30	26,17	0	0,00	6,90	3,21	69,49	32,31
Spain	19,31	1,80	62,20	5,79	2,86	0,27	19,31	1,80	103,68	9,66
France	22,46	1,12	92,73	4,64	1,20	0,06	0	0,00	116,39	5,83
Italy	4,05	0,26	10,90	0,69	0	0,00	0	0,00	14,95	0,95
Cyprus	0	0,00	2,83	15,91	0	0,00	0	0,00	2,83	15,91
Latvia	0,51	2,53	0,54	2,69	0,41	2,03	0,97	4,86	2,43	12,12
Lithuania	0	0,00	0	0,00	0	0,00	0	0,00	0	0,00
Luxembourg	2,60	6,07	1,65	3,84	0	0,00	0,19	0,44	4,43	10,35
Hungary	0,11	0,11	0,01	0,01	0	0,00	2,13	2,12	2,24	2,23
Malta	0	0,00	0	0,00	0	0,00	0	0,00	0	0,00
Netherlands	18,86	3,13	40,90	6,79	5,00	0,83	30,40	5,05	95,16	15,80
Austria	7,38	2,45	19,33	6,43	0,40	0,13	0	0,00	27,11	9,01
Poland	0	0,00	0	0,00	0	0,00	0	0,00	0	0,00
Portugal	0	0,00	8,54	5,00	0	0,00	2,85	1,67	11,39	6,66
Romania	0	0,00	0	0,00	0	0,00	0	0,00	0	0,00
Slovenia	0,25	0,70	2,15	6,03	0	0,00	0	0,00	2,40	6,73
Slovakia	0	0,00	0	0,00	0	0,00	0	0,00	0	0,00
Finland	0	0,00	0,12	0,06	0	0,00	0	0,00	0,12	0,06
Sweden	0,78	0,20	19,92	5,15	0	0,00	0	0,00	20,70	5,35
United Kingdom	82,39	4,72	158,22	9,06	40,41	2,31	18,55	1,06	299,57	17,15
Total EU-27	322,18	2.55%	1084,83	8.59%	116,78	0.92%	88,10	0.70%	1611,90	12.76%

Notes:

(1) The values of the guarantees are the highest guarantee values for the individual years.

(2) The values of liquidity measures are the highest values for liquidity measures for the individual years.

Source: European Commission, DG Competition.

The effect of the vicious circle was significantly stronger in banks under domestic ownership. The report of the conductors of the comprehensive review of eight Slovenian banks in 2013 indicates that there were significant differences in the required recapitalisation of domestic and foreign banks. For the foreign banks the comprehensive review found a capital shortfall of 78% of capital, which the banks reported for regulatory purposes on 30 September 2013. For banks under domestic ownership this deficit amounted to a full 244% of previously reported bank capital. These differences are undoubtedly conditioned by the allocation of loans. At the foreign banks the allocation of loans and use of credit risk insurance was undoubtedly more effective. This can also be partially explained by access to capital. The foreign banks had better conditions of access to sources of funds, capital and the possibility of transferring risk via their parent banks. The owners of domestic banks did not provide them with the necessary additional capital in time. Because of this they were unable to sufficiently restructure their portfolios, the consequence of which was that a significantly larger capital shortfall was found in the comprehensive review of their balance sheets.

2.4 Resolutions

On the basis of the data shown we can adopt several resolutions:

- 1. Credit expansion before the beginning of the crisis led to an excessively large volume of loans to non-financial corporations, which caused a large volume of non-performing loans.**
- 2. Due to excessive debt, which was to a great extent connected with the privatisation model up to 2008, the deleveraging of both banking and non-banking corporations was urgently necessary. The deleveraging actually occurred, as the loan volume was halved.**
- 3. Due to the lower demand on the end markets and the high real interest rates after 2008 there was lower demand for loans, and in the period up to 2013 there was greater excess demand, and financing became a significant limiting factor to company operations.**
- 4. The already unfavourable situation in the banking system was further exacerbated by insufficient and late actions to stabilise conditions in the banking sector. Data from the European Commission indicate that in the period when it was most needed, 2008-2011, EU countries allocated on average two times more funding for interventions in the banking sector (recapitalisation, transfer of assets to bad banks, guarantees, liquidity loans) than Slovenia did.**
- 5. In 2014 there was a decrease in excess demand and interest rates were lowered, which is the consequence of the transfer of non-performing investments from state-owned banks to the BAMC and has already resulted in lower interest rates and easier access to loans.**
- 6. The significantly narrower range of loans is economically justifiable due to the growth of non-performing loans and higher credit risk, but in order to establish positive loan growth, the banks will first have to clean up their non-performing loans.**

3. FRAMEWORK FOR MANAGEMENT OF SYSTEMIC RISKS (BANK OF SLOVENIA ACTIONS)

Slovenia's ability to respond appropriately to the nascent crisis was, as a result of it joining the monetary union at the very outbreak of the crisis in 2007, and the consequent loss of sovereignty over monetary policy, decisively affected by the relinquishment of traditional mechanisms and instruments for managing systemic risks in the country.

Prior to 2007, Slovenia's management of systemic risks had relied primarily on monetary policy measures exercised by the Bank of Slovenia, and to a lesser extent on fiscal policy and macroeconomic policy measures.

When Slovenia joined the euro area and adopted the euro on 1 January 2007, the Bank of Slovenia lost the power to pursue an independent monetary policy, and consequently within this framework lost the possibility of taking autonomous action via monetary policy instruments to control systemic risks. Furthermore, fiscal policy and macroeconomic policy, and particularly the instruments and objectives of these policies, were not properly defined and coordinated to allow for a rapid (counter-cyclical) response in the aforementioned period.

With regard to the situation in Slovenia, the ECB's pre-crisis monetary policy was insufficiently restrictive to limit the adverse impact of the crisis on Slovenia, while domestic macroeconomic policy and, above all, fiscal policy were not tailored to this fact.

European framework of measures to ensure the stability of the financial sector

In response to the financial crisis, which in the first phase was reflected in a sudden and complete interruption in financing flows on global wholesale financial markets, the ECOFIN meeting of EU finance ministers in Luxembourg on 7 October 2008 passed resolutions on a coordinated international response to the effects of the financial crisis, which were confirmed by the declaration on a concerted European action plan adopted by the Paris summit of euro area countries on 12 October 2008, and by the conclusions of the presidency from the European Council meeting in Brussels on 15 and 16 October 2008.

On the basis of the resolutions passed, a number of Eurosystem countries adopted comprehensive programmes of direct assistance to the financial sector, and shortly after passed the relevant regulations. In Slovenia, on the basis of resolutions passed with regard to the coordinated response by governments, a new Public Finances Act (the ZJF-D) was adopted in November 2008 to regulate the national extraordinary measures to prevent the adverse consequences of the financial crisis.

The measures set out in the ZJF-D included additional government borrowing for the purposes of (a) increasing the government's capital investments in credit institutions, insurance corporations, reinsurance corporations and pension firms, (b) purchasing credit institutions' (non-performing) claims, (c) providing loans to credit institutions, insurance corporations, reinsurance corporations and pension firms, and (d) issuing government guarantees outside the stock of government guarantees set out in the Budget Implementation Act.

The envisaged measures aimed to provide beneficiaries with easier access to liquidity. The law envisaged that the specific measures would be approved by the Slovenian government on the basis of a proposal by the Ministry of Finance, whereby the government's resolutions would have to be based on an assessment of the necessity of the measures by the supervisory authorities responsible for financial corporations. The specific measures also had to comply with the requirements and guidelines of the EMU/EU, including the European Commission guidelines for the protection of competition with

regard to state aid.¹⁵ From the perspective of the deepening crisis in the wider economy, the impact of the ZJF-D was insufficient.

Within the framework of the broader systemic response to the crisis, it should be noted that in the first year of the crisis there was no political consensus in Slovenia with regard to the need to take action to counter the crisis (as was achieved for example in Denmark in 2010¹⁶), nor later in the implementation of integral measures for the banking sector and over-leveraged corporates. **There were delays in the capital strengthening of banks in 2010 and 2011, particularly the government-owned banks, and in corporate restructuring measures.**

Since the outbreak of the crisis in 2008 Slovenia has had five governments, and at important periods of the crisis has had governments without full power (to this can be added the traditional 100 days during which governments are transitioning, ministries are drawing up analysis and work programmes, and governments are generally being constituted).

- between 9 November 2004 and 21 November 2008 the government was headed by Janez Janša;
- from 21 November 2008 the government was headed by Borut Pahor; on 20 September 2011 it lost a confidence vote in the National Assembly, the new government only entering office on 10 February 2012;
- from 10 November 2012 the government was headed by Janez Janša; on 27 February 2013 it lost a confidence vote in the National Assembly, and a new government entered office on 20 March 2013;
- from 20 March 2013 the government was headed by Alenka Bratušek; her resignation brought the government down on 8 May 2014, but a new government only entered office on 18 September 2014;
- since 18 September 2014 the government has been headed by Miro Cerar.

It should be remembered that the Bank of Slovenia was without a governor for part of 2007: Mitja Gaspari's term as governor ended on 31 March, and his successor Marko Kranjec was confirmed in his position on 19 June 2007 (after the National Assembly had failed to confirm two candidates proposed by the prime minister, first Mitja Gaspari, then Andrej Rant), before assuming office on 16 July 2007.

3.2 Management of systemic risks by means of Bank of Slovenia supervisory measures

¹⁵ At that time the following were in force for the purposes of bank resolution and assistance to banks from a state aid perspective: (1) Communication from the Commission on the recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition (OJ C 10/2009 of 15 January 2009), (2) Communication from the Commission on the treatment of impaired assets in the Community banking sector (OJ C 72/2009 of 26 March 2009) and (3) Communication from the Commission on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the state aid rules (OJ C 195/2009 of 19 August 2009). The aforementioned state aid requirements did not (yet) require the bail-in of shareholders or holders of capital (subordinated) instruments in the coverage of bank resolution costs.

¹⁶ Political agreement between the Danish government and Socialdemokraterne, Dansk Folkeparti, Socialistisk Folkeparti, and Radikale Venstre og Liberal Alliance on a number of consolidation initiatives

The measures for the supervision of credit institutions in Slovenia are set out by the Banking Act (ZBan). At the outbreak of the financial crisis in 2008, the ZBan was in force in Slovenia; it offered a limited range of supervisory measures.

As the economic crisis worsened in Slovenia, and after an irresponsible lack of response from owners, particularly of the banks under domestic ownership, to the Bank of Slovenia's requirements for capital strengthening in 2010 and 2011 in light of the rapid increase in credit risk, in March 2012 the Bank of Slovenia drafted comprehensive amendments to the ZBan aimed at strengthening the Bank of Slovenia's supervisory powers, thereby improving the effectiveness of bank restructuring. The government did not discuss the proposed amendments until the end of 2012, when it was clear, in part based on the criticism levelled by international institutions,¹⁷ that the measures to stabilise the banks would have to be incorporated into the Bank of Slovenia's system of supervisory measures. The amendments were adopted by the National Assembly in December 2012.

The Bank of Slovenia also proactively proposed amendments to other regulations, primarily modelled on other EU Member States, to provide for the effective resolution of the problems that had built up at the banks and more widely in the economy. Many of these amendments were not given consideration or were considered only in part or with a considerable delay (for more, see Section 3.5), which in the Bank of Slovenia's assessment also reduced the effectiveness of the action during the crisis.

Throughout the crisis the Bank of Slovenia warned the banks of systemic risks, and required the banks to put in place an appropriate risk management system and to maintain an appropriate level of capital to cover all types of risk. The review of activities presented below only includes the key systemic supervisory requirements related to the management of systemic risks that applied to the entire banking system. There were also a range of supervisory requirements that in the form of supervisory measures were aimed at eliminating deficiencies and violations at specific banks, and indirectly acted to improve the stability of the banking system.

The Bank of Slovenia conducts prudential supervision of the banks pursuant to the Banking Act. The purpose of the supervision is to determine whether a particular bank meets the requirements in connection with the identification, measurement and management of the risk that it is or could be exposed to in its operations, and whether it is maintaining adequate capital to cover these risks (capital adequacy). The Bank of Slovenia imposes supervisory measures when it identifies violations of prudential requirements in a bank's operations, because the bank is failing to provide adequate risk management and consequently is failing to meet its capital adequacy requirements. When during prudential supervision increased risk is identified in the operations of a bank (for reason of internal organisation, the bank's business model, or other [systemic] risks), the bank must ensure adequate coverage of these risks by capital (increased capital adequacy requirements).

Prudential supervision does not aim to restrict banks in taking up risks, provided that the bank provides for adequate coverage of the risks by capital: measures of prudential supervision are therefore tailored to these objectives, and consequently do not allow for the supervisor's direct influence on the determination of a particular bank's business policy with regard to the take-up of risks (the risks associated with the conclusion of specific types of transaction).

Deciding on the risk level of the business model is the right and responsibility of the owners and the senior management appointed by the owners (management boards and supervisory boards).

The Bank of Slovenia systematically supervises the fulfilment of all of its requirements and recommendations, and in the event of identifying violations acts at the level of the individual bank, by means of supervisory requirements with regard to the rules for identifying, measuring and assessing risks at banks, and consequently by means of increased requirements with regard to the maintenance

¹⁷ "The Bank of Slovenia's powers should be strengthened in several areas..." IMF: Republic of Slovenia: Financial System Stability Assessment, Dec 2012.

of regulatory capital and management of risks at the banks at which violations or an increased appetite for taking up risks have been identified.

Through the aforementioned requirements for banks, within the framework of its prudential supervision the Bank of Slovenia acted to restrict the identified systemic risks and pro-cyclical behaviour by banks. That the Bank of Slovenia's actions within the framework of prudential supervision were right and proper was further confirmed by the IMF's report on the assessment of the stability of the financial system conducted in 2012.

Chronological review of measures and activities implemented by the Bank of Slovenia since 1 January 2006

➤ 2006

- **Introduction of an own funds deduction item** (Objective: to reduce credit risk)

As a result of the introduction of the International Financial Reporting Standards (IFRS), the Regulation on the assessment of credit risk losses of banks and savings banks entered into force on 1 January 2006. This regulation significantly changed the existing arrangements for the valuation of the credit portfolios of banks and saving banks and the creation of provisions. The new IFRS required banks to create impairments of financial assets or provisions for commitments under off-balance-sheet items for losses already realised, and not for expected losses.

In light of the previous regulations, which required banks to create provisions conservatively, it was felt even as the regulation was being drafted that the creation of impairments of financial assets or the creation of provisions for commitments in accordance with the IFRS would entail a reduction in the required provisioning in the banking system. The surplus of provisions already created would thus be released and earmarked for distribution to shareholders.

The aforementioned regulation therefore additionally required banks to calculate collective impairments for ratings A to E at the average percentages for each rating applied before the introduction of the IFRS (**Bank of Slovenia's collective methodology**).

The banks had to treat the difference between the actual collective impairments and provisions created on the basis of the IFRS and the impairments in accordance with Bank of Slovenia requirement as a deduction item in the calculation of regulatory capital, thereby deducting it from the bank's original own funds. This meant that to meet their capital adequacy requirements the banks had to secure a higher amount of regulatory capital earmarked for covering the capital requirements for individual risks, as they were unable to apply the effects of any release of provisions that would have resulted from the application of the IFRS alone.

The aforementioned additional regulatory requirement with regard to the application of a deduction item derives from the principle of prudence (the prudential filter) whereby the effects of the release of previously created provisions as a result of the implementation of the IFRS should be neutralised: the Bank of Slovenia's additional requirements meant that accumulated provisions were not transferred to profit for distribution to shareholders, but instead were transferred to reserves.

After the rules on additional deduction items (the prudential filter) had been introduced, banks and auditors **moved to have it revoked several times**. The Bank of Slovenia first discussed such an initiative in autumn 2006, rejecting it with the argument that the aim of the prudential filter is to buffer the impact of the changeover to the IFRS until the implementation of Basel II (1 January 2007; in practice 1 January 2008), while in October 2007 (at its 359th meeting of 2 October 2007) the Governing Board of the Bank of Slovenia supported revoking the prudential filter. When deciding on the timeframe for revocation in December 2007 (363rd meeting of 4 December 2007), the Governing Board of the Bank of Slovenia deferred the decision until a slowdown in the excessive lending activity of the banks. The prudential filter was finally abolished in October 2008.

- **Requirement for banks** (of 4 July 2006) **in connection with the management of risks arising from foreign currency loans, loans tied to foreign currencies** and credit products that expose customers to market risk

- a warning to banks that they should put in place an adequate and effective risk management system comprising policy, the ongoing monitoring and measurement of risks, limit systems and control mechanisms;
- a requirement to comprehensively inform customers of the attributes of the products offered by the bank;
- a requirement for the bank to initially offer customers their products in euros at all times.
- **Requirement for banks** defining criteria for the eligibility of structured securities for inclusion in the liquidity ladder. (Objective: to reduce liquidity risk)
- **Regulatory changes** in the area of liquidity

In addition to the changes related to the introduction of the euro, the transition to Eurosystem monetary policy instruments and the changes required by the introduction of the IFRS, the following changes were introduced:

- The second-bucket liquidity ratio became merely informative in nature;
- The use of internal methodologies for calculating the proportion of stable sight deposits (which must not be lower than 20%) was allowed;
- The percentage for the inclusion of sight deposits by households and non-financial companies was reduced from 85% to 50% in the first bucket and from 60% to 45% in the second bucket;
- The option of including a portion of the loans with residual maturity of more than 180 days at banks with a long foreign exchange position was abolished.

➤ 2007

- **Measures to curb lending growth** (discussed and adopted at the 364th meeting of the Governing Board of the Bank of Slovenia of 18 December 2007):

1. Deferred abolition of the prudential filter

The decision to revoke the deduction item for own funds resulting from the difference between the regulatory requirement for collective impairments of financial assets subject to collective assessment and the actual impairments created was deferred.

2. Swiss franc loans

In a letter of 7 July 2006 the Bank of Slovenia warned the banks of their duty to disclose relevant information and manage the risks arising from foreign currency loans, loans tied to foreign currencies, and products tied to various market variables. On 19 December 2007, the Bank of Slovenia highlighted its expectation that the banks would continue to apply the recommendation in the aforementioned warning as an example of best practice to be consistently implemented in their day-to-day dealings with their customers. In so doing the Bank of Slovenia recommended to the banks that they do business with customers as follows:

- **the bank should always initially inform customers of their offering in euros, and calculate their creditworthiness on this basis;**
- **if, despite being briefed on currency risk, the customer still wishes to raise a loan in a foreign currency or tied to a foreign currency, the bank should calculate creditworthiness taking account of the less favourable terms of raising an equivalent loan in euros.** The bank should then treat the amount thus determined as the maximum possible loan in the counter-value of the foreign currency.

3. Detailed definition of the category of “regulatory high-risk exposures”

The Bank of Slovenia gave a detailed definition of the category of “regulatory high-risk exposures” for the purposes of calculating capital requirements for credit risk. It included:

- all exposures to persons against whom bankruptcy or compulsory composition proceedings have been initiated;
- private equity exposures. A public company is an issuer whose securities are admitted to trading on a regulated market in Slovenia or another Member State (in accordance with the Financial Instruments Market Act) or on a recognised market specified in Appendix II of the Regulation on the calculation of capital requirements for market risk;
- all exposures to venture capital firms and funds. These are companies with the status of a venture capital firm or fund in accordance with the legislation of the country in which they are established;
- all exposures to unregulated venture capital firms and funds. These are companies without the status of a venture capital firm or fund in accordance with the legislation of the country in which they are established, but with at least 50% of their assets invested in private equity firms for the purpose specified in the second paragraph of Article 4 of the Venture Capital Companies Act;
- all exposures to collective investment undertakings (investment funds) with particularly high risk. These are (a) all unregulated investment funds (their operations are not governed by a particular law and/or the subject of control by the competent supervisory body, e.g. hedge funds), and (b) regulated investment funds the majority of whose investments derive from countries to which the OECD or another relevant export agency has assigned the highest minimum export insurance premium;
- all exposures to unregulated entities with at least 50% of their assets invested in financial instruments in the sense of the Financial Instruments Market Act that do not pursue holding company activities. These also include all companies that are established or operate primarily for the purpose of submitting a takeover bid in accordance with the Mergers and Acquisitions Act, including companies that are not the acquirer but are acting in concert with the acquirer, whereby the business reason for the exposure to said company is the financing or refinancing of a takeover of another company.

In accordance with the Regulation on the calculation of capital requirements for credit risk under the standardised approach for banks and savings banks, banks had to assign a weight of 150% to the aforementioned exposures. The regulation entered into force on 1 January 2008.

4. Retained earnings (Objective: capital strengthening)

The Bank of Slovenia recommended that the banks use a major portion of their declared profit for 2007 to create reserves and thus increase their original own funds.

• **Warning with regard to the pro-cyclicality of the IFRS**

As a direct result of the introduction of the IFRS, **provisions declined by 24%, while the banks’ own funds increased by 15% and capital adequacy improved by 1.6 percentage points merely because of a methodological change in accounting standards.** The favourable economic climate in 2006 led to a reduction in the need for current provisioning in accordance with the new criteria. The banks’ provisioning as a proportion of gross income was merely one-half of that in the years before the introduction of the IFRS.

The introduction of the IFRS subsequently had an impact on the banks' business behaviour. Bank lending activity is by its very nature cyclical, and dependent on the phase of the economic cycle. The introduction of the concept of fair value in the valuation of balance sheet items further increased the banks' pro-cyclical behaviour. In a situation of high economic growth, when banks generally overestimate their customers' creditworthiness, their optimistic risk assessments also increased the fair value of loans and other assets. The returns, whether realised or nominal, from higher asset prices and improved loan quality had a direct impact in the form of a relative increase in the banks' operating result, thereby encouraging them to further expand lending activity. The reverse process followed during the economic slowdown. This kind of fluctuation was greater in banking systems that were accompanied by less efficient financial markets with greater fluctuations in prices of financial products, for which reason the performance of these banks was also more variable and less predictable. By their very nature, larger fluctuations in financial categories such as returns, prices, profits, and balance-sheet categories of financial entities represent a greater risk to the maintenance of financial stability in the long term.

➤ 2008

- **Warning with regard to the non-optimal structure and amount of capital** (Objective: capital strengthening)

In 2007 Slovenian banks additionally accelerated their already high credit growth, in which certain domestic banks even outpaced the banks under foreign ownership, which are able to meet the rising capital requirements relatively quickly through increases in capital by their parent banks. In cases of diversified ownership structure at banks and in connection with the deterioration in the financial position of their owners (companies established in Slovenia), delays in the realisation of the announced recapitalisations arose in particular at the banks under majority domestic ownership. Consequently, in the wake of high credit growth and rising capital requirements, these banks faced a deterioration in the structure of regulatory capital: instead of increasing their share capital, they met their capital requirements by issuing subordinated capital instruments (debt). Given the shortfall of original own funds, the banks were only able to include the issued subordinated capital instruments in the calculation of regulatory capital in part, which led to an increase in the issuance of these instruments.

- **Requirement for banks** (of 23 June 2008) in which the Bank of Slovenia informed the banks that the Governing Board of the Bank of Slovenia had passed a resolution in accordance with which exposures to companies of the Pivovarna Laško Group and exposures to the group of acquiring companies related to Infond Holding (Kolonel, Center Naložbe, Atka-Prima, etc.), CPM and other acquiring companies collateralised by shares in Pivovarna Laško (ticker symbol: PILR) should **be treated as a single overall risk** since the aforementioned companies are related in such a manner that the financial difficulties of one company could impact the solvency of the others. Consequently banks were expected to correctly report their exposures to the aforementioned groups of connected clients in their large exposure reports and, where they exceeded the threshold (25% of the bank's capital), to reduce their exposure by 30 September 2008.

- **Measures to mitigate the effects of the financial crisis**

- **Abolition of the prudential filter**

The Bank of Slovenia adopted its first measure to mitigate the effects of the financial crisis in October 2008 by **amending the Regulation on the assessment of credit risk losses of banks and savings banks**, which abolished the effects of the prudential filter in the creation of impairments and provisions (which had been introduced because of the effects of the implementation of the IFRS). The measure had a counter-cyclical effect, as the increase in capital adequacy slowed the contraction in the banks' lending activity.

- **Calculation of liquidity ratios** (Objective: to strengthen liquidity)

In November the Bank of Slovenia adjusted the calculation of liquidity ratios for the value of underlying assets at the central bank. The change in the methodology for calculating the first-bucket liquidity ratio removed the regulatory barrier to increased disbursement of liquid assets from the ECB.

- **Requirement for banks** (of 28 November 2008):
 - **Call to limit the rise in interest rates on sight deposits and short-term deposits.** The Bank of Slovenia called on the management boards of banks to refrain from above-average rises in interest rates on funds in sight savings accounts and shorter-term deposits. In the context of an unlimited government guarantee for bank deposits,¹⁸ the resulting switching of deposits between banks led to increased volatility in deposits, instead of encouraging long-term saving. Their potential application having been announced, measures to sanction the continuing pursuit of inappropriate interest rate policies, where the Bank of Slovenia was at liberty to change how the aforementioned deposits would be taken into account in the calculation of the liquidity ratio, proved unnecessary. (Objective: to reduce income risk).
 - **Call on banks for increased creation of impairments and provisions,** whereby the banks had to take account of the actually disclosed deterioration in the economic conditions of business for corporates in specific sectors, as a result of which the Bank of Slovenia called on the management boards of banks to appropriately evaluate credit risks in the context of the deteriorating economic situation, and to create an adequate level of impairments. (Objective: to reduce credit risk).
 - **Prohibition on banks adjusting their profit or loss** as a result of major losses from trading in securities on account of lower impairments or provisions.

➤ **2009**

- **Requirement for banks** (of 13 January 2009), where the Bank of Slovenia sent the management boards of banks the following for the purpose of compiling final accounts and annual reports for the 2008 financial year:
 - four recommendations on measurement of value and on impairments of financial assets during the financial crisis. **Of importance was the recommendation that objective evidence of the impairment of financial assets in the form of capital instruments also include a significant or longer-term decline in fair value below historical cost, whereby the Bank of Slovenia defined what constitutes a “longer-term” and “significant” decline in the value of financial assets.** The overall loss thereby estimated from the valuation of capital instruments in accordance with the recommendation was to be transferred by banks to the income statement, thus providing a more realistic disclosure.
 - The Bank of Slovenia also recommended that banks **not distribute distributable profit in an amount equal to loss brought forward in the revaluation reserve, but instead allocate the majority of profit generated in 2008 to reserves.**

¹⁸ On 8 October 2008 the finance minister announced that the government had passed a temporary resolution by which it would as of that day extend a government guarantee, without limit on the amount, to guaranteed **deposits** of retail customers and micro and small enterprises at banks in Slovenia. Under an amendment to the Banking Act (the ZBan-1B), which entered into force on 20 November 2008, the government assumed an unlimited guarantee for the net deposits of retail customers and micro and small enterprises at banks in Slovenia until 31 December 2010

- **Requirement for banks** (of 28 January 2009), where the Bank of Slovenia called on banks to:
 - maintain an appropriate level of impairments and provisions; it noted that certain facts from the examination of the first financial statements for 2008 suggest that impairments and provisions did not fully reflect the deteriorating situation and that impairments had actually declined at certain banks;
 - ascribe a proper valuation to Lombard loans, given that the value of collateral had declined;
 - ascribe a proper valuation to corporates with unstable cash flows and high leverage that are unable to settle their liabilities at maturity;
 - ascribe a proper valuation to loans subject to renewal or multiple refinancing;
 - ascribe a proper valuation to loans classed as high-risk exposures;
 - apply an appropriate methodology to collective impairments;
 - coordinate their planned lending activities with available stable funding;
 - retain the profit generated in 2008 in the form of reserves.

Reporting on impairments and provisions, where in January 2009 the Bank of Slovenia enhanced the banks' data reporting system by requiring monthly reporting on the creation of impairments and provisions and classified assets as of April 2009, and requested additional information regarding certain forms of collateral.

- **Requirement for banks** (of 18 June 2009) in connection with activities to improve risk management at the banks:
 - a requirement that the **recurring refinancing of short-term loans with no cash flows from principal repayment should in the calculation of the liquidity ladder be included under long-term loans** (banks could not include loans refinanced more than twice in the first and second buckets of financial assets; in substantive terms they were to be classed as third-bucket financial assets);
 - a requirement for the **proper valuation and impairment of short-term loans** that have been refinanced more than twice and where the customers are unable to repay the principal (banks had to assess and impair such loans on an individual basis; when subject to collective assessment and impairment they were to be assigned to a group satisfying the criteria for a C rating);
 - a requirement for the **financing of M&A activities**, and consequently exposures from loans approved for the purchase of corporate shares and participating interests irrespective of the loan amount and the purchaser, to be classed as **regulatory high-risk exposures** which means 50% higher capital requirements on M&A lending..
 - **Recommendations for creditor banks** (of 3 June 2009): the Governing Board of the Bank of Slovenia adopted recommendations for **coordinated action by creditor banks in the case of corporates in financial difficulties**.

➤ 2010

- **Requirement for banks** (of 20 January 2010):
 - instructing them to **not distribute their net profit or distributable profit for 2009**, but instead to allocate it to other profit reserves to strengthen their capital position;
 - instructing the **management boards of banks and savings banks to assess the need for recapitalisation in 2010**, and to **prepare and carry out recapitalisation procedures in a timely manner** on the basis of this assessment;
 - **amendment to the risk management regulation** in the part relating to credit risk management (additional requirements in the area of the monitoring and treatment of non-performing loans, the establishment of computer-supported records for monitoring the amount of non-performing exposures actually repaid (either by the debtor or from the collateral) and the amount of write-offs of such exposures;
 - **requirement for 80% of the internal assessment of risk-based capital requirements to be met by original own funds:**

the Bank of Slovenia took a decision that within the framework of the internal capital adequacy assessment process (ICAAP) the banks would have to cover 80% of the internal assessment of risk-based capital requirements by original own funds calculated in accordance with the own funds calculation regulation (updated guidelines for the assessment of internal capital adequacy, October 2010). **Through this measure the Bank of Slovenia prevented banks and their owners from meeting the requirement for capital on account of rising credit risk solely by issuing subordinated and hybrid capital instruments, thereby weakening capital structure.**

➤ 2011

- **Requirement for banks** (of 20 January 2011) **to assess their requirement for capital in a timely fashion** in 2010 and to draw up procedures for its strengthening accordingly. The Bank of Slovenia recommended that, in distributing their net profit for the previous year (2009), banks' management boards should exploit the third paragraph of Article 230 of the Companies Act (creation of other profit reserves). Furthermore, the Bank of Slovenia recommended that banks' management boards propose to their general meetings that the distributable profit be allocated in full to reserves in order to strengthen capital.
- The **Regulation on the minimum requirements for ensuring an adequate liquidity position at banks and savings banks** was amended in September, such that the weights applied to the sight deposits of households and non-financial corporations were reduced by 10 percentage points to 40% in the first bucket and to 35% in the second bucket of the liquidity ladder, thus bringing the treatment of such deposits in closer alignment with the treatment envisaged in the LCR liquidity standard. **This reduced the banks' liabilities for investments in the first and second buckets by more than EUR 800 million, thereby making it easier to manage the structure of investments.**
- **Requirement for banks** (of 11 November 2011) **in connection with recommendations for more effective recovery of non-performing investments either from the debtor or from the collateral** (inappropriate assessment and monitoring of the debtor's financial position, deficient contractual regulation of collateral instruments, limited use of new instruments for effective repayment of claims, lack of appropriate conduct during loan approval, inappropriate and outmoded valuation of collateral, absence of appropriate organisational units for handling non-performing investments, insufficient activity on the part of the latter).

➤ 2012

- In February the Bank of Slovenia adopted **amendments to the internal capital adequacy assessment process (ICAAP) guidelines**, whereby the increased profitability risk arising from liability interest rates required additional capital within the framework of the ICAAP for a period of one year in advance. **In the adverse liquidity situation in the Slovenian banking system, this measure curbed the competition for deposits by means of rises in deposit rates, which had a positive impact on the level of lending rates.**
- In March the Bank of Slovenia **amended the definitions of past-due items and significant credit exposure in arrears** in connection with the definition of default for the purpose of calculating capital requirements for credit risk. A credit liability in arrears was classed as significant at the latest when it exceeded 2% of the open exposure or EUR 50,000 for more than 90 days, and was no less than EUR 200 (previously EUR 1,000 EUR for corporate customers and EUR 100 for retail customers).

The same definition was introduced in April for the purpose of identifying defaulters within the framework of the banks' reporting of exposures to individual customers. Reporting by the banks was also supplemented to include reporting on the amount of an exposure where the customer is more than 90 days in arrears. The aforementioned changes achieved a more standardised definition of defaulters.

- By amending the **Regulation on the minimum requirements for ensuring an adequate liquidity position at banks and savings banks** in April, the Bank of Slovenia tightened the conditions for the inclusion of credit lines and the undrawn portion of loans, such that the aforementioned instruments were not included in the calculation of liquidity ratios in their full amount, but gradually up to the amount of 50% of their value. **The measure entailed bringing the treatment of these liquidity resources closer to the requirements of the LCR liquidity standard. In addition, it increased the requirements for liquidity risk management given the persistence of the financial crisis.**
- **With the aim of reducing the proportion of non-performing investments on the banks' balance sheets, which was rising as a result of protracted recovery proceedings, and with the aim of accelerating the process of redeeming real estate collateral**, the Regulation on the assessment of credit risk losses of banks and savings banks was amended in April, such that the banks had to write off financial assets measured at amortised cost that during the recovery proceedings they assess will not be repaid, provided that the conditions for the derecognition of these assets from the statement of financial position according to the IFRS had been met. The aforementioned financial assets had to be administered as off-balance-sheet items until the legal basis had been secured for the conclusion of recovery proceedings. The measure reduced the proportion of non-performing investments by just under 1 percentage point.

➤ 2013

Changes were made to secondary legislation in response to identified risks and to practical experience and findings from supervision:

- a new **Regulation on risk management and the implementation of the internal capital adequacy assessment process for banks and savings banks**, January 2013: The aforementioned changes brought a methodological upgrade to credit risk assessment, but also contributed to the qualitative aspects of credit risk management. **Even in the credit approval**

process the banks had to pay more attention to the formulation of loan agreements, the requirement being for loan agreements to include relevant and clear contractual clauses, and then in the process of credit monitoring they were required to monitor the performance of contractual commitments;

- a new **Regulation on the assessment of credit risk losses of banks and savings banks**, February 2013: The definition of default that the banks used for classifying claims into ratings A to E was brought into line with the definition of default as set out in EU banking legislation. The same definition is applied in the rules of the Eurosystem's prudential framework intended for assessing the eligibility of financial assets as collateral for Eurosystem credit operations.

The following was stipulated: Financial assets and commitments under off-balance-sheet items were to be classified into the **D rating** when they are vis-à-vis debtors: **(a)** for whom there is a great likelihood of loss of part of the asset or the payment under the commitment, **(b)** at whom the bank has identified a significant deterioration in credit quality and in this connection has created impairments or provisions, **(c)** whose financial assets or commitments are classed as non-performing, **(d)** with whom the bank has already suffered a significant economic loss during the write-off or sale of their financial assets, **(e)** whose financial assets have been restructured by the bank in accordance with Article 18 of the aforementioned regulation, where the forgiveness of a significant part of the debtor's liabilities occurred or is likely to occur, **(f)** who pay their liabilities 90 to 180 days in arrears, and occasionally 181 to 360 days in arrears, **(g)** who are insolvent, **(h)** against whom a petition to initiate compulsory composition or bankruptcy proceedings has been lodged with the competent court, or **(i)** who are undergoing compulsory composition or bankruptcy proceedings.

Financial assets and commitments under off-balance-sheet items were to be classified into the **E rating** when they are vis-à-vis debtors: **(a)** who have the same attributes as debtors whose financial assets or commitments have been classified into the D rating, but for whom it is assessed that the claims against them will not be repaid, **(b)** with a disputed legal basis, or **(c)** who pay their liabilities more than 360 days in arrears.

- a new **Regulation on risk management and the implementation of the internal capital adequacy assessment process for banks and savings banks** and a new Regulation on the reporting of individual facts and circumstances of banks and savings banks, May 2013:

Via changes to secondary legislation the Bank of Slovenia was also attempting to encourage the banks to take a more active role in corporate restructuring and in reducing non-performing loans on their balance sheets. The banks were required to strengthen their monitoring of forbore exposures, particularly in respect of corporates for whom the successful forbearance of the banks' exposures required comprehensive operational, ownership and financial restructuring. The banks were accordingly required to draw up corporate exposure forbearance plans, and to report to the Bank of Slovenia in connection with the corporate restructuring agreements concluded.

- a new **Regulation on the minimum requirements for ensuring an adequate liquidity position at banks and savings banks and guidelines for implementing the regulation**, November/December 2013: The changes to secondary legislation also addressed liquidity management at banks, and the banks' policy of expanding into other parts of the financial sector.

A requirement was introduced for banks to monitor and report on their liquidity flows, which aimed to make a positive contribution to the quality of liquidity management at banks. The monitoring and reporting of liquidity inflows and outflows and liquid assets was to allow for better insight into a bank's future liquidity position, the early warning of potential

problem areas and the timely preparation of measures to prevent or bridge liquidity deficits.

- the **Regulation on the documentation for the granting of the authorisation to acquire a qualifying holding to banks and savings banks**, a new **Regulation on the reporting of individual facts and circumstances of banks and savings banks** and the **Regulation on the amounts of annual fees for supervision and fees for decisions on requests for the granting of authorisations**, September 2013: On the basis of the submission of the information and figures prescribed for the intended acquisition of a qualifying holding in the financial sector, the Bank of Slovenia was granted **prior insight into the planned expansion of a bank's operations into other firms in the financial sector, and the consequences of such expansion**. When the bank failed to put in place an adequate system for managing the risks deriving from the acquired investments, or the effective implementation of supervision, the authorisation to acquire a qualifying holding could also be rejected or revoked.

Changes to secondary legislation as a result of the transposition of EU directives and EBA guidelines:

- A **package of regulations** was issued in connection with the transposition of the new financial conglomerates directive, which expanded supervision on a consolidated basis to groups headed by mixed financial holding companies (July 2013). There are no such groups for the moment in the Slovenian financial system.
- The **EBA guidelines on the assessment of the suitability of members of the management body and key function holders** were transposed into Slovenian law via changes to Bank of Slovenia regulations (September 2013).

On the basis of the changes the banks had to adopt and implement policies setting out the criteria of reputation, experience and governance to be met by candidates for positions on management boards and supervisory boards. These criteria were also substantive guidelines for all entities participating in the proposal, selection or appointment of candidates for the aforementioned positions, including the owners of banks and savings banks. This objective was to strengthen corporate governance at banks and savings banks.

- An amendment to the **Regulation on the books of account and annual reports of banks and savings banks** made minor changes to the structure of the statement of cash flows, and the structure of the statement of comprehensive income and the consolidated statement of comprehensive income, as a result of the amendments to IAS 1, having regard for the FINREP 3 form from the draft implementing technical standard on supervisory reporting. The Guidelines for compiling the statement of financial position, the income statement and the statement of comprehensive income, and for calculating performance indicators of banks and savings banks were also amended as a result (December 2013).

➤ 2014

- **Regulation on the implementation of the Regulation (EU) on prudential requirements for credit institutions and investment firms with regard to the implementation of options and discretions and other tasks of the competent authority for credit institutions**, January 2014: For the implementation of new banking legislation, namely the CRR (Regulation [EU] No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation [EU] No 648/2012), which has been applied directly in Member States as of 1 January 2014, a regulation was issued to set out the manner and scope of the implementation of options and discretions and of other tasks that the aforementioned EU regulation assigns to the competent supervisory authority. These are primarily discretions that set out the way in which capital is

calculated for banks during the transition period to full enforcement of the new rules and capital requirements for various types of risk and the treatment of certain other prudential requirements from the EU regulation.

- In response to the practical findings in the implementation of supervision, a new **Regulation on the documentation for demonstrating the fulfilment of conditions to perform the function of a member of the management board of a bank or savings bank** was issued in January.

The amendments related to an **update of the questionnaire in the part applying to the assessment of the reputation and experience of a candidate for the position of a member of the management board of a bank or savings bank, which provided a more comprehensive basis for the assessment of the reputation and experience of the candidate by the Bank of Slovenia**. A new Regulation on the amounts of annual fees for supervision and fees for decisions on requests for the granting of authorisations was published in February, changing the amounts of individual fees and the ratios between individual fees paid by the banks in connection with the granting of various authorisations. The banks aiming to obtain authorisations would thus contribute more to the coverage of the costs of granting authorisations. The amount of other supervisory costs to be covered by all banks via an annual fee would therefore be smaller.

- Amendments to the **Regulation on the assessment of credit risk losses of banks and savings banks**, February 2014: As part of the activities to encourage the banks to act faster in writing off non-performing financial assets and to take a more active approach to forbearance and the redemption of collateral, the regulation set out a definition of forborne financial assets to accord with the definition given by the technical standards for supervisory reporting to the EBA and the ECB, covering the types of forbearance of claims against debtors that could be carried out by the banks, and the accounting framework for the two basic categories of financial assets created as a result of individual types of forbearance.

Requirements were also prescribed for the classification of forborne financial assets into rating categories and in terms of their documentation or recording in books of account. In connection with write-offs a framework was put in place for the faster derecognition of non-performing financial assets from the statement of financial position when the bank judged that a financial asset would no longer be repaid or the conditions for derecognition under the IFRS had been met.

A bank could make an assessment of the write-off of financial assets from a loan agreement or an exercised off-balance-sheet contingency when the following conditions had been met:

- **for an unsecured financial asset, if the debtor was more than one year in arrears with repayment,**
 - **for a financial asset secured by real estate collateral, if the debtor was more than four years in arrears with repayment;**
 - **for an unsecured financial asset, if the debtor was undergoing bankruptcy proceedings.**
- a new **Regulation on the assessment of credit risk losses of banks and savings banks, and Guidelines for implementing the regulation**, March 2014: The requirements for reporting the classification of financial assets were updated. It involved the reporting of **individual transactions** or counterparties to financial assets (the code for the counterparty and the

number of days in arrears at the level of the individual transaction) and the **reporting of forborne financial assets** (type of forbearance, date of initial forbearance, date of last forbearance).

- a new **Regulation on risk management and the implementation of the internal capital adequacy assessment process for banks and savings banks**, April 2014:

The new regulation was adopted with the aim of speeding up the process of restructuring corporates that were over-leveraged but nevertheless had good prospects. It was to contribute to the practical implementation of Slovenian principles of debt restructuring in the economy, via the elaboration of essential elements that had to be taken into account in the financial restructuring of corporates with a large number of creditors, employing a coordinated approach to minimise the losses of all creditors. The risk management process at the banks also had to include an assessment of whether a collective approach to corporate resolution was reasonable, and consequently an approach to such a method of resolution.

A bank not opting to participate in a collective agreement with regard to the approach taken to a corporate in financial difficulty would have to refrain from actions that weaken the position of the other creditor banks in relation to the debtor, in accordance with best practice. A bank opting to participate was committed to upholding certain principles (participation in the appointment of a coordinator to head negotiations between the banks and the corporate, active involvement of the representatives of all the banks in the entire restructuring procedure, approval of a moratorium on the debtor's liabilities with the aim of obtaining the requisite information for deciding on restructuring, a refusal to participate in the restructuring only if not assured of equal treatment of comparable creditors or if not assured of higher repayment than under bankruptcy).

- the **Regulation on eligible assets and documentation for the granting of an authorisation to increase the share capital of banks and savings banks via a non-cash contribution**, October 2014: The regulation represented the operationalisation of the new ZBan-1J, which in December 2012 introduced the option of the recapitalisation of a bank or savings bank via a non-cash contribution for the purposes of meeting capital adequacy requirements in accordance with Bank of Slovenia requirements (in connection with supervisory measures imposed).

The regulation set out the types and criteria of eligible assets for the recapitalisation of a bank via a non-cash contribution, and defined the documentation that the bank must enclose in the request for an authorisation. Debt securities of central governments and central banks of Member States that meet the criteria for eligible collateral for Eurosystem claims and allow the bank the final, free and permanent disposal of the assets were classed as eligible assets for this purpose.

- amendments to the **Regulation on the books of account and annual reports of banks and savings banks**, and the **guidelines for its implementation**, December 2014: The purpose of the amendments was the coordination of the scheme of financial statements intended for publication or for inclusion in the annual report with the FINREP section of the technical standards for supervisory reporting. The banks took account of the amended regulation and guidelines when compiling their annual reports for the 2014 financial year.

3.3 Measures in the area of credit risk for individual banks

With regard to the type of transactions and the composition of assets on the balance sheets of Slovenian banks, credit risk is the key risk. Consequently the capital requirements for credit risk are by far the highest, and account for more than 90% of total risk-based capital requirements.

It is understandable that a significant proportion of supervisory activity is in the area of credit risk, which is the absolute priority of supervision. How supervision is undertaken at a bank and what instructions Bank of Slovenia supervisors have is set out in the Supervisory Manual (public section).

Between 2006 and 2014¹⁹ a total of **960 measures were issued in the area of credit risk**, while in addition several thematic examinations in individual substantive segments were conducted in this area at all banks, particularly in 2007 and 2008. The most notable results of these examinations were requirements to improve the methodology for the classification of claims, the creation of impairments, the assessment of collateral, the organisation of the credit function (e.g. separation of the credit approval function from the credit rating function) at each bank.

The IFRS were introduced at the end of 2006, and significantly changed the rules for the valuation of assets and the creation of impairments. In 2007 the Bank of Slovenia reviewed the implementation of the rules of the IFRS at all banks, with an emphasis on the methodology for creating impairments and provisions, the new standards having allowed the banks to design their own methodologies tailored to the in-house business model and the bank's appetite for taking up risks and risk management capacity.

The Bank of Slovenia also systematically monitored the project for implementing the rules of the Basel II capital directive at the banks in 2007, and reviewed the success of implementation in 2008, identifying deficiencies for which sanctions were not initially imposed. Supervision at the banks during the two years in question focused less on traditional examinations with the imposition of measures, and more on advisory supervision with admonishments to draw the banks' attention to deficiencies and any delays in the implementation of the new regulations, and the exchange of experience and best practice.

Figure 34: Number of measures imposed on banks by year

	NUMBER OF MEASURES IMPOSED	RECOMMENDATION	ADMONISHMENT	REQUIREMENT FROM LETTER	ORDER (number of points)
2006	141	93	18	30	0
2007	99	73	19	5	2
2008	66	40	18	3	5
2009	212	80	83	28	21
2010	72	18	29	18	7
2011	133	43	64	0	26
2012	148	11	41	9	87
2013	46	0	5	0	41
2014	42	0	7	12	23
TOTAL	959	358	284	105	212

The table also makes it evident how in the period of the crisis the **Bank of Slovenia also stepped up its imposition of measures** as a result of the continual deterioration in the position at the banks. The number of milder measures (recommendations and admonishments) was higher in the early years, then

¹⁹ Activities in connection with the determination of the requisite recapitalisation via state aid at the two largest banks were begun in the second half of 2013, within the framework of which a comprehensive assessment of the banks' assets was conducted, while in early 2014 the establishment of the Single Supervisory Mechanism at the ECB initiated extensive activity for the comprehensive assessment of the banks' positions, which encompassed a repeat comprehensive asset quality review and stress tests. All supervisory capacity was directed to these tasks.

in later years there were many more harsher measures imposed via orders requiring specific action by the banks to eliminate identified violations.

As the crisis persisted and borrowers' credit ratings deteriorated, the need for deeper supervision of the credit portfolio was revealed. For regular monitoring of the quality of the credit portfolio and the timely identification of deteriorations even in off-site supervision (supervision based on analysis of regular reports received from the banks), the scope of regular reporting on the credit portfolio was therefore expanded with additional information on individual arrears (September 2007) and on collateral quality (April 2009). The frequency of reporting was also increased (April 2009) from quarterly to monthly reports on the credit portfolio. In supervision at the banks there was greater emphasis on the identification of deficiencies in credit decision-making procedures and the early warning function for non-performing claims and debtors, and on the adequacy of procedures for the recovery of non-performing investments.

Filing of criminal complaints

On the basis of supervisory findings at banks, between 14 October 2008 and 27 February 2015 the Bank of Slovenia filed **20 criminal complaints and reports of suspected criminal offences**, which are now subject to proceedings before other bodies.

Because the criminal complaints also contain financial information about banks and about individual customers that the Bank of Slovenia obtained during supervision of banks, the specific information from the filed criminal complaints is safeguarded as confidential in accordance with the ZBan-1; the first paragraph of Article 228 of the ZBan-1 stipulates that Bank of Slovenia employees, auditors and other experts working under the authorisation of the Bank of Slovenia must safeguard as confidential all information obtained during supervision or other business for the Bank of Slovenia. The second paragraph of the aforementioned article stipulates that persons specified in the first paragraph may not disclose confidential information to any other person or government authority, except in the form of a summary from which the individual bank to which it relates cannot be recognised. Article 231 explicitly stipulates the persons to which the Bank of Slovenia may disclose confidential information as defined by the ZBan-1.

In addition, the Bank of Slovenia worked with other authorities and institutions, and specifically strengthened its cooperation with the police, signing a memorandum of understanding in 2014.

Figure 35: Action taken on the basis of supervisory findings

CRIMINAL COMPLAINTS and REPORTS filed by the Bank of Slovenia	20 cases
Notice that the General Police Directorate is conducting criminal proceedings against an unknown person for reasons of the criminal offence of the unlawful possession of a trade secret (Article 236 of the Criminal Code)	2 cases
COOPERATION with other government authorities	14 cases
Office of the Republic of Slovenia for Money Laundering Prevention	5 cases

With the aim of protecting the bank's interest and restoring each bank's reputation, the Bank of Slovenia imposed a measure on all the banks that received state aid in 2013 and 2014 based on which each bank's management board had to *"ensure, where legally possible, that the bank files claims within the framework of civil proceedings, labour-law proceedings and other relevant proceedings"*

against responsible persons at the bank and against third parties for the reimbursement of damage and all benefits gained through the violation of applicable regulations and the bank's bylaws. The bank's management board must also ensure that the bank informs the competent authorities of any suspicion of a criminal offence in the appropriate manner."

According to the figures available in early 2015, more than 150 criminal complaints had been filed that were subject to process before the competent authorities (police, state prosecutor's office, courts).

Special Inspection Group (SIG) at the Bank of Slovenia

In March 2014 the Bank of Slovenia established the Special Inspection Group for the purpose of cooperating more actively with the judicial authorities and the prosecution authorities, and for the needs of faster responsiveness, analysis and interpretation of bank data and supervisory analysis. Via the SIG the Bank of Slovenia assists the state prosecutor's office and the police in identifying the facts and circumstances connected with irregularities pursuant to the Banking Act.

The activities of the SIG focus primarily on assisting the police under the memorandum of understanding between the police and the Bank of Slovenia, and assisting the Specialised State Prosecutor's Office and, where necessary, the banks.

The work of the SIG is targeted on deeper analysis of individual cases of bad banking practice, 18 different forms and models of which have been identified to date. These are examples of behaviour that deviate from best banking practice, and can encompass elements of criminal offences.

The examples of bad banking practices identified include:

1. MBO loans organised via suppliers or friendly societies
2. transgression of the limits on (indirect) exposure to a group of connected clients
3. registration of subordinated instruments or bank shares with disallowed repurchase clauses and consequent misleading of the supervisor
4. approvals (non-approvals) for investments in qualifying holdings
5. use of loans for purposes other than those specified
6. loans with the involvement or a surety of another company where recovery was not pursued and the claims were instead written off (prematurely)
7. failure to apply for enforcement, failure to register claims in bankruptcy proceedings, omission of due diligence
8. loans to newly established companies at non-standard terms without regard for the company's credit rating
9. loans to companies where members of the supervisory board or their families have ownership relationships
10. purchase of securities by members of the supervisory board above market prices
11. loan reprogramming without regard for economic justifiability, failure to register claims in bankruptcy proceedings and omission of recovery from sureties
12. omission of enforcement and collateral redemption when the appropriate moment arises, thereby increasing the loss to the bank
13. real estate transactions via project management companies that borrowed from the bank having been established (entered in the companies register) just before or even after the signing of the loan agreement
14. manipulation and abuse of valuations
15. options contracts and repo transactions
16. avoidance of maximum exposures via leasing companies
17. avoidance of maximum exposures (connected clients)
18. omission of phases in the credit procedure, deficient documentation for loan approval, etc.

In many cases these practices are the subject of investigation by the police, the prosecutor's office and the courts.

Activities of the SIG:

- special on-site and off-site inspections at banks,
- cooperation with banks in the sense of information, awareness and expert assistance, in accordance with their powers, in the event of the identification of phenomena or irregularities in the area of banking and financial operations that contain elements of criminal offences and that entail an adverse deviation from best banking practice,
- construction of a knowledge base entitled *Model behaviour: cases of bad banking practice*, which will form the basis for the work of the SIG, and also optionally for inspectors from the Banking Supervision Department.

Many examples of bad banking practice that do not necessarily entail criminal offences are to be found in cases of **restructuring**. The purpose and objective of the SIG is to examine such banking operations and similar operations that are damaging to the bank and indicate the potential for corruption and clientelism, and non-compliance with the Banking Act and secondary legislation.

In addition to exercising supervisory functions and working with the prosecution authorities in the cases where suspected criminal offences have been identified, the Bank of Slovenia also has the powers of a misdemeanours authority in accordance with law.

Figure 36: Completed misdemeanours proceedings

Year	Total number of measure imposed
2007	Fine 2
2008	Admonishment 5
2009	Caution 3 Admonishment 5 Fine 2
2010	Fine 2 Admonishment 4 Caution 3
2011	Admonishment 1 Caution 5 Fine 2
2012	Admonishment 11 Caution 6 Fine 1
2013	Admonishment 1 Caution 2
2014	Caution 2 Fine 1
Total	Fine 8
	Admonishment 27
	Caution 21

3.4 Requirements for recapitalisation

Every crisis leads to increased risks in banking operations. Which part of banking operations and consequently bank balance sheets is hit first and hardest (investments in financial instruments, investments in foreign currency, credit portfolio, etc.) depends on the effects of the crisis on the real economy.

The capital at a bank's disposal is the principal instrument by which it absorbs the shock caused to banking operations by the crisis. An adequate level of capital allows a bank to absorb losses and not to cut back on its operations to such a degree that its sound and stable operation or even its viability could be jeopardised.

In adverse business conditions, the focus and concern of supervision primarily lie in verifying that banks have adequate liquidity and capital solidity. In accordance with prudential regulations, banks must have sufficient capital at all times to cover all the risks that they are exposed to.

Each bank is obliged to report certain information about its operations to the Bank of Slovenia, and to make a comprehensive report once a year in the prescribed form on all the risks that it is exposed to in its operations, and on the adequacy of its capital for covering these risks (the internal capital adequacy assessment process or ICAAP). The Bank of Slovenia must review the assessment of the bank at least

once a year and evaluate its compliance (SREP). The result of this process is a notice to the bank about the supervisor's expectations of the bank maintaining a level of capital throughout the next year that the bank itself has defined as adequate and that the supervisor has evaluated as sufficient in the review process. When in the assessment of the supervisor a bank does not have adequate capital to cover all risks, a requirement is issued to the bank in which a deadline is set for the bank to attain a level of capital that suffices to cover the risks at the bank in the assessment of the supervisor. The bank and its owners must maintain this level of capital throughout the year, and until the next assessment of risk and capital and the next requirement on this basis.

The importance of quick action and the right increase in capital is that the adverse consequences for the functioning of the entire economic system are significantly mitigated by timely action, as it prevents a negative spiral of interactions. Losses and weak capital adequacy are significant elements in the assessment of a bank's credit rating, while downgradings reduce investors' appetite for investing in such a bank, which raises borrowing costs, which additionally reduces the bank's profitability.

A bank can also adjust to capital inadequacy by reducing investments: it is primarily lending to good customers capable of repaying loans that can be reduced. This also reduces the bank's income, and simultaneously leads to a deterioration in its performance (e.g. the proportion of total lending accounted for by non-performing loans increases), which again paints a gruesome picture of the bank and leads to further downgrading.

3.4.1 Gap between capital adequacy of banks in Slovenia and across the EU during the crisis

At the outbreak of the financial crisis the average level of capital at Slovenian banks (an overall capital adequacy of 11.7% at the end of 2008) was very close to the average across other European banks (capital adequacy of 12.3%). It is evident from Figure 37²⁰ that the gap **widened** over the next three or four years, and by the end of 2012 average capital adequacy at banks across the EU was almost a third higher than capital adequacy at Slovenian banks.

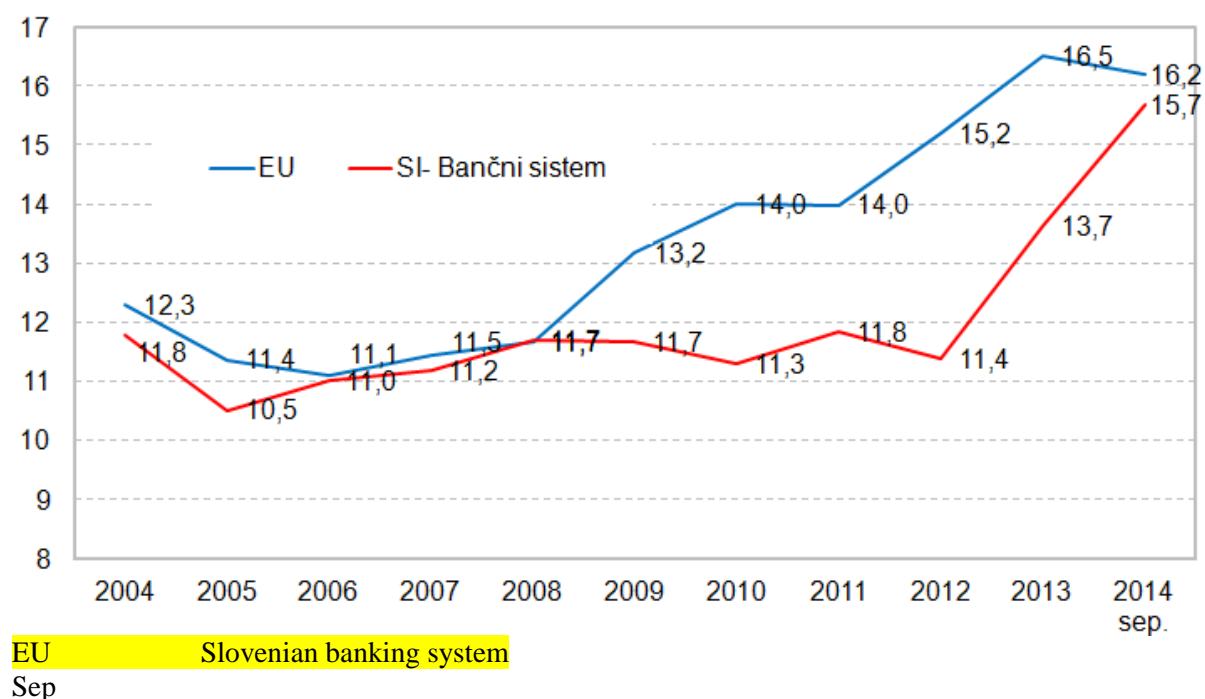
The increase in capital adequacy at banks across the EU was highest in the first two years of the crisis (until 2010), when the rate of growth slowed slightly, although capital adequacy has always displayed a rising trend, reaching over 15 % in 2012.

The capital adequacy of Slovenian banks stagnated and in 2010 and 2012 actually declined slightly below its level of 2008, an indication of inadequate action and the inability to recapitalise (particularly on the part of domestic owners) despite requirements from the Bank of Slovenia to raise capital adequacy.

It was only as a result of EU demands and the threat of the intervention of the troika that the government finally decided to recapitalise five banks, and carried out a recapitalisation in the amount of EUR 3.2 billion before the end of 2013, thereby increasing the capital adequacy of Slovenian banks to 13.7%, and to 15.2% in the first quarter of 2014, although a significant gap remains with banks across the EU. Only with the recapitalisation of Banka Celje in late 2014 and the capital strengthening at other banks did the capital adequacy of the Slovenian banking system reach the European average.

²⁰ This was discussed previously in Section 2.3.2

Figure 37: Gap between capital adequacy of banks in Slovenia and across the EU (average, in percentages)



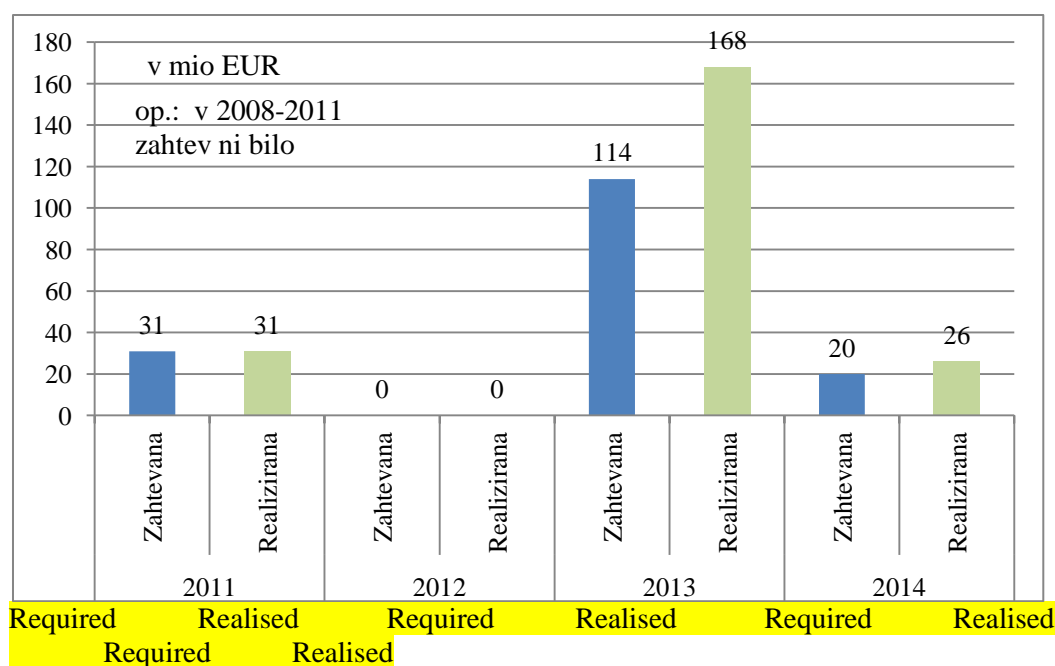
3.4.2 Bank of Slovenia requirements for recapitalisation

The Bank of Slovenia issued a requirement for banks to raise capital 43 times between 2008 and 2014.

Only two banks and two savings banks were never subject to a requirement to raise capital during this period. Two banks were subject to a requirement to raise capital every year.

The banks under majority foreign ownership always met the recapitalisation requirements of the supervisor (the Bank of Slovenia), as is evident from Figure 38.

Figure 38: Banks under majority foreign ownership: recapitalisations required and realised by year (in EUR million)



On six occasions a requirement to raise capital was not met by three small private banks. Two of these (Probanka and Factor banka) had a much higher-risk business model with large exposures to real estate projects, financial holding companies, etc., where the supervisor's requirement to raise capital was imposed every year. In the early years, up to 2010 inclusive, the owners were still able and willing to raise capital, but in the following years their own difficulties in performance and the accumulation of losses at the banks meant that they were no longer able or willing to meet the supervisor's requirements.

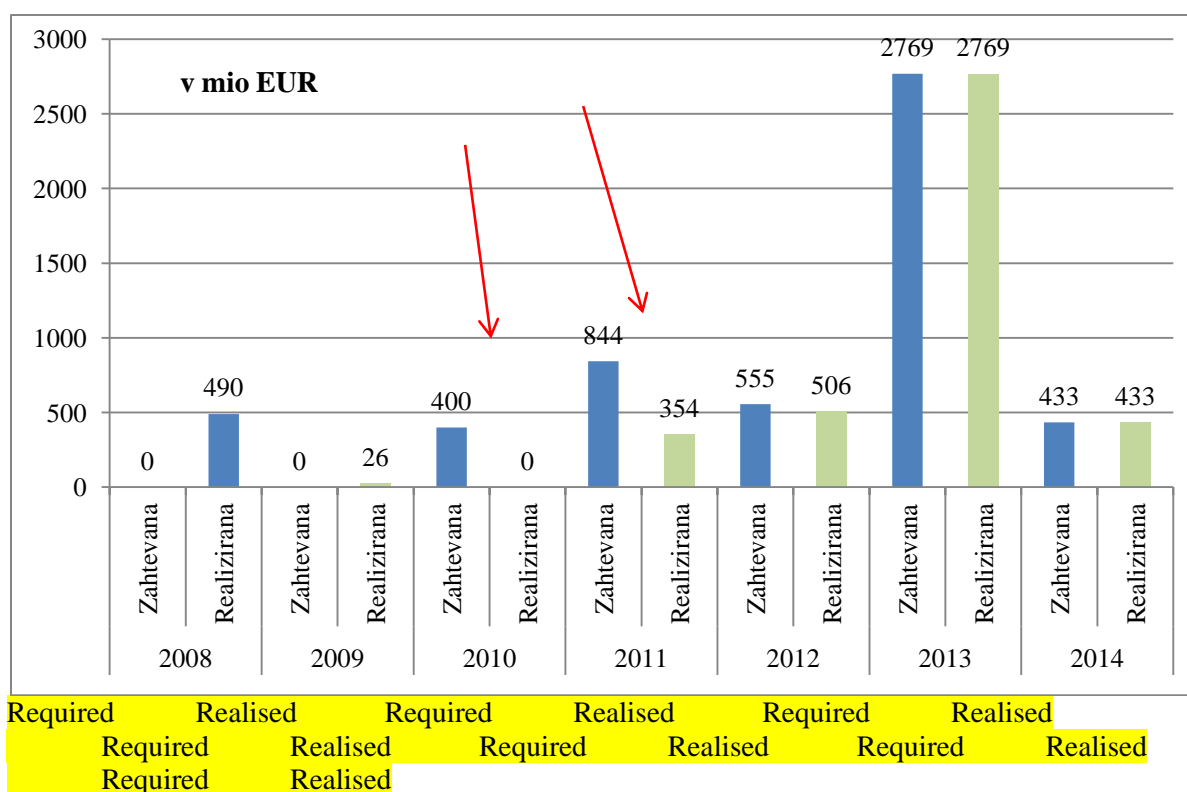
After 2009 there were four occasions on which the three largest banks under direct or indirect government ownership failed to meet the supervisor's requirement to raise capital.

Despite the Bank of Slovenia's intensive efforts (multiple written requirements, information, meetings with the prime minister, the Ministry of Finance²¹ or the supervisory board as representatives of the owner, i.e. the government, particularly regarding the need to recapitalise and strategic issues), the supervisory measures and requirements were not realised in full.

In 2010 the Bank of Slovenia issued a requirement for recapitalisation in the amount of at least EUR 400 million to the three largest banks under majority government ownership. The requirements were not realised. In 2011 the Bank of Slovenia required a recapitalisation in the amount of EUR 844 million, while the inflow of capital realised at the three largest banks amounted to EUR 354 million, as is evident from Figure 39.

Figure 39: Three largest government-owned banks: recapitalisations required and realised by year (in EUR million)

²¹ At least eight letters and meetings on the subject of recapitalisation and strategy to/with the prime minister and at least 14 to/with the Ministry of Finance between 2010 and 2013.



It should be noted that in 2010 and 2011, in the absence of recapitalisation by the owners, most notably the government, the largest banks reduced capital requirements by restructuring their assets and sharply reducing lending activity and improved capital by issuing subordinated bonds (NLB issued the NLB26 in 2010). The recapitalisation requirements were therefore lower in 2012.

That the largest banks were not recapitalised by their owners in 2010 and 2011, despite the Bank of Slovenia's requirements, had an adverse impact on the performance of these banks, the entire banking system and the economy as a whole, given the importance of the aforementioned banks to the entire banking system and the economy.

In an environment of negative or weak economic growth, and a rapid deterioration in the economic situation with a large number of bankruptcies, the absence of recapitalisations was the cause of a freeze in lending and a loss of confidence in the domestic banking system and the country as a whole on the part of domestic and foreign investors, and a major factor in the onset of a rapid downgrading of sovereign risk and consequently of rapid growth in government borrowing costs and increasing difficulty in accessing funding, which almost completely dried up in the second half of 2013, forcing the government into a position very similar to those euro area countries that had to request a bail-out.

The economic situation worsened after 2010, and particularly after 2012 (in 2011 there were twice as many bankruptcies as in 2009, while in 2014 there were twice as many as in 2011), and the untimely and irresponsible response to the Bank of Slovenia's requirements for recapitalisation had an adverse impact on the cost of the government recapitalisation of the banking system in 2013 and 2014, which amounted to EUR 3,649 million.

Slovenia's hesitancy in acting in the early years of the crisis between 2008 and 2011 is evident in the European Commission figures. The table reveals that for Slovenia the total amount of government resolution for banks, including guarantees, in the observation period amounted to

6.73% of GDP (of which recapitalisation was just 0.7% of GDP), while the average across the EU was 12.76% of GDP.²²

3.5 Legal initiatives by the Bank of Slovenia to secure the legal framework for effective action to address the consequences of the crisis and to ensure financial stability

Throughout the crisis the Bank of Slovenia also proactively proposed amendments to regulations, primarily modelled on other EU Member States and having regard for the IMF's recommendations, to provide for the effective resolution of the problems that had built up at the banks in the following areas in particular:

- supervisory powers and measures against banks that fail to attain the required capital adequacy, for the purpose of facilitating an increase in the bank's capital with the involvement of new investors, when the existing shareholders are unable to provide the bank with the requisite capital (certain powers of the Bank of Slovenia as the supervisor were proposed in March 2012, but were only adopted at the end of 2012; despite the deteriorating situation the main actors prioritised a bill to combine the supervisors, namely the Bank of Slovenia, the Securities Market Agency and the Insurance Supervision Agency);
- establishment of the conditions for more effective treatment of the banks' non-performing investments via the transfer of the investments to a special-purpose vehicle owned collectively by the banks, which under a government guarantee would take over the management of individual investments, either in specific sectors, or with regard to a specific debtor (a range of Bank of Slovenia proposals were not included in the bad bank law, the ZUKSB);
- improved insolvency legislation to facilitate more effective restructuring of over-leveraged firms (specific creditors' rights and conditions for expropriation from "bad" owners were only enacted in December 2013, despite the Bank of Slovenia's proposals originating in the first half of 2011).

Many of the changes in legislation proposed by the Bank of Slovenia, particularly after 2010, with the aim of improving the effectiveness of and expanding supervisory powers and the toolkit of measures were not taken into account, or were taken into account only in part or with a delay (for more, see below). In the Bank of Slovenia's assessment, this diminished the capacity for effective and timely action in the crisis.

3.5.1 Bank of Slovenia proposals rejected or ignored

This section examines Bank of Slovenia activities and initiatives (between 2011 and 2014) aimed at bank resolution and improvements in financial stability that were not adopted or were rejected:

◆ Bank restructuring and recovery measures

A document entitled *Analysis of the situation in the banking system* was drafted in July 2012, and included analysis of the legal aspect of various models for treating "toxic assets" at banks, including a general overview of the regulatory changes required to introduce and implement specific resolution models.

²² See Figure 33.

In the document the Bank of Slovenia showed clearly on the basis of analysis that a prerequisite for bank restructuring and recovery was timely and sufficient recapitalisation, which would subsequently allow the banks to put in place an effective mechanism for managing non-performing assets, preferably within the framework of the banking system, with the potential use of government guarantees to reduce further pressure on the banks' capital adequacy.

- The document was forwarded to the Ministry of Finance and the prime minister in July 2012.
- Having regard to the starting points in the document, the Bank of Slovenia drafted a **bank restructuring and recovery bill**, which in terms of measures represented an upgrade to the existing system of banking supervision, and also defined the government's role in the procedure.
- The main highlights of the bill were as follows:
 - the Bank of Slovenia would be responsible for deciding on forcible measures for the purpose of restructuring and recovery in accordance with the supervisory powers and measures set out in the ZBan-1;
 - in addition to the powers under the ZBan-1, the bill set out the Bank of Slovenia's powers with regard to the forcible transfer of a bank's assets to a special-purpose vehicle (SPV);
 - a special agency would be established to supervise the bank restructuring process and the functioning of the SPV, and to decide on bank restructuring and recovery on behalf of the government (i) in its role as investor (recapitalisation) and (ii) via the issue of guarantees to a bank or the SPV for the purpose of managing the banks' non-performing assets as one of the aspects of bank restructuring and recovery;
 - special rules with regard to the establishment of an SPV (by an individual bank or group of banks, or the Slovenian Sovereign Holding, although the company is predominantly under private ownership) to facilitate the (legally) simplified transfer of a bank's assets to an SPV, the possibility of issuing government guarantees for individual exposures of such an SPV, and definition of the basic principles with regard to the management of such an SPV (a Bank of Slovenia authorisation to serve as a member of the senior management);
 - authorisation for the government to issue guarantees for banks' liabilities to the Bank of Slovenia arising from emergency liquidity assistance to the banks.

Result:

- By autumn the government had drawn up its own draft of the **Act Defining the Measures of the Republic of Slovenia to Strengthen Bank Stability** (the **ZUKSB**), in which it took a different approach to key issues in bank recovery and resolution: in its proposal, the power to decide on measures was transferred from the current system of supervision to the government, while the power to implement measures was transferred to the BAMC, which would be established as a company under sole government ownership. With the establishment of the BAMC as the manager of various non-performing assets of the banks, the alternative arrangements for the management of non-performing assets lost its importance, even though as an additional option the ZUKSB envisages the establishment of a separate SPV owned by the banks and the issue of securities by the BAMC for the operations of the aforementioned SPV.
- In response to the government's proposal the Bank of Slovenia put forward numerous comments and proposals, primarily with the aim of harmonising the aforementioned framework with the existing banking supervision system to the greatest extent possible, particularly with regard to the Bank of Slovenia's role in determining the position of a bank,

assessing the adequacy of the restructuring plan and the risk-based capital requirements of a bank, and assessing the effects of the transfer of the bank's assets to the BAMC.

- In addition, the Bank of Slovenia proposed the option of issuing government or BAMC guarantees directly to a bank or an SPV that is established by one bank or by several banks together without being part of the public sector.
- The Bank of Slovenia also warned of the inadequacy (unconstitutionality) of certain solutions included in the draft law by the government with the aim of facilitating the more effective management of assets within the framework of the BAMC (e.g. the BAMC's privileged position in bankruptcy proceedings against debtors, the option of unilateral conversion of the BAMC's claims into equity in the debtor).
- **For the most part, the Bank of Slovenia's proposals and comments with regard to conceptual issues** (anchoring of decision-making on measures in the supervisory system, the Bank of Slovenia's central role in determining the financial position of a bank and in deciding on measures, government guarantees for banks in connection with the management of non-performing assets) **were not taken into account.**
- Based on extensive criticism of the law levelled against the government by international institutions, the Bank of Slovenia was an active participant in the drafting of secondary legislation following the law's adoption and entry into force, and within this framework was able to ensure its own increased role in decisions on restructuring measures and the approval of restructuring plans. The implementation of forcible measures exclusively on the basis of the Bank of Slovenia's supervisory measures was also ensured at the implementation level.

◆ **Improvements to supervisory measures (proposed amendments to the ZBan-1)**

In March 2012 the Bank of Slovenia drafted a proposal of comprehensive changes to the Banking Act aimed at **strengthening the Bank of Slovenia's powers of supervision** at banks, and thus improving the effectiveness of bank restructuring.

From the proposal submitted, the government merely excluded individual provisions on conditions for the recapitalisation of a bank in crisis conditions in connection with the conditions for issuing CoCo bonds, and forwarded this partial proposal to the National Assembly for adoption in a fast-track procedure (the law was published in June 2012).

The other proposed changes to the law, which **set out strengthened supervisory powers and measures**, were not discussed by the government until it was clear, in part based on the criticism levelled by international institutions, that the measures to stabilise the banks envisaged by the government in the ZUKSB must be anchored in the Bank of Slovenia's system of supervisory measures. These changes were only discussed by the government in late 2012, and were not adopted by the National Assembly until December 2012.

Result:

The changes to the ZBan-1 proposed by the Bank of Slovenia **were adopted for the most part**, with the following exceptions:

- rejected in part was the proposal regarding the introduction of an authorisation to serve as a member of a supervisory board, such that the law does not require prior authorisation but does allow the Bank of Slovenia to prohibit a person from performing the function of a supervisory board member, by way of a decision;

- **rejected in full** was the proposal regarding special arrangements for banks that would exclude certain rules of takeover legislation in connection with the acquisition of bank shares, as follows:
 - regarding the definition of a takeover threshold for a mandatory takeover bid for a bank's shares when the holder's holding in a bank's capital exceeds 50% (because regulations governing qualifying holdings apply to lower thresholds);
 - regarding compliance with rules for the calculation of the takeover threshold according to the rules applying to the calculation of qualifying holdings in banks (there is a different toolkit of instruments to be taken into account in the determination of the holding);
 - regarding special rules on sanctions for a holder who exceeds the mandatory takeover threshold, such that the holder may exercise its voting rights up to the amount of the takeover threshold, despite this being a breach of takeover legislation;
- **rejected in part** was the proposal regarding the permanent exclusion of the requirement for a mandatory takeover bid when an investor acquires a bank's shares in the restructuring process at the bank with the aim of ensuring the capital adequacy of the bank in question in accordance with the Bank of Slovenia's requirements, whereby the exclusion would only apply for two years after the acquisition of the shares in the bank (it was only under a later change to the ZPre-1 that this deadline was extended to five years for all cases of debtor restructuring).
- ♦ **General areas affecting banking operations and successful restructuring**
 - **Mergers and acquisitions legislation (amendments to the ZPre-1, amendments to the ZBan-1)**

In early 2011 the Bank of Slovenia put forward a proposal to the Ministry of the Economy for changes to mergers and acquisitions legislation that would allow the banks to covert claims into equity in debtors without additional requirements in connection with a mandatory takeover bid for the remaining shares, and would thus ease the conditions for the financial and operational restructuring of these debtors.

The Bank of Slovenia also highlighted the issue of the improper treatment of banks in the role of creditors when banks exceed the takeover threshold in a firm as a result of the transfer of ownership of collateral in the form of corporate securities (shares), and consequently lose all voting rights in the aforementioned firm, or are obliged to submit a takeover bid for the remaining shares in the firm.

Result:

- The Bank of Slovenia's proposals were partly taken into account in the amendments to the ZPre-1, with regard to the temporary exemption from the mandatory takeover bid in connection with the treatment of shares that a bank obtains as a result of the realisation of collateral.
- The Bank of Slovenia's proposals with regard to the special treatment of investors recapitalising a bank for recovery purposes were only taken into account within the framework of the amendments to the ZBan-1J (end of 2012), and then only in part, as the exemption for such cases (during the recapitalisation of a bank for recovery purposes) was only applied for a period of two years from the acquisition of the shares in the bank.
- It was not until the amendments to the Mergers and Acquisitions Act in mid-2013 (June 2013) that an exemption of this type (in the event of recapitalisation for the purposes of financial

restructuring) was also applied in connection with the recapitalisation and restructuring of other firms, while the deadline for exercising the exemption was extended to five years from acquisition.

Despite the entry into force of legislation that strengthened the Bank of Slovenia's powers of supervision and defined new supervisory measures (in particular when existing bank shareholders fail to provide the required capital, and the conditions for facilitating the involvement of new investors in bank recapitalisations are established by means of supervisory measures), the position of the banks continually deteriorated and the interest of potential investors vanished as a result of the growing lack of confidence in the Slovenian financial and economic model. **Owing to the continuing deterioration in the situation in the economy and Slovenia's rapid sovereign downgrading, the new supervisory measures following the entry into force of the legislation did not bring the desired effects (attempts at recapitalisation on the basis of the imposed measures, despite the easier conditions for new investors, were not successful).**

The amendments to the ZBan-1 and the ZPre-1 with regard to the conditions for restructuring debtors were welcomed, albeit too late for the majority of debtors. The general economic situation deteriorated rapidly, and the possibility of a successful conclusion to restructuring declined significantly for a large proportion of debtors.

- Insolvency legislation (ZFPPIPP)

Back in 2012 the Bank of Slovenia began to officially put forward proposals to change insolvency legislation with the aim of giving creditors greater influence over such proceedings, in particular restructuring processes, and simplifying these proceedings.

Result:

- A working group tasked with drafting legislative amendments was not formed until 2013. Owing to a lack of time and to difficulties in drafting and implementing entirely new insolvency legislation, a compromise solution was adopted, whereby urgent changes were made to the existing insolvency legislation.
- The Bank of Slovenia was an active participant in working groups tasked with drafting new legislation. The legislation (the ZFPPIPP) was amended at the end of 2013.
- The changes facilitated the essential requirements of the Bank of Slovenia: the arrangement of out-of-court proceedings for corporate restructuring, and a greater role and improved position for creditors in the compulsory composition of banks.
- By the first half of 2013 the Bank of Slovenia had also adjusted its regulatory framework to the forbearance of banks' claims against corporates, and allowed corporate restructuring plans to be taken into account in the assessment of risks associated with banks' claims.
- Given the finding that banks were not participating in the corporate restructuring process despite the introduction of the new insolvency legislation, the Bank of Slovenia also amended the risk management regulation in 2014 to require the active participation of banks in the corporate restructuring process.
- The aforementioned changes were supported by the Principles for the financial restructuring of banks, which were drafted in conjunction with the Bank Association of Slovenia.

◆ Act Governing the Taxation of the Total Assets of Banks

At the beginning of 2011, when the government presented a proposal to introduce a tax on the total assets of banks, the Bank of Slovenia took a position opposing the introduction of such a tax. It emphasised that it was not an appropriate measure to stimulate the supply of lending to the non-banking sector, and warned that the government would have to follow common policy regarding the implementation of such taxation and establish a framework comparable to those that exist or are being established in other Member States (particularly with regard to discussions on the implementation of a possible tax on financial transactions).

Result:

- Irrespective of this opposition to the introduction of the aforementioned tax, the government submitted the law to the National Assembly, where it was adopted and began to be applied on 1 August 2011.
- The law had no impact on the revival of lending, as the Bank of Slovenia had forecast.

◆ Act on Prevention of Late Payments (ZPreZP-1)

In March 2011 the National Assembly adopted a law to prevent arrears in payments. The measures enacted to eliminate payment indiscipline included payment deadlines, mandatory multilateral offsetting at the AJPES and, via an amendment adopted in July 2012, the enforcement draft, by which the debtor commits to paying a monetary amount to the creditor. The enforcement draft is also an enforcement order.

Result: In June 2012, before the adoption of the law, the Bank of Slovenia expressed serious reservations with regard to the enforcement draft. Its assessment was that the proposed instrument would not ensure better conditions for achieving greater payment discipline on the market, but could have numerous negative consequences for debtors in particular.

The Bank of Slovenia warned in a letter that it saw possibilities for improving payment discipline primarily in two areas:

- an improvement in the effectiveness of enforcement actions in connection with the assets that debtors hold at banks (proposed centralised implementation of enforcement orders relating to debtors' cash at banks, via a special institution for processing and executing such orders), and
- the establishment of a legal and corporate framework for the introduction of a special instrument for fast automated payments between firms according to direct debit rules (e.g. modelled on the bank offsetting known in Italy as *Ricevuta Bancaria* or *Ri. Ba.*).

The enforcement draft was enacted in law; despite proposals by the corporate sector (the Chamber of Commerce and Industry), it was not made mandatory in public procurement, and its effectiveness remained limited.²³ According to AJPES figures, there were EUR 1.2 million of outstanding liabilities from enforcement drafts in January 2015.

In light of the current knowledge and awareness of the situation, it can be assessed that the measures and other supervisory activities were insufficient to mitigate the impact of the abrupt freeze in the inflow of liquidity from the money markets in the rest of the world, which had an extremely negative effect on the pre-existing structural problems that had built up in the real sector over the decade of high economic growth. Although the monetary and supervisory functions under Bank of Slovenia control had together formed a reasonably robust system of liquid reserves that was comparable to that of other European countries, under the approaching introduction of the euro and the rules applied within the framework of monetary union it began

²³ Enforcement draft should be mandatory in public procurement (Source: <http://mediji.gzs.si/slo/58819>)

to gradually unravel. From the point of view of supervisory action and measures, perhaps there was insufficient consideration of the warning by the financial stability department about the banks' heavy dependence on borrowing in the rest of the world, which fuelled high credit growth. However, the possibilities for taking administrative restrictive measures during the period of convergence with the euro area were very limited.²⁴

Even in the pre-crisis period supervision was subject to frequent criticism, both from inside the banking system and from further afield, that compared with other regimes it was too conservative, particularly in the area of the creation of liquid reserves, capital reserves and impairments.

In the pre-crisis period, like the actual regulatory framework, the methodology of supervision, which had focused on individual risks, was also modified. Insufficient emphasis was given initially to the overall assessment of a bank's business model and long-term viability²⁵ in the context of a proper evaluation of the interaction between individual risks and elements and overall functioning.

Stress tests together with a preliminary asset quality review (AQR) were not used as a tool of comprehensive and enhanced supervision prior to 2013. Comprehensive assessments of this type (an AQR plus stress tests), and in addition the establishment of the first pillar of the banking union, namely the Single Supervisory Mechanism in euro area countries, have in recent years increasingly become the criterion for evaluating the requisite bank recapitalisations.

²⁴ Certain neighbouring non-EU countries passed regulations to administratively limit credit growth.

²⁵ The internal supervisory manual includes the evaluation of the materiality of a bank's individual business functions and an assessment of the bank's strategy.

4. RECOVERY OF BANKS (2013 and 2014)

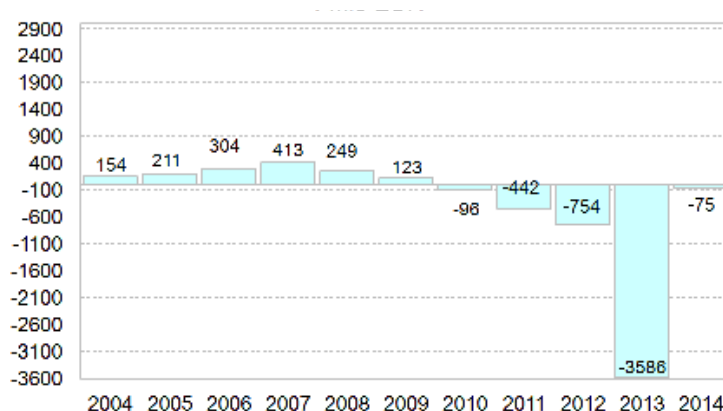
4.1 Requirement for comprehensive assessment of banks and assessment in 2013

The economic situation deteriorated in 2012, while external calls for urgent and immediate measures became louder.

Banking system in 2011 and 2012

- net losses generated in 2011 and 2012 in the amount of EUR 442 million and EUR 754 million respectively

Figure 40: After tax results of the banking system in EUR million



- net impairment and provisioning costs reached EUR 1,207 million in 2011 and EUR 1,599 million in 2012;
- the stock of loans to non-financial corporations fell by EUR 1.1 billion or 5.7% in 2011, and by EUR 1.9 billion or 10.2% in 2012;
- the banking system's return on equity was -12.54% in 2011 and -19.04% in 2012;
- the largest banks were downgraded.

In its document from October 2012, Financial System Stability Assessment (published in December 2012), the IMF highlighted the following points: the Slovenian financial sector was hit hard by the crisis; the banks are very vulnerable due to refinancing risk and the contraction in lending; the strengthening of the banks' financial position must be a short-term priority; and financial restructuring of the banks must be followed by privatisation. It also highlighted the urgent need to recapitalise banks under government ownership and to enhance the governance thereof.

System for supervising economic policies within the EU: The EU has adopted numerous new rules on economic governance. The purpose of the EU's economic governance framework is to detect, prevent and rectify problematic economic trends such as excessive government deficits and public debt, which could stunt or harm economic growth.

In 2010 the EU introduced the **European Semester**, an annual cycle aimed at harmonising economic policy. Every year the European Commission analyses in detail the plans of Member States regarding budgetary, macroeconomic and structural reforms, and issues recommendation for the next 12- to 18-month period.

In the scope of the **Macroeconomic Imbalances Procedure**, the Commission also publishes an Alert Mechanism Report. In the aforementioned report, the Commission determines which countries require an in-depth review (comprehensive analysis) with the aim of identifying possible macroeconomic imbalances and the features thereof. In-depth reviews are part of the processes of preventing and eliminating macroeconomic imbalances covered by the set of budgetary and economic rules known as the “Six-Pack”, which entered into force in December 2011.

The Macroeconomic Imbalance Procedure (MIP) is a surveillance mechanism aimed at the early detection of potential risks, the prevention of harmful macroeconomic imbalances and the elimination of imbalances that are already present in EU Member States. The MIP provides the European Commission and EU Council a mechanism for addressing the necessary recommendations to an affected Member State before imbalances become excessive.

If a Member State does not take action in accordance with the recommendations by a given deadline, the EU issues a warning. The EU may issue a warning with incentives or sanctions for major macroeconomic and budgetary imbalances.

Based on an in-depth review conducted **for Slovenia** and an assessment of Slovenian plans (National Reform Programme and Stability Programme), the European Commission presents its in-depth review and recommended measures that are adopted by the EU Council. The EU Council first adopted measures for Slovenia in 2011, and every year thereafter.²⁶

On 28 November 2012 the **European Commission**, pursuant to Regulation (EU) No 1176/2011, adopted an Alert Mechanism Report, in which it defined Slovenia as one of the Member States for which an in-depth review is required. For Slovenia it highlighted, the “fast accumulation of internal imbalances with a high increase in unit labour costs, private sector credit and house prices. The highly leveraged banking sector is under considerable strain as the economy is now in the early stages of a difficult deleveraging process.”

On 10 April 2013 the European Commission published the results of the in-depth review for Slovenia (Macroeconomic Imbalances Slovenia 2013) with the finding that excessive macroeconomic imbalances exist in Slovenia.

Its call to conduct an asset quality review (AQR) and stress tests stated the following on page 39 of the report: “*A new third-party asset quality review and a new thorough stress test are needed to quantify the challenges and ensure that the strategy, the overall fiscal envelope and the selection of tools are appropriate. These assessments would ideally be conducted by internationally recognised consultants under the guidance of a steering committee comprising the relevant international financial institutions and the Slovenian authorities. The asset quality review and stress test should cover the entire banking system (with the systemically relevant banks constituting an absolute minimum) and would inform a system-wide viability assessment.*”

Slovenia submitted its National Reform Programme 2013-2014 and its Stability Programme 2012-2016 to Brussels on 9 May 2013. In the latter, the Slovenian government reported that Slovenia had adopted the Government Measures to Strengthen the Stability of Banks Act (ZUKSB), under which the Bank Assets Management Company (BAMC) was established as “an institutional platform for the recovery of banks”. In the scope of the aforementioned programme, the government also presented in

²⁶Council recommendation of 12 July 2011 on the National Reform Programme 2011 of Slovenia and delivering a Council opinion on the updated Stability Programme of Slovenia, 2011-2014, Council recommendation of 10 July 2012 on the National Reform Programme 2012 of Slovenia and delivering a Council opinion on the updated Stability Programme of Slovenia, 2012-2015, Council recommendation of 9 July 2013 on the National Reform Programme 2013 of Slovenia and delivering a Council opinion on the updated Stability Programme of Slovenia, 2012-2016 and Council recommendation of 8 July 2014 on the National Reform Programme 2014 of Slovenia and delivering a Council opinion on Stability Programme of Slovenia, 2014.

detail a plan for the transfer of the non-performing claims of the three largest banks to the BAMC, based on the stress tests performed by the Bank of Slovenia according to the bottom-up approach.²⁷

Government Measures to Strengthen the Stability of Banks Act (ZUKSB) The ZUKSB was adopted by the National Assembly on 23 October 2012 to strengthen the stability of banks with the aim of maintaining the stability of the financial system in Slovenia. The aforementioned act stated that bank recovery activities would be carried out via the BAMC.

The ZUKSB laid down possible measures that could be adopted by the Slovenian government with the aim of strengthening banks. They include:

- **the purchase or acquisition against payment of the assets of a bank** (transfer to the BAMC);
- **government guarantees to enhance bank stability** (for the liabilities assumed by the BAMC; for the liabilities of a special purpose entity established by banks or the BAMC for the purpose of assuming risks; and for the liabilities of banks from borrowing at the Bank of Slovenia arising from measures to provide the requisite liquidity of banks as a last resort);
- **an increase in the share capital of banks** and the payment of other capital instruments issued by a bank that in accordance with the law governing banking are taken into account in the calculation of the bank's original own funds.

Factor banka and Probanka. The first measures under the ZUKSB were implemented at Factor banka and Probanka on 6 September 2013. Based on the proposal of the interdepartmental committee, the government discussed the Bank of Slovenia's initiative to implement two measures. Under the first measure, the Slovenian government issued a guarantee to ensure the liquidity and solvency of Factor banka and Probanka. Under the second measure, the Bank of Slovenia initiated the orderly wind-down process at both banks on 6 September 2013, as they were no longer able to survive on the market over the long term.

During this time, particularly during the first half of 2013, public speculation (also among those making daily policy decisions) that Slovenia would request an **international financial assistance** strengthened and echoed internationally. The social "mood" was evident from newspaper headlines.

With regard to Slovenia's National Reform Programme 2013-2014 and its Stability Programme, the EU Council issued Council recommendation of 9 July 2013 on the National Reform Programme 2013 for Slovenia and delivering a Council opinion on the Stability Programme of Slovenia, 2012-2016, in which it recommended that Slovenia take the following action in the period 2013-2014 (recommendation no. 4):

- **take the necessary steps, with input from European partners, to contract an independent external adviser to conduct a system-wide asset quality review;**
- **to complete this exercise in 2013, with faster progress in the cases of the two banks already been subject to the State aid procedure; and**

²⁷The Bank of Slovenia has performed stress tests for Slovenian banks in accordance with EU practices for 10 years. In addition to macro tests according to the top-down approach, it also performs micro tests according to the bottom-up approach, which it uses to test the sensitivity of the banks to selected shocks. Under the adverse scenario, the tests performed according to the bottom-up approach for the period 2013 to 2014 (a preliminary AQR was not performed) indicated a shortfall in Core Tier 1 capital at the end of 2014 in the amount of EUR 2,403 million.

- **to provide additional capital should the asset transfer or the asset quality review reveal additional shortfalls.**

The ECB issued the following requirement to perform an asset quality review (AQR) and bottom-up stress tests by independent external contractor: **“The ECB insists on the need for a rigorous and credible system-wide AQR and comprehensive bottom-up stress tests.”**

The decision on state aid²⁸ from December 2013 also states (in reference to the past): “Slovenia had to carry out a bottom-up and top-down stress test and asset quality review of the Slovenian banking sector which was conducted by independent consultants.”

As a result and in the scope of competences as banking supervisor, the Bank of Slovenia embarked on the aforementioned asset quality review and stress tests in July 2013 in cooperation with the Ministry of Finance.

The Governing Board of the Bank of Slovenia discussed and approved the scope, number of banks included, contractors, the allocation of costs, disclosure method and timetable at its session of 30 July 2013.

Stress tests have been used by supervisory authorities for a number of years as one of the tools used to assess the capital soundness of a specific institution should certain adverse macroeconomic circumstances emerge. With the outbreak of the recent financial crisis and under the heavy influence of trends and requirements from the US (and IMF), stress tests together, with a preliminary asset quality review (AQR), are being used increasingly as a criterion for assessing the required recapitalisations of banks in the EU/euro area, as well.

Within the EU, the Committee of European Banking Supervisors (CEBS) began the practice of periodic EU-wide stress tests back in 2009, which was followed in subsequent years (from 2010 on) by its successor, the European Banking Authority (EBA). Systemically important EU banks (including Slovenian banks) were included in the aforementioned stress tests, which required the coverage of a representative portion of the European and national banking market. The stress tests performed by the EBA in cooperation with the ECB and national supervisory authorities were carried out all of those years in accordance with a standard methodology, limitations and assumptions.

Stress tests are performed according to the bottom-up approach, always include two macroeconomic scenarios (a baseline scenario and an adverse scenario) and cover a multi-year time horizon (initially a two-year time horizon, followed by a three-year time horizon since 2013). EU-wide stress tests always focus on an assessment of specific risks associated with the solvency of banks. The most significant risks include credit, market, country and securitisation risks, and risks associated with a rise in funding costs.

Due to doubts as to whether the assessment of credit portfolios is realistic, an asset quality review (AQR) was added to stress tests in recent years (since 2012). As a result, reviews of all banking systems in countries where major macroeconomic imbalances were identified in the past (Portugal, Spain, Greece, Ireland, Slovenia and Cyprus) were carried out in the form of so-called comprehensive assessments. The comprehensive assessment of a banking system thus includes an asset quality review (AQR), and bottom-up stress tests.

In an AQR, an independent contractor assesses the adequacy of the classification of a bank’s claims, the adequacy of the valuation of collateral and thus the adequacy of the creation of impairments and provisions, which could result in a requirement to create additional impairments and provisions, which in turn reduces a bank’s capital.

²⁸ europa.eu/rapid/press-release_IP-13-1276_en.doc

Based on a portfolio appropriately assessed as such (as the result of an AQR), stress tests are performed. The latter reveal the actual surplus/shortfall in capital that a bank would generate if an individual scenario (baseline or adverse) is realised. The capital shortfall that a bank would incur under the adverse scenario and during the final year of the time horizon of stress tests always serves as the basis for assessing the need for recapitalisation.

The ECB joined the aforementioned practice of performing comprehensive assessments of banking systems in 2014. The ECB's aim prior to assuming direct supervision over systemically important banks on 4 November 2014 was to verify the quality of the comprehensive assessment process. It therefore carried out a comprehensive assessment that included an AQR, stress tests and the join-up of results.

Alongside the three systemically important banks (NLB, NKBM and Abanka), the exercise as a whole also covered seven other banks on the basis of the predetermined criteria. Those banks were: **Gorenjska banka, Banka Celje, UniCredit Banka Slovenije, Hypo Alpe Adria Bank, Raiffeisen bank, Probanka and Factor banka.** The last two were only involved to a limited extent, in line with their orderly wind-down processes.

The Bank of Slovenia hired Oliver Wyman to perform the stress tests according to the bottom-up approach, Deloitte and Ernst & Young for the AQR, Roland Berger to perform stress tests according to the top-down approach, and several independent appraisers for real estate valuations. By hiring specialised independent external institutions, the Bank of Slovenia ensured an independent review and objective assessment of the capital shortfall in accordance with the requirements of the European Commission and Council.

A decision was adopted whereby the Bank of Slovenia would cover the costs of stress tests for all 10 banks included in the exercise, and the costs of an AQR for banks that did not request aid in accordance with the ZUKSB. The three banks that requested aid under the ZUKSB bore the costs of the AQR themselves.

Terms of reference setting out the scope and work method for individual parts of the exercise were coordinated and agreed for all areas included in the exercise (bottom-up stress tests, the AQR, real estate valuation and the top-down challenge). The terms of reference are also an integral part of contracts with the individual consultants.

Difference between the bottom-up and top-down challenge. Stress tests under the top-down approach are less precise, as they are performed on more aggregated data than the banks themselves report. The bottom-up approach is based on more detailed data for each specific bank, while an assessment includes a broader range of a bank's assets and is adapted more closely to the risks specific to an individual bank. International practice dictates that stress tests be performed according to the bottom-up approach if they serve as the basis for assessing additional capital requirements. This applies to the comprehensive assessment carried out by the ECB, the EBA's stress test methodology and internal stress tests by the Bank of Slovenia.

Bottom-up stress tests include the following three main elements:

- **an estimate of expected losses, which includes:** losses from performing and non-performing claims and from restructured claims in various portfolios subject to observation, and losses from investments in securities (treasury assets/financial assets);
- **an estimate of a bank's loss absorption capacity,** which includes: the stock of impairments and provisions for the observed portfolio as at the end of 2012, a bank's profit prior to the creation of impairments and provisions in the period 2013 to 2015, and the surplus of capital over the

minimum Core Tier 1 requirements of 9% and 6% (according to the baseline scenario and/or adverse scenario); and

- **an estimate of the expected capital shortfall/surplus under the baseline and adverse scenarios**, which is equal to the surplus/shortfall of expected losses over the expected absorption capacity.

The comprehensive assessment was coordinated and supervised by a steering committee comprising the Bank of Slovenia, the Ministry of Finance, the European Commission (DG Comp and DG FIN), the European Central Bank (ECB) and the European Banking Authority (EBA). The stress test methodology was defined by the ECB and EBA²⁹.

The subject of the AQR was the verification of data completeness and integrity, a review of individual loans, collateral valuation and the identification of impairment shortfalls. The results of the AQR also served as the basis for bottom-up stress tests. The aim of the stress tests was to assess the capital shortfall/surplus of individual banks in the baseline and adverse scenarios for a three-year projection period (2013-2015). Assumptions used in the scenarios were defined:

- based on the European Commission's spring forecast of macroeconomic developments, revised downwards on the basis of macroeconomic figures for the first quarter of 2013, for the baseline scenarios; and
- by the ECB/European Systemic Risk Board (ESRB) for the adverse scenario.

Figure 41: Macroeconomic scenarios

Makroekonomska scenarija	Dejanski	Osnovni scenarij				Neugodni scenarij		
Letna stopnja rasti (%)	2012	2013	2014	2015		2013	2014	2015
<i>Napovedi EK/ECB</i>								
BDP	-2,3	-2,7	-1,5	0,1		-3,1	-3,8	-2,9
Zasebna potrošnja	-2,9	-4,8	-3,5	-1,2		-5,3	-7,7	-6,5
Bruto investicije	-9,3	-6,0	-2,7	1,0		-8,1	-13,1	-3,6
Prispevek neto izvoza k rasti BDP	3,3	2,6	1,4	1,0		2,9	1,1	1,3
Zaposlenost	-1,3	-2,6	-1,4	-0,3		-2,7	-2,5	-1,8
Brezposelnost (v % delovne sile)	8,9	11,3	11,5	11,5		11,4	12,6	14,0
EURIBOR (3m, v bazičnih točkah)	57	25	50	79		58	156	222
Zahtevana donosnost 10-letne državne obveznice (v b.t.)	581	602	682	702		638	820	845
HICP	2,8	1,9	1,4	1,5		1,8	1,5	1,9
Cene stanovanjskih nepremičnin	-8,2	-9,6	-4,3	-2,4		-11,0	-12,2	-7,1
Tekoči račun plačilne bilance (v % BDP)	2,7	5,0	5,4	6,0		5,3	7,2	6,1
Javni dolg (v % BDP)	54,1	64,1	66,2	69,6		64,7	71,5	84,4
<i>Napovedi Banke Slovenije</i>								
Bruto posojila zasebnemu nebančnemu sektorju	-5,1	-7,2	-3,8	-1,9		-7,5	-6,5	-5,4
Deposits volume (private non-banking sector, YoY growth rates)	-1,3	1,0	0,8	0,8		0,6	-0,5	-0,6

Macroeconomic scenarios	Actual	Baseline scenario			Adverse scenario		
Annual growth, %	2012	2013	2014	2015	2013	2014	2015
<i>EC/ECB forecasts</i>							
GDP	-2.3	-2.7	-1.5	0.1	-3.1	-3.8	-2.9
Private consumption	-2.9	-4.8	-3.5	-1.2	-5.3	-7.7	-6.5
Gross investment	-9.3	-6.0	-2.7	1.0	-8.1	-13.1	-3.6
Contribution of net trade to GDP	3.3	2.6	1.4	1.0	2.9	1.1	1.3

²⁹Full report on the comprehensive review of the banking system (<http://www.bsi.si/en/banking-supervision.asp?MapaId=1601>).

growth							
Employment	-1.3	-2.6	-1.4	-0.3	-2.7	-2.5	-1.8
Unemployment (as % of workforce)	8.9	11.3	11.5	11.5	11.4	12.6	14.0
3m-EURIBOR, basis points	57	25	50	79	58	156	222
Required yield on 10-year government bonds, basis points	581	602	682	702	638	820	845
HICP	2.8	1.9	1.4	1.5	1.8	1.5	1.9
Residential real estate prices	-8.2	-9.6	-4.3	-2.4	-11.0	-12.2	-7.1
Current account, as % GDP	2.7	5.0	5.4	6.0	5.3	7.2	6.1
Public debt, as % GDP	54.1	64.1	66.2	69.6	64.7	71.5	84.4
Bank of Slovenia forecasts							
Gross loans to private banking sector	-5.1	-7.2	-3.8	-1.9	-7.5	-6.5	-5.4
Stock of deposits (private non- banking sector), year-on-year growth)	-1.3	1.0	0.8	0.8	0.6	-0.5	-0.5

Source: Report on comprehensive review of the banking system and associated measures, www.bsi.si

The **results of the tests, which the government and Bank of Slovenia presented on 12 December 2013**, indicated a potential shortfall in the capital of the banking system (for the eight banks included in the assessment) at the end of the three-year time horizon (end of 2015) of:

- between **EUR 2,725 million** (according to the top-down approach) and **EUR 4,046 million** (according to the bottom-up approach) under the baseline scenario and a requirement of a Core Tier 1 capital ratio of 9%; and
- between **EUR 3,280 million** (according to the top-down approach) and **EUR 4,779 million** (according to the bottom-up approach) under the adverse scenario and a requirement of a Core Tier 1 capital ratio of 6%.

Based on the identified potential shortfall under the adverse scenario in the amount of EUR 4,779 million, the government and Bank of Slovenia reported back on 12 December 2013 that EUR 3.012 billion would be required for the recapitalisation of NLB, NKBM and Abanka, and that the Slovenian government would provide the necessary funds, two thirds in the form of cash and one third in the form of marketable government securities.

Figure 42: Results of tests: Identified capital shortfall by bank

Banka	Kapitalski primanjkljaj po neugodnem (adverse) scenariju (v mio €)
NLB	1.904
NKBM	1.055
Abanka	756
Banka Celje	388
Gorenjska banka	328
Hypo Alpe Adria banka	221
Raiffeisen banka	113
Unicredit Slovenija	14
Skupaj	4.779

Bank	Capital shortfall under the adverse scenario, EUR million
NLB	1,904
NKBM	1,055
Abanka	756
Banka Celje	388
Gorenjska banka	328
Hypo Alpe-Adria-Bank	221
Raiffeisen banka	113
UniCredit Banka Slovenija	14
Total	4,779

4.1.1 EU rules on state aid

Five banks (NLB, NKBM, Abanka, Probanka and Factor banka) had requested state aid prior to the completion of the comprehensive assessment (i.e. before they were briefed on the results of the AQR), three to ensure stability (NLB, NKBM and Abanka) and two for orderly wind-down procedures (Probanka and Factor banka). Based on a proposal from the interdepartmental committee and in accordance with the ZUKSB, the Slovenian government adopted a decision on the eligibility of the aforementioned banks for state aid and on additional conditions for their recapitalisation (transfer of non-performing assets to the BAMC). The resolution of the banks in question (and subsequently Banka Celje) was based on an assessment of the systemic importance of each individual bank.

With regard to state aid to banks, the extent of state aid must be sufficient to facilitate the recovery and restructuring of a bank in a specific period. With respect to valid risk assessment standards for financial institutions, the level of risk associated with an individual institution is assessed on the international financial markets, particularly following the outbreak of the crisis, based on that institution's ability to cover losses in the event of adverse economic trends. A conservative assessment of capital requirements that derives from stress tests based on the adverse scenario is thus applied as the standard for determining the level of capital required by the banks to ensure their long-term resilience.

In the scope of its assessment of state aid to three banks (NLB, NKBM and Abanka), the European Commission assessed the required level of recapitalisation based on the envisaged restructuring plan of an individual bank and the capital requirements of that bank in the adverse economic conditions set out in the adverse scenario applied in the stress tests. In terms of the recapitalisation of the three aforementioned banks in the scope of state aid aimed at ensuring their successful restructuring and its withdrawal from their ownership structure by a specific deadline, the government had to ensure

recapitalisation in an amount equal to the assessed capital shortfall, taking into account the adverse scenario applied in the stress tests.

Pursuant to the Treaty on the functioning of the EU, the European Commission has exclusive jurisdiction and broad discretion, in terms of the allocation of state aid, for determining which circumstances constitute unauthorised forms of state aid and what constitutes disproportionate interference in competition on the single market. With regard to state aid, the European Commission issued communications that, in some form, represent the exercising of the aforementioned discretion by the Commission in assessing the compliance of state aid, whereby the Commission defines in advance the criteria by which it will assess some specific conduct or circumstances relating to state aid. In exercising its discretion, the European Commission must take into account the communications it has issued in a specific area.

New Commission communications regarding support measures in favour of banks in the context of the financial crisis have been in force since 1 August 2013. The European Commission specifies an appropriate sharing of the burden of securing capital for a bank between the state on the one side and shareholders and the holders of subordinated claims on the other as an important criterion for the permissibility of the use of public funds for the resolution of banks in distress.

In order to receive a positive decision from the European Commission on the compliance of state aid (in the form of recapitalisation and the transfer of assets to the BAMC), the Slovenian government had to establish a legal framework that facilitated the fulfilment of the aforementioned conditions. The rules that facilitated the sharing of the burden entered into force with the Banking Act (ZBan-1L, adopted on 14 November 2013), through the implementation of an emergency measure terminating and/or converting a bank's qualified liabilities. Such a measure is imposed on a bank by the Bank of Slovenia with the aim of ensuring that owners and the holders of subordinated instruments contribute to covering a capital shortfall.³⁰

4.1.2 Recapitalisation through extraordinary measures of the Bank of Slovenia of 18 December 2013

Based on the AQR, a negative balance of capital was identified due to the additional impairments that all five banks (NLB, NKBM, Abanka, Factor banka and Probanka) were required to create. Failure to recapitalise the banks (to such an extent that would cover the aforementioned negative balance of capital and ensure that the banks achieve the minimum required capital adequacy) would be followed by the initiation of bankruptcy proceedings against the banks and the associated requirement to repay guaranteed deposits.

In accordance with the ZBan-1 and taking into account the conditions for state-funded recapitalisation, the Bank of Slovenia adopted **decisions** ³¹ **on 18 December 2013** imposing the following extraordinary measures on five banks:

- the termination of qualified liabilities (equity and subordinated liabilities of the aforementioned banks); and
- the recapitalisation of the banks in question in the form of state aid to cover outstanding losses and ensure capital adequacy.

In the scope of the decision-making process regarding state aid to banks, the Slovenian government complied with the European Commission's requirements and informed the Bank of Slovenia about the

³⁰Article 261a (Measure terminating or converting qualified obligations of a bank).

³¹The decisions can be found on the website www.bsi.si.

conditions for state-funded recapitalisation (the transfer price for assets transferred to the BAMC, the amount of recapitalisation and thus the contribution of shareholders and the holders of subordinated capital instruments). **In order for the Bank of Slovenia to prevent the bankruptcy of the banks and ensure the stability of the financial system, the Bank of Slovenia was forced to ensure the conditions for successful recapitalisation (there were no alternative recapitalisation measures involving private investors) within the limits of its authorisations set out in the ZBan-1.**

The government recapitalised five banks on 18 December 2013, when the European Commission issued decisions on state aid for five Slovenian banks (NLB, NKBM, Abanka, Factor banka and Probanka). A positive opinion from the European Commission was a precondition to begin implementing measures to strengthen the stability of banks. At the same time agreements were signed between the BAMC and NLB and NKBM on the transfer of non-performing claims to the BAMC.

The Slovenian government provided for the following based on decisions regarding extraordinary measures at specific banks of 18 December 2013:

- NLB: recapitalisation in the amount of EUR 1,551 million, comprising EUR 1,141 million in cash and EUR 410 million in Slovenian government bonds;
- NKBM: recapitalisation in the amount of EUR 870 million, comprising EUR 620 million in cash and EUR 250 million in Slovenian government bonds;
- Abanka: recapitalisation in the amount of EUR 348 million in cash;
- Probanka: recapitalisation in the amount of EUR 176 million, comprising EUR 160 million in cash and EUR 16 million in Slovenian government bonds; and
- Factor banka: recapitalisation in the amount of EUR 269 million, comprising EUR 160 million in cash and EUR 109 million in Slovenian government bonds.

Course of decisions on extraordinary measures

The condition for the state-funded recapitalisation of the banks is prior authorisation from the European Commission for state aid from the Slovenian government.

Course of events:

1. On **16 December 2013** the Bank of Slovenia received email notification from the Ministry of Finance that the European Commission was expected to issue a decision on state aid by 10 am on 18 December 2013.
2. Based on the receipt of the aforementioned information, a meeting of the Governing Board of the Bank of Slovenia was held on **17 December 2013** at which time the content of decisions on extraordinary measures and the text of statements on the subscription and paying up of new shares were confirmed. At that time the Bank of Slovenia already had at its disposal all necessary information to issue decisions, including information that state aid would be approved by the European Commission on 18 December 2013. The decisions were signed by the Governor.
3. At 10.38 am on **18 December 2013** the Bank of Slovenia received email notification from the Ministry of Finance that the European Commission had issued decisions authorising state aid, which were published on the latter's website.

4. Based on the Ministry of Finance's notification, the Bank of Slovenia dispatched and delivered decisions regarding extraordinary measures to the banks and the Ministry of Finance that very same day, i.e. **18. December 2013**. If the European Commission had refused to issue authorisation, the decisions on extraordinary measures would not have been dispatched. Based on such circumstances, the Governing Board of the Bank of Slovenia would have been forced to make a new decision on the revocation of authorisation and the initiation of bankruptcy proceedings against the banks. If the European Commission had not issued its decision on 18 December 2013 but at a later date, the Bank of Slovenia's decisions would not have been dispatched until the European Commission's decisions had been received.

5. Following the delivery of the decisions on extraordinary measures to the banks and the Ministry of Finance, the latter signed statements on the subscription and paying up of shares, and executed the payment of cash and the transfer of Slovenian government bonds (as a non-cash contribution to increase the banks' share capital). Following the execution of payments, a new meeting of the Governing Board of the Bank of Slovenia was held on the same day, **18 December 2013**, where the increase in the banks' share capital and the relevant changes to their articles of association were confirmed. The Governing Board also ordered the entry of the decrease and subsequent increase in the banks' share capital in the companies register. Due to the work-related absence of the Governor of the Bank of Slovenia, the decisions confirming the increase in share capital were signed by the Vice Governor of the Bank of Slovenia with the requisite authorisation. Following the entry of the increase in share capital in the companies register, the Governing Board of the Bank of Slovenia issued a decision at a new meeting held on the same day to suspend extraordinary measures at three banks (decisions suspending extraordinary measures at NLB, NKBM and Abanka Vipava) and leave in place extraordinary measures at Probanka and Factor banka until the completion of orderly wind-down of both banks.

Given the course of events, it was extremely important that individual decisions were issued in a timely manner and delivered in such a way that all activities relating to the extraordinary measures could be implemented the same day. Due to the Bank of Slovenia's involvement in the procedure of state aid to the banks (NLB, NKBM and Abanka) which was carried out by the European Commission, the Governing Board of the Bank of Slovenia had already been informed that the European Commission would issue positive decisions on state aid on 18 December 2013 at the time it made its decisions. Because the extraordinary measures could be implemented on the same day of the European Commission's decision, the delivery of decisions on extraordinary measures and the payment of state funds could not be executed until 18 December 2013.

The drafting of decisions for delivery to the banks also requires technical preparations. The Governing Board of the Bank of Slovenia therefore made the relevant decisions at its meeting of 17 December 2013 in order to ensure the conditions for the drafting of decisions, their delivery to the banks and the implementation of measures on 18 December 2013.

Due to the high degree of uncertainty and mistrust among depositors with respect to the success of the recovery of the banks, the Bank of Slovenia assessed that it was urgent to carry out all activities quickly and in a coordinated manner, and thus create the conditions for the normal operations of the banks. Owing to the effects of the extraordinary measures on the business processes of the banks (including the suspension of the authorisation of the supervisory board and general meeting for the duration of the extraordinary measures), it was urgent that the extraordinary measures be implemented and completed in the shortest possible time (i.e. the same day) and thus ensure the conditions for the normal operations of the banks with clients.

The transfer of the assets of five banks to the BAMC was part of the bank recovery measures. That transfer was made on the basis of an agreement concluded between an individual bank and the BAMC. The conditions and transfer price for the aforementioned assets were confirmed by the European Commission, as such a transfer represents a part of the comprehensive state aid measures at a specific bank. The transfer price was set above the assessed market value and, to that extent (the

mark-up over the market price), represented state aid to the bank in question. The European Commission set the final price at which the assets were transferred to the BAMC, taking into account the assessed market value of the aforementioned assets with an additional mark-up in an amount that still justified permissible state aid to the banks.

The effect that the transfer of the banks' assets to the BAMC had on the calculation of their capital (the disposal of assets at the transfer value in exchange for BAMC bonds) was taken into account in the assessment of capital requirements as part of the extraordinary measure on the recapitalisation of the banks.

In accordance with valid legislation (the new ZBan-1L), the Bank of Slovenia had to obtain an assessment from an independent appraiser (**appraisal of the liquidation valuation of the banks' assets**) with respect to extraordinary measures relating to the contribution of shareholders and the holders of subordinated capital instruments. That appraisal indicates the expected amount of payment for such instruments from the sale of a bank's assets in bankruptcy proceedings (assuming that the bank in question is not a going concern) with regard to the order of repayment of claims in bankruptcy proceedings and taking into account other associated rules applied in the bankruptcy of a bank. In the event of extraordinary measures, a bank's creditors are entitled to compensation in the form of the bank's shares (as the result of conversion) only to the extent that their claims would be repaid in bankruptcy proceedings against the bank.

If the value of a bank's assets, taking into account liquidation valuations, would not suffice to repay all of the bank's liabilities to ordinary creditors (depositors), the value of the bank's subordinated liabilities is understood to be equal to zero and the conversion of such liabilities is not possible. Subordinated liabilities in such cases are terminated. The liabilities arising from capital instruments and subordinated debt were therefore terminated at the five banks (and subsequently at Banka Celje).

Deloitte and Ernst & Young performed the liquidation valuations. Liquidation valuations indicated that bankruptcy proceedings would result in a negative balance of capital at all banks, which was also evident from the published decisions of the Bank of Slovenia on extraordinary measures. Those amount were as follows:

- between **-EUR 735.8 million and -EUR 1,559.6 million** at NLB,
- between **-EUR 232 million and -EUR 732 million** at NKBM,
- between **-EUR 317.8 million and -EUR 768 million*** (* correction from the originally stated erroneous amount of -EUR 450 million) at Abanka,
- in the amount of **-EUR 283.3 million** at Factor banka,
- in the amount of **-EUR 214.2 million** at Probanka, and
- (- in the amount of **-EUR 197 million** at Banka Celje in connection with extraordinary measures implemented on 16 December 2014).

The negative balance of capital identified in the event of the banks' bankruptcy (liquidation value) means that subordinated liabilities would not be repaid, even partially, from the liquidation of the bankruptcy estate and taking into account the rules on the settlement of a bank's liabilities to creditors. Given the assessed negative balance of capital in the event of the banks' bankruptcy, it is possible to conclude that even ordinary claims, which are repaid prior to subordinated claims during bankruptcy, would not be repaid in full.

Illustration of the effects of extraordinary measures at six banks

The table below illustrates the planned changes in the capital of the banks in question based on available data from the Bank of Slovenia prior to the implementation of extraordinary measures at

those banks, taking into account the findings of the independent AQR. The calculation/assessment was drawn up on the basis of available data in columns that read from left to right.

Column 2 illustrates capital before the additional asset revaluations/impairments identified in the AQR are taken into account.

Column 4 illustrates capital after the additional impairments identified in the AQR are taken into account. The data in this column illustrates the capital shortfall at all banks (i.e. a bank's assets are not sufficient for the settlement of its liabilities to creditors), which represents a reason for bankruptcy, and the recalculation to liquidation values in the event of bankruptcy.

Column 5 illustrates the shortfall in the banks' assets during bankruptcy. The recalculation of the value of the banks' assets to the liquidation value in the event of bankruptcy indicates an even larger shortfall (than in column 4), as the value of the banks' assets in the bankruptcy estate is not even sufficient for the repayment of all liabilities to ordinary creditors. This means that liabilities to the holders of subordinated instruments, which can only repaid after the full repayment of liabilities to the holders of priority and ordinary claims, would not be repaid, even in part. A bank's shareholders are not repaid until the priority, ordinary and subordinated claims of creditors are repaid in full.

The contractual value of a bank's subordinated liabilities are shown in column 7.

The capital shortfall identified in column 4 is reduced with the termination of subordinated liabilities.

The new shortfall (following the termination of subordinated liabilities in full) is shown in column 8.

That (new) shortfall is actually covered by the recapitalisation shown in column 9.

The amount of the recapitalisation shown in column 9 was determined on the basis of stress tests, in which the expected losses of a bank were assessed and the bank's capacity to cover expected losses in normal and adverse operating conditions was determined. The assessed amount of recapitalisation derives from the assumption that a banking group will achieve a Core Tier 1 capital ratio of at least 6% at the end of 2015 in adverse conditions.

Data for Probanka and Factor banka are shown in a separate table, as the implementation of extraordinary measures at the two banks began on 6 September 2013 with the appointment of special administration after it was determined that the banks were illiquid.

Podatki o kapitalu bank (NKBM, Abanke Vipa, NLB in Banke Celje) pred in po izvršenem izrednem ukrepu Banke Slovenije, izhajajoč iz odločb

v tEUR									
Banke	Kapital po stanju na dan 30. 9. 2013 pred knjiženjem oslabitev	Dodatno potrebne oslabitve, ugotovljene v AQR po stanju na dan 30. 9. 2013	Kapital po stanju na dan 30. 9. 2013, upošteva oslabitve po AQR (pred odpisom podrejenih obveznosti)	Kapitalski primanjkljaj v primeru stečaja (izhajajoč iz likvidacijskih vrednosti sredstev)	Nominalna vred. podrejenih instrumentov brez obresti (iz odločbe)	Učinek na kapital ob odpisu podrejenih instrum., upošteva obresti do datuma izbrisa	Kapital po izvršenem bail-in in pred dokapitalizacijo	Znesek dokapitalizacije	Stanje kapitala po dokapitaliz.
1	2	3	4 (= 2 - 3)	5	6	7	8 (= 4 + 7)	9	10 (= 8 + 9)
Nova KBM	258.819	325.889	-67.070	-732.000	55.838	57.111	-9.960	870.000	860.041
Abanka Vipa	131.108	396.324	-265.216	-768.000	120.000	120.000	-145.216	348.000	202.784
NLB	834.624	1.152.599	-317.975	-1.559.613	250.019	257.379	-60.597	1.551.000	1.490.404
SKUPAJ	1.224.551	1.874.812	-650.261	-3.059.613	425.857	434.489	-215.772	2.769.000	2.553.228
Banka Celje	161.391	213.566	-52.175	-197.000	92.020	96.078	43.903	190.000	233.903
SKUPAJ	1.385.942	2.088.378	-702.436	-3.256.613	517.877	530.567	-171.869	2.959.000	2.787.131

Data regarding the capital of banks (NKBM, Abanka Vipa, NLB and Banka Celje) before and after the implementation of extraordinary measures set out in Bank of Slovenia decisions

EUR

thousand

Bank	Capital as 30 September 2013 prior to the booking of impairments	Additional required impairments, identified in the AQR, as at 30 September 2013	Capital as at 30 September 2013 taking into account impairments from the AQR (prior to the write-off of subordinated)	Capital shortfall in the event of bankruptcy (based on the liquidation value of assets)	Nominal value of subordinated instruments, excluding interest (from decisions)	Effect of the write-off of subordinated instruments on capital, including interest until the write-off date	Capital following the bail-in and prior to recapitalisation	Amount of recapitalisation	Balance of capital following recapitalisation
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			liabilities)						
1	2	3	4 (= 2 - 3)	5	6	7	8 (= 4 + 7)	9	10 (= 8 + 9)
Nova KBM	258,819	325,889	-67,070	732,000	55,838	57,111	-9,960	870,000	860,041
Abanka Vipava	131,108	396,324	265,216	768,000	120,000	120,000	-145,216	348,000	202,784
NLB	834,624	1,152,599	317,975	1,559,613	250,019	257,379	-60,597	1,551,000	1,490,404
Total	1,224,551	1,874,812	650,261	3,059,613	425,857	434,489	-215,772	2,769,000	2,553,228
Banka Celje	161,391	213,556	-52,175	197,000	92,020	96,078	43,903	190,000	233,903
Total	1,385,942	2,088,378	702,436	3,256,613	517,877	530,567	-171,869	2,959,000	2,787,131

Opombe:

Stolpec 2: Znesek pri NKBM sestoji iz stanja kapitala v računovodskih izkazih v višini 245.679 tEUR in pozitivnega učinka iz predčasnega odkupa dela podrejenih obveznosti v znesku 13.140 tEUR (zaradi nižje odkupne vrednosti).

Pri Banki Celje znesek kapitala predstavlja izračun kapitala pred upoštevanjem poslovnega izida banke za poslovno leto 2013, v katerem so bile knjižene oslabitve po AQR.

Stolpec 3: Znesek pri Banki Celje 3 vključuje samo izgubo iz leta 2013 (126.257 tEUR), povečano za učinke iz prevrednotenja podrejenih obveznosti po pošteni vrednosti (-87.309 tEUR), ker je bila večina ugotovitev iz neodvisnega pregleda sredstev knjižene že v letu 2013 (dodatne potrebne oslabitve po AQR po stanju na 31.12.2012 znašajo 208.800 tEUR).

Stolpec 4: Pri Banki Celje se znesek razlikuje od zneska v odločbi (-51.389 tEUR) ker ta znesek vključuje tudi obresti od podrejenih obveznosti od 30.9. do datuma izbrisa (786 tEUR).

Stolpec 8: Znesek negativnega računovodskega kapitala, ki ga je z dokapitalizacijo pokrila država. V tem znesku so še upoštevani učinki konverzije coco instrumenta pri NKBM (102.400 tEUR) in NLB (341.200 tEUR) med letom, sicer bi bil znesek potrebne dokapitalizacije še višji.

Znesek pri Abanki Vipava ne vključuje dodatnega zneska dokapitalizacije s strani države v znesku 243 mio (znesek skupne dokapitalizacije znaša 591 mio EUR).

Notes:

Column 2: The amount for NKBM comprises the balance from the latter's financial statements of EUR 245,679 thousand and the positive effect from the early redemption of a portion of subordinated liabilities in the amount of EUR 13,140 thousand (due to a lower redemption value).

The amount of capital for Banka Celje comprises the calculation of capital prior to the inclusion of the bank's operating results for the 2013 financial year, in which impairments were booked according to the AQR.

Column 3: The amount for the Banka Celje only includes the loss from 2013 (EUR 126,257 thousand), increased by the effects of the revaluation of subordinated liabilities to fair value (-EUR 87,309 thousand), because the majority of findings from the independent AQR were booked already in 2013 (additionally required impairments according to the AQR amounted to EUR 208,800 thousand as at 31 December 2012).

Column 4: The amount for Banka Celje differs from the amount in the decision (-EUR 51,389 thousand) because that amount also includes interest from subordinated liabilities from 30 September until the write-off date (EUR 786 thousand).

Column 8: Amount of negative book capital that was covered by state-funded recapitalisation. This amount already includes the effects of the conversion of CoCo instruments at NKBM (EUR 102,400 thousand) and NLB (EUR 341,200 thousand) during the year, otherwise the amount of required recapitalisation would have been even higher.

The amount for Abanka Vipava does not include the additional amount of state-funded recapitalisation of EUR 243 million (the amount of total recapitalisation is EUR 591 million).

Podatki o kapitalu bank (Factor banke in Probanke) pred in po izvršenem izrednem ukrepu Banke Slovenije, izhajajoč iz odločb

v tEUR								
Banke	Kapital po stanju na dan 30.6.2013 brez upoštevanja dodatnih oslabitev po AQR	Izračunani učinki na kapital (upoštevaje ugotovitve AQR)	Kapital po stanju na dan 30.9.2013 (Factorb) in 6.9.2013 (Prob), upoštevanje oslabitve po AQR (pred odpisom podrejenih obveznosti)	Nominalna vred. podrejenih instrumentov brez obresti (iz odločbe)	Učinek na kapital ob odpisu podrejenih instrum., upoštevanje obresti do datuma izbrisa	Kapital po izvršenem bail-in in pred dokapitalizacijo	Znesek dokapitalizacije	Stanje kapitala po dokapitalizaciji
1	2	3 (= 4 - 2)	4	5	6	7 (= 4 + 6)	8	9 (= 7 + 8)
Factor banka	77.721	-361.068	-283.347	22.727	23.469	-259.878	269.000	9.122
Probanke	45.516	-259.679	-214.163	40.937	41.306	-172.857	176.000	3.143
SKUPAJ	123.237	-620.747	-497.510	63.664	64.775	-432.735	445.000	12.265

Opombe:

Stolpec 3: Iz poročila AQR z dne 12.3.2013 izhaja, da mora Factor banka po stanju na dan 31.12.2012 dodatno oblikovati za 353.400 tEUR oslabitev, Probanke pa za 249.100 tEUR. Stolpec 4: Kapitalski primanjkljaj je bil podlaga tudi za izbris podrejenih obveznosti, kar je potrdil neodvisni zunanji revizor. Razlog za stečaj, zapisan v odločbi o izredni upravi je v nezagotavljanju ustrezne likvidnostne pozicije iz 184.člena Zban-1.

Stolpec 7: Znesek negativnega računovodskega kapitala, ki ga je z dokapitalizacijo pokrila država. V tem znesku so še upoštevani učinki konverzije obveznice FB23 Factor banke (2.407

Data regarding the capital of banks (Factor banka and Probanka) before and after the implementation of extraordinary measures set out in Bank of Slovenia decisions

EUR thousand

Bank	Capital as at 30 June 2013, excluding impairments according to the AQR	Calculated effects on capital (taking into account the findings of the AQR)	Capital as at 30 September 2013 (Factor banka) and 6 September 2013 (Probanka) taking into account impairments from the AQR (prior to the write-off of subordinated liabilities)	Nominal value of subordinated instruments, excluding interest (from decisions)	Effect of the write-off of subordinated instruments on capital, including interest until the write-off date	Capital following the bail-in and prior to recapitalisation	Amount of recapitalisation	Balance of capital following recapitalisation
1	2	3 (= 4 - 2)	4	5	6	7 (= 4 + 6)	8	9 (= 7 + 8)
Factor banka	77,721	-361,068	-283,347	22,727	23,469	-259,878	269,000	9,122
Probanka	45,516	-259,679	-214,163	40,937	41,306	-172,857	176,000	3,143
Total	123,237	-620,747	-497,510	63,664	64,775	-432,735	445,000	12,265

Notes:

Column 3: The AQR report of 12 March 2013 revealed that Factor banka and Probanka required additional impairments in the amount of EUR 353,400 thousand and EUR 249,100 thousand respectively as at 31 December 2012.

Column 4: The capital shortfall was also a basis for the write-off of subordinated liabilities, which was confirmed by the independent external auditor. The reason for bankruptcy stated in the decision on extraordinary measures was failure to ensure an appropriate liquidity position as set out in Article 184 of the ZBan-1.

Column 7: Amount of negative book capital that was covered by state-funded recapitalisation. The effects of the conversion of bonds are already taken into account in that amount.

The table below illustrates changes in the capital of the banks in question on account of extraordinary measures implemented by the Bank of Slovenia, and takes into account available data from the audited annual reports of those banks for the 2013 financial year, and from the unaudited final report of Banka Celje for the 2014 financial year, as the Bank of Slovenia implemented extraordinary measures at the latter during 2014. The table was prepared taking into account available data, and is viewed by column from right to left.

The balance in column 9 is the result of the **actual booking of impairments/revaluation of the banks' financial assets**, the effects of the write-off of the banks' qualified liabilities and the recapitalisation of the banks by the government (columns 3, 6 and 8).

Column 7 shows the calculation of capital taking into account the effects of the write-off of subordinated liabilities, such that the effect of recapitalisation (from column 8) is excluded from capital (column 9).

Column 4 shows the capital shortfall taking into account the actual booking of revaluations at the banks (impairments) and excluding the effects of the write-off of subordinated liabilities and excluding recapitalisation. The amounts in column 4 indicate that the banks booked higher impairments in their financial statements as at 31 December 2013 (and for 2014 for Banka Celje) than were identified as necessary in the scope of the AQR. The figures in column 4 likewise indicate that the banks had a negative balance of capital as at 31 December 2013 that was actually higher than the balance assessed by the Bank of Slovenia for the purpose of extraordinary measures (column 4 in the first and second tables). The failure of a bank's assets to cover its liabilities is reason for bankruptcy or for the recalculation of the bank's assets at liquidation values in the event of the bank's bankruptcy.

Column 3 shows a bank's operating results for 2013 (excluding the effects of the write-off of subordinated liabilities), which is largely a reflection of revaluations. Column 2 shows the calculation of capital before operating results from column 3 are taken into account (the booking of revaluations/impairments).

Podatki o kapitalu bank pred in po izvršenem izrednem ukrepu Banke Slovenije, izhajajoč iz revidiranih letnih poročil bank

v tEUR								
Banke	Izračun kapitala pred upoštevanjem poslovnega izida (vključno s knjiženjem oslabitev) za leto 2013 (pri Banki Celje tudi za 2014)	Poslovni izid za leto 2013 po obdavčitvi v katerem so knjižene ugotovitve iz neodvisnega pregleda sredstev in brez pozitivnih učinkov iz naslova izbrisanih podrejenih obveznosti	Kapital po knjiženju oslabitev in pred odpisom podrejenih obveznosti	Nominalna vred. podrejenih instrumentov brez obresti (iz odločbe)	Učinek na kapital ob odpisu podrejenih instrum. (knjiženo)	Kapital po izvršenem bail-in in pred dokapit.	Znesek dokapitalizacije	Stanje kapitala po dokapitalizaciji iz letnega poročila bank po stanju na dan 31.12.2013 oz. pri Banki Celje na dan 31.12.2014 (nerevidiran)
1	2 (= 4 - 3)	3	4 (= 7 - 6)	5	6	7 (= 9 - 8)	8	9
Nova KBM	304.212	-713.611	-409.399	55.838	57.111	-352.288	870.000	517.712
Factor banka	83.257	-363.120	-279.863	22.727	23.469	-256.394	269.000	12.606
Probanka	52.076	-265.760	-213.684	40.937	41.306	-172.378	176.000	3.622
Abanka Vipra	173.571	-428.877	-255.306	120.000	120.000	-135.306	348.000	212.694
NLB	1.082.746	-1.797.657	-714.911	250.019	257.379	-457.532	1.551.000	1.093.468
SKUPAJ	1.695.862	-3.569.024	-1.873.162	489.521	499.264	-1.373.898	3.214.000	1.840.102
Banka Celje	150.170	-234.667	-84.497	92.020	96.078	11.581	190.000	201.581
SKUPAJ	1.846.032	-3.803.691	-1.957.659	581.541	595.342	-1.362.317	3.404.000	2.041.683

Data regarding the capital of banks before and after the implementation of extraordinary measures by the Bank of Slovenia decisions, based on audited annual reports

EUR								
thousand								
Bank	Calculation of capital before operating results for 2013 (and 2014 for Banka Celje) are taken into account	Operating results for 2013 after taxes that include the findings from the independent AQR and exclude the positive effects from subordinated liabilities	Capital following the booking of impairments and prior to the write-off of subordinated liabilities	Nominal value of subordinated instruments, excluding interest (from decisions)	Effect of the write-off of subordinated instruments on capital (booked)	Capital following the bail-in and prior to recapitalisation	Amount of recapitalisation	Amount of capital following recapitalisation from the annual reports of the banks as at 31 December 2013 and 31 December 2014 for Banka Celje (unaudited)
1	2 (= 4 - 3)	3	4 (= 7 - 6)	5	6	7 (= 9 - 8)	8	9
Nova KBM	304,212	-713,611	-409,399	55,838	57,111	-352,288	870,000	517,712
Factor banka	83,257	-363,120	-279,863	22,727	23,469	-256,394	269,000	12,606
Probanka	52,076	-265,760	-213,684	40,937	41,306	-172,378	176,000	3,622
Abanka Vipra	173,571	-428,877	-255,306	120,000	120,000	-135,306	348,000	212,694
NLB	1,082,746	-1,797,657	-714,911	250,019	257,379	-457,532	1,551,000	1,093,468
TOTAL	1,695,862	-3,569,024	-1,873,162	489,521	499,264	-1,373,898	3,214,000	1,840,102
Banka Celje	150,170	-234,667	-84,497	92,020	96,078	11,581	190,000	201,581
TOTAL	1,846,032	-3,803,691	-1,957,659	581,541	595,342	-1,362,317	3,404,000	2,041,683

Stolpec 2: Pri NKBM znesek vključuje tudi povečanje kapitala zaradi konverzije Coco instrumenta (pred konverzijo izkazanega kot podrejena obveznost banke) med letom 2013 v znesku 102.400 tEUR.

Stolpec 3: Znesek pri Banki Celje sestoji iz: izgube iz leta 2013 (-126.257 tEUR), povečane za učinke iz prevrednotenja podrejenih obveznosti po pošteni vrednosti (-87.309 tEUR) in izgube leta 2014 (-21.101 tEUR), saj so bile ugotovitev iz neodvisnega pregleda sredstev knjižene še v letu 2013.

Stolpec 4: Negativna vrednost računovodskega kapitala je povod za stečaj in podlaga za izračun likvidacijske vrednosti sredstev banke, ki je bistveno nižja od podrejenih obveznosti.

Stolpec 7: Znesek negativnega računovodskega kapitala, ki ga je z dokapitalizacijo pokrila država. V tem znesku so že upoštevani učinki konverzije coco instrumenta pri NKBM (102.400 tEUR) in NLB (341.200 tEUR) ter obveznice FB23 Factor banke (2.407 tEUR) med letom, sicer bi bil znesek potrebne dokapitalizacije še višji.

Stolpec 8: Znesek pri Abanki Vipra ne vključuje dodatnega zneska dokapitalizacije s strani države v znesku 243 mio (znesek skupne dokapitalizacije znaša 591 mio EUR).

Column 2: The amount for NKBM also includes an increase in capital due to the conversion of CoCo instruments (prior to the conversion disclosed as the bank's subordinated liabilities) during 2013 in the amount of EUR 102,400 thousand.

Column 3: The amount for the Banka Celje comprises the loss from 2013 (-EUR 126,257 thousand), increased by the effects of the revaluation of subordinated liabilities to fair value (-EUR 87,309 thousand), and the loss from 2014 (-EUR 21,101 thousand), as the findings from the independent AQR were booked already in 2013.

Column 4: The negative value of book capital is a reason for bankruptcy and the basis for the calculation of the liquidation value of a bank's assets, which is considerably lower than the value of subordinated liabilities.

Column 7: Amount of negative book capital that was covered by state-funded recapitalisation. This amount already includes the effects of the conversion of CoCo instruments at NKBM (EUR 102,400 thousand) and NLB (EUR 341,200 thousand) and FB23 Factor banka bonds (EUR 2,407 thousand) during the year, otherwise the amount of amount of recapitalisation would have been even higher.

Column 8: The amount for Abanka Vipra does not include the additional amount of state-funded recapitalisation of EUR 243 million (the amount of total recapitalisation is EUR 591 million).

4.2 Stress tests in 2014

Before assuming full supervisory responsibilities under the new Single Supervisory Mechanism (SSM), the ECB embarked on the comprehensive assessment of the operations of euro area banks in November 2013 (based on adoption of the relevant EC regulation).

The objectives were to promote transparency, to eliminate deficiencies and, above all, to build confidence in the European banking system through the strengthening of capital. The comprehensive assessment included three main elements: a supervisory risk assessment, stress tests, and a combination of an asset quality review and stress tests. It included 123 systemically important banks.

Three Slovenian banks, NLB, NKBM and SID banka, were included on the basis of the criterion of the three largest banks in a Member State as measured by total assets as at 30 September 2013.

The purpose of the asset quality review was to verify the adequacy of internal policies and processes in the area of credit operations, to review exposure to individual clients in selected risk portfolios, including the appraisal of collateral values and the level of impairments, to review the adequacy of the calculation of collective impairments, and to assess the adequacy of the level of impairments in selected risk portfolios. Assessments of required impairments deriving from a sample of corporates formed the basis for calculating the shortfall in impairments across the entire portfolio and for reviewing the assessments of collective impairments. Additional impairments were primarily required for claims against highly indebted corporates and against restructured corporates, while there was also a need for additional impairments deriving from affiliates. The shortfall in impairments identified as such reduced the initial level of capital before the performance of stress tests.

Stress tests are used to determine the resilience of the balance sheet in stress scenarios. A baseline scenario and an adverse scenario are envisaged, and the resilience of the balance sheet is determined for the three-year period from 2014 to 2016. In each year credit institutions had to attain a common equity Tier 1 capital ratio of at least 8% under the baseline scenario, and at least 5.5% under the adverse scenario.

None of the Slovenian banks would disclose a capital shortfall at the end of 2016 under the baseline scenario of the stress test. The total capital surplus of the three banks under the baseline scenario amounts to EUR 754.7 million.

Two banks (NLB and NKBM) would disclose a small capital shortfall of **EUR 65 million** at the end of 2016 under the adverse scenario, while SID banka would again disclose a capital surplus under the adverse scenario. Measures were taken at the two banks with a small capital shortfall, and the effects of the restructuring improved profitability in 2014 to the extent that the identified capital shortfalls

will be covered by retained earnings. **These results confirmed the results of the stress tests performed in 2013**

4.2.1 Difference between assessments for 2013 and 2014

A comprehensive review of the banking system was carried out in Slovenia in 2013, but the comprehensive assessment of the banking system performed in 2014 was based on different points of departure.

The banks' consolidated figures as at the end of 2012 formed the basis for the comprehensive review in 2013, while the assessment in 2014 is based on the figures for the end of 2013. After the asset quality review in 2013, non-performing claims from the portfolios included in the review as at the end of 2012 were mostly transferred to the BAMC. For this reason, the banks did not require additional impairments relating to those claims. However, the proportion of the banks' non-performing loans (NPL) rose sharply in 2013 due to the adverse economic situation. As a result, the banks were forced to create additional impairments for those loans, and thus recorded a high loss.

Portfolios in the rest of the world were included in the assessment alongside other risk portfolios in 2014. Conservative macroeconomic scenarios based on the autumn macroeconomic forecasts of the ESRB and the ECB from 2013 were applied in the stress tests. The scenarios deviate markedly from the actual developments in 2014 and from the Bank of Slovenia's current forecasts. However, the use of those forecasts was mandatory for all countries and deviations from forecasts were not possible: any deviations from the forecasts for individual countries would hinder or render impossible the comparability of results between different countries (with respect to different initial criteria). Conservative stress test parameters (credit parameters, changes in interest rates, etc.) were also calculated on their basis.

The findings of the comprehensive assessment of the banks' operations confirm that the clean-up of bank balance sheets and recapitalisation in 2013 were executed to the minimum sufficient extent to ensure resilience in the event of the realisation of adverse economic developments, and to an optimal extent from the point of view of public funds. The balance sheet clean-up and recapitalisation are already yielding results: the two banks are profitable and are performing well in 2014, which is also improving their capital positions.

Recapitalisation in 2013 and 2014 was merely a necessary condition for the final recovery of the banking system, not a sufficient condition. A longer-term improvement in the state of the banking system and new impetus in credit growth and economic growth will only be possible after the implementation of radical measures in the area of the operational, ownership and financial restructuring of the real sector.

Figure 43: The methodology used to perform stress tests in Slovenia in 2013 was previously applied in Ireland in 2011 and Spain in 2012. A standard methodology for all euro area countries was applied during the stress tests in 2014.

DEJSTVA	
2013	2014
ECB/EBA metodologija Irska 2011 – BlackRock Španija 2012 – Oliver Wyman Slovenija 2013	ECB/EBA metodologija EUR 19 članic – Oliver Wyman
Predpostavke • Osnovni scenarij: EK • Neugoden scenarij: ECB	Predpostavke • Osnovni scenarij: EK • Neugoden scenarij: ECB/ESRB
Podatki Slovenija	Podatki Slovenija

FACTS	
2013	2014
ECB/EBA methodology Ireland 2011 – BlackRock Spain 2012 – Oliver Wyman Slovenia 2013	ECB/EBA methodology Euro area (19 countries) – Oliver Wyman
Assumptions • Baseline scenario: EC • Adverse scenario: ECB	Assumptions • Baseline scenario: EC • Adverse scenario: ECB/ESRB
Data Slovenia	Data Slovenia

What is published on the Bank of Slovenia's website at www.bsi.si (Banking supervision – Stress tests)?

- Methodology used in 2013 is disclosed in the document Report on comprehensive review of the banking system and associated measures;
- Methodology used in 2014 is accessible in the document Summary of the methodology used in EU-wide stress tests for 2014;
- Results of stress tests in 2013 and 2014;
- Costs of the comprehensive review of the banking system in 2013;
- Frequently asked questions and answers regarding the reorganisation of the Slovenian banking system; and
- Decisions on extraordinary measures for NLB, NKBM, Abanka, Factor banka, Probanka and Banka Celje.

4.2.2 Effects and challenges of recovery

The bank recovery process in 2013 and 2014 has contributed to a significant reduction in risk in the banking system. Although domestic macroeconomic conditions have improved, the contraction of the banks' balance sheets continued in 2014. The banks made net repayments of liabilities on the wholesale markets for the fifth consecutive year, albeit at a significantly slower pace than in 2013, and through the early repayment of liabilities to the Eurosystem.

On the other side, **growth in loans to non-financial corporations remains sharply negative**, although there are signs of a gradual stabilisation. The deepening of the decline in corporate loans came to a halt in 2014. The aforementioned loans were down 19.5% in year-on-year terms in December, or by 13.7% excluding the effects of measures to stabilise the banking system.

The most recent survey figures (BLS) show that (estimated) **corporate demand for loans increased in 2014** after a long period of decline, and that the banks' credit standards are not being tightened further, which is increasing the likelihood that the contraction in loans to non-financial corporations will begin to slow in the upcoming period. Negative growth in consumer loans to households also persists but is improving, while year-on-year growth in housing loans stood at 0.6% in December 2014. Loans to households remain the least risky segment of the banks' credit portfolio and, in the context of rising consumer confidence, represent a potential source for improving the quality of the banks' overall credit portfolio.

The reasons for the **contraction in corporate loans in 2014** were more or less unchanged from 2013: the relatively high leverage in the corporate sector was reduced very slowly and limited creditworthy demand, and the banks remained reluctant to take up additional credit risk with tightened credit standards, despite the improvement in capital adequacy ratios.

The **structure of bank funding** likewise **remains unstable**, and will be adjusted further in the future. The improvement in the macroeconomic situation in 2014 helped ease the corporate financial recovery, with the anticipated further revival of the business cycle. However this will only be reflected in the financial cycle gradually and with a lag, even though it is increased credit growth that would have the most beneficial impact on bank performance and on an improvement in the quality of the credit portfolio.

In the wake of the pronounced improvement in the capital adequacy of the banks after the measures implemented in December 2013, it should be noted that the maintenance and improvement of capital adequacy relies primarily on a reduction in lending activity and adjustments to the risk structure of bank investments, and the corresponding decline in capital requirements. More so than growth in capital, additional requirements to increase capital adequacy could result in a further contraction in loans and thus a renewed deterioration in the quality of the banks' credit portfolio. The lower capital adequacy of the domestic banks relative to the EU average (the difference in September 2014 was still 0.5 percentage points) forces bankers to use capital prudently.

Credit risk remains high and very significant, but for the moment is stabilising. Non-performing claims (classified claims more than 90 days in arrears) rose during the first months of 2014, but subsequently stabilised. They rose again in September and fluctuated downwards in October and December due to the transfer of the non-performing claims of Abanka and Banka Celje to the BAMC. The proportion of non-performing claims fell to 11.9% in December, similar to the level recorded at the end of 2011. Excluding Factor banka and Probanka, that proportion fell to 10.5%. Non-performing claims also declined in absolute terms in 2014 in the corporate sector in particular, although the contraction in bank lending activity meant that this was not reflected in an improvement in the quality of the credit portfolio. The quality of the credit portfolio of non-residents is notably low: it was not subject to resolution via transfer to the BAMC, and is dependent on the economic recovery in the countries of the western Balkans in particular.

The **proportion of non-performing claims** accounted for by SMEs was up last year to stand at 44.8% of total non-performing claims against corporates. This indicates the urgency of more active measures by the banks themselves to resolve non-performing claims by means of sale, faster write-offs, etc., and greater risk segmentation of borrowers in the approval of new loans.

The deleveraging and restructuring of over-indebted corporates is proceeding slowly. Bank of Slovenia guidelines from December 2014 on the creation of impairments and provisions for claims against corporates with which a master restructuring agreement has been concluded were adopted for

the purpose of speeding up corporate restructuring and more actively including the banks in these processes.

Attention must be given to the bank's income risk, which is on the rise despite an improvement in performance and a higher net interest margin. The banks' interest income was down by 11.5% in 2014, primarily due to the contraction in lending activity. However, the banks mitigated the aforementioned effect by lowering interest expenses through the substitution of more expensive sources of funding with more affordable sources. In addition to the contraction in the scope of operations, an environment of low interest rates and the question of whether the banks will be able to generate sufficient income to cover operating costs and impairment costs place additional pressure on the banks' income risk.

The effect of cuts in reference interest rates is passed through primarily to the banks' deposit rates, while **lending rates on new transactions are declining very slowly**. The retention of high spreads over average euro area interest rates is encouraging creditworthy customers to seek financing in the rest of the world, and could result in the loss of a source of bank income over the longer term.

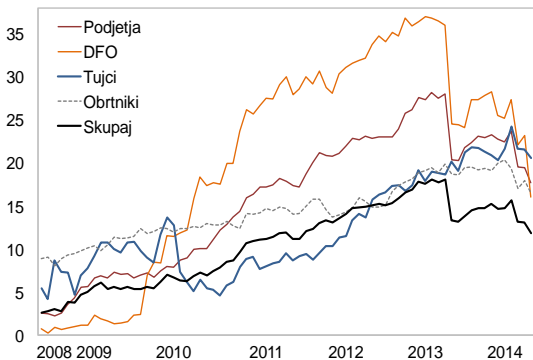
The restoration of confidence in the domestic banks has seen **household deposits returning to the banking system**. This positive development was particularly notable at the large domestic banks, which in 2013 recorded the largest fall in savers' confidence and decline in household deposits. The banks will remain exposed to the risk of a less-stable funding structure as a result of the projected low rates of growth in household deposits over the next two years.

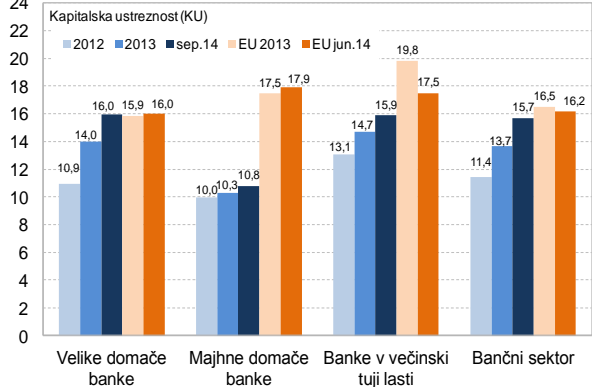
Expected moderate growth in wages in the context of a slight increase in household spending, declining deposit rates and households' renewed interest in alternative forms of investment indicate that growth in deposits will be modest in the future. ECB policy indicates that the funding it provides continues to be a sufficient source of liquidity. However, the banks' perception regarding the sufficiency of creditworthy demand continues to hinder the placement of such funding in corporate loans.

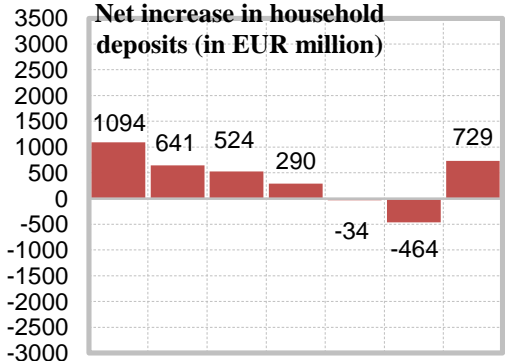
Figure 44: Effects and challenges of bank recovery

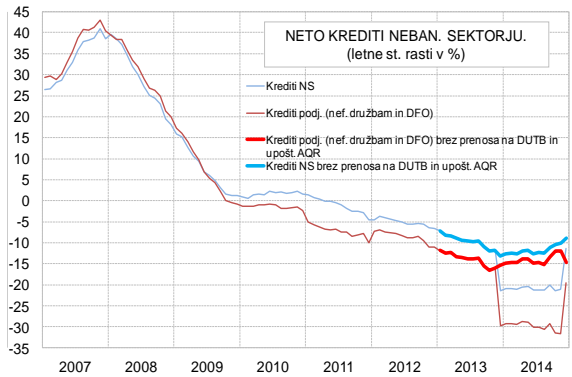
Where have signs of bank recovery and its effects already been seen	Where do important challenges still remain for the banking system and in a broader sense
The basis has been put in place for normal banking operations, improved indicators of confidence in both the government and the banks, and a slowdown in the contraction in the banks' turnover.	Despite the recovery, credit risk remains significant and particularly high in individual segments. Funding risk decreased in the wake of good liquidity and improved access to financial markets, but the problem of an unstable funding structure remains. Income risk is becoming the key for banks.
A decrease in required yields on government bonds. Slovenia faced the highest required yields on government bonds (10-year) in 2012, the maximum value of 7.45% being reached in mid-August. During a time of uncertainty surrounding the results of the stress tests and comprehensive review of banks, around October 2013, the required yields remained around 6.7% for some time. The required yield on Slovenian 10-year	The large proportion of securities on bank balance sheets is increasing the banks' dependency on the sovereign rating. The effect is thus broader, given that insurance corporations are also tied to sovereign ratings.

Where have signs of bank recovery and its effects already been seen	Where do important challenges still remain for the banking system and in a broader sense
<p>government bonds reached a historic low of 1.3% at the end of February 2015.</p> <p>Figure: Required yields on Slovenian and German 10-year government bonds</p>  <p>Yields on Slovenian 10-year government bonds Yields on German 10-year government bonds</p> <p>Sovereign upgrading by Moody's (to Baa3, comparable to BBB- at other rating agencies) and confirmation of the sovereign rating by S&P (A-).</p> <p>Access to financial markets. The government has access to financial markets at extremely favourable price conditions and can focus on long-term issuance of bonds, even in excess of 10 years, which was completely unimaginable just one year ago. Access to financial markets was confirmed both by NLB with the issue of a bond, and by corporates, such as Petrol. Lower premiums for country risk also reduce financing costs on financial markets for other entities.</p>	
<p>The proportion of non-performing claims, i.e. classified claims more than 90 days in arrears, dropped from 18.1% in November 2013 to 11.9% at the end of 2014, and to 10.5% excluding Factor banka and Probanka. The proportion of non-performing claims in the corporate sector dropped from 28.1% in November 2013 to 17.7% by the end of 2014. The key contribution to the reduction in the proportion of non-performing claims comes from the transfer of non-performing claims to the BAMC (the first transfer to the BAMC at the end of 2013 reduced the proportion of non-performing claims by 4.9 percentage points, the second by 1.7 percentage</p>	<p>Despite the falling proportion of non-performing claims, credit risk remains one of the key risks, and is still at a high level. The banks will have to additionally strengthen their active role in the resolution or write-off of non-performing claims, in particular in the following three segments:</p> <ul style="list-style-type: none"> - non-performing claims against non-residents; given that they were not subject to the transfer to the BAMC, the proportion of non-performing claims is highest in this segment, reaching 20.6% at the end of 2014. Non-performing claims against non-residents thus

Where have signs of bank recovery and its effects already been seen	Where do important challenges still remain for the banking system and in a broader sense
<p>points in October 2014, and the third by 0.9 percentage points in December 2014).</p> <p>In addition to the transfers to the BAMC, the banks reduced the amount of non-performing claims by an additional EUR 650 million over the final quarter of 2014.</p> <p>Figure: Proportion of classified claims more than 90 days in arrears, by segment</p>  <p> Corporates OFIs Non-residents Sole traders Total </p>	<p>accounted for 25.6% of all non-performing claims in the banking system in 2014. They account for around 45% of all non-performing claims at three banks that transferred non-performing claims to the BAMC (NLB, Banka Celje and Factor banka).</p> <ul style="list-style-type: none"> - Non-performing claims against SMEs; following the transfer of non-performing claims to the BAMC, which primarily included large domestic enterprises, the proportion of debtors with arrears of more than 90 days was concentrated at small and medium-sized enterprises (SMEs). Non-performing claims against SMEs accounted for 44.8% of total non-performing claims against corporates at the end of 2014, the figure having stood at just 28.7% at the end of 2013 prior to the first transfer, although the arrears were larger. - dynamics of changes in the quality of the credit portfolio; in our opinion the proportion of non-performing claims excluding the transfers to the BAMC would have increased by 1.6 percentage points until April 2014, and would then have remained stable. The key driver of the increase in the proportion of non-performing claims was the contraction in turnover, not an increase in the stock of non-performing claims. For a change in the dynamics, it will be important that the contraction in the stock of non-performing claims, which is not linked to the transfers to the BAMC, outpaces the contraction in classified claims.
<p>Rise in the capital adequacy ratio. The capital adequacy of the banking system stood at 16.7% in September 2014 (on an individual basis), having stood at 11.8% a year earlier (September 2013).</p> <p>The Slovenian banking system has matched average capital adequacy across the EU, in particular at the large domestic banks, while the small domestic banks still trail banks of comparable size across the EU.</p> <p>Figure: Capital adequacy of the banking system</p>	<p>Requirements with respect to capital adequacy levels will continue to tighten. Under the new European directive, which introduces new macro-prudential instruments in the form of capital buffers, capital requirements for banks will further tighten. Despite Slovenian banks narrowing the gap by which they trail the EU average for capital adequacy ratios, the gap will again widen if the banks fail to keep strengthening their capital ratios in the future.</p>

Where have signs of bank recovery and its effects already been seen	Where do important challenges still remain for the banking system and in a broader sense
<p>and bank groups compared with the EU average (consolidated basis)</p>  <p>Overall capital adequacy 2012 2013 Sep 2014 EU 2013 EU June 2014 Large domestic banks Small domestic banks Banks under majority foreign ownership System overall</p>	
<p>High liquidity ratios The first-bucket liquidity ratio at the level of the banking system is 60% above the regulatory requirement (1.6), and all banks exceed the regulatory requirement by at least 10%, while the ratio was 20% above the regulatory requirement at the beginning of December 2013. The other liquidity ratios also reflect the favourable liquidity of the banking system.</p>	<p>Where will the banks direct the excess liquidity? The holding of excess liquidity brings negative income effects. Given the banks' reluctance to take up new credit risk, there is a likelihood of taking up greater market risk.</p>
<p>TURNOVER</p> <p>Slowdown in the contraction of total assets The total assets of the banking system declined by EUR 1.6 billion in 2014, by EUR 5.8 billion in 2013 and by EUR 13.2 billion in total between 2010 and 2014.</p> <p>LIABILITIES</p> <p>Slowdown in the contraction in wholesale funding The stock of liabilities to foreign banks declined by EUR 801 million in 2014, although it recorded a significant increase in December for</p>	<p>Stabilisation of the structure of bank funding:</p> <ul style="list-style-type: none"> - a stable and predictable funding structure - diversification of funding, reduced dependence on wholesale funding, new sources of funding such as the issue of

Where have signs of bank recovery and its effects already been seen	Where do important challenges still remain for the banking system and in a broader sense																
<p>the first time since 2011, of EUR 209 million. The stock of issued securities increased by EUR 2 million in 2014. The total stock of wholesale funding thus declined by EUR 800 million in 2014, compared with a EUR 2.8 billion decline in the previous year.</p> <p>All segments of deposits by the non-banking sector (NBS), other than non-residents, recorded an increase in deposits in 2014. A year-on year increase in deposits by the NBS of 8.3% in 2014, corresponding to an annual increase in deposits of EUR 1.88 billion.</p> <p>The restoration of confidence in the banking system is most evident in the increase in household deposits, which rose by EUR 729 million in 2014, where half of the annual increase (EUR 360 million) was accounted for by the large domestic banks, and a quarter (EUR 178 million) by the savings banks.</p> <p>Net increase in household deposits (in EUR million)</p>  <table border="1"> <thead> <tr> <th>Year</th> <th>Net increase in household deposits (in EUR million)</th> </tr> </thead> <tbody> <tr> <td>2008</td> <td>1094</td> </tr> <tr> <td>2009</td> <td>641</td> </tr> <tr> <td>2010</td> <td>524</td> </tr> <tr> <td>2011</td> <td>290</td> </tr> <tr> <td>2012</td> <td>-34</td> </tr> <tr> <td>2013</td> <td>-464</td> </tr> <tr> <td>2014</td> <td>729</td> </tr> </tbody> </table> <p>A return of household deposits to banks and stable inflow despite lower deposit rates Excluding Factor banka and Probanka, the stock of household deposits declined by EUR 320 million in the second quarter of 2013 as a result of the crisis in Cyprus, where holders of guaranteed deposits were to participate in bank resolution for the first time, and because of speculation that Slovenia could be next in line to request international assistance. After the publication of the results of the comprehensive review of the banks at the end of 2013, the bank recapitalisations and the transfer of non-performing claims from two of the largest banks to</p>	Year	Net increase in household deposits (in EUR million)	2008	1094	2009	641	2010	524	2011	290	2012	-34	2013	-464	2014	729	<p>covered bonds</p>
Year	Net increase in household deposits (in EUR million)																
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Where have signs of bank recovery and its effects already been seen	Where do important challenges still remain for the banking system and in a broader sense
<p>the BAMC, the stock of household deposits increased by EUR 315 million in the first quarter of 2014, thereby compensating for the majority of the outflow of deposits in the previous year. Household deposits recorded very stable growth of EUR 160 million per quarter over the following three quarters.</p> <p>INVESTMENTS</p> <p>A reversal in the credit growth trend is forecast.</p> <ul style="list-style-type: none"> - Less negative credit growth. The stock of loans to the non-banking sector (NBS) declined by EUR 13.1 billion between 2011 and 2014. Year-on-year growth stood at -21.4% at the end of 2013, but at -11.4% at the end of 2014, or -7.8% if the effects of bank recovery (transfers to the BAMC, effects of the comprehensive review and excluding Factor banka and Probanka) are ignored. The situation was similar with corporate loans, which declined by EUR 13 billion between 2009 and 2011. Year-on-year growth stood at -29.8% at the end of 2013, while reaching -19.5% at the end of 2014 or -13.7% if the effects of bank recovery are ignored. <p>Figure: Growth in loans to the non-banking sector and to corporates, including and excluding the effects of the transfers to the BAMC</p>  <p>NET LOANS TO NON-BANKING SECTOR (annual growth, %)</p> <p>Loans to the NBS Loans to corporates (non-financial corporations and OFIs)</p>	<p>Credit growth Despite some positive signals in credit growth, lending rates and loan demand, the forecasts for 2015 suggest that credit growth will remain negative in 2015, unless the measures implemented by the ECB and the Bank of Slovenia have an extremely positive impact. The reasons were primarily as follows:</p> <ul style="list-style-type: none"> - weak creditworthiness and high leverage are significant limiting factors in corporate credit demand, and the number of bankruptcies is still growing. - the healthy parts of the economy, most notably exporters, are also obtaining financing in the rest of the world, on the capital market, or are financed by internal resources, given that growth in corporate deposits at banks has exceeded 10% for the second year in succession. - the reluctance of the corporate and household sectors to take on new investments and raise new loans, and the banks' aversion to taking up credit risk have also been significant limiting factors in credit growth. Credit standards remain tight, while lending rates remain above the euro area average. - the unstable structure of funding and the large proportion of current liabilities also represent a significant limiting factor on the supply side. - Until the stock of new loans outpaces the maturing of existing loans and impairment costs, credit growth on bank balance sheets will remain negative. <p>What could be an alternative or how to better regulate syndicated loans? This was an important form of financing for large corporates and major investments in the past, via which banks shared the risk amongst themselves. However, banks have lost confidence in this type</p>

Where have signs of bank recovery and its effects already been seen	Where do important challenges still remain for the banking system and in a broader sense
<p>Loans to corporates (non-financial corporations and OFIs), excluding transfer to BAMC and AQR Loans to the NBS, excluding transfer to the BAMC and AQR</p> <ul style="list-style-type: none"> - The number of banks recording positive growth or a slowdown in the contraction in loans prior to impairments, i.e. gross loans to the NBS, is rising. A total of eight banks recorded positive annual growth in loans to the NBS in 2014, compared with six banks in the previous year, while the annual growth improved in 2014 (larger increase or smaller contraction) at 13 banks. - The annual stock of new long-term corporate loans was up 19% on the previous year. When corporates succeed in replacing short-term loans with long-term loans (maturity of more than one year), the stock of new short-term loans declines more notably (by 33.6% in 2014), since short-term loans to the same corporate can be granted multiple times during the year and thus count several times, while all of them can be replaced by just one long-term loan. - The banks have identified higher credit demand, which is indicated by the survey figures of five banks participating in the ECB's bank lending survey. The same survey also finds that the banks' credit standards remain strict. The Bank of Slovenia survey, in which all banks participate, also confirms that the contraction in credit demand began to slow in the first half of 2014 in line with the recovery in economic activity. Excess demand for credit was nevertheless up slightly, the banks citing the customer's poor credit rating, the customer's refusal to accept the bank's terms and the eligibility of collateral as the main reasons for rejecting loans. - A higher stock of new housing loans, and a rising number of transactions on the real estate market. Housing loans recorded very modest year-on-year growth in 2014 (only 0.6%), although the stock of new housing loans was up 6.1% on the previous year. A further decline of 7.3% 	<p>of financing since experiencing the financial crisis, when a coordinated resolution agreement was hard to reach when corporates hit problems in making repayments.</p> <p>The banks' write-offs are failing to relieve the indebtedness of the corporate sector. Measures for systemic corporate deleveraging could be beneficial, but there must remain awareness of the moral hazard issue.</p>

Where have signs of bank recovery and its effects already been seen	Where do important challenges still remain for the banking system and in a broader sense
<p>in the prices of residential real estate was recorded over the first three quarters of 2014. The number of transactions in used housing meanwhile increased significantly, and was up 30% over the first three quarters of 2014 in year-on-year terms.</p> <p>The banks became increasingly active in writing off non-performing claims. While the amount of write-offs of financial assets in 2012 totalled EUR 403 million, banks wrote off EUR 2.4 billion and a further EUR 1.6 billion in financial assets in 2013 and 2014, respectively.</p> <p>Slowdown in the decline in the LTD ratio for the non-banking sector. Over the last two years, the banks have made rapid cuts in the LTD ratio with the objective of reducing dependence on wholesale funding or reducing capital requirements. The LTD ratio fell by 32 percentage points between 2008 and 2012, and by a further 22 percentage points in 2013 alone. The decline slowed to 19.5 percentage points in 2014, or 17.7 percentage points if Factor banka and Probanka are excluded.</p> <p>The Bank of Slovenia introduced a new macro-prudential measure (the GLTDF) to limit the pace of the reduction in the LTD ratio or to require higher liquidity ratios. The instrument helped to slow the decline in the LTD ratio, which in contrast to 2013 was based more on an increase in deposits and less on a contraction in lending, although the banks' liquidity reserves also increased. A declining LTD ratio is beneficial, as it indicates reduced dependency on wholesale funding and a higher proportion of stable funding such as deposits by the non-banking sector. However, an accelerated decline in the LTD ratio, in particular via a pronounced contraction in lending in the context of a simultaneous increase in deposits by the non-banking sector, increases the systemic liquidity risk in funding (a decline in the second-bucket liquidity ratio) and the possibility of an additional deterioration in the quality of the banks' credit portfolio. With the GLTDF macro-prudential instrument, the ratio of the annual change in loans to the non-banking sector (before impairments) to the annual change</p>	

Where have signs of bank recovery and its effects already been seen	Where do important challenges still remain for the banking system and in a broader sense
<p>in deposits by the non-banking sector, the banks are given the choice of meeting the minimum requirements with regard to the GLTDF or achieving higher liquidity ratios. The instrument thus limits the pace of the reduction in the LTD ratio, or in the event of a further contraction in lending in the context of an increase in deposits protects depositors via the requirement for higher liquidity ratios.</p>	
<p>The banks improved their net interest margin and cost-efficiency. The banking system recorded pre-tax loss of EUR 67.5 million in 2014, the lowest figure of the last five years.</p> <p>Interest rates on new household deposits fell by around 2 percentage points over the last two years; short-term rates were down 1.6 percentage points while long-term rates were down 2.6 percentage points, with identical falls in 2013 and 2014 (short-term by 0.8 percentage points and long-term by 1.3 percentage points each year). The decline in interest rates on deposits by the private non-banking sector with a maturity of 1 to 2 years halted completely in the final quarter of 2014; the decline in deposit rates on the shortest maturities (up to 3 months) also slowed sharply.</p> <p>Since the third quarter of 2013 there has been a significant decline in the dispersion of interest rates on deposits by the private non-banking sector among banks.</p> <p>The fall in deposit rates also gave banks space to reduce interest rates on loans. The largest fall in lending rates in 2014 was on new corporate loans of up to EUR 1 million, which were down 1.1 percentage points, compared with just 0.2 percentage points the previous year.</p>	<p>Income risk The banks' ability to generate income has diminished in the context of a contraction in turnover and an environment of low interest rates. Given the decline in net income, impairment costs remain relatively high, despite their significant decline. The banks are thus faced with an increasing challenge in achieving the positive returns that enable them to generate the required capital for continued growth via retained earnings.</p> <p>Client segmentation and reticence from creditworthy clients, with respect to household deposits on one side and corporate financing on the other, as corporates increasingly secure their financing from the rest of the world and on the capital markets.</p> <p>For the first time since the start of the crisis, the household sector recorded a positive net inflow into mutual funds, in the amount of EUR 72 million, which was a positive reflection of increased household confidence and a readiness for new investments and the take-up of additional risk. This entails an additional challenge for banks to not overly limit the inflow of one of the more stable sources of funding by lowering interest rates on deposits.</p> <p>In the event of increased uncertainty due to unforeseen events, there is now a greater risk of outflows of deposits to the rest of the world than was present in 2013, when differences in the return on deposits were significantly larger under a deposit guarantee of the same size. Meanwhile interest rates on deposits of maturities of up to 1 year had approached the countries with the lowest interest rates by the end of 2014. Interest rates on short-term corporate deposits are equal to those in Austria, while interest rates on household deposits are higher</p>

Where have signs of bank recovery and its effects already been seen	Where do important challenges still remain for the banking system and in a broader sense
	<p>merely by 0.3 percentage points.</p> <p>Despite their decline, lending rates still exceed the euro area average: interest rates on new corporate loans of up to EUR 1 million were up 1.5 percentage points in 2014, and up 2.1 percentage points on loans of more than EUR 1 million.</p>
<p>Corporate indebtedness Slovenian corporates are not out of line with other euro area countries in terms of indebtedness with regard to debt. However, the shortfall in capital means that they face high leverage, as the ratio of debt capital to equity, which is limiting their creditworthiness.</p>	<p>Inflow of capital into the corporate sector Privatisation and a more encouraging environment for the inflow of capital would be a more favourable solution for the economy in this respect than would be further corporate deleveraging and contraction in turnover.</p>

The **European Commission** published its report on Slovenia's financial and economic position on 26 February 2015 (Country Report Slovenia 2015), which will serve as the basis for the drafting of the May recommendations and measures. The report determines progress but highlights five key challenges: non-performing loans, corporate deleveraging, privatisation, fiscal framework, and foreign direct investments.

In the February 2015 report, the International Monetary Fund (IMF) highlighted, *inter alia*, the reduction in the stock of non-performing loans and the speeding up the restructuring of the corporate sector and the privatisation of state-owned banks as key challenges for Slovenia after the recapitalisation of the state-owned banks.

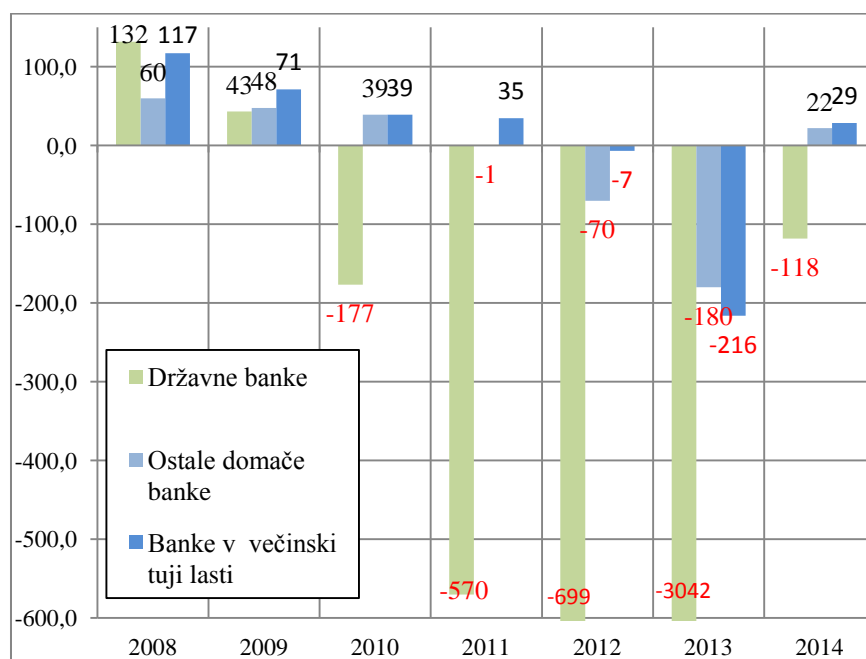
5. ASSESSMENT OF CORPORATE GOVERNANCE IN BANKS

The majority owner in the Slovenian banking system is the state; following recapitalisation under the state aid procedures, state-owned banks have a 58% market share in terms of balance sheet totals. By share of state ownership in banks, Slovenia ranked at the top of the euro area even before the state recapitalisations of 2013/2014.

The quality of bank governance can be assessed in part through the number of measures decreed as part of implementing prudential supervision and supervision over the operation of bank management bodies (management boards and supervisory boards) and through the speed of response by the owners in the event of demands to strengthen the capital base with the aim of ensuring safe and stable bank operations and thereby the safety of citizens' deposits, and also through the monitoring of trends indicating bank performance.

There has been in particular poorer governance and business operations, along with the assumption of greater risks by domestically owned – and especially state-owned – banks, for which a strengthening of the capital base had not been ensured in good time, as is evident from the pre-tax profit trends and capital returns as well as from the asset side throughout the period before and during the crisis.

Figure 45: Pre-tax profit

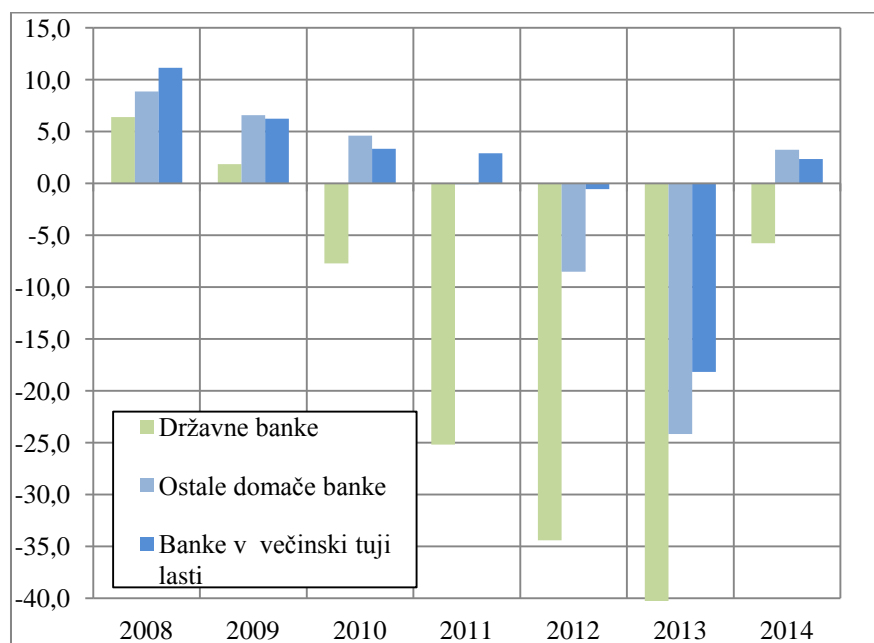


State-owned banks

Other domestic banks

Banks under majority foreign ownership

Figure 46: Return on equity

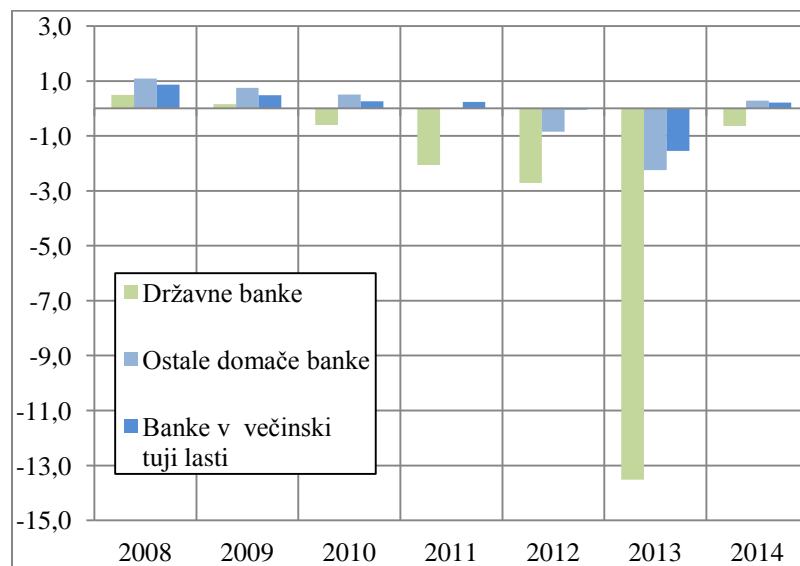


State-owned banks

Other domestic banks

Banks under majority foreign ownership

Figure 47: Return on assets



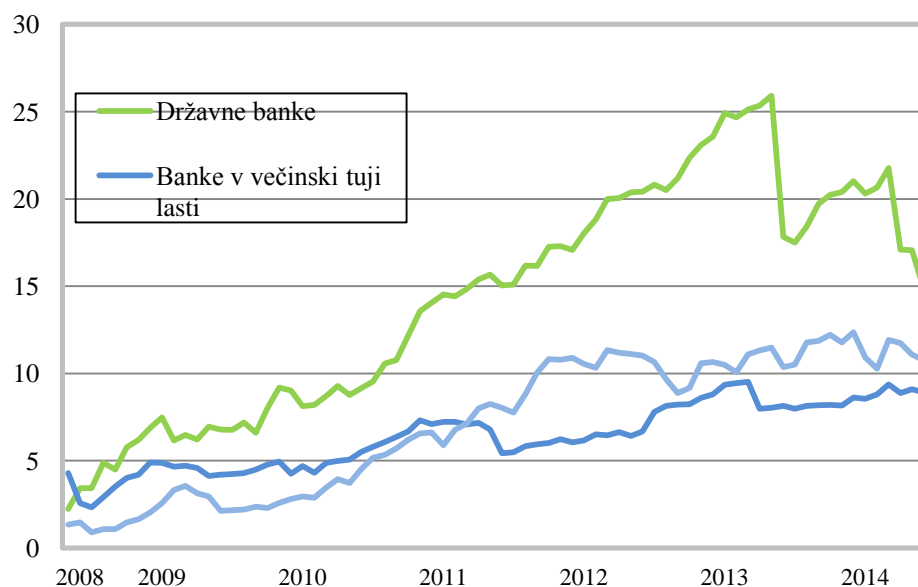
State-owned banks

Other domestic banks

Banks under majority foreign ownership

The weak governance and assumption of greater risk in the period before the crisis are indicated in particular by a comparison of trends in the proportion of non-performing loans by bank groups. Domestic (especially state-owned) banks took on significantly greater risk, stemming from business strategies adopted by the management bodies and owner.

Figure 48: Proportion of non-performing claims more than 90 days in arrears



State-owned banks

Banks under majority foreign ownership

A consequence of the poorer governance of state-owned banks before and during the crisis can also be seen in the identified capital shortfall in the 2013 stress tests. The shortfall at five domestically owned banks holding jointly 53 percent of the market, amounted in total to EUR 4,431 million, while the shortfall at three foreign-owned banks covered, which hold jointly 13 percent of the market, amounted to EUR 348 million. Using the same methodology for reviewing assets and stress tests for all banks, and despite their operation in the same environment and under the same supervision from the Bank of Slovenia, major differences were apparent in the required recapitalisation among banks in domestic (state) and foreign ownership.

In October 2012 the International Monetary Fund (IMF) highlighted in its report Republic of Slovenia: Financial System Stability Assessment the weak governance of state banks as one of the key issues: *"Weak governance in public banks and an externally financed boom in lending to construction companies and management buyouts/corporate takeovers are at the root of the current problems."* At the same time it called for privatisation, which must follow the financial restructuring of state-owned banks: *"Reducing government influence on the day-to-day operations and lending decisions of banks will help improve the risk management practices and the efficiency and stability of the banking system over the longer term."*

The governance of state-owned banks, whose stability has a decisive influence on the stability of the entire financial system, was directly affected by the models of state asset management, which the government, using its majority in the National Assembly during the crisis, modified (Capital Assets Management Agency - AUKN, Pension Fund Management - KAD, Slovenian Compensation Company - SOD, Slovenian Sovereign Holding - SDH³²), along with the absence of a clear and "final" state strategy regarding bank ownership.

³² At the onset of the crisis (2007/2008), state ownership of the biggest banks was fragmented; participating interests in NLB as at 31 December 2008 were held by the Republic of Slovenia 33.10%, SOD 5.05% and KAD 5.01%; interests in NKBM were held by the Republic of Slovenia 41.5%, and KAD and SOD 4.8% each (Sources: annual reports of NLB and NKBM for 2008)

Capital Assets Management Agency – AUKN: In April 2010 the National Assembly adopted the Capital Asset Management of the Republic of Slovenia Act, which served to establish the AUKN. The act laid down that as the representative of the Republic of Slovenia, the AUKN would exercise the rights deriving from shares and interests owned by the state, that it would dispose of portfolio investments independently, while it would manage investments whose book value exceeded EUR 20 million and strategic investments with prior approval of the government on the basis of a programme of disposal. In the recapitalisation of NKBM in 2011, where given the shortage of budget funds the state did not participate, the AUKN took the view that a “significant reduction in the state’s interest at such a low price was not economically justified”. The pre-emptive right of the state to purchase NKBM recapitalisation shares was transferred to the state companies Gen-energija, Pošta Slovenije and Eles, which participated with joint funds of EUR 47.5 million in the recapitalisation of NKBM and maintained state ownership of the bank.

Slovenian Sovereign Holding – SDH: The entry into force of the Slovenian Sovereign Holding Act (ZSDH) in December 2012 served to terminate the AUKN, and the management of Republic of Slovenia capital assets was taken up by the SOD board on behalf of and for the account of the Republic of Slovenia. It was envisaged that immediately after the implementation of the Republic of Slovenia asset classification (which would include a definition and categorisation of investments into asset segments, target interests in capital assets and methods of selling) SOD and Republic of Slovenia would carry out all the necessary procedures in order to increase the share capital of SDH through capital investments as non-cash contributions. SDH properly came into being only on the day the revised version of the ZSDH-1 entered into force, in April 2014. SDH took over the competence and obligations of SOD and is continuing to manage capital assets owned by SDH and the Republic of Slovenia.

Changes of government were frequently followed by changes in the supervisory boards of state banks, and then frequently changes of management board members. In the past seven years at the NLB management board there have been four chairmen of the board³³ and twelve different members of the board, and since the end of 2012 alone five different people have chaired the supervisory board³⁴.

In July 2014 the Bank of Slovenia presented to the public the document **Bank of Slovenia view of strategic challenges for economic policy in Slovenia**, in which it pointed out explicitly:

“Good corporate governance should lead to greater efficiency in the banking sector. On 21 June 2013 the National Assembly adopted a commitment for the complete sell-off of the stake in one state bank (NKBM) and for a reduction in the participation in the biggest bank (NLB) in the medium term to 25% plus one share. /.../ Success of the bank privatisation process depends on fulfilment of the commitments from the Slovenian Government and on the interest of investors in purchasing interests in Slovenian banks. /.../ Privatisation of a large portion of the economy in the short term is not feasible, so it is important in the interim period for state companies to be governed by professional managers pursuing solid business and governance practices. The Government must quickly obtain parliamentary consent for the strategy to select and classify capital investments that will be managed by Slovenian Sovereign Holding. It is important how Slovenian Sovereign Holding will be governed and managed.”

State commitment following first recovery

In order to finalise the first recovery in the 1990s, NLB and NKBM successfully met seven requirements (shown in the text below), but no government nor any convening of the National

³³ M. Kramar (1.2.2004-31.1.2009), D. Veselinovič (1.2.2009-3.9.2009), B. Jašovič (1.10.2009-30.9.2012), J. Medja (1.10.2012-)

³⁴ J. Medja (up to 30.9.2012), K. Vidic (up to 24.4.2013), S. Cunder (up to 10.6.2013), F. Arhar (up to 14.4.2014), G. Podbevšek (current supervisory board chairman).

Assembly to date have carried out privatisation, which was envisaged as the final step in recovery following completion of the first recovery. **In its 1997 Annual Report the Bank of Slovenia noted “The urgently needed privatisation will be ensured by the government and National Assembly”,** as can be seen in the original:

Okvir 5: Zaključek bančne sanacije

V letu 1997 se je končala sanacija dveh bank, ki sta ob sanaciji postali državni – Nove Ljubljanske banke d.d. (NLB), Ljubljana in Nove Kreditne banke Maribor d.d.. Sanacija se je po preteku dobrih štirih let končala uspešno. Večina slabih starih posojil je bila v zameno za državne obveznice prenesena na Agencijo za sanacijo bank in hranilnic, in ker od leta 1993 ne nastajajo nova slaba posojila v večjem obsegu, kot je običajno za banke, imajo banke gotovo precej manj slabih posojil, kot so jih imele v začetku leta 1993. Povečala se je kapitalska ustreznost bank in izboljšala likvidnost, donosnost obeh bank pa je med najvišjimi v slovenskem bančništvu.

Za dokončanje sanacije sta banki morali izpolniti več pogojev Banke Slovenije:

1. morali sta biti likvidni,
2. izpolnjevati sta morali ukrepe denarne politike,
3. razpolagati sta morali vsaj z jamstvenim kapitalom, ki je potreben za ohranitev njunega dosedanjega obsega dovoljenih bančnih dejavnosti,
4. obseg poslovanja sta morali usklajevati tako, da dosega obseg jamstvenega kapitala najmanj 8% zneska celotne aktive in aktivnih zunajbilančnih postavk, razporejenih in ponderiranih po stopnjah rizičnosti,
5. oblikovati sta morali vse potrebne dolgoročne rezervacije za zavarovanje pred potencialnimi izgubami,
6. spoštovati sta morali predpisane zahteve glede največje izpostavljenosti do enega komitenta in
7. spoštovati sta morali dovoljeni okvir naložb v zemljišča, zgradbe, poslovno opremo ter kapitalske deleže v bankah in nebančnih organizacijah.

6. junija 1997 je izdala Banka Slovenije odločbi o zaključku sanacijskega postopka v obeh bankah. Po sprejetju statuta in vzpostavitvi organov upravljanja, je Banka Slovenije 22. julija 1997 izdala ugotovitveni odločbi o uveljavitvi odločb o zaključku sanacijskega postopka v obeh bankah. Zaključek sanacije obeh bank pomeni konec posebnega statusa teh bank in njunega prednostnega obravnavanja oziroma pomeni, da veljajo za obe banki po sanaciji enaka določila za varno in skrbno poslovanje kot za vse druge banke. Za njuno privatizacijo pa bosta poskrbela vlada in državni zbor RS.

Box 5: Conclusion of bank recovery

In 1997 the recovery was completed for two banks, which upon recovery became state banks – Nova Ljubljanska banka d.d. (NLB), Ljubljana and Nova Kreditna banka Maribor d.d. After a process lasting over four years the recovery was completed successfully. The majority of the existing non-performing loans were transferred – in exchange for government bonds – to the Bank and Savings Bank Recovery Agency, and since 1993 no new non-performing loans have arisen in any notable extent, as is usual for banks, and the banks certainly have considerably fewer non-performing loans than they had at the beginning of 1993. The capital adequacy of the banks was increased and liquidity improved, and the yield of both banks is among the highest in the Slovenian banking sector.

In order to complete the recovery, the banks had to fulfil several Bank of Slovenia conditions:

1. they had to show liquidity;
2. they had to fulfil monetary policy measures;
3. they had to dispose of at least guarantee capital necessary to maintain their current scope of licenced banking activities;
4. they had to coordinate their scope of operations such that the extent of guarantee capital reached at least 8% of the amount of all assets and off-balance sheet asset items set out and weighted by level of risk;
5. they had to formulate all the necessary long-term provisions as security against potential losses;
6. they had to abide by the prescribed requirements regarding the greatest exposure to a single customer and
7. they had to keep within the permitted framework of investments in land, buildings, business equipment and capital interests in banks and non-banking organisations.

On 6 June 1997 the Bank of Slovenia issued a decision concluding the recovery procedure at the two banks. Following adoption of the articles of association and establishing of the management bodies, on 22 June 1997 the Bank of Slovenia issued a determination on the implementation of decisions concluding the recovery procedure at the two banks. The conclusion of recovery at the two banks signals the end of the special status of these banks and their priority treatment, and means that following recovery the two banks are governed by the same provisions regarding safe and diligent operation that apply to all other banks. And the Slovenian Government and National Assembly will ensure their privatisation.

5.1 Bank of Slovenia measures in the area of bank governance

As part of regular creditworthiness checks, supervision over the inspection of risk also assesses the control environment as a mechanism for managing risk. Part of the control environment that is highly important for the overall operation of banks is the area of organisation and governance.

For reasons of frequent deficiencies and weaknesses in risk management, which appeared as a result of inappropriate organisation and management of banks as well as a lack of supervision over the work of the management board, **34 measures were issued since 2008 in the area of the bank's governance – this being directly connected with the work of management boards and supervisory boards.**

The largest number of measures were issued owing to inappropriate procedures or bad practices in decision-making both by the management boards and supervisory boards (cautions relating to prevention of conflicts of interest, non-fulfilment of recommendations of the auditing company, inadequacy of procedures for forward transactions and cashing in securities, non-supply of documentation between the management board and supervisory board, improper assessment of internal capital etc.). At the same time a large number of measures were issued owing to the inadequate composition of management bodies (especially owing to the inadequate qualification level of supervisory board members).

Year	2013	2012	2011	2010	2009	2008
No of measures	4	6	4	17	2	1

Of **34 measures issued**, the three biggest state-owned banks that received state aid were the recipients of a full **23 measures**, while foreign-owned banks received **4 measures**.

Moreover in connection with 13 members of bank supervisory boards control procedures were initiated owing to identified conflicts of interest and in connection with 18 members of management boards control procedures were initiated and measures decreed owing to breaches of the regulations or bad practices in bank management (ranging from reminders to revocation of authorisation to perform the office of board member).

In addition to the stated measures, which were issued as part of checks on specific risks, in the same period eight banks were subjected to **12 independent inspections of their organisation and governance**. Half of them, i.e. six inspections, were carried out at state-owned banks, of which inspections of governance and organisation were carried out three times at NLB (plus the area of corporate governance at NLB was comprehensively inspected as part of the World Bank technical assistance in 2006/2007).

Year	2013	2012	2011	2010	2009	2008
Number of inspections	2	2	2	4	0	2

Bank data show clearly that in the period since 2010, the compositions of all management and supervisory boards of banks that received state aid in 2013 and 2014 changed, while there were also major changes in the entire banking system.

Given the importance of the quality of corporate governance for successful and safe operation of the banking system, in addition to measures decreed and the strengthening of regulations in this area³⁵ the

³⁵ In the period since 2011 the following Bank of Slovenia regulations have been adopted and supplemented in the area of corporate governance:

- 1) **Remuneration** (both regulations have been in force since 6 August 2011, Official Gazette of the Republic of Slovenia 62/11; they involve transposition of the CRD III directive in the part of remuneration policies):
 - The Regulation on risk management and implementation of the process of assessing internal capital adequacy for banks and savings banks (Official Gazette of the Republic of Slovenia No. 135/06, as amended)

Bank of Slovenia asked the EBRD to review the corporate governance practices and produce recommendations in the area of control over corporate governance and internal controls. The EBRD is advising the Bank of Slovenia over further development of methodologies for assessing members of bank management bodies, the remuneration policies at banks and the solidity of the system of internal controls at banks. On the conclusion of the project and final report from the EBRD, the Bank of Slovenia will incorporate these methodologies into its own methodologies, processes and internal procedures.

Based on numerous talks with the Bank of Slovenia and banks to date the EBRD has already identified a specific issue in the area of corporate governance and has formulated certain preliminary recommendations. Of these, the most important recommendations are those concerning the following areas:

1. The process of appointment and assessment of suitability of members of the supervisory board. Proposals of candidates for members of supervisory boards of state-owned banks are often published only at the actual shareholders' meetings, when these persons have at the same time been appointed to their positions. In the EBRD's opinion, such practice does not allow the prior assessment of suitability of these members, either on the part of the bank or of the Bank of Slovenia.
2. The issue of the independence of supervisory board members and members of auditing committees. The practice of appointments, as described in the first indent, may be a reason why supervisory board members are not independent to the extent that they are able to carry out their duties with complete impartiality. Moreover the EBRD takes the view that external members of auditing committees of a bank supervisory board cannot be considered to be independent members since they are not responsible for the final decisions of the supervisory board in connection with matters which they are drafting and co-formulating.
3. Prevention of conflicts of interest in appointing members of governing bodies. Based on an analysis of membership in the governing bodies of certain banks, the EBRD identified cases of members who might have systematic conflicts of interest with the bank. Since such cases cannot be entirely avoided, given the relatively small size of the Slovenian market, the EBRD

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- Regulation on the diligence of members of the management and supervisory boards of banks and savings banks (Official Gazette of the Republic of Slovenia No. 62/11 as amended)
 - 2) **Assessing the suitability of members of management and supervisory boards and holders of key offices** (the regulations in this part have been in force since 7 September 2013; Official Gazette of the Republic of Slovenia 74/13; this involved transposition of EBA guidelines on assessing the suitability of governing body members;
https://www.eba.europa.eu/documents/10180/106695/EBA_2012_00220000_SL_COR.pdf)
 - Regulation on the diligence of members of the management and supervisory boards of banks and savings banks (Official Gazette of the Republic of Slovenia No. 62/11 as amended)
 - The Regulation on risk management and implementation of the process of assessing internal capital adequacy for banks and savings banks (Official Gazette of the Republic of Slovenia No. 135/06, as amended)
 - Regulation on the reporting of individual facts and circumstances of banks and savings banks (Official Gazette of the Republic of Slovenia, No. 42/09, as amended)
 - Regulation on the documentation for the granting of authorisations to provide banking and financial services and for status changes (Official Gazette of the Republic of Slovenia No. 28/07, as amended)
 - Regulation on the documentation for demonstrating fulfilment of the conditions for performing the function of a member of the management board of a bank or savings bank (Official Gazette of the Republic of Slovenia, No. 74/13, as amended)
 - 3) **System of internal controls** (regulation in this part in force since 1 January 2007)
 - The Regulation on risk management and implementation of the process of assessing internal capital adequacy for banks and savings banks (Official Gazette of the Republic of Slovenia No. 135/06, as amended)

highlighted the importance of the Corruption Prevention Agency (as an independent authority) and in particular its role of dealing with individuals in terms of their integrity. The EBRD takes the view that candidates for membership of management and supervisory boards should declare that they are not subject to investigation by that agency and that they have no systemic conflict of interest with the bank.

The EBRD will conclude the technical assistance project in the middle of 2015, when it will hand over to the Bank of Slovenia the entire set of its recommendations and methodologies concerning the areas in question, and will carry out relevant training for the Bank of Slovenia and banks.

Equally, in order to ensure adequate implementation of supervision and comparability with international standards, in 2010 and 2012 the Bank of Slovenia requested the IMF to perform an assessment of the stability of the Slovenian financial system.³⁶ **The findings were that the implementation of the Bank of Slovenia's supervisory function was adequate, high-quality and comparable, but during the crisis it did not ensure sufficient human resources. All the recommendations regarding possible further improvements were implemented, except for some relating to legislation, which were not supported in the procedures of adopting amendments to the Banking Act.**

5.1.1 Current Bank of Slovenia proposals for legislation that will facilitate better bank governance

With the aim of improving the corporate governance of banks the Bank of Slovenia has for a long time been drawing attention to the urgent need to introduce **licencing for members of bank supervisory boards**. It is persevering with this idea in the latest draft revision of the Banking Act (ZBan-2), which is in the legislative procedure.

The procedure of prior vetting of supervisory board members and prior authorisation of the supervisor to perform the office of member of a bank supervisory board is an important condition for improving the quality of bank governance, and an added assurance that the proposers will consistently carry out appropriate prior selection procedures, in line with the requirements of the European acquis, for candidates for membership of bank supervisory boards. Such practice is especially important in respect of the growing role of bank supervisory boards in managing bank risks, where the new European regulations require the active involvement of supervisory boards in determining and implementing bank policies in the area of risk management. If a candidate for member of a supervisory board does not meet the criteria for suitability, it is only right for such candidate not to be granted approval to perform the office of member of a supervisory board, especially with a view to protecting the interests and standing of the bank. We would also point out that in the event of discovering subsequently that a member of a supervisory board does not meet the suitability criteria, the Bank of Slovenia should prohibit the appointed supervisory board member from performing that office, and the bank should dismiss that member and appoint a new member at the general meeting. The reasons for dismissing an individual member and the impact on the operation of the bank would thereby become a subject of public debate and conjecture, which would reflect negatively on the bank's reputation and confidence of depositors regarding the safe operation of the bank.

Prior approval for a supervisory board member is thereby further confirmation that the required procedures for the selection of suitable candidates at the bank have been followed appropriately and the candidate meets the requirements for performing the office. Practice to date related to the appointment of supervisory board members (where no prior approval of the Bank of Slovenia is required and where subsequent assessment and prohibition are the only options) has shown that in the procedures of selecting and appointing members of supervisory boards, the requirements regarding fulfilment of conditions for membership have frequently not been observed. An improvement to

corporate governance of banks will therefore require in particular a block on the appointment of unsuitable candidates for supervisory board membership, and by requiring prior approval, standards of professionalisation for that office will be established.

5.2 Comparison of approach to supervising corporate governance in the period prior to and after entry into the ECB single supervisory mechanism

Before entering the single supervisory mechanism (SSM) the Bank of Slovenia used its own supervisory manual (known as the POT manual³⁷), which included the area of reviewing the suitability of corporate governance. After joining the SSM, in part for the purpose of reviewing the suitability of corporate governance, the Bank of Slovenia – like all other participating countries – had to adopt the ECB supervisory manual and thereby switch from supervising under its own methodologies. For the purpose of reviewing the differences between the former and current approach to reviewing this area, the Bank of Slovenia has conducted a comparative analysis of the content of the two manuals.

We have found that the approaches of the Bank of Slovenia and the ECB do not differ in systemic terms. Both adhere to the requirements of the EU acquis (capital requirements directive³⁸), which lay down the general structure of internal systems at banks (including corporate governance). Under these requirements, banks must establish the following governance structure, the suitability of which must be monitored by the supervision authority.

- a solid organisational framework with precisely defined responsibilities (including corporate governance),
- effective risk management processes (identification, monitoring, risk reduction),
- an adequate internal control system,
- remuneration policies and practices that accord with pro-active risk management.

Regulatory approach of the Bank of Slovenia regarding corporate governance

Even before entry into the SSM, the Bank of Slovenia regulations and its supervision of bank corporate governance adhered to the same structure of internal systems of governance, as was already defined in 2007 in the capital requirements directive, and which is also inherent in the ECB manual (as is evident from the requirements for the governance system structure deriving from Article 124 of the ZBan-139). The detailed requirements regarding corporate governance are further regulated in the Regulation on the diligence of members of the management and supervisory boards of banks and savings banks (Official Gazette of the Republic of Slovenia, No. 62/11, as amended; hereinafter: the Due Diligence Regulation).⁴⁰ This regulation lays down the professional and ethical standards of governance on the individual bank level, it addresses policies concerning professional and ethical standards of governance and the assessment of suitability of members, it defines the work of members

³⁷ Risk assessment process

³⁸ Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC; <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013L0036&rid=2>

³⁹ The first paragraph of Article 124 of the ZBan provides: Banks shall establish and implement a sound and reliable internal governance system, which must comprise: 1. **a clear organisational structure** with precisely defined, transparent and consistent internal relationships with regard to responsibilities, 2. **effective procedures for identifying, measuring or assessing, managing and monitoring the risks** to which the bank is or could be exposed in its operations, 3. **an appropriate system of internal controls**, including appropriate administrative and accounting procedures, and 4. **an appropriate remuneration system**, which must be compatible with and promote effective and sound risk management, including separate remuneration policies and practices for employees whose work is of a specific nature and who can have a significant impact on the risk profile within the framework of their professional activities and duties.

⁴⁰ <http://www.bsi.si/library/includes/datoteka.asp?DatotekaId=5316>

in terms of their diligence, responsibility, independence and professional qualifications and addresses the issue of conflicts of interest.

The identical approach to the regulatory and supervisory treatment of corporate governance by the two institutions is no coincidence, since it is founded on the aforementioned directive as well as on the practice of the EU supervisors, which has always adhered to the guidelines of the Committee of European Banking Supervisors (CEBS, now the European Banking Authority or EBA) relating to the Guidelines on the Application of the Supervisory Review Process under Pillar 2 (GL03, January 2006⁴¹). The capital requirements directive and the stated CEBS guidelines were indeed adopted by all supervisors that are now members of the SSM, and this is also reflected in the similar content, approach and concepts of the ECB manual, since its development included all the participating Member States.

The Bank of Slovenia set out the principles of supervisory review of corporate governance of banks in the POT manual,⁴² which lays down the basic guidelines for scrutiny of this area on pages 47-51. A sample:

“Governance covers (1) the quality and make-up of managerial or supervisory bodies, (2) the decision-making process, (3) the process of strategic planning, (4) the culture of risk management and (5) the quality of internal auditing. Bank governing bodies can make a decisive contribution to risk management through the appropriate composition and organisation of a management team suited to the scope and complexity of business, through a clear and understandable segregation of duties, adequate management supervision and checks, through the development of an appropriate culture of risk management and by establishing high-quality internal auditing. By monitoring the bank through reports, direct reviews and in conversations with the bank, the Bank of Slovenia assesses individual elements of governance, and the quality of governance as a whole, and monitors trends in the development of governance at the individual bank.”

Comparison of supervisory manuals of the Bank of Slovenia and ECB regarding corporate governance

A comparative analysis of the two manuals showed that both documents give special emphasis to the quality, composition and responsibility of the governing body. This area of inspection includes the process of selecting new candidates, adequate control of conflicts of interest and the functioning of the governing body in various fields, as well as checking transparency and disclosure in the area of corporate governance. Here both manuals require adequate professional qualifications and the qualities and experience of individuals that are necessary for managing the bank's business. An assessment is made of the numerical suitability and checks are performed on professional references and work experience of individual members, their familiarity with the bank's strategy, the impact of the individual on implementation of the strategy, mastery of the work process and so forth. A special feature of the ECB manual is the slightly more detailed treatment of supervisory board committees, which in the Slovenian case are part of the requirements of Bank of Slovenia regulations, i.e. the Due Diligence Regulation.

Analysis has also shown that the Bank of Slovenia manual laid special emphasis on decision-making and strategic planning at the governing body level, which the ECB manual currently does not specifically address. In assessing the quality of the strategic planning process, the Bank of Slovenia determined its scope and clarity and checked the involvement of the management board and employees in planning, its frequency and the adequacy of the pertaining information.

⁴¹ <http://www.eba.europa.eu/documents/10180/585173/GL03.pdf/9705f895-fbfa-4e39-bac9-3def3127f545>

⁴² <http://www.bsi.si/library/includes/datoteka.asp?DatotekaId=2437>

Corporate structure and organisation is the next important field for which both manuals take a similar approach. As part of these checks, the Bank of Slovenia assessed the general culture of risk management, which included an assessment of the tendency of the management team towards accepting risk and the attitude of the governing body to developing a system of creditworthiness controls and risk management methodologies. In this respect the analysis showed that the risk management culture, in the sense of organising internal controls and corporate structures of the bank, is well covered in both supervisory manuals and is very similar in substance. Both approaches are oriented towards obtaining an assurance from the supervisor that the bank is properly organised at all levels of the internal controls system, that it has effective and independent control functions (for instance an internal audit department) and that the business, control and monitoring processes are adequately documented.

Supervision over the Bank of Slovenia

In connection with the accusations of the Bank of Slovenia avoiding the supervision of the Court of Audit, it should be pointed out that auditing of the Bank of Slovenia's operations is specially regulated in the Bank of Slovenia Act. In accordance with that act the operations of the Bank of Slovenia are audited by an independent international auditor. A special arrangement for the auditing of the Bank of Slovenia was adopted in support of its independence, which is laid down in the Slovenian Constitution and in the Treaty on the Functioning of the European Union (TFEU).

The provisions for auditing take into account that Article 27 of the Protocol to the TFEU on the Statute of the European System of Central Banks and of the European Central Bank provides that the financial statements of the European Central Bank (ECB) and the national central banks should be audited by independent external auditors, in our case one that the Bank of Slovenia selects pursuant to the Public Procurement Act and which it proposes for the final selection process, where it is first scrutinised by the ECB Governing Council and is then recommended to the EU Council, which also confirms the auditor.

Auditors are selected and operate in accordance with the Good Practices for the selection and mandate of External Auditors laid down by the ECB, and the requirements regarding the auditing of subjects of public interest are governed by the Regulation of the European Parliament and the Council No 537/2014.

The Court of Audit Act does not envisage supervision of the Bank of Slovenia, nor is the act set up for such supervision. To date the issue of the Court of Audit's competence for auditing has come up just once – in 2012 (as mentioned in the article) and even then the Court of Audit did not require an audit of the Bank of Slovenia's operations, but a review of its supervisory activities. The Bank of Slovenia explained to the Court of Audit the arrangements for auditing implementation of the Bank of Slovenia's tasks – with the finding that the law does not envisage the provision of information to the Court of Audit. Following the Bank of Slovenia's explanations, the Court of Audit no longer brought up this issue.

In accordance with the Bank of Slovenia Act, the Bank of Slovenia reports on its work to the National Assembly. In this context the National Assembly is briefed on the annual report and financial plan of the Bank of Slovenia. The Bank of Slovenia provides all the information requested either by the National Assembly or the Finance and Monetary Policy Committee (unless by law there are express limitations on this).

In addition to the Minister of Finance, a representative of the Finance and Monetary Policy Committee is always invited to meetings of the Bank of Slovenia's Governing Board. Since 2002 that has been 24 times a year. The Governing Board of the Bank of Slovenia also deliberates over the operations of the Bank of Slovenia. The claims that no one performs scrutiny of the operation of the Bank of Slovenia are not true.

6. ENHANCING SUPERVISION TO PREVENT A REPEAT OF THE CRISIS

Measures to prevent a future crisis

In response to the multifaceted financial and economic crisis in the EU, in June 2012 the heads of government and state agreed to form a banking union. This will supplement the economic and monetary union, while at the same time on the EU level it will enable the centralised application of rules for banks in the euro area (and wider).

The banking union is based on three pillars:

1. the Single Supervisory Mechanism – SSM;
2. the Single Resolution Mechanism – SRM and
3. the associated financing arrangements, covering the Single Resolution Fund (SRF), the Deposit Guarantee Schemes (DGS) and the common safety element (credit line – ESM).

These pillars are based on two sets of rules that apply to all Member States: the capital requirements for banks (especially CRD IV) and the provisions of Directive (EU) No 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms (BRRD Directive) of May 2014. Slovenia has already partly implemented the directive in its legislation through the Authority and Fund for Bank Resolution Act (ZOSRB), and will implement it fully through the revised version of the Banking Act, with the deadline for transposition of the directive having passed on 1 January 2015.

6.1 Single Supervisory Mechanism

For banks in the euro area, the Single Supervisory Mechanism represents one – and the first – of the pillars underpinning the future Banking Union, and came into full effect in 2014.

Since 4 November 2014 the ECB has been formally in charge of supervising banks in the euro area, but given the decentralised system of supervision the national supervisors, including the Bank of Slovenia, still perform all the existing and certain additional supervisory tasks. Establishing the SSM has had a major influence on the operating processes within the Bank of Slovenia. In addition to the changes in the processes and activities of individual departments, there have been changes to a certain extent in the decision-making procedures at the Bank of Slovenia's Governing Board.

The introduction of the SSM has produced changes mainly in processes and activities in the areas of a) licencing, b) supervising and monitoring the operation of banks and c) reporting.

a) Licencing: The ECB is now the competent authority for issuing and revoking licences for credit institutions to perform their business, but requests for licences to perform the activities of a credit institution in Slovenia are lodged, as before, with the Bank of Slovenia (with pertaining documentation) in accordance with the regulations in Slovenia. The Bank of Slovenia has retained the competence to assess fulfilment of the conditions for issuing/rejecting requests for licences. If the conditions for issuing a licence are met, the Bank of Slovenia sends to the ECB for its approval a draft decision with a proposal for issuing a licence. Otherwise, as it has done to date, the Bank of Slovenia denies the request for a licence. The ECB can deny the issuing of a licence only in the event that the conditions provided in the relevant EU have not been met. The ECB must support such denial in writing.

b) Monitoring and supervision of banks: In accordance with the SSM Regulation, supervision is performed on two levels:

- direct supervision of banks classed in the group of important banks;
- checking supervision at less important banks, which falls within the competence of national supervisors.

For Slovenia the criterion for determining important banks was the three biggest banks in each country. Under this criterion, the biggest banks in Slovenia are the NLB Group, NKBM Group and UniCredit Banka Slovenije. The last of the three also falls within the group of subsidiary banks from EU banking groups that are systemically important European banks, and their supervision is also within the direct competence of the ECB. As part of a banking group, the subsidiary banks in Slovenia – which include, in addition to UniCredit Banka Slovenije, SKB, Banka Koper, Banka Sparkasse, Raiffeisen and Sberbank – are under the direct supervision of the ECB.

Supervision is within the competence of the **Joint Supervisory Team (JST)**. In line with the established methodology, and proceeding from the risk profile of the bank and the national supervisor's familiarity with the bank, the JST makes up an annual programme of supervision. The programme is reviewed and adopted by the Supervisory Board (SB). The JST is charged with implementing the programme, which is monitored through half-yearly reporting to the ECB by the national supervisors and the JST. The JST (head of review) is also charged with drawing up measures against banks, and also proposes supervisory measures as part of the assessment of capital requirements (Pillar II), and approval of measures goes to the SB.

The less important banks (this group includes Abanka, Banka Celje, SID, Gorenjska banka, Probanka, Factor banka, DBS, Delavska hranilnica, Lon, Hranilnica Vipava and Hypo Alpe Adria Bank) are supervised by the ECB indirectly through supervision of the work of the national supervisor and by ensuring a level playing field and quality in supervision. The ECB requires national supervisors to perform supervision under the same rules and procedures from the single supervision manual.

For less important banks the national supervisor has the power to draw up and implement a supervision plan in accordance with the SSM manual. The programme must adhere to the ECB supervision strategy and the thematic reviews envisaged by the ECB. The plan, with its reasoning, is sent to the ECB, which can request an amendment/supplementation of the plan and may request reporting on implementation of the plan. Based on the development of macroeconomic conditions the ECB may also assess increased risk and require a review of individual banks. The competence to order measures against less important banks is retained by the competent bodies of the national supervisor, except for licencing procedures and ownership of qualified participating interests.

c) Reporting: In order to monitor bank operations, within the SSM the ECB has set up its own system of risk assessment. It has also set up a central credit register.

6.2 Macro-prudential policy and macro-prudential instruments

The latest crisis has revealed the deficiencies in existing financial supervision, which could not foresee or prevent the build-up of systemic risks in the financial system. With the aim of improving the effectiveness and coordinated functioning of macro-prudential supervision in Member States and at the EU level, in December 2011 the European Systemic Risk Board (ESRB) issued the Recommendation⁴³ to Member States that they should set out in national legislation the authority empowered to conduct macro-prudential policy.

⁴³Recommendation on the macro-prudential mandate of national authorities (ESRB/2011/3).

Macro-prudential supervision means the prevention and mitigation of systemic risks in the financial system, and includes banks, insurers, the financial instruments market, investment companies, management companies and leasing companies. The ultimate objective of macro-prudential policy is to contribute to safeguarding the stability of the entire financial system, including strengthening the resilience of the financial system and preventing and reducing the build-up of systemic risks, thereby ensuring the financial sector's sustainable contribution to economic growth.

With the adoption of the Act on the Macro-Prudential Supervision of the Financial System (ZMbNFS) on 21 December 2013, the legal basis was laid for the implementation of macro-prudential supervision in Slovenia.

The ZMbNFS improves supervision over financial institutions that, due to ownership or other cross-links, operate in different segments of the financial system. The ZMbNFS strengthens cooperation between sectoral supervisory authorities that are otherwise only responsible for the supervision of their own segment, while threats from one segment can pass through to the entire financial system if not identified in a timely and efficient manner. The act introduces the Financial Stability Committee, which comprises eight members – two representatives each from the Bank of Slovenia, the Insurance Supervision Agency and the Securities Market Agency and the Ministry of Finance, the latter two having no voting rights – and which is competent for the formulation of macro-prudential policy, which it implements together with the supervisory authorities.

On 6 January 2015 the Bank of Slovenia confirmed the Guidelines for macro-prudential policy and thereby put in place an operational framework for macro-prudential policy and supervision of the banking system.

The interim objectives of the Bank of Slovenia's macro-prudential policy in the area of the macro-prudential supervision of the banking system are:

- 1) mitigating and preventing excessive credit growth and excessive leverage;
- 2) mitigating and preventing excessive mismatching in maturity structure and illiquidity;
- 3) limiting the concentration of direct and indirect exposures;
- 4) limiting the systemic impact of misaligned incentives with a view to reducing moral hazard;
- 5) strengthening the resilience of financial infrastructures.

The macro-prudential instruments that Bank of Slovenia is already applying are a) the ratio of the annual change in the stock of loans to the non-banking sector (before impairments) to the annual change in the stock of deposits by the non-banking sector (GLTDF) and b) limiting deposit interest rates.

a) GLTDF:

GLTDF is the ratio of the annual change in the gross stock of loans to the non-banking sector (before impairments) to the annual change in the stock of deposits by the non-banking sector. The instrument contributes to meeting the interim objective of mitigating and preventing excessive mismatching in maturity structure and illiquidity. The instrument has made a decisive contribution to slowing down adjustment of the LTD ratio for the non-banking sector.

The minimum requirements for GLTDF are that a bank with a positive annual inflow in deposits by the non-banking sector, achieves $GLTDF \geq 0\%$, i.e. there is no contraction in lending. In the second year of the instrument's application, the requirement is tightened such that $GLTDF \geq 40\%$. Should the bank fail to meet even the minimum requirements for GLTDF, its requirements with regard to liquidity ratios are tightened each subsequent quarter.

The banks first had to comply with the requirements of the Regulation at the end of June 2014. At that time six banks failed to meet the minimum requirements, and this fell to five at the end of September 2014. All of them fulfilled the corrective measures.

The instrument is effective, since the decline in the ratio of net loans after impairments to deposits by the non-banking sector (the LTD ratio) slowed year-on-year. The developments in GLTDF at the large domestic banks and at the banks under majority foreign ownership are also more stable. The LTD ratio for the banking system overall stood at 93% at the end of September 2014, down 15 percentage points on December 2013. The decline in the LTD ratio over the first nine months of 2014 was 91% of the decline in the ratio over the same period of the previous year for the banking system; the corresponding figure at the banks under majority foreign ownership was 78%. Compared with the same period of 2013, the decline in the LTD ratio in 2014 was based more on an increase in deposits, and less on a contraction in lending.

b) Limits on deposit rates

In March 2012 the Bank of Slovenia introduced the instrument of limiting deposit rates for deposits by the private non-banking sector.⁴⁴ The objective was to limit the excessive raising of liability interest rates and reduce the bank's income risk.

In 2011 and 2012 banks "competed" for deposits by the non-banking sector by raising deposit rates. The competition was the result of the impeded access to the financial markets by the banks under majority domestic ownership, and the need to reduce the LTD ratio at the banks under majority foreign ownership. Between December 2010 and December 2013 there was no significant change in the nominal value of deposits by the private non-banking sector, which remained at EUR 21 billion. This indicates that the rise in deposit rates thus had no significant impact in the form of an increase in the stock of deposits at banks, but caused deposit switching between banks and a rise in the banks' funding costs.

Effects of the instrument: The average interest rate on deposits that are subject to the instrument declined by 1.7 percentage points between January 2013 and October 2014. With the exception of a single bank, all the banks recorded a decline in the average interest rate. There has also been a notable narrowing of the distribution of interest rates on deposits of all maturity buckets since the second half of 2013, which indicates diminishing competition between the banks with regard to the setting of liability interest rates. A comparison of the average liability interest rates in Slovenia with the average liability interest rates across the euro area reveals (1) that average interest rates on household deposits in Slovenia fell much more sharply than in other countries. By September 2014 the average interest rate on household deposits of up to 1 year was just 0.3 percentage points above the corresponding rate in Austria, the spread having stood at 1 percentage point a year earlier. The spread on deposits of 1 to 2 years narrowed from 2.2 percentage points in September 2013 to 1 percentage point in September 2014. (2) Although average interest rates on corporate deposits of 1 to 2 years are falling, they remain among the highest in the euro area.

In light of the above, it can be concluded that the instrument has contributed to a reduction in deposit rates, although it is assessed that measures aimed at the stabilisation and recovery of the banks played the main role in the lowering of deposit rates (Stability of the Slovenian Banking System, January 2015).

6.3 Single Resolution Mechanism

On 1 January 2016 the Eurosystem Member States will commence full and direct implementation of a regime that envisages the establishing of a common fund for bank resolution, to which all banks based

⁴⁴For a detailed description see the Financial Stability Review, May 2014, p. 38.

in Eurosystem Member States must contribute (non-refundable). This fund will be administered by a special Single Resolution Board, which will also decide on the use of fund assets for the purpose of resolution of institutions based in any Member State of the Eurosystem. The Bank of Slovenia, which the ZOSRB appointed as the national bank resolution authority, appointed a representative to the joint Single Resolution Board.

The BRRD Directive provides a common (EU) legal framework for bank resolution measures, including bank resolution through "bail-in" measures, which in addition to conversion and write-off of capital instruments include administrative deletion or conversion of ordinary bank liabilities into equity, for the purpose of ensuring the bank's capital adequacy.

In view of the BRRD Directive, the measure of administrative winding up or conversion of bank liabilities into equity will be used for all bank liabilities except for individual liabilities that are expressly excluded by the directive (e.g. secured deposits up to EUR 100,000 and certain others, especially short-term bank liabilities).

With regard to the directive, the competent authority will be able, in exceptional cases, to exclude from the measure of deletion or conversion of liabilities into equity individual other bank liabilities (i.e. in the event that deletion/conversion of such liabilities is not feasible within a reasonable time, or where an exception to deletion/conversion of certain liabilities is vital to maintain continuity of key functions and services of a bank, or if deletion/conversion would cause disproportionate effects that would jeopardise the functioning of the financial system, or if deletion/conversion of such liabilities would reduce the value of assets and thereby disproportionately increase the burden for other creditors beyond an extent that they would bear in the event of bankruptcy).

On 1 January 2016, as stated, the EU will commence the Single Resolution Mechanism (SRM), the fundamental objective of which is the uniform and effective resolution of banks in difficulty. The basis for this is Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010 (the SRM Regulation).

The purpose of the SRM is to supplement the Single Supervisory Mechanism (SSM), which became operational on 4 November 2014, when the ECB took over responsibility for carrying out direct supervision of important banks and bank groups in the euro area, along with responsibility for carrying out direct supervision of less important banks through the implementation of standard rules for carrying out SSM supervision (more below). **As an important enhancement to single supervision, the SRM will ensure that at banks where supervision is being carried out as part of the SSM and they are in severe difficulty, their resolution would be managed efficiently with minimal costs for taxpayers and the real sector.** Introduction of the single mechanism will have a positive effect both on fulfilling the objective of transferring the burden of resolution to the banking sector and thereby reducing moral hazard, and in terms of increasing public and investor confidence in banks in the EU. Moreover the link between the sovereign debt crises and banks in difficulty will be broken.

The SRM Regulation centralises the use of common instruments for resolution and powers of resolution that are available to national resolution authorities defined in Directive 2014/59/EU. In Slovenia, pursuant to the Bank Resolution Authority and Fund Act (Official Gazette of the Republic of Slovenia No 97/2014), the Bank of Slovenia was appointed national resolution authority. Centralised application of resolution powers has been assigned to the **Single Resolution Board**, whose membership includes a representative of the Bank of Slovenia, and the **national resolution authorities**, where the rules on the establishing and operation of the SRM in Member States are applied directly.

The Single Resolution Board is authorised to take decisions related to important entities or groups under direct supervision of the ECB or cross-border groups. The national authorities help the Board in resolution planning, in drafting decisions on resolution and implementing resolution procedures. For entities and groups that are not important or cross-border, the national authorities have full independent responsibility for resolution planning, for assessing the feasibility of resolution and implementing resolution measures (in accordance with the ZBan-1, the valid Slovenian regulation, extraordinary measures), but they must heed the common framework of rules of conduct in the SRM, as applicable to the SSM, within which the ECB determines the method of the single approach to supervision both for important banks that are under the direct jurisdiction of the ECB, and for less important banks that are supervised by national supervisors.

When the Single Resolution Board decides that all criteria are met for resolution to be initiated, it will determine a scheme (method) for resolution of the bank or bank group. The Council and Commission are included in procedures of adopting the resolution scheme, which enters into force if within 24 hours of the Board adopting it the Council or Commission do not oppose it or the Commission approves it. Opposition of the Council and Commission is limited by the condition that the resolution of the bank or banking group is in the public interest, or by the right of the Commission to significantly change the amount of use of the resolution fund proposed by the Board (change of 5% or more). The Council approves or opposes the Commission proposal, without changing it. The Board advises the national resolution authorities, which in turn take all the necessary steps to implement the resolution scheme, in other words carry out the resolution procedures. The Commission is particularly involved in the case of approval of state aid or aid from the fund, which may be made conditional on the acceptance of conditions or commitments.

After 1 January 2016 the Single Resolution Board will thus decide for important banks, in line with Regulation (EU) 806/2014, and in cooperation with the ECB, on the fulfilment of conditions for resolution and on the resolution scheme for the bank or bank group. In the event of implementing resolution, the Bank of Slovenia in its capacity of national resolution authority will carry out the resolution procedure in accordance with the received instructions from the Single Resolution Board, taking account of internal acts and the operational framework of the SRM. In the case of less important banks, if the use of the Single Resolution Fund is not envisaged, the Bank of Slovenia will decide independently on the fulfilment of all conditions for resolution and on the method of bank resolution.

6.3.1 Bank Resolution Fund

The Bank of Slovenia will establish a special fund for bank resolution at the end of March 2015 pursuant to the Bank Resolution Authority and Fund Act (ZOSRB),⁴⁵ which the National Assembly adopted on 17 December 2014. The fund will be financed through bank contributions and in the future the fund's assets will be used for financing the resolution of banks within the framework of the extraordinary measures that can be imposed by the Bank of Slovenia.

The target level of assets in the fund is EUR 350 million (or 2.3% of total guaranteed deposits at all banks in Slovenia; guaranteed deposits amount to approximately EUR 15 billion).

The fund's assets can be used for financing the extraordinary measures imposed by the Bank of Slovenia. Under the act, the assets may be used for: 1. the payment of the founding capital or the maintenance of the capital adequacy of a bridge bank to which the assets and liabilities of a specific bank would be transferred in accordance with a Bank of Slovenia ruling; 2. the recapitalisation of a bank to ensure capital adequacy, if past losses of the bank are first covered; 3. the provision of loans,

⁴⁵ The act partly transposes into Slovenian law Directive 2014/59 establishing a framework for the recovery and resolution of credit institutions and investment firms (banking union). The directive will be transposed in full with the revised version of the Banking Act.

guarantees, sureties or other forms of collateral to a bridge bank or to a bank against which extraordinary measures have been imposed.

The Resolution Fund, as established pursuant to the ZOSRB, represents merely a temporary solution regarding the financing of bank resolution measures without the involvement of the national budget. According to the act, the fund will cease its operations on 31 December 2024.

6.3.2 Deposit guarantee fund

The system of guarantees for deposits at banks in Slovenia is regulated by the valid Banking Act (ZBan-1), which lays down the guarantee of all banks based in Slovenia that, in the event of bankruptcy of any bank based in Slovenia, they will ensure the necessary funds to pay out guaranteed investor deposits. Banks must ensure funds for paying out guaranteed deposits based on a call from the Bank of Slovenia, when the bankruptcy of the bank is initiated.

The drafting and adoption of a special act is planned for 2015 in order to transpose into Slovenian law Directive 2014/49/EU on deposit guarantee schemes, which requires Member States to set up a special fund for deposit guarantees, which will serve to collect contributions from banks for the purposes of possible payments of guaranteed deposits in the event of bankruptcy of an individual bank. In Slovenia cash contributions will be collected “ex ante” from banks for the payment of guaranteed deposits at banks in the event of bankruptcy.

The establishing of a fund was first envisaged in the proposed revision of the ZBan-2, which is already in legislative procedure, but the decision prevailed to enshrine the fund in a special law that would comprehensively regulate the system of guarantees for deposits as part of the resolution procedures (BRRD Directive) and winding up of banks.

Under the proposed revision the fund would be set up and administered by the Bank of Slovenia. The banks would pay regular yearly cash contributions into the fund until the total amount of assets held in the fund reaches a level equal to 0.8% of all guaranteed deposits at all banks (around EUR 120 million). In an individual year the contribution of banks would be a maximum of 0.1% of all guaranteed deposits at all banks, and the Bank of Slovenia could also borrow for the fund, if there were insufficient assets or funds were not available in due time for paying out the guaranteed deposits of a bank in bankruptcy.

6.4 Credit Register

Within the framework of the ECB/SSM the Bank of Slovenia is preparing a project to set up a credit register (ANAKREDIT) involving a **multi-purpose central credit register**, whose primary purpose will be to establish and ensure high-quality reviews of data on credit exposure in the Slovenian financial system on the macro and micro levels and in connection with the ESCB Single Supervisory Mechanism. The credit register will include the ECB requirements that will be prescribed in the regulation on the expanded collection and sharing of detailed credit data. The ECB Governing Council is expected to adopt this regulation in June 2015.

The Central Credit Register will serve the needs of macro-prudential supervision (below), ensuring financial stability, supervision of financial institutions, controlling and managing credit risk, preventing over-indebtedness, monetary policy operations and analytical and statistical needs.

The Bank of Slovenia also made a commitment to the European Commission that it would establish a Central Credit Register as a major step to improve the management of credit risk in Slovenia. We envisage the register covering lending to natural and legal persons at the individual contract level,

current reporting of changes and the required mandatory access to the register prior to the approval of new loans.

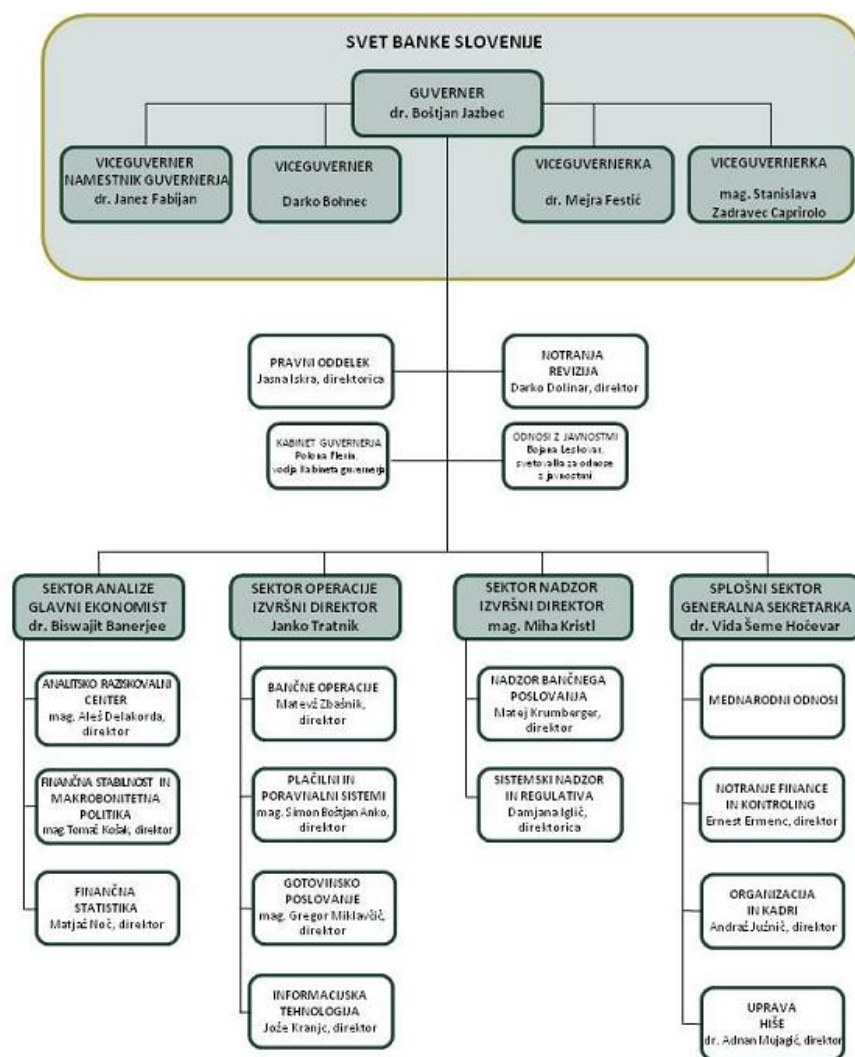
For the needs of the Central Credit Register the Bank of Slovenia is drafting a new law that will, after obligatory consultation with the ECB, be submitted to the National Assembly after the adoption of the aforementioned ECB regulation. The Central Credit Register, which will be managed by the Bank of Slovenia, is expected to be introduced in two phases, the first at the beginning of 2016 and the second phase in the second half of 2017.

6.5 Change to the internal structure of the Bank of Slovenia

In line with the adopted Bank of Slovenia strategy for 2015-20 and for achieving the objectives of more effective measures and fulfilment of tasks, the **Bank of Slovenia has been reorganised internally. Four divisions** have been formed and these are now headed by: 2 executive directors (Janko Tratnik and Miha Kristl), a chief economist (Dr Biswajit Banerjee) and a secretary general (Dr Vida Šeme Hočevar).

Given the shortage of human resources in the area of banking supervision, the Bank of Slovenia is directing greater attention to this in various ways.

Figure 49: Organizational structure of the Bank of Slovenia



GOVERNING BOARD OF THE BANK OF SLOVENIA

GOVERNOR

Dr Boštjan Jazbec

VICE-GOVERNOR

DEPUTY-GOVERNOR

Dr Janez Fabijan

VICE-GOVERNOR

Darko Bohnec

VICE-GOVERNOR

Dr Mejra Festić

VICE-GOVERNOR

Stanislava Zadravec-Capriolo

LEGAL DEPARTMENT

Jasna Iskra, Director

INTERNAL AUDIT

Darko Dolinar, Director

GOVERNOR'S OFFICE

Polona Flerin, Head of the Governor's Office

PUBLIC RELATIONS

Bojana Leskovar, Public Relations Adviser

ANALYSIS DIVISION

CHIEF ECONOMIST

Dr Biswajit Banerjee

OPERATIONS DIVISION

EXECUTIVE DIRECTOR

Janko Tratnik

SUPERVISION DIVISION

EXECUTIVE DIRECTOR

Miha Kristl

GENERAL AFFAIRS

SECRETARY GENERAL

Dr Vida Šeme Hočevar

ANALYSIS AND RESEARCH CENTRE

Aleš Delakorda, Director

BANKING OPERATIONS

Matevž Zbašnik, Director

BANKING SUPERVISION

Matej Kramberger, Director

INTERNATIONAL RELATIONS

FINANCIAL STABILITY AND MACRO-PRUDENTIAL POLICY

Tomaž Košak, Director

PAYMENT AND SETTLEMENT SYSTEMS

Simon Boštjan Anko, Director

SYSTEMIC SUPERVISION AND PRUDENTIAL REGULATION

Damjana Iglič, Director

INTERNAL FINANCE AND CONTROLLING

Ernest Ermenc, Director

FINANCIAL STATISTICS

Matjaž Noč, Director

CASH DEPARTMENT
Gregor Miklavčič, Director

ORGANISATION AND PERSONNEL
Andraž Južnič, Director

INFORMATION TECHNOLOGY
Jože Kranjc, Director

BUILDING SERVICES DEPARTMENT
Dr Adnan Mujagić, Director